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The Future of Taxes is Now!

Andrew Duncan

Brigham Young University, chaselarsonmsr@gmail.com

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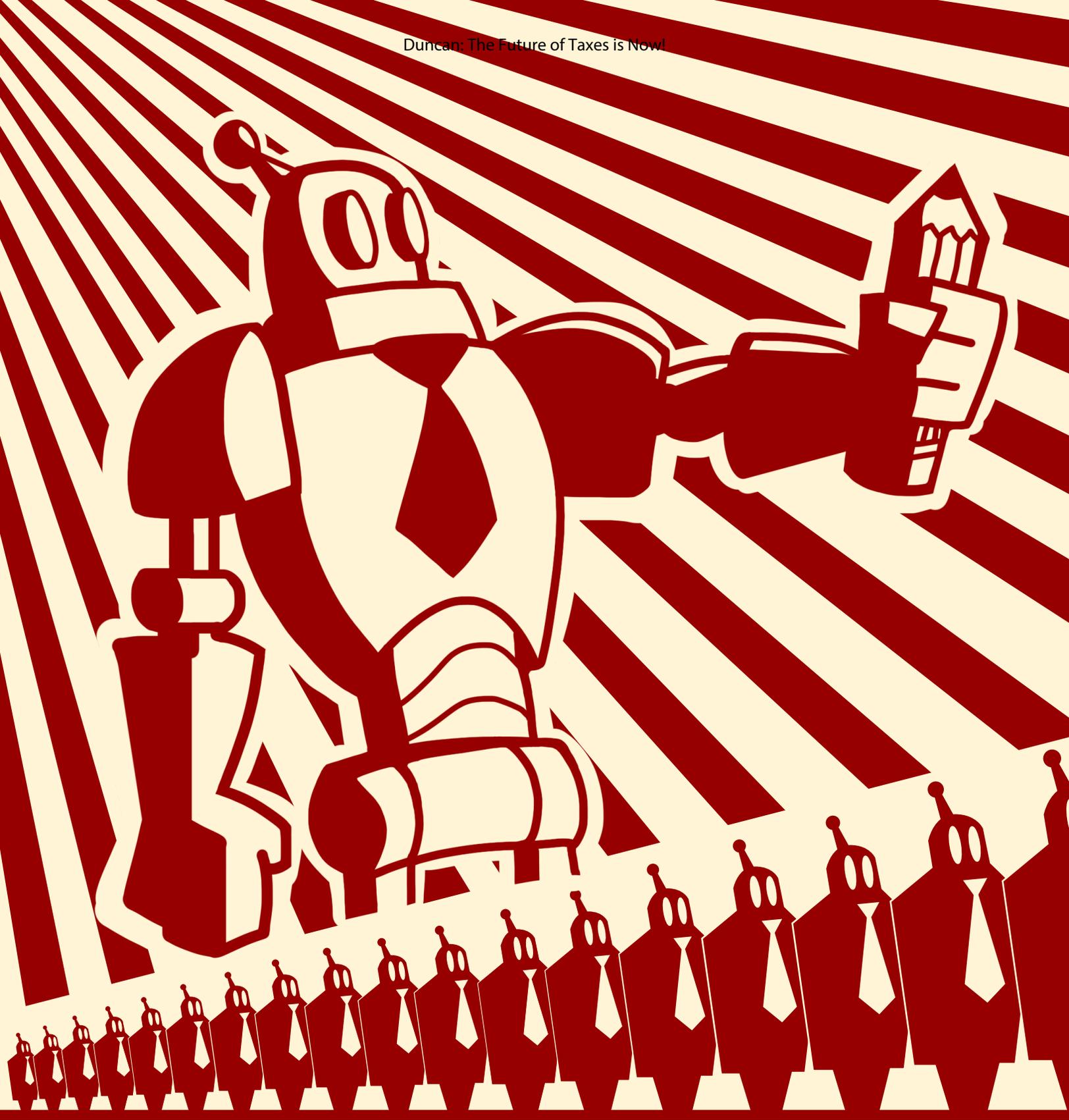
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THE FUTURE OF



TAXES IS NOW!

BY ANDREW DUNCAN

Who really enjoys doing their taxes? According to Pew Research, “34% like or even love doing their taxes” while 56% said they dislike doing their taxes due to the complicated process and the amount of time it takes to file their taxes.¹ For this reason, tax professionals have always been necessary, but the trend is slowly shifting. Modern technological advances have created self-preparation software, like TurboTax, that is cheaper than seeing a professional and easier than tax filing once was. The professional tax industry is changing, and as a result, industry consolidation has led to fewer professionals who need to prepare tax returns each year.

More work for the existing base may appear to be a good sign, but the fact is there are fewer jobs available, fees are staying the same or decreasing, and a greater number of households are switching from tax professionals to self-preparation software. When surveying the landscape, taxpayers quickly discover that they have more options than ever when it comes to filing their returns, leading to massive industry consolidation and a need for greater efficiency for tax professionals, lower switching costs for households, and more stringent regulation on tax professionals. The rise of tax software and tax help programs have forced professionals to find a differentiation factor or value-added service, otherwise they are forced to lose to the machine of do-it-yourself software.

MARKETPLACE: THEN VERSUS NOW

Throughout history, governments have enacted taxes as a means to pay for things from infra-

structure to wars. The government needs money to function and to provide its citizens safety and peace. As a result, a marketplace was created with the opportunity for professionals to take advantage of their technical accounting skills and tax knowledge. Financial advisement and tax preparation services were created to help reduce the tax liability that individuals and corporations owe the government. Since the creation of this space, taxes have been disproportionately filed by tax professionals until this relatively new emergence of personal tax software which has disrupted the industry.

TAX PROFESSIONALS

Households have three traditional avenues to choose from when they file their taxes. They can file through (1) a CPA or a tax preparation franchise, (2) tax filing software, or (3) free tax filing programs like VITA (Volunteer Income Tax Assistance). For decades, tax professionals were seen as the best option to prepare and file taxes due to complex laws and regulations that were constantly changing; in addition, the tax laws were tedious and time-consuming to figure out.

SOFTWARE RELATED CONSOLIDATION

The use of software has drastically reshaped the tax industry. Tax software wasn't widely available until the late 1990's and early 2000's with the advent of the computer and the internet. The IRS began allowing e-filing in 1990 with only 4 million using this method.² In a space once dominated by pen and paper, last tax season finished with 92% of all returns filed using e-file software, leaving only 8% submitted via paper. This shift is something people never would have foreseen 20 years ago.³

Tax software, used by households and professionals, has triggered a significant

shift in market demand. Households continue to demonstrate a need for tax professionals, but that percentage is slowly declining. Self-preparation software has taken more than a third of the market which has contributed to wiping out more than half a million jobs.⁴

Software has allowed individuals to prepare their own returns rather than seek professional help. Mark Cussen's article, “The Gloomy Future of the Tax Preparation Industry” indicates that roughly 160 million households filed during 2012; of those, 60% used tax professionals, 30% used self-preparation tax software, and 10% used other programs like VITA.⁵ Software has taken hold of a market once dominated by professionals. In a matter of 10 years, market share for self-preparation software went from nearly 0% to 30%, which translates to nearly 48 million households performing their own taxes in 2012 and that number is quickly growing.⁶ In 2018, the market share for self-preparation software had increased to 38%.⁷

Increased productivity from the use of tax software drove an increase in the overall number of returns performed by professionals. Between 2004 and 2013, the average number of returns done by individual tax preparers went from 64 to 122. The material increase in tax software usage, both for professional and personal purposes, has forced a massive consolidation in the market, reducing the tax professional workforce from 1.23 million in 2004 to 663 thousand by 2013.⁸ Fewer preparers are being forced to perform roughly the same amount of work which has created a great deal of strain as fewer professionals are entering the work force. Figure 1 showcases the decline in the labor force as the number of returns is increasing. The number performed by each professional has increased drastically over this 10-year period.⁹

A bevy of software options are now available that were not previously accessible. In the early 2000's only a handful of companies

Tax Professionals and Returns

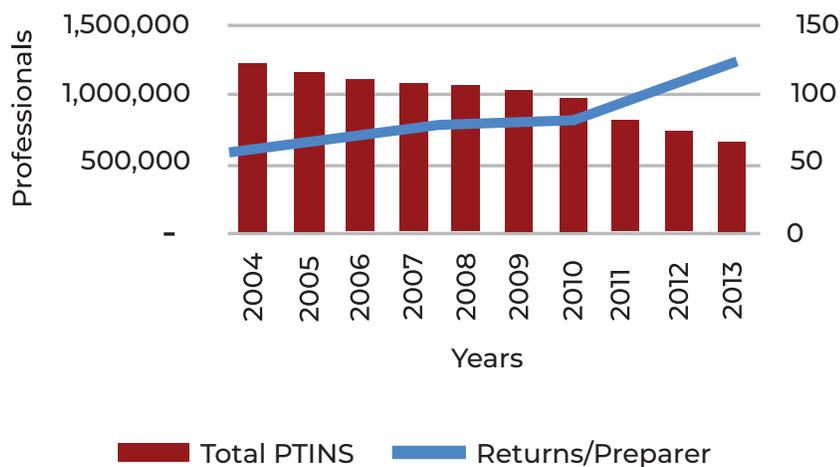


Figure 1: Returns Filed by Tax Professionals is Increasing

Data Source: <https://www.irs.gov/pub/irs-soi/13resconreturnprepar.pdf> and prepared by writer

provided an e-file option. Now, there are too many to count. According to The Journal of Accountancy, in the 2018 tax software survey, the individual product survey responses for the top five tax software products, for professionals, by market share are Ultra Tax CS (19.1%), Lacerte (17.5%), CCH ProSystem fx (16.4%), Drake (14.3), and ProSeries (12.7%).¹⁰ These services differ from self-preparation options in that they allow tax professionals to perform the following functions:

- Perform state returns from all 50 states as well as federal returns
- Generate a larger number of forms
- Research various laws and line items
- Manage client files and tax returns (current and previous)
- Add carry over items from previous years (i.e. previous year's tax return; federal and state amounts)
- Invite clients to submit documents electronically, allowing the system to populate data automatically for preparers

- Provide tax planning insight and suggestions for future years¹¹

Self-preparation software primarily provides households a limited number of filing options, such as automating part of the process and fulfilling state and federal filing requirements. Professional versions may cost substantially more but they include a variety of options to simplify and enhance a tax professional's arsenal. As far as self-preparation software goes, TurboTax has by far the largest foothold at 65% of total market share, followed by H&R block and TaxAct.¹²

REGULATION

The Internal Revenue Service required all tax professionals to register with the federal government and obtain a unique identification number, also known as a Preparer Tax Identification Number (PTIN).¹³ In addition to obtaining a PTIN, the IRS requires that tax professionals be attorneys, CPAs, or complete continuing education requirements of 15 hours per year to maintain a good level of understanding of current tax laws.¹⁴ The implementation of PTINs ensures greater safety for households

seeking professional help due to greater barriers to entry such as education. The requirement of PTINs could also further advance the decline in the number of tax professionals because the government requires a high degree of training, education, and certification.

ADD-ON SERVICES AND MARKET DEMAND

Tax professionals maintain high, fixed costs compared to other industries, including leases, utilities, advanced software for preparation (e.g. ProSeries, a \$7000-a-year software investment), CTEC certification or CPA license, advertising, wages, and more. In order to stay afloat, these expenses need to be met, but with tax software's suffocating fee prices, tax professionals may soon need to find a new line of work.¹⁵ Tax professionals must utilize their customer base to add-on additional services such as auditing, bookkeeping, financial planning, etc. to remain relevant in the changing business landscape.

These services can save clients the headache of doing it themselves and can generate substantial income for preparers in the process. According to IBISWorld, tax professionals on average generate earnings before interest and taxes (EBIT) of 22.3%.¹⁶ Margins have expanded primarily due to the fallout brought about from industry consolidation and the add-on of these higher margin services. Add-on services typically don't require marketing or advertising since the customer is typically already there. Add-on services will continue to take on an increasingly important role for tax preparers to stay relevant in an ever changing marketplace.

These professionals have the proper training, licensing, and experience to ensure services are done correctly and are up to date with new regulatory changes. Each year, the IRS releases a new tax code and

requires tax preparers who are not CPAs, enrolled agents, or tax attorneys to pass an annual ethics test and complete 15 hours of continuing education to ensure quality work.¹⁷ According to the IRS, paid preparers make a math error 1.3% of the time, whereas self-prepared errors occur 6.8% of the time.¹⁸ These numbers decrease with the e-filing process to .6% and 1.1% respectively.¹⁹ Tax professionals maintain relevance due to lower error rates on complex returns and the additional services they provide.

Traditionally, the target market for tax professionals has been anyone who needs their taxes done; the introduction of software has changed that. According to IBIS-World, customer base for tax professionals consists primarily of individuals with income more than \$74,999, with a smaller portion dedicated to businesses, and non-profits making over \$75,000.²⁰ IBIS-World concludes that households with income less than \$30,000 are price sensitive and have been targeted by organizations using free services as a hook to generate demand.²¹ Households with income from \$30,000 to \$74,999 are typically looking for ways to maximize their deductions and have more disposable income than lower income brackets to spend on tax professionals.²² However, this income bracket has been targeted by self-preparation services due to higher levels of education, tech savviness, and a willingness to try and do their own taxes.

MOVING FORWARD

Individual and business taxation will continue. As a result, professionals can expect increasing competition from other firms and self-preparation tax software. Customers have an increasing number of alternatives for tax preparation, from self-preparation software across different platforms to tax professionals. Preparers will need to differentiate themselves

through add-on services, marketing, professionalism, relationships, and dependability in order to maintain relevance and profitability. Otherwise, they may find themselves looking elsewhere for work.

CONCLUSION

Advancement in tax software has dramatically shifted the tax preparation industry with businesses and households moving away from tax professionals to self-preparation tax software. Software has increased efficiencies for both professionals and self-preparers alike. The increased efficiency and ease of use has drastically reduced the amount of opportunities available to professionals to differentiate themselves. The work force in this industry has faced significant pressure and has nearly been cut in half in a matter of only a few years.²³

The future remains uncertain as tax professionals continue to fight an uphill battle against new changes in the market. Professionals must focus on key relationships and introduce new services such as financial planning, bookkeeping, and audit work to retain clients and remain relevant. 

Notes

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⁴"Income Tax Return Statistics."

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¹²Cussen, "The Gloomy Future Of The Tax Preparation Industry."

¹³Julia Kagan, "Preparer Tax Identification Number – PTIN," accessed March 20, 2019, <https://www.investopedia.com/terms/p/ptin.asp>.

¹⁴Kagan, "Preparer Tax Identification Number – PTIN."

¹⁵Duncan, interview.

¹⁶Marisa Lifschutz, "Tax Preparation Services in the US," IBIS-World, August 2018, <https://clients1.ibisworld.com/reports/us/industry/currentperformance.aspx?entid=1399>.

¹⁷Cussen, "The Gloomy Future Of The Tax Preparation Industry."

¹⁸Langetieg, Payne, and Vigil, "Return Preparer Industry Analysis."

¹⁹Langetieg, Payne, and Vigil, "Return Preparer Industry Analysis."

²⁰Lifschutz, "Tax Preparation Services in the US."

²¹Lifschutz, "Tax Preparation Services in the US."

²²"Income Tax Return Statistics."