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ABSTRACT

This Article analyzes the "TurboTax defense" under section 6664(c) of the Internal Revenue Code. The Article addresses the issue of whether reliance on computer tax software may be permitted as reasonable cause in good faith exempting taxpayers from the accuracy-related penalty of section 6662(a). It suggests (1) the courts have missed an opportunity to clarify when a TurboTax defense is justifiable, (2) the software companies, in conjunction with the IRS, should work together to promote a more equitable, efficient, and effective use of computer tax software, (3) the Treasury should promulgate detailed guidelines or regulations establishing when a TurboTax defense can be used by an individual taxpayer, (4) the IRS should consider offering taxpayers the option of assessing their tax due or refund owing, and (5) the current informal partnership between the software companies and the IRS should be critically assessed to address advances in software technology and increasing taxpayer reliance on commercial tax preparation software.

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I. THE BIRTHPLACE OF THE "TURBOTAX DEFENSE"

The "TurboTax defense" has its origins rooted in the laughter at the 2009 congressional testimony of Timothy F. Geithner surrounding his nomination for Secretary of the U.S. Treasury.[1] Geithner was subsequently confirmed, and as one of his many functions, was in charge of the Internal

1. *See Nomination of Timothy F. Geithner: Hearing Before the S. Comm. on Fin.*, 111th Cong. (2009), http://permanent.access.gpo.gov/gpo5024/619271.pdf [hereinafter *Geithner Hearings*].

Revenue Service, a bureau of the U.S. Department of Treasury, until January 25, 2013.[2] Before his 2009 nomination, Geithner worked for the International Monetary Fund (IMF).[3] During his period of employment with the IMF, he received several W-2 wage statements, all of which did not contain federal, state, or FICA tax withholdings (i.e., Medicare and Social Security).[4] This was because the IMF, as an international organization, was exempt from FICA withholding requirements under section 3121(b)(15).[5] It was also a policy of the IMF not to withhold taxes.[6] As a consequence, IMF employees like Geithner were responsible for remitting their own federal, state, and FICA taxes on their income.[7]

During the years 2001 through 2004, Geithner received W-2 statements from the IMF, and because he mistakenly believed he was a regular employee, he failed to remit self-employment taxes on his IMF

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2. *See Timothy F. Geithner*, COUNCIL ON FOREIGN REL., last accessed Sept. 13, 2013, http://www.cfr.org/experts/latin-america-and-the-caribbean-business-and-foreign-policy-financial-markets/timothy-f-geithner/b4076/bio. In 2001, Mr. Geithner left the Treasury Department and went to work for the Council on Foreign Relations temporarily. *Id.* He also became the director of the Policy Development and Review Department of the IMF, where he worked from 2001 to 2003. *Tim Geithner*, U.S. DEP'T OF THE TREASURY, last updated Jan. 26, 2013, http://WWW.treasury.gov/about/history/Pages/tgeithner.aspx. He was succeeded by Jacob. J. Lew, who was confirmed as the new Secretary on Feb. 27, 2013. Press Release, *Jacob J. Lew Confirmed as Secretary of the Treasury*, U.S. DEP'T OF THE TREASURY, Feb. 27, 2013, http://www.treasury.gov/press-center/press-releases/Pages/tg1864.aspx.

3. *Geithner Hearings*, *supra* note 1, at 5.

4. *Id.* at 208 (Committee Staff Memorandum submitted by Senator Grassley). Mr. Geithner also had other tax issues. He had amended his tax returns to pay additional taxes and interest

> for infractions, such as an early-withdrawal penalty from a retirement plan, an improper small-business deduction, a charitable-contribution deduction for ineligible items, and the expensing of utility costs that went for personal use. The other cloud for Mr. Geithner involved an immigrant housekeeper whose work-authorization papers expired during her tenure working for [him].

Jonathan Weisman, *Geithner's Tax History Muddles Confirmation*, WALL ST. J., Jan. 14, 2009, http://online.wsj.com/article/SB123187503629378119.html.

5. I.R.C. § 3121(b)(15) (excluding service for an international organization from the definition of "employment" with respect to which FICA imposes a tax).

6. *Geithner Hearings*, *supra* note 1, at 208 (Committee Staff Memorandum submitted by Senator Grassley).

7. *Id.* ("IMF employees are responsible for meeting their own tax obligations, including federal income taxes, state income taxes and self-employment taxes. The IMF provides employees with several documents throughout the year to help employees understand and meet their tax obligations.").

income.[8] Such was the case even though his IMF income was "grossed-up" each year by a special tax allowance provided by the IMF to assist in paying his federal and state income tax obligations, as well as the employer's portion of social security taxes.[9] Furthermore, Geithner certified (more than once) that he would pay his self-employment taxes when he applied for the allowances.[10] Finally, he had been advised by a colleague at the IMF to pay his self-employment taxes.[11] Notwithstanding the aforementioned, relying on

8. *Id.* at 4, 13–14 (*Mr. Geithner*: "I paid income taxes, taxes on my W-2 income, as I always had done so. I believed, mistakenly, that I was supposed to file as an IMF employee, as I would normally file tax as an employee generally. Now, that was a mistake. As I look back at all the documents that I provided to the committee in response to your careful questions, it was very clear, both in the initial documents the IMF staff gave me to explain the way the IMF system worked, in the quarterly statements I received from the IMF, in the annual tax forms I received, in all those documents, looking back, it was very clear. But when I made that initial mistake and I failed to correct it initially, I repeated it over the times I had income from the IMF, even in those years where a tax preparer prepared my returns. In 2006 when the IRS conducted its audit, I went back and hired an accountant to help me work through that problem, and I paid what the IRS auditor at that point said I owed. Now, if I had thought about it more carefully at the time and I had asked more questions, I would have gone back and asked a bunch more questions about that, and I would have approached it differently. But as I said in my opening statement, these were careless mistakes, they were avoidable mistakes, but they were completely unintentional. I take full responsibility for them. Again, I apologize for putting you in the position where you have to spend so much time looking through these questions, particularly now.").

9. *Id.* at 47 (*Senator Bunning*: "I have found that the IMF goes to great lengths to make sure that employees comply with their U.S. tax obligation. One current IMF employee, who describes himself as a 'lifelong Democrat,' called my office to express his disbelief that you did not know about it. Every year, you had to file a written request for a gross-up payment to the Social Security tax. I have one of the statements you signed right here. It says, 'I hereby certify that I will pay the taxes for which I have received tax allowance payments.' You provided this to the committee. But why did you not provide it to your accountant when he was preparing your returns for the 2003 tax year?" *Mr. Geithner*: "Senator, as you said, I provided that form to the committee. I absolutely should have read it more carefully. I signed it each year. I signed it in the mistaken belief that I was complying with my obligations. And you are right that this is my responsibility. In those years that my accountant prepared my returns, he also did not catch my error. But those are my responsibilities, not his."). It is worth noting that any sort of "gross up" in income to pay for taxes would also be gross income under section 61, subject to federal, state, and FICA taxes.

10. *Id.*

11. *Id.* (*Senator Bunning*: "This individual called me and explained that you were counseled to pay self-employment tax, but you and your accountant later ignored that advice. Can you explain why this person — why did you ignore her

his own judgment and that of his tax accountant, Geithner failed to pay self-employment taxes as required by law.[12] It was not until a 2006 audit by the IRS that he finally acknowledged his easily avoidable, and presumably unintentional, "mistake."[13]

During the January 2009 nomination hearings for Treasury Secretary, he was questioned about the special tax allowances he received from the IMF to assist in the payment of his taxes. It was then that reliance on TurboTax[14] hit national recognition as a plausible legal argument for tax penalty avoidance.[15] The pertinent testimony at the hearing was as follows:

> Senator Grassley. Did you receive statements with these checks that indicated the amount of the allowance that should be used for income and self-employment taxes? If yes, why did you remit your income taxes but not your self-employment taxes? . . . .
>
> Mr. Geithner. I did not, and I should have. I mistakenly believed that I was meeting my obligations fully, including self-employment taxes, but I did not prepare my returns in a way that caught that mistake initially.
>
> Senator Grassley. Did you use software to prepare your 2001 and 2002 tax returns?
>
> Mr. Geithner. I did.
> Senator Grassley. You did not?
> Mr. Geithner. I did.
> Senator Grassley. Oh, you did?
> Mr. Geithner. Yes.

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advice at the IMF?" *Mr. Geithner*: "Senator, I relied on the judgment of my accountant. I should not have relied on that judgment. That is my responsibility, not theirs.").

12. *Id.*

13. *Id.* at 14, 46 (*Mr. Geithner*: "Senator, the first time I learned that I had not met my obligations to pay self-employment tax, this was when I received the notice from the IRS auditor that they had conducted an audit of my tax returns. As I said, I took that extraordinarily seriously. That was the first time I was made aware that I had not complied. Until that point, I felt I had complied.").

14. While there are numerous tax preparation software companies out there, only two companies provide the tax software used by the vast majority of individuals who prepare and file their own returns electronically. This consumer software is TurboTax and H&R Block at Home (formerly TaxCut). *See infra* notes 73–75 and accompanying text.

15. *See Geithner Hearings*, *supra* note 1, at 15.

> Senator Grassley. All right. Which brand did you use? [Laughter.]
> Mr. Geithner. I will answer that question, Senator, but I want to say, these are my responsibility, not the tax software's responsibility.
>
> Senator Grassley. All right.
> Mr. Geithner. But I used TurboTax to prepare my returns. [Laughter.]
> Senator Grassley. Did the software prompt you to report income and pay self-employment taxes on your IMF income?
>
> Mr. Geithner. Not to my recollection, Senator.[16]
> Senator Grassley. If yes—well, not to your recollection.[17]

It is clear from the above congressional testimony the soon-to-be Secretary was assuming full responsibility for his omissions and not directly placing responsibility on the tax software for his failure to manually enter self-employment taxes into the software.[18] His statement has also been the primary position of the U.S. Tax Court towards tax preparation software as discussed in *Bunney v. Commissioner* stating, "[t]ax preparation software is only as good as the information one puts into it."[19] In many respects, Geithner was merely reiterating this general rule, most likely reading the *Bunney* case beforehand. Although, as discussed herein, there are now two more-recent Tax Court cases where taxpayers have had limited success in avoiding the accuracy-related penalty by asserting a "software defense" (referred to herein as the "TurboTax defense").[20] The majority of cases on the other hand have been tremendously unsuccessful in asserting a viable TurboTax defense. Although, as will be discussed in greater detail in this Article, creative arguments could have been made in many cases that taxpayers did in fact reasonably rely on the tax software to accurately prepare their returns and the software failed to do so. Unfortunately, however, the courts have missed the opportunity to clarify exactly when such a defense is warranted, and the IRS (and the Treasury) has also failed to

16. *Id.* If Mr. Geithner were doing his taxes today with TurboTax, he would have received such a prompt. *See infra* notes 243–44 and accompanying text.

17. *Geithner Hearings*, *supra* note 1, at 15.

18. *See id.*

19. 114 T.C. 259, 267 (2000). *See also infra* Part IV.D.2.b.

20. *See* Thompson v. Commissioner, 94 T.C.M. (CCH) 24, 25, T.C.M. (RIA) ¶ 2007-174, at 1201 (2007); Olsen v. Commissioner, T.C. Summ. Op. 2011-131, 2011 WL 5885082, at *3 (Nov. 23, 2011). *See also infra* Part IV.A.

make any substantive contributions in the area of penalty relief when tax software is involved.

In Geithner's case, however, he never directly asserted a TurboTax defense for penalty relief. He also never went to the U.S. Tax Court or the IRS Appeals Office to dispute his tax issues any further, but rather he merely paid up in light of his own clear negligence.[21] Nevertheless, even though he was negligent with no colorable excuses, he ended up paying no penalties whatsoever.[22] For the two years he was audited, 2003 and 2004, he paid additional taxes and interest and the IRS agreed to waive all penalties.[23] With regard to the tax years 2001 and 2002, although the statute of limitations on assessment had expired,[24] Geithner "voluntarily" amended his returns upon learning of his candidacy for Treasury Secretary, again paying only his applicable share of taxes and interest (and no penalties).[25] According to his testimony, the IRS initially assessed penalties for the tax years 2003 and 2004, but advised him to apply for a waiver, as this was a "'common' problem" among IMF employees.[26] The IRS thereafter granted his waiver

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21. *Geithner Hearings*, *supra* note 1, at 65 (*Mr. Geithner*: "Senator, as you said, an IRS audit is an extremely serious thing. I took it very seriously. I looked very carefully at what they said I owed. I paid what they said I owed. As I said to you many times, when I think back on it now I should have asked a lot more questions. I should have taken more care in considering it at the time. But when the IRS conducts an audit and they tell you that this settles your obligations, I paid what they said I owed.").

22. *Id.* at 62 (*Mr. Geithner*: "You are right. I had many opportunities to see it, but having missed it initially, I kept missing it." *Senator Kyl*: "Thank you for that. That was not really the point I was trying to make. What a lot of my constituents have said is, obviously there is no defense that 'I just missed it' when you are audited by IRS. In fact, most people, even if they have a relatively small obligation, pay a penalty on that. That is another issue about why, in effect, somebody in your position received what could be considered preferential treatment without having to be penalized.").

23. *Id.* at 207 (Committee Staff Memorandum submitted by Senator Grassley).

24. *Id.* at 66 (*Senator Kyl*: "But that is different from the question I just asked you. You are not now then saying that it did not occur to you, prior to your nomination, that you might also have an obligation for 2001 and 2002, which is barred by the statute of limitations. Is that correct?" *Mr. Geithner*: "Senator, of course I was aware of the fact that I had began work at the IMF in 2001 and 2002, but again, I did what I thought was the right thing to do at that time, which is, the IRS told me what I owed—").

25. *Id.* at 207 (Committee Staff Memorandum submitted by Senator Grassley).

26. *Id.* at 63 (*Mr. Geithner*: "When the IRS conducted its audit and told me what I owed, their initial assessment included an assessment of penalties. But at that point they explained to me—and I paid those penalties initially, as you would expect

application.[27] Even President-elect Obama at the time weighed in on the thorny issue at a press conference on January 14, 2009, stating, among other things,

> "Look is this an embarrassment for him? Yes. He said so himself. But it was an innocent mistake. It is a mistake that is commonly made for people who are working internationally or for international institutions. It has been corrected. He paid the penalties."[28]

President Obama and the press must have been unaware of the penalty waiver Geithner received.

Notwithstanding the above factual background, the urban legend of tax and penalty avoidance commonly referred to as the "TurboTax defense"[29] was born. Recall that Geithner stated in his own words, "I did not prepare my returns in a way that caught that mistake initially."[30] In other words, the very nature of the software "made me do it."[31] Whether a consequence of a high-profile figure avoiding penalties, or his stature as the highest-ranking official at the Treasury, taxpayers in the Tax Court quickly began asserting various versions of a "If Geithner could do it, why can't I?" defense.[32]

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me to do. But at that point they explained to me that they had found this to be a—they used the word, I think, 'common' problem and they encouraged me to apply for a waiver of my penalties, and they subsequently granted that waiver. But that was a judgment they made. That just goes to the point, I think, that they felt this was a common enough problem that it was not unusual in my circumstances.").

27. *Id.*

28. *Obama: Geithner Will Be Confirmed at Treasury*, NBC NEWS.COM, Jan. 15, 2009, http://www.nbcnews.com/id/28674350/ns/politics-white_house/t/obama-geithner-will-be-confirmed-treasury/#.UZ0ViKW2d68.

29. All references to the TurboTax defense in this Article are not limited to the brand TurboTax but also include any other brand of commercial tax preparation software used by taxpayers.

30. *Geithner Hearings*, *supra* note 1, at 15.

31. Presumably, Mr. Geithner was implying that TurboTax did not catch the error of assessing self-employment tax on his IMF earnings because they were stated on a W-2 statement, rather than on a Form 1099. As a result, he was not prompted by the program to enter social security taxes. *See infra* notes 243 - 244 and accompanying text.

32. *See, e.g.*, Lam v. Commissioner, 99 T.C.M. (CCH) 1347, 1349, T.C.M. (RIA) ¶ 2010-82, at 507 (2010) ("At trial Ms. Lam did not attempt to show a reasonable cause for petitioners' underpayment of taxes. Instead, she analogized her situation to that of the Secretary of the Treasury, Timothy Geithner. Citing a Wikipedia article, Ms. Lam essentially argues that, like Secretary Geithner, she used TurboTax, resulting in mistakes on her taxes."); Parker v. Commissioner, T.C. Summ. Op. 2010-78, 2010 WL 2507529, at *7 n.15 (June 21, 2010) ("We shall

The thesis of this Article is that the courts and the IRS need to properly address through penalty relief the increasing taxpayer reliance on tax preparation software. Under certain circumstances the taxpayer should be provided with equitable relief. Relief not from the underlying tax due, of course, but rather from the various applicable penalties imposed by the IRS—specifically the accuracy-related penalty which applies in many cases involving tax software. This Article analyzes the various court cases where some form of a "software defense" (a.k.a. TurboTax defense) was asserted by taxpayers to avoid penalty application.[33] We suggest the Tax Court missed several opportunities in these cases to provide relief where equity warranted such. Tax preparation software has become so widespread among taxpayers in recent years that the existing body of tax law surrounding its usage falls incredibly short. Consumer tax software has become the new norm among taxpayers far surpassing the old-school pencil and paper return submissions and gaining equal status to returns prepared by professional return preparers.[34] In response to such, we recommend that the Treasury promulgate detailed regulations (or amend existing regulations) to adequately address when taxpayers should and should not be able to use tax software as an equitable defense to the accuracy-related penalty. At the moment, the Code, its regulations, and other administrative pronouncements are entirely silent on the aforementioned issue. As discussed in greater detail herein, since the IRS benefits from the use of tax software by taxpayers, the IRS correspondingly should assume some of the risks associated with the

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address briefly petitioner's contention that the IRS granted 'favorable treatment' in a case involving U.S. Secretary of the Treasury Timothy Geithner, which petitioner described as 'incredibly similar' to the instant case. According to petitioner, 'there should not be different, or favorable rules for the well-connected.'"). *See also* vertical equity discussion *infra* Part V.D.

33. Many of the cases involving such assertions are in nonbinding Tax Court summary opinions. The U.S. Tax Court issues three types of opinions: regular decisions, memorandum opinions, and summary opinions. Regular decisions and memorandum decisions constitute legal precedent. Regular decisions typically involve cases that involve issues of first impression or unusual points of law, whereas memorandum decisions involve the application of existing law or an interpretation of the facts. *See Taxpayer Information: After Trial*, U.S. TAX CT., last updated Oct. 18, 2011, http://www.ustaxcourt.gov/taxpayer_info_after.htm. In the past, memorandum decisions were not accorded the same degree of precedential weight as regular decisions but now the distinction between the two is not so much of an issue. Taxpayers with disputes involving $50,000 or less (including penalties) can petition to have their cases heard by the Small Cases Division of the U.S. Tax Court under section 7463(a). If a taxpayer decides to pursue this route, however, the court issues a summary opinion and the decisions entered may not be reviewed by any other court and cannot be used as legal precedent for any other cases under section 7463(b).

34. *See* statistics *infra* notes 56–60 and accompanying text.

software's usage. Furthermore, while the IRS and software companies may have worked well in the past, they need to retool their relationship so that it promotes more equitable, efficient, and effective use of tax software by taxpayers. We also suggest that in the future more-radical action might also be warranted to address the issue of tax software, such as simplifying the Code or having the IRS summarily assess the tax due or refund owing of individual taxpayers.

Part II of this Article discusses the history, types, and methodology of computer software and illustrates its growing widespread usage and taxpayer dependence. Part III of the Article discusses the current statutory and regulatory rules governing the accuracy-related penalty, including the reasonable cause and good faith exception thereto. Part IV analyzes the various Tax Court decisions and suggests that while the courts have generally correctly decided these cases, they could have been more instructive in the application of what the law should be. Part V advocates that while the IRS and software companies may have worked well in the past, more needs to be done to promote accuracy, security, privacy, reliability, and fairness in the tax system, including establishing software specific regulations or guidelines addressing penalty relief. Part VI looks to the future and advocates a complete tax overhaul as one solution to the tax software dilemma or the adoption of either a domestic federal taxing model similar to the state of California, where the state determines the tax of certain low-income taxpayers, or a foreign taxing model similar to that of Singapore, where the government assesses the tax of its taxpayers. Part VII summarizes by providing a brief conclusion.

II. THE EVOLUTION OF TAX SOFTWARE

As the tax system becomes more complex, an increasing number of taxpayers have turned to their computers or to paid preparers to assist them with their returns.[35] In 1980, not a single individual taxpayer used computer software to prepare his or her return.[36] Today, more than nine in ten

35. *See* Lawrence Zelenak, *Complex Tax Legislation in the TurboTax Era*, 1 COLUM. J. TAX L. 91 (2010) [hereinafter Zelenak, *Legislation in the TurboTax Era*]. Zelenak argues the following: "In the past thirty years, computer software has revolutionized the preparation of federal income tax returns," *Id.* at 92, and, "Congress has responded by imposing unprecedented computational complexity on large numbers of taxpayers — primarily through the expanded scope of the alternative minimum tax and the proliferation of phase outs of credits, deductions, and exclusions," *Id.* at 91.

36. David Keating, *A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens*, NAT'L TAXPAYERS UNION, Apr. 17, 2012, http://www.ntu.org/news-and-issues/taxes/tax-reform/ntupp130.html [hereinafter Keating, *A Taxing*

individual income tax returns are prepared with the assistance of a paid preparer or computer software.[37] In addition, almost all professional tax preparers now use tax software.[38] The continued use of such software by consumers is only likely to rise in the foreseeable future.[39]

Trend]. The number of taxpayers using paid preparers "has soared by approximately two-thirds since 1980 and by roughly one-fourth since 1990." *Id.*

37. *Prepared Remarks of IRS Commissioner Doug Shulman Before the AICPA, Washington, DC*, IRS, Nov. 7, 2012, http://www.irs.gov.uac/Newsroom/Commissioner-Doug-Shulman-Speaks-at-AICPA-Meeting [hereinafter *Shulman Remarks*].

38. *Return Preparation and Filing Options*, IRS, last updated Sept. 3, 2013, http://www.irs.gov/Filing ("E-file is the norm."). The reason for this is a 2011 rule requiring many professional preparers to electronically file. The rules require any tax return preparer anticipating filing eleven or more 1040-type forms during the calendar year to use IRS e-file. All members of a firm must e-file if any one member of the firm meets the eleven or more threshold. Those who are subject to the e-file requirement are referred to as "specified tax return preparers." *See Most Tax Return Preparers Must Use IRS e-file*, IRS, last updated Sept. 4, 2013, www.irs.gov/Tax-Professionals/e-File-Providers-&-Partners/Most-Tax-Return-Preparers-Must-Use-IRS-e-file ("Even if you are an authorized e-file provider, clients for whom you prepare one of the returns identified above may choose to file on paper if the return will be submitted to the IRS by the taxpayer. As described in Rev. Proc. 2011-25, tax return preparers in this situation should obtain and keep a signed and dated statement from the client. Also, in this situation and in the cases of administratively exempt returns or returns filed by a tax return preparer with an approved hardship waiver, specified tax return preparers generally should attach Form 8948, *Preparer Explanation for Not Filing Electronically*, to the client's paper return.").

39. The big winners in this game are the tax preparers and the software companies. *See* Keating, *A Taxing Trend*, *supra* note 36 ("Nearly 80 percent of taxpayers with AMT [Alternative Minimum Tax] liabilities use paid preparers."). In addition, the piecemeal tax legislation and the new Medicare Taxes on net investment income make tax calculations more complex and result in the increased use of computer software. *See* Timothy R. Koski, *Tax Planning for the New Medicare Taxes*, 88 PRAC. TAX STRATEGIES 148 (2012); Zelenak, *Legislation in the TurboTax Era*, *supra* note 35. Interestingly, the IRS reported in 2009 that "the number of tax software providers appears robust, four companies dominate the market." INTERNAL REVENUE SERV., RETURN PREPARER REVIEW 10 (2009), http://www.irs.gov/pub/irs-utl/54419l09.pdf [hereinafter IRS PREPARER REVIEW]. But by 2012, two companies now dominate the consumer tax software market. *See infra* notes 73–75 and Part VI.B.

A. History and Current Statistics

During the first part of the twentieth century, only a small number of high-income Americans had any federal income tax obligations.[40] If taxpayers needed assistance with their taxes they could easily go into a local IRS office or hire an accountant, attorney, or other tax preparer.[41] By the end of World War II, however, more than 75 percent of Americans had an obligation to file a federal income tax return.[42] In order to satisfy the growing demand for taxpayer assistance, store front offices began to open in various parts of the country. For example, H&R Block started its first office in Kansas City in 1955 and currently has approximately 11,000 offices throughout the United States.[43] This type of convenience-store tax preparation service was further expanded in the early 1960s when local IRS offices no longer helped taxpayers prepare their returns.[44]

By the late 1970s and early 1980s, tax preparation software was developing,[45] and the news media began to report on this newfound technology.[46] Michael Chipman of San Diego, the founder of ChipSoft, Inc. (which later merged with Intuit, Inc. in 1993), first developed their tax

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40. *See* IRS PREPARER REVIEW, *supra* note 39, at 6, n.4. ("Less than six percent of Americans had an income tax obligation as late as 1939.").

41. *Id.* at 6.

42. *Id.* at 6 n.5.

43. *Profile: H&R Block Inc (HRB.N)*, REUTERS, last accessed May 27, 2013, http://www.reuters.com/finance/stocks/company/ Profile?symbol=HRB. H&R Block, Inc. currently provides tax preparation services via a nationwide network of approximately 12,000 company-owned and franchised offices in the U.S. and abroad. H&R BLOCK, 2013 ANNUAL REPORT 24. H&R Block, Inc. generated annual revenues of $4.4 billion in fiscal year 2008. H&R BLOCK, 2008 ANNUAL REPORT 1. Jackson Hewitt, which used to be the second-largest tax return preparation service, operates more than 6,800 company-owned and franchised offices, including 2,800 located in Walmart stores. They also are located in more than 400 Sears stores. *See About Us*, JACKSON HEWITT, last accessed May 28, 2013, http://www.jackson hewitt.com/About-Us/About-Us. They went bankrupt and have now been restructured. *See* Rachel Feintzeig, *Jackson Hewitt Hosts a Dance Party*, WALL ST. J. BLOG, Jan. 5, 2012, 1:07 PM, http://blogs.wsj.com/bankruptcy/2012/01/ 05/jackson-hewitt-hosts-a-dance-party/.

44. *See* IRS PREPARER REVIEW, *supra* note 39, at 6.

45. *See* Don Nunes, *Computer Programs Aid Tax Return Preparation*, WASH. POST, Feb. 14, 1983, at WB23.

46. *See, e.g.*, *id.*; Ellen Benoit, *The Tax Preparation Revolution*, FORBES, Jan. 17, 1983, at 69. *See also* John W. Hazard, *Doing Your Taxes by Computer*, U.S. NEWS & WORLD REPORT, Mar. 19, 1984, at 86; William D. Marbach, *Now, the Electronic Tax Man*, NEWSWEEK, Mar. 19, 1984, at 106; David E. Sanger, *Software for Doing Your Own Return*, N.Y. TIMES, Mar. 4, 1984, § 12, at 76 (articles published the following year in three of the country's leading magazines).

software—the forerunner to TurboTax—in the mid-1980s.[47] Three months of design work on the software in 1983 eventually resulted in $19 million in annual revenue by 1990.[48]

The first users of tax software were predominantly paid preparers.[49] In 1982, Jackson Hewitt Tax Services,[50] a competitor of H&R Block, required all of its preparers to use software for its individual tax returns.[51] This was an innovative and "radical" move.[52] By 1987, around 13 percent of paid preparers used tax software, and 48 percent of all individuals used paid preparers.[53] During the 1990s, software use was rapidly increasing, particularly among CPAs.[54] By 2012, nearly 100 percent of paid tax preparers used some form of tax software.[55]

In the early 1990s, 41 percent of individual taxpayers prepared their returns the old-fashioned way (i.e., with pencil and paper), 51 percent used paid preparers, and only 8 percent prepared their own returns on computers.[56] By the early 2000s, however, a dramatic transition had occurred. The number

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47. *Michael Chipman*, FORBES, last accessed May 28, 2013, http://www.forbes.com/profile/michael-chipman/. Intuit was founded by Scott Cook and Tom Proulx in March 1983, incorporated in California in March 1984, and in 1993, reincorporated in Delaware. They are publically traded and are listed in NASDAQ as INTU. *See Investor FAQs*, INTUIT, last accessed Sept. 14, 2013, http://investors.intuit.com/company-information/investor-faqs/default.aspx.

48. SUZANNE TAYLOR & KATHY SCHROEDER, INSIDE INTUIT: HOW THE MAKERS OF QUICKEN BEAT MICROSOFT AND REVOLUTIONIZED AN ENTIRE INDUSTRY 146–47 (2003) [hereinafter TAYLOR & SCHROEDER, INSIDE INTUIT].

49. Zelenak, *Legislation in the TurboTax Era*, *supra* note 35, at 94.

50. For more information on Jackson Hewitt, see *Jackson Hewitt, Inc. History*, FUNDING UNIVERSE, last accessed Sept. 14, 2013, http://www.fundinguniverse.com/company-histories/jackson-hewitt-inc-history/.

51. Daniel B. Grunberg, *Case Study: Information Technology at Jackson Hewitt Tax Service*, 15 J. CONSUMER MARKETING 282, 283 (1998).

52. *See* Zelenak, *Legislation in the TurboTax Era*, *supra* note 35, at 94.

53. Eric Toder, *Changes in Tax Preparation Methods, 1993-2003*, 107 TAX NOTES 759, 759 (May 9, 2005).[hereinafter Toder, *Changes in Tax Preparation Methods*].

54. *See* Tracey Anderson, Mark Fox & Bill N. Schwartz, *History and Trends in E-filing: A Survey of CPA Practitioners*, CPA J., (Oct. 2005), [hereinafter Fox & Schwartz, *CPA Survey*] (the survey indicated that 99 percent of respondents e-file the individual return and that the most popular tax preparation software used by CPAs include ProSystem fx, Lacerte, and UltraTax, which accounted for 80 percent of use).

55. *See Return Preparation and Filing Options*, *supra* note 38.

56. *See* Toder, *Changes in Tax Preparation Methods*, *supra* note 53, at 759; ERIC J. TODER, URBAN INST. & TAX POLICY CTR., RETURN-FREE TAX SYSTEMS AND TAXPAYER COMPLIANCE COSTS (2005), www.urban.org/uploadedpdf/900816_Toder_051705.pdf; IRS PREPARER REVIEW, *supra* note 39, at 7–8.

of taxpayers that manually prepared their own returns was reduced by two-thirds to only 13 percent.[57] Those taxpayers using tax preparers increased to 62 percent and 25 percent prepared their own returns on computers.[58] The sheer volume of returns by taxpayers using computers to prepare their individual returns has since then been increasing year-over-year at a rate of almost 12 percent.[59] By 2012, over 90 percent of individual returns were prepared with the assistance of a paid preparer or computer software.[60]

With the increase in software use, came the increase in electronic filing.[61] In 1986, the IRS adopted a pilot program for electronic filing.[62] In 1998, Congress passed the Internal Revenue Service Restructuring and Reform Act, setting forth the following goal: 80 percent of all returns should

57. Toder, *Changes in Tax Preparation Methods*, *supra* note 53, at 759.

58. *Id.*

59. ELEC. TAX ADMIN. ADVISORY COMM., ANNUAL REPORT TO CONGRESS 4 (2011), http://www.irs.gov/pub/irs-prior/p3415--2011.pdf [hereinafter ETAAC 2011 REPORT].

60. *Shulman Remarks*, *supra* note 37. *See also* ELEC. TAX ADMIN. ADVISORY COMM., ANNUAL REPORT TO CONGRESS 6 (2013), http://www.irs.gov/pub/irs-pdf/p3415.pdf [hereinafter ETAAC 2013 REPORT].

61. The use of computerized tax software and electronic filing significantly reduces the number of taxpayer errors and IRS processing costs as well as allowing the IRS to more efficiently integrate data. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-297, TAX ADMINISTRATION: MANY TAXPAYERS RELY ON TAX SOFTWARE AND IRS NEEDS TO ASSESS ASSOCIATED RISKS 5–7 (2009), http://www.gao.gov/assets/290/286461.pdf [hereinafter GAO-09-297] ("IRS estimates that processing an electronically filed return costs the agency $0.35 per return while processing a paper return costs $2.87 per return. Using IRS's current cost estimates based on fiscal year 2005 return data, we estimate IRS would have saved approximately $143 million if the 56.9 million paper returns in 2007 had been filed electronically. Electronically filed returns also have higher accuracy rates than paper-filed returns because tax software eliminates transcription and other errors. IRS processes electronically filed returns in less than half the time it takes to process paper returns, facilitating faster refunds.").

62. INTERNAL REVENUE SERV., ADVANCING E-FILE STUDY: PHASE 1 REPORT 91 (2008), http://www.irs.gov/pub/irs-utl/irs_advancing_e-file_study_phase_1_report_ v1.3.pdf [hereinafter IRS E-FILE STUDY #1]. The tax preparer community originated this idea where "private sector partners created the external infrastructure consisting of data entry software, origination networks for sending return records to transmitters, and transmission centers where returns were formatted, bundled, and sent to the IRS in batches over telephone lines." *Id.* at 13. "At that time, the IRS identified data standards and transmission standards and created a gateway for receiving batch transmissions of returns . . . ." *Id.* For a detailed chart on the history of e-file, see *id.* at 22 tbl. 2–6.

be filed electronically by 2007.[63] This has been interpreted to include only individual returns.[64] In 2011, the IRS ceased sending paper forms to taxpayers in an effort to further encourage the use of computerized tax preparation software and electronic filing.[65] The percentage of returns filed electronically nearly quadrupled over a ten-year period from 10.8 percent in 1993 to 40.5 percent in 2003.[66] It reached 46.8 percent by 2004.[67] In 2010, there were approximately 116 million tax returns filed electronically, and of those, 34.2 million returns were e-filed by taxpayers without the assistance of a paid preparer.[68] By 2012, 70.72 percent of the major return types were filed electronically,[69] and the estimated individual electronic filing rate was

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63. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 2001(a), 112 Stat. 685, 723. The 80 percent goal is derived from Title II, section 2001(a) as follows:

> (a) IN GENERAL. — It is the policy of Congress that —
>
> (1) paperless filing should be the preferred and most convenient means of filing Federal tax and information returns;
>
> (2) it should [b]e the goal of the Internal Revenue Service to have at least 80 percent of all such returns filed electronically by the year 2007; and
>
> (3) the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of such returns.

The 2007 goal was subsequently moved forward to 2012. *See* IRS OVERSIGHT BD., ELECTRONIC FILING 2007 ANNUAL REPORT TO CONGRESS 5–6 (2008), http://www.treasury.gov/irsob/reports/2008/2007_e-Filing_report.pdf.

64. IRS OVERSIGHT BD., ELECTRONIC FILING 2012 ANNUAL REPORT TO CONGRESS 7 (2012), http://www.treasury.gov/irsob/reports/2013/IRSOB~E-File%20 Report%202012.pdf [hereinafter IRS OVERSIGHT BD., 2012 REPORT].

65. Ed O'Keefe, *IRS to Stop Mailing Income Tax Forms*, WASH. POST, Sept. 27, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/09/27/ AR20 10092705058.html.

66. *See* Fox & Schwartz, *CPA Survey*, *supra* note 54, at Exhibit 1. CPAs who did not e-file started using software in 1993 and those who did e-file started four years later. *Id.*

67. *Id.*

68. *See SOI Tax Stats—Number of Returns Filed Electronically, by Type of Return and State—IRS Data Book Table 4*, IRS, last updated Mar. 25, 2013, http://www.irs.gov/uac/SOI-Tax-Stats-Number-of-Returns-Filed-Electronically,-by-Type-of-Return-and-State-IRS-Data-Book-Table-4 (follow "2010" hyperlink). These include taxpayers that prepared their tax returns using their personal computer and either completed their return online at the IRS website or purchased commercial tax preparation software, downloaded it onto their computer, prepared their returns, and transmitted them electronically to the IRS through an online filing company. *Id.* at n.4.

69. ETAAC 2013 REPORT, *supra* note 60, at 3.

slightly over 80 percent.[70] By fulfilling the congressional objective set in 1998 for individual returns, the IRS has indeed reached an historic moment.[71]

B. Types and Methodology

Numerous versions of tax software programs are readily available for purchase in the United States. Almost half of these are designed for those who self-prepare (consumer software), and about half are intended for the professional tax preparer (commercial software).[72] The most popular consumer software brands are TurboTax, H&R Block at Home (formerly TaxCut), and TaxACT.[73] About 60 percent of all individual taxpayers that use tax software use TurboTax and its share of the market has dramatically increased over time.[74] Its closest competitor is H&R Block at Home.[75] For CPAs, the most commonly used commercial software programs are ProSystem fx, Lacerte,[76] and UltraTax.[77]

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70. IRS OVERSIGHT BD., 2012 REPORT, *supra* note 64, at 7.

71. There were those who predicted that the IRS would never reach this goal. For example, Steven Holden, a former official in the Electronic Tax Administration at the IRS, noted in a report funded by the IBM Center for the Business of Government that the 80 percent e-file goal "was likely never attainable . . . [because] . . . the proportion of users who will not adopt an innovative technology, especially one involving the transmission of their tax data electronically to the IRS, surely exceeds 20%." *See* IRS IRS E-FILE STUDY #1, *supra* note 62, at 9 (alteration in original) (quoting STEPHEN H. HOLDEN, A MODEL FOR INCREASING INNOVATION ADOPTION: LESSONS LEARNED FROM THE IRS E-FILE PROGRAM 26 (2006)).

72. "We estimate the consumer software segment alone includes over thirty companies offering online software tools that enable taxpayers to self-prepare their individual returns . . . ." INTERNAL REVENUE SERV., PREPARED STATEMENT OF DAN MAURER, INTUIT, INC. 1 (2009) [hereinafter INTERNAL REVENUE SERV., STATEMENT OF DAN MAURER]. *See also* INTERNAL REVENUE SERV., ADVANCING E-FILE STUDY: PHASE 2 REPORT (2010), http://www.irs.gov/pub/irs-utl/irs_advancing_e-file_study_phase_2_report.pdf [hereinafter IRS E-FILE STUDY #2].

73. *See* GAO-09-297, *supra* note 61, at 3 n.5. 2nd Story Software, "a privately held development and marketing company," makes TaxACT. *Id.* In 2008, these top three software companies accounted for 88 percent of all returns filed electronically by individuals and accepted by the IRS. *Id.* at 25. Now the consumer industry is dominated by TurboTax and H&R Block at Home (formerly TaxCut).

74. *DIY U.S. Online Tax Prep Filings Up 11 Percent vs. Year Ago*, COMSCORE, May 31, 2012, http:www.comscore.com/Insights/Press_Releases/2012/5/DIY_U.S._Online_Tax_Prep_Filings_Up_11_Percent_vs._Year_Ago, [hereinafter COMSCORE].

75. *Id.* Intuit's TurboTax "represent[s] over half of the returns filed electronically by individual taxpayers." GAO-09-297, *supra* note 61, at 3.

76. Intuit runs Lacerte along with another commercial software called ProSeries. Intuit also runs three other consumer software program lines: Quicken, TurboTax, and QuickBooks. *See* Press Release, *Intuit Records Third-Quarter*

Consumer tax software is offered in several versions: retail,[78] online,[79] and in downloadable forms.[80] The software is generally sold using a tiered pricing structure that varies depending on the complexity of the return.[81] For example, TurboTax offers four versions: Basic,[82] Deluxe,[83] Premier,[84] and Home & Business.[85] H&R Block at Home also offers similar versions, but with different names: Basic ("Simple Tax Situations"), Deluxe ("Homeowners/Investors"), Premium ("Self-employed/Rental Property Owners"), and Premium & Business ("Small Business Owners").[86] The cost

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Revenue of $1.9 Billion, INTUIT, May 17, 2012, http://investors.intuit.com/press-releases/press-release-details/2012/Intuit-Records-Third-Quarter-Revenue-of-19-Billion/default. aspx.

77. *See CPA Survey*, *supra* note 54.

78. GAO-09-297, *supra* note 61, at 4, n.6 ("'Retail' indicates packaged tax software products purchased at a retail store.").

79. *Id.* ("'Online' indicates tax software programs that individuals use directly on a tax software company's Web site when preparing and filing their return."). TurboTax's online software allows a preview of the program. *Compare TurboTax Online Tax Software*, TURBOTAX, last accessed May 30, 2012, http://turbotax.intuit.com/personal-taxes/online/compare.jsp [hereinafter TURBOTAX, *Compare*]. This program will take all your information—even the most complicated return with foreign income, various capital gain calculations, self-employment, small business deductions, hobby income, hobbies, rentals, etc.—and generate an estimated tax refund/obligation, though of course all of the forms are withheld until the software is purchased.

80. GAO-09-297, *supra* note 61, at 4 n.6 ("'Downloadable' indicates a tax software program primarily available on a tax software company's Web site that individuals can purchase and then download directly to their computer to use later in preparing and filing their return.").

81. *See* TURBOTAX, *Compare*, *supra* note 79. For example, Intuit, Inc., the company that produces TurboTax, prices its software as follows: Basic $34.99; Deluxe $49.99; Premier $74.99; and Home & Business $99.99.

82. *Id.* This most basic version primarily applies to simple returns prepared on Form 1040-EZ with a standardized deduction.

83. *Id.* This is used by taxpayers claiming typical Schedule A deductions (e.g., home mortgage interest, real property taxes, charitable contributions, etc.).

84. *Id.* This is used by taxpayers owning rental properties, investments in passive entities (i.e., Schedule K-1) and having capital gain transactions (i.e., Schedule D).

85. *Id.* This is primarily for self-employed taxpayers or sole proprietors filing a Schedule C. TurboTax also has TurboTax Business that applies to taxpayers that are not sole proprietorships, but rather are filing separate C-corporation, partnership, or S-corporation returns. *TurboTax Business*, TURBOTAX, last accessed Sept. 13, 2013, https://turbotax.intuit.com/small-business-taxes/.

86. *H&R Block at Home Tax Software*, H&R BLOCK, last accessed Sept. 20, 2013, http://www.hrblock.com/tax-software/ index.html. Prices: Basic $29.95; Deluxe $54.95; Premium $74.95; and Premium & Business $89.95.

of this software is considerably less than the cost of H&R Block and professional tax preparers.[87] Thus, this consumer software offers the do-it-yourselfer an inexpensive and convenient alternative.

Each type of consumer software makes filing most returns relatively simple.[88] TurboTax uses pictures, colors, and a question-and-answer format.[89] H&R Block at Home is slightly less consumer-friendly; it asks more "business-like" questions and generally follows the income/ deductions/credit format of the 1040 form.[90] With both software programs, "[a]ll data can be edited, deleted or reviewed at any time" in a non-linear fashion.[91] Both keep a running account of any tax liability or refund as you go along.[92] At the end of the process, the program prints out the taxpayer's information in acceptable tax forms.[93] As one commentator noted, "With the use of good tax preparation software, the complexity of the Code need no longer equate with a complex tax preparation process."[94]

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87. Elizabeth Rosen, *Where to Get Tax Preparation Help*, US TAX CENTER, June 13, 2013, http://www.irs.com/articles/where-to-get-tax-preparation-help.

88. *See* IRS IRS E-FILE STUDY #1, *supra* note 62, at 69. The authors experimented with some very difficult issues and found that the tax software was challenging. For example, calculating foreign passive income is difficult if you do not already understand the modification to adjusted cost basis determinations.

89. *See* TURBOTAX, *Compare*, *supra* note 79.

90. Cara Scatizzi, *TaxCut Premium vs. TurboTax Premier*, AM. ASS'N OF INDIVIDUAL INVESTORS, last accessed May 30, 2013, http://www.aaii.com/computerized-investing/article/taxcut-premium-vs-turbotax-premier, [hereinafter Scatizzi, *TaxCut vs. TurboTax*].

91. *Id.*

92. *Id.* Refunds can be directly deposited and payments can be made directly from bank accounts. "A great feature in TaxCut is the summaries for each section[—]personal information, income, deductions, credits and taxes. This program also has a Take Me To [sic] button, which delivers you directly to the table of contents with links to each of the sections and data summaries. TurboTax presents a summary of each section as well, but you must expand specific sections to see the actual data you entered. The concise nature of TaxCut[']s summaries helped when checking and reviewing data entry. TurboTax does have a Topic List [sic] option that can be found in the Tools section. This allows you to move more easily from section to section if you need to update or review data. Both programs offer error checking as well as deduction finding. TurboTax finds appropriate deductions more easily than TaxCut, but both will account for a variety of deductions and credits and each includes a miscellaneous category."

93. Joshua D. Rosenberg, *A Helpful and Efficient IRS: Some Simple and Powerful Suggestions*, 88 KY. L.J. 33, 41 (1999–2000) [hereinafter Rosenberg, *A Helpful and Efficient IRS*] ("[T]ax preparation software is becoming (although it has not yet become) easier to use than the forms were, even in the days before the forms became the intricate behemoths that they are today.").

94. *Id.* ("What the tax forms did for taxpayers three decades ago is what tax preparation software does today.").

Many versions also integrate taxpayer data from prior year returns if the taxpayer so chooses.[95] They also allow direct electronic transmissions from various financial institutions, most of which provide stock basis numbers.[96] With participating employers, even the taxpayer's W-2 can be electronically transmitted into the program.[97] Consequently, many taxpayers need do "little more" than enter certain data changes in income and expenses from prior years.[98] For many low-income taxpayers with simple returns, the major consumer software companies provide for free online tax preparation services and electronic filing.[99]

The software companies also offer a wide variety of extra services. They provide for state tax filing and e-filing.[100] The services include online chats, postings with "tax experts," and telephone conversations with software representatives.[101] These companies even provide taxpayers the option of having a representative of the company accompany them on an audit.[102]

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95. *See* Scatizzi, *TaxCut vs. TurboTax*, *supra* note 90.

96. *Id.* Form 1099 information reports can be transmitted directly from source companies. For example, all versions of TurboTax allow tapping into a database of 400,000 participating employers to pull W-2 and 1099 data. It can also link into 'Mint.com' and 'Its Deductible' to determine charitable deductions. *See* TURBOTAX, *Compare*, *supra* note 79.

97. *See generally* TURBOTAX, *Compare*, *supra* note 79.

98. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 42 ("Much of the information could be imported from past years, so that after their first filing taxpayers would have to do little more than enter certain changes in status, income, or expenditures from past years.").

99. *See* FREEFILE, IRS, last accessed Sept. 21, 2013, http://.www.freefile.irs.gov. Free File Alliance, LLC (FFA) is a consortium of tax preparation companies that have partnered with the IRS to provide online electronic preparation at no charge. This is discussed below in Part V.D.1. and Part VI.B.1.

100. *See* TURBOTAX, *Compare*, *supra* note 79.

101. TURBOTAX, last accessed May 30, 2013, http://turbotax.intuit.com. For example, the TurboTax website claims to have available "Personalized Tax Expert Advice" via phone or online chat sessions to get answers so you can file your taxes. The website states these experts are highly trained tax professionals that are CPAs and Enrolled Agents. Taxpayers can also seek advice online from the "TurboTax Live Community" where they can ask questions which are answered by other taxpayers in similar situations or TurboTax tax experts. The tax software also provides step-by-step GPS-type guidance through sophisticated tax issues. In addition, it performs various checks for errors after the correct data has been entered into the program.

102. *See id.* Taxpayers can also obtain audit support to assist them with step-by-step guidance in the event they audited by the IRS. H&R Block at Home (formerly TaxCut) and TaxACT provide similar services. *See id.*; *File Online Now*, H&R BLOCK, last accessed Sept. 13, 2013, http://www.hrblock.com/; *Features & Benefits*, TAXACT, last accessed Sept. 13, 2013, http://www.taxact.com/taxes-online/free-online-tax.asp?s=OLSTD. *See also* discussion *infra* Part V.D.2.

No official software methodology exists for condensing the Code into software language. Moreover, the IRS makes "no direct evaluation of software packages for accuracy or usability."[103] In fact, the software programs may not even be uniform in their methodology, and in some cases, their calculations have proven to be flawed.[104] For example, in both 1994 and 1996, consumers complained of software issues with TurboTax. In 1994, depreciation was calculated incorrectly, and in 1996, numerous other errors were found.[105] When the software error does occur, the taxpayer either pays too much tax or not enough, increasing his or her risk of incurring the accuracy-related penalty.

In their defense, the software companies contend, "[T]he market adequately regulates the industry."[106] In other words, the consumer is free to determine which software is most suitable and reliable. This argument is weak, though, in light of the market dominance of only two companies. Consumers may also be hesitant to experiment with lesser-known brands without a history of market confidence. Moreover, given the complexity of the tax law and computer methodology, it would seem almost impossible for the taxpayer to properly evaluate the strengths and weaknesses of various brands of tax software.

In their respective contracts, the software companies state they are not tax professionals, yet their advertisements sometimes indicate otherwise. The software companies insulate themselves in the fine print of their contracts by stating the company is not a professional "tax advisor."[107] These contracts also indicate that consumers use the product "at [their] own risk."[108] Nevertheless, TurboTax advertises on television and elsewhere that it is unique in providing tax expertise.[109] For the first nine months of 2011,

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103. IRS PREPARER REVIEW, *supra* note 39, at 10. *See also* discussion *infra* Part V.A.3.

104. Keating, *A Taxing Trend*, *supra* note 36.

105. In 1994, a customer discovered that depreciation calculations were not accurate. In 1996, the errors revolved around self-employed taxpayers, contributions to individual retirement accounts, and depreciation of cars and real estate—much to the general dissatisfaction of a great number of customers. TAYLOR & SCHROEDER, INSIDE INTUIT, *supra* note 48, at 173, 219–20.

106. IRS PREPARER REVIEW, *supra* note 39, at 39.

107. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 51.

108. *See, e.g.*, *TurboTax Terms of Service*, TURBOTAX, last accessed May 30, 2013, http://turbotax.intuit.com/corp/terms-of-service.jsp.

109. *See* Margaret Collins, *TurboTax Offers Live Tax Advice to Lure Clients from H&R Block*, BLOOMBERGBUSINESSWEEK, Feb. 14, 2012, http://www.business week.com/news/2012-02-14/turbotax-offers-live-tax-advice-to-lure-clients-from-h-r-block.html#p1.

> Intuit has hired more than 700 tax attorneys, certified public accountants and IRS enrolled agents since April to provide free tax

Intuit spent $93 million on advertising and H&R Block spent $114 million.[110] In an effort to protect their market share, both of these companies have previously lobbied the IRS to adopt strict regulations requiring registration, continuing education, and other restrictions for tax preparers.[111] These regulations were adopted by the IRS. However, on January 18, 2013, the U.S. District Court for the District of Columbia, in a decision that was affirmed by Court of Appeals for the District of Columbia, enjoined the IRS from enforcing the new regulatory requirements on tax preparer's.[112] The regulations would have decimated many "mom-and-pop" preparers.[113] Intuit has also lobbied aggressively to prevent California from adopting ReadyReturn, a state government program that calculates the returns of certain low-income taxpayers.[114]

> advice by phone and through online chat. That includes the team of 26 advisers from around the country that Alleva manages. Alleva is a CPA [firm] and has worked for Intuit as an adviser for three years.
>
> . . . .
>
> TurboTax advisers generally work from their homes and also may have their own tax- preparation business . . . . They receive an average of two calls an hour and inquiries range from tax treatment of retirement income to cancellation of debt . . . . Those taking calls answer questions rather than prepare returns . . . . All of them have tax preparer identification numbers from the IRS . . . ."

Id. As to H&R Block: "While all the company's tax professionals don't have to be attorneys, CPAs or enrolled agents, new hires are required to complete more than 110 hours of training." *Id.*

110. *Id.* ("In the first nine months of last year, H&R Block topped advertising spending among tax preparers at $114 million, a 13 percent increase from the same period in 2010, according to the latest available data from Nielsen Holdings NV. Intuit was second, dedicating about $93 million in the first three quarters of 2011, which was a 7.6 percent increase. Jackson Hewitt, the second-largest U.S. tax preparer, trailed with the next biggest expenditure of $18 million.").

111. *See* discussion *infra* Part VI.B.2.

112. Loving v. IRS, 917 F.Supp. 2d 67 (D.D.C. 2013), *modified*, 920 F.Supp. 2d 108 (D.D.C. 2013), *motion for stay denied*, 111 A.F.T.R.2d 2013-1384 (D.C. Civ. 2013), *aff'd*, 2014 WL 519224 (D.C. Cir 2014). *See* Micheal Cohn, *IRS Loses Lawsuit*, PTS FIN. SERVICES, Jan. 18, 2013, http://ptsfinancial services/wordpress. com/2013/01/21/irs-loses-lawsu/.

113. *See Beating the H&R Tax Blockers*, WALL ST. J., Feb. 5, 2013, http://online.wsj.com/article/SB10001424178873237019045782781025604785 38.html [hereinafter *Beating H&R*].

114. Rebecca Valencia, Note, *Get Ready for the Return! How to Make Filing Tax Returns More Efficient: Applying the State of California Franchise Tax Board's Ready Return to the Federal Tax System*, 37 RUTGERS COMPUTER & TECH. L.J. 130, 132 (2011) ("The TurboTax developer spent a million dollars on lobbying efforts.") [hereinafter Valencia, *Get Ready for the Return!*].

III. THE ACCURACY-RELATED PENALTY AND EXCEPTIONS

The "software did it" excuse in most cases arises in the context of section 6662, involving the accuracy-related penalty. Section 6662(a) imposes an accuracy-related penalty for any "underpayment of tax required to be shown on [the taxpayer's] return."[115] The purpose of this statutory provision is to encourage "full and honest disclosure" by the taxpayers in the preparation of their federal income tax returns.[116] The penalty is equal to 20 percent of the underpayment amount,[117] and it increases to 40 percent of the underpayment amount in certain limited situations such as a gross valuation misstatement.[118] The penalty only applies, however, in those situations described in section 6662(b).[119] Subsection (b) applies to any portion of the underpayment attributable to one or more of the following: (1) Negligence or disregard of the rules or regulations; (2) Any substantial understatement of income tax; (3) Any substantial valuation misstatement . . . ; (4) Any substantial overstatement of pension liabilities; (5) Any substantial estate or gift tax valuation understatement; (6) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law; (7) Any undisclosed foreign financial asset understatement.[120]

The accuracy-related penalty under section 6662(a) is not "stacked," regardless of the number of violations under subsection (b). This means that it does not matter how many types of misconduct are violated under subsection (b), only one subsection (a) penalty applies.[121] Therefore, it is technically just a single penalty under the statute that applies in various circumstances. For example, if the underpayment of tax on the taxpayer's return is "attributable to both negligence and a substantial understatement of tax, the maximum accuracy-related penalty [under subsection (a)] is 20

115. I.R.C. § 6662(a).

116. Conor F. Larkin, *Tax Court Wrestles with "Geithner Defense" to Accuracy-Related Penalties*, 65 TAX LAW. 415, 416 (2012) [hereinafter Larkin, *Tax Court*].

117. I.R.C. § 6662(a).

118. The penalty increases to 40 percent under section 6662(h)(1) when there is a gross valuation misstatement. It also increases to 40 percent under section 6662(i)(1) when there is an underpayment attributable to one or more "nondisclosed noneconomic substance transactions." Finally, it increases under section 6662(j)(3) when there is any portion of the underpayment "attributable to any undisclosed foreign financial asset understatement."

119. I.R.C. § 6662(b).

120. *Id.*

121. Reg. § 1.6662-2(c).

percent."[122] More complicated rules apply, however, when the understated tax is a result of various tax rates and multiple acts are involved, or when the 40 percent and the 20 percent rates are triggered.

A. Defining Negligence and Substantial Understatement

Virtually all of the cases involving taxpayer reliance on tax software (and their efforts to avoid the accuracy-related penalty) involve either (1) negligence or disregard of the rules or regulations by the taxpayer, and/or (2) a substantial understatement of income tax. Our research did not uncover any other violations of section 6662(b) where a software defense was asserted. Nevertheless, one could imagine such a defense, and the principles discussed herein could be equally applicable to other violations of section 6662(b), such as a gross valuation misstatement, a substantial estate or gift tax valuation understatement, etc. Section 6662(a) most likely applied to Treasury Secretary Geithner before the IRS so gracefully waived his penalties.

1. Negligence or Disregard of the Rules

A taxpayer is negligent if the taxpayer fails "to make a reasonable attempt to comply" with the provisions of the Code.[123] The taxpayer has a "disregard" for the rules when the taxpayer acts with "careless, reckless, or intentional disregard."[124] The Treasury Regulations further expand on the definition of negligence, stating it includes the failure to "exercise ordinary and reasonable care in the preparation of a tax return."[125] Under the regulations, negligence is "strongly indicated" in a number of situations, including when the "taxpayer fails to include . . . income shown on an information return, as defined in section 6724(d)(1)" (e.g., Form 1099), or when the "taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion . . . which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances."[126] Certainly Geithner's exemption from Social Security and Medicare taxation was "too good to be true," existing only within the "Alice in Wonderland" corridors of the IMF. The regulations also elaborate on the term "disregard," stating a taxpayer is "'careless' if the taxpayer does not exercise reasonable diligence to determine the correctness of a return

122. *Id.*
123. I.R.C. § 6662(b)(1), (c).
124. I.R.C. § 6662(c).
125. Reg. § 1.6662-3(b)(1).
126. Reg. § 1.6662-3(b)(1)(i), (ii).

position that is contrary to the rule or regulation."[127] A taxpayer is "'reckless' if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe."[128] Disregard reaches the level of "'intentional' when the taxpayer knows of the rule or regulation that is disregarded."[129] As discussed in greater detail herein, mere blind reliance on tax preparation software and the failure to conduct even a "cursory review" of the generated return may also constitute negligence or disregard of the rules.

2. Substantial Understatement

A taxpayer has a "substantial understatement" of income tax under the Code when the amount of the understatement exceeds the greater of: 10 percent of the tax required on the return or $5,000.[130] An understatement is the correct tax required to be shown on the return over the amount of the tax imposed actually shown on the return, reduced by any rebates within the meaning of section 6211(b)(2).[131] The understatement amount is reduced by any portion attributable to the tax treatment of an item by the taxpayer if there is "substantial authority" for the position.[132] If the relevant facts attributable to the item are adequately disclosed to the IRS in the return or in a statement attached to the return, the taxpayer need only demonstrate a "reasonable basis" for the taxpayer's position.[133] It is unclear exactly how tax preparation software handles these types of sophisticated tax judgment calls when a return position is uncertain.[134] For example, if a tax return position is aggressive, the tax software should recommend disclosure so the lower standard applies.[135] On the other hand, if the return position is postured in substantial authority, the taxpayer may not necessarily want to disclose. To the best of the authors' knowledge, the current technology of tax preparation

127. Reg. § 1.6662-3(b)(2).

128. *Id.*

129. *Id.*

130. I.R.C. § 6662(d)(1)(A). A similar threshold applies to corporations, except "$5,000" is replaced with "$10,000,000." I.R.C. § 6662(d)(1)(B).

131. I.R.C. § 6662(d)(2)(A).

132. I.R.C. § 6662(d)(2)(B)(i).

133. I.R.C. § 6662(d)(2)(B)(ii).

134. Oftentimes the software attempts to educate the taxpayer. For example, as to the issue of whether an activity is a hobby, the software goes through the factors in Regulation section 1.183-2(b): the amount of time, the intent of the taxpayer, and other factors.

135. Under Regulation section 1.6662-4(f)(1), disclosure that is not evident on the return itself is made on Form 8275, unless the position is contrary to a treasury regulation, in which case Form 8275-R is used.

software does not have the programmed ability to decipher these types of complex professional judgment calls that venture into artificial intelligence.

B. The Reasonable Cause and Good Faith Exception

Section 6664(c)(1) sets forth an exception to the accuracy-related penalty if the taxpayer demonstrates "reasonable cause" for the underpayment and the taxpayer acted in "good faith."[136] This exception also applies to the civil fraud penalty under section 6663.[137] Therefore, even if a taxpayer acted negligently (or there was a substantial understatement), the penalty may nevertheless be avoided if reasonable cause and good faith exist. This exception is particularly pertinent to cases involving the accuracy-related penalty because under the fraud provision, once the IRS has proven fraudulent intent, it is difficult to reconcile such with the taxpayer acting reasonably and in good faith. This exception to the accuracy-related penalty (and the civil fraud penalty) does not apply, however, to acts triggering the economic substance doctrine under section 6662(b)(6).[138]

The taxpayer carries the burden of proving reasonable cause and good faith.[139] Taxpayers using tax preparation software often posture their defense against the accuracy-related penalty under this equitable exception. The legislative history of the exception indicates Congress wanted to create a "standardized exception" for all of the accuracy-related penalties that harmonized with the standards used by the IRS in ascertaining the additional tax due.[140] Before the 1989 Act, separate sections were applicable to the

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136. I.R.C. § 6664(c)(1).

137. *Id.*

138. I.R.C. § 6664(c)(2).

139. Sanders v. Commissioner, 77 T.C.M. (CCH) 2237, 2244, T.C.M. (RIA) ¶ 99,208, at 1282 (1999) ("Petitioners bear the burden of proving that they were not negligent or that they had reasonable cause for the underpayment and that they acted in good faith.").

140. H.R. REP. NO. 101-247, at 1392–93 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2862–63 ("The bill provides special rules that apply to each of the penalties imposed under the new structure. First, the bill provides standardized exception criteria for all of these accuracy-related penalties. The bill provides that no penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith. The enactment of this standardized exception criterion is designed to permit the courts to review the assertion of penalties under the same standards that apply in reviewing additional tax that the Internal Revenue Service asserts is due. By applying this unified exception criterion to all the accuracy-related penalties, the committee believes that taxpayers will more easily understand the standard of behavior that is required. The committee also believes that this unified exception criterion will simplify the administration of these penalties by the IRS.").

various acts set forth in section 6662(b).[141] The accuracy-related penalty as a result could be applied cumulatively under the old law (i.e., under different sections) with multiple penalties incurred in a single transaction.[142] Congress found a unified exception (to a unified penalty) would thereby simplify the administration of the revised accuracy-related penalty and also require the IRS to consider more carefully its appropriateness before assessment.[143] Congress was especially concerned the IRS was "too routinely and automatically" imposing the accuracy-related penalty, and therefore the standardized reasonable cause/good faith exception would result in an expansion of the "scope for judicial review of IRS determination of these penalties."[144] It also would result in "greater fairness of the penalty structure and [would] minimize inappropriate determinations."[145] The legislative history of the exception is consistent with the authors' position discussed herein; namely, that a TurboTax defense grounded in reasonable cause and good faith should exist to protect taxpayers from routine penalty application.

In ascertaining whether a taxpayer has acted with reasonable cause (and in good faith) the IRS considers all facts and circumstances on a "case-by-case basis."[146] The regulations indicate "the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[147]

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141. *Id.* at 1388, 1989 U.S.C.C.A.N. 2858.

142. *Id.*

143. *Id.* at 1393, 1989 U.S.C.C.A.N. 2863.

144. *Id.* ("The committee is concerned that the present-law accuracy-related penalties (particularly the penalty for substantial understatements of tax liability) have been determined too routinely and automatically by the IRS. The committee expects that enactment of standardized exception criterion will lead the IRS to consider fully whether imposition of these penalties is appropriate before determining these penalties. In addition, the committee has designed this standardized exception criterion to provide greater scope for judicial review of IRS determinations of these penalties. Under the waiver provision contained in present law, the Tax Court had held that it can overturn an IRS determination of the substantial understatement penalty on reasonable cause and good faith grounds only if the Tax Court finds that the IRS abused its discretion in asserting the penalty. The committee believes that it is appropriate for the courts to review the determination of the accuracy-related penalties by the same general standard applicable to their review of the additional taxes that the IRS determines are owed. The committee believes that providing greater scope for judicial review of IRS determinations of these penalties will lead to greater fairness of the penalty structure and minimize inappropriate determinations of these penalties.").

145. *Id.*

146. Reg. § 1.6664-4(b)(1).

147. *Id. See* Compaq Computer Corp. v. Commissioner, 113 T.C. 214 (1999) (sophisticated taxpayer with investment experience should have taken steps to ascertain the bona fide nature of a questionable economic transaction), *rev'd on other grounds*, 277 F.3d 778 (2001); Barranti v. Commissioner, 76 T.C.M. (CCH)

A taxpayer using tax preparation software presumably is exerting more effort to accurately assess his or her tax liability as compared to preparing a return manually.[148] However, as previously mentioned, the Tax Court does not consider the use of tax preparation software in and of itself as per se reasonable cause in good faith. Nor do the authors suggest that such should be the case. Circumstances that may evidence reasonable cause and good faith include, among others, an "isolated computational or transcriptional error,"[149] or "an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer."[150] "Reliance on an information return, professional advice, or other facts" may also constitute reasonable cause in good faith if, "under all the circumstances, such reliance was reasonable."[151] The taxpayer's level of sophistication is therefore critical in ascertaining whether reasonable cause exists. For example, a taxpayer's education and business experience is "relevant in determining whether [a] taxpayer's reliance on tax advice was reasonable and made in good faith."[152] Interestingly, as discussed below, the only two successful TurboTax cases each involved sophisticated taxpayers. Therefore, contrary to the regulations, the taxpayers' respective education levels did not create any higher standard of care when determining reasonable cause.

1. Isolated Computational or Transcriptional Error

As stated, an "isolated computational or transcriptional error" under the regulations may constitute reasonable cause in good faith in certain circumstances.[153] Inadvertent data input errors by taxpayers should therefore fall within this regulatory language. Software computational errors should also be covered under this exception as well.[154] The regulations, however, do not specifically address tax software errors (whether computational in nature or otherwise). The regulations, on the other hand, do indicate that reliance on "erroneous information" mistakenly "included in data compiled by the various divisions of a multidivisional corporation" may be evidence of

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957, 963, T.C.M. (RIA) ¶ 98,427, at 2540 (1998) (married couple each blamed the other for omitted income items and excessive deductions).

148. When doing taxes with traditional forms, the taxpayer constantly needs to refer to the instructions or IRS publications for guidance. With tax software, guidance is provided automatically with screens, prompts, or just by clicking on "explain."

149. Reg. § 1.6664-4(b)(1).

150. *Id.*

151. *Id.*; *see also* Reg. § 1.6664-4(b)(2) Ex. 1.

152. Reg. § 1.6664-4(c)(1).

153. Reg. § 1.6664-4(b)(1).

154. *See* discussion *infra* Part IV.C.

reasonable cause and good faith.[155] If such is the case, arguably the erroneous entry of information into tax software (which is isolated and/or inadvertent) should be treated similarly. It would seem that both situations involve the input of erroneous information down the chain of process, whether it be by a division of the taxpayer or otherwise.

2. Honest Mistake of Fact or Law

An honest misunderstanding of *fact* can also be grounds for the reasonable cause (in good faith) exception to the accuracy-related penalty. The regulations provide that reliance on factual errors reported on a Form W-2, Form 1099 or other form could indicate reasonable cause and good faith if the taxpayer "did not know or have reason to know" the information was erroneous.[156] However, if the information is inconsistent with other information furnished to the taxpayer or if the taxpayer knew of the transaction, the taxpayer will be considered to have known or had reason to have known of the factual error.[157] Therefore, a taxpayer may not reasonably rely on facts that are incorrect if the taxpayer should have known better.

An honest misunderstanding of *law* can also indicate reasonable cause and good faith. In cases where it appears that the legal issue was not previously considered by the court and/or the statutory language was not entirely clear, taxpayers may claim they acted with reasonable cause and in good faith on such.[158] For example, no penalty was imposed for a substantial underpayment in a Tax Court case of first impression concerning the interplay between tax and bankruptcy laws.[159] Similarly, a taxpayer should therefore be able to rely on software prompts involving the tax law if for some reason a critical element of the tax law was lost in translation when the

155. Reg. § 1.6664-4(b)(1).

156. *Id. See also* Olsen v. Commissioner, T.C. Summ. Op. 2011-131, 2011 WL 5885082 (Nov. 23, 2011) (taxpayer made an error in transcribing information from a Schedule K-1); discussion *infra* Part IV.A.1.

157. Alan J. Tarr & Pamela Jensen Drucker, *Civil Tax Penalties*, 634 TAX MNGT. PORT. (BNA) A-28 (2011).

158. *Id.* at A-32.

159. *See* Williams v. Commissioner, 123 T.C. 144, 153–54 (2004). The Tax Court has allowed the issue-of-first-impression exception to apply in negligence cases. *See, e.g.*, Everson v. United States, 108 F.3d 234, 238 (9th Cir. 1997); Gee v. Commissioner, 127 T.C. 1, 6 (2006); Bunney v. Commissioner, 114 T.C. 259, 266 (2000); Lemishow v. Commissioner, 110 T.C. 110, 114 (1998). The Tax Court has also applied this exception for substantial understatement of income tax. *See* Mitchell v. Commissioner, 79 T.C.M. (CCH) 1954, 1955, T.C.M. (RIA) ¶ 2000-145, at 816–17 (2000). However, at least one district court has declined to apply this exception for substantial understatement. *See In re* CM Holdings, Inc., 301 F.3d 96, 108 (3d Cir. 2002).

computer programmers wrote the software or there was a material omission involving appropriate advice (i.e., appropriate software guidance).

3. Reliance on Professional Advice

Taxpayer reliance on professional tax advice is typically one of the most commonly asserted reasonable cause (in good faith) exceptions.[160] The term "advice" is defined in the regulations as

> any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty.[161]

Advice includes any communication by the professional tax advisor.[162] A professional tax advisor generally includes a competent tax expert, such as a certified public accountant, or an attorney experienced in federal tax matters.[163] An enrolled agent has also been held to be a competent tax

160. Reliance on the advice of a tax advisor is generally limited to substantive issues that are "technical or complicated," meaning it is still the taxpayer's "responsibility to file, pay, or deposit taxes." I.R.M. § 20.1.1.3.3.4.3(2), (3). To qualify for the waiver, the taxpayer's reliance must be both reasonable and in good faith. The taxpayer need not challenge his or her independent and competent advisor, however, to confirm the advice is correct, or seek a second opinion, particularly when the taxpayer seeks advice concerning a question of law. United States v. Boyle, 469 U.S. 241, 251 (1985) ("When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.").

161. Reg. § 1.6664-4(c)(2).

162. *Id.*

163. Kidder v. Commissioner, 78 T.C.M. (CCH) 602, 605, T.C.M. (RIA) ¶ 99,345, at 2135 (1999) (the taxpayers were not liable for the negligence penalty because they relied on their accountant); Fowler v. Commissioner, 84 T.C.M. (CCH) 281, 286–87, T.C.M. (RIA) ¶ 2002-223, at 1407 (2002) (taxpayers were not liable for the accuracy-related penalty because they relied on their accountant); DeCleene v. Commissioner, 115 T.C. 457, 477 (2000) (taxpayers were not liable for the accuracy-related penalty when relying on accountants and attorneys who structured and recommended a reverse like-kind real estate exchange that failed to qualify for nonrecognition under section 1031); Favia v. Commissioner, 83 T.C.M. (CCH)

expert.[164] The regulations make it clear though that advice by a tax advisor standing alone does not automatically indicate reasonable cause.[165] For example, it may not be reasonable to rely on the tax advice of a friend or relative or someone the taxpayer knew (or should have known) lacked knowledge of the relevant federal tax law.[166] Reliance may also not be reasonable if "the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law."[167] The advice also cannot be grounded in "unreasonable factual or legal assumptions[,] including assumptions as to future events."[168] Moreover, the taxpayer cannot fail to discuss all of the relevant details with the advisor.[169] In the software context, presumably this requires that the taxpayer correctly and completely input all information into the software before any reliance on the software occurs. The taxpayer's "education, sophistication and business experience" is also pertinent in determining whether the reliance is reasonable.[170] Applying this to software, more deference should therefore be accorded to those taxpayers with less sophistication—not more. On the other hand, perhaps unsophisticated taxpayers should not be using such software at all, given the complexity of federal tax law.[171]

The Tax Court requires the taxpayer prove by a preponderance of the evidence that (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the advisor the requisite information; and (3) that the taxpayer in fact relied in good faith on the advice.[172] The taxpayer must demonstrate he or she actually relied on the advice, not merely that the professional failed to carry out the taxpayer's

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1876, 1878, T.C.M. (RIA) ¶ 2002-154, at 990 (2002) (petitioner not liable for the accuracy-related penalty because he relied on a certified public accountant to prepare his return).

164. Wickersham v. Commissioner, 102 T.C.M. (CCH) 101, 107, T.C.M. (RIA) ¶ 2011-178, at 1246 (2011) (an eighth grade–educated taxpayer who relies on an enrolled agent constitutes reasonable cause in good faith even though it was the most complex return ever prepared by the agent).

165. Reg. § 1.6664-4(b)(1).

166. Reg. § 1.6664-4(b)(2), Ex. 2.

167. Reg. § 1.6664-4(c)(1).

168. Reg. § 1.6664-4(c)(1)(ii).

169. Reg. § 6664-4(c)(1)(i).

170. Reg. § 1.6664-4(c)(1).

171. *See* discussion *infra* Part IV.D.5.

172. *See* Neonatology Assocs. v. Commissioner, 299 F.3d 221, 234 (3d Cir. 2002); Ellwest Stereo Theatres of Memphis, Inc. v. Commissioner, 70 T.C.M. (CCH) 1655, 1660, T.C.M. (RIA) ¶ 95,610, at 3896 (1995).

instruction.[173] At the moment there are no cases on point specifically addressing the issue of whether it is reasonable to rely on the "tax advice" communicated by tax preparation software or its representatives. However, as discussed herein, there are a few cases that tap dance around the issue and a strong argument exists supporting such a position. The Code and regulations are also silent in this regard.

4. Other Good Faith Exceptions

While reliance on a tax advisor has been the most commonly claimed reasonable cause (in good faith) exception, other common factual scenarios that have been successful include the following: "[d]eath, serious illness, or unavoidable absence of the taxpayer" or the taxpayer's immediate family,[174] the taxpayer's records are unavailable because of a natural disaster,[175] the IRS provided the taxpayer with erroneous written advice,[176] the taxpayer is serving in the Armed Forces in a "combat zone,"[177] or the taxpayer is a victim of a fire, casualty, or natural disaster.[178] On the other hand, taxpayers generally have failed to evidence reasonable cause in situations involving unreasonable reliance on a tax advisor,[179] the failure to investigate the underlying facts of the transaction,[180] the taxpayer's records are generally not available,[181] the taxpayer does not have the ability to pay,[182] the taxpayer is ignorant of the law,[183] the taxpayer's mistake, forgetfulness,

173. Woodsum v. Commissioner, 136 T.C. 585, 593–94 (2011) (where preparer inadvertently left out a $3.4 million income item and the taxpayer reviewed the return but failed to catch the error).

174. I.R.M. § 20.1.1.3.2.2.1.

175. *Id.* § 20.1.1.3.2.2.2.

176. I.R.C. § 6404(f); Reg. § 301.6404-3(a), (b).

177. I.R.C. § 7508 (postpones the time for performing certain acts by reason of service in a combat zone, presidentially declared as such).

178. I.R.M. § 20.1.1.3.2.2.2. Brown v. Commissioner, 74 T.C.M. (CCH) 624, 629, T.C.M. (RIA) ¶ 97,418, at 2754–55 (1997) (taxpayers were not liable for the accuracy-related penalty when they lost their records in a house fire).

179. Estate of Maltaman v. Commissioner, 73 T.C.M. (CCH) 2162, 2167–68, T.C.M (RIA) ¶ 97,110, at 661–64 (1997).

180. Novinger v. Commissioner, 61 T.C.M. (CCH) 3024, 3027–29, T.C.M. (RIA) ¶ 91,289, at 1468–70 (1991); Rogers v. Commissioner, 60 T.C.M. (CCH) 1386, 1394–97, T.C.M. (P-H) ¶ 90,619, at 3039–44 (1990). *But see* Everett v. Commissioner, 58 T.C.M. (CCH) 1366, 1374, T.C.M. (P-H) ¶ 90,065, at 289 (1990) (finding petitioners' independent investigation prior to purchasing limited partnership interests to be "reasonable and prudent").

181. Crocker v. Commissioner, 92 T.C. 899, 916–17 (1989).

182. Jones v. Commissioner, 25 T.C. 1100, 1106 (1956).

183. Niedringhaus v. Commissioner, 99 T.C. 202, 217–18 (1992).

or carelessness,[184] "misfeasance" by an employee or agent of the taxpayer,[185] the taxpayer's heavy work load or time pressures,[186] objections based on constitutional or religious beliefs,[187] or relying on forms provided by third parties.[188] As discussed below, myopic reliance on tax software also has been held unreasonable thereby warranting the imposition of the accuracy-related penalty.

IV. CASE LAW ON SOFTWARE RELIANCE AND PENALTY AVOIDANCE

Although the cases are arguably correct in this area, the courts are missing an opportunity to issue clear guidance to the IRS and the taxpayers with respect to software reliance and use. First, the cases should set forth clearer guidelines in situations when a TurboTax defense could be relied upon. These situations could include, for example: (1) an isolated computer data entry error; (2) the taxpayer exercised ordinary care and prudence in the software navigation yet made an honest mistake of fact or law; (3) the taxpayer relied in good faith on the software and made a bona fide effort to comply yet was in error due to the complexity of the tax issue; (4) the software generated incorrect "tax advice," either by guidance error or an omission of guidance; (5) the software company's "tax expert" was in error (via chat, electronic postings, email, or telephone); (6) the software made a critical application error (e.g., failed to update correctly, program processing errors, failed to save the taxpayers saved entries, etc.); (7) the software made a computational error; or (8) the return was electronically transmitted in error (e.g., was never received by the IRS, part of the data was transmitted but not all, etc.). Second, the cases should also set forth guidelines describing situations where a TurboTax defense is clearly *not* available. These circumstances might include: (1) when the taxpayer furnished inadequate data; (2) when the taxpayer repeatedly inputted data incorrectly; (3) when the taxpayer should have reviewed the final tax return and discovered the mistake; (4) when the taxpayer made a mistake of fact or law that is so elementary the taxpayer should have known better; (5) when the issue was so uncertain, complicated, or controversial that a tax advisor should have been

184. Logan Lumber Co. v. Commissioner, 365 F.2d 846, 853 (5th Cir. 1966).

185. Conklin Bros. of Santa Rosa, Inc. v. United States, 986 F.2d 315, 317–19 (9th Cir. 1993).

186. Pflug v. Commissioner, 58 T.C.M. (CCH) 685, 688, T.C.M. (P-H) ¶ 89,615, at 3107 (1989); Nosek v. Commissioner, 58 T.C.M. (CCH) 712, 714–15, T.C.M. (P-H) ¶ 89,622, at 3134–35 (1989).

187. Garner v. United States, 424 U.S. 648, 653 (1976); United States v. Lee, 455 U.S. 252, 260–61 (1982).

188. Whitmarsh v. Commissioner, 99 T.C.M. (CCH) 1349, 1350–51, T.C.M. (RIA) ¶ 2010-083, at 509–10 (2010).

sought; (6) when the taxpayer did not preserve the software instructions and exhibits in circumstances where an error could have been documented; and (7) when the taxpayer did not have the basic knowledge to understand the computer program or the tax advice conveyed.

A. The Successful TurboTax Cases

The only cases in the Tax Court where the TurboTax defense has had limited success are *Olsen v. Commissioner*[189] and *Thompson v. Commissioner*.[190] Both of these cases involved sophisticated taxpayers. In *Olsen*, the taxpayer was a patent attorney and in *Thompson* an aeronautical engineer. In *Olsen* the taxpayer made an isolated transcriptional error. In *Thompson*, the taxpayer was careful but made an honest mistake of fact or law. In this section of the Article we suggest that most taxpayers should be relieved of the accuracy-related penalty when they rely in good faith on the tax software and make a bona fide effort to comply with the tax laws. We further contend the tax software itself (or the company) should be construed as a tax advisor, and in certain circumstances a tax preparer, for the purposes of penalty relief.

1. Isolated Computational or Transcriptional Error

In *Olsen*, the taxpayer was relieved of the accuracy-related penalty when he acted reasonably (according to the court) by preparing his return with tax software and upgrading his software to aid him with a tax form he was unfamiliar with (i.e., a Form K-1). The husband had prepared the couple's joint return using tax software; the wife had received K-1 interest income from a trust of which she was a beneficiary, but the husband did not know what do to with the interest income, as he was "unfamiliar with the form."[191] Attempting to appropriately handle the unfamiliar form, he upgraded his tax software to a more comprehensive version. During the software's interview process he correctly entered the name and tax identification number of the trust; however, while transcribing the remaining information, he omitted the interest income making a "data entry error."[192] He then ran a final error check on the software, but again failed to discover the error. Distinguishing the instant case from *Bunney*, the Tax Court cited the "isolated transcription error" exception in Regulation section 1.6664-4(b)(1).[193] Under certain circumstances an isolated transcription error under

189. T.C. Summ. Op. 2011-131, 2011 WL 5885082 (Nov. 23, 2011).
190. 94 T.C.M. (CCH) 24, T.C.M. (RIA) ¶ 2007-174 (2007).
191. *Olsen*, 2011 WL 5885082, at *1.
192. *Id.*
193. *Id.* at *2. For *Bunney*, *see supra* text at note 19.

the above regulation may constitute reasonable cause in good faith to avoid the accuracy-related penalty. The court stated the taxpayer was "forthright and credible" and he merely made an "isolated error" in transcribing the form's information.[194]

Analogous to the taxpayer in *Bunney*, the taxpayer in *Olsen* failed to report income. As mentioned, the taxpayer contended the omission was due to the fact he was "unfamiliar with the [tax] form." The court in *Olsen* ruled for the taxpayer because it characterized the taxpayer's mistake as an "isolated error" in data transcription rather than simple negligence in preparing the return. As previously discussed, reliance on factual errors on a W-2 or Form 1099 when the taxpayer did not know or have reason to know the information was erroneous can also be grounds for a good faith exception to the accuracy-related penalty.[195] There was no mention, however, in *Olsen* that the taxpayer received an incorrect K-1. Rather, he simply did not know what to do with it and was hoping the software on its own did.

The current tax software on the market is not as "tax form-driven" as the traditional paper and pencil preparation method; that is, it is not highly form-driven, at least from the user's perspective.[196] In both TurboTax and H&R Block at Home the taxpayer is merely responding to questions and referring to prompts and is not being asked to fill out the various forms or know their respective relationships.[197] In fact, most users rarely see the actual tax forms until the return is complete.[198] For example, when reporting investment income from Schedule K-1, a paper and pencil taxpayer would typically report the interest and dividends on lines 8 and 9 of the Form 1040 and capital gains on lines 5 and 12 of Schedule D. [199] However, these forms and their respective relationships to the tax items and the tax return are not self-evident from the software. Therefore, when a taxpayer in good faith uses TurboTax and mistakenly commits an isolated transcription error he or she arguably should be relived of an accuracy-related penalty, similar to the taxpayer in *Olsen*. In other words, taxpayers using tax software are relying on the software itself to appropriately assess and understand the various informational reporting forms, the various schedules, and the tax items and their respective relationships to the line items on the return itself. With the modernity of tax software, users are now far less likely to be intimately

194. *Id.*

195. *See* discussion *supra* Part III.B.2.

196. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93 and accompanying text.

197. *See* Scatizzi, *TaxCut vs. TurboTax*, *supra* note 90 and accompanying text.

198. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93.

199. *How to Report Income from Schedule K-1 Form 1041*, EHOW MONEY, last accessed May 7, 2013, http://www.ehow.com/how_2155503_report-income-from-schedule-k1.html.

familiar with the various forms, schedules, and line items as compared to the past when manual preparation was the only choice.

Another important factor behind the court's decision in *Olsen* evidencing good faith was that the taxpayer diligently prepared the couple's joint return on tax software. Therefore, the very fact that he used software was in his favor. He also purchased an upgrade in the software (perhaps unnecessarily) in an attempt to handle the Schedule K-1 and he conducted a final "error check." Arguably these two actions were indicia of the taxpayer's good-faith effort to accurately assess his taxes. Moreover, these factors, combined with the fact that the error was "isolated" or singular in this case, make it a good case for future taxpayers utilizing tax software. However, the courts should have used this case as an opportunity to expand on the isolated transcription error exception in the context of software.

2. Honest Mistake and Good Faith Compliance

In a second successful case, *Thompson*,[200] an aeronautical engineer claimed a deduction for flight lessons that advanced his skill level for his existing job, but because this new skill also qualified him for a new trade as a commercial pilot, the deduction claimed was disallowed. Nevertheless, the Tax Court waived the accuracy-related penalty in this case presumably because the tax software was not designed to recognize and apply the appropriate rules to the taxpayer's unique factual circumstances.

At first glance one would have thought given the language of the regulations, the taxpayer's education and business experience would have worked against him in this case when asserting reliance on tax software—but apparently not. As previously mentioned, the taxpayer in *Olsen* was also highly educated. In *Thompson* the taxpayer deducted certain educational expenses on his Schedule A for flight school fees he incurred. At the time, the taxpayer was employed as an aeronautical engineer and was pursuing a commercial pilot's license on his spare time. Therefore, even though these educational expenses maintained and improved his knowledge as to his engineering job, they also qualified him for a new trade or business (i.e., that of a commercial pilot). As a consequence, they were not deductible under section 162(a).[201] In preparing his return the taxpayer, of course, used tax

200. Thompson v. Commissioner, 94 T.C.M. (CCH) 24, T.C.M. (RIA) ¶ 2007-174 (2007).

201. *See* Reg. § 1.162-5(a). Under this regulation, an employee may generally deduct educational expenses if either of the following occurs: (1) the expenses are incurred to improve or maintain the skills required by the taxpayer's trade or business, or (2) the expenses incurred are associated with satisfying the requirements imposed by law for retention of employment, rank, or compensation rate.

software. The Commissioner assessed a deficiency and applied the accuracy-related penalty. The Tax Court agreed with the Commissioner that the expenses were not deductible because they qualified the taxpayer for a new trade or business. The court stated, however, that the petitioner was not liable for the penalty because the taxpayer "made a reasonable attempt to comply with the internal revenue laws and exercised ordinary and reasonable care by obtaining software to aid him in the preparation of his 2002 Federal income tax return."[202] Here again, the taxpayer's use of tax software in and of itself provides some assistance in penalty relief. In other words, using tax software evidences a taxpayer's "effort[s] to assess the taxpayer's proper tax liability."[203]

The tax issue in *Thompson* associated with the underlying tax has been frequently litigated and analyzed.[204] Regulation section 1.162-5 sets forth two positive rules and two negative rules for education expenses.[205] To be deductible, the expenses must maintain or improve skills required by the taxpayer's employment or other trade or business *or* meet requirements imposed by the employer, applicable law, or regulation as a condition of retaining employment. However, the regulation requires the taxpayer to demonstrate that the educational expenses do not meet the minimum educational requirement of the taxpayer's employment or other trade or business *and* are not part of a program of study qualifying the taxpayer for a new trade or business. The taxpayer must be carrying on a trade or business (or fall within the temporary exception), pass *one* of the two positive tests (the skill-maintenance or employer-mandate tests), and avoid *both* of the two negative tests that have been identified in previous cases (the entry-level and upward-bound tests).[206]

Obviously, the rule is complex. The facts of *Thompson* are unclear and the taxpayer may not have intended to become a commercial pilot.[207] The taxpayer presumably improved his skills as an engineer by studying the skills of a pilot. Nevertheless, the taxpayer had a colorable case for his position—even if he ended up being wrong. As previously indicated, it seems that in similar circumstances, other taxpayers should also be allowed to assert some form of a TurboTax defense to limit their liability from the

202. *Thompson*, 94 T.C.M. (CCH) at 25, T.C.M. (RIA) ¶ 2007-174 at 1201.

203. *See* Reg. § 1.6664-4(b)(1).

204. *See* NANCY E. SHURTZ, EDUCATION PLANNING: TAXES, TRUSTS, AND TECHNIQUES 380–386 (2009) [hereinafter SHURTZ, EDUCATION PLANNING]. *See also* 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 22.1.1, at 22-2 (3d ed. 1999).

205. *See* SHURTZ, EDUCATION PLANNING, *supra* note 204, at 381–84 (discussion of the two positive tests); *see also id.* at 384–86 (discussion of the two negative tests).

206. *Id.*

207. The facts of the case do not indicate that this is the case.

accuracy-related penalty. In other words, the presumption should be in favor of a good-faith exception when the taxpayer diligently uses tax software (perhaps of certain authorized brands by the Service). A taxpayer should be relieved of the accuracy-related penalty even though an honest mistake of fact or law transpired, so long as such mistake is reasonable in light of all facts and circumstances.

The tax software program could have also made fatal errors at several different points in the tax advice process. For example, a tax rule could have been misinterpreted. Even if the tax rule was interpreted correctly, it is possible the software engineer could have made a mistake in transcribing the tax rule to the programming language. The software could have misguided the taxpayer or simply provided no guidance whatsoever. The software also could have defaulted by allowing a deduction once the taxpayer checked the box for "maintain and improve."[208] It is even possible for the error to reside with the computer itself and not the software at all. Given the possibility of error on the part of the software, and the difficulty for the taxpayer in discovering that error,[209] the courts should give more deference to taxpayers diligently calculating their taxes in good faith using tax software. Simply put, the days of preparing tax returns manually are over. In the days foregone, the predominate intelligence behind the preparation and correctness of a return was the taxpayer or the taxpayer's return preparer. With the advent of tax software (and its widespread proliferation) a substantial portion of the user's duties involve mere data entry, similar to beginning accountants at the large accounting firms. Most of the analysis itself (i.e., application of law to the facts) is reserved to the program. This trend will only increase in the future as tax software becomes more sophisticated.

3. The Tax Software Company as a "Professional Tax Advisor" or "Return Preparer"

Thus far, professional tax advice has not yet been expanded in the case law or the regulations to include tax preparation software. However, the question arises as to whether tax software may be construed as a professional tax advisor, or if not the software, perhaps the companies that sell such

208. The IRS has argued that the software companies should be cautious as to their default answers. *See* GAO-09-297, *supra* note 61, at 11 ("IRS is working with software companies to ensure their packages make users enter a 'yes' or 'no' response to questions about having a foreign bank account and signature authority. Prior to this change, some companies' software defaulted to a 'no' response.").

209. *See* cases cited *infra* Part IV.B (where software companies apparently changed their programs after several cases were lost using the TurboTax defense).

software and their representatives. A question also arises as to whether the software could be construed as a "tax preparer."

Reliance on the tax guidance communicated by tax software or its "tax experts" is arguably reliance on a form of professional tax advice under Regulation section 1.6664-4(b)(1). As previously mentioned, this "advice" does not have to be in any particular form.[210] One would assume it is not unreasonable to presume that tax preparation software will provide correct advice—particularly if the brand is a well-known national brand such as TurboTax or H&R Block at Home.

The most relevant case on point involving tax software as a "professional tax advisor" is the Seventh Circuit case *Reynolds v. Commissioner*.[211] This case involved a sophisticated taxpayer who practiced law and also worked full time for the IRS.[212] The IRS assessed a deficiency because of a number of improper deductions claimed by the taxpayer and his spouse attributable to his law practice, a family farm, and certain rental properties.[213] The IRS also determined the taxpayers were negligent, and the Tax Court sustained the imposition of the accuracy-related penalty.[214] The Seventh Circuit agreed with the Tax Court in light of the husband's "experience, knowledge and education" as a licensed attorney, certified public accountant, and IRS audit supervisor.[215] In their defense, the taxpayers stated they used TurboTax to prepare their returns, which was a "tax preparer."[216] The court disagreed, stating the petitioners' argument goes nowhere, because in order to demonstrate a reasonable cause (in good faith) exception under Regulation section § 1.6664-4(b)(1), the taxpayers needed to at least make a "threshold showing that reliance on TurboTax caused them to make substantive errors in their tax preparation."[217]

The court seems to indicate that a prerequisite to construing tax software as a "tax preparer" entails demonstrating the software made "substantive errors."[218] Such a showing, however, could be difficult. For example, if the software is *not* giving any advice on the topic when advice *should* be given, it would be difficult to prove a negative. Furthermore, if the software did not apply certain threshold tests or if the tax law is not appropriately covered, then it may be difficult for the taxpayer to make a showing of substantive error. *Reynolds* is also a challenging case because of

210. *See* Reg. § 1.6664-4(c)(2).
211. 296 F.3d 607 (7th Cir. 2002).
212. *Id.* at 609.
213. *Id.* at 610.
214. *Id.* at 618–19.
215. *Id.* at 618.
216. *Id.* at 619.
217. *Id.*
218. *Id.*

the husband's education and tax sophistication. Unlike *Olsen* and *Thompson* (who were also well-educated) this particular taxpayer was a lawyer, CPA, and an IRS audit supervisor. The authors suggest that in different circumstances (i.e., when the taxpayer is an ordinary person and not a tax expert) the software as a tax advisor should carry more weight.

The Supreme Court decision in *United States v. Boyle* held that "[w]hen an accountant or attorney *advises* a taxpayer on a matter of tax law . . . it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney."[219] This also seems to be the situation when a taxpayer utilizes tax software. When a taxpayer provides full disclosure and inputs all the relevant information into the program, the taxpayer expects the software to apply the tax law and calculate her tax liability correctly. Thus, it is only reasonable to expect the software to be competent as to the tax advice provided in most situations. As we discuss later, if the tax issues are so complicated or of such a controversial nature (e.g., a tax shelter) that a tax professional should have been sought or if for any reason the taxpayer "should have known better," then reliance might not be justifiable.[220] On the other hand, perhaps there should be a duty imposed on the software companies to provide special prompts or alerts when a professional tax advisor must be sought. The professional tax advisor may also be the "tax expert" provided by the software company.

Furthermore, just because the taxpayer using the tax software should have asked a professional tax advisor does not necessarily mean the taxpayer should per se lose on a TurboTax defense. As stated in *Boyle*, the taxpayer need not seek a second opinion on the advice rendered. The court stated: "'Ordinary business care and prudence' do not demand such actions," which "would nullify the very purpose of seeking the advice of a presumed expert in the first place."[221] Likewise, just because the software companies in their respective contracts state they are not "tax advisors," they nevertheless advertise they are and therefore should be considered as such.[222] Anything other is misleading.

To date, the authors are not aware of any cases or administrative pronouncements where the tax software itself has been held to be a professional tax advisor or a tax return preparer. Revenue Ruling 85-187 is as close as the administrative pronouncements get, but rather than the tax software being the return preparer, the IRS determined the firm that provided the software was a tax preparer.[223] The ruling involved a firm that furnished

219. 469 U.S. 241, 251 (1985).
220. *See infra* Part IV.D.3.
221. *Boyle*, 469 U.S. at 251.
222. *See* discussion *supra* Part II.B.
223. Rev. Rul. 85-187, 1985-2 C.B. 338.

specialized tax preparation software to tax practitioners. The issue before the IRS was whether the firm that provided such software was a "tax return preparer" under section 7701(a)(36).[224] Section 7701(a)(36) defines a return preparer as, "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title."[225] A person is not a return preparer if the person merely provides "typing, reproducing, or other mechanical assistance" with respect to preparing the return.[226] Generally, a person that provides computerized services for completing returns from information supplied by the taxpayer, or the taxpayer's advisor, is not considered a preparer if the services provided are limited to mechanical calculations and processing.[227] In other words, to rise to the level of a return preparer the "person must give 'advice directly relevant to the determination of the existence, characterization or amount of an entry on a return or a claim for refund,'" and the entry itself must be a "substantial portion" of the return.[228] Is this not what tax preparation software does each year for millions of taxpayers?

In the ruling, tax practitioners would complete worksheets on their clients' various deductions, income, and other tax items.[229] The practitioners would then submit the worksheets to the firm providing the computerized tax preparation service. The tax practitioners, however, made the substantive decisions about the application of the law to the facts when completing the worksheets. The hired firm would then enter the worksheet data into specialized tax software, generate a return, and forward it to the tax practitioners, who would sign and file the final returns. The software firm never met face-to-face with the practitioners' clients. The IRS nevertheless held the firm providing the software assistance was a tax preparer. The software firm had gone beyond mere mechanical assistance when it made certain substantive determinations concerning tax law application. Specifically, the software made a substantive determination in the application of section 48(q) when computing depreciation.[230] Similarly, TurboTax also routinely calculates depreciation for taxpayers who rely on

224. *Id.*

225. I.R.C. § 7701(a)(36)(A).

226. I.R.C. § 7701(a)(36)(B)(i).

227. *Id.*

228. United States v. Deaton, 754 F. Supp. 102, 103 (1990) (quoting Rev. Rul. 85-188, 1985-2 C.B. 339) ("Thus, in order to be deemed a 'preparer,' the statute contemplates the performance of more than mere ministerial acts.").

229. Rev. Rul. 85-187, 1985-2 C.B. 338.

230. *Id.* The firm's program was not updated to the current tax law in effect for 1983—the tax year at issue—and therefore, incorrectly calculated the deprecation deduction based on the old law, which was no longer in effect.

the software to calculate the appropriate deduction.[231] In addition, tax software makes other complex tax calculations and thus other situations could arise in which the software could act as a tax preparer.

Based on the above ruling, it is therefore arguable that TurboTax should also be considered a tax preparer. Unfortunately, however, the courts have missed the opportunity to discuss this very important issue. The authors suggest that the IRS should establish guidelines that elaborate on the situations where the software company (or the software itself) is considered a tax advisor or tax preparer. This will result in a heightened duty of care by the tax software companies. For example, perhaps the software should simply shut down (or proceed no further) with the filing of an improper return (i.e., the return cannot be e-failed, cannot be printed, cannot be saved, etc.). Such could be the case when a live professional tax advisor is warranted, when certain errors remained unresolved, when the audit risk is exceptionally high, and so forth. At the moment, improperly e-filed returns are routinely bounced back or rejected by the IRS when certain information is missing or contradictory (e.g., return information does not match IRS records, when dependents are claimed on another's return who has already filed with the IRS, returns with no taxable income, returns where the form W-2 box 1 is blank, returns that exceed the IRS limit for a particular form, returns containing forms that cannot be e-filed, prior year tax returns, etc.).[232] TurboTax itself may even disqualify you from e-filing if it contains certain overridden values. An override is when the taxpayer manually overrides a TurboTax calculation using a particular function in the program. Nevertheless, one can print and file. Clearly, more IRS guidance would assist in this area by establishing under what conditions the tax software should be considered a tax advisor or return preparer.

B. Cases the Taxpayer Should Have Won

In most cases where the TurboTax defense was raised, the taxpayer lost. Nonetheless, in several cases an argument can be made that the taxpayer should have won. In each of the unsuccessful cases the taxpayer was unable to document or prove the software made the improper advice, miscalculated the tax, or had a software guidance or application error. As mentioned previously, though, proving a negative might be difficult—particularly when highly complicated rules are cloaked in the user-friendly format of tax software. If the software does not ask the right question or gives no prompt or advice when it would be reasonable to do so, the taxpayer in those circumstances could easily (and unknowingly) end up with the wrong result.

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231. *See* TURBOTAX, *Compare*, *supra* note 79.

232. *See Common efile Mistakes and IRS-Rejected Tax Returns*, EFILE.COM, last accessed Sept. 26, 2013, http://www.efile. com/tax-return/tax-return-help/.

The authors have discovered the software companies in some circumstances appeared to have changed their programs to add prompts *after* taxpayers lost their cases. These prompts would now guide taxpayers to a correct decision if a similar case arose today. In at least three of the cases in which the taxpayer lost on a TurboTax defense, it appears as if the software companies "fixed" the tax problem litigated by the courts: (1) the Geithner fix, (2) the *Au* fix, and (3) the *Anyika* fix.

1. The Geithner Fix

Perhaps sheer guilt was the collective reasoning behind the IRS's announcement of a settlement initiative in 2006 for employees in similar situations to Mr. Geithner—those employed by foreign embassies, foreign consular offices, and international organizations such as the IMF.[233] Geithner was apparently too late to participate in the program. Taxpayers participating in the initiative were offered reduced penalties if they complied with the settlement agreement (but not a complete waiver).[234] Interestingly, after a case similar to that of Mr. Geithner (in which the taxpayer lost), TurboTax changed its software program to "fix" the Geithner dilemma.

In *Parker v. Commissioner*,[235] the taxpayer had worked for the IMF and analogized his situation to that of Mr. Geithner. The Tax Court was unsympathetic to the TurboTax defense—particularly in light of the taxpayer's previous rejection of a settlement initiative offer by the government.[236] In *Parker*, the taxpayer prepared his tax returns using

233. Announcement 2006-95, 2006-2 C.B. 1105.

234. *Id.* § 3(a)(7) ("The IRS will assess an applicable accuracy penalty on underpayments under I.R.C. § 6662 and/or applicable additions to tax under I.R.C. § 6651 for failure to file and/or failure to pay for only one of the taxable years 2003, 2004, or 2005, the year to be determined by the IRS based on the year with the highest tax deficiency. No other penalties will be assessed for adjustments relating to foreign embassy, foreign consular office or international organization income for the taxable years 2003, 2004, and 2005.").

235. T.C. Summ. Op. 2010-78, 2010 WL 2507529, at *7 n.15 (June 21, 2010) ("The record in this case does not establish any facts relating to the case to which petitioner refers involving U.S. Secretary of the Treasury Timothy Geithner. In any event, those facts would be irrelevant to our resolution of the issue presented here. Regardless of the facts and circumstances relating to the case to which petitioner refers involving U.S. Secretary of the Treasury Timothy Geithner, petitioner is required to establish on the basis of the facts and circumstances that are established by the record in his own case that there was reasonable cause for, and that he acted in good faith with respect to, the underpayment for each of his taxable years 2005 and 2006 that is attributable to his failure to report self-employment tax.").

236. *Id.* at *6 ("On the record before us, we reject petitioner's claimed reliance on TurboTax.").

TurboTax, and similar to Geithner, failed to include his self-employment taxes on his IMF income.[237] Contending the accuracy-related penalty should be waived, the taxpayer stated TurboTax provided "erroneous information" and made "[im]proper calculations" when he entered his W-2 wages because the program did not correctly address his self-employment taxes.[238] The taxpayer further stated he even "paid extra for the opportunity to . . . ask TurboTax professionals if FICA taxes were included in [his] tax computations," and the experts incorrectly stated they were.[239] The taxpayer contended he relied on the "professional [advice]" of the software and its tax experts.[240] The court rejected the taxpayer's assertion of reasonable cause, stating the taxpayer was aware of his self-employment tax responsibility because the W-2 forms he received clearly indicated FICA taxes were not withheld.[241] To a degree, this case is consistent with other software cases, in that a taxpayer's omission of data is the taxpayer's fault. On the other hand, data sometimes may not be entered if the advice indicates such is not necessary. With regard to the TurboTax representatives as professional advisors, the court stated the taxpayer did not present any credible evidence that such "experts" told him self-employment taxes were already included in the computation of his taxes.[242] In the software context, this would mean the software guidance did not request the pertinent information from the taxpayer during the interview process, or if the software did, the data was not integrated properly.

The most recent version of TurboTax now has a prompt that alerts the taxpayer to this issue. To the question, "Do Any of These Apply to This W-2?" there are eleven boxes that can be checked including one that states the following: "I worked in the U.S. for a foreign government or international organization and need to pay self-employment tax."[243] In addition, there is an "Explain This" prompt, which can be clicked to have the issue discussed in greater detail.[244] Thus, if a case similar to *Parker* or that of Mr. Geithner arose today, the taxpayer would clearly be alerted to the fact that he owes self-employment tax on his IMF income and thus would avoid the accuracy-related penalty.

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237. *Id.* at *2.

238. *Id.* at *3–4.

239. *Id.* at *5.

240. *Id.*

241. *Id.* at *6–7.

242. *Id.* at *6.

243. *See TurboTax Premier: Investments and Rental Property*, TURBOTAX, last accessed Sept. 13, 2013, http://turbotax.intuit. com/personal-taxes/cd-download/premier.jsp [hereinafter TURBOTAX, *Premier*]. Note that when Mr. Geithner was asked, "Did the software prompt you . . . ?" Geithner responded, "Not to my recollection." *Geithner Hearings*, *supra* note 1, at 15.

244. *See* TURBOTAX, *Premier*, *supra* note 243.

2. The Gambling or Au Fix

One can imagine a number of circumstances in which software guidance as to tax advice should have been given and the taxpayer ends up with the incorrect result. *Au v. Commissioner*[245] is such a case that involved a basic misinterpretation of the tax law. In this case, husband and wife taxpayers used H&R Block's software, TaxCut (now H&R Block at Home), to prepare their joint income tax return.[246] The IRS asserted a deficiency because of certain disallowed gambling losses.[247] On the taxpayers' Schedule A they claimed $40,488 in gambling losses as "other miscellaneous deductions," even though they had no offsetting winnings.[248] The accuracy-related penalty was imposed because of their negligence and substantial understatement. The taxpayers asserted reasonable cause, stating they "followed the instructions" on the software, which was "approved by the IRS."[249] They admitted, though, that they were unaware of the Code provision disallowing the losses and that they did not consult a professional tax advisor or any IRS publications. As with most of the cases, the court expected the taxpayers to introduce "software instructions" that were misleading. The court stated in relevant part,

> We doubt that the instructions, if correctly followed, permitted a result contrary to the express language of the Code. Petitioners may have acted in good faith but made a mistake. In the absence of evidence of a mistake in the instructions or a more thorough effort by petitioners to determine their correct tax liability, we cannot conclude that they have shown reasonable cause for the underpayment of tax on their 2006 return.[250]

Again, the court is not setting forth the proper standard of proof. The authors contend that an omission is difficult to prove and a presumption of good faith should be in the taxpayer's favor when tax software is used.

245. 100 T.C.M. (CCH) 400, T.C.M. (RIA) ¶ 2010-247 (2010).

246. 100 T.C.M. (CCH) at 400, T.C.M. (RIA) ¶ 2010-247 at 1453.

247. 100 T.C.M. (CCH) at 400, T.C.M. (RIA) ¶ 2010-247 at 1452.

248. 100 T.C.M. (CCH) at 400, T.C.M. (RIA) ¶ 2010-247 at 1453. Under section 165(d), losses from wagering transactions are only permitted as a deduction to the extent of any gains from such transactions. The taxpayers in this case "acknowledge[d] . . . they had no gains from their gambling activities during [the tax year] 2006," which was the year they inappropriately claimed the losses. *Id.*

249. 100 T.C.M. (CCH) at 401, T.C.M. (RIA) ¶ 2010-247 at 1453.

250. *Id.*

The most recent version of TurboTax[251] now has a prompt that alerts taxpayers to this issue. When discussing deductions, TurboTax has a separate page with a large heading "Gambling Losses." [252] On this page is a simple example: "You reported total gambling and prize winnings of $2,000. You can deduct up to $2,000 in gambling losses if you itemize deductions."[253] This page describes the law as follows: "Gambling losses can be deducted as an itemized deduction up to the total of reported gambling and prize winnings."[254] Thus, if a taxpayer similar to *Au* had gambling losses today, the taxpayer would be alerted to the disallowance of the deduction.

3. The Passive Loss or Anyika Fix

According to the courts, alleging software reliance and nothing more is one of the typical mistakes made by taxpayers. In other words, the cases hold the taxpayer must evidence some affirmative problem with the software guidance or advice. The Tax Court docket is full of cases similar to *Bunney* with taxpayers unsuccessfully asserting various versions of the TurboTax defense. One such case is *Anyika v. Commissioner*.[255] In this case the IRS denied a married couple's rental real estate losses claimed on their joint returns for the years 2005 and 2006.[256] The husband was employed as an engineer working 37.5 hours per week, 48 weeks per year, while the wife was a nurse working 24 hours per week. In addition to his regular job as an engineer, the husband also participated in real estate on the side—"purchasing, renovating, managing, and selling rental properties." The taxpayers prepared their returns using TurboTax and did not consult any outside tax professionals. As a consequence, they misunderstood the passive loss limitations rules of section 469(a)(1) when the husband misinterpreted the "real estate professional" exception contained in subsection (c)(7)(B).[257] The court sustained the IRS's disallowance of the taxpayers' real estate

251. *See* TURBOTAX, *Premier*, *supra* note 243. The authors understand that TaxCut was used by the taxpayers in the case, but the authors are using TurboTax Premier (2012 version) as an example here.

252. *See id.*

253. *See id.*

254. *See id.*

255. 101 T.C.M. (CCH) 1322, T.C.M. (RIA) ¶ 2011-69 (2011).

256. 101 T.C.M. (CCH) at 1323, T.C.M. (RIA) ¶ 2011-69 at 465.

257. 101 T.C.M. (CCH) at 1324, T.C.M. (RIA) ¶ 2011-69 at 467. The taxpayer husband mistakenly thought this particular subsection only required he work for at least 750 hours actively managing real property in order to be construed as a "real estate professional" thereby avoiding the passive loss rules. Unfortunately, however, subsection (c)(7)(B) required that he additionally "devote more than one-half of his total personal services working hours to his real estate business," which was technically impossible given his employment as an engineer. *Id.*

losses.[258] The court also found the taxpayers were negligent in taking such deductions and sustained a section 6662 accuracy-related penalty.[259]

Asserting reasonable cause, the taxpayers pointed the finger at TurboTax for any "miscalculations" on their returns.[260] The court, though, stated the taxpayers failed to demonstrate "any evidence showing the information that they entered into the software program."[261] To place fault on the software "a preliminary showing . . . would be required to decide whether the software program is in any way at fault . . . . [M]isuse of tax preparation software, even if unintentional or accidental, is no defense to penalties under section 6662."[262] Here again, the court is requiring that the taxpayers demonstrate with particularity the software error. Interestingly, however, the court in this case incorrectly characterized the taxpayers' error as that of software "misuse" when it was not. Rather, the error involved a misinterpretation of the law, specifically the passive loss limitation rules. It is very likely that the software did not inform the taxpayer correctly as to these rules, which are highly complicated and intensely fact-driven.

The most recent version of TurboTax now has guidance that walks taxpayers through various prompts to ascertain the applicability of the section 469(c)(7)(B) exception.[263] A page appears in the software program with the following caption in large print: "Let's See If You're a Real Estate Professional."[264] Then this simple rule follows: "Real estate professionals may pay less in taxes," with an "Explain This" prompt that states, "You are considered to be a real estate professional (i.e., in a real property trade or business) if . . . ."[265] The main page has a series of boxes that can be checked regarding the number of hours spent on the activity, etc.[266]

The passive loss limitation rules, though, are so complex that taxpayers commonly make mistakes in this area. A Government Accountability Office study has reported that over $12 billion of revenue has been lost as a result of taxpayers' mistakes involving the passive loss rules.[267] It would therefore be reasonable if the IRS (or a third-party expert)

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258. 101 T.C.M. at 1323, T.C.M. (RIA) ¶ 2011-69 at 465.

259. 101 T.C.M at 1326, T.C.M. (RIA) ¶ 2011-69 at 469.

260. *Id.*

261. *Id.*

262. 101 T.C.M. at 1326, T.C.M. (RIA) ¶ 2011-69 at 469–70.

263. *See* TURBOTAX, *Premier*, *supra* note 243.

264. *Id.*

265. *Id.* This page also defines the various types of real property activities that could qualify as a trade or business: development, construction, redevelopment, reconstruction, acquisition, conversion, rental operation, management, and leasing.

266. *Id.*

267. GAO-09-297, *supra* note 61, at 12 n.25 (citing U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-956, TAX GAP: ACTIONS THAT COULD IMPROVE RENTAL REAL ESTATE REPORTING COMPLIANCE 3 (2008) (stating that half of all

assessed the software in complex tax situations similar to *Anyika* to ascertain its accuracy.[268] At the very least, the taxpayer should have the right to have a representative of the software company accompany him or her (at a reasonable fee) to an audit where a software defense is being asserted.[269] Lastly, the Treasury should establish detailed regulations in this area.[270]

The *Anyika* case is another example where the court simply got it wrong. The taxpayer should not be required to prove that the software program omitted important tax advice. Second, the courts should be showing sympathy for taxpayers in these complex tax situations. One would think the more complicated a tax transaction becomes, the more likely software error could occur. When taxpayers in good faith use tax software and diligently enter their data in order to comply with the tax laws, the courts should establish a presumption that no accuracy-related penalty should be imposed.

C. Software Errors Through No Fault of the Taxpayer

In addition to software guidance errors or omissions, the software itself could create an error through no fault of the taxpayer. For example, it seems reasonable there could be situations in which the taxpayer should be able to argue a software application, computational, or electronic filing error occurred warranting penalty relief.[271] The consumer software companies make "accuracy guarantees" to alleviate consumer concerns with software error.[272] Both TurboTax and H&R Block at Home offer these limited

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individual taxpayers misreported their rental real estate income and expenses, resulting in an estimated $12.4 billion of lost revenue)).

268. GAO-09-297, *supra* note 61, at 12. The GAO has "recommended that IRS expand outreach efforts to external stakeholders, including software providers, as part of an effort to reduce common types of misreporting related to rental real estate." See our recommendation in Part V.A.3 below.

269. *See* discussion *infra* Part V.D.2.

270. *See* discussion *infra* Part V.D.3.

271. *See* discussion *infra* Part V.C. In 2007, taxpayers were delayed in filing their taxes when the TurboTax e-file system could not handle the eleventh-hour return surge. The government did not penalize the taxpayers for their late tax returns. Jordan Robertson, *No Penalty for Tax Filers Hit by Glitch*, WASH. POST, Apr. 18, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/04/18/AR2007 041800213.html. *See also* GAO-09-297, *supra* note 61, at 15.

272. TurboTax states on its website, among other things,

> Intuit works diligently to ensure the accuracy of the calculations on every form prepared using TurboTax. If you are the Primary or Secondary taxpayer on a return prepared using TurboTax with the most recent update available prior to filing your return, reviewed your return for reasonableness, and you pay an IRS or State penalty and/or interest solely because of a calculation error on a form within TurboTax; and not as a result of (among other things):

> - Your failure to enter all information accurately;
> - Willful or fraudulent omission or inclusion of information on your tax return, such as overrides;
> - Misclassification of information on the tax return;
> - Failure to file an amended return to avoid or reduce an applicable penalty/interest after Intuit announced updates or corrections to the Software in time for you to file an amended return;
>
> then Intuit will reimburse you in the amount of the IRS or State penalty and/or interest paid by you to the IRS or State up to the date of the first notice.

Frequently-Asked Questions About the TurboTax Accuracy Guarantee, TURBOTAX, last accessed June 9, 2013, http://turbotax.intuit.com/support/iq/Accuracy-Guarantee/TurboTax-Accuracy-Guarantee-FAQs/GEN84587.html#one (emphasis omitted). TaxACT states on its website, among other things, "[i]f you are assessed a penalty due to a calculation error in TaxACT Online Free Edition, Deluxe or State, we'll pay the penalty and interest." *TaxACT Online (Over the Web Users) Guarantees*, TAXACT, last accessed Sept. 26, 2013, http://www.taxact.com/company/guarantees.asp.

> TaxACT® guarantees the accuracy of its calculations in the Free Edition, Deluxe and State Editions of TaxACT only. If the IRS assesses a penalty due to a calculation error generated by TaxACT Free Edition, Deluxe or State on the Consumer's tax form, TaxACT will reimburse Consumer the amount of the penalty and interest attributed to the calculation error. This remedy is limited to Consumer's personal return and does not apply if Consumer uses TaxACT to prepare returns for persons or entities other than Consumer. This guarantee and warranty does not apply if Consumer overrides amounts within any tax return.
>
> The ultimate responsibility for any tax returns prepared using TaxACT software remains with Consumer. This Guarantee does not apply to, and TaxACT has no responsibility or liability for, Consumer's failure to enter all required information accurately, Consumer's willful or fraudulent omission or inclusion of information on a tax return, Consumer's wrongful classification or description of information on a tax return, or Consumer's failure to file a timely tax return.

Id. (follow "Read More" hyperlink).

H&R Block, which produces TaxCut (now H&R Block at Home), on its website contains the most detailed guarantee stating, among other things,

> (A) Block undertakes to reimburse you, after you pay the IRS, for the amount of the penalty and interest paid by you that you would otherwise not have been required to pay, up to a maximum of ten thousand dollars ($10,000), due to either of the following three situations in connection with your use of the Tax Program, but

only if you meet all of the conditions described in Section 6(B) below:

1. The penalties and/or interest are assessed against you by the IRS for a 2012 tax year return due solely to an arithmetic error made by the Tax Program, and not to an incorrect entry of data or any other reason; or
2. The penalties and/or interest are assessed against you by the IRS for a 2012 tax year return due solely to incorrect advice provided to you by Block on Block's designated message board in connection with the Signature Tax Program or Online Office Program and your reliance on that advice results in your payment of a penalty and/or interest to the IRS. (This excludes any communication with you by telephone or otherwise in connection with these services.)
3. The penalties and/or interest are assessed against you by the IRS for a 2012 tax year return due solely to an error made by Block in the preparation of your tax return that results in your payment of a penalty and/or interest to the IRS when you paid Block to prepare and sign your tax return.

Block will reimburse you for penalties and/or interest paid by you in the above situations to state tax authorities only for those individual states for which you have paid Block for use of the state portion of the Tax Program and used such Tax Program to file the state tax returns. Under no circumstances will Block pay additional taxes due, unless you accept and pay an additional fee for the Peace of Mind® Extended Service Plan which is only available when you obtain certain Supplemental Services, and then only in accordance with the Peace of Mind® Extended Service Plan terms and conditions.

(B) Block will only pay the penalties and interest described above in Section 6(A) above, if all of the following conditions are met:

1. The penalty or interest must not be due to an incorrect entry of data by you or any third party (including through any automated tax data import feature). The penalty or interest must not be due to your failure to follow instructions in the Tax Program, your failure to correct and resolve errors identified by the Tax Program, a claim for an improper or unsupportable deduction, a failure to report income, your failure to provide all necessary information to Block, or any other reason outside the control of Block.
2. You notified Block at Attn: H&R Block At Home Calculations Guarantee Claims, H&R Block Digital Tax Solutions, P.O. Box 10435, Kansas City, MO 64171-0435

guarantees to their customers. Customers are reimbursed for any penalties and the interest paid to the IRS as a result of a "calculation error" associated with the use of their software.[273] The guarantees, though, only insure accurate "computations." Furthermore, the guarantees contain numerous exclusions, such as when the taxpayer entered the incorrect information,

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> within 30 days after you learned of the mistake or received a notice from any tax authority regarding your tax return. In addition, you sent Block complete documentation of the penalty and interest including all correspondence to and from each tax authority, a copy of your tax returns as filed with each tax authority, proof that you paid the penalty and/or interest, and any other relevant information Block reasonably requests.
> 3. You took any action reasonably requested by Block, including filing an amended tax return if necessary, to limit any further penalties and interest from accruing.
> 4. The penalty and interest was for a return filed before April 15, 2012, or if the filing date is properly extended, before August 15, 2012. However, if you filed your return late, Block will not pay interest from April 15, 2012 to the date you actually file your return.
> 5. The penalty or interest pertains only to your individual tax return and not a business return.
> 6. You have complied with all terms and conditions of this Agreement, including the license restrictions and you have not intentionally provided any false information in connection with your account registration or tax return.
> 7. You paid the applicable fee, if any, to Block for license of the Tax Program(s) and any applicable Supplemental Services at the time of the initial filing or printing of your tax return.
> 8. The penalty or interest must not be based upon incorrect advice you receive from Block that you knew was incorrect at the time you filed your return.
>
> In no event will Block reimburse you for more than an aggregate of ten thousand dollars ($10,000) in interest and penalties owed to the IRS and any state revenue authorities based upon all tax returns you filed for the 2012 tax year, regardless of whether the tax returns are federal or state returns. THIS SECTION 6 STATES BLOCK'S ENTIRE OBLIGATION AND LIABILITY, AND YOUR SOLE AND EXCLUSIVE REMEDY, FOR ANY ERRORS IN YOUR RETURN CAUSED BY THE TAX PROGRAM OR BY BLOCK.

Accuracy of Calculations, H&R BLOCK, last accessed Sept, 25, 2013, http://www.hrblock.com/popups/accurate_calculations_ guarantee_online.html.

273. *See generally id.*

misclassified information on the return, failed to follow the software instructions, failed to report an item of income, claimed improper deductions, and so on.[274] Therefore, the utility of these accuracy guarantees is questionable. They certainly do not apply to a misapplication of the law to a set of facts or a fact. The guarantees also only apply to penalties and interest "paid," and thus, if the applicable penalty is waived, only the interest would be reimbursed. The authors suggest that if the software itself results in an arithmetic error or an algorithm error, or if the software makes an application, guidance, or electronic filing error through no fault of the taxpayer, the accuracy-related penalty should be waived by the IRS.

D. Cases Where the Taxpayer Should Have Known Better

While the court cases and IRS guidelines should specify situations when it is clear a taxpayer can rely on a TurboTax defense, they also should make it evident when a taxpayer *cannot* rely on such a defense. These situations might include: (1) when the taxpayer inputted inadequate data; (2) when the taxpayer inputted data incorrectly; (3) when the taxpayer should have reviewed the final tax return; (4) when the taxpayer made a mistake of fact or law that is so elementary the taxpayer should have known better; (5) when the issue was so uncertain, complicated, or controversial more advice should have been sought; (6) when the taxpayer did not preserve the software instructions and exhibits in circumstances where an error could have been documented; and (7) when the taxpayer does not have the knowledge to understand the basic operation of the computer program or the plain language of the tax advice conveyed.

1. Incorrect Entries and Failure to Review the Return

While the case law is clear that taxpayers generally cannot place fault on TurboTax for incorrect information entered,[275] as mentioned previously, there is an isolated error exception.[276] In this section, we discuss the cases where the courts correctly decided the taxpayer should lose. In these cases the taxpayers furnished inadequate data, made incorrect entries, and failed to review their final tax returns before submission.

In *Maxfield v. Commissioner*, a married couple claimed a series of improper deductions on their joint return using tax software.[277] The court determined the taxpayers were negligent and the accuracy-related penalty

274. *See generally id.*

275. *See* Maxfield v. Commissioner, T.C. Summ. Op. 2006-27, 2006 WL 354656 (Feb. 16, 2006).

276. *See* discussion *supra* Part III.B.1.

277. *Maxfield*, 2006 WL 354656, at *3.

applied. The taxpayers, alleging reasonable cause, blamed TurboTax. The court, however, stated in relevant part, "The 'TurboTax' program depends on the entry of correct information. Petitioners certainly knew that they were deducting personal expenses when they entered items such as routine meals, clothing, insurance, etc."[278] The TurboTax defense was therefore unsuccessful. By entering improper deductions, the taxpayers were misusing the software beyond its intended purpose. In other words, just because the software allowed the entry of incorrect information does not mean that the software is at fault. Furthermore, most likely the software made it clear to the taxpayers which personal expenses were deductible,[279] although one can imagine a scenario where the software's internal guidance or instructions make the taxpayer incorrectly believe an expense is deductible by law when it is not. Nevertheless, deducting expenses for personal meals and clothing ventures into the realm of cheating. Simply put, most taxpayers have enough common sense to know better notwithstanding any software.

In a similar case, *Moore v. Commissioner*, a high school teacher claimed duplicate deductions.[280] The taxpayer ran a tutoring business in addition to his regular occupation as a teacher and took the position that the tutoring business constituted two separate businesses (i.e., two Schedule Cs).[281] Finding that only one business existed, the court disallowed the taxpayer's second Schedule C deductions.[282] The taxpayer also claimed similar erroneous duplicate deductions on his Schedule A.[283] As a consequence the taxpayer was liable for the accuracy-related penalty.[284] In an effort to avoid the penalty, the taxpayer stated he "relie[d] completely" on his computer program.[285] In response to this, the court stated, among other things,

> [H]e supplied the information that the program, in turn, placed on the tax return and the appurtenant schedules. In that process, however, he is not relieved from reviewing the information on the tax return to determine whether it is correct. Petitioner is well educated, and we cannot accept as reasonable his explanation that he merely puts in the numbers and relies completely on the computer program.

278. *Id.*

279. The programs prompt you as to the personal deductions that are allowed as well as deductions allowed for business, investment, etc. *See* TURBOTAX, *Compare*, *supra* note 79.

280. T.C. Summ. Op. 2011-51, 2011 WL 1479951, at *2 (Apr. 18, 2011).

281. *Id.* at *1.

282. *Id.* at *3.

283. *Id.* at *2.

284. *Id.* at *4.

285. *Id.*

> That explanation is not sufficient to permit petitioner to avoid the penalty.[286]

Consistent with the regulations, the court considered the taxpayer's education as a relevant factor in determining whether his reliance was reasonable. A high school teacher would arguably know that the entries would result in an incorrect return. Here again the taxpayer should know better.

Sometimes taxpayers might not input "incorrect" data, but rather "incomplete" information, into the tax preparation software. In *Jacobson v. Commissioner*,[287] the taxpayer, a retired engineer, omitted on his return short-term capital gains associated with the sale of certain stock upon his retirement. The taxpayer stated he did not receive a Form 1099 or he must have "misplaced" it during his retirement.[288] The omitted income though was substantial, equaling $166,000 in gross proceeds, which even a cursory review of the tax return should have revealed.[289] The court stated the accuracy-related penalty was appropriate because of the taxpayer's blatant negligence.[290] Having prepared his return with tax software, the taxpayer tried the Hail Mary TurboTax defense.[291] The court, citing *Pratt v. Commissioner*,[292] however, stated that "reliance on a preparer or software is not reasonable where even a cursory review of the return would reveal inaccurate entries . . . We reject petitioner's claimed reliance on tax preparation software since he input incomplete information into the software."[293] In other words, it is difficult to find fault in the software when the software itself does not have a fighting chance due to incomplete data.

The *Pratt* case did not directly involve tax software. It involved unsophisticated taxpayers that did not even bother to review their joint return that was prepared and filed by their accountant.[294] With regard to one of the tax years at issue, the taxpayers stated the amount of gross receipts on the return were so significantly overstated, there was "no way" the taxpayers' business could have earned over one million dollars in that year.[295] The court

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286. *Id.* at *3–4.

287. T.C. Summ. Op. 2010-130, 2011 WL.3489549 (Sept. 7, 2010).

288. *Id.* at *2.

289. *Id.*

290. *Id.*

291. *Id.*

292. 84 T.C.M. (CCH) 523, T.C.M. (RIA) ¶ 2002-279 (2002).

293. *Jacobson*, T.C. Summ. Op. 2010-130, 2011 WL.3489549 at *2.

294. *Pratt*, 84 T.C.M. (CCH) at 524, T.C.M. (RIA) ¶ 2002-279 at 1686. The petitioners were, husband and wife, running a sole proprietorship sheet metal business. The husband, who ran the business, had a tenth grade education, and the wife was a homemaker. *Id.*

295. *Pratt*, 84 T.C.M. (CCH) at 528, T.C.M. (RIA) ¶ 2002-279 at 1690.

imposing the accuracy-related penalty stated a mere "cursory look" by the taxpayers at the return would have easily revealed the substantial increase in gross receipts was not accurate.[296] The taxpayers were unreasonable and not acting in good faith when they signed their return in blind reliance on their accountant.[297] Therefore, according to *Pratt*, a taxpayer should not be able to blame tax software when a reasonable person would review the return and discover the error.

Another case involving "incomplete information" is *Hopson v. Commissioner*.[298] In this case, the taxpayers, a husband and wife, failed to include in their gross income certain retirement plan distributions amounting to $60,882.[299] The petitioner husband prepared their joint return using tax software (the same as he had done for nearly twenty years previously).[300] The husband acknowledged receiving a Form 1099-R.[301] Nevertheless, the taxpayer simply failed to input the distributions into the software during its interview process.[302] The taxpayer stated he completed the software's interview process, but inadvertently omitted the distributions from income.[303] After finalizing their return he ran an "error check" of the information entered which found no mistakes.[304] After generating the final return, neither taxpayer reviewed it for accuracy.[305] A deficiency occurred and the IRS and the Tax Court determined the accuracy-related penalty was appropriate.[306] The husband admitted receiving the 1099-R and he knew the distributions were income, yet the taxpayers nevertheless blamed the software.[307] The court disagreed that the software was to blame:

> The omission of the distributions resulted in the failure to report over 40 percent of petitioners' total income for the year. Granted this was a one-time event, but petitioners nevertheless had a duty to review their return to ensure that all income items were included. Petitioners were not permitted to bury their heads in the sand and ignore their obligation to ensure that their tax return accurately reflected their income for 2006. In the end, reliance on tax return

296. *Pratt*, 84 T.C.M. (CCH) at 530, T.C.M. (RIA) ¶ 2002-279 at 1693.
297. *Id.*
298. T.C. Summ. Op. 2009-130, 2009 WL 2614712 (Aug. 25, 2009).
299. *Id.* at *1.
300. *Id.*
301. *Id.*
302. *Id.*
303. *Id.*
304. *Id.*
305. *Id.*
306. *Id.* at *3.
307. *Id.* at *2.

> preparation software does not excuse petitioners' failure to review their 2006 tax return.[308]

The taxpayers, therefore, did not act with reasonable cause in good faith when they failed to input the IRA distributions into the software. A reasonable person under the circumstances would have reviewed the return and discovered the error.

Both *Jacobson* and *Hopson* involved substantial omissions of income and the failure to conduct even a cursory review of the tax return. The Tax Court therefore recited the rule of *Magill v. Commissioner*,[309] which normally arises in the context of reliance on a professional tax advisor; namely, "[e]ven if all data is furnished to the preparer, the taxpayer still has a duty to read the return and make sure all income items are included."[310] As indicated in *Bailey v. Commissioner*, "[t]he duty of filing accurate returns cannot be avoided by placing responsibility upon an agent. The fact that petitioner told the person who made up the partnership return about the sale of leasehold interests . . . cannot excuse his failure to read the return and ascertain the inclusion of this item."[311] In other words, "[t]he voluntary failure to read a return and blind reliance on another for the accuracy of a return are not sufficient bases to avoid liability for negligence additions to tax."[312] *Jacobson* and *Hopson* managed to carryover the general rules relating to reliance on a professional preparer into the context of tax preparation software. The courts were implicitly suggesting that tax preparation software is analogous to a professional tax advisor, just as we are suggesting in this Article. Nevertheless, just like in the case of a professional tax advisor, the taxpayer should still have a duty to review the return before a successful TurboTax defense.

2. Mistake of Fact Versus a Mistake of Law

The case law also is clear that situations may arise when the taxpayer should have known that they were making simple mistakes of fact or law. Even in those situations where it may be difficult to distinguish between fact and law, if the taxpayer makes a mistake that is so elementary that the

308. *Id.* (citations omitted).
309. 70 T.C. 465 (1978).
310. *Id.* at 479–80.
311. Bailey v. Commissioner, 21 T.C. 678, 687 (1954).
312. Bollaci v. Commissioner, 61 T.C.M. (CCH) 2137, 2139, T.C.M. (RIA) ¶ 1991-108, 534 (1991).

taxpayer should know better, then the TurboTax defense should be unavailable.[313]

a. A Taxpayer's "Mistake of Fact" Is Not the Software's Problem

One such Tax Court case is *Madduri v. Commissioner*,[314] where the taxpayers contended TurboTax "allowed" them to input their W-2 wages on their Schedule C, and thus, it was the fault of the software.[315] This is the other side of the Geithner excuse; namely, the software permitted me to do it, so "it must be legal."[316] This case involved a husband and wife filing a joint return.[317] The husband mistakenly thought he was an independent contractor rather than an employee of a company he worked for.[318] As a result, he reported all of his wages from his employer on Schedule C, which could then be utilized to offset various business related deductions.[319] The Commissioner assessed the accuracy-related penalty because of the taxpayers' substantial understatement of income tax.[320] In their defense, the husband asserted, "Turbo-tax [sic] [allowed him] to put W-2 [wages] into Schedule C, so then [he] thought it was legal." The court disagreed, stating the taxpayer's "mistaken belief" he was an independent contractor was not reasonable under the circumstances, nor was it in good faith.[321] It was the taxpayer's responsibility to determine his tax status as an independent contractor, not that of software.[322] *Madduri* therefore indicates reasonable cause (i.e., "software error") does not exist simply because the software permitted the taxpayer to input information incorrectly.

Defining an employee versus an independent contractor has been difficult enough for the courts and the IRS to reconcile.[323] In many circumstances, such a determination could be difficult for tax software to handle and the taxpayer should consider seeking advice beyond the software

313. *But see* Thompson v. Commissioner, 94 T.C.M. (CCH) 21 , T.C.M. (RIA) ¶ 2007-194 (2007) (aeronautical engineer claiming improper deductions for flight school used reasonable care by obtaining software to prepare tax return).

314. T.C. Summ. Op. 2009-117, 2009 WL 2230781 (July 27, 2009).

315. *Id.* at *3.

316. *See id.*

317. *Id.* *1.

318. *Id.*

319. *Id.*

320. *Id.*

321. *Id.* *3.

322. *Id.*

323. John Bruntz, *The Employee/Independent Contractor Dichotomy: A Rose Is Not Always A Rose*, 8 HOFSTRA LAB. & EMP. L.J. 337, 337 (1991).

in such a situation.[324] Determining one's status as an independent contractor or an employee may be one of those factual determinations tax software simply does not have the ability to judge. Now whether or not the software has a duty to alert the consumer that outside advice must be sought is something the courts and the IRS will have to wrestle with. Certainly, a regulation on the subject could provide helpful guidance. Nevertheless, as in the *Madduri* case, a W-2 is often a clear indication of employee-employer status versus that of independent contractor.[325] It is also not likely that this error would occur today using TurboTax because W-2 information is imputed at the beginning of the process.[326] The taxpayer would therefore have to override this part of the program to include such on Schedule C.

A more unusual case of asserted software error is that of *Choe v. Commissioner*,[327] which involved a basic mistake of fact. In this case, the Commissioner disallowed certain legal and professional expenses, depreciation, and automobile expenses in connection with the taxpayer's business.[328] The taxpayer was a loan officer that started his own business as a loan consultant. In connection with his new business he claimed various expenses. During the year in dispute, the taxpayer's automobile was totaled in a crash and the taxpayer received insurance proceeds equal to the fair market value of the vehicle. Because the taxpayer informed the software that the vehicle was used in his business, however, it automatically deducted depreciation allowed or allowable on the vehicle reducing the vehicle's tax basis. As a consequence, the insurance proceeds resulted in a gain on the taxpayer's return.[329] The court found that the taxpayer did not use the vehicle for business use and thus the gain was incorrectly computed.[330] *Choe* is one of the few cases discovered by the authors in which the tax software made an actual error.

One can imagine all sorts of other scenarios in which the question of fact would seem so elementary that the taxpayer (or in some circumstances the software) should have known better. The issue then becomes where exactly the blame resides. For example, whether an expense is personal or

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324. *Id.* at 338 ("Little guidance is available for an absolute determination because the various common law and statutory distinctions are widely divergent and subject to broad ranges of interpretation."). *See also* discussion *infra* Part IV.D.3.

325. *Madduri*, T.C. Summ. Op. 2009-117, 2009 WL 2230781 (July 27, 2009).

326. Using the Turbo Tax Premier (2012 version) the authors noted that the data entry of the W-2 information occurs in the beginning of the entry process after certain basic taxpayer information.

327. T.C. Summ. Op. 2008-90, 2008 WL 2852249, at *1 (July 24, 2008).

328. *Id.*

329. *Id.*

330. *Id.* at *2. *See also* TURBOTAX, *Pemier*, *supra* note 243.

business,[331] whether income is rental or portfolio, whether the taxpayer is married under state law, and so forth, all seemingly elementary factual questions on the surface, but under the right circumstances, the analysis can drill down 100 feet deep into an intensive inquiry with different legal results based on various junctures.[332] In other circumstances different facts and circumstances might even render the ultimate legal result even more uncertain. Therefore, it seems that if taxpayers have a reasonable argument for their position in reliance on tax software (like in the *Thompson* case), the courts should presume the taxpayer acted in good faith and allow relief from the accuracy-related penalty. On the other hand, if the issue is uncertain, complex or confusing, the taxpayer should seek more advice provided that the software instructs the taxpayer to do so.

b. Who Is at Fault for a "Mistake of Law" - the Software or the Taxpayer?

All sorts of circumstances may arise where a sophisticated legal judgment call cannot be resolved by computer software; provided, however, this may change with further advances in technology. The Tax Court often cites *Bunney v. Commissioner*[333] for the general proposition that "tax preparation software is only as good as the information one inputs into it," and thus, is not reasonable cause to avoid the accuracy-related penalty. As stated previously, it is not the "responsibility" of the software to ensure correct data entry, but rather that of the taxpayer. *Bunney* involved a taxpayer with a number of improper tax items on his return, including improperly claimed deductions, duplicated deductions, omitted taxable gain from the sale of his residence, and omitted income from more than one-half of his IRA distributions.[334] With regard to the improper deductions claimed, the omitted gain from the residence sale, and the omitted IRA income (not attributable to his former spouse) the court determined he was negligent, and

331. *See* William A. Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip — A Conceptual Analysis*, 18 STAN. L. REV. 1099, 1099 (1966). *See also* Daniel I. Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 859 (1974).

332. *See, e.g.*, Timothy J. Vitollo, *The DOMA Disparity: Transfer Taxation of Same-Sex Spouses in Community Property and Common Law States*, 26 PROBATE & PROP. 11 (2012). *See also* INTERNAL REVENUE SERVICE, ANNUAL REPORT FROM THE COMMISSIONER OF THE INTERNAL REVENUE SERVICE ON TAX LAW COMPLEXITY (Jun. 5, 2000) (listing the three top sources of complexity as the alternative minimum tax, estimated taxes, and filing status determinations).

333. 114 T.C. 259 (2000).

334. *Id.*

thus liable for the penalty.[335] In his defense, the petitioner asserted he acted with reasonable cause and in good faith.[336] He stated the Form 1040 was a "complicated return" and "he utilized tax software to prepare his return."[337] The court disagreed, finding no evidence of reasonable cause.[338] In other words, the mere fact that a tax return is "complicated" is no excuse for one's negligent behavior.

The court's opinion was silent regarding the sophistication of the taxpayer, and whether the taxpayer sought outside tax advice, professional or otherwise. The return was certainly complicated, considering the items described in the case, which included IRA income, the section 72(t)(1) penalty, personal residence gain, Schedule F depreciation, and the like. The case does not indicate, however, that the software could not process such complexity. Instead, the taxpayer merely asserted he used tax preparation software, as if somehow, the complexity of the return was the software's fault.[339] As illustrated in *Bunney*, if a taxpayer does not have the sophistication to correctly operate the tax software, or if the taxpayer fails to input the correct data, it is the taxpayer's problem and not that of the software. Complexity should only lend itself to reasonable cause when the software is in error.

3. So Complicated the Taxpayer Should Seek More Advice

Bunney was arguably a case where the return was so complicated that the taxpayer should have sought outside advice. In an ideal world, the tax software itself would alert the taxpayer of such; perhaps providing a refund of any software fees incurred. The complex nature of the return should be balanced with the sophistication of the taxpayer using the software. The authors suggest that a return can be so sophisticated that the taxpayer "[fails] to exercise ordinary and reasonable care in preparation of his tax return" under Regulation section 1.6662-3(b)(1) when prepared with computer software. But this should only be the case after the taxpayer has

335. *Id.* at 266–67.

336. *Id.* at 267.

337. *Id.*

338. *Id.*

339. An interesting question arises as to whether preparing your own return with computer software in and of itself can constitute negligence under section 6662(b)(1). *See infra* Part IV.D.5. A closer examination of *Bunney* also indicates the taxpayer did not assert the software made a: (1) computational error; (2) incorrectly counted his deductions twice; (3) provided incorrect tax advice concerning the retirement plan distributions (or the improper tax items); (4) was not updated to the current law; (5) incorrectly applied the tax rules to the facts; (6) failed to include previously entered income; or (7) that there was an omission or clerical error that occurred when he transcribed his information into the program. *Id.*

been put on notice of the software's shortcomings. It is important to keep in mind that each year software evolves a step further and therefore it is unreasonable to assume that a taxpayer is going to be aware of the software's internal capacity at any given moment in time. Similar to any other professional tax advisor, reasonable reliance does not require an inspection inside the brains of the tax preparer. When the preparer cannot handle an issue, it is the preparer's responsibility to inform the taxpayer of such.

Another complicated return was at issue in *Lam v. Commissioner*,[340] which involved a business and investment property with related-party use of a dwelling unit. In this case, the husband and wife taxpayers were denied certain losses attributable to their rental real estate under the vacation home rules of section 280A because the home was used for personal use (i.e., the wife's father lived there rent-free). Presumably, the rental income and expense deductions also should have been on Schedule E rather than on Schedule C as claimed by the taxpayer.[341] The taxpayers' stock losses were also incorrectly claimed on Schedule C and thereby disallowed by the Service and transferred to Schedule D as capital losses. The taxpayers prepared their joint returns using TurboTax. Trying to avoid the accuracy-related penalty, the taxpayers stated they consistently filed their returns with TurboTax and confused capital gains and losses with ordinary gains and losses.[342] The court stated the taxpayers may have acted in good faith, but they did not behave "in a manner consistent with that of a prudent person."[343] The taxpayers did not seek the advice of a tax professional, or visit the IRS website for instructions on filing Schedule C.[344] The court stated that it did "not accept petitioners' misuse of TurboTax, even if unintentional or accidental." The court went on to note that "[i]t was not a flaw in the TurboTax software which caused petitioners' tax deficiencies . . . [and t]he duty to file an accurate return generally cannot be avoided by shifting responsibility to a tax return preparer." However, the court did state that reliance on a tax professional could be reasonable cause and good faith for the purposes of avoiding a section 6662(a) penalty. Still, "such reliance, standing alone does not serve as an absolute defense to negligence; it is merely a factor to be considered."[345]

340. 99 T.C.M. (CCH) 1347, 1347–48, T.C.M. (RIA) ¶ 2010-82, at 505 (2010).

341. Rental real estate income and losses are generally reported on Schedule E, unless the taxpayer materially participated in the residential rental activity by providing substantial services similar to a hotel.

342. *Lam*, 99 T.C.M. (CCH) at 1348, T.C.M. (RIA) ¶ 2010-82 at 505.

343. *Lam*, 99 T.C.M. (CCH) at 1349, T.C.M. (RIA) ¶ 2010-82 at 507.

344. *Id.*

345. *Id.*

Again, the court seemed to miss the opportunity to hold that in some circumstances tax software could be considered a tax advisor or tax preparer. While there could be some situations where independent professional tax advice might be necessary—for example, where the taxpayer must deal with multiple trusts or other entities—in most situations the software should be able to handle these tax issues.[346] On the other hand, when the taxpayer does not have an understanding of some basic or elementary issue, and thereby misuses the program, the taxpayer should not be able to assert the TurboTax defense.

4. When the Taxpayer Can Document Software Error

Contrary to what most of the taxpayers argue, a taxpayer will not be able to prove software error in every case. Only in some circumstances will the taxpayer be able to prove with documentation that the tax software made a mistake. For example, the taxpayer might be able to print out the prompt that indicates the guidance was incorrect.

In *Paradiso v. Commissioner*,[347] the taxpayer had the ability to show documentation of such reliance. This case involved the "failure to file" penalty under section 6651(a)(1).[348] In *Paradiso,* the taxpayer stated he used TurboTax to prepare his "draft" return, and because the tax software showed he was entitled to a refund, he never filed the return.[349] The petitioner also contended he relied on the advice of his broker, who stated a return was not required. The court stated there was no evidence the broker was an accountant, attorney or tax professional, or that the broker in fact stated a return was not required.[350] The court held the taxpayer did not have reasonable cause under the circumstances. Because the taxpayer failed to produce any evidence of the information he entered into TurboTax, the court was unable to determine if any error on the software's part occurred.[351] In this case, a printed return would have shown that with the data furnished, no liability would arise. Again, there may be other situations when the taxpayer could document software error, such as when there is an affirmative guidance mistake, and when there is a calculation error.

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346. Just as an example, the authors tried to calculate foreign passive income and the application was difficult if you do not already understand the modification to adjusted cost basis determinations.

347. 90 T.C.M. (CCH) 110, T.C.M. (RIA) ¶ 2005-187 (2005).

348. Under section 6651(a)(1) an additional tax is imposed on taxpayers that fail to file, unless the taxpayer demonstrates the failure was due to reasonable cause and not willful neglect. I.R.C. § 6651(a)(1).

349. *Paradiso*, 90 T.C.M. (CCH) at 111, T.C.M. (RIA) ¶ 2005-187 at 1386.

350. 90 T.C.M. (CCH) at 112-13, T.C.M. (RIA) ¶ 2005-187 at 1388.

351. *Id.*

5. *When the Taxpayer Lacks Computer Competency or Basic Tax Knowledge*

As indicated previously a taxpayer's education and intelligence is often relevant in the Tax Court when determining whether a TurboTax defense is justifiable. In almost all of these cases, the judge determined the relative sophistication of the taxpayer as well as the manner in which the taxpayer approached his or her tax reporting responsibilities.[352] In other words, well-educated taxpayers are often relieved of the accuracy-related penalty tax for software use, whereas uneducated taxpayers are not.[353] Presumably, this is because they are able to approach their tax software preparation with a greater degree of precision.[354] In some circumstances, however, one's educational level should hurt the taxpayer's chances.[355] The Tax Court has frequently rejected the argument that the taxpayer's lack of a formal education is sufficient to establish a lack of negligence.[356] Of course, a lack of formal education by no means is conclusive that a person is unsophisticated as to tax software or the relevant tax laws. It nevertheless is apparent that a TurboTax defense should not be available to taxpayers who lack basic computer skills to perform the operational tasks of the software and basic tax knowledge to navigate such software.[357]

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352. *See* Reynolds v. Commissioner, 296 F.3d 607 (7th Cir. 2002); Moore v. Commissioner, T.C. Summ. Op. 2011-51, 2011 WL 1479951 at *1 (2011). Although not discussed directly in every case, the facts often indicate sophistication by indicating the profession of the taxpayer, such as engineers, high school teachers, loan officers, and such.

353. *See* Thompson v. Commissioner, 94 T.C.M. (CCH) 24, T.C.M. (RIA) ¶ 2007-174 (2007); Olsen v. Commissioner, T.C. Summ. Op. 2011-131, 2011 WL 5885082 at *1 (Nov. 23, 2011).

354. *Olsen*, T.C. Summ. Op. 2011-131, 2011 WL 5885082 at *1 (Nov. 23, 2011) (patent attorney taxpayer purchased the premier version of the tax software).

355. *See* Reynolds v. Commissioner, 296 F.3d 607 (7th Cir. 2002).

356. *See* Singer v. Commissioner, 74 T.C.M. (CCH) 120, T.C.M. (RIA) ¶ 1997-325 (1997) (taxpayer who quit high school was liable for the penalty); Hogard v. Commissioner, 73 T.C.M. (CCH) 2552, T.C.M. (RIA) ¶ 1997-174 (1997) (taxpayer who graduated from high school was liable for the penalty); Lax v. Commissioner, 68 T.C.M. (CCH) 115, T.C.M. (RIA) ¶ 1994-329 (1994) (taxpayer who graduated from high school was liable for the penalty); McPike v. Commissioner, 71 T.C.M. (CCH) 1988, T.C.M. (RIA) ¶ 1996-46 (1996) (taxpayer who graduated from high school and took some graduate courses was liable for the penalty).

357. There could be other circumstances when a TurboTax defense would not be justifiable. For example, one situation may be when the taxpayer has a past history of penalties.

V. THE IRS AND SOFTWARE COMPANY DUET

While taxpayers may not have fared well in the Tax Court asserting a TurboTax defense, it is undeniable that tax software (and electronic filing) has dramatically transformed the manner in which federal income taxes are determined. In 2012, nearly one hundred percent of all professional tax preparers used software,[358] over ninety percent of taxpayers in general used software, and over eighty percent of individual taxpayer returns were electronically filed.[359] While these technological developments have arguably been beneficial ones, taxpayers have suffered under software error.[360] Certainly capitalism and competition have thrived and helped the profits of both the software industry and tax preparers.[361] The IRS has also become a more effective and efficient administrator of the tax system with the growth of both tax software and electronic filing.[362] Aside from the

358. *See* discussion *supra* Part II.A.

359. Congress set a goal of increasing electronic filing to 80 percent in 1998. *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 § 2001(a)(2), 112 Stat. 685, 723. As the e-filing program developed, commercial software developers saw "opportunities to create new filing products and introduced a new level of competition to the business of helping taxpayers." *IRS IRS E-File Study #1*, *supra* note 62, at 13.

360. In the theory of disruptive innovation, new technologies can overtake traditional ones. *See* CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL 42–48 (1997). In our case, tax software is replacing the pen and pencil. However, it is not replacing mom-and-pop preparers, H&R Block storefront operations, or the higher-end accountant and legal tax attorneys. The market for tax advice has changed since 1980 but not much since 1990. The market for paid record keepers has probably increased as well. *See also* Cassandra Burke Robertson, *The Facebook Disruption: How Social Media May Transform Civil Litigation and Facilitate Access to Justice*, 65 ARK. L. REV. 75, 97 (2012) (Facebook and other social media likely have a disruptive effect on civil litigation by supplying "a tremendous amount of information, connectivity, and communication in ways that may empower self-represented litigants.").

361. Intuit, for example, has averaged about $3 billion in net revenue, and H&R Block, Inc. generated revenues of $4.4 billion in 2008, GAO-09-297, *supra* note 61, at 3 n.5

362. *See* GAO-09-297, *supra* note 61, at 6–7 (reporting that through the use of electronically filed returns, the IRS has both increased revenues by $175 million and reduced costs by $2.52 per return). In addition, these returns are processed in half the time as paper returns and have a higher accuracy rates. *Id.* E-file returns are also "available for audit several months sooner than paper returns, [helping the audit selection process and] allowing more time before the three-year statute of limitations expires." Jay Starkman, *E-Filing and the Explosion in Tax-Return Fraud*, WALL ST. J., Jan. 13, 2013, http://online.wsj.com/article/SB10001424127887323374504578222130665022160.html [hereinafter Starkman, *E-Filing and Tax Fraud*].

general lack of a TurboTax defense in the Tax Court, taxpayers have benefited to a degree as a result of the convenience, cost effectiveness, and reliability of tax software,[363] and by the quick refunds from e-filing.[364]

The software companies have worked in a cooperative partnership with the IRS since the 1980s. Shortly after developing tax software, the software companies originated the idea of electronic filing and encouraged the IRS to start their first pilot program in 1986.[365] For over twenty-five years, the IRS and software companies have worked to increase the use of software and e-filing. While this past partnership has been a successful one,[366] more needs to be done to assure the accuracy, security, privacy, reliability, efficiency, and fairness of the tax system. The more that is done the less likely taxpayers will need to rely on a TurboTax defense.

A. Accuracy

Certainly, accuracy is very important to taxpayers who want to use tax software to prepare federal as well as state income tax returns. An inaccurately prepared return is tantamount to no software at all. Accuracy generally has two aspects: accuracy in "applying the law" and accuracy in "computation."[367] The IRS has reported the "single most important factor" among taxpayers influencing their decision concerning the use of tax software was its ability to accurately apply the tax laws through appropriate application of the tax provisions and accurate computations.[368]According to one study, accuracy beat out "in descending order, privacy/security, ease of use, cost, speed of filing, and speed of refund."[369] Thus far, the IRS and software companies have worked well in updating information and forms after late year-end tax changes.[370] The IRS has also made inroads in testing

363. GAO-09-297, *supra* note 61, at 29.

364. *Id.* at 6, 29 (software that is electronically filed has "[f]aster refunds" as well as "[f]ewer errors due to not needing to process paper," as well as "[l]ess incidence of lost documentation.).

365. *IRS E-File: A History*, INTERNAL REVENUE SERV., June 2011, http://www.irs.gov/uac/IRS-E-File:-A-History.

366. The software companies and other tax preparers were the ones to originate the use of electronic filing in the 1980's. *See IRS E-File Study #1*, *supra* note 62, at 13. The IRS has also partnered with the states and other government agencies. *Id.* at 10.

367. *See*, *IRS IRS E-File Study #1*, *supra* note 62, at 52.

368. *Id. See also* GAO-09-297, *supra* note 61, at 10.

369. *See IRS E-File Study #1*, *supra* note 62, at 53; *see also* ETAAC 2011 REPORT, *supra* note 60, at 14.

370. Congress passed The Tax Relief Act of 2012 into law on December 17, 2010. *See* H.R. 3630, 112th Cong. (2nd Sess. 2012) (enacted); *see also Congress Passes 2012 Payroll Tax Holiday Extension,* CLIFTONLARSONALLEN, last accessed

for accurate computations in tax software. However, more needs to be done in assessing the accuracy of the tax software in applying the tax law to various fact patterns. As illustrated previously in the aforementioned court cases, the software does not necessarily always sufficiently address complicated facts as applied to law.

1. The Latest Tax Forms and Annual Updates

The IRS provides companies with all the latest forms and regularly works with software industry groups and advisory councils on annual updates to tax laws and procedures.[371] In 2000, the IRS developed a National Account Manager (NAM) to serve as the main communication channel between the tax software industry and the IRS.[372] NAM communicates regularly with software companies about issues of mutual interest including tax law changes, updates to IRS forms, and publications.[373] Software companies also contact the NAM when they encounter technical issues such as a disruption to electronic filing.[374] With the recent trends in Congress to extend or change tax law at the end of the year,[375] continuation of this partnership is essential to assuring accurate tax returns.

2. The Participants Testing System

To assist with software accuracy, the Service requires tax software companies to pass its Participants Acceptance Testing System (PATS), which includes verifying that computations are correct, tax rate schedules are updated and returns transmitted electronically are compatible with IRS systems.[376] The downside of the PATS system is it does not go any further to

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June 16, 2013, http://www.cliftonlarsonallen.com/Tax-Watch/Congress-Passes-2012-Payroll-Tax-Holiday-Extension.aspx. Congress passed the American Taxpayer Relief Act of 2012 on January 3, 2013. *See* H.R. 8, 112th Cong. (2nd Sess. 2013); *see also* Matthew Daly, *Fiscal Cliff: Obama Signs American Taxpayer Relief Act Into Law*, HUFFINGTON POST, Jan. 3, 2013, http://www.hufingtonpost.com/2013/01/03/fiscal-cliff-obama_n_2398544.html.

371. *See* GAO-09-297, *supra* note 61, at 11.

372. *Id.*

373. *Id.*

374. *Id.*

375. In December 2011, the legislature extended the Bush tax cuts for another year. Then in the "fiscal cliff" legislation of January 1, 2013, Congress made many of the tax cuts permanent while increasing taxes on the wealthy. *Congress Approves Last-Minute Deal To Make Most Tax Cuts Permanent*, GRANT THORNTON, Jan. 3, 2013, http://www.grantthornton.com/staticfiles/GTCom/Tax/TF_TLU_TPU%20files/TLU_2013-01A.pdf.

376. GAO-09-297, *supra* note 61, at 10–11.

monitor the "taxpayer guidance" in such tax software so it is not "sufficient in helping taxpayers prepare accurate tax returns."[377]

The IRS has worked with the tax software industry on an ad hoc basis[378] to clarify some of its guidance. For example, in 2009, the IRS took issue with some of the default responses to questions in tax software that related to foreign bank accounts.[379] When the software asked the taxpayer whether they had a foreign bank account and the taxpayer did not respond to the question, the software would just default to a "no" response. The IRS also worked with a group of tax software developers to ensure software used by paid preparers eliminated default answers relating to the earned income tax credit.[380]

3. Risk Assessment of Software

Although the IRS tests all software used to e-file to assure that these returns can be processed like tax returns submitted by pencil and paper, the IRS does not test the software to check for misapplications of the tax law.[381] One study of tax software packages found that the packages incorrectly prepared tax returns in eighty percent of the cases.[382] In addition, the study found that "the tax software packages' own internal validity checks did not identify the errors."[383] Thus, it seems that the IRS should perform some kind of testing of the software to assess the risks of error in the software. In the alternative, the IRS should hire third-party experts who can assess the accuracy of the software in a comprehensive and systematic way.[384]

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377. *Id.* The IRS does, however, monitor the acceptance rate of electronically transmitted tax returns and prepares a "report card" to software companies at the end of each filing season, which includes the reasons for rejected returns (e.g., social security number mismatches, incomplete schedules, etc.). *Id.*

378. The IRS claims they do not assess the tax software, but how did they know this was a problem?

379. *See* GAO-09-297, *supra* note 61, at 11.

380. *Id.* at 12. They also have "worked with a group of tax software developers to ensure software used by paid preparers eliminated default answers where taxpayers' answers are critical to return EITC accuracy, and incorporated a 'note' capability in the tax software enabling the preparer to record additional inquiries and taxpayer responses." *Id.*

381. *See id.* at 12, 15.

382. *See* DEP'T OF THE TREASURY, OPPORTUNITIES EXIST TO IMPROVE TAX SOFTWARE PACKAGES 10–11 (Jan. 2005), http://www.treasury.gov/tigta/auditreports/2005reports/200540025fr.pdf.

383. *Id.* at 14. The IRS used the same scenarios in this study and "found that 7 (54 percent) of the 13 tax return preparation software packages available on IRS.gov prepared inaccurate tax returns." Thus, the software used by IRS employees and volunteers was also inaccurate.

384. *See generally id*.

The importance of accurate tax return preparation software will increase as more taxpayers choose to prepare their own tax returns with tax software or pay preparers to prepare their tax returns, and to e-file. The complexity of the tax law presents a significant challenge.[385] Testing for all issues arising under every tax provision is not feasible. Guaranteeing the accuracy of tax software is also not possible. However, conducting risk assessments and testing for those provisions creating the greatest risks would help ensure tax returns are prepared correctly and reduce the number of tax returns rejected.[386] It might even be possible that the IRS (or third-party) could help make the software more "consumer friendly."[387]

B. Security and Privacy Protections

Security and privacy are also common concerns of the taxpayer. Security relates to protecting the taxpayer's private information so it is not changed, corrupted, or lost.[388] Privacy is about ensuring that the taxpayer's information is only disclosed to those authorized to see or receive it.[389] With identity theft and refund fraud on the rise, taxpayers have legitimate concerns about these issues.[390]

Numerous federal and state laws exist to protect the security and privacy concerns of the taxpayer. First, pursuant to the Federal Trade

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385. *See* discussion *infra* Part VI.C. *See also* ETAAC 2013 REPORT, *supra* note 60, at 9 ("ETAAC renews its support for bipartisan focus on longer-term strategic changes including simplification to better administer annual tax law changes.").

386. *Tax Return Preparation Options for Taxpayers*: *Hearing Before the S. Finance Comm.*, 109th Cong. 1 (Apr. 4, 2006) (written statements of Nina Olson, National Taxpayer Advocate), http://www.irs.gov/pub/irs-utl/ntatestimonysfc_tax_ return_ preparation_process040406.pdf.

387. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 42. Rosenberg argues that the IRS should "make available [to the taxpayer] user-friendly tax preparation software that does not simply promise to calculate tax liability in the future but does so for the taxpayers at the time that data is entered." For example, he recommends that prompts could suggest to taxpayers that they "do the right thing." *Id*. at 58.

388. *See IRS E-File Study #1*, *supra* note 62, at 53.

389. *Id.*

390. *See* Starkman, *E-Filing and Tax Fraud*, *supra* note 362. Tax identity theft occurs when the taxpayer uses a real name and social security number but fabricates a W-2 or Schedule C. Fraud also arises from unethical practices of the return preparer. *Id.* Tax fraud is the third largest theft of federal funds after Medicare/Medicaid and unemployment insurance fraud. Refund fraud occurs when thieves have refund checks deposited to their own accounts. *Id.*

Commission Act,[391] the Federal Trade Commission (FTC) requires all authorized e-file providers to be subject to the FTC Safeguards Rule, which requires software companies to "develop, implement, and maintain a comprehensive information security program."[392] The FTC has vigorously litigated both security breaches[393] and deceptive claims concerning security and privacy policies (but not in the tax software context).[394] Unfortunately, these FTC Safeguards have been criticized as too general with "little to no guidance concerning particular types of security controls that should be implemented and does not require any type of proactive third-party review, verification or associated certification."[395]

The Gramm-Leach-Bliley Act[396] also relates to the issue of privacy, but it too is quite general. It requires that software companies ensure the security and confidentiality of customer's records and information by developing, implementing, and maintaining a documented information Security Program.[397] The act requires software companies provide their customers with privacy notices and protection guarantees.[398] Section 7612 imposes criminal penalties on anyone who knowingly or recklessly makes unauthorized disclosures in connection with the preparation of a return.[399] Section 6713 imposes monetary penalties on unauthorized users of taxpayer information.

Since the IRS does not have the capacity to receive electronic returns directly from the individual taxpayers,[400] it has promulgated its own security

391. *See* Federal Trade Commission Act, 15 U.S.C. §§ 41–58 (2010) (providing general restrictions in a broad range of security and privacy areas).

392. Standards for Safeguarding Customer Information, 16 C.F.R. § 314.3 (2002).

393. *Student Lender Settles FTC Charges That It Failed to Safeguard Sensitive Consumer Information and Misrepresented Its Security Practices*, FED. TRADE COMM'N, Mar. 4, 2008, http://www.ftc.gov/opa/2008/03/studlend.shtm. *But see also IRS E-File Study #2*, *supra* note 72, at 3 n.3 (describing FTC actions as aggressive).

394. *Online Apparel Retailer Settles FTC Charges That It Failed to Safeguard Consumers' Sensitive Information, in Violation of Federal Law*, FED. TRADE COMM'N, Jan. 17, 2008, http://ftc.gov/opa/2008/01/lig.shtm.

395. *See IRS E-File Study #2*, *supra* note 72, at 6.

396. Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338, 1436 (1999) (the FTC, not the IRS, is responsible for ensuring compliance under this Act).

397. *See id.*

398. *See id.* at 1437.

399. *See* Reg. § 301.7216-3.

400. *See* GAO-09-297, *supra* note 61, at 15. "Tax software companies have been reliable providers of electronic filing services, with one recent exception." *Id.* That one exception in 2007 was when Intuit's products experienced some disruption

requirements for authorized e-file providers, including software companies.[401] Unfortunately, the IRS has "limited assurance that the standards have been adequately implemented or software companies are complying with the standards."[402] Without appropriate monitoring "the confidentiality and integrity of the taxpayer's data are at an increased risk of being inadequately protected against fraud and identity theft."[403] The IRS has recently come up with new e-file security and privacy standards relating to web security, including weekly third-party vulnerability scans, a written privacy policy, and the prompt reporting of security incidents.[404] Unfortunately, these standards are currently just optional, so compliance is a serious concern.[405]

More measures need to be taken to alleviate certain security and privacy concerns. Intuit suggests "the IRS should consider setting clearer security requirements of tax administration by specifying those frameworks that would provide an adequate data protection safeguard."[406] They suggest that an industry standard as to data protection be implemented[407] and that that an independent third-party periodically verify a company's implementation of this standard issuing a certification.[408] The Government Accountability Office has also made some suggestions. Essentially, it wants the IRS to use mandatory standards or require compliance with its existing standards.[409] Tax practitioners have also warned of growing tax identity theft, refund fraud, and return-preparer fraud and have suggested the IRS compare names on bank records against its own files before a refund is made.[410]

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in their ability to file electronically on tax day but this "did not have a significant effect on tax administration." *Id.*

401. *Id.* at 13.

402. *Id.* at 14.

403. *Id.*

404. Nick Staples, *New IRS E-file Security and Priority Standards*, GEMINI SECURITY SOLUTIONS, Jan. 9, 2009, http://securitymusings.com/article/716/new-irs-e-file-security-and-privacy-standards.

405. *Id.*

406. INTERNAL REVENUE SERV., STATEMENT OF DAW MAURER, *supra* note 72, at 6.

407. *Id.* Intuit suggests that ISO 27000 series is one example of this type of standard. They argue "the focus should be on a 'controls based' framework that sets the right outcomes, but enables companies to respond quickly in a fast-moving security environment." *Id.*

408. *Id.* Intuit recommends that either "highly competent security companies" or "accounting firms" make these assessments. *Id.* at 7. They use as an example "SAS 70 audit" which is "frequently relied on by financial services companies to demonstrate compliance to federal banking regulators." *Id.*

409. *Id.*

410. *See* Starkman, *E-Filing and Tax Fraud*, *supra* note 362 ("The national taxpayer advocate has recommended that taxpayers be allowed to tell the IRS to

C. Reliable and Efficient Administration

Both the IRS and taxpayers benefit from reliable and efficient administration. The taxpayer benefits from the easy, convenient, and cost-effective use of tax software, as well as the speed of filing and quickness of refund receipt with e-filing.[411] In some circumstances, the taxpayer using software and e-filing can receive their refund in as little as seven days.[412] The taxpayer expects the system to be reliable,[413] and in only one instance (on tax day in 2007) did the e-filing system temporarily break down.[414]

Since the IRS must process more than a billion transactions and many millions of returns each year,[415] it is also seeking a cost effective and efficient way to enforce the tax law. Not only does the IRS want the taxpayer to file, but to correctly determine the amount of tax owed. To assure that this goal is being fulfilled, the IRS must establish an efficient procedure to determine when taxpayer returns are incorrectly filed and a procedure to audit and collect the deficiencies.[416] Error rates are less with computer generated returns compared with those manually prepared. Furthermore, error rates are less when individuals prepare their returns than when either H&R Block or tax and accounting specialists prepare returns.[417] Computer generated returns also reduce the administrative costs to the IRS and increase the collection of revenue.[418] E-filing increases efficiency of the audit process and of the examiner's analysis and testing of the books and records.[419] For

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accept their return only when filed on paper, thus preventing e-file tax-identity theft. So far the IRS has failed to allow this. Less effective methods are to request an 'electronic filing PIN,' and file Form 14039, 'Identity Theft Affidavit,' so that the IRS might apply additional return-screening procedures. Sadly, conventional credit-monitoring services are useless against income-tax identity theft.").

411. *See* GAO-09-297, *supra* note 61, at 15.

412. *See* Starkman, *E-Filing and Tax Fraud*, *supra* note 362.

413. *Id.*

414. GAO-09-297, *supra* note 61, at 15.

415. ELEC. TAX ADMIN. ADVISORY COMM., ANNUAL REPORT TO CONGRESS 4 (2012), http://www.irs.gov/pub/irs-utl/Pub3415_6_2012.pdf [hereinafter ETAAC 2012 REPORT]. ("Currently over 95,000,000 million returns are prepared by paid preparers which include the reporting of 5.7 trillion dollars of income.").

416. *See* GAO-09-297, *supra* note 61, at 6 ("Electronically filed returns also have higher accuracy rates than paper-filed returns because tax software eliminates transcription and other errors").

417. *See* Sagit Leviner, *The Role Tax Preparers Play in Taxpayer Compliance: An Empirical Investigation With Policy Implications*, 60 BUFF. L. REV. 1079, 1096-1098 (2012).

418. *See IRS E-File Study #1*, *supra* note 62, at 7.

419. *Use of Electronic Accounting Software Records; Frequently Asked Questions and Answers*, INTERNAL REVENUE SERV., last accessed June 18, 2013, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Use-of-Electron

example, e-filed returns are "available for audit several months sooner than paper returns allowing more time before the three-year statute of limitations," and the IRS has even "boasted that its e-file database is a 'rich and fertile field' for selecting audits" which could bring in "an additional $175 million annually."[420]

The IRS and the software industry have worked well in the past to promote the use of software and assure reliable and effective e-filing. By partnering with the software industry the IRS has shifted some of its costs to them.[421] However, more needs to be done to reduce e-file rejections, improve real-time access to critical information, and require software identification or bar coding on all software-prepared returns.

1. Specific Requests

On several occasions the IRS had made special requests to the software industry - requests that helped with tax administration. In 2003, an IRS study found that cost was the major reason taxpayers did not elect to e-file.[422] At that time, many software companies charged a separate fee for the software and a separate fee for the e-filing option.[423] It was thus much cheaper for the taxpayer to just print out the return prepared by the software and mail it to the IRS. For the 2009 filing season, the IRS requested that the software companies bundle their rates.[424] The two largest tax software companies complied with the request.[425] This action directly helped increase the rate of e-filing.[426]

In 2008, the IRS asked tax software companies to hold returns with the alternative minimum tax (AMT) until it was able to process them.[427] The AMT calculation is perhaps one of the most difficult that higher income taxpayers face and the most difficult for the IRS to monitor.[428] Again, the software companies complied with this request. The plan prevented the system from clogging until the IRS could handle those returns.

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ic-Accounting-Software-Records;-Frequently-Asked-Questions-and-Answers.

420. *See* Starkman, *E-Filing and Tax Fraud*, *supra* note 362.

421. *See IRS E-File Study #2*, *supra* note 72, at 2 (the industry has invested funds in innovative technology than has inured to the benefit of the IRS).

422. *See IRS E-File Study #1*, *supra* note 62, at 56.

423. *Id.* at 58.

424. *Id.*

425. GAO-09-297, *supra* note 61, at 26 (the two leading tax return preparation software products, Intuit TurboTax and H&R Block at Home (formerly TaxCut), both bundle e-file in their online versions).

426. *Id*. at 8.

427. *Id.* at 11.

428. *Id.*

2. Reducing E-File Rejects

The IRS monitors acceptance rates for electronically transmitted returns and the reasons for rejected returns. It then provides a "report card" to software companies at the end of each filing season.[429] Although the IRS makes sure that returns transmitted electronically are compatible with IRS systems before the start of the filing season, it does not test throughout the filing system.[430] Testing throughout the filing system is important because of the "potential effect of late tax law changes" on rejections if software company systems are not compatible with IRS systems.[431]

E-file rejects are a serious problem because almost one in five taxpayers have their returns rejected when they e-file.[432] Rejects occur when IRS codes signify an error in the return. The IRS then sends the return back to the taxpayer (or tax preparer) for correction.[433] The most common type of reject is the IRS's current identity proofing mechanism—the AGI/PIN signature.[434] The next most common rejection is when the taxpayer fails to match with taxpayer dependents and their social security numbers.[435] Another error is simply a mismatch of the taxpayer's name and their tax identification number.[436] If the IRS could share this information with the software industry (and tax preparers), then the rejects would go down.

Rejects "cause significant anxiety for those that have already made a decision to e-file, which is communicated to family, friends, and increasingly through social networks."[437] To "maintain taxpayer system confidence" and reduce individual return rejects, the IRS must engage in a "focused, persistent, and collaborative effort with industry."[438] Report after report of the Electronic Tax Administration Advisory Committee (ETAAC) has recommended that the IRS partner with the software industry to affect more

429. *Id.* at 11.

430. *Id.*

431. *Id.* at 15.

432. *See* ETAAC 2011 REPORT, *supra* note 59, at 4. *See also* ETAAC 2012 REPORT, *supra* note 415, at 6.

433. *See* Starkman, *E-Filing and Tax Fraud*, *supra* note 362 ("A discrepancy may result in a rejection code, a letter from the IRS Automated Underreporting Unit, or a computerized audit out of a centralized IRS office in Ogden, Utah. There is no cost to the IRS for requesting extra information when it's received electronically.").

434. *See* ETAAC 2011 REPORT, *supra* note 59, at 4.

435. *See* ETAAC 2012 REPORT, *supra* note 415, at 6.

436. *Id.* at 36.

437. *See* ETAAC 2011 REPORT, *supra* note 59, at 4.

438. *See* ETAAC 2012 REPORT, *supra* note 415, at 6.

real-time processing of information.[439] In the legacy e-file system the time could be as much as 48 hours after submission to the IRS that the error was found.[440] With the modernized e-file system the wait is about two hours (or more if state tax returns are submitted), but even in this shortened time the taxpayer has moved on to other tasks.[441] As ETAAC concludes:

> [I]f the IRS allows the tax industry to have access to IRS tools and resources to validate tax return information before transmitting a return, the industry could reduce the number of the most common errors producing rejects before transmission rather than after transmission."[442] By providing this access the "IRS could reach over 95% of taxpayers and benefit from the network of contact from the private tax industry."[443]

This communication would result in the IRS experiencing "lower volume of contact from the taxpayers on the issue" and "lower operational costs."[444]

Another way for the IRS to improve e-filing would be to develop the capability to receive electronic returns directly from individual taxpayers.[445] Now, taxpayers who file their returns on their home computers using software products are sending their returns to authorized electronic filing providers.[446] If the IRS had the capability to receive returns, the tax paying system would be more efficient. This could also help with privacy and security concerns.[447]

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439. *See* ETAAC 2011 REPORT, *supra* note 59, at 35; ETAAC 2012 REPORT, *supra* note 415, at 38 ("ETAAC strongly encourages the IRS to collaborate and partner with the tax preparation and software industry on the tools recommended later in the ETAAC report. These types of partnerships will help the IRS reach a broader number of taxpayer and expedite achieving valuable steps toward real time processing."). Later in the report, the ETAAC identifies the tools that the industry would like to access: (1) taxpayer prior year IN or AGI lookup tool; (2) Taxpayer identification number matching; (3) dependent information validation; and (4) first time homebuyer credit tool. *Id.* at 37.

440. *Id.* at 38.

441. *Id.*

442. ETAAC 2012 REPORT, *supra* note 415, at 39.

443. *See id.* at 37.

444. *Id.* at 35. They point out that "the use of the tool does not create any additional disclosure than in the current processing environment." *Id.* at 36.

445. ETAAC 2012 REPORT, *supra* note 415, at 36.

446. *See id.*

447. *See* GAO-09-297, *supra* note 61, at 15.

3. Real-Time Access to Critical Information

Related to the real time access to taxpayer identification information to curb e-filing rejects is the need of the taxpayer to access old tax returns and current information from W-2, 1099 and other tax forms as well as access current income and expense information from IRS sources during the return preparation stage. The software companies are able to access the W-2 and 1099 forms through private employers and investment and banking firms[448] but also would benefit from the ability to obtain IRS information. The IRS does allow a direct deposit of the refund into the taxpayers' account, but as mentioned earlier, this raises security concerns. If security protection can be assured, the IRS should allow access to its informational system.[449]

The Electronic Tax Administration Advisory Committee in its 2012 report discussed the "Real-Time Tax System" concept whereby the "IRS could match information submitted on a tax return or provide detailed third-party information to a taxpayer at the beginning of return preparation and processing and provide the opportunity for taxpayers or tax preparers to fix the tax return in the event it contains data not matching IRS records."[450] The 2012 ETAAC report concludes that from "improved tax administration including greater accuracy and compliance, taxpayer service delivery and convenience, and tax return problem prevention, the positive elements are compelling and should be pursued."[451] They recommend further studies, given "continually late enacted tax legislation and overall tax rule complexity."[452] This Real-Time System could also be helpful if the IRS decides to take a more active role in the calculation of taxes.[453]

4. Software Identification and Bar Codes

Currently, the IRS requires a software identification number on all returns filed electronically.[454] However, this identification does not specify which type of software is used to prepare those returns.[455] The IRS does not require any software identification on the paper filed returns prepared using software (the so called V-Coded returns).[456] The number of taxpayers that are using tax software but choosing not to electronically file is decreasing.[457]

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448. *See supra* PART II.B.
449. *See supra* PART V.B.
450. ETAAC 2012 REPORT, *supra* note 415, at 12.
451. *Id.*
452. *Id.*
453. *See* discussion *infra* Part VI.E.
454. *See* GAO-09-297, *supra* note 61, at 10, n.21.
455. *See id.* at 10.
456. *Id.*
457. ETAAC 2012 REPORT, *supra* note 415, at 6.

Still, it would make sense for the IRS to require software identification numbers as well as require software companies to include bar codes on individual paper returns. The identification numbers would identify: (1) the specific software package or tax software version was used by the taxpayer; and (2) whether the return that was filed non-electronically was prepared using software.[458] Bar coding would require the return to be printed with a two-dimensional bar code that could be scanned into the IRS's system. Having this identification "would not only allow IRS to better target its research but also its enforcement activities and efforts to increase use of tax software and electronic filing."[459] The Government Accountability Office has recommended that the IRS develop a plan to require such numbers.[460] It has also recommended that the IRS require software companies to include bar codes on individual paper returns.[461]

About half the state revenue agencies already use bar coding technology, which easily converts data on paper returns to electronic data and eliminates manual transcription.[462] Bar coding is "less expensive and more accurate than processing paper returns . . . [but] less efficient than electronic filing."[463] Thus, the IRS should follow in the footsteps of these states to make their own system more effective.

D. Fairness

Fairness, in the traditional tax policy sense, can either be about horizontal equity or vertical equity.[464] Horizontal equity relates to treating

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458. *IRS E-File Study #1*, *supra* note 62, at 189. *See also* GAO-09-297, *supra* note 61, at 10 ("Having a more complete software identification number would not only allow IRS to better target its research but also its enforcement activities and efforts to increase use of tax software and electronic filing.").

459. *IRS E-File Study #1*, *supra* note 62, at 189.

460. *See* GAO-09-297, *supra* note 61, at 6; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-567, INTERNAL REVENUE SERVICE: FISCAL YEAR 2009 BUDGET REQUEST AND INTERIM PERFORMANCE RESULTS OF IRS'S 2008 TAX FILING SEASON 6 (Mar. 2008).

461. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-38, TAX ADMINISTRATION: 2007 FILING SEASON CONTINUES TREND OF IMPROVEMENT, BUT OPPORTUNITIES TO REDUCE COSTS AND INCREASE TAX COMPLIANCE SHOULD BE EVALUATED 3-5 (Nov. 2007); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-27, TAX ADMINISTRATION: MOST FILING SEASON SERVICES CONTINUE TO IMPROVE, BUT OPPORTUNITIES EXIST FOR ADDITIONAL SAVINGS 2-4 (Nov. 2006).

462. *See* GAO-09-297, *supra* note 61, at 6. *See also IRS E-File Study #1*, *supra* note 62, at 83 (chart highlighting the states that use two-dimensional barcodes on V-coded returns).

463. *See* GAO-09-297, *supra* note 61, at 6.

464. *See* Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 577 (1965).

taxpayers who are in similar circumstances the same. Vertical fairness relates to treating taxpayers in different situations fairly, based on their ability to pay. A number of factors make up the criteria of fairness. Consistency and uniformity go into fairness as well as degree of culpability of the taxpayer. The IRS and software companies have worked well in the past to provide free filing for low-income taxpayers.[465] But more needs to be done by the IRS and the software companies. First, the software companies or the tax software should be considered as tax advisors/tax preparers and the software companies should take a more active role in the audit process. Second, the treasury should pass regulations for TurboTax and other software companies.

1. Free Electronic Filing

Many of the companies that sell tax software have partnered with the IRS to provide free tax return preparation and electronic filing services to eligible taxpayers.[466] These qualifying taxpayers[467] can use products from the Free File Alliance, LLC (FFA), a consortium of tax preparation companies that provide this service.[468] Data shows that in 2007, four million taxpayers filed through FFA.[469]

2. More Involvement of Software Companies in Audits

Although the software companies offer an audit service to the taxpayer,[470] based on the respective opinions, none of the taxpayers in the litigated cases appear to have paid for this service. It would make sense to treat software companies or the software as tax preparers and require the companies to bundle their rates for this service, thus spreading the risk to other taxpayers. In the alternative, the software companies should advertise this service and reduce their audit rates.

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465. *See* GAO-09-297, *supra* note 61, at 5–6.

466. *Id.*

467. *Id.* at 6 n.7 ("FFA products annually would cover 70 percent of taxpayers based on adjusted gross income. For 2009, the 70 percent equates to taxpayers with an adjusted gross income level of $56,000 or less.").

468. *Id.* In 2002, the IRS entered into an agreement with the FFA to not compete with the members who would provide free online tax return preparation and filing to certain taxpayers. This would be the IRS free "fillable tax forms" program. *Id*. at 9.

469. *Id*. at 6. *See* discussion, *infra* VI.B.1.

470. *See Audit Defense Membership Agreement*, INTUIT TURBOTAX, last accessed Sept. 28, 2013, https://turbotax.intuit.com/corp/auditdefense.jsp ("TaxResources, Inc. (TRI) will provide the audit defense services for the tax return described on the membership certificate in return for the applicable membership fee and compliance with all applicable terms of this agreement").

3. TurboTax Regulations

The IRS should provide detailed regulations as to when a taxpayer may assert a tax software defense. In these regulations, the IRS should specify the circumstances in which the taxpayer can rely on the software and the circumstances that would clearly not justify such a defense. Given the complexity of the tax system and the taxpayer's responsibility to comply, tax software offers both a cost effective and convenient alternative to paid preparers.[471] With its simple methodology, software has the ability to educate taxpayers as well as help them to easily fulfill their civic responsibilities.[472] To accommodate this use, the Treasury and IRS should promulgate TurboTax regulations. This Article has attempted to make suggestions and give examples of the specifics of those rules.

The strongest argument in favor of implementing these rules is equity. The IRS is relying on taxpayers to fulfill their duties to pay their taxes and the taxpayer has the burden to comply. It is only horizontally fair to allow taxpayers that rely on the "advice" of software programs to be treated the same as those that rely on professional tax preparers. Therefore, if a taxpayer in good faith uses tax software, accurately inputting the data and reviewing the return, a presumption of reasonable cause should be given in the taxpayer's favor before imposition of the accuracy-related penalty.

While it is not fair to the majority of taxpayers who pay for tax preparers or otherwise comply with their taxing responsibilities to assume the costs of administration and collection from taxpayers who deviate from filing correctly, an accuracy-related penalty is only fair if a taxpayer is appropriately culpable. If the penalty is enforced strictly, without reference to whether a taxpayer acted in good faith, or relied on tax advice appropriately, the penalty would be unfair. If the penalty is too severe, taxpayers may have less incentive to respect and abide by the tax system and if the taxpayers believe the IRS does not respect their good faith efforts to comply with the complex Code, they may cheat. Given that the IRS (or a third-party) does not generally assess tax software as to its accuracy, and the IRS benefits from software use, it seems only fair that the IRS should give more deference to the taxpayers who in good faith use tax software to file their taxes.

Vertical equity is also an issue with tax software. Why should there be "one set of rules for the well-connected and another for everyone else?"[473] As Conor F. Larkin states in his article: "it is patently unjust and inequitable to penalize taxpayers for failing to understand and comply with the Code

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471. *See* discussion *supra* in Part II.

472. *Id.*

473. Larkin, *Tax Court*, *supra* note 116 ("[This] violates the most basic principles of sound tax policy, and of political justice generally").

while at the same time shielding the Code's chief executive, the Secretary of the Treasury, from its obligations and penalties."[474] With tax software regulations, the IRS can establish a level playing field and the rich and powerful will not be favored with penalty waivers over the ordinary citizen who ends up in the Tax Court.

VI. THE FUTURE

While the relationship between the IRS and the software companies has generally been a good one, serious problems exist. First, the taxpayers are the losers, as they assume all the costs and risks of collecting and calculating their tax. Second, the market concentration and power of the software companies raises concerns over their significant influence over the IRS and their impact on public policy. Lastly, the current partnership does nothing to alleviate the problems of complexity and cheating in the system. In fact, the availability of software may have "eliminated the complexity constraint" in Congress and made the system entirely more complicated.[475] All of these problems should compel us to consider a new and better model for the future—one in which the tax system is simplified, cheating is reduced, and the IRS takes a more assertive role in assessing the taxes due or refund owed.

A. The Unreasonable Costs and Risks to the Taxpayer

Under the current system, taxpayers have the personal responsibility to voluntarily pay their taxes.[476] In fact, in the United States, more individuals file their tax returns each year than vote in a presidential election.[477] At the lowest income levels, the taxpayers have an obligation to collect their tax information, and if they work, decide the proper amount to be withheld from their wages.[478] On a more advanced level, taxpayers must predict their income tax in order to pay their necessary quarterly estimated tax, decide whether to itemize or take the standard deduction, and calculate

474. *Id.* at 425.

475. *See* Zelenak, *Legislation in the TurboTax Era*, *supra* note 35, at 99, n.22. "[T]here is good reason to suspect that it is no accident that the increase in tax return complexity has coincided with the triumph of return preparation software." *Id.* at 99.

476. *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (2000).

477. Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 37.

478. *See id.* A problem for low-income taxpayers is often they withhold too much and then they think they do not have to pay taxes, thus missing out on claiming the earned income tax credit.

their tax under the regular or alternative methods.[479] They assume the expense of keeping records, buying tax software or hiring a tax preparer. The estimated cost to the taxpayer of this responsibility "exceeds $10,000,000,000 per year."[480]

The taxpayer assumes not only the out-of-pocket costs for preparing their returns, but a considerable amount of their time is occupied with this endeavor. The IRS estimates the time it takes to file the simplest return is three hours.[481] The time for a more advanced return can run several days.[482] The taxpayer also assumes the additional expense on an audit or when tax fraud is involved.[483] Lastly, taxpayers take on huge psychological burdens, including the frustration of filling out a correct return, the pains of procrastination from the tax deadlines, the anxiety of an audit, and in the case of tax fraud, the pain of seeking redress.[484] Taxpayers list "the burdens and stress associated with the filing process as the primary reasons they avoid paying federal income taxes."[485]

B. Market Concentration and Domination

Intuit and H&R Block dominate the current consumer software market. H&R Block also dominates the storefront tax preparation market. Together these two companies have aggressively lobbied for more stringent tax preparer regulations. The final outcome of these regulations may in the end cause a detrimental impact on many mom-and-pop tax preparation outfits due to the various compliance costs. The significant market presence

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479. The IRS predicts that the taxpayer will spend over three hours per year in recordkeeping activities. *See* Gary Cohn, *Figuring the Time to the Bottom Line It Takes 9 Hours and 17 Minutes to Fill Out a Basic Form 1040, The IRS Estimates*, PHILLY.COM, Feb. 14, 1989, http://articles.philly.com/1989-02-14/business/26151216_1_irs-estimates-tax-experts-tax-law. *See also* INTERNAL REVENUE SERV., 1040 INSTRUCTIONS 102 (2012), last accessed June 19, 2013, http:www.irs.gov/pub/irs-pdf/i1040.pdf. The cost of keeping records is estimated to be $100 million on an annual basis. *See* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 8–12 (2d ed. 1995) [hereinafter HALL & RABUSHKA, THE FLAT TAX].

480. HALL & RABUSHKA, THE FLAT TAX, *supra* note 479, at 8–12.

481. *See id.*

482. *See id.* (The IRS on instructions to their forms calculates the estimated time it takes to fill out the form).

483. *See* Starkman, *E-Filing and Tax Fraud*, *supra* note 362.

484. *See* Valencia, *Get Ready for the Return!*, *supra* note 114, at 138. *See also* Joseph Bankman, *Simple Filing for Average Citizens: The California Ready Return*, 107 TAX NOTES 1431, 1431 (June 2005) *http://taxprof.typepad.com/taxprof_blog/files/2005-11952-1.pdf* [hereinafter Bankman, *Simple Filing*] ("Some taxpayers react to the filing requirement like a deer caught in headlights, and never file.").

485. *See* Valencia, *Get Ready for the Return!*, *supra* note 114, at 138.

of these two companies has also influenced the IRS into passing up on the critical opportunity of free return filing.

1. Free-File Problems

The free file system of course has its problems. As indicated, the IRS previously agreed not to compete with the FFA, thus giving up their ability to assure the tax system is fairly administered.[486] FFA estimates that in 2007, 95 million taxpayers or 70 percent of the taxpayers were eligible for FFA use.[487] However, other data suggests that much fewer taxpayers avail themselves of the service.[488] Naturally providing the service arrives at a financial cost to the software industry and thereby participation in such is presumably to retain a substantial market presence. Furthermore, when taxpayers arrive at the web sites of these companies, they are much more likely to view a $19.99 price for their easy returns, and only afterward an advertisement indicating they can freely file.

2. Tax Preparer Regulations Held Invalid

Another example of the tax preparation industry's significant influence has been in the area of the newly adopted tax preparer regulations. The software companies had previously prepared a report on requiring stricter standards for tax preparers.[489] The IRS followed up on this recommendation by promulgating tightened standards for commercial tax preparers.[490] Under the new regulations, all paid tax preparers that sign a return as a preparer have to obtain a preparer tax identification number (PTIN), register and pay a fee, obtain a background check, pass a competency test, obtain fifteen hours of continuing education credits, and follow certain ethical rules.[491] However, the IRS has since been enjoined

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486. GAO-09-297, *supra* note 61, at 6, n.7.

487. *IRS E-File Study #1*, *supra* note 62, at 17.

488. *Id.*

489. *See id.*

490. *See* IRS PREPARER REVIEW, *supra* note 39, at 32–38.

491. T.D. 9527, 2011-2 C.B. 1. Under the regulations, the IRS would be able to suspend or discipline tax return preparers who engage in unethical or disreputable conduct. *See IRS Is Watching IRS Tax Preparers More Closely*, LAWYERS.COM, last accessed June 19, 2013, http://taxation.lawyers.com/income-tax/IRS-Will-Watch-Tax-Preparers-More-Closely-in-2011.html; Requirements for Tax Return Preparers: Frequently Asked Questions, INTERNAL REVENUE SERV., last accessed June 21, 2013, http://www.irs.gov/Tax-Professionals/Requirements-for-Tax-Return-Preparers:-Frequently-Asked-Questions.

from enforcing these new regulations.[492] In the suit, the Institute for Justice, a public-interest legal group challenged the rule on behalf of three independent tax preparers. The court determined that Congress should decide this important issue, which could have a widespread adverse impact on "mom-and-pop advisers."[493]

3. Lobbying and Advertisements

Intuit and H&R Block expended considerable time and money lobbying in favor of the aforementioned tax preparer regulations.[494] In 2009 there were four companies that dominated the tax software market.[495] This quickly was reduced to three.[496] The current market is dominated almost entirely by Intuit.[497] The company has a sixty percent share of the market and is growing.[498] Intuit also spent millions of dollars lobbying aggressively against the California ReadyReturn system.[499] According to Stanford professor Joseph Bankman, it is obvious why— "[t]hey have a franchise to protect."[500] Their lobbying efforts, however, have failed.

C. Growing Complexity and Incomprehensibility of the Tax System

The current tax system is complicated[501] and the development of tax software just makes it easier for Congress to respond by enacting "tax laws of unprecedented computational complexity"[502] under the implicit understanding that the software can process the complexity into a plain language user-friendly format.[503] This complexity, however, "turn[s] the income tax into a black box, the inner workings of which are

492. Loving v. IRS, 917 F.Supp. 2d 67 (D.D.C. 2013), *modified*, 920 F.Supp. 2d 108 (D.D.C. 2013), *motion for stay denied*, 111 A.F.T.R.2d 2013-1384 (D.C. Cir. 2013), *aff'd* 2014 WL 519224 (D.C. Cir 2014). *See also* Adam Halpern, *Court Strikes Down IRS Tax Return Preparer Regulations*, JD SUPRA, Jan. 23, 2013, www.jdsupra.com/ legalnews/court-strikes-down-irs-tax-return-prepar-29555/.

493. *See Beating H&R*, *supra* note 113.

494. *See id.*

495. *See* IRS PREPARER REVIEW, *supra* note 39, at 10.

496. *See* GAO-09-297, *supra* note 61, at 3 n.5 (pointing out that Intuit, H&R Block at Home (formerly TaxCut), and TaxAct were the three companies providing the tax software to a majority of individuals).

497. *See* COMSCORE, *supra* note 74, and accompanying text.

498. *See id.*

499. *See* Valencia, *Get Ready for the Return!*, *supra* note 114, at 132.

500. *See* Bankman, *Simple Filing*, *supra* note 484, at 1434.

501. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 38.

502. Zelenak, *Legislation in the TurboTax Era*, *supra* note 35, at 99, n.22.

503. *Id.* at 91 (the difficulty of making these computations can be "overcome by the widespread adoption of software").

incomprehensible to the average taxpayer, thereby undermining both the democratic legitimacy of the tax system and the ability of taxpayers to engage in informed tax planning."[504] As one commentator noted, "Taxation with comprehension is as important to democracy as taxation without representation."[505] If taxpayers must act on all the incentives in the tax system, they must understand the law.[506]

Study after study has indicated that both software[507] and tax preparers make mistakes calculating the federal income tax.[508] Article after article by tax experts "bemoan[s] not just the complexity of the Code itself . . . but the complexity of the discussion of tax complexity!" [509] The tax policy literature is replete with commentators recommending the tax system be simplified.[510] It is clear to the authors that the more complicated the tax software becomes the more likely software error is to occur,[511] and a more optimal system would be one in which the IRS plays a more active role in assessing one's tax due or refund owing.

D. The Problem with Cheating

Tax evasion is a serious tax problem in the United States. Estimates from lost revenue from evasion are in excess of $353 billion annually, or

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504. *Id.* at 119. (citing Charles E. McLure, Jr., *Economics and Tax Reform: 1986 and Now*, 113 TAX NOTES 362 (Oct. 23, 2006)). According to McLure, a black-box system is "hardly a recipe for good governance in a democracy." Zelenak, *Legislation in the TurboTax Era*, *supra* note 35, at 102.

505. Zelenak, *Legislation in the TurboTax Era*, *supra* note 35, at 102–103 ("If taxpayers do not have at least a rough idea of the process through which their tax liabilities are determined, they can have no way of evaluating the fairness of the tax system, as applied either to themselves or to others.").

506. *Id.* (quoting Austan Goolsbee, *The TurboTax Revolution: Can Technology Solve Tax Complexity?*, THE CRISIS IN TAX ADMINISTRATION 124, 138 (Henry J. Aaron & Joel Slemrod eds., 2004)).

507. *See* discussion, *supra* PART V.A.

508. *See* IRS PREPARER REVIEW, *supra* note 39, at 13–17. In one study, the GAO targeted 19 outlets of chain commercial tax return preparation firms and found only two had calculated the tax correctly. In another study, the Treasury Inspector General of Tax Administration targeted 28 unenrolled tax return preparers in large metropolitan areas and found that 17 incorrectly filed the tax owed or refund due. *Id.*

509. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 52, n.55.

510. *Id.* Some have argued that taxpayer confusion can create opportunities for policy makers to raise revenue. *See* Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REG. 253, 310 (2011). Others have argued that creating taxpayer confusion or misguidance is objectively wrong. *See* Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1933–37 (1994).

511. *See* discussion, *supra* PART IV.D.

equal to about 15 percent of the total tax owed.[512] The likelihood of being audited on an income tax return is low (less than 1 percent at certain times), and therefore taxpayers assess their risk and often error on the side of not paying their fair share of taxes.[513] Moreover, when taxpayers see others cheating, they often incorrectly assume they too can cheat.[514] Clearly evasion imposes costs on the taxpayers that do comply with the law. To address the aforementioned, some commentators have suggested everything from adopting a value added tax to a flat tax.[515] The IRS already has a matching system in place that checks on certain income and deductions. If more automation could occur, however, then tax evasion could be further reduced.[516]

E. The Need for More IRS Involvement in Calculation of Taxes

The authors recommend that the income tax system be simplified and the IRS assume a greater role in assessing the tax due or refund owing of taxpayers. Such a system would shift the burden and risks off the taxpayer, reduce the influence of the software companies, and help alleviate the cheating problem that exists in the current tax system. Suggesting that the government take a more active role in this regard is not a new concept.

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512. Allen J. Rubenfield & Ganesh M. Pandit, *Tax 'Cheating' by Ordinary Taxpayers: Does the Underreporting of Income Contribute to the 'Tax Gap?'* CPA J. (Mar. 2007). These statistics were for 2007. For 1997, the estimate was $195 billion per year or $1,600 per taxpayer. *See* INTERNAL REVENUE SERV., MODERNIZING AMERICA'S TAX AGENCY 6 (1999), http://trac.syr.edu/tracirs/atwork/v07/docs/IRSPUB3349.PDF.

513. *See* Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX. L. REV. 121, 166 (1989) ("[Taxpayers] do a rudimentary cost-benefit analysis and determine it is not worth the time and money to comply."). *See also* Jonathan Ping, *Chances of Getting Audited: IRS Audit Rates 2010*, MY MONEY BLOG, Jan. 31, 2011, http://www.mymoneyblog.com/chances-of-getting-audited-irs-audit-rates-2010.html (a taxpayer's chances of being audited are l in 100 if taxpayer makes less than $200,000, but are greater if taxpayer makes more income).

514. *See* John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, *in* WHY PEOPLE PAY TAXES 43, 47 (Joel Slemrod ed., 1992) ("One of the most consistent findings in survey research about taxpayer attitudes and behaviors is that those who report compliance believe that their friends (and taxpayers in general) comply, whereas those who report cheating believe that others cheat.").

515. *See generally* HALL & RABUSKA, THE FLAT TAX, *supra* note 479.

516. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 59 ("It would be quite easy for the IRS to work with some of these credit card issuers to devise a system that would allow records of tax-significant transactions to be made accessible to the IRS.").

Professor Rosenberg has recommended the IRS "develop and make available user-friendly tax preparation software" to the taxpayer.[517] Another author has suggested that each state taxing authority should "provide complimentary software akin to the commercial 'TurboTax' program, enabling testators to generate a draft will based upon user response collected during an electronic interview."[518] In light of this, we focus below on the California ReadyReturn system that has had widespread taxpayer satisfaction and the Singapore model where the government calculates the tax for all of its citizens.

1. Domestic Models

a. The California ReadyReturn

California has developed an online tax assessment model called ReadyReturn[519] that "sidesteps commercial tax preparers and software providers by enabling taxpayers to e-file their California income taxes using income and tax liability information pre-calculated by the state."[520] To qualify, the taxpayer must be a California resident with a simple return.[521] The taxpayer must be a single or head of household taxpayer (with no more than five dependents) who claims the standard deduction, has only wage income from one employer, and only the renter's credit.[522] The system is also available to qualifying upper middle-income taxpayers. [523] The system is "ready" in that the information is provided to the taxpayer (rather than from the taxpayer) and the taxpayer can then modify or change it if the taxpayer disagrees.[524]

The ReadyReturn system reduces the filing burden on the taxpayer, which was the main objective of the program.[525] First, taxpayers consider it "more convenient" and "easier to understand" than the prior return

517. *Id.* at 42.

518. Reid Kress Weisbord, *Wills for Everyone: Helping Individuals Opt Out of Intestacy*, 53 B.C. L. REV. 877, 881 (2012).

519. *See ReadyReturn: Your California Tax Return May Be Ready and Waiting For You*, STATE OF CAL. FRANCHISE TAX BD., last accessed June 23, 2013, https://www.ftb.ca.gov/readyreturn/ [hereinafter *California ReadyReturn*].

520. Valencia, *Get Ready for the Return!*, *supra* note 114, at 131.

521. *See California ReadyReturn*, *supra* note 520.

522. *Id*

523. *See ReadyReturn – General Information*, STATE OF CAL. FRANCHISE TAX BD., last accessed June 23, 2013, https://www.ftb.ca.gov/readyreturn/about.shtml. For 2012, the taxpayer must have earned less than $169,730 if single or $254,599 if head of household. *Id.*

524. *See* Bankman, *Simple Filing*, *supra* note 484, at 1432.

525. *See* Valencia, *Get Ready for the Return!*, *supra* note 114, at 138.

process.[526] Second, taxpayers save "significant time during the filing process."[527] Third, it saves taxpayers money.[528] ReadyReturn assesses "no direct charge for using the service," and thereby the taxpayer saves the expense of tax software or a professional tax preparer.[529] Lastly, the system serves an educational component, allowing taxpayers to better understand the tax system and even "defend their tax returns in an appeal."[530]

The ReadyReturn system also reduces the costs to the state and makes the administration of the tax system more efficient. It is "designed to leverage other established programs" and "the government's extra cash flow can be used to improve and expand ReadyReturn in subsequent taxable years."[531] With the system, "there is less room for human error."[532] Rather than the government checking on the information filed by the taxpayer, the taxpayer checks on the government.[533] ReadyReturn makes "it more difficult for taxpayers to cheat" and by "empower[ing] taxpayers by offering them whatever information the government already has," may even help "create trust between the government and its citizens" and "further mitigate taxpayer noncompliance."[534]

b. The Simple Return

Even the IRS has come up with a proposed tax program called Simple Return, a tax assessment system modeled on the California ReadyReturn program.[535] Under this program, the IRS would calculate the taxes of low-income taxpayers; relieving them of not only the chore of filling in tax forms, but also reducing their frustration and anxiety. A study of the Simple Return program, however, has noted the following disadvantages:

> [1] little relief for filers with complicated returns or business income or low income filers in complicated living arrangements; [2] lack of an IRS computing infrastructure;

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526. *Id.* at 139

527. *Id.* ("[T]he majority of the surveyed participants of the 2004 and 2005 Pilot Programs described ReadyReturn as more convenient than their prior year tax return process and easier to understand.").

528. *Id.* at 140.

529. *Id.* at 139.

530. *Id.* at 142.

531. *Id.* at 140.

532. *Id.* at 141.

533. *See* Bankman, *Simple Filing*, *supra* note 484, at 1431.

534. *See* Valencia, *Get Ready for the Return!*, *supra* note 114, at 141–43.

535. REPORT TO THE CONG. ON RETURN-FREE TAX SYSTEMS: SIMPLIFICATION IS A PREREQUISITE, DEPT. OF THE TREASURY 27 (Dec. 2003), http://www.treasury.gov/resource-center/tax-policy/Documents/noreturn.pdf.

> [3] absence of timely third-party information reports needed to pre-fill a return; [4] need for considerable investment in technology and manpower; [5] potential that a pre-filled return that omitted income, or misstated the return in a taxpayer's favor could reduce tax compliance and collections; [6] difficulty or impossibility of adapting Simple Return to address all the special credits for low-income households; and finally, [7] even with technological improvements, the inability for many taxpayers to prepare returns as soon after the close of the year as they currently file their returns in order to obtain their tax refunds. [536]

However, with simplification, several of these issues—(1) and (6) above—could be solved. Additional funding could solve (2), (4), and (7) and data from California ReadyReturn showed considerable budgetary cash flows after the initial cost investment.[537] The IRS could mandate that third-party information reports be due on a timely basis, solving (3) and with such information and other technological improvements tax compliance and collections could be maintained.[538] More importantly, such a system would shift much of the burden of filing off the taxpayer, reduce their frustration and anxiety, as well as help with taxpayer compliance [539]

2. International Models

While tax systems around the globe differ in the way the government is involved in the calculation of the taxpayer taxes, the countries that are demonstrative as possible models for the future are those of the United Kingdom and Singapore. The British system has a limited system, similar to "the 'pre-filled' tax returns used in other countries[540] or the Ready Return method used in California"[541] while Singapore has a much more comprehensive system.

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536. *See* ETAAC 2011 REPORT, *supra* note 59, at 40.

537. *See* Valencia, *Get Ready for the Return!*, *supra* note 114, at 140.

538. *See* Rosenberg, *A Helpful and Efficient IRS*, *supra* note 93, at 59.

539. *Id.* (key benefits would be relieving taxpayers from the chore of filling in tax forms, and reducing the frustration and anxiety of taxpayers at tax time).

540. *See* Toder, *Changes in Tax Preparation Methods*, *supra* note 53, at 3 (referencing Japan, Germany, United Kingdom). Toder sets forth other questions: "can you trust in the IRS calculations; do you want a bigger role for government; won't this cost the government more to calculate; is it not better to have private industry and market competition? Is it not the taxpayer's responsibility as a citizen to pay taxes (the taxpayer is still responsible for collection of the information under this system), what about the transparency of the tax burden?" *Id.*

541. *IRS E-File Study #1*, *supra* note 62, at 94.

a. The British System

Her Majesty's Revenue & Customs (HMRC) is similar to our IRS, and is responsible for administering and collecting tax revenues in the United Kingdom.[542] HMRC administer the "Pay As You Earn" (PAYE) and Self Assessment (SA) systems: the "two major approaches to individual tax assessment and filing in the United Kingdom."[543] Under PAYE, tax is withheld from an employee's earnings by the employer and paid to the HMRC.[544] This is similar to our W-2 withholding program. However, the method of determining the withholding amount differs under the program. HMRC sets the rate based on the taxpayer's previous year's earning.[545] They then include a code on paychecks and end-of-year wage summaries. If the PAYE code is correct, that is, if the income tax due is the same as the amount withheld, then no further action is required of the taxpayer. If the code is incorrect, the taxpayer must file a SA tax return.[546] Those who are self-employed or have multiple sources of income must also file the SA return.[547]

b. The Singapore System

A more radical approach to tax assessment and collection is the system of Singapore where the Inland Revenue Authority of Singapore (IRAS)[548] calculates the tax for almost all taxpayers.[549] The IRAS receives employment information from employers and then sends out a notice informing taxpayers of their tax liability.[550] Like the PAYE and ReadyReturn

542. *Id.* at 93. The HMRC collects and administers the following: (1) "direct taxes paid by taxpayers or their businesses on money earned, Capital Gains Tax, Corporation Tax, Income Tax, Inheritance Tax, and National Insurance Contributions," (2) "indirect taxes paid by taxpayer on their business on money spent on goods or services," (3) "Excise duties, Insurance Premium Tax, Petroleum Revenue Tax, Stamp Duty, Stamp Duty Land Tax, Stamp Duty Reserve Tax, and Value Added Tax." They also pay and administer the "Child Benefits and the Child Trust Fund and Tax Credits," as well as (4) "collect Environmental Taxes, enforce the National Minimum Wage, and service student loans."

543. *Id.*

544. *Id.*

545. *Id.* at 94.

546. *Id.* ("In 2005, PAYE coding accuracy was 73.3%, and the estimated number of SA taxpayers affected in 2004-2005 by coding errors was 1.4 million.").

547. *Id.*

548. *Id.*

549. *See generally Filing Tax: Do I Have to File Tax*, INLAND REVENUE AUTHORITY OF SINGAPORE, last updated Nov. 21, 2013, http://www.iras.gov/sg/irasHome/page.aspx?id=1448.

550. *See id.*

systems, the taxpayers that agree with the notice, do nothing.[551] However, if the taxpayers disagree with the assessment then they can simply send in a correction.[552] The IRAS then reconsiders this new information and recalculates the tax. Unlike PAYE, no withholding is done throughout the year on wage income from residents.[553] In other words, the individual taxpayer is responsible for saving enough money to pay for their taxes.[554] However, many employers regularly give bonuses the month that taxes are due, so paying taxes is not a hardship for most employees.[555]

The tax system of Singapore is noted for its simplicity. It has a comprehensive base and low rates.[556] It has a liberal exemption, which means that large numbers of Singaporeans do not even pay taxes.[557] Most would agree that a prerequisite to a return free tax system would require tax simplification.

VII. CONCLUSION

As discussed in this Article, tax software has dramatically transformed the way taxes are determined and remitted. The advent of such has produced a number of victorious winners but it also has included some who have not been so fortunate. The IRS has come out ahead with a far more efficient and effective tax administration system. The software companies, commercial tax preparers and the accountants have also greatly benefitted from the TurboTax revolution. Many low-income taxpayers have also gained with the modernity of free electronic filing and an all-around more convenient, cost effective, and reliable method to calculate their taxes or refund, as the case may be. On the other hand, not all taxpayers are beneficiaries of computerized tax computation. A number of taxpayers have suffered under the software revolution with their cases piling up in the Tax Court. And to their dismay, the notorious TurboTax defense has gained very little traction against the accuracy-related penalty or any other penalties for that matter.

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551. *See IRAS: How to Read My Tax Bill*, INLAND REVENUE AUTHORITY OF SINGAPORE, last accessed July 5, 2013, https://www.iras.gov.sg/irasHome/page04.aspx?id=372.

552. S*ee id.*

553. *See After Getting Tax Bill (Notice of Assessment)*, INLAND REVENUE AUTHORITY OF SINGAPORE, last accessed July 5, 2013, https://www.iras.gov.sg/irasHome/page_ektid294.aspx.

554. *See id.*

555. *See id.*

556. Nancy Shurtz, *Sweden, Singapore, and the States: A Comparative Analysis of the Impact of Taxation on the Welfare of Working Moms*, 55 ST. LOUIS U. L.J. 1087, 1107–08 (2011).

557. *Id.* at 1106.

As previously mentioned, the Tax Court has missed almost every opportunity to clarify and expand upon exactly when a TurboTax defense is justifiable. Instead, the defense has remained rather illusive in the courts and before the IRS, primarily relegated to urban legend. The current lack of any concrete guidance concerning a TurboTax defense violates principles of both horizontal and vertical equity. The IRS has also contributed to this inequity by failing to promulgate regulations or otherwise address the issue through other administrative pronouncements. The authors recommend the Treasury and the IRS issue regulations describing and defining the exact contours of a TurboTax defense. The downside of the recent advances in software technology should by no means be borne exclusively by the increasingly reliant taxpayer. Critical errors on one's tax return are no longer limited to human intervention. Computers now interpret vast amounts of taxpayer data and apply the tax laws to various fact patterns in many respects the same as a live practitioner. The IRS and the Tax Court can only ignore this issue for so long, as it will surely rise again as computers and software increase in sophistication. The role of the trusted tax advisor will someday shift almost entirely from a guy named Bob to a science-fiction-style Hal like computer preparing one's return and providing particularized tax advice along the way.

The longstanding partnership between the software industry and the government also needs considerable revamping. The taxpayer is also an interested party in this joint undertaking and thereby its interests must also be considered. The IRS and the software companies must do more to increase the accuracy, security, privacy, reliability, and fairness of the tax system. One possible route to such may be developing an entirely new and simplified tax system whereby the IRS becomes more involved in assessing one's tax. The TurboTax defense should not be limited to taxpayer legend. Nor should it be a defense that only the high-and-mighty can assert when backed into a corner of laughter - sometimes the software does make a mistake and when that happens equity demands relief.