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Strict Liability and Tax Penalties

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STRICT LIABILITY AND TAX PENALTIES

WILLIAM A. DRENNAN*

*Only the little people pay taxes.***

*Tax evaders [are] stealing from their fellow citizens. The more successfully they escape what they owe, the more the rest of us have to pay.****

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** Claire A. Hill, *Tax Lawyers Are People Too*, 26 VA. TAX REV. 1065, 1068 (2007) (quoting real estate magnate Leona Helmsley). At death, analysts estimated Leona Helmsley's estate at \$8 billion. Ray D. Madoff, Op-Ed, *Dog Eat Your Taxes?*, N.Y. TIMES, July 9, 2008, at A23.

*** Jeffrey L. Yablon, *As Certain as Death—Quotations About Taxes*, 110 TAX NOTES 103, 159 (2006) (quoting Elliot L. Richardson, a former United States prosecutor).

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Introduction

Taxpayers who fail to pay their fair share cause each honest taxpayer to pay on average over \$2000 extra in federal income taxes every year.¹ This extra burden falls primarily on the working class and the poor, who must pay the amount required by law because of withholding, information reporting, and other restrictions.

This Article asserts that the current monetary penalty system fails to curb tax dodging because it is a fault-based, negligence style system, and any fault-based system would fail because of systemic features of our federal income tax. This Article proposes a new strict liability style penalty system, tempered by a graduated penalty rate and an exception for any nonfrivolous tax position conspicuously disclosed.

An example demonstrates the failure of the current system. Texas Furniture King Ed Robinson won a multi-million dollar jury verdict in connection with a business deal.² The jury award stated that approximately three percent was

1. The IRS estimates the difference between what taxpayers *should* pay and what they *actually* pay at \$345 billion annually. I.R.S. News Release IR 2007-137 (Aug. 2, 2007) (amount for the year 2001), *available at* 2007 WL 2200669. Based on approximately 170 million federal income tax returns annually, each taxpayer pays an extra \$2000 each year (\$345 billion/\$170 million = \$2029). *See* MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 15 (2008); *see also* IRS 2002 Data Book, Oct. 1, 2001-Sept. 30, 2002, at 18 (Table 2, line 1), *available at* <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=136474,00.html> (179,631,000 total income tax returns filed in calendar year 2001, including 5491 corporate returns, 3868 estate and trust returns, and 2134 partnership returns).

2. Ed Robinson opened the “largest furniture showroom in South Texas,” but when the venture did not go as planned, he sued his bankers. *Robinson v. Comm’r*, 102 T.C. 116, 118 (1994), *aff’d in part, rev’d in part*, 70 F.3d 34 (5th Cir. 1995), *cert. denied* 519 U.S. 824 (1996). The jury awarded approximately \$60 million in damages in response to Robinson’s argument that the bank failed to release a lien after he repaid the debt secured by the lien. *Id.* at 121.

for mental anguish, and at the time, damages received for mental anguish were tax-free.³ The jury concluded that the remaining ninety-seven percent was for lost profits and punitive damages, which are taxable to the recipient.⁴

With an appeal pending, in lieu of the jury award, the Texas Furniture King agreed to accept ten million dollars in settlement, as long as he could allocate the damages.⁵ In the settlement, the Texas Furniture King basically flipped the jury's allocation.⁶ He allocated ninety-five percent to tax-free mental anguish damages and only five percent to taxable damages.⁷ On his federal income tax return, the Texas Furniture King reported only five percent of the damages as taxable.⁸

The IRS happened to audit, and the auditor spotted the issue. At trial, the Texas Furniture King's attorney said that the tax return was merely a "starting point . . . to negotiate with the [IRS] . . ." Although the IRS, the Tax Court, and the Fifth Circuit all concluded that the Texas Furniture King's tax position was bogus,¹⁰ the Texas Furniture King was not liable for any tax penalties.¹¹

3. *Robinson* involved the 1987 and 1988 tax years. *Id.* at 117. In 1987, a taxpayer could exclude damages for "personal injuries," including damages for mental anguish, from gross income. See I.R.C. § 104(a)(2) (pre-1996); *Fabry v. Comm'r*, 223 F.3d 1261, 1270-71 (11th Cir. 2000) (involving damages received in 1992). After 1996, the exclusion is only available for damages from "personal *physical* injuries." I.R.C. § 104(a)(2) (2008) (emphasis added).

4. The origin and nature of the claim determines whether damages received are taxable. See *Hort v. Comm'r*, 313 U.S. 28, 30-31 (1941).

5. *Robinson*, 102 T.C. at 123. The defendant, a bank, agreed because it could deduct all amounts paid as ordinary and necessary business expenses, including the punitive damages, regardless of the allocation. See I.R.C. § 162(a) (2008); Rev. Rul. 80-211, 1980-2 C.B. 57 (stating that a taxpayer can deduct punitive damages for fraudulent acts if the fraudulent acts were "perpetuated in the ordinary conduct of its business activities"). In *Robinson*, the bank agreed to "work with [Robinson] on the allocation . . . to minimize [his] Federal income tax liability." *Robinson*, 102 T.C. at 123. The Tax Court noted that the "Bank . . . did not care about the manner of allocation." *Id.*

6. *Id.* *Robinson* set out the allocation in the judgment order, which was "simply 'rubber stamped'" by the trial judge. *Robinson v. Comm'r*, 70 F.3d 34, 38 (5th Cir. 1995).

7. *Robinson*, 102 T.C. at 123.

8. *Id.* at 124.

9. *Id.*

10. *Robinson*, 102 T.C. 116; *Robinson*, 70 F.3d 34 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996). The IRS and the courts concluded that the tax consequences must follow the economic substance, as reflected by the jury's allocation. *Robinson*, 102 T.C. at 134-36; *Robinson*, 70 F.3d at 38. The Tax Court found that "[Robinson] deliberately and unilaterally arrived at the allocations . . . solely with a view to Federal income taxes, and not to reflect the realities of their settlement," and concluded that "this Court will not blindly accept the terms contained in a settlement agreement, especially when the circumstances behind the agreement indicate that the allocation . . . was uncontested, non-adversarial, and entirely tax-motivated." *Robinson*, 102 T.C. at 129. The Fifth Circuit affirmed that analysis. *Robinson*, 70 F.3d at 38.

11. Neither the Tax Court opinion, nor the Fifth Circuit opinion, indicates that the IRS

The Texas Furniture King likely incurred no economic detriment for claiming this outrageously aggressive tax position, except for attorneys' fees to fight the IRS,¹² and he could have dodged millions in taxes if the IRS had not audited or if the auditor had missed the issue. Likewise, under current law, any other taxpayer who underpays taxes, is caught on audit, but is not penalized, may incur little or no economic detriment for filing falsely.¹³

Part I of this Article posits that unlike the working class and the poor, wealthy taxpayers often have the opportunity to take aggressive tax positions.¹⁴ Often the economic transactions of the wealthy are not subject to withholding or information reporting, and their transactions are more likely to have uncertain tax consequences. Because the IRS annually audits less than three percent of all taxpayers with income in excess of \$200,000,¹⁵ there is a ninety-seven percent chance that the IRS will never challenge a rich taxpayer's aggressive position.¹⁶

Part II asserts that our current tax penalty system is fault based because a taxpayer generally can escape penalties if the taxpayer's position had at least a twenty percent chance of success, or the taxpayer relied on a tax advisor, or the taxpayer filed in good faith. In practice, this encourages the rich to pay

asserted a penalty.

12. Robinson likely earned investment income on his tax underpayment at a rate at least equal to the rate of interest charged by the IRS on tax underpayments. *See infra* note 13.

13. Although a taxpayer must pay interest on a tax underpayment from the due date, I.R.C. § 6601(a) (2008), a taxpayer can earn interest income on the amount saved from underpaying taxes, *see, e.g.*, John Herbert Roth, *The Disparate Treatment of Nonqualified Preferred Stock: Yet Another Tax Classification Nightmare*, 32 CUMB.L. REV. 605, 614 (2001-2002) ("[S]he can reinvest those deferred tax payments in an interest bearing investment, *i.e.*, the time value of money effect."). For example, during 2007, an individual who earned in excess of eight percent on invested funds (compounded daily) would have profited from underpaying income taxes. Each of the Revenue Rulings regarding the interest rate on tax underpayments for the four calendar quarters in 2007 stated that the rate was eight percent (compounded daily). Rev. Rul. 2006-63, 2006-52 I.R.B. 1143; Rev. Rul. 2007-16, 2007-13 I.R.B. 807; Rev. Rul. 2007-39, 2007-26 I.R.B. 1449; Rev. Rul. 2007-56, 2007-39 I.R.B. 668.

14. An "'aggressive' tax position" has a "low probability of success on the merits." Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 263 (2007).

15. The IRS audited 2.87% of the federal income tax returns for individuals with an income of \$200,000 or higher in fiscal year 2007. IRS, *IRS Announces Consistent Progress in Services and Enforcement: IRS Fiscal Year 2007 Enforcement and Services Results*, TAX NOTES TODAY, Jan. 17, 2008, at 3 [hereinafter *2007 Enforcement and Services Results*], available at LEXSTAT 2008 TNT 13-10.

16. "Under government rules, tax returns are accepted as filed unless the IRS audits and then challenges a return." DAVID CAY JOHNSTON, *FREE LUNCH: HOW THE WEALTHIEST AMERICANS ENRICH THEMSELVES AT GOVERNMENT EXPENSE (AND STICK YOU WITH THE BILL)* 83 (2007).

less than their fair share. Signs indicate that the government seldom imposes tax penalties, and tax dodging is rampant.¹⁷ As an example, even in an especially active year, the IRS only imposed the negligence penalty against one of every 217,391 individual taxpayers, and only against one of every 2076 individuals audited.¹⁸

Part III explains that scholars are divided into two camps and have not proposed a comprehensive, viable monetary penalty system.¹⁹ On the one hand, scholars who emphasize that economic considerations motivate taxpayer behavior tend to propose outrageously high monetary penalties that would be politically unfeasible for the government to enact or enforce.²⁰ On the other hand, scholars who emphasize that norms²¹—such as the desire to contribute to the common good—control taxpayer behavior, tend to ignore monetary penalties or maintain that any strengthening of monetary penalties will exacerbate tax dodging.²²

17. See *infra* Parts II.B, II.C.

18. See *infra* note 81 and accompanying text.

19. Substantial legal scholarship emphasizes the importance of norms in influencing taxpayer behavior. See, e.g., Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367, 368-69 (2002) [hereinafter Kahan, *Signaling or Reciprocating?*] (“When [people] perceive that other individuals are voluntarily contributing to public goods [by paying taxes], most individuals are moved by honor, generosity, and like dispositions to do the same.”); Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U.L. REV. 333, 340-44 (2001); Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599, 602-03 (2007) (“The key to [explaining taxpayer behavior] is ‘tax morale,’ the collective name for all the non-rational factors and motivations—such as social norms, personal values and various cognitive processes—that strongly affect an individual’s voluntary compliance with laws.”); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1789 (2000) (emphasizing the importance of social norms in tax compliance, particularly a taxpayer’s fear of being stigmatized as a “bad type” for failing to pay his or her fair share of taxes); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 601 (2007) [hereinafter Raskolnikov, *Costs of Norms*] (considering the “darker side of social norms,” including tacit understandings that allow or encourage tax avoidance).

Other scholarly articles emphasize economic motivations. See James Andreoni, Brian Erard & Jonathon Feinstein, *Tax Compliance*, 36 J. ECON. LITERATURE 818 (1998); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003); Logue, *supra* note 14; Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569 (2006) [hereinafter Raskolnikov, *Crime and Punishment*]; see also *id.* at 576-77 (listing other economic literature).

20. See Lederman, *supra* note 19, at 1465 (“[E]conomic models of tax compliance . . . counsel extremely high sanctions”); *id.* (“[A]n audit rate of 1 percent would require a \$99,000 penalty [for a \$1000 error]”); Logue, *supra* note 14, at 268.

21. Norms are “[i]nformal, legally unenforceable rules of behavior.” Raskolnikov, *Cost of Norms*, *supra* note 19, at 601.

22. See, e.g., Kahan, *Signaling or Reciprocating?*, *supra* note 19, at 377; see also Robert

Part III then challenges the essential foundation of the current penalty system by considering whether the government should design tax penalties on concepts of fault as in a negligence system, or on a strict liability basis, and reaches a novel conclusion. Because of the complexity of the federal income tax, the low risk of audit, and other features, this Article asserts that *any* fault-based monetary penalty system will fail. As evidence, this Article explores the largely ignored tendency of judges to disregard specific statutory or regulatory directions to estimate the odds of success for a disputed tax position and instead to create new judicial doctrines that excuse taxpayer failures whenever the tax issue is novel or otherwise uncertain.

As a result, Part IV proposes a new strict liability style penalty system, featuring a false-filing-without-disclosure penalty. Although this proposal presumes that some taxpayers, at least in part, are motivated by economic considerations, it also acknowledges the importance of norms. Specifically, this Article asserts that by drawing on both normative and economic factors, a monetary penalty at a reasonable rate, such as twenty-five percent, can influence taxpayer behavior.

Part IV also introduces features of the proposal that avoid the harshness that would result from a pure strict liability approach. For example, a taxpayer who genuinely desires to file accurately but faces uncertainty could disclose the uncertainty in detail, on a separate form, when filing the tax return. While this likely would ensure an IRS audit, in exchange the taxpayer would be immune from penalties as long as the position was not frivolous. Also, the proposal includes a graduated penalty rate. Tax underpayments up to \$5000 would only be subject to a maximum five percent penalty, and any tax underpayments from \$5000 to \$10,000 would only be subject to a maximum ten percent penalty. Current law imposes a flat twenty percent penalty.²³

Part V anticipates potential challenges, and possible adjustments. Appendix A provides a proposed statute for the new false-filing-without-disclosure penalty.

I. The Current System Allows and Encourages the Rich to File Aggressively

Self-assessment, complexity, and the audit lottery all allow the wealthy to file aggressively, not accurately.²⁴

J. Wood, *Accuracy-Related Penalties: A Question of Values*, 76 IOWA L. REV. 309, 322 (1991).

23. I.R.C. § 6662(a) (2008).

24. This Article considers aggressive tax filing, not fraudulent or criminal tax behavior. See *infra* Part II. When a taxpayer's behavior crosses the line from negligent to fraudulent, the penalties are more severe. A taxpayer guilty of civil fraud is subject to a penalty of seventy-five

A. Self-Assessment

Our tax system often allows the rich to be on the honor system.²⁵ Courts and commentators customarily state that the federal income tax is self-assessed.²⁶ The government leaves it to each taxpayer to file a complete and accurate tax return.²⁷

For the vast majority of the working class and the poor, however, self-assessment is a myth. On the income side, wages are subject to withholding,²⁸ which requires the employer to deduct the taxes and pay the IRS before the worker has a chance to file an annual income tax return. Also, interest, dividends, and proceeds from the sale of property are subject to information-reporting rules, which require the payer to send the IRS a Form 1099 stating the amount the taxpayer received before the taxpayer has a chance to file a tax return.²⁹ If the worker or recipient fails to report part or all of the wages,

percent of the tax underpayment. *Id.* § 6663(a). “[F]raud mean[s] an actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing.” *Mitchell v. Comm’r*, 118 F.2d 308, 310 (5th Cir. 1941), *quoted in* MICHAEL I. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶7B.02[3], at 7B-17 (2d ed. 2004). In addition, there are several criminal penalties for tax violations. *See, e.g.*, I.R.C. § 7201 (tax evasion is a felony, punishable by up to five years in prison and a fine of \$100,000).

25. For example, taxpayers receiving cash for selling goods or providing services are usually on the honor system. Technically, the tax law requires any person engaged in a trade or business that pays over \$600 in rent, compensation, or other income to file an information return (Form 1099) to report the payment to the IRS. I.R.C. § 6041(a). However, for cash payments, this rule likely is breached more than followed, in part because the penalty for a failure to file an information return (Form 1099) is only \$50. *See* I.R.C. § 6721(a)(1). The IRS reports that sole proprietors who operate on a cash basis pay tax on less than twenty percent of their income. *See infra* note 103-04 and accompanying text. Barter exchange transactions, many offshore transactions, and various other arrangements provide similar opportunities. *See* Rev. Rul. 79-24, 1979-1 C.B. 60 (barter exchange); *infra* note 111 (offshore transactions); *infra* notes 105-07 (other tax shelters).

26. “Our complex and comprehensive system of federal taxation, relying as it does upon self-assessment and reporting, demands that all taxpayers be forthright in the disclosure of relevant information to the taxing authorities.” *United States v. Arthur Young & Co.*, 465 U.S. 805, 815 (1984); *see* *Couch v. United States*, 409 U.S. 322, 335 (1973); *Helvering v. Mitchell*, 303 U.S. 391, 399 (1938); *see also* Richard Lavoie, *Analyzing the Schizoid Agency: Achieving the Proper Balance in Enforcing the Internal Revenue Code*, 23 *AKRON TAX J.* 1, 3 (2008).

27. I.R.C. § 6012(a)(1)(A); Treas. Reg. § 1.461-1(a)(3) (1999).

28. I.R.C. § 3402(a)(1).

29. *Id.* § 6042 (requiring information reporting on dividends); *id.* § 6049 (information reporting on interest payments); *id.* § 6045 (information reporting on sales by brokers, including real estate transactions).

interest, dividends or sale proceeds on the tax return, the government's computer-matching program will promptly send a bill for the tax deficiency.³⁰

On the deduction side, the working class and the poor have little discretion in claiming deductions because of documentation requirements³¹ and the standard deduction.³² A taxpayer who claims the standard deduction cannot claim any itemized deductions,³³ and over eighty-two percent of taxpayers with adjusted gross income below \$50,000 use the standard deduction.³⁴

Frequently the wealthy can influence whether the payer files an information return (Form 1099)³⁵ and the amount reported. On the deduction side, "over [ninety-three] percent of [taxpayers] with an [adjusted gross income] greater than \$200,000 itemized."³⁶ "[S]tatistics indicate that itemizers engage in significantly more [tax] evasion than nonitemizers."³⁷ In addition, third-party reporting or stringent documentation requirements do not apply to many of the

30. SALTZMAN, *supra* note 24, ¶ 8.04[3], at 8-21 ("The [IRS] matches the information returns (e.g., Forms W-2 and 1099) of some individual taxpayers with their income tax returns to detect nonfiling or underreporting of income."); *see also* Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 698 n.13 (discussing the "dramatic effectiveness of withholding and information reporting in obtaining compliance by payees . . ."); Raskolnikov, *Crime and Punishment*, *supra* note 19, at 577 n.33 ("Withholding and reporting increase the probability of detection . . . to almost 100% . . .").

31. "Information reporting severely limits the scope for tax evasion on many significant income and deduction items . . ." Andreoni et al., *supra* note 19, at 821. For example, the government strictly regulates the amount of home mortgage interest that may be deducted because any bank or other financial institution receiving at least \$600 of mortgage interest on any one mortgage in a calendar year must report the amount to the IRS on Form 1098. I.R.C. § 6050H(a); *see also id.* § 170(f)(17) (documentation requirements for charitable contributions).

32. I.R.C. § 63(c). In 2009, the standard deduction for a married couple filing jointly is \$11,400. Rev. Proc. 2008-66, § 3.10, 2008-45 I.R.B. 1107. The amount for a single individual, or a married person filing separately, is \$5700; for a head of household the amount is \$8350. *Id.*

33. I.R.C. § 63(c). An individual who claims the standard deduction merely deducts a fixed amount, *see supra* note 32, rather than deducting state and local taxes, home mortgage interest, charitable contributions, employee work expenses, and other itemized deductions.

34. Gerald Prante, *Most Americans Don't Itemize on Their Tax Returns*, FISCALFACTS (Tax Foundation), July 23, 2007, <http://www.taxfoundation.org/research/show/22499.html> (only 17.92% itemize deductions).

35. The penalty for failing to file an information return is only \$50. I.R.C. § 6721(a)(1); *see supra* note 25. However, a decision not to file may greatly assist an owner, director, important supplier, or other insider trying to dodge a tax liability. *See* Lederman, *supra* note 30, at 737 ("Transacting with a familiar party is . . . a red flag that . . . the parties might not be acting independently . . . and . . . that the government cannot free ride on their independence . . .").

36. Prante, *supra* note 34, at 4 (93.34% itemize deductions).

37. Andreoni et al., *supra* note 19, at 821.

tax deductions claimed by the wealthy.³⁸ As a result, wealthy taxpayers can truly self-assess, and in some cases choose not to pay the correct amount of tax.³⁹

B. Complexity

Another fundamental feature of the U.S. income tax is complexity.⁴⁰ The U.S. income tax is complex for several structural reasons that have been explored in previous authorities.⁴¹

38. Record-keeping requirements apply to travel, transportation, entertainment, meals, and lodging expenses. See I.R.C. §§ 274, 280F. In contrast, taxpayers may simply estimate and deduct the amount of other expenses incurred in carrying on a trade or business. I.R.C. § 162(a) (allowing a deduction for business expenses); *Cohan v. Comm'r*, 11 B.T.A. 743, 761 (1928), *aff'd and rev'd*, 39 F.2d 540, 544-45 (2d Cir. 1930); see Ira B. Stechel, *Travel and Transportation Expenses – Deduction and Recordkeeping Requirements*, 519-2nd Tax Mgmt. (BNA) A-4 (“*Cohan v. Comr.* . . . allowed a court to approximate the amount of deductible expenses incurred by a taxpayer . . .”).

39. See *infra* Part II.C.2.

40. Justice Learned Hand said

In my own case the words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, [purpose] . . .

Learned Hand, *Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947), *quoted in* Jeffrey L. Yablon, *As Certain as Death—Quotations About Taxes*, 110 TAX NOTES 103, 111 (2006). Albert Einstein said, “[T]he hardest thing in the world to understand is the income tax.” *Murphy v. IRS*, 460 F.3d 79, 92 (D.C. Cir. 2006) (citation omitted), *vacated* 2006 WL 4005276, *quoted in* Yablon, *supra*, at 108.

41. Commentators frequently identify three causes of complexity. First, the income tax attempts to measure the success of economic transactions, and the economic transactions of wealthy individuals in the United States can be very complex. Logue, *supra* note 14, at 249.

Second, Congress seeks to achieve many social policy goals through tax incentives, regardless of whether those tax incentives are consistent with sound tax policy. *Id.*; see also GRAETZ, *supra* note 1, at xi (“[O]ur current income tax is a mess because politicians ask it to do too much Presidents and members of Congress . . . seem to believe that an income tax credit or deduction is the best prescription for every economic and social problem our nation faces.”).

Third, Congress and the Treasury Department adopt many tax laws to close tax loopholes or to address tax-saving transactions created by taxpayers that have no economic substance. “[The tax planner’s] cat-and-mouse game is to work the loopholes in the system until the government finds them and draws them closed.” David Cay Johnston, *The Loophole Artist*, N.Y. TIMES, Dec. 21, 2003, at SM18; see also Logue, *supra* note 14, at 248-51.

The wealthy tend to engage in more complex economic transactions, which can involve uncertain tax results and again allow more discretion in filing.⁴² In contrast, the tax rules encountered by the working class and the poor tend to be simpler and difficult to avoid.⁴³

C. Audit Lottery

The risk that the IRS will audit a particular taxpayer is small.⁴⁴ Over ninety-nine percent of all individual income tax returns escape audit.⁴⁵ The IRS audits less than three percent of all returns filed by taxpayers with income in excess of \$200,000.⁴⁶ “[T]he vast majority of people who fudge[] on their taxes, or flat-out cheat[] . . . [get] away with it.”⁴⁷

The low risk of audit provides taxpayers, like the Texas Furniture King, an opportunity to use their tax returns as a mere first offer. Under standard negotiating practices, when one party makes a first offer, that first offer is substantially less generous than what the party will submit as a “best and final offer” after extensive negotiations.⁴⁸ One reason is that the other side may simply choose not to negotiate and will accept the first offer. That is precisely

42. The tax rules tend to clearly define a taxpayer’s obligations for routine transactions, such as performing services in exchange for compensation. I.R.C. § 61(a)(1).

43. Although the tax rules are clearer, preparing the tax return can be time consuming. The average taxpayer devotes 26.4 hours annually in connection with tax compliance and filing. See IRS, 1040 INSTRUCTIONS 2008, at 89, available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

44. This Article assumes that IRS audit activity will remain relatively constant. See *infra* note 44 and accompanying text. Arguments could be made to increase the audit rate. The IRS collects approximately \$6 for every \$1 it spends on enforcement. Andreoni et al., *supra* note 19, at 822. The IRS funding level, however, is very political. See Lederman, *supra* note 19, at 1456 (“Since the late 1990s, the political climate for the IRS generally has been one in which hard enforcement is disfavored.”); Raskolnikov, *Crime and Punishment*, *supra* note 19, at 596 (“[R]esource constraints, political pressures, and general fiscal difficulties that are likely to persist well into the future make a substantial increase in the probability of detection somewhat unrealistic.”).

45. The IRS audits 0.9% of all tax returns filed. IRS, DATA BOOK 2007, OCT. 1, 2006 – SEPT. 30, 2007, at 23 (2008), available at <http://www.irs.gov/pub/irs-soi/07databkrevise.pdf>.

46. The IRS audits 2.87% of tax returns reporting income in excess of \$200,000. See 2007 *Enforcement and Services Results*, *supra* note 15.

47. JOHNSTON, *supra* note 16, at 84.

48. In most situations,

[p]articipants in exchange bargaining (that is, where one side’s gain is the other’s loss) do not expect the first offer to be the final offer Therefore, unless you are operating in the exceptional setting in which the parties expect the best offer first, it is counterproductive to make an offer intended for acceptance until there has been an exchange of at least a few progressively more attractive proposals.

ALVIN L. GOLDMAN, *SETTLING FOR MORE: MASTERING NEGOTIATING STRATEGIES AND TECHNIQUES* 200 (1991).

what happens when the IRS fails to audit a tax return, and ninety-seven percent of the time, the IRS fails to audit the rich.⁴⁹

D. Distributive Justice Problem

The federal income tax raises revenue to finance public goods, such as national defense and the public highway system.⁵⁰ Because the government seeks a certain dollar amount in taxes, if one group pays less, another group must pay more.⁵¹ If the rich pay less than their fair share, the working class and the poor pay more.

II. The Current Fault-Based Penalties Fail to Discourage Aggressive Filing

Although self-assessment, complexity, and the audit lottery provide an opportunity for wealthy taxpayers to avoid paying their fair share, a robust penalty system could counterbalance those forces. A stiff penalty for losing can turn a smart play into a foolish gambit.⁵² Unfortunately, the current fault-based penalty system fails.

A. Our Current System Is Fault Based

Legal sanctions to deter behavior may be fault based, as in a negligence system, or may use strict liability principles.⁵³ In a pure strict liability system, the actor is automatically liable for causing harm. In contrast, in a fault-based system, the actor who causes harm will only be liable if the actor failed to fulfill certain duties, or if certain circumstances were present. Currently, a taxpayer who underpays is *not* automatically liable for a penalty. Instead, the taxpayer generally can avoid the penalty if (i) the tax position had at least a

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

50. GRAETZ, *supra* note 1, at 3 (“[T]he minimal requirement for a tax system should be that it raises sufficient revenue to pay for government expenditures.”).

51. President John F. Kennedy said, “To the extent that some people are dishonest or careless in their dealings with the government, the majority is forced to carry a heavier tax burden.” Yablon, *supra* note 40, at 160.

52. In contemplating whether to claim a particular tax position, a taxpayer’s decision will consider “the size of the penalty in the event of both detection and rejection.” Logue, *supra* note 14, at 245. Even when the risk of detection is small, a penalty will deter an actor if the penalty is set high enough. See STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 473-79 (2004).

53. SHAVELL, *supra* note 52, at 474.

twenty percent chance of success, (ii) the taxpayer relied on a tax advisor, or (iii) the taxpayer filed in good faith.⁵⁴

1. No Penalty if Taxpayer Had a Twenty Percent Chance of Success

The negligence penalty is the monetary sanction generally applicable for taxpayers claiming aggressive tax positions. Echoing the fault-based theory of liability in tort,⁵⁵ the courts define tax negligence as the failure to do what a reasonable and ordinarily prudent person would do under the circumstances.⁵⁶

Surprisingly, the tax negligence penalty teaches that a prudent taxpayer would claim a tax deduction anytime the taxpayer has at least a twenty percent chance of success.⁵⁷ In effect, in the tax world, you are acting prudently if there is an eighty percent chance that you are wrong. As a result, “a negligence . . . standard places relatively little tension on a taxpayer’s decision to take an aggressive position”⁵⁸ The penalty is a flat twenty percent of

54. See *infra* Part II.A.1-3.

55. See Dennis J. Ventry, Jr., *IRS Penalty Study: A Call for Objective Standards*, 112 TAX NOTES 1183, 1185 (2006) (“[Historically] classic tort theory defined noncompliant behavior. Taxpayers were penalized only if their behavior rose to the level of negligence.”).

56. “The term *negligence* includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.” Treas. Reg. § 1.6662-3(b)(1) (1991). “A return position that has a reasonable basis as defined in [*id.* § 1.6662-3(b)(3)] is not attributable to negligence.” *Id.* The courts define “negligence” for tax purposes as the failure to do what a reasonable and ordinarily prudent person would do under the circumstances. See *Barlow v. Comm’r*, 301 F.3d 714, 723 (6th Cir. 2002); *Howard v. Comm’r*, 931 F.2d 578, 581 (9th Cir. 1991); *Neely v. Comm’r*, 85 T.C. 934, 947 (1985).

57. I.R.C. § 6662(c) (2008). The penalty for “negligence or disregard of rules or regulations” applies when the taxpayer’s position does not have a reasonable basis. Treas. Reg. § 1.6662-3(b). “The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.” *Id.* § 1.6662-3(b)(3). The Congressional Joint Committee on Taxation states that a tax position meets this standard if it has a “20 percent likelihood of success if challenged.” JOINT COMM. ON TAXATION, COMPARISON OF JOINT COMMITTEE STAFF AND TREASURY RECOMMENDATIONS RELATING TO PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 13 (No. JCX-79-99, 1999) [hereinafter JOINT TAX COMMITTEE COMPARISON], available at <http://www.house.gov/jct/x-79-99.pdf>; see also Lavoie, *supra* note 26, at 20 (twenty percent standard); Logue, *supra* note 14, at 255 (twenty percent standard).

58. See *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 100th Cong. 17 (Mar. 31, 1988 and July 28, 1988) [hereinafter *1988 Hearings*] (statement of Dennis E. Ross, Assistant Secretary for Tax Policy), quoted in Dennis J. Ventry Jr., *Vices and Virtues of an Objective Reporting Standard*, 112 TAX NOTES 1085, 1088 n.39 (2006) [hereinafter Ventry, *Vices and Virtues*].

the tax underpayment caused by the negligent position.⁵⁹

Other probabilities of success apply in special situations. For example, the “substantial understatement penalty”⁶⁰ applies when the erroneous tax position triggers a tax underpayment that exceeds ten percent of the total tax required to be shown on the taxpayer’s return.⁶¹ The taxpayer must have had at least a forty percent, rather than a twenty percent, chance of success to avoid the substantial understatement penalty.⁶² This penalty is fault based, in part, because the “[f]ailure to have [at least a forty percent chance of success for a position claimed] should be seen as fault”⁶³

In certain narrowly defined circumstances, the taxpayer must satisfy a fifty percent standard to avoid a penalty.⁶⁴

59. I.R.C. § 6662(a). Thus, if the aggressive tax position caused a \$1000 tax underpayment, the penalty would be \$200.

60. *Id.* § 6662(d)(1); Treas. Reg. § 1.6662-4(b)(1) (1991).

61. Also, the substantial understatement penalty only applies if the tax underpayment exceeds \$5000. I.R.C. § 6662(d)(1)(A).

62. *Id.* § 6662(d)(1)(A). A taxpayer is not subject to the substantial understatement penalty for a tax return position that has “at least a 40 percent likelihood of success if challenged.” JOINT TAX COMMITTEE COMPARISON, *supra* note 57, at 14; *see also* Treas. Reg. § 1.6662-4(d)(3)(I); Lavoie, *supra* note 26, at 20 (forty percent standard); Logue, *supra* note 14, at 254, 291 (forty percent standard).

63. Ventry, *Vices and Virtues*, *supra* note 58, at 1090 (quoting 1988 Hearings, *supra* note 58, at 38 (statement of Dennis E. Ross, Treasury Deputy Assistant Secretary for Tax Policy)). Arguments that the “substantial understatement” penalty is a “no fault” penalty are fallacious. In discussing the substantial understatement penalty, former IRS Commissioner Gibbs pointed out that a taxpayer’s position can be wrong, and the taxpayer can avoid the penalty, and Gibbs concludes, “it is difficult for me to understand how that is no-fault.” *Id.* at 1090 n.53 (quoting 1988 Hearings, *supra* note 58, at 37 (statement of former IRC Commissioner Lawrence Gibbs)). In addition, another former IRS Commissioner stated, “‘No-fault’ . . . was the wrong label to put on [the substantial understatement penalty].” *Id.* at 1090 (quoting 1988 Hearings, *supra* note 58, at 166 (statement of former IRS Commissioner Donald C. Alexander)). Former IRS Commissioner Egger agreed, stating, “Rather, the ‘more accurate description’ . . . ‘would be a penalty on undisclosed aggressive positions that are wrong.’” *Id.* (quoting 1988 Hearings, *supra* note 58, at 153 (statement of former IRS Commissioner Roscoe Egger, Jr.)). Also, the substantial understatement penalty is fault based because a taxpayer will not be liable for the penalty if she filed in good faith. I.R.C. § 6664(c)(1).

64. Two situations require a taxpayer to satisfy a “more likely than not” standard. First, in the case of a “tax shelter,” the penalty will apply unless “the taxpayer reasonably believed that the tax treatment of such item was more likely than not the proper treatment.” I.R.C. § 6662(d)(2)(C)(i)(II); Treas. Reg. § 1.6662-4(g)(1)(i)(B). A “tax shelter” includes “any . . . plan or arrangement, if a significant purpose of such . . . plan[] or arrangement is the avoidance or evasion of Federal income tax.” I.R.C. § 6662(d)(2)(C)(iii). Second, in the case of a reportable transaction, a penalty will not apply if “the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.” *Id.* § 6664(d)(2)(C). In addition, a tax return preparer may be subject to a penalty unless she had a “reasonable belief that the position would

2. No Penalty Because of a “Good Faith” State of Mind

Even if a taxpayer’s position did not have at least a twenty percent chance of success, the taxpayer still will avoid the negligence penalty if the tax return was filed in “good faith” with “reasonable cause.”⁶⁵ The inquiry includes “[a]ll facts and circumstances.”⁶⁶ Thus, to impose the negligence penalty, “the IRS [must] establish the taxpayer’s state of mind, a tricky proposition.”⁶⁷ The regulations expressly provide that “an honest misunderstanding of fact or law” qualifies the taxpayer for penalty immunity.⁶⁸ Indeed, “[r]easonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances.”⁶⁹

3. No Penalty Because of Reliance on a Tax Advisor

Furthermore, a taxpayer is immune from penalties even if the tax position did not have a twenty percent chance of success, as long as the taxpayer “relied in good faith on advice (including the opinion of a professional tax advisor) as to the [tax] treatment.”⁷⁰

This immunity basically is available if the tax advisor performs a thorough job,⁷¹ which often generates a significant fee. As a result, wealthy taxpayers with the opportunity to save substantial taxes by taking aggressive positions can purchase penalty insurance from tax advisors.⁷²

more likely than not be sustained on its merits” *Id.* § 6694(a)(2)(B).

65. *Id.* § 6664(c)(1); Treas. Reg. § 1.6664-4(a) (1991). Also, this exception is available when the substantial understatement penalty otherwise would apply. I.R.C. § 6664(c)(1).

66. Treas. Reg. § 1.6664-4(c)(1).

67. Ventry, *Vices and Virtues*, *supra* note 58, at 1088.

68. Treas. Reg. § 1.6664-4(b)(1).

69. IRS, INTERNAL REVENUE MANUAL § 20.1.1.3.1.2.1 (2008) [hereinafter INTERNAL REVENUE MANUAL], available at http://www.irs.gov/irm/part20/irm_20-001-001.html (other facts and circumstances to consider include “[t]he taxpayer’s education[,] . . . if the taxpayer has been penalized before, . . . [and] [t]he level of complexity of a tax or compliance issue.”).

70. Treas. Reg. § 1.6664-4(c)(1).

71. “[T]he taxpayer must furnish the advisor with all necessary and relevant information to make a determination.” Alan J. Tarr & Pamela J. Drucker, *Civil Tax Penalties*, 634-2nd Tax Mgmt. (BNA) A-157 (citations omitted). The tax advisor must base the advice on “all pertinent facts and circumstances and the law.” Treas. Reg. § 1.6664-4(c)(1)(i). The advisor cannot base the advice on “unreasonable factual or legal assumptions” or an unreasonable representation by the client. *Id.* § 1.6664-4(c)(1)(ii). Also, the advisor must have “knowledge in the relevant aspects of Federal tax law.” *Id.* § 1.6664-4(b)(2) (Example 1); *id.* § 1.6664-4(c)(1). In addition, the advice must set forth the analysis. *Id.* § 1.6664-4(c)(2).

72. An opinion letter from a tax advisor is a “[v]irtual insurance policy against the imposition of penalties” Ventry, *Vices and Virtues*, *supra* note 58, at 1090.

This immunity for reliance on a tax advisor has been crucial for the growth of the tax shelter industry. “The solution [to the risk of civil penalties] has been for the tax shelter promoter to obtain and furnish to the taxpayer . . . an opinion of independent tax counsel”⁷³

4. *The Failure of the Failure-to-Pay Penalty*

In addition to the negligence penalty, the current system includes a failure-to-pay penalty.⁷⁴ Unfortunately, this penalty also fails to deter aggressive behavior. Despite its name, the IRS typically does not impose the failure-to-pay penalty when a taxpayer fails to pay the correct amount of tax.

The failure-to-pay penalty only applies if a taxpayer fails to pay within ten days of receiving an IRS notice demanding payment after all of the taxpayer’s appeal rights have expired.⁷⁵ Thus, a taxpayer can file aggressively; wait to see if the IRS audits; refuse to pay the amount in controversy until all chances of appeal expire, and still avoid the failure-to-pay penalty simply by paying the deficiency within ten days of receiving the IRS’s notice of demand for payment.

Its purpose was to correct an interest rate problem. Congress enacted the penalty in 1969 to discourage taxpayers from taking advantage of the artificially low interest rate charged by the IRS on tax underpayments.⁷⁶ Congress subsequently eliminated the fundamental problem when it provided for a floating interest rate on tax underpayments.⁷⁷ Accordingly, the Congressional Joint Tax Committee recommends the repeal of the current failure-to-pay penalty.⁷⁸

73. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1940-41 (2005).

74. I.R.C. § 6651(a)(2), (3) (2008).

75. *Id.* § 6651(a)(3). If the tax due is less than \$100,000, the payment window is twenty-one days, rather than ten days. *Id.*

76. S. REP. NO. 91-552, at 2336 (1969), reprinted in 1969 U.S.C.A.N. 2027 (“[Because] the current cost of borrowing money is substantially in excess of the [six] percent interest rate provided by the [Internal Revenue Code], it is to the advantage of taxpayers in many cases to file a return on the due date but not to pay the tax”).

77. Today the interest rate is a floating rate set at three percent above a rate periodically established by the federal government. I.R.C. § 6621(a)(2); see also *id.* § 6601(a) (charging interest at the rate in I.R.C. § 6621).

78. JOINT TAX COMMITTEE COMPARISON, *supra* note 57, at 11 (indicating that the interest paid by taxpayers on tax underpayments renders the failure-to-pay penalty unnecessary).

B. Fault-Based Penalties Are Rarely Imposed

Statistics and reported cases demonstrate that the IRS and the courts rarely impose the current fault-based penalties.

1. Statistics Evidencing the Failure to Impose Penalties

Through 2004, the IRS published statistics each year on the number of times it assessed the negligence penalty, and the number of times a court, or the IRS, waived an assessed negligence penalty under the “reasonable cause” exception.⁷⁹ On average, for the seven-year period ending in 2004, the IRS assessed the negligence penalty only 672 times per year, and a court or the IRS waived an assessed negligence penalty 325 times per year.⁸⁰ Even during its most aggressive year during that period, the IRS only imposed the negligence penalty against one out of every 217,391 individual taxpayers who filed a

79. See IRS, SOI Tax Stats – IRS Data Book, <http://www.irs.gov/taxstats/article/0,,id=102174,00.html> (last visited Oct. 19, 2009) [hereinafter IRS, SOI Tax Stats] (tables indicating “Civil Penalties Assessed and Abated, by Type of Penalty and Type of Tax,” for the years 1995 through 2004). The IRS also published statistics on the imposition and waiver of the negligence penalty against corporations. *Id.*

80. The following chart summarizes the statistics (for individual taxpayers) from the IRS Data Books for the fiscal years 1998 through 2004.

<u>Year</u>	(1) <u>Times Negligence Penalty Assessed</u>	(2) <u>Reasonable Cause Waivers</u>	(column 1 minus column 2) <u>Times Negligence Penalty Imposed</u>
2004	395	53	342
2003	425	118	307
2002	576	109	467
2001	548	274	274
2000	642	306	336
1999	656	527	129
1998	1,465	892	573
Total	4,707	2,279	2,428
Avg. Per Year	672	325	347

These statistics are from the IRS Data Book for each year. IRS, SOI Tax Stats, *supra* note 79. In particular, the statistics from 2002 through 2004 are from Table 27, Civil Penalties Assessed and Abated, by Type of Penalty and Type of Tax, for the applicable year. The same table of information was numbered differently for the earlier years. In 2001 and 2000, it was Table 26; in 1999 it was Table 29; in 1998, it was Table 28.

federal income tax return, and the IRS imposed the penalty against only one out of every 2076 individuals audited.⁸¹ These statistics are consistent with similar numbers for 1994 through 1998.⁸² Unfortunately, the IRS does not provide statistics regarding the substantial understatement penalty,⁸³ and the statistics provided after 2004 mix the negligence penalty, the substantial understatement penalty, and several other penalties.⁸⁴

81. The “Times Negligence Penalty Imposed” column below (column (1)) is taken from the chart in *supra* note 80.

Year	(1)	(2)	(3)	(4)	(5)
	Times Negligence Penalty Imposed	Total Indiv Tax Returns Filed (in thousands)	Percentage of Total Tax Returns Penalized (col. 1/col. 2)	Total Tax Returns Audited (in thousands)	Percentage of Audited Returns Penalized (col. 1/col. 4)
2004	342	130,134	.00026%	997	.0343%
2003	307	130,341	.00023%	849	.0362%
2002	467	129,441	.00036%	743	.0628%
2001	274	127,097	.00022%	731	.0375%
2000	336	124,877	.00027%	617	.0544%
1999	129	125,227	.00010%	1,100	.0117%
1998	573	123,000	.00047%	1,192	.04807%
Total	2,428	890,117		6,229	
Avg.	347	127,160	.00027%	890	.0390%

These statistics are from the IRS Data Book for each year. IRS, SOI Tax Stats, *supra* note 79. In particular, the statistics from 2000 through 2004 are from Table 10, Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return. For 1998 and 1999, the same table information is at Table 15.

In the 1998 tax year, the IRS imposed the penalty against approximately one out of every 217,391 taxpayers who filed a return ($1/.000047 = 217,391$), and against approximately one out of every 2076 individuals audited ($1/.000481 = 2,076$).

82. See Richard C. Stark, *A Principled Approach to Collection and Accuracy-Related Penalties*, 91 TAX NOTES 115, 139 (2001) (reporting that if one ignores the times when the penalty is waived for “reasonable cause,” the penalty is assessed against “one for every 1,000 individual returns that the IRS says it looked at and a bit more than one for every 100,000 income tax returns filed”).

83. *But see id.* at 138-39 (indicating that the IRS Data Books for the tax years 1995 through 1998 provided information on the “accuracy penalties” and that separate statistics are not provided for the negligence penalty and the substantial understatement penalty).

84. For example, for 2005, Table 27, titled “Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2005” does not include a separate line for either the negligence penalty or the substantial understatement penalty, but instead includes a single line titled “accuracy.” IRS, SOI Tax Stats, *supra* note 79. Note 1 of that Table provides that the line titled “accuracy” includes “penalties for negligence; substantial understatement of income tax;

2. Courts Create Exceptions That Excuse Taxpayers Faced with Uncertainty

Under current law, judges often refuse to penalize a taxpayer despite IRS arguments to the contrary. A judge required to determine whether a fault-based penalty applies, based on a probability that the taxpayer's position would succeed, must make difficult determinations. First, the judge must evaluate the tax law at two different moments—(i) at the time the taxpayer filed the tax return, and (ii) “on the last day of the taxable year to which the return relates.”⁸⁵ Second, the judge must determine, as of those two moments, the odds that the taxpayer's position would prevail.⁸⁶

The Internal Revenue Code and the Treasury Regulations set out detailed rules to follow in applying certain penalties. As an example, the rules for the substantial understatement penalty include: a list of the types of authorities, including cases and IRS rulings, that may and may not be considered in determining the strength of the taxpayer's position;⁸⁷ rules on how to assign a “weight” to each applicable authority;⁸⁸ rules on how to balance all the applicable authorities in deciding the odds that the taxpayer's position would win;⁸⁹ and if the taxpayer's position did not have at least a forty percent chance of success, how to determine whether the taxpayer acted in “good faith” or had “reasonable cause” for making the mistake.⁹⁰

substantial valuation misstatement; substantial overstatement of pension liabilities; substantial estate or gift tax valuation understatement . . . and understatement of reportable transactions . . .” *Id.* In 1989, Congress consolidated the negligence penalty and four other penalties into a group called the “accuracy-related penalties.” Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 102 Stat. 2106 (1989); I.R.C. § 6662(b) (2008) (setting forth the five accuracy-related penalties).

85. Treas. Reg. § 1.6662-4(d)(3)(iv)(C) (1991).

86. *See supra* note 58 and accompanying text.

87. The Treasury Regulations provide a list of the types of items that a judge may consider as authority. *Id.* § 1.6662-4(d)(3)(iii).

88. The judge determines the “weight” to give to each item of authority based on its “relevance[,] . . . persuasiveness, and the type of document providing the authority,” *id.* § 1.6662-4(d)(3)(ii), and the judge must determine the various weights “in light of the pertinent facts and circumstances,” *id.* § 1.6662-4(d)(3)(i).

89. *Id.*

90. If the judge determines that the taxpayer did not have substantial authority, the judge can still waive the penalty if the taxpayer acted in “good faith” and had “reasonable cause” for taking the tax position. I.R.C. § 6664(c)(1). Taxpayers frequently argue that their reliance on a tax advisor constitutes reasonable cause. *See Tarr & Drucker, supra* note 71, at A-156 to A-158 (discussing several tests that judges may apply to determine if the taxpayer's reliance on a tax advisor constituted reasonable cause for the incorrect tax position).

Although the statute and regulations provide these incredibly detailed rules, in many cases courts abandon any type of structured analysis and create their own standards. While the trend has gone largely unnoticed in the legal scholarship,⁹¹ judges have deftly avoided their role as odds-makers by creating a string of judicial exceptions. The courts have let taxpayers who filed falsely escape the penalty by inventing the following excuses: the transaction was complicated;⁹² the law was unsettled;⁹³ the issue was “novel”;⁹⁴ the taxpayer’s position was not “clearly erroneous”;⁹⁵ the taxpayer’s position was “reasonably debatable”;⁹⁶ and at least five other judicially created excuses.⁹⁷

91. One author wrote, “Out of the hundreds of Tax Court cases involving the substantial authority standard that have been decided since the adoption of the substantial understatement penalty [in 1982], the legal researcher can count on his fingers the cases in which any meaningful consideration is given the application of the standard.” Merrill Glenn Jones II, Note, *Osteen v. Commissioner: In Search of a Workable Test for Substantial Authority in “All or Nothing” Substantial Understatement Penalty Tax Cases*, 31 WAKE FOREST L. REV. 1185, 1206 (1996). That article has not been cited by subsequent scholars (as of June 17, 2009).

92. *Berger v. Comm’r*, 67 T.C.M. (CCH) 3144, 3148 (1994); *Estate of Bradley v. Comm’r*, 74 T.C.M. (CCH) 210, 219 (1977) (stating that no penalties applied because the tax result turned on “complex and inter-related contractual documents”).

93. *Crawford v. Comm’r*, 65 T.C.M. (CCH) 2540, 2552 (1993) (concluding that a penalty should not be imposed on certain adjustments because there was “confusion” about the law); *Unger v. Comm’r*, 58 T.C.M. (CCH) 1157, 1162 (1990), *aff’d* 936 F.2d 1316 (D.C. Cir. 1991). Not surprisingly, the Tax Court has also held that the *negligence* penalty does not apply if the law is unsettled. *See Hummer v. Comm’r*, 56 T.C.M. (CCH) 657, 661 (1988) (“[A]t the time [taxpayer] filed his [tax] return . . . the law was still sufficiently unsettled and uncertain that . . . [the taxpayer], a lay person with no particular tax background or knowledge, cannot be said to have been negligent . . .”); *see also* Tarr & Drucker, *supra* note 71, at A-30.

94. *Booth v. Comm’r*, 108 T.C. 524, 578 (1997) (emphasis added).

95. *Osteen v. Comm’r*, 62 F.3d 356, 358-59 (11th Cir. 1995) (emphasis added). *Osteen* considered whether the taxpayers were engaged in farming and horse breeding operations as a business or as a hobby. *Id.* This is a fact specific tax issue. *Id.* The Eleventh Circuit reversed the Tax Court’s imposition of the substantial understatement penalty. *Id.* at 360. The Eleventh Circuit stated that because the record contained evidence for both the taxpayers’ position and the IRS’s position, “[o]nly if there was a record upon which the Government could obtain a reversal under the *clearly erroneous* standard could it be argued that from an evidentiary standpoint, there was not substantial authority for the taxpayer’s position.” *Id.* at 359 (emphasis added); *see also* *Streber v. Comm’r*, 138 F.3d 216, 223 (5th Cir. 1998) (following *Osteen*).

96. *Williams v. Comm’r*, 123 T.C. 144, 153-54 (2004) (emphasis added).

97. Courts use at least five other judicially created excuses. First, there was “no prior relevant authority contrary to [the taxpayer’s] position,” *Dunnegan v. Comm’r*, 1996-1 U.S. Tax Cas. (CCH) ¶ 50,234, at 83,877 (3d Cir. 1996), and the taxpayer’s position was “arguably supportable,” *id.* at 83,878. Second, the taxpayers “reasonably believed” that their tax treatment was proper. *Wimpie v. Commissioner*, 67 T.C.M. (CCH) 2091, 2096 (1994). Third, the authority was “a somewhat confusing mix” on the issue. *Peerless Indus., Inc. v. Comm’r*, 1994-1 U.S. Tax Cas. (CCH) ¶ 50,043, at 83,175 (D.C. Pa. 1994), *available at* 1994 WL 13837, at *10. Fourth, the taxability turns on the facts, and there were “some factors” supporting the

C. Failure to Deter Aggressive Taxpayer Behavior

This failure of the penalty system contributes importantly to an overall tax compliance crisis, evidenced by the so-called “tax gap” and other signs.⁹⁸ The “tax gap” is the difference between the amount of taxes people should pay, and the amount they actually pay.⁹⁹ The IRS estimates that taxpayers only pay approximately eighty-five percent of the taxes they owe.¹⁰⁰ As the working class and the poor must pay their fair share because of withholding, information reporting, and other structural features, much of the fifteen percent tax gap likely could be traced to the wealthy.¹⁰¹

taxpayer’s position. *Highland Farms, Inc. v. Commissioner*, 106 T.C. 237, 257 (1996) (noting that a key fact was the “intent of the parties”). Fifth, the issue turns on a case-by-case analysis of the facts, including the intent of the taxpayer, and there are “few bright lines to guide taxpayers and tax practitioners.” *Jorgl v. Comm’r*, 79 T.C.M. (CCH) 1318, 1327 (2001), *aff’d per curiam*, 264 F.3d 1145 (11th Cir. 2001).

98. David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 331 (2007) (“Tax shelters have proliferated in the United States [because of several factors, including] . . . the inadequacy of tax penalties . . .”).

99. Press Release, Office of Tax Policy, U.S. Dep’t of the Treasury, A Comprehensive Strategy for Reducing the Tax Gap 5 (Sept. 26, 2006), *available at* <http://www.ustreas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf> [hereinafter Press Release, Office of Tax Policy].

100. I.R.S. Fact Sheet, FS-2005-14 (Mar. 2005), *available at* <http://www.irs.gov/newsroom/article/0,,id=137246,00.html> (“For Tax Year 2001, all taxpayers paid \$1.767 trillion on time, a figure that represents from 83.4 percent to 85 percent of the total amount due.”). The tax gap was \$345 billion in 2001. I.R.S. News Release IR 2007-137, *supra* note 1; *see also* Dustin Stumper, *Everson Pledges to Narrow Growing Tax Gap*, 110 TAX NOTES 807, 807 (2006). IRS audits likely will reduce the final tax gap to approximately \$290 billion. *See* I.R.S. News Release IR 2007-137, *supra* note 1. The tax gap is defined as the “amount of true tax liability imposed by law for a given tax year that is not paid voluntarily and timely.” IRS, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 6 (2007), *available at* www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

101. Unfortunately, the IRS does not provide estimates on how taxpayers at different income levels contribute to the tax gap. *See* I.R.S. News Release IR 2005-38 (Mar. 29, 2005) *available at* <http://www.irs.gov/newsroom/article/0,,id=137247,00.html>; Press Release, Policy, *supra* note 99, at 5.

However, in 2008 a congressional subcommittee reported that offshore tax abuses cost the U.S. Government \$100 billion in taxes every year. PERMANENT SUBCOMM. ON INVESTIGATIONS, U.S. SENATE, STAFF REPORT: TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, 108th Cong., at 5 (July 17, 2008) [hereinafter REPORT ON TAX HAVEN BANKS], *available at* http://hsgac.senate.gov/public/_files/071708PSIRreport.pdf. It seems likely that the wealthy would use offshore tax tricks more often than the working class or the poor. In addition, the precise contribution of the wealthy to the tax gap depends on the definition of the wealthy. Reports indicate that tax underpayments by small businesses and sole proprietors account for a substantial portion of the tax gap. *See supra* note 24 and accompanying text; *see also* Raskolnikov, *Crime and Punishment*, *supra* note 19, at 575 (“According to many estimates,

Noncompliance is rampant among individuals operating a business, particularly those receiving cash payments. “[S]elf-employed individuals operating businesses on a cash basis report just [nineteen] percent of their income to the IRS.”¹⁰² Noncompliance is widespread throughout the cash economy, which is approximately nine percent of the U.S. gross domestic product.¹⁰³ Compliance is also an issue for non-cash sole proprietors because “self-employed individuals who . . . operate non-farm businesses are estimated to report only about [sixty-eight] percent of their income for tax purposes.”¹⁰⁴

In addition to the tax gap, there are other signs of a tax compliance crisis. “[T]he tax shelter crisis is perhaps the most visible side of the tax compliance problem”¹⁰⁵ “Tax shelters have proliferated in the United States [because of several factors, including] . . . the inadequacy of tax penalties”¹⁰⁶ Congress is particularly concerned about abusive tax scams using offshore bank accounts. “For one scheme alone, the IRS estimates that there may be hundreds of thousands of taxpayers with offshore bank accounts attempting to conceal income from the IRS,”¹⁰⁷ and a government report states that “[e]ach year, the United States loses an estimated \$100 billion in tax revenues due to offshore tax abuses.”¹⁰⁸

III. Bridging the Gap—A Monetary Sanction That Considers Norms

A. The Split, and the Gap, in the Academic Scholarship

Government officials, tax practitioners, and scholars agree tax avoidance is

the largest portion of the tax gap is due to underreporting of income by small businesses and self-employed individuals, most of which falls under the rubric of tax evasion. . . . A recent report attributes 67% of the tax gap to this type of evasion.”). As this Article has described the wealthy to include all individuals with income over \$200,000, *see supra* note 15 and accompanying text, which likely includes many sole proprietors, for purpose of this Article, a large portion of the tax gap likely can be traced to the wealthy.

102. *Id.* (emphasis added).

103. *The \$350 Billion Question: How to Solve the Tax Gap: Hearing Before the U.S. Senate Committee on Finance*, 109th Cong., at 8 (2005) (prepared testimony of Treasury Inspector General J. Russell George) (footnote omitted), available at www.senate.gov/finance/sitepages/hearing041405.htm [hereinafter *The \$350 Billion Question*].

104. *Id.* at 7 (footnote omitted).

105. Raskolnikov, *Crime and Punishment*, *supra* note 19, at 575.

106. Schizer, *supra* note 98, at 331.

107. S. REP. NO. 108-192, at 108 (2003) (emphasis added), available at http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.183&filename=sr192.pdf&directory=/diska/wais/data/108_cong_reports.

108. REPORT ON TAX HAVEN BANKS, *supra* note 101, at 4.

rampant,¹⁰⁹ although some scholars wonder why taxpayers do not cheat more in light of the extremely low risk of an audit.¹¹⁰

The legal scholarship, which attempts to explain or improve taxpayer behavior, can be divided along a spectrum, with an emphasis on economic motivation on one end, and an emphasis on motivation inspired by norms on the other.¹¹¹ The economic camp begins with the assumption that taxpayers will file aggressively if the expected benefit in tax savings exceeds the cost.¹¹² Because audit rates are so low, this group suggests that the government should impose extremely high penalties to influence behavior. For example, as the chance the IRS will audit is only one percent,¹¹³ the penalty rate must be 100 times the tax underpayment to deter aggressive tax filing.¹¹⁴ However, it would not be politically feasible for Congress to enact, and for the IRS to enforce, such an extreme approach.¹¹⁵

In contrast, the other camp asserts that taxpayers pay almost eighty-five percent of their fair share of taxes because of a variety of norms, such as the desire to contribute to the public good and to reciprocate in response to the fact that other taxpayers generally comply.¹¹⁶ These scholars warn that strengthening monetary penalties will send the wrong normative signal to taxpayers and actually reduce taxpayer compliance.¹¹⁷ The argument is that taxpayers are less likely to comply if the tax laws seem harsh or if the IRS appears punitive and inflexible.

109. "One (and, perhaps, the only) good thing about tax avoidance is that it unites theoretically inclined academics, hard-nosed practitioners, and result-oriented government officials . . . [they all] believe that there is too much tax avoidance today." Raskolnikov, *Crime and Punishment*, *supra* note 19, at 570.

110. See Posner, *supra* note 19, at 1807 ("[T]he high level of tax compliance is not explained."); *id.* at 1783-84 ("Why do people pay their taxes? . . . Only 1% are audited, but 83% of taxes are paid.").

111. See *supra* note 18 and accompanying text.

112. See Logue, *supra* note 14, at 267-68.

113. See *supra* note 45 and accompanying text.

114. Logue, *supra* note 14, at 267 ("[T]he optimal fine for tax underpayments ought to be the amount of [the] tax underpayment divided by the probability of detection.").

115. Lederman, *supra* note 19, at 1466 ("[I]t is not politically realistic for the government to impose . . . extremely high monetary penalties for tax evasion . . .").

116. See *supra* notes 19 and 22.

117. Kahan, *Signaling or Reciprocating?*, *supra* note 19, at 377 ("[F]ar from promoting compliance, simply increasing the penalties for evasion has been shown to undermine it, at least in societies that otherwise enjoy relatively compliant norms."); Kornhauser, *supra* note 19, at 618 (arguing that a procedure to "shame" taxpayers by publicly disclosing their tax underpayments may actually "backfire" and decrease voluntary compliance). *But see* Lederman, *supra* note 19, at 1485 (asserting that the studies cited by Professor Kahan "do not provide convincing support for [his] proposition").

As a result of this split, there is a gap. We need a proposal for a monetary penalty system imposed at a reasonable rate that can encourage accurate tax filing. Both normative and economic factors likely influence taxpayer behavior, and the relative importance will remain a topic for research and debate.¹¹⁸ In the meantime, the monetary penalty system clearly is broken. It should be revamped to properly leverage economic motivation without ignoring norms.

B. General Criteria for Choosing Between Negligence or Strict Liability

The failure of the current monetary penalty system calls for a reevaluation of the basic structure. Laws designed to deter harmful behavior typically seek to shift the harm to the actor.¹¹⁹ For example, if an actor can choose an action that causes harm to third parties, tort law and other legal regimes often try to shift the harm to the actor.¹²⁰ Because a taxpayer who underpays taxes harms the other members of society,¹²¹ the legal system should impose a cost to deter that behavior.

A legal system can use one of the “two basic forms of harm-based liability: strict liability, and fault-based liability.”¹²² Typically, policymakers consider certain factors in choosing the form.

On the one hand, fault-based legal regimes are appropriate when the act does not always cause harm, when under certain circumstances the benefit from the act likely will exceed the harm,¹²³ or if society prefers not to penalize

118. See Raskolnikov, *Crime and Punishment*, *supra* note 19, at 579 (“Clearly, more experimental results would be helpful in resolving theoretical debates. In the meantime, the best one can do, it seems, is to explicitly ground any proposal aimed at improving tax administration in one of the competing views about taxpayer behavior.”).

119. “[S]ociety wants to make individuals and firms internalize the expected value of the harm that their decisions might cause; harm, in this instance, would be the amount of under-paid taxes.” Logue, *supra* note 14, at 261.

120. Jeffrey Orenstein, Comment, *Show Me the Money: The Suitability of Product Disparagement to Art Experts*, 13 GEO. MASON L. REV. 905, 922 (2005) (“[T]he corrective justice approach to tort law defines the principles under which it is justified to shift a loss from one actor to another.”).

[Under the conventional] economic analysis of tort law . . . cost internalization through strict liability is well understood to achieve efficiency in certain settings For example, in the products liability context, if a product manufacturer is trying to decide whether to manufacture and sell a particular product . . . [or] make a particular safety innovation . . . the existence of a strict liability tort rule induces that company ex ante to take into account the expected harm

Logue, *supra* note 14, at 261.

121. *Id.*; see *supra* Part I.D.

122. SHAVELL, *supra* note 52, at 474.

123. *Id.* at 476 n.4 (stating that under a fault-based system, “a party who commits an act and

under certain circumstances (e.g., the actor is a volunteer). Fault-based liability systems can be difficult to apply because the judge must know, or guess, “[the] likelihood and the benefit from the act”¹²⁴ and whether the special circumstances were present.

On the other hand, a strict liability system always penalizes the actor when the actor causes harm and is caught.¹²⁵ A strict liability system generally is easier to administer because “[t]he only information required by the [judge] is the level of harm.”¹²⁶

These criteria indicate that for taxation a strict liability system is superior for four reasons.¹²⁷ First, all aggressive filers caught on audit have harmed society.¹²⁸ Second, the direct benefit to the aggressive taxpayer never exceeds the cost to society.¹²⁹ Third, vexing administrative problems arise when judges are forced to consider the indirect benefit of each taxpayer’s aggressive filing.¹³⁰ Fourth, as discussed in the previous section, additional problems

causes harm will be held liable if and only if [the expected harm exceeds the expected benefit].”).

124. *Id.* at 477.

125. *Id.* at 474.

126. *Id.* at 475.

127. One might initially describe our current tax laws as a strict liability system because when a taxpayer files aggressively, is caught on audit, and the IRS proves that the taxpayer paid less than the lawful share, the government requires that the taxpayer pay the tax underpayment plus interest. Logue, *supra* note 14, at 290-91 (“[The current tax penalty regime] is a combination of (1) strict liability with respect to back-taxes and interest and (2) a *fault-based system . . . for penalties.*”) (emphasis added). However, merely requiring the taxpayer to pay the tax (and interest) if caught may leave the taxpayer in as good a position as if the taxpayer filed accurately. *See supra* notes 12-13 and accompanying text. Given the extremely low risk of audit, the absence of a meaningful economic penalty creates a huge incentive to file aggressively, *see infra* note 239 and accompanying text, which has contributed to the crisis discussed in Part II.C.

128. Logue, *supra* note 14, at 261.

129. In all cases, the aggressive taxpayer’s tax savings will equal the tax revenue shortfall experienced by society.

130. While it seems absurd, if one applied the fault-based concepts slavishly, presumably a guilty taxpayer could argue that the tax underpayment generated numerous indirect benefits to society. *See SHAVELL, supra* note 52, at 476 (“Under [a fault-based] rule a party who causes harm is liable and bears a sanction . . . only if the social authority finds that the expected harm exceeded [the] expected benefits.”). For example, a business owner underpaying taxes might benefit society by hiring persons who otherwise would be unemployed, by purchasing environmentally-friendly equipment, or by spending the tax underpayment which will increase spending and grow the economy.

arise if the judge must consider many other factors before imposing a penalty.¹³¹

C. Any Fault-Based System Will Fail with the Federal Income Tax

In addition to these general factors, specific aspects of the federal income tax system make any fault-based penalty system inappropriate. As discussed above, the current system allows three fault-based excuses. Even if a redesigned system includes just one, it likely would allow and encourage the rich to file aggressively.

1. Probability of Success Tests Force Judges to Act as Bookies and Inspires Exceptions

An exception based on the probability of success of the taxpayer's position requires a judge to estimate the odds on a legal position. Not only is the judge asked to serve as a bookie, the judge acts as a bookie after the fact. The judge "[makes] an ex post assessment of the ex ante likelihood that the taxpayer would ultimately succeed on the merits."¹³² As the current situation demonstrates,¹³³ judges will resist the role of odds-maker or bookie because the federal income tax system is complicated,¹³⁴ and assigning a percentage to a tax outcome "impl[ies] exactitude in an assessment that actually represents only a general expectation regarding the outcome."¹³⁵ Judges will conclude that "using percentages to define the strength of a legal position is always fraught with some peril"¹³⁶ at best, and is a "fool's errand at worst."¹³⁷ As under current law,¹³⁸ judges would refuse to act as bookies and instead would create judicial tests which permit taxpayers to escape penalties whenever uncertainty was present.¹³⁹

Some may argue that although the twenty percent negligence standard, or the forty percent substantial understatement standard, is problematic, a greater

131. See *supra* Part II.B.2 (discussing that judges create new excuses to avoid penalizing taxpayers faced with any uncertainty).

132. Logue, *supra* note 14, at 284.

133. See *supra* Part II.B.2.

134. See *supra* Part I.B.

135. Lavoie, *supra* note 26, at 20.

136. *Id.* at 5.

137. *Id.* at 5 n.19.

138. See *supra* Part II.B.2.

139. One standard that judges likely would be willing to apply is "frivolous." Courts often apply the frivolous standard because various rules penalize parties in litigation for frivolous positions or tactics. See, e.g., FED. R. CIV. P. 11 (imposing sanctions for frivolous pleadings, motions, and other filings); *Urban v. United Nations*, 768 F.2d 1497, 1500 (D.C. Cir. 1985) (imposing sanctions against plaintiff for filing frivolous actions).

than fifty percent standard, commonly called a “more-likely-than-not” standard, would fix these problems. One commentator has stated, “under the elevated more likely than not standard, it would be nearly impossible for a court to find against a taxpayer [on the merits] and at the same time acknowledge that the taxpayer’s position was more likely than not correct.”¹⁴⁰ While it is not certain how judges would react if greater than fifty percent became the general standard,¹⁴¹ the same forces that have led judges to adopt judicial exceptions¹⁴² still would be applicable. The income tax system still will be complex; judges still will be uncomfortable determining whether a legal position had a certain percentage of success, even if that percentage is fifty-one percent. Additionally, judges still will not want to penalize a taxpayer in the absence of a breach of a clear duty, and judges still will want the discretion in particular cases to find that a taxpayer owes the tax but is not liable for a penalty.

2. *Reliance on a Tax Advisor Loophole Bails Out the Rich*

The U.S. Supreme Court, in dicta, has stated that “[w]hen an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice.”¹⁴³ Under current law, a taxpayer wishing to take an aggressive position can achieve penalty immunity if the taxpayer can find a tax advisor who will say that the position has at least a twenty percent chance, or a forty percent chance if the substantial understatement penalty applies.¹⁴⁴

Tax advisors who need to pay the bills tend to issue opinion letters that provide penalty protection to clients.¹⁴⁵ Indeed tax advisors have crafted twelve different standards to describe the likelihood of a tax position succeeding, ranging all the way from “not frivolous” to “will succeed,”¹⁴⁶ in their efforts to adapt to whatever odds or standards a client needs to avoid

140. Ventry, *Vices and Virtues*, *supra* note 58, at 1091.

141. Congress has only adopted the more-likely-than-not standard for taxpayers in certain narrow circumstances. *See supra* note 64 and accompanying text.

142. *See supra* Part II.B.2.

143. *United States v. Boyle*, 469 U.S. 241, 251 (1985) (emphasis omitted). *Boyle* did not involve reliance on substantive advice from a tax advisor. Instead, the taxpayer was penalized for a procedural mistake, namely the failure to file a tax return on time. *Id.* at 243.

144. *See supra* Part II.A.1 (regarding the probability standards).

145. Chirelstein & Zelenak, *supra* note 73, at 1941.

146. Jasper L. Cummings, Jr., *The Range of Legal Tax Opinions, with Emphasis on the ‘Should’ Opinion*, 98 TAX NOTES 1125, 1132 (2003) (discussing the “will succeed” opinion); *id.* at 1126 (discussing the opinion that a tax position is not “frivolous”). “The growing number of [types of] legal opinion[s] . . . seems most pronounced in the area of tax opinions, due in part to the IRS’s gradations of taxpayer positions for various penal[ies] . . .” *Id.* at 1125.

penalties. Commentators describe the competition among tax advisors to issue opinion letters as the “race to the bottom.”¹⁴⁷

An exception for reliance on a tax advisor poses distributive justice problems because it greatly benefits the rich. Tax advisors need to charge fees for their services, and rich taxpayers with big tax dollars at stake are more likely than the working class or the poor to purchase tax opinions to provide penalty immunity.

3. Good Faith State of Mind Exception Excuses False Filing

A system that grants immunity to taxpayers who file in “good faith”¹⁴⁸ forces the judge to determine the taxpayer’s state of mind.¹⁴⁹ When performing the required psychoanalysis, given the complexity of the income tax, a judge likely will be more inclined to say the taxpayer was confused, rather than evil.

The term “penalty” carries substantial legal baggage. In general, a “penalty” is a “[p]unishment imposed on a *wrongdoer*.”¹⁵⁰ Often judges deciding tax cases, such as Court of Claims judges and U.S. District Court judges,¹⁵¹ are not experts in tax law.¹⁵² Even Tax Court judges who have tax expertise may not have a great deal of experience in the particular branch of the tax law involved in a certain case. Sometimes judges may not even have enough confidence in their own knowledge of the tax laws to prepare their own tax returns.¹⁵³ Like fifty-six percent of all United States taxpayers, the judge might use a paid tax advisor to prepare his or her personal income tax return,¹⁵⁴ or like many of the remaining taxpayers, may rely on a computer program.¹⁵⁵ Under these circumstances, a judge may be reluctant to make a

147. See Schizer, *supra* note 98, at 360; Ventry, *Vices and Virtues*, *supra* note 58, at 1089.

148. See, e.g., I.R.C. § 6664(c)(1) (2008); Treas. Reg. § 1.6664-4(a) (1991).

149. Treas. Reg. § 1.6664-4(c)(1); see *supra* Part II.A.2.

150. BLACK’S LAW DICTIONARY 1168 (8th ed. 2004) (emphasis added).

151. 28 U.S.C. § 1346(a)(1) (2006) (granting these courts jurisdiction for certain tax cases).

152. See Andre L. Smith, *Deferential Review of Tax Court Decisions of Law: Promoting Expertise, Uniformity, and Impartiality*, 58 TAX LAW. 361, 404 (2005) (“Circuit court judges should not feel free to reverse experts such as Tax Court judges on matters that properly invoke their expertise.”).

153. See Steven L. Schooner, *The Future: Scrutinizing the Empirical Case for the Court of Federal Claims*, 71 GEO. WASH. L. REV. 714, 743 n.97 (2003) (“Today, the Claims Court has no Judges with tax practice backgrounds of any magnitude.”).

154. “[A]bout 56 percent of all the individual tax returns filed for tax year 2002 used a paid preparer” *Paid Tax Return Preparers: Hearing Before the S. Comm. on Finance*, 108th Cong. 2 (2006) (statement of Michael Broster, Dir. of Strategic Issues), available at www.gao.gov/new.items/d06563t.pdf.

155. Raskolnikov, *Crime and Punishment*, *supra* note 19, at 616 n.189 (noting that “[eighty-five percent] of all individual tax returns are prepared using computer software” (citing Allen

finding of bad faith against a taxpayer and impose a penalty, unless the taxpayer's position is frivolous.

D. Economic Considerations in Designing a Penalty System

1. Preliminary Economic Model

In designing a new penalty system, it is appropriate to consider taxpayer motivations. If taxpayers always behave virtuously without legal incentives, penalties to deter wrongful actions are superfluous. Often, penalty design begins with a contrary assumption—that economic considerations are the sole determinant of behavior. While this can be a helpful start, eventually this Article will expand the analysis to consider other factors¹⁵⁶ because normative factors also influence taxpayer behavior.¹⁵⁷

On the economic side, one can begin with Justice Oliver Wendell Holmes' "bad man,"¹⁵⁸ who has been given the title "homo economicus."¹⁵⁹ Economics alone motivates homo economicus. He engages in socially harmful behavior unless his total expected cost from behaving badly, including penalties, equals or exceeds his total expected cost of behaving lawfully.¹⁶⁰

The works of utilitarian Jeremy Bentham and economist Gary Becker provide a method for estimating the amount of the penalty necessary to deter homo economicus.¹⁶¹ The "Bentham-Becker"¹⁶² method calculates the penalty

Kenny, *IRS Issues New Taxpayer-Burden Estimates*, 108 TAX NOTES 1503, 1503 (2005)); see also GRAETZ, *supra* note 1, at 14.

156. See *infra* Part III.E.

157. Professor Raskolnikov states that "most models suggest that nominal penalties and the probability of punishment play important roles in shaping taxpayer behavior." Raskolnikov, *Crime and Punishment*, *supra* note 19, at 577. He then discusses the literature arguing that norms influence behavior and states, "In sum, experimental data lends some support to all existing theories of taxpayer behavior, while giving a decisive advantage to none." *Id.* at 579.

158. Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) ("A man who cares nothing for an ethical rule which is believed and practised [sic] by his neighbor is likely nevertheless to care a good deal to avoid being made to pay money . . ."); see Logue, *supra* note 14, at 244-45.

159. See Logue, *supra* note 14, at 244-45; Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003).

160. Logue, *supra* note 14, at 245.

161. Jeremy Bentham, the founder of Utilitarianism, studied the impact of penalties on behavior. Gary Becker, the winner of the 1992 Nobel Prize in Economics, emphasized that because actors weigh both the risk of detection and the potential penalty, "the best policy is to maximize the fine and minimize surveillance [with limits]." See *id.* at 266.

162. See *id.* at 268; John D. Mueller, *How Does Fiscal Policy Affect the American Worker?*, 20 NOTRE DAME J.L. ETHICS & PUB. POL'Y 563, 603 (2006).

“by dividing the harm caused by the probability of detection.”¹⁶³ In the federal income tax arena, if one merely uses the actual risk of audit for all individuals, the Bentham-Becker method requires a staggering penalty rate.

For example, assume the taxpayer is homo economicus. He is considering whether to claim a tax deduction and believes that if audited, the IRS and the courts ultimately will disallow the tax deduction. If he claims the tax deduction on his tax return, he will save \$1 in tax. If the risk that the IRS will audit is one percent, to deter Homo Economicus, the total cost to Homo Economicus if the IRS detects would need to be \$100.¹⁶⁴ Thus, with a one percent audit rate, the Bentham-Becker model teaches that the income tax penalty should approximate ninety-nine times the tax underpayment.

2. Adjusting the Risk of Detection

This purely economic analysis can be adjusted somewhat because typically the relevant risk of detection is higher. First, although the audit rate for all taxpayers is only one percent,¹⁶⁵ the audit rate for taxpayers earning over \$200,000 is closer to three percent.¹⁶⁶ Under the Bentham-Becker model, the required penalty drops by almost two-thirds merely with this adjustment.¹⁶⁷

Second, it is the perceived risk of audit that will influence the taxpayer's behavior when completing a tax return. The focus on the perceived risk of audit, rather than the actual risk of audit, is based on the principle that the tax penalty system should improve taxpayer compliance, rather than raise a specified amount of revenue.¹⁶⁸ This focus is appropriate because “the direct

163. Logue, *supra* note 14, at 266.

164. *See id.* at 268 (Tax Savings/Risk of Detection = \$1/1% = \$100); *see also* Lederman, *supra* note 19, at 1465 (“[E]conomic models of tax compliance . . . counsel extremely high sanctions . . .”); *id.* (“[A]n audit rate of 1% would require a \$99,000 penalty [for every \$1000 tax underpayment] . . .”). Nevertheless, even a purely economic analysis could be refined by including factors other than the risk of audit. For example, considering the chance that the taxpayer would prevail on audit would reduce the potential cost. On the other hand, potential attorneys fees needed to battle with the IRS would increase the anticipated cost.

165. *See supra* note 45 and accompanying text.

166. In 2007, the audit rate was 2.87%. *2007 Enforcement and Services Results*, *supra* note 15, at 3.

167. With a one percent risk of detection, the Bentham-Becker penalty is 100 times the cost of filing accurately. *See supra* note 164 and accompanying text. With a three percent risk of detection, the penalty is thirty-three-and-one-third times the cost of filing accurately. *See supra* note 45 and accompanying text.

168. If the goal is to force noncompliant taxpayers caught on audit to pay a big enough penalty to reimburse society for all tax underpayments made by all taxpayers, whether or not they are audited, the focus would be on the actual rate of audit, and the penalty rate would have to be huge. *See supra* note 164 and accompanying text. Instead, the IRS and the U.S. Supreme Court have both adopted the principle that the tax penalty system should improve taxpayer

revenue from enforcement is a tiny fraction of the revenue from voluntary compliance.”¹⁶⁹

In the real world, a taxpayer’s risk of audit does not depend solely on the taxpayer’s amount of income, and taxpayers taking aggressive positions likely will assume that their risk of audit is higher than the national average.¹⁷⁰ IRS examiners manually select some tax returns for audit,¹⁷¹ but the IRS selects most audited returns using complex computer scoring procedures collectively referred to as the Discriminant Function (the “DIF”).¹⁷² The IRS changes the DIF periodically based on the results of the National Research Program which identifies characteristics that signal tax underpayments.¹⁷³ The IRS keeps the DIF scoring procedures confidential.¹⁷⁴ As a result, one particular taxpayer can never be sure of the chance of being audited in any year.

In fact, “survey results suggest that people greatly overestimate the probability of an IRS audit.”¹⁷⁵ A taxpayer who files aggressively may estimate that the chances of being audited are higher than the general population, particularly because the taxpayer can never know the DIF score and how that score compares to other taxpayers. Also, when it comes to income tax audits, many individuals may be pessimistic.¹⁷⁶

Thus, if an aggressive taxpayer believes the chance of being audited is four-to-one, the Bentham-Becker formula calculates a penalty of only four times the tax underpayment. This rate is significantly lower than the one hundred times

compliance. The IRS Manual states, “In order to make the most efficient use of penalties, the [Internal Revenue] Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance.” INTERNAL REVENUE MANUAL, *supra* note 69, at Exhibit 20.1.1-1 (Penalty Policy Statement 20-1), available at <http://www.irs.gov/irm/part20/ch01s02.html#d0e2996>, quoted in Raskolnikov, *Crime and Punishment*, *supra* note 19, at 579 n.44. The U.S. Supreme Court has stated that civil tax penalties “ensure full and honest disclosure [and] . . . discourage fraudulent attempts to evade the tax.” *Helvering v. Mitchell*, 303 U.S. 391, 399 (1938); *see also* Wood, *supra* note 22, at 320 (“Compliance . . . would seem to be the touchstone of sound civil penalty policy.”). *But see Helvering*, 303 U.S. at 401 (also noting that civil tax penalties “reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer’s fraud”).

169. Lederman, *supra* note 19, at 1462.

170. Posner, *supra* note 19, at 1808 (“People are apparently quite ignorant about the probability that they will be audited . . .”).

171. SALTZMAN, *supra* note 24, ¶ 8.03[3], at 8-22.

172. *See id.* ¶ 8.03, at 8-19.

173. *Id.* ¶ 8.03[2][b], at 8-20.

174. *Id.* ¶ 8.03[2][a], at 8-19.

175. Andreoni, *supra* note 19, at 844-45.

176. The pessimists may believe in “Murphy’s Law,” which provides that “[i]f anything can go wrong, it will.” Murphy’s Laws Site, <http://www.murphys-laws.com/murphy/murphy-laws.html> (last visited Aug. 5, 2009).

required with a one percent risk of detection.¹⁷⁷ Nevertheless, this still exceeds a penalty rate that Congress, or the general public, would find acceptable.¹⁷⁸ The populace may perceive an excessive penalty rate as a punishment that does not fit the offense.¹⁷⁹ Fortunately, norms also discourage taxpayers from filing aggressively.

E. Norms Reduce the Monetary Penalty Needed to Change Taxpayer Behavior

Many norms encourage taxpayers to file accurately. These norms include: (i) a desire to avoid regret;¹⁸⁰ (ii) a fear of damage to reputation,¹⁸¹ a fear of shame, or a fear of social stigma;¹⁸² (iii) a desire to convince themselves and others that they are responsible and law abiding;¹⁸³ (iv) a sense of duty;¹⁸⁴ (v)

177. See *supra* note 164 and accompanying text. The following chart demonstrates that as the *perceived* risk of detection rises, the required penalty under the Bentham-Becker model drops.

<u>Perceived Risk of Detection</u>	<u>Required Penalty Factor</u>
3%	33-1/3-to-1
10%	10-to-1
25%	4-to-1
50%	2-to-1
100%	1

The “required penalty factor” is one divided by the “perceived risk of detection.” See Logue, *supra* note 14, at 267 (“[T]he optimal fine for tax underpayments ought to be the amount of [the] tax underpayment divided by the probability of detection.”).

178. Lederman, *supra* note 19, at 1466 (“[I]t is not politically realistic for the government to impose . . . extremely high monetary penalties for tax evasion . . .”).

179. *Id.*

180. Andreoni, *supra* note 19, at 855.

181. Posner, *supra* note 19, at 1791 (“[P]eople care about their reputations, and will take steps to protect them.”); Andreoni, *supra* note 19, at 822.

182. Professor Posner emphasizes that if an aggressive taxpayer is detected, he may be “revealed . . . to be a bad type, and [will be] stigmatized.” Posner, *supra* note 19, at 1789. The consequences can include loss of employment opportunities and loss of income. *Id.* at 1793. However, Professor Posner points out that in a civil tax matter, as long as the taxpayer pays any federal income tax deficiency promptly after the amount is finally determined and there is no reported court opinion, the matter remains confidential, and no stigmatizing by third parties will result. *Id.* at 1796; see also Andreoni, *supra* note 19, at 822 (regarding stigmatizing).

183. “The actual payment [of taxes] is a signal that one belongs to the good type.” Posner, *supra* note 19, at 1794.

184. Andreoni et al., *supra* note 19, at 855.

a belief that others pay their fair share of taxes, which inspires the taxpayer to reciprocate;¹⁸⁵ and (vi) a desire to contribute to a collective enterprise.¹⁸⁶

Other norms may either encourage or discourage accurate filing, depending on the taxpayer's particular views. These norms include: (i) the perceived fairness of the tax system;¹⁸⁷ (ii) the perceived fairness of the individual's particular tax burden;¹⁸⁸ or (iii) satisfaction with government spending and programs.¹⁸⁹ There are also norms which discourage tax compliance.¹⁹⁰

In addition, a legal rule itself may signal the appropriate behavior for persons who desire to act in accordance with certain norms. Individuals who are "collectivist-oriented"¹⁹¹ desire to convince themselves and others that they

185. John S. Carroll, *How Taxpayers Think About Taxes: Frames and Values*, in *WHY PEOPLE PAY TAXES* 47 (Joel Slemrod ed., 1992) ("One of the most consistent findings in survey research about taxpayer attitudes and behaviors is that those who [comply] believe that their friends (and taxpayers in general) comply, whereas those who [cheat] believe that others cheat."), *quoted in* Lederman, *supra* note 19, at 1469; Kahan, *Signaling or Reciprocating?*, *supra* note 19, at 368-69 ("[I]ndividuals in collective action settings behave . . . like moral and emotional reciprocators. When they perceive that other individuals are voluntarily contributing to public goods, most individuals are moved by honor, generosity, and like dispositions to do the same." (footnote omitted)).

186. Kornhauser, *supra* note 19, at 610 ("A collectivist-oriented . . . individual will be more willing to pay taxes . . . She will see paying taxes as a gain, fulfilling personal desires and civic obligations and not just a loss of personal income.").

187. Professor Posner points out that refusing to pay a state use tax on goods purchased from out-of-state suppliers does not carry the same stigma as violating the federal income tax. Posner, *supra* note 19, at 1794.

188. Andreoni et al., *supra* note 19, at 850.

189. Kornhauser, *supra* note 19, at 614 (discussing the taxpayer's perceived level of participation in government and the responsiveness of government officials); Andreoni et al., *supra* note 19, at 851.

190. Commentators have identified at least six factors. First is perceived unfairness of the system. Andreoni et al., *supra* note 19, at 851 ("The taxpayer may believe that the . . . tax system treats him unfairly relative to others . . ."). Second is the perception that other people are not paying their fair share of taxes. If a taxpayer believes others are cheating and she files honestly, she may feel like a "chump." Kornhauser, *supra* note 19, at 613; *see also* Andreoni et al., *supra* note 19, at 851 ("In psychological terms, an unfair tax system could lead people to 'rationalize' cheating."). Third is dissatisfaction with the way the government spends tax dollars. "[A] taxpayer [who] feel[s] 'cheated' . . . may reciprocate by refusing to pay [her] full tax liability." Andreoni et al., *supra* note 19, at 851-52 ("[T]he higher the level of government waste . . . the less the individual is willing to contribute."). Fourth is dissatisfaction with the government as a whole. *Id.* at 851 (In a survey, "participants whose responses . . . indicated an alienation from government or a negative attitude toward laws were significantly more likely to have engaged in evasion during the experiments."). Fifth is a desire to be a rebel or a revolutionary. Kornhauser, *supra* note 19, at 610. Sixth is an anti-establishment world view. *Id.* at 610-11 ("[A] Jeffersonian belief that small government is the best government" may diminish compliance.).

191. *Id.* at 610.

are law-abiding, desire to avoid damage to reputation, or wish to reciprocate if other members of society are acting in a certain manner; all may consider the way the legal rules judge an action.¹⁹² Legal rules are particularly important when complete information about how others act is unavailable or is not known by the actors.¹⁹³

The economic analysis of taxpayer behavior discussed above focused exclusively on the risk of audit, but norms also can help deter a taxpayer from filing aggressively. Although the impacts of the various norms are inherently difficult to quantify, many taxpayers will add these factors to a potential monetary penalty when deciding how to act.¹⁹⁴ In determining the necessary monetary penalty to change taxpayer behavior, norms that encourage compliance may allow a penalty at a reasonable rate to influence behavior.

For example, assume Connie Conscience and her tax advisors are working on her individual tax return. If she claims a tax deduction for a particular payment, she will save \$3000 on her income taxes. As the amount involved is not sufficient to trigger the substantial understatement penalty,¹⁹⁵ the applicable penalty under current law is the negligence penalty. After discussions with her tax advisor, Connie Conscience understands there likely is a three percent chance that the IRS will audit her tax return,¹⁹⁶ and if the IRS audits there is a twenty-five percent chance (approximately) that the deduction will succeed. Because her position has a twenty-five percent chance, under current law, the negligence penalty will not apply.¹⁹⁷ If the IRS audits and her

192. See Jeffrey J. Rachlinski, *The Limits of Social Norms*, 74 CHI.-KENT L. REV. 1537, 1538 (2000) (“[C]hanges in law can influence social norms. For example, passing a law against smoking in public places had a dramatic effect on smokers”); Steven Shavell, *Law Verses Morality as Regulators of Conduct*, 4 AMER. L. & ECON. REV. 227, 254 (2002) (“[L]egal rules can affect our moral beliefs, as well as the operation of the moral sanctions.”); Michael A. Livermore, *Reviving Environmental Protection: Preference-Directed Regulation and Regulatory Ossification*, 25 VA. ENVTL. L.J. 311, 335 (2007) (“Within the field of scholars interested in the ‘expressive’ function of law a number of theories have been proffered to explain how law changes social norms.” (footnote omitted)).

193. Because tax return information is confidential, only the IRS can provide complete statistical data on taxpayer compliance. See I.R.C. § 6103(d) (2008).

194. “[T]he *effective* sanction is not just the tax penalty, but the *sum* of the tax penalty and lost opportunities resulting from observers revising downward their beliefs about the violator’s type” Posner, *supra* note 19, at 1795 (second emphasis added).

195. The substantial understatement penalty only applies if the tax underpayment is \$5000 or more (the greater of ten percent of the tax required to be shown on the return for the taxable year or \$5000). I.R.C. § 6662(d)(1)(A).

196. See *supra* note 15 and accompanying text.

197. See *supra* notes 57-61 and accompanying text. However, if the IRS audits and a court decides that the chance of success was less than twenty percent, the negligence penalty would apply. See *supra* notes 57-61 and accompanying text.

deduction ultimately is denied, Connie will have to pay only the \$3000 tax underpayment, plus interest at the government rate,¹⁹⁸ and will not have to pay a penalty. If she claims the deduction, Connie will invest the \$3000 tax savings, and any economic detriment to Connie will be minimal.¹⁹⁹

Connie Conscience values being a law-abiding citizen, contributing to the common good, and doing the right thing. Normally if she thinks there is a seventy-five percent chance that refraining from an action is fair and just, and that there is only a twenty-five percent chance that taking the action is appropriate, she would not do it. However, her tax advisor appropriately points out that there is no sanction for claiming a tax position with a twenty-five percent chance of success, and indeed the government expects that persons in her position will claim this deduction.²⁰⁰ Under these circumstances, Connie claims the deduction.

Replacement of the current fault-based negligence penalty with strict liability might change Connie Conscience's behavior. In that case, the tax advisor could no longer tell Connie that the government expects a reasonably prudent person in her situation to take the deduction, or that if the IRS audits she likely will not need to pay any penalty. Instead, Connie now understands that the tax law recognizes a duty to pay the correct amount of tax on time²⁰¹ and that if the IRS audits and spots the issue there is a seventy-five percent chance she will owe a monetary penalty, which she could have avoided if she had not filed aggressively. Connie also reflects that even if the IRS fails to audit her tax return, her conscience will bother her because there will be a seventy-five percent chance that she did not pay her fair share. Connie Conscience decides not to claim the deduction.

IV. The Proposal: The False-Filing-Without-Disclosure Penalty

This Article proposes the replacement of the current fault-based penalty system with a new strict liability style system. The new system would signal that paying the correct amount of tax on time is an important duty. It would impose a penalty on any failure to pay the proper amount of tax with the original filed tax return, with three exceptions.

198. I.R.C. § 6601 (requiring that taxpayers pay interest on a tax underpayment); *id.* § 6621(b) (describing the method for calculating the amount of interest on a tax underpayment).

199. *See supra* note 13.

200. *See supra* notes 56-59 and accompanying text (regarding the negligence penalty).

201. The U.S. Supreme Court recognized this duty in 1950. *Manning v. Seeley Tube & Box Co. of N.J.*, 338 U.S. 561, 565 (1950) (“[T]he taxpayer had a positive obligation to the United States . . . to pay its tax.”); *id.* at 568 (“[T]he United States is to have the possession and use of the lawful tax at the date it is properly due.”).

The major exception is if the taxpayer filed a Disclosure Statement, IRS Form 8275, with her tax return regarding a nonfrivolous position. For these purposes, “frivolous” would have its traditional legal meaning—a position would be frivolous if it “[lacks] a legal basis or legal merit.”²⁰² Thus, the new penalty could be described as the false-filing-without-disclosure penalty.²⁰³

The other two exceptions would apply when the taxpayer reports the correct amount of tax due on her original tax return but (i) is unable to pay because of a financial emergency, or (ii) is unable to pay and signs an installment payment plan with the IRS.²⁰⁴

Strict liability will be consistent with the current low, flat income tax rates.²⁰⁵ Congress drastically reduced tax rates for the wealthy in the Tax Reform Act of 1986,²⁰⁶ and as part of the bargain, Congress anticipated that the wealthy would pay tax on their remaining taxable income.²⁰⁷ Because the wealthy benefit greatly from today’s comparatively low tax rates, it is only fair that a significant penalty apply when a wealthy taxpayer fails to pay his or her fair share.

A. Basic Features of the Strict Liability Style System

The new penalty system would have the following four basic features.²⁰⁸

(1) *Maximum Twenty-Five Percent Penalty Rate.* The penalty rate would be one percent on the underpayment per month, generally reaching a maximum of twenty-five percent in the twenty-fifth month.²⁰⁹ Wealthy

202. BLACK’S LAW DICTIONARY, *supra* note 150, at 692; *see* *Ozee v. Am. Council of Gift Annuities*, 143 F.3d 937, 941 (5th Cir. 1998) (an argument which cannot be made with a “straight face” is frivolous, and is “sanctionable”). Judges and attorneys are very familiar with the “frivolous” standard because judges generally can sanction litigators for frivolous appeals, motions, and other actions. *See supra* note 139.

203. *See supra* note 63.

204. *See infra* Part IV.A(iv).

205. *See* I.R.C. § 1(i)(2) (2008); Rev. Proc. 2008-66, §3.01, 2008-45 I.R.B. 1107 (tax rates for 2009).

206. Pub. L. No. 99-514, § 541, 100 Stat. 2085, 2096 (reducing the maximum tax rate from fifty percent to twenty-eight percent, beginning in 1988).

207. STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 7 (Comm. Print 1987), *available at* <http://www.jct.gov/jcs-10-87.pdf> (“[D]eductions that benefit[] a limited number of taxpayers . . . are restricted by the [1986] Act [a]s part of the approach . . . to reduce tax rates through *base-broadening*”) (emphasis added).

208. If existing tax penalties are not adequate to deter fraudulent or criminal behavior, the new penalty could apply in those situations. The current failure-to-file penalty applies with added gusto when the failure-to-file is fraudulent. In that case, the statute triples the failure-to-file penalty. *See* I.R.C. § 6651(f).

209. Other civil penalties accrue over time. The failure-to-file penalty accrues at the rate

taxpayers who file aggressively and are caught would almost always be subject to the maximum twenty-five percent penalty because significant IRS audits rarely conclude within two years of the original date for filing a tax return.²¹⁰ As discussed in Part IV.B.2, as relief for the working class and the poor and any taxpayer making a relatively small mistake, the maximum penalty rate would be lower for tax underpayments less than \$10,000.

Because of the modest maximum marginal income tax rate of thirty-five percent on taxable income generally, income subject to the proposed twenty-five percent penalty would still only be subject to an effective combined rate of approximately forty-five percent.²¹¹ In recent history, marginal tax rates exceeded that figure even when no penalties applied.²¹²

(2) *No Exception Based on the Odds of Success.* The new penalty system would not force judges to act as bookies, estimating ex post the ex ante odds that a legal position would succeed. Instead, the judge would determine whether the position was correct, and if not, the new penalty would automatically apply unless one of the three exceptions applies. Under the key exception, if the taxpayer disclosed the tax position on IRS Form 8275, Disclosure Statement, the judge would only impose a penalty if the position was frivolous under general legal standards. The frivolous test is not based on a mathematical probability, but instead whether a litigant can argue the position with a “straight face.” Judges have extensive experience applying this general frivolous standard.²¹³

of five percent per month for five months. *Id.* § 6651(a)(1). The failure-to-pay penalty accrues at the rate of 0.5% per month for fifty months. *Id.* § 6651(a)(2).

210. The proposed penalty would not provide an exception for a taxpayer who extends the due date for filing the tax return. Under current law, an individual can elect to extend the due date for filing IRS Form 1040 from April 15 to August 15 by submitting IRS Form 4868 on or before April 15. Treas. Reg. § 1.6081-4(b) (1996). Such a taxpayer can avoid the failure-to-pay penalty by paying at least ninety percent of the tax ultimately due with the extension form on April 15. Treas. Reg. § 301.6651-1(c)(3)(i) (1996). In contrast to current law, the proposed penalty would not excuse a ten percent underpayment.

211. I.R.C. § 1(i)(2) (Supp. V 2005) (current tax rates). For example, if a taxpayer at the highest marginal tax rate failed to report \$100 of taxable income, that would result in a \$35 tax underpayment. If that failure is subject to a twenty-five percent penalty, the penalty would be \$8.75 [$\$35 \times 25\% = \8.75]. The combined income tax and penalty would be \$43.75 [$\$35 + \8.75].

212. As recently as 1986, the maximum effective tax rate for a wealthy taxpayer (not subject to any penalties) was fifty percent. From 1965 through 1980 the maximum rate was seventy percent. At the end of World War II the maximum rate was ninety-four percent. See JEFFREY L. KWALL, *THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS* 7 (3d ed. 2005) (listing the highest marginal tax rates).

213. See *supra* notes 130, 202; see *infra* note 228.

(3) *No Exception for Reliance on a Tax Advisor or for “Good Faith” Filing.* “The taxpayer should not be able to elude [her tax] obligations through her tax practitioner. Or, stated differently, the taxpayer should not be able to accomplish through an agent what she cannot accomplish directly.”²¹⁴ The exception for “good faith” filing can allow judges to excuse taxpayer mistakes whenever any uncertainty exists.²¹⁵ As a result, neither the exception for reliance on a tax advisor, nor the good faith exception, would be available under the new system.

(4) *Two Minor Exceptions.* An exception would be available for a taxpayer who fully reported the tax liability on a timely filed tax return but is unable to pay because of a financial emergency, including but not limited to uninsured damage caused by a flood, tornado, hurricane, theft, or other unforeseeable events. Also, the new penalty would not apply to a taxpayer who originally reported the full tax liability, was unable to pay, voluntarily entered into an installment payment plan with the IRS, and made the scheduled payments.²¹⁶

Like other tax penalties, a taxpayer would not be allowed to deduct the new penalty as interest or as a business expense.²¹⁷

B. Ameliorating the Harshness of a Pure Strict Liability Approach

1. Protection for Conspicuous Disclosure of Nonfrivolous Positions

A strict liability approach is needed, in part, because of the low risk of audit. This risk changes drastically if the taxpayer alerts the IRS about a potential tax underpayment, and provides the IRS with an audit roadmap. Congress and the IRS have already created a procedure for taxpayers to notify the IRS about a risky tax position. A taxpayer can file IRS Form 8275, Disclosure Statement, with a tax return.²¹⁸ On the Form 8275, the taxpayer identifies and describes

214. Dennis J. Ventry, Jr., *Tax Politics and a New Substantial Understatement Penalty*, 113 TAX NOTES 91-96 (2006).

215. *See supra* Part II.A.2.

216. Current law cuts the failure-to-pay penalty in half once the taxpayer enters into an installment payment plan with the IRS. *See* I.R.C. § 6651(h) (2008).

217. The current failure-to-pay penalty “does not represent interest paid on an indebtedness which is deductible under [§] 163(a) [as interest], but rather represents an amount paid for allowing the indebtedness to accrue. The [failure to pay] penalty . . . does not serve the same function as that served by the imposition of interest . . .” *May v. Comm’r*, 65 T.C. 1114, 1116 (1976). The negligence penalty and the substantial understatement penalty are additions to tax, *see* I.R.C. § 6662(a), and therefore are not tax deductible.

218. For certain purposes, the IRS will disregard an attempted disclosure of information unless the taxpayer accurately completes the Form 8275. “For example, [the] disclosure will not be considered adequate if [the taxpayer] attach[es] a copy of an acquisition agreement . . . to disclose the issues involved in determining the basis of certain acquired assets.” Instructions for IRS Form 8275, at 3 (revised Feb. 2009 for use with the Aug. 2008 revision of Form 8275),

the uncertain position in detail.²¹⁹ The risk of audit should approach one hundred percent when the taxpayer files a Form 8275.²²⁰

Unfortunately, current law only rewards a taxpayer filing IRS Form 8275, Disclosure Statement, with a slight edge in avoiding the substantial understatement penalty,²²¹ and the negligence penalty applies the same whether or not the taxpayer files a Form 8275.²²² Thus, the reward for conspicuously disclosing a position is not great.²²³

Under the new proposal, as long as a position disclosed on Form 8275, Disclosure Statement, is not frivolous,²²⁴ the taxpayer would not be subject to a penalty.²²⁵ This protection is appropriate because the risk of audit would approach one hundred percent.²²⁶ Under the proposal, the taxpayer seeking

available at <http://www.irs.gov/pub/irs-pdf/i8275r.pdf>.

219. Part I of IRS Form 8275 requires the taxpayer to describe the item, state the schedule and line number on which the item appears, and the dollar amount involved. IRS, Form 8275, Disclosure Statement, at 1 (revised Aug. 2008), available at <http://www.irs.gov/pub/irs-pdf/i8275.pdf>. Part II requires a “detailed explanation” which “must include information that reasonably can be expected to apprise the IRS of the identity of the item, its amount, and the nature of the controversy or potential controversy.” Instructions for IRS Form 8275, *supra* note 218, at 3.

220. The new system would require that the taxpayer place the Form 8275 on top when assembling the Form 1040 and the related schedules and attachments. See IRS, 1040 INSTRUCTIONS 2007, at 62, available at <http://www.unclefed.com/IRS-Forms/2007/i1040.pdf> (setting forth the rules for assembling the tax return).

221. A taxpayer who fails to file a Form 8275, Disclosure Statement, can be subject to the substantial understatement penalty if her position has less than a forty percent chance of success. If a taxpayer files a Form 8275, the forty percent standard drops to a twenty percent standard. I.R.C. § 6662(d)(2)(B).

222. See *id.* (the “disclosure” exception applies only to the substantial understatement penalty).

223. “[M]ost taxpayers are likely to choose not to disclose and face a low risk of paying 120% or so of a given tax liability plus interest rather than to disclose and take a much higher risk of paying 100% of the same liability.” Raskolnikov, *Crime and Punishment*, *supra* note 19, at 582; see also *id.* at 583 (“[T]he existing inducement to disclose is unlikely to work in many cases, and it is least likely to work [when] it would be needed most.”).

224. See *supra* notes 139 and 202 (defining “frivolous” under this proposal).

225. The proposed system might encourage a few taxpayers to file Form 8275, Disclosure Statement, and to claim tax positions which have less than a twenty percent chance of success, but are not frivolous. However, most taxpayers likely will be reluctant to trigger an audit by filing a Form 8275, Disclosure Statement, because during an audit, the IRS may find other positions to challenge, either on the same tax return, or on a tax return for a prior or later tax year, if the statute of limitations is still open. See I.R.C. § 6501(a) (generally the statute of limitations on tax matters is three years).

226. Raskolnikov, *Crime and Punishment*, *supra* note 19, at 582 (“The variation of nominal penalties for disclosed and undisclosed transactions is relatively modest. On the other hand, the probably of detection increases dramatically with disclosure.”).

penalty protection must attach the Form 8275, Disclosure Statement, on the top of IRS Form 1040, to reduce the odds that the IRS would overlook it.²²⁷ For taxpayers who file electronically, the IRS should adopt procedures to ensure that Form 8275 is not overlooked.

Immunity would not be available when disclosing a frivolous position. Otherwise, taxpayers might file Form 8275 for bogus tax positions and hope to win the audit lottery. Including a frivolous standard in the new penalty system will not create significant problems like other probability standards because “frivolous” will have its customary legal meaning, and judges are accustomed to applying that standard.²²⁸ In the same way that judges routinely penalize frivolous litigants, judges likely will not hesitate to penalize taxpayers behaving frivolously.

Including the disclosure exception for nonfrivolous positions has one other significant advantage. Generally a party in litigation may maintain a nonfrivolous position without fear of sanctions.²²⁹ Under this proposal, a taxpayer who files a Form 8275, Disclosure Statement, can litigate a nonfrivolous tax position before paying the tax, without fear of a penalty.²³⁰

2. Graduated Penalty Rate for Small Mistakes

Despite the other relief provisions, a strict liability approach still may appear harsh, particularly for small tax underpayments. Although the rate of the negligence penalty is now a flat twenty percent,²³¹ it was only five percent

227. See *supra* note 220.

228. See *supra* notes 139, 202 (describing the “frivolous” standard under this proposal). Parties generally can raise nonfrivolous arguments without fear of sanction. See I.R.C. § 6673 (stating that if the taxpayer’s litigation position is frivolous, penalties and court costs can be imposed); see also T.C. R. 33, available at <http://www.ustaxcourt.gov/notice.htm> (U.S. Tax Court Rules of Practice and Procedure); MODEL RULES OF PROF’L CONDUCT R. 3.1 (2002), cited in Lavoie, *supra* note 26, at 8 n.34. Also, parties generally can maintain contradictory positions. See, e.g., William L. Davis, *Tools of Submission: The Weakening Broad-Form ‘Mandate’ in Texas and the Roles of Jury and Judge*, 24 REV. LITIG. 57, 101 (2005) (“[T]he Texas Rules of Civil Procedure permit parties to make alternative arguments—even when doing so is self-contradictory . . .”).

229. Lavoie, *supra* note 26, at 7 (“[T]axpayers should have the legal right to challenge their obligation to pay such impositions even if they only have a small chance of success.”); see *supra* note 228.

230. When the IRS sends a notice of deficiency to a taxpayer, the taxpayer generally has ninety days to “file a petition with the Tax Court for a redetermination of the deficiency,” and except as otherwise provided, the IRS cannot assess the deficiency, or seek to collect, until the end of the ninety-day period. I.R.C. § 6213(a). If the taxpayer files a petition with the Tax Court within the ninety-day period, then the IRS cannot assess and collect “until the decision of the Tax Court has become final.” *Id.*

231. I.R.C. § 6662(a).

before 1982.²³² Graduated rates will make the proposed penalty much milder for many taxpayers. Accordingly, the proposed maximum penalty rate is only five percent on the first \$5000 of a tax underpayment, and only ten percent on the next \$5000 of a tax underpayment. Even taxpayers at the highest marginal tax rate (in 2009) could make mistakes in reporting taxable income up to \$14,000 and still be subject to only a five percent penalty,²³³ or mistakes up to \$28,000 in taxable income and still be subject to only a ten percent maximum penalty.²³⁴ For the poor and most working-class individuals, the chance of making a mistake in excess of \$28,000 is slim or nonexistent. Thus, a large percentage of taxpayers likely would only be facing a maximum penalty of ten percent at most.

V. Anticipating Challenges and Modifications

A. Challenges Based on the Complexity of Tax Law

Commentators may argue that this proposal fails to appreciate the complexity of the federal income tax system, and the bona fide uncertainty that honest taxpayers face.

1. Argument to Penalize Only Taxpayers Who Intentionally Underpay

It may be argued that a “penalty” should only be imposed after a judge determines that the actor has done something wrong.²³⁵ When the government has made the laws so complex that even experts disagree about the proper tax treatment of bona fide economic transactions,²³⁶ should we penalize ordinary citizens who make mistakes?

A pure strict liability sanction likely would penalize many actors who did not intentionally underpay. However, the proposal in this Article is more nuanced. The option to disclose nonfrivolous positions and be immune from penalties, the low risk of audit, the graduated penalty rate, and other factors, will restrict the unfair results to a few, truly unusual cases. Three examples

232. See Stark, *supra* note 82, at 135.

233. For example, in 2009, the tax rate for a married couple filing jointly is thirty-five percent on their taxable income over \$372,950. Rev. Proc. 2008-66, 2008-45 I.R.B. 1107, § 3.01 (Table 1). A couple taxed at the thirty-five percent marginal tax rate would need to make a mistake in excess of \$14,000 to cause a tax underpayment in excess of \$5000 (\$14,000 error x 35% tax rate = \$4900 tax underpayment). Taxpayers taxed at a lower rate could make bigger mistakes and still be subject to only the five percent penalty rate.

234. The size of the error subject to the five percent and ten percent rates combined is simply twice the size of the error subject to the five percent rate. See *supra* note 233.

235. See *supra* note 150 and accompanying text (implying that only a “wrongdoer” should be penalized).

236. See *supra* Part I.B.

highlight how the proposal would apply when the taxpayer underpays taxes, and the taxpayer arguably did not intentionally underpay.

First, Greta Gambler believes there is a fifty percent chance that she is entitled to deduct a payment. Greta claims the deduction, and chooses not to file the IRS Form 8275, Disclosure Statement. The IRS audits, and Greta loses on the merits. Greta Gambler is liable for the proposed penalty even though some may argue that she acted appropriately. However, on closer inspection this result is appropriate.

Greta Gambler took a calculated risk with the odds in her favor,²³⁷ but happened to lose the gamble. The odds were in Greta's favor because even if her annual income exceeds \$200,000, the risk of audit was only about three percent.²³⁸ If she had filed Form 8275, she would have been immune from the penalty.²³⁹ While disclosure would forfeit the "advantage of having the questionable item overlooked [by the IRS]," this is "an advantage to which [she] is not entitled [because] [t]ax liabilities should be determined by the tax law, not the vagaries of audit."²⁴⁰

This analysis applies whenever the taxpayer believes her chance of success is fifty percent or less.²⁴¹ In these situations, a taxpayer should either file Form 8275, Disclosure Statement, or be prepared to pay a penalty if she loses the audit lottery. Although the disclosure approach requires the taxpayer to file an extra form,²⁴² it results in the taxpayer paying the correct amount of tax and avoids distributive justice problems.

Second, Edith Error transposes numbers, or makes a math error, on her tax return. In this situation, the taxpayer would not file a Form 8275, Disclosure Statement, because she has no idea she is claiming a questionable position, or making a mistake. Because she underpaid her taxes and did not disclose, Edith

237. Professor Raskolnikov describes the gambler's choice under current law. "Without disclosure the taxpayer is playing the audit lottery and facing exceedingly favorable odds." Raskolnikov, *Crime and Punishment*, *supra* note 19, at 582. "[M]ost taxpayers are likely to choose not to disclose and face a low risk of paying 120% or so of a given tax liability plus interest rather than to disclose and take a much higher risk of paying 100% of the same liability." *Id.*

238. *See supra* note 15.

239. *See supra* Part IV.B.1.

240. Jerome Kurtz, *Penalty Revision and the Case for Section 6661*, 43 TAX NOTES 1617, 1618 (1989), *quoted in* Ventry, *Vices and Virtues*, *supra* note 58, at 1090.

241. When the taxpayer believes her chance of success is less than fifty percent, she is taking a greater risk and relying on the audit lottery even more.

242. The IRS estimates that the average taxpayer will need to spend approximately six hours to file Form 8275. Instructions for IRS Form 8275, *supra* note 218, at 3 (three hours and thirty-five minutes for recordkeeping; fifty-three minutes for learning about the law or the form; and fifty-nine minutes for preparing and sending the form to the IRS).

Error would be liable for the penalty under this proposal. It may be argued that this is unfair because Edith did not intentionally underpay, and she did not believe she was filing aggressively.

As a preliminary matter, current law may penalize Edith Error in this situation. The regulation provides that a taxpayer who “procrastinated . . . and hurriedly gathered together [her] tax records [and] . . . prepared a return” would not be eligible for the reasonable cause exception.²⁴³ In addition, the penalty under this proposal likely will be minimal because the IRS computer-matching program will catch these errors quickly,²⁴⁴ and the proposed penalty only accrues at the rate of one percent per month.

Third, Opal Optimistic is considering whether to claim a deduction. She knows the tax result is not absolutely clear, but believes she has a greater than fifty percent chance of success. Opal claims the deduction and does not file the IRS Form 8275, Disclosure Statement. The IRS audits, and her position eventually fails on the merits because Opal and her tax advisor made a legal or factual error. The proposal would penalize Opal. Commentators may argue this is inappropriate because the taxpayer acted reasonably. In this scenario, it seems unlikely that the taxpayer should file a Form 8275, Disclosure Statement, because she believes her position is a winner.

While this result may seem harsh, a few circumstances cushion the impact. As a preliminary matter, the low risk of audit makes it unlikely that the IRS will catch the mistake. If the transaction in question occurs each year for several years, the IRS likely will not catch it every year. Also, if the amount of the tax underpayment is under \$10,000, the penalty rate will only be five or ten percent. In addition, Opal and her tax advisor did make a mistake, which they might have avoided by exercising greater diligence.

As discussed in Part II.C, a fault-based penalty system creates problems that threaten the integrity of the entire federal income tax system. This Article asserts that although this proposal will penalize Opal Optimistic and similarly situated taxpayers in isolated situations, the benefits of the new proposal will far outweigh the problems.

2. *Argument for Immunity for Reliance on a Tax Advisor*

When faced with uncertainty, one can argue that a reasonably prudent person would seek the advice of an expert, and then follow that advice.²⁴⁵ The current system grants immunity to taxpayers using that approach.²⁴⁶

243. Treas. Reg. § 1.6664-4(b)(2) (1992) (Example 4).

244. See SALTZMAN, *supra* note 24 (regarding the IRS computer-matching program).

245. The U.S. Supreme Court has expressed this view in dicta. *Boyle v. United States*, 469 U.S. 241, 251 (1985); see *supra* note 143 and accompanying text.

246. See *supra* Part II.A.3.

Although this argument has theoretical appeal, in practice, it grants immunity for wealthy taxpayers claiming big deductions. A wealthy taxpayer can purchase an opinion letter from a tax advisor, which can serve as penalty insurance.²⁴⁷ Indeed, in response to the fear that tax advisors were selling opinion letters without proper due diligence,²⁴⁸ in 2004 the government began a process to regulate the manner in which taxpayer representatives issue opinion letters that provide penalty protection.²⁴⁹ The new rules have led to substantial administrative costs²⁵⁰ and bitter debates in the tax world.²⁵¹ However, the rules may have no practical impact on substantial transactions for wealthy taxpayers.²⁵²

247. “The solution [for convincing taxpayers to invest in tax shelters] has been for the tax shelter promoter to obtain and furnish to the taxpayer (at the taxpayer’s expense) an opinion of independent tax counsel [T]he effect of such an opinion—or so it is hoped—is to immunize the taxpayer from the danger of civil penalties.” Chirelstein & Zelenak, *supra* note 73, at 1940-41; see also Matthew Piper, Note, *Gimme Shelter: How the Accountant’s Contingency Fee and the Attorney’s Opinion Letter Have Contributed to the Proliferation of Abusive Tax Shelters*, 83 N.D. L. REV. 261 (2007).

248. The applicable legislative history states,

The Committee believes that it is critical that the Secretary [of the Treasury] have the authority to censure tax advisors as well as to impose monetary sanctions against tax advisors because of the important role of tax advisors in our tax system. Use of these sanctions is expected to curb the participation of tax advisors in . . . tax shelter activity

S. REP. NO. 108-257, at 106 (2004).

249. In 2004, Congress granted the Secretary of the Treasury authority to “impose standards applicable to the rendering of *written advice* with respect to any entity, transaction plan or arrangement . . . which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.” American Jobs Creation Act of 2004, § 822(b), Pub. L. No. 108-357, 118 Stat. 1418, 1587 (codified at 31 U.S.C. §330(d) (Supp. IV 2004) (emphasis added).

250. Juan F. Vasquez, Jr., *Section 10.35(b)(4)(ii) of Circular 230 Is Invalid (But Just in Case It Is Valid, Please Note That You Cannot Rely on This Article to Avoid the Imposition of Penalties)*, 7 HOUS. BUS. & TAX L.J. 293, 294-95 (2007) (discussing the legend that generally must appear on e-mails sent by tax lawyers as a result of the Circular 230 regulations).

251. “Ever since Treasury issued amendments to Circular 230 covering formal opinions as well as other forms of written advice, there has been a torrent of objections from tax advisers.” Deborah H. Schenk, *The Circular 230 Amendments: Time to Throw Them Out and Start Over*, 110 TAX NOTES 1311, 1311 (2006).

252. See Vasquez, *supra* note 250, at 329-30 (“Circular 230[] . . . is a troubling misstep The regulation eviscerates the plain meaning of the Internal Revenue Code, well established case law and agency regulation, sidesteps the Administrative Procedure Act, treats similarly situated taxpayers inequitably, is overbroad, and is contrary to First Amendment and Federalism concerns.”); Schenk, *supra* note 251, at 1315 (“[Circular 230] raises substantial First Amendment questions.”).

The enactment of the proposed penalty, and the repeal of the current penalties, would end this debate over opinion letters²⁵³ because it would eliminate the demand for opinion letters sold as penalty insurance.²⁵⁴ The proposed penalty would apply whether or not the taxpayer relied on a tax advisor.

3. *Over-Deterrence Argument*

Another potential challenge is that under the proposal, a taxpayer who has a meritorious position, but not a bullet-proof position, will refrain from taking the position out of fear. The taxpayer may fear that the analysis is overly optimistic, or that the ultimate decision-maker will make a mistake. In that scenario, the taxpayer may overpay taxes to avoid the risk of the proposed penalty.

In response, it seems unlikely that many people will be deterred from claiming appropriate positions that can reduce their taxes, particularly because of the low audit rates. Furthermore, the taxpayer can eliminate the penalty risk by filing a Disclosure Statement, IRS Form 8275, with the tax return.

4. *Problems When the Ultimate Decision-Maker Is Wrong*

When the ultimate decision-maker in a tax case is wrong and decides against the taxpayer, the new proposed penalty will exacerbate the problem. Under current law, the ultimate decision-maker might be wrong on the merits, but can decide that the taxpayer's position met the applicable standard to avoid penalties²⁵⁵ or qualified for another exception.²⁵⁶ The proposal in this Article will eliminate this beneficial flexibility, and the taxpayer may be doubly wronged.

253. This proposal only eliminates the demand for opinion letters to avoid the negligence and substantial understatement penalties. There will be many other penalties, and other situations, for which taxpayers will seek opinion letters from tax advisors. *See* Schizer, *supra* note 98, at 360 (arguing that taxpayers will still seek opinion letters for honest advice against taking overly aggressive positions).

254. *Id.* ("The cleanest way to avoid this race to the bottom [with tax advisors competing to sell opinion letters as penalty insurance] . . . is to strip away the penalty protection function from tax opinions.").

255. *See supra* Part II.A.1 regarding the applicable standards.

256. *See supra* Part II.A.3 (the exception for reliance on a tax advisor); *supra* Part II.A.2 (the exception for "good faith" filing).

In response, the tax system allows multiple levels of appeals,²⁵⁷ which hopefully reduce the risk of a wrong decision if the taxpayer can afford to keep appealing. Also, because of the low audit rates, it is more likely that a taxpayer will never be challenged than that the IRS will audit and the taxpayer will be a victim of a bad decision.

B. Problems Based on the Law of Unintended Consequences

In his breakthrough article, *The Unanticipated Consequences of Purposive Social Action*,²⁵⁸ American sociologist Robert K. Merton observed that governmental action almost always triggers unanticipated consequences.²⁵⁹ The proposed penalty system likely will not escape this law. The costs of negative unintended consequences,²⁶⁰ however, will be small compared to the benefits.

1. Negative Impacts on the Working Class and the Poor

Sometimes the working class and the poor make mistakes on tax returns. In addition to the low risk of audit, two other factors will minimize the impact of the proposed penalty system.

First, when a taxpayer is trying to file accurately, the taxpayer may make one or more mistakes that cause a tax underpayment, but may make one or more mistakes that cause a tax overpayment. The proposed penalty would only apply to a net underpayment.²⁶¹

257. If the taxpayer disagrees with the IRS auditor's conclusions, the taxpayer can appeal to the IRS Appeals Office. See Donald C. Alexander & Brian S. Gleicher, *IRS Procedures: Examinations and Appeals*, 623-2nd Tax Mgmt. (BNA) A-80. If not satisfied with the settlement offer from the IRS Appeals Officer, the taxpayer can petition the Tax Court within ninety days of receiving the IRS notice of deficiency. I.R.C. § 6213(a) (2008); Robert A. Levine & Theodore D. Peyser, *Tax Court Litigation*, 630-2nd Tax Mgmt. (BNA) A-1; *id.* at A-7 (As an alternative to petitioning the Tax Court, the taxpayer "can pay the tax, file a claim for refund, and then file suit for a refund in either a federal district court or the Court of Federal Claims."). A taxpayer can appeal the decision of the trial court to a Federal Circuit Court of Appeals, and the taxpayer can appeal that court's decision to the U.S. Supreme Court.

258. Robert K. Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOC. REV. 894, 896 (1936), available at <http://www.compilerpress.atfreeweb.com/Anno%20Merton%20Unintended.htm>.

259. "The law of unintended consequences, often cited but rarely defined, is that actions of people—and especially of government—always have effects that are unanticipated or unintended." Rob Norton, *Unintended Consequences*, in THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David Henderson ed., 2008), available at <http://www.econlib.org/LIBRARY/Enc/UnintendedConsequences.html>.

260. A government action also can have beneficial, or neutral, unintended consequences. See Norton, *supra* note 259.

261. There would only be a tax underpayment if the errors in favor of the taxpayer had a

Second, the working class and the poor may make mistakes that are quickly caught by the IRS computer-matching program,²⁶² particularly because most, if not all, of their income will be subject to withholding or information reporting.²⁶³ As a result, the penalty may be only one or two percent if the computers catch the mistake quickly.

A more serious potential problem for the working class and the poor is the risk of receiving income, and then suffering a cash shortage at the time the tax payment is due. This risk should be nonexistent for wages subject to withholding because the employer withholds the taxes before paying the employee.²⁶⁴ However, other types of income such as compensation received as an independent contractor, interest, dividends, and proceeds from the sale of property are not subject to withholding, and it is the taxpayer's responsibility to retain sufficient funds to make quarterly estimated tax payments, or to pay the tax due by April 15th. Although the proposed penalty could drive a working class or poor individual who is short on cash even further in debt, the proposal includes exceptions for financial emergencies and for taxpayers who enter into an installment payment plan with the IRS.²⁶⁵

Another special concern for the working poor is the earned income credit. This refundable credit is only available to taxpayers with earned income below \$43,415 in 2009,²⁶⁶ and unfortunately it is complex.²⁶⁷ Many taxpayers calculate the credit wrong every year.²⁶⁸

greater impact on the tax owed than errors in favor of the government.

262. *See supra* note 30.

263. *See supra* notes 28-30 and accompanying text.

264. Problems could arise if the employer does not withhold enough, perhaps because of mathematical errors, clerical errors, or errors in the number of dependants claimed on IRS Form W-4.

265. *See supra* Part IV.A(iv).

266. This is the maximum amount for joint filers with two or more qualifying children in 2009. Rev. Proc. 2008-66, § 3.06, 2007-45 I.R.B. 1107. The maximum for joint filers with one qualifying child is \$38,583, and for joint filers with no qualifying children, the maximum is \$16,560. *Id.*

267. *See* Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 415 n.41 (2005) ("Many will perform complex calculations . . . only to find that they do not qualify . . . or that they qualify for a credit that does not entirely offset their costs. For those taxpayers, the [credit] is burdensome complexity, not beneficial complexity.").

268. "The Earned Income Credit . . . was the source of many errors by taxpayers and tax practitioners in preparing returns." U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: CONTINUING PROBLEMS AFFECT OTHERWISE SUCCESSFUL 1994 FILING SEASON 2 (1994), available at <http://www.gao.gov/archive/1995/gg95005.pdf>, quoted in Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790, 793 n.14 (2007).

The proposed graduated penalty rate would mitigate the impact of the proposal on these taxpayers.²⁶⁹ Moreover, a taxpayer claiming the earned income credit frequently owes no additional tax with her return, usually because of withholding on wages. The taxpayer files a tax return merely to claim the earned income credit, and in those cases the government could treat the tax return as a refund claim. As a result, the new penalty would not apply because there is no tax underpayment.

2. *Exacerbating Antipathy Toward Government*

Norms that may decrease compliance include perceptions that the tax rules are unfair²⁷⁰ or that the IRS is a bully. This proposal will increase the maximum penalty rate for inaccurate filing from twenty percent to twenty-five percent, and will eliminate exceptions that may be viewed as taxpayer friendly, such as the exception for reliance on a tax advisor, the exception for tax positions with at least a twenty percent chance of success, and the exception for an “honest misunderstanding of fact or law.”²⁷¹ As a result, policymakers, practitioners, and scholars who emphasize norms may argue that this proposal will make tax enforcement more inflexible and will cause more taxpayers to file aggressively.²⁷²

At least four factors may prevent negative taxpayer perceptions. First, the proposal adds a twenty-five percent penalty, but removes the twenty percent negligence and substantial understatement penalties and the current failure-to-pay penalty, which can reach twenty-five percent. Second, under this proposal, most taxpayers would only face a five percent penalty or a ten percent penalty, not a twenty-five percent penalty.²⁷³ Third, the proposed penalty will reduce the discretion in administering tax penalties, increasing the chance that the tax system will treat similarly situated taxpayers the same. In particular, wealthy taxpayers using tax dodges will no longer find shelter from tax penalties by purchasing opinion letters from tax advisors. Taxpayers may respond favorably to a more just system. Fourth, taxpayers may perceive that the new penalty system will decrease tax cheating. If people believe that their

269. *See supra* Part IV.B.2.

270. Lavoie, *supra* note 26, at 3-4 (“Taxpayer compliance is linked to perceptions regarding the overall fairness of the tax system. When taxpayers perceive the [IRS] as overreaching, they lose faith in the system and voluntary compliance is harmed.” (footnote omitted)); *see also* Andreoni, *supra* note 19, at 851; Kornhauser, *supra* note 19, at 615-16.

271. *See* Treas. Reg. § 1.6664-4(b)(1) (1992).

272. *See supra* note 22 and accompanying text.

273. *See supra* notes 233-34 (even for taxpayers in the highest marginal income tax bracket, the penalty rate would only be five percent for mistakes up to \$14,000, and the penalty rate would only be ten percent for mistakes from \$14,000 to \$28,000).

neighbors are complying with the tax laws, reciprocal motivations to comply will strengthen.²⁷⁴

3. *Practical Impact When the IRS Attempts to Settle a Case*

When a court considers a single issue, normally the court must use an all-or-nothing approach.²⁷⁵ In contrast, an IRS Appeals Officer has great flexibility in settling a tax dispute. An IRS Appeals Officer can consider the hazards of litigation,²⁷⁶ and settle cases on a percentage, with the taxpayer winning anywhere from nothing to eighty percent on an issue.²⁷⁷ Also, an IRS Appeals Officer can waive an asserted penalty even if the settlement calls for the IRS to collect all of the asserted tax underpayment. Part of this flexibility would disappear under the proposed penalty system. The IRS would have to collect the proposed penalty on any tax underpayment, except in cases of disclosure, a financial emergency, or when the taxpayer and IRS entered into an installment payment agreement.²⁷⁸

Nevertheless, as long as the IRS Appeals Officer and the taxpayer are aware of the strict liability nature of the new penalty system, they could factor that into their settlement negotiations. Thus, rather than agreeing to a fifty percent settlement with no penalty, the parties might agree on a forty percent settlement that would automatically trigger the proposed penalty.

4. *Practical Impact When a Court Decides a Tax Case*

Currently a judge has tremendous flexibility in deciding whether to enforce the negligence or substantial understatement penalties. Under this proposal, that flexibility would disappear. In effect, the stakes in tax dispute cases would automatically rise. With a new twenty-five percent strict liability style penalty and a thirty-five percent maximum marginal tax rate, a judge deciding

274. See Kahan, *Signaling or Reciprocating?*, *supra* note 19, at 367-69.

275. Generally in a tax case, either the amount received is taxable or it is not; either the payment is deductible or it is not; either the penalty applies or it does not. There are exceptions. For example, in valuation cases, a court can choose a figure between the value proposed by the IRS and the value proposed by the taxpayer. See, e.g., *Turner v. Comm'r*, 13 T.C.M. (CCH) 462 (1954); see also *Cohan v. Comm'r*, 11 B.T.A. 743 (1928), *aff'd and rev'd* 39 F.2d 540 (2d Cir. 1930).

276. See INTERNAL REVENUE MANUAL, *supra* note 69, § 8.1.3.4 (Appeals Officer), available at <http://www.irs.gov/irm/part8/ch01s02.html#d0e1092>; Lavoie, *supra* note 26, at 10.

277. Generally, the IRS will not settle for less than twenty percent on an issue because the public might view that as a "nuisance" payment to prevent the IRS from harassing the taxpayer. Lavoie, *supra* note 26, at 10 n.50.

278. See *supra* Parts IV.A(ii), IV.B.1 (discussing the three exceptions to the proposed new penalty system).

against a wealthy taxpayer²⁷⁹ will force the taxpayer to pay approximately forty-five percent of the amount in controversy to the IRS.²⁸⁰ As a result, some may argue that judges may decide more close cases for the taxpayer. However, from 1965 to 1980, the maximum marginal tax rate alone, without penalties, exceeded sixty percent,²⁸¹ and judges decided cases against taxpayers during that period.

5. Greater Demand for IRS Guidance

This proposal may increase demand for IRS guidance on uncertain issues. Subject to various exceptions, a taxpayer currently can request a letter ruling from the IRS on an uncertain issue for a fee of \$11,500 per ruling request.²⁸² Taxpayers who can choose whether to enter into a transaction, and can wait for an IRS response, may find this letter ruling process desirable. Other taxpayers may simply file a Disclosure Statement, IRS Form 8275, with the tax return to avoid a penalty for claiming an uncertain tax position.

C. Features of the Proposal That May Need Adjustment

1. The Twenty-Five Percent Rate

A twenty-five percent rate is used for other civil tax penalties, including the current failure-to-file penalty and the current failure-to-pay penalty.²⁸³ Nevertheless, there is no magic in the twenty-five percent figure. This proposal's objective, to promote accurate tax filing, might be better served with a slightly higher or lower penalty rate. The rate, however, likely should not be set significantly higher or lower for the following three reasons.

First, a significantly higher rate could trigger ability-to-pay problems. With a thirty-five percent maximum income tax rate and a twenty-five percent

279. In 2009, the thirty-five percent rate applies to taxable income over \$372,950, except in the case of married individuals filing separately, in which case the thirty-five percent rate applies to taxable income over \$178,850. Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 § 3.01 (Table 4).

280. IRC § 1(i)(2) (2008). For example, if a taxpayer fails to report \$100 of taxable income, the tax deficiency will be \$35 ($\$100 \times 35\% = \35). The penalty on that tax deficiency would be \$8.75 ($\$35 \times 25\% = \8.75). Thus, the combined tax and penalty would be \$43.75. *See supra* note 211.

281. *See supra* note 212 and accompanying text.

282. Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 56 § 15 (discussing the fees); *id.* at 68 (Appendix A, § (A)(3)(c)) (\$11,500 for "all other requests" after February 1, 2008).

283. *See* I.R.C. § 6651(a)(1) (stating that the penalty rate for the failure-to-file penalty is five percent per month for five months, for a maximum penalty of twenty-five percent); *see id.* § 6651(a)(2) (stating that the penalty rate for the failure-to-pay penalty is 0.5% per month for fifty months, for a maximum of twenty-five percent).

penalty rate, the combined rate would be approximately forty-five percent.²⁸⁴ Thus, if the taxpayer receives a \$1 “accession to wealth,”²⁸⁵ fails to pay the tax on time, is audited, is taxed at the maximum rate and is liable for the new twenty-five percent penalty, the total amount due will be approximately forty-five cents (plus interest). In that scenario, the taxpayer hopefully will still have the money to pay the tax obligation and will have approximately fifty-five cents remaining. However, if Congress set the penalty rate significantly higher, for example at fifty percent, the combined rate would then be approximately fifty-five percent, and taxpayers would be less likely to have the wealth to pay the obligations, particularly if the value of their investments significantly declined between the time they received the amount and the time they must pay the tax and penalty.

Second, a significantly higher rate could be viewed as excessive, particularly when a taxpayer makes an honest mistake and fails to disclose. A penalty significantly higher than twenty-five percent could be perceived as outrageous and could trigger anti-IRS or anti-government reactions, which in turn might reduce taxpayer compliance.²⁸⁶

Third, the wealthy may view a penalty with a significantly lower rate as trivial, and it would have no impact on taxpayer behavior.

2. *The Accrual Rate of the Penalty*

The timing of the accrual also could be reconsidered. The proposed accrual rate of one percent per month, reaching a maximum in the twenty-fifth month, would give taxpayers an incentive to review their tax returns shortly after April 15th to correct errors. Also, bookkeepers, accountants, and other third parties who provide necessary information to taxpayers may spot corrections shortly after April 15th. Thus, honest taxpayers may benefit from the gradual build-up of the penalty. The twenty-five month build-up period likely will not assist wealthy taxpayers who file aggressively and then are caught on audit because a significant audit would rarely conclude within twenty-five months of the date the taxpayer filed the return.²⁸⁷

Nevertheless, it may be appropriate to more closely coordinate the accrual period with the time needed for the IRS computer-matching program to catch taxpayer errors.²⁸⁸ Many of the errors caught by the IRS computer-matching program likely are unintentional. Thus, for example, if the IRS generally

284. IRC § 1(i)(2); *see supra* note 280 (regarding the forty-five percent combined figure).

285. Generally, an amount received will only be subject to income tax if there is an “accession to wealth.” *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

286. *See supra* note 22 and accompanying text.

287. The IRS generally has three years to audit a tax return. I.R.C. § 6501(a).

288. *See supra* note 28 (regarding the IRS computer-matching program).

completes its computer-matching program within three months for timely-filed tax returns, it might be preferable for the proposed penalty to build-up at an even lower rate for the first three months.²⁸⁹

3. Coordination with Other Penalties

If the existing civil fraud penalties and criminal penalties are adequate to deter fraudulent and criminal tax behavior, the new penalty would not need to apply when the civil fraud or criminal penalties apply.

Also, in regards to coordinating with other penalties, the wealthy who file aggressively may tend to file tax returns on time to avoid the failure-to-file penalty,²⁹⁰ and only the uninformed and the procrastinators fail to file on time. As a result, if both penalties apply to a taxpayer, perhaps the proposed penalty should be offset by the failure-to-file penalty.²⁹¹

Conclusion

Our current tax system has accuracy-related penalties²⁹² that seldom penalize inaccuracies, and a failure-to-pay penalty that seldom penalizes failures to pay.

A taxpayer can dodge the accuracy-related penalties by (i) relying on the advice of a tax advisor; or (ii) showing that she believed she was acting with reasonable care and in good faith; or (iii) showing that the position had at least a one-out-of-five chance of success in the case of the negligence penalty, or at least a two-out-of-five chance for the substantial understatement penalty. A taxpayer can dodge the failure-to-pay penalty by filing inaccurately, waiting to see if the IRS catches the error, and then promptly paying the amount due after all chances of appeal expire. As a result, the current system sends confusing signals that encourage wealthy taxpayers to file aggressively, not accurately.

Congress should repeal the existing accuracy-related penalties and the failure-to-pay penalty. In their place, Congress should enact a strict liability style penalty that will send a clear message. In Appendix A, this Article

289. The government would need to impose some minimal penalty for the first four months to discourage taxpayers from delaying payment for four months. Another approach might be to apply a lower penalty rate on tax underpayments detected by the IRS through the computer-matching program if the tax underpayment is under a certain dollar amount (e.g., \$500).

290. I.R.C. § 6651(a)(1) (the failure-to-file penalty).

291. Except in cases when the failure-to-file and failure-to-pay is intentional, there is no need to impose a double penalty because the penalty will not change conscious behavior. Instead, in those situations, a single twenty-five percent penalty should be sufficient.

292. The negligence penalty and the substantial understatement penalty are described as accuracy-related penalties. I.R.C. § 6662(b)(1)-(2).

provides a proposed statute to adopt a “false-filing-without-disclosure” penalty. The U.S. Supreme Court has declared that our tax system relies on taxpayers paying the correct amount of tax on time.²⁹³ This proposal will penalize taxpayers who shirk their duty.

293. *Manning v. Seeley Tube & Box Co. of N.J.*, 338 U.S. 561, 565 (1950).

APPENDIX A

Proposed Statute to Create a New False-Filing-Without-Disclosure Penalty.

New IRC §6651A. False-Filing-Without-Disclosure Penalty.

(a) ADDITION TO THE TAX – In the case of a failure to pay any amount of any tax required to be shown on a return listed in I.R.C. § 6651(a)(1) on or before the date prescribed for payment of such tax (determined without regard to any extension of time for filing), unless it is shown that such failure is described in subsection (c), there shall be added to the amount due one percent of the amount of such tax underpayment if the failure is for not more than one month, with an additional one percent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five percent in the aggregate, provided that the penalty rate on the first \$5000 of any tax underpayment shall not exceed five percent, and the penalty rate on the next \$5000 of any tax underpayment shall not exceed ten percent.

(b) PENALTY IMPOSED ON NET AMOUNT DUE – For purposes of subsection (a), the amount of the tax underpayment shall be reduced by the amount of any part of the tax which is paid on or before the beginning of such month and the amount of any credit against the tax which the taxpayer may claim on the return.

(c) EXCEPTIONS – This section shall not apply to –

(1) Any failure to pay a tax based on a nonfrivolous position disclosed by the taxpayer in such manner as designated by the Secretary in regulations.

(2) Any month during which an installment agreement under I.R.C. § 6159 is in effect for the payment of such tax, and the taxpayer pays all installments when due under such agreement.

(3) Any failure to pay a tax liability reported on an original filed return to the extent the failure to pay is caused by a financial emergency.

[RELATED STATUTORY CHANGES – The existing failure-to-pay penalty provisions would be excised from I.R.C. § 6651; the substantial understatement penalty and the negligence penalty would be excised from I.R.C. § 6662; and I.R.C. § 6664 would be amended as appropriate.]