

IRS Grants Election Extension to TurboTax User

by Crystal Tandon

In a not-yet published private letter ruling obtained by Tax Analysts, the IRS granted relief to a taxpayer who claims he overlooked an investment income election worth over \$70,000 because he used TurboTax software.

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In the March 22 ruling provided to Tax Analysts by the taxpayer's enrolled agent, the IRS considered and granted a request to make a late election to treat capital gains as investment income under sections 163(d)(1) and 163(d)(4)(B). By making the election, the taxpayer will be able to deduct otherwise disallowed investment interest expense. The IRS determined that when the taxpayer filed his return he did not understand that the option to make the election existed or would affect his liability.

According to Claudia Hill, president of Tax Mam Inc., the enrolled agent representing the taxpayer in filing the private letter ruling request, the taxpayer prepared his 2002 joint return using TurboTax. The return included over \$270,000 in investment interest expense, Hill said, a significant portion of which was determined to be nondeductible by TurboTax because the taxpayer lacked adequate investment income. The taxpayer's 2002 return also included substantial long-term capital gains from investment property, but the taxpayer said the software did not consider an election to characterize all or part of those gains as investment income, which would have given the taxpayer a larger investment interest expense deduction, Hill said.

The average taxpayer would not benefit from making the election because the unused investment expense can be carried over, said Hill, but the savings in this case were substantial because of the taxpayer's substantial investment interest expense.

A spokesperson for Intuit, the maker of TurboTax, defended the popular software. "I suspect any claim that TurboTax did not alert a customer to the availability of the election is not accurate" said Bob Meighan, vice president of customer advocacy for Intuit. "TurboTax definitely alerts customers to the election option and fully explains the implications. This is a clear case of a customer improperly using the software or at least using it in a manner which will not provide the guidance and tips one would expect from software."

Meighan also noted that it would be unusual for a taxpayer to benefit in the long run from making the election, which optimizes tax due in the current year at the expense of future years.

"TurboTax intentionally leaves this decision to make the election with the customer. That is the right way to handle it. The software notifies the customer that they have the option to make the election and lets the customer make the choice," he said.

Forms vs. Interview

TurboTax provides two methods for entering data. The first option, recommended by Intuit, is the interview method, which prompts a user to enter data in response to specific questions that vary depending on the user's prior responses. The other option is a forms-based method to enter the data, which allows a user to enter information directly on the tax forms.

According to Meighan, using the forms-based method to prepare a return bypasses the guidance and tips that TurboTax provides in the interview process. He characterized the process as similar to pulling out the tax forms and putting in the numbers manually, and then allowing TurboTax to simply do the calculations.

When following the forms-based method, a TurboTax user does not receive guidance or analysis, said Meighan. "You are basically on your own . . . you do not have any of the guidance that TurboTax is all about," he said.

"If you're going to drive at night without the lights on . . . then you take the risk you may not arrive at the correct destination," Meighan added.

Intuit provided Tax Analysts with a copy of the relevant interview screens from TurboTax's 2004 product to show that its product, when used in the interview method, asks the right questions to avoid the problem encountered by Hill's client. The screens ask the user to consider the amount of capital gains that they want to be treated as investment income and tell them of possible benefits if they do so. However, when a member of Hill's staff ran the client's scenario through TurboTax's 2004 edition using the forms method for entering data rather than the interview mode, the preparer received no hints suggesting the election was available, said Hill.

Intuit also provided Tax Analysts with a copies of the interview-method screens for 2002, the tax year at issue in the private letter ruling, which prominently disclose the investment income election option to taxpayers with investment interest expense. The screens also provide specific information about capital gains rates and the ability to carryover unused investment interest expenses in future years.

The taxpayer's private letter ruling does not state which method the taxpayer used to prepare his 2002 return or even what brand of software he used. The ruling also doesn't state what consideration the IRS gave to the taxpayer's use of the software in reaching its conclusion.

Hill acknowledged that the return generated by TurboTax for her client was not incorrect, it just did not calculate the lowest possible tax liability under the unusual circumstances used in the model.

Even when a software program tells a user of the election, Hill said, it may not provide the taxpayer with the best decision. "A key element of the problem is the overall complexity of the tax laws," said Hill. "If you have a complex return, you may need to have a tax professional review the return." In fact, that was how this taxpayer caught the error; after two years of using tax preparation software, he sought the advice of Hill in 2004, who reviewed the old returns and found the mistake.

While the taxpayer's situation in the ruling was complicated, Hill said, other individual taxpayers using home tax preparation software could also encounter the same problem if they have similar circumstances.

Meighan said that if a taxpayer is using the recommended interview mode, the user will likely receive adequate notice and guidance.

Accuracy Guarantee

TurboTax currently offers a "100% guaranteed accurate calculations" policy, which according to Meighan would extend to calculation errors resulting in an overpayment. The policy provides for reimbursement of any IRS or state penalties imposed because of TurboTax calculation errors, according to Intuit's Web site.

Since a return prepared without making the investment income election would still be correct, it is unclear whether the policy benefits a taxpayer who overpays tax due to missed elections. In any case, "there are no penalties or interest when the government owes you \$70,000," said Hill.

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