The TurboTax defense
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Tuesday, March 27, 2012

As April 15 approaches, we remember when the tax preparation software TurboTax first gained national recognition - the day in 2009 when Timothy Geithner was questioned by the Senate on his nomination to be the U.S. Treasury Secretary.

The IRS had discovered that Geithner had failed to pay his self-employment taxes (i.e., Social Security and Medicare) on his International Monetary Fund income. When questioned, he said he used TurboTax and that his returns were not prepared "in a way that caught" his embarrassing mistake. Fortunately for Geithner (although admittedly negligent), the IRS waived his tax penalties. Yet this type of waiver hardly is ever available to similarly situated taxpayers who would owe interest on their back taxes plus a 20 percent penalty.

Cases in the U.S. Tax Court indicate taxpayers have attempted to assert a tax software excuse for penalty relief, but except for two cases, their efforts have largely fallen on deaf ears. Yet, an argument can be made that the advice and guidance provided by tax software should be in most cases the equivalent of the advice of a tax preparer. It is possible that the advice had been programmed incorrectly into the software and thus it makes sense to allow the taxpayers some relief from the IRS's arsenal of penalties.

The TurboTax defense was successful in Olsen vs. Commissioner, where the taxpayer failed to input into his tax software certain income from his wife's beneficial interest in a trust because he was "unfamiliar with the form" the couple received. The court determined the "forthright and creditable" taxpayer simply made an "isolated error" in transcribing the information into the software, and thus, penalty relief was warranted.

In the other case, Ronald Z. Thompson vs. Commissioner, an aeronautical engineer took a deduction for flight lessons that arguably could have improved his business know-how at his existing job, but because the lessons qualified him for a commercial pilot's license and thus a new trade or business, the deduction was disallowed. Yet the taxpayer was spared the penalty.

Most tax software companies do offer "accuracy guarantees," reimbursing customers for any penalties and interest paid. However, they often only reimburse for software errors that are "computational" in nature.

The correct application of the law to the facts has always been the taxpayer's primary responsibility, and therefore it cannot easily be shifted to the software. So TurboTax's final "error check" and its "audit risk
meter" might provide you some comfort, but these tests are not going to save you from IRS tax penalties.

The tax code and its regulations do, however, provide some limited relief from penalties, if the taxpayer can demonstrate he or she acted reasonably and in good faith in preparing the return. For example, a taxpayer using computer software may have his or her penalties waived under the "isolated error" exception for typos.

As the usage of commercial tax software increases each year, the IRS, the Tax Court and Congress should reconsider their positions on waiving penalties so when that tax software does instruct to turn right on a left turn only - the taxpayer is not left running off the road.

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