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# Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design

LEIGH OSOFSKY†

## INTRODUCTION

Taxpayers who want to reduce their tax liability through tax planning face a dilemma. In order to do so, they often must bear costs that seem, at first glance, to have nothing to do with getting the desirable tax result. For example, imagine that an accounting firm approaches the tax director of a major corporation and explains that, by entering into a complex tax planning scheme, the tax director can reduce the corporation's tax liability by a whopping \$500 million. The accounting firm explains that the only real catch is that in order to get this incredible tax benefit under the tax law, the corporation must subject itself to undesirable business risk.<sup>1</sup> The tax director agrees to enter the corporation into the scheme, subjects it to the undesirable business risk, and obtains the incredible tax savings. Efficiency-minded academics see a puzzle with this situation. Why should the desirable tax result be conditioned upon bearing undesirable business risk? In

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1. Readers familiar with the frictions literature will recognize this scenario as akin to that posed by Daniel N. Shaviro in Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221, 223 (2000) [hereinafter Shaviro, *Economic Substance*]. Shaviro's discussion of frictions will be examined in more detail at the text accompanying notes 41 and 47.

particular, since the corporation is worse off, and no one is better off, as a result of the corporation bearing the undesirable business risk, the business risk requirement itself appears to be ill-conceived.<sup>2</sup>

Prominent economists and tax scholars have answered this question by developing the compelling and important theory of "frictions." According to this theory, tax law relies on frictions, or nontax costs, in order to make tax planning more expensive. The goal is to deter these transactions, which are viewed as socially wasteful.<sup>3</sup> Under this theory, at least with respect to the tax law,<sup>4</sup> a friction serves no useful role, other than to deter the tax planning. For example, in the case discussed above, business risk would be a good friction if it stopped the tax director from entering into the scheme. It would be a bad friction if the tax director went through with the scheme, albeit after taking on the undesirable business risk. This focus on the deterrence aspect of frictions has caused scholars to generally agree upon two pieces of conventional wisdom regarding frictions. Good frictions should (1) deter tax planning rather than cause it to continue in a more wasteful fashion, and (2) not impose costs on regular business transactions.<sup>5</sup>

In this Article, I argue that frictions serve a more extensive and complex role than has been recognized previously. Although not focused on in the tax literature, frictions function first as screening mechanisms, by tracking underlying characteristics of taxpayers and imposing different costs on different groups. A large body of literature regarding optimal tax theory addresses screening

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2. *See id.*

3. David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315-16 & n.5 (2001) [hereinafter Schizer, *Frictions as a Constraint*].

4. The friction may be valuable for reasons having nothing to do with the tax law. *See, e.g., id.* at 1338 (explaining how frictions, such as a taxpayer's desire to engage in public trading, can serve important nontax functions and that reformers should be careful not to undermine frictions that serve similarly important nontax functions).

5. *See discussion infra* at text accompanying notes 45-50.

taxpayers.<sup>6</sup> At base (and as explained in more detail in Part II), screening mechanisms in the optimal tax context track characteristics indicative of ability and impose greater costs on high ability taxpayers trying to obtain low tax rates or other benefits, in order to target the low rates or benefits more accurately to low ability taxpayers. Scholars have not yet connected this literature with their understanding of frictions, because tax scholarship has not conceived of tax planning as a screening problem. This Article makes the connection, exploring how tax planning presents a similar (and related) screening problem, and how frictions serve as screening mechanisms. The tax system must screen between tax planners and non-planners and then deter tax planners, in order to preserve revenue, fairness, and efficiency. When frictions are designed appropriately as screening mechanisms on tax planning, they do so by tracking characteristics of tax planners and imposing greater costs on them.

Recognizing how frictions screen complicates conventional wisdom and suggests a more robust framework for the design of frictions throughout the tax law. In particular, understanding how frictions function as screening mechanisms reveals that a friction that deters tax planning rather than causes it to continue in a more wasteful fashion may nonetheless be a failed friction and that imposing costs on regular business transactions is not always a flaw. Instead, the key inquiry is whether a friction imposes *differential*, and greater, costs on tax planners, relative to non-planners, thereby reducing the overall social costs from tax planning. This inquiry suggests a broader framework for evaluating frictions. First, frictions must impose greater costs on tax planners than non-planners. Second, as to tax planners, the friction must deter tax planning, rather than causing it to continue in a more wasteful fashion. Third, the benefits from the first two steps (from increased efficiency and lower tax liability for non-planners) must outweigh costs that taxpayers bear as a result of the friction.

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6. See discussion *infra* at text accompanying notes 63-83.

This new framework can lead to concrete improvements in many different types of frictions. It can help sharpen the screening capacity of existing frictions that already serve as promising screening mechanisms. For example, the so-called wash sale rule<sup>7</sup> does a reasonable job of identifying characteristics likely to correlate well with tax planning motivation and imposing greater costs on taxpayers more likely engaged in such planning. As a result, the wash sale rule is designed reasonably as a screening mechanism for tax planning (even though, as scholars have pointed out, it may not do a great job actually deterring such planning).<sup>8</sup> However, viewing frictions as screening mechanisms can help improve the wash sale rule, by targeting costs more appropriately to tax planners.

This framework can also help reveal and rethink potentially undesirable frictions. Unlike the wash sale rule, other frictions in the tax system systematically impose higher costs on taxpayers based on characteristics other than tax planning motivation, in a manner that ultimately may undermine the desirability of the friction. For example, the so-called use-it-or-lose-it rule for flexible spending accounts<sup>9</sup> is a friction. The use-it-or-lose-it rule arguably may serve as a powerful means of deterring tax planning. However, the use-it-or-lose-it rule imposes particularly high costs on taxpayers who are less sophisticated decision makers and on those taxpayers with lower marginal tax rates.<sup>10</sup> Systematically imposing higher costs on taxpayers who are less sophisticated decision makers or who face lower marginal tax rates is difficult to defend at best and highly perverse at worst.<sup>11</sup> Viewing frictions as screening mechanisms is essential to recognizing these perversities and charting a path toward reform.

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7. I.R.C. § 1091 (2006).

8. See, e.g., David M. Schizer, *Scrubbing the Wash Sale Rules*, TAXES, Mar. 2004, at 67, 67 [hereinafter Schizer, *Scrubbing the Wash Sale Rules*].

9. Prop. Treas. Reg. § 1.125-5(c), 72 Fed. Reg. 43937, 43957 (Aug. 6, 2007).

10. See discussion *infra* Part IV.B.2.

11. See discussion *infra* Part IV.B.2.

Finally, this framework can help analyze the utility of prospective frictions. For example, scholars often discuss tax law uncertainty as a promising friction to deter tax planning. However, tax law uncertainty fails entirely as a screening mechanism on tax planning because it does not target tax planners in particular. Applying the screening framework can suggest ways to make tax law uncertainty a more targeted friction on tax planning. In short, viewing frictions as screening mechanisms complicates basic assumptions about the design of frictions, provides a broader framework to think about how to craft successful frictions, and, therefore, offers concrete improvements to existing tax law.

This Article proceeds as follows. Part I sets forth the current understanding of frictions and the social waste framework that underlies this analysis. Part II explores screening mechanisms in optimal tax theory. Part III explains how tax planning presents a similar, and related, screening problem to that set forth in optimal tax theory. Part IV explains how frictions serve as screening mechanisms, how this insight has conceptual importance for the design of tax law, and how the conceptual lessons should translate into concrete tax law reform. The Conclusion describes potential future lines of research.

## I. EXISTING FRICTIONS LITERATURE

This Part provides background regarding the existing frictions literature, to which this Article responds. The concept of frictions grows out of an important strain of tax scholarship, grounded in efficiency, which generally views tax planning as a form of social waste. As a result, this Part begins first by defining tax planning, as understood in the frictions literature, and by briefly explaining the efficiency mode of analysis and the assumption that tax planning is socially wasteful. This Part then describes the existing frictions literature, its focus on deterrence, and the resulting conventional wisdom regarding frictions.

### A. *Tax Planning and Social Waste*

As an initial matter, while tax planning could be defined very broadly to include any activity designed to reduce taxation,<sup>12</sup> when discussing “tax planning,” the existing frictions literature and, as a result, this Article, focuses on a narrower set of activity. Specifically, the frictions literature focuses on planning transactions in order to reduce tax liability, including through the postponement of taxes, tax arbitrage across taxpayers subject to different tax rates, and tax arbitrage across streams of income subject to different tax rates.<sup>13</sup> The frictions literature does not tend to focus on underlying behavioral changes designed to reduce taxation, such as substitutions of leisure for labor.

The frictions literature is set within a prominent line of tax scholarship, rooted in economics, which examines tax law design with efficiency as a major criterion.<sup>14</sup> Efficiency

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12. The economics literature sometimes distinguishes between different types of behavioral responses designed to reduce tax liability: real shifts in underlying behavior in response to tax (such as a switch from work to leisure); avoidance activity (or investing time and resources in order to find legal ways, other than through changes in underlying behavior, to reduce tax liability); and evasion activity. *E.g.*, Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 INT'L MONETARY FUND (“IMF”) STAFF PAPERS 172, 178 (1996). Defined broadly, tax planning could fit within all of these categories and sometimes within multiple categories at the same time.

13. *See, e.g.*, Joseph E. Stiglitz, *The General Theory of Tax Avoidance*, 38 NAT'L TAX J. 325, 325 (1985). Some might simply refer to this behavior as “tax avoidance” (and indeed Stiglitz does). In this Article, I refrain from doing so because much of the frictions literature uses the term “tax planning” (to refer to the types of tax planning transactions referred to in the text), *see, for example*, Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 233 (2010) (explaining that the “thrust of this tax-planning literature is that frictions can be a powerful constraint and should be used as a regulatory tool to combat wasteful tax planning”), and to avoid some of the tricky issues that accompany the “tax avoidance” label, *see, for example*, Ilan Benshalom, *The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law*, 85 N.Y.U. L. REV. 1, 44 (2010) [hereinafter Benshalom, *New Poor at Our Gates*] (discussing futility of attempts to define tax avoidance).

14. This is not to say that scholars working with efficiency are unconcerned with other questions, such as equity and distribution. Rather, equity and distribution are central concerns, which are often bracketed in considering the design of the tax law (or the tax base). Sometimes this is done “to simplify and clarify the analysis.” *See, e.g.*, Daniel N. Shaviro, *An Efficiency Analysis of*

analysis focuses on minimizing the “social cost” of taxation.<sup>15</sup> In particular, efficiency-minded scholars tend to concentrate on one particular social cost of taxation, the so-called “deadweight loss” from taxation.<sup>16</sup>

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*Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 4 (1992) [hereinafter Shaviro, *An Efficiency Analysis of Realization*]. Sometimes this is done under the belief that non-efficiency considerations, such as distribution, are best dealt with by adjusting the rate schedule, whereas efficiency considerations should dominate the design of the tax base. See, e.g., David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1676-79 (1999) [hereinafter Weisbach, *Line Drawing*].

15. Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 TAX L. REV. 229, 229 (2011). The social cost of taxation includes a variety of costs, including the administrative and compliance costs of the tax system, as well as the deadweight losses from taxpayers shifting their behavior (through substitution, avoidance, and evasion activities) to reduce the tax liability they have to pay. Joel Slemrod and Shlomo Yitzhaki included all of these social costs of taxation in their explication of the marginal efficiency cost of funds (“MECF”). Slemrod & Yitzhaki, *supra* note 12. As a result, scholars have at least nominally begun to take the full array of social costs of taxation into account in their analyses. See, e.g., LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 90-94 (2008) (discussing administration and enforcement); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 649-50 (2007) [hereinafter Raskolnikov, *Cost of Norms*] (raising, though not ultimately applying, MECF analysis); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 637-38 (2006) (same); Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 514-18 (2004) [hereinafter Schenk, *An Efficiency Approach*] (examining all of the costs set forth by Slemrod and Yitzhaki); Weisbach, *Line Drawing*, *supra* note 14, at 1665-68 (applying MECF, though not formally incorporating administrative costs). However, the deadweight loss from taxpayers shifting their behavior in response to taxation remains a primary focus of the efficiency analysis. See, e.g., David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1353-54 (2000) [hereinafter Schizer, *Sticks and Snakes*] (citing to MECF, albeit to focus on likelihood of engaging in planning to avoid tax, rather than to focus on administrative and compliance issues).

16. See, e.g., Schenk, *An Efficiency Approach*, *supra* note 15, at 514-18; Shaviro, *An Efficiency Analysis of Realization*, *supra* note 14, at 4; Weisbach, *Line Drawing*, *supra* note 14, at 1650-51. While much of tax scholarship now incorporates the efficiency criteria, the cited works provide relatively extensive discussions in the legal literature of efficiency in tax law. The public finance literature serves as a source of much of the more technical development of the efficiency criteria. For basic public finance texts, see, for example, HARVEY ROSEN, *PUBLIC FINANCE* (6th ed 2002); JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* (3rd ed. 2000). For this point in particular, see, for example,

The cost to taxpayers of changing their behavior so as to reduce or avoid their tax liability is the deadweight loss from taxation.<sup>17</sup> This deadweight loss can best be understood as follows. Imagine that, if a taxpayer engages in her preferred behavior (for example, working), the tax law imposes a tax liability on this activity. When the taxpayer works and pays the tax liability, the payment is simply a transfer of wealth from the taxpayer to the recipients of the payment (the government and, through the government, other members of society). On a net basis, society is not better or worse off by the transfer. What the paying taxpayer has lost, the recipients of the payment have gained. However, imagine instead that the taxpayer changes her behavior so as to avoid the tax liability. For example, she engages in less preferred behavior (such as leisure), which is untaxed, in order to avoid the tax that would otherwise apply. The taxpayer is now better off by the tax not paid. However, this is offset by the loss of the tax revenue to the intended recipients of the tax payment. Thus, no societal net gain exists. In fact, society is worse off because the taxpayer has adopted a less preferred behavior to avoid the tax, which makes her worse off, relative to a world without taxation. Consequently, the cost to her of changing her behavior is a societal net cost, or deadweight loss, from taxation.<sup>18</sup>

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Alan J. Auerbach, *The Theory of Excess Burden and Optimal Taxation*, in 1 HANDBOOK OF PUBLIC ECONOMICS 61, 67 (Alan J. Auerbach & Martin Feldstein eds., 1985); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 310 (4th ed. 1984) (describing how deadweight loss results because an individual will "seek to be a free rider and avoid tax payment by buying or selling less of the taxed product").

17. See Weisbach, *Line Drawing*, *supra* note 14, at 1650-51 (describing deadweight loss in the context of consumer and producer surplus).

18. See *id.* at 1650-52. The analysis gets a bit more complicated. The taxpayer will change behavior in response to taxation for two reasons: (1) because taxation changes the relative prices of various commodities and/or activities (i.e., working becomes more expensive and leisure becomes less expensive, encouraging the taxpayer to engage in more leisure), and (2) because taxation reduces an individual's spending capacity, which should cause a change in behavior (for example, by causing the taxpayer to work more to make up for taxes paid). *Id.* at 1652-53. These two responses are referred to, respectively, as (1) the substitution effect and (2) the income effect. *Id.* at 1653-54. The example

Efficiency-minded scholars have concluded that the deadweight loss from taxation includes not just changes in taxpayers' underlying behavior (such as substituting leisure for work) to avoid taxation, but also includes tax planning. While the assumption regarding the deadweight loss from tax planning is prevalent in much tax scholarship,<sup>19</sup> David Weisbach has most prominently made the formal argument in the legal literature that, as a general matter, tax planning is socially wasteful.<sup>20</sup> This includes both the cost to taxpayers of engaging in less desirable activity and any out of pocket costs they incur to engage in the planning (such as

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in the text (and often efficiency analysis generally) focuses on the substitution effect. For an interesting perspective regarding problems with focusing on the substitution effect, see, for example, Sugin, *supra* note 15, at 231-37.

19. Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 22-24 (2012) ("Scholars generally conclude that the ability of taxpayers to select their tax treatment by arranging their business affairs in particular ways is detrimental to societal welfare, especially where such arrangements lack economic substance."); see, e.g., Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 604-05 (2010) (discussing "inefficient tax planning activities"); Raskolnikov, *Cost of Norms*, *supra* note 15, at 643 ("In general, tax planning is inefficient because tax-motivated changes in behavior produce deadweight losses."); Schenk, *An Efficiency Approach*, *supra* note 15, at 515 (calling avoidance costs "pure social waste"); Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65, 68 (2011) (describing "inefficient tax planning incentives"); Slemrod & Yitzhaki, *supra* note 12, at 181 ("Clearly, any activity to reduce the tax is a pure loss from the social point of view, and therefore creates a deadweight loss.").

20. Weisbach explains that tax planning is "almost always positively bad for society—it is worse than worthless." David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222 (2002) [hereinafter Weisbach, *Ten Truths About Tax Shelters*]. Weisbach allows only a few, potential exceptions to this statement. These include: situations in which Congress intended taxpayers to get special tax treatment for a particular form of a transaction and tax lawyers help clients meet the prescribed form, and situations in which Congress actually intended to change behavior through incentives and penalties. *Id.* at 224-25. The latter exception is discussed at *infra* note 31. For Weisbach's discussion of why these exceptions do not swallow the rule, see *id.* at 225 n.22. One need not get bogged down with how much of the tax code is actually intentionally designed to change behavior through incentives and penalties versus how much of the tax code is designed simply to raise revenue in accordance with the base prescribed in order to accept the point that, at least as to the latter set of provisions, planning around them is socially wasteful.

fees associated with the tax planning transaction).<sup>21</sup> For example, a corporation may wish to issue equity as a means of raising capital. However, when a corporation issues equity and then pays dividends on such equity, the corporation obtains no tax deduction.<sup>22</sup> On the other hand, if the corporation raises capital through debt and then pays interest on the debt, the corporation gets a tax deduction.<sup>23</sup> Corporations therefore may issue debt instead of equity to obtain the tax deduction.<sup>24</sup> Corporations also may spend substantial sums in attorney and other fees trying to create hybrid securities, which are considered debt for tax purposes but equity for accounting purposes.<sup>25</sup> These activities are costly to corporations in numerous ways. Issuing debt instead of equity may result in the corporation being overleveraged, and therefore more susceptible to bankruptcy.<sup>26</sup> Alternatively, a corporation may expend resources it could otherwise put to productive use on massaging a security so that it is treated as debt for tax purposes. Either type of cost (the cost of an inferior capital structure or the out of pocket costs paid to attorneys and the like) are net costs to society because they are nonproductive.<sup>27</sup> They merely transfer funds from the government to the corporation in a costly fashion, without producing anything of value.<sup>28</sup>

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21. See Wojciech Kopczuk, *Tax Simplification and Tax Compliance: An Economic Perspective*, in BRIDGING THE TAX GAP 119, 120 (Max B. Sawicky ed., 2005) (describing costs of tax avoidance through tax planning, including potential risk bearing costs, payments for advisors, the cost of misallocating resources, etc.).

22. Ilan Benshalom, *How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction*, 88 N.C. L. REV. 1217, 1229-30 (2008).

23. *Id.*

24. See *id.* at 1228-32 (describing tax advantage of debt).

25. See *id.* at 1233-34 (describing hybrid securities).

26. *Id.* at 1233 (describing overleveraging problem and citing tax bias in favor of debt as one of the main tax causes of the 2008 financial crisis).

27. Weisbach, *Ten Truths About Tax Shelters*, *supra* note 20, at 222.

28. As Weisbach described, "Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses.

The socially wasteful nature of tax planning is particularly problematic because Congress often simply intends to define the tax law, without affirmatively trying to encourage taxpayers to respond to it. But the very promulgation of the law provides taxpayers with both the incentive and means to engage in tax planning.<sup>29</sup> By way of illustration, when Congress created the distinction for the tax treatment of debt and equity, it is hard to imagine that Congress did so to encourage corporations to issue more debt. Rather, the more reasonable view is that Congress was simply trying to define what created tax liability and what created tax deductions, and interest payments happened to produce tax deductions under this scheme.<sup>30</sup> Every time Congress defines what creates tax liability in terms of particular taxpayer activity (such as paying dividends on equity versus paying interest on debt), taxpayers can then change their activity to reduce their tax liability. These changes often are not the point of the rules, but rather unfortunate revenue and efficiency-reducing byproducts of them.

At bottom, then, at least outside of contexts in which Congress affirmatively wants taxpayers to change their activity in response to a tax provision,<sup>31</sup> tax planning can be

No new medicines are found, computer chips designed, or homeless housed through tax planning." *Id.*

29. See *id.* at 225 n.22 ("Much tax planning is associated with taking advantage of the imperfect rules for income measurement. Rules that measure income imperfectly are not intentional subsidies (even if they are enacted knowing they are imperfect), and planning around them produces social losses."). But see Michael L. Schler, *Ten More Truths About Tax Shelters*, 55 TAX L. REV. 325, 386-87 (2002) (interpreting congressional tax incentives much more broadly). This Article does not intend to rehash the debate between Weisbach and Schler. Instead, this Article rests on the assumption that there are times when Congress creates the tax law without intending taxpayers to change their behavior in response, and yet the creation of the tax law nonetheless causes taxpayers to change their behavior in order to reduce their tax liability.

30. Many would argue that the particular distinction between debt and equity not only is not designed in order to change taxpayer behavior, but also is nonsensical. Many less objectionable distinctions created by the tax law also create efficiency costs by changing taxpayer behavior.

31. In some contexts, which can be referred to as "Pigouvian contexts," the above deadweight loss analysis does not apply. The basic concept behind

seen as socially wasteful and, therefore, objectionable.<sup>32</sup> As a result, the architects of tax law face a fundamental

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Pigouvian taxes and incentives is straightforward. Pigouvian taxes attempt to force taxpayers to internalize externalities. Maureen B. Cavanaugh, *On the Road to Incoherence: Congress, Economics, and Taxes*, 49 UCLA L. REV. 685, 687-88 (2002); Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63 TAX L. REV. 797, 829 (2010). For example, when certain activity imposes negative externalities, Congress may impose taxes on such activity to discourage it. *See, e.g.*, Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-To-The-Bottom" Rationale for Federal Environmental Regulation*, 67 NYU L. REV. 1210, 1214 n.7 (1992) (describing how taxes on polluting can be Pigouvian). On the flip side, Congress may create special incentives for taxpayers to engage in more of certain activity that would produce positive externalities. *See, e.g.*, Deborah H. Schenk & Andrew L. Grossman, *The Failure of Tax Incentives for Education*, 61 TAX L. REV. 295, 308 (2008) (citing to education tax incentives as Pigouvian). In some cases Congress seems to intend to change behavior in a manner that cannot be explained by an externalities analysis. *See, e.g.*, Cavanaugh, *supra*, at 687-88 (describing Congress's expansion of tax-subsidized transportation benefits as promoting an activity with significant negative social costs). However, this Article need not address the social value of responses to incentive tax provisions designed to change activity, which do not appropriately respond to an externality. It is enough to say that taxpayers changing their activity in response to the tax law is often socially wasteful and, therefore, objectionable. On the other hand, when taxpayers respond to an incentive provision put in place by Congress, which was designed to encourage such change, the change at least arguably is not objectionable.

32. A potential counterargument exists. If taxpayers engaging in higher levels of tax planning have higher disutility toward paying taxes, then tax planning may serve as a welfare increasing form of price discrimination. *See, e.g.*, Benjamin Alarie, *Price Discrimination in Income Taxation* (Jan. 30, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1796284](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1796284). Tax planning as price discrimination is an intriguing idea. However, tax planning ultimately makes sense as a form of price discrimination only if taxpayers engaging in tax planning actually have a higher disutility of taxpaying, a claim that may be difficult to prove. *Cf.* Weisbach, *Ten Truths About Tax Shelters*, *supra* note 20, at 223 n.18. Moreover, even if tax planners had a higher disutility of taxpaying, tax planning as a form of price discrimination would still face some problematic hurdles. The welfare increase from taxpayers essentially being able to elect out of taxation through tax planning would have to be weighed against the disutility to other taxpayers of knowing (to the extent that they are aware) that tax planners were able to shirk their taxpaying obligations easily through tax planning. Additionally, the tax system is often envisioned as not just a means of raising revenue, but also a redistributive vehicle. Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 526 (2013). As a result, any welfare gains from taxpayers engaging in tax planning would have to be weighed against the

conundrum. How can they discourage taxpayers from tax planning to reduce their tax liabilities when the very promulgation of the tax law provides taxpayers both the incentive and means to tax plan?

### B. *Existing Frictions Literature*

Tax scholars see frictions as an important solution to this conundrum. The current, most basic understanding of frictions in tax scholarship is that they are nontax costs that make tax planning more difficult or costly. Scholars have identified not only how nontax costs may impede tax planning, but also how tax rules often are crafted to rely intentionally on nontax costs (such as risk) in order to deter such planning.<sup>33</sup>

The concept of frictions arises originally from the work of economists, who recognized a fundamental paradox regarding the tax system. In particular, Joseph Stiglitz identified how, theoretically, under the tax rules themselves, taxpayers could reduce much, if not all, of their tax liability to zero through various tax planning strategies.<sup>34</sup> In contrast to this theoretical possibility, however, taxpayers clearly do owe and pay taxes.<sup>35</sup> The implication was that real world limitations (outside the tax system itself) must limit taxpayers' abilities to engage in this tax planning.<sup>36</sup> Myron Scholes and Mark Wolfson

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welfare losses attributable both to the costs of planning and to the lost redistribution.

33. For just a very small sample of articles relying on or discussing frictions, see, for example, Fleischer, *supra* note 13, at 232-33 (discussing frictions literature in article setting forth theory of regulatory arbitrage); Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 699 (2007) (discussing when third parties can serve as frictions that reduce tax avoidance); Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1150 (2005) (discussing how economic benefit doctrine serves as a friction on nonqualified deferred compensation arbitrage).

34. Stiglitz, *supra* note 13, at 325-28.

35. In 2011, the IRS collected over \$2.4 trillion in taxes. 2011 I.R.S. DATA BOOK 3 (2013), <http://irs.gov/pub/irs-soi/11databk.pdf>.

36. Stiglitz, *supra* note 13, at 335; see also Daniel Shaviro, Commentary, *Evaluating the Social Costs of Corporate Tax Shelters*, 55 TAX L. REV. 445, 445

determined that, indeed, such limitations do exist. Scholes and Wolfson dubbed these limitations "frictions" and defined frictions as "transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly."<sup>37</sup>

The importance of frictions to the tax system led tax law scholars to begin extensively studying frictions.<sup>38</sup> While some tax scholars distinguish frictions from tax rule restrictions designed to deter tax planning,<sup>39</sup> other scholars

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(2002) ("It has been a familiar point, at least since Joseph Stiglitz made it, that without various tax planning frictions large swatches of the existing income tax would collect zero or negative revenue.").

37. MYRON S. SCHOLES & MARK A. WOLFSON, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 7 (1992).

38. David Schizer has led the way on detailed study of how frictions work in practice. Schizer has examined a variety of tax provisions, explaining how and when frictions prevent end runs around tax reforms designed to discourage tax planning. *See, e.g.*, Schizer, *Frictions as a Constraint*, *supra* note 3 (examining the constructive sale and constructive ownership rules and exploring how the latter works better than the former as a result of frictions); David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda for Reform*, 104 COLUM. L. REV. 1886 (2004) (in which Schizer relies on frictions work in proposal for "balance" in taxation of derivatives); William M. Gentry & David M. Schizer, *Frictions and Tax-Motivated Hedging: An Empirical Exploration of Publicly-Traded Exchangeable Securities*, 13 WASH U. J.L. & POLY 9, 10-11 (2003) (empirical study of frictions burdening public exchangeable securities); Schizer, *Sticks and Snakes*, *supra* note 15, at 1365-67 (discussing frictions limiting timing option for securities dealers).

39. *See, e.g.*, Fleischer, *supra* note 13, at 252-64 (distinguishing between legal constraints and transaction costs (or frictions) as two distinct means of discouraging regulatory arbitrage (but acknowledging that at least one type of legal constraint, shotgun antiabuse rules, often relies upon frictions)); Schenk, *An Efficiency Approach*, *supra* note 15, at 508-14 (distinguishing between tax-rule restrictions designed to deter tax planning, direct substitution costs of various tax planning strategies, and frictions on tax planning (which Schenk defines as "restraints on tax planning external to the tax law")). Schizer also relies on this distinction at times in his examination of frictions. The thrust of Schizer's work is that whether or not tax rules work to block tax planning depends on how effectively they are backstopped by frictions. As a result, Schizer is both formally distinguishing between tax rules and frictions and recognizing that tax rules may be frictional (by depending on frictions). *See, e.g.*, Schizer, *Frictions as a Constraint*, *supra* note 3, at 1395-96. These categorizations track the distinction that Scholes, Wolfson, and others drew between frictions ("transaction costs incurred in the marketplace that make implementation of certain tax-planning strategies costly") and tax-rule

have recognized how tax rules themselves may rely on frictions to impede tax planning. These rules themselves can be considered “frictional.”<sup>40</sup> For example, Dan Shaviro has characterized the economic substance doctrine (and statutory and regulatory rules that similarly rely on an economic substance approach) as a frictional impediment on tax planning,<sup>41</sup> a characterization that has received substantial adherents.<sup>42</sup> Scholars have similarly identified other tax rules that intentionally rely on nontax costs to make tax planning more costly and characterized them as frictions on tax planning.<sup>43</sup> As a result, the scholarly discussion and understanding of frictions applies to a broad

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restrictions (“restraints imposed by the taxing authority that prevent taxpayers from using certain tax arbitrage techniques to reduce taxes in socially undesirable ways”). SCHOLLES & WOLFSON, *supra* note 37, at 9.

40. For ease of exposition, frictional tax rules will also simply be referred to as “frictions.”

41. Shaviro, *Economic Substance*, *supra* note 1.

42. *See, e.g.*, Leandra Lederman, *W(h)ither Economic Substance*, 95 IOWA L. REV. 389, 441 (2010) (stating that “[a] risk analysis does impose a friction that provides a disincentive to engage in tax arbitrage” but also voicing objections to this approach); Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 373-74 n.68 (2005) (adopting frictional view of economic substance doctrine); Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PA. L. REV. 1181, 1187-88 (2008) [hereinafter Raskolnikov, *Relational Tax Planning*] (adopting frictional approach but also questioning how well risk serves as a deterrent).

43. *See, e.g.*, Raskolnikov, *Relational Tax Planning*, *supra* note 42, at 1192-97 (identifying, generally, tax rules that require taxpayers to bear risk to obtain the desired tax treatment as frictions and including within this discussion rules such as the wash sale rule and other waiting period rules, the constructive sale rule, the constructive ownership rule, straddle rules, conversion transaction provisions, certain nonrecognition rules, the at risk limitations, tax-free contribution to corporation requirements, liquidation-reincorporation rules, and various judicial common law doctrines). David Schizer also describes the wash sale rule as frictional, in that the rule “burdens loss harvesting with a nontax cost (or so-called ‘friction’): taxpayers have to give up economic exposure to the depreciated asset (or double their exposure) for a specified period.” David M. Schizer, *Scrubbing the Wash Sale Rules*, *supra* note 8, at 69-70. Technically, Schizer implicitly is distinguishing between the tax rule (the wash sale rule) and the friction that it relies upon (changed economic exposure). *See id.* However, for all intents and purposes, Schizer is characterizing the wash sale rule as a frictional tax rule, in that the entire purpose of the wash sale rule is to leverage the nontax cost of changed economic exposure to deter loss harvesting.

swath of anti-tax planning rules that exist throughout the tax code.<sup>44</sup>

In analyzing frictions, scholars predominantly focus on how frictions can better deter tax planning from occurring, an approach that primarily views frictions as “deterrence vehicles.”<sup>45</sup> In focusing on the deterrence aspect of frictions, scholars have concluded that frictions should: (1) deter tax

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44. However, not all tax rules should be understood properly as frictional, as that term is used in this Article. Theoretically, any tax rule has a frictional element. Any time a tax rule is promulgated, it excludes certain taxpayers from the ambit of the rule. Nontax costs then presumably serve as a (not necessarily successful) deterrent on taxpayers who do not already fit within the ambit of the rule from engaging in tax planning to fit within the rule. For example, tax liability depends on a couple’s marital status. For some couples (those subject to the so-called “marriage penalty”), tax liability would be lower if they were not married than if they were married. See Kerry Abrams, *Marriage Fraud*, 100 CAL. L. REV. 1, 16 (2012). The cost of being unmarried solely for tax purposes inevitably serves as a friction, deterring couples who would otherwise be married from being unmarried solely to fit within the unmarried couples category for tax purposes. However, the friction in this case is an inevitable byproduct of the definitional tax rule, not an independent requirement relied upon in order to make tax planning more costly. Another way of understanding the distinction is that the rules regarding taxation of unmarried individuals are not designed to deter individuals from becoming unmarried for tax reasons. They simply define tax liability for whoever happens to be unmarried. Frictions, as they are contemplated in this Article, have at least some deterrence element to them. In other words, tax rules that are characterized as frictional (such as economic substance) arise as *independent* requirements to deter tax planning. This is distinguishable from the promulgation of tax rules which, simply because of their definitional feature, naturally impose costs on some taxpayers getting the most desirable tax treatment.

45. See, e.g., Shaviro, *Economic Substance*, *supra* note 1, at 223 (explaining that the desirability of the economic substance approach depends on (1) the desirability of deterring the tax planning at issue, and (2) how well the economic substance approach succeeds at “generating such deterrence rather than simply inducing taxpayers to jump through a few extra hoops before getting the desired tax consequences anyway”). Schizer’s seminal work, *Frictions as a Constraint on Tax Planning*, was a detailed study of exactly when frictions stop planning rather than causing it to continue in a more wasteful fashion. See generally Schizer, *Frictions as a Constraint*, *supra* note 3. Limited exceptions apply. Dan Shaviro and David Weisbach briefly described antiabuse doctrines, including the economic substance doctrine, as “merely rough sorting devices . . . to separate transactions designed purely at wholesale tax elimination from real business transactions.” Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 94 TAX NOTES 511, 513 (2002).

planning rather than cause it to continue in a more wasteful fashion, and (2) not impose costs on regular business transactions. Dan Shaviro has most colorfully elaborated on the first criterion with his description of the “back-somersault” friction.<sup>46</sup> In discussing the economic substance doctrine, Shaviro explained that “one might as well condition favorable tax consequences on whether the taxpayer’s chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool’s Day, if such a requirement turns out to achieve a better ratio of successful deterrence to inducing wasteful effort in meeting requirements that are pointless in themselves.”<sup>47</sup> This basic understanding has been influential in evaluating frictions.<sup>48</sup> Scholars and policymakers alike also emphasize the second criterion: costs that frictions impose on regular business dealings, or non-planners, are undesirable flaws of the rules.<sup>49</sup> For example, David

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46. Shaviro, *Economic Substance*, *supra* note 1, at 223.

47. *Id.*

48. See, e.g., Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1254 (2008) (“Frictions can create value where they operate to bolster narrow tax provisions in curtailing wasteful tax avoidance behavior. But frictions can also create social costs. With respect to some taxpayers, for example, frictions may simply raise the cost of socially wasteful behavior rather than deterring it.”); see also Schizer, *Frictions as a Constraint*, *supra* note 3, at 1320 (focusing on total planning waste from planners in response to frictions and noting that “[t]he added waste from their continuing efforts sometimes will outweigh the savings from those who stop”); David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 103 (2002) [hereinafter Weisbach, *An Economic Analysis*] (emphasizing the tradeoff by explaining that “[a]n increase in the strength of anti-avoidance doctrines will reduce sheltering (the change in elasticity) but also make those shelters that remain worse (the distortionary effect)”).

49. This view is widespread across both policy and academic circles. For representative scholarly discussions, see, for example, Raskolnikov, *Relational Tax Planning*, *supra* note 42, at 1247 (discussing undesirable “distortions in the behavior of innocent taxpayers”) and Schizer, *Frictions as a Constraint*, *supra* note 3, at 1320 (discussing how frictions may be costly because they “undermine ‘good’ transactions that are not tax motivated”). In policy circles, frictions often are subject to withering criticism to the extent that they are perceived to impose costs on ordinary business transactions. For a particularly fervent attack along these lines, see, for example, Sheldon I. Banoff, Katten Muchin & Zavis, Comments on Proposed Reg. Section 1.701-2, (May 19, 1994), *reprinted in*

Weisbach has called the application of frictions to taxpayers not motivated by tax planning an “error” and suggested that frictions should be made weaker in anticipation of these types of errors.<sup>50</sup>

## II. SCREENING MECHANISMS

Recognizing how frictions function first as screening mechanisms, screening taxpayers based on underlying characteristics, and then secondarily as deterrence vehicles provides a whole new line of understanding and analysis. This Part begins this process by exploring how screening mechanisms work in the related optimal tax context, in which the role of screening mechanisms is currently much better understood.

Optimal tax theory is the renowned and highly influential public finance theory that serves as a central model for progressive taxation.<sup>51</sup> Optimal tax theory assumes that individuals vary according to some underlying characteristic, which dictates their relative well-beings.<sup>52</sup> Typically, this underlying characteristic is assumed to be ability.<sup>53</sup> Optimal tax theory then attempts to reach a central redistributive goal: as a result of the presumed declining marginal utility of consumption,<sup>54</sup> the tax and transfer system should redistribute from high ability

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*Partnership Antiabuse Regs Should Be Rescinded, Banoff Asserts*, 94 TAX NOTES TODAY, June 2, 1994, LEXIS, 1994 TNT 106-24.

50. Weisbach, *An Economic Analysis*, *supra* note 48, at 108 (describing application of frictions to transactions without tax motivation as an “error”).

51. N. Gregory Mankiw & Matthew Weinzierl, *The Optimal Taxation of Height: A Case Study of Utilitarian Income Redistribution*, AM. ECON. J., Feb. 2010, at 155, 155 (describing optimal taxation as “a centerpiece of modern public finance . . . for which William Vickrey (1945) and J. A. Mirrlees (1986) won the Nobel Prize”).

52. Jeff Strnad, *The Progressivity Puzzle: The Key Role of Personal Attributes* 1 (John M. Olin Program in Law and Economics, Working Paper No. 293, 2004).

53. *See, e.g., id.*

54. Declining marginal utility of consumption means that, as the total amount of consumption increases, an additional unit of consumption results in a smaller increase in utility. *Id.* at 7.

individuals to low ability individuals.<sup>55</sup> However, this is easier said than done. Much optimal tax scholarship assumes that taxpayers' underlying abilities are not directly observable.<sup>56</sup> As a result, ability must be indirectly observed as a function of taxpayers' income.<sup>57</sup> High-income taxpayers are assumed to be high ability, and therefore should be taxed at a higher rate.<sup>58</sup> Nonetheless, if high ability taxpayers are taxed at a higher rate when they earn high income, they can masquerade as low ability taxpayers by earning less income, which they can do by substituting leisure for work.<sup>59</sup> As Part I made clear, this shift in behavior to avoid taxes would be an undesirable efficiency cost. The fundamental dilemma of optimal tax theory, then, is how to meet its redistributive goal while minimizing the efficiency costs (principally assumed to be lower work effort) that flow from using indirect measures (principally income) as a means of screening high ability from low ability taxpayers.<sup>60</sup>

While traditional optimal tax theory focuses on setting the tax and transfer rates optimally, so as to allow the desired amount of redistribution subject to the efficiency constraints,<sup>61</sup> economists have also developed a variety of

55. See Kyle Logue & Joel Slemrod, *Genes as Tags: The Tax Implications of Widely Available Genetic Information*, 61 NAT'L TAX J. 843, 847 (2008).

56. See, e.g., Nicholas Stern, *Optimum Taxation with Errors in Administration*, 17 J. PUB. ECON. 181, 181-82 (1982) (citing James Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971)); Strnad, *supra* note 52.

57. Stern, *supra* note 56, at 181-82.

58. David A. Weisbach, *Toward a New Approach to Disability Law*, 1 U. CHI. LEGAL F. 47, 74 (2009) [hereinafter Weisbach, *Toward a New Approach*].

59. *Id.*

60. *Id.* (explaining, with regard to optimal tax theory, that "it is now standard in the economics literature to view taxation as an information or screening problem").

61. Legal tax scholars who have examined optimal tax theory have tended to focus on this solution to the optimal tax screening problem. The seminal work that introduced optimal tax theory to the legal literature was Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987). Bankman and Griffith focused on the traditional task of setting the optimal tax rate/transfer in

other mechanisms to respond to the optimal tax screening problem. These other mechanisms rely on various inherent characteristics of taxpayers to better target redistributive tax or transfer policies toward low ability (or, under some formulations, needy) individuals.<sup>62</sup> As a result, these mechanisms can be thought of more formally as “screening mechanisms,” designed to separate different taxpayers (in the optimal tax context, based on relative ability, well-being, or need).<sup>63</sup>

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response to the optimal tax screening problem. *Id.* A number of examples exist of legal tax scholarship taking into account other solutions to the optimal tax screening problem. For example, David Weisbach examined “tagging” disabilities. Weisbach, *Toward a New Approach*, *supra* note 58. Lily Batchelder has discussed how inheritances may serve as tags for utility and ability. Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 22-23 (2009). Moreover, the (largely theoretical) endowment tax literature imagines taxing taxpayers based on inherent ability. As a result, in discussing the endowment tax, some legal scholars have discussed the tagging literature. *See, e.g.*, Ilan Benshalom & Kendra Stead, *Values and (Market) Valuations: A Critique of the Endowment Tax Consensus*, 104 NW. U. L. REV. 1511, 1538 (2010). In another context (an article addressing the consumption/income tax debate), Joseph Bankman and David Weisbach raised, but did not endorse, the notion of taxing savings as an indicator good. Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1453-55 (2006). Chris Sanchirico has offered a different view of taxation and indicator goods. Chris William Sanchirico, *Tax Eclecticism*, 64 TAX L. REV. 149, 210-16 (2011). Benjamin Alarie recently has discussed tagging in his account of tax planning as price discrimination. Alarie, *supra* note 32, at 20.

62. *See, e.g.*, Ritva Immonen et al., *Tagging and Taxing: The Optimal Use of Categorical and Income Information in Designing Tax/Transfer Schemes*, 65 ECONOMICA 179, 179 (1998) (discussing economists’ exploration of categorical information); Wojciech Kopczuk, *Redistribution When Avoidance Behavior is Heterogeneous*, 81 J. PUB. ECON. 51, 66 (2001) (“[I]f possible, the tax function should also depend on variables other than taxable income.”); Mankiw & Weinzierl, *supra* note 51, at 156; Alan D. Viard, *Optimal Categorical Transfer Payments: The Welfare Economics of Limited Lump-Sum Redistribution*, 3 J. PUB. ECON. THEORY 483, 483-84 (2001).

63. A separate, large literature has developed addressing transfers to the poor and poverty relief. It is this literature which has done significant work exploring some of the screening mechanisms discussed in the text, in particular ordeals and, to a lesser extent, indicator goods. However, the issue of poverty relief, although framed in terms of poverty and need, rather than the optimal tax framing of redistribution and efficiency, is really the other side of the same coin. Both poverty relief and the classic redistributive aim of optimal tax theory attempt to redistribute to less able, or needier, individuals, creating the same

The first such mechanism is tagging. George Akerlof famously developed the notion that various characteristics, such as age or disability, could be used to “tag” needy individuals.<sup>64</sup> As Akerlof explained, these tags should identify groups of people who are, on average, needy.<sup>65</sup> Individuals with these tags could then receive targeted benefits, with relatively low efficiency cost, because non-needy individuals would not be able to obtain the tag and therefore could not masquerade as needy.<sup>66</sup> Ideally, tags are observable, immutable, and well correlated with the relevant measure of neediness or well-being at issue.<sup>67</sup> A tag need not *cause* neediness in order to be useful. Rather, it simply has to be a reliable, observable, and relatively non-imitatable indicator of neediness.<sup>68</sup>

However, often these three features will not all exist. Akerlof, for example, originally contemplated female-headed households as a tag for neediness, in accordance with Aid to

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perverse efficiency incentives. Both can be seen as part of the same optimal tax problem, and indeed, have been so seen by at least some scholars. *See, e.g.*, Timothy Besley & Stephen Coate, *The Design of Income Maintenance Programmes*, 62 REV. ECON. STUD. 187, 187-88 (1995) [hereinafter Besley & Coate, *The Design of Income Maintenance Programmes*] (explaining how income maintenance paper contributes to literature on screening and citing to Mirrlees); Louis Kaplow, *Optimal Income Transfers*, 14 INT'L TAX & PUB. FIN. 295, 322 (2007) (“The overall theme of this article is that questions involving the design of transfer programs are best analyzed by reference to what is already understood about optimal income taxation and what can be learned from extensions of that framework.”). Indeed, Albert Nichols and Richard Zeckhauser’s seminal work regarding indicator goods and ordeals was set within the optimal tax framework. Albert L. Nichols & Richard J. Zeckhauser, *Targeting Transfers Through Restrictions on Recipients*, 72 AM. ECON. REV. 372, 372 (1982).

64. George A. Akerlof, *The Economics of “Tagging” as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning*, 68 AM. ECON. REV. 8, 8 (1978).

65. *Id.*

66. *Id.* at 8-17.

67. Logue & Slemrod, *supra* note 55, at 848.

68. *Cf.* Mankiw & Weinzierl, *supra* note 51, at 164-65 (“What matters for optimal height taxation is the consistent statistical relationship between height and income, not the reason for that relationship.”).

Dependent Children policy.<sup>69</sup> Having a female-headed household, of course, is not an immutable characteristic and using such a criterion to distribute aid may create perverse (and inefficient) incentives for families.<sup>70</sup> Other tags, like disability, can be difficult to observe and may not always correlate well with well-being.<sup>71</sup> The upshot is that underlying characteristics that correlate with ability or need may screen individuals in a more efficient manner than simply observing their incomes. Practically, though, it may be difficult to find tags that meet the criteria well enough,<sup>72</sup> or that are politically palatable enough, to use.<sup>73</sup>

As a result of some of these difficulties, economists have explored other screening mechanisms, the most relevant of which is ordeals.<sup>74</sup> Just like tags, ordeals rely on underlying characteristics of groups of individuals to screen between them. Ordeals are costs attached to a desirable benefit.<sup>75</sup> Ordeals are designed to be relatively more costly to non-

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69. Akerlof, *supra* note 64, at 9.

70. *See id.*

71. Weisbach, *Toward a New Approach*, *supra* note 58, at 52, 64.

72. Even when a characteristic does not meet the ideal characteristics of a tag, it can still provide useful information that can be incorporated into the tax system. *See, e.g.*, Batchelder, *supra* note 61, at 22-23 (explaining that inheritances do not fit perfectly as tags because they are mutable, but that they nevertheless serve as important measures of endowment).

73. It turns out that height is actually a remarkably good indicator of earning ability. Nonetheless, most would reject a tax system based on height. This example highlights the political difficulties that may prevent the use of some of the most promising tags. Mankiw & Weinzierl, *supra* note 51, at 155-56. Tags are nonetheless frequently, albeit imperfectly, integrated into tax and transfer systems. *See, e.g.*, Viard, *supra* note 62, at 483 ("An important component of most countries' tax-transfer systems is the provision of transfer payments to categories of individuals defined by (nearly) exogenous characteristics, such as date of birth or disability.").

74. *See, e.g.*, Timothy Besley & Stephen Coate, Shorter Paper, *Workfare Versus Welfare: Incentive Arguments for Work Requirements in Poverty-Alleviation Programs*, 82 AM. ECON. REV. 249, 249, 259 (1992) [hereinafter Besley & Coate, *Workfare Versus Welfare*]; Tomer Blumkin et al., *The Desirability of Workfare as a Welfare Ordeal Revisited* 3 (Inst. for the Study of Labor ("IZA"), Discussion Paper No. 5130, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1663170](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663170).

75. *See* Nichols & Zeckhauser, *supra* note 63, at 372, 376.

needy individuals, as a means of screening these individuals out from obtaining the benefit.<sup>76</sup> A good example of an ordeal is a workfare requirement to receive welfare. At various points in various countries, working in the public sector or obtaining work training has been a requirement to receive welfare benefits.<sup>77</sup> One possible reason for these requirements is that work and work training produce human capital.<sup>78</sup> However, another explanation is that participating in workfare requirements is costly in terms of opportunity cost. This opportunity cost is likely to be greater for individuals who are less needy and have better, alternative opportunities. As a result, a workfare requirement may serve as an ordeal, imposing greater costs on relatively non-needy individuals, discouraging them from obtaining welfare benefits meant to be targeted to the truly needy.<sup>79</sup> The key to ordeals is that they impose greater costs on the group that ideally would be excluded from receiving a benefit.<sup>80</sup>

It merits emphasizing that good screening mechanisms, whatever the type, share a number of important features. Good screening mechanisms separate between a group of individuals who should be screened in for a certain benefit

76. *Id.* at 376-77.

77. Katherine Cuff, *Optimality of Workfare with Heterogeneous Preferences*, 33 CAN. J. ECON. 149, 150 (2000).

78. Robert Moffitt, *Welfare Work Requirements with Paternalistic Government Preferences*, 116 ECON. J. F441, F444 (2006).

79. Much debate has ensued about whether workfare makes sense as a screening mechanism. Much of the argument turns on whether we should take into account the disutility of the needy as a result of working in maximizing social welfare. Compare, e.g., Besley & Coate, *Workfare Versus Welfare*, *supra* note 74, at 260 (examining argument for workfare when objective is poverty alleviation, not welfare maximization), and Besley & Coate, *The Design of Income Maintenance Programmes*, *supra* note 63, at 207 (concluding that workfare must be justified in non-utilitarian terms), with Blumkin et al., *supra* note 74, at 3-4, 15-17 (making a welfarist case for workfare requirements). This debate does not impact the basic example that workfare requirements can serve as a screening mechanism by acting as an ordeal on obtaining welfare.

80. Nichols & Zeckhauser, *supra* note 63, at 377. Ordeals theoretically can also work if they impose the same cost on needy and non-needy individuals, but the needy individuals get greater utility from the underlying transfer, making the cost less of a deterrent to the needy. *Id.* at 376-77.

(*i.e.*, low ability individuals in the case of optimal tax theory) and those who should be screened out (*i.e.*, high ability individuals in the case of optimal tax theory) by systematically imposing higher costs (or conferring lower benefits) on the latter than the former. They do so by identifying and relying on characteristics that generally separate the group that should be screened in from the group that should be screened out.

Understanding the fundamentals of screening mechanisms reveals important insights, which are both crucial to the design of frictions and yet not readily apparent absent this screening foundation. First, even good screening mechanisms often will not separate two groups perfectly. For example, height may correlate very well with earning ability, and therefore serve as a good screening mechanism.<sup>81</sup> However, a given tall individual, of course, may in fact not have a high earning ability. Despite the individual's height, the individual may have other particular characteristics that render the individual incapable of earning a high amount. The fact that a height screening mechanism gets it wrong in a particular case does not mean that height is a poor screening mechanism. Height's value as a screening mechanism depends on how well it tracks high earning ability as a general matter, not whether it gets every case right. In other words, what matters for a screening mechanism (and therefore for a friction) is determining what groups systematically bear the costs of the screening mechanism, not whether an individual bears a cost in a particular case.

Additionally, since all the screening mechanisms track characteristics as a means of separating groups, the distinction between the screening mechanisms will not always be analytically clear. Take tags and ordeals as an example of this phenomenon. Once a tag is chosen, unless it is completely immutable (which often will not be the case),<sup>82</sup> individuals can change their behavior in response to the

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81. Mankiw & Weinzierl, *supra* note 51, at 155-56.

82. Logue & Slemrod, *supra* note 55, at 849 ("In addition, a tag need not be totally immutable (even blindness can be self-induced), but it must be relatively so—relative, again, to the other options, such as income.").

tag, at which point it can still function as a screening mechanism, albeit more like an ordeal. For example, take the tag of female-headed household contemplated by Akerlof.<sup>83</sup> As an initial matter, to the extent that having a female-headed household correlates well with neediness, it can be used as a tag for neediness. However, once having a female-headed household becomes a criterion for redistribution, individuals have the incentive to change their behavior to mimic neediness. Nonetheless, the cost to individuals of acquiring a female-headed household, solely in response to the criterion for redistribution, is necessarily borne by those taxpayers that would not otherwise have a female-headed household. Thus, to the extent that pre-existing likelihood of having a female-headed household correlates with neediness, the criterion of female-headed household can still function as a screening mechanism, albeit in the form of a somewhat distortionary ordeal. Generalizing the point, for screening mechanisms (and therefore frictions), the key is not whether the screening mechanism necessarily deters particular undesirable behavior, but rather whether it imposes higher costs on the undesirable behavior, thereby lowering its likelihood of occurring.

### III. THE SCREENING PROBLEM WITH TAX PLANNING

These screening mechanisms are relevant to tax planning because tax planning presents a screening problem, which is both strikingly similar and related to the screening problem at the heart of optimal tax theory. In the optimal tax context, some taxpayers earn low income because they are low ability and others do so because they are mimicking low ability taxpayers to reduce their taxes. The tax system needs to distinguish between low ability and high ability taxpayers. After doing so, the tax system needs to deter high ability taxpayers from earning low income, in order to preserve revenue, redistribution, and efficiency. With tax planning, some taxpayers pay low taxes because

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83. Akerlof, *supra* note 64, at 9.

that is what they owe under the tax laws, without engaging in tax planning to reduce their taxes, and others pay low taxes because they engaged in tax planning to reduce their tax liability. The tax system needs to distinguish between taxpayers based on their level of tax planning motivation. After doing so, the tax system needs to deter taxpayers from engaging in tax planning to maintain revenue, redistribution, and efficiency. In both cases, it is important to note that the task is not merely deterrence, but rather, principally, a screening problem, followed by deterrence of those taxpayers that the tax system wishes to exclude from low tax liability.

Indeed, the optimal tax screening problem and the tax planning screening problem can even be seen as two sides of the same coin. Reducing work effort (and savings) in response to taxation (the traditional focus of optimal tax theory) and tax planning are the principal means of reducing tax liability.<sup>84</sup> As a result, taxpayers that reduce work and taxpayers that tax plan really present the same problem for the government's efforts to collect tax revenue in order to fund redistribution and other needs, and they also create analogous efficiency costs. Economists have reached a rough consensus that the response of work effort to taxation appears to be small, whereas alternative responses to taxation, including, principally, tax planning, appear to be large.<sup>85</sup> Thus, the tax planning screening problem seems to pose a greater threat to revenue and redistribution than the optimal tax screening problem that scholars have extensively focused on.

The concept of tax planning as a screening problem is based on an important, foundational point: taxpayers may be engaging in very similar activity with varying degrees of tax planning motivation. As a general matter, evidence suggests that taxpayers exhibit varying degrees of tax

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84. See Martin Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax*, 81 REV. ECON. & STAT. 674, 674 (1999) (incorporating what he calls "tax avoidance" into deadweight loss from the income tax and showing how including more than just labor and saving response is crucial in understanding deadweight loss).

85. Kopczuk, *supra* note 62, at 51-53.

planning motivation. Despite the conventional assumption made in the economics literature that taxpayers will tax plan until the cost of doing so equals the tax savings from planning,<sup>86</sup> taxpayers often fail to take straightforward steps to reduce their tax liability. For example, a very high percentage of taxpayers receives tax refunds from the U.S. government.<sup>87</sup> Since receiving a refund means that the taxpayer has given the government an interest free loan, a taxpayer's receipt of a refund indicates the taxpayer's failure to minimize the cost of taxation. Recent research has attributed this phenomenon, at least in part, to the powerful impact of inertia, rather than solely to rational behavior such as a response to uncertainty regarding tax liability.<sup>88</sup> Similarly, taxpayers often do not engage in the strategic trading of stock holdings that they would if they were engaging in optimal tax planning to reduce their tax liability.<sup>89</sup> When facing a decision about whether to sell stock with a built-in loss or built-in gain, taxpayers engaging in optimal tax planning generally should sell the built-in loss stock to recognize the tax loss but defer the tax gain.<sup>90</sup> And yet, evidence suggests that many taxpayers do the exact opposite, perhaps owing to behavioral explanations such as loss aversion.<sup>91</sup> At the same time, other

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86. See, e.g., Slemrod & Yitzhaki, *supra* note 12, at 186 ("A rational taxpayer will be ready to sacrifice up to, but no more than, one dollar in order to save a dollar of taxes.")

87. Over three-quarters of taxpayers receive refunds. Damon Jones, *Inertia and Overwithholding: Explaining the Prevalence of Income Tax Refunds*, 4 AM. ECON. J.: ECON. POL'Y 158, 158 (2012); see also Jannett Highfill et al., *Tax Overwithholding as a Response to Uncertainty*, 26 PUB. FIN. REV. 376, 376 (1998) (similar statistic noted with earlier data set).

88. See generally Jones, *supra* note 87.

89. Deborah Schenk provides a good explanation of this phenomenon. Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 385-87 (2004) [hereinafter Schenk, *A Positive Account of the Realization Rule*].

90. *Id.* at 386; see also Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1882-84 (1990) (valuing the timing option).

91. See Brad M. Barber & Terrance Odean, *Are Individual Investors Tax Savvy? Evidence From Retail and Discount Brokerage Accounts*, 88 J. PUB. ECON. 419, 423-27 (2003) (finding evidence that households realize gains faster

evidence exists of tax-motivated selling of losses at year end<sup>92</sup> and of taxpayers responding to changes in capital gains rates,<sup>93</sup> indicating more optimal tax planning. The list of missed tax planning opportunities in some circumstances, balanced by examples of strategic tax planning, could go on and on. While it is possible to argue that taxpayers sometimes have high psychic costs of tax planning, which would technically be consistent with the conventional economic assumption that taxpayers tax plan until the cost of doing so equals the tax savings from planning, the more reasonable conclusion seems to be that not all taxpayers engage in the maximum amount of “rational” tax planning at all times.<sup>94</sup> Even the same taxpayers may exhibit different dispositions toward tax planning in different contexts.

Why would taxpayers engage in different levels of tax planning? Any number of reasons is possible. However, we can conceptualize an answer to this question by imagining that taxpayers consist of a number of different types. Type A taxpayers have the ability and desire to engage in tax

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than losses and that they exhibit other suboptimal tax planning decisions, such as misallocating assets between taxable and retirement accounts, but also finding evidence of tax-loss selling in December); Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, 40 J. FIN. 777, 785-90 (1985) (finding empirical evidence of tendency to sell built-in gain stock and hold built-in loss stock and attributing tendency to a variety of behavioral causes).

92. James M. Poterba & Scott J. Weisbenner, *Capital Gains Tax Rules, Tax-Loss Trading, and Turn-of-the-Year Returns*, 56 J. FIN. 353, 365-66 (2001).

93. See, e.g., Zhonglan Dai et al., *Capital Gains Taxes and Asset Prices: Capitalization or Lock-in?*, 63 J. FIN. 709, 709-11 (2008) (examining both buyer and seller reactions to capital gains rate change).

94. See Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489, 491 n.12 (2011) [hereinafter Osofsky, *The Case Against*] (suggesting that while it is often possible to interpret actual, behavioral responses in a rational actor model, doing so may strain credulity). Readers familiar with the tax compliance literature are familiar with the notion that taxpayers do not always act in accordance with some “rational” taxpaying model. As a result, taxpayers appear to comply with their tax liabilities to a greater degree than “rational” taxpayer models predict. See, e.g., *id.* at 522-23. This intuition has not been fleshed out to the same degree in the context of tax planning and efficiency.

planning. As a result, they engage in tax planning to reduce tax liability. Type B taxpayers also have the desire to engage in tax planning but lack the ability to do so. (For example, they just don't hold the assets that lend themselves to tax planning in a particular case). As a result, they do not engage in tax planning. Type C taxpayers have the opportunity to engage in tax planning, but they face higher costs in doing so, in terms of acquiring the relevant information, etc. (For example, they hold the assets that lend themselves well to tax planning, but they don't run in tax-educated circles that inform them about how to tax plan). As a result, they also do not engage in tax planning. Finally, Type D taxpayers have the ability to tax plan (including the opportunity, information, and decision making ability to do so), yet they simply dislike tax planning, and therefore do not engage in it. In any event, given how tax planning reduces revenue, distorts redistribution, and creates inefficiency,<sup>95</sup> frictions should help the tax system target relatively higher costs toward the Type A taxpayers (the tax planners) and away from the other types of taxpayers (the non-planners), just as optimal tax screening mechanisms help direct higher costs toward high ability taxpayers.<sup>96</sup>

The screening problem with tax planning is difficult because even when taxpayers are engaging in very similar activity, some may be doing so for tax planning reasons,

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95. An implicit assumption is that the tax law itself is desirable, or set optimally, such that planning around the tax law does not improve social welfare. For a similar assumption, see Weisbach, *An Economic Analysis, supra* note 48, at 90 (assuming that "the government is optimally implementing the tax law," which includes the assumption that "the government is subject to a budget constraint and chooses tax laws that maximize the welfare of its citizens").

96. In contrasting Type A and Type D, some might say that Type A has a higher disutility from taxpaying, and therefore we should be happy about Type A tax planning and Type D not tax planning. However, this is not necessarily the case. Type D may just face a higher disutility from tax planning, which is completely independent of the level of disutility from taxpaying. In other words, we can view the Type D taxpayer as simply facing higher costs to tax plan, much as Type C has higher costs than Type A to tax plan. Type D might hate taxpaying just as much as Type A, but Type D also happens to dislike tax planning for whatever reason as well.

some may not, and some may have a level of motivation that falls somewhere in between. The easiest way to understand this concept is through a specific example. As alluded to above, sales of built-in loss stock confer a tax benefit. The infamous realization rule in tax law dictates that a gain or loss must be "realized" in order for the gain to be taxed or for the loss to be deducted.<sup>97</sup> While what constitutes realization can be a very difficult question, some aspects of realization are clear. In particular, mere appreciation or depreciation of stock does not constitute realization; on the other hand, outright sales of stock to a third party should trigger realization.<sup>98</sup>

As a result, taxpayers have a tax incentive to sell built-in loss stock in order to take a tax loss, thereby potentially offsetting gains and reducing tax liability.<sup>99</sup> Indeed, a taxpayer may wish to sell built-in loss stock merely to trigger the tax loss, without truly divesting of ownership in the stock. Absent any rules preventing the taxpayer from doing so, such a taxpayer (a Type A taxpayer) might sell the stock to trigger the tax loss and then repurchase the stock (or similar stock), thereby obtaining the tax loss, without really divesting economically.<sup>100</sup>

On the other hand, taxpayers may have nontax reasons for selling built-in loss stock. They may anticipate future depreciation in the stock's value, or they may simply need the proceeds. The list could go on and on. Taxpayers not motivated by tax planning may similarly repurchase the stock after the sale. For example, a Type B, C, or D taxpayer may be forced to sell stock because she needs capital and not as part of a tax plan. However, after the sale

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97. I.R.C. § 1001 (2006); *Eisner v. Macomber*, 252 U.S. 189, 219 (1920).

98. *Eisner*, 252 U.S. at 212-13.

99. A number of loss limitation rules apply including, principally, the limitations on the use of capital losses. See I.R.C. § 1211 (2006). Moreover, the realization rule does not apply in all contexts. For example, different rules apply to securities dealers. See I.R.C. § 475 (2006).

100. Tax lawyers will recognize that this raises problems under the wash sale rule, discussed below. See discussion *infra* Part IV.B.1. The important point for now is how taxpayers engaging in very similar activity may have different levels of tax planning motivation.

she receives an unexpected amount of cash and so repurchases the stock. Alternatively, a Type B, C, or D taxpayer may sell stock because she no longer wishes to hold it. However, after the sale, the taxpayer reassesses and determines that, in fact, the stock likely will appreciate in value and repurchases the stock.<sup>101</sup> While selling built-in loss stock (perhaps followed by its repurchase) presents a significant tax planning opportunity for Type A taxpayers, taxpayers can engage in similar or identical activity with very different levels of tax planning motivation.

#### IV. FRICTIONS AS SCREENING MECHANISMS

Although not focused on in the tax literature, frictions serve not only as deterrence vehicles, but also as screening mechanisms. This realization has conceptual importance for the design of tax law, and also suggests concrete reforms of particular tax provisions. This Part first sets forth the conceptual importance of frictions as screening mechanisms and then uses a number of case studies to illustrate how the conceptual lessons can translate into concrete reforms.

##### A. *Conceptual Importance of Frictions as Screening Mechanisms*

Frictions serve as screening mechanisms by imposing *differential* (and higher) costs on Type A taxpayers (tax planners) than Type B, C, or D taxpayers (non-planners). This screening is akin to how optimal tax screening mechanisms screen between different types of taxpayers by imposing higher costs on high ability taxpayers than low ability taxpayers. This key differential cost point complicates conventional wisdom regarding frictions and calls for a more complex framework for evaluating and designing frictions throughout the tax code.

First, understanding the differential cost point complicates the widely held belief that frictions are successful if they deter tax planning rather than cause it to

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101. See Osofsky, *The Case Against*, *supra* note 94, at 497 n.29 (raising the example and flagging for future consideration).

continue in a more wasteful fashion. The workfare for welfare screening mechanism, which comes from the optimal tax context, provides an instructive analogy. As described previously, workfare can be used as a means of targeting welfare more directly to needy individuals. Ideally, the workfare requirement causes non-needy individuals to abandon their attempts to obtain welfare, thereby allowing needy individuals to obtain more of the available welfare. However, even if workfare does an exceptional job at deterring all non-needy individuals from obtaining welfare, it would still fail as a screening mechanism if it imposes similarly high costs on needy individuals, causing them to abandon attempts to obtain welfare as well. In the case of frictions and tax planning, even if a friction does an exceptional job at deterring tax planners (rather than causing planning to continue in a more wasteful fashion), it may nonetheless be a failed friction if it imposes similarly high costs on non-planners. The gains from imposing costs on tax planners to deter them from tax planning are (1) raising more revenue, which can lower the relative tax burden of non-planners, and (2) higher efficiency because of less tax planning. If a friction subjects non-planners to high costs, then non-planners may (1) face a high enough tax burden (including both actual tax liability and any other costs they must bear from frictions) so as to offset any revenue gains from reduced tax planning, or (2) engage in inefficient behavior in response to the friction, thereby lowering any efficiency gains. As a result, the question is not just whether the friction imposes costs on tax planners that deter tax planning, but rather whether it imposes *relatively* higher costs on tax planners, thereby deterring their tax planning to a greater extent than it imposes countervailing burdens on non-planners.

Second, the differential cost point helps elucidate why, notwithstanding conventional wisdom to the contrary, a friction imposing costs on non-planners is not necessarily an error, or a lamentable flaw to be fixed. Again, using the workfare for welfare example, the workfare requirement will impose costs on needy individuals, by subjecting them as well to a workfare requirement. However, the fact that the workfare requirement imposes costs on needy individuals is not a flaw, as long as the workfare

requirement systematically imposes greater costs on non-needy individuals, thereby screening the non-needy out from receiving welfare to a greater extent than would occur absent the rule. Said another way, if the screen imposes a cost on needy individuals, but allows them to garner a greater share of welfare benefits, then the screen's costs on the needy may be unobjectionable. In the context of tax planning, a friction that imposes costs on non-planners nonetheless may place appropriately larger costs on tax planners, discouraging the planning and producing more tax revenue. This increased tax revenue may then allow lower relative tax liability to be allocated to non-planners than would occur absent the rule. This better allocation of relative tax liabilities similarly may make the cost placed on non-planners unobjectionable, rather than a flaw of the friction.

The above discussion reveals that the analysis regarding frictions is more complicated than that suggested by the current literature. As discussed, asking whether frictions deter tax planners to a greater extent than causing them to continue in a more wasteful fashion does not determine whether a friction is a good friction. Nor does asking whether a friction imposes costs on non-planners decide whether a friction is a bad friction. Indeed, even putting the two questions together does not improve matters significantly, because doing so does not elucidate when a friction should impose costs on non-planners, or when a friction that deters well should nonetheless be abandoned. The comprehensive inquiry necessary to analyze these questions is: does the friction impose *relatively* greater costs on planners than non-planners, thereby reducing overall social costs?

Understanding this central inquiry suggests a more robust framework for evaluating frictions than the one articulated by the existing scholarship. Again, applying the screening mechanism analogy from optimal tax helps establish general principles that are also applicable to frictions and tax planning. With optimal tax, the point of using a tag, such as height, as a screening mechanism for earning ability is to better target lower tax liability toward

low ability taxpayers and/or reduce the distortion engendered by using income as a proxy for earning ability.<sup>102</sup> Whether the screening mechanism (such as height) ultimately makes sense, then, depends on how this screening mechanism performs along a number of dimensions. These include (1) the screening dimension: how well height separates between high and low ability taxpayers as an initial matter, and (2) the deterrence dimension: whether height does a reasonably good job at preventing high ability taxpayers from changing their behavior in response to the tag itself.<sup>103</sup> When the screening mechanism functions by imposing a burden on taxpayers (such as in the case of an ordeal, like a workfare requirement), there is a third dimension to the analysis. The screening mechanism's value added from criteria (1) and (2) must outweigh the costs the taxpayers ultimately (and would not otherwise) bear as a result of the ordeal.

In the context of tax planning, frictions, as screening mechanisms, must be evaluated across all these dimensions. (1) As an initial matter, frictions must impose relatively higher costs on tax planners than non-planners. (2) As to the tax planners, the friction must do a better job at deterring tax planning rather than causing it to continue in a more wasteful fashion. (3) Finally, any costs that either tax planners or non-planners actually end up bearing as a result of the friction must be outweighed by the benefits of the friction. These benefits include the increased efficiency from deterring tax planning and the ability to allocate relatively lower tax liabilities to non-planners. While much work remains to be done in thinking about how to take into account all of these different dimensions, and how to balance them against each other, identifying how frictions function as screening mechanisms and focusing on the relatively underappreciated, screening dimension of the analysis is nonetheless essential for tax law design.

Moreover, recognizing the different parts of the analysis suggests ways to evaluate the tradeoffs between them. In

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102. See discussion *supra* at text accompanying notes 61-73.

103. See Logue & Slemrod, *supra* note 55, at 848-49.

particular, the screening dimension may be in tension with the deterrence dimension. Improving a friction as a screening mechanism may weaken it as a deterrence vehicle by offering tax planners more avenues to avoid the friction. On the other hand, making it harder to evade a friction may inadvertently create screening costs by imposing higher costs on taxpayers not highly motivated by tax planning. The potential tension between screening and deterrence does not mean that screening should be ignored entirely. Instead, we should begin to evaluate the tradeoff in a systematic fashion. We might assign various welfare costs to undesirable screening outcomes, with the welfare costs depending on how nefarious we view the particular screening outcomes to be. For example, because sex and race discrimination violate equal protection norms, we might view a friction that imposes greater screening costs on the basis of a taxpayer's sex or race as being more nefarious than a friction that imposes greater screening costs on the basis of a taxpayer's relative level of risk aversion.<sup>104</sup> We could weigh these costs against net efficiency and revenue gains that the friction produces as a result of deterring wasteful tax planning.<sup>105</sup> Implicit in this calculus would be a determination of how important deterrence versus screening was in a particular situation. When the wasteful tax planning is either particularly wasteful or poses a particularly great threat of reducing tax revenues substantially,<sup>106</sup> then the efficiency and/or revenue gains from preventing such planning would be particularly large, likely overriding many screening concerns. On the other hand, when the tax planning is limited, or the screening outcomes are particularly problematic, focusing on screening would become more important. In the extreme, a very undesirable screening outcome may require the

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104. See, for example, *infra* note 153, indicating that race appears to be correlated with flexible spending account usage.

105. These net gains should subtract out any more wasteful planning that occurs as a result of the friction.

106. See, e.g., Joseph Bankman, *The Tax Shelter Problem*, 57 NAT'L TAX J. 925, 927 (2004) (describing tax shelter, which, if it had worked and had been marketed to corporations, could have come close to wiping out the corporate income tax base).

elimination of the friction altogether, even if it serves a strong deterrence role.<sup>107</sup> We could also apply this calculus to various, alternative formulations of the friction, in order to craft the optimal friction in light of the deterrence/screening tradeoff.

### B. *Concrete Reforms of Tax Law*

Focusing on frictions' screening role and integrating the conceptual lessons discussed above can suggest concrete reforms of the tax law. Sometimes existing frictions do a reasonably good job of screening for tax planning, despite the lack of scholarly attention to screening. Nevertheless, focusing on screening can help make the frictions work better. In other cases, frictions are screening in particularly perverse ways, requiring significant reform. A number of examples from the tax code help illustrate these points, beginning with the wash sale rule.<sup>108</sup>

1. *The Wash Sale Rule.* The wash sale rule provides a useful example of how frictions inherently serve as screening mechanisms and how frictions can serve reasonably well as screening mechanisms on tax planning (rather than as screening mechanisms for some other taxpayer attribute, such as ability). It also illustrates how focusing on frictions as screening mechanisms can make frictions even better suited to meet their screening role.

As illustrated previously, taxpayers may sell built-in loss stock for a variety of reasons, with varying degrees of tax motivation.<sup>109</sup> The so-called wash sale rule, found in § 1091 of the Internal Revenue Code, impacts taxpayers' abilities to sell built-in loss stock for tax reasons. The wash sale rule generally disallows a tax loss deduction on the disposition of depreciated stock or securities if the taxpayer acquires "substantially identical" stock or securities within thirty days prior or subsequent to the disposition that would

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107. Indeed, the screening issues at the heart of the use-it-or-lose-it rule, discussed below, suggest a strong need to reform the rule to remedy the screening problems. See discussion *infra* Part IV.B.2.

108. I.R.C. § 1091 (2006).

109. See discussion *supra* at text accompanying notes 99-101.

otherwise trigger the deduction.<sup>110</sup> So, if a taxpayer sells stock<sup>111</sup> at a loss but purchases substantially identical stock (within the ambit of § 1091) within either thirty days prior to or subsequent to the sale, then the taxpayer does not get to deduct the loss for tax purposes.<sup>112</sup>

The wash sale rule, like all frictions, imposes nontax costs on a desirable tax outcome. In the case of the wash sale rule, taxpayers seeking to obtain a tax loss on the sale of built-in loss stock, who nonetheless want to continue holding the stock, have a number of avenues available to them. A taxpayer can purchase the same stock (the “replacement stock”) thirty-one or more days prior to the sale of the original built-in loss stock and still obtain the loss on the sale. In such a case, the taxpayer is purchasing the replacement stock prior to the wash sale rule’s thirty day waiting period. A taxpayer can purchase the same stock (the “replacement stock”) thirty-one or more days after the sale of the original built-in loss stock and obtain the loss on sale. In such a case, the taxpayer is purchasing the replacement stock after the wash sale rule’s thirty day waiting period. Or, the taxpayer can obtain a substitute position for the built-in loss stock (the “substitute position”) within thirty days of the disposition, as long as the substitute position is not “substantially identical” to the built-in loss stock within the ambit of the wash sale rule.<sup>113</sup> This set of options means that the principal cost that the wash sale rule imposes on taxpayers is the cost of altering their economic exposure to the original built-in loss stock, in order to be able to take a tax deduction on the sale of the stock at a loss. This altered economic exposure can take the form of doubled up economic exposure to the built-in loss stock for at least thirty days prior to the sale of the original built-in loss stock, or no economic exposure to the built-in loss stock for at least thirty days after the sale of the

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110. I.R.C. § 1091(a) (2006).

111. At times in this discussion, I will refer to “stock” rather than “stock or securities” simply in order to make the exposition more straightforward.

112. § 1091(a). The taxpayer adjusts the basis of the stock purchased to reflect the disallowed loss deduction. § 1091(d).

113. § 1091(a).

original built-in loss stock, or slightly different economic exposure in the case of a purchase of a substitute position during the waiting period.

Like with all frictions, the wash sale rule functions as a screening mechanism. Specifically, any time a friction (or cost to obtain a particular tax outcome) is put in place, the cost will not affect all taxpayers equally. Rather, the cost will affect taxpayers differently, thereby screening between them based on some underlying characteristic(s). The wash sale rule principally screens among taxpayers with different motivations for selling built-in loss stock. As alluded to previously, taxpayers may sell built-in loss stock for a variety of reasons. These reasons determine the social waste from the sale. If a taxpayer sold built-in loss stock for purely tax reasons, followed by a repurchase, the sale and repurchase would be a prime example of tax planning, because the sale and repurchase are pure behavioral distortion, and they simply reduce the taxpayer's tax liability at the expense of tax revenue raised. Alternatively, a taxpayer may have some nontax motivations for selling stock (such as a need for cash, or some doubts about the stock's future performance), along with some tax motivations (the desire to sell built-in loss stock to take a beneficial tax deduction). In such a case, there is still social waste from the sale of the stock, because it would not have happened absent tax considerations. However, the sale is not as socially wasteful as if the taxpayer only had tax motivations for the sale. Finally, a taxpayer selling built-in loss stock purely for nontax reasons does not produce any social waste from the sale.

The wash sale rule screens between taxpayers producing these varying degrees of social waste by functioning as a tag, albeit a highly imperfect one. Specifically, the wash sale rule uses sale and repurchase of substantially identical stock within a short period of time as likely correlated with, and therefore indicative of, tax planning motivation. Taxpayers exhibiting such characteristics are then subject to a higher tax burden. However, the tag in this case is far from immutable. Namely, in light of the wash sale rule, tax planners can simply alter their economic exposure to the original built-in loss stock in order to avoid the rule.

Nonetheless, the wash sale rule functions secondarily, and reasonably well, as an ordeal on tax planning, because it systematically imposes relatively higher costs on tax planners. In particular, the changed economic exposure requirement of the wash sale rule is going to be more costly for taxpayers who (1) want to obtain a deduction on sale of the built-in loss stock and yet (2) prefer not to change their economic exposure to the built-in loss stock. Importantly, taxpayers are systematically more likely to exhibit these characteristics (and therefore to find the wash sale rule more costly) the higher the level of social waste (or tax planning motivation) from a sale. The taxpayer who sells built-in loss stock solely for tax reasons is engaged in the most tax planning because the pure tax play from selling stock and immediately repurchasing it is entirely socially wasteful.<sup>114</sup> This taxpayer wants to obtain a tax loss deduction on sale of the built-in loss stock and also likely has the strongest preference for not changing economic exposure to the built-in loss stock. The only reason this taxpayer wishes to sell the stock is to obtain the tax loss. As a result, the taxpayer ideally would like to hold onto the

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114. This discussion focuses on the tax planning option of a taxpayer selling stock and then repurchasing it. As described in the text, other options exist (*e.g.*, purchasing an additional share of stock prior to the sale or purchasing stock within the waiting period that is not characterized as “substantially identical”). These alternative planning vehicles can be seen most easily as workarounds to the principal rule, which disallows a sale of stock followed by a repurchase within thirty days of the same stock. If this principal rule were the only rule, taxpayers could easily evade it by instead purchasing the same stock immediately prior to the sale or immediately purchasing stock that is substantially identical (with minor alterations) either before or after the sale. As a result, the rules regarding purchase of stock prior to the sale and purchase of substantially identical stock can be seen as backstop rules to the principal rule regarding repurchase of stock after the sale. Of course, as frictions, these backstop rules produce their own costs, which act as screening mechanisms. While I do not explore these in the text, it is reasonable to assume that the taxpayers more likely engaged in tax planning are those taxpayers that would be more likely to purchase the same stock in very close proximity but prior to a sale or to purchase substantially identical stock close in time to a sale. As a result, these backstop rules also seem reasonably likely to impose higher costs on taxpayers more likely engaged in tax planning. The analysis for these backstop rules, then, is similar to the analysis for the principal rule in the text. Additionally, future work would benefit from viewing these frictions as screening mechanisms, allowing for a deeper probing of these assumptions.

built-in loss stock. If the taxpayer did have a desire to change economic exposure to the stock, the taxpayer could have done so. The pureness of the tax planning motivation is the very thing that makes the prospect of changed economic exposure particularly costly.

Next, a taxpayer selling the stock for some tax reasons and some nontax reasons produces some social waste, but not as much social waste as if solely tax reasons caused the sale. The fact that this taxpayer has some nontax motivations for the sale likely makes the prospect of changed economic exposure less costly than if solely tax motivations had caused the sale. For example, the taxpayer may have some doubts about the future performance of the stock, though not enough to sell absent tax considerations. These doubts, though, make changed economic exposure less costly than if the taxpayer had solely tax reasons for the sale.

Finally, the taxpayer who sells the stock without tax motivation produces no social waste. For this taxpayer, the prospect of changed economic exposure is likely least costly.<sup>115</sup> The taxpayer may have sold the stock precisely to change economic exposure to it (for example, because of a belief that the stock was going to depreciate further in value). Or, the taxpayer may have sold the stock to meet another need (such as a need for cash), and this need outweighed the desire for continued economic exposure to the stock. Either way, the prospect of changed economic exposure should not be particularly costly, at least at the time of the sale, for a taxpayer selling either in order to change economic exposure or to meet some other, superseding need.<sup>116</sup>

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115. This is not to say that the changed economic exposure requirement does not *end up* being costly to the taxpayer who sold without any tax motivation. This issue is discussed in more detail in the text that follows.

116. See Raskolnikov, *Relational Tax Planning*, *supra* note 42, at 1186-87 (concurring with this view and arguing that "real" (not tax-motivated) transactions will continue unaffected because taxpayers who want to get rid of the loss security for good will care little about its possible appreciation during the next thirty days").

The overall relationship between tax planning motivation and likely costliness of the wash sale rule does not mean that the wash sale rule perfectly imposes costs relative to a taxpayer's level of tax planning motivation. At times, even taxpayers with very little tax planning motivation may find the changed economic exposure required by the wash sale rule to be costly. Sometimes, this situation will occur predictably. Certain types of taxpayers who engaged in sales without tax planning motivation will reacquire within the waiting period, resulting in disallowance of the tax loss deduction. For example, many mutual fund investors are enrolled in automatic dividend reinvestment programs, whereby their dividends are reinvested in the same fund automatically.<sup>117</sup> If a taxpayer invested in such a program sells a portion of her holding at a loss and does not stop the automatic dividend reinvestment on the remaining portion, then a portion of the loss may be disallowed.<sup>118</sup> This is true even if the taxpayer has purely nontax motivation for the sale. In less predictable situations, taxpayers with little or no tax motivation for the original sale may nonetheless end up finding the changed economic exposure required by the wash sale rule to be costly.<sup>119</sup> For example, a taxpayer may sell stock at a loss without any tax planning motivation, believing the stock is going to go down in value further and then, within the thirty day waiting period, change her mind and believe the stock is now going to appreciate in value.<sup>120</sup> Even though this taxpayer had no tax planning motivation for the sale, maintaining changed economic exposure during the waiting period to preserve the tax loss from the sale may prove costly.<sup>121</sup>

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117. See CBIZ, *The Wash Sale Rules*, IN TOUCH, May 2011, at 4, available at [http://www.cbiz.com/pdfs/CBIZ\\_InTouch\\_May2011.pdf](http://www.cbiz.com/pdfs/CBIZ_InTouch_May2011.pdf) (explaining this issue).

118. See *id.*

119. See Osofsky, *The Case Against*, *supra* note 94, at 497 n.29.

120. See *id.*

121. See *id.* (discussing similar concerns); Schizer, *Scrubbing the Wash Sale Rules*, *supra* note 8, at 70 (describing "a taxpayer who sells depreciated property because she no longer wants it . . . [who] may then be deterred from reacquiring it when circumstances change").

Understanding how screening mechanisms work reveals that, despite these potential mismatches, the wash sale rule works reasonably well as a screening mechanism on tax planning. Just as height may serve reasonably well as a screening mechanism for high earning ability, even if it gets the relationship between height and earning ability wrong in particular cases, so might the wash sale rule serve reasonably well as a screening mechanism on tax planning, even if it imposes the occasional cost on taxpayers with low tax planning motivation. The relevant question is: are taxpayers more likely engaged in tax planning systematically more likely to find the wash sale rule to be costly? While the answer to this question is ultimately empirical and unknowable with certainty, making the question clear nonetheless allows for a reasoned design of the rule. It does seem likely that taxpayers who reacquire a stock position in close proximity to a sale (thereby failing to meaningfully change their economic exposure to the stock that was sold) are more likely to be engaged in a tax play. As a result, taxpayers engaged in tax planning to a greater extent seem systematically more likely to find the wash sale rule to be costly. Therefore, even if, on an ex post basis, the rule does not always impose costs on the right taxpayers, its design makes it a promising screen on tax planning.

Nevertheless, understanding how the wash sale rule is functioning as a screening mechanism can help improve its screening abilities. While, as discussed previously, imposing costs on non-planners may be part of a well-designed friction,<sup>122</sup> evaluating a friction necessarily involves examining how, if at all, the friction is systematically imposing costs on characteristics other than tax planning. The wash sale rule does systematically impose predictable costs on taxpayers less motivated by tax planning, such as taxpayers enrolled in automatic dividend reinvestment programs through a mutual fund, or taxpayers who have otherwise delegated active management of part of their stock or security holdings to other parties, who may then engage in sales or acquisitions that would trigger the wash

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122. See discussion *supra* Part IV.A.

sale rule.<sup>123</sup> Applying the screening mechanism terminology, this mismatch can be understood most easily as a problem at the tagging stage. Namely, the wash sale rule operates based on the assumption that sales of built-in loss stock, accompanied by repurchases in a short time frame, are highly correlated with tax planning motivation. However, certain predictable exceptions to this general correlation exist. As a result, the friction's screening can be improved by becoming more fine-grained. Using optimal tax as an analogy, take height being used a strong indicator of earning ability. Imagine, however, that tall people who did not attend kindergarten systematically do not tend to have high earning ability. In such a case, "tall people who attended kindergarten" would be a stronger screen for earning ability than simply "tall people." Applying this logic in the context of tax planning, the wash sale rule may be a sharper screening mechanism for tax planning if the rule excluded certain passive sale and repurchase transactions, such as through mutual fund automatic dividend reinvestment programs. Of course, whether it ultimately makes sense to shore up screening should depend on the perceived costs of the screening errors, as balanced against any deterrence costs from improving screening.<sup>124</sup>

Viewing the wash sale rule as a screening mechanism on tax planning also can cause a more fundamental rethinking of the rule. The wash sale rule was put in place as part of the Revenue Act of 1921, along with some of the most basic rules regarding taxation of capital gains and losses.<sup>125</sup> The legislative history suggests that the rule was put in place in order "to prevent evasion through the medium of wash sales,"<sup>126</sup> which is consistent with the friction's dual role as a screening mechanism and deterrence vehicle. Of course, the nature of stocks and securities (and who holds them) has changed substantially since 1921. Such changes should be considered in

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123. See CBIZ, *supra* note 117, at 6-7.

124. See *supra* text accompanying notes 104-106.

125. Revenue Act of 1921, Pub. L. No. 67-98, § 214(a)(5), 42 Stat. 227 (1921).

126. S. REP. NO. 67-275, at 14 (1921).

determining whether and how the wash sale rule should be updated. For example, as the volatility of stock increases, even taxpayers not selling stock for tax planning reasons are more likely to repurchase the stock during a shorter period of time. As stocks become more passively managed by large pension funds and the like, the impact of the wash sale rule on such passively managed funds becomes greater and potentially more problematic, which supports the argument in favor of more exceptions and carveouts.

2. *The Use-It-or-Lose-It Rule.* The importance of recognizing how frictions serve fundamentally as screening mechanisms also comes into sharp relief when examining the use-it-or-lose-it rule<sup>127</sup> in the context of flexible spending accounts. The use-it-or-lose-it rule can be seen as an ordeal that makes tax planning more costly. However, the use-it-or-lose-it rule screens for more than just tax planning. Among tax planners, it also systematically imposes higher costs on taxpayers who are less sophisticated decision makers, and taxpayers who are in lower marginal tax brackets. While many screening mechanisms impose costs on characteristics other than their primary target, the use-it-or-lose-it rule does so in a way that is undesirable at best, and highly perverse at worse. Recognizing how the use-it-or-lose-it rule is screening suggests potential reforms to improve the rule. The use-it-or-lose-it rule thus provides a good example of how understanding a friction's screening role is essential, even if the friction performs well as a deterrence vehicle.

Understanding the (arguable) need for a friction at all in the context of flexible spending accounts requires understanding a bit about their history.<sup>128</sup> The congressional

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127. Prop. Treas. Reg. § 1.125-5(c), 72 Fed. Reg. 43937, 43957 (Aug 6, 2007).

128. The following discussion attempts to provide the best possible justification for the use-it-or-lose-it rule as a friction. Many would argue that there is no reason to limit taxpayer use of flexible spending accounts as a means of financing current health and dependent care needs in a tax advantaged manner. See, for example, the criticism of the use-it-or-lose-it rule discussed in Matthew Dalton, *No Changes for FSA 'Use-It-or-Lose-It' Rule in 2012*, TAX NOTES TODAY, Oct. 15, 2012, LEXIS, 2012 TNT 199-8. Under this argument, the use-it-or-lose-it rule serves no reasonable role, even as a deterrence vehicle. However, as discussed in the text, there is at least some argument that, based

authority for flexible spending accounts is in § 125 of the tax code, which allows taxpayers to choose between receiving taxable cash or non-taxable benefits, without being taxed on receipt of the non-taxable benefits.<sup>129</sup> Under § 125, the IRS has taken the position that employers can provide their employees with insurance for specified needs, including health and dependent care needs, without the employees being taxed on the receipt of that insurance.<sup>130</sup> Taxpayers, however, have ignored the IRS's narrow, insurance interpretation and have relied on this authority to engage in broader tax planning through flexible spending accounts.<sup>131</sup> Specifically, taxpayers have seen flexible spending accounts as a more general means of avoiding taxation on their salary by diverting such salary into flexible spending accounts to fund health and dependent care needs.<sup>132</sup>

While the general unpopularity of the use-it-or-lose-it rule<sup>133</sup> has obscured the IRS's perspective, the interaction between flexible spending accounts and other provisions of the tax code helps bolster the case for some sort of friction on flexible spending account usage. If taxpayers could allocate as much salary income as they wanted to flexible spending accounts, and then simply retrieve any unused funds without any penalty or risk, taxpayers could use flexible spending accounts to create a dollar-for-dollar deduction for health or dependent care needs, in a manner not otherwise allowed (in the case of dependent care needs)

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on the history of flexible spending accounts and other tax code provisions, taxpayers are using them to create unintended tax planning benefits, and, therefore, the use-it-or-lose-it rule serves a reasonable deterrence goal. Whether or not the use-it-or-lose-it rule serves a reasonable role as a deterrence vehicle, it is highly problematic from a screening perspective.

129. I.R.C. § 125 (2006).

130. See Prop. Treas. Reg. § 1.125-5(c), 72 Fed. Reg. 43937, 43957 (Aug 6, 2007).

131. For a good description of this history, see Adam Chodorow, *Charitable FSAs: A Proposal to Combine Healthcare and Charitable Giving Tax Provisions*, 2011 BYU L. REV. 1041, 1050 (2011).

132. See *id.* at 1049-53.

133. See Dalton, *supra* note 128 (describing "tsunami" of comments advocating elimination of use-it-or-lose-it rule).

or even explicitly disallowed (in the case of health care needs) by other provisions of the tax code. In particular, take § 213 of the code, which limits taxpayers' abilities to deduct medical expenses.<sup>134</sup> Section 213 places a significant floor on deductibility of medical expenses.<sup>135</sup> A taxpayer's medical expenses are only deductible to the extent they exceed 10% of the taxpayer's adjusted gross income.<sup>136</sup> However, if taxpayers faced no penalty for retrieval of unused funds from flexible spending accounts, taxpayers could just allocate large amounts of salary to flexible spending accounts to cover any medical expenses that might arise and then retrieve any unused funds. The net result would be that these taxpayers would obtain a deduction from income tax (via the funds invested in the flexible spending account and actually used to pay for medical expenses) for the same expenses for which § 213 disallows a deduction, albeit through a wasteful tax planning technique.<sup>137</sup>

The use-it-or-lose-it rule serves as a friction on broader tax planning by taxpayers. Under a so-called use-it-or-lose-it rule, taxpayers must use the money they put aside in a flexible spending account in a given tax year, or else forfeit it.<sup>138</sup> Importantly, the use-it-or-lose-it feature of the flexible

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134. I.R.C. § 213 (Supp. IV 2011).

135. *See id.*

136. I.R.C. § 213(a); *see* Patient Protection and Affordable Care Act, Pub. L. 111-148, §§ 9013(a), (d), Mar. 23, 2010, 124 Stat. 868 (2010).

137. Of course, one way to limit this gambit would be to place a cap on the amount of funds that can be invested in a flexible spending account. Indeed, a newly effective \$2,500 cap limits allocations of salary to health flexible spending accounts. I.R.C. § 125(i) (Supp. IV 2011). This cap serves as a limit on tax planning, but not a deterrent (or friction) below the cap. In particular, the cap prevents taxpayers from using flexible spending accounts to make medical expenses in excess of \$2,500 deductible on a dollar-for-dollar basis, but it does nothing to deter the tax planning below this \$2,500 cap. Moreover, the cap limits flexible spending account usage even as to those taxpayers viewing the flexible spending accounts as insurance, rather than a way to make medical expenses deductible on a dollar-for-dollar basis. Finally, the cap in this particular case only applies to health flexible spending accounts. *Id.*

138. Recent changes to the rules allow a two and half month grace period to use the funds. I.R.S. Notice 05-42, 2005-23 I.R.B. 1204. Even more recent changes (which occurred as this Article was going to press) allow an employer,

spending accounts is a friction. It is a friction, as scholars understand frictions, because it imposes a nontax cost on taxpayers' abilities to turn taxable salary income into nontaxable salary to finance current health and dependent care needs.<sup>139</sup> The use-it-or-lose-it rule dictates that taxpayers cannot receive a refund of any amounts placed in flexible spending accounts that are unused in a particular tax year.<sup>140</sup> As a result, the use-it-or-lose-it rule subjects taxpayers to risk that the money they set aside in a flexible spending account will have to be forfeited, because they end up not having sufficient health or dependent care needs in a given year to use all of the funds. Alternatively, the use-it-or-lose-it rule subjects taxpayers to the risk of having to use money in a flexible spending account to pay for care the taxpayer does not particularly want, to avoid forfeiting the funds. The risk of losing the funds (or of having to use them suboptimally) is a nontax cost that reduces the likelihood that taxpayers will engage in tax planning.

The use-it-or-lose-it rule appears to be quite effective in deterring taxpayers from broadly tax planning through flexible spending accounts. While it is difficult to isolate the impact of the rule, it appears that the rule has limited

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at its option, "to amend its § 125 cafeteria plan document to provide for the carryover to the immediately following plan year of up to \$500 of any amount remaining unused as of the end of the plan year in a health FSA." I.R.S. Notice 2013-71 (Oct. 31, 2013), *available at* <http://www.irs.gov/pub/irs-drop/n-13-71.pdf>. Employers may choose between either the grace period or a carryover of up to \$500 of unused amounts, but not both. *Id.* The continued adherence to the use-it-or-lose-it rule, accompanied by the modifications, reveals both the belief by the Treasury Department and the IRS that some friction is necessary, and an implicit acknowledgment of the costs imposed by a friction.

139. *See, e.g.*, JOSEPH BANKMAN ET AL., FEDERAL INCOME TAXATION 62-63 (16th ed. 2012) (raising a question about the reasons for the use-it-or-lose-it rule and explaining how the rule may limit the use of flexible spending accounts); *see also* SCHOLLES & WOLFSON, *supra* note 37, at 226 (describing how the use-it-or-lose-it rule means that "[t]he optimal amount of funding [health care flexible spending accounts] is some amount below your best guess of medical costs because overfunding costs more than underfunding").

140. Prop. Treas. Reg. § 1.125-5(c), (o), 72 Fed. Reg. 43938, 43960 (Aug. 6, 2007) (describing use-it-or-lose-it rule and what the employer may do with "experience gains or forfeitures," and explaining that "in no case may the experience gains be allocated among employees based (directly or indirectly) on their individual claims experience").

taxpayers' use of flexible spending accounts.<sup>141</sup> For example, data shows that approximately 37% of taxpayers eligible to use health care flexible spending accounts do so.<sup>142</sup> This low rate is often attributed in part to the use-it-or-lose-it rule and the accompanying risk of forfeiture.<sup>143</sup>

Despite its apparent success as a deterrence vehicle (and entirely apart from whether deterring tax planning is even an appropriate goal in this context), the use-it-or-lose-it rule is particularly problematic because of how it functions as a screening mechanism. Indeed, focusing on the screening problems with the use-it-or-lose-it rule reveals perversities with the rule otherwise lost in popular discourse. As an initial matter, the use-it-or-lose-it rule can be seen as an ordeal on tax planning. In particular, those taxpayers who want to use flexible spending accounts broadly in order to turn taxable salary into a non-taxed means of funding their own health and dependent care needs, while ignoring the IRS's more limited view of these accounts as insurance vehicles, are likely to find the prospect of losing funds as a result of this planning to be costly. On the other hand, taxpayers who intend to use the

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141. See JANEMARIE MULVEY, CONG. RESEARCH SERV., RL32656, HEALTH CARE FLEXIBLE SPENDING ACCOUNTS 5 (2012).

142. *Id.* Moreover, the average annual contribution by those who contributed to health care flexible spending accounts was only \$1,420. *Id.*

143. See, e.g., Chodorow, *supra* note 131, at 1077 n.164 (describing lack of empirical evidence explaining low participation in and low funding of flexible spending accounts, but citing aversion to the loss of potential funds invested and the administrative burdens of tracking medical spending and submitting receipts as likely reasons); Colin M. Ramsay & Victor I. Oguledo, *Optimum Allocations to Health Care Flexible Spending Accounts*, 15 N. AM. ACTUARIAL J. 448, 450-51 (2011) (explaining that fear of forfeiture explains underinvestment in flexible spending accounts and citing supporting survey data); Lawrence Zelenak, *Of Head Taxes, Income Taxes, and Distributive Justice in American Health Care*, 69 LAW & CONTEMP. PROBS. 103, 117 (2006) (indicating that, while "hard data are not readily available," low flexible spending account usage is generally attributed, in part, to the use-it-or-lose-it rule and in part to administrative burdens of participating in and offering the accounts); Ashlea Ebeling, *ObamaCare Calls Flexible Spending Account Use-It-Or-Lose-It Rule Into Question*, FORBES (Jun. 19, 2012, 8:51 PM), <http://www.forbes.com/sites/ashleaebeling/2012/06/19/obamacare-calls-flexible-spending-account-use-it-or-lose-it-rule-into-question/> (claiming that "millions of folks don't take advantage of [flexible spending accounts] because of the dreaded 'use-it-or-lose it' rule").

flexible spending accounts more narrowly as a means of getting insurance (in accordance with the IRS's interpretation of the rules) are less likely to find the prospect of losing funds to be costly.

However, in addition to imposing relatively higher costs on taxpayers more likely motivated by broader tax planning, the rule also systematically imposes higher costs on particular types of taxpayers in undesirable ways. Significantly, the rule tends to impose the greatest costs on taxpayers with the following characteristics: those who are less sure of their health or dependent care needs in a given year (who therefore are less capable of estimating the likelihood of incurring various levels of expenses); those who are less sophisticated decision makers (who therefore are less capable of evaluating whether investment in a flexible spending account makes sense in light of the risks imposed by the use-it-or-lose-it rule); and those with lower marginal tax rates (who therefore have less to gain from investing in the flexible spending account and more to lose as a result of the use-it-or-lose-it rule). The first characteristic may seem like a somewhat arbitrary, but relatively innocuous, basis upon which to screen taxpayers. However, the latter two characteristics are more problematic.<sup>144</sup>

As an initial matter, by imposing greater costs on taxpayers who are less sophisticated decision makers, the use-it-or-lose-it rule problematically tends to impose relatively higher costs on taxpayers who already suffer a deficit that likely negatively impacts their well-being. Determining how much (if any) salary income to divert to

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144. As a general matter, by relying on a characteristic (such as willingness to live in public housing, or willingness to bear a workfare requirement) as a means of tracking an underlying trait (such as neediness), screening mechanisms often benefit one group over another in unintended ways. For example, using willingness to bear a workfare requirement as a screen for neediness, based on a theory that needier individuals have lower opportunity costs in meeting workfare requirements, imposes a relatively greater burden on needy individuals who happen to have a higher disutility toward working. While at times these discrepant burdens might not undermine the value of the screening, at others they are problematic enough that they potentially undermine the screening endeavor. The latter appears to be the case with the use-it-or-lose-it rule. See *supra* text accompanying notes 105-107 for discussion of assigning welfare costs to undesirable screening outcomes.

flexible spending accounts, in light of the use-it-or-lose-it rule, can require a relatively high-level decision process. For example, one model regarding what investment in a health care flexible spending account makes sense first requires taxpayers to determine a minimum and maximum of potential health expenses for the year, then create a probability distribution of the likelihood of various levels of expenses in this range, and then determine the incremental expected value of investing funds in the flexible spending account.<sup>145</sup> According to the model, the taxpayers should continue investing in the flexible spending account until the incremental expected value of doing so is negative.<sup>146</sup> No shortage of other models, each with their own complexities, exists.<sup>147</sup> Of course, taxpayers can choose to invest in flexible spending accounts without going through any of these models, and they may choose to invest in, but underfund, accounts to avoid risk of forfeiture without going through a painstaking decision process. However, those who can apply the models or similar reasoning are at an advantage. The important point is that the use-it-or-lose-it rule imposes relatively greater costs on taxpayers with lower capacity to deal with tradeoffs and decisions under uncertainty. The lower a taxpayer's capacity for such decision making, the more costly the use-it-or-lose-it rule becomes. Imposing greater costs on taxpayers with lower decision making capacity is fundamentally problematic because taxpayers

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145. Franklin Lowenthal & Philip Storrer, *Medical FSAs: An Expected Value Analysis*, 100 TAX NOTES 521, 523 (2003).

146. *Id.* at 523-24. At the conclusion of their model, Lowenthal and Storrer describe it as "simple." *Id.* at 524. This is clearly relative.

147. See, e.g., Rolf Auster & John T. Sennetti, *Optimal Use of Flexible Spending Arrangements: A Marginal Analysis Approach*, NAT'L PUB. ACCT., Mar. 1994, at 15; Jayanta Bhattacharya et al., *Optimal Contributions to Flexible Spending Accounts*, 76 ECON. LETTERS 129 (2002); James H. Cardon & Mark H. Showalter, *An Examination of Flexible Spending Accounts*, 20 J. HEALTH ECON. 935 (2001); James H. Cardon & Mark H. Showalter, *Flexible Spending Accounts as Insurance*, 70 J. RISK & INS. 43 (2003) [hereinafter Cardon & Showalter, *Flexible Spending Accounts as Insurance*]; John T. Cuddington, *Optimal Annual Contributions to Flexible Spending Accounts: A Rule-of-Thumb*, 62 ECON. LETTERS 59 (1999); Thomas S. Nunnikhoven, *Finding the Optimal Allocation to a Health-Care Reimbursement Account*, 11 INS.: MATHEMATICS & ECON. 223 (1992); Ramsay & Oguledo, *supra* note 143.

with lower decision making capacities likely make poorer decisions along a number of dimensions, reducing their overall well-being.<sup>148</sup> Systematically imposing relatively greater costs on such taxpayers through the use-it-or-lose-it rule is difficult to defend as a matter of tax policy.<sup>149</sup>

The use-it-or-lose-it rule also systematically imposes greater costs on taxpayers with lower marginal tax rates, which perversely makes the rule more costly to lower income taxpayers. Scholars have recognized how being able to exclude amounts from income (or, equivalently, being able to deduct the same amounts from income) is more beneficial to high income individuals, because of their

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148. For a discussion of the tax policy implications of a clearly related, but different concept, see Lee Anne Fennell, *Willpower Taxes*, 99 *GEO. L.J.* 1371 (2011). Fennell examines the impact of willpower on well-being and contemplates how the tax system should treat willpower. *Id.* For a study supporting the notion that having lower decision making resources can affect the quality of decisions, see Baba Shiv & Alexander Fedorikhin, *Heart and Mind in Conflict: The Interplay of Affect and Cognition in Consumer Decision Making*, 26 *J. CONSUMER RES.* 278, 282-86 (1999) (finding that availability of processing resources determines the extent to which individuals can engage in higher-order decision making governed more by cognition and less by affect).

149. One possible defense is that people who are poor decision makers are less likely to turn tax savings into reasonable consumption decisions and, therefore, they are less likely to produce as great of marginal utility from such tax savings. As a result, so the argument would go, the tax system should potentially distribute tax savings away from them. See Fennell, *supra* note 148, at 1394-97 (discussing this argument in the context of tax policy toward willpower); see also Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 *STAN. L. REV.* 745, 784-85 (2007) (examining argument in the context of savers, when savings may indicate higher ability generally or may indicate high ability as a consumer). Defending this argument, though, depends on a tricky relationship between poor decision makers likely being less well off (and therefore starting with lower utility and presumably higher marginal utility) and their potential lower ability to turn tax savings into marginal utility to the same extent as a better (and likely better-off) decision maker. Making a serious determination of whether social welfare (as measured by some function of individual utilities) improves as a result of distributing tax savings away from poor decision makers, given this tricky relationship, is likely difficult or impossible. As a result, the policy decision ultimately comes down to whether it is reasonable to impose greater tax burdens on those with lower decision making capacity. Again, the reasonableness of such a policy is simply difficult to defend, even if some might argue it is defensible. At the least, we should be considering more seriously cases in which frictions, as screening mechanisms, raise these sorts of questions.

higher marginal tax rates.<sup>150</sup> For example, take a taxpayer (Taxpayer H) in the 35% marginal tax bracket and another taxpayer (Taxpayer L) in the 15% marginal tax bracket. When Taxpayer H gets to exclude \$100 from income, the value to Taxpayer H of doing so is  $\$100 \times .35 = \$35$ . When Taxpayer L gets to exclude \$100 from income, the value to Taxpayer L of doing so is  $\$100 \times .15 = \$15$ . The same exclusion is worth less to Taxpayer L than Taxpayer H, simply because of their marginal tax brackets. This analysis is true for investments in flexible spending accounts as well. Since investing in flexible spending accounts means that the amount of the investment is excluded from the taxpayer's income, taxpayers in higher marginal tax brackets gain more from the exclusion than taxpayers in lower marginal tax brackets. Given the progressive nature of the income tax schedule, this means that higher income individuals have more to gain from investing in flexible spending accounts than do lower income individuals.

Importantly, the use-it-or-lose-it rule makes this discrepancy even worse. As a result of the use-it-or-lose-it rule, lower income taxpayers not only have less to gain from investing in flexible spending accounts, they also have more to lose. This can best be understood by using the same running example. Imagine that Taxpayers H and L both invest \$100 in a flexible spending account. Now imagine that each of Taxpayers H and L fail to use \$10 of the amounts invested in their flexible spending accounts. The cost to taxpayers of any amounts forfeited pursuant to the use-it-or-lose-it provision is the amount forfeited  $\times$  (1 - the marginal tax rate).<sup>151</sup> As a result, the cost to Taxpayer H of forfeiting \$10 is  $\$10 \times .65 = \$6.50$ . The cost to Taxpayer L of

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150. See, e.g., Lily L. Batchelder et al., *Efficiency & Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 24 (2006).

151. The explanation for this is straightforward. Had the taxpayer not invested the funds in the flexible spending account (and forfeited them), the taxpayer would have had to pay tax equal to the amount forfeited  $\times$  the marginal tax rate. So, by forfeiting the funds, the taxpayer only loses the amount forfeited  $\times$  (1 - the marginal tax rate). State and local income taxes and FICA taxes are also avoided by investing in flexible spending accounts. These taxes are ignored for the purposes of this analysis because they do not affect the conclusions, which follow from the federal income tax rates.

forfeiting \$10 is  $\$10 \times .85 = \$8.50$ . Taxpayer L, the lower income taxpayer, not only has less to gain from investing in the flexible spending account, but also has more to lose because of the use-it-or-lose-it friction.<sup>152</sup>

Indeed, the statistics regarding taxpayers' usage of flexible spending accounts seem to reflect how the use-it-or-lose-it rule disproportionately burdens poorer decision makers and lower income individuals. Researchers have found that highly educated and high income taxpayers are the primary users of flexible spending accounts and that being in a higher marginal tax bracket is strongly associated with increased participation in flexible spending accounts.<sup>153</sup> This finding is in line with the analysis above. As a friction, the use-it-or-lose-it rule necessarily imposes

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152. Taking risk aversion into account complicates the analysis. If individuals are assumed to have decreasing absolute risk aversion, then, counterfactually assuming a proportional income tax, flexible spending account investment may decline with income. The reason is because, under these assumptions, as income increases, the marginal utility of consumption declines. As a result, the marginal benefit of tax savings from investing in a flexible spending account decreases. Cardon & Showalter, *Flexible Spending Accounts as Insurance*, *supra* note 147, at 49-50. However, this analysis is both inconsistent with the actual, progressive tax rate structure, and with actual evidence of higher income individuals using flexible spending accounts to a greater extent (discussed in text below). As a result, at least in practice, higher income taxpayers having greater absolute dollars to gain and less to lose as a result of higher marginal tax rates does, indeed, appear to make flexible spending account investment more valuable for them, as suggested by the analysis in the text. Moreover, some models explain why higher income taxpayers should invest in flexible spending accounts to a greater extent, even controlling for marginal tax rates. See, e.g., Barton H. Hamilton & James Marton, *Employee Choice of Flexible Spending Account Participation and Health Plan*, 17 HEALTH ECON. 793, 803 (2008) (relying on income effect, which causes higher income taxpayers to have higher optimal health-care expenditures, which dominates reduced risk aversion by higher income taxpayers).

153. Roger Feldman & Jennifer Schultz, *Who Uses Flexible Spending Accounts: Effects of Employee Characteristics and Employer Strategies*, 39 MED. CARE 661 (2001); Hamilton & Marton, *supra* note 152, at 802-03. Additionally, researchers have determined that, after controlling for other demographic characteristics, non-white taxpayers tend to use flexible spending accounts less than white taxpayers. The study does not appear to define white or non-white. The study speculates about some potential reasons for this finding, but more investigation would be needed in order to make any conclusions. Hamilton & Marton, *supra* note 152, at 802-03.

greater costs on some taxpayers than on others. However, even if the friction serves as a powerful deterrence vehicle on tax planning as a general matter, it is screening for more than tax planning motivation in a manner that is problematic at best and highly perverse at worst. Viewing frictions as screening mechanisms is the key to unearthing these perversities.

Additionally, understanding the screening problems with the use-it-or-lose-it rule suggests potential reforms. Congress has in recent years repeatedly considered reform of the flexible spending account rules,<sup>154</sup> and the IRS is currently considering potential changes to the use-it-or-lose-it rule.<sup>155</sup> An easy fix to the use-it-or-lose-it rule's screening problems would be to eliminate it entirely. However, doing so would undermine any value that the rule may have as a deterrence vehicle. If the government wants to keep some limit on the broad use of flexible spending accounts as a tax

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154. See, e.g., H.R. 3105, 107th Cong. (2001) (proposing to allow carry forward of up to \$2,000 of health care flexible spending account funds, inclusion in income at time of carry forward, and distributions of amounts in later years (along with interest on such amounts, which interest would be included as ordinary income, presumably at the time of the distribution)); H.R. 63, 107th Cong. (2001) (proposing to allow distribution of unused flexible spending amounts, which would then be included in income). Other legislative proposals, with slightly different perspectives, have also been put forth. See, e.g., H.R. 2114, 108th Cong. (2003) (proposing allowing rollovers of unused health care flexible spending amounts to Archer MSAs); H.R. 4804, 107th Cong. (2002) (proposing allowing a carry forward of up to \$500 of unused health care flexible spending amounts, or distributions (which distributions would be subject to tax)); H.R. 167, 107th Cong. (2001) (proposing carryover of up to \$3,000 of unused flexible spending amounts, which could also be rolled over into various tax-advantaged accounts).

155. Recently, in light of longtime questions about the use-it-or-lose-it rule and a new \$2,500 annual cap (indexed for inflation) that the Patient Protection and Affordable Care Act placed on contributions to health care flexible spending accounts, the IRS has suggested that it is reconsidering the use-it-or-lose-it rule, at least in the limited context of health care flexible spending accounts. See I.R.S. Notice 12-40, 2012-26 I.R.B. 1046, 1046. The gist of the IRS's reconsideration seems to be that the annual cap may lower the value of any tax deferral enough so that the use-it-or-lose-it rule is less necessary. Indeed, Notice 2012-40 states that "[t]he \$2,500 limit, while not addressing the 'use-or-lose' rule, limits the potential for using health FSAs to defer compensation and the extent to which salary reduction amounts may accumulate over time." *Id.* at 1047.

planning vehicle, then another solution is needed, one which should be sensitive to secondary screening problems.

For example, consider the following alternative friction, called the “use-it-or-pay-a-penalty” rule. Under this rule, taxpayers could retrieve any unused funds, subject to a penalty (in addition to the regular income and other taxes that would now be owed on the salary income). The penalty would be equal to the amount of funds retrieved, multiplied by the taxpayer’s marginal tax rate.<sup>156</sup> This use-it-or-pay-a-penalty friction would serve a number of goals. First, from a screening perspective, ideally any applicable friction would be more costly as a taxpayer’s tax planning motivation increased. As a general matter, a taxpayer’s inclination to use flexible spending accounts broadly to turn taxable salary into nontaxed income likely increases as the taxpayer’s marginal tax rate increases (and the value of the exclusion from income therefore increases). By tying the strength of the friction to a taxpayer’s marginal tax rate, the use-it-or-pay-a-penalty rule would indeed make the friction on tax planning stronger as a taxpayer’s marginal tax rate (and therefore likely tax planning motivation) increases. Second, the use-it-or-pay-a-penalty friction would not suffer from the same secondary screening infirmities as the use-it-or-lose-it rule. Since the friction now would apply a penalty equal to the amount retrieved  $\times$  marginal tax rate, the friction would become less costly as a taxpayer’s marginal tax rate declined. As a result, the friction should tend to impose lower, rather than disproportionately higher, burdens on lower income taxpayers. Additionally, the calculus regarding whether or not to invest in a flexible spending account (and how much to invest) should become simpler when the potential penalty for investing funds and

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156. This would change the size of the penalty taxpayers face relative to the use-it-or-lose-it rule. For example, under the use-it-or-lose-it rule, a taxpayer in the 30% marginal tax bracket would lose \$70 as a result of investing \$100 in a flexible spending account and not using it. Under the use-it-or-pay-a-penalty rule, the taxpayer would lose \$30, on top of income taxes owed of \$30. Since there is no reason to think that the existing friction has deterrence set just right through the \$70 penalty, the use-it-or-pay-a-penalty rule is preferable since, as described in the text, it ameliorates the use-it-or-lose-it rule’s screening perversities.

not using them (the amount invested  $\times$  marginal tax rate) equals the benefit from investing the funds and using them (the amount invested  $\times$  marginal tax rate).<sup>157</sup> Indeed, the use-it-or-pay-a-penalty rule should allow taxpayers to make a relatively straightforward determination about whether or not to invest based simply on the likelihood of using the funds. As a result, the use-it-or-pay-a-penalty rule should lessen the disproportionately greater burden placed on poorer decision makers. Understanding how frictions function as screening mechanisms thereby can help preserve a friction on broad flexible spending account use (to the extent it is desirable to do so), while minimizing perverse screening costs.

3. *Additional Applications.* The examples of the wash sale rule and the use-it-or-lose-it rule offer basic principles that can be extended across the tax code. Namely, these two examples illustrate how frictions impose different costs on different taxpayers and ideally impose higher costs on tax planners, but the examples also show that frictions may track other taxpayer characteristics in undesirable ways. Asking whether a friction is reasonably imposing costs relative to the level of tax planning motivation or unreasonably imposing costs relative to other underlying characteristics can elucidate problems with frictions and can suggest ways to fix the problems that would not otherwise be apparent.

As an example of this methodology, take the strategic application of tax law uncertainty as a means of deterring tax planning. Scholars have suggested that uncertainty can

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157. Reducing complexity arguably weakens the friction's role as a deterrence vehicle. For discussion of the tradeoff between deterrence and screening, see *supra* text accompanying notes 105-107. In this case, reducing the deterrence of the friction as a side-effect of reducing the perverse screening impact seems justifiable. The friction does still exist and does still act as a deterrence vehicle. It also still screens, by imposing relatively higher costs on those taxpayers attempting to use frictions as a broad tax planning vehicle (rather than simply a form of insurance). As a secondary screening effect, it also will still impose relatively higher costs on taxpayers relatively less sure of their health and dependent care needs, but this appears to be a much more innocuous secondary screening effect.

play a role in deterring tax planning.<sup>158</sup> On the other hand, the IRS in recent years has unrolled a concerted program aimed at reducing uncertainty for large business taxpayers, a group of taxpayers often engaged in very aggressive tax planning. Specifically, the IRS now offers large business taxpayers a suite of guidance programs explicitly designed to provide them with increased certainty regarding their tax liability prior to tax return filing.<sup>159</sup> So what explains this disconnect between scholarly support for uncertainty as a friction and the IRS's efforts to ameliorate uncertainty through guidance programs? While scholars have focused on the arguable utility of uncertainty as a deterrence vehicle, it is problematic from a screening perspective. Understanding the dual role of frictions as deterrence vehicles and screening mechanisms suggests ways to make uncertainty more viable as a friction by sharpening its screening abilities.

As an initial matter, uncertainty can be used as a friction because it relies on nontax costs to make tax planning more difficult or costly. As scholars have argued, taxpayers who wish to engage in tax planning in the face of uncertain tax law cannot know exactly what they need to do to ensure that they will obtain their desirable tax outcome.<sup>160</sup> Uncertainty therefore can impose extra costs on these tax planners by forcing them to add extra bells and

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158. See, e.g., Tim Edgar, *Financial Instability, Tax Policy, and the Tax Expenditure Concept*, 63 SMU L. REV. 969, 1013 (2010) (describing tax law uncertainty as "an additional friction that constrains tax-driven innovation" in the context of publicly traded securities).

159. For a more comprehensive description of these programs and the IRS's new certainty initiatives, see Leigh Osofsky, *Some Realism About Responsive Tax Administration*, 66 TAX L. REV. 121 (2012) [hereinafter Osofsky, *Some Realism*].

160. The assumption here is that, under clear tax law, tax planners would simply be able to meet the requirements in order to obtain the desirable tax outcome. If the tax planning could be proscribed by clear tax law, then uncertainty would not be necessary as a friction and, indeed, may encourage tax planning as a result of potential uncertainty seeking and the lower prospect of penalties under uncertain law. See Osofsky, *The Case Against*, *supra* note 94, at 497 n.29 (suggesting as much).

whistles to their transactions in order to gain a higher level of certainty of desirable tax treatment.<sup>161</sup>

However, a problem with uncertainty as a friction is that it does not impose costs systematically relative to the level of tax planning motivation. In other words, even when uncertainty is valuable as a deterrence vehicle, it does not function well as a screening mechanism on tax planning. Applying the screening mechanism terminology, uncertainty cannot reasonably be seen as a tag or ordeal for tax planning motivation because it does not systematically track characteristics of tax planners. As a general matter, individuals tend to exhibit a phenomenon known as “uncertainty aversion,” whereby individuals tend to avoid uncertainty, or unknown probabilities.<sup>162</sup> Not only taxpayers engaged in wasteful tax planning schemes are likely to find uncertainty costly. Taxpayers, as a general matter, are likely to find an increasingly uncertain tax code, and concomitant uncertainty regarding tax liabilities, to be costly. This is particularly true in the large business context, in which large business taxpayers face reporting requirements that depend upon the certainty of their tax positions.<sup>163</sup> Moreover, some evidence suggests that taxpayers with the strongest tax positions, least likely to be overturned, are the most likely to find uncertainty particularly costly.<sup>164</sup> Taxpayers with the strongest tax

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161. For some discussions of uncertainty in this regard see, for example, James S. Eustice, *Abusive Corporate Tax Shelters: Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 165 (2002) (suggesting that uncertainty may be used to stop “excessively tax-driven transactions,” albeit after distinguishing between uncertainty and a narrower conception of “frictions”); Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, in TAX AND CORPORATE GOVERNANCE 229, 241-42 (Wolfgang Schön ed., 2008) (discussing how uncertainty can increase frictional impediments, or “back-flips,” required to deter aggressive tax planning).

162. See Sarah Lawsky, *Probably? Understanding Tax Law’s Uncertainty*, 157 U. PA. L. REV. 1017, 1065-66 (2009).

163. In particular, see FIN. ACCT. STANDARDS BD., INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES (2006), available at [http://www.fasb.org/pdf/aop\\_FIN48.pdf](http://www.fasb.org/pdf/aop_FIN48.pdf).

164. See Jeff T. Casey & John T. Scholz, *Boundary Effects of Vague Risk Information on Taxpayer Decisions*, 50 ORG. BEHAV. & HUM. DECISION PROCESSES 360, 387-88 (1991) (finding uncertainty aversion in the reporting context when

positions are often going to be engaging in routine business transactions, rather than aggressive tax planning. As a result, increasing tax law uncertainty potentially imposes greater costs on routine business transactions than on aggressive tax planning. Making the tax code more costly to taxpayers in general, and in particular to taxpayers more likely engaging in routine business transactions rather than aggressive tax planning, does not direct costs well based on tax planning motivation.

Understanding the screening aspect of frictions can help ameliorate these shortcomings by suggesting ways to make uncertainty a more tailored friction on tax planning. For example, the IRS could couple its offers of certainty through guidance (and accompanying certainty regarding tax liabilities) with requirements likely to restrict such certainty to taxpayers that are generally engaged in routine business transactions. In particular, the IRS could restrict any guidance to taxpayers that met certain criteria over the course of a specified time period prior to the guidance request including: paying at least a certain percentage of taxes relative to pre-tax income, not having engaged in any tax shelters or abusive transactions, etc.<sup>165</sup> Taxpayers engaging in routine business transactions should be more likely eligible for guidance under these criteria, and therefore more able to reduce the costs to them of uncertainty, without completely undermining the potential value of uncertainty as a friction on taxpayers engaging in more aggressive tax planning. Additionally, the IRS could offer more nonbinding and informal, but publicly available, guidance about how the tax law applies in routine business transactions. As a result, the guidance, even though nonbinding on the IRS, could serve as comfort for taxpayers engaging in routine business transactions. At the same

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experimental taxpayers faced favorable probability estimates regarding probability of detection and penalties).

165. The IRS would have to consider the resource costs of providing guidance to these taxpayers. See Osofsky, *Some Realism*, *supra* note 159, for a discussion of this concern. The IRS could address these costs in a number of ways, including fee collection in exchange for guidance, publishing redacted forms of guidance more routinely in order to reduce requests regarding similar, routine transactions, etc.

time, such guidance would do little to reduce the uncertainty facing taxpayers engaging in aggressive tax planning transactions.<sup>166</sup> While clearly the details of any of these proposals would need to be fleshed out and costs and benefits would have to be weighed,<sup>167</sup> uncertainty alone is simply too blunt of a tool. Focusing on screening offers a more productive path forward.

### CONCLUSION

As I illustrate in this Article, we need to integrate an important, new concept into the design of tax law. Frictions, or costs on tax planning, exist throughout the tax code. While the existing scholarship focuses primarily on the deterrence aspect of these frictions, they also have an important screening function. This basic insight complicates conventional wisdom regarding how to evaluate frictions and suggests concrete reforms of existing tax law.

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166. Currently, IRS guidance is either of the type that taxpayers generally can rely upon it (such as revenue rulings) or of the type that only the taxpayer actually receiving the guidance can rely upon on it (such as letter rulings and other informal guidance). Taxpayers are already warned that "since each Revenue Ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same." Treas. Reg. § 601.601(d)(2)(v)(e) (as amended in 1987). However, such limitations have not succeeded in preventing tax planners from using IRS guidance in an unanticipated manner. See Eustice, *supra* note 161, at 143-44 (discussing phenomenon). The nonbinding nature of guidance, suggested in the text, may provide the Service more leverage to prevent guidance from being used in such a manner.

167. Immediate concerns include questions such as: exactly what should the cutoff of taxes paid relative to pretax income be? What taxpayers might this unfairly exclude or include? What should the definition of "tax shelter" be for these purposes? Who makes these determinations? Are the resource costs in making these determinations worth any benefit they create? These concerns may be ameliorated to the extent that the IRS is exercising its rights to offer or deny guidance based on whatever taxpayer characteristics it chooses and it is simply making those characteristics more explicit. In any event, this Article certainly does not mean to answer all these questions or ultimately endorse these particular ideas. Rather, the Article offers examples of the types of ideas that we might consider after closely examining uncertainty as not just a deterrence vehicle but also a screening mechanism.

Frictions, when properly constructed, can serve as screening mechanisms on tax planning, ideally placing relatively greater costs on taxpayers more engaged in such planning. Constructing frictions without recognizing their fundamental role as screening mechanisms can result in particular groups of taxpayers bearing higher costs in unintended and perverse ways. In contrast, understanding frictions as screening mechanisms can improve their screening function, or, alternatively, suggest that screening effects make the friction altogether undesirable. In any event, exploring how frictions screen between different taxpayers is a crucial, but currently underappreciated, dimension of tax law design.

Viewing frictions as screening mechanisms raises many future lines of analysis. As an initial matter, many other frictions across the tax code can and should be examined as screening mechanisms, thereby raising a whole series of questions about how and why such frictions are screening. Viewing frictions as screening mechanisms also raises additional empirical questions. For example, how has the nature of stockholding changed since the 1921 Revenue Act? How might this affect the ideal wash sale rule? How might the use-it-or-lose-it rule be screening for demographic characteristics other than those explored in detail in this Article and what might this mean for the use-it-or-lose-it rule? Moreover, recognizing frictions as screening mechanisms raises a number of potentially far reaching theoretical questions. How, exactly, should various welfare weights (or costs) be assigned to different screening outcomes? When should taxpayers themselves bear the administrative costs of screening mechanisms and might their doing so help deter tax planning? For example, as to the latter question, if taxpayers ultimately found to have no economic substance for a transaction had to bear the cost of trial fees to determine economic substance, would this rule be disproportionately costly to aggressive tax planners, thereby helping to deter such planning?

In sum, once we recognize that frictions serve as screening mechanisms, there is a whole line of analysis that we should undergo. Scholars have done extremely valuable work examining when frictions deter tax planning rather than causing it to go through in a more wasteful fashion.

But frictions do more than fulfill this role as deterrence vehicles. This Article has highlighted the other, underappreciated role of frictions as screening mechanisms. Frictions impose substantial costs on taxpayers throughout the tax code. It is time to ask, in a rigorous way, how different groups of taxpayers are bearing these costs differently, based on underlying characteristics, and how these differences should affect tax law design.