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NOTES

ELECTRONIC TAX RETURNS AND THE PREPARER PENALTIES

I. INTRODUCTION

In 1985, the Internal Revenue Service ("IRS") ruled that developers of tax-preparation software may be considered return preparers.[1] Thus, software companies who produce computer programs and sell them to taxpayers for use in preparing income tax returns may be subject to preparer penalties. Unfortunately, since 1985 there has been no further guidance given about how the penalties will be applied to software developers. This is true although Congress, as a part of the Revenue Reconciliation Act of 1989[2] ("1989 Act"), completely rewrote the preparer penalties contained in the Internal Revenue Code (the "Code"). The purpose of this Note is to examine how the penalties should be enforced against software developers for an understatement of a taxpayer's tax liability.

In recent years the development of tax-preparation software has become an enormous growth industry.[3] A major factor in this growth is the introduction of electronic filing of federal income tax returns. Now, for the first time in history,[4] all United States taxpayers who are due a refund may electronically file their federal income tax returns with the IRS.[5] However, the IRS has not yet fully developed a system that would allow taxpayers who owe money to file electronically due to the complexity of making electronic payments.[6] From its beginning in 1986, the electronic filing program has grown from five participants process-

1. Rev. Rul. 85-189, 1985-2 C.B. 341.

2. Pub. L. No. 101-239, § 7721, 103 Stat. 2106 (1989) [hereinafter the 1989 Act].

3. *See Sears Ties Loans to Electronic Filing*, AM. BANKER, Nov. 1, 1989, at 7.

4. The Internal Revenue Service expanded electronic filing beginning with the 1989 tax year to include the entire United States.

5. It is estimated that seventy percent of the 107 million returns that will be filed in 1990 are eligible to be filed electronically. *Taxpayers Will Pay Premium for Filing Electronic Form 1040*, Chicago Tribune, Feb. 4, 1990, at C9, col. 1.

6. Medearis, *Firm's Software Offers Electronic Efficiency for Taxing Times; Taxes: Softview Inc., An Oxnard Maker of Tax Preparation Software, Hopes to Cash In On The IRS Push Toward On-line Tax Filing*, L.A. Times, Feb. 4, 1990, at D4, col. 1.

ing 25,000 electronic returns to 9,429 participants in 1989 processing nearly 1,200,000 electronic returns.[7] By 1995, the IRS hopes to process 30 million individual tax returns.[8] Electronic returns will eventually become the norm.[9]

The IRS attributes the overwhelming growth of electronic filing to the benefits it provides to taxpayers, practitioners, and the federal government. For the taxpayer, the IRS promises considerably faster payment of refunds.[10] Also, individual taxpayers may have their refunds deposited directly into their savings or checking account.[11] For tax practitioners, the IRS acknowledges receipt of return information within forty-eight hours from the time of transmission.[12] Electronic filing allows practitioners to offer their clients a special service. However, the biggest winner in electronic filing is the federal government. First, electronic filing saves tax dollars since it reduces the cost for processing, storing, and retrieving tax returns.[13] Second, electronic filing reduces the problems of recruiting and training temporary workers each year.[14] Third, electronic returns have a much higher accuracy rate than paper returns.[15]

Tax preparation software can run the gamut from passively providing blank forms to actively advising on substantial tax issues. Tax prep-

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7. I.R.S. Publication 1345 at 1 (1990).

8. Late changes to law pose major problem for Electronic Filing, IRS Aide says. DAILY TAX REP. Aug. 22, 1989.

9. Sing, *The Dos and Don'ts of Electronic Tax Filing*, L.A. Times, Dec. 23, 1989, at D3, col. 1 (quoting a prediction by David Green, managing partner of Alder, Green & Hasson, a Los Angeles accounting firm that, "[by] the year 1995, electronic filing will be the normal, accepted means of filing your individual and business tax returns, and by 2000, the IRS will be 98% paper-free").

10. Refunds from electronic returns should take about three weeks, while paper returns can take four to ten weeks, depending on how early you file. Reid, *The 1040 Form Goes Electronic: IRS Promises That Computer Filing Will Speed Taxpayer Refunds*, Wash. Post, Jan. 26, 1990, at A1, col. 1.

11. *Electronic Filing of Federal Tax Returns: Questions and Answers About the IRS Electronic Filing Program*, I.R.S. Publication 1336 (1990).

12. *Id.*

13. "[The] processing costs for an electronic return averages about 4 cents each, one-tenth the cost of receiving and entering a return on paper." Reid, *supra* note 10, at A1, col. 1 (quoting Wilson Fadley of the IRS).

14. Miastkowski, *It's Tax Time; Ideas and Trends; Includes Related Article on Hints on Buying a Tax Package*, LOTUS, Jan. 1989, at 9.

15. In 1989, the error rate on electronic returns was approximately three percent. Paper returns, on the other hand, averaged about sixteen percent. The IRS attributes this "to the fact that electronic returns are verified for accuracy by the electronic filing software and are not acknowledged as accepted until most errors are corrected." In addition, electronic returns do not contain simple errors of omission or mathematics since the computer tax-preparation software have built-in error checking. I.R.S. Publication 1345 (1990).

aration software generally puts simulated tax forms on the computer screen, and then calculates an individual's taxes based on information entered on the keyboard. The taxpayer will normally have the option of printing the finished tax forms, which the taxpayer can then mail to the IRS. Also, many software programs give the taxpayer the option of filing electronically.

Many computer tax-preparation software programs also offer additional assistance. For example, a computer program may use a rule-based expert system[16] that prompts the taxpayer for information. From this information, the program generates a list of income items and deductions specific to the taxpayer's situation. In addition, the software may provide on-line help screens designed to provide guidance on substantive tax issues.

The IRS considers software that decides a taxpayer's eligibility for a deduction or credit to be the riskiest because the taxpayer might take a position not supported by authority.[17] An understatement of tax liability normally occurs here due to a misapplication or a misinterpretation of the tax laws when the developer designed the software. For example, through a series of questions a program may conclude that the taxpayer may take a home-office deduction even though the taxpayer does not satisfy all the requirements.

Also, a developer's negligence may cause an understatement of tax liability.[18] For example, the software developer may fail to reprogram the software to account for changes in the tax law.[19] As a result, the computer program may fail to calculate correctly, or it may use the wrong tax table. In addition to negligence by software developers in the development of the preparation software, there are other examples of negligence that deal more specifically with electronic filing.[20] For example, the software developer may transmit incorrect or incomplete data that differs from the data authenticated and verified by the taxpayer. An unauthorized third party may be able to intercept information from a taxpayer's return. The developer may fail to transmit return data to the service or fail to transmit on time. Additionally, the

16. An expert system works by applying deductive principles to data in its database which allows it to solve problems normally thought to require human intelligence. *See* Note, *Expert Software Systems: The Legal Implications*, 8 COMPUTER/L.J. 455 (1988).

17. Soma and Thomas, *Micro Tax Software for Tax Preparation*, 14 COLO. LAW. 393 (1985).

18. *See infra* text accompanying notes 112-113.

19. *See* Miastkowski, *supra* note 14, at 9. Late changes in the tax law are "a nightmare for developers of tax software, who must scramble to incorporate the latest changes and ship the updated software as far as in advance of January 1 as possible."

20. Niemic, *The Electronic Tax Return: Is Paperless Filing Here?*, 26 JURIMETRICS J. 138 (1985) at 157-58.

developer may improperly disclose or control the return data, or fail to comply with the electronic filing agreement. This Note will focus on the negligent development of software.

This Note examines how and why the civil tax-preparer penalties should be enforced on developers of tax-preparation software. It addresses how private actions by taxpayers to recover individual penalties from software developers are an insufficient means of encouraging the developer's compliance with the tax laws. This Note assumes that developers market their software nationwide through major software retailers for use by the public.[21] This Note takes the position that the existing theories of liability used by the IRS are sufficient for software errors that result in an understatement of tax liability. This is true when the understatement is caused by a misapplication or a misinterpretation of the tax laws or when the error is caused by the software developer's negligence. The use of a computer should not alter the standard of care.[22] Yet, the use of a computer may require a reassessment of how an actor safely discharges these obligations.[23] In practice, identical standards may result in stricter application for negligence by software developers than for negligence by individual tax-preparers.

II. POLICIES FOR SUBJECTING DEVELOPERS OF TAX-PREPARATION SOFTWARE TO THE PREPARER PENALTIES

When it applies tax preparer penalties to software developers, society must balance the benefits of expanding electronic filing against the need to protect the integrity of the tax system. Imposition of penalties will no doubt effect the use of tax-preparation software. Strict application of civil penalties will motivate both the production and the use of more error-free software. Yet, too strict a penalty structure may have a chilling effect on both the development and the use of computer software.

For any penalty structure to be effective, the penalty imposed must be high enough so that the cost of the penalty exceeds the cost of compliance. Yet, too strict a liability standard may deprive society of the benefits of electronic returns. The ideal penalty structure should be high enough to motivate software developers to prepare each line of code as if every return is going to be audited. When evaluating the cost of the penalty, a developer will consider both the penalty amount and

21. This Note will not discuss instances where a tax practitioner is using the software to complete the returns of his customers.

22. *See* Nimmer & Krauthaus, *Computer Error and User Liability Risk*, 26 JURIMETRICS J. 121 (1986).

23. *Id.*

its probability of being imposed. The IRS will only catch an error through an audit of a customer of the developer. Since the current penalties are small, to produce a deterrence the IRS must employ an audit system which catches most of the understatements the computer program produces. Moreover, to be effective, the IRS must enforce the penalty every time it discovers the understatement. Since 1985, when the IRS first ruled that preparer penalties may apply to software developers, there have been no reported cases of enforcement. It is not clear whether this is due to of a lack of willingness to enforce the penalties or a lack of an opportunity for enforcement.

Market forces and the availability of private actions by taxpayers may also have an effect on compliance. Yet, as discussed below, neither of these external factors are sufficient to protect the integrity of the tax system. For continued expansion of electronic filing, taxpayers need to know that they can rely on tax-preparation software to comply with the tax laws.[24] Failure to enforce tax preparer penalties effectively will place a greater burden on taxpayers because insufficient motivation to produce error-free software increases an individual's chances of having to defend the imposition of a penalty. Thus, market forces may eventually drive error-prone software developers out of business. Yet, this will not occur until the bad software victimizes taxpayers. It would not be fair to penalize the taxpayer for an understatement caused by the software if the developer is not penalized. Therefore, this method of policing tax-preparation software is probably not the most desireable.

III. PRIVATE ACTIONS ARE INSUFFICIENT TO PROTECT THE INTEGRITY OF THE TAX SYSTEM

Private actions will often be too impractical for a single taxpayer because of the litigation cost and the difficulty of recovering against a software developer. Although the taxpayer may have both contractual claims and tort claims, each claim presents its own barriers to recovery.

A. CONTRACTUAL CLAIMS

1. *The Uniform Commercial Code*

The first barrier the taxpayer must overcome when pursuing a cause of action in contract is whether Article 2 of the Uniform Commercial Code ("U.C.C.") applies to software transactions. This has been a subject of dispute for many years. In recent years, the bulk of author-

24. This Note does not suggest that reliance on tax-preparation software should be cause for waiving the individual civil tax penalties. This subject is beyond the scope of this Note. The taxpayer must believe that tax-preparation software is a reliable means of completing their tax returns.

ity and opinion considers computer software, especially mass-produced software, to be a good, not a service.[25] Thus, the U.C.C. should apply.

a. Warranties

The U.C.C. provides consumers with three possible warranties under which to recover damages. These warranties include express warranties, implied warranties of merchantability, and implied warranties of fitness for a particular purpose. Yet, these warranties do not provide the taxpayer with a viable solution since the software developer may limit or disclaim all of them.

First, a taxpayer may seek recovery under a theory of breach of express warranty. The breach of express warranty includes the difference in value between the defective and warranted software,[26] plus incidental and consequential damages.[27] A seller creates an express warranty when s/he makes a promise or an affirmation of fact about goods.[28] The difficulty is that express warranties usually appear with warranty disclaimers and limitations on remedies.[29] Thus, the taxpayer may be prevented from claiming breach of warranty.

Second, a taxpayer may seek to recover under a theory of breach of an implied warranty. The existence of an implied warranty does not depend on any claims by the seller. There are two types of implied warranties under U.C.C. Article 2 that may serve as protection for the purchaser of tax-preparation software. First, since the developer is a merchant with respect to the goods, an implied warranty of merchantability arises.[30] This is a warranty that the goods are fit for the ordinary purposes for which the buyers use such goods.[31] The second implied warranty is the implied warranty of fitness for a particular purpose.[32] This warranty exists when the seller knows the buyer's intention to use such goods for a particular purpose and the buyer is relying on the seller to furnish goods suitable for this purpose.[33] This warranty will usually exist since the developer specifically designed the software for preparing tax returns. Yet, both implied warranties may

25. *See* RRX Industries, Inc. v. Lab-Con, Inc., 772 F.2d 543 (9th Cir. 1985) (held a California version of the U.C.C. to be applicable to a contract for the purchase of software without any discussion of whether software is a good).

26. U.C.C. § 2-714(2) (1978).

27. *Id.* §§ 2-714(3), 2-715.

28. *Id.* § 2-313.

29. *See* Gemignani, *Products Liability and Software*, 8 RUTGERS J. COMPUTER TECH. & L. 173, 177 (1981).

30. U.C.C. § 2-104 (1978).

31. *Id.* § 2-314.

32. *Id.* § 2-315.

33. *Id.*

be disclaimed. An implied warranty of merchantability may be disclaimed either orally or in writing. The writing must be conspicuous, and the word merchantability must appear in the written or oral disclaimer.[34] The U.C.C. allows implied warranties of fitness for a particular purpose to be disclaimed by general language if the language is in writing and is conspicuous.[35]

b. Breach of Contract

Unless the parties agree otherwise, the U.C.C. also provides that the buyer often may recover consequential damages arising from any breach of contract.[36] Unless unconscionable,[37] the U.C.C. provides that consequential damages may be limited or excluded.[38] This remedy may not be satisfactory, however, since vendors typically limit liability by excluding "indirect, special or consequential damages" and by making replacement of the defective product the sole remedy.[39]

2. *Magnuson-Moss*

The Magnuson-Moss Warranty Federal Trade Commission Improvement Act ("Magnuson-Moss") provides purchasers of "consumer products" with additional protection against warranty disclaimers.[40] Tax-preparation software packages sold directly to the public should be

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34. *Id.* § 2-314(2).

35. *Id.* § 2-316(2) at comment 4.

36. U.C.C. § 2-715 provides:

> Consequential damages (include) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not have been prevented by cover or otherwise; and injury to person or property proximately resulting from any breach of warranty.

Id. § 2-715.

37. The purpose of the doctrine is to prevent "oppression and unfair surprise and not [to disturb an] allocation of risks because of superior bargaining power." *Id.* § 2-302 at comment 1.

38. *Id.* § 2-719(3).

39. *See* Note, *Expert Software Systems: The Legal Implications*, 8 COMPUTER/L.J. 455, 469 (1988). ChipSoft, Inc.'s 1990 version of TURBOTAX contains the following disclaimer:

> EXCEPT AS PROVIDED ABOVE, AND SUBJECT TO ANY CONTRARY PROVISIONS OF APPLICABLE STATE LAW, CHIPSOFT, INC. DISCLAIMS ANY AND ALL IMPLIED WARRANTIES, INCLUDING WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE, AND WARRANTY COVERAGE FOR INCIDENTAL OR CONSEQUENTIAL DAMAGES.

Contrast this with MECA Corporation, the maker of ANDREW TOBIAS' TAXCUT, that advertises that if TAXCUT calculates an error that causes an IRS penalty—MECA will pay it.

40. 15 U.S.C. § 2301(1) (1982) (stating that consumer products are "any tangible property which is distributed in commerce and which is normally used for personal, family, or household purposes").

considered a "consumer product" even though it also may have commercial applications.[41] Where a dispute arises about whether the product is a "consumer product," there is a presumption favoring coverage.[42] Magnuson-Moss gives the consumer a choice of whether to sue under the Act in state or federal court.[43] For federal jurisdiction the taxpayer must satisfy the amount in controversy requirement.[44] This should be sufficiently high to preclude most taxpayers from litigating in federal court under Magnuson-Moss.

The primary purpose for Magnuson-Moss was to regulate the content and effect of written warranties for consumer products.[45] Yet, since Magnuson-Moss does not require warranties, and it only limits the use of disclaimers, software manufacturers can avoid Magnuson-Moss's disclaimer provisions by refusing to make warranties of any kind.[46]

There is a distinction between full and limited warranties in Magnuson-Moss.[47] If a manufacturer purports to make a full warranty,[48] then Magnuson-Moss prohibits the manufacturer from disclaiming implied warranties of any kind.[49] If the manufacturer only makes a limited warranty, then the manufacturer may limit the duration of the implied warranty.[50] The manufacturer may not disclaim or modify any implied warranty to a consumer with respect to the product.[51] In addition, Magnuson-Moss provides that any disclaimer or limitation of implied warranties that violates the statute is ineffective for purposes of federal and state law.[52]

Magnuson-Moss also requires disclosure of any legal remedies available to the consumer in the contents of a written warranty.[53] Although Magnuson-Moss provides taxpayers with additional protection, it per-

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41. 16 C.F.R. § 700.1(a) (1984).
42. *Id.*
43. 15 U.S.C. § 2310(d)(1) (1988).
44. *Id.* § 2310(d)(3).
45. Note, *Taking the "Byte" Out of Warranty Disclaimers*, 5 COMPUTER/L.J. 531 (1985)[hereinafter *Warranty Disclaimers*].
46. *Id.*
47. 15 U.S.C. § 2303(a) (1982).
48. Code section 2303(9)(a)(1) requires that, in order to label a warranty a "full warranty," the supplier or seller must stand behind the product by agreeing to fix or replace defective parts at no cost and by granting the consumer an option of either replacement or a full refund where the consumer's product cannot be fixed satisfactorily after a reasonable number of attempts. *Id.* § 2304(a).
49. *Id.* §§ 2304(a)(2), 2308(a).
50. *Id.* § 2308(a),(b). The warranty may limit the "duration of a written warranty of reasonable duration if such limitation is conscionable and is set forth in clear and unmistakable language and prominently displayed on the face of the warranty." *Id.*
51. *Id.*
52. *Id.* § 2308(c).
53. *Id.* § 2302(a)(9).

mits exclusions or limitations of consequential damages for breach of warranties.[54] The exclusion or limitation must appear conspicuously on the face of the warranty.[55]

B. Private Tort Actions

Although software developers may avoid liability in contractual causes of action through the use of disclaimers, contractual disclaimers do not bar recovery in tort. Still, a consumer pursuing recovery under tort theories faces many problems in proving his or her case. The tort remedies that may be available to taxpayers include: negligence, strict product liability, and misrepresentation. This Note discusses the fact that most taxpayers will have difficulty recovering purely economic losses in tort actions and how each of these potential remedies pose their own barriers to recovery.

1. *Recovery of Purely Economic Loss*

The majority of jurisdictions do not permit the recovery of economic loss[56] in tort actions.[57] Tort law traditionally has been concerned with redressing injuries which involve physical harm.[58] The seminal case adopting this rule is *Seely v. White Motor Company*.[59] The plaintiffs in *Seely* sought to recover lost profits and a refund of the purchase price of a defective truck. In *Seely*, California Supreme Court Justice Peters' concurring and dissenting opinion indicated that defects in the

54. *Id.* §§ 2304(a)(3), 2302(a)(6).

55. *Id.*

56. The definition of "economic loss" adopted by courts which have considered this issue is "the diminution in the value of the product because it is inferior in quality and does not work for the general purposes for which it was manufactured and sold." *See* Pennsylvania Glass Sand Corp. v. Caterpillar Tractor Co., 652 F.2d 1165, 1169 (3rd Cir. 1981) (quoting Comment, *Manufacturer's Liability to Remote Purchasers for 'Economic Loss' Damages—Tort or Contract?*, 114 U. PA. L. REV. 539, 541 (1966)). The items most frequently sought as damages for unsuitable products are the reduction in value caused by the defect, costs of repair or replacement, and loss of profits. *Id.*

57. *See* East River Steamship Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 868 (1986); Sanco, Inc. v. Ford Motor Co., 579 F. Supp. 893, 896 (D. Ind. 1984).

58. The distinction between economic loss and physical injury has been stated as follows:

> There can be no doubt that the seller's liability for negligence covers any kind of physical harm, including not only physical injuries, *but also property damage to the defective chattel itself*, as where an automobile is wrecked by reason of its own bad brakes . . . . But where there is no accident and no physical damage, and the only loss is a pecuniary one, through the loss of the value or use of the thing sold, courts have adhered to the rule . . . that purely economic interests are not entitled to protection against mere negligence.

Pennsylvania Glass Sand Corp., 652 F.2d at 1170 n.15 (citing W. PROSSER, LAW OF TORTS § 101 (4th ed. 1971))(emphasis in original).

59. 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965).

quality of goods and economic losses were not recoverable from the manufacturer under the theory of strict liability, and that these types of losses should be relegated to the law of contracts governing commercial transactions, *i.e.*, to express and implied warranties.[60]

In his opinion for the majority, Justice Traynor analyzed the types of risks protected by the laws of tort and contract and explained the policy reasons underlying the rule that economic losses should only be recoverable in contract.

> The distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the 'luck' of one plaintiff in having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products. He can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands. A consumer should not be charged at the will of the manufacturer with bearing the risk of physical injury when he buys a product on the market. He can, however, be fairly charged with the risk that the product will not match his economic expectations unless the manufacturer agrees that it will. Even in actions for negligence, a manufacturer's liability is limited to damages for physical injuries and there is no recovery for economic loss alone.[61]

In *Sanco, Inc. v. Ford Motor Company*,[62] the court adopted the majority rule as articulated by Justice Traynor and held that, in a negligence action, the plaintiff, Sanco, would be permitted to recover neither the costs of repairing the defective trucks it purchased from the defendant, Ford Motor Company, nor for the profits lost due to the truck's down time. Instead, the plaintiff's remedy lies in the expectation-bargain protection of warranty law.[63] The court reasoned that:

> . . . tort action traditionally presupposes that the plaintiff has been exposed to an unreasonable risk of injury to his person or his property. Qualitative defects which merely disappoint the buyer's expectations of the product's performance do not expose the user or his property to any risk of physical harm. When a product does not perform as expected, the buyer's remedy should be governed by the rules of contract, which traditionally protect expectation interests.[64]

60. 63 Cal. 2d at 20, 403 P.2d at 153, 45 Cal. Rptr. at 25.
61. 63 Cal. 2d at 18, 403 P.2d at 151, 45 Cal. Rptr. at 23.
62. 579 F. Supp. 893 (D. Ind. 1984).
63. *Id.* at 899.
64. *Id.* at 897.

The court recognized that imposing tort liability on a manufacturer would increase the cost of doing business. The court believed that the increased cost is justified when a product causes personal injury or even when it causes damage to itself or other property. However, the court did not believe that increased costs are justified when a product causes only economic loss.[65] The court reasoned that society has a great interest in spreading the cost of physical injuries. Yet, when a plaintiff has suffered only economic loss the court stated that the societal interest in cost spreading was insufficient to justify requiring "the consuming public to pay more for their products so that a manufacturer can insure against the possibility that some of his products will not meet the . . . needs of some of his customers."[66] The court also agreed with Justice Traynor's conclusion in *Seely* that subjecting a manufacturer to liability under a tort theory would be inappropriate in that it would represent an unwarranted extension of tort law into the decision of the legislature to enact the sales provisions of the Uniform Commercial Code.[67]

Finally, the court noted that the Restatement (Second) of Torts,[68] was in apparent agreement with the majority rule. The court interpreted the Restatement as stating that "a manufacturer is to be liable for 'physical harm' caused by its negligence in the manufacture of a chattel dangerous unless carefully made."[69] The court points out that the Restatement section does not extend the manufacturer's liability to encompass purely economic loss.[70]

At the same time, a minority of jurisdictions allow recovery for economic loss in tort. The United States Supreme Court in *East River Steamship Corp. v. Transamerica Delaval, Inc.* enumerated the rationales for this result.[71] First, the Court stated that those courts which reject the *Seely* approach do so because they find it arbitrary that economic losses are recoverable if a plaintiff suffers bodily injury or property damage, but not if a product injures itself. Second, they find no inherent difference between economic loss and personal injury or property damage, because all are proximately caused by the defendant's conduct. Finally, the minority courts believe recovery for economic loss would not lead to unlimited liability because they think a manufacturer can predict and insure against product failure.

In addition, the Court in *East River* recognized an intermediate po-

65. *Id.*

66. *Id.* (citing Seely v. White Motor Co., 63 Cal. 2d 9, 18; 403 P.2d 145, 151; 45 Cal. Rptr. 17, 23 (1965)).

67. *Id.* at 898.

68. RESTATEMENT (SECOND) OF TORTS § 395 (1965).

69. *Sanco*, 579 F. Supp. at 893.

70. *Id.*

71. 476 U.S. 858, 868-71 (1986).

sition in which a tort action would be allowed if the defective product creates a situation potentially dangerous to persons or other property, and loss occurs as a proximate result of that danger and under dangerous circumstances.[72] In this suit in admiralty law, the court rejected both the minority view and the intermediate position and held that a manufacturer in a commercial relationship has no duty under either a negligence or a strict products liability theory to prevent a product from injuring itself which results in purely economic loss.[73]

2. *Negligence*

Even in jurisdictions that allow recovery of purely economic damages, it is extremely difficult to prove negligence by a software developer. A cause of action based on negligence requires proof of the following elements.[74] The taxpayer must show: 1) that the developer owes a duty of care to the plaintiff based upon a certain standard of conduct; 2) that the developer breached this duty; and 3) that the breach proximately caused the understatement of tax liability.[75]

Scholars are in agreement that a software manufacturer owes a duty of care to the purchaser of his or her software.[76] The difficult question is to what standard of care will a software developer be held. Although the traditional test is one of reasonable care,[77] most commentators agree that the current lack of articulated competence standards in the programming industry makes the familiar techniques of framing a uniform standard futile.[78] Moreover, even after the courts decide upon a standard of care, the complexity of software development compounds the difficulty of finding negligence. The plaintiff must prove that the manufacturer breached its duty, a very difficult thing to prove. The relative youth of the computer industry prevents courts from adequately relying on trade custom and usage to find a breach of duty.[79] Further, no established professional codes of conduct or industry standards exist to guide programmers.[80] Thus, courts cannot rely on com-

72. *Id.* at 869-70.

73. *Id.* at 870.

74. W. PROSSER & W. KEETON, HANDBOOK OF THE LAW OF TORTS § 30 (5th ed. 1984).

75. *Id.*

76. Gemignani, *supra* note 29, at 189.

77. "[R]easonable man of ordinary prudence", "[b]ut if a person in fact has knowledge, skill, or even intelligence superior to that of the ordinary person, the law will demand of that person conduct consistent with it." *See* W. PROSSER & W. KEETON, *supra* note 74, at § 32.

78. Frank, *Tort Adjudication and the Emergence of Artificial Intelligence Software*, 21 SUFFOLK U.L. REV. 623, 629 (1987).

79. *Warranty Disclaimers*, *supra* note 45, at 546.

80. *Id.*

mon practices of others in the industry to guide their decision-making.[81]

The shortcut of *res ipsa loquitur* probably would not apply to help the plaintiff to prove that the developer breached his/her duty.[82] Given the complexities of computers, one cannot say that errors usually do not occur without negligence.[83] Yet, a court may conclude that tax preparation software has become so commonplace and straightforward that errors usually arise only due to negligence and, thus, the doctrine may apply.[84] In any event, the plaintiff would still have to show that, more likely than not, the negligence was the defendant's and not that of a third person or the plaintiff him/herself.

Under common law principles of negligence, the program's defect must cause the consumer's injury.[85] Like many other cases involving negligence the problem of causation is difficult to prove. Yet, proving causation may not be insurmountable with respect to mass produced computer software. A software error is often reproducible because the program can be rerun multiple times.[86] If a program fails the same way every time and produces the same error every time then a defect may be presumed.[87] If on the other hand, it later runs perfectly, the taxpayer will find it much more difficult to prove that the software caused the tax deficiency.

Even if the consumer successfully proves that the manufacturer was negligent in developing the program, the manufacturer has several defenses. Contributory negligence[88] or assumption of risk,[89] for example, might be available. Either of these theories, if successfully proven by the manufacturer, can relieve him or her of liability. Contributory negligence may arise in the use of tax-preparation software if the customer tries to use the program beyond its capabilities or is negligent in following the program's instructions. Alternatively, a software developer may argue that the taxpayer assumed the risk of a new technology.

3. *Strict Product Liability*

Strict liability poses its own obstacles to recovery.[90] First, section

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81. *Id.*

82. *See* Gemignani, *supra* note 29, at 191.

83. *Id.*

84. Nycun, *Liability for Malfunction of a Computer Program*, 7 J. COMPUTERS, TECH. & L. 1, 12 (1979).

85. W. PROSSER & W. KEETON, *supra* note 74, at § 30.

86. Gemignani, *supra* note 29, at 195.

87. *Id.*

88. RESTATEMENT (SECOND) OF TORTS § 463 (1965).

89. *Id.* § 496A.

90. The RESTATEMENT (SECOND) OF TORTS § 402A provides:

(1) One who sells any product in a defective condition unreasonably dangerous

402A of the Restatement (Second) of Torts specifically mentions that the defective product must have caused "physical harm." Therefore, as discussed earlier, courts have been hesitant in awarding damages in strict liability for purely economic losses.[91] Since a federal income tax deficiency would be an economic loss, most jurisdictions will not apply strict liability.

A second obstacle that the consumer must overcome is that s/he would have to prove that the product is defective and that the defect is unreasonably dangerous.[92] Consumers in California have an easier time since that state no longer requires that the consumer prove that the product was unreasonably dangerous.[93] In California, the plaintiff only has to prove that the product is defective and that it caused the injury. In *Cronin v. J.B.E. Olson Corp.*,[94] the California Supreme Court stated that "a requirement that the plaintiff also prove that the defect made the product 'unreasonably dangerous' places upon him a significantly increased burden and represents a step backward in the area pioneered by the court."[95]

The two defenses to a charge of strict liability are product misuse[96] and assumption of risk.[97] In addition, courts will not apply strict liabil-

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to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate consumer, or to this property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

(2) The rule stated in Subsection (1) applies although

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not brought the product from or entered into any contractual relation with the seller.

RESTATEMENT (SECOND) OF TORTS § 402A (1965).

91. Gemignani, *supra* note 29, at 197.

92. RESTATEMENT (SECOND) OF TORTS § 402A (1965).

93. Cronin v. J.B.E. Olson Corp., 8 Cal. 3d 121, 134-35, 501 P.2d 1153, 1163, 104 Cal. Rptr. 433, 443 (1972) (reasoning that such a requirement is inappropriate in a products liability suit).

94. 8 Cal. 3d 121, 501 P.2d 1153, 104 Cal. Rptr. 433 (1972).

95. 8 Cal. 3d at 133, 501 P.2d at 1162, 104 Cal. Rptr. at 442.

96. RESTATEMENT (SECOND) OF TORTS § 402A comment h provides that "[a] product is not in a defective condition when it is safe for normal handling and consumption. If the injury results from abnormal handling . . . the seller is not liable." RESTATEMENT (SECOND) OF TORTS § 402A comment h (1965).

97. The RESTATEMENT (SECOND) OF TORTS § 402A comment n provides:

> the form of contributory negligence which consists in voluntary and unreasonably proceeding to encounter a known danger, and commonly passes under the name of assumption of risk, is a defense under this section as in other cases of strict liability. If the consumer discovers the defect and is aware of the danger, and nevertheless proceeds unreasonably to make use of the product and is injured by it, he is barred from recovery.

Id. comment n.

ity if the danger posed was unavoidable due to the current state of art at the time of manufacture.[98]

4. *Tortious Misrepresentation*

The taxpayer may have an additional cause of action if the software developer misrepresents the attributes or the capabilities of its product. The two types of tortious misrepresentation are intentional and negligent misrepresentation. Intentional misrepresentation, or fraud, requires a showing that the software developer intentionally made a false statement of a material fact upon which the taxpayer reasonably relied his or her detriment.[99] "Mere 'puffing' or predictions about future performance are not actionable."[100] Most jurisdictions will not allow a negligent misrepresentation claim where unintentional misrepresentations are not actionable in contract due to a warranty disclaimer[101] because recognition of this type of action would defeat the purpose of the contractual disclaimer.[102]

IV. PREPARER PENALTIES AND COMPLIANCE

A. ALL DEVELOPERS OF TAX-PREPARATION SOFTWARE SHOULD BE CONSIDERED RETURN PREPARERS

An income tax preparer is either someone who prepares a return for compensation or employs a person to prepare a return for compensation.[103] The preparer does not necessarily have to be the person who mechanically enters the figures on a return. It is sufficient to furnish a taxpayer or another preparer with enough information and advice to make completing the return or the claim for a refund largely a mechanical or clerical matter.[104] Thus, a person may be considered an income tax preparer even if they did not review the information on the return or the claim for a refund.[105] Yet, anyone who merely furnishes typing, reproducing, or other mechanical assistance is not an income tax return preparer.[106]

If it can be determined that the role of software developers goes be-

98. *See* Bruce v. Martin-Marietta Corp., 544 F.2d 442, 447 (10th Cir. 1976).

99. *See Warranty Disclaimers, supra* note 45, at 551.

100. *Id.*

101. *Id.*

102. *Id.*

103. I.R.C. section 7701(a)(36)(A) defines an income tax 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 subtitle A, or any claim for refund of tax imposed by subtitle A." I.R.C. § 7701(a)(36)(A) (1982).

104. Treas. Reg. § 301.7701-15(a)(1) (1982).

105. *Id.*

106. I.R.C. § 7701(a)(36)(B)(i) (1988).

yond mechanical assistance, they may be held liable for preparer penalties.[107] It is not clear where the IRS draws the line for mere mechanical assistance. However, the IRS will consider the software developer to be an income tax preparer if the program determines a taxpayer's eligibility for various deductions and credits.[108] Thus, if using the computer program results in an understatement of tax liability for the taxpayer, the software company may be subject to a penalty under section 6694 of the Code.[109] The rationale behind this provision is that an individual who buys tax-preparation software may be unaware that the program is incomplete or inadequate and, therefore, may use it to create an erroneous return.[110] Additionally, because tax-preparation software may be used by other tax practitioners, both the tax practitioner and the software developer may be subject to the penalty.[111] On the other hand, surely the IRS will not consider the seller of programmable calculators an income tax preparer simply because the calculator could be used to help prepare returns. Yet, it is not clear how the IRS will classify a software program that operates somewhere in between these two extremes.

The best policy is for the IRS to consider all developers of software to be income tax preparers if the software is designed to produce a completed return. Taxpayers are just as likely to rely on the software regardless of the level of its sophistication. It is unrealistic to expect taxpayers to double check the output of the computer program.

As a policy matter, society should encourage taxpayers to file their returns electronically. To require the taxpayer to challenge the tax-preparation software, to seek a second opinion, or to try to monitor the software on the provisions of the Code themselves would nullify the very purpose of using the software. Moreover, a computer program, especially where it is making simple calculations, will be no more accurate with human intervention.[112] Since individuals are not infallible, human errors may often override otherwise accurate computer information.[113]

107. One interesting twist is that the IRS stated that they will not, until further notice, assert the preparer penalties, with respect to a claim or refund, prepared after December 31, 1989 against a preparer who is not required to sign the return. However, this is probably not the IRS's intent. I.R.S. Notice 90-20, 1990-1 C.B. 328.

108. Rev. Rul. 85-189, 1985-2 C.B. 341.

109. I.R.S. News Release IR-86-62 (May 5, 1986).

110. *Id.*

111. *See* Rev. Rul. 85-187, 1985-2 C.B. 338.

112. *See* Nimmer & Krauthaus, *supra* note 22, at 128.

113. *Id.*

B. How the Preparer Penalties Should be Applied to Developers of Tax-Preparation Software

1. *Background*

Tax penalties help to preserve the integrity of the tax system, and have been a part of the tax laws since the Revenue Act of 1913.[114] Congress added section 6694 with the Tax Reform Act of 1976 to regulate income tax preparers.[115] Before 1976, preparers were subject only to criminal penalties for willfully helping in the preparation of a fraudulent return.[116] Congress found that these criminal penalties were inadequate.[117] Thus, Congress added section 6694 primarily to deter preparers from engaging in negligent or fraudulent practices designed to understate tax liability.[118]

In 1989, Congress completely rewrote the preparer penalties for understatement[119] of taxpayer liability. Section 6694(a), as amended by the 1989 Act, imposes a penalty of $250 if any part of an understatement of tax on a return or claim for refund is attributable to "a position for which there was not a realistic possibility of being sustained on its merits."[120] Further, the preparer must have known or should have known of this position and it was not disclosed or it was frivolous.[121] The preparer may avoid the penalty by showing that there was reasonable cause for the understatement and that s/he acted in good faith.[122] The 1989 Act increased the penalty for wilful or reckless conduct from $500 to $1,000.[123]

The statute does not define "realistic possibility of being sustained on the merits." The legislative history suggests that Congress intended the new standard to be stricter than the "old negligent behavior" standard.[124] Yet, the new standard does not require certainty.[125] Nor does

114. *See* JOINT COMMITTEE ON TAXATION, DESCRIPTION OF TAX PENALTIES, JCS-9-88, 100th Cong., 2nd Sess. (1988), Joint Committee Print, JCS-9-88, prepared by the Staff of the Joint Committee on Taxation.

115. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1203, 90 Stat. 1520 (codified at 26 U.S.C. 6694); *see also* Brockhouse v. United States, 749 F.2d 1248, 1251 (7th Cir. 1984).

116. *See* H.R. REP. NO. 658, 94th Cong., 2d Sess. 273-76, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 2897, 3169-71.

117. *Id.*

118. *Id.* at 278, 1976 U.S. CODE CONG. & ADMIN. NEWS at 3174.

119. *See* I.R.C. § 6694(e) (West Supp. 1989) (provides in pertinent part: " 'understatement of liability' means any understatement of the net amount payable with respect to any tax imposed by subtitle A or any overstatement of the net amount creditable or refundable with respect to such tax").

120. *Id.*

121. *Id.* § 6694(a).

122. *Id.*

123. *Id.* § 6694(b).

124. Rev. Proc. 90-20, 1990-10 I.R.B. 17.

it require a preparer to conclude that the position is more likely than not to succeed.[126] The IRS says, for example, that it will

> treat a position as having a realistic possibility of being sustained on its merits if reasonable and well-informed analysis by a person knowledgeable in the law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on the merits.[127]

This standard is applicable to lawyers and certified public accountants.[128] The IRS will not impose the preparer penalties to non-frivolous positions if the preparer sufficiently discloses the position on the return or claim for refund.[129] Negligent behavior that would have been subject to the penalty under former section 6694 of the Code will continue to be subject to the penalty as amended by the Act.[130] Neither the Act nor the legislative history suggests how the amendments apply to developers of tax-preparation software.

2. *Application to Understatements Caused by Misapplication or Misinterpretation*

Liability standards for understatements caused by misapplications or misinterpretations of the tax laws should have the same practical effect when applied to either software developers or individual tax-practitioners. First it must be determined whether there is "a realistic possibility of being sustained on the merits." Like an individual tax-practitioner, the software developer would have to show that a person knowledgeable in the tax law would conclude that after a reasonable and well informed analysis, that the position had approximately a one in three or greater chance of being sustained on the merits. If not, the IRS may impose a penalty unless the program includes a disclosure statement as part of the return. The disclosure statement should satisfy section 6662(d)(2)(B)(ii). Still, a disclosure statement will not be a defense to a frivolous position.

One may argue that software developers should be held to a higher

125. *Id.*
126. *Id.*
127. *Id.*
128. COM. REP. ON THE OMNIBUS BUDGET RECONCILIATION ACT OF 1989, Pub. L. No 101-239 (1989), *reprinted in* 10 Fed. Taxes (P-H) 61586.
129. The IRS has determined that for purposes of section 6694, disclosure is sufficient if it constitutes adequate disclosure for purposes of section 6662(d). I.R.C. § 6694(a)(3) (1982). In addition, I.R.C. section 6662(d)(2)(B)(ii) provides in pertinent part: "The amount of the understatement . . . shall be reduced by that portion of the understatement which is attributable to . . . any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return." *Id.* § 6662(d)(2)(B)(ii).
130. *Id.* § 6694.

standard than individual tax-practitioners since an incorrect position contained in a computer program will affect many more returns than one taken by an individual preparer. Yet, this is not always true. Many individual tax-practitioners work for large organizations and these individuals may simply be applying the law as set forth in the company policy and procedures. If this is the case, the same misinterpretation of the tax laws is likely to result in many errors.

There are countervailing policy arguments that support not having a stricter standard applied to software developers than is applied to individual tax-practitioners. First, like individual tax practitioners, software developers owe a duty[131] to promote the best interests of their customers by minimizing tax liabilities while maximizing their total return. Too strict a standard may cause a conflict of interest. Software companies may become so preoccupied with avoiding the penalties that they may sacrifice the interest of their customers. Second, in addition to increasing the occurrences of errors, more returns also create a built-in deterrent against risky software. The greater the number of returns prepared means the greater the chance that one of the software developer's returns will be audited. Therefore, a software developer is at a greater risk of being caught and subjected to a penalty. Third, too strict a standard would have a chilling effect on software developers willing to take unsettled positions in the tax law. Ultimately, this may reduce the number of tax cases that challenge controversial areas of the Code.[132]

Also, there are policy arguments for not applying a lesser standard of liability to software developers. In addition to owing a duty to their customers, tax preparers also have a responsibility to the tax system.[133] They must, therefore, limit their advice to what is legal, ethical, and reasonable under the Treasury Regulations and the Code. The integrity of our voluntary self-assessment tax system relies not only on taxpayer compliance with the revenue laws, but also on practitioner guidance.[134] In summary, although tax-preparation software has a greater probability of non-compliance with the tax laws, there are sufficient offsetting social benefits to warrant imposing the same standard on software developers and individual practitioners.

131. The duties may have different sources. For instance, the tax-practitioner may be under both a professional and a contractual duty, whereas the software developer may be under a contractual duty only.

132. *See generally* Note, *Painting the Gray Zone Grayer: Why Substantial Authority Fails as a Replacement for the Reasonable Basis Standard in Assessing Practitioner Conduct Under Circular 230*, 8 VA. TAX R. 743 (1989).

133. *Id.*

134. *Id.*

3. *Application to Understatements Resulting from Negligence*

Unlike suits alleging misapplication or misinterpretation of the tax laws, a negligence suit against a software developer for understatement of tax liability is not likely to be sustained on the merits. The software developer will be unable to show that a person, knowledgeable in the tax law, would conclude, after a reasonable and well-informed analysis, that the position had approximately a one in three chance or greater of being sustained on the merits. No authority would support this position. Yet, the software developer may claim that it had a reasonable basis for its position and that it acted in good faith.

To determine what is a reasonable basis one needs to look at the negligence provisions of the prior law. Under the prior law, a return preparer was subject to a penalty for an understatement due to the preparer's negligent or intentional disregard of the rules or regulations.[135] The courts defined negligence as a lack of due care or a failure to do what a reasonable and prudent person would do under the circumstances.[136] The tax preparer had the burden of proof on the issue of whether the preparer had negligently or intentionally disregarded a rule or regulation.[137]

Here, the same liability standard has a much stricter practical effect on software developers than on individuals. Errors caused by a software developer that results in understatements of its user's tax liability will rarely, if ever, be upheld under the negligence provisions of the prior law.

a. *Guidelines For The Application of Preparer Penalties Under the Negligence Standard*

In 1980, the IRS set forth factors to be considered in determining whether to assert the preparer penalties.[138] The fact finder will adjudge the nature of the error causing the understatement, the frequency of errors, and the materiality of errors. When the above factors suggest negligence, the fact finder will then consider the preparer's office in order to decide if the penalty should be applied.[139] Neither the

135. The Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7732(a), 103 Stat. 2106, 2402 (amended 1989). Prior to 1989, the penalty was $100 for negligence and $500 for wilful misconduct.

136. Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968).

137. Treas. Reg. § 1.6694-1(a)(5) (1986).

138. Rev. Proc. 80-40, 1980-2 C.B. 774, 775. Revenue Procedure 80-40 was actually a modification of a harsher rule which had been issued earlier in Revenue Procedure 80-28, 1980-1 C.B. 304. In Revenue Procedure 80-28, the IRS did not take into account the materiality of the tax nor the degree of the preparer's oversight.

139. *Id.*

IRS nor the courts have given any guidance as to how these factors would be applied to an understatement caused by an error in a tax-preparation program. The following disscussion attempts to show that an understatement resulting from a software developer's negligence will rarely, if ever, be upheld under these IRS guidelines.

i. Nature of the Error Causing the Understatement

The fact finder will consider both the complexity of the provision in question and the ease with which it could be detected upon inspection. First, the fact finder must decide whether "the provision that was misapplied or not discovered was so complex, uncommon, or highly technical that a competent preparer of returns of the type at issue might reasonably be unaware or mistaken as to its applicability."[140] Second, the fact finder must decide whether "a general review of the return would have disclosed the error to the preparer."[141] The IRS in Revenue Procedure 80-40 provides that "an isolated mathematical or clerical error ordinarily reflects no more than mere inadvertence. Thus, it will not result in the assertion of the penalty, unless such an error may be of such magnitude or be so conspicuous that it should have been discovered after its commission."[142]

Unfortunately, neither the cases nor the rulings define "complex" nor do they determine how much knowledge is necessary to avoid the imposition of the penalty. In applying this provision to a software developer, there are several issues that must be addressed. First, to whom should we compare software developers to decide if they acted reasonably? For instance, should we compare software developers only to other software companies, or to all return preparers? Second, if we decide to compare to all other developers, how does one define a reasonable software developer and should we hold software developers to a standard higher than that to which individuals are held?

No income provision is so complex, uncommon, or highly technical that the trier of fact should find the software company to be unaware of or mistaken about its applicability. The IRS should not allow software developers that market their products to consumers to claim that a tax provision, applicable to individuals, is beyond the capabilities of their programs. Unlike individual tax-practitioners, software developers who market their product through some general distribution chain cannot

140. *Id.*

141. *Id.*

142. *Id. See also* Rev. Rul. 80-262, 1980-2 C.B. 375 ("An inadvertent error made by a return preparer in either listing or totaling on Schedule B, Form 1040, the separate amounts shown on Forms 1099-INT furnished by a taxpayer that does not result in substantial understatement of tax and is the only error on the return does not subject the preparer to the negligence penalty under section 6694(a) of the code.").

control the expertise of the buyer.[143] Individual tax-practitioners have much more flexibility in limiting the types of returns they choose to prepare.

Also, unlike individual tax practitioners, software developers do not review the completed returns of their customers. Thus, irrespective of its magnitude or conspicuousness, the software developer will not discover the error after the commission. Since the developer cannot discover errors after their commission, society seems justified in imposing a higher standard on developers to prevent errors from occurring in the first place.

In addition, software developers enjoy at least two advantages over individual tax practitioners. First, software developers may include in their programs cross-checking schemes to catch frequent errors. Second, the program will operate consistently for each use. This allows the developer to anticipate problems beforehand and test for possible errors. Once the program is proven to be error-free it will continue to be for each subsequent use.

ii. Frequency of Errors

An isolated error may result in the assertion of a preparer penalty if the error is sufficiently obvious, flagrant, or material. Yet, generally the IRS will not impose a negligence penalty for an isolated error.[144] On the other hand, a pattern of errors on a return is presumptive of negligence.[145] Generally a pattern of errors will result in the assertion of the penalty though no single error occurring in isolation would have triggered the penalty.[146]

A malfunction in a program is likely to result in an erroneous result in all returns used for the same purpose. The court must then decide whether this is an isolated error. All the understatements may have resulted from one bug in the program, but there is a pattern of errors since the bug caused understatements in multiple returns. The best and the most likely answer is that it will be considered a pattern of errors.[147]

iii. Materiality of Errors

The IRS will generally not impose a negligence penalty if the understatement is immaterial since an error resulting in an immaterial

143. Weinstein, *The Performance Audit: Minimizing Software Liability (Part I)*, 29 IDEA 127, 131 (1988).

144. Rev. Proc. 80-40, 1980-2 C.B. 774, 775.

145. *Id.*

146. *Id.*

147. *See* Rev. Rul. 80-263, 1980-2 C.B. 376.

understatement will not be as great an indication of negligence as a similar error resulting in a material understatement.[148] Yet, the understatement, though immaterial, may result in the assertion of the penalty if the error or errors creating the understatement are sufficiently obvious, flagrant, or numerous.[149]

Revenue Procedure 80-40 does not give any examples, measurements, or stated percentages of materiality. Yet, as part of the 1989 Act, Congress added section 6662, which imposes penalties for "substantial"[150] understatements of tax liability. Section 6662 fixes "substantial" as ten percent of the tax required to be shown on the return or $5,000 for taxpayers other than corporate taxpayers, whichever is greater. Although it is unclear whether the courts will interpret materiality to be ten percent, the IRS and the courts generally consider five percent or less to be immaterial.[151]

At least one court has held that a $1,568.24 understatement, resulting from $6,576.22 of overstated losses from a subchapter S corporation allocated to the shareholder, was material.[152] In *Brockhouse v. United States*,[153] the Seventh Circuit ruled that a $10,538.76 understatement of taxes for an omitted income of $15,291.20 was material.

The liability standard will have a much harsher practical effect on software developers than it has on individual preparers. This is true since understatements produced by computer software will most likely always be material insofar as errors should be aggregated from all returns using the program in question.[154] Thus, in developing the new regulations for preparer penalties, the IRS should define "material" to avoid any ambiguities.

iv. When the Penalty Will Not be Applied

Although all the relevant facts and circumstances may suggest negligence, the IRS has indicated that it will not assert a preparer penalty under the following two circumstances.[155] First, the IRS will generally not apply a penalty if the preparer's normal office practices suggest that the error in question would rarely occur. Second, the IRS generally

148. *See* Rev. Proc. 80-40, 1980-2 C.B. 774, 775.

149. *Id.*

150. The IRS often uses the words "material" and "substantial" interchangeably. *See* Rev. Proc. 80-262, *supra* note 142.

151. Arzoo, *Preparer Penalties and Compliance*, THE TAX ADVISER, Jan. 1987, at 38.

152. *Id.* (citing Meyer Papermaster, E.D. Wisc., 1980 (47 AFTR 2d 81-1552), *aff'd* by court order, 7th Cir., 1982).

153. 749 F.2d 1248 (7th Cir. 1984).

154. *See supra* note 138.

155. Rev. Proc. 80-40, 1980-2 C.B. 774, 775.

will not impose a penalty where a preparer relies in good faith upon information furnished by the taxpayer.

A) *Normal Office Practices*

The IRS will generally not apply a penalty if the preparer's normal office practices, when considered with other facts and circumstances, suggest that the error in question would rarely occur.[156] In addition, the preparer must show that s/he followed normal office practices in preparing the return in question. Examples of normal office practices, as applied to individual preparers, include: 1) a system to promote accuracy and consistency in the preparation of returns, such as a checklist; 2) a method for obtaining the necessary information from the taxpayer; 3) an examination of the prior year's return; and 4) review procedures.[157]

Even the best office procedures are no defense against flagrant errors, or a pattern of errors either on a particular return or an error repeated on many returns.[158] Revenue Procedure 80-263[159] illustrates that a pattern of errors, though immaterial, may be material when taken together. In the IRS ruling, the preparer did not list all income shown on a taxpayer's Forms 1099-INT and 1099-DIV, incorrectly totaled itemized deductions, and used the wrong tax table. The IRS stated, "[a]lthough each error, if the sole error on the return, would not result in the imposition of the penalty, all the errors taken together suggest that the return was negligently prepared."[160] The IRS rejected the preparer's argument that his normal office practice, considered with other facts and circumstances, suggested that the errors in question would rarely occur. The IRS stated, "in this situation the normal office practice of the preparer will not relieve them [sic] from the penalty because there is a pattern of errors."[161] This statement is in contrast to Revenue Ruling 80-262,[162] where the IRS ruled that no negligence penalty would be imposed for an inadvertent error when the error did not result in a substantial understatement of tax and it was the only error on the return.

Revenue Ruling 80-264[163] illustrates an instance in which a preparer's normal office practices, taken with other factors, will prevent the penalty from being imposed. The income tax preparer did not re-

156. *Id.*
157. *Id.*
158. *Id.*
159. 1980-2 C.B. 376.
160. *Id.*
161. *Id.*
162. 1980-2 C.B. 375.
163. 1980-2 C.B. 377.

port a substantial minimum tax liability resulting from a net capital gain deduction shown on the individual taxpayer's return. Although this was the only error on the return, the IRS determined that the facts and circumstances suggested negligence by the preparer. The IRS reasoned that the understatement was substantial and that someone could have discovered the error by reviewing the return. The preparer's only defense was that his normal office practice was to apply the minimum tax provisions correctly. The preparer presented a checklist that showed when the minimum tax must be considered. The preparer's work papers indicated that someone had reviewed the checklist. The IRS found that the error would rarely occur based upon the knowledge of the taxpayer, the internal procedures for review, and other facts and circumstances. Since the error was not flagrant, the IRS ruled that the preparer was not liable for a penalty for negligently disregarding the rules and regulations.

As an analogue to office practices, computer software companies could be judged on the quality control procedures of their products. Yet, in reality, this exception will very rarely apply because any error that results from a program bug will be repeated on many returns. All the errors taken together will suggest negligence by the software developer. In addition, it would not be very effective to consider the office practices of software developers. Just as in private negligence actions against computer manufacturers, the difficult question is what standard of care to apply to software developers. As mentioned above, most commentators agree that the current lack of articulated competence standards in the programming industry makes the familiar techniques of framing a uniform standard futile.[164] The relative youth of the computer industry prevents courts from adequately relying on trade custom and usage to decide if the developer's normal office practices, when considered with other facts and circumstances, suggest that the error in question would rarely occur. It would be equally difficult for the developer to show that s/he followed normal office practices in preparing the return in question. Finally, no professional codes of conduct or industry standards exist to guide software developers.[165] Thus, courts have little guidance since they cannot rely on common practices of others in the industry to form a standard of care.[166]

B) *Good Faith Reliance on Information Provided by the Taxpayer*

Secondly, the penalty under section 6694(a) of the Code generally

164. Frank, *Tort Adjudication and the Emergence of Artificial Intelligence Software*, 21 SUFFOLK U.L. REV. 623, 629 (1987).

165. *Id.*

166. *Id.*

will not apply where an individual tax preparer relies in good faith upon information furnished by the taxpayer.[167] Thus, the tax preparer need not audit, examine, or review books and records, business operations or documents, or other evidence to independently verify the taxpayer's information. Yet, the preparer may not ignore the implications of information furnished to the preparer or the information the preparer already knew. The preparer should make reasonable inquiries if the information as furnished appears incorrect or incomplete. Additionally, some sections of the Code require the existence of specific facts and circumstances, such as maintenance of specific documents, before a deduction may be properly claimed.

The Seventh Circuit, in *Brockhouse v. United States*,[168] held that "a taxpayer negligently disregards a rule or regulation under section 6694(a) if his or her negligent failure to inquire into information provided by the taxpayer results in the filing of a return that violates a rule or regulation."[169] The tax preparer in *Brockhouse* was a C.P.A. who prepared returns for a professional corporation and for the corporation's sole shareholder. The corporation had deducted interest paid to the shareholder, but the shareholder did not give this information to the C.P.A. when the C.P.A. prepared his individual returns. The tax preparer never asked whether any of the interest expense shown on the corporate trial balance sheet was paid to the taxpayer. In fact, the corporation had paid the shareholders interest income in the amount of $15,291.20, which they did not report on their return. This resulted in an underpayment of federal income taxes of $10,538.76.

The court in reaching its conclusion addressed the applicable standard of care. The court stated that negligence in this context is generally a "lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances."[170] The court noted that section 6694(b), relating to willful disregard of rules or regulations, expressly provides that a preparer may not rely without verification on information supplied by the taxpayer if that information appears incomplete or incorrect.[171] While the regulation under section 6694(a) does not contain such an express provision, the court noted that it does provide that a preparer is not negligent if he or she "exercises due diligence in an effort to apply the rules and regulations to the information given" to him or her.[172] The court interpreted the due diligence re-

167. Rev. Proc. 80-40, 1980-2 C.B. 775.

168. 749 F.2d 1248 (7th Cir. 1984).

169. *Id.* at 1251.

170. *Id.* (quoting Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044 (1968)).

171. Treas. Reg. § 1.6694-1(b)(2)(ii) (1990).

172. *Id.* § 1.6694-1(a)(1).

quirement to mean that a preparer must act as a reasonable and prudent person with respect to the information supplied to the preparer. The court held that "if the information supplied would lead a reasonable, prudent preparer to seek additional information, it is negligent not to do so. A reasonably prudent preparer would inquire about additional information where apparently the information supplied was incorrect or incomplete and it is simple to collect the necessary additional information."[173] The court found that the facts here supported the district court's finding that the tax preparer was negligent in not asking whether any of the interest paid by the corporation was paid to the sole shareholder.[174]

A court will not likely find that a developer of tax-preparation software was negligent because it failed to inquire into information provided by the taxpayer which resulted in the filing of return that violated a rule or regulation. First, under existing technology the software program will neither be able to ascertain the implications of the information the taxpayer furnishes nor have any existing knowledge about the taxpayer which s/he has not entered into the computer. Second, computer software has far less capability to determine that the information furnished appears incorrect or incomplete. Finally, the computer program has no means of ensuring that a taxpayer possesses the necessary documents before claiming a particular deduction. One possible exception is that the IRS may find that an expert rule based program did not contain the appropriate inquiries in order to find facts and circumstances to determine that the taxpayer was eligible to take a particular deduction. Here, the practical application of the negligence provisions may result in the penalty being imposed much less on software developers. Software is not yet so sophisticated that it can handle situations like this as effectively as a human actor. Also, as discussed above, rule-based expert systems should be encouraged as a matter of public policy.[175]

b. Policy Reasons for a Stricter Practical Affect

The negligence standard, as it applies to developers of tax-preparation software, is a much stricter standard. Its practical effect approaches a standard akin to strict liability. Although a stricter standard may have a chilling affect on the development of software, there are no redeeming social benefits from negligent behavior. Here there are no conflicts of interest. Neither the government nor the taxpayer benefits from errors in a computer program. Imposition of the civil penalties is

173. *Brockhouse*, 749 F.2d at 1252.

174. *Id.*

175. *See supra* Section IV.B.2.

no greater burden on the software developers than the marketplace itself imposes. The penalties will just work quicker to eliminate error-prone software. In the long run, intense competition between software developers will probably be a much greater motivator to produce error-free software than the threat of civil tax penalties. In addition, the stricter practical application of the negligence standard follows from general negligence principles.

For instance, it is often difficult to figure out what a reasonable person would have done in a particular situation. In response, the courts have developed a balancing test as a rough guide on whether a defendant's conduct was so risky as to involve an unreasonable threat of injury. Judge Learned Hand stated the most famous formulation of this test in *United States v. Carroll Towing Co.*[176] Judge Hand stated that liability would exist if the burden of what the defendant would have to bear to avoid the liability was less than the gravity of the potential injury times the probability that the harm will occur from defendant's conduct.[177] Thus, if a reasonable person would realize that a potential injury, if it came to pass, would be extremely severe, there would be liability though it was relatively unlikely to occur. Burden on the defendant depends not only on the cost to the defendant to avoid the harm but also on the broader social utility of the conduct which society would have to forego.

With tax-preparation software, the burden of the civil tax penalties would impose no greater burden than currently imposed by market functions. The burden of reducing the probability of error is also much less. Once the program is tested and verified, the program will operate consistently with each use. It will not be prone to careless errors like an individual tax-practitioner. The social utility from allowing error prone software is very small, if any at all. The likelihood of error is much greater since the error will repeat itself for all taxpayers using this function of the software program. Also, the severity of harm that results from a single error will be greater because of the same reason. Because the error will be repeated on many returns this will result in a much greater loss of revenue to the federal government than a single error by an individual tax-practitioner.

Finally, the policy arguments for imposing strict liability in tort also support a stricter application of the preparer penalties for negligence. First, the consumer relies on the skill and judgment of the software developer. Consumer reliance in the area of computers and in tax may be higher because these areas are beyond the comprehension of the lay consumer. Second, software developers are in the best position

176. 159 F.2d 169 (2nd Cir. 1947).
177. *Id.* at 173.

to avoid the harm. Third, the software developer may spread the risk of error by adjusting its sales price. Finally, the developer placed the product in the stream of commerce and thus it is justifiable to require the developer to bear the risk of the error. Under strict liability, developers will have a greater incentive to act to avoid errors.

V. CONCLUSION

The use of tax-preparation software will continue to increase with the growth of electronic filing of federal income tax returns. Additionally, the complexities of tax-preparation software will continue to increase with the advances in technology and, thus, according to the IRS, become more risky. Both these factors will put additional pressure on the IRS to provide guidelines as to how it intends to apply the civil tax preparer penalties to developers of tax-preparation software. This Note has taken the position that the IRS does not need to develop different theories of liability for individual tax preparers and developers of tax-preparation software. Yet, this Note does recognize that, in practice, identical standards of liability will probably result in stricter application to software developers when the understatement is caused by the developer's negligence. The IRS should specifically address how the preparer penalties will be applied to software developers when it updates the regulations.

The preparer penalties, as they are currently written, will serve to meet the competing goals of expanding electronic filing while protecting the integrity of the tax system. The current standard of liability is strict enough to motivate both the production and the use of more error free software. Yet, the standard is not so strict as to have a chilling effect on both the development and the use of tax-preparation software. This Note has taken the position that all developers of tax-preparation software irrespective of their level of sophistication because the level of sophistication is not likely to have an effect on the taxpayer's reliance on the program in producing their tax returns. This Note suggests that the penalties are necessary because competitive market forces and the availability of private causes of action by taxpayers are not sufficient to protect the integrity of the tax system.

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