

Tax Time Troubles

Mystery Shopper Testing Exposes
Poor Quality Tax Preparation and
Refund Anticipation Check Abuses

Native Assets Research Center // Research Report 2011-6 // May 4, 2011





ACKNOWLEDGEMENTS

This research was funded by the Annie E. Casey Foundation and the W.K. Kellogg Foundation. We thank them for their support but acknowledge that the findings and conclusions presented in this paper are those of the authors alone, and do not necessarily reflect the opinions of the Foundations. This paper was by written Sarah Dewees, Senior Director of Research, Policy and Asset Building Programs, First Nations Development Institute, and Shawn Spruce, Financial Education Consultant. We thank Marvin Ginn, Executive Director of Native Community Finance, for his assistance with this project. We also thank Peter Skillern of the Community Reinvestment Association of North Carolina and Chi Chi Wu of the National Consumer Law Center for their assistance in guiding this project.

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Suggested citation: First Nations Development Institute (2011). "Tax Time Troubles: Mystery Shopper Testing Exposes Poor Quality Tax Preparation and Refund Anticipation Check Abuses." Longmont, CO: First Nations Development Institute.

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EXECUTIVE SUMMARY

Background

Between February 1st and April 18th 2011, First Nations Development Institute conducted 12 “mystery shopper” tests of paid tax preparers in New Mexico. These mystery shopper tests were conducted in Gallup, Grants, Bernalillo, Farmington, and Albuquerque, New Mexico, all communities with a high Native American population and close to Indian reservations.

Key Findings

I. Poor Quality Tax Preparation

By far the biggest problem documented during this mystery shopper test was that the majority of taxpayers received poor quality tax preparation from the paid preparers they visited. In seven cases, the tax preparation process was stopped or changed to avoid having the paid preparer file an inaccurate tax return. In our small sample of 12 mystery shoppers, 10 of the taxpayers encountered problems with inaccurate, illegal, or unprofessional behavior (this includes visits to major chains such as H&R Block, Liberty Tax Service, Jackson-Hewitt, as well as Sun Loans and Freedom Tax Service, a mom-and-pop store, and two other smaller chains).

The following problems were encountered by taxpayers:

A. Inaccurate tax preparation.

1. Failure to include unemployment insurance benefits as taxable income.
2. Failure to claim qualified student loan funds as taxable income.
3. Advising a tribal member that he didn't have to pay state tax on income earned off his reservation.
4. Lack of knowledge regarding how to properly file a Schedule C.
5. Lack of knowledge regarding how to handle dividend income.
6. Preparer told a tax filer that federal employees do not pay social security because they have a good retirement plan (this information is inaccurate in this case).
7. Preparer didn't know how to handle paperwork associated with a rollover of a Roth IRA.
8. Preparer put the incorrect mailing address on the tax return form.
9. Preparer failed to file a Form 8379- Injured Spouse Allocation Form.

B. Illegal activities on the part of tax preparers.

1. Operating without an IRS Preparer Tax Identification Number.
2. Tax preparer indicated she used her own bank account for taxpayer's e-file and direct deposit.
3. Encouraging tax fraud by making up frivolous expenses on the Schedule A.

C. Unprofessional behavior on the part of tax preparers.

1. Failure to provide the payment voucher in the tax filer's packet of financial records.
2. Failure to provide copies of the tax return in the tax filer's packet of financial records.
3. General unprofessional behavior: negative reaction when errors were pointed out; taking personal calls while working on a tax return.

II. Inadequate or Non-existent Refund Anticipation Check (RACs) Disclosures

We collected information on whether our mystery shoppers were steered toward bank products such as RACs, and whether they were informed of no cost alternatives such as free e-filing and direct refund deposit into one's bank account. There are disclosure requirements for products like RACs, so we were also interested in whether accurate information was being disseminated about these products. We found the following problems:

- A. Failure to inform the tax filer that they are taking a Refund Anticipation Check and presenting the Refund Anticipation Check as a default, without other options.**
- B. Failure to disclose the free e-file, direct deposit option.**
- C. Rushing clients through documents without allowing time to comprehend them.**
- D. Disseminating factually inaccurate information.**

III. Unnecessary or Unreasonable Tax Preparation Fees and Lack of Disclosure of Fees

Recent research suggests that some tax preparation businesses charge very high prices to prepare basic tax returns and may pad bills with unusual or unnecessary fees.¹ In our research, we did not document any fees that seemed unusually high compared to past findings. The average cost for a basic 1040 tax form ranged between \$50 (EZ) and \$100. However, we did document several fees for software usage, document handling, and for each individual tax form even though computer software packages compute these forms automatically. More importantly, we documented a troubling lack of disclosure of fees and a refusal to provide detailed estimates of costs before the tax service was provided. This lack of disclosure of costs seems out of line with standards in other industries and makes it very difficult for customers to shop for the best deal. Any way you look at it, low income tax payers (who often qualify for the Earned Income Tax Credit) can save a great deal of money by visiting either a Volunteer Income Tax Assistance site or using FreeFile online where they are not charged for their 1040 tax form or any additional forms files. We documented the following issues:

- A. Unusual fee structures for tax preparation services.**
- B. Lack of disclosure of fees.**
- C. Mysterious discounts that tax preparers can't clearly explain.**

IV. Changes in the Tax Preparation Industry are Leading to the Decline of the Refund Anticipation Loan (RAL) Product and Heavy Competition Among Existing Businesses

There are several new dynamics at play in the tax preparation industry this year, the most important being that a number of banks stopped partnering with tax preparation firms to offer RALs. In our research, we found that no tax preparation firms offered the testers a RAL, and in some cases testers were discouraged from applying for a RAL. While some companies still advertise RALs or RAL-like products at their stores, there did not seem to be a lot of interest in selling them to our testers. This is good news that this costly product seems to be disappearing from the marketplace, but we are concerned that other products may emerge, like Refund Anticipation Checks, to recapture the revenue stream previously associated with RALs.

¹ Wu et al. (2010). *Tax Preparers Out of Compliance: Mystery Shopper Testing Exposes Violations of Refund Anticipation Loans Laws in Arkansas, New York, and North Carolina*. Raleigh, NC: Community Reinvestment Association of North Carolina and Wu et al. (2010). *Tax Preparers Take a Bite Out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuse in Durham and Philadelphia*. Raleigh, NC: Community Reinvestment Association of North Carolina.

V. Privacy Issues Remain a Concern

Tax returns contain highly sensitive financial and personal information such as an individual's social security number and home address. Professional tax preparers should follow confidentiality rules under Section 7216 of the Internal Revenue Code, which prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information. Despite these rules, three of our testers became concerned about personal data they had given to their tax preparers. We encountered the following problems:

- A. Taxpayer given someone else's W-2 forms.**
- B. Tax preparer made copies of social security cards but did not give information about privacy policies.**
- C. Asking for a signed Power of Attorney form from a tax payer.**
- D. Lack of safeguards for sensitive financial information.**

VI. Tax Preparation Software May Have Problems That Contribute to Inaccurate Returns and High Fees for Customers

In 2010, the IRS announced plans to study the quality of tax preparation software used by hundreds of tax preparers and tax filers. An estimated 94 million professional and individual returns were completed in 2009 using tax software, and currently there is no regulation of tax software quality or content. The IRS is interested in both the accuracy of tax preparation software programs and the role of software companies in adding additional taxpayer fees for the use of their products.² Our small sample of mystery shoppers uncovered problems with the software packages that the sampled paid tax preparers were using. In one case, the software package appeared to be charging the tax filer for a fee she had already paid in advance (see Appendix A) and in another case, the tax preparer struggled to account for retirement contributions for a taxpayer who was self-employed, had a detailed Schedule C, and had made estimated payments.

VII. Policy Recommendations

Every year millions of Americans file their taxes and turn to a paid tax preparation firm for help. Unfortunately, this mystery shopper research project suggests that many tax preparation firms are providing low quality services and taking advantage of vulnerable low-income filers by imposing unnecessary fees or steering them towards an unnecessary Refund Anticipation Check product.

We support the small business owners that are offering needed tax preparation services to their clients but saw room for improvement in terms of staff training, disclosure of fees, and customer service in this project. This is especially true in communities with a high percentage of low-income tax filers who rely on the Earned Income Tax Credit, the Child Tax Credit, and other programs to make ends meet. We applaud the IRS's new policy that requires tax preparers to register with the IRS and to pass a competency exam by 2013. We also commend the IRS for studying the software packages that many of these tax preparers are using and working to address the risks associated with the dependence on unregulated tax preparation software. We offer the following additional policy recommendations:

- A. Disclose all fees associated with tax preparation.**
- B. Improve training to reduce errors.**
- C. Standardize disclosures related to RAC- like products and enforce compliance.**
- D. The tax preparation industry should adopt and follow a code of conduct.**
- E. Continue to provide resources to Volunteer Income Tax Assistance programs.**

² The 2010 report *Major Changes in the Quick Tax Refund Loan Industry* by the National Consumer Law Center documented that many software packages include "junk" fees or additional fees that are added on to a tax preparer's charges.

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I. Introduction

Filing tax returns can be an intimidating process and each year approximately 60% of all individual taxpayers turn to a paid tax preparer to file their returns. These customers assume that the paid tax preparers are assisting them with meeting their legal filing requirements and are providing a high quality service for a reasonable price. Unfortunately, our research reveals that many providers in this largely unregulated industry were providing low quality service in New Mexico that could expose taxpayers to legal liability and financial problems. In addition, tax filers are being taken advantage of and tricked into paying unnecessary fees or purchasing unnecessary products.

Between February 1st and April 18th 2011, First Nations Development Institute conducted 12 “mystery shopper” tests of paid tax preparers in Gallup, Grants, Bernalillo, Farmington, and Albuquerque, New Mexico, all communities with a high Native American population and close to Indian reservations. In 2008, 51% of all tax filers in New Mexico used a paid tax preparer to help them file their tax returns, and 64% of all filers claiming the Earned Income Tax Credit (EITC), who tend to be lower income, used a paid tax preparer. This amounted to over 480,000 New Mexico tax filers (130,000 EITC filers) who relied on paid tax preparation firms to help them file accurate tax returns.³

We conducted mystery shopper visits in five counties in New Mexico (see below). We focused our tests on these counties because most of them have communities with relatively high Native American population and a high percentage of tax filers claiming the EITC. In addition, in three of these counties, use of paid preparers by EITC filers was higher than the state average and use of Volunteer Income Tax Assistance (VITA) sites was lower.

Table 1: Characteristics of New Mexico Counties

County	% Native American population	% of total returns claiming EITC 2008	% of EITC filers using a paid preparer 2008	% of EITC filers using a VITA Site 2008
Cibola	40%	29%	73%	1%
Bernalillo	5%	18%	55%	7%
McKinley	75%	42%	84%	1%
San Juan	37%	26%	80%	2%
Sandoval	16%	17%	55%	5%
State	10%	22%	64%	4%

³ Data from the Brookings Institute *EITC Interactive* website: www.brookings.edu/metro/eitc/eitc-homepage.aspx. Figures computed by the authors.

This project replicated earlier mystery shopper studies conducted by the Community Reinvestment Association of North Carolina and The National Consumer Law Center in 2008 and 2010.⁴ The goal of this work was to see if the findings in earlier studies were corroborated, to assess the quality of tax preparation services in communities with a high Native American population and close to Indian reservations, and to test the hypothesis that the tax preparation firms are steering people toward expensive products such as Refund Anticipation Loans or Refund Anticipation Checks.

Earlier assessments of tax preparation services found that taxpayers often receive low quality service, are pushed into using high cost tax products such as Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs), and are charged frivolous or high fees.⁵ In addition, previous research suggests that many tax preparers do not disclose that RALs and RACs are voluntary bank products and do not reveal the costs associated with such products or the alternatives to them such as free e-filing and using direct deposit of tax refunds into one's bank account.⁶ Finally, previous research also found that tax preparers are not following the highest standards of practice⁷ and demonstrate problems with protecting the confidential data of tax filers and disclosing information on tax preparation fees.

Recent research on RALs and RACs suggests that use of these products is often geographically concentrated and these products are used disproportionately by ethnic minorities and lower income tax filers.⁸ Previous research by First Nations Development Institute suggests that filers in Native American communities use bank products such as RALs and RACs more often than filers in non-Native communities.⁹ Recent research on the patterns of tax filers in New Mexico suggests that McKinley and Cibola counties, two counties with high Native American populations, had higher than average use of RALs and RACs by tax filers in past years. While previous research suggested higher use of these products by Native American tax filers, there was no evidence that these products were being heavily marketed or pushed on tax filers. This report documents that some Native American filers are indeed being automatically signed up for RACs or steered toward such products by paid preparers.

4 See Wu et al. (2010). *Tax Preparers Out of Compliance: Mystery Shopper Testing Exposes Violations of Refund Anticipation Loans Laws in Arkansas, New York, and North Carolina*. Raleigh, NC: Community Reinvestment Association of North Carolina and Wu et al. (2010). *Tax Preparers Take a Bite Out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuse in Durham and Philadelphia*. Raleigh, NC: Community Reinvestment Association of North Carolina.

5 Again, see Wu et al. (2010). *Tax Preparers Out of Compliance: Mystery Shopper Testing Exposes Violations of Refund Anticipation Loans Laws in Arkansas, New York, and North Carolina*. Raleigh, NC: Community Reinvestment Association of North Carolina and Wu et al. (2010). *Tax Preparers Take a Bite Out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuse in Durham and Philadelphia*. Raleigh, NC: Community Reinvestment Association of North Carolina.

6 A Refund Anticipation Check is a product that allows the tax provider to open a temporary bank account in the filer's name into which the IRS direct deposits the refund check. After the refund is deposited, the bank issues the client a check and closes the bank account. Documented fees for Refund Anticipation Checks have ranged from \$30 to \$60 at different tax preparers. Such a product is unnecessary if a client already has a bank account. A Refund Anticipation Loan is a short term loan issued by a bank using a filer's tax refund as collateral. Such a product allows a filer to get access to funds usually in a few days rather than 5-10 days if they used direct deposit into a bank account. In past years, many tax preparers were heavily marketing Refund Anticipation Loans and a large number of EITC filers were using them. In 2011, there were only 3 major banks offering lines of credit to tax preparers and very few tax preparation firms seem to be offering Refund Anticipation Loans.

7 See the IRS webpage "Tips for Choosing a Tax Preparer" at www.irs.gov/individuals/article/0,,id=133088,00.html for some best practices.

8 See Theodos, B., Brash, R., Compton, J., Masken, K., Pindus, N., Steuerle, C. (2010). *Who Needs Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks*. Washington D.C.: Urban Institute; Keeley, C. L. S. and Griffith, M.W. (2007). *Predatory Tax-Time Loans Strip \$324 million From New York City's Poorest Communities: An Analysis of Tax Refund Anticipation Lending in NYC 2002-2005*. New York, NY: Neighborhood Economic Development Advocacy Project; and Duda, S., Buitrago, K., and Smith, G. (2010). *Diverted Opportunity: Refund Anticipation Loans Drain Wealth from Low Wealth Tax Filers and Communities of Color*. Chicago, IL: Woodstock Institute.

9 See First Nations Development Institute (2009). *Borrowed Time: Use of Refund Anticipation Loans Among EITC Filers in Native American Communities*. First Nations Development Institute: Longmont, CO and First Nations Development Institute (2011). *Use of EITC and Predatory Tax Products in New Mexico*. First Nations Development Institute: Longmont, CO.

II. Testing Background

Testers were recruited in early 2011, asked to sign a consent form, and given information about the project. For the majority of testers, we calculated their tax returns before they went to the selected tax preparers so that we could more easily catch any errors and also avoid any instances of serious tax liability or fraud. Testers were instructed to visit a paid tax preparer and inquire about getting a RAL or RAC if they had a large enough tax refund. The majority of the mystery shoppers were Native American and were enrolled tribal members, which allowed us to test tax preparer's knowledge of tax law related to tribal citizenship. A researcher from First Nations Development Institute accompanied the testers during the visits to the paid tax preparation firms and paid for all expenses associated with filing tax returns. Detailed case studies for each mystery shopper test were written up using a rubric of key data points. Quotes from these case studies are provided in this report, and Appendix A includes two examples of the case studies.

During our visits to the communities of Gallup, Grants, Bernalillo, Farmington, and Albuquerque, New Mexico, we saw tax preparation services being offered by a variety of different companies. In addition to the national chains of Jackson-Hewitt, H&R Block, and Liberty Tax, we saw tax preparation services offered by pawn shops, rent-to-own furniture stores, personal loan companies, independent businesses, and mom-and-pop businesses. We tried to visit as many different types of tax preparation firms as possible in this study to gather information about the range of companies that offer tax preparation services.

Testing was focused on finding out more about the costs associated with RALs and RACs, and the marketing and other practices used to promote these products. However, other issues related to the quality of tax preparation services, lack of disclosure of fees, and confidentiality quickly emerged from our research. Given the changes in the tax preparation industry this year, none of our testers were able to get a RAL, so we only have data on RAC products. This research does reveal some interesting dynamics related to the tax preparation industry, however, including aggressive competition for business, most likely as a strategy to make up for declining revenues due to the decrease in credit available for offering RALs. Overall, testers documented many different issues related to the RAC product, the quality of tax returns, and low levels of professionalism by tax preparers. These are presented and analyzed below.

III. Major Finding # 1: Poor Quality Tax Preparation

By far the biggest problem documented during this mystery shopper test was that the majority of taxpayers received poor quality tax preparation from the paid preparers they visited. In seven cases, the tax preparation process was stopped or changed to avoid having the paid preparer file an inaccurate tax return. In our small sample of 12 mystery shoppers, 10 of the taxpayers encountered problems with inaccurate, illegal, or unprofessional behavior (this includes visits to major chains such as H&R Block, Liberty Tax Service, Jackson-Hewitt, as well as Sun Loans and Freedom Tax Service, a mom-and-pop store, and two other smaller chains).¹⁰ The following problems were encountered by taxpayers:

A. Inaccurate Tax Preparation

In our small sample of 12 mystery shopper tests, several errors were made on tax returns. One customer had to file an amended return, and in two other cases, testers opted to get a paper return prepared for them to mail in (or modify and then send in) because they felt uneasy with some aspect of the tax preparation or filing process. In five cases, the taxpayer or our researcher had to intervene and correct the tax preparer so an incorrect return would not be filed. The following errors were made by tax preparers:

¹⁰ The two mystery shopper visits with high quality service and where no incidents took place were at an H&R Block in Santa Ana Pueblo and a Liberty Tax in Bernalillo.

1. Failure to include unemployment insurance benefits as taxable income (Form 1099-G).

In one case, the tax preparer failed to claim unemployment insurance and therefore qualified the taxpayer for the Earned Income Tax Credit. This error could have significant ramifications because if the IRS caught the omission of the 1099-G, the refund would be lowered to the correct amount and the EITC would be denied. A taxpayer can be disallowed from taking the EITC for 10 years if the credit is claimed and the taxpayer is later determined ineligible. This taxpayer had to file an amended return.

The preparer failed to enter \$2,831 in unemployment income from Form 1099-G. This was gross negligence as she apparently just overlooked the statement while it was sitting on her desk with other paperwork she had been given. Compounding this error is the fact that upon completion of the return the preparer required the taxpayer to review and sign a tax document checklist for income verification purposes. This checklist listed all the taxpayer's sources of income including the 1099-G, along with their applicable line item amounts. The preparer had even initialed every one of these amounts. The \$2,831 income omission lowered the taxpayer's taxable income to the threshold to qualify for the EITC. This resulted in an EITC and a reduction of Federal tax owed compared to what was originally calculated by our VITA control site. This meant that the taxpayer appeared to get a Federal refund that was larger than the refund calculated by our VITA control site. The taxpayer had to get an amended return to correct these errors.¹¹

2. Failure to claim qualified student loan funds as taxable income (Form 1098-T).

One example:

When the tax preparer started to do the return she became confused about Form 1098-T which reported income from tuition. The qualified expenses were less than the scholarship amount and therefore VV had to report some income from her scholarship. The tax preparer expressed confusion over the 1098-T and asked her supervisor what to do with it. The supervisor told her that because line 5 was smaller than line 1, VV didn't have to claim income. This was factually inaccurate. Because VV was concerned about the accuracy of the form, she chose to get a paper return, so she could modify it if necessary. She was charged \$251.50. Interestingly, she was told she could not take her paper return home that day but rather had to pick it up the next day.

Another example:

Preparer did not know what to do with a 1098-T that listed a \$662.65 in line 4 (adjustment from prior year). She stated "Technically I think I'm supposed to subtract \$662.65 from \$2,235, but I'm not sure. We can probably just leave it out because it's highly unlikely that IRS can track it. Let's leave it for now and worry about it later." Before completing the return she readdressed the issue again, stating that she wasn't sure how to handle it and asked the taxpayer that if it was ok, she would just ignore it. The taxpayer agreed to this. I didn't know the tax code regarding this matter but found out later that she should have increased her income on line 7 by this amount.

3. Advising a tribal member that he didn't have to pay state tax on income earned off his reservation.

New Mexico law clearly states "If you or your spouse, or both, were enrolled members of a New Mexico federally recognized Indian nation, tribe, or pueblo, your income is exempt from base income IF:

- You lived on the land of the Indian nation, tribe, or pueblo of membership when you earned it, AND
- You earned that income on the lands of that nation, tribe or pueblo.

You must meet both conditions."¹²

¹¹ Quotes from the case study reports are included in this report in italic font. In some cases, the taxpayer's initials are used.

¹² Source: 2010 New Mexico Personal Income Tax Form Packet.

One tax preparer did not seem to be aware of this state law:

The most glaring mistake occurred when preparer told AB he could fully exclude his entire income of \$46,492 from his New Mexico state return. (Wife was non-Native so this was not an issue for her). The preparer said Native Americans do not have to pay state tax regardless of where they are enrolled or on which reservation they are working. The taxpayer is an enrolled member of a pueblo but lives in Farmington and had income from three sources: a different pueblo from where he was enrolled, the Navajo Nation, and a \$10,865 retirement distribution from a previous non-Native employer located in another state. The preparer included total income from all three sources when calculating the state deduction.

4. Lack of knowledge regarding how to properly file a Schedule C.

There were several examples of tax preparers who had difficulty completing an accurate Schedule C. This is especially concerning given that many Native Americans have self-employment income and need expert tax advice when filing their tax return. In this first example, the preparer had trouble entering in small business expenses:

The preparer was friendly. However she asked hardly any questions and just started entering information from the taxpayers two W2's. A few minutes later she turned away from her computer and said the return was finished and it would cost \$170 (1040EZ). I said "Wait a second this person has self-employment income too." She stared at us blankly for a few seconds and said "Oh." At this point the taxpayer showed her a list of business expenses from a small part time food service business he started last year. The preparer then started entering expenses onto Schedule C-EZ. She never asked if GM had records of these expenses or advised him that he should keep records. After completing the 1040-EZ she began explaining the entire return. She did a fairly good job of explaining all of the major deductions and income calculations, but then stated that GM owed \$400 in Self-Employment Tax and owed \$1,100 dollars total tax for the year.

Before coming in I had completed GM's entire return and knew he owed no self-employment tax (the start-up business had taken a \$374 loss for the year) and had calculated owed tax of \$130. Her mistake was in using Schedule C-EZ which does not allow for Cost of Goods Sold. Fortunately we had brought a hand written Schedule C in with all of GM's expenses. The preparer then used our Schedule C to complete the Schedule C on her computer while we looked over her shoulder and made sure she made all the correct line entries. So we basically did the form for her (for which she later charged \$93). Thank goodness we had done all of our homework. GM stated after we left the office, "Geez, she really didn't know what she was doing. Are they all that bad? She was gonna have me owe \$1,100 if we hadn't known any better. What a rip off!"

Another example:

The visit went fairly smoothly until the preparer hastily completed Schedule C-EZ and missed over \$1,000 of expenses the taxpayer had provided. When I pointed this out she became visibly agitated and began questioning us as follows:

- *She repeatedly questioned the legitimacy of his mileage expense stating that he could not claim commuter miles (irrelevant because the taxpayer is self-employed and was claiming business miles not commuter miles).*
- *She stated sales tax was not deductible. I told her it was and she said "No it's not." Finally she checked with a supervisor who confirmed that it was.*

She had to change the schedule C twice and by the second time became noticeably frustrated and unprofessional in her behavior. By this time she rushed through the process of explaining the return and never even explained to the taxpayer how he needed to send his payment voucher and check in for tax owed. Finally, she failed to include a copy of Schedule C-EZ among copies of return.

A third example, in which the preparer struggled with entering pre-paid estimated taxes:

I completed my entire return by hand before arriving at the office and brought all forms with me. Everything started off smoothly. When he moved on to the Schedule C he appeared surprised when I presented a handwritten Schedule C listing a considerable amount of expenses. He questioned my auto expenses in a manner that suggested he didn't think I knew how to properly deduct mileage and had entered my actual miles instead of calculating them at .5. When I was able to thoroughly explain my mileage calculation he looked even more surprised. I then proceeded to go line by line giving him exact totals of the various expenses. He again looked shocked when I had substantial contract labor to deduct. Finally, after completing the form I checked his computer for accuracy and noticed he had put the wrong figure for deductible meals. When I pointed out his error he became extremely defensive and said in an abrupt tone "No, I'm not wrong. You are." He then showed me a worksheet and began explaining that meals had to be calculated at 50%. I said "The figure I gave you was already adjusted. I know meals are not 100% deductible." We moved past the schedule C and he hastily finished the rest of the return without checking to see if I had any adjustments to Gross Income. He then announced that I owed \$21,000 in federal tax. I said "No that's not right, I made over \$20,000 in estimated payments and I have deductible retirement contributions." He didn't have a clue for how to handle the retirement contributions, and seriously struggled with the software in the process. Finally he had to ask the owner of the business for help. He struggled even more when he had to enter my prepayments, but this actually appeared to be a software glitch that occurred when entering both federal and state prepayments. Again the store owner had to assist. He finally finished and after the lengthy ordeal his refund matched mine exactly.

5. Lack of knowledge regarding how to handle dividend income.

The preparer did not know where to enter \$31 in dividend income from a 1099 Composite Form. She had to call someone who told her where to enter the figure. I found this alarming because it was a very basic issue that I think even a relatively inexperienced preparer would probably have no difficulty with.

6. Preparer told a tax filer that federal employees do not pay social security because they have a good retirement plan.

The preparer was friendly and seemed reasonably thorough in both the questions she asked and her knowledge of the tax code. She wasn't sure why no social security was withheld on one W-2, but said that federal employees do not pay social security because they have a good retirement plan so not to worry about it. This information is inaccurate for this situation.

7. Preparer didn't know how to handle paperwork associated with a rollover of a Roth IRA.

The preparer was friendly and took the appointment seriously, but it was obvious he was not capable of completing the return. He asked very few intake questions. And almost immediately he began deferring to senior associate A. (who was not much older than R.) for guidance and clarification. These two young staffers appeared to be the only two people working in the office. About half way through the visit while struggling with how to handle a direct rollover into a Roth IRA, A. completely took over completing the return. She struggled as well though, stating at one point that she had never dealt with something like this before. Alarming considering this was a pretty basic issue.

8. Preparer put the incorrect mailing address on the tax return form.

AB emailed me on April 5th and informed me that upon review of his return, the preparers had incorrectly listed his address by using his former street address (from another town) with his current city and zip code. This should not be a problem for the federal refund because he is receiving direct deposit, but must be fixed for the state refund which is to be sent by mail.

9. Failure to file a Form 8379 - Injured Spouse Allocation Form.

We discovered later that the tax preparer forgot to file a Form 8379. We went back to request it, and even though we had purchased a Gold Guarantee, we were asked to pay an additional fee. We argued with them and they eventually filed it for free.

B. Illegal Activities on the Part of Tax Preparers

Unfortunately, some of the tax preparers we visited were not following basic ethical or even legal guidelines. In 2011, the IRS began requiring that tax preparers register with the IRS to obtain a Preparer Tax Identification Number (PTIN). Tax preparers will eventually be required to pass a competency exam which will be available sometime in mid-2011 and will be phased in over a period of time. David R. Williams, head of the new IRS Return Preparer Office, was quoted in the Columbus Dispatch in January 2011 saying: "There are many, many, many, many thousands—if not hundreds of thousands—of dedicated people who are professional and work hard and prepare accurate tax returns. It's also true that there are many unscrupulous preparers out there who take advantage of taxpayers, who file erroneous returns, and who, frankly, disappear when the taxpayer is contacted by the IRS — leaving the taxpayer to clean up the mess."¹³ Unfortunately, we encountered some of these unscrupulous preparers. We encountered the following problems:

1. Operating without an IRS Preparer Tax Identification Number.

One of the mom-and-pop tax preparation firms was operating without an IRS Preparer Tax Identification Number. When asked why she didn't have a number, she replied, "Oh, I just haven't gotten around to it this year." More distressing was that when we reported her to the local IRS office and filled out a form, officials at that office did not seem concerned:

I went to the Albuquerque IRS office the next day to report the preparer for no certification number. I waited about 45 minutes to speak with someone and was given a form to mail off (Form 3949 A). One employee actually chuckled when I told him the issue and said "I've never heard of the IRS cracking down on anyone doing taxes without a certification number. Only time I ever heard of anyone getting in trouble was a woman who got busted by the state."

2. Tax preparer indicated she used her own bank account for taxpayer's e-file and direct deposit.

One tax preparer offered an unusual E-filing and RAC option:

The preparer said she could e-file for \$50. We said "Sure why not" but when she didn't ask us to sign a Form 8879 (E-file Signature Authorization), I got a little suspicious, especially because she wasn't using business software, but just a plain consumer version of H&R Block's "Tax Cut" software. So I asked her if we need to sign a form for e-file, and she said no.

At this point the taxpayer opted not to e-file and requested a paper return to mail. I'm thinking she is probably just going through IRS Free File and submitting returns like they are her own. Then she charges \$50 for the service.

¹³ "IRS tracking paid tax preparers: New law imposes annual fee on staffs." Sunday, January 2, 2011, Columbus Dispatch. Downloaded from www.dispatch.com/live/content/business/stories/2011/01/02/irs-tracking-paid-tax-preparers.html on April 19, 2011.

I did ask what she did if someone could not afford to pay upfront. She hesitated for a moment and then said: "I just put my account number and routing number on the return and write the client a check when their refund comes in. I take my fee out before I write the check."

3. Encouraging tax fraud by making up frivolous expenses on the Schedule A.

One tax preparer encouraged tax fraud by making up frivolous expenses for the Schedule A form:

While completing Schedule A, the tax preparer never asked if the taxpayers had proof of numerous expenses, nor did she mention that they should keep records of these expenses. She also included numerous expenses the taxpayers do not technically qualify for, i.e. employment stuff such as clothing expenses, personal cell phones (calculated for 99% business use), and numerous commuter expenses (Form 2106) that the taxpayer was not eligible to claim. She would ask questions like, "about how much did you spend on clothing?" and then write it down without asking for records of expenses.

C. Unprofessional Behavior on the Part of Tax Preparers

Unfortunately, many tax preparers we visited also demonstrated highly unprofessional behavior. Quite a few tax preparers failed to provide customers with copies of their tax returns, and a few tax preparers reacted negatively when their errors were pointed out. We encountered the following problems:

1. Failure to provide a payment voucher in tax filer's packet of financial records.

In one case, the tax preparer failed to include the payment voucher needed to send into the IRS for the taxes owed:

I double checked the taxpayer's entire packet and realized the preparer had forgotten to include a payment voucher (for which she had charged \$5). The payment voucher is needed for when we send in the taxes owed. I had to ask them to print that for me.

2. Failure to provide copies of the tax forms in the tax filer's packet of financial records

In several cases, the tax preparer did not provide copies of the tax forms until asked to do so.

One example:

Upon reviewing copies of tax forms and documents following the visit I discovered that the copies of the actual state and federal returns were not included with the packet, just all of the consent forms and summary sheets. I called the taxpayer and informed her that the returns were missing and she said she would stop by over the weekend and pick up the copies. Apparently they don't print copies of the returns until after submitting the return to IRS. I discovered this because the same thing happened on Sunday at (another branch of the store) in Farmington. Here again they provided everything but copies of the return to the taxpayer, but this time I made sure to request copies. I really don't think they would have provided them had I not asked.

Another example:

Upon completion I noticed there were no copies of my actual returns, just the e-file authorization and NM PIT Declaration that lists AGI, total tax, and refund amount. I said I needed full copies and he said "You have them right there." I said no, I need the full returns not these summary sheets. He said "No! You don't get copies of those, you don't need them. I don't have to give them to you." I had to say, "Oh yes you do! Those are my forms and I want them." He went off to appeal to the owner who was sitting at a desk behind us. The owner said casually "Sure, he's entitled to them if he wants them. Print them and just mark them as 'copies do not file.'"

3. General unprofessional behavior: negative reaction when errors were pointed out; taking personal calls while working on a return.

In three cases, the tax filer had to point out errors in the tax return and the tax preparer reacted negatively to being corrected. One example:

When I pointed out his error he became extremely defensive and said in an abrupt tone “No, I’m not wrong. You are.” He then showed me a worksheet and began explaining that meals had to be calculated at 50%. I interrupted him quickly and said “The figure I gave you was already adjusted. I know meals are not 100% deductible. I even adjusted them for high cost cities I travel to that have higher allowances than the standard per diem rates.” At this point he got really angry, even red in the face.

One tax preparer took numerous personal calls during the tax preparation process:

The preparer took numerous personal calls while working on the return. She apologized sincerely stating she was supposed to be off today, but was filling in for an employee. During one call she got so distracted she had to start a worksheet over because she had completely lost her train of thought and couldn’t remember specific totals she had calculated.

IV. Major Finding # 2: Inadequate or Non-existent RAC Disclosures

Recent research has suggested that residents of some Native American communities use RALs and RACs at a higher rate than those in non-Native communities. We were interested in testing the hypothesis that tax preparation firms are steering people toward expensive bank products such as Refund Anticipation Loans or Refund Anticipation Checks. We collected information on whether our mystery shoppers were steered toward bank products such as RACs, and whether they were informed of low cost alternatives such as free e-filing and direct deposit into one’s bank account. There are disclosure requirements for products like RACs, so we were also interested in whether accurate information was being disseminated about these products. We found the following problems:

A. Failure to inform the tax filer that they are taking a Refund Anticipation Check and presenting the Refund Anticipation Check as a default, without presenting other options.

One tax filer was automatically given a RAC:

No options were given and the preparer automatically signed CC and CH up for a RAC with fees to be extracted directly from the refund while stating that the total fee would only be \$67.50. She never once explained that this service was actually a bank product that had a fee associated with it. She had the taxpayers sign forms which disclosed all of this information, but she never took the time to explain the forms. Later she did randomly mention direct deposit by stating that some people choose direct deposit but sometimes IRS enters bank account numbers incorrectly and refunds get credited to the wrong accounts so it is safer to get a check mailed to their office. At one point she also stated there was a charge for e-file. I found a consent form (for release of information to banks for use in offering RALs and RACs) among copies to take home. CC and CH did not sign this form, but their names are printed on the signature line making it look really suspicious.

Another example:

The taxpayer was offered and accepted a two week guaranteed refund which was basically a RAC although never explicitly called one. What I found most alarming is the tax return preparer did not offer Direct Deposit but said instead that the taxpayer would receive check payment through this office. I asked about Direct Deposit but she said a check was safer. I asked why and she said that if any little thing is out of whack on the return it’ll take longer to get

a refund with direct deposit than with a check. I'm sure they push for mail because it is easier to extract payment than if the customer chooses Direct Deposit. The bottom line is that the taxpayer paid an extra \$65.95 for a refund that will be paid by a check that she has to pick up that may take as long as 3 weeks to deliver. Even though free direct deposit without a guarantee gimmick will only take about 10 days.

B. Failure to disclose the free e-file, direct deposit option.

In past studies, researchers have documented that some tax preparers fail to mention that a taxpayer can simply e-file their return and opt for direct deposit into their own bank account for free and will receive their refund in 5-10 day using this approach. Previous studies have documented that tax preparers may only offer bank products such as RACs or RALs. Our mystery shopper study found that about half of the tax firms visited mentioned that the customers could use the free e-file option with direct deposit. In the rest of the cases, they were steered toward using a RAC-like product. In two instances, customers were automatically put into a RAC without being asked. Here is one example of what a customer was offered:

The taxpayer was not offered free e-file with direct deposit, but the preparer did include a "Bank Refund Transfer Application and Agreement Disclosure" that provided this information. However it was one of many closing documents and consent forms requiring the taxpayer's signature at the end of the visit, and the preparer did not explain it to the taxpayer. The preparer offered the following options for receiving a refund in this order:

Option A: Pay nothing today by having \$307.95 automatically deducted from your refund. This option includes a two week guarantee for receiving your refund.

Option B: Pay \$242 cash today and have your refund mailed to you in about 6 weeks. However, another employee seated at a desk across from the taxpayer stated that people who choose this option usually get their checks in about 2 weeks.

Option C: Get a loan (for a portion of your refund) through the bank in 48 hours and get your remaining refund in about two weeks.

Another tax preparer offered these options for payment:

Option A: Pay a fee of \$227 today and have your refund directly deposited in your bank account in about 10 days.

Option B: Apply for a loan. The preparer stated this was the fastest way to get a refund (by a couple of days because the loan office and bank are closed on Sunday).

Option C: Get a RAC or refund anticipation check which she said is basically the modern version of the old Rapid Refund. The fee is \$32.95 which will be subtracted from the refund. The preparer stated this was a pretty good deal as the taxpayer would get her refund sooner than Option A (estimate of March 4-8 for Federal with the State refund probably sooner than that). I thought this was odd because those dates are further out than the 10 days she estimated for Option A (maybe she meant 10 business days, I don't know). She said there was no charge for direct deposit but a \$52.95 charge if the taxpayer requested check payment. The preparer also stated there might be an additional \$13 State RAC fee, but that she wasn't sure. There ultimately was.

There was great variation in how the filing options were presented by different tax preparation firms, and at times the advantages and disadvantages of these specific options were not clearly explained by the tax preparer. The bottom line is that often the free e-filing option was not presented or the tax preparer provided inaccurate information.

C. Rushing clients through documents without allowing time to comprehend them.

Another technique that some tax preparers use is to rush filers through signing many documents without fully explaining them. This is one example:

This was a really shocking and distressing experience. The preparer made horrendous errors when completing this return that significantly altered the taxpayer's tax liability. She also, although friendly and polite, came across as flippant and obtuse at times, specifically when she gave the taxpayer a small stack of consent forms to sign at the completion of the return. The taxpayer asked what all the forms she was signing were, and the preparer laughed casually, saying "Oh, they're just forms." A short while later she joked again, saying: "If I get \$4,000 I'm not going to ask a lot of questions. I just want it!"

D. Dissemination of factually inaccurate information.

As indicated above, two preparers actually gave out factually inaccurate information related to e-filing. One tax preparer claimed there was a charge for e-filing and that,

"...some people choose direct deposit but sometimes IRS enters bank account numbers incorrectly and refunds get credited to the wrong accounts so it is safer to get a check mailed to the office."

Another claimed that a RAC was safer:

I asked about Direct Deposit but she said a check was safer. I asked why and she said that if any little thing is out of whack on the return it'll take longer to get a refund with direct deposit than with a check.

V. Major Finding # 3: Unnecessary or Unreasonable Tax Preparation Fees and Lack of Disclosure of Fees

Recent research has suggested that some tax preparers charge very high fees to prepare basic tax returns and may pad bills with unusual or unnecessary fees.¹⁴ In our research, we did not document any fees that seemed unusually high compared to past findings. The average cost for a basic 1040 tax form ranged between \$50 (EZ) and \$100. However, we did document several fees for software usage, document handling, and for each individual tax form even though, as anyone who has prepared their own taxes using a software package knows, the software packages compute these forms automatically. More importantly, we documented a troubling lack of disclosure of fees and a refusal to provide detailed estimates of costs before the tax service was provided (see Appendix C). This lack of disclosure of costs seems out of line with standards in other industries, leads to information asymmetry,¹⁵ and makes it very difficult for customers to shop around for the best deal. Any way you look at it, low-income tax payers (who often qualify for the Earned Income Tax Credit) can save a great deal of money by either visiting a Volunteer Income Tax Assistance site or using FreeFile online where they are not charged for their 1040 tax form or any additional forms filed. We documented the following issues:

14 Wu et al. (2010). *Tax Preparers Out of Compliance: Mystery Shopper Testing Exposes Violations of Refund Anticipation Loans Laws in Arkansas, New York, and North Carolina*. Raleigh, NC: Community Reinvestment Association of North Carolina; Wu et al. (2010). *Tax Preparers Take a Bite Out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuse in Durham and Philadelphia*. Raleigh, NC: Community Reinvestment Association of North Carolina; and Wu, C., Skillern, P. (April 2011). *Tax Time 2011: Mystery Shopper Testing In New York and North Carolina Finds Continuing Problems with Tax Preparers*. Raleigh, NC: Community Reinvestment Association of North Carolina.

15 Economists describe information asymmetry as a situation in which one party in a transaction has more or better information than the other. This can create an imbalance of power in transactions and lead to decisions that do not maximize economic utility for one party in the transaction.

A. Unusual fee structures for tax preparation services.

While it was difficult to compare fees due to lack of disclosure, we did document fees for things like software and bank transmittal services. More concerning were charges associated with different tax forms such as the Schedule M - Making Work Pay Credit (ranging between \$5 and \$22), the Earned Income Tax Credit (ranging between \$37 and \$55), and the Child Tax Credit (\$22). These forms are usually automatically computed by the software package yet seem to be costing (often low-income customers) a high price at tax preparation firms.

B. Lack of disclosure of fees.

Our testers always asked for an estimate of the costs associated with filing their returns. While everyone was given a vague estimate, unfortunately only 2 out of 12 received anything resembling an accurate, detailed estimate. Most people were told that the cost varied based on the number of forms filed, etc., and were quoted a general amount for preparing a Federal Form 1040. Many of the estimates were very confusing and made it difficult for the tester to determine total estimated costs. Two were told they would receive a detailed estimate after the taxes had been calculated. Only two tax preparation firms had wall signs indicating fees associated with filing different tax forms and other services. One of the testers ended up paying less than the amount they were verbally quoted at the beginning of the session, but fees for most preparers were much more than what was quoted at the beginning of the visit.

More shocking was the fact that none of our testers were given a detailed, itemized receipt after they had paid for their services, making it impossible to determine what the fees were for without asking. Many receipts indicated lump sum amounts for the federal and state tax returns and RAC bank product, and no receipt provided a breakdown of fees associated with filing different tax forms. In all cases, the tester had to ask for more information. In most cases the tester had to write information from a computer screen but in two cases the tax preparer did provide a copy of the detailed list of fees after being asked. This tester describes one such experience:

The preparer gave a non-written estimate of \$150 (note: ended up paying \$272.95). She said the fees are all based on the forms the taxpayer files. She also said that all fees are based on a flat rate and never on a percentage of the refund. I asked if she had a list of charges for each form, and she said she didn't know, but she would check on it after completing the return. She also mentioned, as an example, that a Schedule C has a flat rate in addition to separate fees for each line item. I did not get an itemized bill, but at the conclusion of the visit she did address my request for a fee structure statement. She asked a manager who told her she had to go into a special menu on her computer to retrieve the information which was listed for all states where H&R Block maintains offices. She printed the entire document and gave it to me.

C. Mysterious discounts that tax preparers can't clearly explain.

Several companies indicated they were offering a discount on tax preparation fees, but could not clearly explain their discounts.

One example:

The preparer did not provide an estimate stating cost is based on specific form fees. She did ask who prepared the taxpayer's taxes last year and what the fee was. I asked why she had asked and was told they provide a discount, upon completion of the return, based on competitors' fees (roughly 25-50% off depending on various factors she could not explain).

Later we were told that we were getting a \$200 discount. This \$200 discount was quite a story. When we left Wal-Mart to go to the Rio Rancho office to apply for a RAL, the preparer called the Rio Rancho office and told them we were on our way and explained that she had calculated what sounded like a 50% discount called a "March Madness Deal." When we got to Rio Rancho the preparer there told us the total fee for everything was \$113. She said that was really low and the Wal-Mart preparer had given us too good a deal and would probably have to answer for it later.

However, after deciding not to get a RAL, the taxpayer opted to return to Wal-Mart and file the return because she wanted that preparer to get the credit for the return. By the time we got back to Wal-Mart, they had figured out the price of \$113 was too low. They now wanted to charge us over \$200. I ended up negotiating with them for the \$168 price and the preparer simply wrote in the \$200 discount.

VI. Major Finding # 4: Changes in the Tax Preparation Industry Are Leading to the Decline of the RAL Product and Heavy Competition for Existing Businesses

There are several new dynamics at play in the tax preparation industry this year, the most important being that a number of banks stopped partnering with tax preparation firms to offer RALs. In the last year, the group of six major banks offering lines of credit for such products was reduced to three. This was the result, in part, of the Office of the Comptroller of the Currency asking banks to stop making RALs. In addition, the IRS stopped offering the debt indicator this year which further reduced the due diligence that banks could perform before offering customers a loan against their tax returns.

In our research, we found that no tax preparation firms offered the testers a RAL, and in some cases testers were discouraged from applying for a RAL. While some companies still advertise RALs or RAL-like products at their stores, there did not seem to be a lot of interest in selling them to our testers. When we did inquire about getting a RAL, we were told the fees range from \$100 or \$150 depending on the amount requested. For the most part, tax preparers seemed to think that the RALs were “not worth the hassle” and some tax preparers stated that they were no longer available.

This is good news that this costly product seems to be disappearing from the market place, but we are concerned that other products may emerge to recapture the revenue stream previously associated with RALs. In our visits to tax preparation firms, as documented above, we did note unusual fees and in some cases aggressive marketing of RACs, and at one site we noted that the company would put one’s tax refund on a debit card. The debit card could only be used at a limited number of stores, which captures those funds in a limited market.¹⁶

At many of the commercial tax preparation sites, testers were offered new or additional products to purchase. At Jackson-Hewitt, the “Gold Guarantee” was sold to several customers as a service that “covers the tax payer in the event of audits or mistakes the taxpayer might make (e.g. failure to provide paper records, etc.).”¹⁷ This product cost an additional \$42.00. At Sun Loans, the tax filer was offered a roadside assistance plan, which she declined. At H&R Block, the Second Look Review and the Peace of Mind Guarantee were offered:

The preparer pushed supplemental products hard, specifically a Second Look Review and a Peace of Mind Guarantee. The Second Look allows H&R to review your previous year’s return (from another preparer) for errors. It seems like a rip off because if they find any problems, the taxpayer will have to pay extra to fix them. Although the preparer was very courteous, the preparer did push hard. She also asked the taxpayer to send referrals her way.

We saw aggressive competition for business, including one firm that was eager to sign the tester up for an appointment in 2012. Many firms offered mysterious “discounts” off fees paid, but had trouble explaining how these discounts worked or what amounts were being discounted. Another firm provided a coupon for a pizza place, and one firm even provided a 15% “Native American Discount” in an effort to gain favor among the surrounding Pueblos and reservations.

¹⁶ While a debit card may be a useful product for those without bank accounts, it is concerning that the tax refund can only be used at certain businesses (including the pawn shop that offers it) and many of these cards have high fees associated with their use.

¹⁷ Unfortunately, these guarantees do not seem to hold up to their advertised purpose. When one taxpayer who had received the Gold Guarantee went back to request that a Form 8379 be filed for her (which should have been caught the first time), she was told she would have to pay an additional \$50.

Finally, we noticed that many of the firms, including many chain stores, would not accept a credit card or check to pay for tax preparation. This policy makes it difficult for lower-income individuals, who have less financial resources, to pay for tax preparation services in advance, and therefore increases the probability they will have to use a RAC to access their tax refund and pay for tax preparation fees. We recommend that future research document these new products and techniques that are being used to extract more revenue from taxpayer clients so we can continue to monitor these trends.

VII. Major Finding #5: Privacy Issues Remain a Concern

Tax returns contain highly sensitive financial and personal information including an individual's social security number, birth date, and home address. Professional tax preparers should follow confidentiality rules under Section 7216 of the Internal Revenue Code, which prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information. Despite these rules, three of our testers became concerned about personal data they had given to their tax preparers. We encountered the following problems:

A. Taxpayer given someone else's W-2 Forms.

In one case, the tax preparer provided the taxpayer with a copy of her federal and state return but attached someone else's W-2 Forms.

VV stopped the tax return preparation due to concerns about accuracy. She requested that she be given a paper return so she could file it herself (or have it corrected at the VITA site). She was told to come back the next day because they could not prepare "same day" paper returns. She returned the following day and picked up her packet with the paper return in it. She was halfway home before she realized that someone else's W-2s were attached to her return.

B. Tax Preparer made copies of social security cards but did not give information about privacy policies.

Another taxpayer was asked to give the clerk copies of her social security card so H&R Block could keep it on file. The taxpayer did so, even though she was not provided with any information about H & R Block's privacy policy.

The preparer also made copies of the taxpayer's driver's licenses and social security cards. The wife did not have her social security card and he said that was fine, no big deal. When asked why he made copies he said it was to provide proof for their records. He didn't specify exactly what kind of proof, but said if there's a problem later it is easier to fix with proof (proof of identity is I think what he meant).

C. Asking for a signed Power of Attorney form from taxpayer.

On one test visit, the taxpayer was automatically asked to fill out a Power of Attorney form:

Probably the most alarming incident occurred when preparer told the taxpayer to sign a Power of Attorney form. Apparently they use Power of Attorney instead of a bank product consent form to have refunds sent to their office. They even put their business' mailing address on the customer's return. I told her the taxpayer didn't need to sign Power of Attorney because he wasn't getting a refund anyway. She said "Oh yeah, that's right" and had to reprint the return to show taxpayer's address.

D. Lack of safeguards for sensitive financial information.

At a Liberty Tax in Albuquerque, the tester felt that there was a lack of privacy during the tax preparation process:

The return was completed in a one room office with four desks and no dividers. There was another customer sitting at a desk across the room and I could hear everything that was going on with his return, so I'm sure he could hear all my numbers too.

In another case, few precautions were taken to protect confidential data that the tax preparer was handling:

When we were waiting in the “waiting area,” we could clearly hear the conversation between the preparer and her client in the next room. The husband commented “Don’t worry about people sitting here and listening while my wife is doing your taxes. She’s talking to that guy about an old return so it’s not important, but if she was completing an actual return I would turn up the TV in the living room so you wouldn’t be able to hear anything. I’ll do the same for you if anyone comes in while having your taxes done.”

All of these issues raise questions about the protection of sensitive financial and personal data by these paid tax preparers.

VIII. Major Finding #6: Tax Preparation Software May Have Problems That Contribute to Inaccurate Returns and High Fees for Customers

In 2010, the IRS announced plans to study the quality of tax preparation software used by hundreds of tax preparers and tax filers. An estimated 94 million professional and individual returns were completed in 2009 using tax software, and currently there is no regulation of the quality or content of these software packages. The IRS is interested in both the accuracy of tax preparation software programs but also the role of software companies in adding additional taxpayer fees for the use of their products.¹⁸ Our small sample of mystery shoppers uncovered problems with the software packages that many paid tax preparers were using. In one case, the software package appeared to be charging the tax filer for a fee she had already paid in advance (see Appendix A) and in another case, the tax preparer struggled to account for retirement contributions for a taxpayer who was self-employed, had a detailed Schedule C, and had made estimated payments:

Software glitches arose for me both while trying to determine deductible retirement contribution limits and inputting quarterly estimated tax payments. Retirement: the SEP contribution worksheet would not accept a \$13,500 contribution. Preparer did not know how to complete the worksheet, but it is the same worksheet that’s in the book so I told him to enter the plan percentage and conversion factor. This enabled him to complete the worksheet, but the bottom line figure would still not transfer to the 1040. That’s when the owner had to come over and fiddle with the program to get the \$13,500 to transfer. Estimated Payments: For the federal return, the software would not transfer the 4 quarterly pre payments (\$20,000) that the preparer entered into a worksheet, to the 1040. He kept changing the dates to see if that work, but to no avail. He fiddled with it for about 5 minutes, then gave up. Then when he finally finished the return, the \$20,000 transferred to the 1040. Seemed like a glitch that it didn’t transfer sooner. He couldn’t get estimated payments to transfer to the state form (PIT) either. I think that transfer was delayed until completion too.

Several other tax preparers appeared to have problems with the software package they were using. We recommend that future research continue to collect information on this topic.

IX. Policy Recommendations

Every year millions of Americans are required to file their taxes and many turn to a paid tax preparation firm for help. Unfortunately, this mystery shopper research project suggests that many tax preparation firms are providing low quality services and taking advantage of vulnerable low-income filers by imposing unnecessary fees or steering them towards an unnecessary Refund Anticipation Check product.

¹⁸ The 2010 report *Major Changes in the Quick Tax Refund Loan Industry* by the National Consumer Law Center documented the fact that many software packages include “junk” fees or additional fees that get tagged on to a tax preparers return.

We support the small business owners who are offering needed tax preparation services to their clients but saw room for improvement in terms of staff training, disclosure of fees, and customer service in this project. This is especially true in communities with a high percentage of low-income tax filers who rely on the Earned Income Tax Credit, the Child Tax Credit, and other programs to make ends meet. We applaud the IRS's new policy that requires tax preparers to register with the IRS and to pass a competency exam by 2013. We also commend the IRS for studying the software packages that many of these tax preparers are using and working to address the risks associated with the dependence on unregulated tax preparation software. We offer the following additional policy recommendations:

- A. Disclose all fees associated with tax preparation:** Given that the fees for tax preparation are not disclosed beforehand or even after the service is provided, it makes it difficult for the customer to shop around for the best deal. We recommend that tax preparation firms clearly list all their fees in a wall poster¹⁹ and then provide a detailed, itemized bill before receiving payment for service.
- B. Improve training to reduce errors:** We applaud the IRS's decision to require tax preparers to pass a competency exam. Such a standard already exists for the volunteers working at IRS-supported Volunteer Income Tax Assistance sites. We encourage the IRS to mandate a rigorous training standard that addresses all the issues raised in this report related to common errors on tax returns. In addition, we encourage specialized training on issues related to filing a Schedule A, Schedule C, retirement contributions, and any other forms or worksheets that preparers struggled with during our research.
- C. Standardize disclosures related to RAC-like products and enforce compliance:** Two of our mystery shoppers were automatically signed up for a RAC without their permission. There needs to be a standardized disclosure related to RAC-like products that is enforced, and customers need to know where to go to report violations in this area. This is increasingly important as the income associated with RALs has diminished and tax preparation firms are looking for new revenue streams.
- D. The tax preparation industry should adopt and follow a code of conduct:** While several of the tax preparation firms we visited were very professional and helpful to our testers, in some cases tax preparers reacted negatively to being corrected or being asked questions. Given the sensitive legal and financial nature of paying taxes, a customer should be assured of high quality customer service when visiting a tax preparation firm.
- E. Continue to provide resources to Volunteer Income Tax Assistance programs:** Low-income tax filers should have access to reliable, accurate, and no- and low-cost tax preparation services so they can keep more of their hard earned money. We recommend that the IRS VITA grant program continue to provide funding to VITA sites and that other sources of funds be cultivated to support VITA programs and low-cost alternatives to paid tax preparation.

X. Conclusion

First Nations Development Institute conducted this mystery shopper research in Native American communities in 2011 to assess the quality of tax services provided and gather data on the marketing of Refund Anticipation Checks and Refund Anticipation Loans. While our survey did not use a random sample and therefore is not generalizable to the larger population, it does raise some serious concerns about the quality of tax preparation services offered to residents of McKinley, Cibola, San Juan, Sandoval, and Bernalillo Counties in New Mexico. Given that a high percentage of residents in McKinley, Cibola, and San Juan Counties apply for the Earned Income Tax Credit, and a majority of them use paid tax preparers to access their tax refunds, this research raises serious questions about the quality and prices of services provided to low-income taxpayers.

¹⁹ In New York City and the state of New York, RAL providers are required to have wall postings (see NY Tax Law Section 32; NY General Business Law Section 372; and New York City Administrative Code Sections 20-739 to 20-741.1).

We found evidence that some taxpayers are automatically being signed up for a Refund Anticipation Check product, even though they have a bank account and could have saved money and time by using e-filing and directly depositing their refund into their own bank account. Several services seemed overpriced and there was a lack of disclosure on many fees leading to information asymmetry and limiting the customer's ability to shop around for better prices. Finally, despite the relatively high prices paid to prepare tax forms, many taxpayers had to correct their tax forms because they were riddled with errors and could have led to serious legal and financial liability down the road. It's also interesting to note that no preparers offered to waive fees for forms in which taxpayers had to provide significant assistance to preparers who lacked the ability to complete them correctly.

We acknowledge that there is a large population of individuals who benefit from the services provided by paid tax return preparers, and commend the small business owners who meet this market demand in an ethical and professional manner. We encourage tax preparers to develop and follow a code of conduct to ensure the highest quality of service is provided to customers, and the IRS to provide rigorous training and testing to ensure that all tax forms are completed accurately. We hope that others will conduct research on the quality of tax preparation services in their communities so we can continue to monitor any new trends in this dynamic marketplace.

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APPENDIX A: SUMMARY OF "MYSTERY SHOPPER" VISIT TO SECURITY FINANCE

April 14, 2011

Mystery Shoppers: CC and CH
Occupations: clerk, disabled (married couple)
Total Income: \$47,816

Store: Qualifies for: Child Tax Credit, Making Work Pay Credit
Security Finance, 1625 Rio Bravo Blvd SW Suite 8, ABQ, NM
Bank Partner: Republic Bank

Total Charges: \$197.90 in fees (we think)
\$29.95 administration fee paid to Republic Bank
\$32.95 Transmitter Fee paid to Drake Software


Summary of Visit:

CC and CH visited the Security Finance office on April 14th. They had had their taxes prepared at Security Finance the previous year. When CC and CH asked about the cost of the return, they were told that the base cost for returns starts at \$75, but they are currently offering discounts as high as 50% off. When they asked about qualifications of the staff to prepare taxes, the tax preparer told them she had in-house training. The preparer has 10 years tax prep experience (5 at Security, 5 at a previous business). She also said her office completes about 200 returns a year, more than any other Security Finance office in town. Some offices do as few as 17 returns a year.

The taxpayers have been coming to Security Finance for the last two years. Their returns for both 2008 and 2009 were in the company database and the preparer knew CC by name when we came in. The taxpayer currently owes IRS for 3 years of back taxes for when she was a paid contractor and did not make large enough estimated tax payments. The preparer was very friendly and asked a lot of good questions when preparing the return, such as additional sources of income, mortgage interest, and information on a disabled daughter and two grandchildren (all dependents taxpayers are claiming for the first time). She also informed the taxpayers that because they are claiming three new dependents they could potentially be targeted for an audit. I thought that was good information.

Overall the preparer seemed knowledgeable and efficient, with no noteworthy issues to report during the actual completion of the return. She also gave the taxpayers a 50% discount off the \$135 prep fee, which amounted to \$67.50 (this was a really low price and she made it sound like it was the final price, but there were actually additional charges we had to decipher for ourselves). The \$67.50 fee was paid up front, but appeared again on the bank product information form. The preparer never once mentioned that the administration and software fees would be extracted from the refund. I saw it when reviewing the final forms and questioned it. I said, "This return is costing us more than \$67.50." and she smiled sheepishly and said, "Yeah, I know, there's added cost there. That's how they do it."

The taxpayer made it clear from the beginning of the visit that she owed back taxes. The preparer stated that because of this we would have to pay the fee upfront before she could e-file.



Major Issue: No options were given and the preparer automatically signed the taxpayers up for a RAC with fees to be extracted directly from the refund while stating that the total fee would only be \$67.50. I found a consent form (for release of information to banks for use in offering RALs and RACs) among copies to take home. The taxpayers did not sign this form, but their names are printed on the signature line making it look really suspicious. The preparer never once explained that this service was actually a bank product that had a fee associated with it. She had the taxpayers sign forms which disclosed all of this information, but she never took the time to explain the forms. At one point she also stated there was a charge for e-file. Later she did say that some people choose direct deposit but sometimes IRS enters bank account numbers incorrectly and refunds get credited to the wrong accounts so it is safer to get a check mailed to the Security Finance office.

The taxpayers were not offered a RAL because tax preparer knew the taxpayers owed back tax, but the company had Republic Bank RAL posters on the walls.

As stated we were made to believe the return was only costing us \$67.50. We were also told the fee had to be paid upfront because the taxpayer owed back taxes therefore having the fee extracted from the refund was not an option. I was also told I had to pay the fee in cash because they had no credit card machine (something we've been told before).

I paid the \$67.50 and then when reviewing all of the forms in the packet saw the bank form that listed \$130.40 in fees that were not mentioned. That's when I made the comment about the return costing more than \$67.50. At the time I was focusing on the \$29.95 Tax Admin fee and the \$32.95 software fee, but did not pay much attention to the \$67.50 tax prep fee. When we got in the car to leave I reviewed all of the forms again and I suddenly realized that because the tax prep fee was listed on the bank form that it too would be extracted from the refund even though we had already paid it in cash. Essentially meaning the taxpayer was going to be charged \$67.50 twice!

I went back into the office where they were in the process of closing for the night and informed them that they were double billing us for the return. The preparer was friendly, but clearly did not understand what my concern was. She kept trying to say that they had to charge us upfront because we owed back taxes and the IRS would very likely take the whole refund and might not allow any fees to be extracted.

I went round and round with the preparer for at least 10 minutes and could not get her to understand that they were billing us twice. She acted very condescending and kept saying “How can I make you understand?” and “You just don’t understand what I’m trying to tell you.” She was friendly and the disagreement was not heated, but it was very frustrating. Finally she called a corporate office in South Carolina for clarification but could not get through to anyone. Then she called her store manager who told me the same thing as the preparer: that they had to charge us because of the back taxes.

I continued trying to make the preparer understand that because they had already charged us \$67.50 in cash and because \$67.50 was still listed on the bank form (as a fee to be withheld) the taxpayer would be charged twice. I also told them I didn’t have a major problem paying \$67.50 twice, it was a really low fee to begin with. I just wanted them to acknowledge the fact that they were billing us twice. In all honesty I don’t think the preparer understood the issue and double charging us was not intentional, they just didn’t think to remove the fee from the bank form after we paid up front.

Finally another preparer came over and said “Ok, I understand what you are trying to say, that you are being charged twice. The way it works is the IRS will automatically delete the \$67.50 because you already paid it to us.” I said “Thank you for finally acknowledging my concern which is all I really want.” Our preparer laughed and said to the new preparer: “Well where have you been all this time? You do a better job of explaining than I do!”

I then told the new guy that I had absolutely zero confidence that the IRS would actually do that (delete the fee). How would they even know the fee was already paid? It wasn’t listed as paid anywhere except the handwritten receipt we were given. That’s when he said “Well it doesn’t matter. Even if IRS does withhold the \$67.50 you have a receipt you can show them as proof you already paid us.” My reply was “Well that’s a huge inconvenience, why should we have to deal with the hassle of fixing your mistake?” His reply was “Well that’s just the way our computers are set up, we can’t change them.”²⁰ This whole aftermath ended up taking about 20 minutes.

20 This problem with Drake Software charging hidden fees to tax payers was documented in the 2010 National Community Law Center RAL study. See Wu, C. & Fox, J. (2010). *Major Changes in the Quick Tax Refund Loan Industry: The NCLC/CFA 2010 Refund Anticipation Loan Report*. Boston, MA: National Consumer Law Center.

SUMMARY OF "MYSTERY SHOPPER" VISIT TO T & R TAX

April 15, 2011

Mystery Shopper: DR
Occupation: artist
Total Income: \$3,841
Qualifies for: Earned Income Tax Credit, Making Work Pay Credit

Store: T & R Tax, Rio West Mall, Gallup, NM 87305

Total Charges: \$148.05 in fees
\$37 Schedule C
\$100 Form 1040
\$11.05 tax

Summary of Visit:

DR visited the T& R Tax on April 15th. T & R Tax is located next to T & R Pawn & Jewelry in the Rio West Mall in Gallup New Mexico.

When DR asked about the cost of the return, he was told that there are no free estimates provided. But preparer said she would do one for the taxpayer as a courtesy. This was also the only business we have seen that clearly displays fees for all forms. When asked about her qualifications to prepare taxes, the preparer stated that there is an in-house training that recruits are invited to (not open to the public). The preparer has an accounting degree and stated that they look for people with accounting or business backgrounds.

The taxpayer resides in Albuquerque, but agreed to ride with me to Gallup to have his taxes completed at T & R Tax. The taxpayer brought a notebook listing various business expenses. The preparer was curt, mildly unfriendly, and rushed through process at times. She was fairly thorough in the beginning though, and asked a decent amount of intake questions. Interesting Observation: The business is set up to do a large volume of tax returns. There were 15 intake stations where taxpayers are initially screened and statements are collected. They are then told to sit in the waiting area while workers in the back input information into computers, and are then called back when returns are ready.

The visit went fairly smoothly until the preparer hastily completed SCH C-EZ and missed over \$1,000 of expenses the taxpayer had provided. When I pointed this out she became visibly agitated and began questioning the expenses in a condescending tone as follows:

- She repeatedly questioned the legitimacy of his mileage expense stating that he could not claim commuter miles (irrelevant because taxpayer is self-employed and was claiming business miles not commuter miles).
- She stated sales tax was not deductible. I told her it was and she said “No it’s not.” Finally she checked with a supervisor who confirmed that it was.

She had to change the Schedule C twice and by the second time was visibly irritated. By this time she rushed through the process of explaining the return and never even explained to the taxpayer how he needed to send his payment voucher and check in for tax owed. Then, when we got our packet, we found out that the preparer failed to include a copy of the Schedule C-EZ among the copies of the other documents in her packet. We also were only given a hand written receipt, and no detailed invoice.

These places are not used to people who ask questions or have any prior knowledge of the tax code. They definitely do not appreciate having their mistakes pointed out and really appear to resent it when they have to fix their own mistakes.

Probably the most alarming incident occurred when she told the taxpayer to sign a Power of Attorney form. Apparently they use Powers of Attorney instead of a bank product consent form to have refunds sent to their office. They even put their (T & R Tax) mailing address on the customers return.

I told her taxpayer didn’t need to sign a Power of Attorney because he wasn’t getting a refund anyway. She said “Oh yeah, that’s right” and had to reprint the return to show taxpayer’s address.

APPENDIX B: ISSUES FOUND WITH PAID TAX RETURN PREPARERS

ID#	Federal Refund Amount	State Refund Amount	Total Refund Amount	Total fees - tax prep, bank product, etc.	% of total refund	Qualified for EITC?	Provided Copy of Tax Return	Issues	Accepted Cash Only?	Software problems?
1	\$6,537	\$230	\$6,767	\$252	4%	Yes	Yes	Tax preparer did not know how to enter income from 1099-T; taxpayer had to wait a day to pick up a paper return; when checked paper return, someone else's W-2s were attached; tax preparer didn't claim tuition income from Form 1099-T.		
2	\$1,232	\$151	\$1,383	\$273	20%	Yes	No	Preparer did not know what to do with Form 1099-T; tax preparer said that RAC would provide access to refund faster than direct deposit.		
3	\$4,139	\$483	\$4,622	\$308	7%	Yes	Yes	Tax preparer did not know where to enter dividend income from a 1099 composite form; preparer failed to enter \$2,831 in Unemployment Insurance payments; tax payer was inaccurately qualified for EITC; taxpayer given a RAC by default; preparer stated that a RAC was safer than direct deposit into a bank account; preparer told taxpayer, "Oh, they are just forms. If I get \$4,000, I am not going to ask a lot of questions. I just want it!"		
4	owed	owed	owed	\$159	NA	No	Yes	No problems. 15% Native American discount offered.		
5	\$2,247	\$359	\$2,606	\$168	6%	No	No	Preparer offered mysterious discounts that she could not explain; preparer said federal employees don't pay social security; preparer did not give copies of tax returns to taxpayer; preparer took personal calls while completing tax return.	told cash only	
6	\$298	\$71	\$369	\$294	80%	Yes	Yes	No problems. Tax preparer pushed Second Look Review and Peace of Mind Guarantee.		
7	\$1,631	\$2,010	\$3,641	\$177	5%	No	No	Tax preparer did not know how to handle a direct rollover to a Roth IRA; tax preparer made up expenses for the Schedule A and did not ask for documentation of any expenses claimed; tax preparer told taxpayer he could fully exclude his income for the purposes of state taxes because he was an enrolled tribal member.		Yes

APPENDIX B: ISSUES FOUND WITH PAID TAX RETURN PREPARERS CONT'D

ID#	Federal Refund Amount	State Refund Amount	Total Refund Amount	Total fees - tax prep, bank product, etc.	% of total refund	Qualified for EITC?	Provided Copy of Tax Return	Issues	Accepted Cash Only?	Software problems?
8	owed	\$56	\$56	\$182	325%	No	Yes	Tax preparer had difficulty with the Schedule C form; Tax preparer failed to include Cost of Goods Sold; Tax preparer forgot to give customer 1040 payment voucher.		
9	\$3,880	\$381	\$4,261	\$198	5%	No	Yes	Taxpayer given a RAC by default; Tax payer not told about direct deposit option or asked to sign consent form for a RAC; Tax payer was double billed due to a software glitch; documents and forms requiring signatures not adequately explained.	told cash only	Yes
10	owed	\$162	\$162	\$148	91%	No	No	Tax preparer did not know how to expense a Schedule C-EZ specifically in relation to sales tax and mileage; preparer speeded through the return and failed to explain how to send payment in; preparer failed to include copy of Schedule C-EZ among copies of return; preparer was rude and abrupt when errors were pointed out; tax payer told to sign Power of Attorney form.		
11	\$442	\$210	\$652	\$48	7%	No	Yes	Tax preparer did not have PTIN; preparer did not take proper precautions for protecting confidential data; preparer was going to charge \$50 for a questionable e-file procedure; preparer claimed to use her bank account for a RAC-like option.		Yes
12	\$3,642	\$273	\$3,915	\$290	7%	No	No	Preparer did not know how to calculate traditional IRA and SEP IRA contributions; taxpayer charged for unnecessary Auto Expense worksheet; software glitches causes major delay in the input of tax prepayments; open office floor provided no protection for taxpayer confidentiality; taxpayer was told he was not entitled to a copy of his tax return; preparer made erroneous assumptions about taxpayer's self-employment income, expenses and deductions that caused numerous errors and delays.		

APPENDIX C: DISCLOSURE OF TAX FEES

ID#	EITC	Total return, Fed and State	Total tax prep fees	% of total refund	General verbal estimate given?	Wall Sign Indicating Fee Breakdown?	Itemized Receipt Given?	Fees Paid Matched Verbal Estimate?	Fee Paid for 1040?	Fee Paid for EITC
1	Yes	\$6,767	\$252	4%	Yes	No	No	No	No detailed breakdown of fees acquired	No detailed breakdown of fees acquired
2	Yes	\$1,383	\$273	20%	Yes	No	No	No	\$89.98	\$37.78
3	Yes	\$4,622	\$308	7%	Yes	No	No	No	No detailed breakdown of fees acquired	No detailed breakdown of fees acquired
4	No	owed	\$59	NA	Yes	No	No	No	\$60.00	NA
5	No	\$2,606	\$68	6%	Yes	No	No	No	\$77.25	\$55.00
6	Yes	\$369	\$94	80%	Yes	Yes	No	No	No detailed breakdown of fees acquired	NA
7	No	\$3,641	\$77	5%	Yes	No	No	No	No detailed breakdown of fees acquired	NA
8	No	\$56	\$82	325%	Yes	No	No	No	\$96.00	NA
9	No	\$4,261	\$198	5%	Yes	No	No	No	No detailed breakdown of fees acquired	NA
10	No	\$162	\$148	91%	Yes	Yes	No	No	No detailed breakdown of fees acquired	NA
11	No	\$652	\$48	7%	Yes	No	No	Yes	\$48.00	NA
12	No	\$3,915	\$290	7%	Yes	No	No	No	No detailed breakdown of fees acquired	NA





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