Comments of the

National Consumer Law Center
(On behalf of its Low-Income Clients)

and

Consumer Federation of America
U.S. Public Interest Research Group

Regarding

Notice of Proposed Rulemaking
Amendments to Section 7216 Regulations and Revenue Guidance

26 CFR Part 301

[REG-137243-02]
RIN-1545-BA96

and

Revenue Procedure 2005-93
[Notice 2005-93]

These comments are submitted by the National Consumer Law Center (on behalf of its low income clients),[1] Consumer Federation of America,[2] and U.S. Public Interest Research Group[3] regarding proposed changes by the Internal Revenue Services (IRS) to its regulations implementing Section 7216 of the Internal Revenue Code, 26 U.S.C. § 7216. As you know,

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[1] The **National Consumer Law Center, Inc. (NCLC)** is a nonprofit organization specializing in consumer law issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys around the country, representing low-income and elderly individuals, who request our assistance with the analysis of consumer cases to determine appropriate claims and defenses their clients might have. As a result of our daily contact with these practicing attorneys, we have seen numerous examples of victimization, embarrassment, identity theft, countless hours spent cleaning up credit records, and other harms that result from inadequate safeguards of consumer information and lack of privacy protections. It is from this vantage point – many years of dealing with the abuses of unfettered sharing of private information thrust upon the less sophisticated and less powerful in our communities – that we supply these comments. Fair Credit Reporting (5th ed. 2002) is one of the eighteen practice treatises that NCLC publishes and annually supplements. We also issue annual reports on the tax refund anticipation loan industry and have commented before of the need for privacy protections for taxpayers. These comments were written by Chi Chi Wu, Staff Attorney, and are submitted on behalf of the Center's low-income clients.

[2] The **Consumer Federation of America** is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education.

[3] **U.S. PIRG** serves as the federal lobbying office for the state Public Interest Research Groups, which are non-profit, non-partisan public interest advocacy organizations.

Section 7216 governs how tax preparers may use and disclose confidential taxpayer information. The statute is highly protective of taxpayer information, prohibiting any tax preparer from disclosing return information or using it for any other purpose than preparing the taxpayer's return. Congress apparently considered these protections necessary because of the extremely sensitive and confidential nature of tax return information, which often can reveal all of a taxpayer's innermost financial secrets.

The IRS has heralded the proposed changes to the Section 7216 regulations as updating the safeguards for taxpayer information, suggesting that the changes improve privacy protections. Unfortunately, we do not agree. While we applaud the IRS for making a few improvements, such as requiring consent for off-shoring of taxpayer information, we believe the proposed rule actually significantly reduces overall privacy protections for taxpayers.

This reduction of privacy protections is especially troubling given the largely voluntary nature of the U.S. tax system. Our system depends on taxpayers providing detailed personal financial information to the federal government in order to ensure accurate payment of taxes, the lifeblood of government. Erosion of public confidence in the security and privacy of that information undercuts the pact between taxpayers and their government to keep this information safe, creating fears that the information will be exploited by identity thieves, database brokers, and public and private entities intent on fishing expeditions into taxpayers' financial lives.

The proposed rule must be significantly revised in order for it to provide real protections for taxpayer privacy. In particular, we urge that:

1. The IRS should eliminate the exception allowing tax preparers to obtain the taxpayer's consent to use confidential tax return information to cross-market ancillary products.

2. If a consent exception is still permitted, the IRS must improve the requirements for such consent so that it is truly meaningful and knowing.

3. The IRS must not allow preparers to use the consent exception to disclose return information to third parties for marketing purposes. The IRS proposed changes to the exception will permit tax preparers to sell databases of highly sensitive and personal information to the highest bidder.

4. Some of the exceptions for disclosure without consent should be narrowed.

5. The IRS should ask Congress to increase the penalties for violation of Section 7216 and to give taxpayers the right to seek redress when their rights are violated.

1. **There Should Be No Consent Exception for Marketing Based On Tax Return Information.**

The IRS continues to permit tax preparers to use confidential taxpayer return information to sell ancillary products, such as refund anticipation loans (RALs), to consumers. All that the tax preparer needs to obtain for this marketing is the taxpayer's signature on a piece of paper (an

easy task for the reasons discussed in the next section). In fact, the IRS is now proposing to expand the consent exception for marketing by letting third parties use it, as discussed in section 3 of this comment.

Instead of expanding the consent exception for marketing, the IRS should eliminate it. The ability of tax preparers to use highly private and sensitive tax return information to market ancillary products to consumers does more harm than good for taxpayers. It is especially harmful because of the high level of trust that exists in the relationship between taxpayers and their paid preparers.

Taxpayers rely heavily on paid preparers, which creates an enormous potential for exploitation. As one tax preparer described: "Throughout my tax preparation career, I have found that there is an extremely strong trust relationship between the preparer and his or her client . . . . However, this preparer – client trust relationship can present opportunities for abuse."[4]

U.S. Senator Norm Coleman has made a similar observation, noting: "your tax preparer probably knows more about your personal life than your best friend. We cannot allow this kind of trust relationship to be betrayed by the tax preparer or the company for a financial gain that occurs at the expense of their client."[5]

It is this trust relationship plus the current consent exception for marketing that has enabled the growth of the $1 billion refund anticipation loan (RAL) industry. Without the exception, preparers could only offer RALs to those who actively sought the loans. Thus, the consent exception is partly responsible for the ability of preparers to actively pitch these high cost, high risk loans with triple digit APRs to mostly low-income taxpayers, especially Earned Income Tax Credit (EITC) recipients. Eliminating the consent exception would reduce RAL volume tremendously, saving hundreds of millions for taxpayers.

In addition to RALs, tax preparers sell other unrelated financial products such as Individual Retirement Accounts, mortgages (including potentially subprime mortgages) and investment products. In fact, the largest commercial preparation chain, H&R Block, is expanding its business model based on cross marketing using tax return information and the strong trust relationship between a taxpayer and preparer.[6] Block publicly has boasted about its ability to exploit confidential tax information. In an interview with *American Banker*, Block CEO Mark Ernst stated that Block advisors know "virtually everything" about their clients' financial lives, so "we can use it to their advantage and our advantage to customize advice unique to their financial situation." Mr. Ernst is further quoted as stating, "Clients are willing to share their information. We have a relationship with millions of clients who come to our door

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[4] Statement of Pat Eckelberry before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.

[5] Opening Statement of Senator Norm Coleman U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.

[6] Peter Tufano and Daniel Schneider, *H&R Block and "Everyday Financial Services,"* Harvard Business School, October 2004, at 3.

once a year, and when they come to our doorstep, they bring all their personal information and effectively pay us to update our database."[7]

If the consent exception for marketing is not eliminated, it should be greatly curtailed. For example, the use of tax return information for cross-marketing should be limited to identity information. Thus, preparers could cross-market to taxpayers because the taxpayers were their customers, but could not exploit the highly confidential and sensitive financial information contained in a tax return to sell other products to the taxpayer. Also, the consent exception should be limited to marketing that occurs *after* the end of the tax preparation session, a sort of cooling down period. Tax preparers could pitch products to their clients, but should be required to wait at least 24 hours instead of soliciting taxpayers during or immediately after the tax preparation session when the taxpayer is at her most vulnerable state of confidence.

2. **The Format of the Consent Document Must Be Improved So That Consent Truly is Given on a "Knowing" Basis.**

If the consent exception for marketing is retained, the IRS must at a minimum vastly improve the form of consent. The fundamental problem with the consent exception for marketing is that taxpayers often do not give their consent as an affirmative, conscious and deliberate act. Even with all the protections of the current regulation, the consent form or forms become just another piece of paper to be signed by taxpayers.

We appreciate the new protections added by the proposed revenue procedure (pursuant to 26 C.F.R. § 301.7216-3(a)(3)) to consent forms, such as minimum type size, mandatory warning language, and minimum page size. These protections are a good start to ensuring that preparers do not bury a consent provision *within* a document by using small fonts, confusingly technical or arcane lingo, or placing it inconspicuously in the middle of a long document.

However, the IRS should go further in ensuring that consumers truly give their consent, as the proposed regulation requires, on a "knowing" basis. The currently proposed standards in the revenue procedure do not ensure that consumers will give consent "knowingly". Even though it will be a stand alone document, the consent form will become another document in a stack of papers thrust upon taxpayers at the end of a long process.

The key issue is that receiving a form versus having the chance to actually read, digest and understand it are completely different things. The consumer may not be given the chance to review the consent form. For instance, the lead plaintiff in one RAL case, *Hood v. SBBT*, recounts how she was rushed through the process and told to "sign here and here" so that her paperwork could go in the next "batch".[8]

Even without such overt rushing, very few consumers are willing to make a tax preparer wait so that she can read every page in a stack of documents. Tax preparers get paid by the return. Every minute the preparer is waiting for a consumer to read the paperwork is a minute

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[7] David Breitkopf, "H&R Block CEO Touts Cross-Sales Goals, American Banker, May 9, 2003, at 11.

[8] *See* Complaint, Hood v. Santa Barbara Bank & Trus*t*, Case No. 1156354 (Cal. Super. Ct. County of Santa Barbara March 18, 2003), available at www.consumerlaw.org/action_agenda/cocounseling/content/s_barbara_case.pdf.

the preparer is not spending working on the next customer's return. The social and psychological pressure is for the customer to display trust of the preparer by signing quickly.

The consumer also probably has little inclination to read the entire stack of documents. After all, she gets this paperwork after probably waiting for a significant amount of time to see a preparer, and spending a fair amount of time just getting her return prepared. Many clients go to a tax preparer's office after a long day at work or may have small children with them. If a taxpayer is going to review anything, it likely to be her tax return, not the consent form.

Furthermore, even if she wanted to read the consent, the taxpayer may not be able to do so. Many taxpayers, especially the low wage workers who receive the EITC, may have limited education and literacy skills.[9] They may also be limited English proficient. About 1 in 20 adults in the U.S. are non-literate in English, or about 11 million people. Overall, 14% of adults have below basic literacy skills.[10]

Moreover, the timing of the consent is often an issue. We note that proposed § 301.7216-3(b)(1) imposes a new requirement that the taxpayer's consent be obtained *before* any marketing pitches. We support that requirement. Currently, taxpayers are solicited for products such a RAL *during* the tax preparation process, but preparers might not give the consumer the paperwork until the *end* of the process, after the consumer has committed herself to getting the product. According to a former employee of a commercial chain "[w] hile the paperwork disclosure of the fees and finance charges [for a RAL] was thorough, it came after the verbal sales presentation."[11]

Ensuring that preparers give taxpayers the consent for cross-marketing is important because once a consumer has agreed to buy a product, she is unlikely to back out as a result of a consent form or any other paperwork, because she has psychologically committed to product. As one consumer put it, after having told the tax preparer she wanted a RAL "at this point, I was confused and didn't feel like I could change my mind because she had already finished all the paperwork."[12] Another consumer stated "I was under the impression that having made my choice it was too late to back out of it."[13]

An important issue will be ensuring that preparers abide by the requirement to obtain the taxpayer's consent before any marketing pitches. Interestingly, the requirements for electronic signatures in the proposed revenue procedure at § 5.02 are less vulnerable to this issue because the process leaves an electronic trail that can be checked to see if the consent is given first.

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[9] For example, an estimated 46 to 51% of the general population and 76% of food stamp recipients do not have adequate literacy skills to complete the multiple tax forms necessary to claim the EITC itself. Michael O'Connor, *Tax Preparation Services for Low Income Filers*, 90 Tax Notes 231, January 8, 2001.

[10] National Center for Education Statistics, National Assessment of Adult Literacy: A First Look at the Literacy of America's Adults in the 21st Century, Dec. 15, 2005.

[11] Statement of Pat Eckelberry before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.

[12] Statement of Julie Burbach before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.

[13] Statement of Maerine Henderson before the U.S. Senate Permanent Subcommittee on Investigations, Hearing On Tax Related Financial Products Can Be Costly, April 15, 2005.

Furthermore, the protections required for electronic consent forms are superior in another way. They require active entry of unusual information instead of a signature, which can be routinized. Given the superiority of the electronic consent form, the IRS should require similar measures for non-electronic consent forms. This would not be a difficult task, given that the vast majority of commercial preparation firms use software programs for their preparers to enter data and produce a tax return. The IRS should require protections similar to those for electronic consent forms to be built into such software programs.

Thus, the IRS should require that the software for commercial preparation forms include a consent screen. The screen must be shown to the consumer. The IRS should require the text of the consent to be read aloud by an audio output (thus ensuring they are understood by taxpayers with limited literacy skills). The screen would be required before any marketing pitches and the software program would not permit paperwork for a cross-marketed product to be generated without the consent "signature" being completed. The taxpayer would actively need to indicate consent by typing in her name or entering her Social Security Number. She would be required to check off boxes for multiple uses and multiple disclosures using the computer keyboard, and these uses and disclosures must be read to her out loud.[14] The IRS would need to audit the software of the major commercial chains as well as the providers of software for independent preparers (e.g. TurboTax Professional or Taxwise) to ensure these requirements are met.

Finally, even with the strictest rules, the creativity of the human mind is unlimited and can create consent forms that appear to be something other than an agreement to be cross-marketed. For example, one consent screen for an on-line program was titled "Consent to Receive Personalized Tax Tips and Information," misleading consumers into believing they were receiving tax advice and obscuring the fact that the consumers were agreeing to waive privacy rights. The method to address new forms of subterfuge is a simple one from Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45(a)(1), *i.e.*, a generalized standard prohibiting deception in consent forms. An anti-deception standard in the consent rule would be flexible enough to respond to new schemes by preparers.

3. **The Proposed Changes to the Privacy Rule Permit Sale of Taxpayer Return Information to the Highest Bidder.**

The most disturbing change in the proposed regulation from the current regulation relates to the ability of tax preparers to make disclosures of return information to third parties for marketing purposes. In particular, the proposed regulations:

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[14] An example of similar heightened protections to ensure knowing and meaningful consumer consent is the Federal Trade Commission's Telemarketing Sales Rule provision governing "free-to-pay" transactions. These are transactions in which a consumer agrees to a trial offer, the company already has the consumer's credit card number, and it is up to the consumer to cancel after the "free" trial offer. These transactions are considered to pose such a great risk of harm that the FTC instituted the following special protections to obtain consumer consent, all of which the telemarketer must meet: 1) obtaining the consumer's express agreement to be charged using a particular account number; 2) requiring the consumer to recite at least the last four digits of the account number to be charged; and 3) making an audio recording of the entire telemarketing transaction not just a verification after the initial sales pitch. 16 C.F.R. § 310.4(a)(6).

- Removes the "affiliated group" restriction, i.e., the restriction that limit cross-marketing using return information to only products offered by the tax preparer or its affiliated entities.
- Authorizes disclosure of an entire return at 26 C.F.R. § 301.7216-3(d).
- Retains the ability of tax preparers to disclose tax return information to third parties with the taxpayers' consent, at 26 C.F.R. § 301.7216-3(d).

The combination of these provisions means that tax preparers are free to seek consent to give tax return information to third parties for the purpose of having these third parties solicit the taxpayers. Once in the hands of a third party, the protections of Section 7216 will not apply.

Note that there is no prohibition against preparers receiving compensation for disclosing taxpayer return information to third party. Thus, removal of the "affiliated group" restriction would give tax preparers the green light to seek consent to sell confidential, highly personal tax information to the highest bidder.

For example, a tax preparation office could compile all of the information in the tax returns of clients who signed a consent form. Such an aggregation of data would be a simple effort give that many preparers store returns into electronic format. The preparer could compile an extremely rich database -- a veritable gold mine -- of information on its clients, including income, residence, employer, number and age of children, homeownership, mutual fund investments, charities to whom the taxpayer contributes, even the name of the taxpayer's day care provider. These databases could then be sold to data brokers, such as ChoicePoint (the infamous data broker that sold confidential information to identity thieves).

Since the data broker is not a tax preparer, it would not be bound by Section 7216 or the regulation. It is free to use the information as it pleases subject to other federal laws that are much less protective. It could sell the tax return data to companies for the purpose of marketing any number of products to the taxpayer. For example, the same database could be used to market college savings plan to a taxpayer whose returns show minor children, mutual funds to a taxpayer whose returns show other mutual fund investments, or even new cars to taxpayers with older cars who deduct vehicle expenses (since the age of the taxpayer's car is included in IRS Form 2106). It could also be sold to a large debt collection agency or creditor who would now have the location of the assets and bank accounts for any debtors.

Given the recent highly publicized instances of data security breaches by data brokers, credit card processors, financial institutions, and merchants, we are astounded that the IRS has proposed changes that would remove the lone barrier to data brokering by tax preparers.[15] Surely the IRS would not want to be remotely responsible for a data security breach involving tax return information in the future.

Finally, we find that the rationale for the proposed changes, *i.e.*, that they allow taxpayers "to control and direct the use of their own tax return information as they see fit" to be extremely

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[15] For a listing of these data breaches, *see* Privacy Rights Clearinghouse, A Chronology of Data Breaches Reported Since the ChoicePoint Incident, available at www.privacyrights.org/ar/ChronDataBreaches.htm.

naive. Taxpayers do not get the opportunity to "control and direct" the use of their return information. As discussed in the last section, taxpayers get a piece of paper stuck in a stack of papers they are instructed to sign by preparers upon who the taxpayers depend and trust. The informational and power disparities between a preparer and a taxpayer make the idea of the taxpayer directing the preparer on information sharing ludicrous.

4. **Disclosures Without Consent.**

The IRS has created a number of new exceptions in 26 C.F.R. § 301.7216-2, which do not require the consent of the taxpayer. We are troubled by some of these exceptions:

> *Disclosures to IRS to facilitate electronic tax administration (*§ 301.7216-2(b)). This exception is too broad. It permits sharing of taxpayer information for the extremely expansive purpose of "assisting in the administration of electronic filing programs." Such as an exception could include any number of reasons, so long as they are somehow related to electronic filing, such as promoting or marketing of e-filing services. This exception should be limited specific necessary purposes, such as investigation of compliance by electronic return originators.
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> *Disclosures to federal agencies (*§ 301.7216-2(f)(4)(i)). This exception permits a tax preparer to share return information when *any* federal agency issues an administrative order, summons, subpoena or *demand*. This last provision allowing for disclosures upon "demand" is too broad, because it could be interpreted to allow any federal agency to simply ask for tax return information even if the agency does not have authority to issue formal legal orders compelling information disclosure (*e.g*. a subpoena or administrative order). Furthermore, it is not limited to demands for information in defined circumstances, such as criminal investigations, investigations of return preparers, etc. For example, this exception could be interpreted as allowing the Department of Homeland Security to issue informal "demands" from tax preparers of any return information in the preparer's files associated with Individual Taxpayer Identification Numbers. This exception should be limited to formal legal orders requiring information disclosure within the agency's legal authority to compel, and only for specific purposes related to criminal investigation or tax administration purposes.
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> *Disclosures for statistical information or for audits of return preparers (*§ 301.7216-2(o) and § 301.7216-2(f)(5)). These purposes do not necessarily require disclosing the personal identifying information of the taxpayer. Thus, these exceptions should require that taxpayer identifying information (name, address, SSN) be redacted from the returns unless there is some compelling reason why the identity of the taxpayer is necessary for statistical or audit purposes.
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> *Disclosures for payment (*§ 301.7216-2(l)). This exception allows preparers to use tax return information to obtain payment from a taxpayer to the extent necessary to process the payment. This exception should make clear that it does NOT apply to debt collection activities by the preparer or efforts to seek delinquent payments. The IRS should not

permit tax preparers to use confidential tax return information, *e.g.* name of employer or bank account numbers, to seize assets of a taxpayer.

5. **Enforcement of Section 7216.**

The current enforcement scheme under Section 7216 provides penalties that are simply too weak to provide a real deterrence for violating the privacy rights of taxpayers. We urge the IRS to seek legislation from Congress to increase the penalties under Section 7216 and to establish a right for taxpayers harmed by privacy violations to seek redress from tax preparers.

The current penalty for a criminal violation of Section 7216 is a $1,000 fine or one year imprisonment or both. Furthermore, the government must prove that the violation was "knowing or reckless" -- a high standard to meet. For many tax preparers, the $1,000 penalty would be insignificant compared the profits to be made by trading in taxpayer information. According to the Department of Labor's cost of living calculator, that $1,000 fine, adopted in 1971, is now the equivalent of just $204. Increasing it to $4,800 would account for inflation through 2005. As for the one year imprisonment, while it might seem significant, we question how often it is actually imposed to create a real deterrent. We note that a search of the Westlaw state and federal database found no published cases in which a preparer was given a prison sentence for violation of Section 7216.

The proposed rule revises §301.7216-1(a) to note that there is also a potential civil penalty available under Section 6713. However, like the criminal fine, the civil penalty -- $250 per violation with a cap of $10,000 -- is too small in amount to be an effective deterrent. Again, the $250 penalty adopted in 1988 is now worth only about $150. More importantly, the $10,000 cap is insignificant for a commercial preparation chain. Not only is $10,000 in 1988 is worth less than $6,000 now, but it is a drop in the bucket compared to the millions they earn in cross-marketing ancillary products.

In addition to increasing the criminal and civil monetary penalties for Section 7216 violations, IRS should ask Congress to establish a private right of action for taxpayers whose privacy rights have been violated. Several decades of collective experience in the field of consumer rights has taught us that the most effective deterrent is to arm the consumer herself with the ability to seek redress from the offender. Given its limited staffing and budget, the IRS does not have the resources to pursue and bringing enforcement action against every tax preparer who violates Section 7216. Lack of enforcement essentially renders nugatory any rights under Section 7216, depriving injured taxpayers of any remedy for privacy violations. Rights without a remedy are a toothless paper tiger.

Conclusion

Given the enormous technological advances in electronic information gathering and sharing, and the disturbing security data breaches that have occurred, it is ever more important to protect the privacy of consumer information. There is no more critical area, and no more sensitive financial information, than a consumer's tax return.

In light of these developments, the IRS role should be to increase protections for taxpayer privacy. While the proposed rule does so in a few respects, such as requiring consent for off-shoring of information, it also decreases protections. The IRS needs to go forward, not backwards, in taxpayer privacy protections.