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Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement

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REVEALING CHOICES: USING TAXPAYER CHOICE TO TARGET TAX ENFORCEMENT

Alex Raskolnikov*

People pay their taxes for many different reasons. Some choose to game the system, paying only when the cost of noncompliance outweighs its benefits. Others comply out of habit, a sense of duty or reciprocity, a desire to avoid feelings of guilt or shame, and for many other reasons. Our tax enforcement system has ignored this variety of taxpaying motivations for decades. It continues to rely primarily on audits and penalties, at least where information reporting and withholding are impossible. Fines and audits deter those rationally playing the tax compliance game, but are wasteful or even counterproductive when applied to others. The shortcomings of the current one-size-fits-all approach to tax enforcement are well understood. They also appear to be insurmountable.

This Article argues that it is possible to design a more tailored regime. The idea is to separate taxpayers based on their taxpaying motivations by creating two different enforcement regimes and inducing taxpayers to choose one when they file their annual returns. With this separation accomplished, the government can target enforcement by matching enforcement policies to taxpayer types. Those who choose to game the system will be deterred by higher penalties in one regime. Everyone else will be induced to comply by cooperative enforcement measures in the other. If successful, separation and targeted enforcement will improve tax compliance without raising its social cost, or keep the level of compliance unchanged while making tax administration more efficient.

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INTRODUCTION

Most Americans pay most of their taxes most of the time. That is as far as useful generalizations can go. If decades-long research of tax compliance has produced one clear finding, it is that taxpayers' motivations for complying with the tax law differ. Some are afraid of audits, others of

penalties; some are constrained by peer disapproval, others by their own guilty feelings; some follow a duty, others a habit, and there are even those (like Justice Holmes) who pay their taxes because they like it.¹ Just as many reasons explain significant and persistent *noncompliance*.

The government's efforts to reduce tax avoidance and evasion have largely ignored this bewildering variety of motivations. Audits, penalties, withholding, and information reporting have remained the weapons of choice for decades. Scholars have long acknowledged the severe limitations of this approach, but have offered few innovative solutions. Not surprisingly, the government's attempts to improve tax compliance over the past forty years have been largely unsuccessful.

This Article suggests a radical departure from the traditional approach to tax administration. I argue that the government should abandon its current one-size-fits-all strategy and begin to target enforcement based on taxpayer motivations. The proposal faces an obvious problem: Motivations are hidden from the government and are not always clear to taxpayers themselves. This problem, the Article argues, can be solved by using information-forcing mechanisms developed in legal and economic literatures and adopted by businesses around the world. The specific solution considered in detail involves replacing the existing regime with a menu of two different ones and forcing taxpayers to choose between them when they file their annual returns. Selecting a regime will induce taxpayers to sort themselves based on their reasons for complying with the tax law. The choice of regime, that is, will reveal taxpaying motivations to the tax administrator.

The first of the two proposed regimes (the *deterrence regime*) will look very similar to the current one, except statutory fines in that regime may be higher (perhaps much higher) than they are today. The second regime (the *compliance regime*) will have relatively low penalties, but taxpayers choosing it will be required to accept certain conditions. Because these conditions will be very costly for rational, deterrence-oriented taxpayers who try to game the tax system (*gamers*) but much less costly for all others, the former will prefer to face higher penalties in the deterrence regime while the rest will elect the alternative.

For example, to avoid the deterrence regime a taxpayer may be required to agree that, in any future dispute with the IRS, the government's position will be presumed correct unless proven otherwise by clear and convincing evidence. This will be a dramatic (extremely costly) concession for anyone interested in using tax shelters to game the system. But to those who pay taxes out of a sense of reciprocity, this will not be a cost at all. These reciprocators are uninterested in exploiting loopholes, so agreeing to abide by tax rules that are (almost) loophole-free will be easy for them.

1. "I like to pay taxes. With them I buy civilization." Randolph E. Paul, *Taxation for Prosperity* 277 (1947) (quoting Oliver Wendell Holmes, Jr.).

A pro-government presumption is hardly the only measure that is likely to impose varying costs or benefits on gamers and reciprocators. A precommitment to binding arbitration, a waiver of the tax preparer privilege, more demanding standards and stronger sanctions for tax advisors, enhanced prefiling assistance, and cooperative, problem-solving audits are other possible compliance regime features likely to facilitate the desired separation.

If reciprocators are the only group of taxpayers who will be separated from gamers by the proposed reform, the dual regime idea is not particularly robust. The proposal's most attractive feature, however, is that it requires extremely weak assumptions about taxpayer motivations. The pro-government presumption and other conditions just described are likely to impose relatively low costs not only on reciprocity-driven individuals, but also on those who are significantly constrained by a sense of duty, those motivated by feelings of guilt or shame, habitual compliers, and even some calculative utility maximizers. Only for a specific group of taxpayers—rational actors whose marginal compliance decisions depend primarily on the expected tax penalty calculus—will the proposed conditions be very costly. These gamers will mostly choose the deterrence regime.

Distinguishing gamers from everyone else (rather than dividing taxpayers along other lines suggested in the literature²) is particularly useful

2. Bruno Frey distinguishes between a person's intrinsic and extrinsic motivations. See Bruno S. Frey, *Tertium Datur: Pricing, Regulating and Intrinsic Motivation*, 45 *Kyklos* 161, 161, 166 (1992) (differentiating the two, and noting that external intervention can either support or damage an individual's intrinsic motivation). Valerie Braithwaite suggests that taxpayers have several motivational postures toward tax authorities. See Valerie Braithwaite, *Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions*, in *Taxing Democracy: Understanding Tax Avoidance and Evasion* 15, 18 (Valerie Braithwaite ed., 2003) [hereinafter Braithwaite, *Dancing*] (describing these postures as commitment, capitulation, resistance, disengagement, and game playing). Both approaches are descriptive. Neither author suggests how the government should adjust its enforcement strategies to account for differences among taxpayers. Braithwaite expressly acknowledges that attitudes do not translate directly into behavior. See *id.* at 33 (reporting that correlations between motivational postures and compliance-related activities are uniformly low). Leandra Lederman proposes to distinguish salary earners from those who earn primarily business income and to concentrate deterrence efforts on the latter. See Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 *Ohio St. L.J.* 1453, 1462–63 (2003) (“[A] norms-based appeal might be cost-effective with respect to taxpayers with primary wage and investment income. . . . [A]dditional enforcement with respect to groups of self-employed taxpayers might succeed in shifting the norm from noncompliance to compliance.”). The suggestion—based on a well-known fact that salary income is misreported much less than business income—does not account for differences in taxpayer motivations. As a result, it focuses on a consequence rather than a cause. For example, the fact that an individual pays taxes on her entire salary reveals only that she has no opportunity to hide salary income. This taxpayer may be a gamer hiding a considerable amount of investment income offshore. A business income recipient, in contrast, may be paying every penny he owes out of a sense of duty, as Lederman herself points out. See *id.* at 1507–08 (noting one self-employed couple's deliberate selection of “an accountant who would not cheat,” though suggesting

because a well-developed economic model of deterrence provides clear prescriptions for improving tax compliance among gamers. Using the same strategies with non-gamers is wasteful at best and counterproductive at worst. At the same time, policy instruments that are effective with non-gamers may well decrease compliance among gamers. Separating these two broad categories of taxpayers will allow the government to target enforcement by matching enforcement policies to taxpayer types. Gamers will face large statutory fines, adversarial examinations, and highly public tax prosecutions in the deterrence regime. Non-gamers will be induced to comply by helpful, readily available prefilling advice, respectful audits, mass media campaigns emphasizing widespread compliance, and the like in the compliance regime.

Targeted tax enforcement is likely to be superior to the current one-size-fits-all approach on welfarist grounds. It can produce stronger deterrence and improved voluntary compliance at a lower social cost (or, if one prefers to keep the level of deterrence unchanged, improved voluntary compliance at a much lower social cost). As important, a dual enforcement system based on taxpayer choice is bound to be more politically acceptable than an across-the-board application of most features found in either environment.

The proposed dual regime contemplates a radical overhaul of our tax enforcement system. Yet it is well grounded because some of today's tax rules already reflect differential enforcement based on taxpayer choice.³ These rules, however, are isolated and have a very limited reach. The Article's goal is to explore how an information-forcing dual enforcement regime can be used to reform—and significantly improve—the entire tax administration.

The Article begins by arguing that the current unsatisfactory state of tax compliance is caused by the government's failure to take account of taxpayer motivations. Separating gamers from all others and targeting tax enforcement, Part I suggests, can improve social welfare and reduce avoidance and evasion. Part II explains how forcing taxpayers to choose

such behavior might be atypical). While it is possible that people particularly averse to paying taxes choose occupations where income is not subject to withholding or information reporting, empirical support for this self-sorting hypothesis is limited. See Joel Slemrod, *Small Business and the Tax System*, in *The Crisis in Tax Administration* 69, 94–95 (Henry J. Aaron & Joel Slemrod eds., 2004) [hereinafter Slemrod, *Small Business*] (suggesting small business sector's growth during periods of higher tax rates is connected to noncompliance opportunities in that sector).

3. For instance, taxpayers and tax preparers may currently avoid penalties by choosing to take a more conservative position without disclosing it on a return or by adopting a more aggressive position and disclosing it to the IRS. See I.R.C. §§ 6662(d)(2)(B), 6694(a)(2) (2006) (providing rules for taxpayers and preparers, respectively). Similarly, tax amnesties and settlements usually promise reduced penalties to those taxpayers who choose to reveal their abusive transactions to tax authorities. See, e.g., I.R.S. Announcement 2002-2, 2002-1 C.B. 304 (announcing amnesty); I.R.S. Announcement 2004-46, 2004-21 I.R.B. 964 (announcing settlement offer).

between two enforcement regimes should separate taxpayers based on their motivations. Part III introduces and discusses a variety of specific features that are likely to produce this separation. Part IV highlights strengths and weaknesses of the proposed dual enforcement environment. A brief conclusion follows.

I. RESPONDING TO DIFFERENCES IN MOTIVATIONS WITH TARGETED ENFORCEMENT

Over the past four decades, Congress, the Internal Revenue Service (IRS), legal academics, economists, psychologists, and political scientists have devoted significant effort to studying and improving tax compliance. Yet estimates of the total taxes paid as a fraction of the total taxes that should be paid hover between eighty and eighty-five percent, seemingly impervious to the ebb and flow of legislative attacks and administrative initiatives.⁴ The reason for this lack of success, this Part suggests, is three-fold. First, most government measures assume a model of taxpayer behavior that, while useful, fails to capture the motivations of millions of taxpayers. Second, alternative behavioral models are numerous and varied, making it difficult to design specific enforcement policies. And third, while the limitations of the current one-size-fits-all approach to tax administration are widely acknowledged, there have been few suggestions for designing more tailored regimes.

A. *Playing the Tax Compliance Game*

Penalties, audits, and constraints on opportunities to evade or avoid tax laws have dominated tax administration for decades.⁵ The unstated (and sometimes stated) premise of this approach is a model of taxpayer

4. In 1992, the tax gap (taxes owed but not paid) represented about the same proportion of taxes owed as in 1973—17.3%. James Andreoni et al., *Tax Compliance*, 36 J. Econ. Lit. 818, 819 (1998). The latest estimate is for 2001, and it is slightly over 16%. Eric Toder, *What Is the Tax Gap?*, 117 Tax Notes 367, 367 (2007). Uncertainty associated with the estimating procedures used to determine the tax gap and changes in the estimating methodology that have taken place over time raise some doubts about the gap's true size. Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, J. Econ. Persp., Winter 2007, at 25, 27 [hereinafter Slemrod, *Cheating Ourselves*]; see also Toder, *supra*, at 372–76 (providing detailed discussion of factors that contribute to uncertainty in measuring tax gap).

5. See, e.g., Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. Rev. 333, 343 (2001) [hereinafter Kahan, *Trust*] (“[T]ax-enforcement policy . . . continues to reflect the conventional model’s emphasis on material incentives.”); Lederman, *supra* note 2, at 1456 (noting that IRS tax enforcement reflects “standard answer” for improving compliance—the provision of incentives). A period of increased attention to taxpayer service that started in 1998 came to an abrupt end when the government recognized the magnitude of the tax shelter crisis just a few years later. See, e.g., David Cay Johnston, *I.R.S. Is Bolstering Efforts to Curb Cheating on Taxes*, N.Y. Times, Feb. 13, 2000, at A1 (reporting large increase in IRS budget to curb tax evasion); Slemrod, *Cheating Ourselves*, *supra* note 4, at 38 (referring to post-1998 decline in enforcement as “temporary phenomenon”).

behavior that underlies the economic analysis of deterrence.⁶ In that model, taxpayers are viewed as rational individuals who maximize their expected utility by comparing the costs and benefits of paying taxes with those of failing to pay.⁷ Taxpayers are trying to game the system; the government is trying to beat them at their game. To evaluate the cost of noncompliance, these gamers discount statutory (or nominal) penalties by the probability that they will actually have to pay these fines (probability of punishment). In order to strengthen deterrence, the model suggests, the government needs to increase expected penalties by raising nominal sanctions, probability of punishment, or some combination of the two.

The major impact of economic analysis on legal scholarship and tax administration is understandable. The deterrence model is rigorous, tractable, and capable of generating concrete policy prescriptions that coincide with some deep-seated intuitions. Moreover, numerous experiments suggest that at least some taxpayers are indeed gamers who act consistently with the model's predictions.⁸

However, it is beyond doubt that this model fails to describe the behavior of many individuals. Given extremely low existing penalties, gamers have no incentive to pay any tax.⁹ Yet numerous taxpayers comply with tax law even though they have a clear opportunity to evade or avoid their obligations.¹⁰ When researchers experiment with varying the probability of detection, the effect on compliance is not as stark as the economic model suggests it should be.¹¹ And the impact of altering

6. See Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 *Colum. L. Rev.* 569, 579 n.44 (2006) [hereinafter Raskolnikov, *Self-Adjusting Penalty*] (citing legislative history and IRS policy statements articulating deterrence-based approaches).

7. The foundational article is Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 *J. Pub. Econ.* 323 (1972), modified in Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 *J. Pub. Econ.* 201 (1974).

8. See James Alm & Sarah Jacobson, *Using Laboratory Experiments in Public Economics*, 60 *Nat'l Tax J.* 129, 134–35 (2007); Andreoni et al., *supra* note 4, at 842.

9. See, e.g., Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 *Nat'l Tax J.* 355, 358 (1985) (“Application of the standard economic theory of crime to tax avoidance . . . produces an unambiguous prediction of behavior: throughout the 1970s *no one* should have paid the taxes they owed . . .”).

10. See Andreoni et al., *supra* note 4, at 821 (concluding that, even taking lack of opportunity to evade taxes on certain types of income into account, “taxpayers still appear to be more honest than might be expected” from the expected penalty calculation). While it has been argued that the disparity between actual taxpayer compliance and that predicted by the deterrence model can be explained by risk aversion, the degree of risk aversion needed to explain existing compliance by taxpayers who have an opportunity to evade is unrealistically high. Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 *Law & Pol’y* 102, 102 (2007).

11. See, e.g., Andreoni et al., *supra* note 4, at 841–44, 846 (reviewing empirical evidence); Feld & Frey, *supra* note 10, at 108 (comparing studies); Joel Slemrod et al., *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled*

nominal penalties is decidedly ambiguous.¹² Moreover, when researchers ask randomly selected individuals to explain their motivations for paying taxes, fear of audits and penalties is not at the top of the list.¹³ Clearly, not every taxpayer is a rational gamer straight out of Gary Becker's model of crime and punishment.¹⁴ It is hardly surprising, therefore, that the continuing emphasis on fines and audits has produced no apparent improvement in tax compliance.¹⁵

B. *Beyond Gaming*

If gaming the system is not the primary taxpayer motivation, what is? The list of alternative "nonrational" explanations is long. There is evidence that some people pay taxes to avoid the feelings of guilt or shame they would experience if their noncompliance were detected and prosecuted.¹⁶ Researchers argue that taxpayers may be guided by a sense of duty, sometimes conceptualizing it as a decisionmaking heuristic.¹⁷

Experiment in Minnesota, 79 J. Pub. Econ. 455, 465 (2001) (finding that higher audit rates increased reported income and taxes paid by low- and middle-income taxpayers, especially those with greater opportunities to evade, but decreased reported income of high-income taxpayers).

12. See, e.g., Andreoni et al., *supra* note 4, at 842, 846 (evaluating studies); Feld & Frey, *supra* note 10, at 108 (finding mixed results in empirical studies); Slemrod, *Cheating Ourselves*, *supra* note 4, at 38 (concluding that "there has been no compelling empirical evidence addressing how noncompliance is affected by the *penalty* for detected evasion, as distinct from the *probability* that a given act of noncompliance will be subject to punishment").

13. See Harold G. Grasmick & Robert J. Bursik, Jr., *Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model*, 24 *Law & Soc'y Rev.* 837, 840-41, 851 (1990) [hereinafter Grasmick & Bursik, *Conscience*] (showing that effect of guilt (also referred to as "shame" or "self-imposed punishment") on deterring tax cheating is more than one-and-a-half times greater than effect of legal sanctions, which, however, is greater than effect of threat of embarrassment (or socially imposed punishment)); Harold G. Grasmick & Wilbur J. Scott, *Tax Evasion and Mechanisms of Social Control: A Comparison with Grand and Petty Theft*, 2 *J. Econ. Psychol.* 213, 223-25 (1982) [hereinafter Grasmick & Scott, *Tax Evasion*] (reporting that feelings of guilt are stronger inhibitor of tax evasion than threat of stigma, which, in turn, is stronger inhibitor than threat of legal sanctions).

14. See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169 (1968).

15. It is conceivable, of course, that every time Congress or the IRS has strengthened deterrence by raising statutory penalties or increasing audit rates, some other policy or economic or social change negated what would have been the positive effect of these measures on tax compliance. Because it will never be possible to control for all variables when introducing policy changes in real life, statements like the one made in the text are inevitably imprecise. But it is worth noting that, to my knowledge, no research has unearthed specific changes that repeatedly offset a positive effect of stronger deterrence-oriented measures introduced over the past four decades.

16. See, e.g., Andreoni et al., *supra* note 4, at 850-51; Grasmick & Scott, *Tax Evasion*, *supra* note 13, at 214-15.

17. See John T. Scholz & Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 *Am. J. Pol. Sci.* 490, 493 (1995) ("The duty

Some models incorporate taxpayers who comply out of habit.¹⁸ Survey data indicate that tax compliance is related to attitudes toward government,¹⁹ perceptions of fairness of the tax burden,²⁰ and the direct versus representative nature of democratic institutions.²¹ Other explanations include taxpayer morale,²² psychological contract,²³ motivational postures,²⁴ and social identity.²⁵ These nonrational (or “irrational”) reasons for tax compliance do not suggest that non-gamers act randomly or without purpose. Rather, these taxpayers are nonrational in a formal sense: They have preferences other than the two basic preferences for consumption and leisure that underlie the traditional neoclassical model of deterrence.²⁶

In addition to the variety of theories of taxpayer behavior, empirical research has identified numerous factors that affect taxpaying decisions. Age,²⁷ gender,²⁸ marital status,²⁹ educational level,³⁰ religious conviction,

heuristic claims that the citizen’s sense of duty to obey laws provides . . . cues for compliance decisions . . .”).

18. See Michael J. Graetz et al., *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 *J.L. Econ. & Org.* 1, 7 (1986) [hereinafter Graetz et al., *Tax Compliance Game*] (introducing model that includes “‘habitual compliers’—individuals who endeavor to report taxable income correctly without regard either to the costs and benefits of playing the audit lottery or to their perceptions about the compliance behavior of others”).

19. See Andreoni et al., *supra* note 4, at 845, 851.

20. See *id.* at 851.

21. See Feld & Frey, *supra* note 10, at 113 (summarizing several studies of Swiss cantons).

22. See Bruno S. Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 *J. Comp. Econ.* 136, 137 (2007).

23. See Feld & Frey, *supra* note 10, at 104.

24. See Braithwaite, *Dancing*, *supra* note 2, at 18.

25. See Natalie Taylor, *Understanding Taxpayer Attitudes Through Understanding Taxpayer Identities*, in *Taxing Democracy*, *supra* note 2, at 71, 74–75.

26. See Allingham & Sandmo, *supra* note 7, at 325–27 (introducing utility function of putative tax evader that depends on income and reputation, but restricting further analysis to utility function depending solely on income); Becker, *supra* note 14, at 177 n.16 (describing putative criminal’s utility function as depending solely on income, albeit stating that income may include “psychic income” without further elaboration).

27. See Andreoni et al., *supra* note 4, at 840–41 (reporting that older taxpayers are more compliant).

28. See *id.* at 841 (finding that women are more compliant than men).

29. See *id.* at 840 (reporting that single people are more compliant than married couples).

30. See James Alm & Benno Torgler, *Culture Differences and Tax Morale in the United States and in Europe*, 27 *J. Econ. Psychol.* 224, 228, 237 (2006) (finding that “individuals with the lowest education have the highest tax morale,” defined as “moral principles or values that individuals hold about paying their tax”).

tions,³¹ taxpayer reference groups,³² and even emotional arousal³³ have all been shown to matter. There is evidence that differences among national cultures influence tax compliance as well.³⁴ None of these factors should have any effect if everyone is a gamer.³⁵

Another suggestion is that people pay their taxes out of feelings of reciprocity.³⁶ Of all nonrational theories of human behavior, the theory of reciprocity has the strongest empirical foundation.³⁷ Numerous experiments have shown that a substantial portion of subjects consistently act in direct contradiction to the rational utility maximizer model. They share assets in an investment game despite clear material incentives to

31. Compare Michael R. Welch et al., "But Everybody Does It . . .": The Effects of Perceptions, Moral Pressures, and Informal Sanctions on Tax Cheating, 25 *Soc. Spectrum* 21, 43–45 (2005) (reporting almost no differences based on religiosity), with Harold G. Grasmick et al., "Render unto Caesar What Is Caesar's": Religiosity and Taxpayers' Inclinations to Cheat, 32 *Soc. Q.* 251, 263 (1991) (finding that highly religious taxpayers are less inclined to commit tax evasion than less religious ones).

32. See Frank A. Cowell, *Cheating the Government: The Economics of Evasion* 102–03 (1990) ("Evidence . . . suggest[s] that whether or not a taxpayer is compliant with tax demands is significantly affected by the social grouping in which the taxpayer finds himself."); Marco R. Steenbergen et al., Taxpayer Adaptation to the 1986 Tax Reform Act: Do New Tax Laws Affect the Way Taxpayers Think About Taxes?, in *Why People Pay Taxes: Tax Compliance and Enforcement* 9, 29–30 (Joel Slemrod ed., 1992) (noting that taxpayers' commitment to complying with tax law depends on attitudes of those with whom taxpayers interacted in the months leading to a major tax reform); Welch et al., *supra* note 31, at 45 (finding that those who perceive that many members of their community commit tax evasion are more likely to evade themselves).

33. See Giorgio Coricelli et al., Tax Evasion: Cheating Rationally or Deciding Emotionally? 32 (*Inst. for the Study of Labor, Discussion Paper No. 3103, 2007*), available at <http://ssrn.com/abstract=1028476> (on file with the *Columbia Law Review*) (concluding that tax compliance decision is "cognitively demanding" and finding positive correlation between time taken by subjects to make this decision and emotional arousal).

34. See James Alm et al., Economic and Noneconomic Factors in Tax Compliance, 48 *Kyklos* 3, 4 (1995) (finding that both level of compliance and change in that level in response to different policy instruments vary significantly between U.S. and Spanish experimental subjects); Andreoni et al., *supra* note 4, at 822 (noting that "evasion varies widely across nations, reaching extremely high levels in some developing countries").

35. If any of these factors affect perceived probability of punishment or perceived nominal fine, this evidence supports (rather than undermines) the deterrence model. Research suggesting such a relationship is very limited, however. See, e.g., Grasmick & Bursik, *Conscience*, *supra* note 13, at 848–49 (reporting that males and older respondents perceive lower expected sanctions—legal as well as those based on shame and embarrassment—than females and younger individuals, but finding no similar relationship based on education level).

36. See Kahan, *Trust*, *supra* note 5, at 340–44 (describing "trust model" of collective action, under which individual citizens' motivations to pay taxes stem from "their perception that other citizens are or are not inclined to pay," and reviewing empirical support for the model).

37. For a review, see Christina M. Fong et al., Strong Reciprocity and the Welfare State, in 2 *Handbook of the Economics of Giving, Altruism and Reciprocity* 1439, 1447–50 (Serge-Christophe Kolm & Jean Mercier Ythier eds., 2006).

the contrary.³⁸ They make contributions in a public good game where the rational strategy is to contribute nothing.³⁹ They irrationally respond to nonbinding assurances of future cooperation (so-called cheap talk).⁴⁰ At the same time, people do not like being taken advantage of—their cooperation is conditional. When players observe that others “defect,” they reciprocate with their own defections and cooperation unravels.⁴¹ But if cooperative players can punish defectors while maintaining cooperation with nondefecting players, they do so even when the punishment is costly to the cooperators themselves.⁴² Again, a rational player would never do such a thing.

The theory of reciprocity has made significant inroads into classical economics, as well as law and economics.⁴³ Yet the link between public good, ultimatum, and similar games and real-life tax compliance is tenuous. While taxpayers do seem to care about the tax compliance of others in making their own taxpaying decisions, the connection is weak.⁴⁴

38. See Joyce Berg et al., *Trust, Reciprocity, and Social History*, 10 *Games & Econ. Behav.* 122, 123–24 (1995).

39. Fong et al., *supra* note 37, at 1448–49.

40. See Alm & Jacobson, *supra* note 8, at 139.

41. See Fong et al., *supra* note 37, at 1449.

42. *Id.*

43. See Samuel Bowles & Herbert Gintis, *Walrasian Economics in Retrospect*, 115 *Q.J. Econ.* 1411, 1413–19 (2000) (explaining that “over the closing fifteen years of [the twentieth] century . . . an empirically grounded view of economic behavior . . . has arisen to challenge the *Homo economicus*” (emphasis omitted)); Fong et al., *supra* note 37, at 1457–59 (relating reciprocity principle to citizens’ opinions on welfare state policies); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 *Colum. L. Rev.* 1641, 1644–45 (2003) (positing that theory of reciprocity explains existence of certain legally unenforceable contracts).

44. One of the exceedingly few studies examining changes in actual tax compliance in response to stimulants other than threats of audits and penalties is Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance: From Theory to Intervention*, 26 *J. Econ. Psychol.* 862 (2005) [hereinafter Wenzel, *Misperceptions*]. Wenzel addressed the “self-other discrepancy,” revealing that while taxpayers largely believe in honest taxpaying, they attribute to others a more accepting attitude toward tax cheating. See *id.* at 864–65. Informing taxpayers of this discrepancy, including the fact that others also believe in honest tax compliance, reduced non-work-related deductions, but had no effect on work-related deduction claims, even though information about the discrepancy provided to taxpayers expressly referred to these claims. *Id.* at 877–78. Studies finding that taxpayer perceptions of other taxpayers affect taxpaying attitudes and intentions (rather than actions) are more numerous. See Cowell, *supra* note 32, at 102–03 (“Evidence . . . [suggests] that whether or not a taxpayer is compliant with tax demands is significantly affected by the social grouping in which the taxpayer finds himself.”); Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, in *Why People Pay Taxes*, *supra* note 32, at 193, 213 (finding that taxpayers evincing less faith in honesty of others have more permissive attitudes towards tax evasion); Steenbergen et al., *supra* note 32, at 9, 29–30 (linking taxpayers’ commitment to compliance to attitudes of those with whom they interacted in the months leading to a major tax reform); Welch et al., *supra* note 31, at 22 (finding that “the more prevalent an individual perceives tax evasion to be within the community, the less likely the individual will be to judge the act harshly, the less likely he or she will be to fear informal sanctions

When asked, real taxpayers repeatedly assert that their main reason for paying taxes honestly is personal integrity⁴⁵ or anticipation of the guilt they would feel if they failed to comply.⁴⁶ Reciprocal motivations are at the bottom of the list, behind the threat of sanctions.⁴⁷ More generally, recent research indicates that the connection between the results of reciprocity-testing games and reciprocal behavior in daily interactions is complex.⁴⁸ Some responses that have been initially attributed to reciprocity appear to have a different cause.⁴⁹ In sum, while many of us may well be contingent reciprocators,⁵⁰ it is premature to conclude that reciprocity is the primary cause of tax compliance. At least for the purposes of designing real-life policy proposals, it is more reasonable to view reciprocity as just one more nonrational explanation of taxpayer behavior, alongside many others.

Finally, nonrationality is not the only reason one may be a non-gamer. Even purely rational actors may not respond to tax penalties and audits in a way predicted by the economic model of deterrence. An illegal immigrant working for cash and not reporting his income to the IRS has much more to worry about than fines for tax evasion. If a bank lends to a small entrepreneur based on his taxable income, the entrepreneur's incentive to report his earnings truthfully is not based solely (or even primarily) on expected tax penalties.⁵¹ And the tax director of a large corporation may care little about relatively small statutory fines in the

directed against it, and the more inclined the individual will be to commit tax evasion in the future").

45. See IRS Oversight Bd., 2005 Taxpayer Attitude Survey tbl.4, available at <http://www.ustreas.gov/irsob/releases/2006/02212006.pdf> (on file with the *Columbia Law Review*) (reporting that personal integrity was primary reason for tax compliance in each year from 2002 to 2005).

46. See *supra* note 13 and accompanying text.

47. See IRS Oversight Bd., *supra* note 45, at tbl.4 (observing that "belief that your neighbors are reporting and paying honestly" ranked last among reasons given by respondents).

48. See Susan K. Laury & Laura O. Taylor, Altruism Spillovers: Are Behaviors in Context-Free Experiments Predictive of Altruism Toward a Naturally Occurring Public Good?, 65 *J. Econ. Behav. & Org.* 9, 28 (2008) (concluding that "altruistic behavior in the laboratory can be predictive of contributions to naturally occurring public goods, but not in a uniform manner").

49. See Nicholas Bardsley & Rupert Sausgruber, Conformity and Reciprocity in Public Good Provision, 26 *J. Econ. Psychol.* 664, 665–67 (2005) (finding that conformity—rather than reciprocity—accounts for about one-third of cooperative actions in a public good game).

50. Considerable experimental evidence suggests that forty percent to sixty percent of people are contingent reciprocators. See, e.g., Ernst Fehr & Simon Gächter, Reciprocity and Economics: The Economic Implications of Homo Reciprocans, 42 *Eur. Econ. Rev.* 845, 847 (1998).

51. See Robert A. Kagan, On the Visibility of Income Tax Law Violations, in 2 *Taxpayer Compliance: Social Sciences Perspectives* 76, 94 (Jeffrey A. Roth & John T. Scholz eds., 1989). Similarly, consider the following statement by a computer consultant: "The whole consultancy requires integrity and honesty . . . if you were detected evading it would be damaging to your business, so it's not worth it." Maria Sigala et al., Tax

Internal Revenue Code, but be mortified by the possibility of telling the CFO that the company must restate its earnings because of tax adjustments.⁵² Thus, not only is there strong evidence that many taxpayers act nonrationally, but even fully rational taxpayers are not necessarily gamers.

In sum, gamers are a fairly narrow group—they are rational taxpayers whose marginal compliance decisions are made primarily based on the expected tax penalty calculation.⁵³ Non-gamers, in contrast, are a broad category that includes reciprocators, rational taxpayers motivated by factors other than expected tax penalties, and those complying out of habit, a sense of duty, a desire to avoid feelings of guilt or shame, and for other irrational reasons. Yet our tax enforcement is built on the assumption that everyone is a gamer.⁵⁴ No wonder progress in improving tax compliance has been slow.

C. *The Tax Enforcement Conundrum*

Scholars have long recognized that existing expected penalties are wholly inadequate to deter gamers.⁵⁵ Overall compliance is relatively high only because major sources of income (such as salaries, dividends, and interest) are subject to withholding, information reporting, or both. When neither mechanism is practical or politically acceptable, compliance rates decline.⁵⁶ This is hardly a surprise. Audit rates are exceed-

Communication and Social Influence: Evidence from a British Sample, 9 J. Community & Applied Soc. Psychol. 237, 239 (1999).

52. “Accounting for income taxes was the top reason for adverse audit opinions and restatements during 2005 and 2006. It’s also currently the highest risk area of financial reporting and it’s causing quite a stir within audit committees and the C-suite.” Bob Norton, *A Practical Approach to Tax Governance*, Investment Dealer’s Dig., Apr. 23, 2007, at 18, 18.

53. Note that “narrow” in this context is not synonymous with “small.”

54. This is a bit of an overstatement. The IRS does have several programs based on cooperation with taxpayers rather than deterrence, including the Prefiling Agreement Program, the Advance Pricing Agreement Program, the Compliance Assurance Program, and the Joint Audit Planning Program. See Amy S. Elliott, *IRS Evolves to Meet Challenges of Global Tax Environment*, 121 Tax Notes 898, 898–99 (2008) (discussing potential use of these programs in context of multinational enterprises). Nevertheless, these deviations from the one-size-fits-all approach treating everyone as a gamer are minor compared to the potential reforms discussed in this Article. For instance, the Compliance Assurance Program involves only 94 taxpayers, see id., and merely 773 advance pricing agreements have been completed since the program began in 1991. Lisa M. Nadal, *Nearly 800 APAs Completed Since Program Began*, IRS Says, 118 Tax Notes 1365, 1365 (2008).

55. For a numerical example showing that at a 2% audit rate (an unrealistically high audit rate for individuals), an adequate penalty based on the deterrence model is 4900%, see Lederman, *supra* note 2, at 1464–65.

56. “The IRS reports that the net misreporting rate is 53.9, 8.5, and 4.5 percent for income types subject to ‘little or no,’ ‘some,’ and ‘substantial’ information reporting, respectively, and is just 1.2 percent for those amounts subject to both withholding and substantial information reporting.” Slemrod, *Cheating Ourselves*, *supra* note 4, at 30 (citation omitted).

ingly low and have been falling for decades.⁵⁷ Granted, the probability of punishment that matters is the perceived rather than the actual one. Some evidence suggests that many taxpayers overestimate the likelihood that their tax returns will be examined.⁵⁸ Yet those with the largest opportunity to evade have the most realistic view of audit coverage.⁵⁹ Understanding the exceedingly favorable odds of playing the audit lottery, and being aware of very modest statutory fines,⁶⁰ these taxpayers pay very little tax. If everyone were a gamer, we would at least have a clear idea about how to strengthen deterrence.⁶¹ The fact that many taxpayers do not fit the gamer mold makes things considerably more complex.

57. See Jeffrey A. Dubin et al., *The Changing Face of Tax Enforcement, 1978–1988*, 43 *Tax Law.* 893, 896–97 (1990) [hereinafter Dubin et al., *Changing Face*] (noting that audit rate fell from over 6% in 1965 to roughly 2% in 1978, and to 1% by 1988); Slemrod, *Cheating Ourselves*, *supra* note 4, at 38 (“Between 1996 and 2004, the share of nonbusiness individual returns audited dropped from 1.67 percent to 0.74 percent.”).

58. See Andreoni et al., *supra* note 4, at 844 (describing one study indicating that people “greatly overestimate” their probability of audit); Grasmick & Scott, *Tax Evasion*, *supra* note 13, at 222 (reporting that 37.9% of respondents believed they “probably or definitely would be caught if they engaged in tax evasion”); Scholz & Pinney, *supra* note 17, at 497–99 (finding mean estimate of probability of being caught by IRS is 48%, with standard deviation of 29%).

59. See Andreoni et al., *supra* note 4, at 844 n.75 (citing study showing “significant positive correlation between subjective and objective measures” of audit probability among a subset of better-informed taxpayers); Scholz & Pinney, *supra* note 17, at 507 (reporting that an increase in subjective probability of getting caught for “tempted” taxpayers with good opportunities to cheat closely tracks an increase in actual audit probability); Loretta J. Stalans et al., *When Do We Think About Detection? Structural Opportunity and Taxpaying Behavior*, 14 *Law & Soc. Inquiry* 481, 495 (1989) (determining that “[i]ndividuals with high structural opportunity perceived significantly lower likelihood that the IRS would detect underreporting income or overstating deductions than did individuals with low or medium structural opportunity”).

60. For a discussion of existing statutory penalties for tax noncompliance, see, for example, Raskolnikov, *Self-Adjusting Penalty*, *supra* note 6, at 581–83.

61. Whether a substantial across-the-board increase in penalties and audit rates is realistic as a political matter is another question. See, e.g., Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 *Tax Notes* 506, 514–15 (2007) [hereinafter Bankman, *Eight Truths*] (reporting that “[i]n California, at least, folks who are otherwise enthusiastic about reducing the tax gap become much less so when they are told that audits and greater use of penalties may play a role”); Graetz & Wilde, *supra* note 9, at 358 (“[A] large increase in the applicable sanction in light of the very low probability of its application quickly becomes irrelevant as a policy matter. In this country, at least, legal, moral and political constraints make this necessarily so.”); see also Slemrod, *Cheating Ourselves*, *supra* note 4, at 43 (suggesting that popular notion that punishment should fit the crime may make courts reluctant to apply draconian penalties needed to assure appropriate level of deterrence). Yet it is surely worth remembering that not so long ago audit rates used to be ten times higher than what they are today. Compare Dubin et al., *Changing Face*, *supra* note 57, at 898 (reporting that audit rate for high-income returns was over 10% in 1978), with Allen Kenney, *Everson Touts Increased IRS Enforcement in Fiscal 2004*, 105 *Tax Notes* 1071, 1071 tbl.1 (2004) (reporting that field audit rate of high-income individuals was 0.53% in 2004, and combined field and correspondence audit rate of high-income individuals was as low as 0.79% in 2001).

Audits are expensive. They consume government resources and taxpayers' time and energy. If an audited taxpayer pays her taxes out of a sense of duty or reciprocity, to take two examples, an audit is not a particularly effective policy instrument. First, this taxpayer is much less likely than a gamer to take a questionable or illegal position. Thus, most audits of duty- or reciprocity-bound taxpayers will produce no adjustments. Second, if this taxpayer underpays her taxes, she is almost certain to do so by mistake. No doubt, collecting mistakenly unpaid taxes increases government revenues and may induce the taxpayer to be more careful in the future. Yet an audit of a duty- or reciprocity-bound taxpayer will not produce the large indirect deterrent effect often emphasized by academics and government officials,⁶² at least not among other like-minded individuals. Those who pay taxes for reasons other than the fear of punishment cannot be induced to comply by strengthening this fear.

Furthermore, the kind of audit required to deter a gamer is very different from that needed to strengthen voluntary compliance. The cooperative, problem-solving, even forgiving approach critical to maintaining positive attitudes toward the tax law among non-gamers is, at best, wasted on gamers. More realistically, this approach reduces their compliance by lowering the likelihood (perhaps actual, and certainly perceived) that a violation will be detected during an examination.⁶³ At the same time, the adversarial, formalistic, even inquisitorial audits needed to deter gamers may alienate non-gamers, undermining voluntary compliance.⁶⁴ Neither approach works well for all taxpayers.⁶⁵

62. See, e.g., Dubin et al., *Changing Face*, supra note 57, at 904 (estimating ratio of indirect to direct effect of doubling audit rate as 5:1); Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance*, 35 *Pub. Fin. Rev.* 500, 519 (2007) (estimating same ratio as about 15:1).

63. The strong emphasis on taxpayer service and shift away from deterrence that followed the 1997 congressional hearings was probably a factor (if not a major factor) in the wave of tax shelters of the late 1990s and early 2000s. See, e.g., Jon Almeras, *IRS Restructuring: Ten Years Later*, 120 *Tax Notes* 281, 281 (2008) (suggesting that "the accusations against the IRS [made at the 1997 hearings] were overblown and that the restructuring gutted the agency's enforcement efforts").

64. For anecdotal evidence of crowding out of voluntary compliance by unusually thorough audits, see John Braithwaite, *Through the Eyes of the Advisers: A Fresh Look at High Wealth Individuals*, in *Taxing Democracy*, supra note 2, at 245, 248–49 [hereinafter Braithwaite, *High Wealth Individuals*].

65. In a certain sense, the government's auditing strategy is already not uniform. For instance, the IRS has increased audit rates for some narrow categories of taxpayers based on their observable characteristics. The compliance rate for small businesses is much lower than for salaried employees, so the IRS pays particular attention to the former. In 2001, for instance, total audit coverage for all individual returns without business income (Schedule C) was 0.51%, while it was 1.55% for individual returns with business income. See Slemrod, *Small Business*, supra note 2, at 92. Similarly, returns that raise "red flags" are examined more often than the rest. The IRS uses a secret "discriminant index function" to identify suspect returns. See Dubin et al., *Changing Face*, supra note 57, at 900. These audit selection strategies are reasonable, but they miss the larger point. They

Raising penalties across the board leads to similar problems. Tax law is notoriously complex and ambiguous. What seems to be a clear rule in one section of the Code may be overridden by an obscure provision in a different part of the tax statute.⁶⁶ Some transactions have no clear tax treatment at all.⁶⁷ Even when dealing with straightforward rules, auditors make mistakes, and so do taxpayers. For all these reasons, even those whose tax positions are uncontroversial (or only mildly aggressive) worry about being penalized. The resulting risk-bearing losses—a form of deadweight loss—reduce social welfare.⁶⁸ The higher the statutory penalties, the larger these losses.

High fines lead to other social costs as well. They result in more vigorous resistance from offenders, longer trials, higher attorney fees, and so on.⁶⁹ For gamers, higher penalties at least produce an offsetting social benefit of stronger deterrence.⁷⁰ But for non-gamers no such benefit exists. Thus, a dramatic increase in statutory fines is particularly inefficient if many taxpayers are not trying to game the system.

If incurring the social costs of higher fines without improving tax compliance does not seem like a good idea, doing the same while *decreasing* compliance is clearly a bad one. Yet this is precisely what happens if the vast empirical literature describing the so-called crowding out effect reflects taxpayer behavior. Sanctions introduced into a game environment dominated by contingent reciprocators crowd out voluntary compliance, turning some reciprocators into rational utility maximizers.⁷¹ Mate-

aim to create appropriate incentives for gamers, but fail to address the fundamental difference in taxpaying motivations between gamers and everyone else.

66. For instance, neither section 1222, providing the rules for calculations of capital losses, nor section 1211, containing limitations on deductible losses and found in the same subchapter of the Code, makes any mention of the straddle rules of section 1092, which limit capital losses that may be deducted in any given year. See I.R.C. §§ 1092, 1211, 1222 (2006).

67. Widely used financial instruments that have no clear tax treatment include so-called variable delivery prepaid forwards and credit default swaps. See Jeremiah Coder, Treasury, IRS Officials Clarify Financial Guidance Comments, 117 Tax Notes 436, 436 (2007) (noting that Treasury Department intends to provide additional guidance regarding treatment of such instruments).

68. See, e.g., Joel Slemrod & Shlomo Yitzhaki, Tax Avoidance, Evasion, and Administration, in 3 Handbook of Public Economics 1423, 1449 (Alan J. Auerbach & Martin Feldstein eds., 2002) (explaining that risk-bearing costs borne by tax evaders worrying about possible penalties are deadweight loss).

69. Richard Craswell, Damage Multipliers in Market Relationships, 25 J. Legal Stud. 463, 468–70 (1996).

70. For an explanation of the relationship between risk-bearing losses and deterrence, see A. Mitchell Polinsky & Steven Shavell, The Optimal Tradeoff Between the Probability and Magnitude of Fines, 69 Am. Econ. Rev. 880 (1979) [hereinafter Polinsky & Shavell, Optimal Tradeoff].

71. E.g., Ernst Fehr & Armin Falk, Psychological Foundations of Incentives, 46 Eur. Econ. Rev. 687, 693–98 (2002) (discussing experimental results showing that “voluntary cooperation is substantially and significantly weakened by the availability or actual use of [an] incentive”); Mark Lubell & John T. Scholz, Cooperation, Reciprocity, and the Collective-Action Heuristic, 45 Am. J. Pol. Sci. 160, 173–74 (2001) (finding that

rial rewards consistently undermine people's "intrinsic motivation" to perform individual tasks.⁷² Crowding out has been observed in a variety of real-life settings, with effects as diverse as late pickups of children from day care centers,⁷³ deteriorated blood donations,⁷⁴ diminished effort in performing volunteer work,⁷⁵ and overharvesting of common natural resources.⁷⁶ In each case, the introduction of negative (and even positive) material incentives led to reduced cooperation, decreased effort, or diminished compliance. There are reasons to believe that crowding out is a real concern in tax enforcement.⁷⁷

That deterrence-based approaches such as penalties and audits fail to improve the compliance of non-gamers hardly means that nothing else does. Scholars have suggested a number of measures that should have a positive effect on these taxpayers, including: stressing the high degree of overall tax compliance;⁷⁸ highlighting the large tax burden borne by the wealthy;⁷⁹ informing taxpayers that most of their fellow citizens have

introduction of penalties into nice, reciprocal environments reduces cooperation, while also diminishing deterrent effect of penalties compared to nonreciprocal environments); Ann E. Tenbrunsel & David M. Messick, Sanctioning Systems, Decision Frames, and Cooperation, 44 *Admin. Sci. Q.* 684, 691–94 (1999) (reporting that introducing infrequent inspections and small fines reduces both cooperation and expectation of cooperation).

72. See Edward L. Deci et al., A Meta-Analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation, 125 *Psychol. Bull.* 627, 658 (1999); Fehr & Falk, *supra* note 71, at 713–16 (discussing crowding out phenomenon, and noting that negative impact of reward on intrinsic motivation is consistent regardless of whether reward is engagement contingent, completion contingent, or performance contingent).

73. See Uri Gneezy & Aldo Rustichini, A Fine Is a Price, 29 *J. Leg. Stud.* 1, 3 (2000) (reporting that introduction of small fines for late child pickups from daycare increased number of late pickups, destroying informal norm against being late).

74. See Richard M. Titmuss, The Gift of Blood, in *Philosophy of Welfare* 170 (Brian Abel-Smith & Kay Titmuss eds., 1987) (stressing that offering monetary compensation for blood donations undermines the sense of civic duty, leading to decreased quality of donated blood).

75. See Uri Gneezy & Aldo Rustichini, Pay Enough or Don't Pay at All, 115 *Q.J. Econ.* 791, 791, 794–95 (2000) (finding that performance varies in nonmonotonic ways with incentives, including a decline in performance when incentives are small compared to when they are absent).

76. See Elinor Ostrom, Collective Action and the Evolution of Social Norms, *J. Econ. Persp.*, Summer 2000, at 137, 149–51 (reporting results of study of irrigation systems in India, where lower levels of voluntary cooperation with water management rules were observed in systems with significant government intervention).

77. See, e.g., Richard D. Schwartz & Sonya Orleans, On Legal Sanctions, 34 *U. Chi. L. Rev.* 274, 299–300 (1967) ("The threat of punishment appears . . . to produce some resistance to compliance.").

78. See Dan M. Kahan, The Logic of Reciprocity: Trust, Collective Action, and Law, 102 *Mich. L. Rev.* 71, 83 (2003) (discussing Minnesota Department of Revenue study in which taxpayers were informed that actual compliance rates were much higher than commonly believed).

79. See Peggy A. Hite, An Investigation of Moral Suasion and Vertical Equity Arguments on Intended Taxpayer Noncompliance, 19 *Law & Pol'y* 1, 7, 14 (1997) (reporting that "vertical equity" arguments were more effective in improving compliance of experimental subjects with balances due than those owed refunds).

strong, negative views of tax evasion;⁸⁰ emphasizing the value of government programs and their connection to tax dollars;⁸¹ providing taxpayers with helpful, readily available advice;⁸² assuring nonadversarial, respectful treatment on audit;⁸³ and creating positive incentives for compliant taxpayers.⁸⁴ Granted, some of these strategies may be better tailored to one type of non-gamers (for instance, reciprocators), while other measures may work better for other types (such as duty-bound individuals or habitual compliers). Yet as far as we know, all of these policy instruments are at least somewhat effective in facilitating the compliance of most non-gamers.⁸⁵

Nonetheless, it is far from clear that the government should pursue these cooperative enforcement strategies in the current enforcement environment. First, these measures are likely to embolden gamers. “If *this* is how the government plans to enforce its tax laws,” gamers will think, “we can avoid and evade with impunity.”⁸⁶ Second, empirical evidence about the effectiveness of these approaches is speculative, sparse, and decidedly mixed.⁸⁷ This should be expected if the tested population in-

80. See Wenzel, *Misperceptions*, *supra* note 44, at 877 (demonstrating that letters informing taxpayers that they are mistaken in thinking that others believe tax cheating to be more acceptable than they view it themselves have positive effect on tax compliance).

81. See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, *in* 2 *Taxpayer Compliance: Social Sciences Perspectives*, *supra* note 51, at 47, 63–64 (discussing potential of campaign to publicize “benefits and protections” paid for by taxes, particularly if targeted at certain kinds of taxpayers).

82. See Michael Wenzel, *Tax Compliance and the Psychology of Justice: Mapping the Field*, *in* *Taxing Democracy*, *supra* note 2, at 41, 55 [hereinafter Wenzel, *Mapping the Field*] (reporting studies showing that taxpayers value access to, and provision of, information by the Australian Tax Office).

83. See Feld & Frey, *supra* note 10, at 106–08 (arguing that respectful treatment by tax authorities leads to higher compliance, “particularly in [Swiss] cantons using referendums and initiatives in political decision-making”); Sheffrin & Triest, *supra* note 44, at 207 (“[H]earing reports of bad behavior by the IRS lowers the perceived fairness of the tax system and reported future compliance.”).

84. See Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, *in* *Why People Pay Taxes*, *supra* note 32, at 223, 246 (concluding from data that “responsive service and procedural fairness are positive incentives that affect normative commitments to tax compliance”).

85. These measures have been shown to improve tax compliance (or, more generally, law obedience and cooperation), yet they do not alter the rational calculus of gamers. Therefore, they must appeal to non-gamers.

86. See *supra* note 63 and accompanying text (tracing prevalence of tax shelters in late 1990s and early 2000s in part to increased emphasis on respectful treatment rather than deterrence).

87. For example, analysis of a single experiment involving responses of real taxpayers led one group of researchers to conclude that moral appeals have no effect on tax compliance while another commentator reached the opposite conclusion. Compare Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 *Nat'l Tax J.* 125, 131–32 (2001) (finding no statistically significant effects from normative appeals), with Stephen Coleman, *Minnesota Dep't of Revenue, The Minnesota Income Tax Compliance Experiment 18–19* (1996),

cludes both gamers and non-gamers. Third, if one takes a dynamic view of tax administration, as Dan Kahan pointed out, the choice of enforcement policies depends critically on the reasons for the existing level of compliance. If most taxpayers are currently deterred by the fear of sanctions (i.e., most are gamers), only stronger deterrence will produce positive results. If contingent reciprocators and other non-gamers predominate, stronger deterrence will have the opposite effect.⁸⁸ While the first scenario appears unlikely in light of existing statutory penalties and audit rates, no one really knows.

In sum, the tax administrator faces a conundrum. While a number of policy instruments are available, applying any given one to the entire taxpayer population is ineffective, inefficient, or both. How can this conundrum be resolved?

D. *Targeting Enforcement to Resolve the Conundrum*

The answer appears close to the surface. There are (very roughly) two types of taxpayers: gamers and everyone else. We have a clear understanding of deterrence-based approaches that are effective with gamers. We also have a reasonably good grasp of the cooperative enforcement strategies that are likely to be successful with other taxpayers. Each set of strategies, however, gives rise to social costs when applied to the “wrong” category of actors and may reduce compliance of individuals in that category.

What we need is to match enforcement strategies with taxpayer types—to *target* tax enforcement. We can do this only if we design a system that accomplishes two goals. First, it must compel each taxpayer to choose her type—gamer or non-gamer. Second, it must force each taxpayer to reveal her chosen type to the government. Once the IRS induces taxpayers to reveal their choices, it can facilitate a separation between gamers and non-gamers and target enforcement by applying deterrence-based measures to gamers and cooperative enforcement strategies to everyone else. Designing a mechanism that will allow the government to achieve this separation and targeting is not easy. The benefits of successfully doing so, however, should be great.

The most obvious advantage of separating gamers from the rest—assuming for the moment that it can be accomplished effectively—is that strengthening deterrence becomes less inefficient if only gamers are involved. Because a targeted enforcement regime will apply high statutory fines only to gamers, the number of taxpayers affected by these fines will be relatively low. Non-gamers will not be exposed to large penalties and

available at http://www.taxes.state.mn.us/taxes/legal_policy/research_reports/content/complnce.pdf (on file with the *Columbia Law Review*) (finding statistically significant effect based on the same data set). For an explanation of this inconsistency, see Lederman, *supra* note 2, at 1474 n.112.

88. See Kahan, *Trust*, *supra* note 5, at 345–46.

will not incur high risk-bearing costs. They (and society) will also save additional expenses related to more contentious audits and longer trials that accompany highly punitive sanctions.

Another benefit of separating taxpayers by type is less tangible. It is well understood that increasing the visibility of tax enforcement is a double-edged sword. On the one hand, publicizing tax prosecutions, highlighting new and larger penalties, and trumpeting increased audit rates informs the public that the government is vigilant in collecting tax revenues.⁸⁹ In economic terms, these measures increase the expected cost of noncompliance by raising the perceived probability of detection and, perhaps, informing rational individuals about the true magnitude of nominal fines. On the other hand, this kind of publicity backfires. It reminds taxpayers that many among them—including the rich and famous—disregard their tax obligations, often by hiring expensive tax advisors available only to the wealthy. It also raises the specter of an oppressive tax collector dead set on intervening in personal affairs of law-abiding citizens. Whether these taxpayers are reciprocators or those intrinsically motivated by duty, patriotism, or a desire to avoid feelings of guilt, their motivation to cooperate and comply may well be crowded out by highly public tax enforcement.⁹⁰

This problem will be solved if taxpayers are sorted based on their taxpaying motivations. Only tax enforcement against gamblers will be highly public. Non-gamblers will not be disappointed by the existence of aggressive tax avoiders because those avoiders will live by a different set of rules. They will not be a part of the ingroup to which non-gamblers belong, so their well-publicized punishment will provide non-gamblers with no reason to suspect that their fellow non-gamblers are abusing the system.⁹¹

89. For a list of high-profile taxpayers prosecuted for tax evasion, see Dubin et al., *Changing Face*, *supra* note 57, at 906; see also David Cay Johnston, *Wesley Snipes Is Charged with Tax Fraud*, *N.Y. Times*, Oct. 18, 2006, at E3; Floyd Norris, *KPMG, a Proud Old Lion, Brought to Heel*, *N.Y. Times*, Aug. 30, 2005, at C1.

90. See, e.g., Schwartz & Orleans, *supra* note 77, at 276–77 (noting that some instances of tax evasion begin after widely-publicized prosecutions, on the view that, “[i]f that is the kind of thing the government waits for . . . they’ll never come after me” (internal quotations omitted)); Sheffrin & Triest, *supra* note 44, at 211–14 (“Publicizing the ‘tax gap’ increases the degree to which others are viewed as dishonest. Estimates . . . suggest that this shift in perceived honesty will result in an increase in noncompliance.”).

91. For a discussion of the importance of group identification to tax compliance decisions, see, for example, Taylor, *supra* note 25, at 74 (“It is when self-perception is at the level of social identity, where greater similarity to ingroup others and greater dissimilarity to outgroup others is perceived, that attitudes and behaviour become more aligned with ingroup norms.”); Michael Wenzel, *An Analysis of Norm Processes in Tax Compliance*, 25 *J. Econ. Psychol.* 213, 216 (2004) (“[P]eople are more likely to be influenced by others who are considered members of . . . the group with which one identifies in a given situation In contrast, when the influence source . . . is not part of . . . the group . . . one does not expect to agree with them because they are considered ‘different.’”); Wenzel, *Mapping the Field*, *supra* note 82, at 43 (“Most models of tax evasion assume that taxpayers are motivated to maximise their individual outcomes; they

Separating gamers from other taxpayers will also allow the government to conserve resources in facilitating voluntary compliance among non-gamers. Cooperative strategies aimed at providing rewards that are likely to boost morale and encourage compliance of cooperative taxpayers will be concentrated on these individuals. Gamers who are either indifferent to such measures or view them as a sign of IRS weakness will be insulated from accessing the benefits of cooperation.

Furthermore, separating—or even creating a perception of separating—gamers from non-gamers will resolve the seemingly insurmountable problem of uncertainty regarding the predominant reason for existing tax compliance. Because of this uncertainty, it is unclear whether more deterrence or more cooperative enforcement is needed to improve compliance under the current system. Once separation is achieved, that question will become moot: Gamers will be forced to comply by stronger deterrence; all others will be induced to pay taxes by an emphasis on cooperative enforcement.

Finally, if a taxpayer is subject to regulation by government agencies other than the IRS, those agencies will be able to use the regulatee's revealed *tax* type (gamer or non-gamer) in their *non-tax* enforcement efforts. It appears reasonable to assume that if a company's managers prefer to take aggressive tax positions, they are also more likely to take aggressive positions with respect to financial accounting, securities disclosure, anticompetitive activities, consumer safety studies, and the like. If so, the benefits of deploying information-forcing mechanisms in one regulatory area (such as tax enforcement) may extend well beyond it, allowing separation and targeted enforcement in other areas and producing large additional social savings.⁹² In fact, an intriguing research project would involve determining which regulatory environment is particularly conducive to the introduction of features that will effectively and cheaply separate gamers from non-gamers. Once this environment was found, other regulators (potentially including the IRS) could take advantage of the resulting separation.⁹³

In sum, targeting can enable the government to increase deterrence and improve voluntary compliance while reducing the social cost of tax administration. It can also strengthen morale and eliminate the undesirable side effects of a uniform deterrence-based approach. This is an attractive package. While, as far as I know, identifying these benefits and proposing to capture them by separating gamers from the rest is new to

do not consider the possibility that taxpayers define themselves as members of social groups and act in terms of the interests and norms of their group and fellow group members.”).

92. Of course, if the assumption that a tax gamer is also a gamer in other regulatory areas is mistaken, this strategy will not work.

93. An even more provocative question is whether private parties interacting with a given taxpayer may find it useful to know whether this taxpayer is a gamer or non-gamer for tax compliance purposes. That inquiry is beyond this Article's scope.

the literature, the idea that the one-size-fits-all approach to tax administration leaves much to be desired is not.⁹⁴ Progress in designing tailored solutions has remained slow, however, because recognizing the need for targeted strategies is very different from developing them.⁹⁵ Gamers are not going to reveal themselves in response to a government questionnaire. If they can gain advantage by masking their type, they will try to do so. Moreover, people are complicated and may act as gamers in one set of circumstances and as reciprocators in another.⁹⁶ A viable system of targeted tax enforcement must overcome all these complications.

II. REVEALING TAXPAYER MOTIVATIONS WITH A DUAL ENFORCEMENT REGIME

This Part demonstrates how well-known approaches to mitigating information asymmetries can be used to compel taxpayers to reveal their core motivations for complying with the tax law to the government. It also emphasizes that the benefits of separation and targeted enforcement are independent of the level of deterrence.

A. *Penalty Default and Schedule Selection in Tax Administration*

Two related mechanisms for inducing actors to reveal private information are well understood. One solution is to impose a punitive default and allow individuals to elect out of it in a way that produces information about them. Another approach is to force actors to choose from a menu of options structured in such a way that an actor's choice discloses salient information about his preferences. In either case, agents are compelled to choose a course of action and their choices produce information sought by the principal. Agents' choices are revealing.

The best-known enunciation of the first idea comes from Ian Ayres and Robert Gertner, who also coined the term "penalty default."⁹⁷ While

94. See, e.g., Feld & Frey, *supra* note 10, at 104 ("Thoughts on the impact of deterrence and rewards on tax compliance highlight the importance of a differentiated approach."); Kidder & McEwen, *supra* note 81, at 63 ("[B]y identifying particular types of compliance and noncompliance and their social correlates, it may be possible to target enforcement strategies to particular audiences . . ."); Lubell & Scholz, *supra* note 71, at 176 (concluding that "[c]oercive institutions need to tailor enforcement to match the social capital in different subpopulations," but acknowledging "difficulties in developing such flexible enforcement institutions").

95. See, e.g., Slemrod, *Cheating Ourselves*, *supra* note 4, at 41 (emphasizing "[t]he difficulties of separating out whether people pay their taxes because they feel they 'ought to,' or whether they fear the penalties attendant to not doing so").

96. See, e.g., Braithwaite, *Dancing*, *supra* note 2, at 15, 21 (citing "evidence of individuals simultaneously holding a conception of self as citizen who should pay taxes with good grace, and a conception of self as a business adviser who makes a living out of game playing on behalf of those who want to avoid their tax obligations"). For an explanation of how this Article's proposal addresses motivational complexity, see *infra* text accompanying notes 217–223.

97. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *Yale L.J.* 87, 97 (1989); see also Ian Ayres, *Ya-Huh*:

Ayres and Gertner focused primarily on the exchange of information between private contractors, they recognized that the penalty default may be used to force individuals to reveal information to government instrumentalities, specifically the courts.⁹⁸

Bradley Karkkainen showed that administrative agencies may benefit from a penalty default regime as well.⁹⁹ He demonstrated that subjecting land developers to the highly restrictive “no take” provision of the Endangered Species Act (the “regulatory penalty default”¹⁰⁰) forced the industry to develop solutions that, while satisfying the industry’s needs, were more beneficial to endangered species than preserving the status quo. The developers—with an abundance of local knowledge, flexibility, and creative thinking—were repeatedly able to generate ideas that would have never occurred to Washington bureaucrats in the Department of the Interior.¹⁰¹

Information asymmetry is at the center of the tax enforcement conundrum. Taxpayers know (or at least can know) their taxpaying motivations, but the IRS does not. Can a penalty default regime reduce this asymmetry just as it does in contract negotiations and environmental regulation?

Attempting to adapt the penalty default idea to tax administration runs into an immediate problem: Interactions between the IRS and tens of millions of taxpayers are very different from the bilateral negotiations of contractual counterparties or the ongoing give and take between the Department of the Interior and private developers. Penalty defaults in contract law force parties to reveal private information, but policymakers and judges designing these defaults need not anticipate what this information might happen to be in every case. The contractual counterparty stands ready to respond to whatever information is revealed. Similarly, the administrative agency in Karkkainen’s example did not need to anticipate the innovative solutions of private developers. The Department of the Interior needed only to create an incentive to develop solutions, which it did by imposing a penalty default. But an agency that processes over 130 million tax returns each year cannot react to individual taxpayers’ unique responses. If a penalty default is to be successful on that scale, the government must define not just the punitive default regime, but the alternative system as well, and it must do so in a way that will produce critical information about taxpayers merely from their choice of

There Are and Should Be Penalty Defaults, 33 Fla. St. U. L. Rev. 589 (2006). For earlier formulations of the same idea, see Lucian Ayre Bebchuk & Steven Shavell, Information and the Scope of Liability for Breach of Contract: The Rule of *Hadley v. Baxendale*, 7 J.L. Econ. & Org. 284 (1991); Charles J. Goetz & Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 Yale L.J. 1261, 1299–1300 (1980).

98. See Ayres & Gertner, *supra* note 97, at 97.

99. See Bradley C. Karkkainen, Adaptive Ecosystem Management and Regulatory Penalty Defaults: Toward a Bounded Pragmatism, 87 Minn. L. Rev. 943, 970–75 (2002).

100. *Id.* at 965.

101. See *id.* at 971–75.

enforcement environment. In order to do so, the government must have a clear idea about the information it is trying to obtain. As the analysis in Part I of this Article suggests, the government should be seeking to understand taxpayer motivations.

This adaptation of the penalty default idea to tax enforcement brings it very close to a second information-forcing mechanism: menus. Businesses use menus to pry information from their customers all the time. Price discrimination is the clearest example.¹⁰² When a car company sells its products under two different brands (such as Ford and Lincoln, Toyota and Lexus, or Volkswagen and Audi), or when an airline or a railroad offers seats in first, business, and economy classes, these businesses attempt to separate customers with a strong preference for luxury from the rest. Theater and opera companies use a similar approach when they discount matinee tickets compared to those for evening shows. One of the most stark (and most despised) menu choices used to separate business from non-business travelers is the so-called “Saturday night stay” requirement imposed by many airlines.¹⁰³ To purchase cheaper tickets, flyers are required to spend Saturday night at their destination. Airlines assume that weary business travelers (or their employers) will pay more to return home on Saturday while vacationers will spend an extra day at their destinations to pay less. Forcing travelers to choose between spending Saturday night at home or on the road enables airlines to learn about each customer’s type and her ability to pay higher prices.¹⁰⁴

If businesses use menus as information-revealing tools so widely, surely the IRS can do so as well. In fact, mechanism design theory and, more specifically, the so-called “schedule selection problem” provide a theoretical foundation for this approach. Recent work suggests that in many circumstances, “requiring agents with private information to select from a menu of incentive schedules can yield efficiency gains” by allowing the principal to screen agents more effectively.¹⁰⁵ One of the examples

102. I thank Scott Hemphill for this suggestion.

103. See, e.g., Scott McCartney, *Airlines to Business Fliers: Pay More*, *Virginian-Pilot* (Norfolk), Aug. 24, 2008, at D2 (describing renewed effort by airlines to implement requirement after previously abandoning it in the face of competition from low-cost carriers). I am grateful to Dan Shaviro for this suggestion.

104. See *id.* (“For many years the Saturday-night requirement was a tactic airlines used to separate business travelers from leisure customers. The Saturday-night stay forced many business travelers to either pay hundreds of dollars more for each ticket, or to spend an extra night or two on the road to save money.”).

105. See Erzo F.P. Luttmer & Richard J. Zeckhauser, *Schedule Selection by Agents: From Price Plans to Tax Tables 1* (Feb. 2008) (unpublished manuscript, on file with the *Columbia Law Review*), available at <http://www.nber.org/~luttmer/scheduleselection.pdf>. These gains arise

because the menu of schedules induces each type [of agent] to select the schedule that contains relatively few distortions to the action that that type is likely to take. In addition, a menu of schedules benefits the principal because it gives him a more flexible tool to redistribute rents to suit his objectives.

Id. at 26.

used by Erzo Luttmer and Richard Zeckhauser to demonstrate the advantages of multiple schedules is the U.S. tax system. This is hardly surprising. The central problem of the optimal tax theory is the information asymmetry between taxpayers and the government. Ability—the ideal tax base—cannot be taxed because individuals have no incentive to reveal their ability to the tax collector. Using multiple schedules may provide a partial solution to this problem, Luttmer and Zeckhauser show, by inducing taxpayers to reveal their type (high or low ability) before they know their actual ability precisely.¹⁰⁶

The tax enforcement conundrum exists for a very similar reason: Taxpayers' types are critical private information that the government does not possess. Therefore, a menu—or a choice of “enforcement schedules” in lieu of the current one-size-fits-all approach—is likely to produce welfare improvements by inducing taxpayers to reveal their types before they know their precise tax situations in a given year and before they decide what specific reporting positions to take.

How can the penalty default and schedule selection mechanisms be used to separate taxpayers based on their taxpaying motivations? No doubt, many possible strategies are available. This Article considers the most basic one. The suggested strategy is simple for two reasons. First, while taxpayers clearly think about tax compliance in a great variety of ways, and while taxpayers could conceivably be sorted in multiple groups reflecting this heterogeneity, I propose to divide all taxpayers into only two groups: gamers and non-gamers. Thus, the suggested menu has the fewest possible choices. Second, while two entirely new enforcement regimes can be designed for gamers and non-gamers, I suggest that one of the regimes in the new dual structure should be essentially the same one we have today. Therefore, only one new regime needs to be developed. Evaluating the effectiveness and feasibility of this relatively simple reform should shed considerable light on the use of more complicated information-forcing mechanisms in tax (and, more generally, law) enforcement.

Because the current regime is deterrence oriented, I will call its equivalent in the new dual structure the deterrence regime (DR). Gamers respond well to deterrence, so the goal is to compel them to choose DR. The second enforcement regime should be designed for non-gamers. Because these taxpayers are indifferent or averse to deterrence and responsive to cooperative enforcement, the second regime should have lower statutory fines than those in DR.¹⁰⁷ In addition, this regime should emphasize taxpayer service and voluntary compliance. I will refer to it as the compliance regime (CR). If the proposed strategy

106. *Id.*

107. If a taxpayer choosing DR is subject to regulations by government agencies other than the IRS, and if the choice of a tax regime provides valuable information to these other agencies as discussed above, see *supra* text accompanying notes 92–93, the cost of electing DR may include not only higher expected *tax* penalties, but also additional scrutiny from non-tax regulators.

works, gamers and non-gamers will separate themselves into two enforcement regimes, each designed for those taxpayers who choose it.

To accomplish this separation, CR should have a number of unique features that satisfy three conditions. First, these features should be substantially more costly for gamers than for other taxpayers, such that these two broad categories of actors face different incentives when deciding which regime to choose. Second, these CR features should be sufficiently costly for gamers to keep them in DR despite its higher nominal penalties. Finally, these features should be few and simple enough to be grasped by millions of taxpayers. Are there features that satisfy these requirements? Before answering this question, it is important to take a brief pause and refocus the analysis.

B. *Targeting Versus Deterrence*

Thus far, the discussion has been implicitly based on the premise that tax enforcement needs to be strengthened by increasing deterrence for those who respond to it without imposing high costs on others and without interfering with their reasons to comply. While I hold this view, it is important to emphasize that targeting—and *not stronger deterrence*—is at the core of this Article's inquiry. The two are *not* interconnected. Targeted tax enforcement is likely to be superior to the current one-size-fits-all approach—producing higher compliance at a lower social cost—at any given level of deterrence.

Thus, if stronger deterrence is desirable, we should increase nominal civil penalties in DR (perhaps significantly) compared to what they are today.¹⁰⁸ In theory, deterrence may also be strengthened by setting audit rates in DR higher than in CR. However, for the reasons that become clear once the proposal is fully analyzed, audit rates should not vary between the regimes.¹⁰⁹

If, on the other hand, the current level of deterrence is viewed as acceptable, nominal DR penalties need not be higher than they are today. What is important is that these penalties are substantially higher than those in CR. Thus, even if one thinks that the existing state of tax compliance is just about right, it still makes sense to consider the proposed dual regime framework. In that case, statutory fines in DR will be relatively low (for instance, the same as now), while fines in CR will be

108. Reasons to limit the proposed dual regime to civil violations are discussed below. See *infra* Part IV.B.2.

109. See *infra* Part IV.C. In that respect, the proposal corresponds to the original idea expressed by Gary Becker, who argued that nominal penalties rather than detection efforts should be used to adjust deterrence. See Becker, *supra* note 14, at 193; Louis Kaplow, *The Optimal Probability and Magnitude of Fines for Acts that Definitely Are Undesirable*, 12 *Int'l Rev. L. & Econ.* 3, 3 (1992) (referring to idea as a “well-known suggestion”); Polinsky & Shavell, *Optimal Tradeoff*, *supra* note 70, at 880 n.3 (reciting argument and listing commentators who accepted it).

even lower (or, perhaps, there will be no fines at all). The social benefits of separation and targeting will obtain in this case as well.

III. DESIGNING THE COMPLIANCE REGIME

Relatively high nominal sanctions in DR will nudge *all* taxpayers toward the alternative, lower-penalty regime. Yet to capture the benefits of targeted enforcement, only non-gamers should choose CR. This Part considers a number of potential separation-inducing CR features. Some of these features are suggested by a more nuanced consideration of the familiar expected penalty formula; others emerge from an inquiry that goes beyond the confines of the traditional deterrence model. The point of the analysis is not to make a specific proposal, but to evaluate whether the dual enforcement regime in tax administration is feasible, and, if so, what features it might have.

A. *Conceptualizing the Compliance Regime*

The basic expected penalty calculation discounts nominal penalties by the probability that these penalties will actually be imposed (the probability of punishment). Two of the three prominent traditional enforcement measures—statutory sanctions and audits—are directly related to this calculation.¹¹⁰ Statutory sanctions are synonymous with nominal penalties.¹¹¹ Audits affect probability of punishment.

Conceivably, one may attempt to separate gamers from non-gamers by varying just these two parameters. For instance, DR can have high (higher than now) nominal penalties, but low (same as now) audit rates. CR then should have the opposite combination: low (same as now) penalties and high (higher than now) audit rates. If the resulting expected penalties in DR are slightly lower than in CR, gamers will choose DR. Assuming that the voluntary compliance of many non-gamers will be crowded out by large sanctions but not by more frequent audits, this simple solution could be quite effective.

It is unclear, however, how pervasive crowding out is, or to what extent non-gamers are less averse to audits than to fines.¹¹² What is clear is

110. The third traditional enforcement measure involves constraining opportunities to underpay tax.

111. This is true as long as only civil violations are considered.

112. There is some evidence suggesting that intrusive detection efforts crowd out voluntary compliance. See, e.g., Braithwaite, *High Wealth Individuals*, *supra* note 64, at 248–49 (describing response of one Australian taxpayer to more intrusive measures as, “if the [tax authority] thinks I’m ripping the system off, maybe I should start doing it” (internal quotations omitted)); Tenbrunsel & Messick, *supra* note 71, at 703–04 (concluding that surveillance and sanctioning regimes with low probability of detection and weak fines may reduce voluntary cooperation, and regimes with higher probabilities of detection and fines increase “cooperation” in the aggregate only because it becomes the economically rational choice).

that taxpayers of all stripes resent being audited.¹¹³ Audits are also costly for the government.¹¹⁴ If decades of stagnant or falling audit rates suggest anything, it is that a substantial increase in audit coverage is highly unlikely.¹¹⁵ Finally, the government has been extremely secretive about its audit strategies.¹¹⁶ If these strategies remain unknown or highly obscure, it is unclear how gamers and non-gamers would respond to changes in audit rates, if at all. For all these reasons, it is worth considering whether other features of the expected penalty calculation may be adjusted to separate gamers from the rest.

This requires a more detailed analysis of expected penalties. Both the probability of punishment and the nominal fine need to be disaggregated. Probability of punishment is a combination of (at least) three different probabilities. First is the *probability of audit*, P_A . Second is the (conditional) probability that once a return is audited, the aggressive position will be detected. This is the *probability of detection*, P_D . Third is the (conditional) probability that once a return is audited and the possible understatement is detected, the IRS will assert a deficiency and prevail in court (including on appeal). I will call this the *probability of conviction*, P_C . Thus, the expected payment, $EP(\text{tax})$, of an understated tax liability, T , may be expressed as follows:

$$EP(\text{tax}) = P_A \times P_D \times P_C \times T$$

Assume (consistent with actual U.S. tax law) that tax fines are calculated as a percentage, f , of the underlying tax underpayment,¹¹⁷ so the absolute amount of fine is $f \times T$. Not every underpayment of tax triggers imposition of a penalty.¹¹⁸ The *probability of fine*, P_F , is a (conditional¹¹⁹) probability that the IRS will assert a penalty and prevail in court (including on appeal) not only on the substantive issue, but with respect to the penalty imposition as well. Therefore, the expected penalty with respect to the underpaid tax liability, $EP(\text{penalty})$, is:

$$EP(\text{penalty}) = P_A \times P_D \times P_C \times T \times P_F \times f$$

113. For a description of persistent taxpayer resistance to audits, see Bankman, *Eight Truths*, supra note 61, at 514–15; Raskolnikov, *Self-Adjusting Penalty*, supra note 6, at 595.

114. See Raskolnikov, *Self-Adjusting Penalty*, supra note 6, at 595–96 (“[C]urrent audit costs are so significant and the budgetary constraints so great that one of the IRS’s latest objectives is to *reduce* the time spent on each audit.”).

115. Others agree. See, e.g., Bankman, *Eight Truths*, supra note 61, at 516 (“Expanding audits would require political support we do not now have.”).

116. See Raskolnikov, *Self-Adjusting Penalty*, supra note 6, at 590 (“Audit strategies such as the audit selection formulas are among the IRS’s most closely guarded secrets.”).

117. See, e.g., I.R.C. § 6662(a) (2006) (imposing accuracy-related penalty equal to twenty percent of underpayment); § 6663 (imposing fraud penalty equal to seventy-five percent of portion of underpayment attributable to fraud).

118. See, e.g., § 6662(b) (conditioning imposition of penalty on negligence, disregard of rules and regulations, etc.); § 6664(c) (stating exception to accuracy- and fraud-related penalties where taxpayer had “reasonable cause” and acted in good faith with respect to a tax position).

119. I will omit the term “conditional” for the remainder of the discussion.

We can now combine the expressions for the expected tax payment and the expected penalty payment into a single formula for the expected payment, EP :

$$EP = EP(\text{tax}) + EP(\text{penalty}) = P_A \times P_D \times P_C \times T \times (1 + P_F \times f)$$

This expanded expected payment formula reveals that the government may have many more ways to separate gamers from non-gamers than by varying nominal sanctions (f) and audit rates (P_A).¹²⁰ Furthermore, some promising strategies are unrelated to the expected payment calculation. All of these strategies are considered next.

B. *Increasing the Probability of Conviction*

Probability of conviction for tax noncompliance depends primarily on the aggressiveness of a given position. Not all gamers are equally aggressive. Some underpay their taxes without any justification at all. These are *tax evaders*.¹²¹ For instance, taxpayers who have offshore bank accounts and check the box on their returns stating precisely the opposite belong to this category. The same is true of “informal suppliers” such as street vendors and household workers who fail to report their cash earnings.¹²² Probability of conviction for tax evasion is close to one (or 100%). A fine may or may not be imposed,¹²³ but an evader is all but certain to pay his tax liability if the violation is detected on audit.

The same is clearly not true of taxpayers taking aggressive but (more or less) defensible positions. These are *tax avoiders*. The more sophisticated among them use third parties to develop and implement questionable strategies. Some pay millions of dollars for highly complex tax shelters based on financial engineering and obscure provisions of the tax law.¹²⁴ Others learn how to “push the envelope” from tax accountants and preparers. The least sophisticated avoiders take aggressive reporting positions all by themselves. They overstate the value of property contrib-

120. This basic model does not incorporate an additional cost arising due to risk-bearing, even though I discuss risk-bearing losses throughout the paper. See, e.g., *supra* text accompanying note 68. The omission is justified because I use this model in a very limited way: (1) to structure the discussion of potential CR features by relating them to the individual components of the model, and (2) to make a limited marginal deterrence point that is not negated by omitting risk-bearing losses, see *infra* Part III.B.3.

121. For a discussion of the terminological confusion in descriptions of various forms of tax noncompliance, and the suggestion to use the terms “evasion” and “avoidance” in the manner described in the text, see Raskolnikov, *Self-Adjusting Penalty*, *supra* note 6, at 610.

122. The compliance rate for this category of taxpayers is only thirteen percent. Slemrod, *Small Business*, *supra* note 2, at 84.

123. See *infra* text accompanying notes 136–140 (discussing current features of tax litigation that make imposition of fines uncertain).

124. For a sample of the vast literature discussing the tax shelter problem, see, for example, Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 *Tax Notes* 1775 (1999); Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 *Colum. L. Rev.* 1939 (2005); David P. Hariton, *Kafka and the Tax Shelter*, 57 *Tax L. Rev.* 1 (2003).

uted to a charity (but do not make up the contribution itself), deduct questionable (but plausible) “home office” expenses,¹²⁵ or write off so-called “hobby losses” as business costs.¹²⁶ Whatever the level of sophistication, the tax avoidance game is always the same—adopt tax-reducing positions that have *some* plausibility and hope that even if these positions are audited and detected, the IRS will settle for a portion of the underlying tax liability without assessing penalties. The less aggressive the position, the lower the probability of conviction.

The two potential CR features discussed next change this calculus, bringing the probability of conviction for tax avoiders close to one. The result is a higher expected payment for avoiders without a substantial additional burden on non-gamers.

1. *The Pro-Government Presumption.* — Tax avoidance critically depends on the ambiguity of tax rules and unintended results of clear provisions. Positions taken by tax avoiders—by definition—are neither clearly right nor clearly wrong. The chance of success in litigation emboldens these gamers and makes it more likely that the IRS will settle a claim.

It is possible to change this state of affairs by tipping the scale in the government’s favor in CR. In general, the substantive tax law should be the same in both regimes. However, taxpayers electing CR can be required to accept that it will be easier for the IRS to win disputes in that regime than in DR. How this pro-government shift in burden is accomplished—and how dramatic the shift happens to be—is less important than the shift itself. One possibility is that CR would contain a presumption that the government’s determination of tax liability is correct unless proven otherwise by clear and convincing evidence.¹²⁷ Or there can be a very strong general anti-avoidance rule requiring the adjudicator to use a pro-government interpretation of the tax law. Another possibility would be a presumption that the government’s application of the existing extra-statutory doctrines (such as substance-over-form and economic substance¹²⁸) is correct unless clearly erroneous. An even more far-reaching CR rule would provide that all ambiguities (legal, factual, or both) in any tax dispute will be resolved in favor of the government.¹²⁹ One way or

125. See, e.g., *Popov v. Comm’r*, 246 F.3d 1190, 1191–92 (9th Cir. 2001) (permitting professional violinist to take home office deduction for portion of rent and utilities allocated to apartment’s living room, where she practiced).

126. See, e.g., *Nickerson v. Comm’r*, 700 F.2d 402, 405–08 (7th Cir. 1983) (allowing taxpayer to deduct losses associated with operating farm in his spare time).

127. For the existing rules regarding burdens of proof, production, and persuasion in just one possible venue for tax litigation (the U.S. Tax Court), see 4 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 115.4.2 (2d ed. 1992).

128. See, e.g., Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 12 (2000) (discussing both doctrines).

129. For example, any time a judge deciding a tax case is prepared to admit that the “framework of statutes and regulations for deciding this case is simple, but not clear,” *Moss v. Comm’r*, 758 F.2d 211, 212 (7th Cir. 1985), the government would win. Courts deal with ambiguity in tax law all the time. See, e.g., *Bryan v. Itasca County*, 426 U.S. 373, 390–91

the other, the deck in any tax controversy will be stacked in the government's favor.

This government-favoring rule will be costly for tax avoiders. Their tax minimization strategies depend entirely on "gray areas" of the tax law, and the pro-government presumption will eliminate (or significantly reduce) these gray areas. Of course, there will still be positions that favor the taxpayer, but whose proper treatment is not quite certain—some ambiguity will remain. Its extent, however, will be dramatically reduced.

How will the IRS-favoring presumption affect non-gamers? For many, there will be no effect at all. Duty- and reciprocity-bound taxpayers and even some rational actors are not interested in searching for loopholes and taking uncertain aggressive positions. If one is paying taxes to support one's government, there is no point in taking positions that would have been disallowed by Congress had it considered them in advance. If one is complying with the tax law based on a belief that others are doing the same, one is not interested in finding strategies that others are *not* using. And if one is a tax director concerned about restating corporate earnings, the last thing on one's mind is adopting schemes that, if detected on audit, will lead to a controversy with the IRS.

Granted, there are (and will continue to be) situations where the proper tax treatment of a given transaction is not entirely clear. Yet non-gamers choosing CR will face these situations infrequently because they will not search for schemes designed to produce tax uncertainty. Where uncertainty is inevitable, there will often be a conservative position that is likely to be correct. Non-gamers taking this position will have nothing to fear from the IRS. If the uncertainty is even more profound, then CR features such as disclosure, pre-filing advice, and cooperative, problem-solving audits, discussed below, will give non-gamers several alternative opportunities to resolve it.¹³⁰

The pro-government presumption will be costly for sophisticated and unsophisticated avoiders alike, inducing them to avoid CR. However, this presumption will *not* affect the cost-benefit calculus of evaders. As noted above, the probability of conviction for evaders is close to one hundred percent today, and it will remain so in DR. The pro-government presumption will assure that this probability is just as high (if not slightly

(1976) (addressing ambiguity in statutory provision barring state taxation of Indian property); *Merkel v. Comm'r*, 192 F.3d 844, 848 (9th Cir. 1999) (construing code section where key term, "liabilities," is undefined); *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1526–27 (10th Cir. 1991) (pointing out that "[t]he law is unclear as to the relationship between the step transaction doctrine and the business purpose requirement").

130. See *infra* Part III.E.2. In addition, a taxpayer will always be able to take one of several plausible positions that produces the smallest tax savings, even if this position is not the one most likely to be correct. For instance, if position A is 40% likely to be correct and favors the taxpayer, and positions B and C are each 30% likely to be correct and each favors the government, the taxpayer may always choose either B or C and not worry about a conflict with the IRS.

higher) in CR. This virtual parity will not create an affirmative incentive for evaders to choose DR over CR. Simply put, losing what evaders never thought they had (a chance to prevail in litigation) will not be costly for them.

2. *Binding Arbitration with the IRS.* — Adversarial litigation is central to our legal system. It protects important values, especially if one of the litigants is the federal government, as is the case in federal tax controversies. Yet the ability to litigate helps aggressive taxpayers in many ways. Sometimes, generalist judges fall for taxpayer gimmicks.¹³¹ Adherents to literal methods of statutory interpretation occasionally adjudicate existing extrastatutory anti-abuse doctrines out of existence.¹³² Fear of setting an unfavorable precedent may stop the IRS from litigating a dispute in favor of waiting for a stronger case.¹³³ Those who can afford expensive legal advice may outsmart and outmaneuver government litigators.¹³⁴ Tax avoiders benefit from all these features of the existing regime.

Taxpayers who elect CR can be required to give up these advantages. They may have to agree to resolve their disputes with the IRS through binding arbitration conducted by specialized, independent government arbitrators (perhaps organized into panels formed within the Treasury Department but outside of the IRS). While taxpayers will have an opportunity to be represented by counsel, arbitration will be informal, and arbitrators' decisions will not be subject to appeal. A prototype for this binding arbitration system exists today, albeit in a much weaker form: the IRS Office of Appeals.¹³⁵

131. Taxpayers have a choice of litigating their disputes with the IRS in the Tax Court, the district courts, or the Court of Federal Claims. Bittker & Lokken, *supra* note 127, ¶ 115.1. Only the Tax Court has specialist judges with an expertise in adjudicating tax controversies. For a recent example of a misguided opinion by a panel of prominent appellate jurists, see *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006), vacated, No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006), opinion after reinstatement of appeal, 493 F.3d 170 (2007).

132. See, e.g., *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 623–24 (D. Md. 2004), *aff'd in part, rev'd in part*, 436 F.3d 431 (4th Cir. 2006). Commentators referred to the district court decision as “preposterous.” Chirelstein & Zelenak, *supra* note 124, at 1964. The district court judge described the taxpayer’s plan undertaken solely to minimize taxes and involving a double-deduction of a single economic loss as “a thing of grace and beauty.” Karen C. Burke, *Black & Decker’s Contingent Liability Shelter: “A Thing of Grace and Beauty?”*, 106 *Tax Notes* 577, 577 n.* (2005).

133. See, e.g., Sheryl Stratton, *Government, Tax Bar Disagree over Impact of Coltec*, 113 *Tax Notes* 523, 524 (2006) (reporting practitioner’s belief that “[t]he law is being written on a slate that the government is selecting through docket management”).

134. See, e.g., David M. Schizer, *Enlisting the Tax Bar*, 59 *Tax L. Rev.* 331, 335–36 (2006) (“[G]overnment litigators . . . usually are more leanly staffed and less experienced than taxpayer’s counsel. . . . [The government] must settle most of its cases and, when it litigates, it sometimes offers concessions it should not offer, and at times loses cases that it should win.”).

135. See, e.g., Tim Gray, *IRS Office of Appeals: A Dispute Resolution Profile*, 44 *Tax Notes* 1466, 1466 (1989).

Avoiders, and, to a lesser extent, evaders, will be reluctant to relinquish the benefits of current formal dispute resolution mechanisms. In addition, if binding arbitration is combined with the pro-government substantive presumption, the cost of choosing CR for gamers of both types will increase further. Today, interpretive canons and evidentiary rules allow litigants to shape the evidence on which the outcome of a trial is based.¹³⁶ Procedural rules occasionally prevent disputants from advancing winning arguments.¹³⁷ Currently, these features favor taxpayers and the government equally: Either the IRS or a taxpayer may benefit from a procedural exclusion or an interpretive canon. This rough balance will shift if the pro-government presumption is adopted in binding arbitration hearings. For instance, any evidence introduced by the government will help its case. Only overwhelming evidence produced by a taxpayer will give her a chance of overcoming the presumption. Thus, relaxing evidentiary (and other) rules will give the government an additional advantage, further increasing the probability of conviction.

Binding arbitration will also increase the probability of paying a fine (P_F) for evaders. Today, this probability is already high. Unlike avoidance, evasion is nearly impossible to justify based on legal arguments.¹³⁸ Yet P_F is not quite one hundred percent for two reasons. A tax evader may convince a judge or jury that an underpayment of tax that has no plausible legal justification was simply a mistake. The evader may also escape penalty on a technicality, for instance if critical evidence favoring the government is inadmissible or if judicial error requires the reversal of a trial judge's decision against the taxpayer.¹³⁹ The opportunity to exploit technicalities will be much reduced for those who accept binding arbitration because the procedural rules of arbitration hearings will be much less strict.¹⁴⁰ There is also a reason to expect that government arbitrators will be better at distinguishing actual mistakes from flagrant cheating than generalist judges. Experience in making these determinations will make it so. Today's generalists see relatively few tax evasion cases; CR arbitrators will see plenty. These arbitrators will learn patterns of behavior and gain insight into how people think of—and argue about—their

136. For instance, the parol evidence rule allows parties to exclude certain extrinsic evidence. For a discussion of this rule in the tax context, see Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. Chi. L. Rev. 601, 635–36 (2007).

137. See, e.g., *Rothman v. Hosp. Serv. of S. Cal.*, 510 F.2d 956, 960 (9th Cir. 1975) (“It is a well-established principle that in most instances an appellant may not present arguments in the Court of Appeals that it did not properly raise in the court below.”).

138. An evader may argue that he acted in good faith believing that he did nothing wrong, see I.R.C. § 6664(c) (2006), but he may not raise substantive legal arguments justifying a tax position that, by definition, has no legal justification.

139. See, e.g., *United States v. Cohen*, 510 F.3d 1114, 1125–27 (9th Cir. 2007) (vacating trial court decision due to failure to admit testimony of tax protestor's psychiatrist).

140. See, e.g., Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 Stan. L. Rev. 1631, 1647 (2005) (referring to informal process as characteristic feature of arbitration).

taxpaying decisions. Quite likely, evaders will have a hard time pleading an innocent mistake in CR—a clear disincentive to choose this regime.

In sum, there are many reasons why binding arbitration, especially if combined with a pro-government presumption, will impose significant costs on avoiders and, to a lesser extent, evaders. Non-gamers, in contrast, are unlikely to view binding arbitration as highly undesirable. They will primarily want to make sure that they are protected from rogue, vindictive, or simply incompetent IRS agents. A right to require a second look by an independent arbitrator will satisfy this need. Losing other opportunities to defend one's tax position (such as the possible exclusion of damaging evidence on technical grounds) will be of little concern for most non-gamers. After all, their compliance decisions are not based on these opportunities.¹⁴¹ Thus, binding arbitration will be very costly for gamers, giving them an incentive to choose DR. Non-gamers will not be affected nearly as much, making it more likely that they will elect CR to avoid higher DR fines.

3. *Limitations on Increasing the Probability of Conviction.* — While the two features just considered will assure some separation of gamers from the rest, the extent of this separation is a more difficult question. The probability of conviction (like any other probability) is upward-bounded—it cannot exceed one hundred percent. Nominal fines, in contrast, can be increased infinitely. Because of this disparity, when statutory penalties in DR reach a certain critical level, even certainty of conviction of detected tax avoidance in CR will not stop avoiders from choosing that regime, defeating the separation objective. Moreover, even for nominal fines below the critical level, it will be particularly difficult to prevent the most aggressive avoiders from electing CR, as the following discussion demonstrates.

If CR has both features discussed thus far, the probability of conviction will become (roughly) 100%. What nominal fine imposed in DR (f^{DR}) will induce a gamer to choose CR? Assume that audit rates (P_A), probability of detection (P_D), and probability of fine (P_F) are identical in both regimes.¹⁴² Expected payment in DR (EP^{DR}) is:

141. Empirical uncertainty makes this conclusion less definite with respect to non-gamers motivated primarily by feelings of guilt. In general, these taxpayers are probably more concerned with penalties than with additional tax assessments. A penalty suggests that the taxpayer's actions were inappropriate while an additional tax assessment merely corrects a mistake. This reasoning, however, is speculative, making it difficult to evaluate (1) whether guilt-driven taxpayers are likely to incur substantial costs by accepting the pro-government presumption and binding arbitration, and (2) whether they are likely to be more concerned with larger sanctions in DR or with a higher probability of having to pay taxes due (with low or no penalties) in CR.

142. The assumption regarding a constant probability of detection P_D is relaxed in the next section. Variations in the probability of audit P_A are addressed in Part IV.C. An assumption that the probability of fine P_F remains constant requires an explanation. Theoretically, P_F may be varied just like any other probability. In fact, it can be set at one by switching to a strict liability regime. Yet, holding P_F constant is not an unreasonable

$$EP^{DR} = P_A \times P_D \times P_C^{DR} \times T \times (1 + P_F \times f^{DR})$$

where P_C^{DR} is the probability of conviction in DR. The expected payment in CR (EP^{CR}) is:

$$EP^{CR} P_A \times P_D \times 1.0 \times T \times (1 + P_F \times f^{CR})$$

where 1.0 reflects the fact that the probability of conviction in CR is 100% ($P_C^{CR} = 1.0$). The avoider will choose DR as long as EP^{DR} is less than EP^{CR} , a condition that will hold if:

$$f^{DR} < (1 + P_F \times f^{CR} - P_C^{DR}) \div (P_C^{DR} \times P_F)^{143}$$

Consider a numerical example. Assume that a tax avoider takes a questionable position that is just as likely to be sustained as it is to be rejected by a court. Probability of conviction in DR is 50% ($P_C^{DR} = 0.5$). A position that has a fifty-fifty chance of success is unlikely to be penalized (assume $P_F = 0.1$). To make things more concrete, assume that nominal CR fines are the same as they are today. Thus, if a penalty is imposed, it will almost certainly equal 20% ($f^{CR} = 0.2$).¹⁴⁴ The inequality then becomes:

$$f^{DR} < 10.4^{145}$$

This is a fairly dramatic outcome. The current 20% penalty may be increased fifty times (or 5000%), yet a gamer will still prefer DR to CR. The intuition is that a very high DR penalty will be imposed only with a very low probability (10%), and, moreover, the tax itself will be paid with a moderate probability (50%, if the understatement is found). In contrast, once a tax understatement is detected in CR, it is certain to be paid.

The good news is that by increasing the probability of conviction in CR, the government can give itself a lot of room to raise nominal fines in DR while still effectively separating avoiders from the rest. There is bad news, however, as well: Making conviction a virtual certainty in CR creates a marginal deterrence problem.

assumption. Expected penalty depends on the product of this probability and the nominal fine ($P_F \times f$), and this product can be adjusted by changing either variable. Two reasons suggest that f (rather than P_F) should be changed if a change in their product is desired in DR. First, changes in statutory fines are more visible. Second, they are more concrete. If a fine goes up from 20% to 40%, there is little doubt about the nature of the increase or its precise magnitude. If a liability standard changes from a “gross disregard of rules and regulations” to a “lack of due regard to rules and regulations,” however, even a smart gamer will need legal advice to decipher the meaning of the change. Moreover, it is surely unclear whether this change raises P_F by 50%, 100%, or some other amount. In CR, by contrast, a change in $P_F \times f$ should be accomplished by an increase in P_F (rather than f) because it is less visible and is less likely to crowd out voluntary compliance. Thus, the constant P_F assumption is a simplification that may occasionally fail to hold.

143. The condition is $P_A \times P_D \times P_C^{DR} \times T \times (1 + P_F \times f^{DR}) < P_A \times P_D \times 1.0 \times T \times (1 + P_F \times f^{CR})$. Dividing both sides by $P_A \times P_D \times T$ leads to $P_C^{DR} + P_C^{DR} \times P_F \times f^{DR} < 1 + P_F \times f^{CR}$; which is equivalent to $P_C^{DR} \times P_F \times f^{DR} < 1 + P_F \times f^{CR} - P_C^{DR}$; and the inequality in the text.

144. See I.R.C. § 6662(a) (2006) (imposing a 20% fine on accuracy-related underpayments).

145. $f^{DR} < (1 + 0.1 \times 0.2 - 0.5) \div (0.5 \times 0.1)$.

Compare the somewhat cautious avoider just considered with a highly aggressive avoider who takes a position that has an 80% chance of being overruled in DR ($P_C^{DR} = 0.8$). Because there still is a colorable pro-taxpayer argument, the nominal fine today (and in CR, by assumption) is still 20% ($f^{CR} = 0.2$). The likelihood that this fine will be imposed, however, is higher, reflecting the aggressiveness of the strategy (say 60%, or $P_F = 0.6$). Solving for f^{DR} yields:

$$f^{DR} < 0.67^{146}$$

The break-even nominal DR fine is dramatically lower for highly aggressive positions than for moderately aggressive ones. The intuition is that as positions become less defensible, the probability of conviction (P_C^{DR}) and the probability of paying a fine (P_F) both approach 100% in DR—as do the respective probabilities in CR. As this happens, the break-even fine in DR (f^{DR}) approaches the nominal CR penalty (f^{CR} , which in our example is 0.2, or 20%).¹⁴⁷

Two unhappy conclusions follow from this analysis. First, at any level of nominal DR penalties, highly aggressive avoiders are more likely to elect CR than moderately aggressive ones. Second, a dramatic increase in statutory DR fines will make it worthwhile for the most aggressive avoiders to elect CR, defeating the separation objective, at least as long as the pro-government presumption and binding arbitration are the only measures used to achieve the separation. The same is true for evaders.¹⁴⁸ Thus, while these two measures will successfully separate moderately and mildly aggressive avoiders from non-gamers even if statutory fines in DR are *an order of magnitude* higher than in CR, other steps will be needed to deal with the most blatant gamers in this case. Alternatively, nominal DR fines that are significantly (two to three times) but not dramatically (forty to fifty times) higher than in CR will induce aggressive avoiders as well as moderate and cautious ones to elect DR, producing the desired separation, albeit with a lessened deterrent effect for gamers in DR.

C. Raising the Probability of Detection

Not all questionable positions are detected on audit. Gamers, no doubt, are keenly aware of this fact. Raising the probability of detection during an IRS examination is another way of deterring gamers from choosing CR.

1. *No Tax Preparer Privilege.* — The attorney-client privilege is a fundamental feature of our dispute resolution system. The work product privilege is important as well. Both protections may be invoked by the

146. $f^{DR} < (1 + 0.6 \times 0.2 - 0.8) \div (0.8 \times 0.6)$. Note that the existence of risk-bearing losses exacerbates the problem because higher DR penalties provide an additional inducement for risk-averse gamers to choose CR.

147. The inequality reduces to $f^{DR} < (1 + 1 \times f^{CR} - 1) \div (1 \times 1)$, or $f^{DR} < f^{CR}$.

148. This statement ignores the additional cost borne by evaders (and very aggressive avoiders) due to an increase in probability of fine resulting from the binding arbitration feature which will, at the margin, impede some evaders from electing CR.

accused against the government and private parties alike in a vast array of controversies.¹⁴⁹

The tax preparer privilege is different. It may be raised only against the government¹⁵⁰ and in many more cases than either of the above protective rules.¹⁵¹ Moreover, this privilege applies in addition to (rather than in lieu of) the attorney-client and the work product privileges.¹⁵² While the tax preparer privilege is less robust,¹⁵³ its existence, no doubt, helps taxpayers to conceal certain aspects of their tax planning. In terms of our model, this privilege reduces probability of detection.

Eliminating the tax preparer privilege will clearly be costly for gamers, especially for sophisticated avoiders.¹⁵⁴ Confidential discussions with non-lawyer advisors, evaluations of the odds of prevailing on audit and of possible outcomes of settlement negotiations, and explanations of steps taken solely for tax avoidance purposes will all lose protection from being revealed to the IRS.¹⁵⁵ Non-gamers, by contrast, are unlikely to care about elimination of this privilege. If a taxpayer instructs her accountant to take conservative positions and “do the right thing,” she will have no reason to worry about concealing interactions with the preparer from the government.¹⁵⁶

149. See, e.g., Bruce Kayle, *The Tax Adviser's Privilege in Transactional Matters: A Synopsis and a Suggestion*, 54 *Tax Law.* 509, 510–12 (2001) (providing brief overview of both types of privilege).

150. See I.R.C. § 7525(a)(2) (2006) (limiting application of privilege to tax matters before IRS and federal proceedings by or against United States).

151. The privilege extends to “federally authorized tax practitioner[s],” a group that includes certified public accountants, enrolled agents, and actuaries. § 7525(a)(1); Bittker & Lokken, *supra* note 127, ¶ 112.2.1.

152. The privilege is defined as an extension of the attorney-client privilege to advice given by federally authorized tax practitioners other than attorneys. § 7525(a)(1); Bittker & Lokken, *supra* note 127, ¶ 112.2.1.

153. For instance, it does not apply to criminal matters and tax shelter promoters. § 7525(a)(2), (b).

154. Sophisticated avoiders discuss their tax planning with preparers. While the wealthiest among them speak largely to lawyers (or to non-lawyers while lawyers are involved, see *infra* note 155), other sophisticated avoiders discuss their taxes with non-lawyers. Losing the preparer privilege will be particularly costly for that group. Unsophisticated avoiders and evaders will be affected by a loss of the tax preparer privilege much less. See *infra* text accompanying notes 188–189.

155. While the tax preparer privilege does not apply to tax shelters, it does apply to confidential communications aimed at making sure (and, in fact, ensuring, at least in the eyes of the client and her non-lawyer advisor) that a tax-motivated transaction is not a tax shelter within the meaning of section 6662(d)(2)(C). It is also the case that some discussions between taxpayers and non-lawyers are covered by the attorney-client privilege. However, this happens only if a client has retained an attorney and a number of other conditions are met. See *United States v. Kovel*, 296 F.2d 918, 920–23 (2d Cir. 1961) (exploring circumstances in which attorney-client privilege attaches to communications between non-lawyers and a lawyer's client); Kayle, *supra* note 149, at 519–20 (discussing *Kovel*). In the vast majority of tax preparation cases no attorney is involved.

156. An elimination of the tax preparer privilege in CR will neither contravene longstanding legal principles nor conflict with a well-informed congressional decision.

2. *Narrow Separating Measures.* — Some relatively narrow measures may also prove to be effective in raising the probability of detection in CR. Consider, for instance, the \$50 billion-a-year problem of offshore bank accounts.¹⁵⁷ Thousands of taxpayers lie on their returns, denying ownership of these accounts. Detecting these lies on audit is all but impossible because the accounts are maintained at foreign banks located in tax havens with strict privacy laws that prohibit financial institutions from disclosing the identity of accountholders without their permission.¹⁵⁸ The government can force a taxpayer to consent to disclosure of this information, but only as part of a grand jury investigation.¹⁵⁹ Obviously, the tax administrator's ability to obtain information in this manner is limited.¹⁶⁰

Non-gamers do not hide income offshore. They will have no reason to resist if they are required, as part of entering CR, to authorize any foreign bank located in any foreign jurisdiction to provide the IRS with information about any account over which they have a right of withdrawal (whether in person or as agents). Needless to say, gamers who do have hidden offshore bank accounts will be extremely reluctant to agree to this, as doing so will dramatically increase the odds that their evasion will be detected.¹⁶¹ Note also that while this condition sounds fairly complex,

The privilege was added to the Internal Revenue Code only in 1998. See Alyson Petroni, Note, Unpacking the Accountant-Client Privilege Under I.R.C. Section 7525, 18 Va. Tax Rev. 843, 844 (1999). It was enacted in the aftermath of congressional hearings that demonized the IRS based on the unverified testimony of disguised IRS victims, some of which later proved to be false. See Lee A. Sheppard, Penalty Scheme Up for Reappraisal, 119 Tax Notes 669, 670 (2008). And it was advocated primarily by accountants seeking a stronger position in their then-unfolding competition with law firms for tax advice services (including highly profitable tax shelter business). See Randolph J. Buchanan, Corporate Tax Shelter Exception to the Accountant-Client Privilege, 96 Tax Notes 1619, 1622 (2002).

157. The \$50 billion-a-year number is a middle-of-the-road estimate. See Robert Goulder, Senators Criticize Treasury's Complacency on Offshore Evasion, 115 Tax Notes 521, 521 (2007) (quoting Prof. Avi-Yonah's \$50 billion estimate, referring to competing estimates ranging from \$40 to \$70 billion).

158. See, e.g., *Doe v. United States*, 487 U.S. 201, 203–04 (1988) (describing such accounts, and noting that Cayman Islands law, for example, makes unauthorized disclosure of confidential information a criminal offense).

159. See *id.* at 219 (holding that such compelled disclosure does not violate Fifth Amendment).

160. An IRS settlement offer to holders of offshore bank accounts—under which holders were required to divulge information and pay back taxes in exchange for reduced penalties—had little success. See Martin A. Sullivan, Keeping Score on Offshore: U.K. 60,000, U.S. 1,300, 116 Tax Notes 23, 26–27 (2007) (describing initiative and reporting disappointing results).

161. The odds will remain below 100% because when the IRS audits a taxpayer with an undisclosed offshore bank account, it will not know which foreign banks it should ask about the existence of this taxpayer's accounts. Furthermore, offshore evaders may try to get around the new disclosure rule by holding offshore accounts through designees (who, presumably, will be foreigners not subject to the same disclosure requirement themselves). This response will be costly, however, because offshore evaders will have to assume the risk that their designees will run away with the money. For a detailed analysis of "relational tax

it may be expressed in very straightforward terms. Taxpayers electing CR can simply be required to permit the IRS to acquire as much information about them from foreign banks as the Agency can currently receive from financial institutions located within the United States.

Disclosure of so-called tax accrual workpapers is another measure that will result in a limited increase in the probability of detection affecting some gamers. Accrual workpapers are records containing a taxpayer's (or, more likely, tax advisor's) notes and calculations related to tax return preparation. These records may include the evaluation of strengths and weaknesses of a given tax position, estimates of the likelihood of losing in a dispute over the position with the IRS, and the expected settlement value of the position.¹⁶² While many wealthy individuals and businesses possess tax accrual workpapers, public companies are now required to maintain a special set of these documents that is particularly useful to the IRS. These special workpapers underlie each company's public disclosures pursuant to the recently adopted FIN 48.¹⁶³ This accounting standard requires companies to create reserves for uncertain tax positions and sets forth the rules for determining the amount of those reserves.¹⁶⁴ Workpapers supporting FIN 48 disclosures are especially valuable to the IRS because they are more likely than ordinary workpapers to lead an auditor to questionable tax planning.

Currently, the IRS follows a "policy of restraint," requesting workpapers only in a narrow set of circumstances.¹⁶⁵ Many taxpayers believe that the IRS has no power to compel production of these papers in any case.¹⁶⁶ Another CR condition, then, can be a requirement that taxpayers reveal FIN 48 workpapers (or all workpapers) to the IRS without asserting any privileges (except for situations where disclosure may give rise to criminal liability). Needless to say, tax avoiders will loathe the prospect of giving the IRS a roadmap of their avoidance. Non-gamers, in

planning" of a type just described, see Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. Pa. L. Rev. 1181, 1197–1201 (2008).

162. While there is no universally accepted definition of tax accrual workpapers, for a recent description, see *United States v. Textron Inc.*, 507 F. Supp. 2d 138, 142–43 (D.R.I. 2007), *aff'd in part, vacated in part*, No. 07-2631, 2009 WL 136752 (1st Cir. Jan. 21, 2009), *reh'g en banc granted*, No. 07-2631, 2009 WL 775439 (1st Cir. Mar. 25, 2009).

163. See Fin. Accounting Standards Bd., *Interpretation Number 48: Accounting for Uncertainty in Income Taxes* ¶¶ 20–21 (2008), available at http://www.fasb.org/pdf/aop_FIN48.pdf (on file with the *Columbia Law Review*) (detailing disclosure requirements). For a description of FIN 48, see, e.g., Joann Weiner, *Uncertainty All Around: FIN 48 at NTA's Spring Symposium*, 115 Tax Notes 1001, 1001–03 (2007).

164. See Financial Accounting Status Board, *supra* note 163, ¶¶ 1–24.

165. See Weiner, *supra* note 163, at 1003.

166. It is not entirely clear which side has a better argument, and taxpayers appear to have the upper hand at the moment. See *Textron*, 2009 WL 136752, at *15 (holding that tax accrual workpapers are protected by work product privilege); *Regions Fin. Corp. v. United States*, No. 2:06-CV-00895-RDP, 2008 WL 2139008, at *7 (N.D. Ala. May 8, 2008) (same).

contrast, will welcome (or at least not mind) a resolution of genuinely uncertain issues.

Yet another example of a narrow separating measure involves subjecting potentially aggressive tax planning to the public eye rather than just the IRS's gaze. Peter Canellos and Edward Kleinbard have long advocated for disclosure of the so-called Schedule M—a tax worksheet prepared by public companies to reconcile their tax and financial accounting figures.¹⁶⁷ Requiring companies that elect CR to disclose their Schedules M to the public will increase the likelihood that questionable tax schemes will be detected by third party observers such as academics and whistleblowers. Again, corporations that have no appetite for aggressive tax structures will accept this measure much more readily than companies that view taxes as just another cost of doing business, to be minimized as much as possible.¹⁶⁸

It is worth noting that Canellos and Kleinbard have urged making Schedules M publicly available for *all* public companies; the IRS believes that it *already* has the power to demand production of tax accrual workpapers; and there is no good reason why taxpayers should be able to hide assets offshore regardless of whether or not the dual enforcement regime is adopted. All these narrow separating strategies are worth implementing (or reaffirming) even in the *current* system. Similarly, there is little doubt that existing audit levels are unacceptably low. When the probability of an IRS examination is less than one percent, neither the existing regime nor any realistic alternative can produce a significant improvement in tax collections. More speculatively, such measures as a pro-government presumption and binding tax arbitration may be worth adopting in some form not just as optional CR features, but across the board. Nonetheless, this Article's goal is not to add to the chorus of voices calling for a substantial increase in audit rates, or to argue for a complete overhaul of our dispute resolution system. Therefore, this Part's discussion is focused on evaluating whether certain policy instruments may be used as separating features in the dual enforcement regime, rather than evaluating whether any of these instruments should be applied across the board.

167. See Peter C. Canellos & Edward D. Kleinbard, *Disclosing Book-Tax Differences*, 96 *Tax Notes* 999, 999–1000 (2002).

168. Compare, for instance, the following statements by two high-ranking corporate tax officials: "I want to know what the right answer is. I don't want to have tax reserves. I want to file my tax return correctly." Nanci Palmintere, Vice President and Dir., Global Tax and Trade, Intel Corp., Session 10: Risk of Controversy with the Tax Authorities, Panel Before the Tax Council Policy Institute's Eighth Annual Tax Policy & Practice Symposium (Feb. 2007), in *Taxes*, June 2007, at 137, 163. "[T]he tax department does look to exploit opportunities to reduce tax. It's not merely a compliance shop but also looks to minimize the company's worldwide tax liability." Rick D'Avino, Vice-President and Senior Tax Counsel, GE Capital and NBC Universal, Session 5: Developing a Global Corporate Tax Risk Strategy, Panel Before the Tax Council Policy Institute's Eighth Annual Tax Policy & Practice Symposium (Feb. 2007), in *Taxes*, June 2007, at 83, 88.

D. *Limiting Opportunities to Take Aggressive Positions*

The opportunity to take aggressive positions is not directly reflected in the expected payment calculus, but it is critical to overall deterrence. It is no accident that for income subject to information reporting and withholding at the source, the level of compliance approximates one hundred percent.¹⁶⁹ Gamers lacking the opportunity to game the system pay their taxes. Yet an attempt by Congress to expand withholding to new types of income proved to be so unpopular that the relevant legislation was repealed before going into effect.¹⁷⁰ While gamers clearly had an incentive to stop the expansion, the impact it would have had on non-gamers is not entirely clear. It is uncertain whether these taxpayers view withholding as evidence of government distrust or as a “good housekeeping” policy that simplifies the payment of their taxes. Further empirical research is needed on this issue. In the meantime, this subsection focuses on other measures that might limit the opportunity to take aggressive tax positions, measures that are both unlikely to burden non-gamers and certain to create additional obstacles for gamers thinking about choosing CR.

1. *Higher Standards for Tax Preparers.* — Regulation of tax return preparers is an important element of modern tax enforcement. Constraining the kind of advice they may provide limits tax planning opportunities for seventy-eight million taxpayers who use return preparation services.¹⁷¹ Today, preparers are governed by their own set of rules.¹⁷² Congress recently experimented with making these rules more stringent than those applying to taxpayers, but it ultimately retreated to the historical status quo of equivalent compliance benchmarks for taxpayers and preparers.¹⁷³ While I agree that in the current system this equivalence is appropriate,¹⁷⁴ a set of preparer standards that is substantially more de-

169. See, e.g., Slemrod, *Small Business*, supra note 2, at 84.

170. See Bittker & Lokken, supra note 127, ¶ 111.5.3; John T. Scholz, *Compliance Research and the Political Context of Tax Administration*, in 2 *Taxpayer Compliance: Social Sciences Perspectives*, supra note 51, at 12, 16.

171. The figure is from 2006. See U.S. Gov't Accountability Office, *GAO-08-38, 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated 17* (2007), available at <http://www.gao.gov/new.items/d0838.pdf> (on file with the *Columbia Law Review*) [hereinafter *GAO Report*].

172. See I.R.C. § 6694 (2006) (specifying penalties for tax return preparers); Treas. Dep't Circular 230, 31 C.F.R. pt. 10 (2008) (setting forth standards of practice before IRS).

173. See Jeremiah Coder, *Change in Penalty Standard Will Not Require Total Rewrite of Regs*, 121 *Tax Notes* 132, 132 (2008).

174. This does not mean, however, that I agree with the congressional solution to the disparity between the rules applying to taxpayers and preparers. Rather than equalizing down, Congress should have equalized up by strengthening the standard applying to taxpayers. For a thoughtful argument that the current taxpayer compliance standards are inadequate, see Michael Doran, *Tax Penalties and Tax Compliance*, 46 *Harv. J. on Legis.* 111 (2009).

manding than the current one can be a useful feature of the compliance regime.

To appreciate how more stringent preparer standards can facilitate the separation of gamers from non-gamers, consider the current rules first. Very generally, a taxpayer is not subject to penalties as long as he takes a position that is supported by “substantial authority,” that is, has a 33% to 40% chance of being upheld if challenged.¹⁷⁵ If a taxpayer discloses a position to the IRS, he has to meet only a lower “reasonable basis” standard to avoid fines.¹⁷⁶ Either way, a taxpayer may take a position that has less than a fifty-fifty chance of being correct, yet not be subject to penalties. While preparer penalties currently contain the same thresholds, and while this parity should be maintained in DR, preparers assisting taxpayers who choose CR can be made subject to a more demanding standard. Specifically, they may be fined for advising with respect to any substantial position unless it *should* (has at least a 60–80% chance of being sustained) or even *will* (has at least a 90–95% chance of being sustained) be upheld if challenged.¹⁷⁷ The elective nature of CR makes all the difference in the analysis.

It is true that subjecting preparers to higher standards will create a potential conflict of interest: Taxpayers electing CR will be entitled to take aggressive positions without exposing themselves to fines, yet their advisors will risk penalties for counseling about these positions. However, if a CR taxpayer asking about an aggressive position is a non-gamer, she will have no desire to push the limits of the law. In this case there will be no taxpayer interest with which the preparer’s penalty-induced conservatism will conflict. If, on the other hand, a taxpayer is a gamer who elects CR to escape higher statutory fines in DR, we will *want* the preparer to impede this taxpayer’s aggressive planning. The resulting conflict of interest will be desirable because its anticipation will prevent some gamers from electing CR.

Another potential problem with high preparer standards is that the tax treatment of some business-motivated transactions may be so uncertain that these transactions cannot be reflected on a return in a way that should or will be upheld if challenged. The tax consequences of these deals are simply unclear. Forcing taxpayers contemplating these transactions either to forgo them or to be forced into DR would be inefficient. The solution to this dilemma is three-pronged. First, the preparer can be

175. The “substantial authority” rule (but not its numerical translation) may be found in section 6662(d)(2)(B)(i).

176. See § 6662(d)(2)(B)(ii). It is generally believed that positions that have a 20–25% chance of success if challenged satisfy this standard.

177. Because tax advice can take place long before a taxpayer actually files a return and elects an enforcement regime, and because the advisor may not be the person who ultimately prepares the taxpayer’s return, the taxpayer will need to give written assurance to the advisor regarding which regime the taxpayer will ultimately choose. If the taxpayer violates this promise, the preparer penalty may either cease to apply, or it may remain in place, giving the advisor a cause of action against the taxpayer.

permitted to advise a CR taxpayer with respect to transactions with uncertain tax treatment without fear of penalties as long as the tax position adopted on the return produces the smallest tax savings of those available.¹⁷⁸ Alternatively, the taxpayer may be permitted to take the position with the highest likelihood of being correct (even if it favors the taxpayer),¹⁷⁹ but both the taxpayer and the advisor should then be required to provide the IRS with a concise disclosure of the transaction, the amount of tax liability in question, and the tax analysis of the critical issue(s) (including the reason for uncertainty and the alternative tax treatments).¹⁸⁰ Among other things, this disclosure will help the IRS in spotting advisors who happen to assist taxpayers with highly uncertain transactions time after time. This information will be valuable in evaluating both the advisor and the advisor's clients.¹⁸¹ A third alternative to resolving highly uncertain tax questions in CR will be to request prefiling advice from the IRS, advice that should be readily available in that regime, as discussed below.¹⁸²

2. *Higher Penalties for Tax Preparers.* — Tax preparers are subject to penalties today, and they will face sanctions in both regimes under consideration. There is no reason, however, that preparer penalties should be the same in CR and DR. In contrast with statutory fines applicable to taxpayers, preparer sanctions should be higher in CR.

Three considerations make the analysis of preparer and taxpayer penalties different. First, there are many fewer preparers than taxpayers. Therefore, even if the per-individual risk-bearing loss produced by high fines is the same for preparers and taxpayers, the aggregate social cost of high preparer sanctions in CR is likely to be much smaller.¹⁸³ Second,

178. For an example, see *supra* note 130.

179. That is, a taxpayer may take position A from the example in note 130, *supra*—a position with only a forty percent chance of success, but with the higher likelihood of being correct than positions B or C favoring the government.

180. These conditions should limit overdisclosure—a serious problem with the current disclosure rules. See Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 *UCLA L. Rev.* (forthcoming Aug. 2009), available at <http://ssrn.com/abstract=1285342> (on file with the *Columbia Law Review*) (investigating sources of and solutions to overdisclosure in tax shelter reporting).

181. The idea that aggressive advisors are a valuable source of information about their aggressive clients is reflected in the current rules aimed at tax shelters. See § 6112 (requiring material advisors to keep lists of their tax shelter clients and make these lists available to IRS for inspection on request).

182. See *infra* Part III.E.3.

183. This is true as long as the same total social gain results from making taxpayers on the one hand and preparers on the other equally compliant. In fact, the conclusion is even stronger because the total gain from deterring preparers is larger. A single preparer made more conservative by higher fines inhibits the aggressive tax planning of many taxpayers who use his services. Thus, compared to larger taxpayer sanctions, higher preparer penalties produce a larger social gain per unit of deadweight loss. On the other hand, if a preparer serves 100 clients, and each return has only a slight chance of triggering a preparer penalty, the cumulative probability of incurring a penalty may be significant. It is not entirely clear how to compare the resulting higher risk-bearing loss of

considerable evidence suggests that preparers are often gamers.¹⁸⁴ High fines deter gamers well. Finally, preparers are agents, not principals. If a principal is a reciprocator who detests tax shelters, it is less important whether the preparer's aspiration is to file a return showing the lowest possible tax liability or one that will go through an audit unchallenged. Thus, even if high penalties turn some non-gamer preparers into gamers through crowding out or a similar mechanism, the negative effect on tax compliance will not be as significant as when this metamorphosis happens to taxpayers themselves.¹⁸⁵

Preparer-focused measures will be effective even if preparers initially decide to respond to the suggested CR features not by giving more conservative advice in that regime, but by varying prices for their advice based on its aggressiveness. In short, price discrimination should not work in CR. Preparers who decide to provide aggressive advice in CR will have to charge more to compensate for exposing themselves to larger expected sanctions.¹⁸⁶ Conceivably, the same preparer may prepare both conservative and aggressive CR returns. Most preparers, however, will specialize.

Specialization will help preparers to establish a reputation—a useful marketing tool. In addition, providing aggressive return preparation requires expertise that is costly to develop and maintain. A preparer who becomes an expert in aggressive return preparation will waste her skills by working on conservative returns. To prevent preparers from establishing a broad client base by giving aggressive advice both in DR and CR, the government may require preparers to commit to a single regime.¹⁸⁷ As a

the preparer to the 100 smaller risk-bearing losses that are incurred by individual taxpayers if they are exposed to higher penalties themselves.

184. Compared to self-prepared returns, professionally prepared ones are less likely to contain obvious mistakes (or indefensible positions) and more likely to reflect plausible but aggressive positions. Preparers, in other words, induce (or at least assist) taxpayers in gaming the system. See, e.g., Steven Klepper et al., *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 *J.L. & Econ.* 205, 226 (1991) (suggesting that preparers induce noncompliance with ambiguous rules while facilitating compliance with clear ones); see also Andreoni et al., *supra* note 4, at 847 (pointing out that Klepper et al. explanation ignores possible selection effect, but also discussing study by Erard that found use of lawyer or CPA to be “significantly associated with increased noncompliance, even after controlling for self-selection”). It is likely that one has to be a gamer oneself to encourage others to engage in gaming.

185. Steps should be taken to assure that preparers follow their clients' wishes regarding the aggressiveness of return positions rather than their own. See *infra* text accompanying note 241.

186. I assume that preparers are truthful with their clients, have no intrinsic preference for preparing particularly aggressive returns, and there is price competition in the return preparation industry.

187. That is, each preparer will have to declare to the IRS that he will assist in preparing returns only subject to DR or CR. If the IRS identifies a preparer who repeatedly gives aggressive advice after having elected CR, the government may ban this preparer from participating in that regime in future years.

result, some CR preparers will decide to be aggressive and charge more, while others will assist only with conservative returns and charge less.

Once taxpayers engage in comparison shopping, aggressive preparers will have to explain the reason for their higher fees. Non-gamers will not use expensive CR preparers because these taxpayers will be unwilling to pay a premium for taking aggressive positions. Gamers who elect CR, in contrast, will all prefer more aggressive, higher-cost preparers. This will give the IRS a clear opportunity to identify disguised gamers and to penalize aggressive preparers. As soon as an audit discovers a gamer in CR, the IRS can examine other clients of that gamer's preparer. If the government announces this approach (as it should), aggressive advice in CR will become extremely costly for preparers and taxpayers alike.

In sum, whether or not the substantive standards applying to preparers are higher in CR than in DR, violation of these standards can be penalized more severely when the return being prepared is for a CR taxpayer. Higher sanctions will make preparers more cautious in advising taxpayers who contemplate taking questionable positions. Gamers who choose CR will have a hard time finding advisors willing to assist them in their games. Non-gamers, on the other hand, will care little if preparers become more conservative. These taxpayers have no interest in obtaining aggressive advice, so foregoing an opportunity to receive it will be no loss to them. Thus, higher preparer penalties in CR will be more costly for gamers than for other taxpayers—a feature that will facilitate the desired separation between gamers and the rest.

Unfortunately, measures affecting return preparers are unlikely to have a significant impact on evaders and unsophisticated avoiders. Some evaders do not file returns at all. Unsophisticated avoiders calculate their taxes themselves. In both scenarios, no preparer is ever involved.¹⁸⁸ Other evaders lie to their preparers, for instance, by not telling them about cash receipts or by denying ownership of offshore bank accounts. It is possible that in some cases a preparer is an accomplice in filing a fraudulent return. Yet the empirical data suggests that preparers tend to stay away from clearly indefensible positions.¹⁸⁹ Evaders, no doubt, take this tendency into account. Thus, other measures will be needed to prevent evaders and unsophisticated avoiders from choosing CR.

E. *Rewarding Non-Gamers*

Imposing different costs on gamers and non-gamers is not the sole means of separating the two groups. An obvious alternative is to vary ben-

188. However, either an evader or an unsophisticated avoider may retain a non-lawyer representative (such as a CPA or enlisted agent) during an audit.

189. See Klepper et al., *supra* note 184, at 210 n.27 (citing a Westat survey finding that there is "a strong aversion to preparing a return that [preparers] know includes clear legal breaches").

efits. This can be done in one of two ways. First, CR may provide benefits whose value is higher to non-gamers than to gamers. Second, CR may provide benefits equally valuable to all taxpayers in such a way that makes them much more likely to be received by non-gamers. This section considers benefits of each kind.

1. *Reimbursement of Costs for Prevailing Taxpayers.* — Some of the costs borne by taxpayers as the result of a tax audit are intangible: anxiety, disillusionment with the government officials, and the like. Many costs, however, are financial: payments to advisors, forgone income, and so on. Similar costs are incurred by taxpayers who decide to pursue binding arbitration or litigation. It makes sense to reimburse CR taxpayers for all these financial costs, but only if they are audited, a deficiency is assessed against them, they decide to contest that deficiency, and they prevail.

The idea of reimbursing taxpayers for audit costs is not new. Yet the typical argument is that taxpayers should be made whole whenever the IRS examiners conclude that the return is essentially correct.¹⁹⁰ In contrast, the reimbursement proposed here will take place only if the IRS contests the reported tax liability but later loses in arbitration or litigation. Economic analysis of litigation expenses is well developed.¹⁹¹ However, it does not address nonrational taxpayers such as many non-gamers. Thus, while a reimbursement of litigation and audit costs is hardly a revolutionary concept, the specific proposal made here has not been studied thus far.

Reimbursement will be effective in benefiting non-gamers more than gamers as long as the probability of conviction in CR is high (for instance, because one or both possible CR features discussed in Part III.C are adopted). Consider a tax avoider who contemplates choosing CR. If his aggressive position is detected on audit, arbitration (or litigation) makes little sense when CR features some form of pro-government presumption. Because this gamer has no chance of success in arbitration, the likelihood of receiving a reimbursement (that is, its expected value) is extremely low. A non-gamer, by contrast, will contest an auditor's determination only if she believes that the auditor is mistaken. Sometimes this belief will be unjustified, but on other occasions it will be correct, and the non-gamer will end up being reimbursed for her costs. Overall, the proposed reimbursement will be viewed as meaningless by gamers and will have a clear positive value to non-gamers, at least to the rational ones.

The reimbursement will also have a symbolic value: The government has made a mistake, wasting the taxpayer's time, energy, and resources, and it compensates the taxpayer for this imposition. Again, this intangi-

190. See Bankman, *Eight Truths*, *supra* note 61, at 515 (suggesting "intent here would be to reassure the average voter that she need not worry about misuse of audit power").

191. For a summary of the basic conclusions, see, for example, Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 *J. Legal Stud.* 575, 587-88 (1997) [hereinafter Shavell, *Fundamental Divergence*].

ble aspect of the proposed reimbursement will have a different effect on gamers and many non-gamers. Reasons do not matter to rational actors (gamers and non-gamers alike). They will always prefer a \$150 payment to a \$100 payment combined with an apology. But many nonrational individuals care about reasons.¹⁹² These taxpayers will appreciate the mere fact of an apologetic act by the government. A brief letter from the IRS acknowledging a mistake and stressing the compensatory nature of reimbursement will help frame the payment as an act of reconciliation, boosting a taxpayer's morale and assuring continuing compliance.¹⁹³

2. *Different Audit Strategies and Separate Enforcement Staffs.* — Much has been written about the benefits of “responsive regulation.”¹⁹⁴ The key idea is that a regulator has nothing to gain and a lot to lose by starting its relationship with a regulatee in an adversarial manner. Hostile, disrespectful treatment by the government undermines (or eliminates) the private party's predisposition to comply voluntarily, forcing the regulatee to dig in his heels. Because cooperative, problem-solving enforcement is always cheaper than contentious negotiations and eventual litigation—for private parties and government agencies alike—responsive regulation proponents argue that each regulator-regulatee relationship should start in a respectful, cooperative manner. If a particular regulatee does not respond to this approach, the regulator should gradually switch to increasingly adversarial enforcement. The metaphor of an iron fist in a velvet glove aptly describes this strategy.¹⁹⁵

While several scholars have argued that responsive regulation should work well in tax enforcement, it is difficult to see how this can be so as

192. See, e.g., Kahan, Trust, *supra* note 5, at 344 (“As the trust and reciprocity literature shows, individuals don't just *respond* to financial incentives; they *interpret* them as signs of others' attitudes and intentions.”).

193. Compare Feld & Frey, *supra* note 10, at 109–10 (urging rewards for “good” taxpayers in form of monetary payments or in-kind benefits such as public transportation discounts and free access to museums, without explaining, however, how tax authority can identify “good” taxpayers), with Michael Wenzel, A Letter from the Tax Office: Compliance Effects of Informational and Interpersonal Justice, 19 Soc. Just. Res. 345, 348–54 (2006) (summarizing arguments that apologies and expressions of regret from government officials promote interpersonal justice, perceptions of fairness, and, therefore, compliance, and adding further support for these propositions with an original experiment).

194. The foundational work is Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992) [hereinafter, Ayres & Braithwaite, *Responsive Regulation*]. For a review of how this concept has been applied to tax enforcement, see Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 Law & Pol'y 3 (2007) [hereinafter Braithwaite, *Responsive Taxation*].

195. Another oft-used metaphor is “speak softly while carrying a big stick.” See Ayres & Braithwaite, *Responsive Regulation*, *supra* note 194, at 19. More technically, the literature has developed the concept of an “enforcement pyramid,” with persuasive approaches forming the base of regulatory action, and increasingly coercive measures applied as lower-tier measures fail. See *id.* at 35–36, 38–40 (presenting enforcement pyramid concept); Braithwaite, *Responsive Taxation*, *supra* note 194, at 4–5 (applying enforcement pyramid concept to tax administration).

long as tax administration continues with a one-size-fits-all model. The success of responsive regulation depends critically on a regulator being able to decide whether a regulatee is willing to comply voluntarily, or needs a gentle nudge, the threat of substantial sanctions, or perhaps even criminal prosecution in order to cooperate or comply. To make this determination, the regulator must engage with each regulatee on a continuous basis.¹⁹⁶ With tens of millions of regulatee-taxpayers, this is simply impossible.

Introducing a dual enforcement regime changes the analysis. The choice between DR and CR can be thought of as an effort by the IRS to contact each taxpayer and inquire whether he (she, or it) would like to cooperate. If so, CR welcomes each of them. If not, DR offers familiar adversarial audits. Of course, unlike in an extended one-on-one regulatory engagement, where a regulator can easily detect adversarial tactics that follow a regulatee's (false) commitment to cooperation, the election between DR and CR may be gamed. Yet the promise of cooperative, consumer-friendly audits in CR will have a separating effect nonetheless. Gamers do not care about niceness. They prefer mean but incompetent auditors who cannot find any of their tax shelters to respectful but sharp examiners who eventually unearth all of their aggressive schemes. But for many non-gamers, respectful treatment and a cooperative attitude from government regulators have independent value. A promise of respectful, problem-solving audits will provide significant inducement for these individuals to elect CR, without giving gamers a strong reason to do the same.

Perhaps respectful auditors are less likely to detect noncompliance. If so, gamers will prefer cooperative CR auditors to adversarial DR examiners. Even in this case, however, nonrational non-gamers will derive an additional intangible benefit from cooperative examinations. Moreover, a respectful audit need not be an ineffective one, as the responsive regulation literature has aptly demonstrated.¹⁹⁷ A velvet glove will cover an iron fist only as long as the taxpayer cooperates. A shift to adversarial enforcement will always be available in CR, ensuring that respectful audits remain effective in the face of uncooperative taxpayers (who are

196. It is no accident that Ayres and Braithwaite's work builds the responsive regulation idea upon insights from the repeat prisoner's dilemma game. See Ayres & Braithwaite, *Responsive Regulation*, supra note 194, at 20–27. For the same reason, until a recent attempt to apply the responsive regulation approach to the entire Australian, New Zealand, and East Timor tax systems, it had been applied only to “small regulatory communities where encounters with inspectors occur face-to-face, as in regulation of the environment, nursing homes, and occupational health and safety standards.” Jenny Job et al., *Culture Change in Three Taxation Administrations: From Command-and-Control to Responsive Regulation*, 29 *Law & Pol'y* 84, 85 (2007).

197. See John Braithwaite, *Meta Risk Management and Responsive Regulation for Tax System Integrity*, 25 *Law & Pol'y* 1, 3–11 (2003) (discussing increasingly adversarial regulatory options in dealing with tax preparation software developers and companies engaged in transfer pricing); Braithwaite, *Responsive Taxation*, supra note 194, at 4–5 (discussing enforcement pyramid with escalating sanctions).

likely to be gamers hiding in that regime). For all these reasons, the promise of cooperative, perhaps even sympathetic, audits can be another feature distinguishing CR from DR.

Several years ago, Australian revenue authorities decided to adopt a responsive regulation approach to tax enforcement.¹⁹⁸ Auditors were instructed to abandon their typical, confrontational posture and to emphasize cooperation and joint problem solving, at least until it became clear that this “soft” approach did not work with a particular taxpayer. One of many interesting findings from this countrywide experiment is that the reform confused Australian tax examiners. They had developed their investigatory skills and attitudes toward taxpayers in a highly adversarial, anti-taxpayer enforcement agency. These auditors knew how to be formalistic and tough; they had no idea how to be flexible and cooperative.¹⁹⁹

The Australian experience suggests that it may be difficult for IRS auditors to adjust their attitudes when interacting with taxpayers subject to both regimes. Therefore, DR and CR should have separate audit staffs.²⁰⁰ In addition to making it easier for the IRS examiners to develop audit techniques and cultures appropriate for each regime, creating separate audit staffs will signal the seriousness of the government’s commitment to voluntary compliance in CR.

3. *Profiling Assistance with Resolving Questionable Positions.* — The last thing gamers want is to tip off the IRS about their questionable positions.²⁰¹ The chance to win the audit lottery is a major factor in calculating expected penalties. Making aggressive transactions unnecessarily complex is a well-known trick used to hide them during an audit. Be-

198. See Vivienne Waller, *The Challenge of Institutional Integrity in Responsive Regulation: Field Inspections by the Australian Taxation Office*, 29 *Law & Pol’y* 67, 68–69 (2007) (describing model as adopted in Australia).

199. See *id.* at 76, 81 (pointing out that Australian Tax Office’s commitment to formalistic procedures was “in tension with the flexible approach of responsive regulation” and that “field officers seemed uncomfortable with admitting how they tried to detect non-compliance, but emphasized building relationships”). For a broader discussion of challenges involved in switching from adversarial to cooperative tax enforcement, see Job et al., *supra* note 196, at 92–97.

200. Even in this case CR auditors will need to learn when and how to switch to more adversarial negotiations once they detect taxpayer resistance. To the extent the Australian experience suggests that this switch may be difficult to achieve, the problem will remain even in a dual regime with separate enforcement staffs. However, many CR audits are likely to result in no adjustments, and a portion of those that do will remain cooperative. Therefore, a large portion of CR auditors will rarely need to switch to an adversarial posture. They will fully benefit from developing specialized cooperative examination skills without simultaneously maintaining adversarial ones. In addition, it may be easier for a cooperative auditor to become more adversarial in the face of a taxpayer’s refusal to cooperate than it is to do the same simply because a taxpayer happened to elect one regime or another.

201. Revealing dubious schemes to the IRS amounts to setting both the probability of audit and the probability of detection to one.

cause the government will reject aggressive interpretations more often than not, gamers will not disclose these interpretations voluntarily.

Non-gamers have a different view. They do not engage in aggressive schemes on purpose. But given the tax law's complexity, non-gamers occasionally stumble into questions that have no clear answers. They would be happy to get the government's view of what the right answer is and move on. In fact, many non-gamers today are frustrated by their inability to have their questions answered by an IRS representative.²⁰² Some may view this as a breach of an implicit contract obligating taxpayers to responsibly calculate and pay their taxes and the government to provide taxpayers with timely and useful assistance.²⁰³

The IRS has already started what might be considered a pilot project for creating a dual enforcement system involving prefilling advice. For several years, it has run the so-called Compliance Assurance Program for some of the largest corporate taxpayers. The idea is that a company should present all of its uncertain tax issues to the IRS before it files its return. The parties can then quickly identify areas of agreement, work together to resolve differences, and set aside issues where no agreement can be reached. Only the last category of questions is examined on audit. Needless to say, only companies that "want to file [their] tax return[s] correctly" rather than to minimize their taxes at all costs participate in the program.²⁰⁴

These observations suggest that another CR feature worth considering is much more robust prefilling assistance from the IRS (compared both to what exists today and what will continue to exist in DR). Implementing this measure will involve a significant investment in hiring and training the IRS agents needed to answer numerous taxpayer inquiries. Yet this investment may be well worth making because improved taxpayer assistance is likely not only to facilitate the separation of gamers from the rest, but to increase compliance among non-gamers as well.

Needless to say, many design details of this proposal will need to be addressed. For instance, it will be important to decide to what extent the improved CR prefilling advice will bind the IRS.²⁰⁵ Several solutions appear reasonable. For instance, if CR includes a pro-government pre-

202. For instance, an IRS taskforce recently "discovered problems with the way in which formal and informal advice was being rendered by legal counsel. Overall, the task force criticized the process by finding that the timeliness, quality, and efficiency of the legal advice was insufficient and needed improvement." David L. Click & Jennifer B. Green, *New IRS Legal Advice Vehicles: Still Room for Improvement*, 112 *Tax Notes* 985, 988 (2006) (citation omitted).

203. See Feld & Frey, *supra* note 10, at 103–04 (explaining taxpayer's duty to pay as "a complicated interaction between taxpayers and the government establishing a fair, reciprocal exchange that involves the giving and taking of both parties").

204. See Palmintere, *supra* note 168, at 163. The Advance Pricing Agreement program and the Private Letter Ruling program have similar features.

205. Currently, any informal IRS advice—such as answers to taxpayers' telephone inquiries—is completely nonbinding on the IRS. See, e.g., *Pistillo v. Comm'r*, 57 T.C.M.

sumption, this presumption may be negated if the position contested on audit has been blessed by an IRS representative before the return is filed. Alternatively, such a position may receive a presumption of correctness. To take another example, a gamer may decide that it is to his advantage to elect CR, disclose one relatively strong but questionable position, but keep the really aggressive parts of his return private. This way, the gamer would insulate himself from high penalties in connection with a particularly large transaction while taking a gamble on many smaller ones. One way to deal with this situation (at least in part) would be to deny assurances that come with receiving prefilling advice for a disclosed position if an audit uncovers aggressive nondisclosed positions on the same return.

In sum, there are many potential separating mechanisms that create value for non-gamers without benefiting gamers nearly as much. There are also numerous separating features that impose costs on gamers without significantly burdening non-gamers. In evaluating the merits of the proposed dual enforcement regime, there is no reason to focus on any particular one (including the pro-government presumption and binding arbitration that may have anchored the reader's view by virtue of being introduced early in the discussion). Rather, the variety of separating mechanisms considered in this Part suggests that policymakers will have many options if they embrace the conceptual approach suggested in this Article.

F. *Separation Versus Targeting*

Having considered a number of separating features, this Part concludes with a point of clarification: Separation is related to—but not coterminous with—targeting.

Separating features create incentives that compel gamers to choose DR while inducing non-gamers to opt for CR. Targeting facilitates compliance by each group of taxpayers. While there is no necessary connection between the policy instruments that accomplish each objective, there is a substantial overlap between them. For instance, cooperative audits, cost reimbursements to prevailing taxpayers, and measures aimed at deterring aggressive preparers not only enable separation, but also encourage (or facilitate, in the case of preparer-oriented measures) voluntary compliance.

Yet the overlap is not complete. Some separating features do nothing to encourage cooperative taxpayers. Binding arbitration and a pro-government presumption, to take two examples, do not strengthen a sense of duty, trust in government, or feelings of reciprocity. These features are unrelated to targeting. Likewise, targeting does not necessarily facilitate separation. Appeals to taxpayer conscience, publicity about the high level of overall CR compliance, and information about important

(CCH) 874, 881 (1989) (“[I]nformational assistance provided to a taxpayer by the [IRS] is not binding on [it].”), rev'd on other grounds, 912 F.2d 145 (6th Cir. 1990).

programs funded by tax dollars are examples of targeted cooperative enforcement strategies that have no separating effect. They do not impose differential costs on—or provide differential benefits to—gamers and non-gamers, at least nothing nearly as substantial as those resulting from the separating features discussed in this Part.

The point of fleshing out the relationship between separation and targeting is analytical clarity. There is no reason to think that separating features that also have a targeting effect are necessarily preferable to those that do not.²⁰⁶ Rather, separating features should be evaluated based on how effective and efficient they are in facilitating separation.²⁰⁷ Once it is achieved, the government may experiment with many non-separating instruments to induce continuing compliance among non-gamers.

IV. PROS AND CONS OF THE DUAL ENFORCEMENT REGIME

In keeping with the spirit of the preceding discussion, the purpose of this Part is not an exhaustive exploration of the pros and cons of each possible feature of the dual enforcement regime. Rather, the goal is to highlight some clear advantages of the proposal and to address some of its shortcomings.

A. *Advantages of the Dual Regime Framework*

The main advantage of a dual enforcement structure—the separation of taxpayers by type that enables targeted tax enforcement—has already been discussed. Consideration of specific CR features reveals additional benefits.

1. *Lower Social Cost of Tax Enforcement.* — Many separating CR features will dramatically reduce the social cost of tax enforcement. If tax planning opportunities in CR are restricted while deterrence in DR is strengthened, tax planning costs will decrease. Tax advisors will waste less effort developing questionable schemes. Taxpayers will waste less time searching for aggressive tax advisors. Contests involving the application of the tax preparer privilege will disappear if the privilege does not exist. If the only dispute resolution system available in CR is binding arbitration, litigation costs will be eliminated. Because some of these costs are externalized by the litigants and borne by the society as a whole, this is a particularly attractive result.²⁰⁸ And, of course, risk-bearing losses in CR will be small because nominal penalties will be low.

206. Of course, separating features that are detrimental to targeted enforcement should be used with particular caution, as should targeting instruments that inhibit separation.

207. At the same time, if two features are equally effective separators, but one also encourages voluntary compliance while the other one does not, the first feature is more attractive and may be adopted even if it is more costly than the second one.

208. See Shavell, *Fundamental Divergence*, *supra* note 191, at 577–78 (“[T]he legal costs that an individual party bears generally are less than the full social legal costs, that is,

Furthermore, the opportunity for gamers to elect CR will reduce the per-taxpayer cost of higher DR fines. Among the many factors affecting which gamers will flee from large DR fines, one is risk aversion.²⁰⁹ High penalties are more costly for relatively more risk-averse gamers, so they are more likely to elect a low penalty regime. Those who remain will not be as averse to uncertainty, and their risk-bearing losses will be smaller.

2. *Benefits of Combining the Two Regimes.* — Each of the two regimes considered here has flaws. The shortcomings of each, however, are alleviated by the existence of the other. The deficiencies of DR as the *only* enforcement environment are clear. High nominal penalties applicable to all taxpayers create large risk-bearing and other deadweight losses, possibly decrease compliance, and are unrealistic politically. The existence of CR, offering much lower statutory fines, will go a long way toward eliminating all these limitations.

When considered in isolation, CR has many weaknesses as well. The pro-IRS presumption and constraints on return preparers will make it difficult for taxpayers to challenge government's interpretations of the law. They will also limit taxpayers' opportunities to test the line between permissible and illegal positions. Binding arbitration will undermine the development of precedent, inhibit the public articulation of values, and conceal overly aggressive enforcement from public scrutiny and judicial review.²¹⁰ In a legal system that has some or all of these features, rules remain imprecise and poorly targeted, standards fail to acquire content through the development of precedent, lawmakers have no incentives to produce high-quality legislation, public values remain obscure, and business transactions are impeded by uncertainty and the threat of unchallenged government power.²¹¹

The existence of DR will alleviate most of these concerns. In that regime, the IRS will have no advantage, taxpayers will be free to test the boundaries of acceptable tax planning with the assistance of zealous advocates, and courts will contribute to doctrinal development and act as a check on unduly aggressive tax administrators. To ensure that decisions made in CR do not introduce confusion and uncertainty into the tax law,

the costs borne by both litigants and by the state itself.”). While litigation may produce positive externalities as well, see *id.*, many of these externalities (such as deterrence of unwanted behavior) are absent when the other party to a suit is a federal agency.

209. Other factors include aggressiveness of tax positions, opportunities to conceal tax avoidance or evasion (with better opportunities pointing toward choosing DR), and the necessity of relying on a tax advisor or preparer (if the need exists, DR is more attractive).

210. For an example of a seminal tax case that simultaneously laid the foundation of an important extrastatutory anti-abuse doctrine and announced a taxpayer's right to tax planning, see *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (articulating the business purpose doctrine while asserting that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted”).

211. Many of these shortcomings have been emphasized by the opponents of alternative dispute resolution. See, e.g., Sternlight, *supra* note 140, at 1661.

they should have no precedential value.²¹² Substantive tax law should be the same for both regimes, and its content should be determined under the familiar rules and protections of DR. Under these conditions, the benefits of a fully adversarial system will remain largely intact, while its costs will be substantially reduced.

Recognizing the importance of maintaining DR side by side with CR underscores a key point that may be obscured by this Article's attention to voluntary compliance: There is nothing wrong with being a gamer and choosing DR! Gamers' preferences are as valid as those of reciprocators, duty-bound taxpayers, and everyone else. Moreover, we need gamers to make sure that DR will fulfill its crucial role in the dual enforcement system.

3. *Benefits of Choice Between the Two Regimes.* — Some of the proposed CR features will force taxpayers electing that regime to sacrifice important rights. As the politics of plea bargaining, consensual police searches, and the Supreme Court's Fourth, Sixth, and Seventh Amendment jurisprudence demonstrate, however, giving individuals an opportunity to reject oppressive government treatment makes the treatment much more acceptable. As long as a person consents, she may be searched without reasonable cause,²¹³ interrogated without being represented by counsel,²¹⁴ and convicted without exercising her constitutional right to trial.²¹⁵ Choice—even if illusory—changes the terms of legal discourse and public debate.

Taxpayer choice, of course, is at the center of the dual regime. And so it should be. It is clear that a substantial increase in statutory fines is all but impossible if the fines are applied across the board.²¹⁶ It is equally unlikely that taxpayers will accept losing a right to defend their tax positions in a court of law in all circumstances. Yet it does not appear wholly unrealistic that policymakers and taxpayers will agree to substantially higher nominal DR fines and at least some of the suggested CR features if these fines and features are optional.

212. If policymakers are particularly concerned with assuring this result, CR arbitrators should produce no written decisions at all, and only announce their bottom line conclusions. This rule may be disappointing, however, for the losing side. An alternate solution would be to exempt decisions of CR arbitrators from the disclosure requirements of the Freedom of Information Act, 5 U.S.C. § 552 (2006).

213. See, e.g., Adrian J. Barrio, Note, Rethinking *Schneekloth v. Bustamonte*: Incorporating Obedience Theory into the Supreme Court's Conception of Voluntary Consent, 1997 U. Ill. L. Rev. 215, 219–22 (describing Supreme Court jurisprudence on consensual searches).

214. See, e.g., William J. Stuntz, Waiving Rights in Criminal Procedure, 75 Va. L. Rev. 761, 762–63 (1989) (noting that despite Sixth Amendment's facially robust protections, waivers of right to counsel are common, and thus "uncounseled confessions in the police station are commonplace").

215. See, e.g., Right to a Jury Trial, 37 Geo. L.J. Ann. Rev. Crim. Proc. 519, 523–24 (2008).

216. See Graetz & Wilde, *supra* note 9, at 358.

The inevitable argument that the dual regime is oppressive and denies taxpayers important rights can be met with a convincing response. If one is not interested in gaming the system, one can always choose CR and enjoy prefilling advice and cooperative auditors who will correct one's mistakes. And if the auditor turns out to be wrong, there will be resort to an independent arbitrator and the possibility of a reimbursement of costs combined with an apology. If, however, one likes to pay as little tax as possible and is interested in pushing the limits of acceptable tax planning, there is a regime where one has every opportunity to pursue these goals. But one is also required to bear the cost of being wrong, a cost that today is indefensibly low for any well-informed, rational actor undertaking the expected penalty analysis.

4. *Dealing with Complex Motivations.* — The schematic approach to taxpayer motivations used to formulate and discuss the dual enforcement framework—while surely richer than the standard deterrence story—is, nonetheless, unrealistic. Some of us may be pure gamers or unwavering reciprocators, but many are likely to act for multiple and varying reasons. Thoughts about penalties may combine with feelings of shame and a sense of duty to produce an ultimate decision about how much tax one should pay.²¹⁷ How will a dual regime accommodate this complexity?

In short, reasonably well. If people are driven by mixed motivations, it is still possible to target enforcement by inducing taxpayers to choose a predominant one. The dual enforcement regime will accomplish this by requiring an affirmative choice between DR and CR. In making this choice, taxpayers presumably will think about their relationship with tax authorities and contemplate their income sources and tax planning opportunities. In the end, they will opt for the regime that is right for them, essentially deciding which of their motivations predominates. In addition to helping the IRS in its targeting efforts, this important process of self-reflection will prompt taxpayers to (re)evaluate their view of the government and, perhaps, (re)consider their attitudes toward taxes, spending, and law enforcement. These are precisely the thoughts that will make taxpayers better citizens regardless of which regime they end up choosing.

Empirical evidence supporting the idea that people vary by type—and do not merely act out of many conflicting motivations in an unpredictable fashion—is limited. Yet it certainly exists. Psychologists have developed a self-categorization theory that provides for cognitive foundations of social identity.²¹⁸ Michael Wenzel has introduced a concept of taxpayer identity and demonstrated that people with different identities

217. The idea that an individual is an aggregation of multiple selves is now dominant in sociology and psychology. See Braithwaite, *Dancing*, supra note 2, at 14, 21 (raising possibility that taxpayers may hold multiple motivational postures simultaneously).

218. See Michael Wenzel, *The Multiplicity of Taxpayer Identities and Their Implications for Tax Ethics*, 29 *Law & Pol'y* 31, 34–35 (2007).

have different views on the acceptability of tax evasion.²¹⁹ Other researchers have found that participants' decisions in a multiparty social dilemma game varied depending on whether their "decision frame" was "Business" or "Ethical."²²⁰ In a different experiment, responses to the threat of sanctions depended on whether subjects had high or low moral reasoning, as determined by the Defining Issues Test.²²¹ Choice of college major, it turns out, is a strong predictor of one's type. Compared to psychology students, economics majors declared significantly less income in a tax compliance game, were significantly less cooperative, and were less concerned with the moral implications of tax evasion.²²² Surveys show that taxpayer attitudes toward the tax collector fall into fairly defined and internally consistent patterns that differ significantly from each other.²²³ In sum, when faced with cooperation/compliance dilemmas in experiments and in real life, people do seem to exhibit different character types and these types do appear to determine people's attitudes, intentions, and behavior.

Granted, these arguments provide only a partial answer to the problem of motivational complexity. In deciding whether this answer is satisfactory, one should keep in mind the existing enforcement regime. Today, virtually *every* taxpaying citizen is treated as a gamer.²²⁴ Taxpayers have no opportunity to embrace and reveal a different predominant motivation. From this baseline, the proposed dual regime is a clear step forward.

219. See *id.* at 43–44 (describing effects of three identities—exclusive individual identity, inclusive national identity, and an intermediate subgroup or interest group identity—on tax ethics).

220. See Tenbrunsel & Messick, *supra* note 71, at 694, 696. Frames were determined based on respondents' answers to the question of whether they thought of their decision to cooperate as a personal, business, ethical, environmental, or legal decision (the game involved lobbying for new environmental legislation). While varying the sanction's strength affected cooperative behavior of those adopting the business frame, it had no effect on those who maintained the ethical one. *Id.* at 701.

221. Specifically, researchers found that only those with low moral reasoning altered their tax evasion intentions in response to a threat of legal sanctions. See Steven E. Kaplan et al., *The Effect of Moral Reasoning and Educational Communications on Tax Evasion Intentions*, *J. Am. Tax'n Ass'n*, Fall 1997, at 38, 48. The Defining Issues Test "assess[es] both . . . capacity for and usage of moral reasoning in decision making." *Id.* at 39. It "is a psychometric instrument with high statistical reliability . . ." *Id.* at 41. Contrary to the authors' expectations, neither sanction threats nor moral appeals had a statistically significant effect on intentions to evade of those with high moral reasoning. *Id.* at 48.

222. John Cullis et al., *Tax Framing, Instrumentality and Individual Differences: Are There Two Different Cultures?*, 27 *J. Econ. Psychol.* 304, 315 (2006). Because there were many more females among psychology majors, it remains unclear whether gender differences or some other factor(s) affecting the subjects' taxpaying decisions drove the result. *Id.*

223. See Braithwaite, *Dancing*, *supra* note 2, at 15, 18 (listing five postures, including "game playing").

224. Such measures as the Compliance Assurance Program, the Advanced Pricing Agreement Program, the Private Letter Ruling Program, and the like affect only a tiny fraction of all taxpayers. See *supra* note 54.

Of course, an even more nuanced system would better reflect the heterogeneous motivations of various taxpayers. If we could design practical and inexpensive ways to separate reciprocators from duty-bound taxpayers from habitual compliers from rational non-gamers, and if we knew what policy instruments were particularly well-suited for taxpayers of each type, we could improve our tax enforcement even further. Yet this Article's effort to develop features that are likely to separate just two broad taxpayer categories suggests that further fine tuning will be difficult. Furthermore, while scholars have an idea about enforcement measures that are likely to be effective for non-gamers generally,²²⁵ little is known about which of these measures (or other instruments) will be effective with any given subcategory of non-gamers. Thus, the limited proposal advanced in this Article is a reasonable first step.

Another possibility for further fine tuning would involve varying enforcement based on easily identifiable characteristics of gamers and non-gamers. For instance, it may be beneficial to have somewhat different rules in DR, in CR, or in both regimes for businesses and individuals, for large corporations and small proprietorships, for public and private companies, and so on. However, it makes sense to examine such further differentiation only after becoming convinced that the information-forcing mechanisms discussed here can successfully produce the basic separation of gamers and non-gamers, and that this separation is likely to come at a reasonable social cost—the topic considered next.

B. *Weaknesses and Uncertainties of the Dual Regime Framework*

1. *Separating Equilibrium or No Separation?* — It would be naïve to assume that all gamers will choose DR and all non-gamers will elect CR. A separating equilibrium—the one where each regime contains only taxpayers of a single type—is implausible. The question, then, is what mix of taxpayers is likely to exist in each regime.

Non-gamers will have few reasons to prefer DR (with a caveat discussed in the next section). For gamers, however, the choice will be more difficult. Higher DR penalties will be unattractive, but many CR features will be unappealing as well. At least for some gamers, the cost of facing DR fines will be higher than the cost of accepting CR conditions—these taxpayers will opt for CR. DR will therefore be populated mostly by gamers, while CR will contain a mix of gamers and non-gamers. The result will be only a partial separation. Even this imperfect outcome, it is worth emphasizing, is likely to be more efficient than no separation at all because it will allow some targeting, albeit only to a limited extent.

The degree of separation will depend crucially on the relative costs of the two regimes for gamers. These costs, in turn, will be determined by the difference between statutory DR and CR fines and by the CR separating features. Comparing the effect of some of these features to that of

225. See *supra* note 85.

larger DR fines will be easy. For instance, both nominal penalties and probability of conviction are reflected in the expected payment formula.²²⁶ Thus, CR measures aimed at increasing the latter can be directly compared to the effect of DR fines on the former. For other separating features, however, a similar comparison is impossible. Steps restricting opportunities to adopt aggressive positions, such as stronger preparer sanctions (to take just one example), do not affect any of the expected tax payment variables. Thus, no formula can determine what combination of CR conditions will equal the overall deterrent effect of any given increase in nominal DR penalties, let alone decide the optimal relationship between those variables.

The uncertainty will be great, but perhaps not much greater than the existing system's indeterminacy. Despite decades of tinkering with the two basic variables (audit rates and nominal penalties), we know exceedingly little about what levels of these variables are optimal or even appropriate. If the dual regime is adopted, policymakers will at least have one clear indicator that the system does not work as designed: the number of taxpayers in each regime. For instance, if very few taxpayers choose DR, its nominal sanctions are too high. If all but a few choose DR, the opposite is true. The alternative explanation that will have to be considered in either case is that the CR separating features are ineffective and need to be replaced with different ones. Overall, while a lot is unknown about the proposed dual regime, additional uncertainty from switching to it may not be particularly great.

2. *The Price of Rights.* — Most people value their rights. To some, rights are important for instrumental reasons, as a means of securing or protecting valuable entitlements. Others, however, approach rights in a deontological sense—they value rights for rights' sake.

Many potential CR features deny, or at least impinge on, valuable rights. Binding arbitration denies the right to trial. A pro-government presumption denies the right to test the limits of the law. Absence of a return preparer privilege denies the right to keep communications with preparers confidential. These concessions will not be particularly costly to non-gamers with an instrumentalist outlook because these taxpayers will not expect to invoke the rights in question in the first place.²²⁷ Deontological non-gamers, however, present a problem. Even though they have no rational reason to prefer DR, they will be compelled to choose it because they will be unwilling to surrender their rights by accepting some of the CR conditions.

226. See *supra* text accompanying note 120.

227. While an instrumentalist approach presumes rational thinking, it is possible that an individual is only partially rational. For instance, one may think of a right to trial in instrumentalist terms, yet be compelled to pay taxes by a sense of duty or desire to avoid feelings of guilt or shame. Nonrationality, one should remember, does not mean random or unpredictable behavior. See *supra* text accompanying note 26.

It is difficult to address this problem other than by acknowledging it. In contrast to the voluminous empirical data on contingent reciprocators, little is known regarding the proportion of the population that cares deeply about rights, the number of those who are deontologists, the average strength of their rights-regarding preferences, and the importance to these individuals of specific rights affected by each of the suggested CR features. In light of this pervasive uncertainty, I can only make a few points suggesting that the problem is at least manageable.

People routinely surrender rights similar to those under consideration here when they engage in private contracting. A binding arbitration clause is a staple of credit card agreements, employment contracts, tax preparation agreements, and other contracts entered into by tens of millions of taxpayers.²²⁸ Even when consumers' health and lives—rather than mere dollars—are at stake, they routinely agree to binding arbitration.²²⁹ Nor is the widespread surrender of valuable rights in exchange for offsetting benefits limited to private law. The pervasiveness of plea bargains provides clear evidence that citizens are willing to give up their constitutional rights even when their freedom is at stake.²³⁰ The adversary in such cases is the government, not a credit card or insurance company. If the right to defend one's liberty in a court of law is routinely sacrificed, it is difficult to see how the right to contest the determination of a fixed monetary amount in court (as opposed to in front of a neutral arbitrator) can be highly valued by most taxpayers.

To be sure, these arguments are imprecise. Yet precision will be impossible until substantial empirical evidence is assembled to address the questions posited earlier in this section. For now, the analysis must be limited to analogies and casual observations. Even so, it is reasonable to assume that people have much stronger deontological views regarding their right to freedom than concerning their right to a given sum of money. Therefore, the reform discussed in this Article should be limited to civil violations. Furthermore, not all CR features will affect rights

228. See Ronald J. Mann, "Contracting" for Credit, 104 Mich. L. Rev. 899, 919–20 (2006) (discussing impact of credit card arbitration clauses on utility of unconscionability doctrine); Sternlight, *supra* note 140, at 1638 (noting proliferation of mandatory arbitration across range of consumer contexts). As one court remarked, "[t]he reality [is] that the average consumer frequently loses his/her constitutional rights and right of access to the court when he/she buys a car, household appliance, insurance policy, receives medical attention or gets a job." *Knepp v. Credit Acceptance Corp.*, 229 B.R. 821, 827 (Bankr. N.D. Ala. 1999).

229. Arbitration clauses appear with increasing frequency in hospital services agreements, health maintenance organizations contracts, and nursing home contracts. Sternlight, *supra* note 140, at 1639.

230. See, e.g., Robert E. Scott & William J. Stuntz, *Plea Bargaining as Contract*, 101 Yale L.J. 1909, 1912 (1992) ("[Plea bargaining] is not some adjunct to the criminal justice system; it *is* the criminal justice system."); Jennifer L. Mnookin, *Uncertain Bargains: The Rise of Plea Bargaining in America*, 57 Stan. L. Rev. 1721, 1722 (2005) (book review) (stating that less than five percent of federal criminal defendants go to trial, and vast majority of others participate in plea bargains).

equally. Narrow measures such as agreements to disclose foreign bank accounts and FIN 48 workpapers are not nearly as much of a sacrifice as mandatory binding arbitration. Carrot-based approaches such as respectful auditors, improved prefiling advice, and selective cost reimbursements do not impinge on rights at all. If one is seriously concerned about deontological rights-regarding non-gamers, one will prefer to rely on these approaches to separate gamers from the rest.

3. *Dealing with Fraud.* — Increasing the probability of conviction through a pro-government presumption and binding arbitration makes no difference if a taxpayer believes that this probability is already one hundred percent. Constraining tax preparers has no effect on tax compliance if a taxpayer lies to a preparer about her cash receipts. Nor does it matter to this taxpayer whether her communications with the preparer are privileged. For all these reasons, CR will do relatively little to impose costs on tax evaders. Because higher DR fines will be costly for them, evaders will have a strong incentive to choose CR. This is an undesirable result.

Dealing with this problem is difficult, and no perfect solutions emerge. But before we consider more general approaches, it is worth pointing out three categories of evaders who will be unable to hide in CR. First are those who fail to file their tax returns.²³¹ These taxpayers should be automatically assigned to DR and face its higher penalties if they are caught. The second category consists of those who fail to pay their assessed tax liabilities.²³² These taxpayers are known to the IRS, and their liabilities are not contested. The government will be equally free to pursue them in both regimes. Finally, some evaders will be effectively deterred by narrow separating CR features. Few tax evaders with secret offshore bank accounts will elect CR if a blanket consent to disclosure of banking information is one of its features. Evaders falling in these three categories account for no less than \$110 billion in uncollected taxes each year—hardly an insubstantial amount.²³³

Nonetheless, a significant portion of evaders do file returns and could expect to remain undetected and unaffected by narrow separating measures. What can the government do to prevent them from choosing CR? First, taking an *ex ante* approach, the government may preclude certain categories of taxpayers from electing CR in the first place. We have a fairly good idea of which sectors of the economy exhibit the lowest compliance rates. For instance, this rate for so-called “informal suppli-

231. Almost eight percent of the tax gap (or \$27 billion) is attributable to failures to file. See Toder, *supra* note 4, at 367–68.

232. Almost ten percent of the tax gap (or \$33.3 billion) is attributable to failures to pay. See *id.*

233. The \$110 billion figure is a result of adding the estimated \$50 billion number reflecting offshore tax evasion, see *supra* note 157, to the \$27 billion and the \$33.3 billion figures from the two preceding footnotes.

ers” is a meager thirteen percent.²³⁴ Most likely, noncompliance here is simply a failure to report cash receipts (evasion) by small street vendors, domestic workers, and the like.²³⁵ It is highly unlikely that a large number of taxpayers in this category are duty-bound or driven by reciprocity.²³⁶ Thus, relatively little will be lost if the government assumes that all these taxpayers are gamers and places them in the appropriate (DR) regime. The drawback, of course, is that some informal suppliers dutifully pay their taxes. Forcing them into a high penalty environment may produce the detrimental effects discussed above.

Another solution is to make CR unavailable to fraudulent taxpayers *ex post*. That is, even if a tax evader files a return and elects CR, her election will be nullified if she is caught, the IRS alleges fraud, and it wins in court (or in arbitration).²³⁷ The problem with this solution is its effect on non-gamers. People make mistakes. While an elaborate, aggressive tax scheme cannot be plausibly explained as an error, a failure to report income may be, and the explanation may be truthful. If the draconian measure just described can apply to mistaken taxpayers, many of the problems associated with an across-the-board increase in nominal fines will come back into the picture.

A reasonable middle-of-the-road solution is to combine *ex post* and *ex ante* approaches. Taxpayers found guilty of tax evasion in CR should be penalized (*ex post*) by losing the opportunity to elect that regime in the future.²³⁸ Granted, this penalty will fail to stop evaders from electing CR, because they will prefer one “free ride” in that regime. Yet they will have to choose when to “redeem” their free ticket by electing CR and taking the risk of being caught and subsequently forbidden to make this election in the future. In any case, this approach is a compromise that has the substantial added benefit of gradually removing evaders from CR.

In sum, it will be difficult to keep some types of tax evaders in DR. This does not mean, however, that an introduction of the dual regime will *benefit* these gamers. If nominal sanctions and audit rates in CR are the same as they are today, several of the proposed separating features will make CR more costly for evaders than the existing regime. For instance, if the binding arbitration feature is adopted, the probability of fine in CR will be higher than it is now. The chance of future exclusion from CR will add another cost. At the same time, several types of evaders will be forced to accept DR and face stronger deterrence. Overall, there-

234. See Slemrod, *Small Business*, *supra* note 2, at 84–86.

235. See Slemrod, *Cheating Ourselves*, *supra* note 4, at 30 (referring to widespread belief among tax professionals that while the wealthy tend to reduce their taxes through avoidance, the poor mostly engage in outright evasion).

236. Observing widespread tax evasion by peers, a reciprocator would stop paying taxes as well.

237. At that point, the taxpayer will also regain a right to trial, appeal, and all other taxpayer-favorable DR features.

238. The same should be true of those who are caught engaging in highly aggressive avoidance in CR.

fore, the dual enforcement regime is likely to produce some increase in compliance even among tax evaders.

4. *Responding to Administrability Concerns.* — While this Article's goal is not to undertake a detailed analysis of a specific policy proposal, it is worth making a few points about implementation issues. The specific idea discussed here—and under any other information-forcing menu of enforcement schedules—contemplates that taxpayers consider a choice and make an affirmative election. Is it realistic to expect that much from over 130 million taxpayers? To answer this question, we need to consider three separate issues: whether most taxpayers can be made aware of this choice; whether they are likely to actually make this choice; and whether they can be expected to make the choice that is right for them.

Information dissemination is the least challenging of these tasks. There are two main reasons for this guarded optimism: return preparers and tax preparation software.²³⁹ In 2006, nearly 78 million individual returns (61% of the total) were filed by preparers.²⁴⁰ Surely tax professionals can be educated about the election and urged to stress its importance to their clients. To minimize the preparers' influence on their clients' choice of regime, preparers should be required to explain the choice to their clients (perhaps even following a template approved by the IRS) and face penalties for failing to do so.²⁴¹ Meanwhile, approximately 2.5 million corporate returns are filed each year.²⁴² All, or almost all, are prepared by lawyers and accountants. It is hard to imagine that many corporations will fail to pay attention to the introduction of the dual enforcement regime.

About 24 million individual returns filed without third-party assistance in 2006 (19% of the total) were assembled using tax preparation software.²⁴³ Computer programs can be easily modified to open with a screen announcing the substance of the CR/DR election and urging taxpayers to take time and decide which regime they prefer. Four or five bullet points describing the main DR and CR features (perhaps with a

239. Note that preparation software—rather than electronic filing—is the key. The growing popularity of the latter, however, is likely to contribute to increased use of the former.

240. See GAO Report, *supra* note 171, at 17.

241. Note that a potential problem of preparers steering taxpayers to a particular regime will exist whether or not the special preparer-focused measures discussed in Part III.D are adopted. For instance, audits are bound to be more contentious in DR because taxpayers in that regime will dispute questionable positions (while taxpayers will have little to gain from doing the same in CR). An unscrupulous preparer hoping to earn fees during contentious audits will have an incentive to steer clients toward DR even if preparer standards and penalties are the same in both regimes.

242. Slemrod, *Small Business*, *supra* note 2, at 92.

243. Of these, about 15 million were filed in paper form, and around 9 million were e-filed. See GAO Report, *supra* note 171, at 14, 17. (These figures were calculated by the author based on the GAO data.)

link to another screen enumerating the rest) seem to be well within the limited attention span of a typical taxpayer.

In addition, an educational campaign during the tax filing season (TV, radio, and Internet ads, mass mailings, and so on) can help ensure that even those who prepare their own returns using pencil and paper (about 20% of the total, and declining) are aware of the new choice they need to make. While the election requirement initially may catch some taxpayers off guard, word of the dual regime will spread, and within a few years most individuals will be fully aware of it.

The second concern—assuring that taxpayers actually choose one of the regimes—is more serious. Granted, it should be possible to compel the majority of taxpayers to make this choice. Return preparers can be required to ensure that their clients choose one of the two regimes. Tax preparation programs can do the same simply by disallowing users from advancing to further screens without selecting DR or CR. IRS computer systems can reject any electronically filed return that does not reflect an affirmative choice of regime as well. But there is not much that can be done to force taxpayers doing their taxes by hand and filing returns by regular mail to choose between DR and CR. Thousands (and, perhaps, millions) of these taxpayers may fail to make this choice in any given year—they will simply fail to check either a “DR” or a “CR” box on their returns. While it would be possible for the IRS to reject all such returns as incomplete, an alternative solution would be to make one of the two regimes a default.

Neither DR nor CR is an obvious candidate for the default regime (with the exception of making DR a default for non-filers, as discussed above²⁴⁴). The penalty default approach suggests that the default should be countermajoritarian—the regime relatively few taxpayers would have chosen upon careful deliberation.²⁴⁵ Efficiency-based arguments focused on transaction costs and insights from behavioral economics point in the opposite direction. Choices are costly, and majoritarian defaults save those costs.²⁴⁶ Numerous studies have shown that defaults are sticky—people often accept them out of inertia.²⁴⁷ If so, the default regime should be the one most taxpayers would have preferred in any case.

Whichever consideration predominates in theory, the practical implications are uncertain. It is unclear whether a substantial majority of

244. See *supra* text accompanying notes 231–233.

245. See Ayres & Gertner, *supra* note 97, at 91 (“In contrast to the received wisdom, penalty defaults are purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other or to third parties . . .”).

246. See *id.* at 90 (describing dominant view at the time).

247. See, e.g., Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 *Q.J. Econ.* 1149, 1150 (2001) (finding that participation in pension plans is significantly higher when default choice is to contribute to such plan). For a more wide-ranging elaboration on the theme of sticky defaults, see Richard H. Thaler & Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (2008).

taxpayers would prefer DR or CR upon thoughtful deliberation once the dual system is introduced. Without knowing the answer to this question, the debate about whether a majoritarian or a countermajoritarian default is more appropriate has little policy relevance.

Two other considerations do provide clear prescriptions, but unfortunately they, too, point in opposite directions. On the one hand, the choice between DR and CR is, at bottom, a rational choice. It requires comparing the cost of higher expected sanctions in DR to the cost of CR separating features. The burden of making a rational choice should be placed on rational actors. This logic suggests that CR should be chosen as the default regime, forcing gamers to make an affirmative DR election. On the other hand, if CR contains one or more features abridging taxpayers' rights, imposing this regime on careless taxpayers who fail to make an election appears problematic. In the end, policymakers will need to decide which of these considerations should determine the outcome.

The final question is whether most taxpayers will recognize which regime is right for them. Assuming the government calibrates the relative expected costs correctly, gamers will have no trouble making the decision. Because some non-gamers may be unsure how to choose between unfamiliar options, the government should nudge them in the right direction.²⁴⁸ Framing is very important for nonrational individuals, so it is not an accident that the proposed name of the new enforcement environment is the compliance regime. This name is meant to suggest to taxpayers that if they think of themselves as complying with the tax law voluntarily, they should choose CR. Moreover, the educational campaign launched by the IRS when the DR/CR choice is introduced should go beyond simply informing taxpayers about the new dual enforcement regime. Rather, it should emphasize which taxpayers would do better by electing CR—those uninterested in minimizing their taxes by taking aggressive positions.

C. Audit Rates and the Credibility of Government Commitments

The discussion thus far has assumed that audit rates in both regimes are identical. That is, the government does not use the new information about taxpayers (their choice of regime) to adjust its examination strategy. If the IRS cannot credibly commit to maintaining the same audit coverage in DR and CR, this assumption is decidedly unrealistic. Once variable audit strategies are allowed, however, the analysis becomes significantly more complex. Tax compliance becomes a game rather than a gamble. Both the government and taxpayers continuously adjust to each other's actions.²⁴⁹ Several attempts to model this interaction show that

248. See Thaler & Sunstein, *supra* note 247, at 1–8 (describing how changes in way choices are presented can influence selection).

249. No doubt, taxpayers will respond to other CR separating features just like they would have responded to varying audit rates. The difference between these features on the one hand and audit coverage on the other is on the government's side. Once the

the task is exceedingly complicated and removed from realities of day-to-day tax administration.²⁵⁰

If basing audit coverage on taxpayers' choices of regime will clearly aid tax enforcement, a credible commitment to a uniform audit strategy will be impossible. If, however, it is uncertain which regime should feature more frequent audits, maintaining identical audit rates may be the government's best option, making its decision to do so credible. A number of competing considerations suggest that this is precisely the situation the government will face.

On the one hand, a familiar analysis suggests that audit rates should be higher in DR. Audits are the best deterrent. Because most taxpayers in DR will be gamers who respond to deterrence, they should be audited more heavily. Audits are also costly, and these costs are largely wasted if auditors find no noncompliance. Taxpayers are likely to be more compliant in CR. Hence, a lower audit rate is appropriate there. In addition, there is some evidence that intrusive control by authorities crowds out voluntary compliance.²⁵¹ This is yet another reason to have relatively low audit rates in CR.

On the other hand, audits may be used to approach a separating equilibrium—a critical consideration in the proposed dual regime. Gamers will compose the majority of taxpayers in DR. CR, however, will contain both non-gamers and gamers (some evaders and the most aggressive avoiders). By increasing CR audit coverage, the government will enhance its capacity to identify gamers who elect CR and deny them a chance to do so again. In addition, more frequent CR audits will deter evaders from electing CR in the first place. Both considerations suggest that audit rates should be higher in CR to facilitate separation.

In sum, the conventional deterrence analysis suggests that audits should be more frequent in DR while the goal of reaching a separating equilibrium points strongly toward the opposite conclusion. It is unclear which of these competing considerations should prevail. But the mere presence of strongly competing considerations makes the government's precommitment not to vary audit rates between the two regimes credible.

One type of audit selection technique, however, is not subject to this logic. Some taxpayers will choose DR in one year and CR during the next. If this happens once or twice, there may be an innocuous explana-

government creates the dual regime and announces CR features such as binding arbitration or high preparer penalties, it will be fairly difficult to keep changing these features without compromising the entire tax enforcement mechanism. Furthermore, any such subsequent changes will be highly public. Neither constraint applies to the government's adjustment of audit rates, which can be done continuously and surreptitiously, forcing taxpayers to anticipate the government's response to taxpayers' initial adjustments and leading to the complexities mentioned in the text.

250. For an example of one such model, see Graetz et al., *Tax Compliance Game*, *supra* note 18, at 5–9. For a discussion of the numerous limitations of game-theoretic models, see Raskolnikov, *Self-Adjusting Penalty*, *supra* note 6, at 629.

251. See *supra* notes 64, 71 and accompanying text.

tion. For instance, a taxpayer may initially elect DR by mistake. Once the mistake is realized, the taxpayer will change her election in future years. If, however, a taxpayer repeatedly jumps from one regime to another, he reveals himself as a gamer. Auditing this taxpayer in CR is likely to detect aggressive tax planning and enable the IRS to prevent this taxpayer from hiding in CR in the future.

CONCLUSION

The one-size-fits-all approach to tax enforcement has reached its limits. This Article explores how information-forcing mechanisms such as the penalty default and menu selection may be used to improve tax administration. The specific reform considered in detail is the most basic application of these mechanisms—a dual enforcement regime designed to force many taxpayers to reveal their motivations for paying taxes to the IRS. Armed with this information, the government will be able to target enforcement, improving tax compliance while reducing its social cost.

The merits of the proposed reform turn on the resolution of two key questions. First, is it fruitful to separate taxpayers based on whether or not they are gamers? Second, is it possible? The Article answers both questions in the affirmative—the first one decisively, the second one more tentatively. Gamers are unique because their behavior is well described by a thoroughly developed economic model. We know how to deter gamers. We also have an idea about strategies that are likely to influence all others, and it is clear that the two sets of approaches are very different. Thus, the gamer/non-gamer division is a productive one.

It is also achievable—certainly for avoiders, and to a limited extent for evaders. Whatever one thinks of the specific compliance regime features discussed in this Article, it is clear from their sheer number and variety that policy instruments that impose different costs or bestow different benefits on gamers and non-gamers do exist. These instruments may be deployed to accomplish the desired separation, even if imperfectly. Considering how to improve this separation—and how to move beyond the basic dual regime structure examined in this Article—is a promising avenue for future research that should be pursued in addition to (if not in lieu of) the ongoing discussion of audits, fines, and deterrence.