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Cooperative Tax Regulation

Dennis J. Ventry, Jr.

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Cooperative Tax Regulation

DENNIS J. VENTRY, JR.

This Article describes a new approach to tax regulation based on cooperation, information sharing, and interest convergence. Currently, tax regulation in the United States relies too heavily on sticks and not enough on carrots. While recognizing that taxpayers will comply with the law in the presence of effective deterrence and enforcement, this Article optimizes the use of penalties as a compliance instrument by, among other things, rewarding compliant taxpayers, engaging taxpayers and their advisors in a participatory process, and appreciating the elegant power of cognitive devices that portray payment of taxes as a bonus rather than nonpayment of taxes as a penalty. Even with optimal penalties, tax officials cannot currently enforce the law effectively due to severe resource and information asymmetries. To overcome these debilitating shortcomings, the government must improve funding, recruiting, training, and retention. It must also partner with taxpayers and practitioners to strengthen detection, enforcement, and prosecution of abusive tax avoidance. Cooperative tax regulation can accomplish a cultural shift not only in taxpaying but also in tax advising and tax administration. Ultimately, it can produce a regulatory environment of collaboration rather than adversity, ex ante resolution rather than ex post controversy, and certainty rather than secrecy.

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Cooperative Tax Regulation

DENNIS J. VENTRY, JR.*

I. INTRODUCTION

In February 2006, the Internal Revenue Service announced that it failed to collect as much as \$353 billion in taxes owed for tax year 2001.¹ The “tax gap,” the difference between what taxpayers should pay and what they pay on a timely basis, reflected a compliance rate of 83.7%.² Congress reacted strongly. Senator Max Baucus (D-MT) called the tax avoidance unpatriotic and responsible for the federal deficit. “When people and companies . . . don’t pay their taxes, the burden for paying this country’s expenses falls even more heavily on Americans who do their duty every April 15.”³ It was the government’s obligation “to go after scofflaws and tax cheats big and small, who are contributing to the deficit by not contributing their fair share.”⁴ Baucus and others urged the Bush administration to move aggressively,⁵ and to rework preliminary proposals which were forecast to net \$3.5 billion over ten years, just one-tenth of one

* Acting Professor of Law, UC Davis School of Law. I thank Ellen Aprill, Jonathan Baker, Steven Bank, Joseph Bankman, Mortimer Caplin, Susan Carle, Michelle Kane, Leandra Lederman, Edward McCaffery, Andrew Pike, Deborah Schenk, William Simon, Jay Soled, and Kirk Stark. I also thank a number of individuals in private law practice, none of whom disclosed client confidences nor discussed specific transactions, as well as several government tax officials, none of whom disclosed taxpayer information. In addition, I benefited from comments received at the Advanced Topics in Taxation Colloquium at Northwestern School of Law, the Critical Tax Theory Conference at UCLA School of Law, the Junior Tax Scholars Workshop at Boston University School of Law, and the Washington College of Law Junior Faculty Workshop.

¹ IRS News Release IR-2006-28 (Feb. 14, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>.

² Press Release, U.S. Department of the Treasury, Testimony of Treasury Assistant Secretary for Tax Policy Eric Solomon Before the Senate Finance Committee on Ways to Reduce the Tax Gap (Apr. 18, 2007), available at <http://www.treas.gov/press/releases/hp360.htm>.

³ Press Release, Sen. Max Baucus, *Baucus Calls New Tax Gap Numbers “Unacceptable,” Calls for Bolder IRS Action to Collect Taxes Owed* (2006) [hereinafter *Baucus Press Release*], available at <http://finance.senate.gov/press/Bpress/2005press/prb021406a.pdf>; see also *GSA Contractors Who Cheat on Their Taxes and What Should Be Done About It: Hearing Before the Permanent Subcomm. on Investigation, 109th Cong. 2* (2006) (statement of Sen. Carl Levin, D-MI) (“[W]hen so many Americans fail to pay the taxes that they owe, it begins to undermine the fairness of our tax system, forcing honest taxpayers to make up the shortfall needed to pay for basic federal protections.”).

⁴ *Baucus Press Release*, *supra* note 3.

⁵ See, e.g., Memorandum, Sen. Charles Grassley, *Tax Gap Numbers* (Feb. 14, 2006), available at <http://finance.senate.gov/press/Gpress/2005/prg02106b.pdf>; Stephen Joyce, *Everson Urges Fiscal 2008 Request Approval; Conrad Calls Tax Gap Proposals ‘Too Modest’*, 31 DAILY TAX REP. (BNA), at G-1 (Feb. 15, 2007) (quoting Sen. Kent Conrad, D-ND, demanding a “far more aggressive approach” to close the tax gap).

percent of the estimated \$3.5 trillion tax gap.⁶

A slew of recommendations sprung forth. The Bush administration offered sixteen new legislative proposals⁷ to implement the Treasury Department's "comprehensive, integrated, multi-year strategy" to close the tax gap.⁸ At the same time, legislators introduced more than a dozen tax gap bills.⁹ Closing the gap became a priority for the IRS¹⁰ and a bipartisan issue for Congress.¹¹ The revenue to be gained from closing the tax gap was "low-hanging fruit," according to Charles Rangel (D-NY).¹² It could eliminate the deficit,¹³ pay for revising the Alternative Minimum Tax,¹⁴ and reform the health care system.¹⁵

Meanwhile, a minority warned against viewing the tax gap as a policymaking panacea. Charles Grassley (R-IA) noted that politicians had already begun to see the tax gap as "one of those magic elixirs" for all fiscal problems, so much so that he expressed feigned surprise that "folks don't think the tax gap can cure baldness."¹⁶ The Treasury Department had estimated that 54% of the gap involved noncompliance where there was little or no third-party reporting of a taxpayer's liability.¹⁷ Noncompliance for rents and royalties, for instance, equaled 51%, for non-farm proprietor

⁶ *The Tax Gap and How to Solve It: Hearing Before the S. Comm. on the Budget*, 109th Cong. (2006) (written testimony of Mark W. Everson, IRS Commissioner).

⁷ See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals*, at 63–82 (2007) [hereinafter Dep't of the Treasury, *General Explanations*], available at <http://www.treas.gov/offices/tax-policy/library/bluebk07.pdf>.

⁸ IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, at 3 (2007) [hereinafter *Reducing the Federal Tax Gap*], available at <http://www.irs.gov/irs/article/0,,id=172790,00.html>.

⁹ A list of the bills is on file with the Author.

¹⁰ See IRS Oversight Board Annual Report, at 4, 19 (2006) (identifying the tax gap as a primary concern for tax year 2007).

¹¹ See, e.g., Kurt Ritterpusch, *Rangel Says Forging Bipartisan Alliances Will Be Priority Over AMT, Tax Gap Issues*, 224 DAILY TAX REP. (BNA), at G-6 (Nov. 21, 2006) (describing consensus to close the gap).

¹² Kurt Ritterpusch, *Post-Election Action on Closing Tax Gap Deemed Common Ground Issue for Congress*, 208 DAILY TAX REP. (BNA), at G-1 (Oct. 27, 2006) (internal quotation marks omitted).

¹³ See e.g., Letter from Sens. Evan Bayh, Ron Wyden, Charles E. Schumer, Barack Obama, to IRS Commissioner Mark W. Everson, (Jan. 19, 2007), available at 7 TAXCORE (BNA) 15 (Jan. 24, 2007) (explaining that closing the tax gap could "eliminate the unified budget deficit"); Drew Douglas, *Treasury 2008 Budget Plan to Include Renewed Focus on Compliance, Tax Gap*, 13 DAILY TAX REP. (BNA), at G-2 (Jan. 22, 2007) (discussing tax gap proposals to reduce the deficit).

¹⁴ Ritterpusch, *supra* note 12 (discussing how Rangel viewed the tax gap as a way to pay for AMT reform).

¹⁵ 119 CONG. REC. S3058 (daily ed. Mar. 13, 2007) (statement of Sen. Chuck Grassley, R-IA) (noting that many members of Congress perceive the tax gap as a "cure all," and as a way to expand spending on health care).

¹⁶ *Id.*; see also *Examining the Administration's Plan for Reducing the Tax Gap: What Are the Goals, Benchmarks, and Timetables?: Hearing Before the S. Comm. on Finance*, 110th Cong. (Apr. 18, 2007) (opening statement of Sen. Grassley) ("I'm worried that some members have their head in the clouds when it comes to the tax gap. Some members view the tax gap as money in the pocket to spend on favorite proposals. Nothing could be further from the truth.").

¹⁷ IRS, *Tax Gap Figures*, at 3 (2001), available at http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf.

income, 57%, and for farm income, an astounding 72%.¹⁸ Meanwhile, compliance rates for income subject to automatic withholding (wages and salaries) and information reporting (interest and dividend income) hovered around 99 and 95%, respectively.¹⁹ Proceeding on the assumption that people pay taxes only when they have to, and that increased enforcement by itself was not an effective alternative,²⁰ the majority of tax gap proposals expanded information reporting.²¹ But this approach barely dented the \$353 billion shortfall.²² In addition to yielding too little revenue, critics charged that the approach threatened taxpayer privacy, burdened taxpayers with excessive compliance costs, and tipped the regulatory balance decidedly away from taxpayer service.²³

With the benefit of hindsight, it is clear that the “low-hanging fruit” has already been picked by withholding and information reporting regimes. It is other forms of income—some perched on upper branches, some hidden from view at the subterranean level—that continue to elude tax officials. Capturing this income and reducing the massive avoidance of taxes in a meaningful way requires a multifaceted approach to a difficult problem that only seems to be getting worse.²⁴ The government has three

¹⁸ *Id.* at 2.

¹⁹ *See id.* For the influence of these reporting regimes on tax compliance, see Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 697–99 (2007); Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KAN. L. REV. 971, 972–76 (2003).

²⁰ The Treasury Department has concluded that enforcement by itself cannot close the gap, because: (i) much of the tax gap is due to forms of unreported income that are difficult to detect (i.e., no third-party reporting); (ii) even if detected, tax liability might be uncollectible (due to difficulties in locating the taxpayer or taxpayer insolvency); and (iii) many detected liabilities are so small that it is not cost effective to pursue collection. JAMES M. BICKLEY, TAX GAP AND TAX ENFORCEMENT, CRS REPORT, at 4 (2007), available at http://assets.opencrs.com/rpts/RL33882_20070216.pdf.

²¹ *See* Diane Freda, *Information Reporting Proposals May Become Congressional Revenue Raisers*, IRPAC Says, 206 DAILY TAX REP. (BNA) at G-1 (Oct. 25, 2007) (describing efforts to increase reporting).

²² Nearly 98% of the estimated increase in compliance receipts from the administration’s tax gap recommendations relied on improved information reporting, which were estimated to generate only \$29.5 billion over ten years, not quite 1% of the estimated gap. *See* Dep’t of the Treasury, *General Explanations*, *supra* note 7, at 120–21.

²³ *See, e.g.*, SENATE REPUBLICAN POLICY COMMITTEE, CLOSING THE TAX GAP: NOT THE ‘POT OF GOLD’ THAT SOME HOPE TO DISCOVER 1 (2007), http://rpc.senate.gov/public/_files/031307TaxGapSN.pdf (stating that the administration’s proposals were overly intrusive, adversely altered the relationship between the government and the taxpayer, and insufficiently accounted for “taxpayers dignity, privacy, and their loss of time due to compliance requirements”); *Internal Revenue Service FY 2008 Budget Request: Hearing Before the Subcomm. on Fin. Services and Gen. Gov’t, S. Appropriations Comm.*, 109th Cong. 4 (2007), available at http://appropriations.senate.gov/Hearings/2007_05_09_Testimony_of_Nina_Olson_at_the_May_9_Financial_Services_and_General_Government_Subcommittee_Hearing.pdf?CFID=40356114&CFTOKEN=32695686 (written statement of Nina E. Olson, National Taxpayer Advocate) (noting that under the administration plan, “the IRS would be spending literally twice as much on enforcement as it spends on taxpayer service”).

²⁴ The tax gap for 1973 amounted to \$28.8 billion, IRS News Release, *IRS Sees A Large and Growing Tax Gap*, 20 TAX NOTES 555, 555 (1983), reflecting 91.2% compliance, Daniel Bernick, *Treasury, Practitioners Assess Prospects in Compliance Area*, 20 TAX NOTES 101, 101 (1983), compared to 83.7% compliance for 2001. *See supra* note 2. Moreover, assuming that the tax gap

choices. It can continue picking away at the far fringes of the tax gap. It can impose draconian measures of coercive enforcement, for which there is no political will, nor any good argument even if there were.²⁵ Or it can consider the virtues of cooperative tax regulation.

This Article describes these virtues and articulates an approach to tax regulation based on cooperation, information sharing, and interest convergence. It argues that closing the tax gap requires a relational rather than a coercive tax compliance norm. Such a norm necessitates that tax regulators nurture compliance with both sweeter carrots and sharper sticks. A compliance equilibrium based on reciprocity rather than adversity provides positive incentives for taxpayers and tax regulators to trade secrecy for certainty. Under a cooperative model, taxpayers and their advisors enjoy certainty of outcome with respect to tax reporting positions and fewer post-filing challenges. At the same time, the government is in a better position to identify emerging taxpayer issues and compliance risks, and to shift limited resources from post-filing controversies to other areas of service and enforcement. Such an exchange relationship, characterized by dialogue and transparency, seeks to forge a shared understanding of what it means to comply with the tax law. By no means does the cooperative approach outlined in this Article reject penalties or enforcement as part of an overall compliance strategy. To the contrary, it recognizes explicitly that taxpayers will comply with the law in the presence of effective deterrence and enforcement.²⁶ But it also recognizes that penalties alone and aggressive enforcement will not necessarily improve compliance, and may actually worsen it.²⁷ The challenge for tax officials under the cooperative model “is to play a two-handed game: To deal with the wrongdoing today, while nurturing consent for tomorrow.”²⁸

A cooperative rather than an adversarial compliance norm may appear

grows in proportion to increased tax liability, the \$353 billion gap for 2001 is equivalent to \$400 billion for 2006. ERIC TODER, URBAN INST. AND URBAN-BROOKINGS TAX POL’Y CTR., REDUCING THE TAX GAP: THE ILLUSION OF PAIN-FREE DEFICIT REDUCTION 1 (2007), http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap_revised.pdf.

²⁵ See Joyce, *supra* note 5, at G-1 (quoting Commissioner Everson as saying, “[t]o reduce the tax gap dramatically would take some draconian steps, ones that would fundamentally change the relationship between taxpayers and the IRS, require unacceptably high commitment of enforcement resources, and risk imposing unacceptable burdens on compliant taxpayers”); *Reducing the Federal Tax Gap*, *supra* note 8, at 18 (“[W]hile it may be possible to take action to *reduce* the tax gap, it is not possible to implement a policy that *eliminates* the tax gap without an unacceptable change in the fundamental nature of the current tax compliance system.”).

²⁶ See Edward J. McCaffery & Joel Slemrod, *Toward an Agenda for Behavioral Public Finance*, in *BEHAVIORAL PUBLIC FINANCE* 3, 15–17 (Edward J. McCaffery & Joel Slemrod eds., 2006) (arguing that enforcement provides taxpayers with an extrinsic motivation to comply with tax laws); see also *infra* notes 36–38 and accompanying text.

²⁷ See *infra* note 53 and accompanying text.

²⁸ Valerie Braithwaite, *Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions*, in *TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION* 15, 35 (Valerie Braithwaite ed., 2003) [hereinafter *TAXING DEMOCRACY*].

inapposite in the tax context. After all, the goals of taxpayers and their advisors on the one hand and tax regulators on the other are largely adverse, with taxpayers trying to reduce and avoid taxes at the same time that tax regulators try to collect them. This Article argues that the interests of taxpayers and tax authorities are not all that dissimilar, particularly once we start thinking of taxpayers as interested partners in the regulatory effort and tax advisors as compliance counselors.²⁹ From this perspective, paying one's taxes yields tangible benefits beyond penalty avoidance, while advising taxpayer clients resembles the work performed by securities lawyers; the compliance norm is not "do you have a plausible explanation for your position," but rather "does your position reinforce the public purposes of the law." Tax officials also must adopt new perspectives under the cooperative model. If we make taxpayers, in the words of Justice Holmes, "turn square corners" when dealing with the government,³⁰ it is hard to see why the government should not be held to a similar standard of "rectangular rectitude" when dealing with its taxpayer-citizens.³¹ Cooperative tax regulation requires tax authorities to assist taxpayers, share information with them, and respond to their concerns.

The regulatory model articulated in this Article adopts an approach reflected in the "new governance" and "responsive regulation" literatures. New governance involves "a shift in emphasis away from command-and-control in favour of 'regulatory' approaches which are less rigid, less prescriptive, less committed to uniform outcomes, and less hierarchical in nature."³² Responsive regulation, for its part, emphasizes a dynamic, non-adversarial approach where regulators assist regulated actors in complying with the law, and where regulated actors, as reward for their cooperation, assist regulators in crafting the regulatory environment.³³ Scholars have

²⁹ Legal scholar Robert Gordon has advocated a similar shift in thinking among corporate lawyers. See Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185 (2003).

³⁰ *Rock Island, Ark. & La. R.R. Co. v. United States*, 254 U.S. 141, 143 (1920).

³¹ John MacArthur Maguire & Philip Zimet, *Hobson's Choice and Similar Practices in Federal Taxation*, 48 HARV. L. REV. 1281, 1299 (1935).

³² Gráinne de Búrca & Joanne Scott, *Introduction to LAW AND NEW GOVERNANCE IN THE EU AND THE US 2*, (Gráinne de Búrca & Joanne Scott eds., 2006). The most recognizable American scholar associated with the new governance approach is William Simon. See William H. Simon, *Toyota Jurisprudence: Legal Theory and Rolling Rule Regimes*, in *id.* at 37–38; William H. Simon, *After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer*, 75 FORDHAM L. REV. 1453, 1464 (2006) [hereinafter Simon, *After Confidentiality*]. New governance shares an intellectual heritage with the more ubiquitous "democratic institutionalism." See, e.g., Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 469–73 (1998) (proposing a new form of government, "democratization, through experimentalist connection," in which power is decentralized, information is pooled, and subnational units of government are free to set and attain their own goals).

³³ See generally IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DE-REGULATION DEBATE* (1992); JOHN BRAITHWAITE, *RESTORATIVE JUSTICE & RESPONSIVE REGULATION* (2002).

begun to apply the responsive regulation model to tax.³⁴ According to its most prolific proponent, Australian tax scholar Valerie Braithwaite, “[t]he traditional tax infrastructure of law, auditors, penalties, debt collectors, and court cases needs to be supplemented by measures that boost taxpayers’ commitment to paying tax with or without the tax authority watching over their shoulders.”³⁵ This Article applies these regulatory approaches to U.S. tax regulation, particularly the corresponding virtues of an exchange relationship under which all parties—tax authorities, taxpayers, and tax practitioners—commit to transparency and information sharing, and where the government rewards compliance with leniency, flexible accommodation, and an opportunity to shape legal rules.

The Article proceeds in four sections. Part II applies the cooperative model to the existing tax penalty regime. While strict tax penalties typically embody the failed command-and-control approach to regulation, an effective compliance strategy requires regulatory sticks. Thus, Part II looks beyond the traditional economic deterrence model for tax penalties and explores non-economic motivations for complying with tax laws to help re-conceive the penalty regime. It recommends an interactive approach to tax regulation that rewards compliance with restraint, assistance, opportunities to participate in the rulemaking process, and even tax rebates. Part II also emphasizes that the government must act swiftly and effectively against intransigent noncompliance which, unchecked, undermines the cooperative model.

Part III challenges tax regulators to improve enforcement (which includes much more than penalties) as well as customer service. Like the rest of the Article, Part III argues that people will comply with the law if the law uses effective and fair mechanisms of deterrence, enforcement, prosecution, and punishment. On the enforcement side, Part III proposes increasing the number and thoroughness of audits, shrinking the “resource gap” and “information gap” that currently separates government lawyers from private sector lawyers, and facilitating private enforcement of tax laws. On the service side, it emphasizes a cultural shift in tax administration from command-and-control to collaboration, from ex post controversy to ex ante resolution, and from regulatory intimidation to procedural fairness.

Part IV examines the woefully deficient professional standards currently governing tax practitioners. It argues that weak regulation of tax practice by the professional associations—particularly the American Bar Association and the American Institute of Certified Public Accountants—

³⁴ See, e.g., Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 LAW & POL’Y 1 (2007).

³⁵ Valerie Braithwaite, *A New Approach to Tax Compliance*, in TAXING DEMOCRACY, *supra* note 28, at 1.

has enabled tax avoidance. Moreover, it commends recent efforts by Congress and the Treasury Department to elevate ethical guidelines for tax practitioners. Finally, it recommends a set of substantive legal rules and disclosure requirements designed to improve tax compliance by making tax planning and tax reporting more transparent.

As part of the effort to enhance compliance through increased transparency, tax officials need at their disposal a judicious mix of rules and standards. Part V discusses how rules provide certainty of outcome and lower compliance costs, as well as enhanced due process and fair treatment. It also shows how standards provide coherence to a set of otherwise independent rules by giving them overarching purpose. Part V roots this discussion in an examination of the Treasury Department's regulations governing tax practice. It explores the extent to which the combination of disciplinary rules and aspirational standards contained in the regulations both reflect and conflict with cooperative tax regulation.

II. RE-CONCEIVING THE PENALTY REGIME

Taxpayers comply with the law when they think the law will be enforced. Indeed, taxpayer behavior depends largely "[on] the government itself,"³⁶ both the fairness of its processes³⁷ and its willingness to enforce the law effectively and to prosecute wrongdoers.³⁸ Heavy-handed attempts at enforcement by regulators can backfire, however, resulting in less rather than more compliance.³⁹ The difficulty for tax authorities is crafting a regulatory regime that uses sticks as effectively as carrots.

Historically, the primary enforcement mechanism for U.S. tax officials has been a penalty regime based on an economic deterrence model of detection and punishment. The basic idea behind the economic model is that people respond rationally to maximize expected gain and to minimize expected loss. Thus, to deter non-compliance, regulators raise the magnitude of penalties or the probability of detection. The problem for tax officials is that for penalties to effectively deter non-compliance under the rational economic model, penalty rates would have to be raised to unrealistically high levels. If we assume an audit rate of 2%, twice the level of the current rate,⁴⁰ and we further assume that the IRS always (and

³⁶ McCaffery & Slemrod, *supra* note 26, at 17.

³⁷ See Lars P. Feld & Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, 3 ECON. GOVERNANCE 87 (2002) (arguing that a tax authority's legitimacy depends on fair procedures of tax collection and enforcement).

³⁸ See Margaret Levi, *A State of Trust*, in TRUST AND GOVERNANCE 77, 91 (Valerie Braithwaite & Margaret Levi eds., 1998) (writing that "the willingness to pay taxes quasi-voluntarily or to give one's contingent consent to conscription often rests on the existence of the state's capacity and demonstrated readiness to secure the compliance of the otherwise noncompliant").

³⁹ See *infra* note 53 and accompanying text.

⁴⁰ See *infra* note 126 and accompanying text.

only) catches noncompliance on audit (another optimistic assumption), the penalty rate sufficient to deter underpayment would have to equal 4900% of tax due.⁴¹ Suffice it to say, the economic deterrence model is incapable of curbing noncompliance by itself.

While the motivations underlying tax compliance undoubtedly include economic considerations, rationality involves more than economic inputs. A tax penalty regime that appreciates these other incentives would recognize moral, ethical, and social considerations for paying taxes, and it would view tax penalties as more than punitive instruments. A regime that merely punishes wrongdoers creates an adversarial environment and compliance norm. By comparison, a cooperative tax penalty regime reflects collaborative norms, whereby taxpayers and tax regulators work together, and where taxpayer compliance is rewarded with leniency, technical assistance, and opportunities to participate in the development of legal rules. A cooperative regime must also be able to identify noncompliant behavior, and respond to intransigent noncompliance with escalating sanctions and intervention, which, if ignored, would undermine the cooperative model. To the extent positive incentives do not sufficiently facilitate compliance among recalcitrant tax avoiders, tax authorities should consider no-fault penalties. The imposition of a strict-liability penalty could drastically alter the taxpaying calculus, adding significant risk to overaggressive tax positions and transactions.

A. *From Economic Deterrence to Cooperative Regulation: Sweeter Carrots, Sharper Sticks*

Modern discussions of economic deterrence trace their roots to economist Gary Becker's influential work in the 1960s and 1970s on the relationship between crime and penalties, both real and perceived.⁴² Becker's economic theory of crime restated the goal of penalties as the internalization of the social costs of offenses, rather than the elimination of pain. In the early 1970s, economists Michael Allingham and Agnar Sandmo extended Becker's general theory of deterrence to tax compliance, and argued that the degree of deterrence, calculated as the product of the probability of detection and the size of the penalty, determines the amount of income evaded for any particular taxpayer.⁴³ For the next decade,

⁴¹ The relevant formula can be expressed as $P = (1 - d) / d$, where P is the penalty per dollar of underpayment, and d is the probability of detection. This example is admittedly stylistic, and assumes that the 2% audit rate is completely random, rather than correlating with potential tax-shelter participants. In addition, the computation fails to account for the probability of conviction in addition to detection.

⁴² See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 169-72 (1968) (developing an economic model for understanding the relationship between crime and punishment).

⁴³ Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J.

researchers employed increasingly sophisticated economic models, trading varying degrees of punishment and deterrence to locate the optimal tax compliance package.

Researchers found that maximizing economic gain or minimizing economic loss could not fully explain why people comply with the law; real-world penalty rates were simply too low to explain the relatively high rates of compliance.⁴⁴ It became clear that compliance was not only about risk aversion, and that the economic analysis of deterrence over-simplified why people pay taxes by ignoring other explanatory variables.⁴⁵ Researchers were forced to conclude that models associated with economic theories of tax compliance provided, at best, “tentative guidance . . . in well-specified circumstances.”⁴⁶ It is worth examining briefly the findings to evaluate the role economic deterrence can still play in a re-imagined penalty regime.

Survey research predicts a positive impact of deterrence on avoidance and evasion with higher fines and higher rates of enforcement.⁴⁷ Empirical research reveals more ambiguity, with some studies reporting a positive impact of penalties on compliance,⁴⁸ and others reporting a positive impact of higher probability of detection.⁴⁹ Researchers examining both fines and probability of detection report a positive but small impact on compliance,⁵⁰

PUB. ECON. 323, 324 (1972).

⁴⁴ See James Alm et al., *Why Do People Pay Taxes?* 48 J. PUB. ECON. 21, 36 (1992) (finding that individuals “often pay more in taxes than a simple application of expected utility theory would suggest”).

⁴⁵ See *id.*; Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Facts and Fantasy*, 38 NAT’L TAX J. 355, 357 (1985) (criticizing the application of the economics of crime methodology to tax evasion and avoidance).

⁴⁶ John Creedy, *Tax Modeling*, in TAXATION AND ECONOMIC BEHAVIOR: INTRODUCTORY SURVEYS IN ECONOMICS 133, 135–36 (John Creedy ed., 2001).

⁴⁷ See, e.g., Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, in HANDBOOK OF PUBLIC ECONOMICS 1423 (Alan J. Auerbach & Martin Feldstein eds., 2002); James Andreoni et al., *Tax Compliance*, 36 J. ECON. LIT. 818, 841 (1998) (“[H]igher penalties and audit probabilities discourage cheating.”).

⁴⁸ See, e.g., James Alm et al., *Economic and Non-Economic Factors in Tax Compliance*, 48 KYKLOS 3, 12 (1995) (“When the fine rate increases, the number of individuals at zero compliance falls greatly, and the number at full compliance rises accordingly.”); Ana De Juan et al., *Voluntary Tax Compliant Behavior of Spanish Income Taxpayers*, 49 PUB. FIN. (SUPP.) 90, 97 (1994); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution*, 23 LAW & SOC. REV. 209, 238–39 (1989).

⁴⁹ See, e.g., Jeffrey A. Dubin & Louis L. Wilde, *An Empirical Analysis of Federal Income Tax Auditing and Compliance*, 41 NAT’L TAX J. 61, 61 (1988); Jeffrey A. Dubin et al., *Are We a Nation of Tax Cheaters?: New Econometric Evidence on Tax Compliance*, 77 AM. ECON. REV. 240, 241 (1987) (“[A]n exogenous increase in the probability of detection and conviction or in the penalty rate will increase compliance.”); A. Mitchel Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 879 (1998); Joel Slemrod et al., *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. PUB. ECON. 455, 456–57 (2001) (finding that “treatment effect varies depending on the level of income” and that “[t]he effect was much stronger for those with more ‘opportunity’ to evade”).

⁵⁰ See, e.g., James Alm et al., *Deterrence and Beyond: Toward a Kinder, Gentler IRS*, in WHY PEOPLE PAY TAXES 311, 322–23 (Joel Slemrod ed., 1992) (“[C]ompliance . . . rises when the audit rate

while other researchers have generated ambiguous results as to the effect of fines and detection.⁵¹ In fact, some studies report a “crowding out” of tax compliance when penalties are introduced with a corresponding increase in evasion.⁵²

If we believe that taxpayers, even perfectly rational, utility-maximizing taxpayers, care about considerations beyond narrowly defined economic self-interest, it should come as no surprise that penalties can lower rather than raise compliance. Thirty years of research has demonstrated that deterring noncompliant behavior is not entirely about economic self-interest or subjective probabilities of detection that merely augment the standard economic model.⁵³ Rather, regulating tax compliance involves considerations extending beyond economics, and while some of these motivations can be reduced to monetary values, others cannot. A growing number of researchers have shown that moral, ethical, and social factors—more than threats of economic or legal punishment—determine whether and how taxpayers comply with the law.⁵⁴ Similar considerations might even dissuade tax professionals from advising overaggressive planning strategies.⁵⁵ At the very least, thirty-five years after Allingham and

increases. However, the differences in compliance rates . . . are not large.”); Dick J. Hessing et al., *Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies*, in *id.* 291, 292 (Joel Slemrod ed., 1992).

⁵¹ See, e.g., Hank Elffers et al., *The Consequences of Different Strategies for Measuring Tax Evasion Behavior*, 8 J. ECON. PSYCH. 311, 324 (1987); Nehemia Friedland, *A Note on Tax Evasion as a Function of the Quality of Information About the Magnitude and Credibility of Threatened Fines: Some Preliminary Research*, 12 J. APPLIED SOC. PSYCH. 54, 55 (1982); Kimberly N. Varma & Anthony N. Doob, *Deterring Economic Crimes: The Case of Tax Evasion*, 40 CAN. J. CRIMINOLOGY 165, 165–66 (1998).

⁵² The basic idea behind this finding is that taxpayers balance extrinsic motivations for paying taxes (i.e., penalties and enforcement) with intrinsic motivations (i.e., individual framing decisions such as feelings of civic virtue and desires to avoid shame and stigma), and that raising extrinsic motivations may fail to compensate for the corresponding incursion on intrinsic motivations. Braithwaite, *supra* note 28, at 34–35; Doreen McBarnet, *When Compliance Is Not the Solution but the Problem: From Changes in Law to Changes in Attitude*, in *TAXING DEMOCRACY*, *supra* note 28, at 229; Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043, 1044–46 (1997); Mark Lubell & John T. Scholz, *Cooperation, Reciprocity, and the Collective-Action Heuristic*, 45 AM. J. POL. SCI. 160, 173–75 (2001).

⁵³ Bruno S. Frey & Lars P. Feld, *Deterrence and Morale in Taxation: An Empirical Analysis* 8–11 (CESifo Working Paper No. 760, 2002).

⁵⁴ See, e.g., Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance?: Evidence from a Controlled Experiment in Minnesota*, 54 NAT’L TAX J. 125, 126–28 (2001); Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, 49 PUB. FIN. (SUPP.) 70, 74–77 (1994); Josef Falkinger, *Tax Evasion, Consumption of Public Goods, and Fairness*, 16 J. ECON. PSYCH. 63, 63 (1995); Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863, 865–69 (2004); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1459–62 (2003); Laurie Mason & Robert L. Mason, *A Moral Appeal for Taxpayer Compliance: The Case for a Mass Media Campaign*, 14 LAW & POL’Y 381, 381–82 (1992); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (2000).

⁵⁵ See, e.g., Richard Lavoie, *Deputizing the Gunslingers: Co-opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43, 73 97–98 (2001) (stressing the importance of appealing

Sandmo animated the discussion of why people pay (and don't pay) taxes, there is a consensus that moral, ethical, and social strategies can and should complement traditional punishment and deterrence strategies.

A number of recent proposals for reforming the penalty regime account for multiple taxpaying motivations. None of them reject altogether the economic deterrence model, and some offer sophisticated refinements whereby rational taxpayers consider avoidance and evasion strategies based on expected rather than nominal sanctions.⁵⁶ These proposals build on considerations that previous researchers may have noted but either assumed away or failed to explore fully, such as how non-economic and extra-economic motivations interact with the standard economic model. As importantly, they provide strategies for restructuring the tax penalty regime to reflect cooperative tax regulation.

Restructuring the penalty regime to recognize multiple taxpaying motivations requires acknowledging the power of social norms. These legally unenforceable rules of behavior operate beyond the reach of the current tax penalty system. Aggressive taxpayers and their advisors, moreover, have captured the power of social norms to the detriment of the tax system and other taxpayers⁵⁷ by engaging in "norm-based tax planning," the tacit, informal understandings that reduce tax liabilities and create tax-shifting distortions.⁵⁸

Though social norms can undermine the tax system, they can also reinforce it. In fact, tax compliance norms shared by tax decision-makers at large public corporations have had a positive impact on compliance in recent years. These norms have produced "general liability concerns within organizations" from the corporate taxpayer, outside legal counsel,

to lawyers' conscience rather than self-interest as a way to stop the use of abusive tax shelters); Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. REG. 77, 81 (2006) (arguing that elite corporate lawyers and the tax bar supported recent changes to professional standards due to a "nuanced conception of professionalism").

⁵⁶ E.g., Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569 (2006) (introducing a self-adjusting penalty equal to the fraction of legitimately claimed subtractions to income reported on the same line containing illegitimate subtractions to income); David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 358, 368 (2006) (calling on Congress to raise "marginal deterrence" and increase sanctions on practitioners by having them bear part of the understatement penalty "when a deal they blessed is successfully challenged").

⁵⁷ Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601 (2007).

⁵⁸ Raskolnikov elegantly discusses several examples of informal tax-driven norms, including arrangements associated with the hedging strategy known as variable delivery prepaid forward contracts, *id.* at 613–16, loan tranches, *id.* at 616–18, and the relationship between equity swaps and notional principle contracts, *id.* at 618–20. Other scholars warn that tax rules by themselves are incapable of altering industry norms. E.g., Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1228–30 (2004) (finding that statutory tax law has historically failed to alter norms of corporate behavior with respect to cash retention policies and corporate reorganizations); Kirsch, *supra* note 54, at 916–21 (demonstrating the ineffectiveness of tax provisions designed to reduce tax-motivated expatriations).

and accounting firms.⁵⁹ According to law professor Susan Morse, these tax compliance norms developed as a result of enforcement efforts “wholly unrelated to tax,”⁶⁰ and were instead the product of statutory changes to disclosure and governance procedures for corporations.⁶¹ The tax compliance norm that Morse identifies, as well as the organizational and group dynamics that she describes,⁶² suggest that government efforts designed explicitly to facilitate tax compliance may have an even more powerful effect on tax decision-makers within corporations and on outside tax advisors. Given Morse’s findings, for instance, recent Treasury regulations establishing vicarious liability for tax practitioners responsible for overseeing a firm’s tax practice may have already altered risk and liability concerns within firms and among advisors.⁶³

Self-interest is never far from the surface, a reality that can help as much as hinder efforts to forge cooperative tax regulation. To level the playing field on which taxpayers and tax regulators play, for instance, tax scholar David Schizer recommends asking private lawyers “to help the government in a way that also helps their clients.”⁶⁴ Schizer envisions a partnership between taxpayers, tax advisors, and tax authorities that would raise compliance by explicitly rewarding compliant behavior. Self-interested incentives for assisting reform could involve narrowing overbroad anti-abuse rules;⁶⁵ rewarding lawyers and law firms that issue conservative opinions by granting them leeway in the examination process;⁶⁶ expediting the revenue ruling and pre-filing processes for conservative lawyers;⁶⁷ and further bolstering the reputation of conservative advisors by publishing a list of deviant practitioners.⁶⁸ If just a few of the players privy to the “common knowledge of tax abuse”⁶⁹ withdrew from the game, the stakes would go down (or up, as it were), as former participants partnered with the government—again, if only for self-

⁵⁹ Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 FORDHAM L. REV. 961, 964 (2006).

⁶⁰ *Id.*

⁶¹ For fuller discussion of the changes, see *infra* notes 265–72 and accompanying text.

⁶² See Morse, *supra* note 59, at 984–94.

⁶³ See, e.g., 31 C.F.R. § 10.36 (2007) (subjecting to discipline practitioners with principal authority for overseeing a firm’s tax practice for failure to take reasonable steps to prevent behavior not in compliance with federal regulations).

⁶⁴ Schizer, *supra* note 56, at 333.

⁶⁵ *Id.* at 357–58. For discussion of anti-abuse rules, see *infra* notes 280–86 and accompanying text.

⁶⁶ See Schizer, *supra* note 56, at 361–62 (“Lawyers will want conservative reputations, and clients will want to hire such lawyers, if the government treats opinions of conservative lawyers more favorably than opinions of aggressive ones.”).

⁶⁷ *Id.* at 362.

⁶⁸ See *id.* (“[T]he government . . . [could] keep a list of aggressive advisors.”). In 2008, the IRS began posting on its website final disciplinary decisions for violations of Treasury regulations governing standards of tax practice by tax practitioners. See *infra* note 311 and accompanying text.

⁶⁹ Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131, 131 (2001).

interested reasons—armed with enough knowledge and market power to undermine Gresham's Law.⁷⁰ Moreover, if former participants blew the whistle on tax cheats, perhaps lured by the financial bounties offered under the redesigned IRS whistleblower program,⁷¹ government interests and tax practitioner interests would be further aligned.

A number of commentators extend the partnership model even more explicitly to cultivate cooperative behavior among taxpayers and tax advisors. These voices call for more responsive regulation in broadening the definition of deterrence to include “measures that nurture the social responsibility and ethics of taxpayers,” and that embrace “a dynamic framework” reflecting “the interplay of the taxpayer/tax-authority interaction.”⁷² An expanded conception of deterrence borrows from the “general prevention” approach in the literature on crime, and, according to legal scholar Sagit Leviner, is designed to improve compliance “not only by means of curbing illegal activity but also by encouraging legal behavior, such as by balancing authoritarian deterrence with positive encouragement and assistance.”⁷³ Taxpayer cooperation could be further induced with a mix of cognitive tricks that exploit taxpayers' preference for policies described as bonuses rather than their punitive opposites, such as offering tax rebates for filing taxes on time and without subsequent errors.⁷⁴ Under the partnership model, tax regulators extend to taxpayers “cooperation, positive and helpful service, and open dialogue as a first response to conflicts.”⁷⁵ If a taxpayer refuses the initial offer of cooperation, tax regulators would respond firmly but fairly, slowly ratcheting up enforcement to encourage compliance while continuing to offer

⁷⁰ “Gresham's Law” refers to bad money driving out good money. In the context of tax practice, Gresham's Law refers to “bad” or “low-minded” tax advisors driving out “good” or “public-minded” tax advisors.

⁷¹ See *infra* notes 164–73 and accompanying text.

⁷² Sagit Leviner, *A New Era of Tax Enforcement: From “Big Stick” to Responsive Regulation*, 1500 IRS RES. BULL.: RECENT RES. ON TAX ADMIN. & COMPLIANCE 241, 271–72 (2006), available at <http://www.irs.gov/taxstats/productsandpubs/article/0,,id=151642,00.html> (follow “A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive [sic] Regulation” hyperlink); see also Braithwaite, *supra* note 35, at 3–5 (suggesting responsive regulation should be applied to the tax system); Braithwaite, *supra* note 28, at 15, 35 (arguing for a dynamic approach to containing tax avoidance problems); Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation* 3, 6, 17, 19–20 (Inst. for Empirical Research in Econ., Univ. of Zurich, Working Paper No. 287, 2006), available at <http://ssrn.com/abstract=900366> (commenting on the relationship between taxpayers and tax authorities).

⁷³ Leviner, *supra* note 72, at 255–56.

⁷⁴ The cognitive trick here involves describing payment of taxes as a bonus rather than nonpayment of taxes as a penalty. The field of behavioral economics has long recognized the centrality of “framing” on decision-making and expressed preferences. Researchers have begun to demonstrate the relevance of framing to tax compliance. See, e.g., Edward J. McCaffery & Jonathan Baron, *Framing and Taxation: Evaluation of Tax Policies Involving Household Composition*, 25 J. ECON. PSYCHOL. 679 (2004); Edward J. McCaffery & Jonathan Baron, *The Humpty Dumpty Blues: Disaggregation Bias in the Evaluation of Tax Systems*, 91 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 230, 232, 241 (2003).

⁷⁵ Leviner, *supra* note 72, at 263.

cooperation as a reward. By “genuinely rewarding taxpayers in an exchange relationship,” economists Lars Feld and Bruno Frey suggest, tax regulators can increase tax compliance by improving “tax morale.”⁷⁶ More than a partnership, the taxpayer and tax regulator enter into a “psychological tax contract” that, like other contracts, involves reciprocal rights and duties.⁷⁷ The psychological tax contract requires taxpayers and tax regulators to “treat each other like partners . . . with mutual respect and honesty” throughout the planning, auditing, and litigation stages of the relationship.⁷⁸

Lest this partnership mentality conjure images of holding hands and singing “Kumbaya” around the campfire, it is imperative to place it in the context of give-and-take tax regulation. Substituting a shared governance equilibrium for an adversarial equilibrium necessarily requires that regulators and taxpayers work together in ways previously unimagined. A partnership mentality does not necessarily equate with lax enforcement or insufficient consequences for noncompliant behavior. Indeed, according to Dave Hartnett, Director General of the United Kingdom’s HMRC (Her Majesty’s Revenue and Custom, formerly, Inland Revenue), initiatives in Great Britain aimed at fostering a collaborative compliance norm have successfully avoided creating an environment where tax regulators are “pink and fluffy and only supportive.”⁷⁹ British officials have been “very demanding of business and those who advise them,” requiring heightened, timely disclosures to help “make the system work.”⁸⁰ The reciprocal exchange provides taxpayers more certainty, while the government receives valuable information about taxpaying behavior. In addition, the information gleaned from the partnership model of tax regulation can assist tax officials in better distinguishing between compliant and noncompliant taxpayers.⁸¹ Current evaders and aggressive avoiders may still engage in noncompliant behavior in the presence of the partnership model. But the

⁷⁶ Feld & Frey, *supra* note 72, at 20. For earlier research on the relationship between tax morale and tax compliance, see John G. Cullis & Alan Lewis, *Why People Pay Taxes: From a Conventional Economic Model to a Model of Social Convention*, 18 J. ECON. PSYCHOL. 305, 310 (1997), and Benno Torgler, *Tax Morale and Direct Democracy*, 21 EUR. J. POL. ECON. 525, 525–26, 530 (2005).

⁷⁷ Feld & Frey, *supra* note 72, at 20.

⁷⁸ *Id.* at 4; see also Braithwaite, *supra* note 28, at 17 (stating that while tax authorities may have legal legitimacy, that authority “does not guarantee them psychological legitimacy,” a pre-requisite for long-term compliance).

⁷⁹ Mark A. Weinberger et al., *Keynote Panel: Is the Global Wave of Change in Tax Risk Over or Just Beginning?*, reprinted in 85 TAXES, June 2007, at 38 (remarks of Dave Hartnett, Director General, Compliance Strategy & Business, HM Revenue & Customs).

⁸⁰ *Id.*

⁸¹ Increased information could also buttress other signaling techniques (such as which auditors or lawyers taxpayers use) that might be integrated into existing IRS programs that classify taxpayer behavior into different categories. See Stephen Joyce, *LMSB Launches Issues Classification System to Promote Consistency, Cut Currency Time*, 48 DAILY TAX REP. (BNA) at G-2 (Mar. 13, 2007) (discussing the IRS “industry issue focus” approach, a tiered classification system that categorizes compliance issues across industry lines).

feedback provided by a reciprocal approach can help tax authorities identify noncompliant taxpayers and respond with harsher penalties, aggressive enforcement, regular audits, and ongoing monitoring.⁸²

A cooperative model for tax regulation might still appear vulnerable to “agency capture.” Under this theory, regulators fail to uphold the broader public interest by falling prey to the influence of powerful regulated entities which substitute their own self-serving agenda for the public policy agenda.⁸³ Scholars have identified various federal agencies as victims of capture, including the Federal Aviation Administration (by the airline industry),⁸⁴ the Nuclear Regulatory Commission (by nuclear power companies),⁸⁵ the U.S. Department of Agriculture, Food, Safety, and Inspection Service (by meat and processed foods industries),⁸⁶ and the Bureau of Alcohol, Tobacco and Firearms (by the National Rifle Association).⁸⁷

To date, no one has suggested that the IRS is particularly susceptible to agency capture. While it is true that inviting taxpayer input during rulemaking lacks the tension among competing public interests that exists in other regulatory contexts,⁸⁸ it seems likely the IRS will remain immune to agency capture. Unlike other agencies, the Service does not interact as

⁸² See *Tax Disclosures in Financial Statements: The FASB, SEC and IRS Current Perspectives and Future*, reprinted in 85 TAXES, June 2007, at 58 (remarks of Deborah Nolan, Commissioner, Large and Mid-Size Business Division, IRS) (noting that increased information would help tax officials “treat taxpayers commensurate with their behavior”).

⁸³ See Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1565 (1992) (defining the capture hypothesis); Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1669, 1682–83 (1975) (summarizing capture theory by writing, “[t]o the extent that belief in an objective ‘public interest’ remains, the agencies are accused of subverting it in favor of the private interests of regulated and client firms”); see also Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 547–48 (2000) (describing the “deep interdependence among public and private actors in accomplishing the business of governance”); John Shepard Wiley, Jr., *A Capture Theory of Antitrust Federalism*, 99 HARV. L. REV. 713, 723 (1986) (attributing the shift in antitrust doctrine toward wider application of federal policy to the evolution of agency capture theory). For critiques of capture theory, see DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* 12, 37 (1991) (challenging the prevailing view of the influence of special interests); David Dana & Susan P. Koniak, *Bargaining in the Shadow of Democracy*, 148 U. PA. L. REV. 473, 497–98 (1999) (characterizing capture theory as “imprecise and controversial”); David B. Spence & Frank Cross, *A Public Choice Case for the Administrative State*, 89 GEO. L.J. 97, 104–05 (2000) (suggesting that “this dim view of agency independence is due in part to a combination of the methodological imperatives of public choice scholarship and social scientists’ desire to avoid normative issues”).

⁸⁴ Mark C. Niles, *On the Hijacking of Agencies (and Airplanes): The Federal Aviation Administration, “Agency Capture,” and Airline Security*, 10 AM. U. J. GENDER SOC. POL’Y & L. 381 (2002).

⁸⁵ Mark Seidenfeld, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion*, 51 ADMIN. L. REV. 429 (1999).

⁸⁶ Dion Casey, *Agency Capture: The USDA’s Struggle to Pass Food Safety Regulations*, 7 KAN. J.L. & PUB. POL’Y 142 (1998).

⁸⁷ Timothy D. Lytton, *Lawsuits Against the Gun Industry: A Comparative Institutional Analysis*, 32 CONN. L. REV. 1247 (2000).

⁸⁸ Unlike environmental regulatory rulemaking, for instance, where interest groups align on both sides of issues, few taxpayers align on the side of the IRS.

intimately with the entities it regulates. Moreover, it does not oversee one particular industry with organized representation, but instead regulates hundreds of millions of taxpayers in hundreds of thousands of different taxable industries, thereby diffusing the potential influence of specific interest groups.⁸⁹ In addition, the IRS does not engage in traditional “negotiated rulemaking,” where regulated entities “establish privately bargained interests as the source of putative public law.”⁹⁰ Comparatively, the IRS, somewhat perfunctorily, meets the requirements of the Administrative Procedure Act,⁹¹ publishing notices of proposed rulemaking in the Federal Register, and inviting interested parties to comment. Far from producing undue influence, the process can result in taxpayers, practitioner groups, industry representatives, and trade associations feeling powerless in determining policy outcomes.⁹² Inviting taxpayer input early in the rulemaking process invests taxpayers and their advisors in the regulatory effort, and helps overcome feelings of helplessness and distrust.

Cooperative tax regulation operates within a framework of governance in which traditional criticisms of agency regulation are inappropriate. The cooperative model emphasizes flexible not rigid regulatory approaches, creative not static outcomes, fluidity rather than hierarchy. This dialectic approach achieves a balance of persuasion and punishment that “prevents the emergence of widespread taxpayer resistance and fosters goodwill and cooperation.”⁹³ Moreover, this model is particularly well-suited to tax, where compliance is not always in the interest of taxpayers (especially in the short-term), and where the probability of detection is nearly an irrelevant consideration given current levels of enforcement.⁹⁴

B. *Regulatory Sticks and No-Fault Penalties in an Uncertain World*

Notwithstanding the significant potential of the cooperative model, tax regulation in the United States continues to emphasize punishment and deterrence. Recent changes to the penalty regime, moreover, have been

⁸⁹ For a similar argument that agencies working across industries are less likely to be captured, see generally Jonathan B. Baker, *The Case for Antitrust Enforcement*, 17 J. ECON. PERSP. 27 (2003); Jonathan B. Baker, “Continuous” Regulatory Reform at the Federal Trade Commission, 49 ADMIN L. REV. 859 (1997).

⁹⁰ William Funk, *Bargaining Toward the New Millennium: Regulatory Negotiation and the Subversion of the Public Interest*, 46 DUKE L.J. 1351, 1356 (1997).

⁹¹ See 5 U.S.C. §§ 551, 553 (1995) (defining entities subject to the Act and the requirements governing their rulemaking).

⁹² To the extent capture theory infects tax regulation, it does so at the legislative rather than the administrative level. For a particularly colorful story of tax politics at the legislative level, see generally JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* (1987).

⁹³ Leviner, *supra* note 72, at 263.

⁹⁴ See *infra* Part III.A (discussing the debilitating resource and information gaps).

largely punitive rather than persuasive. In 2004, Congress passed the American Jobs Creation Act (Jobs Act),⁹⁵ which heightened reporting and disclosure requirements⁹⁶ for “reportable transactions,”⁹⁷ tax code speak for “tax shelters.”⁹⁸ As an incentive to disclose information with respect to tax-motivated transactions, Congress significantly raised existing penalties while also adding new ones, only a few of which rewarded disclosure with penalty avoidance or lower penalty rates.⁹⁹ In addition, legislators set more stringent requirements for asserting a defense for engaging in reportable transactions,¹⁰⁰ making it available only in the presence of adequate disclosure,¹⁰¹ substantial authority,¹⁰² and a reasonable belief that the position was “more likely than not” correct.¹⁰³ Moreover, the Jobs Act authorized the Treasury Department to impose stringent monetary penalties on practitioners and firms for violating the new reporting obligations.¹⁰⁴ In particular, the IRS Office of Professional Responsibility may now levy

⁹⁵ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.).

⁹⁶ See, e.g., I.R.C. §§ 6111–12, 6662A, 6707, 6707A (Supp. 2005). Congress replaced the former registration and list maintenance rules with new rules requiring “material advisors” to disclose reportable transactions and maintain detailed lists of investors. See *id.* § 6111 (material advisor reporting requirement); *id.* § 6112 (material advisor list maintenance requirement).

⁹⁷ A “reportable transaction” is the tax code’s term of art for prohibited tax shelter transactions. The tax code defines reportable transactions generally as “of a type which the Secretary determines as having a potential for tax avoidance or evasion.” *Id.* § 6707A(c)(1). Meanwhile, Treas. Reg. § 1.6011-4(b)(2) (2007) specifies particular prohibitive transactions, including: (i) “listed” transactions that have a “significant tax avoidance purpose,” see *id.* § 301.6111-2(b)(2), and are the same as, or substantially similar to, a transaction specifically identified by the Treasury as a tax avoidance transaction; (ii) “confidential” transactions in which the advisor imposes a condition of confidentiality to protect the advisor’s planning strategy; (iii) transactions in which the advisor’s fee is contingent on the success of the planning strategy; (iv) “loss” transactions in which a gross loss exceeds certain thresholds; and (v) “transactions of interest” that have the potential for abuse, but for which the Treasury lacks sufficient information to determine whether they should be identified specifically as tax avoidance transactions.

⁹⁸ Several I.R.C. provisions still refer to “tax shelters” rather than “reportable transactions,” and continue to define the former as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose is the avoidance or evasion of federal income tax. E.g., I.R.C. § 6662(d)(2)(C) (Supp. 2005); Treas. Reg. § 1.6662-4(g)(2) (2008).

⁹⁹ See I.R.C. § 6700 (2000) (raising the shelter organizer penalty for a false statement from \$1000 to 50% of gross income derived from the activity); *id.* § 6707 (increasing the penalty for failure to register a tax shelter transaction from \$500 to \$50,000 for reportable transactions other than listed transactions and up to 75% of gross income derived from the activity for listed transactions); *id.* § 6707A (creating a new taxpayer penalty for failure to disclose a reportable transaction); *id.* § 6708 (establishing a new penalty which replaced the \$50 penalty for failure to maintain investor lists under § 6112 with a \$10,000 per day penalty for failure to turn over information upon request from the IRS); *id.* § 6662A (creating a new taxpayer 20% understatement penalty for reportable transactions, increased to 30% if not disclosed).

¹⁰⁰ See *id.* § 6664(d) (2000) (establishing exceptions for reportable transaction understatements).

¹⁰¹ *Id.* § 6664(d)(2)(A); see also Treas. Reg. §§ 1.6662-3(c)(2), 1.6662-4(e), (f) (2008) (indicating the methods for making adequate disclosures).

¹⁰² I.R.C. § 6664(d)(2)(B); see also Treas. Reg. § 1.6662-4(d) (2008) (defining the substantial authority standard and method for determining whether it has been met).

¹⁰³ I.R.C. § 6664(d)(2)(C) see also Treas. Reg. § 1.6662-4(g)(4) (2008) (describing when a taxpayer is within reason to believe that the tax treatment of an item is more likely than not correct).

¹⁰⁴ See *infra* notes 303–30 and accompanying text (discussing the penalties for practitioners and firms).

steep monetary sanctions (that can amount to double the expected fees charged for advising a reportable transaction) either in addition to or in lieu of other sanctions that may be levied, including censure, suspension, or disbarment.¹⁰⁵ New rules governing tax practice reinforce the reporting requirements by mandating that practitioners affirmatively disclose transactions, via written opinions that fail to meet the elevated more likely than not standard.¹⁰⁶ In 2006, the Treasury Department issued additional reporting requirements for an entirely new category of deals called “transactions of interest,” which Treasury feels have the potential for abuse but for which it lacks sufficient information to determine whether the deals should be identified specifically as tax avoidance transactions.¹⁰⁷

Though these changes to the tax compliance regime reflect a typical command-and-control style of regulation, they appropriately address longstanding information asymmetries separating taxpayers and tax regulators.¹⁰⁸ Like similar efforts to impose transparency in the corporate governance context—with, for instance, disclosure rules under the Sarbanes-Oxley Act¹⁰⁹ and the establishment of the Public Company Accounting Oversight Board¹¹⁰—heightened enforcement and disclosure in the tax context can also increase transparency. In turn, such transparency can facilitate certainty in reporting positions, and reduce costs of compliance as well as enforcement. Indeed, whether through “forced” transparency in the form of more threatening penalties, categories of prohibited transactions, and heightened disclosure rules or through “induced” transparency in the form of various pre-filing alternative dispute resolution initiatives,¹¹¹ openness can lead to certainty for both taxpayers and the government. In addition, stiffer penalties and disclosure obligations send overt signals to taxpayers and their advisors that the government is serious about enforcing the law and prosecuting violators. When it is clear that the government means business, researchers have

¹⁰⁵ 31 C.F.R. § 10.50 (2007).

¹⁰⁶ *Id.* § 10.35(b)(2)(i).

¹⁰⁷ AJCA Modifications to the Section 6011 Regulations, 71 Fed. Reg. 64,488 (Nov. 2, 2006) (to be codified at 26 C.F.R. pts. 1, 20, 25, 31, 53, 54 and 56). In September 2007, the IRS specified the first two such transactions. See Notice 2007-72, 2007-36 I.R.B. 544 (indicating that as of August 14, 2007, a Contribution of Successor Member Interest would be considered a transaction of interest); Notice 2007-73, 2007-36 I.R.B. 545 (indicating that as of August 14, 2007, a Toggling Grantor Trust would be considered a transaction of interest).

¹⁰⁸ See David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1348–51 (2000) (discussing the several advantages taxpayers and tax lawyers have over the government); see also *infra* notes 157–62 and accompanying text (arguing that even if resources were allocated more evenly, there would still be an “information gap” between taxpayers and the government).

¹⁰⁹ Sarbanes-Oxley Act of 2002 § 2(a), 15 U.S.C. § 7201 (2002).

¹¹⁰ 15 U.S.C. §§ 7211–19 (2000) (establishing the Public Company Accounting Oversight Board and defining its rules and procedures).

¹¹¹ See *infra* notes 196–98 and accompanying text (discussing pre-filing initiatives).

shown that taxpayers are more likely to comply with the law.¹¹² This does not mean that tax regulators can rely exclusively on ramping up enforcement while ignoring service, information sharing, and cooperation. It does mean, however, that recent legislative changes to the penalty and disclosure regimes, by providing the IRS a fuller array of sticks and carrots, might induce taxpayers and their advisors to cooperate in a reciprocal tax regulatory environment.

In the event these incentives fail to alter the behavior of particularly intransigent taxpayers, the government should have at its disposal another policy option: a no-fault, strict-liability underpayment penalty. Under this approach, reasonableness and good faith do not provide a defense to challenged taxpayer positions,¹¹³ and legal opinions do not provide penalty protection for taxpayers. In the current world of tax compliance, where state of mind determines culpability, and where legal uncertainty lowers still further the chance a taxpayer will be found culpable (to say nothing of low audit rates that virtually assure asserted positions go unexamined by the government),¹¹⁴ the taxpayer has almost no reason to adopt a conservative approach when choosing between transactions. However, in a world where state of mind does not absolve the taxpayer, and where stricter disclosure rules (even for non-controversial positions) help counteract low audit rates, taxpayers might think twice before choosing overaggressive transactions.¹¹⁵ Of course, taxpayers may still assert overaggressive positions. But they will have to consider the heightened risk before doing so.

No-fault penalties are not unprecedented. In fact, the U.S. tax code currently uses several of them, though they are targeted to certain taxpayers and certain kinds of behavior.¹¹⁶ Furthermore, as law professor Daniel Shavero has noted, once we acknowledge that taxpayers already respond strategically to the legal uncertainty surrounding tax law, “no-fault penalties should not even be controversial” because taxpayers will account

¹¹² See *supra* notes 36–38 and accompanying text (indicating that taxpayer behavior is influenced by the perception of whether the government will enforce the law).

¹¹³ For current treatment respecting penalty abatement, see IRC § 6664(d) (2000) (reducing § 6662A penalty pertaining to accuracy-related understatements on reportable transactions “if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion”); *id.* § 6662(d)(2)(B)(ii) (reducing the substantial understatement penalty for understatements pertaining to tax return positions that are adequately disclosed and that possess a reasonable basis of being upheld upon challenge).

¹¹⁴ For a fuller discussion, see *infra* notes 125–43 and accompanying text.

¹¹⁵ See Daniel Shavero, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters* 4–5 (N.Y.U. Sch. of Law Center for Law, Econ. & Org., Working Paper No. 07-05, 2007), available at <http://ssrn.com/abstract=955354> (discussing why tax penalties “need not have anything to do with wrongdoing”).

¹¹⁶ See, e.g., I.R.C. §§ 6662(e), (h) (imposing no-fault penalties on certain transfer-pricing transactions).

for them like other compliance inputs.¹¹⁷ Imposing penalties on all taxpayers based purely on objective criteria and without regard to state of mind might be susceptible to charges of procedural unfairness depending on how the rules are written. To mitigate such concerns, Congress could require the government to pay for the taxpayer's time and expense if it challenges a position and loses. Moreover, taxpayers could protect themselves against the risk of future penalties by turning to the thriving tax insurance industry.¹¹⁸

Opponents of a no-fault penalty might still object to the approach given the inherently stochastic nature of tax law. More so than other areas of the law, tax rules often provide no clear law at all, whereby the law itself becomes a random variable, with a certain probability that it is X and a certain probability that it is Y. Add the difficulty of assigning particular probabilities to different outcomes—in addition to the fact that regulators and courts can express preferences for form, substance, or any point in between—and making risk assessments becomes a task of partially informed guesswork. In a world of such uncertainty, disclosure rather than substantive regulation may be the preferred course.

The next two sections of the Article address the difficulty of locating certainty in tax law. Part III discusses ways for taxpayers and tax officials to enjoy greater certainty through information sharing, collaboration, and pre-filing resolution rather than post-filing controversy. Moreover, it puts the government in a better position to act on the information it receives by increasing resources in the form of money, personnel, and expertise. Part III also explores various policy opportunities for bringing private enforcement to tax law as a way of adding risk of detection and prosecution to the compliance calculus, and aligning taxpayers on the side of tax collection rather than tax avoidance. Part IV takes the contingent nature of tax as given, but rejects the usual conclusion that legal uncertainty justifies nearly any transaction. Instead, it posits a stricter rather than more lax level of certainty that practitioners and taxpayers must reach before reporting tax positions. It also recommends broader disclosure rules, both to assist the government in cracking down on overaggressive behavior and to provide taxpayers a procedure to assert aggressive positions. A combination of heightened practice standards and disclosure rules can alter compliance norms by adding yet another element of risk to the taxpayer's evaluation of whether and how to comply with the law.

¹¹⁷ Shaviro, *supra* note 115, at 45.

¹¹⁸ See Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 387–95 (2005) (describing a new type of tax risk insurance policy, sometimes called tax indemnity insurance or transactional tax risk insurance, that provides coverage against the IRS disallowing a taxpayer-insured's treatment of a particular transaction).

III. IMPROVING ENFORCEMENT, IMPROVING SERVICE

Improving enforcement alongside service requires balancing regulatory sticks and carrots. It entails enhancing the government's ability to enforce the nation's tax laws through increased resources and relevant taxpayer information. In some respects, improving enforcement requires making the government a better adversary. But creating a better adversary in the context of cooperative tax regulation appreciates that effective enforcement embraces transparency. In this way, enforcement spills over into service, with the government creating a regulatory culture that seeks to understand and inculcate the interests of taxpayers. Traditional regulatory models emphasizing post-filing controversy give way to pre-filing information sharing and issue resolution. The collaborative exchange, in turn, yields greater certainty of outcome for taxpayers and greater certainty of behavior for tax regulators. Moreover, it mitigates the mutual suspicion that currently separates taxpayers and tax regulators, and that contributes to flagging compliance. The IRS has begun to recognize the benefits of the cooperative approach, "establishing an environment where collaboration is priority one,"¹¹⁹ and "reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the burden on taxpayers who comply."¹²⁰ Part III of the Article provides specific recommendations to further mobilize a cooperative regulatory environment, and to equip the government with the necessary tools to work collaboratively with taxpayers.

A. *Closing the Resource and Information Gaps*

In 1998, the IRS Restructuring and Reform Act¹²¹ prompted a radical reshuffling of resources and a shift from enforcement to customer service that was arguably long overdue. Congress recognized that taxpayer perceptions of the system's procedural fairness played an integral role in tax compliance. But politicians overreacted. The IRS "may have made mistakes," former IRS Commissioner Mortimer Caplin has said of the 1998 reforms, "but they were not malicious or systemic."¹²² The crackdown on the IRS forced the agency to cut employees, reduce the number and thoroughness of audits, and slash enforcement appropriations all in the name of customer service.

¹¹⁹ Drew Douglas, *IRS to Focus on Service, Enforcement, Technology to Close Tax Gap*, *Officials Say*, DAILY TAX REP. (BNA), at G-1 (Oct. 23, 2007) (quoting Linda Stiff, acting Commissioner of Internal Revenue).

¹²⁰ *Reducing the Federal Tax Gap*, *supra* note 8, at 57.

¹²¹ Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

¹²² Mortimer M. Caplin, *The Tax Lawyer's Role in the Way the American Tax System Works*, 106 TAX NOTES 697, 699 (2005).

In recent years, the IRS has begun to recalibrate the scales. IRS Chief Counsel Donald Korb has said that while the pendulum swung “way too far” in the direction of service in the 1990s, it is swinging back toward enforcement as the IRS attempts “to get to equilibrium.”¹²³ Former Commissioner of Internal Revenue Mark Everson echoed Korb’s remarks, noting that a “rebalance has been struck between service and enforcement” but not at the expense of service, which, according to Everson, has also improved.¹²⁴

A renewed focus on enforcement appears to have paid dividends. Between 2002 and 2007, enforcement revenues rose an astounding 73%, from \$34.1 billion to \$59.2 billion.¹²⁵ Moreover, between 2000 and 2007, the audit rate for individual taxpayers jumped from an all-time low of 0.49% to a more respectable 1.03%,¹²⁶ while for high-income individuals (defined as persons earning more than \$100,000), the audit rate steadily increased between 2001 and 2005, with tax year 2005 boasting the highest number of reviews since 1995.¹²⁷ Furthermore, in 2007, the government audited a full 7% more total individual taxpayers (1.3 million versus 1.2 million), including an amazing 84% increase for taxpayers earning more than \$1 million.¹²⁸

These numbers are misleading, however. While absolute dollar amounts from enforcement have increased, the IRS has left a significant amount of money on the table. The Service audited 45% fewer total companies between 1998 and 2007.¹²⁹ For every category of business taxpayer—small business, large corporation, and tax-exempt—the IRS performed fewer audits in 2006 than in 1997.¹³⁰ Moreover, although collections in 2007 increased 22% over the previous year, both the number of delinquent taxpayers (866,777) and the amount owed on unassigned collection cases (\$34.9 billion) hit 10-year highs.¹³¹ In addition, the IRS has begun allocating fewer hours to each audit,¹³² relying increasingly on

¹²³ Alison Bennett, *Korb Defends Aggressive Shelter Approach; Vows to Help Efforts to Reach “Equilibrium,”* DAILY TAX REP. (BNA), at G-1 (Oct. 13, 2006).

¹²⁴ William H. Carlile, *Tax Compliance Environment Improved, IRS Commissioner Tells TEI Conference*, DAILY TAX REP. (BNA), at G-1 (Oct. 24, 2006).

¹²⁵ IRS, *IRS Statement on Fiscal Year 2007 Enforcement, with Statistics, Enforcement Revenue Chart*, TAXCORE (BNA) No. 12 (Jan. 18, 2008) [hereinafter *IRS Statement on FY 2007 Enforcement*].

¹²⁶ TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, REFERENCE NO. 2008-30-095, *TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007*, at 45 (2008) [hereinafter *TIGTA*], <http://www.treas.gov/tigta/auditreports/2008reports/200830095fr.pdf>.

¹²⁷ IRS News Release, *supra* note 1.

¹²⁸ *IRS Statement on FY 2007 Enforcement*, *supra* note 125.

¹²⁹ *TIGTA*, *supra* note 126, at 9.

¹³⁰ Stephen Joyce, *IRS to Continue Tax Compliance Push; Effect on Audits, Planning Uncertain*, DAILY TAX REP. (BNA), at S-11 (Jan. 16, 2007).

¹³¹ *TIGTA*, *supra* note 126, at 5.

¹³² See Alison Bennett, *TRAC Asserts ‘Historic Collapse in Audits’; Shott Says Interpretation of Data Is Wrong*, DAILY TAX REP. (BNA), at G-10 (Apr. 15, 2008); Stephen Joyce, *TRAC Says IRS Spends Less Time on Audits: IRS Says Worker Gains Mean More Revenue*, Daily Tax Rep. (BNA), at

“correspondence” audits (i.e., mail audits), which are less effective than in-person audits at detecting underreporting by high-income taxpayers.¹³³ Revenue agents also spent 40% more time in 2006 than in 2001 conducting “no-change audits” that resulted in no additional tax assessment recommendations.¹³⁴ There have even been reports that the Service has pressured agents to prematurely close audits of large corporations as part of negotiated compromises.¹³⁵

The audit rate itself belies improved enforcement. In 2007, the IRS audited only slightly more than 1% of all individual returns,¹³⁶ a marked improvement in the short term,¹³⁷ but far below historical averages. Even then, the IRS could not verify all positions embedded in examined returns.¹³⁸ The other 99% of the time, the opposing party’s assertions went unexamined and unchallenged. The IRS may have even less luck enforcing the tax laws on businesses, despite higher absolute audit rates. In 2007, exams of companies with assets exceeding \$10 million decreased to 16.8%,¹³⁹ while audits of companies with assets of more than \$250 million dropped to roughly 30%.¹⁴⁰ Even for corporations subject to annual audit, there is no guarantee the Service will identify questionable transactions, either because of gaps in the corporate taxpayer’s records,¹⁴¹ concealment of impermissible transactions,¹⁴² or the practice of allowing corporations to set the audit agenda and include for examination conservative transactions while obscuring or omitting aggressive transactions.¹⁴³

Viewed historically, the modern Internal Revenue Service is a shadow

G-8 (Dec. 21, 2006) (reporting twenty percent decline in cycle time spent on large corporate audits between 2002 and 2006).

¹³³ Allen Kenney, *TIGTA Finds Audit-by-Mail More Common Than IRS Says*, 115 TAX NOTES TODAY 219 (2007); see also TIGTA, *supra* note 126, at 8 (reporting that almost 83% of all examinations of individual taxpayers in 2007 were correspondence examinations).

¹³⁴ Stephen Joyce, *TRAC Says IRS Time on No-Change Audits Up; IRS Defends Practices, Cites Improvement*, Daily Tax Rep. (BNA), at G-7 (Apr. 13, 2007).

¹³⁵ David Cay Johnston, *Agents Say Fast Audits Hurt I.R.S.*, N.Y. TIMES, Jan. 12, 2007, at C1, available at Lexis, News Library, NYT File.

¹³⁶ TIGTA, *supra* note 126, at 45.

¹³⁷ See *supra* note 126 and accompanying text.

¹³⁸ See Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 189 (1996) (writing that even if the IRS audits a taxpayer, “it may not notice whatever tax evasion the taxpayer may have engaged in”).

¹³⁹ TIGTA, *supra* note 126, at 45.

¹⁴⁰ *Id.* at 9. According to some observers, the audit rate for these companies may be even lower. See Transactional Records Access Clearinghouse (TRAC), *Audits of Largest Corporations Slide to All Time Low* (2008), available at <http://trac.syr.edu/tracirs/newfindings/current/> (citing a twenty-six percent audit rate).

¹⁴¹ See Rosenberg, *supra* note 138, at 189.

¹⁴² See Graeme S. Cooper, *Analyzing Corporate Tax Evasion*, 50 TAX L. REV. 33, 100 (1994) (finding that businesses conceal tax-motivated transactions from auditors).

¹⁴³ See 1 JOINT COMMITTEE ON TAXATION, STUDY OF PRESENT LAW PENALTY AND INTEREST PROVISIONS, AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, at 223 (1999).

of its former self. During the “golden age” of the IRS in the 1960s, audit levels approached an astonishing 6%.¹⁴⁴ The Service recruited young lawyers from top law schools, entry-level salaries for government lawyers competed with private-sector wages, and IRS employees garnered respect from taxpayers, practitioners, and politicians. In every category, the golden years are a distant memory. Audit levels have fallen to 1%; newly-minted Harvard law graduates choose Wall Street firms with \$160,000 starting salaries and \$30,000 bonuses over positions at the IRS for one-fourth to one-third the remuneration; and the status attributed to working for the IRS has yet to recover from the “disasters” of the late 1990s.¹⁴⁵ It is fair to say that the modern IRS strikes fear only in the hearts of the meek.

Compared to its main competitor, the private tax bar, the Service is short money, personnel, and expertise.¹⁴⁶ The first two deficiencies go hand in hand. Between 1998 and 2007, funding for IRS personnel fell dramatically, resulting in a 23% decline in combined collection and examination function enforcement staff.¹⁴⁷ Moreover, between 1996 and 2003, the number of revenue officers and revenue agents—two groups critical to detecting noncompliance—declined by 40% and 50%, respectively.¹⁴⁸ Overall, the IRS workforce shrunk by nearly 15,000 employees from 2002 to 2008.¹⁴⁹ Meanwhile, IRS workload jumped sharply. The number of taxpayers filing returns grew from 123 million in 1998 to 138 million in 2007, with more complicated returns—such as Schedule C returns—doubling the growth rate of aggregate individual returns.¹⁵⁰

Shortfalls in expertise are harder to quantify. But discussions with leading tax practitioners suggest that this component of the “resource gap” is an even larger problem than personnel and funding issues.¹⁵¹ One

¹⁴⁴ A sizeable though unquantifiable portion of the declining audit rate is attributable to the computerization of tax administration, with computer matching performing much of what audits accomplished in the 1960s. This Article does not endorse raising audit rates to reflect historically high levels, and it recognizes that we cannot “audit our way out of the tax gap” to achieve optimal compliance. Alison Bennett, *Solomon Previews Major Guidance, Outlines Concerns on Tax Gap, Economic Substance*, 47 DAILY TAX REP. (BNA) at G-11 (Mar. 12, 2007) (quoting Assistant Treasury Secretary for Tax Policy Eric Solomon). However, it strongly recommends forging a new audit strategy that includes higher rates of audit as a form of deterrence.

¹⁴⁵ Joyce, *supra* note 130, at 2 (quoting former IRS Commissioner Donald Alexander’s reference to the backlash against the IRS after the 1997 and 1998 Senate hearings, in which witnesses testified—largely falsely—to abusive enforcement actions by the IRS).

¹⁴⁶ David Schizer has drawn a similar conclusion: “In important respects, the private tax bar outmatches their counterparts in government. This imbalance is one of sheer numbers, of access to information, and, at least in some cases, of sophistication and expertise.” Schizer, *supra* note 56, at 331.

¹⁴⁷ TIGTA, *supra* note 126, at 2.

¹⁴⁸ Diane Freda, *NTEU President Kelley Tells Congress More Workers Key to Reducing Tax Gap*, 53 DAILY TAX REP. (BNA), at G-6 (Mar. 20, 2007).

¹⁴⁹ IRS Oversight Board Annual Report 2007, at 9 (2008).

¹⁵⁰ *Id.*

¹⁵¹ These discussions involved practitioners in the Los Angeles, New York, and Washington, DC

seasoned tax lawyer reported that in one of the biggest partnership tax cases of the last twenty years, the investigating revenue agent suspended the audit for several weeks toward the end of the inquiry to attend an entry-level partnership class. In another partnership investigation, a private-sector lawyer spent several hours trying to explain to the investigating agents that, as the agents did understand, reduction of debt inside a partnership is treated as a cash distribution¹⁵² (which had not been reported as income by the partners), but there was the offsetting fact that the debt also increased outside basis when it was first assumed by the partnership, so the distribution was not in excess of basis after all.¹⁵³ The agents relented on this key fact and closed the case, but only after months of resource-intensive investigation. In addition, some practitioners report that 40 to 50% of issues on tax returns get picked up by revenue agents today, whereas of old that figure was 70 to 90%. Professor John Braithwaite has reported a similarly dismal assessment of revenue agent competence among elite tax lawyers. It is “not hard to get things by them,” one of Braithwaite’s interviewee’s shared, while another opined, “[t]he real issue is that the IRS aren’t [sic] smart enough to find these [sophisticated tax shelter] deals on a tax return.”¹⁵⁴

The IRS has implemented aggressive measures to reduce the resource gap. Chief Counsel Donald Korb’s initiatives have been particularly laudable. Korb has launched an aggressive campaign, for instance, to return “a healthy respect for the IRS” by recruiting top legal talent to the Service.¹⁵⁵ To this end, Korb and his deputies have begun aggressively recruiting at the country’s top law schools. The campaign, dubbed “Great Place to Start” and depicted in a glossy brochure containing biographies of tax luminaries whose legal careers began at the IRS, has been wildly successful, with thousands of aspiring tax lawyers vying for entry-level jobs.¹⁵⁶

While recruiting, training, and retaining a top-notch workforce are necessary components for closing the resource gap, they are not sufficient. More drastic measures need to be considered by policymakers and tax officials, including those offered by Dean David Schizer of Columbia Law

legal markets.

¹⁵² I.R.C. § 752(b) (2008).

¹⁵³ *Id.* § 752(a).

¹⁵⁴ JOHN BRAITHWAITE, *MARKETS IN VICE: MARKETS IN VIRTUE* 133 (2005).

¹⁵⁵ Bennett, *supra* note 123.

¹⁵⁶ As testament to the campaign’s success, the Chief Counsel’s Office received over 3000 applications from law students in both 2006 and 2007 and interviewed at more than 150 law schools in both years, compared to 60 schools in 2005. Telephone Interview with Hsinyu Yu, Attorney Recruitment Manager, IRS Chief Counsel Office (Jan. 30, 2008); *see also* Robert Guy Matthews, *It’s Taxing to Recruit Top Law Grads to IRS, but a New Push Betters Returns*, WALL ST. J., Oct. 10, 2006, at B1, available at LEXIS, News Library, WSJNL File; Sheryl Stratton, *After One Year on the Job, IRS Chief Counsel Reviews, Previews*, 107 TNT 292 (Apr. 13, 2005). For the brochure, see http://taxprof.typepad.com/taxprof_blog/files/publication_4063.pdf.

School. With respect to increasing government expertise as part of the effort to combat overaggressive tax planning, Schizer proposes recruiting retiring tax partners to mentor recent law school graduates entering government work,¹⁵⁷ adopting a generous loan forgiveness program for these graduates,¹⁵⁸ increasing the government pay scale to attract a small, elite team of private sector lawyers,¹⁵⁹ retaining the equivalent of a Delta Force of tax academics and highly skilled practitioners for discrete, specialized projects and litigation,¹⁶⁰ and encouraging bar associations to participate and assist in law reform.¹⁶¹

Even with the smartest, best educated, highest paid personnel, the IRS would still be at a disadvantage. Staffing and retention are problems for the Service, but skill level is not the primary issue. Indeed, in many respects, the “information gap” separating tax regulators from private sector tax lawyers is significantly wider than the resource gap. IRS enforcement is so severely handicapped by informational asymmetries that taxpayers can engage in abusive tax planning, accurately report transactions associated with that planning, yet still provide the IRS no indication of abusive activity.

Take the intermediary transaction tax shelter as an example.¹⁶² These transactions typically involve four parties: a seller (S) who wants to sell the stock of a target corporation (T); a promoter-controlled intermediary entity (E); and a buyer (B) who wants to purchase the assets but not the stock of the target. Under the terms of a pre-arranged plan, S purports to sell the stock of T to E. E has arranged financing for the sale through a bridge loan, which is secured by the assets of T. At the same time or shortly after the stock sale, E purports to sell T’s assets to B. The bridge loan is repaid from the proceeds, while any excess proceeds are retained by E as a fee for serving as the accommodation party. As a result of the transaction, S recognizes reduced gain due to its high basis in the stock of T; B receives larger depreciation and amortization deductions based on the fair market value of the assets (i.e., B’s purchase price rather than T’s basis in the assets); and E avoids paying tax on the gain from the asset sale by offsetting the gain with losses from the sale of inflated-basis assets.

¹⁵⁷ Schizer, *supra* note 56, at 347.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 347–48.

¹⁶⁰ *Id.* at 348–49, 351–52.

¹⁶¹ *Id.* at 350–51.

¹⁶² See IRS Notice 2001-16, 2001-9 I.R.B. 730; IRS Notice 2008-20, 2008-6 I.R.B. 406. I am grateful to William Alexander for this example. The IRS has identified this scheme as a “listed transaction,” defined as a “reportable transaction” which “is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction.” I.R.C. § 6707A(c)(2) (Supp. 2000). To date, the IRS has identified thirty-two such transactions. See Listed Abusive Tax Shelters and Transactions, <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html> (listing abusive tax shelters and transactions).

As far as the IRS is concerned, S's tax return reflects a simple sale, while B's reflects a straight asset purchase. The only way for the Service to expose the scheme is to examine together the returns of all four parties. In these transactions, paying more money to private sector attorneys and expert academics or recruiting law students with higher grades or more elite degrees will not uncover the tax shelter activity. In either case, the IRS misses the abusive behavior because there is no indication that anything is wrong. In these situations, information rather than resources separates the government from the private sector. Ultimately, heightened disclosure requirements and more stringent standards of tax practice, subjects discussed in Part IV of this Article, offer a better solution to the problem of information asymmetries.

B. *Extending the Private Enforcement Model to Tax*

Even if public enforcement were stepped up by enhancing government resources, private innovation would outstrip it due to information asymmetries. These asymmetries are difficult to overcome because taxpayers and their advisors perceive substantial benefits to obscuring tax shelter activity. Moreover, these benefits far exceed the discounted probability of detection, prosecution, and punishment. Thus, to the extent the government turns to the private sector for help in improving compliance, it needs to provide incentives to balance the significant economic upside of abusive tax planning. This section of the Article discusses various incentives that flow from extending private enforcement to tax regulation. While this recommendation may appear to be susceptible to charges that it abdicates the essential governmental function of revenue collection, scholars have shown that private enforcement of public law can be a powerful monitoring and prosecutorial mechanism.¹⁶³ Private enforcement is particularly appropriate when regulators—due to asymmetric information, active concealment by regulated parties, and weak enforcement—are unable or unwilling to enforce the law or prosecute offenders effectively. Current tax regulation suffers from all three symptoms, and could benefit significantly from private enforcement efforts.

In 2006, Congress explicitly recognized the benefits associated with private tax enforcement. It amended the little known tax whistleblower statute, Internal Revenue Code (the “Code”) section 7623, by significantly

¹⁶³ See, e.g., William E. Kovacic, *Private Monitoring and Antitrust Enforcement: Paying Informants to Reveal Cartels*, 69 GEO. WASH. L. REV. 766 (2001) [hereinafter Kovacic, *Private Monitoring*]; William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799 (1996); Joshua D. Rosenberg, *Narrowing the Tax Gap: Behavioral Options*, 117 TAX NOTES 517 (2007); Rosenberg, *supra* note 138, at 205–08; Dennis J. Ventry, Jr., *Whistleblowers and Qui Tam for Tax*, 61 TAX LAW. 357 (2008).

expanding the size of rewards paid to informants. The promise of lucrative bounties increased incentives for private persons to expose abusive taxpayer behavior, and added risk of detection and prosecution to the compliance calculus.¹⁶⁴ In addition, the 2006 amendments authorized a new IRS Whistleblower Office¹⁶⁵ to process tips received from informants who “spot tax problems in their workplace, while conducting day-to-day personal business, or anywhere else they may be encountered.”¹⁶⁶ While prior law capped informant awards at \$2,000,000 (and at \$50,000 as late as 1989¹⁶⁷), the revamped law contains no such cap and authorizes awards between 15 and 30% of collected proceeds, including penalties, interest, additions to tax, and any other amounts resulting from the action.¹⁶⁸ The IRS launched the Whistleblower Office in February 2007, and named Stephen Whitlock, former head of the IRS Office of Professional Responsibility, as its first Director.¹⁶⁹ Early indications are that the revamped program is working as planned, with “knowledgeable insiders” submitting bounty claims and turning over “big, fat piles of paper” involving hundreds of millions of dollars.¹⁷⁰ In October 2007, the Whistleblower Office received its first \$1 billion submission,¹⁷¹ followed by a \$2 billion submission two months later,¹⁷² and a \$4.4 billion submission in June 2008.¹⁷³ At 30% of collected proceeds, that equals potential informant awards of \$300 million, \$600 million, and \$1.32 billion.

Congress could further embrace the private enforcement approach by (i) enacting a private attorney general statute for tax, and (ii) authorizing private citizens to bring *qui tam* lawsuits for purported tax violations.¹⁷⁴ Under a private attorney general statute for tax, private individuals would be authorized to make claims against other private parties for failure to pay

¹⁶⁴ Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 406(a)(1), 120 Stat. 2958 (2006).

¹⁶⁵ *Id.* § 406(b).

¹⁶⁶ IRS News Release IR-2007-25 (Feb. 2, 2007), available at <http://www.irs.gov/newsroom/article/0,,id=167542,00.html>.

¹⁶⁷ IRS Publication 733 (rev. 7-80). Congress raised the cap in 1990 to \$100,000. IRS Publication 733 (rev. 11-90).

¹⁶⁸ I.R.C. § 7623(b)(1) (2006).

¹⁶⁹ Dustin Stamper, *Whitlock Tapped to Head New IRS Whistle-Blower Office*, 114 TAX NOTES 628 (2007).

¹⁷⁰ Tom Herman, *Whistleblower Law Scores Early Success, Higher Rewards Attract Informants Submitting Tips*, WALL ST. J., May 16, 2007, at D3, available at LEXIS, News Library, WSJNL File (quoting Director Whitlock).

¹⁷¹ J.P. Finet, *Tax Whistleblower Action Claims \$1 Billion Underpayment by Fortune 500 Company*, 197 DAILY TAX REP. (BNA), at G-5 (Oct. 12, 2007).

¹⁷² J.P. Finet, *Whistleblower Action Claims Major Firm Underpaid Its U.S. Taxes by \$2 Billion*, 238 DAILY TAX REP. (BNA), at G-9 (Dec. 12, 2007).

¹⁷³ *Tax Whistleblower Claims \$4.4 Billion Tax Underpayment by Fortune 500 Company*, 115 DAILY TAX REP. (BNA), at G-4 (June 16, 2008).

¹⁷⁴ “*Qui tam*” is shorthand for “*qui tam pro domino rege quam pro se ipse*” or “he who sues for the king as for himself.”

taxes. As with other such statutes,¹⁷⁵ the idea would be to provide incentives for private persons to bring lawsuits deemed to be in the public interest (in this case, collection of taxes owed but not paid) and for private sector lawyers to represent those plaintiffs. With respect to extending the *qui tam* approach to tax, other federal and state whistleblower statutes, including the wildly successful False Claims Act,¹⁷⁶ already provide for *qui tam* actions,¹⁷⁷ which allow private individuals with knowledge of fraud committed against the government to bring suit on the government's behalf. The informant presents the government with her information, and the government decides whether to prosecute the case or allow the informant to proceed alone as a *qui tam* plaintiff. Bringing the *qui tam* model to tax would add additional risk associated with noncompliant behavior. The threat of *qui tam* lawsuits could alter governance and compliance norms within organizations, and deter noncompliant behavior at the source. Moreover, the *qui tam* approach provides a particularly efficient form of regulation by shifting the cost of compliance to the party or parties with the lower cost of monitoring, i.e., employee insiders, in-house lawyers, and outside tax counsel.¹⁷⁸

Private enforcement of tax laws could also shrink the resource and information gaps by aligning the interests of taxpayers, tax practitioners, and tax regulators. Economic incentives for exposing abusive taxpayer behavior would put taxpayers and tax advisors on the side of enforcement and collection. Private enforcement programs could create a market for practitioners skilled in shepherding whistleblower and *qui tam* plaintiffs through the regulatory and judicial processes. Lured by the prospect of economic gain, these practitioners and their clients would effectively act as government deputies in protecting the revenue and rooting out abusive tax avoidance. In fact, in the short time since Congress enacted sweeping changes to the tax informant statute, the tax whistleblower bar has grown perceptibly, as much as 15–20% according to the national organization of

¹⁷⁵ Examples of private attorney general statutes include the Toxic Substances Control Act of 1976 § 20, 15 U.S.C. § 2619 (2006), the Clean Water Act of 1972 § 505, 33 U.S.C. § 1365 (2000), and the Clean Air Act of 1970 § 304, 42 U.S.C. § 7604 (2000).

¹⁷⁶ 31 U.S.C. §§ 3729–33 (2000). In 2007, recoveries under the False Claims Act exceeded \$1.4 billion. U.S. DEPARTMENT OF JUSTICE, CIVIL DIVISION, FRAUD STATISTICS OVERVIEW, <http://www.lopds.com/files/pdf/stats.fy2007.final.pdf>.

¹⁷⁷ As of September 1, 2008, seventeen states and the District of Columbia had enacted false claims statutes containing *qui tam* provisions. Five additional states had *qui tam* laws that applied exclusively to health care fraud, while two municipalities, Chicago and New York City, had enacted false claims ordinances with *qui tam* enforcement mechanisms. See Taxpayers Against Fraud Education Fund, The False Claims Act Legal Center, State False Claims Acts, <http://www.taf.org/statefca.htm> (last visited Sept. 1, 2008).

¹⁷⁸ See Kovacic, *Private Monitoring*, *supra* note 163, at 774 (“The chief virtue of private monitoring is that it gives monitoring tasks to individuals closest to the relevant information.”). For a fuller treatment of the tax whistleblower statute and the implications of extending *qui tam* to tax, see Ventry, *supra* note 163.

qui tam lawyers.¹⁷⁹

The private enforcement approach reflects an agile compliance strategy that could help the government keep up with “the capacities of professionals advising the private sector for evasive innovation.”¹⁸⁰ Recent legislative enactments, particularly the anti-shelter provisions of the Jobs Act, arm tax officials with improved anti-shelter weapons. But they attack known transactions, while unidentified deals remain hidden. “Narrowly-tailored legislative responses to particular types of shelters are . . . not adequate as a solution to the overall shelter problem,” professors Marvin Chirelstein and Larry Zelenak have written, because legislative fixes “are prospective only,” and taxpayers “merely move on to new types of shelters not yet legislated against.”¹⁸¹ Statutory solutions should aim to uproot abusive activity rather than attack it *post hoc*. Tax authorities need a compliance regime that will detect, deter, and effectively punish noncompliant behavior while rewarding compliant behavior. Extending the private enforcement model to tax and, as discussed in the next section, increasing information sharing among taxpayers, tax advisors, and tax officials, are essential components of such a regime.

C. Diffusing Suspicion and Creating Dialogue

At the same time we improve enforcement and align taxpayer and government interests, we must alter IRS culture.¹⁸² The failure of the prevailing tax compliance regime is as much attributable to deficient compliance and enforcement norms among tax regulators as among taxpayers and their advisors. Over the years, tax regulators have cultivated an “Us vs. Them” mentality, whereby officials resist sharing information with taxpayers whom they view (sometimes correctly) as resistant to sharing information with them. The result is that each side is deeply suspicious of the other, with concerns over process exacerbating the suspicion. Taxpayers complain about unresponsive administrative procedures associated with published guidance, taxpayer-specific issue resolution, and deficiency examinations. To their clients’ concerns, tax advisors add complaints that disciplinary investigations of tax practitioners conducted by the Treasury Department resemble Star Chamber

¹⁷⁹ Telephone Interview with Jeb White, Editor, Quarterly Review, Taxpayers Against Fraud (TAF) (July 3, 2007).

¹⁸⁰ Simon, *After Confidentiality*, *supra* note 32, at 1460.

¹⁸¹ Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1939 (2005).

¹⁸² Altering organizational culture is no easy task, particularly within organizations with entrenched institutional practices such as the IRS. For a case study on changing organizational culture within revenue agencies, see Jenny Job et al., *Culture Change in Three Taxation Administrations: From Command-and-Control to Responsive Regulation*, 29 L. & POL’Y 84 (2007) (describing efforts to change revenue-collecting cultures in Australia, New Zealand, and Timor Leste).

proceedings with no procedural safeguards. Meanwhile, tax regulators are convinced that taxpayers and their advisors thwart reporting procedures by engaging in and failing to disclose abusive transactions. Thus, many of the recommendations already discussed in this Article, such as rewarding taxpayer compliance, encouraging participatory rulemaking, and enhancing private enforcement, are designed to align the interests of tax regulators, taxpayers, and tax advisors. Improving perceptions of procedural justice among taxpayers and advisors can be especially effective in facilitating compliance with tax laws.¹⁸³

Sharing information could go a long way toward mitigating suspicious minds, but only if the information flows in two directions, with taxpayers and tax officials *both* realizing benefits from the exchange. Mutually beneficial communication would provide regulators with additional information to assess levels of compliance and to focus resources. It would also provide taxpayers certainty and assistance in complying with the law. Given that tax risk has become an increasingly salient factor in board rooms,¹⁸⁴ taxpayers are seeking more from tax regulators to assist with compliance. According to Dave Hartnett, Director General of the United Kingdom's tax agency, "tax is creeping into corporate responsibility and into the sort of thing that business leaders as opposed to tax leaders are starting to say about tax, tax risk[,] and the support they want from tax administrat[ors]."¹⁸⁵ Business taxpayers can no longer afford to treat tax as an unknown quantity. They desire more certainty in outcome, even if that means sharing more information with tax officials. Meanwhile, tax authorities are starting to appreciate that disclosure and information sharing offer mutual benefits: "We want compliance with the

¹⁸³ See Valerie Braithwaite, *Tax System Integrity and Compliance: The Democratic Management of the Tax System*, in TAXING DEMOCRACY, *supra* note 28, at 271, 287 (explaining that a taxing agency "that de-legitimizes itself in the eyes of citizens limits its effectiveness and short-changes citizens in terms of what they can expect from democracy"); Karyl A. Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data*, in WHY PEOPLE PAY TAXES, *supra* note 50, at 259, 261 (examining the adequacy of Strümpel's three-variable model of tax enforcement and compliance, focusing specifically on "the effects of enforcement contacts on sanction perceptions, the perceived fairness of tax laws, and future intentions of noncompliance"); Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *id.*, at 223, 227 ("Positive actions by authorities toward taxpayers may be reciprocated by compliant actions on a simple tit-for-tat basis, a direct effect on taxpayers' actions that is not mediated by normative or legitimating processes."); Leviner, *supra* note 72, at 262 (noting that "the perceptions taxpayers have" of procedural fairness "affect the legitimacy taxpayers attribute to the administration and the extent to which they accept its authority"); John T. Scholz & Mark Lubell, *Trust and Taxpaying: Testing the Heuristic Approach to Collective Action*, 42 AM. J. POL. SCI. 398, 408–13 (1998) (examining the results of an empirical study finding that trust in government and trust in other citizens significantly increases the likelihood of compliance with federal income tax laws); Ronald G. Worsham, Jr., *The Effect of Tax Authority Behavior on Taxpayer Compliance: A Procedural Justice Approach*, 18 J. AM. TAX'N ASS'N 19 (1996) (determining that perceived procedural injustice adversely affects taxpayer compliance).

¹⁸⁴ See *infra* notes 331–33 and accompanying text.

¹⁸⁵ Weinberger et al., *supra* note 79, at 35 (remarks of Dave Hartnett).

tax laws,” an IRS official recently told a roomful of practitioners.¹⁸⁶ “You need a level of certainty, so do we.”¹⁸⁷

Reciprocal information sharing can produce mutual benefits even when opposing parties disclose otherwise proprietary information. At the annual Tax Council Policy Institute (TCPI) symposium in 2007, British tax officials discussed their experience with comparing risk assessments of aggressive tax positions prepared by taxpayers with those prepared by the government. The comparison revealed that each side shared similar assessments of each other’s litigating positions, a realization that generated trust and respect.¹⁸⁸ During a later panel at the same symposium, moderator and tax lawyer Armando Gomez engaged IRS Chief Counsel Donald Korb on the issue of reciprocal information sharing and on viewing risk assessments as “a useful tool for getting both sides closer to an agreement on what the right outcome is.”¹⁸⁹ Korb dismissed the idea as “just silly,” and suggested that information sharing should be a one-way street with taxpayers disclosing information and the government receiving it.¹⁹⁰

While Korb has done a great deal during his tenure to facilitate communication between taxpayers and the government, his position at the TCPI conference undermines the principles of cooperative tax regulation. If tax authorities expect taxpayers and tax advisors to adopt a more transparent approach to tax compliance, they have to play by the same set of rules and be willing to alter their own compliance norms. In the words of Director General Hartnett, tax administrators have to “pause occasionally and say to ourselves, am I too close to the immediate issues and is there a bigger goal here and something bigger I can achieve if I start approaching tax in a different way?”¹⁹¹ The “mantra” for tax officials, therefore, should be “transparency, disclosure, and cooperation” flowing in both directions.¹⁹² One-way information flows, from taxpayer to tax official, only exacerbate suspicion, distrust, and noncompliance.

Suspicion and distrust also currently surround the appeals process. Tax practitioners have long questioned whether they really get a “fresh look” when the IRS Office of Appeals examines a challenged position. For their part, tax officials insist that appeals remain independent of agency policy or published guidance. But recent actions by IRS officials belie the

¹⁸⁶ Richard R. Jones et al., *Tax Disclosures in Financial Statements: The FASB, SEC and IRS Current Perspective and Future Plan*, reprinted in 85 TAXES, June 2007, at 66 (remarks of Deborah Nolan).

¹⁸⁷ *Id.*

¹⁸⁸ Weinberger et al., *supra* note 79, at 39 (remarks of Dave Hartnett).

¹⁸⁹ Armando Gomez et al., *Global Tax Enforcement Trends and Worldwide Risks*, reprinted in 85 TAXES, June 2007, at 73 (remarks of Armando Gomez).

¹⁹⁰ *Id.* (remarks of Donald Korb).

¹⁹¹ Weinberger et al., *supra* note 79, at 42 (remarks of Dave Hartnett).

¹⁹² *Id.* at 33.

purported independence, indicating that while Appeals is committed to an independent review of each and every tax question, it is also beginning to conform more closely to official IRS interpretations of the law.¹⁹³ Practitioners rightly wonder, “How can Appeals remain independent and ‘get with the program’ at the same time?”¹⁹⁴ In fact, why even have an appeals process if it merely restates the official views of the Chief Counsel’s office or of published guidance? Of course, appeals officers cannot adopt positions on statutory interpretation contrary to official IRS policy, but that does not prevent them from acknowledging contrary authority or distinguishing the taxpayer’s case from previous interpretations. If the IRS is serious about the perception and application of procedural fairness, it needs to embrace the idea of an independent Appeals Office.¹⁹⁵

To break down still further its adversarial image, the IRS could involve taxpayers and their advisors more directly in regulatory processes. This effort should involve tax officials sitting down with taxpayers and their advisors to discuss and resolve tax positions *before* the taxpayer files a return. The IRS has rolled out several pre-filing initiatives, including the Advance Pricing Agreement (APA) program, the Industry Issue Resolution (IIR) program, the Pre-Filing Agreement (PFA) program, and the Compliance Assurance Process (CAP).¹⁹⁶ In the event taxpayers find

¹⁹³ See Dustin Stamper, *Appeals Needs to Be “On Same Page” as Rest of IRS, Brown Says*, 2007 TAX NOTES TODAY 54-2 (Mar. 19, 2007), available in LEXIS, Fedtax Library, TNT File (“IRS Deputy Commissioner of Services and Enforcement Kevin Brown assured practitioners at a March 19 meeting of the Tax Executives Institute that the IRS is committed to the Office of Appeals’ independence, but he said he wants Appeals to conform more closely to IRS interpretations of the law.”).

¹⁹⁴ Allen Kenney, *IRS Wades Into Murky Waters: Appeals’ Independence*, 114 TAX NOTES 1201, 1201 (2007) (quoting former IRS Chief Counsel B. John Williams).

¹⁹⁵ In a recent ABA Section of Taxation survey, tax practitioners gave the Appeals process mixed reviews. The survey found overall satisfaction of sixty percent, but an even higher percentage expressed the opinion that recent changes to the appeals process negatively affected the office’s independence. For example, nearly eighty percent of respondents believed the office’s involvement in recent IRS tax shelter settlement initiatives made the Appeals Office appear less independent. AMERICAN BAR ASSOCIATION SECTION OF TAXATION, SURVEY REPORT ON INDEPENDENCE OF IRS APPEALS 1–2 (2007).

¹⁹⁶ The first two programs are specific to particular industries, with the APA designed to resolve actual or potential transfer pricing disputes for cross-border transactions “in a principled and cooperative manner,” Rev. Proc. 2006-9, 2006-2 I.R.B. 278, while the IIR identifies disputed issues common to taxpayers in a particular industry, and seeks to resolve them through published guidance rather than post-filing examination. Rev. Proc. 2003-36, 2003-18 I.R.C. 859. Meanwhile, the PFA and CAP programs, though not specific to any particular industry or issue, serve a growing population of business taxpayers. Under the PFA, business taxpayers are allowed to request consideration of a specific issue prior to filing a return, a process that provides certainty of outcome and expedites the resolution of potential future disputes. Rev. Proc. 2007-17, 2007-4 I.R.B. 368. CAP, meanwhile, requires “extensive cooperation” between the government and participating taxpayers, with taxpayers fully disclosing information concerning completed transactions and proposed reporting positions in exchange for full resolution of all material tax issues prior to filing a tax return, in addition to the guarantee that they will not be subject to post-filing examinations for returns filed consistent with the agreed upon resolutions. Announcement 2005-87, 2005-50 I.R.B. 1144. Taxpayers are taking advantage of these programs in increasing numbers. Participation in the CAP program, for instance,

themselves subject to examination by the IRS, the Fast Track Settlement (FTS) program offers a streamlined dispute resolution process.¹⁹⁷ Together, the pre-filing and dispute resolution programs offer taxpayers and advisors the opportunity to participate directly in the resolution of tax issues. Moreover, they provide taxpayers and the government increased certainty of outcome as well as lower costs.¹⁹⁸ Timely, reliable, and participatory guidance enlists taxpayers and their advisors in tax enforcement, and discourages impermissible planning activity by offering tangible incentives for choosing compliance over avoidance.

An open dialogue between taxpayers, practitioners, and tax authorities is crucial to forging a shared understanding of what it means to comply with the law. Absent such dialogue, the parties “may have different and genuinely held understandings of a rule’s meaning, and may each consider theirs the correct and clear meaning.”¹⁹⁹ Moreover, as Valerie Braithwaite has observed, whether or not a taxpayer “does what is asked of him or her is not always visible. Furthermore, whether or not a person interprets the request in accordance with its intent is sometimes far from certain.”²⁰⁰ Active communication between the parties can identify a shared compliance norm, and clarify what is expected of each participant.

One particularly effective way to facilitate communication between taxpayers, advisors, and regulators is to involve all parties in the rulemaking process. In fact, in early 2007, the IRS launched a program to solicit public comments earlier in the guidance process.²⁰¹ Though politicians initially criticized the program as giving private industry too much influence over regulatory functions,²⁰² Chief Counsel Korb reported

has jumped 429% in the last three years. John Herzfeld, *LMSB Personnel Changes Will Not Alter Division Focus on Certainty*, Schott Says, 197 DAILY TAX REP. (BNA), at G-11 (Oct. 12, 2007) (reporting an increase in participating taxpayers from 17 in 2005 to 73 in 2007). Meanwhile, a PricewaterhouseCoopers survey found that 51% of tax professionals surveyed had obtained or were in the process of obtaining an advance pricing agreement. *FIN 48 Work Paper Fears Surface in PricewaterhouseCoopers U.S. Poll*, 247 DAILY TAX REP. (BNA), at G-1 (Dec. 27, 2007). Notwithstanding the success of these programs, high user fees may be dampening greater participation. Lauren Gardner, *Requests for PFA Program Down Since \$40,000 Application Fee Spike*, 100 DAILY TAX REP. (BNA), at G-2 (May 23, 2008) (discussing PFA user fee increase in 2007 from \$10,000 to \$50,000); Molly Moses, *Ratio of Completed APAs on Par with 2006; IRS Creates Spreadsheet for CPM Analysis*, 60 DAILY TAX REP. (BNA), at G-2 (Mar. 28, 2008) (reporting that increase in APA user fee from \$25,000 to \$50,000 is hurting participation).

¹⁹⁷ Rev. Proc. 2003-40, 2003-25 I.R.B. 1044; Announcement 2006-61, 2006-36 I.R.B. 390. The program provides a review of the dispute by the IRS Office of Appeals, which allows all parties (including taxpayers, advisors, revenue agents) to participate in the resolution process. *Id.*

¹⁹⁸ See John Herzfeld, *Korb Renews Warning Against Reliance on Protection of So-Called Wall Street Rule*, 196 DAILY TAX REP. (BNA), at G-7 (Oct. 11, 2007) (quoting Chief Counsel Korb on the compliance benefits of pre-filing resolution and the associated certainty for taxpayers and the government).

¹⁹⁹ Sol Picciotto, *Constructing Compliance: Game Playing, Tax Law, and the Regulatory State*, 29 LAW & POL’Y 11, 12 (2007).

²⁰⁰ Braithwaite, *supra* note 183, at 276.

²⁰¹ IRS Notice 2007-17, 2007-12 I.R.B. 748 (2007).

²⁰² Legislators recoiled upon learning of the program, calling it a classic case of the fox guarding

in late 2007 that the process had “worked beautifully,” thereby quieting concerns on Capitol Hill.²⁰³ The initiative allows the government to “meet the demands of the taxpaying public for more technical guidance” when constrained by “a finite amount of resources,”²⁰⁴ while also opening to the light of day a previously insulated process. Affected taxpayers, bar associations, and trade groups routinely comment on published notices of proposed rulemaking, and many of these groups meet privately with Treasury officials on matters important to their constituents.²⁰⁵ Recognizing that interest group lobbying had become an entrenched aspect of public lawmaking, and that business knowledge and experience, particularly in the tax field, are critical for government officials, the IRS added transparency to a process otherwise hidden from public view. Soliciting comments earlier creates a collaborative, participatory, and informed system. In addition to facilitating communication, the program helps regulators overcome distrust and suspicion by working alongside taxpayers, incorporating their concerns into legal rules, and investing them professionally and personally in compliance.

At their heart, policies that facilitate participatory rulemaking, information sharing, and pre-filing resolution challenge the historically adversarial tax regulatory environment. As we will see in Part IV, the tax professional associations—particularly the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA)—have contributed mightily to this adversarial atmosphere. The ABA’s official ethical guidelines pertaining to tax practice characterize the IRS as an “adversary party rather than a judicial tribunal” or even a “quasi-judicial institution.”²⁰⁶ They further assume that the act of filing a tax return (an act that the taxpayer controls and that merely reports the taxpayer’s financial transactions for the year) will result in a controversy.²⁰⁷ Even ABA guidelines pertaining to marketed tax shelters—guidelines that were designed explicitly to encourage lawyers to

the chicken coop. “We don’t need K Street lawyers writing enforcement regulations to help their clients create tax shelters,” one legislator proclaimed, while another feared that “outside groups” might “skew the IRS’s view,” particularly if special interests wrote the first draft of guidance upon which all subsequent drafts depended. Diane Freda, *Top Senate Finance Panel Members Assail IRS Plan to Let Outsiders Develop Guidance*, 51 DAILY TAX REP. (BNA), at G-6 (Mar. 16, 2007).

²⁰³ Dustin Stamper, *Korb Laments Penalty Pileup, Vows More Practitioner-Driven Guidance*, 117 TAX NOTES 421, 421 (Oct. 29, 2007).

²⁰⁴ Stephen Joyce, *Korb Defends Proposed Guidance Process as Transparent Method of Aiding Taxpayers*, 47 DAILY TAX REP. (BNA), at G-1 (Mar. 12, 2007).

²⁰⁵ Stamper, *supra* note 203, at 421 (quoting Korb as saying, “Let’s not kid ourselves, this has been going on forever where people come in and give us proposed ideas—often in secret”).

²⁰⁶ ABA Comm. on Prof’l Ethics, Formal Op. 314 (1965).

²⁰⁷ ABA Formal Opinion 85-352 warns, without explanation, that “in many cases a lawyer must realistically anticipate that the filing of a tax return may be the first step in a process that may result in an adversarial relationship between the client and the IRS.” ABA Comm. on Prof’l Ethics, Formal Op. 85-352 (1985) [hereinafter Formal Op. 85-352].

cooperate in the crackdown on abusive tax shelters in the early 1980s—restate an adversarial relationship between taxpayers and the IRS with respect to tax shelter opinions issued to taxpayer-clients.²⁰⁸ Achieving an open, transparent, and reciprocal tax regulatory environment requires altering the rules under which tax practitioners plan transactions and advise clients.

IV. ELEVATING PRACTICE STANDARDS AND HEIGHTENING DISCLOSURE RULES

A. *The Failure of Self-Regulation*

In 1980, the IRS reported that abusive tax avoidance was threatening to destroy the tax system. Tax shelters were shunting billions of dollars from the government, overloading the court system,²⁰⁹ and creating a tax administration problem “of major proportions.”²¹⁰ Nearly 200,000 individual tax returns representing 18,000 shelter schemes clogged the IRS examination and appeals process.²¹¹ These returns, IRS Commissioner Jerome Kurtz said, involved almost \$5 billion “in questionable deductions.”²¹² “The great abuse we are finding in this area,” Kurtz warned, “could result in a serious decline in taxpayers’ perception of the fairness and evenhandedness of our administration of the tax system and consequently in the level of voluntary compliance.”²¹³ The Treasury Department’s General Counsel expressed similar fears, stating that the “widespread nature” of tax shelters “undermines the public’s confidence in the fairness of the tax system,” and ultimately “may affect the level of

²⁰⁸ ABA Comm. on Prof’l Ethics, Formal Op. 346 (1982). For a fuller discussion of Opinion 346, see Dennis J. Ventry, Jr., *ABA Formal Opinion 346 and a New Statutory Penalty Regime*, 111 TAX NOTES 1269 (2006).

²⁰⁹ Tax shelter litigation accounted for more of the increase in caseload for the U.S. Tax Court than any other kind of controversy. Between 1980 and late 1982, tax shelter cases tripled from 5000 to over 15,000, comprising nearly one-third of the entire docket. New York State Bar Association Tax Section, *Managing the Tax Court Docket*, 85 TNT 146-93 (July 24, 1985).

²¹⁰ Jerome Kurtz, *Kurtz on “Abusive Tax Shelters,”* 10 TAX NOTES 213, 213 (1980). Beginning in the 1970s, tax shelter promoters began peddling tax-favored investments for high-income individuals involving the leveraged purchase through partnerships of tax-preferred assets such as real estate or oil and gas tax shelters. These transactions were effectively shut down in the 1980s by a combination of legislative fixes—primarily the passive loss rules, see I.R.C. § 469 (2000), and at-risk rules, see *id.* § 465—falling inflation, and general tax reform that curtailed tax preferences and lowered rates. Despite these legislative fixes, and largely due to the ingenuity of tax lawyers, new sheltering techniques involving complex financial transactions and aggressive arbitrage were soon available to high-income taxpayers and corporations. Unlike the individual tax shelters of the 1970s and 1980s, there was no magic legislative bullet to undercut the modern tax shelter transaction. The tax shelter marketplace of the 1990s and 2000s was a different creature altogether, in terms of complexity, dollars lost to the federal treasury, and tax advisors playing loose with the rules.

²¹¹ Kurtz, *supra* note 210, at 213; see also Editor, *Little Consensus on IRS Advisory Group*, 5 TAX NOTES 2 (1977) (discussing the backlog of shelter cases at the examination stage).

²¹² Kurtz, *supra* note 210, at 213.

²¹³ *Id.*

voluntary compliance.”²¹⁴

The Treasury Department felt that tax lawyers were complicit in the proliferation of tax shelters. In particular, the lawyer’s written legal opinion legitimized questionable schemes and provided penalty protection for taxpayer-clients.²¹⁵ Attacking tax shelters meant attacking the legal opinions, which, in turn, meant attacking the opinion writers, who owed “a particular responsibility to Treasury.”²¹⁶ Through opinion writing, tax attorneys “control[led] access to the market place.”²¹⁷ By virtue of that power and “the privileged position given the attorney by our system of law and government,” the tax lawyer shouldered professional obligations that extended beyond blind client fidelity.²¹⁸

The government set about reminding tax practitioners of their multiple responsibilities. By offering amendments in 1980 to Circular 230,²¹⁹ the federal regulations governing standards of tax practice, the Treasury Department raised the ethical bar on tax practitioners, deputizing them (largely involuntarily) in the fight against abusive tax shelters.²²⁰ The 1980 amendments, in combination with subsequent amendments issued in 1986,²²¹ 1992,²²² 2000,²²³ 2001,²²⁴ and 2003,²²⁵ raised due diligence requirements for practitioners writing legal opinions; prohibited opinions

²¹⁴ Robert H. Mundheim, *Mundheim on “Abusive Tax Shelters,”* 10 TAX NOTES 213, 213 (1980); see also James B. Lewis, *The Treasury’s Latest Attack on Tax Shelters*, 11 TAX NOTES 723, 723 (1980) (noting that tax shelters produce “impairment to the fairness of the income tax, the perception of unfairness by the rest of the taxpaying public, and the feared adverse impact on the level and temper of voluntary compliance”).

²¹⁵ Mundheim, *supra* note 214, at 213–14 (noting that “the tax opinion is viewed as fraud insurance” whereby the investor “is protected against loss” from penalties for underpayment of tax).

²¹⁶ Jerome Kurtz, *Professional Opinions as “Tickets to the Audit Lottery,”* 12 TAX NOTES 262, 262 (1981).

²¹⁷ Mundheim, *supra* note 214, at 214.

²¹⁸ *Id.*

²¹⁹ 31 C.F.R. pt. 10 (2007). Circular 230 regulations govern tax practice “in front of the IRS,” which is read broadly to include all written tax advice, from planning to litigation.

²²⁰ See Tax Shelters: Practice Before the Internal Revenue Service, 45 Fed. Reg. 58,594, 58,594–95 (proposed Sept. 4, 1980) (to be codified at 31 C.F.R. pt. 10); Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 49 Fed. Reg. 6,719, 6,722 (Feb. 23, 1984) (to be codified at 31 C.F.R. pt. 10).

²²¹ See Tax Practitioners, 51 Fed. Reg. 29,113, 29,113 (proposed Aug. 14, 1986) (to be codified at 31 C.F.R. pt. 10).

²²² See Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 57 Fed. Reg. 46,356, 46,360 (proposed Oct. 8, 1992) (to be codified at 31 C.F.R. pt. 10).

²²³ See Notice of Proposed Rulemaking, Amendments to the Standards of Practice Governing Tax Shelters and Other General Matters, 65 Fed. Reg. 30, 375 (May 11, 2000).

²²⁴ See Regulations Governing Practice Before the Internal Revenue Service, 66 Fed. Reg. 3,276, 3,294–96 (proposed Jan. 12, 2001) (to be codified at 31 C.F.R. pt. 10); Regulations Governing Practice Before the Internal Revenue Service, 67 Fed. Reg. 48,760, 48,771, 48,774 (July 26, 2002) (to be codified at 31 C.F.R. pt. 10).

²²⁵ See Regulations Governing Practice Before the Internal Revenue Service, 68 Fed. Reg. 75,186, 75,189–90 (proposed Dec. 30, 2003) (to be codified at 31 C.F.R. pt. 10); Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75,839, 75,844 (Dec. 20, 2004) (to be codified at 31 C.F.R. pt. 10).

that failed to reach a “more likely than not” conclusion that the reporting position would prevail if it were challenged and litigated by the government; defined broadly what constituted a prohibited “tax shelter”; and imposed significant disciplinary penalties on practitioners and their firms—including monetary sanctions, public censure, suspension from practice, and even disbarment—for failing to meet the federal practice standards.

The Treasury Department called out the professional associations, particularly the ABA and AICPA, for ineffectually regulating the misconduct of their members. The abject failure of self-regulation was evident in the thriving tax shelter market, and the associations’ abysmally low ethical standards contributed directly to the creation, marketing, and advising of overaggressive transactions. When the Treasury Department first issued proposed regulations to Circular 230, the ABA’s prevailing ethical guidelines allowed a practitioner to advise a client to take advantage of a transaction so long as the practitioner believed in good faith there was a “reasonable basis” for the transaction, even though she may have also believed that the transaction would be challenged, litigated, and disallowed.²²⁶ A transaction that had a reasonable basis of being sustained on the merits was widely recognized to have a 10–20% likelihood of success.²²⁷ Critics characterized it as “noncompliance with scienter”²²⁸ and “anything you can articulate without laughing.”²²⁹ Furthermore, the standard was used to support “any colorable claim,”²³⁰ and it facilitated a race to the bottom among tax practitioners such that “[t]he one with the least conscience gets the best result.”²³¹

To this day, the ABA recognizes the debased reasonable basis standard as a satisfactory level of confidence when advising a client with respect to tax controversy representation, as well as negotiation and settlement proceedings. When advising tax reporting positions, the ABA requires a slightly higher level of confidence—“realistic possibility of success”—which allows the lawyer to advise a position so long as she believes in good faith the advice possesses a 33% likelihood of success.²³² This is the

²²⁶ ABA Comm. on Prof’l Ethics, *supra* note 206.

²²⁷ See Sheldon I. Banoff, *Dealing with the “Authorities”: Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties*, 66 TAXES 1072, 1128 (1988); J. Timothy Philipps et al., *What Part of RPOS Don’t You Understand?: An Update and Survey of Standards for Tax Return Positions*, 51 WASH. & LEE L. REV. 1163, 1193 (1994).

²²⁸ John André LeDuc, *The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Noncompliance*, 18 TAX NOTES 363, 365 (1983).

²²⁹ Lee A. Sheppard, *Ethics Opinion 314 and Tax Shelters Addressed at ABA Meeting*, 22 TAX NOTES 757, 757 (1984) (quoting law professor Bernard Wolfman).

²³⁰ BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, STANDARDS OF TAX PRACTICE: PROFESSIONAL RESPONSIBILITY AND ETHICS 59 (1992).

²³¹ Commissioner Jerome Kurtz and Panel, *Discussion on “Questionable Positions,”* 32 TAX LAW. 13, 24 (1978) (remarks of Commissioner Kurtz).

²³² Formal Op. 85-352, *supra* note 207. For interpretation of the reasonable possibility of success

same standard used by the AICPA.²³³ It effectively means that tax practitioners can advise taxpayer clients on transactions and reporting positions that they believe, if discovered, challenged, and litigated, possess a one in three possibility of being sustained on the merits.

These phenomenally low ethical guidelines encourage a “catch-me-if-you-can” mentality that subverts statutory purpose and Congressional intent. If we are serious about reducing abusive tax avoidance, we must elevate practice standards. As importantly, we must not leave to the professional associations the responsibility of articulating appropriate standards and ethical guidelines. Historically, these organizations have promulgated rules benefiting their members’ interests while undermining the integrity of the tax system. Self-regulation has failed. The history of tax shelters in the United States implicates the professional associations and their depraved practice standards as culprits in aggressive taxpayer behavior, tax avoidance, creative noncompliance, and even evasion.²³⁴ Though the ABA and AICPA have historically been resistant to the government imposing practice standards on its respective membership,²³⁵ Congress and the Treasury Department have forced elevated practice standards and ethical guidelines on a reluctant practitioner community.

Congress and Treasury continue to press for additional reforms. Having succeeded in applying the more likely than not standard to written

standard, see Treas. Reg. § 1.6694-2(b) (2008); Banoff, *supra* note 227, at 1128; Philipps et al., *supra* note 227, at 1193.

²³³ AICPA Federal Taxation Executive Committee, Statements on Responsibilities in Tax Practice (SRTP), No. 1, Tax Return Positions (rev. 1988).

²³⁴ For a discussion of this history from the 1970s to the 1990s, see Dennis J. Ventry, Jr., *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, 111 TAX NOTES 823 (2006); Dennis J. Ventry, Jr., *Tax Shelter Opinions Threatened the Tax System in the 1970s*, 111 TAX NOTES 947 (2006); Dennis J. Ventry, Jr., *Reasonable Basis and Ethical Standards Before 1980*, 111 TAX NOTES 1047 (2006); Dennis J. Ventry, Jr., *The Reaction to the 1980 Proposed Amendments to Circular 230*, 111 TAX NOTES 1141 (2006); Ventry, *supra* note 208; Dennis J. Ventry, Jr., *No Joke: Circular 230 Is Here To Stay*, 111 TAX NOTES 1409 (2006); Dennis J. Ventry, Jr., *Lowering the Bar: ABA Formal Opinion 85-352*, 112 TAX NOTES 69 (2006); Dennis J. Ventry, Jr., *Filling the Ethical Void: Treasury’s 1986 Circular 230 Proposal*, 112 TAX NOTES 691 (2006); Dennis J. Ventry, Jr., *Vices and Virtues of an Objective Reporting Standard*, 112 TAX NOTES 1085 (2006); Dennis J. Ventry, Jr., *IRS Penalty Report: A Call for Objective Standards*, 112 TAX NOTES 1183 (2006); Dennis J. Ventry, Jr., *Tax Politics and the New Substantial Understatement Penalty*, 113 TAX NOTES 98 (2006).

²³⁵ With each government incursion into regulating tax practice standards, the professional organizations have reacted as if the sky were falling. In 1980, after the Treasury Department issued amendments to Circular 230, the New York State Bar Association stated that the government’s attempt to regulate practice standards was inherently dangerous and a threat to “our heritage of freedom.” New York State Bar Association Tax Section, *Circular 230 and the Standards Applicable to Tax Shelter Opinions*, 12 TAX NOTES 251, 259 (1981). In addition, a future chair of the ABA Section of Taxation expressed an opinion shared by the ABA that heightened reporting requirements created “a chilling effect on advocacy.” Paul J. Sax, *Lawyer Responsibility in Tax Shelter Opinions*, 34 TAX LAW. 5, 44 (1980). The Treasury’s more recent amendments to Circular 230 generated a similar reaction. See *infra* notes 293–97 and accompanying text. But see Rostain, *supra* note 55, at 81 (finding a “nuanced conception of professionalism” among elite corporate lawyers and the tax bar supporting reforms in reporting standards).

opinions under Circular 230,²³⁶ Congress passed legislation in 2007 imposing the same standard on tax return preparers under the Code's penalty provisions.²³⁷ Under prior law, the Code merely required practitioners to reach a "realistic possibility of success" determination before advising a taxpayer on undisclosed (non-shelter) positions or transactions.²³⁸ Under new law, practitioners must demonstrate a "reasonable belief" that the tax treatment of an undisclosed position would more likely than not be sustained on its merits before advising the position.²³⁹ For disclosed positions, preparers must show a "reasonable basis" for the position (rather than prior law's "non-frivolous" standard, corresponding to a lowly 5–10% chance of success).²⁴⁰ To address practitioner concerns pertaining to the implementation of the new standard, Treasury issued transitional relief applying prior law to returns filed for tax year 2007.²⁴¹ Moreover, it has continued to evaluate ways to align the standard for preparers with that for taxpayers, the latter of which currently requires taxpayers to meet a lower threshold—"substantial authority"—for reporting a position on a tax return, a level of certainty ranging between 40 and 51%.²⁴² The higher standard for tax practitioners compared to taxpayers "has caused much angst for accountants and attorneys."²⁴³ In particular, practitioners have complained about a potential conflict of interest vis-à-vis taxpayer clients, as well as greater costs for taxpayers, practitioners, and the government.²⁴⁴

²³⁶ See *supra* note 219.

²³⁷ Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28, § 8246, 121 Stat. 200, (2007); see also Prop. Treas. Reg. §§ 6694–95, 73 Fed. Reg. 34,560 (June 17, 2008) [hereinafter Prop. Treas. Reg. §§ 6694–95].

²³⁸ IRS Notice 2008-13, 2008-3 I.R.B. 282.

²³⁹ *Id.*

²⁴⁰ *Id.* A practitioner possesses a "reasonable belief" that the position would more likely than not be sustained on the merits if she analyzes the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(g)(4) (2008) and, in reliance upon that analysis, "reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS." IRS Notice 2008-13, *supra* note 238, at *13–14. "Reasonable basis" under the new law is interpreted in accordance with Treas. Reg. § 1.6662-3(b)(3), the threshold for which reflects "a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim." *Id.*

²⁴¹ IRS Notice 2007-54, 2007-27 I.R.B. 12; IRS Notice 2008-11, 2008-3 I.R.B. 279.

²⁴² Alison Bennett, *Desmond Discusses Range of Issues Under New Preparer Penalty Standards*, 234 DAILY TAX REP. (BNA), at G-11 (Dec. 6, 2007). For the taxpayer understatement penalty and substantial authority requirement, see I.R.C. § 6662(d)(2)(B)(i) (2000); INTERNAL REVENUE SERVICE, EXECUTIVE TASK FORCE, COMMISSIONER'S PENALTY STUDY, REPORT ON CIVIL TAX PENALTIES, CHAPTER 8 (1989), at 43 (substantial authority "should approach" 51% but could extend as low as 45%); Philipps, et al., *supra* note 227, at 1193 ("around 40%"). But see Treas. Reg. § 1.6662-4(d)(2) (2008) (providing an even wider range in defining the substantial authority standard as "less stringent than the more likely than not standard [i.e., 51%] . . . but more stringent than the reasonable basis standard [i.e., 10–20%]").

²⁴³ Diane Freda, *Webcast Highlights Questions on Guidance on Tax Preparer Standards*, 10 DAILY TAX REP. (BNA), at G-4 (Jan. 16, 2008).

²⁴⁴ See New York State Bar Association Tax Section, *Recent and Proposed Statutory Changes to*

Though practitioners had hoped that Treasury would equalize the standards by lowering the tax preparer standard to “substantial authority,”²⁴⁵ Treasury appears committed to the higher, more likely than not standard for practitioners.²⁴⁶ This commitment indicates that to the extent Treasury equalizes the standards, it will raise the threshold for taxpayers rather than lower the threshold for practitioners. A more likely than not requirement for both taxpayers and tax practitioners would encourage taxpayers and their advisors to work together to locate the most likely “correct” answer for return positions. In this way, the more likely than not standard would reinforce the familiar *jurat* on the Form 1040 requiring a taxpayer to attest “[u]nder penalties of perjury” that she has examined her return, and to the best of her “knowledge and belief it is true, correct, and complete.” If the affidavit is to have any meaning—indeed, if “true, correct, and complete” is to have any meaning—it must mean that the taxpayer believes that an asserted position will be adjudged “correct” at least half the time.²⁴⁷ In addition, a more likely than not standard forces practitioners to reject “literalist interpretations that break the connection between language and underlying purpose” of the tax law.²⁴⁸

In addition to reinforcing a purposive approach to statutory interpretation, a more likely than not standard would augment principles of reciprocity, taxpayer-government interaction, and regulatory transparency. If a practitioner and her client wish to assert a position that fails to meet the more likely than not standard, perhaps one they believe in good faith reinforces the purpose of the statute, they should be able to do so as long as they disclose it on the return. Predicting whether a reporting position will prevail if litigated contains inherent uncertainties, particularly when courts can rely on language of the statute, purpose of the transaction, legislative intent, or any combination of the three. Disclosure provides a legitimate option for taxpayers wanting to test or clarify a law or assert a non-

Tax Return Preparer Penalty Rules of Internal Revenue Code Section 6694 and Related Issues, available at 18 TAXCORE (BNA) (Jan. 19, 2008) (urging adoption of substantial authority standard rather than more likely than not standard to unify preparer and taxpayer standards and to avoid conflicts of interest); American Bar Association Section of Taxation, *Comments on Changes to Standards for Imposition of Certain Penalties*, available at 222 TAXCORE (BNA) (Nov. 19, 2007) (discussing increased burdens, conflict of interest, and preference for substantial authority over more likely than not); American Institute of Certified Public Accountants, *Statement Submitted to Senate Finance Committee, Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure* (2007) (arguing that the higher reporting standard would impose “an unworkable burden for the entire tax system” by prompting excessive disclosure).

²⁴⁵ *Id.*

²⁴⁶ See Prop. Treas. Reg. §§ 6694–95, 73 Fed. Reg. 34, 564.

²⁴⁷ The same can be said of I.R.C. § 7206(1) (2000), which makes it a felony for an individual to “willfully” make and subscribe to a tax return which she does not believe “to be true and correct as to every material matter.” See Calvin Johnson, “True and Correct”: *Standards for Tax Return Reporting*, 43 TAX NOTES 1521 (1989).

²⁴⁸ Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 639 (2006).

frivolous but weak position. Additionally, taxpayers could seek pre-filing resolution of uncertain positions from the IRS. To the extent taxpayers prefer review by the courts rather than the Service, Congress or Treasury could institute expedited refund claim procedures whereby taxpayers could report and pay tax liability based on the more likely than not standard, and simultaneously file a refund claim requesting immediate administrative denial of the claim to facilitate judicial review.²⁴⁹

It is important to acknowledge that a more likely than not standard would not necessarily eliminate abusive behavior. First, nearly all of the legal opinions that propped up the most notorious tax shelters of the 1990s and 2000s concluded that the underlying transactions were at least more likely than not correct.²⁵⁰ Elevated standards would not have deterred the creation and marketing of these transactions. Second, raising the required level of certainty to more likely than not—or even “should” or “will”—would do nothing to alter the behavior of tax lawyers who conceive of their role as legal advisors to include *only* a duty to inform clients of potential penalties associated with positions falling below statutory requirements.²⁵¹ Third, heightened reporting standards would not stop lawyers from *orally* advising overaggressive positions, a form of advice not currently covered by Treasury regulations pertaining to *written* opinions.²⁵² In fact, oral advice can circumvent any standard, particularly given the difficulties of

²⁴⁹ *Id.* at 642.

²⁵⁰ *See, e.g.,* Swartz v. KPMG LLP, 476 F.3d 756 (9th Cir. 2007) (involving a legal opinion concluding that a BLIPS [Bond Linked Issue Premium Structure] transaction was more likely than not valid); Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 2007) (involving a legal opinion from a different law firm concluding that a BLIPS transaction was more likely than not valid); Hoehn Family LLC v. PriceWaterhouseCoopers LLP, No. 07-0069, 2007 U.S. Dist. LEXIS 23422 (D. Mont. Mar. 30, 2007) (involving a legal opinion concluding that a FLIP transaction [Foreign Leverage Investment Program] was more likely than not valid); Denney v. Jenkins & Gilchrist, 340 F. Supp. 2d 338 (S.D.N.Y. 2004) (involving a legal opinion concluding that a COBRA [Currency Options Bring Reward Alternatives] transaction was more likely than not valid).

²⁵¹ Imagine the following scenario: A client comes to her tax advisor with a transaction that relies on a literal reading of the statute and that reflects a confidence level of 25% chance of success. How should the tax lawyer advise that client? Many attorneys would respond that all that is required is to predict how the IRS or the courts will react to the transaction. Under this view, it is not the role of the lawyer to say “yes” or “no” to the transaction based on the lawyer’s personal views of the morality of the deal, the purpose of the statute, or what will happen to the tax system if the transaction works. It is the lawyer’s role to review with the client all statutory and non-statutory requirements of the law. But beyond that, the lawyer is merely required to inform the client of the likelihood that the transaction will be upheld if challenged, as well as the likelihood of penalties if it is challenged and not upheld. At that point, the lawyer has fully complied with all applicable ethical and professional duties, and the client can decide for herself if she wants to engage in the transaction and how she wants to report it. The tougher scenario involves the lawyer developing the 25% likelihood of success transaction herself and subsequently peddling it to her client. Even then, many lawyers would condone such behavior so long as the lawyer fully disclosed the risks associated with the transaction.

²⁵² *See infra* note 253. Conversations with practitioners in New York, Los Angeles, and Washington, DC, revealed that some tax lawyers have responded to the more likely than not standard for certain written opinions by issuing advice orally, supplemented by internal memoranda used as talking points with clients, the latter of which are considered privileged and therefore neither disclosable nor discoverable absent client waiver.

policing advice without a paper trail and with the protective shield of privilege.

Notwithstanding these limitations, a more likely than not standard would assist in transforming compliance norms. If we remain concerned about the above loopholes (that is, a limited duty for attorneys and the shift to oral advice not covered by current opinion standards), we might consider extending the heightened standard to oral as well as written advice, and eliminating privilege and work-product protection from pre-return tax planning.²⁵³ Even absent such reforms, a more likely than not reporting standard would discourage literal interpretations of the law in so far as such analyses would lack sufficient authority beyond statutory language.

If policymakers were reluctant to apply the more likely than not standard to areas outside tax law, they might consider extending a radical reform currently taking place *within* tax law. In August 2005, the Department of Justice entered into a deferred prosecution agreement with KPMG as part of its multi-billion dollar criminal tax fraud investigation involving abusive tax shelters.²⁵⁴ The signed agreement is a remarkable document, and imposes permanent restrictions on KPMG's tax practice, including requiring the firm to: cease (with limited exceptions) its private

²⁵³ See Beale, *supra* note 248, at 644–68 (arguing for eliminating privilege and work-product protection from pre-return tax planning). The subject of attorney-client and work-product protection has received considerable attention of late in the tax world. The Financial Accounting Standards Board (FASB) has reinterpreted how tax practitioners should account for uncertainty in income taxes on financial statements. FIN. ACCT. STANDARDS BD., FASB INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES 1 (2006). The FASB Interpretation No. 48 (FIN 48) requires companies to conduct detailed issue-by-issue analyses of all tax positions, an inquiry that generates documents and disclosures tracking legal analysis of tax advisors on a company's transactions. *Id.* at 32. These documents, in turn, may become integrated into the tax accrual workpapers of a company's auditors who review them before signing off on financial statements. Under longstanding Supreme Court precedent, if the documents become part of the auditor's workpapers, they are no longer privileged and therefore subject to disclosure to the IRS. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 815–17 (1984) (finding tax accrual workpapers not privileged if requested under IRS summons power provided in I.R.C. § 7602). Practitioners have expressed concern that disclosure of internal evaluations pertaining to uncertain tax positions waives protection of the evaluations to future discovery requests, and provides tax officials with a heretofore protected roadmap for locating and challenging soft spots in a taxpayer's return. See Tom Jaworski & Allen Kenney, *PCAOB Officials Discuss Tax Accrual Workpapers*, FIN 48, 2007 TAX NOTES TODAY 48-6 (Mar. 12, 2007), available in LEXIS, Fedtax Library, TNT File; Fred F. Murray, *FASB and IRS Working on FIN 48 Implementation*, DAILY TAX REP. (BNA), at J-1 (Mar. 15, 2007). Recently, a federal court in Rhode Island and another in Alabama refused to enforce IRS summonses by finding tax accrual workpapers privileged under the work-product doctrine. *United States v. Textron Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007); *Regions Fin. Corp. v. United States*, No. 2:06-CV-00895-RDP, 2008 U.S. Dist. LEXIS 41940 (N.D. Ala. May 8, 2008). The government has appealed both cases. For a critique of the cases and a discussion of their adverse implications on tax enforcement, see Dennis J. Ventry, Jr., *Protecting Abusive Tax Avoidance*, 120 TAX NOTES 857 (2008).

²⁵⁴ U.S. DEP'T OF JUSTICE, KPMG DEFERRED PROSECUTION AGREEMENT 1 (2005), <http://www.usdoj.gov/usao/nys/pressreleases/August05/kpmgdpagmt.pdf> [hereinafter DPA]; IRS News Release IR-2205-83 (Aug. 29, 2005), available at <http://www.irs.gov/newsroom/article.0,,id=146999,00.html>.

client tax practice as well as its compensation and benefits practice; refrain from developing, marketing, selling, or implementing pre-packaged tax products; and restrict severely its tax preparation services.²⁵⁵

More importantly, the deferred prosecution agreement requires KPMG to apply significantly elevated standards to its tax practice. Rather than the otherwise prevailing more likely than not standard, the agreement requires KPMG to meet a “should” standard for all “covered opinions,”²⁵⁶ as well as for tax return preparation involving “principal purpose”²⁵⁷ or “listed”²⁵⁸ transactions. These elevated standards apply to transactions involving all taxpayer-clients, including individuals, private enterprises, and public corporations. Moreover, the agreement mandates that KPMG adhere to elevated standards when providing covered opinions for individuals and private entities on non-controversial transactions (“should” rather than “more likely than not”) and when providing tax return preparation on all other transactions (“more likely than not” rather than “realistic possibility of success”).²⁵⁹ Only when advising large private entities and public corporations on non-controversial transactions and run-of-the-mill tax return preparation may KPMG follow the same standards as other practitioners.²⁶⁰ While firms have not rushed to adopt similarly high standards, there has been no observable, adverse impact on KPMG’s tax practice associated with the heightened requirements.

B. *Disclosure Rules for Increased Transparency and Certainty*

Practice standards by themselves will not alter practitioner behavior. To animate the standards and to change behavior, tax officials must have at their disposal some way to determine if practitioners are complying with the heightened requirements. Stricter disclosure rules provide the window through which the government can monitor tax practitioner and taxpayer behavior. As part of the deferred prosecution agreement discussed above, KPMG agreed to oversight for three years by an “independent monitor” that, among other things, will ensure that KPMG is acting in accordance with the agreement.²⁶¹ At the end of the monitor’s term, the IRS will

²⁵⁵ DPA, *supra* note 254, at 4–5.

²⁵⁶ Covered opinions include: listed transactions, *see supra* note 162, or a substantially similar transaction, 31 C.F.R. § 10.35(b)(2)(i)(A) (2007); a transaction, the principal purpose of which is the avoidance of tax, *id.* § 10.35(b)(2)(i)(B); or a transaction, a significant purpose of which is the avoidance of tax, if the opinion is either a reliance opinion, a marketed opinion, an opinion subject to conditions of confidentiality, or an opinion subject to contractual protection, *id.* § 10.35(b)(2)(i)(C).

²⁵⁷ *See* 26 C.F.R. § 1.6662-4(g)(2)(ii)(C) (2005) (defining principal purpose as any plan or arrangement designed to avoid or evade federal income tax such that the motive to avoid or evade exceeds any other motivation).

²⁵⁸ *See supra* note 162.

²⁵⁹ DPA, *supra* note 254, at 7.

²⁶⁰ *Id.*

²⁶¹ *See id.* at 18.

oversee KPMG's "compliance with the restrictions and elevated standards" for an additional two years.²⁶² The monitoring can be thought of as an extreme form of mandatory disclosure.

Disclosure, in and of itself, can be a good thing.²⁶³ It helps the government identify prohibited or potentially prohibited behavior. Disclosure also alters norms by adding risk to a taxpayer's evaluation of whether and how to comply with the law. Disclosure provides a particularly effective incentive in the presence of low audit rates, where taxpayers otherwise evaluate risks with little concern that their reporting position will be seen by the government. In fact, disclosure can alter compliance norms not only with respect to plainly prohibited or probably prohibited transactions, but also with respect to probably permissible transactions, particularly if the government might designate those transactions as prohibited in the future.²⁶⁴ Of course, there is such a thing as too much disclosure, where the government cannot process the information or the taxpayer is overburdened by the requirements.²⁶⁵ However, so long as the advantages of disclosure (e.g., altering wasteful planning and avoidance behavior) exceed the disadvantages (e.g., overburdening the government or the taxpayer), disclosure requirements should be included in any tax compliance strategy.

The combination of elevated practice standards and heightened disclosure rules can shift compliance norms. Prevailing standards based on adversarial norms encourage literalist interpretations of the law because such interpretations can provide sufficient authority if challenged and litigated. Meanwhile, practice standards based on a more likely than not norm reinforce a purposive approach to statutory interpretation. With elevated standards, practitioners have to do more than simply rely on statutory language to support a position, particularly in the presence of

²⁶² *Id.* at 25.

²⁶³ See, e.g., Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 69–70 (2001) (stating that to combat "what amounts to audit lottery and to nip schemes in the bud, airtight, focused, prompt and efficient disclosure rules are required"); Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031, 1060 n.96 (2007) (disclosure can alter taxpayer norms, "[e]ven with a low risk of audit"). But see David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73, 73–78 (2001) (arguing that disclosure will not curb abusive behavior, and may even worsen it by producing continual changes to substantive law around which lawyers could plan).

²⁶⁴ This is basically Dan Shaviri's point respecting the new category of reportable deals, "transactions of interest." See *supra* note 107. According to Shaviri, requiring disclosure of these transactions is "important and valuable" for several reasons, including "the prospect that a deal not currently required to be disclosed may subsequently become so," which, in turn, "may serve as a socially valuable deterrent when taxpayers are contemplating in questionable newly designed transactions." Shaviri, *supra* note 115, at 33.

²⁶⁵ See Joshua D. Blank, *Overcoming Disclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. (forthcoming 2009), available at <http://ssrn.com/abstract=1285342> (arguing that mandatory disclosure rules can result in opportunistic overdisclosure that could hamper anti-shelter efforts).

heightened disclosure requirements. They have to examine additional sources of statutory interpretation (such as legislative intent and public purpose), and they have to evaluate how individual statutes interact with other statutes, as well as how that interaction might reinforce or destroy the underlying purpose of the statutes in combination with each other.

Heightened disclosure rules under a more likely than not standard in the tax context should be viewed as part of a larger trend toward greater corporate transparency. Within the last several years, the Sarbanes-Oxley Act (Sarbanes-Oxley) has subjected corporations to significantly stricter disclosure rules²⁶⁶ and internal controls.²⁶⁷ Sarbanes-Oxley also established the Public Company Accounting Oversight Board to regulate the auditors of public companies and to conduct independent investigations and disciplinary proceedings of public accounting violations.²⁶⁸ Other recent changes to federal securities law require registered companies to provide “material historical and prospective textual disclosure”²⁶⁹ relevant to an understanding of its financial condition.²⁷⁰ In addition, the IRS has rolled out new Schedule M-3 as part of the corporate tax return to help the IRS find relevant information (assuming all cash is accounted for properly on the return) by reconciling a corporation’s financial accounting income (i.e., “book income”) with its taxable income (i.e., “tax income”).²⁷¹ Finally, the Financial Accounting Standards Board (FASB) has instituted significant changes to how companies account for uncertainty in income taxes recognized on financial statements. FASB Interpretation No. 48 (FIN 48) clarifies the treatment of unrealized income tax benefits and liabilities on financial statements by requiring domestic public companies to assess whether their tax positions are more likely than not correct and to reflect the results of that assessment in financial disclosures.²⁷² If a taxpayer determines that a position meets or exceeds the more likely than not standard, it can report the tax benefit without setting aside corresponding reserves; if not, it must provide adequate reserves to cover

²⁶⁶ See Sarbanes-Oxley Act of 2002, Pub. L. No. 204, §§ 406–07, 116 Stat. 745; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-47,235, 79 SEC Docket 1077 (Jan. 24, 2003).

²⁶⁷ See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006); Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 34-47,986, 80 SEC Docket 1014 (June 5, 2003).

²⁶⁸ Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C. § 7211 (establishing the Public Company Accounting Oversight Board and outlining its duties).

²⁶⁹ Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Exchange Act Release No. 34-26,831, 43 SEC Docket 1330 (May 18, 1989).

²⁷⁰ See 17 C.F.R. § 229.303 (2008).

²⁷¹ INTERNAL REVENUE SERVICE, DRAFT OF SCHEDULE M-3 (FORM 1120-F), NET INCOME (LOSS) RECONCILIATION FOR FOREIGN CORPORATIONS WITH REPORTABLE ASSETS OF \$10 MILLION OR MORE (2008), available at <http://www.irs.gov/pub/irs-dft/f1120fm3--dft.pdf>.

²⁷² See *supra* note 253.

the contingency. According to the IRS, FIN 48 increases transparency, assists the government in distinguishing between compliant and noncompliant taxpayers, and provides corporate taxpayers greater certainty with respect to tax reporting positions.²⁷³

All these reporting regimes share the same goal of enhanced transparency. Regulated parties possess information that the government wants, but they are reluctant to turn over the information without good reason. Indeed, turning over the information typically puts a party at a disadvantage vis-à-vis other parties. Heightened disclosure rules provide “good reason” to report relevant information, while elevated practice standards provide the framework to evaluate one’s responsibilities under the rules. The last Part of this Article continues this discussion by examining the regulatory tradeoffs between rules versus standards in facilitating compliance, and by evaluating the government’s recent attempts to regulate the behavior of tax practitioners through a combination of the two approaches.

V. RULES VS. STANDARDS AND THE FEDERAL REGULATION OF TAX PRACTITIONERS

A. *Rules vs. Standards and Cooperative Regulation*

As tax regulators continue to work with tax professionals and taxpayers to improve compliance, the government needs at its disposal a judicious mix of rules and standards. Rules provide certainty of outcome and lower compliance costs, and enhance due process and fair treatment. Standards, for their part, breathe life into rules, adding context, intent, and purpose to text and language. In other words, standards provide coherence to a bunch of otherwise independent rules by giving them an overarching purpose. Reliance on rules alone would require that legislators, regulators, and legislative drafters possess a crystal ball to predict all potential uses and abuses of each and every tax provision, both in isolation and in combination with each other.²⁷⁴ Even if policymakers were somehow

²⁷³ See, e.g., Weinberger et al., *supra* note 79, at 60–61 (remarks of Deborah Nolan, viewing FIN 48 disclosures as part of an “environment of increased transparency,” and stating that FIN 48 “increases the corporate taxpayer’s need for certainty, where we might be able to provide a service. And from a practical standpoint, it could provide us with additional information and data for our risk assessment tools as well”).

²⁷⁴ Given the infinite transactional permutations for tax planning, relying on rules alone would be futile and even irresponsible. See David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 TAX L. REV. 29, 33 (2006) (“No government can foresee, let alone draft, rules that produce the ‘right’ tax results under every conceivable permutation of facts that can be constructed by taxpayers in an increasingly complex financial world.”); see also Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673, 707 n.31 (1969) (writing that standards reduce complexity, and “save the tax system from the far greater proliferation of detail that would be necessary if the tax avoider could

equipped with the power to see into the future, reliance on rules alone would yield an unduly complex and distortive regime. Standards by themselves are not the solution either. The flexibility of standards can be a virtue in assisting regulators and courts in responding to unpredictable taxpayer behavior. But such flexibility can also produce increased uncertainty, higher compliance costs, and behavioral distortions. Moreover, standards run the risk of producing a one-way street in favor of the government, with tax authorities administering and enforcing the law with wide and arbitrary discretion. Also, depending on the regulatory culture and whether practitioners have the wrong attitude about what they are supposed to do for clients, standards can encourage literalist interpretations of the law as much as bright-line rules. In fact, bright-line rules may reflect an effort on behalf of regulators to stop abuses of more ambiguous standards.

Coordinated use of comprehensible rules and anti-abuse standards holds the promise of achieving optimal tax compliance with lower costs for taxpayers, tax regulators, and the tax system.²⁷⁵ A balanced compliment of rules and standards allows tax authorities to enunciate general principles and goals underlying the rules, and to rely on tax professionals and taxpayers to implement and fulfill those goals. Recently, courts have scrutinized tax practitioners' alleged compliance with legal rules in light of underlying standards, both with respect to applicable ethical standards as well as common law doctrines such as economic substance, business purpose, and substance over form.²⁷⁶ Complying with the literal terms of a statute or other legal rule was not necessarily enough in these cases; courts required practitioners to show compliance with the purpose of statutory language and respect for the coherence of the system.

Without standards to overlay rules, tax planning would run amok. Bright-line rules encourage literalist interpretations of the law and a myopic focus on form over substance. Faced with a bright-line rule, some tax advisors view it as their job to obscure and expand the line.²⁷⁷ The "ultimate question" in tax practice, law professor James Eustice has noted, is "where 'the line' is between acceptable tax planning and unacceptable

succeed merely by bringing his scheme within the literal language of substantive provisions written to govern the everyday world").

²⁷⁵ For a general discussion of rules and standards in tax law, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557, 586-96 (1992), and David A. Weisbach, *Formalism in the Tax Law*, 66 CHI. L. REV. 860, 863-77 (1999).

²⁷⁶ See *supra* note 250; see also *infra* note 289 for representative cases, and *infra* note 287 for the common law doctrines.

²⁷⁷ See David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 238 (1999) (stating that some lawyers' "reverence for our objective method of determining tax liabilities approaches something like religious fervor (or more cynically, they recognize that results based to the maximum extent on the unadulterated application of objective rules tend to aggrandize both the power and the pocketbook of the tax practitioner)").

overreaching, and, equally important, how clear that line should be.”²⁷⁸ Tax shelters, practitioner-scholar Peter Canellos has said, though perhaps on the legal side of the line, “almost always ignor[e] the underlying purpose of the law.”²⁷⁹ Standards provide a check on unadulterated tax reduction, and they offer the government, courts, and aggrieved taxpayers powerful weapons to wield against overreaching practitioners.

In recent years, the government has balanced rules with standards in its effort to improve compliance. As we have seen, the new rules include an enhanced statutory penalty regime and heightened disclosure requirements.²⁸⁰ With respect to standards, the government has adopted various anti-abuse rules and ethical guidelines to highlight the coherence of an otherwise independent set of rules. The anti-abuse “rules” operate more like standards. Typically promulgated by regulation but occasionally embedded directly in a statute, they override otherwise applicable legal rules when taxpayers enter into aggressive tax avoidance transactions deemed to violate the purposes of the statute or regulation. A transaction can run afoul of an anti-abuse rule even if it otherwise complies with statutory language. The use of such rules covers an increasing number of transactions, including the tax treatment of partnerships,²⁸¹ consolidated returns,²⁸² debt instruments,²⁸³ interest-rate, equity and commodity swaps,²⁸⁴ and net operating loss limitations.²⁸⁵ Essentially, the various anti-abuse rules reflect the spirit of common law doctrines that look to the overarching effect and purpose of a transaction rather than whether a taxpayer complied formulaically with the letter of the law. The anti-abuse rules for partnerships, for example, provide that if a partnership “is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent” of the partnership provisions, the government “can recast the transaction for federal tax purposes.”²⁸⁶ The anti-abuse rules parse the difference between the letter of the law and its spirit.

Anti-abuse rules also reflect explicit application of longstanding judicial doctrines that adopt a purposive rather than a literalist interpretation of the tax law. The most commonly known doctrines include economic substance, business purpose, sham transaction, and substance

²⁷⁸ James S. Eustice, *Abusive Corporate Tax Shelters: Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 136 (2002).

²⁷⁹ Canellos, *supra* note 263, at 52.

²⁸⁰ See *supra* Part IV.

²⁸¹ Treas. Reg. § 1.701-2 (2008).

²⁸² *Id.* § 1.1502-95.

²⁸³ *Id.* § 1.1275-2.

²⁸⁴ *Id.* § 1.446-3.

²⁸⁵ *Id.* § 1.172-3.

²⁸⁶ *Id.* § 1.701-2(b).

over form.²⁸⁷ The economic substance doctrine has been a particularly effective tool in the fight against tax shelters and reflects an amalgam of the other common law doctrines. At its core, it represents a judicial effort “to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.”²⁸⁸ In a stunning series of recent victories for the government, judges have wielded the economic substance doctrine to invalidate abusive transactions.²⁸⁹ Though courts acknowledge that taxpayers possess “an unquestioned right to decrease or avoid . . . taxes by means which the law permits,”²⁹⁰ they also perceive “a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate).”²⁹¹ The anti-abuse rules and judicial doctrines are designed to help taxpayers and tax regulators discern the real from the unreal, and thereby deter abusive tax avoidance behavior.

B. *An Enforceable Normative Standard*

The Treasury Department regulations governing tax practice also attempt to assist taxpayers and tax officials in discerning real from unreal transactions. To this end, the regulations employ a combination of elevated practice standards and strict disclosure rules that produce an enforceable normative standard.²⁹² This standard, backed by the threat of

²⁸⁷ For discussions of these doctrines, see Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU. L. REV. 9 (2001); Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU. L. REV. 149 (2001); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); Canellos, *supra* note 263; Hariton, *supra* note 274; Hariton, *supra* note 277; Dennis J. Ventry, Jr., *Save the Economic Substance Doctrine from Congress*, 118 TAX NOTES 1405 (2008).

²⁸⁸ *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1353–54 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007).

²⁸⁹ See, e.g., *BB&T Corp. v. United States*, 523 F.3d 461 (4th Cir. 2008); *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008); *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007); *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *Coltec Indus.*, 454 F.3d at 1340; *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006); *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *reconsideration denied*, 81 Fed. Cl. 173 (2008); *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007); *H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007).

²⁹⁰ *Jade Trading*, 80 Fed. Cl. at 45. This sentiment is captured most famously in the oft-quoted line from *Gregory v. Helvering*: “The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.” *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). The next line from the opinion is just as famous, though primarily due to its omission by pro-taxpayer courts and commentators: “But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.” *Id.*

²⁹¹ *Coltec Indus.*, 454 F.3d at 1357.

²⁹² See Camilla E. Watson, *Legislating Morality: The Duty to the Tax System Reconsidered*, 51 U. KAN. L. REV. 1197, 1236–37 (2003) (concluding that an enforceable normative standard is needed to discourage abusive tax planning); see also Anthony C. Infanti, *Eyes Wide Shut: Surveying Erosion in*

palpable sanctions, discourages abusive tax avoidance, while encouraging tax practitioners to adopt non-literal statutory interpretations and to make themselves aware of the public purposes underlying the tax laws.

The new Circular 230 rules impose significant responsibilities on tax practitioners. When the Treasury Department proposed its most recent amendments to tax practice standards, practitioners freaked out. Accountants Burgess and William Raby, the latter a former chair of the AICPA's Federal Tax Division, warned that tax practitioners and their clients were helplessly "caught up in a paradigm shift" that could alter tax practice as we know it.²⁹³ Practitioner "hue and cry"²⁹⁴ further charged that the new rules covering legal opinions and other written advice were "irrational" and "impediments to practice."²⁹⁵ They would "drive a wedge between taxpayer and professional advisor," lead to "intimidation tactics," dramatically increase the cost of tax advice, and push clients to disreputable practitioners.²⁹⁶ Taxpayers, tax advisors, tax officials, and the tax system would all be better off if Treasury simply "thr[e]w in the towel," and abandoned its twenty-five year effort to regulate tax shelters by regulating tax professionals.²⁹⁷

Practitioners may have overreacted to the new regulations, but they were right about one thing: the new rules had everything to do with regulating noncompliance by regulating practitioners. There are shortcomings to this strategy, to be sure, and tax officials need to recognize the "intrinsic limits of practitioner regulation in controlling the behavior of clients."²⁹⁸ Tax practitioners cannot change the hearts of taxpayers nor, for that matter, their desire for lower taxes. But tax practitioners do have a responsibility to lead clients, particularly if a client's normative standards threaten the coherence of the system and the underlying purpose of the tax laws. At some point, the practitioner must "stop being a tax advisor and become a professional,"²⁹⁹ obliged to follow a moral compass that asks more of her than morals articulated in positive legal rules.

If we are uncomfortable or unconvinced by such moral injunctions, the

the Professionalism of the Tax Bar, 22 VA. TAX REV. 589, 590 (2003) (writing that there has been a "true erosion in the professionalism of the tax bar").

²⁹³ Burgess J.W. Raby & William L. Raby, *Penalty Protection for the Taxpayer: Circular 230 and the Code*, 107 TAX NOTES 1257, 1257 (2005).

²⁹⁴ Deborah H. Schenk, *The Circular 230 Amendments: Time to Throw Them Out and Start Over*, 110 TAX NOTES 1311, 1318 (2006).

²⁹⁵ Sheryl Stratton, *Tax Officials Spar with Tax Bar over Circular 230*, 107 TAX NOTES 1082, 1082-83 (2005) (quoting practitioners).

²⁹⁶ Dan W. Holbrook, *Imagine the Worst the U.S. Treasury Could Do to Us—They've Done It: Revenge of the IRS: Circular 230 Changes Law Practice*, 41 TENN. B.J. 28, 30 (2005).

²⁹⁷ Schenk, *supra* note 294, at 1311.

²⁹⁸ Michael C. Durst, *The Tax Lawyer's Professional Responsibility*, 39 FLA. L. REV. 1027, 1030 (1987).

²⁹⁹ George Cooper, *The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform*, 80 COLUM. L. REV. 1553, 1581 (1980).

less overtly moral trappings of economic theory can lead us to similar conclusions. Modern economic thought holds that it is appropriate for regulators to shift the cost of compliance to the party or parties with the lower cost of monitoring.³⁰⁰ If the social value of the noncompliant activity is low, moreover, the socially optimal penalty for engaging in noncompliance can be quite large. In the realm of tax compliance, practitioners are undoubtedly in better positions to detect and deter noncompliance at lower cost than taxpayers or tax officials. They are “the first line of defense” against overaggressive tax avoidance.³⁰¹ It is therefore appropriate to shift the cost of compliance to practitioners and to regulate their behavior with an enforceable normative standard as a way to regulate the behavior of taxpayers.³⁰² It is also appropriate to impose severe, socially optimal penalties on their noncompliant behavior, at least insofar as we believe advising aggressive tax avoidance schemes contains little or no social value.

The new federal rules regulating tax practice are far from perfect. In some respects, they are overbroad, sweeping in plainly uncontroversial tax advice.³⁰³ The prevailing regime, in an attempt to improve transparency, also imposes unnecessary costs and inefficiencies on practitioners and clients, by, among other things, requiring practitioners to “prominently disclose” in all written advice that such advice cannot be used for purposes of avoiding penalties.³⁰⁴ This requirement has resulted in the ubiquitous “no-penalty reliance” legend that practitioners now routinely append to every written communication, not just official client communications and

³⁰⁰ See, e.g., Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1, 15 (1974) (concluding that private enforcement of public laws can be more efficient than public enforcement).

³⁰¹ Tom Gilroy, *IRS Chief Counsel Calls Practitioners “First Line of Defense” Against Fraud*, DAILY TAX REP. (BNA), at G-3 (Oct. 25, 2006) (quoting IRS Chief Counsel Korb).

³⁰² Recent changes to securities law also shift the cost of compliance to practitioners on the theory that insiders, particularly lawyer-insiders, are well-positioned to identify, address, and remedy legal violations. For instance, Section 307 of the Sarbanes-Oxley Act requires lawyers representing issuer clients in any capacity to “report up” evidence of a material violation of securities law or breach of fiduciary duty or similar violation within the issuer corporation to the chief legal counsel or CEO. 15 U.S.C. § 7245 (2006). Moreover, it permits lawyers to “report out” such evidence in the event the corporate entity does not stop, prevent, or remedy the alleged wrongdoing. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276 (Jan. 29, 2003).

³⁰³ See, e.g., David T. Moldenhauer, *Circular 230 Opinion Standards, Legal Ethics and First Amendment Limitations on the Regulation of Professional Speech by Lawyers*, 29 SEATTLE U. L. REV. 843 (2006); Michael Schler, *Effects of Anti-Tax-Shelter Rules on Nonshelter Tax Practice*, 109 TAX NOTES 915, 918–19 (2005) (arguing that Circular 230, created “for the purpose of attacking tax shelters,” heavily regulates “normal day-to-day tax practice”). It is worth noting that the government could easily focus the rules on abusive tax avoidance by requiring practitioners to “opt in” rather than “opt out” of the current system; that is, to affirm in writing when a legal opinion can be used by the taxpayer for penalty protection rather than affirming, as currently required, when an opinion cannot be used for penalty protection.

³⁰⁴ 31 C.F.R. § 10.35 (2007).

work product.³⁰⁵ If tax regulators wanted to enhance transparency in the current tax marketplace, they could ask taxpayers and their advisors to disclose what the government really wants: the opinion itself rather than information about certain transactions contained within the opinion.³⁰⁶ What better way to enlist practitioners' help in reducing noncompliance than requiring them to come clean on the kind of transactions they believe to be authorized, or they believe should be authorized, under the tax laws?

Although overbroad in important but not insoluble respects, the disclosure rules contained in Circular 230 move us toward cooperative tax regulation. With respect to legal opinions, Circular 230 requires that all covered opinions³⁰⁷ failing to reach a confidence level of "more likely than not" regarding one or more tax issues must include "appropriate disclosures."³⁰⁸ Circular 230 further specifies that such disclosures must state "prominently" that the opinion does not in fact reach a conclusion at a confidence level of at least more likely than not, and that the opinion cannot be used by the taxpayer for purposes of avoiding tax underpayment penalties. In other words, if a practitioner cannot conclude at a confidence level of at least more likely than not, then she must disclose that lack of confidence, both to the taxpayer and to the government. This approach encourages an honest, interactive approach to tax regulation that turns taxpayers and tax practitioners into stakeholders, partners in the legislative and regulatory effort to buttress tax compliance.

C. Assessing Compliance Risks Under the New Rules

The federal enforceable normative standard governing tax practice alters the cost-benefit analysis associated with noncompliance. In 2004, Congress authorized monetary penalties against practitioners and firms for Circular 230 violations.³⁰⁹ The IRS may impose penalties either in addition to or in lieu of other sanctions that may be levied by the Service,

³⁰⁵ An exemplary no-penalty reliance legend reads:

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing or recommending to another party any matters addressed herein.

Sheryl Stratton, *Circular 230 E-Mails, T-Shirts Attain "Legendary" Status*, 2005 TAX NOTES TODAY 127-1. For a discussion of the costs associated with the no-penalty reliance legend, see *id.*

³⁰⁶ See Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 353-54 (2002) (arguing that not requiring counsel to disclose its opinion about a full transaction "may seriously hurt the Service in its ability to discover and attack tax shelter transactions"). Requiring disclosure of opinions would have to overcome the same kind of privilege and work-product concerns discussed *supra* note 253.

³⁰⁷ For a definition of "covered opinion," see *supra* note 256.

³⁰⁸ 31 C.F.R. § 10.35(c)(3).

³⁰⁹ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 822(a)(1), 118 Stat. 1418, 1586.

including censure, suspension, or disbarment.³¹⁰ It will also post on the IRS website final agency disciplinary decisions pertaining to individual practitioners.³¹¹ The head of the IRS Office of Professional Responsibility (OPR) has said that the agency is not going after mere “foot faults,”³¹² but rather misconduct “out of the mainstream”³¹³ by “really bad actors,”³¹⁴ those “who put a blemish on the industry.”³¹⁵ Indeed, according to Michael Chesman, OPR Director, the IRS wants not only to “get the bad apples,”³¹⁶ but also “to protect the practitioners and the public who are behaving ethically.”³¹⁷ The sanctions will be used “only in extraordinary instances when traditional penalties may not appropriately punish violators,”³¹⁸ and will be focused on “fitness to practice, not punish.”³¹⁹

Despite these assurances, practitioner groups remain wary of the government’s “powerful new weapon to deter prohibited conduct.”³²⁰ They desire more certainty of what will and what will not be considered violations subject to monetary sanction, particularly because penalties could exceed fees collected on a transaction.³²¹ Practitioners are also wary of the process surrounding disciplinary proceedings conducted by the OPR that precede the imposition of sanctions. Though these proceedings are largely consistent with disciplinary procedures under ABA Model Rules

³¹⁰ 31 C.F.R. § 10.50.

³¹¹ *Tax Decisions & Rulings: OPR Posting Final Disciplinary Decisions for Circular 230 Violations on IRS Website*, DAILY TAX REP. (BNA), at K-1 (June 19, 2008); see also IRS Announcement 2008-52, 2008-22 I.R.B. 1040 (announcing disciplinary sanctions for violations of Circular 230); IRS Announcement 2008-50, 2008-21 I.R.B. 1024 (stating that the Office of Professional Responsibility will now publish a list of specific Circular 230 violations).

³¹² Steve Burkholder, *Ex-IRS Official Says Agency “Won War” on Shelters, Has “Fallen Short” on Tax Gap*, DAILY TAX REP. (BNA), at G-1 (Oct. 11, 2007) (quoting Michael Chesman, Director, IRS Office of Professional Responsibility).

³¹³ Diane Freda, *IRS Office of Professional Responsibility Looking for Conduct Outside Mainstream*, DAILY TAX REP. (BNA), at G-6 (Nov. 2, 2007) (quoting Brinton Warren, special counsel in IRS Office of Chief Counsel).

³¹⁴ Diane Freda, *Office of Professional Responsibility Seeks Bad Actors, Not Technical Errors, IRS Says*, DAILY TAX REP. (BNA), at G-6 (Oct. 17, 2007) (quoting unnamed Internal Revenue officials).

³¹⁵ Burkholder, *supra* note 312, at G-1 (quoting Michael Chesman).

³¹⁶ Alison Bennett, *OPR to Focus Sanctions on “Bad Apples,” Work Toward More Transparency in 2008*, DAILY TAX REP. (BNA), at G-1 (Jan. 9, 2008) (quoting Michael Chesman).

³¹⁷ *Id.*

³¹⁸ Stephen Joyce, *IRS Will Infrequently Impose Cash Penalties Due to Circular 230 Violations, Whitlock Says*, DAILY TAX REP. (BNA), at G-1 (Jan. 8, 2007) (quoting Stephen Whitlock, Acting Director, IRS Office of Professional Responsibility).

³¹⁹ Kathleen David, *Whitlock Says Practice, Not Punishment, Focus of Professional Responsibility Office*, DAILY TAX REP. (BNA), at G-5 (Oct. 26, 2006) (paraphrasing Stephen Whitlock).

³²⁰ New York State Bar Ass’n Tax Section, *NYSBA Tax Section Comments on New Monetary Penalty Under Circular 230*, TAXCORE (BNA) (Nov. 19, 2007).

³²¹ See, e.g., ABA Section of Taxation, *ABA Tax Section Comments on Notice 2007-39, on Application of Monetary Penalties in Disciplinary Procedure Under Section 822 of Jobs Act*, TAXCORE (BNA) (Oct. 9, 2007); American Institute of Certified Public Accountants, *AICPA Comments on Notice 2007-39 Regarding Monetary Penalties, Regulations Under Circular 230 on Tax Practice*, TAXCORE (BNA) (Aug. 29, 2007).

and state bar associations, they are unlike bar disciplinary proceedings in which the charging body and the body conducting the trial are distinct. The OPR performs both functions, a procedure that frightens practitioners who have come to expect lax enforcement of ethical guidelines by professional associations reluctant to discipline members.³²²

The OPR—prosecutor, judge, and jury in these proceedings—must be mindful of practitioner anxieties concerning the system’s procedural fairness. If the federal ethical guidelines governing tax practice are to achieve the normative force envisioned in this Article, tax regulators must not abuse their disciplinary powers. Rather, they must impose the same kind of cooperative model on disciplinary proceedings as on procedures associated with guidance, rulemaking, and investigations. The message has to be one of cooperation rather than intimidation, a message that the IRS is keen in sending. Director Chesman has emphasized: “We want to be open, transparent, and a real partner in making sure there are high standards of ethics in the profession.”³²³

In addition to providing the government a process for disciplining wayward practitioners while protecting the interests of ethical practitioners and taxpayers, the new federal rules governing tax practice unify diverse standards among different groups of tax professionals.³²⁴ Officially, the new regulations govern representation of taxpayers “before the Internal Revenue Service.”³²⁵ This group is distinctly interdisciplinary, and includes lawyers, certified public accountants, enrolled agents, and enrolled actuaries.³²⁶ The different professional organizations representing each group of practitioners maintain their own ethical standards. Furthermore, among attorneys, individual state bar associations interpret the standards promulgated by the national association differently. By

³²² For practitioner fears of OPR acting as prosecutor, judge, and jury, see Kathleen David, *IRS Officials Discuss Pending Guidance on Practice Issues, Including Circular 230*, DAILY TAX REP. (BNA), at G-6 (Oct. 26, 2006); Sheryl Stratton, *ABA Tax Section Meeting: Monetary Penalty Guidance Due Out Soon, IRS Officials Say*, 114 TAX NOTES 407 (2007). For historically lax enforcement by professional organizations of ethical violations, see Susan P. Koniak & George M. Cohen, *Under Cloak of Settlement*, 82 VA. L. REV. 1051, 1121 (1996) (finding that disciplinary boards “are notoriously underfunded and . . . unable or reluctant to mount the effort needed to do battle with wealthy class action lawyers and powerful members of the defense bar”). Practitioner-scholar Michael Schler has observed that tax lawyers are not “unduly concerned about [the] threat” of being referred to a state disciplinary board, which is “designed to protect the client, not the Service.” Schler, *supra* note 306, at 366. With respect to tax shelter advice running afoul of Circular 230 standards, Schler notes that the client “has received exactly what it paid for, namely an opinion that provides penalty protection.” *Id.*

³²³ Burkholder, *supra* note 312, at G-1 (quoting Michael Chesman); see also Bennett, *supra* note 316, at G-1 (quoting Chesman as saying, “[w]e will be working to make this office more transparent, and answer questions of how we operate and what we do”).

³²⁴ See James P. Holden, *New Professional Standards in the Tax Marketplace: Opinions 314, 346 and Circular 230*, 4 VA. TAX REV. 209, 210 (1985) (calling Circular 230 “essential if the Secretary is to regulate practice effectively before the Internal Revenue Service because of the interdisciplinary nature of that practice”).

³²⁵ 31 C.F.R. § 10.0 (2007).

³²⁶ *Id.* § 10.3.

offering a uniform set of practice and ethical guidelines that are disciplinary rather than merely aspirational, Circular 230 imposes coherence on the otherwise incoherent world of tax practice. Moreover, although a minority of commentators interprets the reach of the federal regulations narrowly to capture only direct communications with the IRS,³²⁷ the consensus is that the rules govern all written tax advice, from planning to litigation.³²⁸ More importantly, tax officials are prepared to apply the regulations broadly. Director Chesman has indicated that the OPR will be “very aggressive” in using monetary penalties against practitioners who engage in prohibited conduct under Circular 230,³²⁹ and that it will be “an activist office, a standard bearer for ethical behavior.”³³⁰

Practitioners have responded affirmatively to their new ethical responsibilities. Preliminary evidence indicates that shifting some of the costs of tax compliance to practitioners is working as planned. According to KPMG’s Tax Governance Institute, 60% of surveyed companies reported that tax risk was a greater priority for corporate leadership in 2007 than in 2006.³³¹ In addition, Ernst & Young’s annual Tax Risk Services survey revealed that corporate tax departments are spending less time on tax planning and proprietary tax strategies, while devoting more time to complying with recent changes to the tax law and financial reporting requirements.³³² Respondents to Ernst & Young’s worldwide survey reported that 9% of tax departments’ time was allocated to tax financial reporting matters in 2004 compared to 23% in 2006, a jump of more than 150%, and that tax departments spent 40% less time on strategic tax planning in 2006 than in 2004.

These trends in resource allocation away from planning and toward compliance will likely continue as investors demand more information about taxes from corporate executives. “Fully 70 percent of companies surveyed in the Americas, are reporting increasing demands for more and

³²⁷ See, e.g., Arthur L. Bailey & Alexis A. MacIvor, *New Circular 230 Regulations Impose Strict Standards for Tax Practitioners*, 57 TAX EXECUTIVE 28, 36 (2005) (noting some commentators suggest Circular 230 does not apply to attorneys who fail to file a power of attorney to practice before the Service).

³²⁸ See Beale, *supra* note 248, at 618 & n.122 (writing that notwithstanding technical arguments to the contrary, practitioners recognize the broad reach of Circular 230 “because of the potential relevance of any opinion to a tax controversy,” an event that gets you “before the Service”); James P. Holden, *Dealing with the Aggressive Corporate Tax Shelter Problem*, 82 TAX NOTES 707, 710–11 (1999) (criticizing the weak, “technical” argument that “some tax opinions would not be covered because Circular 230 does not explicitly include tax advice to taxpayers”).

³²⁹ Martha Kessler, *IRS Office of Professional Responsibility to Be Aggressive on Penalties, Director Says*, DAILY TAX REP. (BNA), at G-2 (May 8, 2007) (quoting Michael Chesman).

³³⁰ Kathleen David, *“Zealous” Representation Not Reason for Disciplinary Action, Chesman Says*, DAILY TAX REP. (BNA), at G-5 (May 16, 2007) (quoting Michael Chesman).

³³¹ See <http://www.taxgovernanceinstitute.com>.

³³² Stephen Joyce, *Accounting Firms Increase Resources to Meet Reporting Requirements, Survey Says*, 235 DAILY TAX REP. (BNA), at G-9 (Dec. 7, 2006).

better information on tax.”³³³ In addition, the government has made it clear to practitioners that notwithstanding strides in compliance, it expects them “to do more to protect the integrity of the system.”³³⁴ In January 2007, IRS Commissioner Mark Everson admonished the ABA’s Section of Taxation for its complicity in tax shelter activity during the 1990s and early 2000s, stating that he was “not satisfied” with the recent turnaround.³³⁵ “You can do better,” Everson urged, “[w]e need to keep working on this.”³³⁶

VI. CONCLUSION

In February 2008, the government won yet another court decision involving abusive tax avoidance.³³⁷ In a stinging rebuke to the taxpayer’s position, the Seventh Circuit found that the transaction in question—which generated a \$3.6 million tax loss from an investment in which the taxpayer had \$6,000 at risk—bestowed unwarranted tax benefits on both the taxpayer and the shelter organizer, “the sort of thing that the Internal Revenue Service frowns on.”³³⁸ The court detailed how the shelter organizer, disgraced tax lawyer Paul Dagerdas, issued opinion letters while at Jenkins & Gilchrist that “led to the firm’s demise,” and which forced it to pay out more than \$75 million in penalties.³³⁹ Though perhaps lacking the style of the Seventh Circuit, other federal courts have reacted just as negatively to abusive tax avoidance.³⁴⁰ Government victories in 2006 included four appellate court wins,³⁴¹ which preceded three favorable district court decisions in 2007,³⁴² two victories in the Court of Federal

³³³ Press Release, KPMG, Business Struggles with Worldwide Wave of Tax Regulation, Says KPMG International (May 17, 2007) (on file with author).

³³⁴ Sheryl Stratton, *Everson to Tax Bar: You Should Do More*, 114 TAX NOTES 404, 404 (2007) (paraphrasing IRS Commissioner Everson’s comments to the tax bar at a plenary session of the American Bar Association Section of Taxation meeting).

³³⁵ *Id.*

³³⁶ *Id.*; see also Gilroy, *supra* note 301 (quoting Chief Counsel Korb as urging tax practitioners to “self-police” and to help the IRS encourage “self assessment” to protect the integrity of the tax system).

³³⁷ *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008).

³³⁸ *Id.* at 751.

³³⁹ *Id.* at 750.

³⁴⁰ In one case, however, the Court of Federal Claims invalidated a tax shelter purchased by H.J. Heinz Co. in a style similar to that of the Seventh Circuit. The court quipped:

A Heinz promotion from the late 1950s and early 1960s touted its tomato ketchup by stating—“It’s Red Magic Time!” But no amount of magic, red or otherwise, can hide the meat of the transactions in question, the connective tissues and gristle of which have been revealed by the multi-tined substance-over-form doctrine. *Sans sa sauce*, it becomes plain that plaintiffs’ transaction simply was not “the thing which the statute intended.

H.J. Heinz Co. v. United States, 76 Fed. Cl. 570, 593 (7th Cir. 2008) (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)).

³⁴¹ *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007); *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006); *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

³⁴² *Cemco Investors, LLC v. United States*, No. 04-C-3211, 2007 U.S. Dist. LEXIS 22246 (N.D.

Claims,³⁴³ and two U.S. Supreme Court denials of certiorari.³⁴⁴ In 2008, the government has continued to pile up wins with three circuit court victories³⁴⁵ and three favorable district court decisions.³⁴⁶

Indeed, the government has been on a serious roll. The legislative and regulatory attack on tax shelters has ignited the anti-shelter mood of the judiciary, which now more than ever scrutinizes tax practice standards and statutory penalties when analyzing challenged transactions. It has even motivated the ABA to review and update its official position on written tax shelter opinions.³⁴⁷ Despite the indisputable anti-shelter momentum, it is premature to conclude, as some observers have, that “[t]he tax shelter war is over. The government won.”³⁴⁸ The government’s fight against abusive tax avoidance has been episodic. In the not so distant past, courts dealt the government a series of tax shelter losses that followed on the heels of seemingly momentous victories.³⁴⁹ Moreover, though we now point to certain cases as seminal anti-shelter wins, we should not forget that the government lost those cases in the lower courts,³⁵⁰ losses that underscore the contingent nature of the fight against abusive noncompliance.³⁵¹

Ill. Mar. 27, 2007), *aff’d*, 515 F.3d 749 (7th Cir. 2008); Klamath Strategic Inv. Fund, LLC v. United States, 472 F. Supp. 2d 885 (E.D. Tex. 2007); BB&T Corp. v. United States, No. 1:04-CV-00941, 2007 U.S. Dist. LEXIS 321 (M.D.N.C. 2007), *aff’d*, 523 F.3d 461 (4th Cir. 2008).

³⁴³ Jade Trading, LLC v. United States, 80 Fed. Cl. 11 (2007); H.J. Heinz Co. v. United States, 76 Fed. Cl. 570.

³⁴⁴ Coltec Indus., Inc. v. United States, 127 S. Ct. 1261 (2007); Dow Chem. Co. v. United States, 127 S. Ct. 1251 (2007).

³⁴⁵ Cemco Investors, LLC v. United States, 515 F.3d 749 (7th Cir. 2008); Kornman & Assocs. Inc. v. United States, 527 F.3d 443 (5th Cir. 2008); BB&T Corp. v. United States, 523 F.3d 461 (4th Cir. 2008).

³⁴⁶ AWG Leasing Trust v. United States, No. 1:07-CV-857, 2008 U.S. Dist. LEXIS 42761 (N.D. Ohio May 28, 2008); Fifth Third Bancorp v. United States, No. 1:05-CV-350 (S.D. Ohio Apr. 18, 2008); Enbridge Energy Co. v. United States, 533 F. Supp. 2d 716 (S.D. Tex. 2008).

³⁴⁷ See *ABA Formal Op. 346*, 25 ABA SECTION OF TAXATION NEWSQUARTERLY 3, 3 (2006) (explaining that in response to the 2004 amendments to Circular 230, the ABA Standing Committee on Ethics and Professional Responsibility undertook a thorough review of ABA Formal Opinion 346 which provides professional standards for written tax shelter opinions relied upon by third-party non-clients).

³⁴⁸ Pamela F. Olson, *Now that You’ve Caught the Bus, What Are You Going to Do with It?: Observations from the Frontlines, the Sidelines, and Between the Lines, So to Speak*, 60 TAX LAW. 567, 567 (2007).

³⁴⁹ See, e.g., Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001) (reversing the Tax Court’s decision to uphold deficiencies and negligence penalty); United Parcel Serv. of Am., Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001) (reversing the Tax Court’s determination that the restructuring of customer loss claims amounted to a sham); IES Indus., Inc. v. United States, 253 F. 3d 350 (8th Cir. 2001) (reversing the district court and finding as valid a listed transaction generating a foreign tax credit and capital loss).

³⁵⁰ TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004), *rev’d*, 459 F.3d 220 (2d Cir. 2006); Coltec Indus. v. United States, 62 Fed. Cl. 716 (2004), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007); Black & Decker Corp. v. United States, 340 F. Supp. 2d 621 (D. Md. 2004), *aff’d in part, rev’d in part*, 436 F.3d 431 (4th Cir. 2006); Dow Chem. Co. v. United States, 250 F. Supp. 2d 748 (E.D. Mich. 2003), *rev’d*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

³⁵¹ Professor Weisbach explains the contingency:

Recent taxpayer wins show that the series of government wins was a mere

Rather than declare victory over tax avoidance, we would do well to continue strengthening the existing tax compliance regime. To this end, this Article has offered a combination of reforms to move the current regime further from a failed command-and-control approach to one that emphasizes cooperation, information sharing, and interest convergence. Currently, U.S. tax regulation relies too heavily on sticks and not enough on carrots. While recognizing that taxpayers will comply with the law in the presence of effective deterrence and enforcement, this Article optimizes the use of penalties as a compliance instrument by, among other things, rewarding compliant taxpayers, engaging taxpayers and their advisors in a participatory process, and employing cognitive devices that portray payment of taxes as a bonus rather than nonpayment of taxes as a penalty.

Even with optimal penalties, tax officials cannot currently enforce the law effectively due to severe resource and information asymmetries. To overcome these crippling shortcomings, the government must improve funding, recruiting, training, and retention. It must also partner with taxpayers and tax practitioners to strengthen detection, enforcement, and prosecution of abusive tax avoidance. If successfully implemented, cooperative tax regulation can accomplish a cultural shift not only in taxpaying, but also in tax advising and tax administration. It can produce a regulatory environment of collaboration rather than adversity, ex ante resolution rather than ex post controversy, and certainty rather than secrecy. Ultimately, cooperative tax regulation can forge a shared understanding among taxpayers, tax practitioners, and the government of what it means to comply with the law.

coincidence, much like baseball teams on a streak that is merely a property of statistics rather than a change in ball playing skills. Although not literally independent like a coin flip, the analogy is close enough: If we flip enough coins, we are likely eventually to get 10 heads in a row. It may seem like the heads are on a streak, but the odds on each flip have not changed. The apparent advantage for heads and for the government is a result of selective vision.

David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 228–29 (2002) (footnote omitted).