

ENDOGENOUS TAX LAW: REGULATORY CAPTURE AND THE ETHICS OF POLITICAL OBLIGATION

DANIEL T. OSTAS*

I

INTRODUCTION

In a world of polarized public opinion, agreement reigns on at least one legal topic: Special interests wield a disproportionate and undue influence over the creation, implementation, and reform of business regulations. From the political right, Chicago school economists articulate the “capture theory” whereby business actors use the regulatory process to secure private economic advantages, most notably by erecting barriers to entry that generate economic rents.¹ Similarly, political scientists espouse “public choice theory,” examining how lobbying, campaign contributions, and conflicts of interest tilt law in favor of well-connected actors.² From the political left, neo-Marxian critiques emphasize wealth polarization, market power, and the seemingly inevitable corruption of government that results.³ In short, everyone from Hayek to Marx seems to agree that law is endogenous to, or co-determinant with, economic and political forces, and that law is as much a product of those forces as a determinate of them.

Notwithstanding widespread agreement on the endogenous nature of law, in discussions of corporate regulatory compliance, including tax compliance, the law is typically portrayed as an exogenously imposed constraint on business activities.⁴ Employing the rubric of financial risk management (FRM), the

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* JD, PhD Harlow Chair in Business Ethics, University of Oklahoma. dostas@ou.edu.

1. See generally George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGT. SCI. 3 (1971) (providing a seminal statement of regulatory capture); Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975) (explaining the logic of regulation as a barrier to entry); Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987) (modeling both the regulated firm and the politician as “rent-seekers”).

2. For a seminal articulation of public choice theory, see generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965). Precursors include JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962) and ANTHONY DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* (1957). See also Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J. L. ECON. & ORG. 167, 167–69 (1990) (discussing the genesis of public choice theory); Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 65–70 (1998) (offering an overview of the early public choice literature).

3. See generally JOHN K. GALBRAITH, *ECONOMICS IN PERSPECTIVE* 126–39 (1987) (contrasting neo-Marxian from neoclassical critiques of the regulatory process).

4. See, e.g., ANDREW S. BOUTROS, T. MARKUS FUNK & JAMES T. O'REILLY, *THE ABA*

corporate tax advisor frames the taxpayer's legal obligations with sole reference to the likely pecuniary consequences of alternative actions. This framing poses several ethical difficulties. First, FRM frames tax law in strictly positive terms, ignoring the moral dimensions of legal obedience.⁵ Second, tax law is highly influenced by the lobbying process; yet FRM tends to ignore the influence that corporate expertise and resources have on law and legal outcomes. Or, perhaps more accurately, FRM incorporates the role of private prerogatives when conducting a marginal benefit equals marginal cost calculation upon which FRM turns. Third, sometimes tax evasion goes undetected; or alternatively, it can be characterized as tax avoidance to move taxpayer exposure from the criminal to the civil docket.⁶ When tax laws are underenforced, myopic financial calculations counsel willful evasions, and tax obligations are reduced to a licentious admonition to do whatever one can get away with.⁷

Income tax law in the United States is woefully underenforced. A recent study by the U.S. Treasury Department places the U.S. tax gap, defined as the difference between income tax due and income tax collected, at \$600 billion annually.⁸ That amounts to fifteen percent of all income taxes owed, and over a ten-year period, the shortfall comes to a staggering \$7 trillion.⁹ By leaving excess money in the economy, the tax gap curbs the power of monetary policies to achieve price stability.¹⁰ The shortfall also affects fiscal policy as spending is trimmed or other taxes raised to temper the budget deficit. In addition, the gap exacerbates income polarization. Too often one finds two tax systems at play. One system for wealthy and corporate actors who find ways to avoid their tax obligations, and another for the common person subject to income and payroll taxes deducted from every paycheck. Some of the largest corporations and

COMPLIANCE OFFICER'S DESKBOOK (2016) (offering a compliance practitioner's guide to best practices in which legal obligations are taken as externally imposed); GEOFFREY P. MILLER, *THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE* (3d ed. 2020) (portraying regulatory law, including taxation, as an external threat and suggesting that risk management and compliance are inextricably interwoven).

5. See William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1349 (1999) (lamenting that compliance too often derives solely from FRM and ignores the firm's ethical duties of care).

6. See Dan M. Kahan, *Ignorance of the Law Is an Excuse: But Only for the Virtuous*, 96 MICH. L. REV. 127, 145–46 (1997) (noting that a literal interpretation of the tax code, even if declared judicially invalid, removes the potential for imprisonment).

7. A law is "underenforced" when a risk-adjusted *ex ante* calculation shows that it is cost effective to violate that law. See Daniel T. Ostas, *Legal Loopholes and Underenforced Laws: Examining the Ethical Dimensions of Corporate Legal Strategy*, 46 AM. BUS. L.J. 487, 490 (2009); Alexandra Natapoff, *Underenforcement*, 75 FORDHAM L. REV. 1715, 1735–36 (2006) (using regulations concerning undocumented workers to exemplify underenforced laws).

8. Natasha Sarin, *The Case for a Robust Attack on the Tax Gap*, U.S. DEP'T OF THE TREASURY (Sept. 7, 2021), <https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap> [<https://perma.cc/9T4A-ET6A>].

9. *Id.*

10. See RICHARD MURPHY, *THE JOY OF TAX: HOW A FAIR SYSTEM CAN CREATE A BETTER SOCIETY* 61 (2015).

wealthiest individuals notoriously pay little or no income tax,¹¹ and wealth and income disparities continue to spiral upward contributing to a rising cynicism among the taxpaying public.

This article, which builds inter alia upon the research that the author has carried out as the Leading Expert in the area of Business Ethics within the project VIRTEU,¹² examines the symbiosis between taxpayers and government officials that allows this tax gap to persist. The article finds moral blame among both taxpayers and government officials. Turning first to taxpayers, the article notes that people are unlikely to pay a tax unless they feel legally or morally compelled to do so.¹³ The immense scope of the tax gap suggests that calculations are done, and taxpayers often believe that an evasive or overly aggressive tax position will not be challenged; if challenged, it will prevail; and if the position proves invalid, the consequences will be limited to back taxes with interest and a modest fine. With such a mindset, the taxpayer's political obligations are monetized with reference to projected monetary consequences of alternative actions. Sometimes these actions include self-interested lobbying of government officials to secure special tax breaks or to resist changes proposed by others. Too often these calculations counsel unethical tax evasions and overly aggressive tax strategies.

Turning to the role of government officials, studies show that an increase in government spending on U.S. tax enforcement could yield an eight-fold return.¹⁴ Nonetheless, over the past decade, the budget for the Internal Revenue Service (IRS) has been cut by one-fifth.¹⁵ In addition, tax base erosion through the offshoring of profits continues unabated. During a 2007 campaign speech, presidential candidate Barack Obama criticized tax havens. Flashing a smile, he quipped, "You've got a building in the Cayman Islands where 12,000 companies supposedly are located. Now, that's either the biggest building in the world or the biggest tax rip-off in the world!"¹⁶ Notwithstanding his bully pulpit and quick

11. See Jesse Eisinger, Jeff Ernsthausen & Paul Kiel, *The Secret IRS Files: Trove of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax*, PROPUBLICA (June 8, 2021), <https://www.propublica.org/article/the-secret-irs-files-trove-of-never-before-seen-records-reveal-how-the-wealthiest-avoid-income-tax> [https://perma.cc/Y9PK-E6RD].

12. VIRTEU (Vat Fraud: Interdisciplinary Research on Tax Crimes in the European Union) was a two-year international research project funded by the European Anti-Fraud Office (OLAF) of the European Commission (Grant Agreement no: 878619), which aimed at exploring the interconnections between tax crimes and corruption. All the documents produced as well as all the video recordings of the events organized over the course of the project are available online on The Corporate Crime Observatory, which serves as the long-term repository of the project outcomes: www.corporatecrime.co.uk/virteu [https://perma.cc/DTG8-DZTK].

13. See generally TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990) (providing a meta-study of empirical works demonstrating that legal obedience responds to both the instrumental logic of deterrence and the normative logic of ethical self-restraint).

14. See Sarin, *supra* note 8.

15. See Kate Dore, *Top 1% Dodge \$163 Billion in Annual Taxes, Treasury Estimates*, PERS. FIN. (Sept. 9, 2021), https://www.cnbc.com/2021/09/09/top-one-percent-dodge-billions-in-annual-taxes-treasury-estimates.html?fbclid=IwAR1vbsVmAPsWsihTbHRPP_Qef7rOu6odNkr52alkGr0VCiLP5PXXFazx1NE [https://perma.cc/2KNN-VXBC].

16. See Sarah Hashemi & Luis Velarde, *Key Findings from the Pandora Papers Investigation*, WASH.

smile, during his two terms as President, the notorious Cayman building remained open for business. Today, there is an estimated \$32 trillion of untaxed money reported in places where no money was earned and then reinvested around the globe.¹⁷

The judiciary also plays a role in supporting the tax gap. Tax avoidance strategies, by definition, rely on literal interpretations of tax provisions while violating the spirit of the tax code.¹⁸ Tax courts in most, if not all, nations have access to general anti-avoidance rules (GAARs) that enable judges to discount strained literal interpretations of tax law that lead to absurd results.¹⁹ United States judicial precedents have created at least five interrelated GAARs, including the substance-over-form, step transaction, sham transaction, business purpose, and economic substance rules.²⁰ Use of these five GAARs continue to be somewhat sporadic and difficult to predict.²¹ Sometimes a court sides with the literal interpretation, implicitly blaming the legislature for any imprecisions in the Code. At other times, a court looks beyond form to substance and condemns the taxpayer for overreaching. Summarizing the ambivalent status of contemporary precedents, one tax scholar quipped, “Substance controls over form, except, of course, in those cases in which form controls.”²² A more pragmatic and less formalistic judiciary could curb the tax gap.²³

Legislators also share part of the blame by failing to adequately fund IRS activities and to close tax loopholes.²⁴ Consider a profit-shifting scheme initiated with a transfer of intellectual property by a U.S. parent to one of the 12,000 wholly owned subsidiaries domiciled in the Grand Cayman building referenced by President Obama. The subsidiary licenses the property back to its parent in exchange for royalty payments with group profits being assigned to the Caymans and deductions taken in the United States.²⁵ No one involved in the transaction

POST (Oct. 5, 2021), <https://www.washingtonpost.com/business/2021/10/03/takeaways-pandora-papers/> [<https://perma.cc/Q25T-NEEB>].

17. See Sarin, *supra* note 8.

18. See *infra* notes 45–46 and accompanying text (distinguishing tax compliance, tax avoidance, and tax evasion).

19. See Daniel T. Ostas & Axel Hilling, *Global Tax Shelters, the Ethics of Interpretation, and the Need for a Pragmatic Jurisprudence*, 53 AM. BUS. L.J. 745, 765–67 (2016).

20. Jerome B. Libin, *Congress Should Address Tax Avoidance Head-On: The Internal Revenue Code Needs a GAAR*, 30 VA. TAX REV. 339, 340 (2010).

21. See Ostas & Hilling, *supra* note 19, at 765–66.

22. Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 195 (2001).

23. See *infra* notes 112–120 and accompanying text (distinguishing pragmatic from formalistic jurisprudential attitudes among tax courts).

24. See Prem Sikka, *VIRTEU Roundtable, Institutional Corruption and Avoidance of Taxation*, CORP. CRIME OBSERVATORY, at 45:55 (Mar. 12, 2021), <https://www.corporatecrime.co.uk/virteu-institutional-corruption> [<https://perma.cc/ZKC4-N55T>] (discussing the issue of the limited resources available for enforcement agencies).

25. See NICHOLAS SHAXSON, *TREASURE ISLANDS: UNCOVERING THE DAMAGE OF OFFSHORE BANKING AND TAX HAVENS* 13–16 (2011) (explaining how the offshoring of profits functions by artificially manipulating paper money trails).

ever visits the Caymans, nothing is produced there, and the profits are reinvested around the world without ever being taxed beyond the zero percent corporate income tax rates in the Cayman Islands.²⁶ The only connection to the Caymans is a postal address and incorporation papers stamped by a Cayman official. The scheme lacks economic substance, yet when obfuscated and concealed it may be difficult to detect,²⁷ and if detected the courts may decline to invalidate the plan.²⁸

One can only speculate as to why executive branch officials, judges, and legislators fail to adequately disincentivize tax evasion and overly aggressive tax avoidance schemes. Yet, the persistence of the tax gap speaks for itself. Some of the answers can be found in the capture and public choice theories articulated by economists and other social scientists and widely accepted by the lay public. These theories assume that government officials are more interested in their personal wealth and power than in serving the public good. If true, this is an ethical failure. So too is an FRM approach to tax compliance that produces self-interested and disingenuous legal interpretations, recommends manipulative interactions with government officials, and counsels tax evasion whenever it seemingly pays.

This article contends that closing the tax gap requires a proper framing of ethical obligations by both taxpayers and government authorities. In doing so, this article offers stoic philosophy as a guide. Though not a Stoic himself, Socrates reminds us that the unexamined life is not worth living. Taxpayers must engage in honest self-assessment, act with stoic self-restraint, and comply with professionally honest interpretations of the tax code even when evasion seems to pay. Similarly, government officials are honor bound to serve the common good. This includes members of all three branches of government. Armed with stoic virtues, solving the tax gap becomes easy. Without them, no amount of legislation is likely to make a difference.

The argument proceeds in three parts followed by a brief conclusion. Part II grounds the taxpayer's ethical duty to pay taxes in the general ethical obligation to obey reasonably just laws promulgated in reasonably just societies. The discussion contrasts the expansive Socratic view of political obligation with the restricted libertarian philosophy offered by Robert Nozick, who famously equated redistribution through taxation as a form of "forced labor."²⁹ Part II also identifies two rationalizations that derail the moral self-restraint necessary to counter tax evasion and overly aggressive avoidance strategies. The first

26. *Id.*

27. See Shu-Yi Oei & Diane Ring, *Leak-Driven Law*, 65 UCLA L. REV. 532, 536 (2018) ("Tax authorities have traditionally encountered difficulties in obtaining information about hidden offshore wealth and complex offshore tax-minimization structures employed by multinationals.").

28. See Corporate Crime Observatory, *VIRTEU International Symposium – The Professionals: Dealing with the Enablers of Economic Crime – Panel I: The Phenomenon*, YOUTUBE, at 41:15 (July 21, 2021), https://youtu.be/f66_PTdCVyA?t=2475 [<https://perma.cc/39M8-PK9R>] (discussing the current decline in white-collar crime enforcement with Jesse Eisinger).

29. See ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 169 (1974) ("Taxation of earnings from labor is on a par with forced labor.").

rationalization removes the moral content from the law and thereby reduces the obligation to obey law to a financial calculation. The second suggests that tax positions taken pursuant to a self-centered framework of FRM are ethically sufficient when interacting with government officials. As with all rationalizations, both are self-serving, and neither is true. When combined, these two rationalizations turn the stoic obligation to obey law into an unrestrained privilege to exploit legal advantages. This would include concealment and obfuscation of tax practices, and the corruption of the democratic process.³⁰

Part III examines governmental ethics with particular emphasis on the influence of wealthy and corporate taxpayers in the formation and implementation of tax policy. Drawing on the capture theory of regulation and the public choice theory of government, Part III traces the corrupting influences taxpayers have on all three branches of government: executive, legislative, and judicial. The influence derives from the campaign finance system, the lobbying process, and the well-documented revolving door of regulation. The influence appears most directly in a legislative failure to close legal loopholes and to clarify legal ambiguities. It expresses itself in the historical underfunding of IRS activities and a judicial formalism³¹ that rejects robust uses of anti-abuse doctrines established by long-standing precedent.

Part IV offers stoic self-restraint as a means of closing the tax gap. It draws on the Aristotelian virtue of *epieikeia* (decency) as a moral guide to interacting with unintended legal prerogatives created by inevitable imperfections in law.³² Advocating temperance in all things, Aristotle's moral justice demands taking less than what one might when legal opportunities present themselves. Similar views are expressed by Adam Smith's stoic embrace of the virtue of prudence and John Rawls's call for the virtue of civility.³³ Part IV closes by revisiting three commonly cited works on corporate social responsibility (CSR): Milton Friedman's embrace of the profit incentive,³⁴ Edward Freeman's articulation of stakeholder theory,³⁵ and Archie Carroll's notion of a responsibility pyramid.³⁶

30. See Corporate Crime Observatory, *VIRTEU International Symposium – The Professionals: Dealing with the Enablers of Economic Crime – Panel II: The Causes*, YOUTUBE, at 12:14 (July 21, 2021), <https://youtu.be/xrs0PvbHNj0?t=734> [<https://perma.cc/DJD7-AUR7>] (discussing how rationalization facilitates people's unethical conduct with Daniel Ostas).

31. See generally Ostas & Hilling, *supra* note 19 (arguing for a less formal and more pragmatic judicial approach to global tax shelters); Peter Koerver Schmidt, *Legal Pragmatism – A Useful and Adequate Explanatory Model for Danish Adjudication on Tax Avoidance?*, 2020 NORDIC TAX J. 29, 37–40 (2020) (examining the Danish Supreme Court's pragmatic approach to tax adjudication).

32. See ARISTOTLE, *NICOMACHEAN ETHICS* 98–99 (Terence Irwin trans., Hackett Publishing 3d ed. 2019).

33. See *infra* notes 127–133 (noting the complementary virtue-based approaches to political obligation espoused by Aristotle, Smith, and Rawls).

34. See Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at 32 (arguing the only social obligation of a business is to maximize its profits without engaging in fraud).

35. See R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* 24–25 (1984) (explaining that business managers should take external stakeholders into account).

36. See Archie B. Carroll, *Carroll's Pyramid of CSR: Taking Another Look*, INT'L J. CORP. SOC.

All three views of social responsibility denounce unrestrained corporate egoism and contend that profit seeking must be tempered by legal and ethical constraints. Although not all the tax gap derives from corporate activities, much does, and the call for CSR comes to the fore.

Ultimately, both tax fraud and government corruption³⁷ emerge from the familiar triangle of temptation, opportunity, and rationalization.³⁸ This article focuses on the rationalization component. For the taxpayer, the FRM approach to tax compliance offers a moral balm to self-centered tax practices. It enables the taxpayer to shift blame to ineffective government officials who fail to address the tax gap. If a tax position pays, that ends the ethical inquiry for the taxpayer. Elected government officials find moral solace in re-election and use it to rationalize their class biases and self-serving actions. Ethics, of course, demands more of both taxpayer and tax official. This article contends that honest moral reflection can go a long way in removing self-serving rationalizations and accentuating the better side of human nature. The tax gap is not just a function of self-serving calculations, it is a function of inappropriate and indefensible ethical rationalizations as well.

II

THE TAXPAYER'S POLITICAL OBLIGATION

The ethical duty to pay taxes is rooted in the broader political obligation to obey reasonably just laws promulgated in reasonably just societies.³⁹ Philosophical discussions of political obligation trace to Plato's recounting of Socrates's trial and death.⁴⁰ Though Socrates was condemned to die for the crime of corrupting the minds of Athenian youth, Socrates's friend, Crito, offers a means of escape. A dialogue ensues in which Socrates offers four reasons why what would come to be regarded as stoic virtue demands legal obedience. First, Socrates argues that his lifelong residence in Athens implies his *consent* to follow Athenian law. Second, he reasons that because he has benefited from law, the ethics of *reciprocity* require his return obedience. Third, Socrates argues from a principle of *fairness* and finds a duty to obey law rooted in the obedience of others. Finally, employing a *pragmatic* perspective, Socrates notes that if legal obedience became a widespread matter of personal choice, then Athens would surely fail. Socrates chooses virtue over life and refuses Crito's offer to escape.

RESP., at 1, 5 (2016) (examining Carroll's pyramid framework of Corporate Social Responsibility).

37. See Costantino Grasso, *The Dark Side of Power: Corruption and Bribery Within the Energy Industry*, in RESEARCH HANDBOOK ON EU ENERGY LAW AND POLICY 237, 238 (Rafael Leal-Arcas & Jan Wouters eds., 2017) (illustrating the challenges in adopting a legal definition of corruption that captures all of its multifaceted aspects).

38. See generally Leandra Lederman, *The Fraud Triangle and Tax Evasion*, 106 IOWA L. REV. 1153 (2021) (providing a useful guide to the fraud triangle and citations to the relevant literature).

39. See generally THE DUTY TO OBEY THE LAW: SELECTED PHILOSOPHICAL READINGS 1–15 (William A. Edmundson ed., 1999) (introducing a collection of oft-cited works on political obligation).

40. See PLATO, CRITO (Benjamin Jowett trans., Global Grey 2018) (c. 360 B.C.E.)

Of course, not everyone embraces a robust political obligation to obey tax law. Libertarian political philosopher Robert Nozick, for example, famously argued that redistribution in the form of compulsory taxation is morally “on a par with forced labor.”⁴¹ Nozick’s view threatens to provide a rationalization for both tax evasion and the corrupt underenforcement of tax law by government officials. This rhetorical support for evasion and corruption supports the tax gap and frustrates the democratically determined policy justifications underlying tax law. These justifications typically involve pragmatic compromises and the balancing of social norms. Ultimately, tax is used for both monetary and fiscal policy reasons and to alleviate income polarization.⁴² The tax gap frustrates these democratically determined legislative goals.

Comparing Socrates with Nozick, it is important to note that even among political philosophers who find a robust duty to obey law, there is room for permissible civil disobedience.⁴³ Sophocles examined civil disobedience in the play *Antigone*, where his protagonist justifiably defies Creon’s decree that she deems unjust.⁴⁴ Similarly, Harriet Tubman defied slavery laws, Mahatma Gandhi incited a boycott of the British salt tax, and Martin Luther King, Jr. led sit-ins. If the state is unjust, then there is no ethical duty to obey its law. The logic of civil disobedience, however, does not extend to the income tax codes promulgated in accord with due process in democratic societies. Within such societies, some combination of the Socratic appeals to consent, reciprocity, fairness, and pragmatism must carry the day. In short, libertarian philosophers are ethically free to advocate their political positions, but they are not ethically free to disobey tax law.

A. Competing Compliance Frameworks

The tax gap, by definition, derives from tax evasion, tax insolvency, and tax avoidance.⁴⁵ Evasion involves criminal activity without recourse to legal excuse, such as failing to report self-employment income or deliberately falsifying a return. Evasion potentially involves jail time. Insolvency arises when a taxpayer files bankruptcy or otherwise becomes incapable of paying a tax. Avoidance refers to not paying a tax or paying a reduced tax based on the assertion of a literal interpretation of tax law that one knows was not intended by the legislature, and if challenged, may not prevail in court. Of course, if the taxpayer’s

41. See generally NOZICK, *supra* note 29.

42. See Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAXL. REV. 1, 3–4 (2006) (explaining that taxes raise revenue, regulate market activity, and reduce income disparities).

43. See John Rawls, *The Justification of Civil Disobedience*, in CIVIL DISOBEDIENCE: THEORY AND PRACTICE 240, 248–52 (Hugo Bedau ed., 1969) (recognizing that civil disobedience may be justified under certain conditions).

44. See Sophocles, *Antigone*, in THE THEBAN PLAYS 126, 127–28, 138 (E.F. Watling trans., Penguin Books 1953)

45. See Richard Murphy, *The Tax Gap. Tax Evasion in 2014 – and What Can Be Done About It*, PUB. & COM. SERVS. UNION, at 1, 5–6 (2014) (noting that the tax gap is composed of three parts: tax debt, tax avoidance, and tax evasion).

interpretation were to prevail, then no additional tax would be due, and the failure to pay would not be within the tax gap. If the interpretation proves invalid, however, then the taxpayer must pay back taxes with interest and potentially face a civil penalty. Studies estimate that about two-thirds of the tax gap constitutes evasion, one-sixth insolvency, and one-sixth avoidance.⁴⁶

Like all areas of law, tax law must be interpreted. Disputes over tax interpretation typically involve a tension between the letter and the spirit of the law.⁴⁷ The letter, of course, refers to a literal interpretation of the statute or regulation. But words can have more than one meaning, and ambiguity makes law difficult to interpret.⁴⁸ Words can be vague, requiring the drawing of lines between taxable and non-taxable activities without clear guidance.⁴⁹ Tax laws also can have gaps, conflicts, and inconsistencies. This is particularly true when more than one taxing authority claims jurisdiction, as one often finds in interstate transactions and in the global arena.

In taking a tax position, two frameworks for legal compliance present themselves. The first defines a taxpayer's legal obligation with sole reference to the likely consequences of taking the tax position. This orientation follows the economic logic of FRM. It ignores the complex set of normative compromises inherent in tax regulations and the ethical aspirations that the law seeks to advance. The alternative orientation to a tax filing employs the full panoply of interpretive tools, including reference to legislative intent and public purpose inherent in tax law. Here, the compliance norm requires construction of a professionally honest interpretation of the law and self-restraint in adopting such a position when a more disingenuous interpretation seems cost effective. The following subparts contrast these competing frameworks, beginning with FRM.

B. Financial Risk Management

Pursuant to FRM, political obligations are framed with sole reference to projected liabilities. From an ethical perspective, this framework poses several difficulties. First, FRM frames law in strictly positive terms, ignoring the moral dimensions of legal obedience. Second, tax law is highly influenced by the lobbying process; yet FRM tends to ignore the influence that corporate expertise and resources have on law and legal outcomes. Third, sometimes tax evasion goes undetected or is characterized as tax avoidance that may not be upheld if challenged. When tax laws are underenforced, FRM calculations counsel evasion. In short, the FRM approach to compliance exacerbates the tax gap.

46. *See id.* at 2 (estimating that the UK's tax gap is £122 billion a year and that £85 billion is due to tax evasion, £18 billion is due to tax not paid, and £19 billion is due to tax avoidance).

47. *See* Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters*, 54 SMU L. REV. 1 (2001) (discussing "the traditional judicial anti-avoidance doctrines such as the business purpose and economic substance doctrines as well as the substance over form and step transaction doctrines.").

48. *See* REED DICKERSON, *THE INTERPRETATION AND APPLICATION OF STATUTES* 43–48 (1975) (analyzing the inherent ambiguity of language and its effect on statutory interpretation).

49. *See id.* at 43, 48–51 (explaining that vagueness creates uncertainty around how a statute will be enforced).

Consider first the *positivity* of law inherent in the logic of FRM. The positivity of law refers to the way law confronts taxpayers solely as the threat of consequences for non-compliance. In the well-known articulation given by Oliver Wendell Holmes, Jr.,

If you want to know the law and nothing else, you must look at it as a *bad man*, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.⁵⁰

This heuristic, Holmes thought, was necessary to “dispel a confusion between morality and law.”⁵¹ Holmes wrote, “A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money.”⁵² FRM’s economic logic dictates that tax compliance at its finest, and by design, corresponds to the way Holmes’s bad man views and responds to legal norms.

The positivity expressed by Holmes reaches its most celebrated articulation in works of Herbert L. A. Hart. Backing Holmes and other positivists, Hart defends “the separation of law as it is and law as it ought to be,” implying that a judge’s (or taxpayer’s) fidelity to the law does not require any judgment about whether the legal rule in question was “morally desirable.”⁵³ Lon Fuller famously argued against Hart’s positivism with the contention that what makes the law “law” is not merely its form and genesis by the state, but what he calls its inner morality.⁵⁴ According to Fuller, discerning one’s legal obligations requires more than a prediction of the positive threat of enforcement dictated by a regulatory text, because it takes more than state power to make *law*. Ultimately, tax law expresses democratically determined social values and seeks to promote those values. Ignoring those values violates the Socratic virtue of legal obedience and contributes to the tax gap.

The rubric of FRM portrays law as an exogenously imposed given. Yet, taxpayers have a host of legal strategies with which to influence the creation, reform, and enforcement of tax law.⁵⁵ Telling taxpayers to simply follow the law, when they help write the law, can be somewhat circular. Moreover, sometimes tax law is underenforced. Regulators may lack the resources or the political will to adequately monitor taxpayer activities, and taxpayers can often conceal or obfuscate their actions. In such cases, both Holmes’s bad man understanding of political obligation and an FRM approach to tax compliance would counsel aggressive tax positions even if the positions were unlikely to prevail in court. If

50. Oliver W. Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) (emphasis added).

51. *Id.*

52. *Id.*

53. H.L.A. Hart, *Positivism and the Separation of Law and Morals*, 71 HARV. L. REV. 593, 595, 599 (1958).

54. Lon L. Fuller, *Positivism and Fidelity to Law: A Reply to Professor Hart*, 71 HARV. L. REV. 630, 645 (1958).

55. See generally Lynn M. LoPucki & Walter O. Weyrauch, *A Theory of Legal Strategy*, 49 DUKE L.J. 1405 (2000).

a position were challenged, lawyers may advocate strained interpretations of both the law and the facts while characterizing those interpretations as valid. If a literal interpretation is found, then the matter no longer carries criminal sanctions; hence, everything reduces to pecuniary calculations that often counsel tax evasion and illegitimate avoidance strategies.

C. Professionally Honest Interpretations

Of course, there is an alternative to FRM. Taxpayers could comply with a professionally honest interpretation of legal materials even in situations when evasion seems to pay. Tax courts tend to follow the traditional techniques of statutory interpretation.⁵⁶ Statutory interpretation begins with due deference to the plain meaning of the language expressed in the legal rule.⁵⁷ If that language is clear on its face, then that ends the inquiry, and the fact pattern is simply examined under the ordinary language of the rule and a judgment is rendered. In most tax cases, plain meaning analysis suffices, and no further inquiry into meaning is appropriate. In some settings, however, the language of the law seems ambiguous, vague, gap-riddled, or conflicted.⁵⁸ In those situations, interpretation requires inquiry into maxims of construction, legislative purpose, and relevant judicial precedents.⁵⁹

Tax law can be quite complicated,⁶⁰ and taxpayers typically seek professional tax advice before taking a tax position. Although not all tax planners are lawyers, many are. United States lawyers are subject to a code of ethics, most of which are based in part on the American Bar Association's (ABA) *Model Rules of Professional Conduct*.⁶¹ The Preamble distinguishes between the roles lawyers play as *advisors* and as *advocates*. It states,

As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system.⁶²

Absent the zealous advocacy norms of an adversarial setting, tax advisors have a professional obligation to reflect upon the broader duties of the client, including the ethical obligation to abide by a professionally honest interpretation of tax law. ABA Rules state, "In rendering advice, a lawyer may refer not only

56. See generally HENRY CAMPBELL BLACK, HANDBOOK ON THE CONSTRUCTION AND INTERPRETATION OF THE LAWS (2d ed. 1911) (offering a time-honored treatise on the principles of statutory interpretation).

57. See generally ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW (1997) (explaining the theory of textualism).

58. See DICKERSON, *supra* note 48, at 43–53.

59. See YULE KIM, CONG. RSCH. SERV., 97-589, STATUTORY INTERPRETATION: GENERAL PRINCIPLES AND RECENT TRENDS 39–40 (2008).

60. See Diane Ring, *VIRTEU Roundtable, Institutional Corruption and Avoidance of Taxation*, CORP. CRIME OBSERVATORY, at 41:34 (Mar. 12, 2021), <https://www.corporatecrime.co.uk/virteu-institutional-corruption> [<https://perma.cc/E4VM-AZVA>] (discussing the complexity of the tax system).

61. MODEL RULES OF PRO. CONDUCT (AM. BAR ASS'N 2020).

62. *Id.* at Preamble and Scope.

to law but to other considerations such as moral, economic, social and political factors that may be relevant to the client's situation."⁶³ The Comment to Rule 2.1 explains, "It is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied."⁶⁴

III

GOVERNMENTAL ETHICS

A THEORY OF JUSTICE by John Rawls remains one of the most influential works of political philosophy penned in the twentieth century.⁶⁵ Employing contractarian logic and the imagery of a veil of ignorance, Rawls articulates and defends his vision of a just society.⁶⁶ Although his treatise focuses on principles of good governing, Rawls also addresses personal ethics applicable to both taxpayers and government officials.⁶⁷ Political obligation in a just society demands the virtue of *civility*. He writes,

[W]e have a natural duty of civility not to invoke the faults of social arrangements as too ready excuse for not complying with them, nor to exploit the inevitable loopholes in the rules to advance our interests. The duty of civility imposes a due acceptance of the defects of institutions and certain restraint in taking advantage of them.⁶⁸

Rawls recognizes and accepts the egoistic and self-interested aspects of human nature.⁶⁹ He notes that self-interest motivates industry and generates bounty.⁷⁰ Yet, when *unrestrained*, self-interest becomes ethically unjustifiable. Rawls writes, "although egoism is logically consistent and in this sense not irrational, it is incompatible with what we intuitively regard as the moral view. The significance of egoism philosophically is not as an alternative conception of right but as a challenge to any such conception."⁷¹ This unrestrained self-interest can affect both taxpayers who seek to evade and unjustifiably avoid taxes and public officials who personally benefit by facilitating such actions.

A. Special Interests and Executive Tax Policies

Tax policy changes with changing administrations and Congresses. These changes reflect the economic needs of the time as framed by the political

63. *Id.* at r. 2.1.

64. *Id.* at r. 2.1, cmt. 2.

65. *See generally* JOHN RAWLS, A THEORY OF JUSTICE (1971).

66. Under a veil of ignorance, a person is unaware of their initial endowment of wealth and talent. *Id.* at 137. Rawls argues that under such conditions people would agree to form political institutions that (1) guaranteed the greatest possible liberty compatible with similar liberty to others, *id.* at 151, and (2) only permitted social and economic inequalities that would inure to the benefit of all, *id.* at 150.

67. *See id.* at 54.

68. *Id.* at 355.

69. *See id.* at 151.

70. *Id.*

71. *Id.* at 136.

ideologies and self-interest of the current administration.⁷² For example, coming out of the Second World War, the United States enjoyed a golden era complete with a growing middle class supported by labor union membership and free college education for veterans. Income polarization ebbed as the ratio between CEO pay and average worker pay hovered around twenty to one, as compared to 361 to one today.⁷³ Holding most of the world's gold supply and with an industrial base intact, the United States helped rebuild Germany and Japan and supported international institutions, including the World Trade Organization. In the early 1960s, President John F. Kennedy ushered in a stimulus package that included significant tax cuts and efforts to close tax loopholes.⁷⁴ The 1960s were, by all accounts, very prosperous in the United States with high growth rates, low unemployment, and low inflation.

In support of his tax reforms, President Kennedy touted expert knowledge and lobbyist expertise in advocating his public policies. In support of private lobbying, he wrote,

Lobbyists are, in many cases, expert technicians and capable of explaining complex and difficult subjects in a clear, understandable fashion . . . They engage in personal discussions with members of Congress in which they can explain in detail the reason for positions they advocate. . . . Because our congressional representation is based on geographical boundaries, the lobbyists who speak for the various economic, commercial and other functional interests of this country serve a very useful purpose and have assumed an important role in the legislative process.⁷⁵

Hence, as President Kennedy emphasizes, lobbying has virtues and lobbyists play an important role in a representative government. Kennedy's optimistic advocacy of lobbyist-supported tax cuts contributed to his 1960 election.⁷⁶

Notwithstanding President Kennedy's optimism, today, public opinion is more likely to reflect reservations with lobbying than admiration. Perhaps this simply mirrors a more politically cynical time. In a 1964 poll, seventy-six percent of Americans said that they trusted government to do the right thing "just about always" or "most of the time."⁷⁷ Asking the same question in 1994, the number dropped to twenty-one percent, with about half of the respondents stating that

72. See generally MICHAEL G. RUKSTAD, *MACROECONOMIC DECISION MAKING IN THE WORLD ECONOMY* (3d. ed. 1992) (exploring the rhetorical structure of justifications of evolving tax policies from Roosevelt's "New Deal" legislation of the 1930s through the Kennedy tax cuts of the 1960s to the Bush tax increase of 1990).

73. Diana Hembree, *CEO Pay Skyrockets to 361 Times that of the Average Worker*, FORBES (May 22, 2018), <https://www.forbes.com/sites/dianahembree/2018/05/22/ceo-pay-skyrockets-to-361-times-that-of-the-average-worker/?sh=4a6b628a776d> [<https://perma.cc/6XP5-B3RW>].

74. RUKSTAD, *supra* note 72, at 238, 245–46.

75. *Issues of Democracy: Advocacy in America*, 3 ELEC. J. U.S. INFO. AGENCY, June 1998, at 1, 2 (1998) (quoting John F. Kennedy from 1956, prior to his election as president) (second alteration in original).

76. RUKSTAD, *supra* note 72, at 237.

77. David L. Boren, *A Recipe for the Reform of Congress*, 21 OKLA. CITY UNIV. L. REV. 1, 1 & n.1 (1996) (quoting CTR. FOR POL. STUD., UNIV. OF MICH., AMERICAN NATIONAL ELECTION STUDIES 26 (1952–1994)).

the federal government was “controlled by lobbyists and special interests.”⁷⁸ The public concern is not just with unsavory tactics employed by paid lobbyists, but more fundamentally with the ability of politically well-connected groups to shape the law to serve their private interests rather than the public good.

In 1980, presidential candidate Ronald Reagan tapped into a growing cynicism about government regulations. Reagan famously denounced government as the problem, not the solution. With Reagan in office, Congress slashed the top individual tax bracket from fifty to twenty-eight percent and raised social security taxes on workers, while the Executive Branch attacked organized labor and refused to enforce antitrust law. All of this began the steady increase in wealth polarization that continues unabated.⁷⁹ Like Kennedy, Reagan’s rhetorical appeal to “supply-side economics” played to public sentiments and curried political favor with business interests who generally sought lower taxes and less regulation.⁸⁰

Of course, cutting the marginal income tax rate (Presidents Kennedy and Reagan), cutting the capital gains tax rate (President George H. W. Bush), eliminating the estate tax for one year (2010) (President George W. Bush), or cutting the corporate income tax rate by more than ten percent (President Donald Trump) does not contribute to the tax gap.⁸¹ President Trump’s defiant attitude toward tax compliance, however, may be another story. President Trump not only refused to make his taxes public, he also suggested that “he’s ‘smart’ by not paying income taxes.”⁸² His suggestion was that smart people find ways to hide their income. In essence, he used his bully pulpit to rationalize cost effective evasion and avoidance practices. Not surprisingly, during the Trump presidency, Congress cut IRS funding, while the IRS decreased the audit rate more sharply for upper income earners and corporations than for Earned Income Tax Credit recipients.⁸³

In each example, a sitting president drew rhetorical support for tax reforms from economic, and social ideologies that benefitted powerful interests and thereby fostered his own political interests. Perhaps these tax policies reflect sincere attempts to serve the common good. Each disproportionately benefitted

78. *Id.* at 1–2.

79. See RUKSTAD, *supra* note 72, at 267–300.

80. See generally *id.*

81. See, e.g., Tax Cuts & Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (cutting the corporate income tax rate from 35% to 21%).

82. Dan Mangan, *Trump Brags About Not Paying Taxes*, CNBC (Sept. 26, 2016) <https://www.cnbc.com/2016/09/26/trump-brags-about-not-paying-taxes-that-makes-me-smart.html> [<https://perma.cc/CUE8-JGDR>].

83. See generally CTR. ON BUDGET & POL’Y PRIORITIES, *Chart Book: The Need to Rebuild the Depleted IRS* (July 2, 2021) <https://www.cbpp.org/research/federal-tax/the-need-to-rebuild-the-depleted-irs> [<https://perma.cc/RDU7-KBNS>] (documenting a 6.25% drop in IRS funding during the Trump administration, from \$9.6 billion in 2016 to \$9.0 billion in 2020); Sarin, *supra* note 8 (discussing shifts in the audit rates over a ten year period, including the Trump administration, with audit rates dropping most sharply for high-income earners); Dore, *supra* note 15 (discussing shifts in IRS operational priorities over the past decade that tend to favor wealthier taxpayers).

wealthy taxpayers capable of affecting election results through campaign contributions and electioneering under the protection afforded by *Citizen's United*.⁸⁴ This suggests a market for executive actions paralleling the public choice and capture theory models most typically applied to legislative actions. In other words, it suggests a symbiotic relationship between U.S. presidents and wealthy taxpayers and an endogenous set of tax laws influenced by taxpayers, rather than exogenously imposed on them.

B. The Capture of Tax Legislation

The Rawlsian view of good government, buttressed by the virtue of civility, places government tax regulations in a positive light and projects a robust duty of cooperation on the taxpaying public. This view of good government is consistent with the so-called “public interest” theory of regulation, popular in the early to mid-twentieth century.⁸⁵ The theory contends that legislators work for the public interest, or common good, ignoring their own self-interest in reelection or personal financial gain. Pursuant to this view, one’s political obligation is robust, paying taxes becomes a civic virtue, and taxpayers have an ethical duty to cooperate with the spirit of the tax code.

By the early 1970s, this optimistic view of both government and taxpayer behavior began to shift. During that decade, Chicago school economists articulated and developed what is commonly called the capture theory of regulation.⁸⁶ According to the capture theory, businesspersons use the regulatory process to secure private economic advantages, most notably by erecting barriers to entry that generate economic rents.⁸⁷ Regulated firms achieve these advantages, in part, by controlling the flow of information to regulators.⁸⁸ Control also derives from the perverse incentives created by the so-called “revolving door” of regulation whereby regulators are recruited from the industry that they regulate and return to that industry after completing their term of government service.⁸⁹ According to the capture theory, these information flows and conflicts of interest—for example, entry barriers, rate controls, and product standards—mirror those created by economic cartels.⁹⁰

84. 558 U.S. 310 (2010).

85. See Croley, *supra* note 2, at 65–70 (discussing the basic theory underlying public interest theory).

86. See generally Stigler, *supra* note 1 (introducing the “capture theory” of economic regulation).

87. See Posner, *supra* note 1, at 824 (giving the example of private monopolists attempting to dissuade a regulatory agency from changing a rule limiting entry).

88. Donald J. Kochan, “Public Use” and the Independent Judiciary: Condemnation in an Interest-Group Perspective, 3 TEX. REV. L. & POL’Y 49, 81 (1998).

89. See Edna Earle Vass Johnson, “Agency Capture”: The “Revolving Door” Between Regulated Industries and Their Regulating Agencies, 18 U. RICH. L. REV. 95, 95 (1983) (discussing the interchange of personnel between the public and private sector).

90. Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 344 (1974).

Political scientists offer an equally negative view of regulatory law under the rubric of public choice.⁹¹ Like the capture theorists, public choice theorists assert that the substance of most business regulations has much less to do with the public interest than with the private will of the politically well-organized.⁹² According to the public choice perspective, legislators and agency officials respond to special-interest groups that use the lobbying process and campaign contributions to seek private goals. Of course, if competing special interest groups were balanced with each given full voice in the regulatory process, then some semblance of the public good might result.⁹³ But given the logic of collective action, some groups will be represented, and some will not. Interacting with the regulatory process is not cost free, and these costs will only be worthwhile if the benefits derived from the regulatory change are direct and substantial. The result, according to public choice theory, is a set of regulations that systematically favors the politically well-organized with narrow interests at the cost of the common good.

In a 1957 issue of the *Harvard Law Review*, Stanley Surrey examines the effect that lobbyists have on tax legislation.⁹⁴ He begins by noting that “we live in an era when both professional learning and public opinion regard a progressive income tax as the most appropriate method of raising governmental revenue” yet “a progressive income tax is also the most complicated and difficult of taxes to maintain.”⁹⁵ He then examines why Congress repeatedly enacts special tax provisions that add complexity to and reduce the progressivity of the tax system. Major factors include the perception by congresspersons, as fueled by lobbyists, that high rates of taxation are unfair to wealthy taxpayers and that taxation contains a degree of technical complexity that requires specialized expertise.⁹⁶ When combined with the legislator’s desire to help vocal constituents and the lack of a spokesperson for the low to middle-income taxpayer, special legislation in the form of tax loopholes becomes the norm. Surrey laments a lack of executive branch opposition to special legislation and a disinterest on the part of the tax bar to provide a necessary balance.⁹⁷

The influence of special interests on tax legislation found in 1957 persists today.⁹⁸ For example, a recent scholarly study from Finland documents the

91. See generally Abner J. Mikva, *Foreword: Symposium on Public Choice*, 74 VA. L. REV. 167 (1988) (introducing nine articles that consider political topics from a public choice perspective); Croley, *supra* note 2, at 34–56 (using public choice to examine regulatory law).

92. See *id.* at 169 (lamenting that public choice has become a prominent view among political scientists).

93. See generally ROBERT A. DAHL, *WHO GOVERNS?: DEMOCRACY AND POWER IN AN AMERICAN CITY* (2d ed. 2005) (articulating a pluralist system where interest groups balance one another resulting in reasonable legislative actions advancing a common good).

94. See generally Stanley S. Surrey, *The Congress and the Tax Lobbyist: How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).

95. *Id.* at 1145.

96. *Id.* at 1149–52.

97. *Id.* at 1164, 1170.

98. See Prem Sikka, *VIRTEU Roundtable, Institutional Corruption and Avoidance of Taxation*,

ongoing effect that special interest groups are having on efforts by the Organization for Economic Cooperation and Development (OECD) to address tax base erosion and profit shifting (BEPS).⁹⁹ The article concludes that corporate entities and tax professionals systematically lobby to corrode legislative efforts to tackle tax avoidance and to promote loopholes that harm the public through BEPS.¹⁰⁰ The article contributes to a continuing chorus of studies denouncing the capture of tax legislation.¹⁰¹ This literature provides a cynical view of the democratic process and resulting regulatory tax regime. In short, the capture of the legislative branch creates opportunity for self-dealing and exacerbates the tax gap.

C. Influence of Judicial Predispositions

Tax avoidance schemes can be complex, and whether the schemes succeed depends in large measure on the judicial predisposition toward literal interpretations of tax provisions. Consider the double Irish with a Dutch sandwich scheme adopted by Google.¹⁰² Google set up a subsidiary in Ireland, transferring intellectual property in exchange for stock. Pursuant to Irish law, the Irish subsidiary was then combined with a subsidiary in Bermuda, establishing a dual residency regarding tax. The U.S. government perceived the company as Irish because that is where it was incorporated, and the Irish government perceived the domicile as Bermuda because that is where its “mind and management” was centered.¹⁰³ The Irish-Bermuda subsidiary then licensed the intellectual property to a Dutch corporation pursuant to a contractual arrangement that required the Dutch corporation to relicense the property to a second Google-owned subsidiary in Ireland. That second Irish entity then marketed the intellectual property throughout Europe, the Middle East, and Africa. The marketing entity paid royalties to the Dutch company which then paid royalties to the Irish-Bermuda firm, and the income was reported in tax-free Bermuda.¹⁰⁴ Google used these machinations because the transfers between the Irish companies and the Dutch company were not recognized as taxable events under U.S. tax law, and the transfer between two members of the European

CORP. CRIME OBSERVATORY, at 29:35 (March 12, 2021), <https://www.corporatecrime.co.uk/virtue-institutional-corruption> [<https://perma.cc/Y24B-A7KD>] (discussing cognitive capture and psychological standardization of policymakers). For the development of an expansive conception of corruption and its relationship to tax crimes, see Diane M. Ring & Costantino Grasso, *Beyond Bribery: Exploring the Intimate Interconnections Between Corruption and Tax Crimes*, 85 LAW & CONTEMP. PROBS., no. 4, 2022.

99. Lauri Finér, *Who Generated the Loopholes? A Case Study of Corporate Tax Advisors' Regulatory Capture Over Anti-Tax Avoidance Legislation in Finland*, NORDIC TAX J. (forthcoming 2022) (manuscript at 1), <https://sciendo.com/article/10.2478/ntaxj-2021-0005> [<https://perma.cc/ZB7Y-NXY2>].

100. *Id.*

101. *See id.* at 3–5 (providing citation to this literature).

102. *See* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 707–714 (2011) (discussing Google's aggressive tax planning scheme involving Irish and Dutch subsidiary corporations).

103. *Id.* at 709.

104. *Id.* at 712.

Union is not subject to a withholding tax.¹⁰⁵ This aggressive tax planning was quite effective, and Google paid virtually no corporate income tax in the United States, or elsewhere.¹⁰⁶

It is important to note that U.S. tax courts have tools with which to invalidate step transactions schemes of this type. In particular, the U.S. Supreme Court has developed a set of general anti-avoidance rules (GAARs) that disallow hyper-literal, self-serving interpretations of tax regulations. These include the substance-over-form, sham transaction, step transaction, economic substance, and business purpose rules.¹⁰⁷ The doctrine of substance-over-form traces to *U.S. v. Phellis*,¹⁰⁸ where the U.S. Supreme Court directed lower courts to ignore the form of a tax transaction if that form has no substantive content. The sham transaction rule arose in *Higgins v. Smith*, where the Supreme Court held that when a tax event is unreal or a sham, lower courts should “disregard the effect of the fiction as best serves the purposes of the tax statute.”¹⁰⁹ The economic substance rule is now codified at I.R.C. § 7701(a).¹¹⁰

A third GAAR, the business purpose rule, traces to *Gregory v. Helvering*.¹¹¹ Gregory sought to acquire a set of shares from her investment company without declaring a dividend. She first directed her company to sell the shares to a newly formed company, which then transferred the shares to her, and then the newly formed company dissolved. The three steps, taken collectively, satisfied the literal requirements for a tax-free reorganization, so no dividend was declared. Gregory later sold the shares claiming a favorable capital-gains rate. The U.S. Supreme Court held that Congress had intended that a reorganization done for a business purpose should not be a taxable event, but the taxpayer in *Gregory* had no purpose other than to reduce her taxes.¹¹² The favorable treatment was disallowed.

One difficulty with the tax gap is that courts seem reluctant to use GAARs to invalidate avoidance schemes.¹¹³ A court that views itself as a full partner in a governmental attempt to protect the tax base will likely take an expansive view of GAARs and disallow literal arguments akin to the one advanced in *Gregory*. By contrast, a court intent on protecting the letter of the law, as specified in the reorganization provisions of the Code, will likely restrict itself in anti-tax

105. *Id.*

106. *See id.* (“The end result is a near-zero rate of tax on income derived from customers in Europe, the Middle East, and Africa . . .”); Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, BLOOMBERG (Oct. 21, 2010), <https://www.bloomberg.com/news/articles/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes> [<https://perma.cc/GWJ5-3ACM>].

107. *See* Libin, *supra* note 20, at 340 (listing the judicial doctrines that aid interpretation of inadequate statutory language when tax disputes arise).

108. 257 U.S. 156, 175 (1921).

109. 308 U.S. 473, 477 (1940).

110. I.R.C. § 7701(a).

111. 293 U.S. 465 (1935).

112. *Id.* at 470.

113. *See* Ostas & Hilling, *supra* note 19, at 765–71 (discussing the history of GAARs and different countries’ approaches to tax avoidance).

avoidance (ATA) matters.¹¹⁴ The same appears true regarding Google's global profit shifting. Potentially, the ATA doctrines could be used to limit abuses in this area. However, the immense scale of U.S. tax avoidance through profit shifting suggests that relatively little is being done with ATA doctrines to discourage the practice. It is interesting to note that effective January 1, 2020, Google voluntarily announced that it will no longer use the "Double Irish, Dutch Sandwich" loophole.¹¹⁵

Notwithstanding the long lineage of ATA cases, the application of the doctrines has always been controversial.¹¹⁶ Over time, an array of legal commentators has addressed the wisdom of ATA formulations, the appropriate uses of the doctrines, and the potential for abuse.¹¹⁷ At the heart of the debate, one finds fundamentally different views of legal philosophy and the proper relationship between the legislative and judicial branches.¹¹⁸ Some commentators argue that courts need to strictly adhere to the techniques of formal legal reasoning with sole appeal to linguistic analysis and legislative intent in tax cases.¹¹⁹ For these scholars, certainty, predictability, and simplicity provide the measures of legitimacy.¹²⁰ Other scholars contend that these goals are quixotic.¹²¹ They argue that given the recent growth in tax avoidance behavior, a more pragmatic and results-oriented inquiry is necessary.¹²² This requires the courts to move beyond linguistic analysis of legal texts, and beyond inquiries in legislative history, and toward a normative inquiry regarding both the ends sought by tax

114. See generally Schmidt, *supra* note 31 (examining the jurisprudential predispositions of Danish tax courts).

115. Edward Helmore, *Google Says It Will No Longer Use "Double Irish, Dutch Sandwich" Tax Loophole*, GUARDIAN (Jan. 1, 2020), <https://www.theguardian.com/technology/2020/jan/01/google-says-it-will-no-longer-use-double-irish-dutch-sandwich-tax-loophole> [<https://perma.cc/446J-WPV4>].

116. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5 (2000) (discussing the debate surrounding the doctrines, how taxpayer positions have shifted over time, and the introduction of anti-abuse provisions into regulations).

117. *Id.*

118. See generally Assaf Likhovski, *The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953 (2004) (examining the role of tax judges' jurisprudence).

119. See, e.g., Beth Stetson, Alexis Downs, Evan Shough & Dana Blake, *Courts Don't Follow: Reasonable Compensation Rulings and the Exacto Spring Approach*, 15 CHAP. L. REV. 343, 361 (2011) (bemoaning an appeal to economic results as outside the proper limits of legal inquiry).

120. See, e.g., John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1507 (1997) (arguing in favor of literal interpretations of the Internal Revenue Code as a means of promoting certainty and predictability).

121. See, e.g., Brian J. Arnold, *The Interpretation of Tax Treaties – Myth and Reality*, 66 BULL. INT'L TAX'N 2, 7 (2010) (noting that a "rigid, literal interpretation" of tax treaties and tax statutes often leads to "ridiculous" results); Richard J. Kovach, *Taxes, Loopholes, and Morals Revisited: A 1963 Perspective on the Tax Gap*, 30 WHITTIER L. REV. 247, 275–76 (2008) (reviewing the interplay between taxpayers who seek loopholes and taxing authorities who seek to close them); Jeffrey Partlow, *The Necessity of Complexity in the Tax System*, 13 WYO. L. REV. 303, 305 (2013) (noting that simultaneously seeking tax fairness and tax simplicity seems paradoxical because one goal tends to subvert the other).

122. See, e.g., Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 349–51 (2009) (examining empirically verifiable reasons why people obey or disobey law and suggesting reforms to encourage legal obedience).

legislation, and the best means for achieving those ends.¹²³ The judicial inquiry must be practical and rooted in empirical results.¹²⁴

There is no direct evidence regarding the source of the reluctance of tax judges to aggressively use GAARs to discourage tax avoidance. Part of the answer likely lies in the process by which judges are selected. Federal nominations come from the President and require Senate confirmation. Given their desire for reelection, neither the President nor most individual senators are likely to appoint or to confirm politically active tax judges that threaten to disrupt entrenched power structures. In fact, the confirmation hearings often probe the nominee's respect for "the rule of law," likely framed in formalistic and textualist trappings. On the state level, most tax judges are selected by the state legislature, while some are appointed by the Governor. Some states use partisan or non-partisan elections. One suspects that these processes may be subject to capture through campaign finance and lobbying activities that seek politically conservative tax judges ideologically committed to libertarian ideals and to a formalistic jurisprudence. More scholarly research on the source of the judiciary's political and class predispositions toward tax seems warranted.

IV

CLOSING THE TAX GAP

The symbiotic relationship between elected officials and wealthy taxpayers creates a conundrum for those seeking to close the tax gap. There seems to be little to no lobbying efforts in favor of hiring more internal revenue agents. Nonetheless, the Biden Administration has called for significantly increasing the IRS budget, and it has succeeded in doing so, with nearly \$80 billion being allocated to the IRS in the Inflation Reduction Act of 2022.¹²⁵ Ultimately, many taxpayers and governmental officials may need to rethink and reframe the ethical standards to which they hold themselves. Perhaps this rethinking and reframing will undermine, and ideally remove, self-serving rationalizations that may encourage taxpayers to evade their tax obligations and government officials to ignore their public duties. In short, eliminating the tax gap requires an attack on the "rationalization" leg of the corruption-fraud triangle.¹²⁶

123. See, e.g., David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 247–48 (2002) (offering a pragmatic discussion on rules versus standards and the role of uncertainty).

124. See, e.g., Diane A. DiLeo, *Loopholes in Federal Income Taxation: Solutions for Charitable Trust Abuse and Potential Application to Corporate Tax Shelter Abuse*, 36 SUFFOLK U. L. REV. 207, 209, 225–26 (2002) (explaining the dynamic evolution of rules, circumvention, more rules, and suggesting that government should target "not only taxpayers, but also their accountants, attorneys, and financial planners, who are the true catalysts for concocting these schemes"); Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115, 117 (2004) (arguing that overly formalistic jurisprudence, such as the "textualism" associated with Justice Antonin Scalia, promotes unethical business practices by severing the link between moral and legal norms).

125. See Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818 (2022).

126. See generally Lederman, *supra* note 38, at 1153 (discussing the fraud triangle).

A. Stoic Self-Restraint

Stoic philosophy, initiated by Socrates and then propelled by Aristotle, calls for temperance and self-restraint when interacting with law.¹²⁷ In his discussion of justice in *NICOMACHEAN ETHICS*, Aristotle anticipates and answers those who claim that legal compliance *should be* about responding to the positive command of the sovereign coupled with the likely economic consequences to the citizen.¹²⁸ In Aristotle's jargon, the FRM practitioner and the Holmesian positivist both make the mistake of equating the moral virtue of "justice" with a positivistic reading of "legal justice."¹²⁹ Aristotle contends that in practice this positive understanding of moral justice as legal justice requires a corrective virtue that he characterizes in terms of *epieikeia*, alternatively interpreted as equity or decency.

Aristotle recognizes that the law will always be an imperfect institution. He contends that the stoic virtue of decency "rectifies" legal justice. The rectification responds to legal regulation's inherent generality, or universality. Aristotle writes,

[A]ll law is universal, but in some areas no universal rule can be correct; and so where a universal rule has to be made, but cannot be correct, the law chooses the universal rule that is usually correct, well aware of the error being made. And the law is no less correct on this account; for the source of the error is not the law or the legislator, but the nature of the object itself, since that is what the subject matter of actions is bound to be like.¹³⁰

For Aristotle, the limitation of legal regulation is not ontological—a function of the facticity of law—but rather political. The mistake is in the institutional division of labor between lawgiver and legal subject (taxpayer), after the legal regulation takes positive form. Applied to taxation, Aristotle rejects the idea that taxpayers should lean on the positive edge of legal regulation to chase financial gains. His rejoinder from decency would be that the justice of law comes from the purpose of law—its *raison d'être*—not merely its positivistic rendering and sting, and therefore, if good law (well-founded and legitimate) is indeed to be good and serve as a fount of justice, moral virtue requires legal subjects to go beneath the verbal veneer of law to consult its rationale. He writes,

It is also evident from this who the decent person is. For he is one who decides on and does such actions, not an exact stickler for justice in the bad way, but by taking less than he might even though he has the law on his side.¹³¹

Here, Aristotle is expressing the need for stoic self-restraint that cuts an overly entitled sense of legal prerogative down to size. The virtue of decency requires the stickler to avoid taking undue advantage of substantive error manifest in reasonably just laws.

127. See ARISTOTLE, *supra* note 32, at 98–99 (discussing the need for temperance and self-restraint when interacting with law).

128. *Id.*

129. *Id.*

130. *Id.* at 98.

131. *Id.* at 99.

The virtue ethics tradition that follows Aristotle and the Stoics all the way up through Adam Smith and to more recent theorists like John Rawls, hinges on the idea of moderation and self-restraint. To rectify the limitations of FRM, taxpayers need a principle of self-restraint expressly tailored to moderate the incentive and opportunity to capitalize on a legal entitlement *not* to consider their political obligations. Aristotle develops his account of decency to answer this precise theoretical need. Similarly, Adam Smith called for prudence, defined as self-interest tempered by justice and benevolence.¹³² John Rawls called for the virtue of civility and self-restraint when presented with self-serving legal prerogatives.¹³³ In each case, taxpayers are asked to take less than they might if they pressed every opportunity to evade or to unjustifiably avoid tax law.

B. Revisiting the Social Responsibility Pyramid

Corporate executives owe fiduciary duties of loyalty to shareholders and to the organization itself. Presumably, shareholders like wealth. Hence, executives are likely to approach the topic of corporate taxation with an economic orientation. Yet, the executive's economic goals must be tempered with due respect for the law and ethical customs. As Milton Friedman famously stated, the appropriate role for a corporate executive is "to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."¹³⁴

Friedman's formulation, though sometimes criticized, continues to be cited as seminal.¹³⁵ It also proves useful in assessing the executive's competing responsibilities in setting the corporation's tax strategies. If an executive discovers that a strained interpretation of a legal text advances the economic interests of the shareholders, then perhaps the executive must adopt that interpretation. It would seem unlikely that asserting a self-serving interpretation of a law—for example, arguing for a literal construction of a tax regulation without reference to legislative intent—would be illegal. Hence, the only meaningful restraint on the exploitation of legal loopholes, if there is one, would come from ethics.

At first blush, the notion that ethical concerns must control a tax decision, even at the expense of shareholder profit, might seem odd. It should not. The idea is inherent in Milton Friedman's formula suggested some fifty years ago. Perhaps the sense of oddity comes from the perception that individual ethics are

132. See Daniel T. Ostas & Gaston de los Reyes, *Corporate Beneficence and COVID-19*, 27 J. HUM. VALUES 15, 20–22 (2020) (discussing Adam Smith's ethical thought).

133. See RAWLS, *supra* notes 65–70 and accompanying text.

134. Friedman, *supra* note 34.

135. Illustrating the continuing influence of the 1970 publication, the Stigler Center at the University of Chicago Booth School of Business published a fifty-year retrospective with contributions from more than two dozen leading scholars. See STIGLER CTR., *Milton Friedman 50 Years Later*, <https://promarket.org/wp-content/uploads/2020/11/Milton-Friedman-50-years-later-ebook.pdf> [<https://perma.cc/2LH8-W9G8>].

too idiosyncratic and personal to be of much use as a guide to business conduct.¹³⁶ It is true that people sometimes differ on ethical questions. If a lie serves the common good, then a utilitarian will lie; a deontologist will not. Yet, most times, ethical assessments converge. A lie that advances only the narrow interest of the liar is universally condemned. When ethics converge, the executive is morally required to follow the widely shared ethical custom.

The role of ethics becomes even more apparent in Edward Freeman's widely employed stakeholder theory where executives owe legal and ethical duties to each group affected by a corporate decision.¹³⁷ These groups include the local, regional, national, and global societies in which the corporation conducts business. Stakeholder groups also extend beyond stockholders and the organization itself, to include employees, suppliers, financiers, competitors, and end users such as customers, clients, or patients. Stakeholder theory has descriptive, instrumental, and normative dimensions. It describes corporate conduct, provides an instrumental guide to financial risk management, and frames moral obligations.¹³⁸

Ethics also runs throughout the four realms of Archie Carroll's "pyramid of social responsibility."¹³⁹ Initially penned in 1991, the pyramid depicts economic, legal, ethical, and philanthropic responsibilities ascending from its economic base. Apart from Friedman's CSR formulation, "Carroll's CSR pyramid is probably the most well-known model of CSR."¹⁴⁰ Carroll highlights the importance of business ethics. He writes, "Though the ethical responsibility is depicted in the pyramid as a separate category of CSR, it should also be seen as a factor which cuts through and saturates the entire pyramid."¹⁴¹ He notes that economic goals must be attained ethically, and that "most laws grew out of ethical issues, [and] once formalized they represented 'codified ethics' for that society."¹⁴²

An embrace of ethics could cure the tax gap. A proper framing is essential.¹⁴³ Ethical, legal, and economic responsibilities of a corporate executive form a hierarchy. Economic motives must be tertiary to ethical and legal concerns. Shareholders never have legal authority, and seldom have moral authority, to

136. See Lynn Sharp Payne, *Law, Ethics, and Managerial Judgment*, 12 J. LEGAL STUD. EDUC. 153, 154–55 (1994) (emphasizing that ethics are an integral component of managerial judgment).

137. See generally FREEMAN, *supra* note 35 (coining the term "stakeholder" and providing the seminal statement).

138. See generally Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation*, 20 ACAD. MGMT. REV. 65 (1995) (providing an overview of the stakeholder theory of management).

139. See Carroll, *supra* note 36, at 5 (describing how ethical responsibility saturates Carroll's pyramid of CSR).

140. *Id.* at 2.

141. *Id.* at 5.

142. *Id.*

143. See Ann E. Tenbrunsel, *VIRTEU Roundtable, CSR, Business Ethics, and Human Rights in the Area of Taxation*, CORP. CRIME OBSERVATORY, at 16:06 (Feb. 12, 2021), <https://www.corporatecrime.co.uk/virteu-csr-business-ethics> [<https://perma.cc/GCW8-U2SW>] (discussing the business and the ethical frames).

empower an executive to violate the law. Though less appreciated, a similar reasoning informs the relation between economics and ethics. Just as shareholders have no legal authority to empower an executive to behave illegally, they similarly have no moral authority to authorize an executive to behave unethically.¹⁴⁴ Hence, even though an executive is a fiduciary for the shareholders, an executive's economic responsibilities are subordinate to legal and moral obligations.

V

CONCLUSION

In some contexts, a person may appear ruthlessly self-interested, calculating and conniving. In other contexts that same person may demonstrate a capacity for totally selfless behavior, apparently sacrificing their own self gain for the good of others. This complexity of human motivation and behavior suggests that there is more than one reason that a person may obey or disobey the law, including the laws regarding tax fraud and corruption. The corruption–fraud triangle highlights two sometimes conflicting human motivations: pecuniary self-interest and moral self-restraint.

This article highlights the need for moral self-restraint in the realm of tax. The tax gap, defined as uncollected taxes due, has reached staggering levels. Recall that one-sixth of the gap is due to taxpayer insolvency; the remainder constitutes malfeasance, including two-thirds due to evasion (that could result in prison time), and one-sixth due to tax avoidance (that if challenged would result in the paying of back taxes, interests, and a civil penalty).¹⁴⁵ In other words, most of the tax gap constitutes crimes and intentional malfeasances that are currently going unpunished.

The fraud triangle frames white-collar misdeeds with reference to motive, opportunity, and rationalizations. Scholarly discussions of tax malfeasance naturally focus on the opportunity side of the triangle, suggesting changes in international and national government policies¹⁴⁶ that can reduce both tax evasion and the government corruption that supports it. This article, by contrast, highlights the role of ethical reflection in removing the rationalizations that too often provide a psychological balm to a white-collar criminal contemplating an evasive scheme or to a public official considering violation of a public duty.

144. See Kenneth E. Goodpaster, *Business Ethics and Stakeholder Analysis*, 1 BUS. ETHICS Q. 53, 68 (1991) (arguing that investors cannot expect managers to behave in a manner inconsistent with reasonable ethical expectations); Joseph S. Spoerl, *The Social Responsibility of Business*, 42 AM. J. JURIS. 277, 278–79 (1997) (explaining that shareholders cannot require managers to commit acts that would be immoral for the shareholders to perform themselves).

145. See *supra* notes 45–46 and accompanying text (discussing the tax gap).

146. See Diane Ring, *International Tax Relations: Theory and Implications*, 60 TAX L. REV. 83, 83 (2007) (exploring the tensions between the fact that the vast majority of tax rules are “domestic” and the inherent international nature of tax practices).

The article's ethical framing highlights notions of stoic virtue and corporate responsibility. The discussion of ethics draws from Socrates, Aristotle, Smith, and Rawls; the discussion of CSR draws from Friedman, Freeman, and Carroll. The analysis identifies two rationalizations that derail moral self-restraint in tax. The first removes the moral content from tax law and thereby reduces the obligation to obey law to a financial calculation of the likely consequences of alternative tax positions. The second suggests that tax positions taken pursuant to a self-centered notion of risk management are justified when interacting with government officials. When coupled, these views counsel a capture of tax policy through campaign contributions, lobbying, the revolving door of regulation, and similar means that seek to exploit the self-interest of policy makers at the expense of the common good.

From an ethical perspective, the tax gap results from the unrestrained egoism of taxpayers seeking to evade and unjustifiably avoid taxes and of tax officials seeking reelection and personal financial gains. Regarding unrestrained egoism, Rawls states, "The significance of egoism philosophically is not as an alternative conception of right but as a challenge to any such conception."¹⁴⁷ This article asks both taxpayers and tax officials to examine their actions and to exercise a modicum of self-restraint from positions of prerogative. Perhaps this request will find few who answer, but the request is needed, and one can always hope.

147. RAWLS, *supra* note 65, at 136.