

2005

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

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Recommended Citation

Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, COLUMBIA LAW REVIEW, VOL. 106, P. 569, 2006; COLUMBIA LAW & ECONOMICS WORKING PAPER NO. 284 (2005). Available at: https://scholarship.law.columbia.edu/faculty_scholarship/1384

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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. The economic analysis of deterrence suggests that rational taxpayers choose among various avoidance or evasion strategies that are subject to identical statutory sanctions those that are more difficult for the government to find. I argue that many taxpayers do just that. Because probability of detection varies dramatically among different items on a tax return while nominal penalties do not take 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 tax return and, therefore, is not susceptible to the type of generalization on which the current penalties rely. I propose to complement the existing sanctions with a new penalty equal to a fraction of the legitimate subtraction item (such as a deduction, credit, or loss) reported on the same line of a return that contains the illegitimate one. With this penalty in place, the harder it is for the government to find a given avoidance transaction, the higher is the statutory sanction if the transaction is detected. The proposed penalty adjusts itself. As a result, the differences in expected penalties for many forms of avoidance and, to a lesser extent, evasion are reduced, the inefficient incentive to hide noncompliance is diminished, and the overall deterrence is improved.

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* This is a preliminary draft subject to further revisions. Comments are most welcome and should be sent to arasko@law.columbia.edu.

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I. 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 should be done about this is another matter.

This article makes two contributions to the tax avoidance debate. First, it identifies a significant 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 probability 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 to find.

¹ See, e.g., George K. Yin, *JCT Chief Discusses the Tax Gap*, 107 Tax Notes 1449, 1449 (2005) (stating that “[a]ny consideration of major tax reform in this country must give priority consideration to issues of tax compliance and enforcement.”); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 Tax L.R. 215, 228 (2002) (noting that “the explosion of tax shelters is considered by many to be one of the most pressing problems facing our [tax] system today.”); 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 (even if they work under current law) are compromising the entire corporate income tax, and perhaps generating broader disrespect for the tax system.”). The Government Accountability Office believes that tax enforcement is one of the 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.”).

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 set to be relatively high 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.

I propose a new type of penalty that would accomplish this goal for a fairly wide (although limited) set of avoidance 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 on a return. 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 taxpayer looks for an avoidance strategy that will be relatively difficult to detect, she is likely to choose the 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 claim an extra \$1,000 charitable deduction in addition to an appropriately claimed \$10,000 charitable deduction already present on her return rather than taking a \$1,000 farm loss that she has never claimed before. A ten percent increase in charitable deductions is less likely to attract 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 suggestion about variations in probability of detection is correct (even if only in part), we can 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 using a particular credit, deduction, or loss to the legitimate subtraction item of the same type on the return. That is, the tax avoider (such as the lawyer) would be denied not only the tax item claimed inappropriately (the \$1,000 charitable deduction), but a fraction of the perfectly legitimate subtraction claimed on the same line of her tax return as well (e.g., 10 percent 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 improved, 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 taxpayers' decisions. Whatever form of the proposed penalty is adopted, the self-adjusting penalty is likely to improve tax compliance without consuming a lot of government resources while imposing relatively modest costs on most taxpayers.

In addition to identifying and resolving 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.² In addition to a considerable literature focused on formal modeling,³ 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?⁴ Could criminal penalties efficiently deter corporate misdeeds, or would only civil sanctions reach this goal?⁵ Should we set punitive damages by taking into account variations in probability of detection,⁶ by aiming to deny the benefits of the offense to the violator,⁷ or in some

² The foundational work is Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968). For its wide-reaching implications, see, e.g., Richard A. Posner, *ECONOMIC ANALYSIS OF LAW* (2002); A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. Econ. Lit. 45 (2000).

³ See *infra*, text accompanying notes 37-52.

⁴ See, e.g., Dan M. Kahan, *Social Meaning and the Economic Analysis of Crime*, 27 J. Leg. Stud. 609, 615-17 (1998) (arguing with an established view that civil sanctions are more cost-effective than imprisonment expressed, for example, in Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 Am. Crim. L. Rev. 409, 410-11 (1980)).

⁵ See, e.g., Kahan, *supra* note 4, at 618-622 (demonstrating why criminal corporate liability may be efficient, disagreeing with Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. Leg. Stud. 319 (1996) and V. S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 Harv. L. Rev. 1477 (1996)).

⁶ See A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L.R. 869, 874 (1998).

⁷ See Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties*, 87 Geo. L.J. 421, 456 (1998).

other fashion?⁸ Institutional detail, expressive function of the law, and cognitive biases play important roles in these debates.⁹

In contrast, formal models of tax noncompliance have largely ignored the task of analyzing the optimal structure of nominal penalties. Leading scholars have recognized this deficiency,¹⁰ but 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,¹¹ 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 II introduces the tax avoidance problem and economic approach to deterrence. Part III identifies a critical flaw of the existing enforcement regime. Part IV considers and rejects several possible responses and set forth the proposal. Following the discussion of the proposal's key features in Part V, Part VI addresses some of the likely objections. Part VII concludes.

II. Tax Noncompliance: the Problem, the Causes, the Economic Analysis

1. Many Facets of Tax Avoidance

Each year, the government collects over \$300 billion less in taxes than it believes it should.¹² This shortfall—the so-called tax gap—is not only large, but it has nearly tripled over

⁸ See, e.g., Catherine M. Sharkey, *Punitive Damages as Societal Damages*, 113 Yale L.J. 347, 363 (2003) (expressing a view that while economic deterrence is one of the important goals of punitive damages, it is not their exclusive goal).

⁹ See, e.g., Richard Craswell, *Deterrence and Damages, The Multiplier Principle and Its Alternatives*, 97 Mich. L. Rev. 2185, 2219-38 (1998) [hereinafter, *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 4 (focusing on the expressive function of sanctions); Polinsky & Shavell, *supra* note 6, 893-94, 957-62 (addressing potential responses to jury biases, offering detailed jury instructions).

¹⁰ See, e.g., 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, *Fines for Undesirable Acts*] (noting that “it 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) (acknowledging that the effect of penalty structure on tax enforcement has not been considered in most studies of tax noncompliance, including his own); Frank A. Cowell, CHEATING THE GOVERNMENT: THE ECONOMICS OF EVASION 174, 228 n.18 (1990) (remarking that the structure of tax penalties is the “subject [that] is relatively neglected in the literature.”).

¹¹ See, e.g., Shaviro, *supra* note 1, at 237-44 (discussing the implications of the marginal efficiency cost of funds model); David A. Weisbach, *An Economic Analysis of Anti-Tax Avoidance Doctrines*, 4 Am. Law Econ. Rev. 88, 92-99 (2002) (relying on the compensated elasticity of taxable income analysis).

¹² See Allen Kenney, *New IRS Estimates Show Slight Widening of Tax Gap*, 107 Tax Notes 7, 7 (2005). This is a number reflecting voluntary tax payments. After the government's collections efforts it is reduced to about \$250 billion, *see id.*

the past two decades and continues to grow.¹³ Furthermore, the gap is just one of several signs of a serious tax compliance problem. We are in the midst of a well-publicized tax shelter crisis. Large and well-known companies see their tax planning strategies struck down as devious tax shelters and sometimes are forced to pay penalties on top of the tax they had hoped to avoid.¹⁴ 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.¹⁵ Disenchanted wealthy tax shelter investors turn against their former advisers. As a result, some of the nation's largest investment banks, accounting firms, and law firms are facing numerous law suits, including class actions.¹⁶ The Treasury department makes tax shelters one of its top priorities and issues a set of regulations that reach far beyond any previous anti-avoidance measures.¹⁷ Finally, Congress lends a hand to the Treasury's efforts by significantly raising penalties for tax shelter participants and promoters, in some cases to the tune of \$10,000 a day.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 understating of cash receipts. Unlike deductions and credits that appear on returns and must be substantiated if questioned, cash receipts 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 percent for nonfarm proprietor income and 13 percent for informal supplier income.²⁰ A recent report attributes 67 percent of the tax gap to this type of evasion.²¹ In sum, wherever opportunities to

¹³ The gap was estimated at \$90 billion for 1981, *see* Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 Nat'l Tax J. 345, 345 (1985). It has been growing at about 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 is open to question, however, *see, e.g.*, Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 Nat'l L.J. 355, 355 (1985) (explaining why estimating tax noncompliance is "fraught with difficulties").

¹⁴ *See, e.g.*, Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 Tax L.R. 255, 256-57 (2002) (describing the court losses of several major U.S. companies).

¹⁵ *See, e.g.*, Stacey Stowe, *Stanley Works Decides to Stay Put After All*, N.Y. TIMES, Aug. 4, 2002, at C1; *see also* Joel Slemrod, *The Economics of Corporate Tax Selfishness*, 57 Nat'l Tax J. 877, 883 (2004) [hereinafter *Corporate Selfishness*] (citing statement by Sen. Grassley that reincorporations of U.S. companies in tax havens are "immoral").

¹⁶ *See, e.g.*, Susan Simmonds, *Shelter Cases Highlight Uncertain Outcomes*, 106 Tax Notes 45 (2005).

¹⁷ *See infra*, Part III.2 for a discussion of these regulations.

¹⁸ *See* I.R.C. § 6708.

¹⁹ Low-income proprietors are estimated to be the least compliance 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) (hereinafter, WHY PEOPLE PAY TAXES).

²⁰ *See* Joel Slemrod, *Small Business and the Tax System*, in THE CRISIS IN TAX ADMINISTRATION 69, 84 (Henry J. Aaron & Joel Slemrod eds., 2004) [hereinafter, *Small Business*].

²¹ *See* Heather Bennett, *IRS Must Get Grip on Tax Gap, Taxpayer Advocate Says*, 106 Tax Notes 531 (2005).

avoid or evade taxes present themselves, quite a few taxpayers of all stripes are eager to take advantage.

2. *Why Do People Pay Taxes?*

The discussion so far may be viewed as suggesting that an all-out assault on tax noncompliance is long overdue. It is not, at least 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 approach to deterrence was introduced in the modern literature by Gary Becker²² and it goes back to writings of Bentham²³ and Beccaria.²⁴ It suggests that potential offenders take into account not just the size of the possible penalty, but also the likelihood that the penalty will be imposed. Several models have been developed to describe taxpayers' behavior based on these assumptions.²⁵ Unfortunately, the models 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.²⁶

If the economic analysis does not fully explain tax compliance, what does? Perhaps, looking at human beings as more than mere "rational rats"²⁷ may provide the answer. Dan Kahan and others have argued that cultural and social factors play an important role in tax compliance, possibly more important than the threat of punishment. Taxpayers pay taxes, these scholars assert, to avoid feelings of guilt, shame, and peer condemnation accompanying tax evaders, because they value cooperation and believe that others are law-abiding taxpayers, and because they feel pride fulfilling their civic duty.²⁸ On the other hand, those who think that tax laws are

²² Becker, *supra* note 2.

²³ *See id.*, at 185 n.31 (citing Bentham).

²⁴ *See id.*, at 176, n.12 (citing Beccaria).

²⁵ *See infra*, text accompanying notes 57-71.

²⁶ *See, e.g.*, Weisbach, *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."); Graetz & Wilde, *supra* note 13, at 358 ("Application of the standard economic theory of crime to [many] tax avoidance cases . . . produces an unambiguous prediction: throughout the 1970s *no one* should have paid the taxes they owed . . ."). In part, tax withholding rules help most salaried employees to avoid unnecessary 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 percent, *see, e.g.*, Slemrod, *Small Business*, at 85. A well-publicized system of information reporting makes hiding interest, dividend, 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 probability of detection for income subject to either regime to almost 100 percent, necessarily leading to larger expected penalties and greater compliance. Even with these qualifications, however, economic models developed so far do not provide a comprehensive account of the actual taxpayers' behavior.

²⁷ Cowell, *supra* note 10, at 47.

²⁸ *See, e.g.*, Dan M. Kahan, *Trust, Collective Actions, and Law*, 81 B.U.L. Rev. 333 (2001); James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. Econ. Lit. 818, 850-51 (1998). Economists respond that such phenomena as humiliation of an audit and tax prosecution and stigma of

unjust, unfairly administered, or disagree with how the tax revenues are spent are more likely to evade.²⁹ These arguments may have profound consequences for policymakers deciding how to improve tax compliance. 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 rich and powerful is likely to have a negative effect on deterrence by suggesting that tax avoidance is commonplace and socially acceptable, even if risky.³⁰ Finally, 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.³¹

Empirical research of tax avoidance and evasion exists, but it is somewhat sparse and has produced inconclusive results. Data about the actual taxpayers' behavior, results from laboratory experiments, and survey information are each subject to their own limitations and imperfections, making any findings heavily qualified. The most basic predictions of the economic deterrence model—that higher penalties and higher likelihood that the penalties would be imposed improve tax compliance—have not been rigorously tested.³² Several studies suggest that both factors enhance deterrence, but the effect is small.³³ Some scholars report that rewards for being a good citizen and information about compliance by others work better than a threat of punishment for being a cheater.³⁴ Others come to exactly opposite conclusions based on the same experimental data.³⁵ Numerous surveys show that tax evasion is more prevalent among those who believe that they are carrying an unfairly large tax burden.³⁶ In sum, experimental data lends some support to all existing theories of taxpayer behavior, while giving a decisive advantage to none.

being labeled a tax cheat are just additional costs to be taken into account in estimating expected penalties, *see, e.g.*, Skinner & Slemrod, *supra* note 13, at 348.

²⁹ See Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 Can. J.L. Juris. 95, 97 (2005).

³⁰ See Kahan, *supra* note 28, at 340-44.

³¹ See Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453 (2003).

³² See Slemrod, *Corporate Selfishness*, at 887.

³³ See Andreoni et al., *supra* note 28, at 822, 841-42 (discussing studies and concluding that all of them “come with caveats,” but “present a fairly consistent picture in which both penalties and audit probabilities have some deterrent effect, although the magnitude of these effects is still unclear”).

³⁴ See Kahan, *supra* note 28, at 343 (citing the results of a study by the Minnesota Department of Revenue); James Alm, Betty Jackson & Michael McKee, *Deterrence and Beyond: Toward a Kinder, Gentler IRS*, in WHY PEOPLE PAY TAXES 311, 321-323 (reporting that immediate rewards produced more compliance than increased enforcement).

³⁵ See Marsha Blumenthal, Charles Christian & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 Nat'l Tax J. 125, 131-132 (2001) (finding no statistically significant effects from normative appeals); Joel Slemrod, Marsha Blumenthal & Charles Christian, *Taxpayers Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. Pub. Econ. 455, 465 (2000) (finding that higher audit rates increased reported income and tax paid by low- and middle-income taxpayers, especially those with greater opportunities to evade).

³⁶ See Skinner & Slemrod, *supra* note 13, at 348.

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

3. *The General Economic Analysis of Deterrence*

Modern economic analysis of deterrence starts with Gary Becker's observation that when deciding whether or not to violate the law, rational utility-maximizing potential offenders take into account not the nominal penalties (i.e., the sanctions set by the relevant statutory provisions), but the expected ones.³⁷ The difference between the two penalties arises because enforcement of law is less than perfect and some offenses go unpunished. Thus, the expected penalty equals the nominal penalty discounted by the probability that the penalty will be imposed, or

$$EP = NP \times PP$$

where EP is the expected penalty, NP is the nominal penalty, and PP is the probability that the penalty will be imposed, or probability of punishment.

But what should this expected penalty be? Economic theory suggests that rational agents would behave efficiently if they take into account full costs of their actions, not just their internal costs. By equating the expected penalty for a given act to the act's external harm we would force potential offenders to internalize this harm, achieving the efficient level of compliance.³⁸ This insight about the optimal *expected* sanction leads to an elegant proposal for the size of the optimal *nominal* penalty: it should be equal to the external harm (EH) times the reciprocal of the probability of punishment—the so-called “multiplier,”³⁹ or

$$NP = EH \times 1/PP^{40}$$

Unfortunately, things are rarely that simple. First, because imposition of penalties is costly, a portion of these costs that is not internalized by the offenders should be taken into account in setting expected penalties.⁴¹ In addition, the basic formula should be adjusted to account for risk aversion of potential offenders,⁴² other costs borne by them (such as attorney's fees and reputational losses),⁴³ wealth effects,⁴⁴ imperfect information about likelihood of

³⁷ See Becker, *supra* note 2, at 176.

³⁸ For a more detailed explanation, see, e.g., Polinsky & Shavell, *supra* note 6, at 877-87.

³⁹ Richard Craswell, *Damage Multipliers in Market Relationships*, 25 J. Leg. Stud. 463, 464 (1996) [hereinafter, *Damage Multipliers*].

⁴⁰ If a nominal penalty is set at this level, the expected penalty would be equal to the external harm of the behavior being deterred: $EP = NP \times PP = (EH \times 1/PP) \times PP = EH$.

⁴¹ See Craswell, *Damage Multipliers*, at 470.

⁴² See Becker, *supra* note 2, at 178.

⁴³ See Craswell, *Damage Multipliers*, at 465.

⁴⁴ See A. Mitchell Polinsky & Steven Shavell, *A Note on Optimal Fines When Wealth Varies among Individuals*, 81 Am. Econ. Rev. 618 (1991).

detection,⁴⁵ existence of both monetary and non-monetary sanctions,⁴⁶ interaction between general and specific deterrence,⁴⁷ and other considerations.⁴⁸ Finally, in order to reflect a possibility of legal error, the probability of punishing an innocent defendant should be subtracted from the probability of punishing a guilty one in the denominator of the multiplier.⁴⁹

Yet, even if the external harm of a given offense could be measured precisely, and if all adjustments could be made to determine the optimal nominal penalty, the success would be illusory. The adjustment for a possibility of legal error just described is sufficient only if the error rate does not depend on the gravity of the offense or the innocence of a non-offending behavior. This assumption does not hold in many cases. 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 don't cross it.⁵⁰ Whenever error rates vary in this fashion, the only way to maintain the first best level of deterrence is to calculate the multiplier separately for each violation.⁵¹

Furthermore, aside from mistaken decisions to punish or excuse, in many cases more serious offenses result in higher external harms (by definition) and are *also* more likely to be detected and prosecuted. That is, both components of the expected penalty formula vary in the same direction as the gravity of an offense changes. For example, consider a manufacturing plant that produces valuable widgets but also emits pollution, sometimes in excess of the permissible limit. A more egregious environmental violation would produce a larger smoke cloud that would linger longer, raising probability that the violation would be detected. The enforcement agency is more likely to pursue large polluters, raising probability of prosecution. Perhaps, a judge or a jury would be less sympathetic to a flagrant offender, raising probability of conviction. Any of these effects would increase probability of punishment for a more serious violation compared to a less significant one. When this occurs, it is, again, impossible to determine a single probability of punishment (or a single multiplier) that 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.⁵²

⁴⁵ See Omri Ben-Shahar, *Playing Without a Rulebook: Optimal Enforcement When Individuals Learn the Penalty Only by Committing the Crime*, 17 Int. Rev. Law Econ. 409, 409-10 (1997); Lucian A. Bebchuk & Louis Kaplow, *Optimal Sanctions When Individuals Are Imperfectly Informed About the Probability of Apprehension*, 21 J. Leg. Stud. 365 (1992).

⁴⁶ See A. Mitchell Polinsky & Steven Shavell, *The Optimal Use of Fines and Imprisonment*, 24 J. Pub. Econ. 89 (1984).

⁴⁷ See Steven Shavell, *Specific versus General Enforcement of Law*, 99 J. Pol. Econ. 1088 (1991).

⁴⁸ For example, several commentators pointed out that it may be efficient to set expected penalty slightly below the external harm caused by the offense in question, see Craswell, *Damage Multipliers*, at 471, or slightly above that level, see *id.*, at 472-73.

⁴⁹ See *id.*, at 476 (citing models).

⁵⁰ See *id.*, at 476-77.

⁵¹ See *id.*

⁵² See Craswell, *The Multiplier Principle*, at 2187-88.

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.⁵³ In addition, they could lead to the arguably unjust (and politically unacceptable) result when egregious violations would face lower nominal penalties than marginal offenses.⁵⁴ 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 marginal changes in expected penalties and not just to their absolute values.⁵⁵ For example, if two different offenses produce external harms of \$100 and \$200 respectively, the proper *marginal* deterrence will be achieved if the expected penalties are set at \$300 and \$400 respectively, even though their absolute values will be clearly excessive. Becker's original observation that the expected penalty depends on the nominal penalty and the probability of punishment suggests that a *change* in the expected penalty depends on the changes in each of these variables. At the same time, deterring two *equally* harmful offenses by subjecting them to equal nominal penalties may be a misguided approach. If one offense is less likely to be punished than the other, having equal statutory fines for both offenses is undesirable from the marginal deterrence perspective.

In sum, the ideal of optimal deterrence remains elusive. However, achieving optimal marginal deterrence is a worth-wile second-best objective.⁵⁶ If policymakers learn to identify marginal variations in external harms produced by different violations and to counter them by changing either the magnitude of likelihood of fines, the enforcement regime would become more efficient.

4. *The Economic Approach to Tax Evasion*

Starting with Becker's observations, the early attempts to model tax evasion viewed the decision to evade as a choice under uncertainty, or, more technically, a gamble.⁵⁷ A taxpayer

⁵³ See Craswell, *Damage Multipliers*, at 477 (noting that "more realistically, all offenses [of the same type] must be governed by the same multiplier").

⁵⁴ See *id.*

⁵⁵ See *id.*, at 2194. George Stigler who is credited with coining the term "marginal deterrence" quipped that, when considering possible crimes, "marginal decisions are made as in the remainder of life" George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. Polit. Economy 526, 527 (1970).

⁵⁶ Note that the task of optimizing marginal deterrence is easier than reaching an absolute optimum because we don't need to determine the absolute values of external harm—we only need to agree on how they differ among various offenses. Another second-best solution is to settle for a single multiplier or a single fine. For an in-depth discussion, see Craswell, *The Multiplier Principle*, at 2198-2207.

⁵⁷ Economic analysis of tax noncompliance focuses almost exclusively on tax evasion—an unambiguously illegal non-payment of taxes. The seminal taxpayer-as-a-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). The scholarship on the subject is vast and several excellent reviews are available, see, e.g., Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration* 1423, 1429-1438, in *HANDBOOK OF PUBLIC ECONOMICS* (Alan J. Auerbach & Martin Feldstein eds., 2002) [hereinafter, *Tax Administration*]; Andreoni et al., *supra* note 28, at 823-834. The discussion follows the literature in focusing on tax evasion by individuals, see, e.g., Slemrod, *Small Business*, at 83 ("Nearly all the theoretical and empirical literature on tax evasion focuses on evasion by individuals.").

facing known and exogenously fixed nominal penalty and probability of punishment compares the expected gain from tax evasion to the expected cost of tax penalties.⁵⁸ The models are static: all taxpayer's decisions (and, therefore, taxable income) are fixed, and possible responses by the tax authority are ignored. The models suggest that if the expected value of the gamble is positive, taxpayers will evade all tax, and if it is negative, they will fully comply with the law.⁵⁹ This result is modified once taxpayers' risk aversion is taken into account. At some point, a risk averse taxpayer would not undertake additional evasion despite its positive expected value because the size of the bet would be simply too large for her taste.⁶⁰ Furthermore, if probability of detection grows with the size of evasion, it will not be optimal to evade all tax.⁶¹

Despite numerous simplifying assumptions, the consequences suggested by the static models are complicated and largely uncertain. The effect of the tax rate on evasion, for example, depends on whether the penalty is based on income understatement or tax understatement.⁶² Relative risk aversion determines the effect of the taxpayer's income on the magnitude of noncompliance.⁶³ Attempts to model the role of tax practitioners further add to the uncertainty.⁶⁴ In contrast to these ambiguous conclusions, one result is fairly clear: increases in probability of punishment and in nominal penalty decrease incentives to evade.⁶⁵

Dynamic models relax the unrealistic assumption that the relevant parties do not take into account each other's actions. These models treat the interaction between taxpayers and the IRS as a game rather than a gamble.⁶⁶ The IRS tries to maximize the revenue collected, taxpayers respond by deciding how much income to report. The models yield new insights, yet considerable uncertainty remains.⁶⁷ However, an increase in nominal penalties unambiguously increases compliance.⁶⁸

Finally, more general models take into account that rational individuals may respond to taxation in two alternative ways in addition to engaging in evasion.⁶⁹ First, taxpayers may change

⁵⁸ See Slemrod & Yitzhaki, *Tax Administration*, at 1430, 1451-52. The description of this and other models provides only a very general summary highlighting the aspects of the literature relevant for our purposes.

⁵⁹ See *id.*, at 1432.

⁶⁰ See *id.*, at 1430.

⁶¹ See *id.*, at 1432.

⁶² See *id.*, at 1431.

⁶³ See *id.*

⁶⁴ See Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 *Tax L. Rev.* 33, 60 (1994).

⁶⁵ See Slemrod & Yitzhaki, *Tax Administration*, at 1431.

⁶⁶ First such model was proposed in Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 *J. Law. Econ. & Org.* 1, 1 (1986).

⁶⁷ While relaxing some of the very strong assumptions made in the static models, the model offered by Graetz and others itself relies on assumptions that are unlikely to be true. For example, the model assumes that taxpayers know the government's audit strategy, the IRS has an unlimited budget, and taxpayers have only two levels of income, *see id.*, at 8 n.20, 24. Eliminating some of these assumptions dramatically increases complexity of the analysis, *see id.*, at 25, 27.

⁶⁸ See *id.*, at 18.

⁶⁹ See Slemrod & Yitzhaki, *Tax Administration*, at 1436 (citing 4 models).

their work effort and the types of consumption and saving decisions they make (I will refer to these as *real responses*).⁷⁰ Second, they can enter into clearly legal tax minimization strategies. Analysis tends to focus on how such factors as tax rate and wage rate affect the taxpayer's choice among evasion, legal tax minimization, and real responses, and how adopting any given type of response affects the other two. The models add richness and realism to the world described by the more limited static and dynamic models, but this realism comes at a price of further complexity and uncertainty. For example, taking into account only the possibility that, in addition to evasion, taxpayers may respond to taxes by reducing their work effort makes the effect of higher nominal penalties and stronger enforcement ambiguous.⁷¹

In addition to being fairly indeterminate, and in stark contrast with the general deterrence scholarship, models of individuals' tax compliance are entirely unconcerned with devising optimal expected penalties.⁷² This disparity is important because it is impossible to determine the optimal nominal penalty according to Becker's formula without first deciding what the optimal expected penalty is. Furthermore, we need to understand the reasons for this disparity in order to evaluate whether the theoretical framework for economic analysis of tax enforcement should be conceptually different from that applicable in other areas of the law.

Perhaps, the divergence could be explained if we consider the fundamental difference between tax evasion and activities typically addressed by the general deterrence literature, such as pollution, accidents, and the like. Returning to the widget-making plant example, note that pollution is an unfortunate and inevitable side effect of a socially beneficial activity—operation of the plant. Tax evasion has no concomitant welfare enhancing companion. We are concerned with over-detering pollution because this may cause the factory to under-produce. There is no analogous concern with tax evasion. In other words, while pollution (or, more precisely, the pollution-generating manufacturing activity) may be socially beneficial at some level, tax evasion never is.⁷³ Hence, the concern for overdeterrence that looms large in the general deterrence

⁷⁰ For a more elaborate explanation of this term, *see id.* at 1428.

⁷¹ *See id.*, at 1432.

⁷² *See* Kaplow, *supra* note 10, at 222. While several models of optimal tax enforcement exist, they focus on individual elements affecting expected sanctions in a piece meal fashion, *see* Slemrod & Yitzhaki, *Tax Administration*, at 1450-1453 (discussing various models). Thus, some researches attempt to devise optimal auditing rules, *see, e.g.*, Kim Border & Joel Sobel, *Samurai Accountant: A Theory of Auditing and Plunder*, 54 *Rev. Econ. Stud.* 525, 525 (1987); Jennifer F. Reinganum & Louis Wilde, *Income Tax Compliance in a Principal-Agent Framework*, 26 *J. Pub. Econ.* 1, 1 (1985). Others focus on optimal extent of enforcement, *see, e.g.*, Joel Slemrod & Shlomo Yitzhaki, *The Optimal Size of a Tax Collection Agency*, 89 *Scand. J. Econ.* 183, 186 n.2 (1987) (explicitly noting that penalty is not an instrument under consideration because considerations limiting the penalty's size (such as proportionality) cannot be modeled), or optimal randomness, *see* Slemrod & Yitzhaki, *Tax Administration*, at 1450-51 (discussing several models). No widely accepted models of interaction between nominal sanctions and their costs have emerged, forcing scholars to simply assume that nominal penalties are subject to an exogenous ceiling, *see id.*, at 1450. This is unfortunate because, as Louis Kaplow observed, "[t]he optimal fine will be a function of other instruments under study, and the entire character of the optimum with regard to other instruments (here, probability of detection) may differ when the fine is set optimally rather than stipulated." Kaplow, *Fines for Undesirable Acts*, at 9.

⁷³ This is a bit of an overstatement, *see, e.g.*, Wojciech Kopczuk, *Redistribution when Avoidance Behavior is Heterogeneous*, 81 *J. Pub. Econ.* 51 (2001) (discussing the circumstances when some evasion would be desirable).

literature⁷⁴ is absent from the economic models of tax evasion. Because any tax evasion is undesirable, it is impossible to have too little of it.⁷⁵

But why is tax evasion undesirable from the economic perspective? In other words, what is its external harm? The first answer that comes to mind—that the external harm of evasion is the amount of tax evaded—is mistaken. To see why, consider another critical difference between pollution and evasion. Pollution harms the environment and makes people sick, it reduces welfare of the society as a whole. The same is not true of evasion. If evasion succeeds, the evader benefits from extra wealth. If evasion is detected and the evader is forced to pay the tax, someone else benefits from the same funds. The effect of collecting (or failing to collect) the revenue in question is, therefore, redistributive.⁷⁶ On the other hand, government's efforts to combat evasion come with real costs that are borne by the government, the evaders, and even by the innocent taxpayers.⁷⁷ Thus, the two distinctions between evasion and pollution point in the opposite directions. Because evasion does not come attached to a valuable activity that we would like to encourage at some level, it seems that we should strive to eliminate it completely. But because evasion does not produce, it seems, any external harm, yet is costly to counter, it is unclear what is the efficiency-based reason to worry about tax evasion at all.⁷⁸

One answer to this question was suggested by Louis Kaplow. Tax evasion, he argued, upsets the distribution of tax burdens (and, more generally, wealth) in the society.⁷⁹ Assuming this distribution is optimal without evasion, deviating from it gives rise to an “equity effect.”⁸⁰ The value of the social welfare function (which necessarily contains distributive preferences) in the presence of evasion is lower than without it because, by definition, this function is maximized if no evasion takes place. The difference between the two values is the welfare cost of evasion.

The analysis doesn't end here, however. Taxpayers will respond to evasion opportunities by changing their behavior, for example by working less, saving more, or moving to industries where evading is easier (such as cash-based businesses). When the economy fully reflects these responses (i.e., reaches a long-run equilibrium), the equity effect will be replaced by the “efficiency effect.”⁸¹ In addition, as long as some taxpayers with evasion opportunities remain

⁷⁴ See, e.g., Craswell, *The Multiplier Principle*, at 2195 (discussing how case-by-case multipliers would counter a tendency to overdeter); Polinsky & Shavell, *supra* note 6, at 886 (pointing out that if damages are set too high under the negligence rule in presence of mistakes, parties will take excessive inefficient precautions).

⁷⁵ See Joel Slemrod & Shlomo Yitzhaki, *The Cost of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF Staff Papers 172, 182 (1996) (describing tax evasion models as implying that it is optimal to prevent all evasion and ignoring the social costs of tax administration).

⁷⁶ See Slemrod & Yitzhaki, *Tax Administration*, at 1451; Slemrod, *Corporate Selfishness*, at 894.

⁷⁷ See Kaplow, *Fines for Undesirable Acts*, at 9. These costs are discussed in detail below, *see infra*, text accompanying notes 287-294.

⁷⁸ As some of the scholars laboring in this field have observed, “[s]tandard welfare economics does not suggest that there is a terribly strong case for the suppression of tax evasion,” Cowell, *supra* note 10, at 199-200.

⁷⁹ See Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 Nat'l Tax J. 135, 135 (1996).

⁸⁰ *Id.*, at 139.

⁸¹ *Id.*, at 142.

honest while others evade, the honest taxpayers will be treated inequitably because their after-tax income would be lower than socially optimal. Thus, the welfare cost of evasion is likely to have both an equity and efficiency components.⁸²

If we posit that the welfare cost of evasion is its external harm, we can use the analysis developed by the general deterrence literature to optimize expected penalties for tax evasion. But this forces us to consider whether the problems with the multiplier principle identified by this literature are likely to exist in the tax context. Unfortunately, they are. More egregious evasion (for example, evading tax on entire income rather than only on its portion) would produce larger external harm and also is more likely to be noticed, prosecuted, and punished.⁸³ Likelihood of mistaken conviction (or exoneration) may also relate to the size of evasion. A fraudulent but small understatement of income is more likely to be attributed to a taxpayer's mistake than a large one.⁸⁴ Thus, the general deterrence analysis fully applies in the tax enforcement context and it suggests that only case-by-case multipliers would produce optimal tax deterrence.

Moreover, even the case-by-case multipliers are unlikely to help in optimizing tax enforcement as a practical matter. The task of calculating the external harm of evasion is daunting.⁸⁵ The calculation is based on the shape of the social welfare function—a notoriously controversial issue that involves fundamental questions of distributive justice. It is difficult and contentious enough to put values on a person's health or the harm to the environment. One can only imagine the outcry if the government attempts to determine expected penalties for tax noncompliance based on its calculations derived from a (any!) social welfare function. Besides, we have no choice but to value personal injury and environmental damages when the victims seek compensation in courts. Proponents of the economic analysis of deterrence may apply multipliers to these exogenously determined values, as they do, for example, when they rationalize punitive damages.⁸⁶ Scholars thinking about optimal tax enforcement do not have the same luxury—welfare cost of tax noncompliance continues to be only a theoretical concept.

The general deterrence literature suggest that if absolute perfection is out of reach, striving for optimal marginal deterrence would be an efficiency-enhancing strategy. In order to pursue it in tax context, we need to consider the various forms of evasion and avoidance. This analysis has been almost entirely absent from the tax compliance literature.⁸⁷ 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.

⁸² See *id.*, at 146.

⁸³ See Weisbach, *supra* note 1, at 245 (making a similar point).

⁸⁴ See, e.g., Steven Klepper & Daniel Nagin, *The Anatomy of Tax Evasion*, 5 J. Law. Econ. Org. 1, 4-5 (1989) (suggesting that taxpayers perceive that “the larger percentage noncompliance on a line item, the more difficult it will be to excuse the noncompliance as an honest error . . .”).

⁸⁵ Kaplow acknowledges this, but argues that “the only reasonable way to measure [the] equity costs is by reference to a social welfare function, embodying the distributive objectives from which the tax base and rate structure were derived.” *Id.* at 147.

⁸⁶ See, e.g., Polinsky & Shavell, *supra* note 6, at 869.

⁸⁷ The rare exceptions are Jorge Martinez-Vazquez & Mark Rider, *Multiple Modes of Tax Evasion: Theory and Evidence*, 58 Nat'l Tax J. 51 (2005); Klepper & Nagin, *supra* note 84.

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 clearly legal reduction of one's tax liability).⁸⁸ 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.⁸⁹ Economic literature acknowledges the existence of a gray area in the middle, but relegates it to almost an afterthought.⁹⁰

This delineation may be fruitful as a first approximation for developing and testing economic models, but 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.

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 "price" and available in an unlimited amount.⁹¹ These assumptions are largely justified as long as only evasion is considered. Because of the evasion's very nature, 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

⁸⁸ Although one may clearly violate tax law without ever intending to do so, i.e., by mistake, I will follow others in limiting the term tax evasion to intentional violations, *see, e.g.*, Lederman, *supra* note 31, at 1455; Cooper, *supra* note 64, at 35-36.

⁸⁹ *See, e.g.*, Slemrod & Yitzhaki, *Tax Administration*, at 1428. 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.* Yet, Congress believes that any arrangement created with a purpose of "avoidance or evasion of Federal income tax" should be penalized, *see* I.R.C. §§ 6662(d)(2)(C), 6662A(b)(2)(B), 6707A(c)(1). 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 & Lawrence A. Zelenak, *FEDERAL INCOME TAXATION OF INDIVIDUALS*, ¶ 1.03[2] (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.

⁹⁰ *See* Slemrod & Yitzhaki, *Tax Administration*, 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*, at 885.

⁹¹ *See id.*, at 888. The need for this analysis, however, has been clear for some time, *see, e.g.*, Slemrod & Yitzhaki, *supra* note 72, at 190 ("The optimization problem should be expanded to include many types of individuals, with different opportunities to evade and different tastes.")

numbers on the return (at least as long as income is not subject to an information reporting regime).⁹²

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 so omnipresent in the Internal Revenue Code. A choice among these subtraction items necessarily gives taxpayers more freedom to vary their avoidance strategies, and various strategies bring with them various costs. 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.⁹³ Or 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.

Overall, 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 of these variations mean that once a taxpayer decides to engage in tax avoidance, she would have a variety of strategies at her disposal. These strategies would have different, perhaps markedly different, “prices” (i.e., private costs), and they would be available in different amounts. 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 marginal analysis.⁹⁴ A similar inquiry applied in 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 whether or not to avoid may be decidedly secondary. The important decisions are *how* to avoid (i.e., which particular transactions 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 taxpayers’ choices of various evasion and, in particular, avoidance strategies. That is, no existing model aims at, let alone succeeds in, optimizing marginal deterrence.

What are the practical implications of this theoretical analysis? While tax evasion models are largely indeterminate, they consistently demonstrate that nominal penalties and

⁹² 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 84, at 11 (reporting widely diverging noncompliance rates for different categories of income and deductions). 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.

⁹³ *See, e.g.*, Gergen, *supra* note 14, at 281 (discussing “cloaking” expenditures); Shaviro, *supra* note 1, at 244 (noting that well-advised and reasonably liquid taxpayers may always inject enough capital into a tax avoidance transaction to produce “profit” sufficient to satisfy the economic substance requirement).

⁹⁴ 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 92.

probability of punishment play an important role in shaping taxpayers' behavior. Empirical studies confirm these conclusions, even if to a somewhat uncertain extent.⁹⁵ Finally, as discussed below, Congress and the IRS have varied both the nominal sanctions and the likelihood of their imposition in an effort to improve tax administration,⁹⁶ and there are plenty of statements by the representatives of both branches confirming that the attention to these factors has been by no means accidental.⁹⁷ In light of the theoretical support, empirical evidence, and the statutory and regulatory measures focused on the two components of Becker's formula, it is worth taking a closer look at whether the existing tax enforcement regime reflects the core insights of the economic theory.

In undertaking this inquiry, we should remember that optimal expected penalties for tax noncompliance are at best an abstract concept. Necessarily, the task of setting optimal nominal penalties remains for another day. Optimizing marginal deterrence is an attractive second-best objective, but the theoretical framework needed to reach it is largely absent. Thus, in analyzing the deterrence effects of the existing regime, and in considering the merits of any alternatives, the best we can do is to strive for a third-best solution of improving (rather than optimizing) marginal deterrence. Therefore, the following inquiry into the structure of the current statutory sanctions is modest in scope: it considers whether the current 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.

III. A Critical Flaw of the Existing Penalties Regime

1. Nominal Penalties: When They Change and When They Don't

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.⁹⁸ 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 significant offenses resulting in higher nominal penalties. For example, a failure to furnish information about a so-called reportable transaction is

⁹⁵ See *supra*, text accompanying notes 32-36.

⁹⁶ See *infra*, Part III.1-2.

⁹⁷ See, e.g., S. Rep. No. 97-494, at 272-73 (1982) (justifying a new penalty by the need to "deter the [taxpayers'] use of undisclosed questionable reporting positions" taken "in hope that they will not be audited."); H.R. Rep. 101-247, at * (1989) (referring to the need to "reduce the incentives of taxpayers and their advisors to 'play the audit lottery.'"); see also Graetz & Wilde, *supra* note 13, at 355 (suggesting that "[n]ot 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 . . .").

⁹⁸ Other types of penalties apply in specific circumstances, see, e.g., I.R.C. § 32(k) (earned income tax credit disallowed for 10 years following a fraudulent claiming of the credit); I.R.C. § 6707A (taxpayer must disclose a tax penalty in its financial reports).

penalized less severely (\$50,000 per violation) than a similar violation with respect to a so-called listed transaction (\$200,000 or more per violation) on the ground, one presumes, that a listed transaction is certain, while a reportable transaction is only likely, to be abusive.⁹⁹ Similarly, the longer the period when an adviser fails to produce a list of potential tax shelter participants, the higher is the nominal penalty for the failure.¹⁰⁰

Most civil penalties for avoidance or evasion are calculated as a fixed percentage of the understated or underpaid tax liability rather than as a fixed dollar amount. These penalties, too, usually depend on the gravity of the offense. Thus, a nominal penalty for civil fraud (75 percent) is higher than for negligence (20 percent).¹⁰¹ The same is true for underpayments caused by a “gross” valuation misstatement (40 percent) compared to a one that is merely “substantial” (20 percent).¹⁰² In each case, a relatively more egregious violation leads to a larger nominal penalty.

Many fines set as a fixed dollar amount increase with the absolute size of an offense, regardless of how egregious it is. For example, penalties for failure to file correct information returns grow with the number of non-compliant returns.¹⁰³ Penalties 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.¹⁰⁴ Thus on average, 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. Probability of punishment is a cumulative probability that an offense will be detected, 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, the judgments favoring the government will survive appeals, and, finally, the government will actually collect the penalty from a taxpayer. Probability of punishment is a product of individual probabilities for each of these steps.

For the remainder of this article I will focus on a single component of the probability of punishment—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, probability of detection is the smallest among the relevant probabilities and, therefore, has the largest absolute effect on

⁹⁹ See I.R.C. § 6707(b).

¹⁰⁰ See I.R.C. § 6708(a) (the penalty is \$10,000 per each day of violation); *see also* I.R.C. § 6693 (\$50 per day penalty for violating certain reporting requirements by issuers and trustees of simple retirement accounts).

¹⁰¹ See I.R.C. § 6662(a), (b)(1) (20% penalty for negligent understatements), I.R.C. § 6663(a) (75% penalty for fraudulent understatements).

¹⁰² Compare I.R.C. § 6662(h) (40% penalty for gross valuation misstatement) *with* I.R.C. § 6662(a), (b)(3) (20% penalty for substantial valuation misstatement).

¹⁰³ See, e.g., I.R.C. § 6721 (\$50 per failure, up to \$250,000); *see also* I.R.C. § 6722 (similar penalty for failure to file payee statements), I.R.C. § 6723 (similar penalty for failure to comply with other information reporting requirements), I.R.C. § 6693 (similar penalty for failure to provide reports on certain tax-favored accounts), I.R.C. § 6694 (a \$250 per return (or higher) penalty for return preparers who knew or should have known that the taxpayer took an unrealistic position).

¹⁰⁴ Twenty percent of a \$100,000 underpayment is necessarily ten times larger than the same fraction of a \$10,000 underpayment.

the overall probability of punishment.¹⁰⁵ Second, the penalty proposed in this article aims at strengthening deterrence by increasing probability of detection where it is currently particularly low.

The Internal Revenue Code's mechanism for varying nominal penalties depending on the differences in probability of detection is an inducement to disclose.¹⁰⁶ 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.¹⁰⁷ In the absence of disclosure, the taxpayer would be liable for penalties unless the disputed position met a higher "substantial authority" threshold.¹⁰⁸ Similarly, a new penalty for engaging in a reportable transaction is 20 percent if the transaction is disclosed and 30 percent if it is not.¹⁰⁹

Variation of nominal penalties for disclosed and undisclosed transactions is relatively modest. On the other hand, 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 primarily is playing the audit lottery and facing exceedingly favorable odds.¹¹⁰ Therefore, most taxpayers are likely to choose not to disclose and face a low risk of paying 120 percent or so of a given tax liability plus interest rather than disclose and take a much higher risk of paying 100 percent of the same liability.¹¹¹ Furthermore,

¹⁰⁵ As discussed below, the rate at which the IRS imposes penalties is also exceedingly low, *see infra*, note 246.

¹⁰⁶ The recent legislation and Treasury regulations discussed below, *see infra*, text accompanying notes 123-125, 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.

¹⁰⁷ *See* I.R.C. § 6662(d)(2)(B).

¹⁰⁸ *See id.*

¹⁰⁹ *See* I.R.C. § 6662A(c). If a taxpayer uses the services of a "material advisor," the advisor is required to disclose the transaction to the IRS, *see* I.R.C. § 6111, and to provide the government with the taxpayer's name upon request, *see* I.R.C. § 6112. However, an advisor would not be 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* I.R.C. § 6111(b)(1)(B), (c).

¹¹⁰ Over the past several decades average audit rates declined precipitously, reaching an all-time low of 0.49 percent in 2000, *see* Allen Kenney, *Everson Touts Increased IRS Enforcement in Fiscal 2004*, 105 Tax Notes 1071, 1071 (2004). The rate of in-person (rather than correspondence) audits was 0.16% in 2002 and 0.15% in 2004, *see id.* To be sure, audits are targeted and for some categories rates are much higher than on 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 individual and corporate taxpayers between 1996 and 2004, with a slight rebound for some categories during 2001-2004).

¹¹¹ 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: "if 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*

because the probability of having to pay tax if a transaction is revealed is higher for more aggressive transactions while the likelihood that a transaction would be eventually detected is not necessarily dependent of 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 less 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, probability of detection. This would not be particularly troubling if probability of detection remained fairly constant from one strategy to the next. However, there is every reason to think that it differs widely among different taxpayers and strategies, producing variations in expected penalties that are not only significant, but also unintended and undesirable from the marginal deterrence perspective.

2. Deliberate Variations in Probability of Detection

In tax enforcement context, 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 of 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,¹¹² the IRS developed formulas for selecting returns that are more likely to contain questionable items.¹¹³ Furthermore, the IRS has been traditionally focused on the magnitude of potential audit adjustments.¹¹⁴ As a result, audit rates are higher for corporations than for individuals, and for larger corporations compared to the smaller ones.¹¹⁵ Similarly, returns of higher income individuals are examined more frequently than of those with

Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach, 55 Tax L. Rev. 325, 363 (2002).

¹¹² See Robert E. Brown & Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 Kan. L. Rev. 1255, 1261 (2002) (giving a detailed description of the program); Slemrod & Yitzhaki, *Tax Administration*, at 1439.

¹¹³ See, e.g., Brown & Mazur, *supra* note 112, at 1262. As a result of this program, the percentage of examinations resulting in no adjustments dropped from 50 percent to 20 percent at one point, *see id.* However, this percentage has been on the rise because the government’s data became outdated, *see id.*, at 1263. A new program has been put in place in 2001 and the data has just started to arrive, *see* Kenney, *supra* note 12, at 7.

¹¹⁴ See, e.g., Brown & Mazur, *supra* note 112, at 1267 n.35; Jeffrey A. Dubin, Michael J. Graetz & Louis L. Wilde, *The Changing Face of Tax Enforcement*, 43 Tax Law. 893, 903 (1989) (noting that “the audit process is designed to select first returns with the highest potential yield”).

¹¹⁵ See Kenney, *supra* note 110, at 1071.

lower incomes,¹¹⁶ taxpayers with business or farm income face higher chances of an audit than those without it,¹¹⁷ and the unfortunate souls whose returns trigger the audit selection formulas are examined 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 in the neighborhood of one half of one percent.

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 audit effectiveness, 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 can't 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.¹¹⁸ 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.¹¹⁹ This likely means that the rate of detection during typical audits is below (perhaps well below) 50 percent.

Nonetheless, it is quite clear that audit effectiveness (and 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-1.¹²⁰ The government recognized that the two accounting systems create the 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

¹¹⁶ See *id.* 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* (on file with the author) (discussing high audit rates for earned income tax credit recipients).

¹¹⁷ See, Slemrod, *Small Business*, at 92.

¹¹⁸ See, *e.g.*, 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* 291, 292 (concluding that “[d]espite safeguarding respondents’ anonymity . . . , the results showed that documented and self-reported tax evasion did not correspond at all.”).

¹¹⁹ See Beron et al., *supra* note 19, at 73 n.9 (positing a 33% success rate for income subject to reporting on forms 1099); Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations*, in *WHY PEOPLE PAY TAXES* 125, 138 (referring to the IRS estimates that it detects one third of unreported income by individuals and one half of unreported income by corporations); Andreoni et al., *supra* note 28, at 850 (suggesting a 50% success rate).

¹²⁰ 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 40 years). This schedule has recently undergone a major revision, as discussed below, *see infra* text accompanying notes 161-163.

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.¹²¹ A special disclosure requirement forcing taxpayers to separately report all book-tax differences raises probability of detection in an area that, on average, is more likely to encompass noncompliance.¹²²

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 (the so-called "reportable transactions").¹²³ In addition to significant book-tax differences, transactions that result in large losses, involve brief asset holding periods, 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 (the so-called "listed transactions").¹²⁴ The American Jobs Creation Act of 2004 (the "2004 Act") expanded the Regulations' reach even further, and backed them up with new penalties, including a dramatic and heretofore unheard of penalty for tax advisors equal to \$10,000 per each day of a violation.¹²⁵

¹²¹ For a detailed discussion of one such security, see David Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 Tax L. Rev. 499, 517-519 (1994) (describing the MIPS transaction).

¹²² See, e.g., Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775, 1780-81 (1999) (arguing that a modern corporate tax shelter must produce a book-tax difference because executives are unwilling to reduce the corporation's taxes at a cost of diminishing book earnings).

¹²³ See T.D. 9046, 68 Fed. Reg. 10,161 (March 3, 2003) (withdrawing several sets of proposed regulations and promulgating final regulations under Sections 6011, 6111, and 6112). Taxpayers must disclose these transactions separately from their tax returns and, in addition, file the disclosure forms with the Office of Tax Shelter Analysis, see Treas. Reg. § 1.6011-4(a), (e).

¹²⁴ See Treas. Reg. § 1.6011-4(a), (b)(2). Technically, listed transactions are just one type of reportable transactions. 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.

¹²⁵ Under the Act, a failure to disclose a listed transaction or a reportable transaction (as they are defined in the Regulations) with a significant tax avoidance purpose is subject to penalties regardless of whether the transaction is eventually litigated and upheld by a court, see I.R.C. § 6707A. Taxpayers who incurred penalties under these rules must disclose this fact on statements filed with the SEC, if any, see I.R.C. § 6707A(e). A broad range of organizers, promoters, legal advisors, and accountants (the so-called "material advisors") involved in any reportable transaction above a given size must disclose their participation and are subject to serious penalties for failure to comply, see I.R.C. § 6111, 6707. In addition, material advisors are required to keep the lists of their clients who participated in any reportable transaction regardless of its size, see I.R.C. § 6112, and provide any such lists upon the government's request or face a draconian penalty of \$10,000 per day, see I.R.C. § 6708. Finally, the Act added a new penalty for any understatement related to a listed or reportable transaction with a tax avoidance purpose that applies even if participation in this transaction made no difference for the taxpayer's overall tax bill (because, for example, the taxpayer owed no tax for the year in any case), see I.R.C. § 6662A. No doubt, these measures have dramatically increased probability of detection for any transaction subject to the Regulations.

Just like the Schedule M-1, 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 arrangements. Because the probability of finding avoidance is higher if an auditor focuses on these transactions, she should be expected to do just that.¹²⁶

Finally, audit effectiveness is very high when taxpayers themselves highlight their questionable positions for the government. They do so, sometimes, in response to one of several government's programs designed to cajole (rather than force) taxpayers to reveal these positions either before or after they file their returns. Programs in the former category provide certainty in exchange for self-identification.¹²⁷ Post-filing programs such as amnesty and settlement offers entice taxpayers to confess about their tax avoidance in exchange for a reduction in (or elimination of) penalties.¹²⁸ The government has recently used both types of offers and has expressed satisfaction with the results.¹²⁹

Taxpayers who take advantage of any of these programs dramatically change probability of detection for any given strategy. But one would hardly expect them to do so irrationally or accidentally. In case of pre-filing programs, taxpayers who identify themselves most likely believe that nominal penalties would not apply in any case. Settlements and amnesties have little effect on taxpayers' ex ante calculations at the time they decide to undertake avoidance strategies.¹³⁰ In sum, the voluntary disclosure programs are unlikely to change expected penalties to a significant extent.

In contrast, variations in probability of detection due to differing audit rates and mandatory disclosure regimes surely produce divergent expected penalties for various types of taxpayers and transactions. A large company under a continuous audit has a chance that an aggressive transaction reflected on Schedule M-1 would go unnoticed, but the odds are against the taxpayer.¹³¹ The expected penalty is relatively close to its nominal value in this case. On the

¹²⁶ 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 higher percentage of taxpayers who disclose participation in reportable transactions compared to otherwise identical taxpayers who make no such disclosure.

¹²⁷ These programs allow taxpayers to request that the IRS consider (and, hopefully, approve) transactions and arrangements that taxpayer suspects may lead to disagreements on audit. Private letter rulings, advance pricing agreements, and pre-filing agreements are examples of these programs, *see, e.g.*, Michael I. Saltzman, IRS PRACTICE AND PROCEDURE ¶3.03[6] (describing the private letter ruling program), ¶8.15[6][d] (describing the pre-filing agreement program); 13 MERTENS LAW OF FEDERAL INCOME TAXATION § 49A:09 (2004) (describing the advanced pricing agreement program).

¹²⁸ *See, e.g.*, Ann. 2002-2, 2002-1 C.B. 304 (announcing an amnesty); Ann. 2004-46, 2004-21 I.R.B. 964 (making a settlement offer).

¹²⁹ *See, e.g.*, Sheryl Stratton, Kenneth A. Gary, *IRS Riding High on Shelter Enforcement Initiatives*, 105 Tax Notes 497, 498-99 (2004).

¹³⁰ They may have a limited effect to the extent that taxpayers anticipate a future settlement or amnesty when they access nominal penalties.

¹³¹ Even in this case, however, 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) (observing that "finding a shelter in a Schedule M for a Fortune 100 company is not easy work.").

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 deliberate. In fact, the very reason why the largest companies undergo a continuous audit and why taxpayers are required to disclose reportable and listed transactions is that the government is particularly concerned about noncompliance of these taxpayers and by use of these transactions. In case of reportable transactions the deterrence objective is especially clear. The government believes that many transactions covered by the Regulations are aggressive, so the higher expected penalties for these arrangements are designed to deter taxpayers from using them, or, in other words, to induce taxpayers to enter into transactions *not* subject to the Regulations.¹³²

Whether the government's is likely to succeed is less than clear,¹³³ but one can hardly doubt that the measures discussed in this section reflect the government's deliberate efforts to vary expected penalties by altering probability of detection (and, in some cases, nominal penalties as well). The same cannot be said about the disparities discussed next.

3. The Red Flags Strategy and Its (Unintended) Consequences

Mandatory disclosure rules such as Schedule M-1 and the Regulations are just one reason why 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 tax 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.¹³⁴ Understanding what these red flags are and how they help auditors in detecting tax avoidance is crucial for recognizing the serious deficiency of the current tax enforcement regime.

Let's start with a few examples. During the late 1970s IRS auditors noticed something strange on 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 lifestyle or typical investment strategies.¹³⁵ Sure enough, with some investigative work the government discovered what came to be known as the tax shelter crisis of the 1970s.

¹³² Unfortunately for the government, the Regulations will give taxpayers the incentive not to forego tax avoidance altogether, but to eschew tax avoidance of a specific kind: that subject to the Regulations, *see infra*, text accompanying notes 303-307. In contrast, whatever is the reasons for a 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 about taxpayers' responses too much. Corporations will not downsize and rich taxpayers will not waste their assets just to reduce their audit risks.

¹³³ *See infra*, notes 300-307 and accompanying text.

¹³⁴ *See, e.g.*, Long-Term Capital Hold. v. United States, 330 F. Supp. 2d 122, 212 (D. Conn. 2004) (referring to taxpayers' strategy as a "transparent attempt to conceal Long Term's efforts to keep the huge tax losses claimed from raising a red audit flag").

¹³⁵ For a colorful account, see Michael J. Graetz, THE DECLINE (AND FALL?) OF THE INCOME TAX 41-49 (1997).

Fast forward twenty years. IRS personnel examining returns of various U.S. companies could not understand why more and more of them went into the leasing business (or so it seemed).¹³⁶ 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 a transportation or a sewage system of a quaint town somewhere in Europe 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 wide-spread tax avoidance schemes of the recent past. In fact, this arrangement has become so popular that the legislative provision eliminating any doubt (if there ever was one) that this scheme fails to deliver the intended tax benefits is expected to raise more than \$25 billion over the next 10 years according to the Congressional budget estimates.¹³⁷ As with chinchilla breeding, these so-called lease-in, lease-out deals were spotted because they resulted in 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 a prominent hedge fund entered into a transaction of questionable legality that promised to reduce their taxable income by about \$100 million.¹³⁸ However, they understood 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 didn't work. When the court considered whether to allow the loss it was particularly annoyed by the taxpayers' "efforts to keep the huge tax losses claimed from raising a red audit flag."¹³⁹ In fact, taxpayers' evasiveness may have contributed to the court's decision to impose penalties.¹⁴⁰

One need not be a super-wealthy hedge fund manager to be aware of the red flags technique. When a group of taxpayers participating in a study 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

¹³⁶ See *Frontline: Tax Me If You Can*, transcript available at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/etc/script.html>.

¹³⁷ See, e.g., Allen Kenney, *SIL0 Shutdown: How the New Law Could Cripple the Industry*, 105 Tax Notes 638, 638 (2004).

¹³⁸ See *Long-Term Capital Hold. v. United States*, 330 F. Supp. 2d 122, 139 (D. Conn. 2004); see also Alvin C. Warren Jr., *Understanding Long Term Capital*, 106 Tax Notes 681, 686 (2005) (summarizing the transaction).

¹³⁹ *Long-Term Capital*, 330 F. Supp. at 212.

¹⁴⁰ See *id.*, at 211 (the court concluded that the 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.").

certain categories like charitable contributions, it isn't good to vary too greatly from year to year.¹⁴¹

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.¹⁴² 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. It appears highly probable that looking for red flags is one such strategy.¹⁴³ 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 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 a 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.¹⁴⁴

¹⁴¹ John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, in WHY PEOPLE PAY TAXES 43, 58. Researches have also discovered that taxpayers perceive detection to be more likely if "tax was evaded on a large proportion of an item." Hessing, *supra* note 118, at 292.

¹⁴² This is hardly a surprising revelation. Researches discussing TCMP audits repeatedly contrast their thoroughness with a 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 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 119, at 131 (noting that 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.").

¹⁴³ Financial accountants, whose job comes closest to tax auditing, are laboring under similar constraints and respond with a strategy similar to the red flags approach:

We know that auditors can't possibly look at everything Thus, practitioners must pick and choose where to spend their time. They must figure out how to generate the most "bang for the buck" from their audit efforts. Naturally, it's logical to focus on areas that contain the most risk—and that's exactly the intent of a risk-based audit.

Thomas P. Houck, WHY AND HOW AUDITS MUST CHANGE, at 16 (2003).

¹⁴⁴ I do not suggest that 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 position on her tax return that is contrary to a Treasury regulation or an IRS revenue ruling raises a red flag for the government and makes an audit likely, *see, e.g.*, George R. Goodman, *Tax Return Compliance*,

Decisions regarding whether an item is “significant,” whether it is sufficiently “related” to the taxpayer’s business, 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.¹⁴⁵ Audit strategies such as the audit selection formulas are among the IRS’s most closely guarded secrets.¹⁴⁶ The government has been extremely reluctant to release individual return data collected through TCMP out of concern that researchers would use it to reverse-engineer audit patterns.¹⁴⁷ In a rather odd example, the IRS provided a small group of scholars with a detailed data on corporate noncompliance only to withdraw the access shortly thereafter.¹⁴⁸ 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 examples just described, as well as other precedents, demonstrate.¹⁴⁹ Scholars have asserted, in one form or the other, that a 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 on the return.¹⁵⁰ Economists

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 very specific “red flag issue[s]” on one particular return see William D. Samson, *President Nixon’s Troublesome Tax Returns*, 107 Tax Notes 635 (2005). In fact, the disclosure triggers that went into 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.

¹⁴⁵ More typically, the suggestion is informal, *see, e.g.*, Paul Streckfus, *New Analysis: Unmasking Corporate Sponsorship*, 53 Tax Notes 1346 (1991) (reporting that the “Service has indicated informally that [elaborate] contracts [between corporate donors and tax exempt organizations documenting alleged gifts] are a red flag.”).

¹⁴⁶ *See, e.g.*, Dubin et al., *supra* note 114, at 900 (observing that the so-called “discriminant function analysis (DIF)” process of selecting returns for audits “is one of the best kept secrets in government”); Andreoni et al., *supra* note 28, at 820 (noting that the audit selection formula is “strictly guarded”).

¹⁴⁷ *See, e.g.*, Klepper & Nagin, *supra* note 84, at 2 (explaining that “outside 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.”).

¹⁴⁸ *See Rice, supra* note 119, at 126, 131-132 (reporting that he was able to perform the first ever analysis (made outside of the IRS) of the corporate noncompliance data after the IRS “graciously made available” the data during a part of 1988, although soon thereafter “out of concern for the security of the DIF formulas, [the government] again curtailed much of this access.”).

¹⁴⁹ *See, e.g.*, *United States v. Neill*, 964 F. Supp. 438, 452 n.18 (D.C. Cir. 1997) (referring to accountant’s fears that transfers to an offshore account would raise a “red flag” for the IRS); *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 Pharmaceutical*, 838 F.2d 1389, 1393 (5th Cir. 1988) (finding that a W-2 form that was erroneously filed on behalf of the 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”).

¹⁵⁰ 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

model tax evasion based on an “intuitively appealing idea that, *ceteris paribus*, both the absolute amount and the proportion of income concealed may matter” in detecting noncompliance.¹⁵¹ Some models expressly postulate that a relative size of noncompliance (i.e., the amount of incorrectly reported item compared to its true amount) affects the likelihood that a particular line on the return would be examined.¹⁵² Researches note that the auditors look for unusual, “suspicious looking” items¹⁵³ that appear to be “outliers.”¹⁵⁴ Even The New York Times informs its readers that auditors typically search for “red flags, like spikes in income.”¹⁵⁵ There is a small but promising empirical literature showing that taxpayers manage the risk of detection by choosing which line items to misreport.¹⁵⁶ Helping taxpayers to avoid red flags is part of what some tax advisors believe to be “the highest ethical standards.”¹⁵⁷ Red flags even became part the tax folklore.¹⁵⁸

A recent development further boosts the hypothesis. Because auditors decide where to focus their efforts based on items rather than transactions, the level of tax return’s specificity is critically important to the success of the red flags strategy. At an extreme, if a tax return

income in that country, *see* Slemrod, *Corporate Selfishness*, 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, the inverse relationship applies,” *see* Joel Slemrod, *A General Model of the Behavioral Response to Taxation*, 8 Int. 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). 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.

¹⁵¹ *See* Helmuth Cremer & Firouz Gahvari, *Tax Evasion, Concealment and the Optimal Linear Income Tax*, 96 Scand. J. Econ. 219, 222 (1994).

¹⁵² *See* Klepper & Nagin, *supra* note 84, at 4, 16 (positing that when the relative noncompliance is large, “the signs of noncompliance will be more obvious,” and finding from data on taxpayer noncompliance that “percentage noncompliance is inversely related to the true amount per return on a line item . . .”).

¹⁵³ *See* Erard, *supra* note 142, at 103 (remarking that the IRS pays particular attention to “suspicious-looking deductions”).

¹⁵⁴ *See* Beron, *supra* note 19, at 87 (noting that “in screening returns for potential examination, the IRS is “primarily selecting returns that are outliers in terms of reporting behavior.”).

¹⁵⁵ Robert D. Hershey Jr., *A Smarter I.R.S. Learns Your Business*, N.Y. Times, May 14, 1994, at C3 (informing the readers that the IRS is moving to more sophisticated audit techniques).

¹⁵⁶ *See, e.g.*, Martinez-Vazquez & Rider, *supra* note 87, at 52 (offering a theoretical model and econometric analysis supporting this hypothesis); Klepper & Nagin, *supra* note 84, at 2 (suggesting analysis of the government data “at the level of the line item, which is where noncompliance decisions are actually made.”).

¹⁵⁷ Frederic G. Corneel, *Guidelines to Tax Practice Second*, 43 Tax Law. 297, 299, 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.”).

¹⁵⁸ *See* David M. Richardson, *Audit Avoidance via Intent Modification—Is Fred Corneel Onto Something . . . Or Not?*, 92 Tax Notes 277, 279 (2001) (describing a plan to avoid raising a red flag in a fictional dialogue).

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. While increasing the number of items subject to separate reporting forces auditors to process more information, the benefits of the additional disclosure are likely to outweigh the costs because an auditor would not study each additional item with equal care. Rather, she would check for red flags and focus only on those items that raise suspicions.¹⁵⁹

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.¹⁶⁰ The new Schedule M-3 asks the same basic question: what are the differences in taxpayer's tax and financial accounting? However, the level of specificity with which taxpayers must answer the question has risen substantially. Whereas the old Schedule M-1 had identified only eight book-tax differences, the new Schedule M-3 highlights sixty seven!¹⁶¹ This is a great improvement for auditors relying on the red flags approach. As importantly, government's justifications for the new schedule are entirely consistent with this hypothesis. Additional disclosure, the officials have explained, is expected to help the government to "increase transparency"¹⁶² and identify "aggressive transactions."¹⁶³ It will become an "examination tool"¹⁶⁴ that would enable the IRS to "set priorities for use of its resources"¹⁶⁵ by "distinguish[ing] between high-risk and low-risk returns."¹⁶⁶ Moreover, in a somewhat unusual display of openness, a high-ranking Treasury official made no secret of the fact that the government plans to use Schedule M-3 as an audit selection tool.¹⁶⁷ In fact, the government is so convinced that a more detailed disclosure would improve its ability to detect noncompliance that it is planning to revise other forms along the

¹⁵⁹ Taxpayers' costs of disaggregating various items should not be high as long as the more detailed disclosure covers sub-items that would have to be computed in any case on the way to calculating the aggregate numbers.

¹⁶⁰ Scholars recognized that it is difficult to find avoidance even among transactions listed on Schedule M-1 because each line represented a net amount of many unrelated items, *see* Bankman, *supra* note 131, at 15. The government officials explained that the old Schedule M-1 "allowed the IRS to see only large numbers with no details on book-tax difference." Gary, *supra* note 120, at 633.

¹⁶¹ *See* 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 over seventy, *see* Gary, *supra* note 120, at 633.

¹⁶² IRS News Rel. 2004-91 (July 7, 2004) (announcing the issuance of the final version of Schedule M-3).

¹⁶³ *Id.*

¹⁶⁴ Sheryl Stratton, *IRS Addresses Schedule M-3 Questions Through Web Page*, 106 Tax Notes 764, 765 (2005).

¹⁶⁵ *Id.*

¹⁶⁶ Allen Kenney & Wesley Elmore, *Corporate Audit Rate on Track; OIC to Get Help, Say IRS Reps*, 105 Tax Notes 783, 783 (2004). Faced with the new form, "[t]ax directors are wondering what the schedule will highlight for the IRS and how to minimize the risk of examination," Stratton, *supra* note 164.

¹⁶⁷ According to Acting Assistant Secretary of the Treasury for Tax Policy, "Schedule M-3 provides information that will identify taxpayers that may have engaged in aggressive transactions and therefore should be audited." IRS News Rel. 2004-91 (July 7, 2004).

same lines.¹⁶⁸ These plans are entirely consistent with the assumption that the IRS relies on red flags during audits.

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,¹⁶⁹ 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.”¹⁷⁰ 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.”¹⁷¹ In light of this evidence, the only reason to stop short of declaring that the red flags approach is one of the government’s main (if not the main) audit strategies is that, in addition to focusing on LUQ items, auditors are instructed to follow multiple *other* directives as well.

In sum, red flags carry a double-duty in increasing 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 compared to other items on the return. 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, probabilities of detection vary based on audit selection strategies. Second, for those returns that are selected for examination, likelihood of detection is higher if a transaction falls within a category that requires mandatory disclosure or if it is unusual and raises a red flag. In contrast, while nominal penalties depend on the size and aggressiveness of an avoidance scheme, they vary fairly little among different tax planning techniques. 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 selection formulas reflect the government’s efforts to increase deterrence in a particularly problematic area or, perhaps, to raise most revenue given the limited funds available for enforcement. Not surprisingly, the government does not attempt to

¹⁶⁸ *See id.*

¹⁶⁹ *See* Michael I. Saltzman, IRS PRACTICE AND PROCEDURE ¶ 3.01.

¹⁷⁰ Int. Rev. Man. ¶ 4.10.2.3.

¹⁷¹ *See id.*, ¶ 4.10.2.3.1. (listing comparative and absolute size of the item as well as its character among the LUQ attributes, explaining that “airplane expenses claimed on a plumber’s Schedule C” would be an obvious 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; *see id.* at 80 (instructing that “questions should be raised when a pharmaceutical company invests in the sale and leaseback of municipal subway system.”). More generally, agents are urged to pay particular attention to “unusual titles or unusual amounts,” *id.* at 62. The 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.”

conceal the existence of these differences. To the contrary, the IRS makes the information public being fully aware that taxpayers would take it into account.

In contrast, variations in 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, the government recognizes the problem and, therefore, is unwilling to publicize the use of this strategy. This secrecy changes little. The decisions by the hedge fund managers and the taxpayer in the survey described above 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 a common knowledge, the proverbial cat is probably out of the bag.¹⁷²

The economic theory of deterrence suggests that taxpayers would structure their avoidance transactions to produce the lowest expected penalties.¹⁷³ Among other things, this means that taxpayers are likely to expend considerable efforts in order to avoid raising red flags. If so, what was identified earlier as a potential weakness in the existing penalties structure is in fact a critical flaw. Because most taxpayers are likely to face the lowest expected penalties, the overall deterrence is only as strong as these penalties provide. Thus, it matters little that for some tax avoidance transactions expected penalties are fairly high because taxpayers would tend to forego these transactions. Rather, it is critically important that for other avoidance strategies expected penalties are exceedingly low because these are likely to be the strategies used by most taxpayers.¹⁷⁴

¹⁷² See cases cited *supra*, notes 134, 149; Christine Harris, *IRS Officials Address Financial Products and Recent Guidance*, 107 Tax Notes 1100, 1101 (describing a statement by an 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 (2003) (observing that “the IRS Small Business/Self-Employed Division has gained a reputation for ignoring red flags [(such as large losses)] on rich people’s returns.”).

¹⁷³ 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 280. As discussed above, existing nominal penalties vary little, and the variations are rather modest. In a vast majority of 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 connection between the costs of an avoidance scheme and the ease of the scheme’s detection. Perhaps in some cases it may be easier for taxpayers to overstate deductions or credits of a type they already have, but it does not appear that the difference in costs is likely to be so large as to offset a dramatic difference 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 84, at 22 (“Ex ante, taxpayers appear to allocate their noncompliance across line items to minimize expected penalties.”).

¹⁷⁴ This is a familiar idea in tax scholarship. No matter how many tax shelters would the government shut down, the extent of tax avoidance would hardly change as long as there are a few tax shelters remaining 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); David Weisbach, *Formalism in the Tax Law*, 66 U. Chi. L.R. 860, 869 (1999).

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 more taxpayers 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.¹⁷⁵ In plain English, they would try to hide their aggressive transactions. Inevitably, even if unintentionally, the current enforcement regime ensures that 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 suggest that reducing variation in expected penalties for transactions that we would like to deter equally would reduce the existing inefficient incentives and improve overall deterrence.

IV. Eliminating the Flaw, Improving Deterrence

1. 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 transactions that do not raise red flags) by increasing audit rates across the board. Yet, this would hardly solve the problem because even though an overall likelihood of detecting noncompliance would increase, the taxpayers' 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. Raising generally-applicable nominal penalties (such as those for negligence or disregard of rules and regulations) would be similarly ineffective.

Increasing probability of detection by raising audit effectiveness holds more promise. This strategy could go a long way toward resolving the problem because, ideally, it would make the red flags technique unnecessary. If IRS agents have time and expertise to examine each return item as carefully as needed, they would not need shortcuts such as the red flags strategy. Unfortunately, dramatic improvements in audit effectiveness are unlikely. 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.¹⁷⁶ It has been recently renewed, and the IRS has promptly come under attack from

¹⁷⁵ The assumption that two potential schemes have the same size and aggressiveness is made for simplicity only. If scheme A is, say, twice as aggressive or twice as large as scheme B, 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.

¹⁷⁶ The horror stories about "audits from hell" played a significant part in the demise of the TCMP, *see, e.g.,* Amy Hamilton, *The Tax Gap Game and Inklings of a Focus on Noncompliance*, 79 Tax Notes 933, 935 (1998) (referring to "incessant congressional criticism frequently describing TCMP as 'audits from hell'" as playing a role in discontinuance of the program).

Congressmen eager to protect their constituencies.¹⁷⁷ The IRS's attempt to collect detailed taxpayer information in order to improve the administration of the earned income tax credit program has resulted in a law suit against the agency and plenty of scathing rhetoric from Capitol Hill.¹⁷⁸ By any measure, political costs of raising audit effectiveness will not be small. Administrative costs of a meaningful increase may be even higher. Hiring and training more examiners and extending audits will come at a steep price. In fact, current audit costs are so significant and the budgetary constraints are so great that one of the IRS's latest objectives is to *reduce* the time spent on each audit.

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

2. New, *But Not Necessarily Improved*

Ideally, we would like to counter taxpayers' attempts to hide avoidance by raising nominal penalties for those transactions that are harder to detect. Why not do this directly? Thus, if the IRS detects a dubious transaction during an audit and prevails in court, it could levy a penalty whose amount would depend on how difficult it was for the government to find this transaction in the first place. For example, if one strategy was twice as hard to catch as an average avoidance scheme, the penalty would be 200 percent of that imposed under the current rules. This approach would amount to the use of case-by-case multipliers analyzed in detail in the general deterrence literature.¹⁷⁹ Once taxpayers become aware of this regime, they would realize that it doesn't pay to conceal their tax avoidance.

Unfortunately, the difficulties and dangers of this proposal are both numerous and significant. To begin with, the penalty may be so high in a given case that a court would characterize it as a criminal rather than civil sanction.¹⁸⁰ If it does, the penalty may be unconstitutional under the Ex Post Facto clause. Furthermore, retroactive penalties raise Due Process concerns. Courts have been quite deferential when Congress applied higher penalties to

¹⁷⁷ See, e.g., Heidi Glenn, *IRS Enforcement Study Targets Small Business, Manzullo Says*, 107 Tax Notes 538, 538 (2005) (reporting complaints by the House Small Business Committee Chair Donald A. Manzullo that the National Research Program (the TCMP reincarnation) unfairly targets small businesses).

¹⁷⁸ See, e.g., Allen Kenney, *Hartford to IRS: See You in Court*, 105 Tax Notes 1305 (2004).

¹⁷⁹ See *supra*, text accompanying notes 51-54.

¹⁸⁰ Admittedly, a civil penalty would have to be rather extreme to be treated as criminal, see *Hudson v. United States*, 522 U.S. 93, 95, 99-102 (1997) (disavowing a less demanding test for treating civil fines as criminal penalties for double-jeopardy purposes established in *United States v. Halper*, 490 U.S. 435 (1989), reinstating a more demanding multi-factor inquiry). Courts have refused to recast tax penalties as "criminal" or "penal," see, e.g., *Karpa v. Comm'r*, 909 F.2d 784, 788 (4th Cir. 1990) (concluding that a retroactively applied 25% penalty for substantial understatement of tax is a civil rather than criminal sanction and, thus, does not violate the Ex Post Facto clause of the U.S. Constitution, despite relying on *Halper* for its analysis).

transactions that took place before these penalties were enacted.¹⁸¹ However, the opinions dealt with fairly unusual transitional situations reflecting changes from one fixed penalty regime to another.¹⁸² One should hardly presume that judges would be equally willing to endorse a system where most of the penalties are set within a complete discretion of the enforcement agency as a matter of course. Finally, a broad use of ex post penalties would fly in the face of a long standing legislative practice against retroactive application of new tax laws, even when these laws are aimed at shutting down abusive tax shelters.¹⁸³

Doctrinal and historic considerations do not nearly exhaust the list of concerns raised by the proposal. 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 government 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 kind of precision how much higher a penalty in a given case should be compared to the base line case. How would an auditor decide (and the court evaluate) whether it was three times 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 percent of the current sanction. It is also unclear how the base line strategy for which no extra penalties are levied should be set. Should it depend on the type of a taxpayer and the skill level of an auditor?¹⁸⁴ 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.¹⁸⁵ Additional costs for the taxpayers and the government would be enormous. Finally,

¹⁸¹ See, e.g., *Licari v. Comm'r*, 946 F.2d 690, 694-95 (9th Cir. 1991) (holding that retroactive tax penalties must be upheld as long as they are "supported by a legitimate legislative purpose furthered by rational means" and that the purposes behind retroactive tax penalties are "to guard the public fisc by reimbursing the government for heavy burden of investigative and prosecutorial costs incident to ferreting out tax underpayment" and to "benefit[] the public revenue."). In addition to the Due Process challenges, taxpayers made even less successful Equal Protection arguments, see, e.g., *id.* at 693 (addressing both the Equal Protection and Due Process arguments and noting that the latter presents a "thornier issue").

¹⁸² Courts repeatedly assert that retroactive application of tax law is unobjectionable as long as the period of retroactivity is short, see, e.g., *United States v. Carlton*, 512 U.S. 26, 32-33 (1994) (a period of "only slightly greater than one year"); *Licari*, 946 F.2d at 695 (noting that a 4-year period of retroactivity "raises some cause of concern," but upholding the statute nonetheless).

¹⁸³ See *Bankman*, *supra* note 122, at 1781-82; 1788; *Gergen*, *supra* note 14, at 256. In fact, Congress restricted the Treasury's ability to issue retroactive regulations when it amended section 7805 in 1996, see I.R.C. 7805(b)(3) (the Secretary of the Treasury may issue retroactive regulations only to prevent abuse).

¹⁸⁴ Research based on TCMP audits suggests that there is a substantial variation in detection rates across IRS examiners, see *Andreoni et al.*, *supra* note 33, at 850. Another question would be whether the penalty should be reduced for naïve taxpayers whose tax avoidance was more obvious than average.

¹⁸⁵ Today, taxpayers vigorously argue against imposition of penalties equal to a small portion of the tax liability, see, e.g., *Susan Simmonds, Penalties on Appeal in LTCM Shelter Litigation*, 106 Tax Notes 925, 925 (2005) (describing taxpayer's appeal of \$16 million in penalties, but not of the underlying \$106 million tax liability). One can easily imagine the response if a penalty exceeds 100 percent of the tax liability, or

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”¹⁸⁶ provide a strong incentive to search for less uncertain measures.

These problems are hardly surprising. The suggested approach would give so much discretion to the tax enforcement agency that on a rules-standards continuum it would go off the chart, nearing “untrammelled discretion.”¹⁸⁷ 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.¹⁸⁸ The key variable is frequency. 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.¹⁸⁹ Thus, if a given command is applied frequently (by the agents it governs as they learn it and by the 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. The distinction between rules and standards is reduced, although not eliminated, if application of a standard quickly leads to creation of a rule-like precedent.¹⁹⁰

If enacted, the penalty addressed here will be relevant for every taxpayer with respect to each item whose treatment is at all uncertain. The IRS would be free to assert the penalty at will, so courts are likely to face it on many occasions. 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 penalty would be shielded from a court, 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.¹⁹¹ Thus, it would be efficient to counter attempts to conceal tax avoidance with a rule only if the key features of many

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*, at 469.

¹⁸⁶ Weisbach, *supra* note 1, at 251.

¹⁸⁷ Cass R. Sunstein, *Problems with Rules*, 83 Cal. L.R. 953, 960 (1995).

¹⁸⁸ The following discussion is based on Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L.J. 557 (1992).

¹⁸⁹ *See id.*, at 562. 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), it is clear that he uses the latter only as a typical example of the former, *see id.*, at 564.

¹⁹⁰ *See id.*, at 577.

¹⁹¹ *See id.*, at 600. 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.

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. The government's discretion may be constrained. For instance, it may be allowed to take only certain factors into account in deciding how difficult it was to discover a particular avoidance or evasion transaction. The IRS may be required to justify the size of the penalty to a judge.¹⁹² 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 sanctions for inconspicuous avoidance on an *ex ante* basis and without government's involvement in choosing the fine in each particular case in a more or less obscure and arbitrary fashion? That is, can the government leapfrog the taxpayers and increase expected penalties for various types of tax avoidance without knowing what they are and without a significant increase in enforcement costs? As unrealistic as it sounds, the following proposal takes a step toward achieving these goals.

3. A Promising Solution

In order to reduce taxpayers' 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 from gross income—a loss—as an example. Some taxpayers are large and others are small, so a loss that would appear significant and stand out on one return would be entirely inconspicuous on another. Business and personal profiles of taxpayers differ. A substantial farming loss would look odd on a suburban lawyer's return, but not on that of a 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 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 probabilities 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 need to refer to *something* that would make each particular level of nominal penalties applicable. This is true, however, only if we remain bound by the rigid structure of the existing nominal penalties. For these penalties, the measuring sticks are the magnitude of avoidance, its aggressiveness, and whether or not a transaction was disclosed on the return. 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), 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

¹⁹² This, however, would have to be done in camera if the government wants to preserve the secrecy of its examination strategies.

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 will be a subtraction that the taxpayer *already has* on her return and that has some obvious relationship 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 not be dramatic). Otherwise, a deduction or credit resulting from tax avoidance is likely to raise a red flag.

Ideally, we would want a higher nominal penalty in case where a taxpayer has followed this logic, but not in an alternative case where probability of detection will be relatively high. We can advance toward this goal by linking the size of the nominal penalty not just to the amount of the improperly claimed subtraction as we do now, but, in addition, to the amount of a legitimate subtraction of the same type (i.e., reported on the same line) on the taxpayer's return.¹⁹³

The specific form of this linkage is open to further consideration and is discussed in detail below. Whatever form is chosen, the critical feature of the proposed penalty, and the one that distinguishes it from any penalty existing today, is that this linkage makes it unnecessary to search for, and latch onto, any measuring stick. That is, the government need not decide in advance what specific deduction or credit should be made subject to a higher nominal penalty—something it cannot do with much precision in any case.¹⁹⁴ Rather, each taxpayer's own return would provide the answer. Because the proposed penalty depends on individual circumstances 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 marginal deterrence perspective. By raising expected penalties where they are currently at their lowest levels, this self-adjusting penalty would significantly increase overall deterrence. An example would help to demonstrate the point.

¹⁹³ Using a similar approach to deter understatements of income does not work nearly as well. Subtractions raise suspicions when they are unusual or when they increase significantly. The apparent corollary for income is that *absence* of, and *drops* in, income would raise questions. Neither prong of this corollary, however, is necessarily true. While presence of, say, farm income on a doctor's return is a bit strange, absence of, say, gambling income on her return is hardly surprising, even though the doctor may have won a big jackpot. Also, while, for example, drops in business income of a sole proprietor are more likely to be investigated than increases in his profits, the opposite may be true for income of a subsidiary in a tax haven jurisdiction. Thus, making the penalty dependent on changes in income (rather than its absolute amounts) would not solve the problem because both increases and decreases may raise and lower probability of detection, depending on the particular circumstances. These difficulties highlight a discontinuity in the relation between the amount of income and the likelihood of detection that is absent in case of subtractions. With subtractions, the larger the overstatement, the higher the risk. With income, a taxpayer may reduce scrutiny either by understating her income by a relatively small fraction, or, in many cases, by not reporting any income of a given type at all. For these reasons, establishing a direct and intuitive link between the penalty and the amount of total reported income (or a change in that amount) that reflects variations in probability of detection appears difficult while this link is available for subtraction items. Thus, the proposed penalty is limited to avoidance (and, to a lesser extent, evasion) strategies using subtractions. Devising innovative measures that would counter incentives to conceal items of income remains a task for the future.

¹⁹⁴ As Joseph Bankman put it, “[r]egulations cannot [] target ‘next year’s’ tax shelter . . .,” Bankman, *supra* note 122, at 1788.

Consider a corporate taxpayer, say a multinational commercial bank (we'll call it Interbank), choosing from two possible avoidance arrangements that, if successful, would reduce the Interbank's 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.¹⁹⁵ The first structure would enable Interbank to claim \$1 million in foreign tax credits without bearing the economic burden of the related foreign tax.¹⁹⁶ An alternative arrangement would allow the bank to take a \$1M research credit without spending any of its funds on qualifying research activities.¹⁹⁷ Under the current penalty regime, the bank is virtually certain to choose the foreign tax credits structure because it is much less likely to be questioned on audit. Under the proposed regime, the calculation changes dramatically.

Assume, for example, that the proposed self-adjusting penalty (the "Penalty") is set to equal 10 percent of the total legitimate subtraction item reported on the same line of the return as the illegally claimed one.¹⁹⁸ Assume further that the taxpayer has \$100 million of foreign tax credits that are perfectly justified, but, having no research activities, it has no research credits other than those to be generated by the scheme under consideration.¹⁹⁹ 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 zero 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 Penalty in this case would be zero: the bank would lose the entire \$1 million of improperly claimed credits but nothing else.²⁰⁰ If the bank chooses the foreign tax credit shelter, the probability of detection will be much lower—these are typical subtraction items on the bank's returns, and a difference between \$100 and \$101 million is not likely to attract 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 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

¹⁹⁵ These two assumptions will apply to all further examples. For the reasons discussed in note 173 above, these assumptions can be made without loss of generality.

¹⁹⁶ See I.R.C. § 901 (providing for a foreign tax credit).

¹⁹⁷ See I.R.C. § 41 (providing for a research credit).

¹⁹⁸ In the remainder of the article, I will continue to make this assumption except where specifically stated otherwise.

¹⁹⁹ For an example of tax avoidance transaction using foreign tax credits, see *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001). Research expenses have been used in tax shelters before, see, e.g., News Release 81-182 (Oct. 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 (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 my 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 as briefly as possible.

²⁰⁰ The bank may be subjected to some of the existing penalties, such as a 20 percent negligence penalty, depending on the aggressiveness of the structure.

result, the enticing opportunity to knock \$1 million from Interbank's tax bill without taking on much risk is foreclosed, and the deterrence is improved.²⁰¹

The proposed self-adjusting Penalty has several highly useful features. First, its size changes without any input from the government depending on the unique attributes of each particular taxpayer. One such attribute is 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's depreciation deductions, research credits, interest deductions, capital losses, the list goes on and on.²⁰² For instance, 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 prefer the foreign tax credit scheme. If the government has to choose on an *ex ante* basis whether to raise nominal penalties for one type of credit or the other (assuming it is unwilling to raise nominal penalties 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 self-adjusting Penalty.

Another strength of the proposed Penalty is that it self-adjusts to the *size* of a particular taxpayer. One of the significant weaknesses of the tax shelter Regulations is the inevitable administrability-based decision to make the reportable transaction categories subject to numerical thresholds. Thus, only relatively large losses and book-tax differences require disclosure.²⁰³ At the same time, all losses and book-tax differences above the threshold must be reported.²⁰⁴ This regime fails to respond 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. 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.

²⁰¹ The idea that taxpayers who run afoul of a particular rule are penalized by losing the entire benefit provided by that rule is a familiar one in tax law. For instance, certain trusts generally exempt from income tax must pay tax on all of their income for the year if any portion of it is a so-called "unrelated business taxable income," *see* I.R.C. § 664(c). Not surprisingly, this provision has been denounced as "a penalty with a draconian impact" by unfortunate taxpayers subjected to it. *Newhall Unitrust v. Comm'r*, 105 F.3d 482, 486 (9th Cir. 1997). A certain type of a tax-free reorganization becomes entirely taxable if a single dollar of prohibited consideration is paid, *see* I.R.C. § 368(a)(1)(B). A liability assumed in a tax-free transaction that is generally taxable only to the extent it exceeds basis of the transferred assets becomes taxable in its entirety if the transfer has a tax avoidance purpose, *see* I.R.C. § 357(b), (c). The difference between all of these examples and the self-adjusting Penalty is in the Penalty's connection to probability of detecting the violation, a connection absent in any of the examples just described.

²⁰² 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 171, at 62.

²⁰³ *See* Treas. Reg. § 1.6011-4(b)(5), (6).

²⁰⁴ Some particular losses described in the so-called "angel lists" are excepted, *see infra*, notes 304-305.

A third attractive feature of the self-adjusting Penalty is that it works on a continuum, not just as an on/off switch. This flexibility stands in contrast with the rigid existing rules that give taxpayers only two choices: disclose fully or don't disclose at all.²⁰⁵ The Penalty gives taxpayers an opportunity to make marginal decisions. It creates incentives to engage in avoidance through marginally 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,²⁰⁶ her advertising expenses,²⁰⁷ or her expenditures for chefs, waiters, and others working at the restaurant.²⁰⁸ 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,²⁰⁹ but will be certainly more noticeable than a \$5,000 increase in compensation outlays. Correspondingly, the Penalty for the additional advertising deduction (\$180)²¹⁰ will be higher than for taking a depletion deduction (\$0) but lower than the one for overstating compensation expenses (\$1,800).

Fourth, the proposed penalty has a number of advantages over the case-by-case multipliers and other standard-based approaches discussed in the preceding section. First, as any rule, it would be much less costly for taxpayers to learn and for courts to apply. Second, apart from the cost considerations, and in contrast with a standard-like sanction, the Penalty would 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. Third, the Penalty would be less arbitrary from taxpayers' point of view than the standard-like sanction considered earlier. It would penalize taxpayers for using legitimate subtraction items to camouflage the illegitimate ones by denying a portion of the legitimate item. The connection between the penalty and the taxpayers' actions is clear and intuitive. Fourth, the proposed penalty would allow for no government discretion once its size is set by the legislature.

²⁰⁵ As discussed above, the all-or-nothing approach probably means that most taxpayers disclose very little given a choice, *see supra*, text accompanying notes 106-111.

²⁰⁶ These are reported on line 12 of Part II on Schedule C, *Profit or Loss from Business*, Form 1040 (hereinafter "Schedule C").

²⁰⁷ *See* line 8, Schedule C.

²⁰⁸ *See* line 11, Schedule C.

²⁰⁹ These deductions are allowed in connection with oil, gas, and mineral-related operations, *see* I.R.C. § 611; *see also* Boris I. Bittker & Lawrence Lokken, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 24.1.1 (2004).

²¹⁰ 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.)

Hence, it will be cheaper for the government to administer and less susceptible to abuse by enforcement agents compared to the standard-based discretionary sanction.²¹¹

Finally, the suggested Penalty is extremely flexible. Its size can be easily varied. If the penalty equal to 10 percent of the total legitimate subtraction item were viewed as too lenient (harsh), it can be easily increased (reduced). 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, would present policymakers with difficult choices. I discuss the available alternatives and, in some cases, consider merits and demerits of choosing various specific features in the following part. Before focusing on details, however, it is important to acknowledge a limitation of the proposal.

The self-adjusting Penalty applies only to tax avoidance or evasion that involves overstatements of deductions, credits, or 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, for example, that were popular in mid-1990s and were targeted by the constructive sale legislation involve arguably inappropriate non-recognition of gain.²¹² The same issue arises in corporate reorganizations, partnership transactions, securities sales and many other contexts.²¹³ The proposed Penalty does nothing to deter these forms of avoidance. Turning to evasion, it is well-known that although some evade by overstating subtractions,²¹⁴ 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. Another considerable compliance problem—overstatement of tax basis of various capital assets²¹⁵—would be similarly unaffected.

The picture is not entirely bleak, however. Subtraction overstatements play a significant role in total tax noncompliance. The tax shelter waive of the 1970s was all about deductions. It is revealing that many of the listed transactions subject to the new Regulations, including the

²¹¹ Nonetheless, the Penalty may give auditors significant (perhaps, too significant) leverage in their negotiations with taxpayers regarding not only the subtraction item in question, but all other items on the return. These concerns, and the ways to limit the government's power stemming from the self-adjusting Penalty are discussed below, *see infra*, text accompanying note 251.

²¹² *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.R. 1312, 1339 (2001).

²¹³ *See, e.g.*, David P. Hariton, *How to Define "Corporate Tax Shelter"*, 84 Tax Notes 883, 884-885 (1999) (providing examples).

²¹⁴ *See, e.g.*, Wesley Elmore, *Ways and Means Panel Examines Tax Fraud by Prison Inmates*, 108 Tax Notes 65, 65 (2005) (reporting revelations that inmates fraudulently claim a large amount of tax credits).

²¹⁵ *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 an "unpublicized problem of crisis proportions"). While it seems possible, as a technical matter, to set the Penalty equal to a fraction of the real (rather than overstated) basis, this would make little sense because there is no connection between the actual basis and the likelihood that a particular taxable sale would raise a red flag. Besides, the IRS would have seemingly insurmountable problems proving that a taxpayer used an incorrect basis in calculating gain from sale unless it institutes an entirely new basis tracking system, *see, e.g., id.*, at 454-57 (discussing complexity of basis rules and lack of substantiation requirement).

majority of the most notorious ones, involve overstatements of credits, deductions, and losses.²¹⁶ If the Penalty is effective in reducing these overstatements, it is likely to have a significant impact on tax avoidance.²¹⁷ While the Penalty would not solve all problems, much narrower measures, such as the recent Regulations, are generally regarded as worth-while efforts to improve tax enforcement.²¹⁸ Thus, the Penalty's limited reach can hardly be the reason not to give the proposal a serious consideration. Of course, devising enforcement measures that would deter the types of noncompliance unaffected by the proposed Penalty would be extremely useful as well.

V. Focusing on the Details

1. *How Should the Penalty be Determined?*

Two questions about the self-adjusting 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?

To appreciate the importance of the first question, consider a multi-national 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. 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, 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, some alternative combination?

The examples demonstrates that in order to be effective, the Penalty must be carefully linked to the tax return. If the line items on the return are too generic (e.g., all types of interest deductions are reported on a single line), a large increase in deduction for interest paid to a related foreign party in the first example may register only as a slight change in the total interest deduction, 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 unpopular²¹⁹ and very costly.²²⁰ On the other hand, if returns are too specific, auditors would be overwhelmed with information.²²¹

²¹⁶ See Notice 2004-67, 2004-41 I.R.B. 600.

²¹⁷ 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 more efficient way of providing for additional redistribution than adjusting marginal tax rates, *see* Kopczuk, *supra* note 73.

²¹⁸ Scholars hail these measures as “the most important step the government has taken” in its battle with tax avoidance, *see, e.g.*, Bankman, *supra* note 150, at 929.

²¹⁹ 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 114 at 913 (arguing that such enforcement strategy raised issues of fundamental fairness that animated reduction of penalties in 1989).

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 the taxpayer's decisions) to reflect its concerns. 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 probability of detection for overstating this particular deduction, and would also make the Penalty more sensitive to the size of this specific overstatement. At the same time, the government should be careful not to over-compartmentalize tax returns. Finally, because introduction of the Penalty would affect the government's view about the optimal degree of specificity in tax reporting, perhaps the Penalty should not be enacted on a whole-sale basis. Rather, it should be "phased-in" once the IRS determines that a particular item is reflected on a return at the appropriate level of generality.

Unfortunately, the answer to the second question—how high should the Penalty be—is not nearly as satisfactory. Because, as discussed above, we have no means of determining the optimal expected penalty, we simply don't know what nominal penalties would result in efficient deterrence. Recognizing this limitation (which applies to all tax penalties), the proposed Penalty aims at improving marginal deterrence, i.e., it is clearly a second-best solution. But even beyond that, while the Penalty would arguably enhance marginal deterrence, it does not attempt to optimize it. I make no claim that once the self-adjusting Penalty is adopted, the *difference* in the expected penalties for various forms of avoidance or evasion would be equal to the difference in these strategies' external harms. To the contrary, the proposed Penalty is virtually certain to over- or under-deter.²²² Without bringing expected penalties to their absolutely or marginally optimal levels, the proposal is, at most, a third-best solution. However, given lack of the economic analysis of optimal marginal deterrence, a third-best is the best we can do for now.

The more practical considerations discussed below suggest the likely constraints on the magnitude of the self-adjusting Penalty. It is worth noting at the outset, however, that we should not reject the Penalty just because it may be very large in some cases. Tax law has plenty of provisions that lead to fairly disastrous consequences even though they are not always called "penalties." A single dollar of cash consideration converts and entirely tax-free reorganization into a wholly taxable one.²²³ A foreigner who fails to file a tax return loses all of his deductions and credits for the year.²²⁴ A fraudulent claiming of an earned income tax credit (no matter how

²²⁰ See *infra*, text accompanying notes 278-282.

²²¹ Imagine, for instance, how would an auditor search for red flags if interest paid to/by each subsidiary (or during each month of the year) must be reported on a separate line.

²²² This is so because the difference in probability of detection for any two offenses is unlikely to be exactly the inverse of the difference in the proposed nominal Penalties, other than by chance. For example, assume that in a modified Interbank example, the bank has \$100 million of legitimate foreign tax credits and *also* \$10 million of legitimate research credits. The Penalty for improperly claiming \$1 million in research credits is \$1 million, and it is \$10 million for the foreign tax credit overstatement. It appears entirely reasonable to assume that a change from \$10 to \$11 million is more likely to be questioned than a change from \$100 to \$101 million, but I make no claim that probability of detection in the former case is exactly ten times higher than in the latter one. If, for instance, it is only twice as high, increasing nominal penalty ten-fold would be excessive. Empirical research on this subject would be welcome. As new information is obtained, the proposed Penalty may (and should) be adjusted accordingly.

²²³ See I.R.C. § 368(a)(1)(B).

²²⁴ See I.R.C. § 874(a). The same rule applies to foreign corporations, see I.R.C. § 882(c).

small in amount) is punished by denial of the credit for the following ten years.²²⁵ And how can we forget the \$10,000 a day penalty accumulating forever?²²⁶ To be sure, the Penalty would apply in more cases than any of these sanctions (and probably all of them combined). This generality 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.

2. *Fault or No-Fault?*

In its most basic form, the self-adjusting 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's size vary with taxpayers' fault, i.e., should it be *fault-sensitive*? Second, should the Penalty be *fault-based*, i.e., should it apply, in addition to evasion, only to particularly aggressive avoidance? This section addresses both issues.

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 self-adjusting 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 compliments (rather than replaces) the existing ones, why not let each penalty deal with its own problem?

Several responses come to mind. First, by increasing the total fine, the self-adjusting penalty reduces the sensitivity of the overall punishment to aggressiveness of taxpayers' positions. For example, assume that a penalty 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 self-adjusting Penalty of \$1,000, and assuming that probability of detection is the same for both schemes, the total penalties will be \$1,200 and \$1,400 respectively. The fine for a more egregious violation is now only about 17 percent 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 percent versus 100 percent) rather than their absolute amounts (\$200 in each case).

If we consider the effect of variations in the proposed Penalty (rather than its absolute size), the problem becomes even more acute. Assume, for instance, that Interbank's foreign tax credit structure has a very good chance of being upheld in court, and 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.²²⁷ The self-adjusting 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 percent of it), Interbank would have to pay \$101 million if the foreign tax credit is disallowed. The two numbers are grossly disproportionate.

²²⁵ See I.R.C. § 32(k)

²²⁶ See I.R.C. § 6708. This list is far from exclusive, *see supra*, note 201.

²²⁷ See I.R.C. § 6663 (75% penalty for fraudulent understatements).

These examples 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 evaluate how difficult it is for its auditors to detect transactions that do not raise red flags compared to those that do.²²⁸ Policymakers would need to make a judgment comparing these difficulties with variations in taxpayers' fault and to set the magnitude of the Penalty based on this judgment. While the ultimate conclusion is far from certain, if one takes the current nominal fault-based penalties as a given, it appears highly unlikely that a difference between \$1.75 million and \$101 million can be justified. Rather, the Penalty equal to a relatively small fraction of the entire legitimate subtraction item appears much more reasonable.

Finally, in our system where taxpayers face higher penalties for more aggressive schemes, a rational taxpayer would expend more efforts to conceal a more egregious transaction. If so, aggressiveness and probability of detection are systematically related, 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 5 percent of the legitimate subtraction item for non-negligent arrangements, 10 percent for negligent ones, 15 percent for those that are grossly negligent and so on. Structured this way, the Penalty would take into account variations in both probability of detection and degree of taxpayer's fault.

A decision to make the Penalty fault-sensitive leaves the hardest question unresolved. Should it also be fault-based? Most importantly, should it apply to those who are merely mistaken?²²⁹ Until this point, the Penalty has been justified as a measure that would accomplish a very specific goal: deter taxpayers from hiding their avoidance strategies. If one conceptualized the Penalty as punishing 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 self-adjusting Penalty?

As long as the government is using the red flags audit strategy, probability of detection for transactions that do not raise red flags is lower whether a taxpayer deliberately structured a transaction to avoid detection or the transaction simply happened 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 mistake is likely to trigger an audit and be detected for the reasons already discussed. If, however, the inappropriately (and mistakenly) taken subtraction is a charitable deduction, chances that an auditor would notice the

²²⁸ Only a very rough evaluation of an order of magnitude would be required.

²²⁹ A related, but separate question is whether the penalty should apply to taxpayers who knowingly entered into a somewhat questionable transaction that was clearly non-negligent. Unlike the mistaken taxpayers, these persons were aware that they were in a dangerous territory, but decided to proceed anyway hoping that their position would fall on the right side of the line, even if barely. Many (although not all) of the considerations discussed below apply to this case, and I will omit its detailed analysis to avoid further lengthening the discussion.

error are much lower.²³⁰ If taxpayers are more likely to make mistakes that reduce their taxes (as opposed to those that increase them),²³¹ 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 the other. But the government would surely want her to pay particular attention to charitable deductions because their mistaken overstatements are likely to go undetected. By extending the Penalty to mistaken taxpayers, the government, in essence, would be warning them: be extra careful with subtraction items of a certain kind because the auditors are unlikely to challenge your decisions. Because the government would rely on taxpayer's judgments with respect to these items more than with others, and as long as taxpayers have a notice of this reliance, punishing mistaken taxpayers would accomplish a valuable deterrence objective.²³²

On the other hand, introducing a fault-based threshold by applying the Penalty only to particularly aggressive (e.g., negligent) behavior is entirely unrelated to the basic rationale of the proposal. Imagine, for instance, that the lawyer's accountants told her that the farm loss would be found negligent if detected while the extra charitable deduction would probably lose, but just barely. If the proposed Penalty applies only to negligent actions, the lawyer would certainly choose to overstate the charitable deduction, just as she would today. At the same time, if she already has some legitimate farm losses, yet chooses to overstate the vastly more detectable farm loss anyway, the Penalty would apply even though she made no attempt to hide the overstatement. Thus, introducing a negligence threshold would not affect the incentives to conceal for a vast array of arrangements that do not meet it, and it would penalize negligent (and more aggressive) taxpayers even if they do nothing to hide their avoidance.

²³⁰ Note that simply because the lawyer makes many different donations possibly giving rise to charitable deductions, probability that she would make a few mistakes in handling this subtraction item is relatively high. A farm loss, on the other hand, is unusual and is likely to command special attention.

²³¹ Answering this question is difficult. It is well-known that some taxpayers overstate their tax liabilities, and many more understate them, *see, e.g.*, Martinez-Vazquez & Rider, *supra* note 87, 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 very difficult to evaluate what portion of taxpayers underpay their taxes by mistake, as opposed to as a result of avoidance and evasion.

²³² Is it reasonable to assume that taxpayers are (or should be) on notice regarding the new self-adjusting penalty? In many cases, I suggest it is. Many taxpayers use tax preparers or tax preparation software. Educating the preparers and software developers would be inexpensive and highly effective in putting taxpayers on notice. Whether this assumption is warranted in case of low-income taxpayers is a more difficult question. It may appear that many low-income taxpayers are highly unlikely to be aware of potential penalties and statutory changes. In fact, however, a lot of these taxpayers use preparers as well, *see, e.g.*, Dustin Stamper, *Coleman Looking to Stem Tax Shop "Abuses,"* 107 Tax Notes 422, 422 (2005) (describing the use of refund anticipation loans by low-income taxpayers who use the services of tax-preparation firms). On the other hand, some data suggests that significant subgroups of low-income taxpayers have very little knowledge even about a program highly beneficial to them, *see* Elaine Maag, *Disparities in Knowledge of the EITC,* 106 Tax Notes 1323, 1323 (2005). Ultimately, if low-income taxpayers as a group are significantly less likely to be aware of the proposed penalty, they should be exempted as long as they are merely mistaken. If the Penalty has a negligence threshold, such exemption appears less necessary. 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 exemption becomes irrelevant.

These unfortunate results follow not because the Penalty in the preceding example is made fault-dependent, but because it is made to depend on the wrong type of fault. If we want to excuse mistaken taxpayers, we should apply the Penalty only to those who deliberately disguise their aggressive positions. This, however, is entirely unrelated to whether these positions are fraudulent, negligent, or barely illegal. 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 taxpayer thought when it decided to take one type of subtraction or the other? If the burden is placed on a taxpayer, how would it prove a negative (i.e., that it did *not* try to hide a particular subtraction, but just happened to take it)?

To be sure, law frequently attaches consequences to agent's motive, intent, or purpose.²³³ Tax law boasts a business purpose doctrine and an economic substance test that incorporates an inquiry into 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 taxpayer's state of mind are numerous,²³⁴ the extent of prohibited intent is unclear,²³⁵ and as a result, transactions that the Tax Court finds so egregious as to merit penalties end up being upheld on appeal.²³⁶ The existing tools for inferring 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. Basing the Penalty on taxpayers' motivations in the absence of a developed analytical apparatus for evaluating intent to conceal would lead to uncertainty of a magnitude that is difficult to justify. Thus, restricting the proposed Penalty to particularly aggressive substantive positions appears to be a practical, albeit decidedly suboptimal, way to limit the Penalty's reach.

In sum, a no-fault Penalty may be justified on deterrence grounds, but only if the basic rationale is expanded. Introducing a fault-based threshold undermines the Penalty's core deterrence objectives, 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 long-standing sanctions, one sees a clear connection to fault. The so-called accuracy-related penalties apply only if a taxpayer acted with a certain degree of carelessness or understated her tax liability by a significant amount.²³⁷ Any of these penalties, as well as the civil fraud penalty, are waived if a taxpayer had a reasonable cause to take the questionable position (i.e., if she were sufficiently innocent).²³⁸ The recently added penalty for understatements attributable to reportable or listed transactions, while containing no explicit fault-based threshold, is inapplicable if a taxpayer satisfies a stronger version of the

²³³ See, e.g., Weisbach, *supra* note 1, at 252-53 (enumerating some of the areas).

²³⁴ See, e.g., Weisbach, *supra* note 174, at 881 (listing some of the factors).

²³⁵ See, e.g., Bankman, *supra* note 131, at 17.

²³⁶ See, e.g., *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 781 (5th Cir. 2001), *reversing* 113 T.C. 214, 223 (1999).

²³⁷ See I.R.C. § 6662.

²³⁸ See I.R.C. § 6664(c).

reasonable cause exception.²³⁹ None of these penalties would apply to a taxpayer who barely crossed the line.

In contrast, many penalties added to the Code by the 2004 Act apply regardless of taxpayers' fault. If a taxpayer is found to have understated her tax liability having failed to disclose a reportable or listed transaction, no reasonable cause exception is available.²⁴⁰ Although in some (perhaps many) cases listed and reportable transactions with "a significant purpose . . . [of] the avoidance or evasion Federal income tax"²⁴¹ would produce negligent understatements, this will not always be true, as the government was recently reminded by a court.²⁴² Thus, even if a taxpayer barely loses the dispute she would have to pay a penalty equal to 30 percent of the understatement if she failed to disclose the transaction.²⁴³ 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 the penalties apply even if the underlying substantive position is ultimately sustained.²⁴⁴ 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 subject to sanctions.²⁴⁵ Thus, even though taxpayers' fault has been traditionally a prerequisite for imposition of penalties for tax avoidance, the recent Congressional actions suggest that it 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 IRS assesses penalties once it finds tax underpayments is very low.²⁴⁶ If limiting the proposed Penalty to actions that are at least

²³⁹ See I.R.C. § 6662A (penalty for understatement with respect to reportable transactions); I.R.C. § 6664(d) (strengthened reasonable cause exception).

²⁴⁰ See I.R.C. § 6664(d)(2) (excluding non-disclosed transactions from the reasonable cause exception).

²⁴¹ I.R.C. § 6662A(b)(2)(B).

²⁴² See *United States v. BDO Seidman*, 2005 WL 742642 7 (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." (internal quotations omitted)).

²⁴³ See I.R.C. § 6662A(c).

²⁴⁴ "[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 108-538, at * (2004) (explaining the provisions of I.R.C. § 6707A).

²⁴⁵ 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, see 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 "in no event . . . be considered reasonable cause for failing to make a list available to the Secretary." H.R. Conf. Rep. No 108-755, at * n.273 (2004).

²⁴⁶ For example, the rate was 4.1% of all reassessed returns in 1995, see Andreoni et al., *supra* note 28, at 821 (1998). Others suggest even lower rates, see Lederman, *supra* note 31, at 1464 n.49. To be sure, penalties (as well as audits in general) have an indirect deterrence effect, but its size is fairly speculative. Most agree that general deterrence effects are positive, i.e., they induce compliance by taxpayers other than those who were actually audited. Indirect revenue raised as a result of these effects has been estimated to

negligent means that it would apply in exceedingly few cases, we may be more inclined to make it no-fault. 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 the latest government actions, it 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.²⁴⁷ Finally, academics and practitioners alike have suggested that the government routinely fails to assess penalties where it is entitled to do so.²⁴⁸ If the self-adjusting Penalty does not have a reasonable cause exception, and if the IRS actually applies it when it is available, the Penalty may apply in a considerable number of cases even if it is fault-based.

Concerns about complexity and ambiguity of many tax rules and accuracy of their application by the IRS and courts appear to point toward establishing a fault-based threshold. 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.²⁴⁹ If, however, randomness introduces substantial risk-bearing deadweight losses for risk-averse taxpayers, limiting the Penalty's reach may be more efficient.²⁵⁰ Finally, while a Penalty for a barely illegal deduction would appear unfair on an ex post basis, taxpayers always have an option of responding to complexity and legal ambiguity by taking more conservative positions with respect to subtractions potentially subject to a high Penalty.

be five times as high as the direct audit revenue, *see* Dubin et al., *supra* note 114, at 904. Others have discovered, however, that personal knowledge of someone with difficulties with the IRS decreases 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* 193, 206-07. Thus, reliance on general deterrence can hardly provide a justification for limiting the Penalty's reach.

²⁴⁷ These opinions are now “disqualified” for the purposes of providing protection for understatements arising from listed or reportable transactions, *see* 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. pt. 10, § 10.35 (2005).

²⁴⁸ *See* Bankman, *supra* note 174, at 9 (suggesting that “we might start (after a suitable warning period) to impose penalties already on the books for noncompliance.”); Schler, *supra* note 111, at 368 (asserting that taxpayers are often unconcerned about potential penalties because they believe that the IRS would eventually settle for 100% of the tax liability without insisting on collecting fines).

²⁴⁹ *See* Weisbach, *supra* note 11, at 107. Experimental data indirectly supports Weisbach's view, at least for a certain category of taxpayers, *see* Slemrod, *supra* note 35, at 477 (reporting that increased probability of audit led to a *lower* reported income by high-income taxpayers, perhaps because taxpayers believed that the ultimate outcome of the audit depends, at least in part, on their initial report).

²⁵⁰ *See, e.g.*, Suzanne Scotchmer & Joel Slemrod, *Randomness in Tax Enforcement*, 38 J. Pub. Econ. 17, 18 (1989) (arguing that while the cost-minimizing policy by the IRS requires as much randomness as possible, this policy would not maximize social welfare if taxpayers are risk-averse, even if the cost savings are rebated through tax reductions).

Fairness considerations point in both directions. On the one hand, taxpayers who use many different subtraction items 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 potentially 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 standard deduction have no similar opportunities. Currently, taxpayers of the latter type are at a distinct disadvantage. Making the Penalty no-fault offsets this existing unfairness.

There are two additional considerations that bear on the issue. Both suggest that a fault-based threshold should be added. The first is the concern with a 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 taxpayer cooperates on all disputed items. Facing this kind of 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 self-adjusting Penalty into a very 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.²⁵¹

This brings us to the last argument in favor of limiting the Penalty's reach. While the broadly applicable Penalty would provide stronger deterrence, studies suggest that the deterrence rationale fails to resonate with the general public.²⁵² 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 probability 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.²⁵³ 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.

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

²⁵¹ Some taxpayers already believe that IRS would try to collect more money from them than it should, *see* Kent Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *WHY PEOPLE PAY TAXES* 223, 231; Karyl Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data*, in *WHY PEOPLE PAY TAXES* 259, 276. For a discussion of risk-bearing losses, *see infra*, text accompanying notes 279-281.

²⁵² *See* Cass R. Sunstein, David Schkade & Daniel Kahneman, *Do People Want Optimal Deterrence?*, 24 *J. Leg. Stud.* 237, 250 (2000).

²⁵³ *See id.*, at 249.

3. *Additional Fine-Tuning Possibilities*

Policymakers may decide that it would be desirable to vary the Penalty 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 (depreciation deductions) may be viewed as more justified.²⁵⁴ Of course, as already mentioned, nothing would stop Congress from enacting the Penalty only with respect to a specific types of subtraction items.

Another possible reason to differentiate the magnitude of the Penalty would be 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.²⁵⁵ 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.²⁵⁶

A further way of fine-tuning the Penalty is to subject it to caps.²⁵⁷ 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 tax credits. Without a cap, a 10 percent Penalty would be \$10 million in the former case and \$50 million in the latter while the probability of detecting the violation may be essentially identical. Capping the Penalty as a fixed multiple of the illegitimately claimed subtraction item would address the problem. Besides, a capped Penalty is likely to be more politically acceptable and viewed as more fair (or less unfair) on an ex post basis.

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 met a negligence threshold.²⁵⁸ If this is done, both the narrower and the broader deterrence

²⁵⁴ 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 not tax for the year. The *existing* penalty for fraudulent overstatement of this credit (no matter how small) is a denial of the credit for the following ten years, *see* I.R.C. §32(k).

²⁵⁵ Auditors may be able to make more informed judgments when they examine companies required to file Schedule M-3.

²⁵⁶ Of course, the same objective may be achieved by varying existing fault-based penalties based on the nature of the avoidance or evasion.

²⁵⁷ I thank Lily Batchelder for suggesting that caps may be a useful feature of the proposal.

²⁵⁸ Or the caps may apply in all cases, but increase with aggressiveness.

objectives discussed earlier would be achieved to a degree, yet many concerns with imposing the Penalty on mistaken taxpayers would be alleviated.

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.²⁵⁹ By definition, subjecting these schemes to high penalties cannot interfere with any legitimate business or investment. The same is clearly not true of the self-adjusting Penalty. It threatens taxpayers with losing 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.

First of all, this concern 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) deductions and losses before the Penalty was enacted. Especially if the Penalty has a negligence threshold, these adjustments would merely ensure that taxpayers don't 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 forego them out of fear of losing their legitimate subtractions. To eliminate this inefficiency, taxpayers should be given an option to disclose these transactions to the IRS.²⁶⁰ Once a transaction is disclosed, the Penalty would not apply to it.

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 put a sizeable dent in the amount of noncompliance carried out by hiding aggressive avoidance and evasion.

²⁵⁹ See, e.g., Bankman, *supra* note 150, at 929 (noting that the economic substance doctrine is "limited to shelters unconnected to any business").

²⁶⁰ To avoid the overdisclosure problem, see *infra*, text accompanying notes 303-306, the disclosure must be more informative than that required under the Regulations. Rather than merely identifying the uncertain transactions, taxpayers must 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've performed in deciding whether or not to go forward with the disclosure). 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.

VI. Addressing (Some of) the Likely Objections

1. What About Unintended Consequences?

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 the opportunity to reduce their tax liabilities without facing high expected penalties will vanish. Unfortunately (but inevitably), the parties involved may respond to the incentives created by the Penalty in less desirable ways. This section considers several such responses and suggests potential countermeasures.²⁶¹

Starting with the government, there is a reason to worry that once the Penalty is enacted, the red flags strategy will be in jeopardy. Historically, the IRS has been focused on the largest adjustments.²⁶² With low nominal penalties that were rarely applied, this focus lead 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 may 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 an 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's hard to deny that at the margin the self-adjusting Penalty would skew auditors' decisions toward spending extra time on high-volume subtraction items.

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 10 separate transactions of equal size. Finally, assume that all eleven transaction have the same high 95 percent chance of being sustained.

The auditor's chance of successfully disallowing the foreign tax credit are 5 percent, and the expected payoff from focusing the audit efforts on that credit is \$5 million.²⁶³ 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 an 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%,²⁶⁴ and the

²⁶¹ I am grateful to Jack Coffee, Jeff Gordon, Scott Hemphill, Avery Katz, Wojciech Kopczuk, and Susan Sturm for alerting me to some of the incentives addressed in this section.

²⁶² See *supra*, note 114.

²⁶³ It is equal to $0.05 \times 100,000,000$. The Penalty is zero because Interbank has no legitimate foreign tax credits.

²⁶⁴ The probability that Interbank will succeed in defending *each* of the ten research credit-generating transactions is only about 60% ($0.95^{10} = 0.599$). The auditor's chance of success is $(1-0.6) \times 100\% = 40\%$.

auditor's expected payoff is \$40 million.²⁶⁵ Note that even if the foreign tax credit is fairly questionable (say, Interbank has only 66 percent chance of prevailing on the merits), the auditor may still focus on the research credits instead.²⁶⁶

These are certainly unintended results. However, the situation is not as dire as it may first appear. Auditors operate under considerable time constraints. If an agent only has enough time to examine 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 only more conservative positions where a large Penalty may apply. Thus, more realistically, a chance of being sustained is likely to be higher for each of the research credits than for the foreign tax credit.²⁶⁷ Assuming auditors realize this, the urge to focus on research credits would be diminished. Finally, the auditor may take into account that taxpayers are much more likely to contend imposition of relatively large penalties on relatively small understatements. Thus, even though probability of detection in the example is equal for all strategies, probability of punishment may well be higher for the foreign tax credit case, further reducing auditor's incentive to concentrate on research credits.

Furthermore, keeping the Penalty relatively modest and making it fault-based would reduce the incentive to focus on large subtractions and, in particular, on those composed of numerous individual items.²⁶⁸ An even better response would be to change the 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 the renewed vigor.²⁶⁹

Just like the IRS examiners, taxpayers should be expected to adjust to the new penalty regime. First, if the proposed penalty is very large, marginal deterrence may suffer. Imagine, for instance, a highly successful self-employed management consultant who claims approximately \$100,000 of legitimate travel and entertainment ("T&E") expenses each year.²⁷⁰ 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

²⁶⁵ The payoff is equal to $0.4 \times 100,000,000 = 40$ million.

²⁶⁶ Auditor's payoff in this case would be $0.34 \times 100,000,000 = 34$ million, or less than \$40 million from auditing the research credits.

²⁶⁷ This response to the Penalty would make the red flags strategy even more effective than it is today because more aggressive avoidance would gravitate toward arrangements that raise red flags.

²⁶⁸ 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. Interbank stands to lose \$10 million in illegal research credits with a 5% probability and it would also pay a \$9 million Penalty (10% of \$90 million in legitimate research credits) with a 40% probability. Overall, $0.05 \times 10,000,000 + 0.4 \times 9,000,000 = 4,100,000$.

²⁶⁹ Any such incentives would need to be structured to avoid violating the existing rules that prohibit setting production goals or quotas for the IRS agents. For a discussion of these rules, see Charles O. Rossotti, *MANY UNHAPPY RETURNS* 111 (2005).

²⁷⁰ See Schedule C, lines 24(a), (b).

wedding, he can justify deducting \$5,000 (out of \$50,000) as a business expense.²⁷¹ Shortly before the fateful day, a draconian version of the Penalty is enacted—it has no fault-based threshold, no caps, and it equals to the entire amount of the legitimate subtraction item. Because the consultant would now lose the entire \$100,000 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 a virtually unnoticeable difference between \$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.²⁷²

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, varying the Penalty with the egregiousness of an offense 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 overstatement, but a \$20,000 in these deductions for a \$20,000 overstatement, he might think twice before writing off the entire wedding.²⁷³

Enactment of the Penalty would eliminate some of the existing incentives in addition to creating the new 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 effectively limits the intended subsidy. This is a familiar argument against a stronger tax enforcement whatever form it takes. David Weisbach's response seems convincing.²⁷⁴ The Penalty does not affect the subsidies where they clearly apply, it only reduces their aggressive use. If Congress intended a particular incentive to be used 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.

²⁷¹ Generally, unlike business expenses deductible under Sections 162 and 212, expenses for events such as a wedding are personal and non-deductible, *see* I.R.C. § 262. T&E deductions (even if business-related) are further limited by Section 274. Thus, the consultant's position is likely to be rather weak.

²⁷² This concern was first expressed by George Stigler in one of the earliest comments on Becker's work: "If the offender will be executed for a minor assault and for a murder, there is no marginal deterrence to murder. If the thief has his hand cut off for taking five dollars, he had just as well take \$5,000." Stigler, *supra* note 55, at 527-28. One response to Stigler's point is that marginal deterrence can be preserved by varying probability of punishment, *see, e.g.*, Steven Shavell, *A Note on Marginal Deterrence*, 12 Int'l Rev. Law Econ. 345, 345-46 (1992) (explaining that if enforcement is specific, i.e., if probability of detection may vary 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). However, Stigler's suggestion may be mostly correct after all. First, probability of punishment may be more difficult to calibrate than nominal penalties. Second, the difference in nominal penalties is highly transparent while variations in probability of punishment may remain obscure to potential offenders. For additional arguments against Stigler's point, *see* Kaplow, *Fines for Undesirable Acts*, at 10 n.19.

²⁷³ Of course, for really outrageous violations there is always a criminal fraud penalty and a possible jail time for the offenders, *see* I.R.C. § 7207.

²⁷⁴ *See* David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 S.M.U.L. Rev. 73, 81-82 (2001).

Finally, another likely response by taxpayers reflects the very essence of the proposal. The Penalty would affect only taxpayers who use deductions, credits, and losses to evade or avoid tax. While many do so today, faced with the Penalty, taxpayers would attempt to switch to the types of noncompliance that it does not reach. This, however, will be relatively difficult to do. So 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.²⁷⁵ Of course, one can always understate income without any legal justifications. 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.²⁷⁶ These observations suggest that elasticity of substituting income-understating techniques for subtraction-overstating ones may not be particularly high. Nonetheless, facing the Penalty, taxpayers will redouble their efforts to find avoidance mechanisms of the latter type. The government should anticipate this move and shift attention of its auditors more toward detecting income understatements.

2. Are the Costs Worth the Benefits?

As any proposal based on the economic analysis, 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 probability of detection is expensive while imposing higher monetary fines is costless²⁷⁷ has long been disproved. Nominal penalties are not costless, 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.²⁷⁸

In addition, larger sanctions lead to social waste of a kind that is not as readily observable. If offenders are risk-averse, higher monetary fines result in larger risk-bearing costs. These are deadweight losses—costs to offenders that produce no benefits to anyone else.²⁷⁹ To be sure, larger penalties have a stronger deterrence effect on risk-averse potential offenders, reducing expected penalties needed to deter a particular violation.²⁸⁰ However, those who decide

²⁷⁵ Besides, empirical data suggests that those who could understate income relatively easily are already doing it, *see* Klepper & Nagin, *supra* note 84, at 9, 18 (these are taxpayers with income not subject to information reporting; for them, subtraction items present inferior noncompliance opportunities). Thus, taxpayers avoid by overstating deductions and credits precisely because their opportunities to understate income are limited, *see id.* (these are taxpayer without any business income).

²⁷⁶ As Joseph Bankman remarked, “[m]any 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.R. 5, 28 (2000).

²⁷⁷ *See* Becker, *supra* note 2, at 180, 193.

²⁷⁸ *See* Craswell, *Damage Multipliers*, at 468.

²⁷⁹ *See* A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 Am. Econ. Rev. 880, 880 (1979).

²⁸⁰ Because the deterrent effect of any given penalty on risk-averse potential offenders will exceed its expected value, the nominal penalty (or probability of punishment) may be reduced to take risk-aversion into account, resulting in possible cost savings, *see id.*

to commit the offense anyway incur risk-bearing losses solely due to the possibility, but not certainty, of being penalized.²⁸¹ These losses increase with the size of 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. Ambiguity inevitable in any legal system makes 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, a possibility of a mistaken prosecution, a corrupt administrator who abuses the system, incorrect application of a legal rule, or inadequate assistance of counsel mean that there is a chance that penalties would be imposed on innocent individuals.²⁸² The higher the nominal penalties, the more worrisome they are to those who do *not* commit any offenses, the larger are their risk-bearing costs resulting from legal uncertainty and imperfect enforcement.

In sum, while costs of increasing probability of punishment are obvious and substantial,²⁸³ 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.²⁸⁴ Rather, the objective is to achieve a desired expected penalty while minimizing the sum of the costs of larger sanctions and higher likelihood that they will be imposed.²⁸⁵

These insights have been incorporated in the tax compliance literature. However, the difference between evasion and pollution discussed earlier presents yet another issue. The only way of eliminating the harm of pollution is to eliminate the pollution itself. In contrast, because the harm of evasion is redistributive, the government can diminish it without countering the evasion by raising taxes or cutting spending by the amount evaded.²⁸⁶ Thus, when dealing with

²⁸¹ See *id.* This is “the cost of sleepless nights by a modern-day taxpayer who (illegally) underreports his income” Joram Mayshar, *Taxation with Costly Administration*, 93 *Scand. J. of Econ.* 75, 78 n.6 (1991). Note that this worrying by the taxpayer does no good to the society because the offense has already been committed.

²⁸² See, e.g., A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 *J. Econ. Lit.* 45, 61 (2000); Slemrod & Yitzhaki, *Tax Administration*, at 1450.

²⁸³ See, e.g., *supra* text accompanying notes 176-178.

²⁸⁴ Becker was not the only one making this argument, see, e.g., Kaplow, *Fines for Undesirable Acts*, at 3 (referring to this idea as a “well-known suggestion”); Polinsky & Shavell, *supra* note 279, at 880 n.3 (reciting the argument and listing commentators who accepted it).

²⁸⁵ See Craswell, *Damage Multipliers*, at 470.

²⁸⁶ This, of course, would not necessarily diminish the welfare cost of evasion. However, the government may advance toward this goal by redistributing the revenue raised through the additional tax to offset the effect of evasion. It can, for example, increase taxes on the evader (or, more realistically, the group where evasion is prevalent), or reduce government benefits (in essence, negative taxes) the evader (or the group) used to receive. If the tax system is at the optimal level, marginal cost of raising an additional dollar through taxes equals marginal benefit of the last dollar of government spending, so increasing taxes or cutting benefits by the same amount would be equally efficient, see Kaplow, *supra* note 79, at 148 n.6.

tax noncompliance as opposed to torts or pollution, we need to optimize the costs of at least three, not just two, possible responses.²⁸⁷

Joel Slemrod and Shlomo Yitzhaki, building on earlier research, observed that any of these responses may be carried out in many different ways.²⁸⁸ But whatever the government does to marginally increase tax collections, the measure is likely to bring in less revenue than it would have raised if no changes in the system took place on account of the reform. The marginal tax increase resulting from the incremental reform is a private cost to taxpayers. They 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,²⁸⁹ 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 to the marginal revenue raised reduced by the administrative cost of raising it (i.e., by calculating what Slemrod and Yitzhaki call the “marginal efficiency cost of funds” (MECF)) 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 of funds.

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.²⁹⁰ 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 alternatives. 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 when it can be used in practice. Until then, it appears reasonable to evaluate the cost-effectiveness of the proposed Penalty by making qualitative comparisons to 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, and so 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.,

²⁸⁷ See, e.g., Kaplow, *supra* note 10, at 234 (showing that under certain assumptions, the choice between stronger enforcement and higher tax rates is ambiguous).

²⁸⁸ For example, Congress may raise tax rates across the board, change marginal tax rate schedule, or revised substantive legal rules. Of course, it may vary probability of punishment by changing each of its numerous components, see Slemrod & Yitzhaki, *supra* note 75. For a list of earlier related studies, see *id.*, at 1459.

²⁸⁹ In some circumstances, the cost to taxpayers may be less than one dollar, i.e., private and social costs may diverge, see *id.*, at 1461.

²⁹⁰ See Weisbach, *supra* note 1, at 242 (suggesting that some of the parameters of the formula are routinely estimated by the government); Shaviro, *supra* note 1, at 238 (same).

listed as opposed to reportable) transactions is much less costly. The better the government knows what exactly is it looking for, the cheaper it is for the government to find it.²⁹¹

The 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).²⁹² 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.²⁹³ 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 strategies). It is well recognized that all of these costs increase with the size of nominal penalties. But it is also highly likely that these costs are larger for penalties of more general application compared to the 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 applies regardless of a particular technique used to reduce tax liability. 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 self-adjusting 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, they would not be particularly concerned with 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.

As long as the auditors use the red flags approach, the government is always more concerned about the arrangements producing subtractions that are buried in the returns among

²⁹¹ The IRS keenly appreciates this point. Ineffectiveness of its audits was one of the main stimulants for the TCMP.

²⁹² See, e.g., *Clemens v. USV Pharmaceutical*, 838 F.2d 1389 (5th Cir. 1988) (holding that a taxpayers' former employer whose erroneous filing of a W-2 form with the IRS was the most likely reason why the taxpayers had to endure a tax audit was negligent and liable for consequential damages); Rick Warzman, *Taxes 1993: Don't Wave a Red Flag at the IRS*, Wall St. J., Feb. 24, 1993, at C1 ("Nothing strikes the fear of God in people like receiving a letter from the IRS.").

²⁹³ General deterrence effects of audits are somewhat uncertain, see *supra*, note 246.

large subtractions of the same type. This is so not only because these transactions are more likely to be aggressive, although this seems to be a reasonable assumption if one believes that taxpayers try to conceal tax avoidance. In addition, the IRS should be concerned with these transactions because it knows in advance that the likelihood that they would be examined is small. That is, even if the IRS could magically force taxpayers to spread their avoidance strategies evenly across the return items, Becker's formula would still suggest that nominal penalties should be higher for items that are less likely to be questioned, i.e., for items that do not raise red flags. Thus, while the imprecision of the existing penalties is caused by government's imperfect information regarding taxpayer's tax structuring, the precision of the self-adjusting Penalty is based in part on the government's (nearly) perfect information about its own auditing strategy.²⁹⁴

Another way to highlight the Penalty's cost-effectiveness would be to re-articulate 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.²⁹⁵ The self-adjusting Penalty does exactly that.²⁹⁶ On balance, then, the Penalty's higher risk-bearing costs appear to be an entirely reasonable price to pay for improved deterrence.

3. *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, and other highly unpleasant consequences.²⁹⁷ There is a wide-spread sentiment among taxpayers and their advisors that the government has already overreacted.²⁹⁸ Even a high-ranking Treasury official suggested that Congress should pause in its attempts to curb tax noncompliance and give the recent measures time to work.²⁹⁹ 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

²⁹⁴ The information is not perfect, for instance, because of the principal agent problem and information asymmetries. The government cannot fully control the actions of its tax auditors and the auditors would not necessarily provide the government with full information about their actions and findings.

²⁹⁵ See *supra*, text accompanying note 41.

²⁹⁶ I thank Wojciech Kopczuk for suggesting this articulation.

²⁹⁷ These rules are contained in the so-called Circular 230, 31 C.F.R. pt. 10 (2005).

²⁹⁸ See, e.g., New York State Bar Association Tax Section, *Disclosure by Material Advisers*, reprinted in 106 Tax Notes 1569, 1570-71 (2005) (generally supporting the IRS's interpretation of the 2004 Act, but making numerous suggestions to limit the penalties and narrow the scope of the disclosure); Sheryl Stratton, *Tax Officials Spar With Tax Bar Over Circular 230*, 107 Tax Notes 1082, 1082 (2005) (describing several heated exchanges between practitioners and the IRS officials during the American Bar Association's annual meeting regarding the interpretation of a portion of the Circular 230 and practitioners' belief that the regulations are overbroad, too vague, and unnecessarily punitive).

²⁹⁹ See Dustin Stamper, *Treasury Official Suggests Break From Tax Shelter Legislation*, 107 Tax Notes 1067, 1067 (2005) (quoting a statement of Acting Deputy Assistant Secretary of Treasury for tax policy).

need to consider whether these measures are likely to be effective and, if they are, whether they would address the problem that animates the case for the self-adjusting Penalty.

No doubt, backed by the recently enacted penalties, the new disclosure rules increase probability that a particular reportable transaction will be detected.³⁰⁰ For listed transactions, this probability approximates one.³⁰¹ Duties imposed on advisors involved in tax avoidance transactions further increase probability of detection.³⁰² In fact, 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. Trouble is, not all tax avoidance is subject to the Regulations. The number of reporting triggers is limited.³⁰³ The so-called “angel lists” exclude from reporting large categories of transactions that would have been covered by the Regulations otherwise.³⁰⁴ The lists were not short to begin with, and the IRS has expanded them over time.³⁰⁵ Finally, the reportable transaction categories are subject to various numerical thresholds.³⁰⁶

³⁰⁰ In part, the Regulations’ effectiveness comes from a new type of a disclosure regime they have instituted. The disclosure is required to be made not only as a statement attached to the taxpayer’s tax 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 of focus just on the disclosed transactions, *see* Treas. Reg. § 1.6011-4(d), (e). In addition, and in contrast to a regular tax return (or a Schedule M-1 for that matter) which contains aggregate items that reflect many unrelated transactions, the tax shelter disclosure must be done on transaction-by-transaction rather than item-by-item basis (the book/tax difference disclosure is subject to a limited exception). Because one needs to understand the transaction in order to evaluate whether a particular item of income or deduction is appropriate, this mode of disclosure should facilitate more effective auditing of reportable transactions.

³⁰¹ It is not equal to one because a taxpayer may mistakenly decide that its transaction is not sufficiently similar to a listed transaction, may choose the audit lottery even when faced with new penalties, or because an auditor may make a mistake.

³⁰² Nominal penalties for entering into many reportable transactions are now higher as well, *see, e.g.*, I.R.C. § 6662A.

³⁰³ The original version of the proposed regulations was revised to reduce the number of these triggers out of concern with the overdisclosure problem, *see, e.g.*, Dustin Stamper & Sheryl Stratton, *Guidance Coming on New Shelter Rules, Says Treasury Official*, 105 Tax Notes 785, 785 (2004) (citing a Treasury official’s statement that “[o]verdisclosure transactions are the transactions that don’t have the potential for abuse. They not only place a burden on taxpayers, but also place a burden on the Service.”). For instance, the original version of the Regulations defined a reportable transaction to include transactions with tax-indifferent parties and those covered by tax insurance, *see* Prop. Treas. Reg. § 1.6011-4T(b)(3)(i)(E) (prior to amendment by T.D. 8896). These features were not incorporated in the final version of the Regulations.

³⁰⁴ *See* Rev. Proc. 2003-24, 2003-11 I.R.B. 599; Rev. Proc. 2003-25, 2003-11 I.R.B. 601.

³⁰⁵ *See* Rev. Proc. 2004-65; Rev. Proc. 2004-66 (superseding Rev. Proc. 2003-24); Rev. Proc. 2004-67 (superseding Rev. Proc. 2003-25); Rev. Proc. 2004-68.

³⁰⁶ 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). Similarly, only significant book-tax differences (i.e., in excess of \$10 million) trigger disclosure obligations, and no reporting is required unless the business is of relatively large size (i.e., is subject to SEC reporting or has \$250 million or more in gross assets), *see* Treas. Reg. § 1.6011-4(b)(6). Thus, all but fairly large corporations and very wealthy individuals are subject to the new

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.³⁰⁷ 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 automanufacturer. 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 less visible, but by no means a less significant part of the tax compliance problem we need to solve. Besides, even Interbank and the automaker are likely to discover structures that would give them the benefit of various subtraction items without triggering the disclosure requirements before long. Because the self-adjusting Penalty would affect the cost-benefit analysis of all these taxpayers, the recent enforcement measures hardly provide a reason to delay its enactment.

VII. Conclusion

Tax noncompliance continues to be a serious problem. It is abundantly clear that reinforcing existing measures (e.g., raising existing penalties or audit rates) 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 with 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.³⁰⁸ Instead of using uncertainty to justify inaction, we should rely

reporting requirements. Yet, many taxpayers who do not fit either description make a large aggregate contribution to the tax gap.

³⁰⁷ See Staff of Joint Comm. on Taxation, 109 Cong., *Options to Improve Tax Compliance and Reform Tax Expenditures* at 19 (Comm. Print 2005). Transactions with these features remain outside of the Regulations' reach, and will continue to do so for the foreseeable future.

³⁰⁸ As discussed in the Introduction, this task is well under way outside of the tax enforcement area.

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 taxpayers' incentives to hide their aggressive transactions induces wasteful behavior, increases the welfare cost of noncompliance, and lowers overall deterrence. Moreover, taxpayers' ability to deceive the government is hardly uniform. Millions earn only income subject to withholding or information reporting, take a standard deduction, and have no 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 self-adjusting Penalty aims at leveling the playing field. It is not a perfect solution, it will not produce optimal marginal deterrence, and in some instances, it may appear unfair, excessive, or flat out draconian to those who have to pay it. Yet, the Penalty will clearly reduce the undesirable incentives to hide and raise the overall deterrence. Moreover, it will narrow the gap in tax avoidance and evasion opportunities that can be profitably exploited by different types of taxpayers, reducing the clear inequity that pervades our tax system today.