

To: Justin Johnson, Secretary of Administration  
Cc: Sarah London, Governor's Counsel; Bill Griffin, Attorney General Office  
From: Mary Peterson, Commissioner, Department of Taxes  
Re: Abatement of Tax, Penalty & Interest -- 2015 Tax Preparation Software Errors  
Date: August 24, 2016

### **Introduction**

The Vermont Statutes provide that the Commissioner of Taxes may abate certain tax obligations. Specifically, the Commissioner "may ... upon making a record of the reasons therefor, waive, reduce or compromise any of the taxes, penalties, interest or other charges or fees within his or her jurisdiction." 32 V.S.A. § 3201(a)(5).

As discussed earlier this week, I have exercised this statutory authority to abate obligations of taxpayers whose 2015 personal income tax returns were impacted by vendor software issues related to itemized deductions. The Tax Department will not require affected taxpayers to amend their tax returns or pay any additional tax to adjust for the software issues. Also, the Department will refund payments made by affected taxpayers who have already amended returns to adjust for the software issues.

In summary, the reasons my decision are:

1. The expense of requiring thousands of taxpayers to amend their 2015 tax returns would be extremely high relative to amounts recovered.
2. The payments that software vendors have made to the Department – in excess of \$2,400,000 - have made the State whole financially.
3. The burden of pursuing claims against affected taxpayers is compounded by the Department's scheduled transition to new technology over the next several months.
4. Affected taxpayers were not primarily responsible for the problems that impacted their returns, and would be unduly burdened by a cumbersome amendment process this year.

### **2015 Tax Year Income Tax Changes**

In the 2015 legislative session the legislature passed two changes to the personal income tax code retroactive to January 2015. These changes affected only taxpayers who itemize deductions for the personal income tax ("PIT") (generally about 1/3 of Vermont's PIT filers). The first change required taxpayers who itemize to add back any deduction from their federal return for payment of state and local income tax ("SLINC"). This change would be expected to require action by almost every taxpayer who itemizes (except those who claim the federal sales tax deduction instead, and this is very rare). The second change required the taxpayer to add back part of certain deductions if they exceeded a cap ("deduction cap").

The Tax Department created a new form – the IN155 – to capture these changes. Part A of this form led the taxpayer through steps to add back SLINC. Part B led the taxpayer through steps to apply the deduction cap. If correctly completed by the taxpayer, the IN155 would reflect additional taxable income (mostly related to the SLINC add-back) that would result in the taxpayer owing at least a small amount of additional tax. Again, the IN155 was due for most taxpayers who itemize deductions as part of their 2015 tax returns that in most cases are filed by April 15. An extension filer owes the tax by April 15, but need not file the return until October 15 (so an extension filer’s IN155 in essence is due October 15).

### **Tax Year 2015 Software Vendor Inaccuracies**

Each year Vermont “approves” third party software that taxpayers can use to file Vermont taxes. Approval only means that the Department can capture the return information off of a form generated by that software – the Department does not vouch for the software quality or accuracy. The vendor software is sold directly to taxpayers (“DIY”) or to practitioners to use to prepare their client returns (“preparer series”).

Generally, if a taxpayer underpays as a result of a software error, they will be expected to file an amendment with payment or will be assessed. In either case, penalties and interest might be applied depending on the timing. Vendors generally have customer agreements with the taxpayer/customer, who may be entitled to reimbursement of any penalties and interest that are paid.

In April 2016, leadership at the Tax Department learned that flaws in certain software products caused filers to underpay their taxes. The software directed some, but not all, taxpayers who itemize deductions to complete the IN155. If these taxpayers did not complete and file the IN155, they likely underpaid their 2015 taxes.

The Department’s present technology – which is about to be replaced – limits its ability to analyze return data as the returns are filed by taxpayers. The Department can eventually verify Vermont returns using federal data uploaded from IRS repositories, but the complete dataset is not available until months after the filing season. However, in April, the Department analyzed the information that was available and, modeling from that information, determined that the software errors were astoundingly widespread.

The Department discovered IN155 flaws in seven products provided by five different vendors. The Department initially estimated that more than 20,000 taxpayers were impacted and that the impacted taxpayers owed, on average, about \$170 in additional taxes. It was estimated that the State’s FY16 revenue loss was as much as \$3,000,000.

The Department then obtained additional information from vendors and did some additional analysis. As a result, the Department made a downward adjustment and now estimates that the FY 16 revenue loss was about \$2,500,000. Thus the scale remained extraordinary, considering the number of affected taxpayers and the very large impact on State revenues.

The largest impact was traced to taxpayers using Intuit software products – either Turbo Tax or one of the two Intuit preparer series products. Intuit dominates the Vermont tax preparation software market. Working with Intuit data analytics staff, the Department eventually estimated that Intuit software was at the root of most of the taxpayer errors and most of the lost revenue.

### **Tax Department Transition to New Technology**

Aside from the sheer scale of the software vendor inaccuracies for Vermont taxpayers and for the Department, there is another extraordinary circumstance in play. The Department is at a crucial resource-intensive point in its transition to a new platform for processing personal income tax returns. The new platform and technology – called VTax in Vermont – is used by many other states. The filing season for 2015 tax returns is the last time the Department is using its current, limited and out-of-date tax processing platform.

The transition to VTax is critical to the Department's future processing and collection of personal income taxes. The transition requires substantial staff time and resources to assure that VTax will be ready for the start of the 2016 filing season. Phase 3 of the transition started in January 2016, and will conclude with the final conversion to VTax in December of 2016.

According to the Phase 3 schedule, as the 2015 processing tailed off in May/June, Department staff is assigned to complete the cleanup of data on the old system. Training and testing on the VTax platform will continue over the summer through September. Based on our experience with Phases 1 and 2 of the transition, we estimate that this summer cleanup/training/testing will require the equivalent of 1/3 of our FTEs from June through September. This schedule is essential to a successful and timely transition. Meeting these deadlines is a top priority for the Department.

### **Efforts to Resolve the Problem by Facilitating Taxpayer Amendments**

The Department and Intuit worked together to identify impacted taxpayers, to develop parallel outreach plans, to create a process to facilitate amendments, and to establish some incentives by extending the penalty and interest deadlines for taxpayers who amended returns and paid the additional tax. Communications from both the Department and Intuit explained that this was Intuit's error, and that Intuit stood ready to help affected taxpayers pay the correct amount to Vermont.

However, after several weeks, it became apparent to the Department that the amendment process, despite all of the time and effort expended, was inefficient and ineffective. Only 15% of affected taxpayers amended their returns before June 30 – the extended deadline for interest and penalties.

### **Good Faith Payments by Intuit and Other Vendors**

Intuit was the biggest software vendor and was forthcoming in admitting that they "owned" the errors – errors that were their fault. Intuit made an initial payment to the Department in

recognition of the expense caused to the State as the Department worked with the company to assist their customers.

Later, when the amendment process failed to resolve the problem, the Department presented an official demand to Intuit that it make a good faith payment to the State. Ultimately, Intuit agreed on an amount and other vendors also agreed to payments. The Department estimates that these good faith payments to the General Fund essentially make Vermont whole for the revenue shortfall associated with the software errors.

#### **Vendor payments related to TY 2015 software errors**

|                                      |                                       |
|--------------------------------------|---------------------------------------|
| <b>Intuit</b>                        | \$2,375,000.00                        |
| <b>H&amp;R Block</b>                 | \$44,000.00                           |
| <b>Lamson/1040NOW</b>                | \$496.00                              |
| <b>Liberty</b>                       | \$12,169.00                           |
| <b>CCH Small Firm Services (ATX)</b> | \$67,994.00 (pending legal agreement) |

#### **Individual Income Tax Abatements**

The scale of the problems confronting the Department as a result of the software errors was extraordinary in itself. It would have challenged the Department's taxpayer services resources even in an ordinary year. The timing and the importance of the transition to the VTax technology made matters worse to the point of untenable. It became clear that, ultimately, the Department would have to spend an inordinate amount of Vermont's own resources in order to recover payments of mostly small amounts from thousands of individual taxpayers affected by the software errors. This presented a serious risk to the successful, on time launch of VTax.

In these circumstances the statutory abatement of certain tax obligations was the best and perhaps only practical remedy, for several reasons:

First, the cost and burden to the Department of requiring affected taxpayers to amend and pay the additional tax is very high. The number of affected taxpayers is large, while the average underpayment is relatively small. Efforts to facilitate amended filings have been expensive and cumbersome, owing in part that the amendments cannot be made electronically.

Second, the good faith payments made by tax preparation vendors have made the State whole for its revenue losses. The parties responsible for the software errors have addressed the financial problem caused by the errors.

Third, assigning the Department's staff to the tasks of processing amended returns and auditing for compliance would threaten the Department's timely transition to the VTax technology for

the 2016 tax year. That transition is a top priority for the State. Using limited resources to pursue and process amended 2015 tax returns would put that transition at risk.

Fourth, although not a primary consideration, the Department recognizes that taxpayers were not primarily responsible for the mistakes on their returns. The software errors were hit and miss, depending on a number of variables. And because of the uniquely unfortunate timing of this event, impacted taxpayers would be burdened by having to file amended returns using a cumbersome amendment process.

The Department's senior staff analyzed the situation of the 2015 taxpayers who itemized. In general, although there may be some variations, taxpayers fall into four categories. For all the reasons stated above, it was impractical if not impossible to put all of these taxpayers back on equal footing as if they had all filed and paid their taxes correctly in the first instance. The four categories of taxpayers are as follows:

*#1: Paid Right the First Time*

These are the taxpayers who itemized deductions, filed a correct return before April 15, and paid the correct tax amount reflecting the 2015 tax changes. These taxpayers were not affected by the software error. Therefore, no action is required.

*#2: Underpaid Due to Software Vendor Errors*

These are the taxpayers who itemized and underpaid due to software errors, and who did not file amended returns as of June 29, 2016. These are the majority of the impacted taxpayers. At this point, the Department is confident that it would require an inordinate amount of Department resources to obtain an amended return and payment. There are too many outstanding itemizers with too little owed to make this effort cost-effective. The higher priority of our VTax project also makes any such effort more untenable. The Commissioner has accordingly exercised her discretion to abate their taxes and will not take any further action to obtain amendments or payments from this group. The Commissioner believes the goodwill payments made by the software vendors have made the State whole for these abatements.

*#3: Underpaid Initially due to Software Vendor Errors, Then Filed an Amendment*

These are taxpayers who themselves or through their preparers submitted an amendment and payment. They were a minority of a minority – they were impacted, but managed to submit a second filing before the Department's June 29 announcement that it was suspending the processing of amendments. The Department estimates that 15-20% of the impacted filers may have filed amendments. The Department estimates that it processed about \$500,000 from these amendments. The Commissioner has determined that these taxpayers must be treated the same as those taxpayers who underpaid, and that the payments they submitted with amended returns must be abated and refunded. The Commissioner believes the goodwill payments by vendors have made the State whole for these abatements and refunds.

#### *#4: Filing On Extension*

Each year a relatively small number of taxpayers, pursuant to statute, will make a payment by April 15 and obtain an extension to file their returns by October 15. Extension taxpayers generally pay what they think they owe, plus an additional amount since they will be liable for penalties and interest if the April 15 payment proves deficient. Extension returns will run through corrected software. Therefore, extension filers are not impacted by the software errors and no action is required.