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Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty

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CRIME AND PUNISHMENT IN TAXATION: DECEIT, DETERRENCE, AND THE SELF-ADJUSTING PENALTY

*Alex Raskolnikov**

Avoidance and evasion continue to frustrate the government's efforts to collect much-needed tax revenues. This Article articulates one of the reasons for this lack of success and proposes a new type of penalty that would strengthen tax enforcement while improving efficiency. Economic analysis of deterrence suggests that rational taxpayers choose avoidance and evasion strategies based on expected rather than nominal sanctions. I argue that many taxpayers do just that. Because the probability of detection varies dramatically among different items on a tax return while nominal penalties do not take the likelihood of detection into account, expected penalties for inconspicuous noncompliance are particularly low. Adjusting existing penalties will not solve the problem because what is (and is not) inconspicuous depends on a given return and, therefore, is not susceptible to the type of generalization on which the current penalties rely. This Article offers a novel solution. Because taxpayers often hide aggressive subtractions (such as deductions, credits, and losses) by mixing them with legitimate subtractions of the same type, I propose to set the new penalty to equal a fraction of the legitimate subtraction reported on the same line of a tax return that contains the illegitimate one. With this penalty in place, the harder it is for the government to find an aggressive transaction, the higher is the statutory sanction if the transaction is detected. The proposed penalty adjusts itself. As a result, the inefficient incentives to hide noncompliance are diminished and deterrence is improved.

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INTRODUCTION

One (and, perhaps, the only) good thing about tax avoidance is that it unites theoretically inclined academics, hard-nosed practitioners, and result-oriented government officials like few other issues do. Virtually all of them believe that there is too much tax avoidance today.¹ Agreeing on what to do about this is another matter.

1. See, e.g., Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 *Tax Notes* 221, 230 (2000) ("The Treasury has argued, and many practitioners agree, that at present we face a crisis in which undesirable transactions that would undoubtedly be shut down on detection . . . are compromising the entire corporate income tax, and perhaps generating broader disrespect for the tax system."); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 *Tax L. Rev.* 215, 243 (2002) [hereinafter *Weisbach, Ten Truths*] ("[T]he explosion of tax shelters is considered by many to be one of the most pressing problems facing our [tax] system today."); George K. Yin, *JCT Chief Discusses the Tax Gap*, 107 *Tax Notes* 1449, 1449 (2005) ("[A]ny consideration of major tax reform in this country must give priority consideration to issues of tax compliance and enforcement."). In a 2005 report on government operations susceptible to "fraud, waste, abuse and mismanagement," the Government Accountability Office named tax enforcement as one of its "High Risk Areas." See Allen Kenney, *Tax Enforcement Makes GAO's 2005 List of High-Risk Areas*, 106 *Tax Notes* 531, 531 (2005) ("Given the broad declines in IRS's enforcement workforce, IRS's decreased ability to follow up on suspected noncompliance, the emergence of sophisticated evasion concerns, and the unknown effect of these trends on voluntary compliance, IRS is challenged on virtually all fronts in attempting to ensure that taxpayers fulfill their obligations." (quoting Government Accountability Office report)).

This Article makes two contributions to the tax avoidance debate.² First, it identifies a serious weakness of the existing tax enforcement regime. Second, it sketches several potential responses, focusing in particular on a penalty of a new type. The analysis and proposal are grounded in the economic approach to deterrence. In its most basic form, this approach suggests that taxpayers contemplating whether or not to engage in tax avoidance take into account expected rather than nominal penalties. That is, they discount nominal penalties set forth in the Internal Revenue Code by the probability that these penalties will be imposed, a probability that is demonstrably lower than one.

The existing nominal penalties for tax avoidance fail to take into account variations in the probability of detection. Yet this probability differs widely among various avoidance techniques, making expected penalties for some strategies significantly lower than for others. Taxpayers recognize the disparity and, if they decide to engage in tax avoidance at all, tend to choose the type of avoidance that, to put it bluntly, is harder for the government to find.

This strategy is difficult to counter because the opportunity to conceal is unique to each taxpayer. A questionable deduction that is all but invisible on one tax return will raise an obvious red flag on another. The problem is not with the particular type of deduction, but, in large part, with the way it fits with the rest of the taxpayer's return. The current penalty regime makes virtually no attempt to address this problem, focusing instead on transactions that *all* taxpayers are, on average, more likely to use to reduce their tax liabilities.

This Article suggests an alternative approach. I argue that the government should counter taxpayers' incentives to conceal by creating nominal penalties that would vary inversely with the changes in probability of detection. If a nominal penalty prescribed in the statute is higher for the strategies that are harder to detect, it will offset a relatively low probability of detection, resulting in more uniform expected penalties, weaker incentives to conceal, and more effective deterrence.

The new type of penalty proposed here would accomplish this goal for a fairly wide (although limited) set of avoidance and evasion techniques that use various subtractions from gross income (such as losses, deductions, and credits) to reduce tax liability. The key insight is that subtraction items that are likely to raise questions on audit generally fall in one of two categories: They are either unusual for the taxpayer's business or personal situation, or they involve a drastic change in an otherwise typical item. The opposite is also true: Deductions, credits, and losses that are neither atypical nor significantly changed are less likely to invite additional scrutiny. Therefore, if a rational risk-minimizing tax-

2. Somewhat surprisingly, the term tax avoidance has no settled meaning. For a description of the terminological confusion and the precise definition adopted for the purposes of this Article, see *infra* notes 172–175 and accompanying text.

payer looks for an avoidance strategy that will be relatively difficult to detect, she is likely to choose one using those subtractions that are already present on her return, and that are present in a substantial amount.

For example, a suburban lawyer who has decided to overstate her deductions by \$1,000 would probably choose to take an extra \$1,000 charitable deduction in addition to a \$10,000 charitable deduction she claims appropriately rather than taking a \$1,000 farm loss that she has never claimed before. A 10% increase in a charitable deduction is less likely to attract an auditor's attention than an inexplicable farm loss, so the probability of detection, and, therefore, the expected future payment, is lower for the former strategy.

If this insight is correct (even if only in part), it is possible to raise nominal penalties for hard-to-detect strategies without knowing what they are in advance. We can do this by linking the statutory penalty for avoidance or evasion using a particular credit, deduction, or loss to the legitimate subtraction item of the same type. That is, the tax avoider (such as the lawyer) who decides to camouflage an illegitimate deduction by reporting it together with a similar legitimate one would be denied not only the tax item claimed inappropriately (the \$1,000 charitable deduction), but also a fraction of the perfectly legitimate subtraction claimed on the same line of her tax return (e.g., 10% of the \$10,000 charitable deduction).

The main strength of the proposed penalty—and its fundamental difference from any tax penalty existing today—is that it adjusts itself. If a taxpayer's avoidance strategy generates a deduction that has not appeared on her prior returns and is atypical for her business or personal circumstances, the strategy is more likely to be detected. The proposed nominal penalty in this case would be zero, however, because the total amount of the deduction and the amount of the improperly claimed deduction are the same. On the other hand, if a taxpayer inappropriately overstates a deduction that is and has been present on her return in a substantial amount, the overstatement would be much harder to find. However, the proposed self-adjusting penalty in this case would be significantly higher. As a result, the *expected* penalties for the two strategies become much closer than they are today, the payoff from hiding tax avoidance is reduced, and the overall deterrence is increased, all without any additional effort by the enforcement agency.

Many alternative nominal penalties may be devised based on the same fundamental insight. The self-adjusting penalty may be equal to the entire legitimate subtraction item of a type used in the avoidance arrangement, a fraction of that amount, or its multiple. It may or may not take taxpayer's fault into account. It may apply to all forms of avoidance and evasion, or only those using particular deductions, credits, or losses. It may be fine-tuned in many different ways, giving the government significant flexibility in influencing taxpayer decisions. In whatever form it is

eventually adopted, the self-adjusting penalty is likely to improve tax compliance without consuming significant government resources while imposing relatively modest costs on most taxpayers.

In addition to identifying and addressing a systemic flaw in the current enforcement regime, this Article aims to narrow the divide between the economic analysis of tax noncompliance and the general deterrence scholarship. From street gangs to corporate malefactors, from environmental violations to common law torts, scholars have considered how to deter all types of offenses based on rigorous economic analysis.³ In addition to a considerable literature focused on formal modeling,⁴ these inquiries have generated a spirited debate about the types and magnitudes of real-life sanctions. Are monetary fines always more cost effective than incarceration?⁵ Could criminal penalties efficiently deter corporate misdeeds, or can only civil sanctions reach this goal?⁶ Should we set punitive damages by taking into account variations in the probability of detection,⁷ by aiming to deny the benefits of the offense to the violator,⁸ or in some other fashion?⁹ Institutional detail, the expressive function of the law, and cognitive biases play important roles in these debates.¹⁰

In contrast, formal models of tax noncompliance have largely ignored the task of analyzing the optimal structure of nominal penalties.

3. The foundational work is Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968). For discussion of its wide-reaching implications, see, e.g., Richard A. Posner, *Economic Analysis of Law* 215–47 (6th ed. 2003); A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. Econ. Literature 45, 45 (2000) [hereinafter Polinsky & Shavell, *Public Enforcement*].

4. See *infra* notes 162–163 and accompanying text.

5. See, e.g., Dan M. Kahan, *Social Meaning and the Economic Analysis of Crime*, 27 J. Legal Stud. 609, 615–17 (1998) (arguing against established view that civil sanctions are more cost-effective than imprisonment, expressed in Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 Am. Crim. L. Rev. 409, 410–11 (1980)).

6. See, e.g., *id.* at 618–22 (demonstrating why criminal corporate liability may be efficient, disagreeing with Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. Legal Stud. 319, 321–22 (1996), and V. S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 Harv. L. Rev. 1477, 1477 (1996)).

7. See A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869, 874 (1998) [hereinafter Polinsky & Shavell, *Punitive Damages*].

8. See Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties*, 87 Geo. L.J. 421, 455–56 (1998).

9. See, e.g., Catherine M. Sharkey, *Punitive Damages as Societal Damages*, 113 Yale L.J. 347, 363 (2003) (expressing view that economic deterrence is important, but not exclusive, goal of punitive damages).

10. See, e.g., Richard Craswell, *Deterrence and Damages: The Multiplier Principle and Its Alternatives*, 97 Mich. L. Rev. 2185, 2223–36 (1998) [hereinafter Craswell, *The Multiplier Principle*] (discussing, *inter alia*, institutional issues, practical constraints, and symbolic and expressive effects of various penalties aimed at approximating optimal deterrence); Kahan, *supra* note 5, at 610–22 (focusing on expressive function of sanctions); Polinsky & Shavell, *Punitive Damages*, *supra* note 7, at 892–93, 957–62 (addressing potential responses to jury biases, offering detailed jury instructions).

Leading scholars have recognized this deficiency,¹¹ but the lack of attention continues. Furthermore, while tax academics have successfully used sophisticated public finance models to scrutinize current and proposed substantive anti-tax-shelter doctrines,¹² economic analysis of deterrence has remained mostly divorced from the complexities and idiosyncrasies of actual tax enforcement. As a result, both the theoretical analysis of tax penalties and its application to the sanctions that exist (or should exist) today trail similar inquiries in most other areas of the law by a wide margin. This Article begins the process of bridging this gap.

The remainder of the Article consists of five Parts. Part I introduces the tax avoidance problem and the economic approach to deterrence. Part II identifies a critical flaw of the existing enforcement regime. Part III considers and rejects several possible responses and sets forth the proposal. Following the discussion of the proposal's key features in Part IV, Part V addresses some of the likely objections.

I. TAX NONCOMPLIANCE: THE PROBLEM, THE CAUSES, THE ECONOMIC ANALYSIS

A. *The Many Facets of Tax Avoidance*

Each year, the government collects \$345 billion less in taxes than it believes it should.¹³ This shortfall—the so-called tax gap—is not only large, but has more than tripled over the past two decades and continues to grow.¹⁴ Furthermore, the gap is just one of several signs of a serious

11. See, e.g., Frank A. Cowell, *Cheating the Government: The Economics of Evasion* 174, 228 n.18 (1990) (remarking that structure of tax penalties is “relatively neglected in the literature”); Louis Kaplow, *The Optimal Probability and Magnitude of Fines for Acts that Definitely Are Undesirable*, 12 *Int’l Rev. L. & Econ.* 3, 9 (1992) [hereinafter Kaplow, *Fines for Undesirable Acts*] (“[I]t seems inappropriate when analyzing optimal enforcement policy simply to assume, as is commonly done, that the fine is fixed at some stated level”); Louis Kaplow, *Optimal Taxation with Costly Enforcement and Evasion*, 43 *J. Pub. Econ.* 221, 234 (1990) [hereinafter Kaplow, *Optimal Taxation*] (acknowledging that effect of penalty structure on tax enforcement has not been considered in most studies of tax noncompliance, including his own).

12. See, e.g., Shaviro, *supra* note 1, at 237–44 (discussing implications of marginal efficiency cost of funds model); David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, 4 *Am. L. & Econ. Rev.* 88, 92–99 (2002) [hereinafter Weisbach, *Economic Analysis*] (relying on compensated elasticity of taxable income analysis).

13. See Dustin Stumper, *Everson Pledges to Narrow Growing Tax Gap*, 110 *Tax Notes* 807, 807 (2006) (citing estimate of \$345 billion underpayment by taxpayers in 2001 as “the latest and most accurate IRS appraisal of the tax gap”). This number reflects voluntary tax payments. After the government’s collection efforts, the figure is reduced by \$55 billion. See *id.*

14. The gap was estimated at \$90 billion for 1981. Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 *Nat’l Tax J.* 345, 345 (1985). It had been growing at about a 15% annual rate in the decade preceding 1981. See *id.* When adjusted for inflation, the rate of growth is lower. The precision of the tax gap estimate, however, is open to question. See, e.g., Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 *Nat’l Tax J.* 355, 355 (1985) (explaining why estimating tax noncompliance is “fraught with difficulties”).

tax compliance problem. Large and well-known companies see their tax planning strategies struck down as devious tax shelters and are forced to pay penalties on top of the tax they had hoped to avoid.¹⁵ An attempt by an all-American manufacturer to reincorporate in a tax haven is thwarted by outrage on Capitol Hill, a law suit by the state Attorney General, and popular protest.¹⁶ Disenchanted wealthy tax shelter investors turn against their former advisors. As a result, some of the nation's largest investment banks, accounting firms, and law firms are facing numerous law suits, including class actions.¹⁷ Unwilling to risk a criminal conviction, one of the Big Four accounting firms admits wrongdoing in the largest criminal tax case ever filed.¹⁸

While the tax shelter crisis is perhaps the most visible side of the tax compliance problem, it is almost certainly not the most costly one. According to many estimates, the largest portion of the tax gap is due to underreporting of income by small businesses and self-employed individuals, most of which falls under the rubric of tax evasion.¹⁹ Detecting and quantifying this evasion is notoriously difficult because it mainly involves understatements of cash receipts.²⁰ Unlike deductions and credits that appear on returns and must be substantiated if questioned, cash transactions may not be reflected in any set of records. As a result, small business owners and household workers have the lowest level of tax compliance, perhaps as low as 51% for nonfarm proprietor income and 13% for informal supplier income.²¹ A recent report attributes 67% of the tax gap to this type of evasion.²² In sum, wherever opportunities to avoid or evade taxes present themselves, quite a few taxpayers of all stripes are eager to take advantage.

15. See, e.g., Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 *Tax L. Rev.* 255, 257 (2002) (noting court losses of several major U.S. companies).

16. See, e.g., Stacey Stowe, *Stanley Works Decides to Stay Put After All*, *N.Y. Times*, Aug. 4, 2002, § 14 (Conn. Wkly.), at 5; see also Joel Slemrod, *The Economics of Corporate Tax Selfishness*, 57 *Nat'l Tax J.* 877, 883 (2004) [hereinafter Slemrod, *Corporate Selfishness*] (quoting statement by U.S. Senator Charles Grassley that reincorporation of U.S. companies in tax havens is "immoral").

17. See, e.g., Susan Simmonds, *Shelter Cases Highlight Uncertain Outcomes*, 106 *Tax Notes* 45, 48-49 (2005) (listing shelter investor suits in 2004).

18. See I.R.S. News Release IR-2005-83 (Aug. 30, 2005).

19. Low-income proprietors are estimated to be the least compliant group of taxpayers. See, e.g., Kurt J. Beron et al., *The Effect of Audits and Socioeconomic Variables on Compliance*, in *Why People Pay Taxes: Tax Compliance and Enforcement* 67, 86-87 (Joel Slemrod ed., 1992).

20. See, e.g., Joel Slemrod, *Small Business and the Tax System*, in *The Crisis in Tax Administration* 69, 71-72 (Henry J. Aaron & Joel Slemrod eds., 2004) [hereinafter Slemrod, *Small Business*] (giving example of cash-only daycare provider).

21. See *id.* at 85 tbl. 4-5.

22. Heather Bennett, *IRS Must Get Grip on Tax Gap*, *Taxpayer Advocate Says*, 106 *Tax Notes* 531, 531 (2005).

B. *Why Do People Pay Taxes?*

Does it follow that an all-out assault on tax noncompliance is long overdue? Not necessarily. To combat noncompliance one needs to understand why it exists. Why do people pay taxes? Why do they evade? No single theory has all the answers.

The economic analysis of deterrence was introduced in the modern literature by Gary Becker's seminal paper *Crime and Punishment: An Economic Approach*.²³ This analysis suggests that when rational utility-maximizers decide whether to violate the law, they take into account not the nominal penalties (i.e., the sanctions set forth in the statute), but the expected ones.²⁴ The difference between the two arises because enforcement of law is imperfect and some offenses go unpunished. Thus, the expected penalty equals the nominal penalty discounted by the probability that the penalty will be imposed, or probability of punishment:

$$EP = NP \times PP$$

where EP is the expected penalty, NP is the nominal penalty, and PP is the probability of punishment.

This simple formula raises difficult questions. What should the expected penalty be for a particular offense? What is the optimal combination of the two variables that determine the size of this penalty? We will return to these questions later, but at this point we can make two observations. First, Becker's formula demonstrates that the government may vary expected penalties by changing either nominal sanctions or the likelihood that they will be imposed. Second, if the government wanted to deter two offenses equally, subjecting them to equal nominal fines would not produce the desirable result if one offense is less likely to be punished than the other.

Several models of tax evasion have been developed to describe taxpayer behavior based on Becker's approach.²⁵ Some of these models are

23. Becker, *supra* note 3. The approach goes back to the writings of Bentham, see *id.* at 185 n.31 (citing Jeremy Bentham, *Theory of Legislation* 325 (C.K. Ogden ed., Harcourt Brace Co., 1931) (1802)), and Beccaria, see *id.* at 176 n.12 (citing Radzinowicz, 1 *A History of English Criminal Law and Its Administration* from 1750, at 282 (1948) (discussing ideas of C.B. Beccaria)).

24. See *id.* at 176.

25. The scholarship on the subject is vast and several excellent reviews are available. See, e.g., James Andreoni et. al., *Tax Compliance*, 36 *J. Econ. Literature* 818, 823-34 (1998); Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, in 3 *Handbook of Public Economics* 1423, 1429-38 (Alan J. Auerbach & Martin Feldstein eds., 2002) [hereinafter Slemrod & Yitzhaki, *Tax Administration*]. The discussion follows the literature in focusing on tax evasion by individuals. See, e.g., Slemrod, *Small Business*, *supra* note 20, at 83 ("Nearly all the theoretical and empirical literature on tax evasion focuses on evasion by individuals." (citation omitted)).

static,²⁶ others are dynamic.²⁷ Some are focused solely on tax evasion,²⁸ others consider alternative tax reduction strategies such as changes in the work effort.²⁹ Unfortunately, the implications of even the most basic models are far from clear.³⁰ Attempts to make models more realistic quickly increase their complexity and uncertainty.³¹ However, supporting the basic intuition of Becker's formula, most models suggest that nominal penalties and the probability of punishment play important roles in shaping taxpayer behavior.³² At the same time, they fail to explain the "abnormally" high level of tax compliance given the exceedingly low expected penalties, leaving scholars wondering why people pay as much in taxes as they do.³³

If the economic analysis does not fully explain tax compliance, what does? Perhaps, looking at human beings as more than mere "rational

26. The seminal static taxpayer-as-gambler model was offered in Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Econ. 323 (1972) and modified in Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 J. Pub. Econ. 201 (1974).

27. The first dynamic model was proposed in Michael J. Graetz et al., *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J.L. Econ. & Org. 1, 1 (1986).

28. See, e.g., Allingham & Sandmo, *supra* note 26, at 323.

29. See Slemrod & Yitzhaki, *Tax Administration*, *supra* note 25, at 1436–38 (citing four models).

30. For instance, the effect of the tax rate on evasion depends on whether the penalty is based on income understatement or tax understatement. See *id.* at 1431. Relative risk aversion determines the effect of the taxpayer's income on the magnitude of noncompliance. See *id.*

31. See *id.* at 1432.

32. See Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1467 (2003) (noting that studies document relationship between taxpayer compliance and higher audit rates or sanction levels).

33. See, e.g., Graetz & Wilde, *supra* note 14, at 358 ("Application of the standard economic theory of crime to [many] tax avoidance cases . . . produces an unambiguous prediction of behavior: throughout the 1970s no one should have paid the taxes they owed . . ."); Weisbach, *Ten Truths*, *supra* note 1, at 243 ("Perhaps the most surprising fact about tax shelters is that there is not more sheltering. . . . It is not clear, given the wide variety of shelters, why any business pays tax at all."). In part, tax withholding rules help most salaried employees to avoid temptations by putting their employers in charge of collecting and remitting employees' taxes to the government. As a result, compliance rates for these types of income approximate 100%. Slemrod, *Small Business*, *supra* note 20, at 85. A well-publicized system of information reporting makes hiding interest, dividend, and certain other types of income futile as well. See *id.* The system is well understood because every Form 1099 sent to a taxpayer reminds her that the same information is being provided to the IRS. Withholding and reporting increase the probability of detection for income subject to either regime to almost 100%, necessarily leading to larger expected penalties and greater compliance. In addition, if taxpayers overestimate the real probability of detection, the perceived expected penalties are higher than the actual ones. However, experimental estimates of the perceived likelihood of detection are inconclusive. See, e.g., Andreoni et al., *supra* note 25, at 844–45. Even with these qualifications, economic models developed so far do not provide a comprehensive account of the actual taxpayer behavior.

rats" may provide the answer.³⁴ Commentators have argued that cultural traditions and social norms have a powerful influence on tax compliance decisions, possibly more powerful than the threat of punishment. Taxpayers pay taxes, these scholars assert, to avoid feelings of guilt, shame, and peer condemnation, because they value cooperation and believe that others are law-abiding citizens, and because they feel pride in fulfilling their civic duty.³⁵ On the other hand, those who think that the tax laws are unjust or unfairly administered, or disagree with how the tax revenues are spent, are more likely to evade.³⁶

These arguments may have profound consequences for policymakers deciding how to improve tax administration. If they are correct, publicizing a large tax gap and a wide spread of tax shelters, raising penalties, or spending resources on high-profile tax prosecutions of the rich and powerful is likely to have a negative effect on tax compliance by suggesting that tax avoidance is commonplace and socially acceptable, even if risky.³⁷

Empirical research of tax avoidance and evasion is somewhat sparse and has produced inconclusive results. Data about actual taxpayer behavior, results from laboratory experiments, and survey information are each subject to their own limitations and imperfections, making any findings heavily qualified.³⁸ The most basic predictions of the economic deterrence model—that higher penalties and a higher likelihood of incurring them improve tax compliance—have not been rigorously tested.³⁹ Several studies suggest that both factors enhance deterrence, but the effect is small.⁴⁰ Some scholars assert that rewards for being a good citizen and information about compliance by others work better than a threat of punishment for cheating.⁴¹ Others come to exactly the opposite conclusions based on the same experimental data.⁴² Numerous surveys show that tax

34. Cowell, *supra* note 11, at 47.

35. See, e.g., Andreoni et al., *supra* note 25, at 850–51; Dan M. Kahan, Trust, Collective Action, and Law, 81 B.U. L. Rev. 333, 340 (2001).

36. See Marjorie E. Kornhauser, Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?, 18 Can. J.L. & Jurisprudence 95, 97 (2005).

37. See Kahan, *supra* note 35, at 340–44 (discussing trust model of tax compliance). Some scholars suggest that higher penalties and appeals to moral values could work in tandem, especially if they are targeted at different groups of taxpayers. See Lederman, *supra* note 32, at 1462–63.

38. See, e.g., Andreoni et al., *supra* note 25, at 835–38.

39. See Slemrod, Corporate Selfishness, *supra* note 16, at 887.

40. See James Alm et al., Deterrence and Beyond: Toward a Kinder, Gentler IRS, *in* Why People Pay Taxes, *supra* note 19, at 311, 322–23; Andreoni et al., *supra* note 25, at 842; Dick J. Hessing et al., Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies, *in* Why People Pay Taxes, *supra* note 19, at 291, 292.

41. See, e.g., Alm, *supra* note 40, at 321–23 (reporting that immediate rewards produced more compliance than increased enforcement); Kahan, *supra* note 35, at 343 (interpreting results of study by Minnesota Department of Revenue).

42. See Marsha Blumenthal et al., Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota, 54 Nat'l Tax J. 125, 131–32 (2001)

evasion is more prevalent among those who believe that they are carrying an unfairly large tax burden.⁴³ In sum, experimental data lends some support to all existing theories of taxpayer behavior, while giving a decisive advantage to none.

Clearly, more experimental results would be helpful in resolving theoretical debates. In the meantime, the best one can do, it seems, is to explicitly ground any proposal aimed at improving tax administration in one of the competing views about taxpayer behavior. The proposal made in this Article is based on the economic approach.⁴⁴

In relying on the economic theory, however, I recognize that the motivations underlying tax compliance decisions remain controversial. Moreover, even if we posit purely rational taxpayers, we would be unable to derive clear policy prescriptions from the existing economic models. Because of this pervasive uncertainty, I base my analysis and proposal on a fairly weak assumption that many (but not necessarily all) taxpayers exhibit some form of rationality in thinking about their taxes. That is, among various factors that they consider in making tax-related decisions, nominal penalties and probability of punishment play important roles. For the same reason, the following inquiry into the structure of the current statutory sanctions is modest in scope. It considers whether the cur-

(finding no statistically significant effects from normative appeals); Joel Slemrod et al., *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. Pub. Econ. 455, 465 (2001) (finding that higher audit rates increased reported income and tax paid by low- and middle-income taxpayers, especially those with greater opportunities to evade).

43. See Skinner & Slemrod, *supra* note 14, at 348.

44. This choice is consistent with the direction taken by tax policymakers. Faced with the diverging theoretical approaches to tax enforcement, Congress and the IRS have mostly relied on deterrence. They have varied both the nominal sanctions and the likelihood of their imposition in an effort to improve tax administration. See *infra* Part II.A–B. Plenty of statements by the representatives of both branches expressly invoke the deterrence rationale and confirm that the attention to these factors has been by no means accidental. See, e.g., H.R. Rep. No. 101-247, at 1394 (1989), reprinted in 1989 U.S.C.A.N. 1906, 2864 (emphasizing need to “reduce the incentives of taxpayers and their advisors to ‘play the audit lottery’”); S. Rep. No. 97-494, at 272–73 (1982), reprinted in 1982 U.S.S.C.A.N. 782, 1019 (justifying new penalty by need to “deter [taxpayers’] use of undisclosed questionable reporting positions” taken “in the hope that they will not be audited”); see also Graetz & Wilde, *supra* note 14, at 355 (“Not only were the 1981 and 1982 legislative enactments consistent with the basic posture of the economics literature, but the 1982 committee reports seem also explicitly to embrace the economic model . . .”). One of the IRS’s policy statements is even more revealing: “Even though other results, such as raising of revenue, punishment, or reimbursement of the costs of enforcement, may also arise when penalties are asserted, the Service will design, administer, and evaluate penalty programs solely on the basis of whether they do the best possible job of encouraging compliance behavior.” I.R.S., Internal Revenue Manual, Penalty Policy Statement P-1-18 (1992). In 2004, the IRS softened the language, but not the message: “In order to make the most efficient use of penalties, the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.” I.R.S., Internal Revenue Manual, Policy Statement 20-1 (2004).

rent regime creates incentives that are clearly undesirable based on the economic analysis of deterrence. The point, therefore, is not to test whether our tax enforcement system is perfect, but to ensure that it has no obvious flaws.

II. A CRITICAL FLAW OF THE EXISTING PENALTIES REGIME

A. *Nominal Penalties: When They Change and When They Do Not*

In dealing with penalties, the Internal Revenue Code certainly lives up to its reputation. The penalty provisions are numerous, technical, and scattered throughout the voluminous statute. However, once one finds a path through the maze, it turns out that most civil tax penalties for avoidance and evasion are calculated in one of two ways: either as a fixed dollar amount or as a fixed percentage of the underpaid tax liability.⁴⁵ Penalties of both types change based on two variables: aggressiveness of a particular avoidance transaction and its absolute size.

The magnitude of nominal penalties set as a fixed dollar amount frequently depends on the seriousness of a violation, with more egregious offenses resulting in higher nominal penalties. For example, a failure to furnish information about a "reportable transaction" is penalized less severely (\$50,000 per violation) than a similar violation with respect to a "listed transaction" (\$200,000 or more per violation),⁴⁶ presumably on the ground that a listed transaction is certain, while a reportable transaction is only likely, to be abusive. Similarly, the longer an advisor fails to produce a list of potential tax shelter participants, the higher the nominal penalty for the failure.⁴⁷

Most civil penalties for avoidance and evasion are calculated as a fixed percentage of the understated or underpaid tax liability. These penalties, too, usually depend on the gravity of the offense. Thus, a nominal penalty for civil fraud (75%) is higher than for negligence (20%).⁴⁸ The same is true for underpayments caused by a "gross" valuation misstatement (40%) compared to a one that is merely "substantial" (20%).⁴⁹ In each case, a relatively more egregious violation leads to a larger nominal penalty.

45. Other types of penalties apply in specific circumstances. See, e.g., I.R.C. § 32(k) (Thomson 2005) (Earned Income Tax Credit (EITC) disallowed for ten years following fraudulent claiming of credit); id. § 6707A(e) (taxpayer must disclose tax penalty in its financial reports).

46. Id. § 6707(b).

47. See id. § 6708(a) (penalty is \$10,000 per each day of violation); see also id. § 6693 (\$50 per day penalty for violating certain reporting requirements by issuers and trustees of simple retirement accounts).

48. Compare id. § 6663(a) (75% penalty for fraudulent understatements), with id. § 6662(a)-(b)(1) (20% penalty for negligent understatements).

49. Compare id. § 6662(h) (40% penalty for gross valuation misstatement), with id. § 6662(a), (b)(3) (20% penalty for substantial valuation misstatement).

Many fines set in fixed dollar amounts increase with the absolute size of an offense. For instance, penalties for failure to file correct information returns grow with the number of noncompliant returns.⁵⁰ Fines calculated as a fixed percentage of an underpayment or understatement by definition grow in absolute dollar terms as the amount of the underpayment or understatement increases.⁵¹ Thus, larger avoidance transactions are subject to higher nominal penalties in absolute dollar terms.

The Code also provides for variation in nominal penalties based on the changes in probability of punishment, or, more specifically, in one of its principal components. The probability of punishment is a cumulative probability: that an offense will be detected; that it will be selected for prosecution; that the government will prevail at trial on the substantive issue, decide to seek a penalty and convince a court to impose it; that the judgments favoring the government will survive appeals; and, finally, that the government will actually collect the penalty from a taxpayer. The probability of punishment is a product of the individual probabilities for each of these steps.

Throughout the Article, I will focus on a single component of the probability of punishment—the probability of detection—for two reasons. First, as we are about to see, this probability has always been very low for most taxpayers. Quite possibly, it is the smallest among the relevant probabilities and, therefore, has the largest absolute effect on the overall probability of punishment.⁵² Second, the penalty proposed here aims at strengthening deterrence by countering taxpayer incentives to minimize the probability of detection.

The Internal Revenue Code's mechanism for varying nominal penalties depending on the differences in the likelihood of detection is an inducement to disclose.⁵³ In certain cases, penalties are reduced if taxpayers voluntarily highlight questionable transactions on their returns. Thus, an accuracy-related penalty is waived if a taxpayer adequately discloses the relevant facts and her position satisfies a low "reasonable basis" standard.⁵⁴ Without disclosure, the taxpayer is liable for penalties unless

50. See, e.g., *id.* § 6721 (\$50 per failure, up to \$250,000); see also *id.* § 6693 (similar penalty for failure to provide reports on certain tax-favored accounts); *id.* § 6722 (similar penalty for failure to file payee statements); *id.* § 6723 (similar penalty for failure to comply with other information reporting requirements).

51. 20% of a \$100,000 underpayment is necessarily ten times larger than the same fraction of a \$10,000 underpayment.

52. As discussed below, the rate at which the IRS imposes penalties is also exceedingly low. See *infra* note 206.

53. The recent legislation and Treasury regulations discussed below, see *infra* text accompanying notes 70–73, establish a mandatory disclosure regime, but, with one exception mentioned later in the paragraph, do not provide for variation in nominal penalties for the substantive violation based on the likelihood of detection. Rather, these rules penalize violations of the disclosure requirements as an independent offense.

54. I.R.C. § 6662(d)(2)(B).

the disputed position meets a higher “substantial authority” threshold.⁵⁵ Similarly, a new penalty for engaging in a reportable transaction is 20% if the transaction is disclosed and 30% if it is not.⁵⁶

The variation of nominal penalties for disclosed and undisclosed transactions is relatively modest. On the other hand, the probability of detection increases dramatically with disclosure. If the taxpayer highlights the transaction for the IRS, virtually all remaining uncertainty about the future tax payment is due to a possibility that the government may or may not agree with the intended treatment. Without disclosure the taxpayer is playing the audit lottery and facing exceedingly favorable odds.⁵⁷ Therefore, most taxpayers are likely to choose not to disclose and face a low risk of paying 120% or so of a given tax liability plus interest rather than to disclose and take a much higher risk of paying 100% of the same liability.⁵⁸ Furthermore, because the probability of having to pay

55. *Id.*

56. *Id.* § 6662A(c). If a taxpayer uses the services of a “material advisor,” the advisor is required to disclose the transaction to the IRS, *id.* § 6111, and to provide the government with the taxpayer’s name upon request, *id.* § 6112. However, an advisor is not subject to these requirements if she does not meet certain thresholds, including, for instance, if she derives less than \$50,000 in compensation from providing advice to natural persons. See *id.* § 6111(b)(1)(B), (c).

57. Over the past several decades average audit rates declined precipitously, reaching an all time low of 0.49% in 2000. Allen Kenney, *Everson Touts Increased IRS Enforcement in Fiscal 2004*, 105 *Tax Notes* 1071, 1071 (2004) [hereinafter Kenney, *IRS Enforcement*]. The rate of in-person (rather than correspondence) audits was 0.16% in 2002 and 0.15% in 2004. *Id.* To be sure, audits are targeted and for some categories rates are much higher than the average. Yet the rates are very low for some of the least compliant types of taxpayers. See *id.* at 1073 (reporting that audit rate for small businesses declined from 0.58% in 2003 to 0.32% in 2004). Besides, audit rates for virtually all categories have been declining for some time. See *id.* at 1072 (showing declines in audit rates for all categories of taxpayers between 1996 and 2004, with slight rebound for some categories during 2001–2004).

58. Seasoned practitioners agree. Considering the likely effects of a 20% increase in penalty for a tax shelter-related understatement if the position was not disclosed on a return, Michael Schler noted: “[I]f a taxpayer would engage in a transaction without disclosure in the face of a potential 20% penalty, the taxpayer is hardly likely to disclose because of the risk of a 40% penalty.” Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 *Tax L. Rev.* 325, 363 (2002). Theoretically, offenders would disclose their violations voluntarily if the sanction for self-reported violations were no greater than the expected penalty for a nondisclosed offense determined by taking account of the offender’s concealment efforts. See Robert Innes, *Violator Avoidance Activities and Self-Reporting in Optimal Law Enforcement*, 17 *J.L. Econ. & Org.* 239, 241 (2001). Given the diminishingly small likelihood of detecting tax avoidance, the penalty reduction offered by the Internal Revenue Code does not come close to providing an adequate inducement to disclose. Amnesty and settlement offers aim at facilitating disclosure on an ex post basis. See, e.g., I.R.S. Ann. 2002-2, 2002-1 C.B. 304 (announcing amnesty); I.R.S. Ann. 2004-46, 2004-21 I.R.B. 964 (making settlement offer). Because their terms and effectiveness vary from case to case, drawing general conclusions is difficult. Compare Sheryl Stratton & Kenneth A. Gary, *IRS Riding High on Shelter Enforcement Initiatives*, 105 *Tax Notes* 497, 498–99 (2004) (describing successful offer to settle tax shelter), with Jennifer B. Green, *Campus*

tax if a transaction is revealed is higher for more aggressive transactions while the likelihood that a transaction would be eventually detected does not necessarily depend on its aggressiveness, taxpayers have stronger incentives not to disclose more dubious schemes. In sum, the existing inducement to disclose is unlikely to work in many cases, and it is least likely to work where it would be needed most.

As a result, the structure of nominal penalties in the Internal Revenue Code has a potentially serious weakness. Nominal penalties are higher for more aggressive arrangements and for those that reduce tax liability by a larger amount. However, other than varying penalties depending on whether a transaction is disclosed (a variation that is unlikely to be of great significance for the reasons just described), nominal penalties are independent of, and unaffected by, variations in the probability of detection. This would not be particularly troubling if the probability of detection remained fairly constant from one strategy to the next. However, there is every reason to think that it differs widely across different taxpayers and strategies, producing variations in expected penalties that are not only significant, but also unintended and undesirable from the deterrence perspective.

B. Deliberate Variations in the Probability of Detection

In the tax enforcement context, the probability of detection has two main components: audit rate and audit effectiveness. The former is the likelihood that a return will be examined by an IRS agent. The latter is the odds that the auditor will find avoidance during the examination. Changes in both components affect the overall probability.

Starting with audit rates, it is well known that IRS examinations are not conducted at random. Based on the information gathered through the Taxpayer Compliance Measurement Program (TCMP) that ran for almost three decades and is regarded as the best source of information about tax noncompliance,⁵⁹ the IRS developed formulas for selecting returns that are more likely to contain questionable items.⁶⁰ Furthermore, the IRS has been traditionally focused on the magnitude of potential au-

Tour: The IRS Is Coming to Your School, College, or University, 104 Tax Notes 1383, 1383 (2004) (reporting on low response rate to IRS settlement offer). Besides, unless taxpayers anticipate a future settlement or amnesty when they assess nominal penalties (something that can hardly be taken for granted), these programs have little effect on taxpayers' ex ante evaluations of avoidance strategies.

59. See Robert E. Brown & Mark J. Mazur, The National Research Program: Measuring Taxpayer Compliance Comprehensively, 51 U. Kan. L. Rev. 1255, 1261-62 (2002) (giving detailed description of program).

60. See *id.* at 1262. As a result of this program, the percentage of examinations resulting in no adjustments dropped from 50% to 20% at one point. *Id.* However, this percentage has been on the rise because the government's data became outdated. *Id.* at 1264. A new program has been in place since 2001, and the data has just started to arrive. See Allen Kenney, New IRS Estimates Show Slight Widening of the Tax Gap, 107 Tax Notes 7, 13 (2005).

dit adjustments.⁶¹ As a result, audit rates are higher for corporations than for individuals, and for larger corporations compared to smaller ones.⁶² Similarly, returns of higher income individuals are examined more frequently than of those with lower incomes,⁶³ taxpayers with business or farm income face higher chances of an audit than those without it,⁶⁴ and the unfortunate souls whose returns trigger the audit selection formulas are examined much more often than those who manage to file inconspicuous returns. The differences are dramatic. At one extreme, the largest companies undergo a continuous audit. At another, individual taxpayers who earn primarily wage income and take standard deductions face an audit rate below 1%.⁶⁵

In contrast with audit rates that are well known and well documented, audit effectiveness is much harder to estimate because the inquiry involves a counterfactual. To gauge it, we would need to compare the number of questionable transactions actually identified during tax audits with the number of these transactions that would have been identified had auditors been able to spot all of them. They cannot, and there lies the problem. Of course, there is a perfect source of information on the issue—the taxpayers themselves. For obvious reasons, data collected from this source is not particularly reliable, no matter how hard the researchers work to convince the taxpayers who participate in the surveys that their revelations will remain confidential.⁶⁶ The existing estimates of audit effectiveness suggest that somewhere between one-half and two-thirds of noncompliance remained undetected during the unusually thorough TCMP audits.⁶⁷ This likely means that the rate of detection during typical audits is below (perhaps well below) 50%.

61. See, e.g., Brown & Mazur, *supra* note 59, at 1267 n.35 (“[T]he traditional audit approach . . . concentrat[es] on the potential size of [the] tax adjustment.”); Jeffrey A. Dubin et al., *The Changing Face of Tax Enforcement, 1978–1988*, 43 *Tax Law.* 893, 903 (1989) (“[T]he audit process is designed to select first returns with the highest potential yield.”).

62. See Kenney, *IRS Enforcement*, *supra* note 57, at 1071; Allen Kenney, *High-Income Audits Contribute to Record IRS Enforcement Stats*, 109 *Tax Notes* 730, 730 (2005).

63. See Kenney, *IRS Enforcement*, *supra* note 57, at 1071. Certain categories of low-income taxpayers are also subject to high audit rates. See, e.g., Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 *UCLA L. Rev.* 1867, 1884–85 (2005) (discussing high audit rates for EITC recipients).

64. See Slemrod, *Small Business*, *supra* note 20, at 92.

65. See Kenney, *IRS Enforcement*, *supra* note 57, at 1071 (reporting average audit rates for all individuals below 1% in 1998–2004). Wage earners who take a standard deduction present the lowest audit risk because all of their earnings are subject to information reporting. Their audit rates are lower than the average ones.

66. See, e.g., Hessing, *supra* note 40, at 294 (“Despite safeguarding respondents’ anonymity . . . , the results showed that documented and self-reported tax evasion did not correspond at all.”).

67. See Andreoni et al., *supra* note 25, at 850 (suggesting 50% success rate); Beron et al., *supra* note 19, at 73 n.9 (positing 33% success rate for income subject to reporting on Forms 1099); Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by*

Nonetheless, it is quite clear that audit effectiveness (and the probability of detection in general) is higher for transactions of a particular type—those subject to mandatory disclosure regimes. The so-called Schedule M-1 is a case in point. For more than four decades, large and mid-size corporate taxpayers have been required to attach to their tax returns a special form where they reconciled their financial and tax accounting figures, Schedule M-1.⁶⁸ The government recognized that the two accounting systems create opposite incentives: Taxpayers would prefer to have more income for financial reporting purposes, but less income for tax purposes. While tax and financial accounting rules differ and there is nothing inherently wrong when a transaction produces a so-called book-tax difference, there is a higher probability that a tax auditor would find aggressive tax positions if she focuses on these transactions. This is because many of the same considerations that point, for example, to treating a given security as equity (rather than debt) for accounting purposes also suggest that it should be treated as equity for tax purposes. In the end, the proper tax characterization of the security may well be debt. But the question is likely to be close precisely because the security had enough equity-like features to swing the accounting treatment the other way.⁶⁹ A special disclosure requirement forcing taxpayers to report all book-tax differences raises the probability of detection in an area that, on average, is more likely to encompass noncompliance.

The government's latest effort to combat proliferation of abusive tax shelters embodies the same idea on a grand scale. The recent tax shelter regulations (Regulations) identify the most typical features of transactions viewed by the government as tax avoidance and require taxpayers to disclose all transactions that possess any of these features (reportable transactions).⁷⁰ Transactions that result in large losses, involve brief asset holding periods, or are protected by confidentiality agreements or by contingent fee and similar arrangements trigger the disclosure requirements. Taxpayers must also disclose any of the specific transactions designated by the government as, essentially, illegitimate tax shelters (listed

Small Corporations, in *Why People Pay Taxes*, supra note 19, at 125, 138 (referring to IRS estimate that it detects one-third of unreported income by individuals and one-half of unreported income by corporations).

68. See, e.g., Kenneth A. Gary, *Burdens May Outweigh Benefits for Schedule M-3 Filers*, 105 *Tax Notes* 632, 632 (2004) (noting that Schedule M-1 has not been updated in more than forty years). This schedule has recently undergone a major revision. See *infra* text accompanying notes 98–101.

69. For a detailed discussion of one such security, see David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 *Tax L. Rev.* 499, 517–19 (1994) (describing monthly income preferred securities).

70. See *Tax Shelter Regulations*, 68 *Fed. Reg.* 10,161 (Mar. 4, 2003) (to be codified at 26 C.F.R. pts. 1, 20, 25, 31, 53, 54, 56, 301, 602) (withdrawing several sets of proposed regulations and promulgating final regulations under §§ 6011(a), 6111(d), and 6112).

transactions).⁷¹ The American Jobs Creation Act of 2004⁷² (2004 Act) expanded the Regulations' reach even further, and backed them up with new penalties, including an unheard-of fine for tax advisors equal to \$10,000 for each day of a violation.⁷³

Just as the Schedule M-1 does, the Regulations create a class of transactions that will be scrutinized in greater detail than the rest of the return. The reportable transaction categories were chosen precisely because they are more likely to encompass dubious schemes. Because the probability of finding avoidance is higher if an auditor focuses on these transactions, she should be expected to do just that.⁷⁴

Variations in the probability of detection due to differing audit rates and mandatory disclosure regimes produce divergent expected penalties for various types of taxpayers and transactions. A large company under a continuous audit has a chance that an aggressive position reflected on Schedule M-1 would go unnoticed, but the odds are against it.⁷⁵ The expected penalty is relatively close to the nominal one in this case. On the other hand, a small entrepreneur who takes a questionable deduction not subject to any mandatory disclosure regime is unlikely to be audited, the deduction is unlikely to be questioned on audit, and the expected penalty is nowhere near its nominal size.

These variations in the expected penalties, however, are hardly accidental. In fact, the very reason why the largest companies undergo continuous audits and why taxpayers are required to disclose reportable and listed transactions is that the government is particularly concerned about the noncompliance of these taxpayers and by the use of these transactions.⁷⁶ The government's response is to vary expected penalties by delib-

71. See Treas. Reg. § 1.6011-4(a), (b)(2) (as amended in 2003). Technically, listed transactions are just one type of reportable transaction. Because some of the issues raised by listed transactions differ from those raised by all others, I will refer to them separately and will use the term "reportable transaction" to describe all other transactions subject to the Regulations.

72. Pub. L. No. 108-357, 118 Stat. 1418 (2004).

73. I.R.C. § 6708 (Thomson 2005). For a brief summary of the 2004 Act provisions see Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 *Colum. L. Rev.* 1939, 1941 n.6 (2005).

74. In fact, the Regulations are likely to increase both components of the probability of detection—not just the audit effectiveness—because the IRS would audit a higher percentage of taxpayers who disclose participation in reportable transactions compared to otherwise identical taxpayers who make no such disclosure.

75. Even in this case, however, a taxpayer's chances of avoiding detection are far from trivial. See Joseph Bankman, *The Tax Shelter Battle*, in *The Crisis in Tax Administration* 9, 15 (Henry J. Aaron & Joel Slemrod eds., 2004) [hereinafter *Bankman, Tax Shelter Battle*] ("[F]inding a shelter in a Schedule M for a Fortune 100 company is not easy work.").

76. Unfortunately for the government, the Regulations will give taxpayers an incentive to search for new types of tax avoidance that would not be subject to the Regulations. See *infra* text accompanying notes 285–289. In contrast, whatever the reason for higher scrutiny of large corporations and wealthy individuals (it may be revenue maximization in addition to, or instead of, deterrence), the government need not worry

erately altering probability of detection (and, in some cases, the nominal penalties as well). The same cannot be said about the disparities discussed next.

C. *The Red Flags Strategy and Its (Unintended) Consequences*

Mandatory disclosure rules such as Schedule M-1 and the Regulations are just one reason why the probability of detection varies from one transaction to the next and from one item on a return to another. It is no secret that while some arrangements are obvious even to a novice auditor, other schemes are next to impossible to find on a return. This disparity exists, at least in part, because of a strategy used by auditors to detect questionable positions. To use a common metaphor, auditors find tax avoidance by looking for red flags.⁷⁷ Understanding what these red flags are and how they help in detecting tax avoidance is crucial for recognizing the serious deficiency of the current enforcement regime.

Consider a few examples. During the late 1970s, IRS examiners noticed something strange on the returns of urban and suburban doctors, lawyers, and other white-collar professionals. A growing number of these taxpayers were claiming large losses from farming, chinchilla breeding, movie production, and other activities that seemed unusual and unrelated to their lifestyles or typical investment strategies.⁷⁸ Sure enough, with some investigative work, the government discovered what came to be known as the tax shelter crisis of the 1970s.

Fast-forward twenty years. Auditors could not understand why more and more U.S. companies were going into the leasing business (or so it seemed).⁷⁹ When, alarmed by large lease-related deductions, the agents inquired about the underlying transactions, things got even stranger. Why would a prominent U.S. bank, for example, lease the transportation or sewage system of a quaint European town and immediately lease it back to the municipality? Puzzled by this inexplicable activity, the auditors kept asking questions until they discovered one of the most widespread tax shelters of the recent past. In fact, this shelter has become so popular that the legislative provision eliminating any doubt (if there ever was one) that it fails to deliver the intended tax benefits is expected to raise more than \$25 billion by 2014 according to Congressional budget

about taxpayers' responses too much. Corporations will not downsize and rich taxpayers will not waste their assets just to reduce their audit risks.

77. See, e.g., *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 212 (D. Conn. 2004) (referring to taxpayers' strategy as "transparent attempt to conceal Long Term's efforts to keep the huge tax losses claimed from raising a red audit flag").

78. For a colorful account, see Michael J. Graetz, *The Decline (and Fall?) of the Income Tax* 41-51 (1997).

79. See *Frontline: Tax Me if You Can* (PBS television broadcast Feb. 19, 2003), transcript available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/etc/script.html> (on file with the *Columbia Law Review*).

estimates.⁸⁰ As with chinchilla breeding, these so-called lease-in, lease-out deals were spotted because they generated deductions that stood out on returns, i.e., raised red flags.

Another recent example suggests that taxpayers hate to raise red flags just as much as the auditors like to focus on them. Managers of Long-Term Capital Holdings (LTCH)—a prominent hedge fund—entered into a transaction of questionable legality that promised to reduce their taxable income by about \$100 million.⁸¹ However, they realized that including a \$100 million loss on Schedule M-1 would draw unwanted attention from the IRS, so they offset the loss against other gains and reported only the net number. The trick did not work. When the court considered whether to allow the deduction, it was particularly annoyed by the taxpayers' "efforts to keep the huge tax losses claimed from raising a red audit flag."⁸² In fact, the taxpayers' evasiveness may have contributed to the court's decision to impose penalties.⁸³

Apparently, the concealment strategy condemned by the *LTCH* court has been quite popular with wealthy taxpayers. The historic deferred prosecution agreement between the federal government and KPMG contains the following revealing admission:

KPMG tax professionals prepared tax returns for some high net worth individual clients that fraudulently attempted to conceal the shelters from IRS scrutiny. Specifically, some KPMG tax partners worked with high net worth individual clients to use a grantor trust and net the short-term capital losses generated by these tax shelters with the long-term capital gains that the shelters were designed to offset. By this improper and fraudulent conduct, the high net worth individual clients reported on their tax returns only a small net gain or loss created by subtracting the large bogus shelter loss from the large long-term capital gain rather than reporting both large figures on their individual income tax returns. The purpose of making use of this "grantor-trust netting" was to conceal the bogus tax shelter losses from the IRS and thus reduce the risk of an audit of the high net worth individual clients, thereby reducing as well the risk that the IRS would scrutinize the shelters.⁸⁴

80. See, e.g., Allen Kenney, *SILO Shutdown: How the New Law Could Cripple the Industry*, 105 Tax Notes 638, 638 (2004).

81. See *Long Term Capital*, 330 F. Supp. 2d at 139; see also Alvin C. Warren Jr., *Understanding Long Term Capital*, 106 Tax Notes 681, 686 (2005) (concisely summarizing transaction).

82. *Long Term Capital*, 330 F. Supp. 2d at 212.

83. See *id.* at 211 (concluding that taxpayer "has not qualified itself for the reasonable cause defense [due to] its apparent steps to conceal the tax losses from the sale of the . . . stock on the tax returns to thereby potentially win the audit lottery and evade IRS detection").

84. *Deferred Prosecution Agreement*, Exhibit C, para. 25, *United States v. KPMG LLP*, No. 02-0295 (D.D.C. May 4, 2004) (on file with the *Columbia Law Review*).

The intuition behind the focus on red flags is obvious. The government's audit selection formulas are imperfect. Once the audit decision is made, the IRS examiners have neither time nor resources to understand the taxpayer's business or personal situation in all of its minute details in order to examine each line on the return in the most comprehensive manner.⁸⁵ Thus, the government needs strategies that would help it identify, with speed and consistency, the more aggressive returns during audit selection and the areas where avoidance is more likely during audits.⁸⁶ It appears highly probable that looking for red flags is one such strategy. If so, what exactly are these red flags?

With some exceptions, tax returns are compilations of lines showing "items," not a series of reports describing individual transactions. These items reflect taxpayer's income, losses, deductions, and credits in a more or less aggregate manner. The essence of a red flag can be gleaned from the above examples. An item is likely to raise a red flag in one of two cases. First, if only a single-year return is examined, a *significant* item that has no apparent relation to the taxpayer's business or personal circumstances is likely to draw attention. If the audit involves returns for more than one year, a red flag would appear if a given item changes *dramatically* from one year to the next, or if a particular item appears on one and only one return, and there is no ready explanation for either pattern. In sum, the more "unusual" the item is (in the sense just described, and as this term will be used in the remainder of the Article), the more likely it is to be scrutinized on audit.⁸⁷

85. This is hardly a surprising revelation. Researchers discussing TCMP audits repeatedly contrast their thoroughness with the limited inquiry that takes place during regular audits. See, e.g., Brian Erard, *The Influence of Tax Audits on Reporting Behavior*, in *Why People Pay Taxes*, supra note 19, at 95, 98 (comparing "the audits [undertaken as part of the TCMP program that] were unusually thorough in that every line item on the return was examined" with "ordinary IRS audits [that] typically concern only a small number of issues relating to a tax return"); Rice, supra note 67, at 130 ("The IRS assigns some of its most experienced auditors to pore over records [during TCMP audits] much more thoroughly than in a standard operational audit.").

86. While theoretical support is scarce, at least one model suggests that where taxpayers have heterogeneous sources of income some of which are easier to monitor than others, the IRS's optimal audit strategy would be to audit easy to monitor income sources more. See Inés Macho-Stadler & J. David Pérez-Castrillo, *Optimal Auditing with Heterogeneous Income Sources*, 38 *Int'l Econ. Rev.* 951, 963 (1997).

87. I do not suggest that the unusual items just described are the only items that raise red flags. For instance, an IRS official mentioned that a sudden, very large gift to a tax-exempt organization serves as a red flag indicating potential terrorism connections. See Fred Stokeld et al., *EO Reps Take It All In at Georgetown Conference*, 103 *Tax Notes* 642, 645 (2004). Not surprisingly, a disclosure by a taxpayer that she has taken a return position contrary to a Treasury regulation or revenue ruling raises a red flag for the government. See, e.g., George R. Goodman, *Tax Return Compliance*, 76 *Tax Notes* 1201, 1210 (1997). An astute commentator suggested that "[t]he technical term for a return with large income items and obvious offsetting deductions is red flag." Lee A. Sheppard, *News Analysis: Dissecting the Compensatory Option Sale Shelter*, 98 *Tax Notes* 871, 871 (2003). For an entire list of "red flag issues" on one particular return, see William D.

Decisions regarding whether an item is "significant," whether it is sufficiently "related" to the taxpayer's business, and whether a change is "dramatic" are imprecise and unlikely to be made with a high degree of consistency. This is not to say, however, that these rough judgments do not play a major role in determining how tax audits are conducted. The government has not been eager to admit directly anything that specific.⁸⁸ Audit strategies such as the audit selection formulas are among the IRS's most closely guarded secrets.⁸⁹ The government has been very reluctant to release individual return data collected through TCMP out of concern that researchers would use it to reverse-engineer audit formulas.⁹⁰ In light of this extreme secrecy, one should hardly expect clear statements in support of the red flags hypothesis from the IRS.

Evidence of taxpayers' and courts' beliefs that the red flags approach is widely used during audits is admittedly sparse. However, it clearly exists, as the preceding examples, as well as other precedents, demonstrate.⁹¹ Researchers note that the auditors look for unusual, "suspicious-

Samson, *President Nixon's Troublesome Tax Returns*, 107 *Tax Notes* 635, 635-36 (2005). In fact, the disclosure triggers that went into the foundation of the tax-shelter Regulations most likely were red flags prior to their "codification." The difference between these examples and the indicators developed in the text is the level of generality—the latter apply in a much broader context.

88. More typically, the suggestion has been informal. See, e.g., Paul Streckfus, *News Analysis: Unmasking Corporate Sponsorship*, 53 *Tax Notes* 1346, 1346 (1991) ("The Service has indicated informally that [elaborate] contracts [between corporate donors and tax exempt organizations documenting alleged gifts] are a red flag . . .").

89. See, e.g., Andreoni et al., *supra* note 25, at 820 (noting that audit selection formula is "strictly guarded"); Dubin et al., *supra* note 61, at 900 (observing that so-called "discriminant function analysis (DIF)" process of selecting returns for audits "is one of the best kept secrets in government").

90. See, e.g., Steven Klepper & Daniel Nagin, *The Anatomy of Tax Evasion*, 5 *J.L. Econ. & Org.* 1, 2 (1989) ("[O]utside of the IRS very few studies have analyzed the TCMP data, primarily because the IRS limits full access to the data to IRS employees in order to protect the confidentiality of its audit selection rules."). In a rather odd example, the IRS provided a small group of scholars with detailed data on corporate noncompliance only to withdraw access shortly thereafter. See Rice, *supra* note 67, at 126, 131-32 (reporting that he was able to perform first ever analysis made outside of IRS of corporate noncompliance data after IRS "graciously made available" data during part of 1988, although soon thereafter "out of concern for the security of the DIF formulas, [the government] again curtailed much of this access").

91. See, e.g., *United States v. Fawaz*, 881 F.2d 259, 263 (6th Cir. 1989) (suggesting that certain deductions may raise "a red flag inducing the IRS to audit a return"); *Clemens v. USV Pharm.*, 838 F.2d 1389, 1393 (5th Cir. 1988) (finding that W-2 form erroneously filed on behalf of employer "served as a red flag to draw attention to [taxpayer's] tax return"); *Ketchum v. Comm'r*, 697 F.2d 466, 473 (2d Cir. 1982) (concluding that certain deductions "were not simply disclosed in the returns; they were disclosed with a red flag flying"); *United States v. Neill*, 964 F. Supp. 438, 452 n.18 (D.D.C. 1997) (referring to accountant's fears that transfers to offshore account would raise "red flag" for IRS).

looking” items⁹² that appear to be “outliers.”⁹³ The *New York Times* informs its readers that auditors typically search for “red flags, like spikes in income.”⁹⁴ Some tax advisors believe that helping taxpayers to avoid red flags is consistent with “the highest ethical standards.”⁹⁵ Red flags even became part of the tax folklore.⁹⁶

A recent development further boosts the red flags hypothesis. Because auditors decide where to focus their efforts based on items rather than transactions, the level of tax return specificity is critically important to the success of the red flags strategy. At an extreme, if a return contained one aggregate line item showing a taxpayer’s income or loss for the year, there would be no way to distinguish usual from unusual. The more detailed are the items required to be shown on a return (within limits), the better the strategy works.

The comprehensive revision of Schedule M-1 undertaken by the IRS in 2004 followed precisely this strategy. The old form was helpful, but not detailed enough.⁹⁷ The new Schedule M-3 asks the same basic question: What are the differences between the taxpayer’s tax and financial accounting? However, the level of specificity with which taxpayers must answer the question increased substantially. Whereas the old Schedule M-1 identified only eight book-tax differences, the new Schedule M-3 highlights sixty-seven.⁹⁸ This is a great improvement for auditors relying on the red flags approach. As importantly, the government’s justifications for the new schedule essentially articulate the red flags hypothesis. Additional disclosure, the officials have explained, will help the government “increase . . . transparency”⁹⁹ and identify “aggressive transactions.”¹⁰⁰ It “may be used to determine what returns will and will not be audited and

92. Erard, *supra* note 85, at 103 (remarking that IRS pays particular attention to “suspicious-looking deductions”).

93. Beron et al., *supra* note 19, at 87 (noting that in screening returns for potential examination, IRS is “primarily selecting returns that are outliers in terms of reporting behavior”).

94. Robert D. Hershey Jr., *A Smarter I.R.S. Learns Your Business*, *N.Y. Times*, May 14, 1994, at C3 (reporting that IRS is moving to more sophisticated audit techniques).

95. Frederic G. Corneel, *Guidelines to Tax Practice Second*, 43 *Tax Law* 297, 305 (1989) (“It is appropriate to assist the client in structuring a transaction and reporting it on the return in the way least likely to be subject to audit, provided we do not mislead the Service.”).

96. See David M. Richardson, *Audit Avoidance via Intent Modification—Is Fred Corneel onto Something . . . or Not?*, 92 *Tax Notes* 277, 279 (2001) (describing plan to avoid raising red flag in fictional dialogue).

97. The officials explained that “the old Schedule M-1 allowed the IRS to see only large numbers with no details on book-tax differences.” Gary, *supra* note 68, at 633.

98. John H. Ledbetter & Lucinda L. Van Alst, *The New Schedule M-3—An In-Depth Look*, *Taxes*, Nov. 2004, at 33, 34. Counting by line items, the increase is from ten to more than seventy. See Gary, *supra* note 68, at 633.

99. I.R.S. News Release IR-2004-91 (July 7, 2004) (announcing issuance of final version of Schedule M-3).

100. *Id.*

to determine what issues will and will not be examined on the returns selected for audit."¹⁰¹

Finally, if one plunges into the depths of the voluminous materials prepared by the IRS for its field agents and made available to the general public under the Freedom of Information Act,¹⁰² one finds remarkably revealing evidence of the red flags approach. The agency instructs its agents to analyze returns before contacting taxpayers in order to identify "large, unusual, or questionable items."¹⁰³ The government even has an acronym for these items—LUQ—that I suspect is pronounced "lucky." And what are these LUQ items? They are remarkably similar to the ones I have termed "unusual."¹⁰⁴ In light of this evidence, the only reason to stop short of declaring that looking for red flags is one of the government's main audit strategies is that, in addition to focusing on the LUQ items, auditors are instructed to follow multiple *other* directives as well.

In sum, red flags carry a double duty in increasing the probability of detection for transactions that raise them. First, the government is more likely to audit a return that has a red flag. Second, once the return is audited, the unusual item is more likely to be examined with particular care. Thus, there is every reason to believe that the likelihood of detection for items that raise red flags is significantly higher than for those that do not.

We can now summarize the current state of tax enforcement. The existing system combines widely diverging probabilities of detection with largely constant nominal penalties. First, the probability of detection varies based on audit selection strategies. Second, for audited returns, the likelihood of detection is higher for transactions subject to mandatory disclosure regimes and for those that are unusual and raise red audit flags. In contrast, nominal penalties vary little among different tax planning techniques of equal size and aggressiveness. As a result, *expected* penalties differ substantially from one strategy to the next.

Some of these variations are intentional. Differences in expected penalties resulting from the mandatory disclosure rules and audit selec-

101. Charles Boynton et al., *Prelude to Schedule M-3: Schedule M-1 Corporate Book-Tax Difference Data 1990–2003*, 109 *Tax Notes* 1579, 1580 (2005).

102. See Michael I. Saltzman, *IRS Practice and Procedure* ¶ 3.01 at 3-3 (2d ed. 1991).

103. I.R.S., *Internal Revenue Manual: Audit* ¶ 4.10.2.3 (2000).

104. See *id.* ¶ 4.10.2.3.1 (listing among LUQ attributes comparative and absolute size of item as well as its character, explaining that "airplane expenses claimed on a plumber's Schedule C" would be LUQ item). The leasing deals and the strategy of netting items that would otherwise "stand out as an improper item" are mentioned specifically. See *Examination Guide—Abusive Tax Shelters and Transactions*, reprinted in 2005 *T.N.T.* 102-14, at 59 [hereinafter *Examination Guide*]; see *id.* at 80 ("[Q]uestions should be raised when a pharmaceutical company invests in the sale and leaseback of a municipal subway system."). More generally, agents are urged to pay particular attention to "unusual titles or unusual amounts." *Id.* at 62. The *Examination Guide* goes on to explain that "[i]tems can be material in absolute dollar value, relative dollar value, material when viewed on a multiple year comparison, and/or material to the specific industry involved." *Id.*

tion formulas reflect the government's efforts to increase deterrence in a particularly problematic area or, perhaps, to raise the most revenue given the limited enforcement budget. Not surprisingly, the government does not attempt to conceal the existence of these differences. To the contrary, the IRS makes the information public being fully aware that taxpayers will take it into account.

In contrast, variations in the probability of detection caused by the red flags approach are a product of necessity. While this strategy may assist the government in finding *some* tax avoidance, it produces variations in expected penalties that are anything but desirable from the deterrence perspective. Perhaps recognizing the problem, the government is unwilling to publicize the use of this strategy. This secrecy changes little. The decisions by the LTCH managers and KPMG clients were almost certainly motivated by their assumptions that the IRS would be looking for red flags. If federal courts, tax commentators, and (occasionally) even government officials refer to this strategy as common knowledge, the proverbial cat is probably out of the bag.¹⁰⁵

The economic theory of deterrence suggests that rational actors would choose from various avoidance transactions those that produce the lowest expected penalties.¹⁰⁶ Among other things, this means that taxpayers would expend considerable efforts in order to avoid raising red audit flags. Plenty of evidence suggests that many tax avoiders do just that. Because these taxpayers are likely to succeed in lowering their ex-

105. See cases cited *supra* notes 77, 91; see also J. Christine Harris, ABA Tax Section Meeting: IRS Officials Address Financial Products and Recent Guidance, 107 Tax Notes 1100, 1101 (2005) (describing statement by IRS official that "practices that used to raise a red flag under the traditional IRS review process have now become the normal course of business"); Lee A. Sheppard, News Analysis: Confidentiality and Customer Relations, 99 Tax Notes 1303, 1309 (2003) ("[T]he IRS Small Business/Self-Employed Division has gained a reputation for ignoring red flags [such as large losses] on rich people's returns . . .").

106. This statement is entirely accurate only if several assumptions are reasonable. I believe they are. First, taxpayers would focus solely on expected penalties only if nominal penalties are identical (or not materially different). Otherwise, risk-averse taxpayers would prefer higher expected penalties resulting from lower nominal ones. See *infra* note 263 and accompanying text. As discussed above, existing nominal sanctions vary little, and the variations are rather modest. In most situations taxpayers choosing among different forms of noncompliance would be facing identical (or nearly identical) potential penalties. Second, taxpayers would focus exclusively on expected penalties if the costs of various avoidance strategies are the same (or fairly similar). In some cases, such as where a promoter is selling packaged deals and charging a fee equal to a fraction of the tax savings, the costs would be identical. More generally, there appears to be no universal connection between the costs of an avoidance scheme and the ease of the scheme's detection. At the same time, the difference in costs is unlikely to be so large as to offset a dramatic disparity in expected penalties resulting from drastic variations in likelihood of detection. Empirical evidence is sparse, but supportive of the importance of expected penalties. See, e.g., Klepper & Nagin, *supra* note 90, at 22 ("Ex ante, taxpayers appear to allocate their noncompliance across line items to minimize expected penalties.").

pected penalties, the overall deterrence is only as strong as these lowered penalties provide.¹⁰⁷

More specifically, while some taxpayers may engage in avoidance or evasion that is likely to trigger an audit and would be obvious once the return is examined, we should expect that many others would act differently. They would look for avoidance opportunities with the lowest expected penalties, and, faced with the same nominal penalties for all opportunities (assuming equal aggressiveness and size), they would search for the strategies with the lowest probability of detection.¹⁰⁸ In plain English, they would try to hide their aggressive transactions.

If so, what was identified earlier as a potential weakness in the existing penalties structure is in fact its critical flaw. Inevitably, even if unintentionally, the current enforcement regime ensures that the probability of detection for transactions that do not raise red flags is particularly low. This encourages taxpayers to conceal their avoidance, producing social waste while failing to collect revenue. Economic analysis suggests that reducing variation in expected penalties resulting from these concealment efforts is likely to counter the existing inefficient incentives and improve tax administration.

III. ELIMINATING THE FLAW, IMPROVING DETERRENCE

A. *More of the Same?*

If this analysis is correct, how can the government respond? A look at Becker's formula suggests several alternatives. First, the government can raise the probability of detection for all transactions, including the "usual" ones (i.e., those that do not raise red flags) by increasing audit rates across the board. Yet this would hardly solve the problem because even though the overall likelihood of detecting noncompliance would increase, a taxpayer's incentive to conceal would remain unaffected. As long as auditors use the red flags approach, it would pay to hide avoidance no matter how high (or low) the audit rates are. An across-the-board increase in generally-applicable nominal penalties (such as those

107. This is a familiar idea in tax scholarship. No matter how many tax shelters the government shuts down, the extent of tax avoidance will hardly change as long as a few tax shelters remain because all avoiding taxpayers would use these shelters. See Joseph Bankman, Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs, 31 Ohio N.U. L. Rev. 1, 5 (2005) [hereinafter Bankman, Compliance Costs]; David A. Weisbach, Formalism in the Tax Law, 66 U. Chi. L. Rev. 860, 869 (1999) [hereinafter Weisbach, Formalism].

108. The assumption that two potential schemes have the same size and aggressiveness is made for simplicity only. If one scheme is, say, twice as aggressive or twice as large as another, and if the nominal penalty is twice as high for the former as it is for the latter, expected penalties would have the same relative size only as long as probability of detection is identical. If it is not, the scheme for which it is lower would have relatively low expected penalties and the underlying offense would be underdeterred.

for negligence or disregard of rules and regulations) would be similarly ineffective.

Increasing probability of detection by raising audit effectiveness holds more promise. If, for example, IRS agents have the time and expertise to examine each return item as carefully as necessary, they would need no shortcuts. Providing for more mandatory disclosure along the lines of the recent Regulations would also reduce the need to rely on red flags, assuming, of course, that the government thoroughly examines all of the disclosed information. These measures would be particularly welfare-enhancing if a large share of tax underpayments is due to taxpayer mistakes.¹⁰⁹

Unfortunately, dramatic improvements in audit effectiveness are unlikely. The government's prior limited attempts to conduct more thorough examinations highlight the potential perils clearly enough. A relatively small number of comprehensive audits designed to provide the IRS with critical tax compliance information caused enough outrage to shut down the program for over a decade.¹¹⁰ It has been recently renewed, and the IRS has promptly come under attack from Congressmen eager to protect their constituencies.¹¹¹ The IRS's attempt to collect detailed taxpayer information in order to improve the administration of the Earned Income Tax Credit (EITC) program designed to help low-income taxpayers has resulted in a lawsuit against the agency and plenty of heated rhetoric from Capitol Hill.¹¹² When large corporations and wealthy individuals learned about the broad disclosure rules in the initial version of the Regulations, they produced such an outcry that the government quickly cut back.¹¹³ By any measure, the political costs of raising audit effectiveness in any fashion will not be small.

Administrative costs of a meaningful increase may be even higher. Hiring and training more examiners and lengthening audits will come at a steep price. In fact, current audit costs are so significant and the budgetary constraints so great that one of the IRS's latest objectives is to *re-*

109. See Kaplow, *Fines for Undesirable Acts*, *supra* note 11, at 10.

110. The horror stories about "audits from hell" played a significant part in the demise of the TCMP. See Amy Hamilton, *The Tax Gap Game and Inkings of a Focus on Noncompliance*, 79 *Tax Notes* 933, 935 (1998).

111. See, e.g., Heidi Glenn, *IRS Enforcement Study Targets Small Business*, Manzullo Says, 107 *Tax Notes* 538, 538 (2005) (reporting complaints by House Small Business Committee Chair Donald A. Manzullo that National Research Program (TCMP reincarnation) unfairly targets small businesses).

112. See, e.g., Allen Kenney, *Hartford to IRS: See You in Court*, 105 *Tax Notes* 1305, 1305-06 (2004) (discussing events leading up to filing of lawsuit).

113. The initial version of the Regulations defined a reportable transaction to include transactions with tax-indifferent parties and those covered by tax insurance. See *Treas. Reg. § 1.6011-4T(b)(3)(i)(B), (E)* (2000) (prior to amendment by T.D. 8896, 2000-2 C.B. 249). These features were not incorporated in the Regulations' final version. In addition, the government issued, and later expanded, the so-called "angel lists," excepting specific categories of transactions from the reporting requirements. See *infra* text accompanying notes 286-287.

duce the time spent on each audit.¹¹⁴ More thorough audits will impose significant new costs on taxpayers as well, both tangible and intangible. Improved detection is likely to result in more litigation, burdening all parties involved with yet another set of expenses.¹¹⁵

In sum, resource constraints, political pressures, and general fiscal difficulties that are likely to persist well into the future make a substantial increase in the probability of detection somewhat unrealistic. Besides, considerable costs that are likely to accompany a meaningful increase in audit effectiveness suggest that we should evaluate available alternatives. Perhaps, if no other measure could be devised to resolve the problem, the government would need to incur these costs. Before concluding that this is the only available response, however, we should consider whether reforming nominal penalties other than by simply raising them across the board may offer a more viable and cost-effective solution.

B. *New, but Not Necessarily Improved*

Ideally, we would like to counter taxpayer attempts to hide avoidance and evasion by raising nominal penalties for those transactions that are harder to detect. Why not do this directly? That is, if the IRS detects a dubious transaction during an audit and prevails in court, it would levy an additional penalty whose amount would depend on how difficult it was for the government to find this transaction in the first place. For example, if a given avoidance strategy was twice as hard to detect as the average one, the penalty would be 200% of that imposed under the current rules. Once taxpayers become aware of this regime, they would realize that it does not pay to conceal their aggressive positions.

Unfortunately, the difficulties and dangers of this proposal are both numerous and significant. It would be hard to verify the government's claims regarding the difficulty of identifying a given arrangement because no one but the government is engaged in tax audits and can serve to support or challenge the government's assertions. At the same time, given the widespread belief that the current level of enforcement is grossly insufficient, there is a danger that the IRS would ask for higher penalties for those who are caught to compensate for many cases where, it believes, it failed to identify noncompliance. Furthermore, it would be very difficult to determine with any precision how much higher a penalty in a given case should be compared to the baseline case. How would an auditor decide (and the court evaluate) whether it was three or four times as hard to spot a particular scheme as compared to some average reference strategy? Note that the difference between these two multipliers amounts to 100% of the current sanction. It is also unclear how the baseline strategy for which no extra penalties are levied should be set.

114. See, e.g., Crystal Tandon, Nolan Discusses LMSB Compliance Initiatives, Audit Currency Focus, 107 Tax Notes 1366 (2005).

115. These and other costs are discussed in more detail in Part V.C. *infra*.

Should it depend on the type of taxpayer and the skill level of the auditor?¹¹⁶ How arbitrary would this penalty become if the answers to these questions are “no”?

Because the stakes will be high and the uncertainty great, the amount of litigation along the lines just described is likely to dwarf the number of controversies related to the substantive tax issues.¹¹⁷ Additional costs for taxpayers and the government would be enormous. Finally, an ability to drastically increase the penalty based on obscure considerations would give auditors enormous power in their negotiations with taxpayers regarding all other disputed items on their returns—a power that in some cases is likely to be abused. “Thousands of years of history with corrupt tax collectors”¹¹⁸ provide a strong incentive to search for less uncertain measures.

These problems are hardly surprising. The suggested approach would give the tax enforcement agency so much leeway that on a rules-standards continuum it would go off the chart, nearing “untrammelled discretion.”¹¹⁹ Yet an economic analysis of the rules-standards choice suggests that the penalty for hiding tax noncompliance should be more rule-like.

This analysis is based on comparing the costs incurred when legal commands are promulgated, learned, and enforced.¹²⁰ The key variable is frequency.¹²¹ Generally, rules (i.e., ex ante determinations of the law’s content) are costlier than standards (ex post determinations) to promulgate, but are cheaper to learn and enforce.¹²² Thus, if a given command is applied frequently (by the agents it governs as they learn it and by the

116. Research based on TCMP audits suggests that there is a substantial variation in detection rates across IRS examiners. See Andreoni et al., *supra* note 25, at 850. Another question is whether the penalty should be reduced for taxpayers whose tax avoidance was more obvious than average.

117. Today, taxpayers vigorously challenge imposition of penalties equal to a small portion of the tax liability. See, e.g., Sheryl Stratton, *Appeals Court Upholds Penalties in Long Term Capital Holdings*, 109 Tax Notes 22, 22 (2005) (describing taxpayer’s unsuccessful appeal of 40% penalty, but not of underlying tax liability). One can easily imagine the response if a penalty exceeds 100% of the tax liability, or becomes an even higher multiple of the unpaid tax. This point is well understood in the general deterrence literature. See, e.g., Richard Craswell, *Damage Multipliers in Market Relationships*, 25 J. Legal Stud. 463, 469 (1996) [hereinafter Craswell, *Damage Multipliers*].

118. Weisbach, *Ten Truths*, *supra* note 1, at 251.

119. Cass R. Sunstein, *Problems with Rules*, 83 Cal. L. Rev. 953, 960 (1995) (defining “untrammelled discretion” as “the capacity to exercise official power as one chooses, by reference to such considerations as one wants to consider, weighted as one wants to weight them”).

120. The following discussion is based on Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L.J. 557 (1992).

121. *Id.* at 563.

122. See *id.* at 562–63. While Kaplow frequently substitutes the cost of legal advice for the cost of learning in general (whether by acquiring advice, studying the rules, or purchasing software that would apply these rules for the purchaser), see, e.g., *id.* at 569, it is clear that he uses the former only as a typical example of the latter, see *id.* at 574.

enforcers who apply the command), it would be cost effective to promulgate this command as a rule. If, however, the command will be used only rarely, a standard would be more efficient.¹²³ The distinction is reduced, although not eliminated, if application of a standard quickly leads to creation of a rule-like precedent.¹²⁴

If enacted, the penalty addressed here would potentially affect every taxpayer with respect to each item whose tax treatment is at all uncertain. The IRS would be free to assert the penalty at will, so courts would face it on many occasions. The large costs of learning and applying a vague standard in this context suggest that a rule would be preferable. This suggestion is reinforced by the fact that the development of a precedent is unlikely. If the IRS sets the penalty based on its internal evaluations, any justifications for imposing a particular sanction will be shielded from judicial inquiry, and no rules useful for future controversies will develop.

Nevertheless, the case for a rule-based regime is not unequivocal. While hiding aggressive schemes is no doubt common, the economic analysis views violations as frequent only if their specific features are similar enough to merit identical treatment.¹²⁵ Thus, it would be efficient to counter attempts to conceal tax avoidance with a rule only if the key features of many concealment strategies are identical (or at least very similar). The challenge, then, is to devise a more rule-like penalty that would be sufficiently general to cover a variety of concealment techniques, yet specific enough for the future savings to exceed the costs incurred in promulgating the penalty. A number of approaches appear promising. For example, the government's discretion may be constrained. It may be allowed to take only certain factors into account in deciding how difficult it was to discover a particular aggressive transaction. The IRS may be required to justify the size of the penalty to a judge.¹²⁶ Perhaps other incremental steps may be taken to move away from the untrammelled discretion of the original proposal.

Yet the lure of a clear, universal, and easily applicable rule remains strong. Is it possible to raise the sanction for inconspicuous avoidance and evasion without the government's involvement in choosing the fine on a case-by-case basis? Can the government leapfrog the taxpayers and increase expected penalties for various tax avoidance strategies without knowing what they are beforehand, and without a significant increase in

123. *Id.*

124. See *id.* at 577 ("[T]he first enforcement proceeding [can] essentially transform the standard into a rule.").

125. See *id.* at 600 ("The cost of making an advance ruling on millions of possibilities would be excessive, as few would ever arise in any event."). For example, although auto accidents are frequent and are similar in that they involve injuries sustained from human contact with motorized vehicles, each accident has so many idiosyncratic features that trying to account for all of them in a rule would be wasteful because any particular accident is highly unlikely to arise. See *id.*

126. This, however, would have to be done *in camera* if the government wants to preserve the secrecy of its examination strategies.

enforcement costs? As unrealistic as it sounds, the following proposal takes a step toward achieving these goals.

C. A Promising Solution

In order to reduce taxpayer incentives to conceal tax avoidance, we need to create a regime in which transactions that are difficult to detect would be subject to higher nominal penalties on an *ex ante* basis. Easier said than done! There are enormous variations among taxpayers along many different dimensions. Take just one type of subtraction—a loss—as an example. Some taxpayers are large, others are small. A loss that would appear significant and stand out on the return of a small company would be virtually unnoticeable if claimed by a multinational conglomerate. Business and personal profiles of taxpayers differ. A substantial farming loss would look odd on a Manhattan lawyer's return, but not on that of a Nebraska farmer. Some businesses are going through periods of dramatic growth or contraction, others are stable. Large losses on the returns of the former type merely reflect business realities (these are the start-up losses or actual losses of a failing enterprise). Similar losses on returns of a stable entity may indicate tax avoidance. There seems to be nothing we can seize on to use as a measuring stick for deciding when to raise or lower nominal penalties. Perhaps this difficulty lies at the core of the existing system's failure to respond to variations in the probability of detection.

But why do we need a measuring stick? We need it, of course, because if we were to vary nominal penalties for transactions yet unknown, we would need to refer to *something* that would make each particular penalty applicable. This is true, however, only if we remain bound by the rigid structure of the existing nominal sanctions. For these, the measuring sticks are the magnitude of avoidance, its aggressiveness, and whether or not a transaction was disclosed on the return.¹²⁷ Can an *ex ante* penalty be devised without relying on measuring sticks?

Consider again the features that are likely to raise a red flag. Limiting the inquiry to subtraction items (such as a deduction, credit, or loss),¹²⁸ auditors are likely to become suspicious about such an item if it is either atypical for a given taxpayer or it has changed significantly from the prior year or years. Being well aware of that, a taxpayer choosing among several tax avoidance strategies and looking for the one with a lower expected penalty would select a transaction giving rise to a subtraction of a specific type, other things being equal. First, this would be a subtraction that the taxpayer *already has* on her return and that has some obvious connection to her business or personal situation. Second, she would prefer a subtraction that she already has in a relatively *substantial amount* (so that a change caused by the tax avoidance arrangement would

127. See *supra* Part II.A.

128. The reasons for this limitation are discussed below in Part V.A *infra*.

not be dramatic). In other words, taxpayers would use their existing legitimate subtractions to conceal the illegitimate ones.

This suggestion would hardly surprise those studying tax compliance. While the empirical support is far from overwhelming (as is generally true in the tax compliance area), it certainly exists. For example, when a group of ordinary taxpayers agreed to record their daily thoughts related to tax return preparation, one of the participants immortalized the following wisdom:

I was satisfied [at first] with the number [of an anticipated refund for 1987], but looked at my 1986 tax and found out I took quite a bit higher number on charitable contributions [in 1986] so I went back and added more on. On certain categories like charitable contributions it isn't good to vary too greatly from year to year.¹²⁹

Other studies discovered that taxpayers perceive detection to be "more likely if tax was evaded on a large proportion of an item."¹³⁰ Scholars have asserted, in one form or another, that the chance of detecting noncompliance depends on the relationship between the size of an illegally claimed item and the amount of the legitimate item of the same type.¹³¹ Apparently, the government shares this view. A Treasury official recently warned taxpayers against trying "to hide transactions from the IRS by reporting them on a different line."¹³² On a line, that is, where the transaction would be harder to detect.

Economists model tax evasion on the "intuitively appealing idea that *ceteris paribus* both the absolute amount and the proportion of income

129. John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, in *Why People Pay Taxes*, *supra* note 19, at 58.

130. Hessing, *supra* note 40, at 292.

131. For example, Joel Slemrod suggests that shifting income by a corporate parent to a subsidiary in a low-tax country is more likely to go unnoticed if the parent already has a subsidiary generating a significant income in that country. Slemrod, *Corporate Selfishness*, *supra* note 16, at 894. Presumably, this is because a slight increase in the subsidiary's income would not look suspicious, while a sudden jump in its profits would. On a different occasion, Slemrod hypothesized that "[t]he cost of avoidance may also depend on the amount of true income earned. For example, if more gross income makes it easier to hide a dollar of taxable income from the authorities, an inverse relationship applies." See Joel Slemrod, *A General Model of the Behavioral Response to Taxation*, 8 *Int'l Tax & Pub. Fin.* 119, 121 (2001). Similarly, Joseph Bankman observed that the government's relative success in pursuing individual tax shelter clients is partly caused by the difficulty that individuals have in hiding these transactions by integrating them with ongoing business operations. See Joseph Bankman, *The Tax Shelter Problem*, 57 *Nat'l Tax J.* 925, 932 (2004) [hereinafter Bankman, *Tax Shelter Problem*]. That is, it is easier for corporate taxpayers to conceal the improperly claimed deductions and credits because, unlike many individuals, businesses already have legitimate deductions and credits of these types on their returns.

132. Sheryl Stratton, *Government, Practitioners Look at Attacking Shelters from Both Sides*, 109 *Tax Notes* 26, 26 (2005) (referring to statement of Michael J. Desmond, Acting Deputy Tax Legislative Counsel of the Secretary of the Treasury).

concealed may matter" in detecting noncompliance.¹³³ A small but promising empirical literature confirms that taxpayers manage the risk of detection by choosing which line items to misreport.¹³⁴ In one of the very few studies examining tax avoidance at the line item level, Steven Klepper and Daniel Nagin created a model of taxpayer compliance decisions and applied it to the detailed 1982 TCMP data "made available to [the authors]" by the IRS.¹³⁵ They posited taxpayers who perceive that the probability that any given line item will be audited and that misreporting will be detected during the audit depends on two factors: the total amount of noncompliance on a line item, and the amount of noncompliance as a portion of the true amount that should have been reported on that line.¹³⁶ In other words, Klepper and Nagin assumed that, in addition to worrying about the absolute size of their misreporting, taxpayers believe that misstating deductions or income by a little bit is safer than doing so by a lot.¹³⁷ Regression analysis of the actual data strongly supported predictions based on these assumptions.¹³⁸

If the hypothesis that taxpayers try to camouflage their illegitimate subtractions with legitimate ones is correct (even if only in part), we would want a higher nominal penalty where a taxpayer has followed this logic, but not in an alternative case where the probability of detection is relatively high. We can advance toward this goal by establishing a new type of penalty. The size of this novel sanction would be linked not to the amount of the *improperly* claimed subtraction (as is the case for most of the existing penalties), but rather to the amount of a *legitimate* subtraction of the same type (i.e., reported on the same line of the tax return).¹³⁹ With this penalty in place, a taxpayer who uses a legitimate subtraction item to hide tax avoidance risks losing a portion of this item.

An example would help to demonstrate the point. Consider a corporate taxpayer, say a multinational commercial bank (call it Interbank), choosing from two possible avoidance arrangements that, if successful,

133. Helmuth Cremer & Firouz Gahvari, *Tax Evasion, Concealment and the Optimal Linear Income Tax*, 96 *Scand. J. Econ.* 219, 222 (1994).

134. See, e.g., Klepper & Nagin, *supra* note 90, at 2 (suggesting analysis of government data "at the level of the line item, which is where noncompliance decisions are actually made"); Jorge Martinez-Vazquez & Mark Rider, *Multiple Modes of Tax Evasion: Theory and Evidence*, 58 *Nat'l Tax J.* 51 (2005) (offering theoretical model and econometric analysis supporting this hypothesis).

135. Klepper & Nagin, *supra* note 90, at 2. Presumably, the data was not publicly available. The government's reluctance to provide researchers with disaggregated data is, no doubt, the reason why Klepper and Nagin's study is one of very few.

136. *Id.* at 4.

137. *Id.* at 8.

138. See *id.* at 16–17 (discussing empirical support for model's prediction that percentage noncompliance decreases as true income increases).

139. Other formulas for calculating the penalty may be plausible. For instance, the penalty may be tied to a change in a given subtraction item rather than its absolute amount. At least one of the strengths of the formula chosen here is its simplicity—a useful trait for a penalty that would need to be understood by many taxpayers.

would reduce its tax bill by \$1 million each. Assume that the two strategies are equally (more or less) aggressive, and that it would cost Interbank the same to pursue either one.¹⁴⁰ The first strategy would enable Interbank to claim \$1 million in foreign tax credits without bearing the economic burden of the related foreign tax.¹⁴¹ An alternative arrangement would allow the bank to take a \$1 million research credit without spending any of its funds on qualifying research activities.¹⁴² Assume further that because of its extensive international operations, Interbank has \$100 million of foreign tax credits that are perfectly justified. However, having no research activities, it has no research credits other than those to be generated by the proposed scheme.¹⁴³ Today, the bank is virtually certain to choose the foreign tax credit structure because it is much less likely to be questioned on audit. If the new penalty is enacted, the calculation changes dramatically.

Assume that the proposed penalty is set to equal 10% of the total legitimate subtraction item reported on the same line of the return as the illegally claimed one.¹⁴⁴ A shelter producing research credits would have a high probability of detection because these credits would be unusual for Interbank. Even if they had an intuitive explanation, a change from \$0 to \$1 million is likely to draw attention if an auditor is looking at (or if a computer is scanning) Interbank's returns for multiple years. On the other hand, the proposed penalty in this case would be zero: The bank would lose the entire \$1 million of improperly claimed credits but nothing else.¹⁴⁵ If Interbank chooses the foreign tax credit shelter, the probability of detection will be much lower—these are typical subtraction items and a difference between \$100 million and \$101 million is not likely to attract an auditor's attention. However, making an *ex ante* calculation, Interbank's tax director would realize that if the slight chance that the transaction would be caught materializes, the consequences for the

140. These two assumptions will apply to all further examples. For the reasons discussed above, see *supra* note 106, these assumptions can be made without loss of generality.

141. See I.R.C. § 901 (Thomson 2005) (providing for a foreign tax credit).

142. See *id.* § 41 (providing for a research credit).

143. For an example of tax avoidance transaction using foreign tax credits see *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 779–80 (5th Cir. 2001). Research expenses have been used in tax shelters before, see, e.g., I.R.S. News Release IR-81-122 (Oct. 6, 1981), and they remain a difficult and contentious issue today, see, e.g., Crystal Tandon, *Time Spent in PFA Process Has Doubled, IRS Official Says*, 107 Tax Notes 294, 294 (2005) (referring to research and development issues as “more complex issues being considered under the program”). Despite these real life analogies, in this example, and in all that follow, realism will not be one of my goals. Nor should the reader assume that a repeated use of the same basic fact pattern indicates that the proposed penalty has a very narrow application. Rather, this stylized discussion aims at illustrating the points concisely.

144. In the remainder of the Article, I will continue to make this assumption except where specifically stated otherwise.

145. The bank may be subjected to some of the existing penalties, such as a 20% negligence penalty, depending on the aggressiveness of the structure.

bank would be fairly catastrophic—it will lose \$11 million of foreign tax credits. Here, the penalty is high, compensating for a low probability of detection. As a result, the enticing opportunity to knock \$1 million from Interbank's tax bill without taking on much risk is foreclosed, and deterrence is improved.

The proposed penalty has several highly useful features. Most importantly, the link between its size and the amount of the legitimate subtraction reported on the same line as the illegitimate one makes it unnecessary to search for, and latch onto, any measuring stick. The government need not decide in advance what specific deduction or credit should be made subject to a higher nominal penalty and in what circumstances—something it cannot do with much precision in any case.¹⁴⁶ Rather, each taxpayer's own return would provide the answer. Because the proposed penalty depends on individual features of a particular taxpayer, in many instances it would adjust itself: It would be automatically higher where we would want it to be higher and lower where we would want it to be lower from the deterrence perspective.

For instance, the self-adjusting penalty (Penalty) would automatically reflect the *type of subtraction* that is typical or atypical for a given taxpayer's return. For some taxpayers it is easy to hide questionable foreign tax credits; for others it is depreciation deductions, research credits, interest deductions, capital losses. The list goes on and on.¹⁴⁷ Under the existing regime, a taxpayer with no foreign operations but significant research and development expenditures would prefer the arrangement generating research credits for the same reasons that Interbank would opt for the foreign tax credit scheme. If the government has to choose on an *ex ante* basis whether to raise nominal penalties for overstating one type of credit or the other (assuming it is unwilling to raise nominal sanctions across the board), it will not deter both Interbank and the research-focused taxpayer no matter what it does, unless, of course, it adopts the proposed Penalty.

The Penalty would also self-adjust to the *size* of a particular taxpayer. One of the significant weaknesses of the tax shelter Regulations is the government's inevitable administrability-based decision to make the reportable transaction categories subject to numerical thresholds. Thus, only relatively large losses require disclosure.¹⁴⁸ At the same time, all losses above the threshold must be reported.¹⁴⁹ This regime fails to re-

146. As Joseph Bankman put it: "Regulations cannot . . . target 'next year's' tax shelter." Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775, 1778 (1999).

147. The IRS makes the same point to its examiners: "[T]here are no set line items on the return that will alert the agent to the presence of a tax shelter." *Examination Guide*, *supra* note 104, at 62.

148. See *Treas. Reg.* § 1.6011-4(b)(5)-(6) (2003).

149. Some particular losses described in the so-called "angel lists" are excepted. See *infra* notes 286-287.

spond to variations in expected penalties for both large and small taxpayers. For large taxpayers, even a significant loss may be relatively inconspicuous, justifying the disclosure burden. Yet a different type of an equally substantial loss may raise an obvious red flag, making the disclosure mandated by the Regulations unnecessary. Similarly, a much smaller loss on a return of a relatively small business may beg for questioning, justifying the exemption from the reporting rules. But in other cases a loss of the same size may be hard to notice or may have an apparent explanation making scrutiny unlikely. Yet, no disclosure obligations will arise. In contrast with the Regulations, the Penalty needs no thresholds because it automatically adjusts to each taxpayer's scale. The large taxpayer would be deterred without incurring the costs of unnecessary disclosure. The same would be true for the small taxpayer even in the absence of any disclosure requirements.

The Penalty's second attractive feature is that it works on a continuum, not just as an on/off switch. This flexibility stands in contrast to the rigid existing rules that present taxpayers with only two choices: Disclose fully or do not disclose at all.¹⁵⁰ The Penalty gives taxpayers an opportunity to make marginal decisions. It creates incentives to engage in avoidance through relatively more detectable transactions (although not the ones certain to be detected) because these transactions are subject to lower nominal penalties (albeit not the lowest possible ones). If taxpayers follow this strategy, audits become more effective.

For example, imagine a successful owner of a trendy New York City night spot operated as a sole proprietorship who is choosing from three equally (more or less) aggressive and costly opportunities to reduce her taxable income by \$5,000. She may overstate her depletion deduction,¹⁵¹ her advertising expenses,¹⁵² or her expenditures for chefs, waiters, and others working at the restaurant.¹⁵³ Assume that the owner's legitimate deductions of each type are \$0, \$6,000, and \$60,000 respectively, and that these amounts are close to their historic averages. An extra \$5,000 (allegedly) spent on advertising will not be as surprising as an inexplicable depletion deduction,¹⁵⁴ but will be certainly more noticeable than a \$5,000 increase in compensation outlays. Correspondingly, the Penalty for the

150. As discussed above, the all-or-nothing approach probably means that most taxpayers disclose very little. See *supra* text accompanying notes 53–58.

151. These are reported on Form 1040, Schedule C, Profit or Loss from Business (Sole Proprietorship), l. 12 (2005) [hereinafter Form 1040, Schedule C], available at <http://www.irs.gov/pub/irs-pdf/f1040sc.pdf> (on file with the *Columbia Law Review*).

152. See *id.* l. 8.

153. See *id.* l. 11.

154. These deductions are allowed in connection with oil, gas, and mineral-related operations—an unlikely activity for a New York City night spot. See I.R.C. § 611 (Thomson 2005); see also Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 24.1.1 (2004).

additional advertising deduction (\$180)¹⁵⁵ will be higher than for taking a depletion deduction (\$0) but lower than the one for overstating compensation expenses (\$1,800).

Third, the Penalty has a number of advantages over the case-by-case multipliers and other standard-based approaches discussed in the preceding subpart. As any rule, it would be much less costly for taxpayers to learn and for courts to apply. It would also give taxpayers notice regarding the level of potential liability. Perhaps they would not be in a position to determine its exact size, but at least they would have a fairly good idea regarding the order of its magnitude. In addition, the Penalty would allow for no government discretion once its size is set by the legislature. Hence, it will be cheaper for the government to administer and less susceptible to abuse by enforcement agents compared to a vague standard-based sanction.

Finally, the suggested Penalty is extremely flexible. Its size can be easily varied. If the Penalty equal to 10% of the total legitimate subtraction item were viewed as too harsh (lenient), it could be easily reduced (increased). The Penalty can be imposed either by default (perhaps with a limited freedom given to the IRS to waive it), or only in some circumstances based on taxpayer's fault or other factors. The Penalty need not apply to all types of avoidance. If it were thought beneficial (efficient, politically expedient, or for any other reason) to differentiate its size and/or applicability among various types of subtractions, that could be easily done as well. This flexibility, while attractive, presents policymakers with difficult choices. I discuss the available alternatives and, in some cases, consider the merits and demerits of choosing various specific features in the following Part.

IV. FOCUSING ON THE DETAILS

A. What Is a "Legitimate" Item?

Two questions about the Penalty arise as soon as the proposal is formulated. If we are to link the Penalty to the legitimate subtraction item of a type used to avoid the tax, we need to decide exactly *how* this link should be accomplished. That is, how do we define the legitimate subtraction item and what portion of that item should be denied? This subpart deals with the first question; the next subpart tackles the second.

To appreciate the importance of the first question, consider a multinational auto manufacturer with subsidiaries all over the globe and complicated internal financing mechanisms. Assume that this corporation inappropriately deducted some interest paid to its foreign subsidiary.

155. The legitimate subtraction item is a \$6,000 deduction. The Penalty equal to 10% of that item is \$600. Assuming, for simplicity, a 30% marginal tax rate, the increase in tax liability from denial of a \$600 deduction is \$180. While credits reduce taxes directly, deductions achieve the same result indirectly by reducing taxable income. The tax benefit of a deduction is equal to its amount multiplied by the taxpayer's marginal tax rate.

What is the legitimate subtraction item on which the Penalty should be based? Is it the entire interest deduction for the year, all interest paid to related parties, to foreign parties, to foreign related parties, or some other alternative? Or, on an entirely different scale, think of a plumber who overstates his investment interest deduction. Should the Penalty be based on his entire interest (including mortgage interest on his personal residence and business interest), only on the investment interest component, or on some alternative combination?

The examples demonstrate that in order for the Penalty to be effective, tax returns must be carefully designed with the Penalty in mind. If the line items are too generic (e.g., all types of interest deductions are reported on a single line), a large increase in the deduction for interest paid to a related foreign party in the first example may register only as a slight change in the total interest expense, making it hard to detect. At the same time, if the overstatement is found, the Penalty would be very high if (as is likely to be the case) the automaker has many other interest deductions. Thus, overly generic returns would lead to very high Penalties rarely imposed. This would be both highly unpopular¹⁵⁶ and very costly.¹⁵⁷ On the other hand, if returns are too specific, auditors would be overwhelmed with information.¹⁵⁸

Rather than being a cause for concern, this discussion highlights an opportunity. By changing the manner in which interest (or any other subtraction item) is reported, the government can tailor the Penalty (and taxpayers' decisions) to reflect its latest objectives. If the IRS is particularly worried about overstatements of interest paid to related parties, it should add a return line just for that interest. This would increase the probability of detecting overstatements of this particular deduction, and would also make the Penalty more sensitive to the size of this specific overstatement.¹⁵⁹ At the same time, the government should be careful not to overcompartmentalize tax returns. Finally, because introduction of the Penalty would affect the government's view about the optimal degree of tax reporting specificity, the Penalty should not be enacted on a

156. A regime that imposes large penalties on a small number of taxpayers is unlikely to be politically viable. See, e.g., Dubin et al., *supra* note 61, at 913 (arguing that such an enforcement strategy raised issues of fundamental fairness that animated reduction of penalties in 1989).

157. See *infra* text accompanying notes 262–266.

158. Imagine, for instance, how an auditor would search for red flags if interest paid to or by each subsidiary (or during each month of the year) had to be reported on a separate line.

159. While increasing the number of items subject to separate reporting would force auditors to process more information, the benefits of the additional disclosure are likely to outweigh the costs because auditors would not study each additional item with equal care. Rather, they would check for red flags and focus only on those items that raise suspicions. At the same time, taxpayers' costs of disaggregating various items would not be high as long as the more detailed disclosure covers subitems that they had to compute in any case on the way to calculating the aggregate numbers.

wholesale basis. Rather, it should be phased in following a line-by-line review by the IRS.

Revising tax returns would require some balancing, and the importance of a well-designed return will increase. Mistakes could be made, and taxpayers may be saddled with additional compliance burdens without making the Penalty more effective. But the opportunity is also great. By adjusting the manner in which various subtractions are reported, the IRS may significantly change expected penalties in any area of current concern without waiting for Congress to act. If, for example, the IRS believes that today interest deductions are used in many tax avoidance strategies, it could increase the level of detail with which interest is reported. If tomorrow the IRS becomes more concerned with compensation deductions, it could return to a less particularized reporting of interest and require more detailed reporting of compensation expenses. An opportunity to vary the degree of return specificity combined with the proposed Penalty would give the IRS a new and valuable tool in combating tax noncompliance.

From a practical standpoint, the changes in reporting specificity discussed here are hardly revolutionary. The government's experience with the transition from Schedule M-1 to Schedule M-3, which led to a more than eight-fold increase in the number of lines used to report book-tax differences, suggests that more detailed reporting is feasible.¹⁶⁰ Lessons from this transition would be valuable in evaluating the optimal level of detail for reporting subtractions made subject to the Penalty.

B. *How Large Should the Penalty Be?*

Economic theory suggests that the Penalty's size should be such that the resulting expected penalties produce socially optimal deterrence. The general deterrence literature has been preoccupied with devising optimal penalties for decades. The key premise underlying the analysis is that equating the expected penalty for a given act to the act's external harm would force potential offenders to internalize this harm, achieving the efficient level of compliance.¹⁶¹ This insight about the optimal *expected* sanction led to an elegant proposal for the size of the optimal *nominal* penalty: It should be equal to the external harm times the reciprocal of the probability of punishment—the so-called “multiplier.”¹⁶²

160. See *supra* text accompanying notes 97–98.

161. For a more detailed explanation see Polinsky & Shavell, *Punitive Damages*, *supra* note 7, at 877–87.

162. Craswell, *Damage Multipliers*, *supra* note 117, at 464 (1996). If a nominal penalty is set at this level, the expected penalty (EP), which is equal to the nominal penalty (NP) multiplied by the probability of punishment (PP), would be equal to the external harm (EH) of the behavior being deterred: $EP = NP \times PP = (EH \times 1/PP) \times PP = EH$.

Despite considerable successes in refining this formula,¹⁶³ two significant problems have emerged. First, mistakes are inevitable in any real enforcement system. If the error rate varies with the egregiousness of an offense,¹⁶⁴ the only way to maintain the first-best level of deterrence is to calculate the multiplier separately for each violation.¹⁶⁵ Second, more serious offenses often produce higher external harms (by definition) and are *also* more likely to be detected and prosecuted. When this occurs, again, no single probability of punishment (or single multiplier) will produce the optimal nominal penalty for all levels of a given offense. Instead, the multiplier will need to be set taking into account the gravity of the harm on a case-by-case basis.¹⁶⁶

While conceptually possible, the case-by-case multipliers detract from the versatility of the model and, in any case, do not appear to be a particularly realistic solution.¹⁶⁷ In addition, they could lead to an arguably unjust (and politically unacceptable) result when egregious violations would face lower nominal penalties than marginal offenses.¹⁶⁸ Not surprisingly, real enforcement regimes do not strive for absolute precision, adopting decidedly second-best solutions such as single multipliers or single fines instead.¹⁶⁹

163. Numerous additional factors that have been incorporated in the analysis include risk aversion of potential offenders, see Becker, *supra* note 3, at 178, wealth effects, see A. Mitchell Polinsky & Steven Shavell, A Note on Optimal Fines when Wealth Varies Among Individuals, 81 Am. Econ. Rev. 618 (1991), imperfect information about likelihood of detection, see Lucian Arye Bebchuk & Louis Kaplow, Optimal Sanctions when Individuals Are Imperfectly Informed About the Probability of Apprehension, 21 J. Legal Stud. 365 (1992), Omri Ben-Shahar, Playing Without a Rulebook: Optimal Enforcement when Individuals Learn the Penalty Only by Committing the Crime, 17 Int'l Rev. L. & Econ. 409, 409-10 (1997), existence of both monetary and non-monetary sanctions, see A. Mitchell Polinsky & Steven Shavell, The Optimal Use of Fines and Imprisonment, 24 J. Pub. Econ. 89 (1984), and other considerations.

164. This seems to be an entirely realistic assumption. More egregious offenses are much less likely to be mistakenly excused than those that are barely illegal. Completely innocent behavior is much less likely to be erroneously penalized than actions that come close to the line, even if they do not cross it. See Craswell, *Damage Multipliers*, *supra* note 117, at 476-77.

165. See *id.*

166. Craswell, *The Multiplier Principle*, *supra* note 10, at 2187-88.

167. See Craswell, *Damage Multipliers*, *supra* note 117, at 477 ("[M]ore realistically, all offenses [of the same type] must be governed by the same multiplier.").

168. See *id.*

169. See Craswell, *The Multiplier Principle*, *supra* note 10, at 2188. As Richard Craswell and others have demonstrated, a single multiplier or a single fine could, in some circumstances, provide optimal deterrence. See *id.* at 2193-94. However, the same information constraints that make case-by-case multipliers unrealistic make it exceedingly difficult to identify the size of the optimal single multiplier or single fine. For example, in order to set a single multiplier at the optimal level, we need to know how the probability of punishment varies with the egregiousness of an offense, see *id.* at 2223-24, a determination that is likely to be difficult for any given violation and that would have to be made for each type of violation subjected to the single fine.

If precise deterrence is unattainable, what is the practical value of the expected penalty analysis? The answer comes from the observation that in making their decisions, individuals respond to the differences in expected penalties and not just to their absolute magnitudes.¹⁷⁰ Even if we are not sure what the optimal expected penalty for a given offense is, it is clear that in many cases the expected penalty for a more serious offense should be higher. At the same time, two equally harmful offenses should face equal expected penalties. If optimal deterrence is unattainable, striving for optimal *marginal* deterrence—larger expected penalties for more egregious violations—may be an attractive second-best objective.¹⁷¹

In light of the difficulties with setting optimal expected penalties, one would expect the tax compliance scholarship to focus on second-best solutions such as marginal deterrence. How could we evaluate the differences in external harms of tax noncompliance, even if we cannot determine their absolute values? Under what conditions is setting expected penalties to reflect these differences likely to be welfare-enhancing? This kind of analysis has been almost entirely absent from the tax enforcement literature. The omission is due in part to the subject that economists chose to study, and in part to the level of generality at which they chose to study it.

Economic analysis of tax enforcement has been concerned almost exclusively with tax evasion (defined as a clearly illegal, intentional non-payment of taxes), as distinguished from tax avoidance (defined as a

170. George Stigler, who is credited with coining the term “marginal deterrence,” quipped that, when considering possible crimes, “marginal decisions are made here as in the remainder of life.” George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. Pol. Econ. 526, 527 (1970).

171. These seemingly obvious statements are fairly cautious for a reason. There is no doubt that in the first-best world of optimal penalties, marginal deterrence is also optimal. If the expected sanction for each offense is exactly equal to the offense’s external harm, differences in the expected sanctions of any two offenses are necessarily equal to the differences in their external harms. It does not follow, however, that in a second-best world where expected penalties are not optimal the same result regarding the respective differences holds. This is because any given feature of the first-best solution (here, the observation regarding equality in differences between the relative expected penalties and external harms) is not necessarily an attribute of the second-best world. See Richard G. Lipsey & R.K. Lancaster, *The General Theory of Second Best*, 24 Rev. Econ. Stud. 11, 11–12 (1956). Nevertheless, George Stigler’s intuition that “[i]f the offender will be executed for a minor assault and for a murder, there is no marginal deterrence to murder” is too strong to ignore. Stigler, *supra* note 170, at 527. Improving marginal deterrence is likely to be a worthwhile objective in many cases. Not surprisingly, marginal deterrence has commanded considerable attention in the general deterrence scholarship. See generally Dilip Mookherjee & I.P.L. Png, *Marginal Deterrence in Enforcement of Law*, 102 J. Pol. Econ. 1039 (1994); Steven Shavell, *A Note on Marginal Deterrence*, 12 Int’l Rev. L. & Econ. 345 (1992); Stigler, *supra* note 170; Louis L. Wilde, *Criminal Choice, Nonmonetary Sanctions, and Marginal Deterrence: A Normative Analysis*, 12 Int’l Rev. L. & Econ. 333 (1992).

clearly legal reduction of one's tax liability).¹⁷² Thus, to an economist, failing to report cash income is evasion; borrowing under a home equity line of credit rather than from a credit card company is avoidance.¹⁷³ Economic literature acknowledges the existence of a gray area in the middle, but relegates it almost to an afterthought.¹⁷⁴

This approach would puzzle tax lawyers who spend most of their waking hours making difficult judgments about transactions that are neither evasion nor avoidance in the economists' sense of these words. Economists, on the other hand, may be surprised to learn that Congress believes that any arrangement created with a purpose of "avoidance or evasion" of federal income tax should be penalized.¹⁷⁵ Moreover, while the delineation used by the economists may be fruitful as a first approximation for developing and testing economic models, it is of little help to those interested in studying how taxpayers choose among a multitude of alternative tax-motivated arrangements none of which is clearly legal or illegal. Because the proposed Penalty primarily aims at affecting precisely this choice, I will refer to the transactions falling into this intermediate category as tax *avoidance*, as distinguished from tax *evasion* (clearly illegal actions due to deliberate cheating) and tax *planning* (clearly permissible tax reduction strategies). So defined, tax avoidance refers to any transaction or position whose tax treatment is uncertain.

Most economic models neither aim at, nor are capable of, differentiating among various types of tax noncompliance, or even different forms of evasion. They implicitly treat all evasion strategies as having the same

172. Although one may clearly violate tax law without ever intending to do so, I will follow others in limiting the term tax evasion to intentional violations. See, e.g., Lederman, *supra* note 32, at 1455.

173. See, e.g., Slemrod & Yitzhaki, *Tax Administration*, *supra* note 25, at 1428 (explaining that renaming a consumer loan as a home equity loan changes legal form of particular behavior; this is one form of tax avoidance). Another example of what economists call tax avoidance is selling depreciated securities on December 31 to accelerate the losses but waiting to dispose of appreciated securities until January 1 of the following calendar (and tax) year to defer the gains. See *id.*

174. See *id.* at 1428–29 (acknowledging that there are “many gray areas where the dividing line [between evasion and avoidance] is not clear,” but concluding that “[f]ine distinction among the types of behavioral responses to taxation is not possible and is for many issues not crucial”). In one of his recent articles, Joel Slemrod took a different approach, combining evasion with “abusive” avoidance, i.e., tax shelters, in an attempt to “avoid getting bogged down trying to distinguish between what technically is (illegal) tax evasion and what is (legal) tax avoidance.” Slemrod, *Corporate Selfishness*, *supra* note 16, at 878.

175. See I.R.C. §§ 6662(d)(2)(C), 6662A(b)(2)(B), 6707A(c)(1) (Thomson 2005). To be fair to the economists, confusion about evasion/avoidance terminology is pervasive. One popular income tax treatise defines tax avoidance as “lawful modes of minimizing or avoiding tax liability,” Boris I. Bittker, Martin J. McMahon Jr. & Lawrence A. Zelenak, *Federal Income Taxation of Individuals*, ¶ 1.03[2] (2002) (emphasis added), while another defines it as *noncriminal* minimization of tax liability, see Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.2 (2005). Both sources define evasion as fraudulent behavior.

“price” and being available in an unlimited amount.¹⁷⁶ These assumptions are largely justified as long as only evasion is considered. Because of the very nature of evasion, one does not need to develop elaborate strategies, engage in sophisticated legal analysis, pay tax shelter promoters, and carry out costly and economically unnecessary transactions hoping to bolster the dubious schemes used to evade tax. The most common evasion strategy is simple, well known, and equally available to taxpayers large and small: One simply falsifies the income numbers on the return (at least as long as income is not subject to an information reporting regime).¹⁷⁷

The story is markedly different when we turn to avoidance. Unlike evasion, avoidance is often based on overstating any of the deductions, credits, and losses omnipresent in the Internal Revenue Code. A choice among these subtraction items necessarily gives taxpayers more freedom to vary avoidance strategies. Some forms of avoidance are more aggressive than others; some are easier to conceal than others; some are more expensive to implement than others. All these variations mean that once a taxpayer decides to engage in tax avoidance, she faces a variety of strategies with different—perhaps markedly different—“prices” available in different amounts.¹⁷⁸

Because tax enforcement models deal exclusively with evasion, they ignore these variations completely. They posit taxpayers facing a simple choice: to evade or not to evade. This binary decision does not call for

176. Slemrod, *Corporate Selfishness*, *supra* note 16, at 888. The need for this analysis, however, has been clear for some time. See, e.g., Joel Slemrod & Shlomo Yitzhaki, *The Optimal Size of a Tax Collection Agency*, 89 *Scand. J. Econ.* 183, 190 (1987) (“The optimization problem should be expanded to include many types of individuals, with different opportunities to evade and different tastes.”). For a recent and rare exception, see generally K.L. Glen Ueng & C.C. Yang, *Constrained Efficient Fine-cum-Tax Rate Structures: The Case of Constant Relative Risk Aversion*, 71 *Economica* 461 (2004) (exploring model with endogenous fines and coexisting compliers and evaders).

177. In the end, the costs of different forms of evasion may not be entirely uniform. Some types of income are easier to falsify than others. Evasion may also be accomplished through overstating various deductions. In fact, the experimental data suggests that taxpayers are not at all indifferent between which particular types of income to understate and what kinds of deduction to overclaim. See, e.g., Klepper & Nagin, *supra* note 90, at 11. To be sure, the data is sparse and does not allow us to differentiate between avoidance and evasion. However, it suggests that even if the theoretical inquiry is limited to tax evasion, studying marginal deterrence by considering taxpayers’ incentives to engage in evasion of different types is likely to produce new and valuable insights.

178. Prices, or private costs, would differ based on a variety of taxpayer choices. For example, a taxpayer may expend considerable resources trying to embellish the avoidance transaction, hoping to make it look “better” (more plausible, less aggressive) to an auditor or a judge. See, e.g., Gergen, *supra* note 15, at 281 (discussing “cloaking” expenditures). Alternatively, a taxpayer may obtain a legal opinion supporting the transaction, making it more difficult for the government to assess penalties. A taxpayer may also try to conceal the aggressive position, making it more difficult (costly) for the government to detect it.

marginal analysis.¹⁷⁹ A similar inquiry applied in the avoidance context (i.e., to avoid or not to avoid) is a grossly inadequate reflection of reality. The choice faced by taxpayers who decide to engage in tax avoidance is much more complex. In fact, for most taxpayers the question of whether or not to avoid may be decidedly secondary. The important decisions are *how* to avoid (i.e., which particular transactions and subtractions to use) and *to what extent* (i.e., how aggressive one should be). The tax evasion models are simply not designed to analyze these marginal decisions. Thus, they provide no insights into how to optimize taxpayer choices of various evasion and, in particular, avoidance strategies. That is, no existing model aims at, let alone succeeds in, optimizing marginal deterrence.¹⁸⁰

What are the practical implications of this theoretical analysis? Because in most cases optimal nominal penalties (or multipliers) must be set on a case-by-case basis, they do not offer a workable solution. Optimizing marginal deterrence may be an attractive second-best objective, but the theoretical framework needed to reach it is largely absent. Thus, the best we can do is to strive for a *third*-best alternative of improving (rather than optimizing) marginal deterrence.

While this approach is hardly precise, it does offer some concrete guidance. For example, if an overstatement of a foreign tax credit is more harmful to society than the one involving a research credit, but both overstatements result in (roughly) equal expected penalties, we would improve marginal deterrence by raising the expected sanction in the foreign tax credit case. Similarly, if the two overstatements produce (roughly) equal external harms while facing different expected sanctions, marginal deterrence would be enhanced if we reduced this disparity.¹⁸¹

Generally, the existing nominal sanctions reflect the marginal deterrence approach, albeit imprecisely, because they are higher for larger and more egregious violations. By selectively hiding their aggressive

179. The more sophisticated tax evasion models add a decision about how much to evade (i.e., how many dollars to shelter), positing taxpayers as making marginal decisions. Nonetheless, these models give taxpayers only one degree of freedom—the size of evasion. Analysis of tax avoidance demands a much more multidimensional inquiry. A more nuanced analysis of evasion would also take into account existence of different means of evading tax. See *supra* note 177 and accompanying text.

180. My use of the term marginal deterrence differs somewhat from its classic use in economic literature. There, the term refers to deterring those who already decided to violate the law from committing more serious violations. Because I define tax avoidance as any decision whose tax consequences are uncertain (whether legal or illegal), by marginal deterrence I mean a concern with deterring those who decided to avoid tax (i.e., to venture into the realm of somewhat risky tax positions, whether the risk is large or small) from taking relatively more aggressive positions.

181. Offering a precise definition of the external harm of tax noncompliance is challenging, and estimating its magnitude is extremely difficult. Both tasks are beyond this Article's scope. For an explanation why the seemingly obvious answer that the external harm of tax noncompliance is the amount of tax evaded is mistaken see Slemrod & Yitzhaki, *Tax Administration*, *supra* note 25, at 1451.

transactions, taxpayers cause the expected penalties to differ from the nominal sanctions not only in their absolute magnitude, but also in relation to each other, producing a misalignment of expected and nominal penalties. As a result, a more harmful foreign tax credit scheme that is well hidden may face a *lower* expected penalty than a less harmful research credit strategy that is poorly concealed. Even given the great theoretical uncertainty that remains, this result is clearly undesirable from the marginal deterrence perspective. Reducing (or even eliminating) this misalignment caused by variations in probability of detection is likely to be welfare enhancing. This conclusion fully supports the Penalty's core rationale. Yet it is not nearly specific enough to guide us in setting actual sanctions. Fortunately, the more practical considerations suggest the likely constraints on the Penalty's size.

Assume, for instance, that Interbank's foreign tax credit structure has virtually no chance of triggering any of the current fault-based sanctions. The research credit plan is likely to be found fraudulent, although only civil penalties will apply. Under the existing rules, the highest nominal penalty, when added to the tax liability itself, would require Interbank to pay \$1.75 million if it loses the research credit case.¹⁸² The Penalty is zero because Interbank has no other research credits. If, however, the bank chooses a much less aggressive (but also much less detectable) foreign tax credit structure, and if the Penalty is equal to the *entire* legitimate subtraction item (rather than 10% of it), Interbank would have to pay \$101 million if the foreign tax credit is disallowed. The two numbers are grossly disproportionate.

The example suggests that, putting theoretical questions of optimal expected penalties aside, the existing nominal fault-based sanctions should serve as a reference point for setting the Penalty's size. Ultimately, the IRS would need to roughly evaluate how difficult it is for its auditors to detect transactions that do not raise red flags compared to those that do. Policymakers would need to make a judgment comparing these difficulties with variations in taxpayer fault and to set the magnitude of the Penalty based on this judgment. While the ultimate conclusion is far from certain, it appears highly unlikely that a difference between \$1.75 million and \$101 million can be justified. Thus, the Penalty equal to a relatively small fraction of the legitimate subtraction item appears much more reasonable.

At the same time, it is worth noting that while the Penalty should not be draconian or expropriatory in most cases, assuring that it is always modest should not be an absolute priority either. Tax law has plenty of provisions that lead to fairly disastrous consequences even though they are not always called "penalties." A foreigner who fails to file a tax return

182. See I.R.C. § 6663 (Thomson 2005) (setting 75% penalty for fraudulent understatements).

loses *all* of his deductions and credits for the year.¹⁸³ A single dollar of cash consideration converts an entirely tax-free reorganization into a *wholly* taxable one.¹⁸⁴ A fraudulent EITC claim (no matter how small) is punished by denying the credit for the following *ten years*.¹⁸⁵ And how can we forget the \$10,000 *per day* penalty accumulating forever?¹⁸⁶ To be sure, the Penalty would apply in more cases than any of these sanctions (and probably all of them combined). This generality, however, calls for a serious deliberation in setting the Penalty's size, not for marginalizing the Penalty by making it immaterially small in the vast majority of cases.

C. *Should Aggressiveness Matter?*

In its most basic form, the Penalty depends only on the amount of a legitimate subtraction item on a taxpayer's return. It need not take fault into account. Should it? This question raises two separate issues. First, should the Penalty vary with taxpayer fault, i.e., should it be *fault-sensitive*? Second, should the Penalty spare mistaken taxpayers, i.e., should it be *fault-based*?¹⁸⁷ The first question can be disposed of fairly quickly. The much more challenging second question is addressed in the following subpart.

It is not immediately apparent why the Penalty should be fault-sensitive. After all, the existing nominal penalties already vary depending on the aggressiveness of a given transaction. The Penalty is designed to establish a similar variation based on differences in probability of detection—a parameter that no current penalty addresses. As long as the proposed Penalty complements (rather than replaces) the existing ones, why not let each sanction deal with its own problem?

183. See *id.* § 874(a). The same rule applies to foreign corporations. See *id.* § 882(c)(2).

184. See *id.* § 368(a)(1)(B).

185. *Id.* § 32(k).

186. *Id.* § 6708.

187. A taxpayer is "mistaken" about taking an illegal deduction if she claimed it believing that the deduction was legal with a very high probability that was short, however, of 100%. The probability was so high that she was comfortable taking the deduction even assuming it was certain to be examined by the IRS. Because the probability was less than 100%, however, a change in the nominal sanction would influence her behavior. A related, but separate question is whether the Penalty should apply to taxpayers who knowingly enter into questionable transactions that fall short of being negligent. Unlike mistaken taxpayers, these persons are aware that they are in a dangerous territory, but decide to proceed anyway hoping that their position will escape detection, or, if detected, will fall on the right side of the line, even if barely. Many (although not all) of the considerations discussed below apply to this case. For a formal model of how various policy instruments such as penalties and access to information affect decisions of taxpayers uncertain about application of legal rules see Louis Kaplow, *Optimal Deterrence, Uninformed Individuals, and Acquiring Information About Whether Acts Are Subject to Sanctions*, 6 J.L. Econ. & Org. 93, 96–101 (1990) [hereinafter Kaplow, *Optimal Deterrence*]. I will omit a detailed analysis of deliberate risktakers to avoid further lengthening the discussion.

Several responses come to mind. First, by increasing the total fine, the Penalty reduces the sensitivity of the overall punishment to the aggressiveness of taxpayers' positions. For example, assume that a fine is \$200 for a negligent arrangement and \$400 for a grossly negligent one, i.e., it is twice as high for a more aggressive position. If we add a Penalty of \$1000, the total fines will rise to \$1200 and \$1400 respectively. The sanction for a more egregious violation is now only about 17% larger than for a less offensive one. Thus, if the Penalty is large compared to the fault-based fines, and if it does not change based on taxpayer's fault, taxpayers may be under-deterred from taking more egregious positions if they respond to relative differences in total penalties (17% versus 100%) rather than their absolute amounts (\$200 in each case).

Second, in our system of higher tax penalties for more aggressive violations, rational taxpayers would expend more effort to conceal more egregious transactions, at least as long as the expected penalties are sufficiently high to justify the concealment efforts. If so, aggressiveness and probability of detection are systematically related in some cases, and it would make sense to reflect this relation in the structure of nominal sanctions. Fortunately, this could be easily done. All it takes is to vary the Penalty's size based on taxpayer's fault. For example, the Penalty may be set at 1% of the legitimate subtraction item for non-negligent arrangements, 5% for negligent ones, 10% for those that are grossly negligent and so on. Structured this way, the Penalty would take into account variations in both the probability of detection and degree of taxpayer fault.

D. Dealing with Mistakes

Until this point, the Penalty has been justified as a measure that would accomplish a very specific goal: deterring taxpayers from hiding their aggressive strategies. If the Penalty's objective is to punish those who engage in deliberate concealment, applying it to mistaken taxpayers makes no sense. A person who, for example, took a particular deduction believing that it was entirely appropriate could not have possibly tried to hide from the government—she simply had no reason to do this. Is there any deterrence-based justification to sanction this mistaken individual? Put another way, what would be the deterrent effect of a no-fault Penalty?

As long as the government is using the red flags audit strategy, the probability of detecting transactions that do not raise these flags is lower not only if a taxpayer deliberately structures a transaction to avoid detection, but also if the transaction simply happens to be of an inconspicuous type. For example, assume that a Wall Street lawyer actively involved in charitable causes takes a farm loss under a misguided view that she is entitled to do so. The loss is unusual, it is likely to be scrutinized, and the mistake will probably be detected for the reasons already discussed. If, however, the inappropriately (and mistakenly) taken subtraction is a charitable deduction, the chance that an auditor would notice the error is much lower. Yet, because the lawyer makes many different donations

possibly giving rise to charitable deductions, the probability that she would make a few mistakes in handling this subtraction item is higher than the likelihood that she would mistakenly take a farm loss that is atypical for her and would probably command her special attention. As a result, it may well be that the probability of detection is lower precisely for the types of subtractions that are more likely to contain mistakes. If taxpayers tend to err in their own favor (rather than in favor of the public fisc),¹⁸⁸ this example illustrates another undesirable consequence of the red flags strategy.

Under the current rules, the lawyer would face an identical penalty for either overstatement. Therefore, she would have no reason to be more careful with one subtraction item than with the other. But the government would surely want her to pay particular attention to charitable deductions because their mistaken overstatements are more likely to go undetected. By extending the Penalty to mistaken taxpayers, the government, in essence, would be warning them: Be extra careful with subtractions of a certain kind because the auditors are unlikely to challenge your decisions. As long as taxpayers are aware that the government is relying heavily on their judgment with respect to these items, penalizing mistaken taxpayers would accomplish a valuable deterrence objective.¹⁸⁹ This increased deterrence will come at a cost, but it is not obvious that the cost is not worth incurring given the current disappointing state of tax compliance.¹⁹⁰

188. This is not necessarily so. It is well known that some taxpayers overstate their tax liabilities, and many more understate them. See, e.g., Martinez-Vazquez & Rider, *supra* note 134, at 59 (noting that approximately 24% of returns correctly report taxable income, 63% understate it and 13% overstate it). However, it is unclear whether some of those who overpay do so by mistake or as a result of taking unnecessarily conservative positions. Similarly, it is difficult to evaluate what portion of taxpayers underpay their taxes by mistake, as opposed to as a result of avoidance and evasion.

189. Is it reasonable to assume that taxpayers are (or should be) aware of the new Penalty? In many cases, I suggest it is. Many taxpayers use tax preparers or tax preparation software. See, e.g., Joel Slemrod & Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Debate over Taxes* 313 n.7 (3d ed. 2004) (noting that in 2001, 55.4% of returns were signed by tax preparers); Allen Kenney, *IRS Issues New Taxpayer Burden Estimates*, 108 *Tax Notes* 1503, 1503 (2005) (stating that 85% of all individual tax returns are prepared using computer software). Educating the preparers and software developers would be inexpensive and highly effective in putting taxpayers on notice. On the other hand, low-income taxpayers are particularly likely to be unaware of the new Penalty. Cf. Elaine Maag, *Disparities in Knowledge of the EITC*, 106 *Tax Notes* 1323, 1323 (2005) (suggesting that significant subgroups of low-income taxpayers have little knowledge even about a program highly beneficial to them). Penalizing these taxpayers for mistakes would be both harsh and pointless because the punishment would fail to induce more care. If the Penalty has a negligence threshold, however, all mistaken taxpayers will escape it. Also, if the Penalty applies only to particular types of subtractions that are unlikely to be used by low-income taxpayers (e.g., investment interest), the issue becomes moot.

190. For a consideration of costs from imposing sanctions on imperfectly informed individuals, see Kaplow, *Optimal Deterrence*, *supra* note 187, at 118–19.

On the other hand, applying the Penalty only to particularly aggressive (e.g., negligent) behavior is entirely unrelated to the basic rationale of the proposal. Introducing a negligence threshold would not alter the existing incentives to conceal for a vast array of nonnegligent (but nevertheless illegal) tax positions, making the Penalty relatively ineffective. At the same time, it would penalize negligent (and more aggressive) taxpayers who do nothing to hide their tax avoidance.

These unfortunate results follow not because a negligence-based Penalty would be fault-dependent, but because it would depend on the wrong type of fault. If we want to excuse mistaken taxpayers, we should apply the Penalty only to those who deliberately conceal their aggressive positions. This, however, is entirely unrelated to whether these positions are fraudulent, negligent, or barely illegal. To be sure, some taxpayers would make an extra effort to hide their particularly egregious transactions. The LTCH managers and KPMG clients who netted losses against unrelated gains are clear examples. Other taxpayers, however, would do no such thing (because they do not mind taking extra risk, have a low opinion about the government's detection capability, incorrectly evaluate the strength of their substantive position, or for any other reason). Their aggressive subtractions would stand out on a return. In other words, there is no intrinsic relation between how flagrant a particular deduction or credit is as a matter of substantive tax law and how hard a taxpayer tries to hide it from the IRS. It is hardly surprising, therefore, that making the Penalty depend on the strength (or, rather, weakness) of a substantive tax position undermines its effectiveness as a deterrent.

Unfortunately, while the threshold of deliberate concealment would reflect the Penalty's core objective, it would be very difficult to implement. If the burden is placed on the government, how would it go about showing what a taxpayer thought when she decided to take one type of subtraction or the other? If the burden is placed on a taxpayer, how would she prove a negative (i.e., that she did *not* try to hide a particular subtraction, but just happened to take it)?

To be sure, the law frequently attaches consequences to an agent's motive, intent, or purpose.¹⁹¹ Tax law boasts a business purpose doctrine and an economic substance test that incorporate an inquiry into a taxpayer's motivations. These doctrines, however, produce considerable uncertainty despite decades-long attempts to make their application more predictable. The factors that could be relevant in deducing the taxpayer's state of mind are numerous,¹⁹² the extent of prohibited intent is

191. See, e.g., Weisbach, *Ten Truths*, *supra* note 1, at 252–53 (discussing use of intent or motive and their limitations).

192. See, e.g., Weisbach, *Formalism*, *supra* note 107, at 881 (listing some factors, such as whether “the transaction is unusual, whether it offers significant tax benefits, whether it is consistent with the business . . . and whether the individual steps in the transaction make sense”).

unclear,¹⁹³ and as a result, transactions that the Tax Court finds egregious enough to merit penalties end up being upheld on appeal.¹⁹⁴ The existing tools for inferring a taxpayer's motive or intent, however imperfect, would be of little use for discerning whether a taxpayer attempted to hide her aggressive positions because they ask a different question. Thus, tax law simply lacks an analytical apparatus for evaluating intent to conceal.

Moreover, if we develop an effective and administrable test for evaluating intent to escape detection, we would be able to penalize concealment efforts directly, rather than through a seemingly imperfect substitute of the proposed Penalty. Devising this test is likely to be difficult, however. Process crimes such as perjury and obstruction of justice provide the closest analogy because they involve efforts to escape detection. Well-known difficulties with obtaining convictions for any of these offenses suggest that proving intent to mislead or evade detection is not easy.¹⁹⁵

More importantly, penalizing taxpayers' efforts to conceal their aggressive tax strategies and avoid detection by the IRS may turn out to be a self-defeating endeavor. As Chris Sanchirico recently argued, detection avoidance is recursive.¹⁹⁶ Punishing it induces people to stop avoiding detection. But it also induces them to conceal their detection avoidance even more. People hide information from investigators. When accused of hiding, they destroy evidence of their efforts to hide. Confronted with charges of evidence tampering, they lie about it, and then they intimidate witnesses to support their lies. This cycle repeats indefinitely. As a result, unless higher orders of detection avoidance are sanctioned more severely—something that can hardly be done given its infinite regress—punishing detection avoidance leads to more of it, not less.¹⁹⁷

The recursivity problem turns the Penalty's weakness—its lack of a direct link to detection avoidance motivation—into a strength. Because the Penalty is not based explicitly on taxpayers' efforts to conceal, taxpayers would be unable to respond to the Penalty by hiding their concealment. Once they take an aggressive deduction of a kind that is difficult to

193. See, e.g., Bankman, *Tax Shelter Battle*, supra note 75, at 17 ("[T]he amount of non-tax motivation or effect the [economic substance] doctrine requires is unspecified.").

194. See, e.g., *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 778 (5th Cir. 2001).

195. See Chris William Sanchirico, *Detection Avoidance* 50–51 (U. Pa. Inst. of L. & Econ., Research Paper No. 05-18, 2005), available at <http://ssrn.com/abstract=782305> (on file with the *Columbia Law Review*) (explaining that "[g]rossly misleading, yet technically true statements are generally not perjurious" and that "document destruction, witness coercion, and other forms of obstructive behavior are usually not criminal"); *id.* at 56–57 (asserting that proving mens rea necessary to obtain conviction in obstruction crimes usually requires additional investigation, evidence, and deliberation).

196. See *id.* at 32–38.

197. See *id.* at 41–45. Sanchirico assumes that offenders are risk-neutral. See *id.* at 17 n.54.

detect, they are, in essence, presumed to be engaged in detection avoidance. Lying about their true intent, destroying damaging documents, suborning witnesses to perjure themselves, and all other forms of higher order detection avoidance would be of no help. Thus, strengthening the link between the Penalty and the taxpayer's intent to avoid detection by providing an exemption for those who had no such intent may be not only very difficult, but also entirely misguided.

In sum, a no-fault Penalty may be justified on deterrence grounds, but only if its basic rationale is expanded. Introducing a negligence-based threshold undermines the Penalty's core deterrence objective, but limits its reach. Neither solution is conceptually perfect. Thus, again, it is worth taking more practical considerations into account.

Starting with a look at the existing longstanding sanctions, one sees a clear connection to fault. The so-called accuracy-related penalties apply only if a taxpayer exhibited a certain degree of carelessness or understated her tax liability by a significant amount.¹⁹⁸ Any of these penalties, as well as the civil fraud penalty, are waived if a taxpayer acted with reasonable cause (i.e., if she was sufficiently innocent).¹⁹⁹ The recently added penalty for understatements attributable to reportable and listed transactions, while containing no explicit fault-based threshold, is inapplicable if a taxpayer satisfies a stronger version of the reasonable cause exception.²⁰⁰ None of these penalties would apply to a taxpayer who barely crossed the line.

In contrast, many penalties of a more recent vintage apply regardless of taxpayer fault. If one is found to have understated her tax liability arising from a reportable or listed transaction, no reasonable cause exception is available if the transaction has not been disclosed.²⁰¹ Although in some (perhaps many) cases these transactions would produce negligent understatements,²⁰² this will not always be true, as the government was recently reminded by a court.²⁰³ Thus, even if a taxpayer barely loses

198. See I.R.C. § 6662(b) (Thomson 2005).

199. See *id.* § 6664(c).

200. See *id.* § 6662A (setting penalty for understatement with respect to reportable transactions); *id.* § 6664(d) (providing for strengthened reasonable cause exception).

201. See *id.* § 6664(d)(2)(A) (excluding nondisclosed transactions from the reasonable cause exception).

202. The penalty applies to listed transactions and reportable transactions with "a significant purpose of . . . the avoidance or evasion of Federal income tax." *Id.* § 6662A(b)(2)(B).

203. See *United States v. BDO Seidman, LLP*, No. 02-C-4822, 2005 WL 742642, at *9 (N.D. Ill. 2005).

The fact that the IRS characterizes a business or individual's transactions as abusive and unlawful cookie cutter tax shelters does not mean that this characterization is a proper conclusion as a matter of law. Instead, "the issue of whether [BDO] organized or sold tax shelters" in violation of the law is a "complicated question."

Id. (alteration in original) (quoting *United States v. Sidley Austin Brown & Wood, LLP*, No. 03 C 9355, 2004 WL 905930, at *6 (N.D. Ill. Apr. 28, 2004)).

the dispute, she will have to pay a penalty equal to 30% of the understatement arising from an undisclosed transaction.²⁰⁴ The no-fault character of penalties for failure to disclose listed and reportable transactions is even clearer. The legislative history of the 2004 Act emphasizes that these penalties apply even if the underlying substantive position is ultimately sustained.²⁰⁵ In sum, even though the taxpayer's fault has been traditionally a prerequisite for imposition of penalties, the recent congressional actions suggest that this is no longer the case.

Turning our attention from the law on the books to the realities of its application fails to resolve the ambiguity. On the one hand, the rate at which the IRS assesses penalties once it finds tax underpayments is very low.²⁰⁶ If limiting the proposed Penalty to actions that are at least negligent means that it would apply in exceedingly few cases, we may be more inclined to make it no-fault.²⁰⁷ On the other hand, the reason for the historically low penalty assessment rates may not be the fault-based thresholds. Rather, the reasonable cause exception may be the culprit. In fact, based on its latest actions, the government apparently believes that the so-called "penalty opinions" designed to ensure that taxpayers would qualify for this exception are the main reason for the latest tax shelter crisis.²⁰⁸ Finally, academics and practitioners alike have suggested that the government routinely fails to assess penalties where it is entitled

204. See I.R.C. § 6662A(c).

205. The legislative history on this point is clear:

[T]he Committee believes that a penalty for failing to make the required disclosures, when the imposition of such penalty is not dependent on the tax treatment of the underlying transaction ultimately being sustained, will provide an additional incentive for taxpayers to satisfy their reporting obligations under the new disclosure provisions.

H.R. Rep. No. 108-548, at 261 (2004) (explaining provisions of I.R.C. § 6707A). Because there is no reasonable cause exception, a taxpayer (or advisor) who mistakenly failed to file a disclosure form regarding the transaction that is ultimately upheld would be sanctioned. Section 6708, containing the \$10,000 per day penalty for failure to produce the list of tax shelter participants, does have a reasonable cause exception. I.R.C. § 6708(a)(2). The exception is limited, however. For instance, the legislative history stresses that a mistaken failure to maintain the list would "[i]n no event . . . be considered reasonable cause for failing to make a list available to the Secretary." H.R. Rep. No. 108-755, at 610 n.505 (2004) (Conf. Rep.).

206. For example, the rate was 4.1% of all reassessed returns in 1995. See Andreoni et al., *supra* note 25, at 821. Others suggest even lower rates. See Lederman, *supra* note 32, at 1464 n.49.

207. It is worth remembering that penalties have an indirect deterrence effect. Its size, however, is fairly speculative. Most agree that a general deterrence effect induces compliance by taxpayers other than those who were actually sanctioned. Indirect revenue raised as a result of this effect has been estimated to be five times as high as the direct audit revenue. See Dubin et al., *supra* note 61, at 904.

208. These opinions are now "disqualified" for the purposes of providing protection for understatements arising from listed or reportable transactions. I.R.C. § 6664(d)(3)(B). Tax advisors writing these opinions now have to comply with new detailed rules or face disciplinary charges and fines. See 31 C.F.R. § 10.35 (2005).

to do so.²⁰⁹ If the Penalty does not have a reasonable cause exception, and if the IRS actually invokes it when it is available, the Penalty may apply in a considerable number of cases even if it is fault-based.

Concerns about tax law's complexity, ambiguity, and accuracy of its application do not clearly favor either solution. The Internal Revenue Code and the Treasury regulations are notoriously difficult to understand and interpret, making their application somewhat random. However, commentators disagree whether randomness helps the government or the taxpayers. If, as David Weisbach suggests, larger uncertainty regarding substantive outcomes leads to a greater range of bargaining between taxpayers and the IRS, and if taxpayers are likely to capture most of the bargaining surplus, we should be less worried that the Penalty will apply in many cases.²¹⁰ If, however, randomness introduces substantial risk-bearing deadweight losses for risk-averse taxpayers, limiting the Penalty's reach may be more efficient.²¹¹ Finally, while a Penalty for a barely illegal subtraction would appear unfair on an *ex post* basis, taxpayers always have the option of responding to complexity and legal ambiguity by taking more conservative positions with respect to subtractions potentially subject to a high Penalty.

Fairness considerations also point in both directions. On the one hand, taxpayers who use many different subtractions are more likely to make a mistake than those who use only one or two (such as a standard deduction and a child credit). Subjecting taxpayers in the former category to a high Penalty appears inequitable because their use of deductions and credits is not tax motivated. On the other hand, these taxpayers have numerous opportunities to overstate any of the multiple subtraction items they claim, many do so, and these overstatements go undetected precisely because they are typical. Taxpayers taking only a few basic deductions have no similar opportunities. Currently, these taxpayers are at a distinct disadvantage. Making the Penalty no-fault offsets this existing unfairness.

Three additional considerations bear on the issue. All suggest that a fault-based threshold should be added. The first is the concern with a

209. See Bankman, *Compliance Costs*, *supra* note 107, at 9 ("We might start (after a suitable warning period) to impose penalties already on the books for noncompliance."); Schler, *supra* note 58, at 368 (asserting that taxpayers are often unconcerned about potential penalties because they believe that IRS will eventually settle for 100% of the tax liability without insisting on collecting fines).

210. See Weisbach, *Economic Analysis*, *supra* note 12, at 107. Experimental data indirectly supports Weisbach's view, at least for a certain category of taxpayers. See Slemrod et al., *supra* note 42, at 477 (reporting that increased probability of audit led to lower reported income by high-income taxpayers, suggesting that taxpayers may have believed that ultimate outcome of audit depends, at least in part, on their initial report).

211. See, e.g., Suzanne Scotchmer & Joel Slemrod, *Randomness in Tax Enforcement*, 38 *J. Pub. Econ.* 17, 28 (1989) (arguing that while policy minimizing IRS's enforcement costs requires maximum randomness, this policy would not maximize social welfare if taxpayers are risk-averse, even if cost savings are rebated through tax reductions).

potential for administrative abuse. During many audits, examiners disagree with taxpayers (more or less strongly) regarding a variety of return items. The parties usually negotiate and settle most of their disputes. Following the enactment of the no-fault Penalty, an auditor would be able to pick a somewhat uncertain subtraction item typical for the taxpayer's return and threaten a very large fine unless the taxpayer cooperated on all disputed items. Facing this threat, taxpayers would likely concede all (or most) of the items, including those where the auditor's position is mistaken, insufficiently developed, or unjustified. In essence, this strategy would convert the Penalty into a large fine of the most general application, going well beyond its deterrence objective, creating large risk-bearing losses, and increasing public distrust of the IRS.²¹²

Second, while the broadly applicable Penalty would provide stronger deterrence, studies suggest that the optimal deterrence ideal fails to resonate with the general public.²¹³ Even such deterrence-conscious individuals as the upper-class students at the University of Chicago Law School did not think it was appropriate for the government to raise nominal penalties to compensate for a relatively low probability of detection resulting from fewer per capita tax auditors in one state compared to another. The finding suggests that adjusting nominal penalties to compensate for variations in likelihood of detection created by the government without any public justification would be highly unpopular. At the same time, people may be much more willing to punish offenders who deliberately conceal their offenses.²¹⁴ Making the Penalty fault-based is likely to provide it with more popular support (or less outcry) by tying it to bad behavior, even if of a wrong kind.

Finally, looking beyond economic reasoning and field studies, it seems clear that a new regime that imposes harsh penalties on mistaken taxpayers would violate the common notion that the punishment should fit the crime and, therefore, would be widely perceived as unfair. This regime may also undermine the norms of voluntary compliance identified by the noneconomic theories of taxpayer behavior.²¹⁵ These concerns suggest that if we are uncertain about how far the Penalty should reach, we should err on the side of restraint.

In sum, it would likely be a good idea to vary the Penalty depending on the aggressiveness of a particular arrangement. Whether it would be preferable to have it apply only to actions that cross some fault-based

212. Some taxpayers already believe that the IRS tries to collect more money than it should. See Karyl A. Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data*, in *Why People Pay Taxes*, supra note 19, at 259, 276; Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *Why People Pay Taxes*, supra note 19, at 223, 231. For a discussion of risk-bearing losses, see *infra* text accompanying notes 264–265.

213. See Cass R. Sunstein, David Schkade & Daniel Kahneman, *Do People Want Optimal Deterrence?*, 24 *J. Legal Stud.* 237, 250 (2000).

214. See *id.* at 249.

215. See *supra* text accompanying notes 35–36.

threshold such as negligence is less clear, although that, too, appears to be a more practicable and politically acceptable alternative. One solution would be to introduce the Penalty with a fault-based threshold and later eliminate it if the original version of the Penalty proves to be inadequate.

E. Additional Fine-Tuning Possibilities

Opportunities to adjust the Penalty's impact discussed so far do not nearly exhaust the impressive list of policy options it presents. One such option would be to subject the Penalty to caps.²¹⁶ Justifications for caps range from theoretical to pragmatic. Conceptually, the government may decide that once probability of detection reaches a certain (very low) level, further decreases become inconsequential. For instance, it may make no difference to an auditor whether Interbank's overstatement of foreign tax credits by \$1 million is added to \$100 million or \$500 million in legitimate foreign tax credits. Without a cap, a 10% Penalty would be \$10 million in the former case and \$50 million in the latter while the probability of detecting the violation would be essentially identical.

This concern is far from theoretical. For large businesses, legitimate deductions and credits reported on any line usually run in the tens or hundreds of millions. While some illegitimate or questionable subtractions will be significant and easily noticeable even on that scale,²¹⁷ most will be relatively small and (roughly) equally difficult to detect even though the related legitimate subtractions will vary quite a bit. Capping the Penalty as a fixed multiple of the illegally claimed subtraction would ensure that it would not vary significantly without a meaningful difference in actual likelihood of detection.

An alternative (or complementary) use of caps would be to make the Penalty no-fault as a general matter, but to cap it (perhaps at relatively low levels) for taxpayers whose actions have not crossed a negligence threshold. If this is done, both the narrower and the broader deterrence objectives discussed above would be achieved to a degree, yet many concerns with imposing the Penalty on mistaken taxpayers would be alleviated. Besides, a capped Penalty is likely to be more politically acceptable and viewed as more fair (or less unfair) on an *ex post* basis.

A further way of fine-tuning the Penalty is to take account of the existing variations in audit effectiveness. If the IRS is confident in its ability to detect overstatements of a particular subtraction or group of subtractions—whether by relying on their unique features, by using sophisticated statistical analysis, or by some other means—the Penalty should not apply. If the Penalty is phased in gradually, it will be easy to exempt these

216. I thank Lily Batchelder for suggesting that caps may be a useful feature of the proposal.

217. Lease-related deductions described earlier are likely to fit in this category. See *supra* notes 79–80 and accompanying text. A carryback of a very large loss would be another example. See, e.g., *ACM P'ship v. Comm'r*, 157 F.3d 231, 244 (3d Cir. 1998).

subtractions from its reach without signaling to taxpayers which types of overstatements are particularly susceptible to detection by the IRS.²¹⁸

Another reason to apply the Penalty selectively is so that the government can vary it depending on the nature of the benefit involved. For example, it is widely understood that depreciation deductions (technically speaking, the accelerated cost recovery system) are both intended to be, and are, generous subsidies rather than attempts to accurately measure economic deterioration of various wasting assets. In contrast, foreign tax credits are merely adjustments needed to prevent double taxation of income earned abroad by U.S. taxpayers. Imposing (potentially large) Penalties for the schemes designed to abuse the provisions that are already highly beneficial (e.g., depreciation deductions) may be viewed as more justified.²¹⁹

The Penalty also may be varied to distinguish between transactions in which income is deferred or converted into a type subject to lower rates from those eliminating the tax altogether. Erasing income from a return produces larger tax savings than converting its character or deferring it to future years. However, because auditors generally review items, not transactions, they cannot easily distinguish between these types of arrangements. For example, they would not know whether a given deduction is permanent or would produce an offsetting income inclusion later, so the probability of detection would not vary based on this difference.²²⁰ Assuming both deductions are inappropriately claimed, we would want to deter the former type more than the latter. Setting a higher Penalty for subtractions that produce permanent exclusions would improve marginal deterrence.²²¹

Finally, the Penalty would benefit from a safe harbor. Because of the Penalty's very essence, it will have a particularly significant impact on taxpayers' core business and investment activities. Tax shelters are frequently defined as artificially concocted schemes having no integral relationship to the real operations of a sheltering taxpayer.²²² By definition,

218. Relatedly, if a transaction generates more than one type of subtraction, and one of them is buried in a large legitimate subtraction, but another raises an obvious red flag, then the IRS should not assess the Penalty because finding the buried overstatement is not difficult in light of the related obvious one. I thank Reed Shuldiner for alerting me to a potentially inappropriate application of the Penalty in these circumstances.

219. The Earned Income Tax Credit is a case in point. This credit is particularly beneficial because it is refundable, i.e., a taxpayer may receive a check from the government even if she pays no tax for the year. The existing penalty for a fraudulent EITC overstatement (no matter how small) is denial of the credit for the following ten years. See I.R.C. § 32(k) (Thomson 2005). This rule may easily produce a penalty in excess of 1000%.

220. Auditors may be able to make more informed judgments when they examine entities required to file Schedule M-3.

221. Of course, the same objective may be achieved by varying existing fault-based penalties based on the nature of the avoidance or evasion.

222. See, e.g., Bankman, *Tax Shelter Problem*, *supra* note 131, at 929 (noting that economic substance doctrine is "limited to shelters unconnected to any business").

subjecting these schemes to high penalties cannot interfere with any real business or investment. The same is clearly not true of the Penalty. It threatens taxpayers with losing legitimate deductions and credits that they have in large amounts, i.e., that are likely to arise from their ordinary activities. A penalty affecting taxpayers' everyday decisions may be inefficient.

This concern, however, is not as serious as it may first appear. The Penalty would affect the manner in which business activities are reported, not necessarily how they are actually carried out. Moreover, even if the Penalty forces taxpayers to adjust their day-to-day operations, these would be the operations that made business sense only as long as they generated questionable (or illegal) subtractions before the Penalty was enacted. Especially if the Penalty has a negligence threshold, these adjustments would merely ensure that taxpayers do not violate the law aggressively. Yet, in some instances tax treatment of real business or investment transactions may be genuinely uncertain. Because these transactions are not tax-motivated, it would be inefficient if taxpayers forwent them out of fear of losing their legitimate subtractions. To eliminate this inefficiency, taxpayers should be given the option to disclose these transactions to the IRS.²²³ Once a transaction is disclosed, the Penalty would not apply.

The discussion in this Part demonstrates that the Penalty could be easily used as an exceedingly flexible enforcement tool. At one extreme, it could be enacted as a broad sanction applying to all subtraction items without regard to fault and with no exceptions. At the other extreme, the government may start by promulgating the Penalty only for specific deductions or credits viewed as particularly generous and only after the IRS confirms that the given subtraction item is reflected on the returns at the appropriate level of generality. The Penalty would not apply to mistakes and non-negligent violations, it would be capped, and taxpayers would be allowed to avoid it altogether through voluntary disclosure. Perhaps somewhere between these extreme lies a combination that would be both politically acceptable and sufficiently robust to make a meaningful difference in the government's battle with tax avoidance.

223. To avoid the overdisclosure problem, the disclosure must be more informative than that required under the Regulations. See, e.g., I.R.S. Notice 2006-16, 2006-9 I.R.B. (limiting scope of earlier notice that designated particular transaction as listed transaction under Regulations in response to excessive disclosure). Rather than merely identifying the uncertain transactions, taxpayers must be required to tell the government exactly what they think the uncertainty is: What are the material issues, what are the arguments pro and contra, and how strong is the taxpayer's position (i.e., taxpayers must reveal the analysis that they have performed in deciding whether or not to go forward with the disclosure). The government may even require taxpayers to order the discussion of legal issues, starting with those whose tax treatment is most uncertain in the taxpayer's view. Armed with this information, the government should be able to evaluate the merits of disclosed transactions and decide whether or not to contest them on audit without incurring large costs.

V. ADDRESSING (SOME OF) THE LIKELY OBJECTIONS

A. *What About Income Understatements?*

The Penalty would apply only to illegitimately claimed deductions, credits, and losses. Not all tax avoidance is based on these items, however, and most evasion does not involve subtractions at all. Starting with avoidance, hedging and monetization transactions that were popular in the mid-1990s involve arguably inappropriate nonrecognition of gain.²²⁴ The same issue arises in corporate reorganizations, partnership exchanges, securities sales, and many other contexts.²²⁵ The proposed Penalty would do nothing to deter these forms of avoidance. Turning to evasion, it is well known that although some evade by overstating subtractions,²²⁶ the most typical form of evasion is a failure to report income. The Penalty would make no difference for taxpayers engaged in evasion of this type.²²⁷

What justifies limiting the Penalty to subtraction items? In short, the close connection between the likelihood of detecting noncompliance and the amount of legitimate subtractions does not hold when we consider income items. Deductions, credits, and losses raise red flags when unusual subtractions appear on a return or when usual subtractions increase significantly. The apparent corollary is that the absence of income one would expect to see on a given return (i.e., that is “usual” for a given type of taxpayer) and large drops in the usual income would raise questions. This suggests that penalties for understating unusual income items and for small understatements of usual ones should be higher because they are less likely to be scrutinized.

Both of these intuitions, however, are likely to be false. Starting with the first proposition, it is no doubt true that if a Wall Street lawyer reports little or no compensation income, a red audit flag would go up. This income is “usual” and its absence is suspicious. It also appears likely that if this lawyer has some gambling income which she chooses to conceal from the IRS, the likelihood of detection will be small.²²⁸ A high penalty would be justified in this case. But it is probably not true that if the lawyer decided to report *some* gambling earnings but not all of them, her

224. See I.R.C. § 1259. For a detailed explanation of this provision see, e.g., David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 *Colum. L. Rev.* 1312, 1339–45 (2001).

225. See, e.g., David P. Hariton, *How to Define ‘Corporate Tax Shelter,’* 84 *Tax Notes* 883, 884–85 (1999) (providing examples).

226. See, e.g., Wesley Elmore, *Ways and Means Panel Examines Tax Fraud by Prison Inmates*, 108 *Tax Notes* 65, 65 (2005) (reporting that inmates fraudulently claim large amount of tax credits).

227. Another considerable compliance problem—overstatement of the tax basis of various capital assets—would be similarly unaffected. See, e.g., Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question*, 106 *Tax Notes* 453, 453 (2005) (referring to basis overstatements as “unpublicized problem of crisis proportions”).

228. Assume that gambling income is unusual for Wall Street lawyers.

chances of successful evasion would remain high. It seems quite possible that this unusual income item would invite additional scrutiny from the IRS. Having a large penalty in this case would be inappropriate. Thus, higher penalties for understatements of unusual income items would not necessarily coincide with a low probability of detecting these understatements.

The second prong—large drops in income typical for a given taxpayer invite scrutiny—also appears suspect. The problem is similar to the one just discussed: The generalization is just too crude. To be sure, steep declines in the Wall Street lawyer's compensation are more likely to be scrutinized than small drops. Of course, increases in her income would not be a cause for concern at all. But if we consider a multinational company with subsidiaries in tax haven jurisdictions, exactly the opposite would be true. Increases in these subsidiaries' incomes are likely to raise a red flag,²²⁹ while drops, no matter how large, would probably go unexamined.

This discussion highlights a discontinuity in the relationship between income attributes and detection probabilities that is absent in case of subtractions. With subtractions, at least in most instances, the larger the overstatement, the higher the detection risk. A large overstatement of an unusual deduction will certainly attract attention, and even a large overstatement of a typical deduction is more likely to be examined than a small one. With income, a taxpayer may reduce scrutiny either by understating her income just a little, or by not reporting any income at all, depending on the type of income involved. In sum, establishing a link between a new penalty and the amount of reported income (or a change in that amount) that reflects variations in probability of detection appears difficult. Thus, the proposed Penalty is limited to avoidance (and, to a lesser extent, evasion) strategies using subtractions.

While limiting the Penalty to subtractions saps some of its punch, it remains a powerful and far-reaching sanction. Subtraction overstatements play a significant role in total tax noncompliance. The tax shelter wave of the 1970s was all about deductions. It is revealing that many of the listed transactions subject to the new Regulations, including the majority of the most notorious ones, involve overstatements of credits, deductions, and losses.²³⁰ If the Penalty is effective in reducing these overstatements, it is likely to have a significant impact on tax avoidance.²³¹ Of course, the Penalty would not solve all problems. Yet much narrower

229. This is also Joel Slemrod's intuition. See Slemrod, *Corporate Selfishness*, *supra* note 16, at 894.

230. See I.R.S. Notice 2004-67, 2004-41 I.R.B. 600-02.

231. Besides, if more redistribution is desirable, and to the extent tax avoiders tend to be predominately high-income taxpayers while evaders are mostly low-income individuals, reducing avoidance while leaving evasion intact may be a more efficient way of providing for additional redistribution than adjusting marginal tax rates. See Wojciech Kopczuk, *Redistribution when Avoidance Behavior Is Heterogeneous*, 81 *J. Pub. Econ.* 51, 65 (2001).

measures, such as the recent Regulations, are generally regarded as worthwhile efforts to improve tax enforcement.²³² Thus, the Penalty's limited reach can hardly be the reason not to give the proposal serious consideration. Improving income reporting compliance remains a task for the future.²³³

B. *Playing the Tax Compliance Game*

The discussion so far has assumed that neither taxpayers nor the government will change their behavior following the Penalty's enactment, except that taxpayers will become more compliant because an easy opportunity to reduce their tax bills without taking on much risk will vanish. Unfortunately (but inevitably), both the enforcer and its subjects will respond to the incentives created by the Penalty in less desirable ways.²³⁴ Ideally, we would formally model these responses and determine whether the Penalty is an optimal equilibrium strategy for the government. In reality, we have to satisfy ourselves with much cruder estimates.

Becker's formula is static. Nominal penalty and probability of punishment are exogenous and fixed. Potential offenders evaluate their actions based on a given expected penalty. Tax evasion models based on Becker's approach are static as well. Taxpayers estimate the payoff from a fixed gamble and decide whether to make a bet (engage in evasion) at a single point in time. Yet, there can be no doubt that tax enforcement is strategic—it is a game rather than a gamble. The government studies taxpayers' moves and adjusts its responses. Taxpayers try to discern the latest government strategy and modify their avoidance techniques accordingly.

Each side optimizes along numerous dimensions. As the TCMP, the tax shelter Regulations, and the post-2000 tax legislation amply demonstrate, the government simultaneously changes its audit strategy, disclosure rules, nominal penalties, tax rates, progressivity, enforcement budgets, and substantive tax rules to achieve its revenue goals. In response,

232. Scholars hail these measures as "the most important step the government has taken" in its battle with tax avoidance. Bankman, *Tax Shelter Problem*, *supra* note 131, at 929.

233. Economic analysis of deterrence will be useful in this future research. For example, the probability of detecting understatements of income subject to withholding and information reporting rules is much higher than for income not subject to either regime. Setting higher nominal penalties for understatements of the latter type should improve deterrence. Of course, this logic applies to subtractions as well. If a particular type of deduction overstatement is especially easy (hard) to detect, a deterrence rationale suggests that the nominal penalty for overstating this deduction should be lower (higher). These kinds of measures deserve careful consideration, but they extend beyond the scope of the more limited proposal made in this Article. I thank Larry Zelenak for suggesting these avenues for further study.

234. I am grateful to Jack Coffee, Jeff Gordon, Scott Hemphill, Louis Kaplow, Avery Katz, Wojciech Kopczuk, Jeff Strnad, and Susan Sturm for alerting me to some of the potential problems addressed in this section.

taxpayers decide whether to change their work efforts, take fuller advantage of the existing tax preferences, or engage in more (or more aggressive) tax avoidance. In the latter case, they consider to what extent to avoid, what kinds of subtractions or income items to misreport, how much legal advice to acquire, and so on. It can be hardly contested that if the Penalty is adopted, it would amount to just one more move in this endless game.

Although static models have captured most scholarly attention, several attempts to apply game theory to tax evasion have produced many new and important insights.²³⁵ However, these dynamic models are severely limited. They rely on numerous simplifying assumptions, many decidedly unrealistic. For example, the models rely on the concept of Nash equilibrium,²³⁶ which is reached when each player's strategy is the best response to the strategy of the other.²³⁷ This assumes, of course, that players know each other's strategies—something that is certainly not true in the tax compliance game.²³⁸ In addition, the models assume that the government may not vary penalties or taxes,²³⁹ that taxpayers are certain about their true tax liability,²⁴⁰ and that they report only a single piece of information (their taxable income) to the IRS.²⁴¹ None of this accurately reflects reality. Yet, the models are manageably complex only as long as all or most of these assumptions are made at the same time. In sum, while these models have contributed substantially to our understanding of tax enforcement, they remain at such a high level of generality that it is impossible to apply them to a new instrument such as the proposed Penalty. In the absence of formal solutions, this subpart considers several

235. See, e.g., Andreoni et al., *supra* note 25, at 829–31; Graetz et al., *supra* note 27; Jennifer F. Reinganum & Louis L. Wilde, *Equilibrium Verification and Reporting Policies in a Model of Tax Compliance*, 27 *Int'l Econ. Rev.* 739, 754–56 (1986). Just the fact that these models incorporate “honest” taxpayers along with the rational ones makes them much more realistic than their static counterparts. See Andreoni et al., *supra* note 25, at 831; Graetz et al., *supra* note 27, at 9; Reinganum & Wilde, *supra*, at 741–42.

236. See Graetz et al., *supra* note 27, at 8. Nash equilibrium is the central solution concept of game theory. Douglas G. Baird et al., *Game Theory and the Law* 21 (6th ed. 2003).

237. See Baird et al., *supra* note 236, at 21.

238. See, e.g., Graetz & Wilde, *supra* note 14, at 358. Not only are audit rates widely misperceived by taxpayers, see, e.g., Andreoni et al., *supra* note 25, at 833 n.42, but the infamous DIF audit selection formulas are well guarded by the IRS, see *supra* text accompanying note 89.

239. See Andreoni et al., *supra* note 25, at 826 n.23, 829; Graetz et al., *supra* note 27, at 8; Reinganum & Wilde, *supra* note 235, at 742.

240. Andreoni et al., *supra* note 25, at 834.

241. *Id.* at 833. These are just some of many assumptions needed to make models reasonably tractable. For instance, in one of the models, the mere introduction of honest taxpayers (with all assumptions made in the text still being made) “significantly complicate[d] the solution of the model, transforming the simple linear first-order differential equation . . . into a complex non-linear second-order differential equation.” *Id.* at 831.

possible unintended consequences of the Penalty's enactment and suggests potential countermeasures.

Starting with the government, there is reason to worry that once the Penalty is enacted, the red flags strategy will be in jeopardy. Historically, the IRS has focused on the largest adjustments.²⁴² Because nominal penalties were low and rarely applied, this focus led auditors to look for red flags in search of the most significant tax underpayments. With the Penalty in place, this will no longer be a clearly revenue-maximizing strategy. For instance, an auditor studying Interbank's return might be troubled by a \$1 million research credit that has no intuitive explanation. But it would be the \$100 million foreign tax credit that would really grab her attention. If the auditor manages to find any understatement of that subtraction item, the reward will be huge.

From the auditor's vantage point, this is a familiar tradeoff between a low-risk, low-reward alternative (scrutinize the research credit) and a high-stakes risky gamble (try to find a dollar of understatement in the foreign tax credit category within the limited time available). If the auditor is risk-averse, she would not necessarily prefer the latter strategy. However, it is hard to deny that, at the margin, the Penalty would skew auditors' decisions toward spending extra time on high-volume subtractions.

Another perverse incentive would affect a more statistically savvy examiner. Changing the familiar hypothetical somewhat, imagine that Interbank has \$100 million in foreign tax credits and another \$100 million in research credits. However, while the foreign tax credits arise from one gigantic payment received by the bank, the research credits come from ten separate transactions of equal size. Finally, assume that each of the eleven transactions has the same 95% chance of being sustained.

The auditor's chance of successfully disallowing the foreign tax credits is 5%, and the expected payoff from focusing on that credit is \$5 million.²⁴³ Challenging the research credits is much more promising. To see the effect of a high Penalty, assume that it is equal to the entire legitimate subtraction item of the relevant type. If the auditor prevails in reversing the credit for any of the ten separate transactions, Interbank would lose the entire \$100 million in research credits. The probability of that happening is a whopping 40%,²⁴⁴ and the auditor's expected payoff is \$40 million.²⁴⁵ Note that even if the foreign tax credit is fairly ques-

242. See sources cited *supra* note 61.

243. It is equal to $0.05 \times \$100 \text{ million} = \5 million . The proposed Penalty is zero because once the \$100 million foreign tax credit is disallowed, Interbank has no legitimate foreign tax credits.

244. The probability that Interbank will succeed in defending all ten research credit-generating transactions is only about 60% ($0.95^{10} = 0.599$). The auditor's chance of success is thus $(1 - 0.6) \times 100\% = 40\%$.

245. The payoff is equal to $0.4 \times \$100 \text{ million} = \40 million .

tionable (say, Interbank has only a 66% chance of prevailing on the merits), the auditor may still focus on the research credits instead.²⁴⁶

A combination of the two problems discussed thus far reflects a common real life pattern: Larger line items are likely to comprise more subitems. The Penalty would induce auditors to focus on these subtractions both because of their size and composition.²⁴⁷

These are certainly unintended results. Fortunately, countervailing considerations make them less of a concern. Auditors operate under considerable time constraints. If the agent has enough time to examine only one or two of the ten research-credit-generating transactions, her incentive to ignore foreign tax credits would be reduced. In addition, being aware of the Penalty, taxpayers would start taking more conservative positions where a large Penalty may apply. Thus, the research credits are likely to be harder to challenge than the foreign tax credit. Assuming the auditor realizes this, focusing on research credits becomes less attractive. The auditor may also take into account that taxpayers are much more likely to contest imposition of relatively large penalties on relatively small understatements. Thus, even though the probability of detection in the original example is equal for all strategies, probability of punishment may well be higher for the foreign tax credit case, further reducing the auditor's incentive to concentrate on research credits.

Finally, keeping the Penalty relatively modest and making it fault-based would reduce the expected payoff from focusing on large subtractions and, in particular, on those composed of numerous individual items.²⁴⁸ An even better response would be to change auditors' focus. If the IRS officials insist that the auditors' goal is to collect maximum revenue from tax underpayments without taking penalties into account, the proper incentives will be restored. If auditors' evaluations and promotions are made dependent on the tax (but not penalty) revenues collected, the auditors may well pursue the red flags strategy with renewed vigor.²⁴⁹

246. The auditor's expected payoff in this case would be $0.34 \times \$100 \text{ million} = \34 million , or less than the \$40 million from auditing the research credits.

247. I thank Louis Kaplow for suggesting this point.

248. For instance, returning to a more reasonable Penalty of 10%, the auditor's expected payoff from examining research credits would be only \$4.1 million and the incentive to challenge research credits would disappear. In this case, Interbank faces a 5% probability of losing \$10 million in illegal research credits, and also a 40% probability of paying a \$9 million Penalty (10% of \$90 million in legitimate research credits). This translates into a \$4.1 million expected fine which is less than the expected penalty of \$5 million for the foreign tax credit overstatement.

249. Any such incentives would need to be structured to avoid violating the existing rules that prohibit setting production goals or quotas for IRS agents. See 26 U.S.C. § 7804 note (2000) (prohibiting use of "records of tax enforcement results" in evaluating IRS employees or setting their production goals); Temp. Treas. Reg. § 801 (2005) (issuing final and temporary regulations that creatively interpret Congressional prohibition).

Just like the IRS examiners, taxpayers should be expected to adjust to the new Penalty. First, if the Penalty is very large, marginal deterrence may suffer. Imagine, for instance, a successful self-employed management consultant who claims approximately \$100,000 of legitimate travel and entertainment (T&E) expenses each year.²⁵⁰ The consultant's daughter is about to get married, and he is about to spend \$50,000 on this happy event. Amidst the festive thoughts, it occurs to the consultant that perhaps, if he invites a few clients to the wedding, he can justify deducting \$5,000 (out of \$50,000) as a business expense.²⁵¹ Shortly before the fateful day, a draconian version of the Penalty is enacted—it has no fault-based threshold, no caps, and it is equal to the entire amount of the legitimate subtraction item. Because the consultant would now lose the entire \$100,000 legitimate T&E deduction whether he overstates it by \$5,000 or \$50,000, the \$5,000 understatement no longer makes sense. The consultant would either forego deducting any portion of the wedding outlays (the desirable result), or he just might decide to write off the entire cost of the wedding. Of course, the probability of detection would be higher if the total T&E deduction jumps from \$100,000 to \$150,000 compared to the virtually unnoticeable increase from \$100,000 to \$105,000, but the incentive to raise the size of the bet when faced with a huge penalty even for a relatively small violation is undeniable. The Penalty seems to provide insufficient marginal deterrence against more serious offenses.²⁵²

Several measures would help to restore the balance. First, the larger understatement is likely to trigger (or be subject to larger) existing fault-based penalties. Second, making the Penalty fault-sensitive would go a long way toward strengthening marginal deterrence. If the consultant would lose \$10,000 in legitimate T&E deductions for a \$5,000 overstate-

250. See Form 1040, Schedule C, *supra* note 151, ll. 24(a)–(b).

251. Generally, unlike business expenses deductible under I.R.C. §§ 162 and 212 (Thomson 2005), expenses for events such as a wedding are personal and nondeductible. See *id.* § 262. T&E deductions (even if business-related) are further limited by I.R.C. § 274. Thus, the consultant's position is likely to be rather weak.

252. One response is that marginal deterrence can be preserved by varying probability of punishment. See, e.g., Shavell, *supra* note 171, at 345–46 (explaining that if enforcement is specific, i.e., if probability of detection may be varied from one offense to another, optimal penalties would be set at their highest levels and marginal deterrence would be preserved by varying probability of apprehension). This response is not entirely convincing. First, varying the probability of punishment for different levels of the same offense (the problem encountered here) may be more difficult than adjusting it for different offenses. Second, the probability of punishment may be more difficult to calibrate than nominal penalties. Third, at least in the tax enforcement context, the differences in nominal penalties are likely to be more transparent than variations in the probability of punishment. For additional arguments regarding the real-life effects of high penalties on marginal deterrence see Kaplow, *Fines for Undesirable Acts*, *supra* note 11, at 10 n.19.

ment, but \$15,000 in these deductions for a \$10,000 overstatement, he might think twice before writing off the entire wedding.²⁵³

Another likely response to the Penalty's enactment presents a more difficult problem. If the amount of legitimate subtractions claimed in any given year is highly discretionary, taxpayers may elude the Penalty altogether by claiming only legitimate subtractions in some years and only illegitimate ones in others. Charitable deductions present the clearest example of this potential problem because taxpayers have complete control over when they make charitable donations. Capital losses as well as dividends received deductions and foreign tax credits arising from payments made by taxpayer-controlled entities may also be shifted from one year to the next with relative ease. Here, as in many other contexts, the absence of non-tax frictions makes tax enforcement difficult.²⁵⁴

Fortunately, not all subtractions exist in a frictionless world. Some widely used deductions and credits give taxpayers very little latitude over their timing because they are determined by a statutory schedule. Depreciation and amortization deductions clearly fall in this category.²⁵⁵ Many other subtractions arise from operations and activities that are integral to the taxpayer's business. While in theory taxpayers are free to decide when to claim these subtractions, in practice they have little control over their timing. For instance, the management consultant in the previous example would have to travel and entertain as his business dictates every year. He would not be able to shift his legitimate T&E deductions related to the current year to a different one just because he plans to illegitimately deduct the cost of his daughter's wedding. Similarly, a business would not cease paying (and deducting) compensation to its rank-and-file employees in a given year so that it could take aggressive deductions for payments to senior management.²⁵⁶

Furthermore, one should not underestimate the presence of frictions even if none are readily apparent. If taxpayers find it easier (for psychological or any other reasons) to overstate existing charitable deductions rather than to make them out of whole cloth, the problem with discretionary timing is further alleviated. Besides, even for purely rational taxpayers, the cost of foregoing a real charitable donation may be too high to justify the tax planning strategy. I wonder how many of those who donated considerable sums in the aftermath of September 11, the Asian tsunami, or Hurricane Katrina would have decided to forego their donations because they were "scheduled" to take only questionable de-

253. Of course, for really outrageous violations there is always a criminal fraud penalty and possible jail time. I.R.C. § 7207.

254. For a detailed discussion of how frictions affect tax planning opportunities see generally Schizer, *supra* note 224 (defining frictions as "constraints on tax planning external to the tax law").

255. See I.R.C. §§ 167–168 (depreciation deductions); *id.* § 197 (amortization deductions).

256. See *id.* § 162(m) (restricting deductibility of certain excessive compensation).

ductions in that year. Moreover, rational taxpayers would no doubt take into account the fact that a relatively small overstatement of a given subtraction is more likely to be viewed as a mistake. A flagrant phony deduction runs a much higher risk of triggering penalties for negligence or even fraud. Nevertheless, as long as the Penalty is phased in over time, it would make sense to start by applying it to the kinds of subtractions that are more difficult to retime.

In addition to creating new incentives, enactment of the Penalty would reduce some of the existing ones. One could argue that by threatening the use of deductions and credits that were enacted by Congress to incentivize (or subsidize) a particular activity or industry, the Penalty would effectively limit the intended subsidy. This is a familiar argument against stronger tax enforcement whatever form it takes. David Weisbach's response seems convincing.²⁵⁷ The Penalty would not affect the subsidies where they clearly apply; it would only reduce their aggressive use. If Congress intended a particular incentive to be available more broadly than the statute unambiguously states, it should clarify the provision's scope rather than rely on taxpayers to push the envelope and maximize the use of a given incentive by engaging in transactions of questionable validity.

Finally, another likely response by taxpayers reflects the very essence of the proposal. The Penalty will affect only those who evade or avoid tax by using deductions, credits, and losses. While many do so today, faced with the Penalty, they might attempt to switch to the types of noncompliance that the Penalty does not reach. If this switching is easy, the Penalty will not accomplish much.

There are reasons to think, however, that it will be relatively difficult to escape the Penalty's reach. Many current avoidance schemes rely on deductions, credits, and losses precisely because such a wide variety of possible strategies present themselves. The number of ways to justify income understatements is much more limited.²⁵⁸ Of course, one can always understate income without any legal justification. However, it appears improbable that corporate taxpayers and wealthy individuals, i.e., those most likely engaged in tax avoidance, would shift to fraudulent evasion potentially subject to prison sentences.²⁵⁹ These observations sug-

257. See David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 *SMU L. Rev.* 73, 81-82 (2001).

258. Besides, empirical data suggests that those who could understate income relatively easily are already doing it. See Klepper & Nagin, *supra* note 90, at 18 (noting that for taxpayers with income not subject to information reporting, subtractions present inferior noncompliance opportunities). Thus, taxpayers avoid taxes by overstating deductions and credits precisely because their opportunities to understate income are limited. See *id.*

259. As Joseph Bankman remarked, "Many corporate officials are comfortable taking very aggressive tax positions, but very few are willing to lie outright in support of those positions." Joseph Bankman, *The Economic Substance Doctrine*, 74 *S. Cal. L. Rev.* 5, 28 (2000).

gest that the elasticity of substituting income-understating techniques for subtraction-overstating ones may not be particularly high. Nonetheless, faced with the Penalty, taxpayers will redouble their efforts to find avoidance mechanisms of the former type. The government should anticipate this and shift its enforcement efforts toward detecting income understatements.

These are some of the likely unintended responses to the enactment of the proposed Penalty. No doubt other problems will emerge. The government would need to monitor and react to the strategic moves by taxpayers and by its own agents. Quite possibly, the Penalty would not produce a stable equilibrium, and it would have to be abandoned after some time. Or, perhaps it would apply to a given set of subtractions at first, and later its reach would need to be expanded, shrunk, or shifted. To be sure, uncertainty surrounding the promulgation of the Penalty would be significant. However, the same is true of any novel enforcement measure. Moreover, there is no reason to think that the existing enforcement regime has produced (or will produce) a stable equilibrium. Thus, unless we are content with the current state of tax administration, we must accept the uncertainty, do our best to anticipate the consequences, and make the most promising moves among those available. The Penalty would offer the government one new move.

C. *Are the Costs Worth the Benefits?*

As any proposal based on economic analysis must, the Penalty must withstand a cost-benefit inquiry. It does so quite well. Starting, again, with the general deterrence literature, Becker's original intuition that raising the probability of detection is expensive while imposing higher monetary fines is costless²⁶⁰ has long been disproved.²⁶¹ Nominal penalties are costly, and the larger sanctions are more expensive than the smaller ones. For example, higher monetary fines result in more vigorous resistance from offenders, longer trials, higher attorney fees, and so on.²⁶²

In addition, larger sanctions lead to social waste of a kind that is not as readily observable. If offenders are risk-averse, two countervailing effects may produce a net decrease or increase in enforcement costs. On a positive side, larger penalties have a stronger deterrent effect on risk-averse potential offenders, reducing expected penalties needed to prevent a particular violation.²⁶³ However, those who commit the offense

260. See Becker, *supra* note 3, at 180, 193.

261. See, e.g., A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 *Am. Econ. Rev.* 880, 880 [hereinafter Polinsky & Shavell, *Optimal Tradeoff*] (explaining that Becker's conclusion fails to account for risk-bearing losses incurred by risk-averse individuals).

262. See Craswell, *Damage Multipliers*, *supra* note 117, at 468–69.

263. Because the deterrent effect of any given penalty on risk-averse potential offenders will exceed its expected value, the nominal penalty (or probability of

anyway incur risk-bearing losses solely due to the possibility, but not certainty, of being penalized.²⁶⁴ These are deadweight losses—costs to offenders that produce no benefits to anyone else²⁶⁵—and they increase with the size of the nominal penalties.

Compounding the inefficiency caused by risk aversion is the fact that deadweight losses from risk bearing are incurred not only by offenders, but also by those whose actions remain within the bounds of the law. The ambiguities inherent in any legal system make it difficult to determine whether a given behavior falls on the “right” side of the line, making actions that do not violate any laws risky. In addition, the possibility of a mistaken prosecution, a corrupt administrator, an incorrect application of a legal rule, or the inadequate assistance of counsel means that there is a chance that penalties would be imposed on innocent individuals.²⁶⁶ The higher the nominal penalties, the more worrisome they are to those who do *not* commit any offenses, and the larger are their risk-bearing costs resulting from legal uncertainty and imperfect enforcement.

In sum, while the costs of increasing the probability of punishment are obvious and substantial,²⁶⁷ scholars have identified significant, if somewhat less apparent, costs associated with raising nominal penalties. These findings put to rest the idea that the most efficient deterrence will be achieved by maximizing the magnitude of fines.²⁶⁸ Rather, the objective is to achieve a desired expected penalty while minimizing the sum of the costs of larger sanctions and the higher likelihood that they will be imposed.²⁶⁹

These insights have been incorporated by the tax compliance scholarship. However, the difference between tax evasion and offenses such as pollution typically considered in the general deterrence literature makes the tax analysis more multidimensional. To eliminate the harm produced by pollution (or accidents or crimes), we need to deter the offending activity. Of course, the same approach works for tax evasion. But the

punishment) may be reduced, resulting in possible cost savings. See Polinsky & Shavell, *Optimal Tradeoff*, *supra* note 261, at 880.

264. See *id.* These losses are “the cost of sleepless nights by a modern-day taxpayer who (illegally) underreports his income.” Joram Mayshar, *Taxation with Costly Administration*, 93 *Scand. J. Econ.* 75, 78 n.6 (1991). Note that this worrying by the taxpayer does society no good because the offense has already been committed.

265. See Polinsky & Shavell, *Optimal Tradeoff*, *supra* note 261, at 880–81 (noting that imposing higher monetary fines on risk-averse individuals “lower[s] utility due to risk bearing and could more than offset the benefits from controlling participation in the activity”).

266. See, e.g., Polinsky & Shavell, *Public Enforcement*, *supra* note 3, at 60–61; Slemrod & Yitzhaki, *Tax Administration*, *supra* note 25, at 1450.

267. See, e.g., *supra* text accompanying notes 110–112.

268. Becker was not the only one making this argument. See, e.g., Kaplow, *Fines for Undesirable Acts*, *supra* note 11, at 3 (referring to idea as “well-known suggestion”); Polinsky & Shavell, *Optimal Tradeoff*, *supra* note 261, at 880 n.3 (reciting argument and listing commentators who accepted it).

269. See Craswell, *Damage Multipliers*, *supra* note 117, at 470.

government has many alternative means of compensating for the revenues lost to tax noncompliance.²⁷⁰ For example, in addition to changing sanctions and detection efforts, Congress may increase tax revenues by raising tax rates across the board, changing the marginal tax rate schedule, or revising substantive legal rules.²⁷¹

But whatever Congress does to increase tax collections, the measure is likely to bring in less revenue than it would have produced if no changes in the system took place on account of the reform. Joel Slemrod and Shlomo Yitzhaki, building on earlier research, observed that the marginal tax increase resulting from the incremental reform is a private cost to taxpayers.²⁷² These taxpayers would react in different ways (including evasion, avoidance, planning, and real responses) to counter the change and reduce this cost. Because, on the margin, taxpayers would expend one dollar (as a direct outlay, utility loss, or some combination of the two) to save a dollar in additional tax,²⁷³ the difference between the hypothetical marginal revenue assuming no taxpayer response and the actual marginal revenue raised from the reform is a cost of that reform, or its total deadweight loss. By comparing this deadweight loss with the marginal revenue raised less the administrative cost of raising it (i.e., by calculating what Slemrod and Yitzhaki call the "marginal efficiency cost of funds" (MECF)²⁷⁴) we could determine how efficient *any* measure is in raising additional revenue. Thus, we can compare whether at the margin it would be more efficient to increase penalties, raise audit rates, enhance audit effectiveness, or take any number of other steps by calculating and comparing their respective marginal efficiency costs.

The MECF model is promising. The actual and hypothetical marginal revenues may be estimated and marginal administrative costs may be measured, giving us at least a rough value of the deadweight loss and MECF.²⁷⁵ Even if these calculations are imprecise (as they will certainly be), just knowing the magnitude of the MECF values for various measures would go a long way toward eliminating the plainly inefficient alterna-

270. Whether, and to what extent, such alternative means of raising tax revenues actually reduce the external harm of tax noncompliance is a complicated question that is beyond the scope of this Article.

271. See, e.g., Kaplow, *Optimal Taxation*, *supra* note 11, at 234 (showing that under certain assumptions, choice between stronger enforcement and higher tax rates is ambiguous).

272. See Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 *IMF Staff Papers* 172, 182 (1996) [hereinafter Slemrod & Yitzhaki, *Marginal Efficiency*]. For a list of earlier related studies, see Slemrod & Yitzhaki, *Tax Administration*, *supra* note 25, at 1459.

273. In some circumstances, the cost to taxpayers may be less than one dollar, i.e., private and social costs may diverge. See Slemrod & Yitzhaki, *Tax Administration*, *supra* note 25, at 1461.

274. Slemrod & Yitzhaki, *Marginal Efficiency*, *supra* note 272, at 172.

275. See Shaviro, *supra* note 1, at 238 (suggesting that some of formula's parameters are routinely estimated by government); Weisbach, *Ten Truths*, *supra* note 1, at 242 (same).

tives. Clearly, the MECF model is much closer to being of practical significance than the economic theory of optimal tax deterrence. However, it remains to be seen when (and whether) it will be developed to the point where it can be used in practice. Until then, it appears reasonable to evaluate the cost-effectiveness of the proposed Penalty by making qualitative comparisons with the existing ones.

These comparisons make the Penalty look quite attractive. While calculating marginal costs of various enforcement strategies remains a task for the future, it is fairly clear today that these costs depend on the precision of the enforcement effort. The lower the precision, the higher the costs. Consider the administrative costs incurred by the government in raising probability of detection across the board. Increasing audit rates for all taxpayers is very expensive, as is covering very broad categories of transactions by the new Regulations. On the other hand, conducting narrowly targeted audits and requiring disclosure of only specifically defined (i.e., listed as opposed to reportable) transactions is much less costly. The better the government knows what exactly it is looking for, the cheaper it is for the government to find it.²⁷⁶

The inverse correlation between the precision of the enforcement effort and its cost remains strong if we broaden the inquiry beyond administrative costs. Audits, for example, impose considerable compliance costs on taxpayers, both tangible (time and effort to produce records, interact with the auditor, hire an accountant, etc.) and intangible (most of those who have been audited report that the experience is not pleasant).²⁷⁷ If most of the audited taxpayers have engaged in no avoidance or evasion, and, as a result, the government is perceived as incapable of finding noncompliant taxpayers, these costs are largely wasted.²⁷⁸ The same point is true for the compliance costs of forcing taxpayers to disclose numerous unobjectionable transactions under the new Regulations.

This analysis applies to nominal penalties as well. Penalties produce risk-bearing losses, assuming taxpayers are risk-averse. They also lead to larger administrative costs and avoidance costs (i.e., resources spent on planning, executing, and defending tax avoidance and evasion strate-

276. The IRS keenly appreciates this point. Ineffectiveness of its audits was one of the main stimulants for the TCMP. See Brown & Mazur, *supra* note 59, at 1262.

277. See, e.g., Rick Wartzman, *Taxes 1993: Don't Wave a Red Flag at the IRS*, Wall St. J., Feb. 24, 1993, at C1 (noting observation by Thomas Sherman, tax partner at Coopers & Lybrand, that "[n]othing strikes the fear of God in people like receiving a letter from the IRS").

278. General deterrence effects of audits are uncertain. Researchers have discovered, somewhat surprisingly, that personal knowledge of someone with difficulties with the IRS decreases the perceived probability of detection, suggesting that "increasing audit rates may actually have the perverse effect of increasing the level of noncompliance in future years." Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, in *Why People Pay Taxes*, *supra* note 19, at 193, 206-07. Others found no significant effects. See, e.g., Andreoni et al., *supra* note 25, at 843-44.

gies). It is well understood that these costs increase with the size of nominal fines. But it is also highly likely that these costs are larger for penalties of more general application than for more narrowly focused sanctions simply because the broadly applicable penalties affect more taxpayers.

For example, recently enacted penalties for engaging in listed transactions are of little concern to a taxpayer whose tax planning is clearly not covered by the lists. However, the same taxpayer may be quite worried whether her tax strategies would be subject to a negligence penalty that potentially applies to any misreporting. If so, just as with increasing probability of detection, it would be cost effective to raise nominal penalties as narrowly as possible. The problem, of course, is that achieving precision is extremely difficult in either case because the government does not have nearly enough information about the available tax-reduction strategies.

The Penalty is attractive from the cost-benefit perspective because it raises nominal penalties (reducing the need for a costly imprecise increase in probability of detection), and it does so in a narrowly targeted way (limiting the risk-bearing and other losses resulting from higher imprecise nominal penalties). While taxpayers have many different items on their returns, most of them would not be particularly concerned about facing the Penalty with respect to many of these items that are present in relatively small amounts. While they would worry about large items, this is an inevitable price of improved deterrence.

Another way to highlight the Penalty's cost-effectiveness would be to rearticulate the reason underlying the red flags strategy. Auditors use it because it makes finding avoidance easier—that is, less costly. By hiding their aggressive positions, taxpayers make things difficult for the government, i.e., they impose additional external costs. The general deterrence literature has long recognized that offenders should be forced to internalize the costs they impose on others.²⁷⁹ That is exactly what the Penalty does.²⁸⁰ On balance, then, the Penalty's higher risk-bearing costs appear to be an entirely reasonable price to pay for improved deterrence.

D. *Should We Wait a Little?*

Taxpayers and their advisors are just coming to terms with the brave new world of increased disclosure and sanctions following the enactment of the Regulations and the 2004 Act. The Treasury Department has recently imposed new and wide-ranging requirements on any practitioner giving tax advice related to transactions with a tax avoidance purpose. Failure to comply with these rules may lead to monetary fines, censure,

279. See *supra* text accompanying note 161.

280. I thank Wojciech Kopczuk for suggesting this articulation.

and other highly unpleasant consequences.²⁸¹ There is a widespread sentiment among taxpayers and tax practitioners that the government has already overreacted.²⁸² Even a high-ranking Treasury official suggested that Congress should suspend its efforts to curb tax noncompliance and give the recent measures time to work.²⁸³ In this environment, one (and, perhaps, the most immediate) reaction to any proposal to strengthen tax enforcement is that the proposal is premature. Should we just wait and see whether the measures already put in place would be sufficient? To answer this question, we need to consider whether these measures are likely to be effective and, if so, whether they would address the problem that animates the case for adopting the Penalty.

No doubt, backed by the recently enacted sanctions and combined with new duties imposed on tax advisors, the Regulations' disclosure rules increase the chances that a particular reportable transaction will be detected.²⁸⁴ This probability may now be so high that the IRS need not use the red flags approach to examine transactions subject to the new disclosure rules. If so, the Penalty would be in fact superfluous for these transactions.

However, policymakers should not rest on their laurels just yet. Not all tax avoidance is covered by the Regulations. The number of reporting triggers is limited.²⁸⁵ The so-called "angel lists" exclude from reporting large categories of transactions that would have been covered by the Regulations otherwise.²⁸⁶ These lists were not short to begin with, and the

281. These rules are contained in the so-called Circular 230, 31 C.F.R. §§ 10.0–10.93 (2005).

282. See, e.g., Sheryl Stratton, *Tax Officials Spar with Tax Bar over Circular 230*, 107 *Tax Notes* 1082, 1082 (2005) (describing several heated exchanges between practitioners and IRS officials during American Bar Association's annual meeting regarding interpretation of Circular 230 and practitioners' belief that these regulations are overbroad, too vague, and unnecessarily punitive).

283. See Dustin Stamper, *Treasury Official Suggests Break from Tax Shelter Legislation*, 107 *Tax Notes* 1067, 1067 (2005) (quoting statement of Acting Deputy Assistant Secretary of the Treasury for Tax Policy).

284. In part, the Regulations' effectiveness comes from two innovative features. The disclosure is required to be made not only as a statement attached to the taxpayer's return, but also as a separate filing with a special division of the IRS—Office of Tax Shelter Analysis—making it easier for the government to focus just on the disclosed transactions. See *Treas. Reg.* § 1.6011-4(d)–(e) (2005). In addition, and in contrast to a regular tax return which contains aggregate items that reflect many unrelated transactions, the tax shelter disclosure must be done on a transaction-by-transaction rather than an item-by-item basis. See I.R.S. Form 8886, *Reportable Transactions Disclosure Statement* (Dec. 2005), available at <http://irs.gov/pub/irs-pdf/f8886.pdf> (on file with the *Columbia Law Review*). Because one needs to understand the transaction in order to evaluate whether a particular item is reported correctly, this mode of disclosure should facilitate more effective auditing of reportable transactions.

285. See *supra* note 113.

286. See *Rev. Proc.* 2003-25, 2003-1 C.B. 601; *Rev. Proc.* 2003-24, 2003-1 C.B. 599.

IRS has expanded them over time.²⁸⁷ Finally, the reportable transaction categories are subject to various numerical thresholds. As a result, only fairly large corporations and very wealthy individuals are subject to the new reporting requirements.²⁸⁸ Many taxpayers who do not fit either description make a large aggregate contribution to the tax gap.

Moreover, the share of avoidance that is outside of the government's new disclosure net is certain to grow. The Regulations necessarily create incentives that will reduce their effectiveness. They give taxpayers strong motivation to shift to new tax planning strategies that would not need to be reported. Because the reportable transaction definition reaches many tax-minimizing arrangements, avoiding the Regulations would be difficult at first. However, this difficulty is unlikely to persist. While the scope of the reportable transaction definition is broad, the world of conceivable avoidance strategies using various subtraction items is much broader. In fact, the Joint Committee on Taxation has already come up with a list of new categories it believes to be characteristic of tax avoidance.²⁸⁹ Given time and effort—and both are certain to be oversupplied—taxpayers will find a way around the Regulations. Of course, the government can adjust the list of triggers, modify the thresholds, and revise the angel lists to reflect new information. These responses, however, would be delayed, perhaps significantly, given government's inertia and lack of resources.

Returning to our examples, we may safely assume that the Regulations and other recent enforcement initiatives have made a meaningful difference for Interbank and the auto manufacturer. But the management consultant hoping to write off a portion of his daughter's wedding bill, the lawyer padding her charitable deductions, the plumber overstating his investment interest, and the restaurateur taking an aggressive view of what counts as an advertising or compensation expense are unlikely to be affected. They are a less visible, but by no means a less significant, part of the tax compliance problem we need to solve. Besides, before long, even Interbank and the automaker are likely to discover structures that would give them the benefit of various subtractions without triggering the disclosure requirements. Because the Penalty would affect the cost-benefit analysis of all these taxpayers, the recent enforcement measures hardly provide a reason to delay its enactment.

287. See Rev. Proc. 2004-68, 2004-2 C.B. 969; Rev. Proc. 2004-67, 2004-2 C.B. 967 (superseding Rev. Proc. 2003-25); Rev. Proc. 2004-66, 2004-2 C.B. 966 (superseding Rev. Proc. 2003-24); Rev. Proc. 2004-65, 2004-2 C.B. 965.

288. For example, transactions resulting in a loss are covered only if a loss claimed by a corporate taxpayer exceeds \$10 million in a single taxable year or \$20 million in any combination of taxable years. See Treas. Reg. § 1.6011-4(b)(5) (as amended in 2003). For individuals, the respective numbers are \$2 million and \$4 million. See *id.*

289. See Staff of Joint Comm. on Taxation, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures 19–20 (2005), available at <http://www.house.gov/jct/s-2-05.pdf> (on file with the *Columbia Law Review*). Transactions with these features remain outside of the Regulations' reach, and will continue to do so for the foreseeable future.

CONCLUSION

Tax noncompliance continues to be a serious problem. It is abundantly clear that tinkering with the existing measures holds little promise. We need new approaches, creative thinking, and deliberate risk taking in devising innovative ways to strengthen tax enforcement. The government's recent responses to the tax shelter problem reflect this view.

Economic theory of deterrence necessarily relies on abstract models. Attempts to bring this theory to bear on practical solutions, such as the one made in this Article, highlight the theory's considerable indeterminacy. Until this uncertainty is resolved or substantially reduced, we have to wait before devising first-best tax enforcement policies. At the same time, it is clear that economic models offer numerous valuable insights for which we should find (or at least try to find) practical applications.²⁹⁰ Instead of using uncertainty to justify inaction, we should rely on the clear implications of the deterrence theory to detect and reform the features of the current tax administration that are definitely undesirable.

This Article has identified a considerable weakness in the existing enforcement regime. A failure to counter taxpayer incentives to hide their aggressive transactions induces wasteful behavior, increases the welfare cost of noncompliance, and lowers overall deterrence. Moreover, taxpayer ability to deceive the government is hardly uniform. Millions of taxpayers earn only income subject to withholding or information reporting, take a standard deduction, and have few opportunities to reduce their tax liabilities. Millions of others receive income not subject to any monitoring regime, take numerous deductions that are unlikely to be examined, and, in some cases, benefit from highly sophisticated and expensive advice. Taxpayers in this second category have endless opportunities to conceal their aggressive transactions, and many take full advantage of these opportunities. As a result, these taxpayers shift billions of dollars of the total tax burden to those in the first group. In addition to being inefficient, this state of affairs is manifestly unfair.

The proposed Penalty aims at leveling the playing field. It is not a perfect solution. It will not produce optimal absolute or marginal deterrence; and in some instances, it may appear unfair, excessive, or even draconian to those who have to pay it. Yet, the Penalty will diminish the socially undesirable incentives to conceal and strengthen tax enforcement. Moreover, by narrowing the gap in tax avoidance and evasion opportunities available to different types of taxpayers, the Penalty will reduce the clear inequity that pervades our tax system today.

290. As discussed in the Introduction, this task is well under way outside of the tax enforcement area. See *supra* notes 3–10 and accompanying text.