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SOMETHING FROM NOTHING: TAXING ASSETS ACCURATELY

David J. Herzig*

2011 MICH. ST. L. REV. 1057

“The hardest thing in the world to understand is the Income Tax.”¹

INTRODUCTION.....	1058
I. OVERVIEW OF TAXPAYER RECORD KEEPING.....	1063
A. Claim of Impossibility.....	1065
B. Claim of Reliance.....	1070
C. Norm-Deterrence Modality.....	1073
1. <i>Deterrence Model in Uncertainty</i>	1074
2. <i>Norms-Model in Uncertainty</i>	1080
II. CURRENT LAW AND BURDEN SHIFTING.....	1083
A. Zero-Basis Cases.....	1089
B. The <i>Cohan</i> Rule.....	1091
C. Tax Court Rules and the Federal Rules of Evidence.....	1093
1. <i>Tax Court Rule 142</i>	1094
2. <i>Federal Rule 301</i>	1094
III. CLEAR STANDARDS.....	1096
A. New Preliminary Determination Standard.....	1097
B. Better Alternatives to Guessing.....	1099
1. <i>Mark-to-Market Method</i>	1099
2. <i>Modified Auerbach Method</i>	1101
3. <i>Modified Original Issue Discount Approach</i>	1104
4. <i>Most Likely Candidate(s) for Reform</i>	1106
CONCLUSION.....	1108

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1. AS CERTAIN AS DEATH: QUOTATIONS ABOUT TAXES 30 (Jeffery L. Yablon comp., 2010 ed. 2010) (quoting Albert Einstein).

INTRODUCTION

The “tax gap” is the difference between what taxpayers pay and what they owe.² This differential is currently estimated at \$345 billion (about 27% of our current estimated budget deficit).³ One of the largest categories within the tax gap is underreporting.⁴ Underreporting results from the incorrect belief among taxpayers that adequate and accurate records are not necessary.⁵ The failure of taxpayers to accurately report represents the largest component of the underreporting portion of the tax gap; the other components result from intentional misrepresentations by the taxpayer.⁶ It is politically preferable to bridge the collection shortfall through a reduction in underreporting, currently at approximately 17%, rather than by raising taxes, reducing spending, or cutting programs.⁷

The primary reason for the hole in underreporting is the asymmetric information for the reporting of the basis.⁸ The taxpayer possesses all the information while the government has little information.⁹ For example, taxpayers have access to all the records, receipts, and other information needed

2. Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 112 (2009). The government defines the tax gap as “the aggregate amount of true tax liability imposed by law for a given tax year that is not paid voluntarily and timely.” I.R.S., U.S. DEP’T OF THE TREASURY, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 6 (2007), available at http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf [hereinafter 2007 Report] (emphasis omitted); see also Stephanie Hunter McMahon, *To Have and to Hold: What Does Love (of Money) Have to do with Joint Tax Filing*, 11 NEV. L.J. 718, 741 (2011).

3. I.R.S., U.S. DEP’T OF THE TREASURY, UPDATE ON REDUCING THE FEDERAL TAX GAP AND IMPROVING VOLUNTARY COMPLIANCE 1-4 (2009), available at http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf [hereinafter 2009 Report]; STATEMENT OF DOUGLAS W. ELMENDORF, CONGRESSIONAL BUDGET OFFICE, THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION U.S. CONGRESS, CONFRONTING THE NATION’S FISCAL POLICY CHALLENGES 16 (Sept. 13, 2011) (stating that the current 2011 federal deficit is \$1.3 trillion), available at <http://www.cbo.gov/ftpdocs/124xx/doc12413/09-13-FiscalPolicyChallenges.pdf>.

4. Current estimates are at \$290 billion dollars. See 2009 Report, *supra* note 3, at 3.

5. See Walter T. Henderson, Jr., *Criminal Liability Under the Internal Revenue Code: A Proposal to Make the “Voluntary” Compliance System a Little Less “Voluntary,”* 140 U. PA. L. REV. 1429, 1436 (1992) (discussing increasing criminal sanctions to encourage compliance); Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L.J. 1, 17 (2007).

6. According to the Department of the Treasury, Individual Income Tax underreporting accounts for more than \$185 billion of the total Tax Gap. See 2009 Report, *supra* note 3, at 3.

7. See Editorial, *5,100 More IRS Agents*, WALL ST. J., Feb. 15, 2011, at A14; 2009 Report, *supra* note 3, at 4.

8. Leandra Lederman, *Reducing Information Gaps To Reduce The Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1733 (2010).

9. *Id.* at 1735.

to calculate the gain on their assets while the government only has the information reported through third parties. Taxpayers understand that the lack of government knowledge allows for gaming of the system.¹⁰ The information gap creates behavioral distortion in taxpayers of noncompliance or under-compliance with their record-keeping duties.

The taxpayer gaming is then augmented by the failure of courts to provide a clearly articulated standard in the event that taxpayers have failed to meet their record-keeping duties. Since the late 1920s, courts have struggled to articulate and enforce a unified standard for common situations presented when taxpayers must substantiate what they paid for an asset.¹¹ The result of the aforementioned decades of litigation is that most courts and commentators take the position that, if a taxpayer cannot demonstrate the basis of an asset, the default position should be that the taxpayer receives a zero-basis.¹² There is an accepted subset to the zero-basis rule that stands for the proposition that a court should make its best guess of the basis even when the taxpayer fails to produce records.¹³ This is commonly known as the *Cohan* rule.¹⁴

In *Cohan*, the Second Circuit was deciding the amount of income and deduction that that the famous composer/playwright George M. Cohan¹⁵ had

10. *Id.*; see generally Leandra Lederman, *The Interplay Between Norms And Enforcement In Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003) [hereinafter Lederman, *The Interplay*]; Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX. REV. 371 (2008); Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 462-63 (2008); Armando Gomez et al., *Session 4: Global Tax Enforcement Trends and Worldwide Risks*, 85 TAXES 73 (2007).

11. See, e.g., *Reinecke v. Spalding*, 280 U.S. 227 (1930); *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929); *United States v. Anderson*, 269 U.S. 422 (1926).

12. For a sampling of cases over time, see, e.g., *O'Neill v. Comm'r*, 271 F.2d 44, 44-45 (9th Cir. 1959) (holding absent proof basis was zero); *Lerch v. Comm'r*, 877 F.2d 624, 632 (7th Cir. 1989) (holding basis absent proof, especially easily obtained proof, is zero); *United States v. Vittaly*, No. C 04-3186 MHP, 2006 WL 3834229 (N.D. Cal. Dec. 28, 2006) (basis shall be zero if failure to produce any evidence of basis); *Coloman v. Comm'r*, 540 F.2d 427 (9th Cir. 1976) (absent precise and sufficient evidence of basis equals zero-basis); see also DANIEL Q. POSIN & DONALD B. TOBIN, *PRINCIPLES OF FEDERAL INCOME TAXATION* 139 (6th ed. 2003); Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539, 566 (2006) (“[S]ome commentators may believe that such a deemed-zero basis rule exists in the common law of the income tax.”); Calvin Johnson, *The Elephant in the Parlor: Repeal of Step-up Basis at Death*, 121 TAX NOTES 1181 (2008) [hereinafter Johnson, *Elephant in the Parlor*] (“The proposal would, however, simplify carryover basis, by giving a zero basis when the cost of the original owner is not plausibly a burden on the heir.”).

13. *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930); see also Jay A. Soled, *Exploring and (Re)Defining The Boundaries of the Cohan Rule*, 79 TEMP. L. REV. 939, 950-51 (2006).

14. Soled, *supra* note 13, at 943.

15. George M. Cohan was often referred to as “The Man Who Owned Broadway.” *Id.* “He wrote many renowned Broadway show productions and crafted lyrics to such famous

in the development of his Broadway productions.¹⁶ Mr. Cohan had failed to document any expenses.¹⁷ Judge Learned Hand, writing for the Second Circuit, opined that Mr. Cohan clearly had expenses and sent the case back to the lower court to determine the exact amount.¹⁸ It would be the modern equivalent of James Cameron not knowing exactly how much he spent on *Avatar*.¹⁹ Cameron spent millions of dollars, not zero, on the film,²⁰ and Judge Hand recognized the fact that Mr. Cohan, likewise, incurred expenses.²¹ The *Cohan* case created confusion in the courts because Judge Hand, rather than holding for the Internal Revenue Service (“Service”), remanded the case for a determination of the expenses Mr. Cohan incurred, despite the fact that he produced no records.²² Subsequent decisions were then unable to artfully reconcile the tension between the two positions—zero and a court’s best guess.²³

From a straight compliance objective, a blanket zero-basis position would better fit within our current compliance models in our self-reporting system. There are two primary models for the rationale of taxpayer compliance: the deterrence-model and the norms-model.²⁴ A deterrence-model, a clearly enforceable high penalty for noncompliant taxpayers, increases compliance.²⁵ A zero-basis penalty for failure to maintain records would be an effective deterrence-model penalty. The hurdle to applying a universal zero-basis position is the norms-based model. Simplistically, in a norms-based model, taxpayers will not comply unless society believes the taxpayer

songs as ‘Yankee Doodle Dandy,’ ‘Give My Regards to Broadway,’ ‘Over There,’ and ‘It’s a Grand Old Flag.’” *Id.*

16. *Id.*

17. *Cohan*, 39 F.2d at 543.

18. *Id.* at 546.

19. Rebecca Keegan, *How Much Did Avatar Really Cost?*, VANITY FAIR, Dec. 22, 2009, available at <http://www.vanityfair.com/online/oscars/2009/12/how-much-did-avatar-really-cost.html>.

20. In fact, *Avatar* probably cost \$280 million. *Id.*

21. *Cohan*, 39 F.2d at 542-44.

22. *Id.* at 544, 546.

23. See Dodge & Soled, *supra* note 12, at 566–67 (IRS only enforces zero-basis against tax protestors); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 392 (1993) (“An executor’s inability to establish cost basis to the exact dollar should not lead to a zero basis if he can establish approximate cost with reasonable accuracy.”); Soled, *supra* note 13, at 943. The *Cohan* rule was mentioned in 64 Federal tax cases in 2009 alone. See, e.g., *United States v. McFerrin*, 570 F.3d 672, 679 (5th Cir. 2009); *Akers v. Comm’r*, 326 F. App’x. 593, 595-96 (2009); *Houston v. Comm’r*, 98 T.C.M. (CCH) 569 (2009); *Ding v. Comm’r*, T.C. Summ. Op. 2009-186 (2009); *Foster v. Comm’r*, 98 T.C.M. (CCH) 520 (2009); *Rodriguez v. Comm’r*, T.C. Memo. 97 T.C.M. (CCH) 1090 (2009).

24. See *infra* Subsections I.C.1-2.

25. See Doran, *supra* note 2, at 124; Lederman, *The Interplay*, *supra* note 10, at 1464-65.

should.²⁶ A zero-basis position violates current norms-models because of (1) societal beliefs, and (2) a notion of fairness that is part and parcel of the tax system.²⁷ Currently, it is not clear that a taxpayer, until an ex-post examination occurs, even understands or is legally obligated to provide for the basis of an asset.

The complicated basis rules and court decisions have thus resulted in two behavioral distortions. First, because of the nature of the calculation, taxpayers fail to maintain adequate records that are necessary to determine the basis.²⁸ An example is the failure to keep track of dividends paid in the version of stock splits.²⁹ Second, taxpayers utilize the complicated mechanics to game the system. Taxpayer gaming takes two forms: (1) compliance, e.g., record keeping; and (2) manipulation of the complicated rules to shelter taxes.³⁰ This Article focuses on the former. The flaws that exist in the determination of the basis figure over time underscore the tax avoidance opportunities.

Despite the critical nature of the determination and the large impact on the tax gap, the issue of unknown basis continues to be under analyzed. The failure to dig deeper into the policy rationale for basis determinations and the associated default positions has encouraged taxpayer gaming. The fail-

26. See Doran, *supra* note 2, at 133-34.

27. See Leo P. Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases*, 39 HASTINGS L.J. 239, 240 (1988) (“A postulate of any system of taxation is that the burden of paying the tax should be borne equally by all or at least that the burden should be levied in a consistent and rational fashion.”); IRS OVERSIGHT BOARD, 2010 TAXPAYER ATTITUDE SURVEY 5 (Jan. 2011), available at <http://www.treasury.gov/irsob/reports/2011/IRSOB%202010%20Taxpayer%20Attitude%20Survey.pdf> (question 4 asking how much influence among (i) “fear of audit;” (ii) “belief that your neighbors are reporting and paying honestly;” (iii) “third parties reporting your income . . . to the IRS” and (iv) “your personal integrity” accounts for whether you report and pay taxes honestly).

28. See Dodge & Soled, *supra* note 12, at 556-57.

29. See *id.*

30. A fundamental example of this principle is most technical tax shelters derive from artificial basis schemes. See Notice 2000-44, 2000-36 I.R.B. 254, 255 (Sept. 5, 2000), available at http://www.irs.gov/pub/irs-utl/notice_2000-44.pdf. One of the most famous cases involving the 2000-44 shelter is *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010). In *Jade Trading*, three taxpayers sold their cable business and realized an aggregate \$40.5 million capital gain. *Id.* at 1375. Each of the three taxpayers created single-member LLCs which purchased offsetting currency options for net premium paid of \$150,000 to AIG. *Id.* at 1377. For each LLC, the options purchased and sold had a premium of \$15 million and \$14.85 million, respectively. *Id.* Each taxpayer claimed that the LLCs’ basis in the interest was increased by the value of the option purchased (\$15 million), but not decreased by the value of the options sold (\$14.85 million). *Id.* at 1375. Accordingly, each taxpayer claimed a large capital loss upon exiting the partnership (approximately \$14.9 million) with only having \$150,000 at risk. *Id.* at 1377. The IRS has opined that the 2000-44 shelter alone accounted for over \$3.5 billion in improper tax losses. See I.R.S., *IRS Collects \$3.2 Billion from Son of Boss; Final Figure Should Top \$3.5 Billion*, IRS.GOV (Mar. 24, 2005), <http://www.irs.gov/newsroom/article/0,,id=137095,00.html>.

ure to comply is then augmented by the tacit approval by the taxpayer's advisors and the community. Because basis requirements have not been tied to both the underlying reporting rationales and a clearly articulated court standard, the door is open for our current system of substantial noncompliance.

The normative portion is, thus, split into two parts to achieve optimal tax compliance. In proposing a salient model, this Article suggests that there is a simple solution to the problem fitting within the current pedagogy. First, the Service or the court, as the case may be, makes a preliminary finding if the taxpayer has an excusable reason for failure to keep records. If the taxpayer meets this new initial burden, then the courts choose from the following, first-time articulated alternatives to solve the unknown basis problem, namely: (1) mark-to-market method; (2) modified Auerbach approach; and (3) modified original issue discount (OID) approach.³¹ If the taxpayer fails this new initial burden, then, absent records, the default basis is zero.³²

The analysis of this Article yields the following conclusions. First, the courts need to apply a uniform standard of production and persuasion to tax matters. With "vagueness, uncertainty or confusion as to the scope or extent of the burden,"³³ we do not have a practical or just legal system. In order to alleviate the tension between innocent taxpayers and noncompliant taxpayers, a new initial determination must take place. The taxpayer, who then meets this new initial burden, would benefit from application of a predictable methodology from the aforementioned list. This new structure would yield a higher compliance rate for this type of underreporting. Part II provides a brief overview of the taxpayer requirements under current law. Part III explores the foundation for the zero-basis rules and the best-guess rules, reconciling the two ideologies through the explanation of the burden of proof. Part IV sets out the new initial burden and alternatives for the court or the Service to implement under a correctly applied burden of proof.

31. See, e.g., Joseph M. Dodge, *What's Wrong with Carryover Basis Under H.R. 8, 91 TAX NOTES* 961, 961-63 (May 7, 2001) (critiquing the approach taken by EGRTTA and advocating for a deemed realization event) [hereinafter, Dodge, *Carryover*]; Joseph M. Dodge, *Reply: Further Thoughts on Realizing Gains and Losses at Death*, 47 *VAND. L. REV.* 1827, 1829 (1994) [hereinafter Dodge, *Reply*] (advocating for a deemed realization approach over carryover basis); Zelenak, *supra* note 23, at 367-88 (discussing policy of income versus estate tax using constructive sale approach and how to implement structure).

32. See *infra* Part III.

33. J.P. McBaine, *Burden of Proof: Degrees of Belief*, 32 *CALIF. L. REV.* 242, 242 (1944).

I. OVERVIEW OF TAXPAYER RECORD KEEPING

The United States utilizes a self-reporting income tax structure.³⁴ Within that structure, the most critical issue for the reporting of tax liability is the determination of the basis of an asset.³⁵ Basis is especially important because the concept prevents the double taxation of income by identifying amounts that have already been taxed or are exempt from tax.³⁶

Congress granted the I.R.S. Commissioner (“the Commissioner”) the power to prescribe regulations for reporting returns.³⁷ Furthermore, Congress made it the duty of the taxpayer to comply. “The purpose is not alone to get tax information in some form but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished.”³⁸ A taxpayer, thus, has three basic responsibilities: to assess his or her own tax liability; to file the appropriate tax return reporting said liability; and to pay that liability when due.³⁹ A failure to meet these responsibilities results in potential civil and criminal penalties.⁴⁰

In order for a self-assessment collection regime to succeed, the taxpayer’s duty to report must be more than merely not being dishonest, but producing accurate positions.⁴¹ Accurate positions are not as easy to obtain as one might initially believe. The purchase price of the asset, or, in tax par-

34. See 26 C.F.R. § 601.103(a) (2009); *United States v. Rodgers*, 461 U.S. 677, 683 (1983); *G.M. Leasing Corp. v. United States*, 429 U.S. 338, 350 (1977); *United States v. Biscaglia*, 420 U.S. 141, 145-46 (1975); *United States v. Amer. Friends Serv. Comm.*, 419 U.S. 7, 12 (1974); *United States v. Sec. Trust & Sav. Bank*, 340 U.S. 47, 51 (1950); *Bull v. United States*, 295 U.S. 248, 259-60 (1935); see also Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1, 5 (2004) (stating that it is not a voluntary system because the law requires the taxpayer to file, report income, and pay taxes).

35. *Comm’r v. Lane-Wells Co.*, 321 U.S. 219, 223 (1944); *Rodgers*, 461 U.S. at 683; *Bull*, 295 U.S. at 259; Steve R. Johnson, *An IRS Duty of Consistency: The Failure of Common Law Making and a Proposed Legislative Solution*, 77 TENN. L. REV. 563, 594 (2010); Bret Wells, *Voluntary Compliance: “This Return Might Be Correct but Probably Isn’t,”* 29 VA. TAX REV. 645, 662 (2010).

36. I.R.C. §§ 358(a)(1)(B)(ii), 1031(d) (2006); see also Calvin H. Johnson, *The Legitimacy of Basis from a Corporation’s Own Stock*, 9 AM. J. TAX POL’Y 155, 160 (1991).

37. *Lane-Wells*, 321 U.S. at 223.

38. *Id.*

39. See Press Release, U.S. Dep’t of the Treas., A Comprehensive Strategy for Reducing the Tax Gap 5 (Sept. 26, 2006), available at <http://www.treasury.gov/press-center/press-releases/Documents/otptaxgapstrategy%20final.pdf>; Doran, *supra* note 2, at 114.

40. See, e.g., I.R.C. § 6662(a) (Supp. 2010) (imposing accuracy-related penalty equal to twenty percent of underpayment); I.R.C. § 6663 (2006) (imposing fraud penalty equal to seventy-five percent of portion of underpayment attributable to fraud); I.R.C. § 7201 (2006) (criminal tax evasion underreported income).

41. Doran, *supra* note 2, at 115.

lance, the tax basis of the asset, is not static and may change over time. The Code provides a specific set of formulas to determine current basis that require constant alteration.⁴²

The classic example of non-static basis is the effects of corporate mergers, spin-offs, dividends, and stock splits on a share of stock.⁴³ Professors Dodge and Soled illustrate that, since 1982, one share of AT&T has undergone the following changes:

AT&T experienced the following capital-change events: a divestiture, two corporate spin-offs, a stock split, a corporate split-off, a spin-off, and, finally, a reverse stock split. As a result of these events, by the year 2004 A would own thirty shares of common stock in AT&T with a tax basis of \$1.89 per share. In addition, she would hold stock in eleven other companies, each of which may have made stock distributions and experienced several corporate restructuring events of its own.⁴⁴

The aforementioned basis adjustments are not limited to public stocks, but include all taxpayer assets.⁴⁵ A majority of these assets are difficult to determine, such as, closely-held businesses, family-limited partnerships, and real estate and collectibles.⁴⁶ Accountants spend an inordinate amount of time ensuring accurate ownership basis records for non-public businesses.⁴⁷

Essentially, the government looks for a rational taxpayer.⁴⁸ The rational taxpayer would clearly understand the obligations for an accurate state-

42. I.R.C. § 1012 (Supp. 2011). Generally, basis equals cost. *Id.* But certain transaction costs borne by the purchaser in future years are sometimes included in basis. *See* Treas. Reg. § 1.1012-1(b), § 1.263(a)-2(e) (2006).

43. Dodge & Soled, *supra* note 12, at 552-54.

44. *Id.* at 554-55 (internal citation omitted).

45. Treas. Reg. § 1.1001-1(a) (2006) provides:

[t]he general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized.

46. *See* Laura E. Cunningham, *FLPs, the Transfer Taxes, and the Income Tax*, 127 TAX NOTES 806, 809-10 (May 17, 2010) (discussing the inaccuracy of valuation discounts); *see also* James M. Poterba & Scott J. Weisbrenner, *Inter-Asset Differences in Effective Estate-Tax Rates*, 93 AM. ECON. REV. 360 (2003).

47. *See* Dodge & Soled, *supra* note 12, at 552 (stating that in order to provide accurate basis amounts many interrelated calculations reliant on records are necessary).

48. This would be analogous to the Rational Choice Model Theory, e.g., a rational man who is a selfish person of personal utility. *See* 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).

ment of basis and make a cost-benefit analysis for lack of compliance. We have a very high compliance ratio, approximately 84%,⁴⁹ even though the economic calculations support noncompliance. “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.”⁵⁰

It seems that within basis reporting, taxpayers act under the rational choice model. Taxpayers fail to keep records based on one of three main themes: (1) the taxpayer claim of impossibility, as articulated by Dean Erwin Griswold;⁵¹ (2) the taxpayer claim of reliance on advisors and past precedent; and (3) the taxpayer norm-deterrent punishment assessment. The behavior distortion from our stated goal of accurate record keeping tends to come from the lack of a clearly articulated obligation. Thus, all three of these taxpayer beliefs establish the frame for the discussion of this failure to comply.

A. Claim of Impossibility

Basis rules are difficult, and taxpayers do not take the theory and issue of “tax basis so seriously and reverently” as academics.⁵² The basis rules create two main problems for accurate compliance. First, the rules are complicated and beyond the scope of many taxpayers without advice.⁵³ Second, the taxpayers themselves do not keep the records accurately.⁵⁴ Most taxpayers believe that either they will never need the records or that they can piecemeal the records if asked.⁵⁵

Historically, basis record keeping was an area of contention for taxpayers. For example, one of the primary reasons for the movement away from rollover basis in the primary residence to the fixed exclusion amount

Under a rational choice model, actors make decisions based both on complete information about available alternatives, their implications, and on a full awareness of their preferences, which are stable, identifiable and exogenous to—that is, they preexist—any particular decision. By measuring alternatives against preferences, the rational person makes choices that maximize utility.

Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State*, 56 DUKE L.J. 377, 401, 410 n.100 (2006).

49. 2007 Report, *supra* note 2, at 11.

50. Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689, 695 (2009).

51. See *Building Overview: Griswold Hall*, HARV. L. SCH., <http://www.law.harvard.edu/about/administration/facilities/buildings/griswold.html> (explaining Dean Erwin Griswold was Dean of Harvard Law School from 1946 until 1967 and Solicitor General of the United States).

52. Dodge & Soled, *supra* note 12, at 540.

53. See *infra* Part I.B; see, e.g., Dodge & Soled, *supra* note 12, at 547.

54. See Soled, *supra* note 13, at 940; Dodge & Soled, *supra* note 12, at 545.

55. See Soled, *supra* note 13, at 940; Dodge & Soled, *supra* note 12, at 545.

was the burden of record keeping over a long period of time.⁵⁶ There was an outcry at the time that forcing taxpayers to keep records for a lifetime in the rollover basis regime was unduly burdensome. In the revision of Code § 121, Congress alleviated the burden of homeowners in keeping detailed records of improvements.⁵⁷

As discussed on many occasions, there are various reasons taxpayers fail to maintain records despite clear penalties.⁵⁸ Those include the costs and efforts required for compliance; the actual space needed to maintain these records for long periods of time; a method for retrieval of the records; the inadvertent destruction of records through moves and natural disasters; and the thought that the taxpayer can recreate the records at a later date if needed.⁵⁹ The tax implications of the lack of accurate record keeping lead to assertions of inflated basis reporting without adequate administrative supervision.⁶⁰

Moreover, taxpayers, when in doubt, have a propensity to misrepresent their position.⁶¹ The cost of the articulated foggy record-keeping duty is noncompliance. Further complicating the problem is that there are different types of assets, many of which have different reporting requirements.

For a majority of the aforementioned assets, in the Emergency Economic Stabilization Act of 2008 (the “Act”),⁶² Congress required brokers to

56. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312, 111 Stat. 788, 836 (1997) (repealing I.R.C. § 1034 and amending § 121 to limit gain recognition to over \$250,000 for single filers and over \$500,000 for joint filers).

57. See H.R. REP. NO. 105-148, at 347 (1997); S. REP. NO. 105-33, at 36 (1997) (“By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their house.”); see also Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX. REV. 645, 738 (2003); Christine A. Klein, *A Requiem for the Rollover Rule: Capital Gains, Farmland Loss, and the Law of Unintended Consequences*, 55 WASH. & LEE L. REV. 403, 464 (1998); CONG. BUDGET OFF., AN ECONOMIC ANALYSIS OF THE TAXPAYER RELIEF ACT OF 1997 69-70 (2000), available at <http://www.cbo.gov/ftpdocs/19xx/doc1959/tpa97.pdf>.

58. See generally Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX. REV. 187, 203 (2002); Dodge & Soled, *supra* note 12, at 543-82; and Zelenak, *supra* note 23, at 388-91.

59. See Soled, *supra* note 13, at 942, 948.

60. See, e.g., Dodge & Soled, *supra* note 12, at 565.

61. See Dodge & Soled, *supra* note 12, at 563; *Estate and Gift Tax Carryover Basis and Generation-Skipping Trust Provisions and Deductibility of Foreign Convention Expenses*, Hearings Before the Comm. on Ways & Means, 95th Cong. 9 (1977) [hereinafter *Estate and Gift Carryover Basis*] (Statement of Pennell) (discussing the Federal Rules of Evidence and the rules surrounding Exception 16 regarding admissibility of documents over twenty years old). The rule was founded on the premise that since the document was in existence prior to the litigation, then there is no reason to misrepresent it. *Id.* “However, when faced with the problem of establishing a cost basis and acquisition date, it is highly likely that decedents will go to great lengths to make self-serving statements” *Id.*

62. Pub. L. No. 110-343, 122 Stat. 3765 (2008).

report basis in securities.⁶³ The Act switches the burden of determining basis in these assets to the broker.⁶⁴ Under the terms of the Act, the broker must file informational returns that include the taxpayer's adjusted basis in the assets and the character of the gain or loss.⁶⁵ The Act also covers home sales,⁶⁶ mutual funds in 2013,⁶⁷ and, most controversially, trades or businesses that make payments to service providers of over \$600 per year.⁶⁸

Congress thus acted to solve the reporting problem on a go-forward basis for a number of these easy assets. Brokers already were required to produce information containing the sales price of the security, and they often had the purchase price.⁶⁹ They were in the best position to not only track those basis adjustments, but maintain the records. These new requirements will increase compliance on a go-forward basis. Unfortunately, the Act fails in two major areas: (1) it does not provide help for prior years, and (2) the applicable assets are a small subset of taxpayer wealth. Taxpayers maintain substantial investments in alternative asset classes, such as closely-held business, family-limited partnerships, and real estate and collectibles, which will not be affected by the Act.

The 1976 congressional testimony of Dean Erwin Griswold exemplified all the taxpayer problems and beliefs regarding the impossibility of record keeping. In 1976, Congress eliminated the estate tax, replacing it with a modified carryover basis regime. Congress held after-the-fact hearings on the merits of this methodology.⁷⁰ Carryover basis is a system that allows the recipient of property to take the transferor's basis in the proper-

63. *Id.* § 403, 112 Stat. at 3854-60; I.R.C. § 6045(g) (Supp. 2011).

64. Martin J. McMahon, Jr., Ira B. Shepard & Daniel L. Simmons, *Recent Developments in Federal Income Taxation: The Year 2010*, 10 FLA. TAX REV. 565, 607 (2011).

65. *Id.*; Pub. L. No. 110-343, 122 Stat. 3765 § 403(a)(1) (2008); I.R.C. § 6045(g)(2) (Supp. 2011); *see also* Lederman, *supra* note 8, at 1742-43; Dodge & Soled *supra* note 12, at 582-97; Joseph M. Dodge & Jay A. Soled, *Reporting Tax Basis: Dawn of a New Era*, 110 TAX NOTES 784 (2006).

66. I.R.C. § 6045(e) (Supp. 2011).

67. *See* T.D. 9504, 2010-47 I.R.B. 670, 674 (2010), *available at* <http://www.irs.gov/pub/irs-irbs/irb10-47.pdf>.

68. I.R.C. § 6041(a) (Supp. 2011); Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9006, 124 Stat. 119, 855 (2010); *see The 1099 Insurrection*, WALL ST. J., Sept. 15, 2010, <http://online.wsj.com/article/SB10001424052748703897204575488272691514074.html>; *The 1099 Repudiation*, WALL ST. J., Feb. 5, 2011, <http://online.wsj.com/article/SB10001424052748704709304576124090853943176.html>; H. COMM. ON WAYS & MEANS, OVERVIEW OF H.R. 4 AND H.R. ___ (Feb. 14, 2011), *available at* http://waysandmeans.house.gov/UploadedFiles/Overview_HR_and_HR____.pdf (mark up of the bill to repeal the 1099 provisions included in the Health Care bill).

69. *See* Lederman, *supra* note 8, at 1743; *see also* Dodge & Soled, *supra* note 12, at 587-89.

70. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872-77 (1976).

ty.⁷¹ During the discussion and congressional testimony in 1976, it became evident that carryover basis was unworkable.⁷² Luminaries, such as Dean Erwin Griswold, testified that substitute basis was unworkable because even he did not know the cost basis on his stamp collection.⁷³

Dean Griswold has long been considered an expert in taxation.⁷⁴ He held many government posts, such as Solicitor General of the United States.⁷⁵ He was also Dean of Harvard Law School from 1946 until 1967.⁷⁶

Dean Griswold started collecting stamps in 1913 at age eight.⁷⁷ He “followed the stamp market closely, and was impressed with the fact that stamps can be a sound investment.”⁷⁸ In 1939, infantile paralysis struck Mr. Griswold’s wife, and she became paralyzed from the waist down.⁷⁹ The medical expenses far exceeded his salary at Harvard Law School.⁸⁰

According to Dean Griswold, in order to provide for his wife and children in the event that he died, he decided to invest more and more in stamps.⁸¹ “There were two special reasons for this, apart from their investment potential: (1) they do not produce current income, and (2) they present almost no problem of conflict of interest.”⁸² Stamps did not interest anyone else in his family.⁸³ They were solely an investment.⁸⁴ He made special provisions for the orderly disposition of the stamps at his death.⁸⁵ He had no

71. Currently, carryover basis is used for gifts, divorce, and, in 2010, for estates.

72. See *Estate and Gift Tax Problems Arising from the Tax Reform Act of 1976: Hearing Before the Subcomm. on Taxation & Debt Mgmt. Generally of the S. Comm. on Fin.*, 95th Cong. (1977) [hereinafter *Tax Problems*]; THOMAS J. MCGRATH & JONATHAN G. BLATTMACHR, CARRYOVER BASIS UNDER THE 1976 ACT (1977); Dodge & Soled, *supra* note 12, at 541-42. *But see* Zelenak, *supra* note 23, at 388-94 (“After having read hundreds of pages of wildly conflicting testimony on the proof of basis problems of carryover basis under Section 1023, it still is difficult to judge the seriousness of the problem.”).

73. *Tax Problems*, *supra* note 72, at 147-49 (statement of Erwin Griswold).

74. See generally Philip E. Heckerling, *The Death of the “Stepped-Up” Basis at Death*, 37 S. CAL. L. REV. 247, 266-68 (1963) (discussing Dean Griswold’s primary role in the discussion of tax debates at the time); ERWIN N. GRISWOLD, CASES AND MATERIALS ON FEDERAL TAXATION (Foundation Press 1940).

75. *Office of the Solicitor General*, U.S. DEP’T OF JUSTICE, <http://www.justice.gov/osg/aboutosg/osghistpage.php?id=33> (President Johnson appointed him in 1967, and he served until 1973).

76. *Id.*

77. *Tax Problems*, *supra* note 72, at 147-48 (testimony of Erwin Griswold).

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 148.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.*

problem with paying a tax through his estate at the fair market value of the stamps calculated as of the date of death.⁸⁶

Dean Griswold seemed blind-sided by the passage of the 1976 Act.⁸⁷ Like most taxpayers, upon hearing the news of the 1976 Act, he realized that his lack of accurate record keeping created problems for his heirs.⁸⁸ He had two primary complaints.⁸⁹ First, it was a struggle for him at this point to know what his basis was in each of his 10,000 stamps.⁹⁰ He never kept accurate records. He “had no expectation of selling the stamps while [he] lived, and thought that the date of death value would be the relevant figure if they were sold after [he] died.”⁹¹

Second, even if he kept his records, he believed that the computations were extraordinarily complicated.⁹² As Dean Griswold testified,

I have made no count, but in my case, I would guess at least ten thousand items, probably more, will be involved in this process, bought at different times for various prices, some times as single items, but often in groups for an unallocated lump sum, with the groups often broken up and rearranged.⁹³

He believed that the calculations would be extraordinarily difficult for him, let alone his executor.⁹⁴

The sentiments at the time ring true today. How could a person so versed in taxation feel, as he put it:

[s]omehow or other, though, I have not been able to escape the feeling that I have been caught rather badly, and that the effect of the change of the law in 1976, as applied to me, may be unfair, and beyond the contemplation of Congress when the carry-over basis provision was so hastily enacted.⁹⁵

He believed that he could provide for his wife while avoiding any conflicts of interest.⁹⁶ He hoped that the law would apply the carryover basis to assets after 1976.⁹⁷ Clearly, his interest was selfish, but his frustration was com-

86. *Id.*

87. *Id.* “[W]ith little warning, and no public hearings on this matter . . .” *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*; see also *Estate and Gift Carryover Basis*, *supra* note 61, at 77 (Statement of George) (“Stamp and coin collections, jewelry and clothing present particular difficulties in tracing original costs and current values.”).

93. *Tax Problems*, *supra* note 72, at 148 (testimony of Erwin Griswold).

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

mon.⁹⁸ Dean Griswold's testimony highlights the main problem with basis—reliance on the taxpayer's record keeping.

B. Claim of Reliance

Taxpayers are lured into a lack of compliance through the perceived complexity of the tax code; the lack of challenge to taxpayer positions by the Service, e.g., the audit lottery;⁹⁹ and the ambiguous terminology by the court's and tax professional's advice.¹⁰⁰ In other words, taxpayers blame the system for being overly complicated and not telling them that they have a specific duty to comport.

If there is one thing every law student remembers from basic income tax, it is the formula that states that the amount realized less adjusted basis equals gain realized.¹⁰¹ This seemingly simplistic formula is in practice complicated. After all, basis is not just the purchase price of the asset.¹⁰²

The calculation is fluid and changes over time based on such events as capital changes,¹⁰³ capital recovery reductions,¹⁰⁴ and other adjustments.¹⁰⁵ All initial and subsequent basis adjustments rely on accurate record-keeping abilities. Unfortunately for the taxpayer, these records may also be the responsibility of others. For example, assets that inure to taxpayers through

98. See also *Estate and Gift Carryover Basis*, *supra* note 61, at 5 (Statement of Pennell); *id.* at 47 (Statement of Butala) ("Our [the bankers] experience since the beginning of this year [1976] in attempting to establish basis information confirms our belief that major difficulties lie ahead in this area."); *id.* at 58 (giving the example of land purchased in 1894 and a residence established in 1920 with major additions over the years and no real documentation); *id.* at 73, 76 (Statement of George) ("It has been our experience to date that the ideal situation of complete and accurate records as to cost basis is a rare occurrence.").

99. The Audit rate is less than 1% per year. I.R.S. DATA BOOK, 2009 22 (2010), available at <http://www.irs.gov/pub/irs-soi/09databk.pdf>; see also Wells, *supra* note 35, at 649.

100. See Soled, *supra* note 13, at 957 n.97 (citing Terri Cullen, *Ask Personal Journal*, WALL ST. J., Apr. 10, 2003, at D1) ("Technically, if you can't show proof of the purchase price, the IRS can make you pay capital-gains tax on the entire sale. But the tax cops often will accept a reasonable estimate. For instance, if you're fairly certain you bought the stock in 1982 or 1983, an average of the high and low price for that two-year period would probably do.").

101. I.R.C. § 1001(a) (2006).

102. I.R.C. § 1012 (2006) (providing that generally basis equals cost). But certain transaction costs borne by the purchaser in future years are sometimes included in basis. 26 C.F.R. § 1.1012-1(b) and § 1.263(a)-2(e); see also Dodge & Soled, *supra* note 12, at 549-50.

103. I.R.C. § 307(a) (2006).

104. I.R.C. § 1016 (Supp. 2010).

105. I.R.C. § 1016(a). To add a level of complication for the taxpayer, assume that you updated your kitchen at the time you bought your home. Clearly, that should be considered an improvement which increases your basis in the home. However, if five years later you redo your kitchen again, is that also an improvement under section 1016(a)? Either position has support.

gift, divorce, or inheritance take the basis of the original purchaser subject to the aforesaid adjustments.¹⁰⁶

There is often a long lapse in time between purchase or acquisition and sale.¹⁰⁷ On its face, this time lapse lessens the likelihood that taxpayers will have the direct evidence to substantiate their claims. Once the taxpayer must determine the gain or loss, the calculation is above the acumen of the average taxpayer. This causes reliance on third parties to articulate the rules and the responsibilities of the taxpayer. Dean Griswold argued that this burden was too difficult for a taxpayer.¹⁰⁸

Given the complicated nature of basis, taxpayers look to advisors, e.g., certified public accountants (“CPA”) or attorneys.¹⁰⁹ These advisors aid the taxpayer in the preparation of the tax return and offer guidance as to issues of law. This reliance distorts the desired behavior of accurate compliance in two ways. First, the preparer does not hold the taxpayer accountable for the underlying facts on the return. Second, the preparer articulates the Service’s stated position regarding record keeping, which is inapposite to the actual duty.

As an initial matter, the breakdown in the relationship is the lack of due diligence in the collection of factual information to be included on the return from the taxpayer. There is no affirmative duty on preparers to verify the taxpayer’s reported positions.¹¹⁰ The highest standard is for a CPA, who must ask the taxpayer if he has records to substantiate the position on the return.¹¹¹ Lawyers have general ethical duties not to advise clients to engage in aggressive legal positions.¹¹² But neither the CPA nor the lawyer has a duty to verify the facts.¹¹³

106. I.R.C. § 1015(a) (2006).

107. See Soled, *supra* note 13, at 948.

108. *Tax Problems*, *supra* note 73, at 148-49.

109. See Sandra Block, *More Taxpayers Are Preparing Their Taxes On Their Own*, USA TODAY, Apr. 14, 2010, http://www.usatoday.com/money/perfi/taxes/2010-04-14-1Ataxprep14_CV_N.htm (stating that 64% of tax returns filed electronically, which represents 80% of all returns filed, were done by preparers); Soled, *supra* note 13, at 959 n.107 (stating that 56% of returns in 2002 were done by preparers).

110. Soled, *supra* note 13, at 959 (citing I.R.C. §§ 6694(a) and (b) and Rev. Proc. 80-40, 1980-2 C.B. 774 for the proposition that the return preparer has no duty to verify facts, but does have a duty to inquire if on the face facts seem incorrect or incomplete); see also Soled, *supra* note 13, at 959 (citing 2 AM. INST. OF CERTIFIED PUB. ACCOUNTANTS PROF’L STANDARDS, STATEMENT ON RESPONSIBILITIES IN TAX PRACTICE § 1.02(a)(2003)); Wells, *supra* note 35, at 665-67.

111. Soled, *supra* note 13, at 959.

112. See Soled, *supra* note 13, at 960; Wells, *supra* note 35, at 666; ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 352 (1985).

113. See I.R.C. § 6701(a) (2006) (detailing imposition of monetary penalty on preparer for aiding in understatement of tax liability when preparer knows or should have known that understatement would result); I.R.C. § 7206(2) (2006) (noting preparer’s exposure to felony charge for “willfully aid[ing] or assist[ing]” submission of fraudulent tax re-

If preparers practice before the Service, they must also comply with Circular 230¹¹⁴ or they might lose that right.¹¹⁵ Circular 230 provides that preparers must inquire about incorrect facts *but* only if they appear wrong.¹¹⁶ Furthermore, undermining this gatekeeper function is the ability of a concerned preparer to opt out of that role. If preparers believe a position a taxpayer is advocating is untrue or there is a lack of substantiation, they can alleviate their liability by having the taxpayer file without signing off directly on the return.¹¹⁷

Essentially, a “don’t ask, don’t tell” position has been adopted by tax advisors.¹¹⁸ Taxpayers claim they rely on professional advice as to their record-keeping duties and the production of an actual record. When the advice is incorrect, the courts do not often penalize the taxpayer. This results in under compliance.

More important than the lack of a gatekeeper is the lack of a clear standard by the Service for the taxpayer to stay in compliance. At this point, we need to divide basis record keeping into two segments and into two time periods. As stated, *supra*, for marketable securities and real estate transactions, the law has been recently modified to move the burden of record keeping to the broker/dealers.¹¹⁹

For marketable securities purchased before 2011 and non-regulated assets, taxpayers are in the Griswold zone. The primary reason that Dean Griswold’s position gathers support is because there is no clear duty on a taxpayer to keep basis records.¹²⁰ It is argued that because there is no record-keeping mandate in the Code, we should then look to the return requirements.¹²¹ Furthermore, the instructions for Form 1040 state that records

turn); Soled, *supra* note 13 n.111 (“In any event, the attorney would have a strong reason to not want to know about misstatements of fact on a tax return, and that translates into avoiding making factual inquiries in the first place.”).

114. 31 C.F.R. § 10 (2007).

115. Soled, *supra* note 13, at 960; Doran, *supra* note 2, at 119-20 (failure to comply with Circular 230 Rules allows the government the option of either “disbarring or suspending the advisor from practice before the” IRS); 31 C.F.R. § 10.50 (2011).

116. Soled, *supra* note 13, at 960.

117. *Id.* at 960-61.

118. See generally Susan C. Morse et al., *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL’Y REV. 37, 59-60 (2009).

119. This change was motivated by Dodge & Soled, *supra* note 12; see also *supra* Section I.A. Although, it might not be long for the world as Senator Baucus has proposed eliminating the new legislation. See Catherine Clifford, *Top Democrat Backs 1099 Requirement Repeal*, CNNMONEY.COM, Nov. 12, 2010, http://money.cnn.com/2010/11/12/smallbusiness/baucus_1099_repeal/index.htm.

120. Dodge & Soled, *supra* note 12, at 543, 545-47 (“In the Code, there is no explicit requirement that a taxpayer keep accurate track of basis or that a third party supply taxpayers or the IRS with such information.”); see also 26 C.F.R. § 1.6001 (2006). The IRS after notice may impose record-keeping requirements upon the taxpayer. *Id.* § 1.6001-1(d).

121. See Dodge & Soled, *supra* note 12, at 545-47.

should only be kept as long as they are relevant for determining basis.¹²² However, this is not an affirmative obligation but a suggestion.

Taxpayers begin with a misguided assumption that they are not responsible for record keeping or that record keeping is too difficult. This fallacious assumption is then exacerbated by the lack of a duty on the people designed to aid in compliance to ensure accurate reporting. Compounded with this convoluted of events is the lack of a clearly articulated standard to maintain records by the Service.

C. Norm-Deterrence Modality

In the self-reporting system, we associate compliance with penalties. Essentially, taxpayers comply for fear of penalty.¹²³ There are two generally accepted theories for what motivates taxpayers to comply with their legal obligations. The standard deterrence-model states that taxpayers will weigh whether sanctions are more costly than compliance.¹²⁴ The norms-model, on the other hand, states that taxpayers will comply based on societal or personal norms.¹²⁵

It has been argued that neither model accounts for taxpayer compliance and that both are inherently flawed.¹²⁶ In fact, each model actually would require a different penalty structure. The deterrence model should require additional penalties while the norms-model should require less pen-

122. See I.R.S., DEP'T OF THE TREASURY, INSTRUCTIONS FOR FORM 1040 88 (2010), available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

123. See Doran, *supra* note 2, at 111.

124. See *id.*, at 111-12, 124-31 drawing on Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) ("Becker Punishment Model") adopted for tax evasion by Allingham & Sandmo, *supra* note 48, at 323; Yitzhaki, *supra* note 48, at 201; Lederman, *The Interplay*, *supra* note 10, at 1456; Raskolnikov, *supra* note 50, at 689.

125. Doran, *supra* note 2, at 112, 131-38 (drawing on Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599 (2007)). For general discussions of social norms, see ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 123-26 (1991); EDNA ULLMANN-MARGALIT, THE EMERGENCE OF NORMS vii-ix (1977); Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. L. REV. 1577, 1579 (2000); Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 537 (1998); Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 662 (1998); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 907 (1996); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601 (2007).

126. Doran, *supra* note 2, at 112 ("Neither model accounts adequately for taxpayer compliance, and to complicate matters, the two models suggest different roles for tax penalties.").

alties and more inducement.¹²⁷ To then rely on penalties for compliance seems misguided.¹²⁸

Taxpayers must understand that there is a causal connection between their action and the penalty. Because the penalties are not targeted at specific abuses or areas of noncompliance, the underlying conduct to be subject to that penalty is not defined. Furthermore, even if there are penalties for acting in a certain way, e.g., not keeping records, the actions of gatekeepers and the Service do not promote compliance. The problem with both models is that taxpayers across the board do not act as rational gamers with Becker's Punishment Model.¹²⁹

The aforementioned problem with the lack of standards and adequate penalties for failing to keep accurate records is similar to the "Broken Windows" theory by James Q. Wilson and George Kelling.¹³⁰ The theory is that "if a window in a building is left broken *and is left unrepaired*, all the rest of the windows will soon be broken."¹³¹ The core concept is that if one broken window is left unrepaired, it is a signal that no one cares and breaking more windows costs nothing.¹³² The perception is that little infractions will lead to more severe infractions.¹³³ This is analogous to the perception that taxpayers observe with record keeping. Taxpayers do not see the penalty for the small infraction of failing to maintain records.

1. *Deterrence Model in Uncertainty*

Tax penalties make the deterrence model work. Under this theoretical framework, taxpayers will evade tax to the extent that the amount of tax evaded exceeds the total amount the taxpayer would have to pay if he was

127. *Id.*

128. Raskolnikov, *supra* note 50, at 695-96 (taxpayers do not act rationally).

129. *Id.*

130. James Q. Wilson & George L. Kelling, *Broken Windows*, ATLANTIC MONTHLY, Mar. 1982, at 29, available at http://www.manhattan-institute.org/pdf/_atlantic_monthly-broken_windows.pdf.

131. *Id.* at 31.

132. *Id.* The classic example of this theory is crime in New York. Malcolm Gladwell described that one reason attributed to the major reduction in crime in New York in the early 1990's was due to the enforcement of the most fundamental rules. MALCOLM GLADWELL, *THE TIPPING POINT* 141-45 (2000). The police started to enforce rules against turnstile jumping and cleaned up the graffiti on the subways. *Id.* The theory was that if we pay attention and enforce the small crimes, major crimes will be reduced. *Id.*

133. Wilson & Kelling, *supra* note 130, at 31.

caught.¹³⁴ In order for the deterrence model to work efficiently, penalties must be high.¹³⁵

Professor Lederman provided the following simple example of the Becker Punishment Model of determining tax payment:

[a]s a simplified example, assume that a taxpayer is facing a decision whether or not to report \$3,000 of income received in cash. Assume that the applicable tax rate is 33 1/3% so that the tax at stake is \$1,000. Also assume that if the taxpayer is caught, the taxpayer will owe a penalty of \$3,000 plus the tax that was legally due. (Assume for simplicity that all amounts are adjusted to current dollars.) If there is a 2% chance that a taxpayer will be audited and a 100% chance that, if audited, the taxpayer will owe the \$3,000 penalty, the expected penalty for noncompliance is only \$60, while the expected benefit of noncompliance is \$980 (reflecting a 98% chance of retaining the unpaid \$1,000). In other words, the expected value of cheating is \$920, and rationally the taxpayer should cheat whenever the expected value is positive.¹³⁶

Thus, all taxpayers should be acting rationally and not complying with the record-keeping burden. After all, only a small percentage of taxpayers are audited.¹³⁷ This low audit rate has been attributed to lower voluntary compliance.¹³⁸ Moreover, even if you are caught through an audit, there is no guarantee that the audit will uncover your fraud, or that the penalties received will be upheld.¹³⁹

Taxpayers clearly make decisions using Becker's Punishment Model. For example, in 1998, the accounting firm, KPMG, in discussing whether to

134. See Doran, *supra* note 2, at 124 (citing Allingham & Sandmo, *supra* note 48, at 326).

135. *Id.*; see also Kyle Logue, *Optimal Tax Compliance and Penalties When The Law Is Uncertain*, 27 VA. TAX REV. 241, 266 (2007); Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, in 3 TAX AND CORPORATE GOVERNANCE 229, 242 (Wolfgang Schön ed., 2008).

136. Lederman, *The Interplay*, *supra* note 10, at 1464-65.

137. For returns with income of \$1 million dollars or more, approximately 300,000 returns, the audit rate was approximately 4.4%. In fiscal year 2000, the overall audit rate for individuals was .49%. *I.R.S. Releases Audit and Collection Activity Statistics for FY 2000*, TAX NOTES TODAY, Feb. 15, 2001, at ¶ 16, available at LEXIS, 2001 TNT 33-11. For individuals with \$100,000 or more of income it was .96%. *Id.* Each of these audit rates declined every year between 1996 and 2000. See *id.* The IRS did not report similar information in its 2001 collection activity statistics. See generally *I.R.S. Releases Audit and Collection Activity Statistics for FY 2001*, TAX NOTES TODAY, Feb. 28, 2002, at ¶ 4, available at LEXIS, 2002 TNT 41-10.

138. Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, TAX NOTES TODAY, Nov. 14, 2002, at ¶ 19, available at LEXIS, 2002 TNT 224-22 (IRS paper presented at the National Tax Association 95th Annual Conference on Taxation). Plumley found that "if the AuditRate had been one percentage point higher in 1991, the general population would have reported an additional \$56 billion of additional tax voluntarily." *Id.* at ¶ 19-20.

139. Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 189 (1996); see also Lederman, *The Interplay*, *supra* note 10, at 1459.

register a tax shelter named OPIS, made its decision based strictly on economics.¹⁴⁰ Among a multitude of reasons, KPMG rationalized that the Service “was not vigorously enforcing the registration requirement, the penalties for noncompliance were much less than the potential profits from selling the tax product, and ‘industry norms’ were not to register any tax products at all.”¹⁴¹ According to the Senate Report, the KPMG tax professionals “calculated the penalties for noncompliance compared to potential fees from selling OPIS,” stating, “[b]ased upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees. . . . For example, our average [OPIS] deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000.”¹⁴² The penalty compared to compliance would place the firm at such a competitive disadvantage in its sales that KPMG would “not be able to compete in the tax advantaged products market.”¹⁴³

There is a second component regarding the deterrence model given the uncertainty in the courts, e.g., will the court use *Cohan* or zero-basis? Kyle Logue discusses how the deterrent model would work in times of taxpayer uncertainty of the law.¹⁴⁴ First, Logue isolates the norm model and states that there is no distortion in action because his taxpayer’s, Joe’s, societal influences are indifferent to his actions, “or he is indifferent to their opinions.”¹⁴⁵ Logue asserts that the taxpayer’s decision tree, whether to engage in a transaction,

will depend on the ex-ante assessment of (1) the probability that the particular tax position in question will be discovered and scrutinized by the Service, (2) the probability that, if detected, the position would be rejected by the Service and ultimately by a court; and (3) the size of the penalty in the event of both detection and rejection.¹⁴⁶

According to Logue, a strict liability approach with high penalties is needed.¹⁴⁷ This seems to be mostly related to the fact that deterrence will not

140. U.S. S. PERMANENT SUBCOMM. ON INVESTIGATIONS COMM. ON GOV’T AFFAIRS, REPORT ON U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS 13 (2003), available at <http://levin.senate.gov/imo/media/doc/supporting/2003/111803TaxShelterReport.pdf>.

141. *Id.* at 13.

142. *Id.*

143. *Id.*

144. Logue, *supra* note 135, at 241.

145. *Id.* at 245.

146. *Id.*

147. *Id.* at 241. In reality, the formula is quite easy. See Raskolnikov, *supra* note 50, at 716-17.

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 proba-

work if there are low probabilities of detection. In the case of a taxpayer with an unknown basis in an asset, the likelihood of an audit on that singular misrepresentation is de minimis. In order to combat this type of a risk assessment by a taxpayer, Logue argues that a taxpayer “cannot get out of paying taxes simply because the law, ex-ante, was uncertain, even if his interpretation of the law was reasonable.”¹⁴⁸

Nonetheless, the deterrence model’s main weakness derives from its idea of a rational taxpayer.¹⁴⁹ This rational taxpayer analog breaks down in a couple of manners. First, there are “taxpayers with rich and complex motivations for compliance and noncompliance; but the deterrence model generally assumes the richness and complexity away.”¹⁵⁰ The fundamental problem with higher fines is that it will not deter non-rational actors. Taxpayers, such as Erwin Griswold, were not necessarily making rational decisions when deciding to invest without keeping adequate records for his underlying asset, the infamous stamp collection. Moreover, taxpayers who receive property as a gift on their bar mitzvah totally lack a non-compliance motive.¹⁵¹ How can a taxpayer make a cost-benefit analysis if he was never aware of a downside?

Closely associated with this concept is the fact that people are not infallible, as a deterrent model would require. Taxpayers and the Service

bility 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, so the absolute amount of fine is $f \times T$. Not every underpayment of tax triggers imposition of a penalty. The probability of fine, P_F , is a (conditional) 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:

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

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 :

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

Id.

148. Logue, *supra* note 135, at 280.

149. Doran, *supra* note 2, at 129 n.100.

150. Doran, *supra* note 2, at 129-30.

151. Taxpayers take the donor’s basis. I.R.C. § 1015(a) (2006) (“[T]he basis shall be the same as it would be in the hands of the donor, . . . , except that if such basis . . . is greater than the fair market value of the property at the time of the gift, then for the purposes of determining loss the basis shall be the fair market value.”). However, the donor is not required to provide this information to the donee. Dodge & Soled, *supra* note 12, at 558-59; see also I.R.C. § 6103(e) (Supp. 2010); Treas. Reg. § 1.1015-1(a)(3) (as amended in 1971).

make mistakes.¹⁵² By increasing the penalties as a deterrent, we also reduce social welfare.¹⁵³

Second, because the tax law is complex and ambiguous, rules that should be clear are not. The Code was not written as a unified document, and provisions have been enacted in a piecemeal approach. Therefore, there is no internal consistency throughout the document.¹⁵⁴ Third, it is argued that increasing the fines will not have a deterrent effect at all but, rather, would increase noncompliance.¹⁵⁵ The theory describes the crowding-out effect, which reflects taxpayer behavior. The concept is that sanctions that are introduced into a game environment will crowd out voluntary compliance, essentially turning people into maximizers.¹⁵⁶ Effectually arguing that the introduction of negative material incentives will reduce compliance, Professor Kahn argued that:

the reciprocity theory helps to explain why such [audit] threats have sometimes been shown to backfire. When the IRS engages in dramatic gestures to make individuals aware that it is redoubling its efforts to catch and punish tax evaders, it also causes individuals to infer that more taxpayers than they thought are choosing to cheat. This inference in turn triggers a reciprocal motive to evade, which dominates the greater material incentive to comply associated with the higher than expected penalty. Because it misunderstands the contribution that social norms make to tax evasion, the conventional strategy suggests a self-defeating strategy for dealing with it.¹⁵⁷

152. Raskolnikov, *supra* note 50, at 704.

153. *Id.*; see also 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).

154. See Raskolnikov, *supra* note 50, at 704 (providing the example that 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 also I.R.C. § 1092 (Supp. 2007); I.R.C. § 1211 (2006); I.R.C. § 1222 (2010).

155. Raskolnikov, *supra* note 50, at 704.

156. *Id.* at 704-05 (citing 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.”)); see also Mark Lubell & John T. Scholz, *Cooperation, Reciprocity, and the Collective-Action Heuristic*, 45 AM. J. POL. SCI. 160, 173-74 (2001) (finding that 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, 692-93 (1999) (reporting that introducing infrequent inspections and small fines reduces both cooperation and expectation of cooperation).

157. Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner’s Law and Social Norms*, 36 U. RICH. L. REV. 367, 380-81 (2002); cf. Lederman, *The Interplay*, *supra* note 10, at 1497-98 (arguing that Kahn’s use of the Minnesota study was improper).

The final rationale that the increase in penalties will increase noncompliance is not inconclusive. A number of studies have found that the fear of sanctions increases tax compliance.¹⁵⁸ In a telling Minnesota Department of Revenue study, it was found that an audit threat increased compliance.¹⁵⁹ The study tested five different compliance strategies.¹⁶⁰ The subject taxpayers were divided into five groups and a control.¹⁶¹

Taxpayers who were in the audit group were sent a letter stating that their 1994 returns would be subject to heightened scrutiny.¹⁶² In the event that anything irregular was found, there might be an examination of past years' returns.¹⁶³ The study concluded that the threat of an audit increased compliance in 96.7% of the population.¹⁶⁴ As for high-income taxpayers (over \$100,000), the audit letter had mixed results. There was a belief that sophisticated taxpayers make a low bid.¹⁶⁵

Deterrence models alone do not justify compliance.¹⁶⁶ Economic modeling that would justify increased deterrence methodologies cannot account

But cf. Raskolnikov, *supra* note 50, at 704-09 (arguing for a rational taxpayer where penalties alone are not enough).

158. Lederman, *The Interplay*, *supra* note 10, at 1488-90 (citing Robert Mason & Lyle D. Calvin, *Public Confidence and Admitted Tax Evasion*, 37 NAT'L TAX J. 489, 493 (1984) (analysis of results of survey of Oregon taxpayers found that "[s]anction fear . . . is strongly related to compliance."); Michael W. Spicer, *Civilization at a Discount: The Problem of Tax Evasion*, 39 NAT'L TAX J. 13, 15 (1986); Richard D. Schwartz & Sonya Orleans, *On Legal Sanctions*, 34 U. CHI. L. REV. 274, 286-88 (1966). Among other things, the study looked at the first response to an open-ended question about reasons for paying taxes. The taxpayers with the highest socio-economic status (by occupation and education) were quite responsive to the threat of sanction but not to the moral appeal. *Id.* at 290-91. The group with the lowest socio-economic status showed the opposite trend, responding positively to the moral appeal and slightly negatively to the sanction interview. *Id.*; see also John Hasseldine et al., *Persuasive Communications: Tax Compliance Enforcement Strategies for Sole Proprietors*, 24 CONTEMP. ACCT. RES. 171, 189 (2007) (UK taxpayers who received letters from inland revenue saw significantly higher levels of compliance); Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 40 LOY. U. CHI. L.J. 483, 505-06 (2009).

159. Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125, 130-34 (2001) (reporting the results of the experiment). *But see* STEPHEN COLEMAN, THE MINNESOTA INCOME TAX COMPLIANCE EXPERIMENT STATE TAX RESULTS 19 (1996), available at http://taxes.state.mn.us/legal_policy/documents/research_reports_content_complnce.pdf. See also Morse, *supra* note 158, at 505; Lederman, *The Interplay*, *supra* note 10, at 1490-91.

160. COLEMAN, *supra* note 159, at 10-12, 22; Lederman, *The Interplay*, *supra* note 10, at 1490-91; Morse, *supra* note 158, at 505.

161. COLEMAN, *supra* note 159, at 1, 7.

162. *Id.* at 3.

163. *Id.*

164. *Id.* at 10-12, 22.

165. Lederman, *The Interplay*, *supra* note 10, at 1491.

166. See Raskolnikov, *supra* note 50, at 695-97; Lederman, *The Interplay*, *supra* note 10, at 1491; and Kristina Murphy & Karen Byng, *Preliminary Findings from 'The Australian Tax System Survey of Scheme Investors'* 37 (Austl. Nat'l Univ., Res. Sch. of Soc. Sci. Ctr. for

for all the factors that affect tax compliance.¹⁶⁷ Therefore, the norms-model must be examined.

2. Norms-Model in Uncertainty

The norms-model adds to the deterrence model by positing that any failings of the deterrence model can be accounted for through societal and personal norms.¹⁶⁸ There are two parts to this theory. The personal norms portion derives from studies for the impact on tax compliance of privately held ethical and moral convictions, which are referred to here as personal norms.¹⁶⁹ The societal norms portion is relevant because the behaviors and shared ethical beliefs attributed to others have also been demonstrated to influence action.¹⁷⁰ Taxpayers comply because their neighbors, friends, and colleagues all expect them to for the betterment of the group.

Under the norms-model, formal sanctions are not enough for compliance. Rather, peer pressure is necessary. The government, under the norms-model, should “emphasi[ze] procedural justice: officials responsible for enforcing tax laws should deal with taxpayers openly and fairly, without bias or predisposition; and government should ‘give taxpayers the benefit of the doubt when it finds a mistake.’”¹⁷¹

Empirical evidence supports that societal norms play a role in the current 83% voluntary compliance number.¹⁷² Research has shown that individuals will cooperate with others even though self-interest would suggest that they should not.¹⁷³ Other factors come into play—influence of other members of society plays an important role. Empirical evidence shows that taxpayers who believe that compliance is the norm are more likely to comply.¹⁷⁴

Tax Sys. Integrity, Working Paper No. 40, 2002), available at <http://ctsi.anu.edu.au/publications/WP/40.pdf>.

167. See, e.g., COLEMAN, *supra* note 159; Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance (2): A Field-Experiment* (Austl. Nat’l Univ., Res. Sch. of Soc. Sci. Ctr. for Tax Sys. Integrity, Working Paper No. 8, 2001), available at <http://digitalcollections.anu.edu.au/bitstream/1885/41626/2/WP8.pdf>.

168. Doran, *supra* note 2, at 131 & n.111 (for general discussion of social norms).

169. S.H. Schwartz, *Normative Influences on Altruism*, in 10 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 221-279 (L. Berkowitz ed., 1977).

170. R. B. Cialdini & M. N. Trost, *Social influence: Social Norms, Conformity, and Compliance*, in 2 THE HANDBOOK OF SOCIAL PSYCHOLOGY 151, 151-192 (D. G. Gilbert, S. T. Fiske & G. Lindzey eds., 1988).

171. Doran, *supra* note 2, at 133-34.

172. COLEMAN, *supra* note 159; Wenzel, *supra* note 167; Lederman, *The Interplay*, *supra* note 10, at 1470.

173. Lederman, *The Interplay*, *supra* note 10, at 1461.

174. Wenzel, *supra* note 167; Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance (1): A Prestudy* (Austl. Nat’l Univ., Ctr. for Tax Sys. Integrity, Working Paper No. 7, 2001), available at <http://ctsi.anu.edu.au/publications/WP7.pdf> [hereinafter

Personal tax norms are based on the environment in which an individual is raised and will, thus, have environmental influences.¹⁷⁵ As one would expect, the personal norm, like other norms and mores, changes over time and depends on the norms with which the individual identifies at any given point in time.¹⁷⁶ One criticism of the personal norm philosophy is that it may underestimate the role of social norms for tax compliance.¹⁷⁷

There is ample evidence showing that social norms do impact taxpaying attitudes. In a field experiment, conducted by Michael Wenzel, a group of taxpayers were shown feedback about survey findings.¹⁷⁸ The study found that if taxpayers were informed that others reported their tax liability accurately, they were more inclined to comply.¹⁷⁹ The findings showed that people underestimate other taxpayers' normative beliefs supporting tax compliance.¹⁸⁰ Compared to control groups, the feedback was partly effective in significantly reducing deduction claims.¹⁸¹ The Australian National Univer-

Wenzel, *Misperceptions*]; COLEMAN, *supra* note 159, at 5-6; Lederman, *The Interplay*, *supra* note 10, at 1470. Various studies have demonstrated the role of personal norms for taxpaying behavior. *See, e.g.*, Schwartz & Orleans, *supra* note 141 (provided early experimental evidence that appeals to taxpayers' personal conscience could increase their tax compliance); Kathleen M. McGraw & John T. Scholz, *Appeals to Civic Virtue Versus Attention to Self-Interest: Effects on Tax Compliance*, 25 LAW & SOC'Y REV. 471 (1991) (replication of the Schwartz and Orleans study with differing results); Luigi Bosco & Luigi Mittone, *Tax Evasion and Moral Constraints: Some Experimental Evidence*, 50 KYKLOS 297, 297 (1997) (conducted an experiment "to investigate the role played by moral constraints in determining the decision to evade taxes"; "include[ing] not only monetary elements but also psychological and moral factors in the taxpayer's decisional process"); Philip M. J. Reckers et al., *The Influence of Ethical Attitudes on Taxpayer Compliance*, 47 NAT'L TAX J. 825 (1994) (a study asking participants if they would evade taxes); Thomas M. Porcano, *Correlates of Tax Evasion*, 9 J. ECON. PSYCHOL. 47 (1988) (governments which adhere to principle of providing public services according to citizen preferences at reasonable costs have higher levels of compliance); Harold G. Grasmick & Robert J. Bursik, Jr., *Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model*, 24 LAW & SOC'Y REV. 837 (1990) (examining the perceived threat of legal sanctions on illegal behavior including tax cheating).

175. *See* Russell H. Weigel et al., *Tax Evasion Research: A Critical Appraisal and Theoretical Model*, 8 J. ECON. PSYCHOL. 215, 221 (1987) (observing that "the prospect of a large out-of-pocket cost may produce strain and consequent evasion behavior"); Schwartz, *supra* note 169, at 221-79.

176. D. Abrams & M.A. Hogg, *Social Identification, Self-Categorization and Social Influence*, in 1 EUROPEAN REVIEW OF SOCIAL PSYCHOLOGY 195-228 (W. Stroebe & M. Hewstone eds., 1990).

177. *But see* Grasmick & Bursik, *supra* note 174.

178. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174.

179. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174.

180. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; *see also* Lederman, *The Interplay*, *supra* note 10, at 1471-73.

181. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; *see also* Lederman, *The Interplay*, *supra* note 10, at 1471-73.

sity and the Australian Taxation Office conducted the compliance norm experiment.¹⁸²

The study was conducted in two parts. The first part was a pre-study in which students were given surveys.¹⁸³ The surveys asked the students how honest they were in paying their taxes and how truthful others were in the preparation of their taxes.¹⁸⁴ Later, the students were given the results that lead each student to believe that each student was reporting honestly and that the group belief was the same.¹⁸⁵ Another survey was given to the students a short while later.¹⁸⁶ Finally, the students were given two different taxpaying scenarios and asked how they would report the item.¹⁸⁷ The students showed high levels of compliance in the experimental group that was primed to do so.¹⁸⁸

The Australian Taxation office then followed up on the study through a random survey of taxpayers.¹⁸⁹ The same experimental methodology was employed, and a prime for compliance in the experimental group was set.¹⁹⁰ The results showed that for certain deductions there was an apparent causal effect.¹⁹¹

The main weakness in a norms-based model is that the taxpayer must believe that others generally comply with their obligations. So, a prerequisite is the need for clearly articulated expectations and obligations. In the discussion of taxpayer record keeping, this standard is not met. If information, whether anecdotal or actual, is passed through the societal lens that compliance is not required, then the model breaks down. So, penalties must be narrower and stronger in norms-models.¹⁹² Penalties must target only the norm-defying taxpayers.

182. See Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174.

183. See Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174.

184. See Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; Lederman, *The Interplay*, *supra* note 10, at 1471.

185. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

186. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

187. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

188. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

189. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

190. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

191. Wenzel, *supra* note 167; Wenzel, *Misperceptions*, *supra* note 174; see also Lederman, *The Interplay*, *supra* note 10, at 1473.

192. Doran, *supra* note 2, at 133.

Furthermore, in a norms-based model, others' beliefs and behaviors only apply when there is a relevant reference group.¹⁹³ For example, if we refer to the beliefs of tax protestors, an irrelevant group of taxpayers for average citizens, then the beliefs and behaviors prevalent in that group would not allow an observation of positive effects of these alleged norms on the intended group.¹⁹⁴ Under the self-categorization theory of norms-model, an understanding of how people structure their social field, whereby they consider some social norms as relevant to themselves while they reject other social norms, is required:

[t]he essential conclusions for the present research are that, first, people are more likely to be influenced by others who are considered members of one's relevant self-category; that is, members of the group with which one identifies in a given situation. Second, such influence means that the views and behavioural tendencies of fellow group members are internalised as one's true personal convictions.¹⁹⁵

However, when dealing with basis record keeping, the norms-model also breaks down. The penalty system for noncompliance is broad-based and is over-inclusive, e.g., the negligence penalty is for all underreporting, not just this behavior. Because of the lumping together of the perceived innocent taxpayer and the culpable taxpayer, societal values might actually support the position of non-record keeping. The norm might actually be noncompliance.

II. CURRENT LAW AND BURDEN SHIFTING

Against this backdrop of mixed messages sent to a taxpayer, we can now frame the state of the current law. The Service makes an assessment that is presumed to be correct, and then the taxpayer must produce evidence to go forward.¹⁹⁶ Generally speaking, the burden of proof in procedure encompasses two different concepts: (1) the burden to produce evidence, i.e., the burden of production; and (2) the burden of persuasion.¹⁹⁷ The burden to

193. Harold H. Kelley, *The Two Functions of Reference Groups*, in READINGS IN SOCIAL PSYCHOLOGY 410-14 (G. E. Swanson, T. M. Newcomb & E. L. Hartley eds., 1952).

194. Wenzel, *supra* note 167.

195. *Id.* at 6-7.

196. Welch v. Comm'r, 290 U.S. 111, 115 (1933); Niles Bement Pond Co. v. United States, 281 U.S. 357, 361 (1929); Cohen v. Comm'r, 266 F.2d 5, 11 (9th Cir. 1959); Dairy Home Co. v. United States, 180 F. Supp. 92, 95 (D. Minn. 1960); Martinez, *supra* note 27, at 257. *But see* I.R.C. § 7491(a) (2006) (eliminating the presumption of correctness if the taxpayer has met its duties under the statute); John A. Lynch, Jr., *Burden Of Proof In Tax Litigation Under I.R.C. § 7491-Chicken Little Was Wrong!!*, 5 PITT. TAX REV. 1, 2-3 (2007) (stating that I.R.C. § 7491 does not change the presumption when the taxpayer fails to comply).

197. See JAMES BRADLEY THAYER, PRELIMINARY TREATISE ON EVIDENCE AT THE COMMON LAW 355 (1898); 2 CHARLES T. MCCORMICK, MCCORMICK ON EVIDENCE 471-72 (6th ed. 2006); McBaine, *supra* note 33, at 246; Fleming James, Jr., *Burdens of Proof*, 47

produce evidence is the production of the evidence that is satisfactory to a judge on a particular fact sufficient enough to go forward.¹⁹⁸ The burden of persuasion, on the other hand, is persuading the trier of fact that the alleged fact is true.¹⁹⁹

How does a court reach the conclusion that enough evidence has been proffered to meet the burden of production? The old “scintilla” of evidence rule is generally not applied in federal court any longer.²⁰⁰ Rather, the evidence must be such that a reasonable person can draw the inference of the existence of a particular fact.²⁰¹ At that point, the profferer of evidence has met the standard and not failed the test thereby leading to a motion for judgment on the pleadings.²⁰²

But that does not mean that the profferer of the evidence has met the burden of persuading the jury or judge. If he had remained silent, then he would have lost the case on the issue at hand.²⁰³ However, by producing evidence, he now allows the case to move forward.²⁰⁴ In the event that he does not produce any additional evidence, he now risks the jury finding against him on the merits.²⁰⁵ All that he accomplished by meeting the first burden of production is that a jury or judge can make an inference, if they choose, about the issue.²⁰⁶

If a matter cannot be resolved between a taxpayer and the Service, then a trial would occur in one of three forums: the Claims Court, the appropriate federal district court, or the Tax Court.²⁰⁷ The choice of forum is at

VA. L. REV. 51, 51 (1961); John T. McNaughton, *Burden of Producing Evidence: A Function of a Burden of Persuasion*, 68 HARV. L. REV. 1382, 1382 (1955).

198. McBaine, *supra* note 33, at 246-48.

199. *Id.*; James, *supra* note 197, at 51; Lederman, *The Interplay*, *supra* note 10, at 248.

200. *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 595-96 (1993) (the trial judge requires the plaintiff to produce a body of evidence that can be reviewed to determine if there is a sufficient quantum of proof to cause a reasonable juror to exercise a belief probability in favor of plaintiff's theory); 9 JOHN H. WIGMORE, *EVIDENCE IN TRIALS AT COMMON LAW* § 2494 (Chadbourn rev. ed. 1981).

201. *Boeing Co. v. Shipman*, 411 F.2d 365, 374 (5th Cir. 1969); McBaine, *supra* note 33, at 245; Christopher M. Pietruszkiewicz, *Conflating Standards of Review in the Tax Court: A Lesson in Ambiguity*, 44 HOUS. L. REV. 1337, 1366-67 (2008).

202. *See, e.g., A.C. Aukerman Co. v. R.L. Chaides Constr. Co.*, 960 F.2d 1020, 1037 (Fed. Cir. 1992); Francis H. Bohlen, *The Effect of Rebuttable Presumptions of Law Upon the Burden of Proof*, 68 U. PA. L. REV. 307, 314 (1920); John Gamino, *Tax Controversy Overburdened: A Critique of Heightened Standards of Proof*, 59 TAX LAW. 497, 500-01 (2006).

203. CHARLES T. MCCORMICK, *MCCORMICK ON EVIDENCE* 411-37 (5th ed. 1999).

204. *Aukerman*, 960 F.2d at 1037; *Mqckowik v. Kansas City, St. Joseph & Council Bluffs R.R. Co.*, 94 S.W. 256, 262 (Mo. 1906); Edmund M. Morgan, *Some Observations Concerning Presumptions*, 44 HARV. L. REV. 906, 928-29 (1931); Gamino, *supra* note 202, at 501.

205. Morgan, *supra* note 204, at 929; Gamino, *supra* note 202, at 501.

206. McBaine, *supra* note 33, at 246-48.

207. *See Lederman, The Interplay*, *supra* note 10, at 255.

the discretion of the taxpayer. If the taxpayer does not desire to pay the tax due and any penalties, then the only option is the Tax Court.²⁰⁸ Alternatively, if the taxpayer desires to pay the tax due and penalties, then the taxpayer can take the matter to the Federal District Court or the Court of Claims; these are perceived by many taxpayers as more favorable courts.²⁰⁹ The choice of forum will affect “the burden of proof and the risk of nonpersuasion.”²¹⁰

As applied to a tax controversy, the general rules regarding burden of proof add tremendous clarity to the true burden of proof of the taxpayer. As an initial matter, given that we are in a system of self-reporting, the relevant evidence to determine the liability rests with the taxpayer.²¹¹ It would then appear fair to place the burden of persuasion on the taxpayer.²¹² The taxpayer has all the facts related to the basis while the Commissioner only has circumstantial evidence originating from the taxpayer and his records.²¹³

The final unique matter regarding the burden in tax cases is that the Commissioner’s assessment is presumed to be correct.²¹⁴ This presumption helps to clarify the later discussion that the taxpayer must produce competent and relevant evidence to refute the Service’s position.²¹⁵ Upon presentation of the evidence, the burden of persuasion should then rest on the tax-

208. I.R.C. § 6212(c)(1) (2006); I.R.C. § 6213(a) (Supp. 2010); *see also* I.R.C. § 7442 (2006); *Scar v. Comm’r*, 814 F.2d 1363 (9th Cir. 1987); *Lederman, The Interplay*, *supra* note 10, at 256.

209. 28 U.S.C. § 1346(a)(1) (2006); *Lederman, The Interplay*, *supra* note 10, at 256.

210. *See Lederman, The Interplay*, *supra* note 10, at 256; Whitfield & McCallum, *Burden of Proof and Choice of Forum in Tax Litigation*, 20 VAND. L. REV. 1179, 1179-82 (1967).

211. *See Lederman, The Interplay*, *supra* note 10, at 277.

212. *See United States v. Russell Mfg. Co.*, 349 F.2d 13, 16 (2d Cir. 1965); *Sharwell v. Comm’r*, 419 F.2d 1057, 1060 (6th Cir. 1969); *Cohen v. Comm’r*, 266 F.2d 5, 11 (9th Cir. 1959); *United States v. Florida*, 252 F. Supp 806, 811 (E.D. Ark. 1965); *United States v. Fior D’Italia, Inc.*, 536 U.S. 238, 256 n.4 (2002) (Souter, J., dissenting) (“[B]urdens shift to those with peculiar knowledge of the relevant facts.”); *Int’l Bhd. of Teamsters v. United States*, 431 U.S. 324, 359 n.45 (1977) (“Presumptions shifting the burden of proof are often created to reflect judicial evaluations of probabilities and to conform with a party’s superior access to the proof.”); *Campbell v. United States*, 365 U.S. 85, 96 (1961) (“[T]he ordinary rule . . . does not place the burden upon a litigant of establishing facts peculiarly within the knowledge of his adversary.”); *Lederman, The Interplay*, *supra* note 10, at 258.

213. *Lederman, The Interplay*, *supra* note 10, at 277.

214. *Welch v. Comm’r*, 290 U.S. 111, 115 (1933); *Niles Bement Pond Co. v. United States*, 281 U.S. 357, 361 (1929); *Cohen*, 266 F.2d at 11; *Dairy Home Co. v. United States*, 180 F. Supp. 92, 95 (D. Minn. 1960); *Lederman, The Interplay*, *supra* note 10, at 257. However, in the arena of unknown basis assets, I.R.C. § 7491 which shifts the burden to the taxpayer will be inapplicable. *See Camp*, *supra* note 34, at 5.

215. *A. & A. Tool & Supply Co. v. Comm’r*, 182 F.2d 300, 304 (10th Cir. 1950); *Lederman, The Interplay*, *supra* note 10, at 257.

payer.²¹⁶ Unfortunately, the Code does not clearly articulate that the burden of proof rests with the taxpayer.²¹⁷

The addition of Code § 7491 in the Internal Revenue Restructuring and Reform Act of 1998 (“RRA”)²¹⁸ was thought to help in clarifying the burden of persuasion once the taxpayer rebutted the initial presumption.²¹⁹ In the late 1990s, the rhetoric espoused that taxpayers were being treated unfairly.²²⁰ In the Senate Finance Committee Hearings in September 1997,²²¹ a “parade of witness-taxpayers, taxpayers’ representatives, and the Service agents testified (sometimes anonymously behind screens) to the litany of Service wrongdoing. The hearings were a staple in evening newscasts and the daily newspapers and created an outpouring of anger among citizens.”²²² As one tax lawyer testified, “taxpayers are presumed guilty until proven innocent.”²²³

Despite evidence to the contrary that the Service was not abusing its power except on rare occasions,²²⁴ the hearings allowed Congress to establish specific restraints on the Service.²²⁵ Thus, a “newer” and “friendlier” Service was born. The main feature of the RRA was Code § 7491, which purportedly eliminated the presumption of correctness of the Service. This alleged shifting of the burden of production was to have the effect of evening the playing field in the dispute stage.²²⁶

216. *Barnes v. Comm’r*, 408 F.2d 65, 69 (7th Cir. 1969); *Compton v. United States*, 334 F.2d 212, 216 (4th Cir. 1964); *A & A*, 182 F. 2d at 304; Lederman, *The Interplay*, *supra* note 10, at 257-58.

217. *See also* Lederman, *The Interplay*, *supra* note 10, at 272. Moreover, the legislative history seems to indicate that the burden may be on the government. *See* S. REP. NO. 70-960, at 38 (1928); *see also* *Keogh v. Comm’r*, 713 F.2d 496, 501 (9th Cir. 1983); *Sinder v. United States*, 655 F.2d 729, 730 (6th Cir. 1981); *Carson v. United States*, 560 F.2d 693, 694 (5th Cir. 1977).

218. 26 U.S.C. § 7491 (2006).

219. Bernard J. Long, Jr., *Burden of Proof Shift: Tom Jefferson Would Be Proud*, 77 TAX NOTES 625, 625 (1997); Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-Of-Proof Rules*, 84 IOWA L. REV. 413, 423-24 (1999); John R. Gardner & Benjamin R. Norman, *Effects of the Shift in the Burden of Proof in the Disposition of Tax Cases*, 38 WAKE FOREST L. REV. 1357, 1357 (2003).

220. Lynch, *supra* note 196, at 1-3.

221. *Practices and Procedures of the Internal Revenue Service: Hearings Before the S. Comm. on Finance*, 105th Cong. 190 (1997) [hereinafter *Hearings*].

222. Johnson, *supra* note 219, at 424; *see also* Lynch, *supra* note 196, at 3.

223. *Hearings*, *supra* note 221, at 41 (statement of Robert Schriebman, Adjunct Professor of Tax Practice and Procedure, Univ. of S. Cal. Graduate Sch. of Accounting).

224. Ryan J. Donmoyer, *Secret GAO Report is Latest to Discredit Roth’s IRS Hearings*, 87 TAX NOTES 463, 463 (2000) (stating that a 1999 GAO report which disputed the allegation in the 1998 hearings was withheld); *see also* Camp, *supra* note 34, at 81; Lynch, *supra* note 196, at 4.

225. Johnson, *supra* note 219, at 415.

226. Barbara Kirchheimer, “T2”-Ways & Means Panel Considers Taxpayer Rights Proposals, 67 TAX NOTES 12, 12 (1995) (quoting then-Commissioner of the Internal Reve-

Despite what was, at the time, widely believed to be the end of the self-assessment system, the application of Code § 7491(a) has proven rather benign, mostly due to the evisceration of the teeth with subsection (a)(2). Because the taxpayer must comply with his duties of record keeping and information sharing prior to the shift, in practice, the burden stays with the taxpayer. If the taxpayer does not or is unable to provide the required substantiation of the position, the court may refuse to shift the burden of proof.²²⁷

Essentially, Code § 7491 mirrors the judicial framework already in place. It does not eliminate the presumption of correctness imposed by the Tax Court rule and judicial decision.²²⁸ The taxpayer still has the burden of production.²²⁹ If the taxpayer meets this burden of production, then and only then does Code § 7491 come into play. If the taxpayer meets all of the requirements set out in Code § 7491, then the burden of persuasion will rest with the Service.²³⁰ But if, as in the case of the missing information for basis, the taxpayer does not meet the Code § 7491 test, then the old rules would still apply, and the burden would rest with the taxpayer.²³¹ Some courts have unnecessarily confused this proper standard by stating that if the taxpayer has met his burden of production, the burden of persuasion rests with the Service.²³²

In what should be a simple application of a standard set of rules, the case law on the issue of when a taxpayer does not have full proof of basis is unclear. As an initial matter, traditionally it would be necessary to distinguish the cases derived from deductible losses from those derived from attributable income. In basic tax parlance, there are different higher standards for the deductibility of expenses.²³³ For example, there is a statutory rule, Code § 274(d), that requires taxpayers to substantiate travel and entertainment expenses.²³⁴ For establishing gain, however, there is no corollary. Ra-

nue Service Margaret Milner Richardson: “That provision alone would undermine the federal income tax system.”); *see also* Lynch, *supra* note 196, at 5.

227. *See* Abdelhak v. Comm’r, 92 T.C.M. (CCH) 86 (2006); Pham v. Comm’r, 83 T.C.M. (CCH) 1539 (2002); Lynch, *supra* note 196, at 7-8.

228. Johnson, *supra* note 219, at 441; Lynch, *supra* note 196, at 16.

229. Nathan E. Clukey, *Examining the Limited Benefits of the Burden of Proof Shift*, 82 TAX NOTES 683, 687 (1999); Lynch, *supra* note 196, at 16.

230. Johnson, *supra* note 219, at 441; Lynch, *supra* note 196, at 16.

231. *Id.*

232. *See infra* note 281 (showing examples of this confusion).

233. In 1962, Congress amended the rules and required substantiation for deductions under I.R.C. § 274(d). In fact, I.R.C. § 274(d) was enacted to overrule *Cohan*. *See* Pub. L. No. 87-834, § 4(b), 76 Stat. 960, 976-77; Soled, *supra* note 13, at 953-54; Sanford v. Comm’r, 50 T.C. 823, 827-28 (1968), *aff’d*, 412 F.2d 201 (2d Cir. 1969); Temp. Treas. Reg. § 1.274-5T(a)(4) (2011); Adam S. Chodorow, *Maaser Kesafim and the Development of Law*, 8 FLA. TAX. REV. 153, 184 (2007).

234. *See* Dodge & Soled, *supra* note 12, at 566; Soled, *supra* note 13, at 953-54.

ther, there are rules that state that taxpayers do not even have a mandatory record-keeping duty.²³⁵

However, these concepts are not distinguished by the courts and are actually usually intermingled. As a result, there are two lines of cases, depending on the court. The first comes from the Supreme Court cases, *Welch* and *Burnet*.²³⁶ These cases state that the burden is on the taxpayer, and, absent proof, the resulting basis is zero.²³⁷ This is the derivation of the standard often referred to as “prove it or lose it.” The second line of cases derives from the Second Circuit opinion in the *Cohan* case.²³⁸ *Cohan* states that the court may have flexibility in helping the taxpayer guess the appropriate basis amount.²³⁹

Most commentators fall within one of the two camps. Although these cases apply to both income and loss cases, the focus of this discussion will

235. Dodge & Soled, *supra* note 12, at 566; Soled, *supra* note 13, at 952.

236. *Welch v. Comm’r*, 290 U.S. 111 (1933); *Comm’r v. Houston*, 283 U.S. 223 (1931).

237. *Perry & Co. v. Comm’r*, 120 F.2d 123, 126 (9th Cir. 1941) (finding of zero-basis by Commissioner correct); *Glimco v. Comm’r*, 397 F.2d 537, 541 (7th Cir. 1968) (zero-basis upheld without corroborated testimony of taxpayer); *Biltmore Homes, Inc. v. Comm’r*, 288 F.2d 336, 340 (4th Cir. 1961) (zero-basis unless taxpayer produces credible evidence and testimony); *Fihe v. Comm’r*, 265 F.2d 511, 512 (9th Cir. 1958) (zero-basis unless taxpayer produces evidence other than oral testimony); *Zeddies v. Comm’r*, 264 F.2d 120, 126 (7th Cir. 1959) (court made estimate of basis based on all relevant facts); *Pfluger v. Comm’r*, 840 F.2d 1379, 1383 (7th Cir. 1988) (basis only based on objective evidence); *Oates v. Comm’r*, 316 F.2d 56, 59 (8th Cir. 1963) (courts allowed to guess only when taxpayer has clearly shown that entitled to a deduction but only uncertainty as to the exact amount). Also, in many patent cases, oral testimony is held to be insufficient to rebut a presumption because skepticism is “reinforced, in modern times, by the ubiquitous paper trail of virtually all commercial activity. It is rare indeed that some physical record (*e.g.*, a written document such as notes, letters, invoices, notebooks, or a sketch or drawing or photograph showing the device, a model, or some other contemporaneous record) does not exist.” *Woodland Trust v. Flowertree Nursery, Inc.*, 148 F.3d 1368, 1373 (Fed. Cir. 1998); *see also Eibel Process Co. v. Minn. & Ont. Paper Co.*, 261 U.S. 45, 60 (1923) (holding that the oral testimony of prior public use “falls short of being enough to overcome the presumption of novelty from the granting of the patent” when “there is not a single written record, letter or specification of prior date to [the patentee’s] application that discloses any such discovery by anyone.”); *Finnigan Corp. v. Int’l Trade Comm’n*, 180 F.3d 1354, 1356 (Fed. Cir. 1997).

238. *Viana v. Comm’r*, 444 F.2d 770, 774 (3d Cir. 1971) (court used best guess to uphold the tax court’s decision for basis); *Moore v. Comm’r*, 425 F.2d 713, 715 (9th Cir. 1970) (court used best guess in analysis where taxpayer could prove part of facts); *Cohan v. Comm’r*, 39 F.2d 540, 545 (2d Cir. 1930) (court orders lower court to use best guess to calculate basis).

239. *See also Dodge & Soled, supra* note 12, at 566-68 (“This so-called ‘rule’ (which lacks uniformity or clarity) basically holds that a court will estimate the amount of a deduction (in this case, an asset’s basis) if the taxpayer provides some credible evidence to the effect but cannot prove the exact amount.”); *see, e.g., Lerch v. Comm’r*, 877 F.2d 624, 624 (7th Cir. 1989).

be on the income side. To prove losses, there should be a higher standard.²⁴⁰ Essentially, failure to separate the burden of proof into its two components has led courts to believe that the burden of persuasion shifts to the Service if the taxpayer meets the burden of production.²⁴¹

A. Zero-Basis Cases

The line of cases begins with the *Welch* and *Burnet* cases. In *Burnet*, the taxpayer subscribed in 1906 to a fund of potential collectible claims from a bankruptcy estate in the amount of \$305,000.²⁴² By 1920, it became apparent that the claims had little value, and the subscribers were paid \$33,300.²⁴³ The taxpayer took a loss of \$271,700.²⁴⁴ Unfortunately for the taxpayer, in 1918 the Code was revised, and new Section 202(a) provided that all taxpayers had to reset the value of their assets as of March 1, 1913.²⁴⁵ In the event that the fair market value of property acquired before March 1, 1913, was lower than the taxpayer's basis, the lesser amount would be the correct number to establish future gains or losses.²⁴⁶

The Court placed the burden to establish the deductible loss on the taxpayer.²⁴⁷ As will become a trend for the courts, they did not establish the procedural or evidentiary standard under which taxpayers meet their burden.²⁴⁸ In *Burnet*, the taxpayer argued that it was impossible to figure out the March 1, 1913, value and that he had enough to take the loss.²⁴⁹

The Court was unsympathetic to this line of reasoning. It emphatically stated:

The impossibility of proving a material fact upon which the right to relief depends simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof.²⁵⁰

More to the point is that the Court did not buy the taxpayer's assertion that it was impossible to ascertain the value.²⁵¹ It essentially stated that the

240. See I.R.C. § 274(d) (2006).

241. See, e.g., Lederman, *The Interplay*, *supra* note 10, at 258.

242. *Comm'r v. Houston*, 283 U.S. 223, 226 (1931).

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.* at 227.

247. *Id.*

248. *Id.* ("The burden of proof to establish a deductible loss and the amount of it, clearly, was upon the respondent.")

249. *Id.* at 228-29.

250. *Id.* at 228.

251. *Id.*

taxpayer did not even try, and the Court will not excuse a total lack of effort.²⁵²

In *Welch*, the Supreme Court dealt with the complicated issue of whether payments made by a taxpayer of debts owed by his prior company were ordinary and necessary business expenses.²⁵³ Welch was the secretary of the E.L. Welch Company, which operated in the grain selling business, went bankrupt, and went through insolvency proceedings.²⁵⁴ In order to engage in the same line of business and create good will among the past customers of the company, Welch paid off many of the debts of the bankrupt company.²⁵⁵ The Service ruled that these payments were not ordinary and necessary business expenses, but rather capital expenditures.²⁵⁶ The Court agreed with the Commissioner, stating that these payments seem to be not ordinary or necessary but “extraordinary.”²⁵⁷ Thus, unless the taxpayer can prove that expenses are “ordinary or necessary” within the statutory definition, they are not deductible.²⁵⁸

Some commentators incorrectly point to the oft quoted passage of the *Raytheon*²⁵⁹ case as the origination of the deemed zero-basis rule.²⁶⁰ In *Raytheon*, the First Circuit stated that because the record was devoid of evidence as to the basis, the “amount of any nontaxable capital recovery cannot be ascertained.”²⁶¹ Regardless of the true genesis of the “prove it or lose it” position, all the cases lay the foundation for the starting point of the discussion. The apparent standard articulated is that the taxpayer has the burden of proving basis.

In *Commissioner v. Taylor*,²⁶² the final part of the standard is articulated. In the *Taylor* case, the Commissioner determined a deficiency in the amount of \$9,156.69.²⁶³ The case focused on the age-old question of the determination of basis through multiple mergers and reorganizations.²⁶⁴ The Commissioner contended that, not only did the taxpayer have the burden to

252. *Id.* (“[W]e think the record is far from demonstrating the impossibility of supplying evidence from which the required fact might be found.”).

253. *Welch v. Comm’r*, 290 U.S. 111 (1933).

254. *Id.* at 112.

255. *Id.* at 112-13.

256. *Id.* at 113.

257. The Court stated famously, “The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.” *Id.* at 115.

258. The Court found that “[t]he money spent in acquiring [one’s reputation] is well and wisely spent. It is not an ordinary expense of a business.” *Id.* at 116.

259. *Raytheon Prod. Corp. v. Comm’r*, 144 F.2d. 110 (1st Cir. 1944).

260. *Dodge & Soled*, *supra* note 12, at 566 (citing *POSIN & TOBIN*, *supra* note 12).

261. *Raytheon*, 144 F.2d. at 114.

262. 293 U.S. 507 (1935).

263. *Id.* at 508.

264. *Id.* at 509-10.

prove that the Commissioner's determination was erroneous, but also that he had the burden to show the correct amount of the tax.²⁶⁵

The Court disagreed with the Commissioner that the taxpayer must show both the incorrect amount and the correct amount.²⁶⁶ Rather, the Court stated that the rule is the burden is on the taxpayer to show the Commissioner's determination is invalid.²⁶⁷ Often, the evidence used to refute this determination will suffice to show the correct amount. Here, the taxpayer was unable to show the correct amount, but he did show that the Commissioner's position was arbitrary and excessive.²⁶⁸ Thus, the Court remanded the case to hear the evidence of the taxpayer.²⁶⁹

The question that the cases leave generally unanswered is the standard of proof necessary for the taxpayer to meet that burden. Clearly, presenting no evidence will not meet any burden. Further, uncontradicted oral testimony is not binding on the trier of fact.²⁷⁰ So, the taxpayer has the right to produce something to sway the court.

B. The *Cohan* Rule

The courts have tempered the absolute position of *Burnet*, *Welch*, and their progeny with *Cohan*.²⁷¹ Given the underlying position that (1) taxpayers have no affirmative duty to keep records and generally do not keep records, and (2) that the penalty for failure to comply is rather harsh, courts have read into the *Taylor* case the ability to assess the Commissioner's position as being arbitrary and excessive.²⁷² Although *Cohan* was decided prior to *Taylor*, the fundamental principle is supported.

In *Cohan*,²⁷³ the taxpayer deducted various expenses and loans from his income. George M. Cohan was in the business of putting on plays, such as *Give My Regards to Broadway*. Clearly, Cohan paid actors and other employees and incurred travel expenses. Yet, he failed to keep records.²⁷⁴

265. *Id.* at 512.

266. *Id.* at 514.

267. *Id.* at 515 (citing *Lucas v. Structural Steel Co.*, 281 U.S. 264, 271 (1930); *Wickwire v. Reinecke*, 275 U.S. 101, 105 (1927); *Welch v. Helvering*, 290 U.S. 111, 115 (1933)).

268. *Taylor*, 293 U.S. at 513-14.

269. *Id.* at 515-16.

270. *See Glimco v. Comm'r*, 307 F.2d 537, 540-41 (7th Cir. 1968) (citing *Shapiro v. Rubens*, 166 F.2d 659, 666 (7th Cir. 1948)).

271. *Cohan v. Comm'r*, 39 F.2d 540 (2d Cir. 1930).

272. Marcus Schoenfeld, *A Critique of the Internal Revenue Service's Refusal to Disclose How it "Determined" a Tax Deficiency, and of the Tax Court's Acquiescence With This View*, 33 IND. L. REV. 517, 517-18, 539 (2000).

273. *Cohan*, 39 F.2d at 540-43.

274. *Id.* at 542-43.

The court stated, moreover, that he “probably could not have done so.”²⁷⁵ He testified about how much he spent, and the Board (the precursor to the Tax Court as the trier of fact) applied the rule that no evidence means no basis for a deduction.²⁷⁶

The court was unhappy with this result, as it is clear that Cohan spent something. After all, he had a product. So the court opined:

[a]bsolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.²⁷⁷

In *Cohan*, the court appeared to apply the concept, echoed later in *Taylor*, that states that this determination seemed to be arbitrary and excessive.²⁷⁸ However, the court did not decide what or how the Board should apply this standard and remanded back to them to reconsider the evidence.²⁷⁹ Once again, the taxpayer is left wondering exactly what is needed to prove or not prove the taxpayer’s stated tax position.

In application, few courts have followed the *Cohan* rule to actually guess the answer when the taxpayer fails to produce evidence like Mr. Cohan.²⁸⁰ Rather, those courts have taken the position that it is the taxpayer’s burden to produce substantiating evidence. Failure to produce evidence fails to meet any burden, and the taxpayer would lose.²⁸¹ This would then appear to leave a taxpayer in the position of hoping the court likes them, e.g., Mr. Cohan, and forces the trier of fact to guess.

Proponents of the zero-basis position look at the *Cohan* case as an outlier in the discussion. *Cohan* is framed as follows: the Second Circuit stated that the court should make its best guess when the taxpayer does not know his basis.²⁸² But *Cohan*, properly framed as a burden of persuasion case, is consistent with the zero-basis position.

Courts are not limited to making an ad hoc determination of values in the aforementioned basis cases. Lest we believe that this is an isolated issue, time after time, courts are faced with a determination of the value of an as-

275. *Id.* at 543.

276. *Id.*

277. *Id.* at 543-44.

278. *Id.*

279. *Id.*

280. *See, e.g.*, *Rogers v. Comm’r*, 248 F.2d 452 (7th Cir. 1956).

281. *See, e.g.*, *Lerch v. Comm’r*, 877 F.2d 624, 629 (7th Cir. 1989); *Bay Sound Transp. Co. v. United States*, 410 F.2d 505 (5th Cir. 1969); *Oates v. Comm’r*, 316 F.2d 56, 60 (8th Cir. 1963).

282. *See Dodge & Soled, supra* note 12, at 567 (citing *Karara v. Comm’r*, 78 T.C.M. (CCH) 197 (1999), *aff’d without opinion*, 214 F.3d 1358 (11th Cir. 2000), *cert. denied*, 531 U.S. 980 (2000)); *Allnutt v. Comm’r*, 2004 T.C.M. (RIA) 2004-239 (2004); *Golub v. Comm’r*, 78 T.C.M. (CCH) 367 (1999).

set in other contexts. For example, in the case of a prize, the value should be easy—the fair market value of the asset. There is a specific regulation, Treas. Reg. 1.74-1(a)(2), that states, “If the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income.” However, the courts do not take an absolute position. They weigh the value of the prize to the recipient, the secondary market, and other factors.²⁸³

Based on the series of prize cases, courts are just as willing, as in *Cohan*, to use their own best judgment for a value even when an objective standard is called for. As much as advocates argue that *Cohan* is an outlier, it is well within the methodology of the courts. In basis cases, there is a true dispute of fact over the value of the asset. In the prize cases, there is a lesser dispute over the value of the asset. The question is whether that fair market value should be conclusive or if the taxpayer should be able to dispute those facts. This is not substantially different from *Cohan*.

C. Tax Court Rules and the Federal Rules of Evidence

Two final places to consider in determining where the burden to prove basis lies and how it shifts are the Tax Court Rules and the Federal Rules of Evidence. Both sets of rules are applicable because the trier of fact in a tax controversy may be either the Tax Court or the Federal District Court. The forum will depend on whether the taxpayer desires to pay the full tax plus penalties (District Court) or not (Tax Court).²⁸⁴

283. See, e.g., *McCoy v. Comm’r*, 38 T.C. 841, 844 (1962) (The court did not accept the fair market value nor the trade-in value of a car won in a sales contest stating, “[W]e think it is common knowledge of which we may take notice, that when an automobile has been purchased from a dealer the purchaser cannot, on a sale of the car, normally realize the price which he paid for the car, even though it has not been actually used”); *Wade v. Comm’r*, 55 T.C.M. (CCH) 413 (1998) (“objective factors are emphasized, but subjective factors also are given weight in determining the value of prizes and awards to particular taxpayers”); *Turner v. Comm’r*, 13 T.C.M. (CCH) 462 (1954) (the tax court took the striking position of not only rejecting the Service’s and taxpayer’s position but coming up with an independent value of its own stating: “The winning of the tickets did not provide the taxpayers with something which they needed in the ordinary course of their lives and for which they would have made an expenditure in any event, but merely gave them an opportunity to enjoy a luxury otherwise beyond their means. Their value to the petitioners was not equal to their retail cost. They were not transferable and not salable, and there were other restrictions on their use.”).

284. See *supra* Section II.

1. Tax Court Rule 142

According to Rule 142(a) of the Tax Court Rules, the burden of proof shall be on the petitioner.²⁸⁵ The confusion that lies at the heart of the judicial decisions and the tension between the zero-basis and best-guess camps is the confusion over what constitutes this burden of proof. “Proof” is ambiguous, and courts often apply it in many different ways.²⁸⁶ The burden of proof in Rule 142(a) really means that the taxpayer has the initial burden of production, but *not* persuasion.²⁸⁷ Rule 149 then states that the failure to produce evidence in support of an issue of fact as to which that party has the burden of proof may be grounds for a determination against that party.²⁸⁸ In other words, the rule stated in *Burnet* is correct. If the taxpayer fails to produce evidence, then he failed his burden of production, and, thus, the issue should be decided against the taxpayer.²⁸⁹

However, if the taxpayer meets this burden of production, through the introduction of any evidence, then the trier of fact must decide on the merits of the case.²⁹⁰ At that point, the taxpayer shall have the burden of persuasion, and the applicable standard is preponderance of the evidence.²⁹¹ This is where the *Cohan* case fits within the context of the analysis. At that point, the trier of fact can decide the issue. *Cohan* allows the trier of fact to decide the case using the evidence to estimate, to the best of its ability, the appropriate basis of the asset.²⁹²

2. Federal Rule 301

An opposite analysis applies under Federal Rule of Evidence 301. Under Rule 301, there is a clear split between the burden of production and the burden of persuasion:

[i]n all civil actions and proceedings not otherwise provided for by Act of Congress or by these rules, a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of risk of

285. TAX. CT. R. 142(a).

286. The taxpayer has the burden of proof, but there are differences among courts as to what happens when the taxpayer adequately meets this burden. *See, e.g.*, *Cebollero v. Comm’r*, 967 F.2d 986, 990 (4th Cir. 1992) (holding that the burden of proof shifts back to the Commissioner); *United Aniline Co. v. Comm’r*, 316 F.2d 701, 704 (1st Cir. 1963) (holding that the burden of proof does not shift to the Commissioner); Lederman, *The Interplay*, *supra* note 10, at 260.

287. *See* Lederman, *The Interplay*, *supra* note 10, at 274-75.

288. TAX. CT. R. 149(b); *see also* Lederman, *The Interplay*, *supra* note 10, at 274-75.

289. *See supra* notes 236-41 and accompanying text (explaining the *Burnet* case).

290. Lederman, *The Interplay*, *supra* note 10, at 274-75.

291. *Id.*

292. *See supra* notes 273-74 and accompanying text (explaining the *Cohan* case).

nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.²⁹³

The burden of persuasion in a trial stays with the party with whom it was cast originally. However, the burden of going forward, e.g., the burden of production, is the responsibility of the party seeking to rebut or meet the presumption. In a tax litigation matter in federal district court or the Court of Federal Claims, Rule 301 will control.²⁹⁴

The more complicated evidentiary question then arises of what evidence must be presented to meet the burden of production. “The term ‘prima facie evidence’ or ‘prima facie case’ has at least two separate, while related, meanings.”²⁹⁵ “On the one hand, it may mean evidence [that] is sufficient to shift the burden of producing evidence, [thereby entitling] the proponent to a favorable ruling if the opponent fails to produce evidence.”²⁹⁶ “The other meaning is that the proponent has produced enough evidence to go to the finder of fact and to permit a favorable ruling.”²⁹⁷

The nature and amount of evidence that must be presented to meet the burden of production has been described in two ways that diverge in expression and, sometimes, in application.²⁹⁸ Under the first approach, which parallels the first definitional standard, the party with whom the burden is charged must present “some evidence” contradicting the proof of claim.²⁹⁹ Then the judge must weigh the evidence presented by the party against the proof of claim, which itself retains some weight as evidence, e.g., the presumption in tax matters that the Commissioner’s assessment is correct, and any evidence presented by the Service.³⁰⁰ After weighing the evidence, the judge must make a finding of fact as to the validity of the initial assessment.³⁰¹

293. FED. R. EVID. 301.

294. *Id.*

295. *In re Friedman*, 436 F. Supp. 234, 237 (D. Md. 1977). This is the result of the compromise in the adoption of Rule 301 between the Thayer and Morgan views. *See supra* notes 197-99 (describing Thayer’s view) and notes 204-05 (describing Morgan’s view); *see generally* S. REP. NO. 1277 (1974), *reprinted in* 1974 U.S.C.C.A.N. 7051, 7055-56.

296. *In re Friedman*, 436 F. Supp. 234, 237 (D. Md. 1977); J. WIGMORE, EVIDENCE § 2494 (1940); MCCORMICK, *supra* note 197, at § 342.

297. *Friedman*, 436 F. Supp. at 237.

298. *See, e.g.*, Gamino, *supra* note 202, at 502-04.

299. *Id.*

300. Prior to the introduction of Rule 301, this theory is often credited to Thayer. It is called the “Thayer’s bubble bursting” theory. Once the party against whom the presumption was in effect has offered evidence that would support a finding of the non-existence of the presumed fact, the presumption is rebutted and supposedly vanishes. J.B. THAYER, PRELIMINARY TREATISE ON EVIDENCE AT THE COMMON LAW 336 (1898) (Augustus M. Kelley ed., Rothman Reprints 1969); *see, e.g.*, Gamino, *supra* note 202, at 503-04.

301. *See In re Hannevig*, 10 F.2d 941, 942 (2d Cir. 1925) (evidence contradicting the proof of claim); *In re Sabre Shipping Corp.*, 299 F. Supp. 97, 99 (S.D.N.Y. 1969) (“contradictory evidence”); *In re Bradley*, 16 F.2d 301, 302 (S.D.N.Y. 1926) (“some evidence con-

Under the alternative approach, the burden of production is met if the party produces enough evidence to rebut or overcome the prima facie case created by the proof of claim.³⁰² Only then, after a preliminary victory over the presumptive validity of the claim as expressed in the proof of claim, does the objector's additional evidence in nature or amount require the judge to weigh the evidence and find the facts.³⁰³ Most often, this latter view is not followed. The current jurisprudence does not cast this increased standard on taxpayers. Taxpayers do not have to both rebut the zero-basis assertion and prove exactly what the basis is.³⁰⁴ Otherwise, despite the evidence produced by the objector, the judge could conclude that the evidence was not "sufficient to overcome the presumption" of the existence of a zero-basis position.

Therefore, in a basic tax litigation matter outside of the tax court, the Service's assessment will stand unless the taxpayer meets the burden of going forward. The burden must be met with adequate evidence to rebut the presumption. Oral testimony alone is usually insufficient.³⁰⁵ If a taxpayer meets the burden of production, then the burden of persuasion remains with the party with whom it was originally cast.³⁰⁶ In the case of unknown basis, the burden should remain with the taxpayer.

III. CLEAR STANDARDS

Clarifying the procedural and evidentiary standards is the first step to increasing taxpayer compliance. If the presumption is that taxpayers act rationally, based on the deterrent-based and norms-based models, then there must be clear heightened punishment for failure to comply. Fixing the standard that taxpayers received zero-basis if they cannot substantiate the basis, without more, will not increase the norms-model compliance.

tradicting it"); 3 LAWRENCE P. KING, ET. AL., *COLLIER ON BANKRUPTCY* ¶ 502.01[3] (15th ed. 2005) ("some evidence to the contrary").

302. This approach is credited to Professor Morgan. In his view, a presumption is created against a litigant for the same reasons that a plaintiff is saddled with the burden of persuasion. Thus, the Morgan presumption shifts not only the burden of production, but also shifts the burden of persuasion, or proof, as well. Edmund M. Morgan & John MacArthur Maguire, *Looking Backward and Forward at Evidence*, 50 HARV. L. REV. 909, 913 (1937).

303. See *In re Estrada's Market*, 222 F. Supp. 253, 255 (S.D. Cal. 1963) ("evidence to rebut the . . . claim"); 3 *COLLIER* § 502.01 ("enough evidence to rebut the claimant's prima facie case").

304. *Comm'r v. Taylor*, 293 U.S. 507, 512-14 (1935).

305. See *Glimco v. Comm'r*, 397 F.2d. 537, 540-41 (7th Cir. 1968) (citing *Shapiro v. Rubens*, 166 F.2d 569, 666 (7th Cir. 1948)).

306. *Whitney v. Dresser*, 200 U.S. 532, 535 (1906); *In re G-I Holdings, Inc.*, 385 F.3d. 313, 318 (3d Cir. 2004); 1 CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, *FEDERAL EVIDENCE* § 66 (2d ed. 1994).

The mixture of the innocent taxpayer, e.g., Dean Griswold, with the active noncompliant taxpayers will continue to allow taxpayers to misreport their basis.³⁰⁷ Even with a clearly articulated standard, once the taxpayer meets his initial burden of production, the courts are free to make an ad hoc determination.³⁰⁸

One thought to solve the problem would be to shift the burden to the third party providers, e.g., sellers of goods. However, unlike security brokers in the new 1099-B regime, these providers are fragmented. Shifting the record-keeping requirement from the taxpayer to the seller of goods, generally, would be unworkable. Stamp dealers most likely would not be in a position to comply.

One solution, Code § 7491, failed because Congress misconstrued the problem. The attempt to shift the burden to the Service was unsuccessful because taxpayers fell outside of the scope of protection for failure to meet their duties.³⁰⁹ The taxpayer has an issue for a misconstrued standard. This ends up circular, especially for an innocent taxpayer. The proper frame of the question is how we fairly determine the liability of innocent taxpayers while punishing tax gamers.

A. New Preliminary Determination Standard

Courts regularly make preliminary determinations regarding admissibility of evidence when privilege is asserted.³¹⁰ When Federal Rule of Evidence 104(a) controls, the judge follows these basic procedures. First, the judge allows the opposing attorney to both object and conduct voir dire in support of the objection.³¹¹ The voir dire questioning is designed to allow the objecting party to present foundational testimony that may rebut the already proffered foundational testimony. Then, before ruling, the judge considers the testimony submitted by both sides.³¹² The judge is not bound to accept any testimony at face value and, as a general proposition, the

307. See *supra* notes 120-21 and accompanying text (showing that there is no Code requirement that taxpayers keep records and, therefore, a mechanism to ensure accurate reporting is not in place).

308. See *supra* Section II.B (discussing the *Cohan* Rule, which gives courts the ability to assess the Commissioner's position as being arbitrary and excessive and allows courts to make ad hoc determinations).

309. See *supra* notes 219-32 and accompanying text (explaining the effect of I.R.C. § 7491). If the taxpayer fails to meet the § 7491 test, then the burden will still rest with the taxpayer.

310. FED. R. EVID. 104(a).

311. Edward J. Imwinkelried, *Determining Preliminary Facts Under Federal Rule 104*, 45 AM. JUR. TRIALS § 62 (1992).

312. *Id.* at §§ 61-62.

judge evaluates the credibility of the testimony.³¹³ The judge makes a final decision, usually by a preponderance of the evidence standard, about whether the proponent has proven the foundational fact.³¹⁴ If the judge finds that the proponent has failed to meet that burden, the judge sustains the objection. The evidence is excluded and never submitted to the jury.³¹⁵

This Article proposes the following new standard for taxpayers. As is the case currently, absent records, basis in an asset is zero. If there is some evidence, then a preliminary determination would be made to determine if a person is an innocent taxpayer. If it is determined that a taxpayer is an innocent taxpayer, then the court would employ one of the better alternatives to guessing.³¹⁶ If a taxpayer is not determined to be an innocent taxpayer, then the taxpayer's basis is only what he can actually prove.

The new innocent taxpayer determination would be conducted much like a Rule 104(a) hearing. Using Dean Griswold as an example, he would propose that he should be excused from keeping records. The court would conduct a basic hearing allowing all types of testimony. It would be anticipated that the main witness would be the taxpayer. This allows the court to determine what probably happened. It would be up to Dean Griswold to convince the court that he was unable to meet this standard.

The taxpayers who are most likely to succeed in convincing the court would appear to be recipients of property through gift, divorce, or inheritance. The taxpayer who merely stated that it is too difficult to maintain records would no longer be grouped together with innocent taxpayers. The decoupling of these two taxpayers allows heightened compliance with the self-reporting system. From a deterrence model, this new preliminary finding would create a clear zero option. From a norms-model, no longer would there be general empathy for all taxpayers for the duty to accurately report. If the only taxpayers who were subject to the heightened penalties were deviants or protestors, societal acceptance of the position should dissipate.

313. *But see* Edward J. Imwinkelried, *Trial Judges-Gatekeepers or Usurpers? Can the Trial Judge Critically Assess the Admissibility of Expert Testimony Without Invading the Jury's Province to Evaluate the Credibility and Weight of the Testimony?*, 84 MARQ. L. REV. 1 (2000) (proposing some limitations to the judge's ability to evaluate the credibility of testimony offered to lay a Daubert foundation under Rule 104(a)).

314. *See, e.g.*, *United States v. Wilson*, 798 F.2d 509, 512 (1st Cir. 1986); *see also* *Texaco P.R., Inc. v. Dep't of Consumer Affairs*, 60 F.3d 867, 883 (1st Cir. 1995); *United States v. Bay St. Ambulance & Hosp. Rental Serv., Inc.*, 874 F.2d 20, 27 (1st Cir. 1989).

315. When the judge is applying Rule 104(a), the judge acts as a true finder of fact.

316. *See infra* Section III.B (introducing better alternatives to guessing that courts can utilize).

B. Better Alternatives to Guessing

Whether or not a new preliminary standard for the “innocent taxpayer” is adopted, a better system is needed for when the court is faced with making a decision pertaining to the accurate determination of basis. As stated, the current rule is clear. The rule can best be articulated through a basic description of the rules and the shifting burdens (in evidentiary terms).³¹⁷ It appears that the correct standard is that the Service makes either an assessment or a deficiency against the taxpayer.³¹⁸ This assessment cannot be arbitrary or excessive.³¹⁹

At this point, the burden of production shifts to the taxpayer.³²⁰ If the taxpayer cannot produce any evidence, then the taxpayer has failed to meet the burden of production, and the basis should be zero.³²¹ However, if the taxpayer can produce any evidence (even a singular receipt), the scintilla of evidence referred to in the evidentiary literature, then the burden of persuasion shifts to the taxpayer.³²² This burden is under the standard of preponderance of the evidence.³²³

The courts can now bring in the *Cohan* rule to help decide a case wherein there will not be much evidence.³²⁴ The *Cohan* application is important given the historical underpinnings of the basis rules.³²⁵ After all, if there are no requirements that a taxpayer maintain records, to whipsaw them years after the fact seems fundamentally unfair. However, having courts decide the basis arbitrarily also seems unfair.

Once the courts or the Service are faced with a determination of the basis of the taxpayer in an asset, there should be better alternatives than the best-guess method promoted in *Cohan*. The following are alternatives to the *Cohan* estimates the courts are currently applying.

1. *Mark-to-Market Method*

The primary reason we are concerned about basis is because we allow taxpayers to not recognize gain at the end of each year.³²⁶ Historically, we allow the deferral of tax because taxpayers do not have the funds to pay

317. See *supra* Section II.C.

318. See *supra* Section II.C.

319. See *supra* Section II.C.

320. See *supra* Section II.C.

321. See *supra* Section II.C.

322. See *supra* Section II.C.

323. See *supra* Section II.C.

324. See *supra* Section II.B.

325. See *supra* Section II.B.

326. Appreciation is only taxed upon a realization event. *Eisner v. Macomber*, 252 U.S. 189 (1919).

taxes.³²⁷ On paper, taxpayers are wealthier, but without a recognition event, we do not really know what the result of the transaction will be. The mark-to-market method will tax all gains and losses each year.

We have elements of the accrual method taxation through the mark-to-market rules.³²⁸ The investment portfolios subject to those rules have no greater access to cash than individual taxpayers. The benefit of deferral to the individual taxpayers creates distortions in the Code.³²⁹ Haig-Simons advocates believe that both step-up and carryover basis are inimical.³³⁰ Under the Haig and Simons definition of income, this distortion creates an inaccurate accounting of income.³³¹ Different classes of taxpayers are treated differently.

The primary benefit of switching to a mark-to-market method is that we move away from market distortions, especially the locked-in effect.³³² No longer is there a tax motivation for holding investments from year to year. Moreover, no longer are the elderly planning their affairs based on the step-up basis upon death.³³³ Individuals, like Dean Griswold, would not be motivated by keeping their stamp collections until death. Most commentators seem to feel that heirs should not benefit from the income tax deferral, which becomes permanent upon death with the basis step-up.³³⁴ The mark-to-market method eliminates most of the concerns with an unknown basis regime. Basis is calculated each year and easily determined—no more record keeping problems. There is no distortion in holding behavior, tax rates,

327. See Boris A. Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 971 (1967) (Congress adopted the concept that gains should be recognized only through a sale, exchange, or disposition); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113-14 (1986).

328. I.R.C. § 475 (2006); I.R.C. § 1256 (Supp. 2010); see INTERNAL REVENUE SERVICE, TOPIC 429 TRADERS IN SECURITIES (INFORMATION FOR FORM 1040 FILERS), available at <http://www.irs.gov/taxtopics/tc429.html>; see generally Fred B. Brown, "Complete" Accrual Taxation, 33 SAN DIEGO L. REV. 1559, 1562 (1996); Dodge & Soled, *supra* note 12, at 592-93; Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 TAX NOTES 967 (1997); Shakow, *supra* note 327; David A. Weisbach, A Partial Mark-to-Market Tax System, 53 TAX L. REV. 95 (2000).

329. The locked-in effect causes investors to accept a lower before-tax rate of return than they would for new investments, thus leading to an inefficient portfolio selection. See Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991).

330. See Bittker, *supra* note 327, at 971; Shakow, *supra* note 327.

331. ROBERT M. HAIG, THE CONCEPT OF INCOME—ECONOMIC AND LEGAL ASPECTS, IN THE FEDERAL INCOME TAX 7 (R. Haig ed., 1921), reprinted in READINGS IN THE ECONOMICS OF TAXATION 80-81, 207-08 (1959); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 724-25 (1990).

332. Shakow, *supra* note 327, at 1114.

333. Zelenak, *supra* note 23, at 363.

334. See generally Tax Prof email list serve exchange July 13-16, 2010 (on file with author).

or income/estate tax disjunction.³³⁵ Finally, revenues would be greater because the appreciation normally forgiven is now captured.³³⁶

The same benefits for the ease in administration of the mark-to-market method are its downfall. Annual calculations of non-liquid assets would be extremely difficult.³³⁷ The problem is the small business owner or the owner of the 1963 Lincoln Continental in figuring an accurate valuation; although, very few possessions, apart from marketable collectibles, have appreciation. The other main detriment to the accrual method is the historic underpinning of yearly deferral.³³⁸

Immediately, there would be an outcry over the change in the historic approach of our tax system.³³⁹ First, liquidity problems created by this type of system may be severe.³⁴⁰ The initial annual taxpayer compliance costs would be harsh.³⁴¹ Second, we would be abandoning the realization concept imbedded in our Code. This provision prevents hard-to-value assets from being sold prematurely to pay the accruing taxes.³⁴² The doctrinal backlash would make legislative approval difficult.³⁴³

2. Modified Auerbach Method

In 1991, Alan Auerbach³⁴⁴ proposed a solution to deal with the lock-in effect of capital gains while taking into account the outcry resulting from taxing without a realization event. Auerbach proposed that capital gains would be taxed only upon realization, but the capital gains calculation would be grossed up to take into account the interest on the deferral.³⁴⁵

Many versions of this concept have been articulated over time. In 1939, William Vickrey proposed using a system that offsets the locked-in effect by imposing a higher rate of tax on gains held for longer periods of

335. Shakow, *supra* note 327, at 1181-84.

336. Auerbach, *supra* note 329; Fellows, *supra* note 331; and Shakow, *supra* note 327.

337. Auerbach, *supra* note 329, at 168; and Dodge & Soled, *supra* note 12, at 592-93 (arguing that accrual makes sense primarily for liquid publicly tradable assets).

338. *But see* Shakow, *supra* note 327, at 1169-73.

339. Deborah H. Schenk, *An Efficiency Approach To Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 504 (2004).

340. Auerbach, *supra* note 329, at 168-69.

341. *See* Nohel B. Cunningham & Debrah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 346 (1993) (“While practical obstacles to an accrual system remain, it is likely that, in the long run, they can be surmounted.”).

342. Auerbach, *supra* note 329, at 168; Shakow, *supra* note 327, at 1169.

343. *See* Auerbach, *supra* note 329, at 167-78. *But see* Shakow, *supra* note 327, at 1167-70.

344. Auerbach, *supra* note 329, at 167-78.

345. Auerbach, *supra* note 329, at 171; Heckerling, *supra* note 74, at 256.

time.³⁴⁶ This method eliminates both problems associated with basis: (1) the locked-in effect, and (2) the liquidity problems caused by collecting taxes only upon a realization event. Unfortunately, there is a problem with this method in dealing with hard-to-value assets.³⁴⁷ Since these hard-to-value assets do not appreciate in any type of linear or readily ascertainable rate, it becomes administratively difficult to calculate the retrospective tax liability.³⁴⁸ Additionally, this system does not solve the distortions for assets that achieved above normal rates.³⁴⁹

To solve the problems with earlier methods, Auerbach modifies the concept through using public information (the market interest rate) with “the assumption of [an] optimal portfolio choice by investors.”³⁵⁰ Essentially, the only thing that matters is the assumed interest rate taxpayers would be willing to invest. Auerbach takes Vickrey’s system of cumulative averaging and proposes a solution to the weak information on hard-to-value assets.³⁵¹

The Auerbach method as applied to basis has a lot of merit. The main arguments against basis are the locked-in effect, the unfair nature of taxation without a realization event, and the lack of knowledge of basis.³⁵² The Auerbach method solves the problems as to the locked-in effect and the realization effect. However, as applied to basis for lack of knowledge, it is incomplete.

I believe that we could modify the basic premise of this method to solve the lack of basis knowledge issue. Since Auerbach’s theory assumes that taxpayers will act in a market-neutral manner based on an ex post basis, we could input a minimum rate of return to the sale price.³⁵³

346. William Vickrey, *Averaging Income for Income Tax Purposes*, 47 J. POL. ECON. 379, 379-97 (1939); see also Auerbach, *supra* note 329, at 168.

347. Jerry R. Green & Eytan Sheshinski, *Optimal Capital-Gains Taxation under Limited Information*, 86 J. POL. ECON. 1143, 1143-58 (1978).

348. Auerbach, *supra* note 329, at 168.

349. *Id.* (taxpayers under this method would be motivated to game the system through extended holding periods).

350. *Id.* at 169.

351. *Id.* at 177.

352. See, e.g., Johnson, *Elephant in the Parlor*, *supra* note 12, at 1185 (discussing the argument for locked-in effect); Yair Listokin, *Taxation and Liquidity*, 120 YALE L.J. 1682 (2011) (discussion of realization events); Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77, 82 (2011) (discussing the use of market-to-market accounting to avoid deferred gains); Dodge & Soled, *supra* note 12, at 542-44 (discussing that taxpayers fail to keep records and the locked-in effect).

353. *Id.* at 176. It has been argued that the Auerbach method creates a fairness problem because it assumes a gain each year even if there is a loss. See generally David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 29 (2004) [hereinafter Weisbach, *(Non) Taxation*] (“The tax is based on the amount realized less a fictional purchase price which is *always* less than the amount realized. Therefore, the tax imagines that there is *al-*

Rather than have an arbitrary zero basis, we can assume that taxpayers would want to achieve, at minimum, a holding period neutral position. For example, assume that an asset was sold for \$100,000. We would need to know the time the taxpayer last knew the basis.³⁵⁴ Then we would need to calculate the assumed interest rate for which a taxpayer would continue to hold the asset. For example, a taxpayer would hold an asset only if it appreciated at a rate of 7% a year.³⁵⁵ If the taxpayer did not achieve that rate of return, then it would be assumed that the asset would be sold.³⁵⁶

More specifically, one could use a compounding short-term, risk-free rate. This would appear to be more efficient than looking for the long-term, risk-free bond that matches the length of the holding period.³⁵⁷ Furthermore, by using the short-term rate, one avoids the problem of holding periods longer than the length of all available risk-free bonds (often the longest of these is thirty years). Second, rates fluctuate over time, and it is probably most neutral to let the imputed returns ride up and down with changing rates. Finally, by using this method, it is possible to go back to at least the 1920s to find short-term rates, thereby making access to information simple.

To put this in a basic formula, suppose that there are short-term rates of r_1 , r_2 , up through r_{100} , and that the aforementioned rates are the six-month T-Bill rates for every six months of the past fifty years.³⁵⁸ The compounded return one would get in a savings account is the product of $(1+r_1/2)$, $(1+r_2/2)$, all the way up through $(1+r_{100}/2)$.³⁵⁹ After the compounded return number, R , the product of all the factors, the formula will provide how much a dollar would have grown over the holding period. Then the alternative basis can be computed as the value at the time of sale/disposition divided by R .

ways gain on an asset even if there really was a loss. Auerbach himself believed that this presented fairness issues.” Cf. Fellows, supra note 331, at 729 (“This article . . . demonstrates that it produces economic neutrality and fairness among taxpayers, while simplifying the tax system by eliminating the need for provisions designed to reduce deferral advantages or ameliorate the inequities created by the realization-event rule.”).

354. This number, of course, leads to an imperfect result, but in the author’s opinion, a better result than the arbitrary zero-basis.

355. A simple formula would be the AFR rate for years $(\sum t!)/t$.

356. The formula would be a version of a present value formula.

357. One could adjust returns for inflation, but the stated method would adjust the result for only the tax real returns and not inflation. The way to do this would be to adjust the six-month T-Bill rates using, for example, the Consumer Price Index.

358. The basic formulas were created with the help of Professor Thomas Brennan at Northwestern University and are merely present for demonstrative purposes. Any errors in the formulas are the author’s alone.

359. The rate is divided in half because it only applies to a six-month holding period, and one is added because the rates are stated in terms of decimals so one reflects the principal as well as the return on the principal.

There are various downsides to this modified Auerbach method. Generally, the approach taken by the Auerbach method creates equivalence to accrual taxation on an *ex ante* basis.³⁶⁰ The argument is that taxpayers are not able to factor in the taxation until well into the future and not yearly.³⁶¹ More importantly, for the modified Auerbach method to deal with the problem of unknown basis, there are two main limitations. The first is the concept that we are guessing what year a piece of property is being put into service. One of the main components of the formula is a taxpayer, not government, assumption. Second, we are assuming that taxpayers would either retain or dispose of an asset based on a minimum investment return.³⁶²

Assume the taxpayer, as Dean Griswold hypothesizes, does not know the basis of the assets. Furthermore, it would be administratively burdensome to have a system that achieves proper reporting for closely-held assets and hard-to-value assets. This middle ground, then, solves the problem in a manner that is both administratively convenient and fair. Clearly, taxpayers paid more than zero for an asset. Until now, there has not been a reporting duty. This middle ground bridges the gap.

3. Modified Original Issue Discount Approach

When Dean Griswold testified in 1976, the impetus of the problem was the Tax Reform Act of 1976 (TRA of 1976). In that Act, Congress eliminated the estate tax and replaced it with a version of carryover basis.³⁶³ The TRA of 1976 was prompted by the need to finally address the failure of Congress to substantially change the estate and gift tax since the introduction of the marital deduction in 1948.³⁶⁴ Moreover, “[t]he basic structure of the estate and gift taxes ha[d] remained fundamentally unchanged since

360. This approach produces *ex ante* results that are equivalent to a perfect accretion tax but deviates from the *ex post* results that would follow from such a tax. Auerbach, *supra* note 329, at 169, 176; Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. REV. 547, 600-02 (1999). *But see* Weisbach, *(Non) Taxation*, *supra* note 353, at 28-29.

361. Auerbach, *supra* note 329, at 168-69.

362. This also has its limitation given that the Auerbach method locks a taxpayer into a constant return even in loss years. *See* Auerbach, *supra* note 329, at 168-69; Weisbach, *(Non) Taxation*, *supra* note 353, at 28-29. Further, it has been argued that economic development would be hindered by a yearly averaging approach with a capital gains component. Reuben Clark, *The Paradox of Capital Gains: Taxable Income That Ought Not to be Currently Taxed*, in 2 TAX REVISION COMPENDIUM 1243 (1959); Heckerling, *supra* note 74, at 257.

363. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872-77 (1976) (repealed 1980) [hereinafter Former I.R.C. § 1023]. For a detailed discussion of this provision, see THOMAS J. MCGRATH & JONATHAN G. BLATTMACHR, CARRYOVER BASIS UNDER THE 1976 TAX ACT (1977). Dodge & Soled, *supra* note 12, at 541.

364. Representative Albert C. Ullman, Report of the Committee on Ways and Means, H. REP. NO. 94-1380, at 5.

1932.”³⁶⁵ Thus, in reviewing the basic scheme, Congress opened up the discussion to not only modification of the rates, but alternative approaches to taxation.

Estate and gift taxes were instituted to raise revenue.³⁶⁶ The rates were then raised in wartime or periods of economic depression.³⁶⁷ Once the immediate emergency had passed, the estate and gift taxes were lowered or eliminated.³⁶⁸ However, these basic tenets shifted during the 1920s and 1930s amid increasing social concern about unreasonable accumulations of wealth.³⁶⁹ The rates steadily increased until 1941 when the rates went to 77%.³⁷⁰

Despite the high rates that were in effect until the TRA of 1976, the importance of the estate and gift taxes to the federal revenues steadily diminished.³⁷¹ The discussion for the revisions of the TRA of 1976 focused on what combination of income and estate and gift taxes were most appropriate for ensuring the desired degree of progressivity in our tax system. After all, the estate tax should have the limited function of restraining excess accumulation of wealth, not raising additional revenue.³⁷²

Under the TRA of 1976, if an asset had appreciated as of the decedent’s death compared to its original basis, the Service was to apply a formula.³⁷³ This approach was necessary because there was a grandfather date under the statute.³⁷⁴ The 1976 formula used a simple straight-line appreciation assumption.³⁷⁵ At the time, the approach was what was known as a modified original issue discount adjustment.

Original issue discount (“OID”) is a rather simple concept, comparable to compounded interest in a savings account. At its most simple, OID is

365. *An Act to Reform the Tax Laws of the United States: Hearing Before the Committee on Finance on H.R. 10612, 94th Cong. 22, 79 (1976)* (statement of William E. Simon, Secretary of the Treasury).

366. *Id.* at 10.

367. *Id.* at 79-80.

368. *Id.*; see also Curtis Dubay, *The Economic Case Against the Death Tax*, THE HERITAGE FOUNDATION, July 20, 2010, available at <http://www.heritage.org/research/reports/2010/07/the-economic-case-against-the-death-tax>.

369. *Estate and Gift Carryover Basis*, *supra* note 61, at 1 (testimony of Simon).

370. *Id.* at 1 (testimony of Simon) (on estates in excess of \$10,000,000).

371. *Id.* at 2 (testimony of Simon).

372. *Id.* at 3 (testimony of Simon).

373. See I.R.C. § 1023(h)(2)(A)(ii) (before repeal in 1980); see also Joseph M. Dodge, *A Deemed Realization Approach is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 455 (2001).

374. This grandfather date was necessary because Congress wanted a fresh start for taxpayers once the new rules were articulated. See also Dodge, *supra* note 373, at 455.

375. “IRC § 1023(h)(2)(C), (3) (before repeal in 1980) (date-of-death value of tangible personal property discounted back to grandfather date at a rate of 6%; aggregate appreciation in other property, reduced by post-1977 depreciation and depletion, pro-rated back to grandfather date).” Dodge, *supra* note 373, at 454.

the difference between the redemption price of a bond and the issue price. Very simply stated, if you owned a gold watch worth \$2,000 today and it was bought five years ago, the basis under an OID approach would be \$1450.³⁷⁶

Although the OID approach may seem slightly complex, tables are often the simplest way of implementation.³⁷⁷ Commentators have suggested, in the 1976 context, that a

table would cross total holding period (rounded to the nearest full year) against aggregate appreciation to produce the discount rate (computed on an annual basis and rounded off to the nearest one-half of 1%). The second table would be a compound interest table crossing various discount rates against (rounded off) holding periods between the acquisition date and grandfather date. This table would produce a factor that would be multiplied against the acquisition-date value to arrive at the deemed grandfather-date value.³⁷⁸

If the taxpayer attempted to game the system through an initial position of an unknown acquisition date, an arbitrary schedule would be utilized.³⁷⁹ This schedule would punish that taxpayer by assuming a high rate of appreciation (say 10%).³⁸⁰ From a deterrence model, the high rate of appreciation should discourage taxpayers from “losing” the historic basis information.³⁸¹

4. *Most Likely Candidate(s) for Reform*

Ideally, taxpayers would keep basis records for everything. One of the reasons that we do not have a mark-to-market method system currently is that we allow deferral of gains until realization events.³⁸² As a realist, it is understood that taxpayers will not keep these records.

Moreover, there is a real question of whether we should require taxpayers to keep records for potentially de minimis taxation when that requirement is costly, time consuming, and, in general, overburdensome.³⁸³ From a time value of labor perspective, this burden with the lack of enforcement inherently leads to noncompliance.³⁸⁴

Thus, we are left with the quandary of what the default rule should be when taxpayers fail to have adequate records. Because currently there does

376. OID equals the stated redemption price at maturity less the issue price.

377. See Dodge, *supra* note 373, at 455.

378. *Id.*

379. *Id.*

380. *Id.*

381. *Id.* at 456.

382. See *Eisner v. Macomber*, 252 U.S. 189, 190 (1920); Bittker, *supra* note 327, at 971; Shakow, *supra* note 327, at 1113-14.

383. See, e.g., Dodge & Soled, *supra* note 12, at 540-42.

384. See *id.* at 579-80; Zelenak, *supra* note 23, at 390-92.

not appear to be an affirmative obligation on taxpayers to maintain these records, a set of well-defined rules should be in place.³⁸⁵ The solution for the lack of record keeping needs to be reasonably fair (to both the taxpayer and the government) and cannot be strategically exploited.

There are many solutions to this problem, some of which have been discussed here in detail. About half of the proposals presented are not generally alternatives that should be considered solely because of the basis record-keeping problem.³⁸⁶ Obviously, accrual method taxation or treating death as a realization event have, for decades, been considered policy proposals to change the system; the use here is overkill.

It is the author's position that of all the choices, there are two viable alternatives: (1) zero-basis/best guess, or (2) modified Auerbach model. Each alternative has its benefits and detriments. For example, a universal problem with all alternatives is what if a record exists for a singular asset? Does the existence of records trump the default rule? Should the rule be opt-in?

The current alternatives under existing law are zero-basis and best guess.³⁸⁷ As discussed herein, zero-basis seems too harsh to the taxpayer and unfair given the lack of a clear record-keeping requirement. However, the taxpayer's best guess model invites gaming. One could only imagine giving taxpayers the option of picking between actual basis versus their best higher guess. For example, suppose a taxpayer decides to only keep track of basis, or does so only after understanding they needed to, if it will generate a better result than by taking the best guess approach. Essentially, under current law, outside of the new 1099 rules,³⁸⁸ taxpayers are left with two extremes that are not fair to the counterparty and not attractive from a policy perspective.

That leaves us with the modified Auerbach model as the best-fit solution to deal with this problem. Basis has the following problems: (a) accuracy of record keeping,³⁸⁹ (b) administrative costs,³⁹⁰ (c) game-playing,³⁹¹ (d)

385. See Dodge & Soled, *supra* note 12, at 544-47.

386. It is unlikely that policy proposals, e.g., making death a realization event or annual accrual taxation, will be adopted. These proposals advocated for a change in the system more than just a solution to the limited problem of basis reporting. Therefore, it is not likely that they would be adopted solely on the basis record-keeping problem.

387. See Johnson, *Elephant in the Parlor*, *supra* note 11, at 1181; Dodge & Soled, *supra* note 12, at 566.

388. See *supra* notes 62-68.

389. See *supra* Section III.A.; Dodge & Soled, *supra* note 12, at 565-66.

390. See *supra* Section III.A.; Zelenak, *supra* note 23, at 392.

391. See *supra* Section III.A.; Dodge & Soled, *supra* note 12, at 565-66; and Zelenak, *supra* note 23, at 392.

taxpayer burden,³⁹² and (e) fairness. The modified Auerbach model appears to bridge these gaps.

Under the Auerbach method, administrative costs are low because it is merely a formulaic exercise. One would simply input the current value in the formula with an IRS-assumed growth rate, similar to Code § 7520 rate.³⁹³ The result is the basis. The taxpayer's burden goes down severely, and accurate records are no longer required. This solution appears to best balance the taxpayer's and the government's needs.

The primary downside to the Auerbach method is the need for the time component of the formula. The lack of accurate records leaves the time value up to the best guess of the taxpayer. This does invite gaming and potentially inequitable results.

In basic economics classes, a fair business deal is often defined as a situation when both sides are dissatisfied with the result. Using this approach, neither the taxpayer nor the government is completely happy. At times, the taxpayer likely will be receiving a basis lower than if he had kept records. Conversely, the government will be left to accept the taxpayer's assertions for time of ownership, which may skew results in the taxpayer's favor. Overall, the downside is not as severe as any of the current options.

CONCLUSION

Although the zero-basis position is an easy position to articulate and enforce, it is an incomplete position. In fact, there is no statutory rule providing that without substantiation the basis should be zero. There is no binding authority on the Service to allow this type of loose interpretation of the record-keeping requirement, as evidenced by the application of the zero-basis rule for tax protestors.

As stated, one additional problem with the implementation of the *Cohan* rule is that it causes noncompliance. The lack of an articulated standard and a clear burden shifting regime encourages taxpayers to fail to self-report. Whether one believes in a deterrence model or a norms-model, neither can be satisfactorily applied to compel taxpayers to accurately self-report. The cascading penalties for failure to comply are inadequate for a

392. See *supra* Section III.A.; Burke & McCouch, *supra* note 58, at 202-06; Dodge & Soled, *supra* note 12, at 544-65; Zelenak, *supra* note 23, at 388-91.

393. Pursuant to I.R.C. § 7520, the interest rate for a particular month is the rate that is 120% of the applicable federal midterm rate (compounded annually) for the month in which the valuation date falls. That rate is then rounded to the nearest two-tenths of one percent. For example, the rate that is 120% of the applicable federal rate (compounded annually) for January 2011 is 2.34%. That rate is then rounded to the nearest two-tenths of one percent or 2.4% for purposes of I.R.C. § 7520, available at <http://www.irs.gov/businesses/small/article/0,,id=112482,00.html>.

self-reporting system. Therefore, from a policy perspective, it is necessary to create a workable backstop when the records do not exist.

The first part of the new method would be a determination of eligible taxpayers. This would be done through an “innocent taxpayer” determination. If the taxpayer met that standard, or if that new proposed standard is not adopted, then a predictable model would be employed rather than a court’s “best guess.” For basis situations, the best backstop appears to be applying the modified Auerbach model to assets when records do not exist.