

# POINTS TO REMEMBER

**INTRODUCTION:** Three of this issue's Points to Remember discuss matters related to tax practice and procedure. Leandra Lederman and Stephen Mazza discuss the implications of the filing extensions occasioned by Intuit's server problems. Kevin Thorn provides an overview of monetary penalties for practitioner misconduct. Steve Johnson covers two recent Supreme Court's recent decisions, *EC Term of Years Trust* and *Hinck*, each of which resolved an inter-circuit conflict over taxpayer rights. A fourth Point to Remember, by Nancy Beckner, discusses recent administrative developments involving portfolio interest.

— Gail L. Richmond, Fort Lauderdale, FL

## IS A SERVER CRASH REASONABLE CAUSE FOR LATE FILING?

by Leandra Lederman and Stephen Mazza\*

As has been widely publicized, the Service extended by two days its April 17, 2007 filing deadline for taxpayers unable to file last-minute returns because of server problems at Intuit, Inc. (Intuit), the maker of TurboTax. See I.R.S. News Release IR-2007-91 (Apr. 18, 2007). "The IRS will not apply late filing penalties to taxpayers who were affected by this problem." *Id.*

The apparent reason for Intuit's server problems was the volume of last-minute electronic filings. "Julie Miller, an Intuit spokeswoman, said ... 'It was at least [two times the volume of] last year's [filing date], and even our best planning couldn't anticipate that.'" Gregg Keizer, *Late Filers Overwhelm TurboTax Servers*, COMPUTERWORLD, Apr. 18, 2007, available at [http://www.computerworld.com/action/article.do?command=viewArticleBasic&articleId=9017044&intsrc=hm\\_list](http://www.computerworld.com/action/article.do?command=viewArticleBasic&articleId=9017044&intsrc=hm_list). Yet, "[r]ival H&R Block Inc., which sells the TaxCut software and also provides a Web-based tax preparation service, said that while it also saw double the number of late filers yesterday compared to last year, its users experienced no e-filing problems." *Id.*

\* Leandra Lederman, Indiana University School of Law-Bloomington, Bloomington, IN, and Stephen Mazza, University of Kansas School of Law, Lawrence, KS.

The Service routinely extends tax filing deadlines after natural disasters such as hurricanes and earthquakes. In fact, the heavy rainstorms affecting the Northeast on Monday, April 16, also resulted in the Service's grant of a two-day extension to affected taxpayers. The reason given for that extension was "power outages and public transportation problems making it difficult in some cases, if not impossible, for some taxpayers and tax professionals to meet the April 17 filing deadline." See IR-2007-89 (Apr. 16, 2007). (That extension was later extended until April 26, see IR-2007-92 (Apr. 18, 2007).) What is unusual is for the Service to grant an extension of time to file because of a technological failure of a private company.

Before the advent of electronic filing, the United States Supreme Court ruled that a taxpayer cannot avoid the late filing penalty by relying on a third-party agent to file the taxpayer's return. *United States v. Boyle*, 469 U.S. 241 (1985). Acknowledging that a taxpayer may avoid the penalty if the delay is due to "reasonable cause and not due to willful neglect," Code section 6651(a)(1), the Court nevertheless found the taxpayer's duty to file a tax return on time was nondelegable:

The duty is fixed and clear; Congress intended to place upon the taxpayer an obligation to ascertain the statutory deadline and then to meet that deadline, except in a very narrow range of situations....

To say that it was "reasonable" for the executor to *assume* that the attorney would comply with the statute may resolve the matter as between them, but not with respect to the executor's obligations under the statute.... That the attorney, as the executor's agent, was expected to attend to the matter does not relieve the principal of his duty to comply with the statute.

*Boyle*, 469 U.S. at 249-50 (emphasis in original).

Under *Boyle*, Intuit's server failure would likely be insufficient to convince a court that the late filing penalty did not apply (assuming no amnesty by the Service). Of course, in the TurboTax situation, it was the Service that chose to extend the deadline for taxpayers affected by Intuit's server problem. That administrative decision nonetheless implicates the policy reasons in favor of strict deadlines that the Supreme Court set out in *Boyle*:

Deadlines are inherently arbitrary; fixed dates, however, are often essential to accomplish necessary results. The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates. Prompt payment of taxes is imperative to the Government, which should not have to assume the burden of unnecessary ad hoc determinations.

*Boyle*, 469 U.S. at 249 (footnotes omitted).

Does the Service's recent amnesty for those taxpayers who waited until the eleventh hour to try to electronically file their returns using TurboTax undermine the Supreme Court's concerns about preserving filing deadlines? Intuit's server problems differ from natural disasters because, in the

Intuit situation, the agent the taxpayer hired to facilitate filing the return was the cause of the problem. While it may be reasonable for a TurboTax customer to assume that Intuit will follow through on its promise to electronically submit the return to the Service in a timely manner, the reasonableness of that assumption is not the relevant inquiry when it comes to applying the “reasonable cause” exception, according to the Supreme Court. It may resolve the matter between the taxpayer and Intuit (indeed, Intuit said it would refund the filing fees of customers who experienced the problem, see Jordan Robertson, *IRS: No Penalty for TurboTax Users Affected by Overtaxed Computers* (Apr. 19, 2007), at [http://www.octaxregister.com/octaxregister/sciencetech/homepage/article\\_1663193.php](http://www.octaxregister.com/octaxregister/sciencetech/homepage/article_1663193.php)). However, the taxpayer’s expectations about the agent’s behavior do not affect the taxpayer’s “unambiguous, precisely defined duty to file the return.” *Boyle*, 469 U.S. at 250.

One reason the Service may have been inclined to extend the deadline for those affected by the TurboTax problem is the Service’s goal of increasing e-filing. In 1998, Congress set a target for the Service that 80% of individual returns be e-filed by 2007. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (RRA ‘98) section 2001(a)(2). In the short term, that goal is undermined if taxpayers encountering the TurboTax problem decide to file a hard copy. In fact, statistics released on April 6, 2007 show that only about 70.5% of individual returns filed by that date were filed electronically (including those filed by tax professionals). See I.R.S. News Release IR-2007-80 (Apr. 6, 2007) (percentage calculated by the authors). Longer term, the goal of increased e-filing will falter if taxpayers perceive e-filing as unreliable and thus avoid it.

The filing extension also warrants attention because of the critical role that companies like Intuit play in the filing of tax returns. Intuit is more than just a private provider of software that taxpayers can purchase and use to prepare and file their tax returns. In

1998, Congress legislated that “the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of such returns.” RRA ‘98 section 2001(a)(3). The Service has developed a partnership with the Free File Alliance LLC. See Free File Home, <http://www.irs.gov/efile/article/0,,id=118986,00.html> (last visited May 18, 2007). Intuit is one of the private companies that provides a program to Free File. Intuit’s Free File program, “TurboTax Freedom,” was one of the TurboTax programs affected by Intuit’s server problems. See IR-2007-91, *supra*.

The flip side of the push to increase the proportion of returns that are e-filed is that as more returns are filed electronically, the impact of technological failure increases. Intuit’s server failure and the Service’s response to it may thus be a window into a problem with potentially larger impact. Some may argue that advances in technology call for a reconsideration of *Boyle*. The problem with overturning *Boyle* is that it would likely leave the Service and courts to fend with a plethora of “reasonable cause” claims based on delegated filing duties. For example, in *Henry v. United States*, 73 F. Supp. 2d 1303 (N.D. Fla. 1999), the taxpayers:

provided the signed original of their 1993 income tax return to Jack Herms, the Comptroller of their company (Henry Company Homes, Inc.), to file with the Internal Revenue Service [“IRS”]. As the result of a clerical error, Herms mistook the original of the plaintiff’s tax return for a copy to be “filed,” and he filed it with the company records instead of forwarding it to the IRS.

*Id.* at 1304. In that case, the district court found that, under *Boyle*, an agent’s mistake did not constitute reasonable cause for late filing.

*Boyle* certainly teaches that taxpayers should be leery of delegating the return filing function. The Service’s recent extension based on the Intuit

server failure may suggest to taxpayers that they should feel free to wait until the last minute to file because electronic filing delays will be forgiven. However, viewed in light of *Boyle*, the extension—and the publicity that surrounded it—may suggest just the opposite. Now that taxpayers can reasonably anticipate the possibility of technological failure affecting electronic filing, they should take these potential delays into account when preparing to meet their filing obligations.

The Service’s decision to grant amnesty this past filing season may have been the appropriate decision. The Intuit server failure was not only well-documented, eliminating the problems of proof that can arise in “reasonable cause cases;” it was isolated; and it occurred in a critical year for the Service’s e-filing target. Going forward, however, routine extensions for failures of private technology would raise the concerns expressed in *Boyle* more starkly, and the Service may not choose to be so generous.

---

## FINAL PORTFOLIO INTEREST REGULATIONS RE: **LOANS FROM PARTNERSHIPS AND TRUSTS AND OTHER RECENT PORTFOLIO INTEREST DEVELOPMENTS**

by Nancy M. Beckner\*

### BACKGROUND

Interest from U.S. sources received by a nonresident alien or foreign corporation is generally subject to a flat 30% tax to the extent the interest is not effectively connected with the conduct of a trade or business within the United States; an applicable income tax treaty may reduce or eliminate the 30% tax. Sections 871(a)(1)(A) or 881(a)(1). The payor of such interest (or

\* Newville, PA. Of Counsel, Carlsmith Ball LLP.