REFUND ANTICIPATION LOANS AND THE TAX GAP

Leslie Book*

I. INTRODUCTION

The tax gap is an issue drawing increased legislative and administrative attention. The IRS estimates that the gap, the difference between taxes that are legally owed and taxes that are paid on time, was $345 billion for tax year 2001.[1] Voluntary compliance is approximately 83.7%, and the IRS estimates that each percentage of noncompliance costs approximately $21 billion.[2] In the past Congress has admonished the IRS for failing to come up with a comprehensive plan for reducing the tax gap.[3] In 2007, the IRS and Treasury responded by releasing a report outlining the steps the IRS is taking to reduce the tax gap, and outlined the agency's comprehensive plan to attack the elements that contribute to the overall tax gap: nonfiling, underreporting and underpayment.[4]

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1. TREASURY INSPECTOR GEN. FOR TAX ADMIN., REPORT NO. 2008-30-094 ADDITIONAL ACTIONS ARE NEEDED TO EFFECTIVELY ADDRESS THE TAX GAP 1 (2008), *available at* http://www.treas.gov/tigta/auditreports/2008reports/200830094fr.pdf [hereinafter TIGTA REPORT].

2. *Id.*

3. *A Closer Look at the Size and Sources of the Tax Gap: Hearing Before the Subcomm. on Taxation and I.R.S. Oversight of the S. Comm. on Finance*, 109th Cong. 502 (2006) (statement of Sen. Max Baucus, Member, S. Comm. on Finance) [hereinafter *I.R.S. Oversight Hearing*].

4. This comprehensive plan consists of seven elements: (1) reduce opportunities for evasion; (2) make a multi-year commitment to research; (3) continue improvements in information technology; (4) improve compliance activities; (5) enhance taxpayer services; (6) reform and simplify the tax law; and (7) coordinate with partners and stakeholders. INTERNAL REVENUE SERV. & U.S. DEP'T OF TREASURY, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 3-4 (2007), *available at* http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.). This report builds on U.S. DEP'T OF TREASURY, OFFICE OF TAX POLICY, A COMPREHENSIVE STRATEGY

The increased agency and legislative attention on the tax gap coincides with a time of increasing budget deficits and the related governmental quest for increasing revenues without increasing the tax rates or expanding the tax base.[5] Looking for extra dollars from noncompliant taxpayers is less likely to generate political backlash than increasing taxes. Reducing the tax gap is largely a bipartisan rallying cry.[6] Though, as this Article reveals, efforts to reduce underreporting are not free of political risk, especially when targeted at well-heeled and organized parties likely to bear the costs of government efforts.

This Article will look at one such effort: the IRS's attempt to reduce noncompliance associated with lower-income individuals seeking refund anticipation loans (RALs). RALs are loans secured by taxpayers' expected tax refunds, and they have become part of the blossoming tax return preparation industry.[7] Approximately fifty-six percent of RALs are associated with taxpayers who claim the earned income tax credit (EITC),[8] a refundable credit targeted to low- and moderate-income individuals.[9] The RAL lender will issue the refund

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FOR REDUCING THE TAX GAP (2006), which was criticized by Senator Max Baucus shortly after its release for not being a credible plan to reduce the tax gap. TIGTA Report, *supra* note 1, at 3. Since the release of the subsequent report, Senator Baucus has expressed encouragement and described the plan as "an important step toward fairer and more efficient tax administration." *Id.*

5. George Yin, Former U.S. Cong. Joint Comm. on Taxation Chief of Staff, Panelist at the American Bar Association Section of Taxation Meeting, The Tax Legislative Process: Past, Present and Future (May 9, 2008). *See also* Jeanne Sahadi, *IRS Chief: First Steps to Narrow $300B Tax Gap*, CNNMONEY.COM, Mar. 20, 2007, http://money.cnn.com/2007/03/20/pf/taxes/tax_gap_hearing/ (referring to the tax gap as a "magic windfall" for government budget woes).

6. "[L]et me make it clear. We will work to address the tax gap. We owe nothing less to the millions of honest working families who find tax day the toughest day of the year." *The $350 Million Question: How to Solve the Tax Gap: Hearing Before the S. Comm. on Finance*, 109th Cong. 2 (2005) (statement of Sen. Charles E. Grassley, Chairman, S. Comm. on Finance). "It is time to reverse the growth of the tax gap." *I.R.S. Oversight Hearing*, *supra* note 3, at 29 (statement of Sen. Max Baucus).

7. Francine J. Lipman, *The Working Poor Are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 2003 Wis. L. Rev. 461, 465; CHI CHI WU & JEAN ANN FOX, NAT'L CONSUMER LAW CTR. & CONSUMER FED'N OF AM., COMING DOWN: FEWER REFUND ANTICIPATION LOANS, LOWER PRICES FROM SOME PROVIDERS, BUT QUICKIE TAX REFUND LOANS STILL BURDEN THE WORKING POOR 1 (2008), *available at* http://www.consumerfed.org/pdfs/RAL_2008_Report_final.pdf [hereinafter 2008 NCLC REPORT].

8. GOV'T ACCOUNTABILITY OFFICE, REFUND ANTICIPATION LOANS 4 (No. GAO-08-800R, 2008), *available at* http://www.gao.gov/new.items/d08800r.pdf [hereinafter GAO RAL REPORT]. During the 2005 filing season, the IRS estimates that 9.6 million taxpayers eligible for refunds that totaled $28.7 billion applied for RALs. *Id.* at 3. Given the importance of refundable credits, and the EITC in particular, to the popularity of RALs, and the transformation of our tax system to one where many low-income individuals have a negative income tax rate, this Article emphasizes compliance issues relating to the EITC.

9. The claimant must have an adjusted gross income less than $12,590 ($14,590 if married filing jointly) if the claimant does not have any qualifying children, less than

amount to the taxpayer, less any tax preparation, filing, processing, and finance fees. The sum total of these fees can be quite high: from roughly $150 up to $500, depending on the preparer and lender.[10] RALs have created a substantial market, with about $900 million in loan-related RAL fees being generated annually.[11] The presence of fees, and the existence of ancillary service or product providers at or in proximity to the return preparers, raises the question as to whether the allure of these fees is encouraging tax return preparers to act improperly and contribute to the compliance problems associated with returns associated with EITC-fueled refunds.[12]

This Article argues that our general lack of understanding of how return preparers contribute to the decision to comply (or not comply) with our nation's tax laws limits the ability for policy makers to take effective administrative or legislative action aimed at reducing the tax gap associated with returns that are associated with RALs in general, and the EITC in particular. It will look at one such administrative effort, the Treasury's Advanced Notice of Proposed Rulemaking (ANPR),[13] issued in January 2008, which asked for guidance on whether the selling of RALs should be restricted due to such products potentially creating an incentive for preparers to fail to comply with due diligence requirements designed to ensure the accuracy of refund claims.[14] While I applaud

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$33,241 ($35,241 if married filing jointly) with one qualifying child, and less than $37,783 ($39,783 if married filing jointly) with two qualifying children. INTERNAL REVENUE SERV., EITC THRESHOLDS AND TAX LAW UPDATES (2008), *available at* http://www.irs.gov/individuals/article/0,,id=150513,00.html. Originally envisioned as a modest reverse income tax, the EITC has become the nation's largest anti-poverty program. Jeff Engerman, Administering the Earned Income Tax Credit: Paid Preparers, Problems, and Possibilities 2 (May 13, 2006) (unpublished supervised written work requirement, Harvard Law School, on file with author). In 2006, over $45.3 billion in EITC funds were paid out to more than twenty-three million claimants, with an average payment of $1939. BRIAN BALKOVIC, INTERNAL REVENUE SERV., INDIVIDUAL INCOME TAX RETURNS, PRELIMINARY DATA, 2006 6 (2008), *available at* http://www.irs.gov/pub/irs-soi/06inreturnbul.pdf.

10. NAT'L CONSUMER LAW CTR. ET AL., COMMENTS REGARDING THE ADVANCE NOTICE OF PROPOSED RULEMAKING 8 (2008), *available at* http://www.consumerlaw.org/issues/refund_anticipation/content/comments_040708.pdf [hereinafter NCLC COMMENTS].

11. *Id.*

12. The tax gap associated with the EITC has received considerable legislative attention, even though IRS estimates that EITC overclaims only amount to approximately 3% of the tax gap. OMB WATCH, BRIDGING THE TAX GAP: THE CASE FOR INCREASING THE IRS BUDGET 14 (2008), *available at* http://www.ombwatch.org/budget/irstaxgap2008.pdf [hereinafter OMB WATCH, TAX GAP].

13. Guidance Regarding Marketing of Refund Anticipation Loans, 73 Fed. Reg. 1131 (Jan. 8, 2008).

14. The ANPR was issued simultaneously with final regulations promulgated under Section 7216 of the Internal Revenue Code. Treas. Reg. § 301.7216-3 (2008). Section 7216 imposes criminal penalties on tax return preparers who knowingly or recklessly make unauthorized disclosures or uses of information furnished in connection with the preparation of

the IRS's efforts to examine the relationship between incentive and noncompliance,[15] and while there may be sufficient non-tax policy reasons to further regulate such products,[16] I do not believe that there is sufficient evidence from

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an income tax return. 26 U.S.C. § 7216 (2000). While general rules prohibit the preparer's use and disclosure of return information, current rules permit tax preparers to obtain and use confidential tax return information, in furtherance of marketing RALs and other products offered by the preparer or an affiliate of the preparer, so long as the taxpayer provides written consent. 26 C.F.R. § 301.7216-3 (2008). The rule on which the IRS and Treasury were seeking guidance would prohibit the use of information obtained during the tax preparation process for the purpose of marketing RALs and related products. Guidance Regarding Marketing of Refund Anticipation Loans, 73 Fed. Reg. 1131 (Jan. 8, 2008).

15. I have previously argued that agency efforts to reduce noncompliance should take into account incentives that both taxpayers and preparers have to comply with applicable tax laws. *See* Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 AM. U. L. REV. 1163 (2007) [hereinafter Book, *Freakonomics*] (arguing, for example, that the current structure of the earned income tax credit (EITC) and the relative invisibility of the tax return filing process presents structural incentives for certain taxpayers to improperly claim the EITC). I have also argued that the IRS and Congress should take additional steps to enhance the visibility of return preparers , including imposing and enforcing uniform preparer identificaton requirements, and harvesting data on preparer performance. See Leslie Book, [cite this pls http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327046

16. For purposes of this Article I take no view on the merits of that debate. For a more pro-market consideration of RALs, see H&R Block, *H&R Block Voices Concerns with Proposed Rules That Would Limit Solicitation of Refund Anticipation Loans*, 2008 TAX NOTES TODAY 85-21 [hereinafter *Block Comments*]. H&R Block believes that the additional costs associated with the ANPR would effectively prevent taxpayers from seeking such products, though the National Taxpayer Advocate believes that the prohibition would not eliminate the practice. For more on that disagreement, see *id*. at n.114. Block notes, for example, the relatively high customer satisfaction and retention rate with the product. *Id*. at n.36 and surrounding text. On the other side of this debate are the consumer advocates, who place RALs in the spectrum of a whole host of rather costly financial products (like payday loans and high check cashing fees) that exist in the market, and impose relatively high credit and conversion costs. CHI CHI WU ET AL., NAT'L CONSUMER LAW CTR. & CONSUMER FED'N OF AM., ANOTHER YEAR OF LOSSES: HIGH PRICED REFUND ANTICIPATION LOANS CONTINUE TO TAKE A CHUNK OUT OF AMERICANS' TAX REFUNDS 10 (2006) (using the term "high cost fringe financial services" to describe RALs and other financial products, such as payday loans, pawnshop loans, and rent-to-own agreements). The arguments are largely based on the cost of obtaining RALs, as RAL fees, when added to tax preparation fees, can range from roughly $170 to over $500. *See, e.g.*, NCLC COMMENTS, *supra* note 10, at 8. For an interesting discussion of these controversial financial products and a comparison between them and RALs, *see* Michael Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 141-77 (2004). These products, like RALs, tend to attract myriad state, local and national regulatory efforts. *See, e.g.*, John Warner National Defense Authorization Act for Fiscal Year 2007, 10 U.S.C. § 987 (2006) (capping annual percentage rates on loans extended to military personnel at 36%); TENN. CODE ANN. §§ 62-29-201 to 62-29-205 (West 2008) (focusing on disclosure requirements for RALs); TEX. FIN. CODE ANN. §§ 351.001-351.008 (West 2007) (requiring registration of RAL facilitators); 32 C.F.R. § 232.3 (2008) (defining RALs as one of the loan products that fall under 10 U.S.C. § 987). For a discussion of various concerns about high fees and taxpayer privacy, see NCLC COMMENTS, *supra* note 10; Barr, *supra*. For a fascinating discussion of how economists, philosophers, religious thinkers and courts have approached the thorny issue of firms profiting by selling goods or services to the poor, see David Rose, Daniel Schneider & Peter Tufano, H&R Block's Refund Anticipation Loan: A Paradox of

a tax compliance perspective alone to take action that would effectively limit its use. The ANPR highlights the preparers' role in taxpayer compliance decisions, and it is possible that RALs contribute in some way to both taxpayer and practitioner decisions to fail to comply with internal revenue laws. However, the current state of research in this area does not tell us enough about the degree to which RALs contribute to or exacerbate noncompliance problems, either from a demand perspective (i.e. taxpayers themselves), or from the supply side (i.e. the preparers). It is likely that other factors inherent in the relationship between practitioner and the refund-claiming taxpayer contribute to this noncompliance to a greater degree than the presence of RALs, factors such as: 1) the existence of the refund itself and the ability for the preparer to earn preparation fees from that refund; 2) the lack of ongoing relationship between the preparer to either the taxpayer or the tax system generally; 3) competitive pressure on preparers faced with other preparers willing to facilitate or broker tax refund noncompliance; and 4) the relative paucity of IRS audits of preparers to ensure that preparers are meeting up to their various responsibilities.

Part II of this Article situates efforts to reduce the tax gap attributable to low-income taxpayers within the broader context of efforts to reduce the tax gap overall. Part III discusses the arguments that advocates have made in response to the IRS's request for information regarding the effect of RALs on the tax gap. Part IV analyzes the incentives for paid preparers to inflate refunds and discusses how the IRS should turn its immense fact gathering and research capabilities to the issues of practitioners and how practitioners can influence compliance decisions.[17] Part V uses the responsive regulation framework to analyze how the tax laws might be better structured to encourage compliance.

II. GOING AFTER THE BAD GUYS: SOMETIMES EASY, SOMETIMES NOT SO EASY

Tax gap research and data highlight that there is not one tax gap problem, but a series of often distinct areas of systemic noncompliance.[18] Consider the case of the cash economy and small business taxpayers. The cash economy and

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Profitability? (Nov. 17, 2005) (working paper), http://www.people.hbs.edu/ptufano/Rose,%20Schneider,%20and%20Tufano%2011-18-051.pdf.

17. *See* Eric Toder, *What is the Tax Gap?*, 2007 TAX NOTES TODAY 205-43 ("[A] key variable of interest would be relative compliance rates among taxpayers who prepare returns by hand, prepare returns with software, and use paid preparers.").

18. GOV'T ACCOUNTABILITY OFFICE, TAX COMPLIANCE: MULTIPLE APPROACHES ARE NEEDED TO REDUCE THE TAX GAP 5 (2007) ("The tax gap has multiple causes; spans five types of taxes; and is spread over several types of taxpayers including individuals, corporations, and partnerships."); Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*, [hereinafter Book, *Role of Preparers*] *in* INTERNAL REVENUE SERV., NAT'L TAXPAYER ADVOCATE, 2 2007 ANNUAL REPORT TO CONGRESS 63-64 (2007), *available at* http://www.irs.gov/pub/irs-utl/arc_2007_vol_2.pdf [hereinafter 2007 NTA REPORT VOL. 2].

small business taxpayers comprise a significant portion of the tax gap.[19] As Professor Bankman has noted,[20] the risks of popular backlash against the invasive audits necessary to meaningfully ferret out small business noncompliance, as well as the extent of agency resources needed to perform that labor-intensive work, are real and practical impediments to successful reductions in this portion of the tax gap.[21]

Coming on the tenth anniversary of the IRS Restructuring and Reform Act of 1998,[22] IRS has stepped up its compliance activities in many areas to pre-1998 levels.[23] IRS efforts at reducing underreporting have targeted both the very rich, and the working poor, but have largely steered clear of some of the heavy lifting needed to go after those in the middle.[24] Facing widespread criticism that IRS audit rates of people claiming the EITC were too high relative to other taxpayers[25]—only one percent of taxpayers are audited, but nearly forty percent of audits are of returns claiming the EITC[26]—former Commissioner

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19. In 2001, the gross underreporting gap was estimated at $250-292 billion, with individual income tax amounting to about two thirds of that amount. Of that portion, underreporting business income contributed most heavily to the tax gap. INTERNAL REVENUE SERV., TAX GAP FACTS AND FIGURES 6-7 (2005), *available at* http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf.

20. *See* Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 2007 TAX NOTES TODAY 210-42 (weighing the pros and cons of various legislative options to close the tax gap in the cash economy).

21. To combat some of these impediments, Bankman suggests mounting an educational campaign to inform the public on the payoffs to increased audits and providing a $1000 reimbursement for the costs of an audit to those taxpayers who have paid substantially all of their tax liability. *Id.*; *see also* TIGTA Report, *supra* note 1, at 15-16 (noting that there are several significant impediments keeping the IRS from being able to rely solely on audits to eliminate the tax gap).

22. 26 U.S.C. § 6212 (2000).

23. TREASURY INSPECTOR GEN. FOR TAX ADMIN., TRENDS IN COMPLIANCE ACTIVITIES THROUGH FY 2007 2 (2008) (noting that despite decreased enforcement personnel, the IRS has reversed most of the decline in enforcement action following the restructuring that followed the 1998 legislation). TIGTA provides data on the extent of various enforcement efforts and noting for example that in FY 2007, revenue generated from enforcement increased by twenty-two percent to $59.2 billion. *Id.*

24. *See* Bankman, *supra* note 20 (noting that audits in the cash economy are increasingly rare, yet very necessary to close the tax gap in this sector). *See also* Eric Toder, *Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction*, 2007 TAX NOTES TODAY 130-22 (noting that performing both automated collection activities—which typically involve contacts with taxpayers where the amount of underreported or underpaid is known with relative certainty—and EITC audits are the least burdensome on the IRS).

25. ROBERT GREENSTEIN, CTR. ON BUDGET & POL'Y PRIORITIES THE NEW PROCEDURE FOR THE EARNED INCOME TAX CREDIT 5 (2003), *available at* http://www.cbpp.org/5-20-03eitc2.pdf; David Cay Johnston, *I.R.S. Audits Middle Class More Often, More Quickly*, N.Y. TIMES, Apr. 16, 2007, at C6; *Serrano Voices Concern over IRS Policies*, THE SERRANO REPORT, Mar. 30, 2007, *http://serrano.house.gov/Newsdetail.aspx?ID=370*.

26. In fiscal year 2006, the IRS audited over 517,000 returns associated with the

Everson redirected agency resources toward corporate tax abuse and well-publicized shelters.[27] Despite this shift in resources, however, the criticisms have continued.[28] It is fairly easy to explain how the IRS can get away with hundreds of thousands of annual audits of EITC-claiming taxpayers—this group is largely without the voice and power of small business taxpayers, and the "Nickel and Dimed" population is often without the means necessary to raise a ruckus in such a way that politicians or the agency takes note.[29]

For the rich and corporate America, part of the reason why the IRS has been able to place in its compliance crosshairs corporate tax shelters is the backlash following Enron. With the Enron scandal and the publicizing of the arcane (often tax driven) schemes that had the potential to make the corporate income tax truly voluntary,[30] the Bush Administration put high on its priority list the aggressive tax shelter industry that flourished in the 1990s.[31] Even in a business-friendly Republican Administration, major figures in Treasury and the IRS railed against corporate irresponsibility and even a lack of patriotism associated with corporate tax-driven schemes.[32] While the administration could cite to success in its efforts to root out perverse corporate tax abuse, even declaring

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EITC, for an audit rate of approximately 2.25% for EITC recipients. OMB WATCH, TAX GAP, *supra* note 12, at 14. OMB Watch points out that EITC audits result in a significantly lower yield-per-audit compared to other audits. *Id.*; *see also Block Comments*, *supra* note 16, at 85-21 n.67 and surrounding text.

27. *Reporting Improper Payments: A Report Card on Agencies' Progress: Hearing Before the Subcomm. on Fed. Financial Management, Governmental Information and International Security of the S. Homeland Security and Governmental Affairs Comm.*, 109th Cong. 21 (2006) [hereinafter *Fed. Financial Management Hearing*] (statement of Mark Everson, Commissioner, Internal Revenue Service).

28. THE SERRANO REPORT, *supra* note 25; Johnston, *supra* note 25, at C6.

29. BARBARA EHRENREICH, NICKEL AND DIMED: ON (NOT) GETTING BY IN AMERICA (Henry Holt and Co., LLC 2002) (2001). *See generally* Dorothy A. Brown, *Essay: Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790 (2007) (pointing to racial components of low-income tax policy, and the EITC in particular).

30. *See* David Cay Johnston, *Wall St. Firms Are Faulted in Report on Enron's Taxes*, N.Y. TIMES, Feb. 14, 2003, at C2; Elliot Blair Smith, *Enron Unit Turned Tax Shelters into Profit*, USA TODAY, Feb. 14, 2003, at 6B; *see also* U.S. DEP'T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION ANALYSIS AND LEGISLATIVE PROPOSALS 8-11 (1999); Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. CORP. L. 219, 232 (2004).);

31. *See Corporate Inversions: Hearing Before H. Comm. on Ways & Means*, 107th Cong. 10-11 (2002) (statement of Pamela Olson, Acting Assistant Secretary for Tax Policy, U.S. Dep't of Treasury); JOHN BRAITHWAITE, MARKETS IN VICE, MARKETS IN VIRTUE (2005).

32. Recall the backlash generated by Stanley Works' efforts to reincorporate in Bermuda. *See* David Cay Johnston, *Vote on an Offshore Tax Plan is Roiling a Company Town*, N.Y. TIMES, May 9, 2002, at A3; *see also* David Cay Johnston, *Senators Assail Corporate Use of Bermuda as Tax Shelter*, N.Y. TIMES, Mar. 22, 2002, at C5; William M. Welch, *Offshore Tax Shelters Under Fire*, USA TODAY, July 31, 2002, at 3B.

that the tax shelter war "was over" and "the government won,"[33] the government has had somewhat less success in some of its other efforts to target noncompliance among wealthy individuals, including its offshore credit card initiative,[34] which held much promise in rooting out garden variety fraud, but likely would have generated intense backlash given the size and power of the people who the IRS would have targeted.[35] Without the popular indignation that surrounded the Enron-type corporate malfeasance, the IRS apparently decided not to pursue individuals with offshore credit cards, despite the high probability that those individuals were using those cards as a way to hide cash that was likely not reported to the IRS as income,[36] though recent pronouncements suggest that the IRS is moving away from this "hands-off" approach.[37]

The IRS efforts of the past few years to reduce underreporting noncompliance among corporate taxpayers and the very poor appear on the surface to be paradoxical. Yet, those two groups are the proverbial low hanging fruit, with the working poor too powerless to meaningfully object, and the IRS beholden to a Congress controlling its purse, itching to show voters (especially in times of economic slowdown) that corporate America would not run roughshod over

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33. Pamela Olson, *Now That You've Caught the Bus, What Are You Going To Do With It? Observations From the Frontlines, Sidelines, and Between the Lines, So To Speak*, 60 TAX LAW. 567, 567 (2007).

34. *New I.R.S. Request on Credit Card Data*, N.Y. TIMES, Aug. 16, 2002, at C6; *IRS Unveils Offshore Voluntary Compliance Initiative; Chance for "Credit Card Abusers" to Clear Up Their Tax Liabilities*, NAT'L FEDERATION OF INDEPENDENT BUSINESS, Feb. 25, 2002, http://www.nfib.com/object/3724867.html. Mixed results discussed in Pamela Gardiner, *TIGTA Testifies at Senate Finance Tax Gap Hearing*, 2004 TAX NOTES TODAY 141-45. *But see* Douglas Schulman, *Schulman Says Tax Gap, Compliance Proposals Could Generate Revenue*, 2008 TAX NOTES TODAY 75-79 (requesting funding from Senate Appropriations Committee for program designed to increase reporting compliance U.S. taxpayers with offshore activity); *see also* Christopher Costigan, *PayPal Summoned by IRS Regarding Offshore Credit Cards*, GAMBLING911, Apr. 23, 2008, http://www.gambling911.com/PayPal-Online-Gambling-042308.html (mentioning the IRS' efforts to crack down on offshore noncompliance).

35. *But cf.* Lynnley Browning, *Ex-Banker from UBS is Indicted in Tax Case*, N.Y. TIMES, May 14, 2008, at C4 (discussing tax fraud case against UBS banker); Andrew Ross Sorkin, *New Offshore Bank Limits for U.S. Clients, UBS Says*, DEALBOOK.NYTIMES.COM, July 18, 2008, http://dealbook.blogs.nytimes.com/2008/07/18/new-offshore-bank-limits-for-us-clients-ubs-says (discussing UBS decision to stop offering offshore banking services to US clients).

36. *See* Tom Herman, *Offshore Account Holders Bite Their Nails*, WALL ST. J., May 21, 2008, at D1 ("[M]any wealthy Americans use [offshore bank accounts] to illegally shield income.").

37. *Cf. id.* (noting that the likelihood of being caught not reporting money shipped offshore increased resulting from a willingness among nations to exchange information on tax havens); Press Release, Internal Revenue Serv., IRS and Tax Treaty Partners Target Liechtenstein Accounts (Feb. 26, 2008), http://www.irs.gov/newsroom/article/0,,id=179387,00.html (noting that increased information sharing between tax treaty partners is facilitating cracking down on offshore bank accounts).

the income tax system.

The lower-income tax return filers are the lowest of the hanging noncompliance fruit. The IRS—prodded by Congress and the reality that many lower-income individuals enter the tax system not as income taxpayers, but as refund-seekers—annually puts hundreds of thousands of lower or moderate-income individuals through the paces of establishing eligibility for a host of related family status benefit provisions.[38] This process has resulted in the steady drumbeat of hundreds of thousands of low resource intensity correspondence audits of individuals claiming the EITC, related family benefit provisions and refunds based on excessive withholdings of wages.[39] These audits require claimants to establish eligibility with a panoply of tax provisions relating to income level and family status in order to receive a refund or avoid repaying the government money.[40]

The government's efforts at dealing with lower income taxpayer noncompliance have a certain rhythm to them. It has been marked by steady attention, punctuated by creative and sometimes overreaching efforts to get at the relatively stubborn and high rates of noncompliance.[41] Estimates of EITC error rate approximate twenty-five to thirty-five percent, despite the government's

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38. The most important is the EITC, with over $44 billion being claimed by more than twenty-three million recipients in tax year 2006. TAX POLICY CTR., EARNED INCOME TAX CREDIT BY STATE, TAX YEAR 2006 (2008). For a criticism of the IRS's attention to noncompliance among lower-income individuals relative to other systemic issues of noncompliance, see Brown, *supra* note 30.

39. *See* Toder, *supra* note 24 (noting that automated collection activities where underreporting amounts are known with relative certainty and EITC audits require minimal resource expenditure by the IRS).

40. For a summary of these eligibility criteria that must be substantiated in order to receive EITC payments, see Internal Revenue Serv., EITC for Individuals, http://www.irs.gov/individuals/article/0,,id=150557,00.html (last visited Sept. 3, 2008). There is a significant amount of literature discussing the challenges these audits present to low-income claimants, including the likelihood that eligible claimants are denied rightful EITC claims or simply fail to participate in the audit process, resulting in either disallowed refunds or an assessment following a refund which results in a significant liability to the IRS. *See* INTERNAL REVENUE SERV., NAT'L TAXPAYER ADVOCATE, 2 2004 ANNUAL REPORT TO CONGRESS 12-14 (2004), *available at* http://www.irs.gov/pub/irs-utl/nta2004arcvol2interactive.pdf.

41. For example, the IRS' proposal to require pre-certification for EITC payments. INTERNAL REVENUE SERV., IRS EARNED INCOME TAX CREDIT (EITC) INITIATIVE: FINAL REPORT TO CONGRESS, OCT., 2005 8 (2005), *available at* http://www.irs.gov/pub/irs-utl/irs_earned_income_tax_credit_initiative_final_report_to_congress_october_2005.pdf. For a criticism of this program, see ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, ISSUES TO CONSIDER IN ASSESSING IRS' PROPOSALS REGARDING EITC PRE-CERTIFICATION (2003). *See also* David Cay Johnston, *I.R.S. Move Said to Hurt the Poor*, N.Y. TIMES, Jan. 11, 2006, at C6 (reporting that ex post reviews of EITC claims often result in improper freezing of EITC payments).

significant efforts over the past ten years to increase compliance.[42] Periodically, in the face of overreaching IRS efforts, advocates would complain that IRS efforts were too burdensome, threatening notions of fairness and creating the conditions that necessitated the IRS's reversal or reigning in of its efforts.[43] Yet, despite the ebb and flow of those efforts, noncompliance in this area is well above many other parts of the tax system,[44] and far above error rates associated with other benefits' programs (like food stamps and TANF).[45]

III. RALS: GOOD, BAD, OR UGLY? WELL . . . IT DEPENDS ON WHO YOU ASK

A. *Overview of the Role of Preparers*

The use of paid preparers in return filing has steadily grown.[46] While some of the estimated 1.2 million paid preparers are subject to professional standards for their respective professions (CPAs, attorneys, etc.), many others are unaffiliated with any licensed profession, and are not held to any required

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42. Book, *Freakonomics*, *supra* note 15, at 1170. The IRS estimates that in tax year 1999, there was an EITC noncompliance rate of between 27 and 32%, resulting in approximately $8.5 to $9.9 billion in erroneous claims or payments. GOV'T ACCOUNTABILITY OFFICE, EARNED INCOME TAX CREDIT: IMPLEMENTATION OF THREE NEW TESTS PROCEEDED SMOOTHLY, BUT TESTS AND EVALUATION PLANS WERE NOT FULLY DOCUMENTED 1 (No. GAO-05-92, 2004) [hereinafter GAO, EITC]. In tax year 2007, the IRS issued roughly $38 billion in EITC refunds. GOV'T ACCOUNTABILITY OFFICE, PUBL'N NO. GAO-08-166, IRS'S FISCAL YEARS 2007 AND 2006 FINANCIAL STATEMENTS 92 (2007) [hereinafter GAO, FINANCIAL STATEMENTS]. The IRS is able to prevent approximately $1 billion in erroneous EITC payments each year. Office of Management and Budget, ExpectMore.gov: Internal Revenue Service Earned Income Tax Credit Compliance, http://www.whitehouse.gov/OMB/expectmore/summary/10000422.2002.html (last visited Aug. 31, 2008) [hereinafter OMB, *EITC Compliance*]. Despite these efforts to halt erroneous payments, based on a 2001 study on EITC compliance, the IRS estimates that at least $10 billion in improper EITC funds may have been paid out in tax year 2007. GAO, FINANCIAL STATEMENTS, *supra*, at 92. *See* OMB, *EITC Compliance*, *supra* (rating EITC program as "ineffective" due to the high error rate even after compliance activities).

43. Toder, *supra* note 24 ("This attention paid to the tax gap is the latest iteration of a cyclical pattern in which politicians alternatively call for increased IRS enforcement and then complain about the burdens the IRS imposes on the citizenry.").

44. *See* Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867, 1887-91 (2005).

45. For comparative compliance and enforcement rates and a discussion of how compliance and enforcement differ between the EITC and traditional welfare programs see *id.* at 1876-78, 1887-93.

46. From 1996 to 2005, income tax returns filed by paid practitioners have risen from 63 million to 80 million (from 53% to 62% of all returns filed). Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, *in* INTERNAL REVENUE SERV., PUBL'N NO. 1500, THE IRS RESEARCH BULLETIN: PROCEEDINGS OF THE 2007 IRS RESEARCH CONFERENCE 77 (2007).

standards.[47] All paid preparers, whether held to continuing education or professional standards or not, are subject to certain requirements in preparing the return, including signing the return and providing the taxpayer with a copy of the return.[48] These preparers are also subject to civil and even criminal penalties for improper conduct.[49]

The preparer's task consists of filling out the actual tax forms, identifying items affecting the taxpayer's liability, and advising clients on resolving

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47. Book, *Role of Preparers*, *supra* note 18, at 44.

48. The following table summarizes some of the applicable penalties:

Code Section (§)	**Description**	**Penalty**
6694(a)	Understatement of taxpayer's liability due to an unrealistic position (unrealistic position redefined in 2007)	$250 unless reasonable cause or good faith can be shown for the understatement
6694(b)	Understatement of taxpayer's liability due to willful or reckless conduct (willful or reckless conduct redefined in 2007)	$1,000 per claim
6695(a)	Failure to provide a copy of return to taxpayer	$50 per failure up to a maximum of $25,000
6695(b)	Failure to sign return	$50 per failure up to a maximum of $25,000
6695(c)	Failure to furnish identifying number	$50 per failure up to a maximum of $25,000
6695(d)	Failure to retain a copy or list of refunds filed	$50 per failure up to a maximum of $25,000
6695(e)	Failure of employers to file correct information on each tax preparer employed	$50 per failure up to a maximum of $25,000
6695(f)	Negotiation of taxpayer's refund check	$500 per check
6695(g)	Failure to be diligent in determining EITC eligibility	$100 per failure
6701	Aiding and abetting understatement of tax liability	$1,000
6713	Improper disclosure or use of return information	$250 per disclosure up to a maximum of $10,000
7206	Willful preparation of false or fraudulent return or other document	Up to $100,000, 3 years imprisonment, or both
7207	Knowingly providing fraudulent returns or other documents to IRS	Up to $10,000, 1 year imprisonment, or both
7216	Knowingly or recklessly disclosing or using return information	Up to $1,000, 1 year imprisonment, or both

49. For a discussion of various penalties see *supra* note 49. For cases where the IRS has brought injunction actions against preparers for improper conduct, see *infra* note 132.

any uncertainties as to the tax consequences of ambiguous items. Research into the motivations for taxpayers to use paid preparers has determined that people seek out paid preparers because they believe they (i) benefit from using preparers, (ii) lack an understanding of the tax law, (iii) lack the time to file taxes themselves,[50] and (iv) fear an audit and believe that using a paid preparer would minimize the chance of an audit.[51]

Exactly what effect paid preparers have on tax compliance is not entirely clear, though the role of preparers in tax compliance has become an increasingly important area of study,[52] and there have been several calls for more research considering the relationship.[53] Despite the increasing use of preparers and an increased general sense that more research is needed to examine the role that preparers play, the GAO has recently noted

> IRS does little to monitor or track basic information about individual paid preparers. For example, IRS does not collect information on the type of preparers, such as whether the preparer is an enrolled agent or part of a commercial chain, or the number or types of returns filed by the preparer. Having such information could allow IRS to better identify filing errors and target its outreach to specific preparers or preparer groups.[54]

Though there is not much quantitative or qualitative research relating to preparers, there are some likely explanations as to how preparers can contribute to noncompliance.[55] I have previously identified seven ways that preparers

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50. GOV'T ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: MOST TAXPAYERS BELIEVE THEY BENEFIT FROM PAID TAX PREPARERS, BUT OVERSIGHT FOR IRS IS A CHALLENGE 7-12, (No. GAO-04-70, 2003).

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

52. For a discussion of the various ways that gatekeeper measures can temper aggressive tax planning, see Susan Cleary Morse, *Using Salience and Influence to Close the Tax Gap*, 39 LOY. U. CHI. L.J. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1139891 (referring to raising filing standards, reducing privilege, increasing penalties, tightening disciplinary procedure, imposing additional licensing requirements, and modifying tax preparers' investigation obligations as gatekeeping measures to promote compliance). *See* Book, *Role of Preparers*, *supra* note 18, at 74; Steven Klepper, Mark Mazur & Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J.L. & ECON. 205 (1991).

53. *See* Book, *Role of Preparers*, *supra* note 18, at 74; INTERNAL REVENUE SERV., 2007 NAT'L TAXPAYER ADVOCATE, 1 2007 ANNUAL REPORT TO CONGRESS 95 (2007), *available at* http://www.irs.gov/pub/irs-utl/arc_2007_vol_1_cover_msps.pdf [hereinafter 2007 NTA REPORT]

54. GOV'T ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: 2007 FILING SEASON CONTINUES TREND OF IMPROVEMENT, BUT OPPORTUNITIES TO REDUCE COSTS AND INCREASE TAX COMPLIANCE SHOULD BE EVALUATED 18 (No. GAO-08-38, 2007) [hereinafter GAO, 2007 FILING SEASON]. IRS is slowly awakening to the importance of tracking data relating to preparers. *Id.*

55. *See* Book, *Role of Preparers, supra* note 18, at 69-70.

likely contribute to noncompliance and their possible explanation:

1. Ignorance or misunderstanding of the law—poor training, inadequate attention to changes in the law, or complexity of the law;
2. Misunderstanding or failing to understand or learn the facts—language or cultural barrier—can also be related to ignorance or understanding of the law, as the practitioner may not know what information is relevant;
3. Unable or unwilling to detect false or incorrect information, though the unwillingness or inability is not reflective of failing to exercise due diligence;
4. Facilitate noncompliance by not exercising appropriate due diligence to verify facts or information;
5. Aid and abet in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate or excessive deductions or credits;
6. Facilitate continued noncompliance by advising taxpayers how to arrange affairs to minimize chances of detection, including advising taxpayers on practices or positions that are likely to generate ITS attention;
7. Directed noncompliance—working in an environment where there is a culture of noncompliance, either through insufficient quality control or active and affirmative exhortations to take affirmative steps which are meant to minimize liabilities or maximize refunds.[56]

It is important to understand the motivations of the practitioners' willful or negligent noncompliance.[57] For example, the profit motive and motivations to retain clients and attract new customers may drive types four through seven noncompliance.[58]

What little evidence there is suggests that noncompliance is driven by both the practitioners and the taxpayers.[59] Therefore, how preparers react to demand-driven noncompliance is important to understand as well.[60] I have pre-

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56. *Id.* (internal footnotes omitted).

57. *Id.* at 70.

58. *See id.*

59. *Compare* Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 NAT'L TAX J. 398 (1992) *with* Yuka Sakurai & Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?* (Ctr. for Tax Sys. Integrity, Working Paper No. 5, 2001).

60. For these purposes, I refer to demand-driven noncompliance as errors relating to taxpayer submission of inaccurate or incomplete information to practitioners, and supply-side noncompliance as errors relating to preparer conduct, be it by innocent error or intentional noncompliance along the lines set forth above. Of course, characterizing noncom-

viously laid out a hypothesis postulating that preparers respond to taxpayers who wish to understate their taxes (or overclaim refunds) in one of six ways:

1. Refusing practitioners—these practitioners refuse to engage in a relationship with clients they suspect to be dishonest or overly aggressive;
2. Signaling practitioners—these practitioners will signal their unwillingness to prepare returns for clients they expect to be dishonest by making detailed inquiries or requesting back-up documentation;
3. Facilitating practitioners—these preparers facilitate noncompliance by advising the taxpayer how to take improper return positions when they know or reasonably believe that the taxpayer is misstating facts;
4. Indifferent practitioners—these preparers are indifferent to the taxpayer's conduct and are willing to follow taxpayer preference and overlook noncompliance;
5. Incompetent or unsophisticated practitioners—given the due diligence requirements,[61] these preparers should be able to recognize that the taxpayer is taking improper positions, but is unable to detect or suspect taxpayer misconduct because of lack of training, education sophistication, etc.; and
6. Reasonably unknowing practitioners—despite the client's misconduct, the practitioner does not and cannot reasonably know or suspect that the facts the taxpayer alleges are incorrect.[62]

To what degree RALs affect these different causes of noncompliance is unclear, and is the source of a rather heated debate, which is what the next section addresses.[63]

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pliance as purely demand- or supply-driven does not capture the dynamic relationship between the two parties. This aspect of the relationship suggests a greater need for qualitative research that will place researchers in the preparation process. Margaret McKerchar, *Why Do Taxpayers Comply? Past Lessons and Future Directions in Developing a Model of Compliance Behaviour*, *in* TAX ADMINISTRATION IN THE 21ST CENTURY 225, 242 (Michael Walpole & Chris Evand eds., 2001) (emphasizing the importance of identifying the various typologies of noncompliance and urging that additional studies be made relating to actual taxpayer and preparer behavior); Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, *in* 2 TAXPAYER COMPLIANCE 47 (Jeffrey Roth et al. eds., 1989) (postulating that preparers can broker and facilitate both compliance and noncompliance).

61. For a discussion of general practitioner due diligence requirements within the Internal Revenue Code, see Morse, *supra* note 53, at n.60 and surrounding text. There are specific due diligence rules applicable to returns which reflect a claimed EITC. A preparer must complete Form 8867, Paid Preparer's Earned Income Credit Checklist, or an equivalent form. The completion of the checklist must be based on information provided by the taxpayer or reasonably obtained by the preparer. Treas. Reg. § 1.6695-2(b)(1) (2000).

62. Book, *Role of Preparers*, *supra* note 18, at 71.

63. *See infra* notes 65-118 and surrounding text.

B. *RALs and Tax Compliance*

While we may not know much about tax practitioners, we do know that the tax preparation industry as a whole has become, in some significant respects, "a vehicle for cross-marketing of non-tax goods and services."[64] RALs—one example of these non-tax products available from many paid preparers—are short-term loans secured by a taxpayer's anticipated tax refund amount. A taxpayer will borrow against the anticipated refund, and will be required to repay the loan regardless of the size of the actual refund amount. The RAL lender issues the taxpayer the amount of the anticipated refund less any preparation fees, as well as any filing, finance, and processing charges. The IRS refund is then transferred directly to the lender to pay back the loan. RAL customers receive their money between two and six weeks faster than waiting for their refund check.[65]

The creation of RALs has opened up a major market niche,[66] with their popularity largely coming with the advent of the IRS's e-filing program, and their use often associated with the receipt of EITC–generated refunds.[67] RAL providers actually credit RALs with spurring the e-filing program's success, as obtaining a refund faster encouraged e-filing, and served as the source of the preparers' filing and related fees.[68]

RALs are regulated to a limited extent by the IRS and Treasury. In addition to the regulations governing all paid preparers,[69] the preparer may not also is-

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64. *Tax Return Preparation Options for Taxpayers: Hearing Before the S. Finance Comm.*, 109th Cong. 3 (Apr. 4, 2006) (written statements of Nina E. Olson, National Taxpayer Advocate). For example, a number of used car dealers have entered the tax return preparation industry and issued a RAL that can be used as a down payment on a car. *Id.*

65. The difference in time depends on how the taxpayer chooses to file their return and receive their refund. If the taxpayer chooses to file by paper, they can receive their refund in approximately five weeks through direct deposit, or six weeks by having a check mailed to them. If the taxpayer chooses to e-file, they can receive their funds in approximately two weeks through direct deposit, or three weeks by choosing to have the check mailed to them. INTERNAL REVENUE SERV., NAT'L TAXPAYER ADVOCATE, 2 2007 OBJECTIVES REPORT TO CONGRESS 13 (2007), *available at* http://www.irs.gov/pub/irs-utl/2007_objectives_report_vol_ii_ral_final.pdf [hereinafter 2007 NTA Objectives].

66. Estimates for the 2006 tax filing season reveal that RALs provide a nearly $1 billion market, with $900 million in loan fees and as much as $90 million in "other" fees being generated. 2008 NCLC REPORT, *supra* note 7, at 5-8.

67. *See supra* note 8 and surrounding text. Block credits the popularity of RALs on several other factors as well, including that RALs meet seasonal needs by allowing customers a chance to get caught up on financial obligations, provide a sense of closure at tax time (a time of year they argue is fraught with stress for many), and serve the unbanked, who would most likely not have access to other forms of credit. *Block Comments*, *supra* note 16, at nn. 21, 37-39 and accompanying text.

68. *Block Comments*, *supra* note 16, at nn. 21, 37-39 and surrounding text.

69. For these regulations and requirements governing preparer conduct as well as

sue the RAL,[70] and all tax preparers providing electronic filing services are subject to the rules in the IRS's Handbook for Authorized e-file Providers of Individual Income Tax Returns.[71] Because of this requirement that the preparer not also be the lender, preparers and lenders have developed different preparer-lender relationships, including per-RAL compensation arrangements and "participation" arrangements.[72] The per-RAL compensation arrangement is simple: whenever a RAL is taken out, the preparer receives a flat fee from the lender, regardless of the size of the loan.[73] The participation arrangement, however, is a bit more complex. In these instances, the preparer "participates" in the loan by purchasing a less than fifty percent share of the loan.[74] This arrangement seems to rest on an interpretation of Revenue Procedure 98-50 that the preparer is not the lender so long as it does not own a majority share in the loan.[75]

Over time, RAL providers have come under fire from consumer advocates,[76] elected officials,[77] and IRS officials.[78] The criticisms of RALs have fo-

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their associated penalties, see *supra* note 49.

70. Form 1040 E File Program, Rev. Proc. 98-50, 1998-2 C.B. 368.

71. INTERNAL REVENUE SERV., HANDBOOK FOR AUTHORIZED IRS E-FILE PROVIDERS OF INDIVIDUAL TAX RETURNS (I.R.S. Pub. No. 1345, 2004). This publication requires that any preparer issuing a RAL to

> [e]nsure taxpayers understand that by agreeing to a RAL or other financial product they will not receive their refund from the IRS as the IRS will send their refund to the financial institution; advise taxpayers that RALs are interest bearing loans and not a quicker way of receiving their refunds from the IRS; advise taxpayers that if a Direct Deposit is not received within the expected timeframe for whatever reason, the taxpayers may be liable to the lender for additional interest and other fees, as applicable for the RAL or other financial product . . . ; advise taxpayers of all fees and other known deductions to be paid from their refund and the remaining amount the taxpayers will actually receive; secure the taxpayer's written consent . . . to disclose tax information to the lending financial institution in connection with an application for a RAL or other financial product; ensure that if it is also the return preparer that it is not a related taxpayer to the financial institution or other lender that makes a RAL or other financial product within the meaning of § 267 or § 707A; and adhere to fee restrictions and advertising standards . . . .

Id. at 44 (internal parentheses and bullet points omitted).

72. *See* Pacific Capital Bancorp, *Provider Comments on Proposed Rules Restricting Return Preparers' Solicitation of RALs*, 2008 TAX NOTES TODAY 86-25 (LEXIS) [hereinafter Pacific Comments].

73. *Id.*

74. *Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives*, *in* INTERNAL REVENUE SERV., NAT'L TAXPAYER ADVOCATE, 1 2005 ANNUAL REPORT TO CONGRESS 172 (2005), *available at* http://www.irs.gov/pub/irs-utl/section_1.pdf [hereinafter 2005 NTA REPORT].

75. Engerman, *supra* note 9, at 38-39.

76. "RALs drain hundreds of millions of dollars from the pockets of consumers and the U.S. Treasury." 2008 NCLC REPORT, *supra* note 7, at 4. "RALs contribute to tax fraud." *Id.* at 20. "RALs allow them [fraudsters] to get the money for their fraudulent returns before the fraud can be detected by the IRS." *Id.* at 26 (internal quotation marks omitted, brackets original).

77. "RALs drain too many resources away from earned income tax credit families that cannot afford to be fleeced by these excessively priced predatory products." Press Re-

cused on both a social policy standpoint and a tax compliance standpoint. This Part will focus on the debate over RALs' effect on tax compliance.[79]

Because RALs are typically capped at the amount of the anticipated refund, the IRS and the National Taxpayer Advocate have raised concerns about what kind of incentives this creates in preparing returns.[80] In response to these concerns, the Advanced Notice of Proposed Rulemaking, sought comments to determine to what degree RALs and other similar products should be regulated.[81] The IRS and Treasury asked specifically: "If RALs and certain other products create a direct financial incentive for preparers to inflate tax refunds, are there alternative approaches that would eliminate or reduce this incentive?"[82] The rule on which the IRS and Treasury were seeking guidance would prohibit the use of information obtained during the tax preparation process for the purpose of marketing any product.[83] This new rule would effectively keep preparers from initiating any marketing of RALs.[84]

RAL critics argue that both types of preparer-lender arrangements provide financial incentives to inflate refund claims.[85] The critics first contend that preparers have an incentive to push RALs, which means taking measures to promote the loans.[86] And since bigger refunds may make it more likely that the taxpayer will take out a RAL—as they are better able to absorb the preparation and finance charges—the preparer is better served by inflating the refund amount.[87] Inflating the claim is even more tempting, critics say, when the preparer is a retailer[88] (e.g., used car dealer) and not a professional preparer (e.g., H&R Block employee), as retailers might encourage the RAL customer to spend the RAL proceeds in their shops.[89] A bigger refund, therefore, means a bigger down payment on a car for the retailer, or bigger check cashing fees for the check cashing shop.[90]

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lease, Sen. Daniel Akaka, National Taxpayer Advocate Urges IRS to Reevaluate Policies That Facilitate Refund Anticipation Loans (July 13, 2006) (on file with author).

78. "RAL fees combined with return preparation and electronic filing fees significantly reduce a taxpayer's refund." 2005 NTA REPORT, *supra* note 75, at 163.

79. For a discussion of the social policy debate over RALs, *see supra* note 16.

80. Guidance Regarding Marketing of Refund Anticipation Loans, 73 Fed. Reg. 1131 (Jan. 8, 2008).

81. *Id.*

82. *Id.* The IRS and Treasury also asked: "Are there other products that present significant concerns for tax compliance . . . that should be addressed by regulation?" *Id.*

83. *Id.*

84. *Pacific Comments*, *supra* note 73.

85. NCLC Comments, *supra* note 10, at 4.

86. *Id.* at 22.

87. *Id.* at 22-23.

88. *See* GAO RAL REPORT, *supra* note 8, at 5-14 (providing examples of retailers offering tax preparation services and RALs).

89. NCLC Comments, *supra* note 10, at 23.

90. *Id.*

Participation interests are of even more concern to RAL critics. Though the IRS prohibits return preparers from receiving a fee that is contingent on the amount of the refund,[91] preparers seem to be "accomplishing on an aggregate basis what they are prevented from doing on an individual loan basis."[92] This is accomplished because the amount received is not a preparation "fee," but the payment scheme between some preparers and lenders rewards preparers on the total amount of facilitated RALs. [93]

While hard data on the effect RALs have on compliance is scarce, critics note a correlation between audit adjustment rates and RAL indicators.[94] Data from 2004 suggests that returns claiming eligibility for the EITC with RAL indicators had an average adjustment over $300 higher than those without RAL indicators, and had a fourteen percent lower no-change percentage.[95] Furthermore, in 2004, the Director of the IRS Criminal Investigation Division's Refund Crimes Unit found that eighty percent of fraudulent e-filed returns are tied to RALs.[96] Critics argue that this correlation shows that RALs incentivize tax fraud.[97]

RAL critics go on to say that RALs not only provide the preparer with incentives to inflate claims, but provide the taxpayer with an invitation to act improperly as well.[98] A 1993 report on the IRS's e-filing program pays particular attention to the fact that RALs shorten the "exposure period" for the fraudster—the time between the dishonest act and the payoff.[99] The report notes that the length of time between the act of fraud and its payoff is one of the principal deterrents or inducers of fraud—the shorter the exposure period, the more ap-

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91. I.R.S. Pub. 1345, at 45 (Nov. 2004).

92. 2007 NTA Objectives, *supra* note 66, at 7.

93. 2007 NTA REPORT, *supra* note 54, at 95; Engerman, *supra* note 9, at 38.

94. 2007 NTA REPORT, *supra* note 54, at 88. A RAL indicator is a notation on an IRS tax account that indicates that the taxpayer applied for (but did not necessarily receive) a RAL. *See* I.R.S. REPORT 2008-40-170 (Aug. 29, 2008) n.2.

95. The data shows that average adjustment for EITC claims with RAL indicators was $3,264, while it was $2,941 for those without RAL indicators. Those returns associated with RALs had a no-change rate of 13%, while those not associated with RALs has a no-change rate of 27%. *Id.* "No-change" refers to those cases where the IRS initiated an audit, but made no proposed assessment against the taxpayer.

96. Allen Kenney, *IRS Official Shines Spotlight on E-Filing Fraud*, 2004 TAX NOTES TODAY 130-4.

97. *See* NCLC Comments, *supra* note 10, at 23-25. The National Consumer Law Center urges that on the demand side of the equation, the most popular feature of RALs—speed—promotes tax fraud. *Id.* at 25-26.

98. *See id.* at 20-23, 25-26 (analyzing incentives for preparers to inflate refund claims as well as incentives for demand-driven tax fraud).

99. Malcolm Sparrow, *1993 Report on IRS Vulnerability to Refund Fraud,* 1996 TAX NOTES TODAY 35-51, § 2.3.1.

pealing fraud becomes.[100]

If in fact the presence of RALs exacerbates improper taxpayer behavior, critics note that the preparers have no incentive to implement fraud control measures beyond IRS enforcement.[101] In fact, preparers seem to only have the incentives to predict IRS behavior.[102] As the success of the RAL industry largely rests on the volume of RALs, any fraud control beyond expected IRS enforcement would cut into that volume, ultimately affecting profits.[103]

RAL providers, on the other hand, criticize the proposed rule.[104] RAL providers first urge that the RAL industry is already properly regulated.[105] They go on to suggest that, for any problems that *might* exist, effective enforcement of these existing regulations is a better course of action than adopting a rule that would potentially impose significant additional costs for these products.[106]

Addressing the concerns over whether or not RALs create an incentive to inflate refund claims, the providers say that these concerns are completely unfounded.[107] RAL proponents first point to the lack of evidence that preparers and RALs have any causal relationship to tax noncompliance.[108] They urge that the concerns over preparer-initiated noncompliance are based on unsubstantiated claims and hypothetical scenarios put forth by their critics and that the comments "bear little resemblance to the actual value that RALs provide to consumers."[109]

RAL proponents emphasize the common interest in tax compliance between the preparer and the IRS.[110] There are numerous regulations that prepar-

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100. "'Easy money fast' is a much more attractive proposition for fraud perpetrators than 'easy money . . . which you should get in six weeks.'" *Id. Cf.* Dean Beeby, *People Who File Electronically More Likely to Cheat: Report*, THE CANADIAN PRESS, Aug. 10, 2008 (discussing internal report by Canada Revenue Agency comparing error rates among those who e-file and those who file paper returns).

101. NCLC Comments, *supra* note 10, at 27-29.

102. Sparrow, *supra* note 100, § 6.6.

103. NCLC Comments, *supra* note 10, at 28-29.

104. *See generally* Block Comments, *supra* note 16; Pacific Comments, *supra* note 73.

105. IRS rules require that the return preparer not be the lender, and that a flat fee be charged for preparation—the fees received by preparers cannot be contingent upon the amount of the refund claim. *See* Block Comments, *supra* note 16, at nn.48-50 and surrounding text.

106. *See id.*, § text surrounding nn.114-17, where Block argues that the separation of the preparation and product sales envisioned in the ANPR would result in "unduly costly" changes and inhibit the use of such products. I note that the National Taxpayer Advocate believes that the ANPR would not inhibit the use of the product. *See* 2007 NTA REPORT, *supra* note 54, at 83, 90.

107. *See* Block Comments, *supra* note 16, § 5A; Pacific Comments, *supra* note 73.

108. Block Comments, *supra* note 16, § 2A.

109. Pacific Comments, *supra* note 73.

110. *See id.* at nn.87-88 and surrounding text.

ers must comply with, all directed at ensuring compliance.[111] Furthermore, several arrangements between preparers and lenders actually reward the preparer for a low default rate by giving them additional compensation.[112] All of this serves as an incentive to comply with the tax law, proponents say.[113] Furthermore, the participation agreements likewise create the same incentive, as the participating preparer shares in both the gains and the losses achieved by RALs.[114]

The largest chain preparer and facilitator of RALs, H&R Block, goes on to say that even without RALs preparers are already encouraged by the profit motive to maximize the possible refund or minimize tax liability.[115] The marginal profits of RALs simply do not provide any incentives that do not already exist because of the profit motive already present in the industry.[116] Block urges that more research must be done into the effect of RALs on tax compliance, and recommends that the IRS further enforce existing laws before additionally regulating or restricting RALs.[117]

IV. THE INCENTIVE TO PROMOTE AND DETECT ERROR

As the IRS noted, there is insufficient evidence to conclude that at the retail level the presence of RALs is encouraging preparers to become the type of preparer that either promotes noncompliance,[118] or does little in the way to prevent

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111. For examples of these regulations, see *supra* note 50.

112. For example, SBBT, the bank affiliated with Jackson Hewitt, gives preparers an extra $1 per-RAL if losses from that preparer were less than 1%, with an additional $1 for every 25 basis points below 1%. Pacific Comments, *supra* note 73.

113. *Id.*

114. *Id.*

115. Block Comments, *supra* note 16, § 5A.

116. *Id.* Block conducted an inquiry into the possibility that RALs drive tax fraud using internal data. Block chose to look at the rates of amended returns as an indicator of who receives IRS letters. Block found that non-RAL returns actually had a higher change rate than returns with RAL indicators. They further found that the size of the refund, the client's adjusted gross income, and the client's age to be more predictive of amendments than the presence of RALs. This data is certainly not conclusive, as individuals who have erroneously taken a position on a tax return and received a correspondence examination letter may not file an amended return. They would likely agree with the IRS's proposed assessment and sign a consent form to allow immediate assessment or fail to respond to the letter, which would ultimately result in the IRS assessing the change reflected in the correspondence. Block candidly recognizes the limits of its data, and I agree that it does "seem[] clear that further research is necessary before determining that RALs are a causal factor for tax fraud." *Id.* at nn.100-02 and surrounding text.

117. *Id.* at nn.101-02 and surrounding text.

118. IRS COMMENTS, *in* 2007 NTA REPORT, *supra* note 54, at 90-91. For types of noncompliance, see *supra* note 57 and surrounding text.

noncompliance that derives from improper taxpayer conduct.[119] The lack of understanding and research in this area hampers policymakers from taking regulatory action purely based upon a compliance rationale. For example, if research suggested that the marginal profit associated with RALs, either directly or in conjunction with its effect from the sale of services or products fueled by the RAL, produced preparers more willing to actively engage in noncompliance,[120] then this would suggest firm policy options, including possibly limiting profits associated with RALs,[121] or preventing the preparation of returns from those whose principal source of revenues derives from the sale of unrelated services or products.

Even if one believes that the evidence is insufficient regarding the effect on preparers' willingness to act improperly, or act in a manner to prevent taxpayers from acting improperly, it seems probable that the additional speed associated with RALs might embolden improper taxpayer behavior. This is by no means proven, but if the speed associated with RALs increases the propensity of taxpayers to take improper positions on tax returns, preparers and banks have a common incentive in detecting error among claimants, as RAL facilitators stated in comments in response to the ANPR.[122] This statement is correct to a limited extent. Consider that claimants seeking a refund draw IRS scrutiny in a few ways. First, the returns are subject to refund offset against delinquent state or federal taxes, unpaid student loans, child support, and certain other

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119. Noncompliance that, for example, derives from facilitating practitioners, indifferent practitioners, incompetent or unsophisticated practitioners, and reasonably unknowing practitioners (types 3 through 6 practitioners, above) faced with demand-driven noncompliance. *See supra* note 63 and surrounding text.

120. In particular, as I identify above, the inquiry should consider whether RALs produce preparers who are more willing to shirk on their due diligence responsibilities, aid and abet noncompliance, facilitate of future noncompliance, and direct noncompliance (types 4 through 7 noncompliance). *See supra* note 57 and surrounding text.

121. For example, recent legislation caps the annual percentage rate on loans extended to military personnel at 36%. 10 U.S.C. § 987 (2006).

122. Block Comments, *supra* note 16, at n.88 and surrounding text; Pacific Comments *supra* note 73. It is noteworthy, however, that the preparer's interest is not perfectly aligned with the IRS's, as the preparer does not generally face adverse economic consequences with filing returns not associated with a RAL that will subsequently face pre-refund audit. This is so as a general matter, but not necessarily so all the time because the preparer may in fact incur additional costs associated with the filing of an erroneous non-RAL refund return, as it is possible that the return may draw IRS scrutiny on the preparer's conduct. The exception to this statement appears to be with claimants who seek a refund anticipation check (RAC). A RAC is a non-loan bank product that allows a claimant without a bank account to open a dummy account whereby the IRS refund is directly deposited. The preparer will issue the refund in a check or pre-loaded debit card, less preparation and bank account fees. 2005 NTA REPORT, *supra* note 75, at 165. This speeds the refund time to about one to two weeks, compared with forty-eight hours for a RAL and about five to six weeks for paper return. Block Comments, *supra* note 16, at 18.

debts. This non-return specific liability is subject to detection through the IRS's Debt Indicator (DI) program, and that information is detected by the IRS and shared with preparers.[123] Though the DI offsets have implications for the unpaid portion of the tax gap, DI indicators are not related to the incentives for error on the particular return.[124] Claimants alerted of DI problems may not file their returns, and would in fact have an incentive to share tax benefits to which they are entitled with other family members who may have earned income and be in a position to avail themselves of family status benefits and improperly claim a refund that would qualify them for a RAL.[125] Those claimants who end up triggering a DI indicator will not be issued a RAL, lest the loan will likely default, as the IRS would intercept the refund which would have been used to pay back the loan and apply the money to the debt. While the DI is extremely important for the economic viability of RALs,[126] it is not likely particularly significant as a tool of providing preparers with incentives to detect potential claimant error.

The real overlap in IRS and preparer detection incentives relates to ensuring that the return associated with a RAL is not subject to a pre-refund audit.[127] If a refund is frozen in a pre-refund audit, there is a significant risk of RAL default.[128] Through the practice of cross-collection in subsequent years the industry has taken controversial steps to minimize the effect of RAL defaults,[129] the

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123. 2007 NTA Objectives, *supra* note 66, at 8-10. Financial Management Services (FMS) has authority pursuant to I.R.C. § 6402(d) to offset any taxpayer's debt to federal agencies (i.e. unpaid taxes, child support, student loans, etc.) against the taxpayer's refund. The IRS updates its systems to reflect these debts in the Debt Indicator (DI). The Debt Indicator has an entry for every taxpayer that indicates one of four statuses: no outstanding liability (N), IRS debt (I), FMS debt (F), or both IRS and FMS debt (B). *Id.* at 8.

124. The IRS can offset unpaid taxes against the taxpayer's refund pursuant to section 6402. I.R.C. § 6402 (2000).

125. For a discussion of how these tax benefits may be shared and passed on, see Book, *Freakonomics*, *supra* note 15, at 1176-84.

126. In 1994 the IRS terminated the DI due to concerns over filing fraud. After the DI was dropped, RAL volume dropped significantly. At H&R Block, for example, RAL volume was cut from 5.5 million to 2.35 million. When the DI was reinstated in 1999, RAL volume jumped. For the 2006 filing season (the most current year for which the IRS has data), approximately 9 million RALs were issued. NCLC Comments, *supra* note 10, at 26; 2008 NCLC REPORT, *supra* note 7, at 6.

127. Engerman, *supra* note 9, at 33 ("It is important to note that the incentive on the preparer is to avoid pre-refund IRS examination, not all EITC overclaims."); Block Comments, *supra* note 16, § 5A (noting that RAL lenders often tie compensation to performance—preparers receive no compensation if the IRS does not issue a refund on a tax return that the preparer filed); Pacific Comments, *supra* note 73.

128. Pacific Comments, *supra* note 73 ("If tax funds are improperly inflated, as the lender, we are the party that incurs the potential losses when the IRS pays a refund that is less than requested on the return").

129. Standard RAL and RAC contracts contain a cross-collection provision, allowing lenders to collect on subsequent RALs and RACs taken out by defaulting customers. *See* Engerman, *supra* note 9, at 31. The major RAL lenders sign reciprocal agreements whereby

risk of default carries significant costs and places preparer and IRS error detection interests in close alignment. Preparers' compensation arrangements with RAL providers are often closely tied to default rates,[130] and unlike returns that trigger DI notice, there is no advance notification associated with these returns.

The interests of preparers and the IRS are least closely aligned when one considers IRS post-refund error detection and audits, especially given how few IRS civil or criminal compliance efforts are focused on the preparer.[131] At that point the preparer has received its fees, and the individual who is subject to the audit has received the RAL proceeds. IRS compliance activities at this time typically target the taxpayers, and the effect of an examination or audit resulting in an assessment is a liability to the IRS that results in the possibility of administrative collection activities, including offset of future refunds, the filing of a federal tax lien, or administrative collection (like a levy) targeting wages, savings and even certain types of federal benefits.[132] While IRS compliance activities can also focus on the actions of preparers, IRS scrutiny on them has been relatively light,[133] though there have been some high profile civil injunc-

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they will withhold and pay back defaulted RALs before issuing the funds to the customer. 2007 NTA Objectives, *supra* note 66, at 10. The Taxpayer Advocate has expressed concern that this practice might be violating the Fair Debt Collection Practices Act, which requires collectors to inform consumers that the collector is attempting to collect outstanding debt, so as to give the consumer the opportunity to dispute the validity of the debt. *Id.* at 10-11. Given that these cross-collection provisions minimize preparers' risk of loss from default, they decrease the common incentive to detect erroneous EITC claimants.

130. Engerman, *supra* note 9, at 32-33; Pacific Comments, *supra* note 73, at 3.

131. *See* Engerman, *supra* note 9, at 35 (noting that IRS policies governing paid preparers largely inoculate the preparers from being held liable for taxpayer misconduct which they were unable to detect). *See generally* TREASURY INSPECTOR GEN. FOR TAX ADMINISTRATION, WHILE DOCUMENTATION WAS NOT AVAILABLE TO FULLY ASSESS THE RETURN PREPARER PROGRAM, IDENTIFICATION AND PROCESSING OF PREPARER PENALTIES CAN BE IMPROVED (2008-30-147, July 29, 2008) [hereinafter TIGTA PREPARER PROGRAM ASSESSMENT] (discussing several failures to follow IRS guidelines when investigating suspected preparer penalties for misconduct). However, there have recently been some high-profile injunction cases brought by the IRS. The most prominent among these is a civil enforcement action recently brought by the Justice Department against five Jackson Hewitt franchisees operating 125 offices for their role in filing false refund claims totaling $70 million. *See* Complaint, United States v. Smart Tax of Ga., Inc. (N.D. Ga. filed Apr. 2, 2007) (1:07CV-0747); Complaint, United States v. Smart Tax, Inc. (N.D. Ill. filed Apr. 2, 2007) (07C-1802); Complaint, United States v. So Far, Inc. (E.D. Mich. filed Apr. 2, 2007) (Civ. No. 2:07-cv-11460); Complaint, United States v. Smart Tax of N.C., Inc. (E.D.N.C. filed Apr. 2, 2007) (Civ. No 5:07-cv-00125-FL). All of these complaints are available at http://www.usdoj.gov/tax/txdv07215.htm.

132. "[E]xaminations that take place post-refund are entirely irrelevant to the lender [of RALs] and preparer, although the taxpayer will be subject to an assessment by the IRS in the amount of the overpayment." Engerman, *supra* note 9, at 33.

133. *Id.* at 35; Block Comments, *supra* note 16, at n.101 and surrounding text; TIGTA PREPARER PROGRAM ASSESSMENT, *supra* note 132, at 5-6 (citing instances where IRS agents failed to follow penalty procedures when investigating suspected preparer misconduct).

tion cases brought against egregious cases of preparer misconduct.[134]

If the incentives between preparers and the IRS are not as closely aligned as RAL proponents suggest, then one possible policy option is to impose additional costs on preparers to more closely align those interests. One approach could involve an even greater due diligence requirement that is associated with the EITC general, and RALs in particular. This heightened due diligence would build on existing rules that impose additional obligations on preparers who prepare and file returns claiming the EITC, and might explicitly require preparers to take a more assertive role in perusing documents or attesting to the eligibility for a refund.[135] One can question whether it is appropriate for the IRS to effectively outsource error detection to third-party preparers in the manner that I and others have suggested,[136] but given the significant benefits and big business (and profits) associated with this segment of the return preparation industry, and the billions of dollars in improperly claimed refunds associated with returns that are prepared by paid preparers, it is legitimate to shift additional costs to those who may be able to prevent erroneous claims before they are paid. As the banks know well, once the dollars are paid out, it is not likely that there will be a recovery,[137] and post-refund detection of these claimants does little in the way of reducing the tax gap. The key here is calibrating the ex ante incentives to ensure a more effective detection and prevention of claimant error in the private sector, while at the same time not ratcheting up costs for preparation so that the rules divert significant more dollars away from the intended beneficiaries.

For the most part, the evidence (as scant as it is) suggests that RALs exist because taxpayers who have acted in some ways irrationally by overwithholding or failing to claim advanced credits,[138] compound that irrationality by pay-

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134. *See supra* note 132.

135. *See* Book, *Freakonomics*, *supra* note 15, at 1183-84 (suggesting similar due diligence requirements for preparers filing EITC claims for clients).

136. *See* Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 WIS. L. REV. 1103, 1146-49 (2006) (proposing a more stringent set of due diligence requirements for preparers); Taxpayer Advocate, *Federal Tax Return Preparers: Oversight and Compliance*, *in* 2003 TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS 272 (2003) (proposing imposing stiffer penalties for noncompliant preparers); Lawrence Gibbs, Former Comm'r, Internal Revenue Serv., Panelist at the Janet R. Spragens Memorial Symposium: Low-Income Workers and the Federal Tax System (Feb. 23, 2007) (placing tax clinics in the category of government outsourcing).

137. RAL lenders actually "charge-off" any RALs not repaid within ninety days. While a large portion of these funds are recovered, it is most likely due to post-examination release of EITC funds. *See* Engerman, *supra* note 9, at 31.

138. *Cf.* Michael S. Barr & Jane K. Dokko, *Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence From a New Study*, *in* RECENT RESEARCH ON TAX ADMINISTRATION AND COMPLIANCE: SPECIAL PAPERS GIVEN AT THE 2006 IRS RESEARCH CONFERENCE 204-05(2006) (noting that approximately

ing high fees to then get access to that money in an expedited fashion. There are significant non tax compliance policy issues associated with whether these products should be available.[139] The purpose of this Article, however, is to focus on the issue from a tax gap perspective. Banks and preparers make money on this product. 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,[140] or whether the additional profits associated with the facilitating of RALs encourages inappropriate preparer conduct.[141]

The debate in this area is characterized by some imprecise advocacy. Pro-RAL proponents and industry segments who have made the claim that RALs help minimize program error have overstated their claim given how limited the overlapping interests between the government and preparers are. Likewise, opponents of RALs, who raise compliance as one (among many) of the policy reasons why the product should be further regulated or banned, have overstated their case, given that once one accepts that customer satisfaction often flows to commercial preparers who facilitate refunds (whether refunds are speedy or slow), there will be incentives for preparers to either encourage noncompliance or turn a blind eye toward taxpayer misconduct.

The largest private income tax return preparer, H&R Block, likewise overstates its case, and analyzes the incentives from a different perspective, noting that independent of RALs, given the importance of the $250 billion in annual tax refunds, preparers have an incentive to deliver the "maximum possible refund (or lowest tax liability) through entirely lawful means."[142] The problem with this statement is that, meaningful IRS enforcement or due diligence rules that more forcefully require preparer disclosure of the source of information

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80% of taxpayers would like to use the withholding system to save); J. MARK IWRY, USING TAX REFUNDS TO INCREASE SAVINGS AND RETIREMENT SECURITY 9 (2006) ("[A]t least for many households, the current level of withholding is not 'overwithholding,' but a deliberate method of forced savings."); Block Comments, *supra* note 16, at 25 (making mention of "the . . . phenomenon of Americans who value their tax refund as their annual bonus and focus the tax filing event on the receipt of the refund").

139. For a discussion of the players in this debate and their various arguments, see *supra* note 16.

140. *See* Sparrow, *supra* note 100, § 2.3.1 ("The exposure period—the time that elapses between the carrying out of a dishonest act and the receipt of the financial payoff from that act—is one of the most powerful deterrents for fraud available").

141. Such conduct would be along the lines of facilitated noncompliance (both one-time and on a continual basis), advising taxpayers how to misstate or omit income, claim inappropriate or excessive deductions or credits, or directed noncompliance. *See supra* note 57 and surrounding text.

142. Block Comments, *supra* note 16, at n.89 and surrounding text.

backstopping an improper claim are, quite simply, absent.[143] So long as compliance directed at preparers is low, and if there are significant amount of taxpayers erroneously receiving refunds, some preparers may have the incentive to retain or attract new clients through means that not necessarily lawful, or, at a minimum, not reflective of best practice in terms of detecting and preventing error.

While RALs create additional profits, and may in fact allow fringe preparers to prey even further on the sale of non-tax products,[144] it is not clear that marginal RAL profit drives inappropriate preparer conduct among those whose principal business is the preparation of tax returns. Perhaps it does, and it seems more likely given incentives in the fringe preparer industry where RALs fuel purchases of high margin products,[145] but more in the way of evidence is needed if using tax compliance as justification for limiting or banning a product that many individuals use, and at least some research suggests results in significant customer satisfaction.[146]

Ultimately, the debate surrounding RALs surrounds in some ways the battle over professionalizing the return preparer industry. Calls to regulate and license preparers,[147] are based in part upon a desire to emphasize the gatekeeper role that professionals play in the marketplace.[148] To the extent that this debate

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143. Book, *Freakonomics*, *supra* note 15, at 1183-84; Book, *Role of Preparers*, *supra* note 18, at 49-50, 74 (discussing that research will better enable policymakers to fashion rules that will incentivize compliance); Taxpayer Advocate, *Regulation of Federal Tax Return Preparers*, *in* FY 2002 TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS 224-25 (noting the inadequacies of the due diligence requirements) [hereinafter 2002 NTA REPORT].

144. Fringe preparers are tax return preparers whose primary business is not a financial service or tax return preparation. The term includes several different players. Fringe preparers are "businesses that are historically associated with the exploitation of consumers, such as payday loan stores, check cashers, and used car dealers . . . . [S]ome retailers, such as jewelry and furniture stores, are fringe preparers [as well]." NCLC Comments, *supra* note 10, at 29.

145. For example, car dealers have been known to offer tax preparation services, issue a RAL, and then encourage the customer to spend the proceeds on a down payment for a car. Several concerns have been raised about the conflict of interests that exists in situations like these. *See id.*; 2008 NCLC REPORT, *supra* note 7, at 31; 2007 NTA REPORT, *supra* note 54, at 86.

146. GREGORY ELLIEHAUSEN, CONSUMER USE OF TAX REFUND ANTICIPATION LOANS 67 (2005). It is worth noting, though, that this study was partially funded by Jackson Hewitt. *Id.* at iv.

147. 2002 NTA REPORT, *supra* note 144, at 216-30. California has adopted a law requiring certification of federal and state tax return preparers. Cal. Bus. & Prof. Code § 22255. Similarly, Oregon regulates paid preparers, and Maryland has likewise adopted new provisions regulating preparers. Or. Admin. R. 800-015-010 (1) (2002). For a review of the possible positive effects of the state legislation, see GOV'T ACCOUNTABILITY OFFICE, TAX PREPARERS: OREGON'S REGULATORY REGIME MAY LEAD TO IMPROVED FEDERAL TAX RETURN ACCURACY AND PROVIDES A POSSIBLE MODEL FOR NATIONAL REGULATION 7 (2008)

148. Tax preparers play a gate-keeping role in the tax compliance system. The prepar-

highlights the positive role that preparers can play in reducing one important component of the tax gap, then this advances the issue considerably. Even H&R Block has called for increasing the research into RAL's possible causation of fraud and possibly increasing criminal investigations of preparers who may be involved with facilitating improper EITC claims.[149] The relative lack of information regarding paid preparers suggests the need for detailed analysis examining error rates among similarly situated returns that differ materially only through the purchase of a bank product,[150] and quantitative analysis of error rates among different types of return preparers. In addition, a more robust qualitative examination of the effect that RALs or related products have on preparer conduct through expanded use of mystery shoppers and other approaches that will gauge the dynamic relationship between preparers and taxpayers will also help researchers understand the influence of products like RALs on the willingness of preparers and taxpayers alike to act improperly is needed.[151]

The lack of data, however, does not detract from the inadequacy of the IRS's current enforcement regime insofar as that regime can target return preparers. Given the paucity of criminal investigations and civil injunctions on questionable preparers,[152] it seems prudent to enforce in a more robust fashion current rules before broadly and perhaps crudely limiting demand for a product that has not necessarily been driving the high program error rates.

V. CHANGING INCENTIVES, REWARDING CORPORATE BEHAVIOR AND THE POWER OF NORMS: RESPONSIVE REGULATION

In addition to considering the need for additional research to backstop compliance and a more robust effort to enforce current rules, the IRS would benefit from the insights offered in the literature surrounding responsive regulation. Responsive regulation is the idea that regulators must be responsive to the conduct of those they seek to regulate.[153]

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ers perform their tasks of preparing the tax forms, identifying items that affect the taxpayer's liability and advising their clients on resolving any uncertainty as to the tax consequences of ambiguous items. In doing so the preparers, at least in theory, push their clients towards complying with the tax law. *See* Book, *Role of Preparers*, *supra* note 18, at 52; *see also* 2002 NTA REPORT, *supra* note 144, at 224.

149. Block Comments, *supra* note 16, at nn.100-02 and surrounding text.

150. *See generally* Book, *Role of Preparers*, *supra* note 18.

151. *See id.* at 56 (noting that compliance research has been focused on quantitative measurement, providing a body of research that lacks any context to put it in); McKerchar, *supra* note 61, at 242 (emphasizing the importance of identifying the various typologies of noncompliance and urging that additional studies be made relating to taxpayer and preparer behavior).

152. Over the last three years, an average of only 270 investigations have been opened up under the Questionable Refund Program, and only 211 under the Abusive Return Preparers Program. Block Comments, *supra* note 16, at 100-01 and surrounding text.

153. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE

This means that when a regulator is "deciding whether a more or less interventionist response is required" they must consider those who will be controlled by the regulations.[154] "Responsive regulation is not 'a clearly defined program or set of perceptions concerning the best way to regulate' but rather a method that advances the proposition that regulation should be context-dependant."[155] Responsive regulation sets forth a regulatory pyramid with a "series of options that a tax authority might use to win compliance, sequenced from the least intrusive at the bottom to the most intrusive at the top."[156]

"The idea is that an authority that is legitimate and that is engaging seriously with the democratic will of the people does not need coercion at the top of the pyramid to win compliance *in most cases*."[157] The United States current tax administration has a "command-and-control operational system to accomplish

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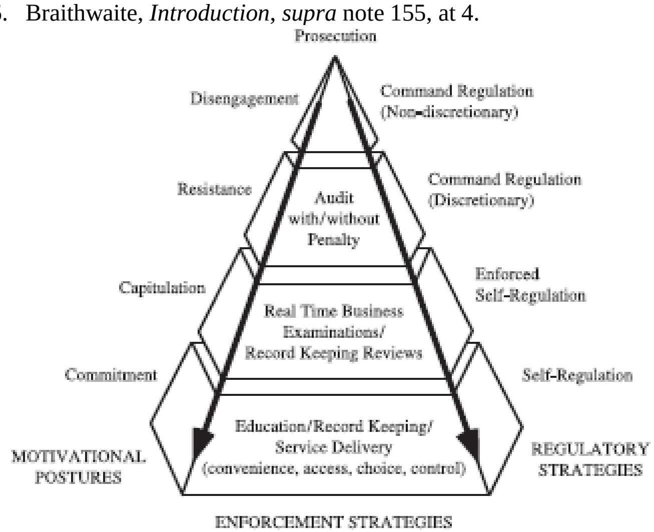
DEREGULATION DEBATE (1992)*; see also* David Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331 (2006) (calling for an increase in sanctions on practitioners focusing on advisors role in blessing a challenged transaction); Dennis Ventry, *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 NAT'L TAX J. 1017 (2000) ("[P]olicy alternatives, regardless of their theoretical or analytical appeal, will have to complement rather than conflict with social and cultural forces to prove successful").

154. Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 L. & POL'Y 3, 4 (2007) [hereinafter Braithwaite, *Introduction*].

155. Sagit Leviner, *A New Era of Tax Enforcement: From 'Big Stick' to Responsive Regulation*, *in* RECENT RESEARCH ON TAX ADMINISTRATION AND COMPLIANCE: SPECIAL PAPERS GIVEN AT THE 2006 IRS RESEARCH CONFERENCE 264 (2006) (quoting AYRES & BRAITHWAITE, *supra* note 154) (internal footnotes omitted).

156. Braithwaite, *Introduction*, *supra* note 155, at 4.



Source: Braithwaite, 2003

157. *Id.* (emphasis original).

their mission of catching 'the scoundrels' who do not pay their tax."[158] This system does not deal well with the contestation that arises from a voluntary system, where taxpayers can argue about how much is owed.[159] As a result, responsive regulation is becoming an alternative for organizing tax administrations, although it may be resource intensive.[160]

Responsive regulation has "several critical elements to its implementation:"[161]

> It refers to the practice of (a) influencing the flow of events (b) through systematic, fairly directed and fully explained disapproval (c) that is respectful of regulatees, helpful in filling information gaps and attentive to opposing or resisting arguments, (d) yet firm in administering sanctions (e) that will escalate in intensity in response to the absence of genuine effort on the part of the regulatee to meet the required standards.[162]

Tax administrations usually operate on the presumption that tax law will influence the flow of events when sanctions are sufficiently certain and severe to offset the gains of non-compliance.[163] Responsive regulation on the other hand "assumes that there is a responsible moral self that can be drawn out by a good regulator and that will enable offenders to change their ways and self-regulate more effectively in the future."[164]

The responsive regulation approach offers hope in changing the previously binary view of preparers associated with the EITC as either facilitators of fraud, or possible case workers to be employed in the traditional benefits model.[165] Administrators should emphasize explicitly what is implicit in the current arrangement with preparers: that there is a partnership between taxpayers, preparers and the government. The need to reward good behavior, rather than just ferret out bad actors, could change the dynamic in the partnership, and contribute to a reinforcing dynamic of compliance.[166]

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158. *Id.*

159. *Id.*

160. *Id.*

161. JOHN BRAITHWAITE, RESTORATIVE JUSTICE AND RESPONSIVE REGULATION (2002).

162. Braithwaite, *Introduction*, *supra* note 155, at 5.

163. *Id.*

164. *Id.* at 9.

165. *See* Engerman, *supra* note 9, at 11-15 (discussing the traditional caseworker model for public assistance programs, where the eligibility is determined ex ante, and the EITC model, where the self-reported tax filing undergoes an ex post review for eligibility).

166. *See* Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Norm Compliance*, 75 Fordham L. Rev. 961, 1012-13 (2006) (describing the Compliance Assurance Program as a cooperative program between corporate tax decision-making groups and the IRS); Schizer, *supra* note 154, at 355-371 (proposing a regulatory framework to align the government's and lawyers' interests in tax administration); Dennis J. Ventry, *Cooperative Tax Regulation* 15 (Am. Univ. Washington Coll. of Law, Working Paper No. 2008-47, 2008) (describing a regulatory scheme that would "raise compliance by explicitly

As others have written, the trick is to encourage positive behavior.[167] This may be difficult if other actors are behaving improperly, but there are tools that the IRS and Congress can use to steer claimants toward better preparers, including favored refund time, differing access to the DI program, differing recordkeeping or due diligence requirements, or explicit discretion from Congress for the IRS to modify or waive certain requirements or penalties for preparers who meet certain low error thresholds.[168]

An interesting example of how the IRS can travel through the responsive regulation pyramid comes to us by way of Australia. The Australian Taxation Office's (ATO) efforts to address noncompliance among barristers in New South Wales (NSW) show how agency action can respond to the actions of those the agency is regulating.[169]

In 1999, a tax officer at the ATO noticed that those in the legal profession under her review had exceptionally high debts to the ATO.[170] While investigating the cause, bankruptcy came up as the source of the debts time and time again.[171] Doubting that the legal market was doomed, she continued the investigation and discovered that wealthy lawyers were dodging income tax by repeatedly declaring bankruptcy, leaving the ATO as their only real creditor.[172]

Following the responsive regulation pyramid, the ATO initially approached the NSW Bar Council to address the issue, seeking a self-regulatory solution as opposed to a more forceful intervention.[173] The Bar Council considered the problem, and thought it more appropriate to have it regulated under the NSW Legal Services Tribunal as opposed to self-regulation.[174] The Tribunal did not have the best track record with addressing problems of noncompliance by barristers, the ATO quickly moved up the pyramid, aggressively bringing in the

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rewarding compliance").

167. *See* Ventry, *supra* note 167, at 16 (citing Leviner, *supra* note 153). Ventry offers an example of incentivizing timely and correctly return filing by offering rebates. *Id.*

168. For example, those preparers with the higher compliance rates could have priority in receiving their refund, thereby getting refunds for their clients quicker. Access to the DI program could be contingent on preparer registration and/or meeting certain compliance thresholds. Those preparers who have lower compliance rates might also be subject to more stringent reporting or due diligence requirements.

169. *See* Braithwaite, *supra* note 32, at 178-81 (telling story of ATO efforts to fight noncompliance among barristers in Australia).

170. The rate of debt default was ten times higher than the rest of the Australian population. *Id.* at 178.

171. *Id.*

172. The ATO identified sixty-two licensed barristers who had declared bankruptcy between 1991 and 2001, with a third of them declaring bankruptcy repeatedly. Some of the lawyers had declared bankruptcy as many as three times in a decade. It was also revealed that barristers were one of the most active demographic groups investing in mass marketed aggressive tax planning schemes. *Id.* at 178-79.

173. *Id.* at 179.

174. *Id.*

most egregious cases before the courts.[175] The Commissioner also spoke publicly about these schemes, and soon enough, the media got involved.[176] Government officials quickly got into the mix, and began intimating that reform in the bankruptcy law might be in order.[177]

The possibility of prohibiting recently bankrupt lawyers from practicing law seemed to light a fire under the NSW Bar Association, who became interested in dealing with the problem.[178] The end result of this turned out to be some "modest law reform," efforts to de-license those barristers with the most egregious histories of noncompliance, and some considerable self-regulatory reform, all of which had the effect of increased tax payments by barristers, increased enforcement of those barristers who remained noncompliant, and a substantial increase in the number of barristers remaining current with their tax returns.[179]

Though the ATO's efforts were focused on aggressive tax shelters and outright tax avoidance, the IRS can take a page from the ATO playbook in addressing supply-side and preparer-initiated errors in returns. The IRS could follow an approach similar to the ATO's. Under this type of regulatory scheme, the IRS could focus on the national preparers who control a large segment of the market, and seek out those return preparers with unacceptably high error rates, bring the problem to their attention, and work with those preparers to create internal controls to ensure increased compliance. An approach like this would likely involve more stringent reporting requirements. Those preparers who are able to demonstrate the internal controls' success and their resulting in increased compliance would no longer be subject to any of the reporting requirements, or perhaps report in less regular intervals. The IRS would move up the regulatory pyramid for those who are unable to make a similar showing, subjecting them to audits and other more intrusive regulatory efforts, including the regular supplying of information regarding internal quality control measures, and the effects of training and internal audits on preparer performance.

A prerequisite for this type of approach, however, is that the IRS must have sufficient information regarding who the good and who the bad actors are in the return preparation industry. There is a deep need for the IRS to collect information by type of preparer, and have a nuanced understanding of error rates by preparer and by issue, with comparisons made between returns associated with RALs and those that are not.[180] Encouraging good behavior must start with the

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175. *Id.* at 180.

176. The Sydney Morning Herald, for instance, ran a series of front-page stories on the lifestyles of these bankrupt barristers. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. *Cf.* GAO, 2007 FILING SEASON, *supra* note 55, at 18 (discussing IRS plan to de-

IRS knowing and acting on information about how certain preparers are interacting with taxpayers. Changing preparer conduct through audits, or even heightened penalties or due diligence rules, should come only after the IRS encourages more positive steps, and only after the IRS directs disapproval with what it perceives to be improper preparer conduct. For example, rather than default to audit when faced with information about likely errors associated with a geographic region of a national chain, one approach would involve the IRS visiting preparers to discuss best practices and reveal that there is information suggesting impermissible error rates associated with those preparers' returns.[181] The IRS could ask that the preparer report back on its internal quality control measures, review corporate culture and education, and encourage self-regulation before the IRS diverts to resource-intensive exercise of audits, and potential use of civil penalties and injunctions. The compliance stick would come at the tail end of government interaction.

There are meaningful steps that Congress can take to encourage the IRS to move in this direction. For example, the possible legislative change that would require registration and certification of preparers,[182] could help facilitate this.[183] This possible additional regulation could be the trigger for the IRS to meaningfully track information related to preparers and encourage better behavior, while at the same time keeping its powder dry for the egregious actors who need more traditional sanction-based approaches.

VI. CONCLUSION

The question that the IRS raised in its ANPR focused on whether RALs contribute to increased demand for overstated tax refunds. This question itself

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velop a database to "serve as a centralized repository of paid preparer information").

181. The IRS should also perhaps consider compiling data related to noncompliance rates of franchise versus company-owned offices in order to determine whether the relative independence enjoyed by franchisees has any effect on compliance. The potential for heightened noncompliance from franchisees is illustrated in the civil enforcement action recently brought by the Justice Department against five Jackson Hewitt franchisees operating 125 offices for their role in filing false refund claims totaling $70 million. *See* Complaint, United States v. Smart Tax of Ga., Inc. (N.D. Ga. filed Apr. 2, 2007) (1:07CV-0747); Complaint, United States v. Smart Tax, Inc. (N.D. Ill. filed Apr. 2, 2007) (07C-1802); Complaint, United States v. So Far, Inc. (E.D. Mich. filed Apr. 2, 2007) (Civ. No. 2:07-cv-11460); Complaint, United States v. Smart Tax of N.C., Inc. (E.D.N.C. filed Apr. 2, 2007) (Civ. No 5:07-cv-00125-FL). All of these complaints are available at http://www.usdoj.gov/tax/txdv07215.htm.

182. *See* Tax Administration Good Government Act, H.R. 1528, 108th Cong. § 141(a)(1)(A) (2004) (granting Secretary of Treasury the power to require registration of federal income tax return preparers).

183. *See* GAO, 2007 FILING SEASON, *supra* note 55, at 18 (noting that in the event that Congress requires registration of preparers, a database could be used as a tracking system for enrollment and testing of preparers).

raises many unanswered questions. For example, does the additional speed in which individuals receive money embolden inappropriate taxpayer conduct? If the answer is yes, assuming practitioners can influence taxpayer compliance decisions, will increased regulation of preparers generally or RALs in particular result in fewer taxpayers willing to misstate facts to generate an improper refund? Do additional profits derived from RALs contribute to preparers' willingness to turn a blind eye to existing due diligence rules? Or even worse, do RALs contribute to conditions where preparers themselves are facilitating the noncompliance through more preparer-generated noncompliance efforts? These questions highlight the lack of information that hampers policymakers in designing effective measures to reduce the tax gap. Until the IRS generates quantitative data that identifies, for example, preparer types and correlates error rates with types of preparers, and generates studies comparing error rates among preparers offering RALs as compared with non RAL-seeking taxpayers, it is difficult to justify taking measures that may effectively limit RALs on compliance reasons alone.

This Article argues that in addition to the importance of additional research relating to preparers to backstop heavy-handed regulatory efforts, the IRS should broadly consider the insights from responsive regulation, and in particular consider ways to encourage preparers to self-regulate. Self-regulation allows the IRS to preserve scarce compliance resources for egregious actors. The focus on RALs in this Article allows for a further inquiry into the special role that preparers play in our tax system, and reflects the possibility that meaningfully working with the preparer community can be a means to reducing the tax gap in the thorny area of refundable credits.