ARTICLES

PROGRESSIVE TAX PROCEDURE

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Abusive tax avoidance and tax evasion by high-income taxpayers pose unique threats to the tax system. These strategies undermine the tax system's progressive features and distort its distributional burdens. Responses to this challenge generally fall within two categories: calls to increase IRS enforcement and "activity-based rules" targeting the specific strategies that enable tax avoidance and evasion by these taxpayers. Both of these responses, however, offer incomplete solutions to the problems of high-end noncompliance.

This Article presents the case for "progressive tax procedure"—means-based adjustments to the tax procedure rules for high-income taxpayers. In contrast to the activity-based rules in current law, progressive tax procedure would tailor rules to the economic circumstances of the actors rather than their activities. For example, under this approach, a high-income taxpayer would face higher tax penalty rates or longer periods where the IRS could assess tax deficiencies. Progressive tax procedure could also allow an exception for low-value tax underpayments, to avoid excessive IRS scrutiny or unduly burdensome rules for less serious offenses.

Progressive tax procedure could address the unique challenges posed by high-end tax noncompliance and equalize the effect of the tax procedure rules for taxpayers in varying economic circumstances. It could also complement the alternative approaches of increasing tax enforcement and activity-based rules while avoiding the limitations of relying exclusively on these responses.

After developing the normative case for progressive tax procedure, the Article illustrates how it could be applied in three specific areas: accuracy-related tax penalties, the reasonable cause defense, and the statute of limitations. These applications illuminate the basic design choices in implementing progressive tax procedure, including the types of rules that should be adjusted and the methods for designing these adjustments.

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Introduction

Abusive tax avoidance and tax evasion by high-income taxpayers pose unique threats to the tax system.[1] These strategies undermine the

[1] Well-advised taxpayers can reduce their taxes through both legal avoidance strategies and illegal evasion and noncompliance. This Article focuses in particular on the case of noncompliance, which it defines broadly to include aggressive avoidance and

tax system's progressive features and distort its distributional burdens. For one example, economist Gabriel Zucman describes the role of "tax havens" in facilitating global tax evasion by wealthy taxpayers.[2] He estimates that unreported foreign accounts cost the U.S. government approximately $35 billion in lost revenues in 2014 alone.[3] For another example, a 2018 *New York Times* exposé on the tax affairs of members of the Trump family illustrated how some taxpayers may be avoiding taxes through "highly suspicious" tax positions available only to the rich.[4] Because of these tax avoidance opportunities, reforms to increase the progressivity of the tax system may not raise as much revenue from high-income taxpayers as desired.[5]

Responses to the challenge of high-end tax noncompliance generally fall within two categories. First, commentators have called for increasing IRS enforcement and funding in order to reverse the trend of declining audit rates of the wealthiest taxpayers.[6] Second, the tax law has developed what this Article terms "activity-based rules," which target the specific strategies that enable tax noncompliance. For example, taxpayers who engage in certain tax shelter transactions or who hold assets abroad face additional compliance obligations and potential tax penalties.[7] Both of these responses, however, offer incomplete solutions to the problems of high-end noncompliance.[8]

This Article presents the case for a new approach to countering high-end tax noncompliance: "progressive tax procedure," a system of means-based adjustments to the tax procedure rules for high-income taxpayers. In contrast to the activity-based rules in current law that

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evasion strategies that do not comply with the substantive law, but not legal avoidance opportunities allowed by the tax rules.

2 *See generally* Gabriel Zucman, The Hidden Wealth of Nations: The Scourge of Tax Havens (2015).

3 *Id.* at 53 tbl.1. Zucman estimates that unreported financial accounts cost governments nearly $200 billion each year. *Id.* at 47–53.

4 *See* David Barstow, Susanne Craig & Russ Buettner, *Trump Engaged in Suspect Tax Schemes as He Reaped Riches from His Father*, N.Y. Times (Oct. 2, 2018), https://www.nytimes.com/interactive/2018/10/02/us/politics/donald-trump-tax-schemes-fred-trump.html. For a more detailed description of the abusive tax avoidance and evasion opportunities available to high-end taxpayers, see *infra* Section I.A.3.

5 For more discussion of the effect of noncompliance on progressive revenue collection, see *infra* Section I.A.2.

6 *See generally, e.g.*, Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential*, 165 Tax Notes Fed. 1099 (2019) (arguing for increasing IRS examinations of high-income earners, introducing new reporting requirements and updating IRS technology to shrink the tax gap); *see also infra* notes 68–69 and accompanying text (describing declining IRS audit rates of high-income taxpayers).

7 For a discussion of these activity-based rules, see *infra* Section I.C.

8 *See infra* notes 215–18 and accompanying text (on the limitations of increasing enforcement); Section II.A (on the limitations of activity-based rules).

focus on potentially abusive activities, progressive tax procedure would tailor rules to the characteristics of the actors—their income, in particular—rather than to their activities.

Tax procedure rules govern critical aspects of tax compliance and administration, including taxpayers' obligations to file returns correctly and on time,[9] the IRS's ability to review and assess reported tax liabilities,[10] civil tax penalties and interest on underpayments,[11] and reporting requirements of taxpayers and third parties,[12] among other items.[13] These rules may all be distinguished from the "substantive" rules governing the calculation of tax liabilities due under each tax instrument.[14]

Beyond these statutory provisions, the tax procedure rules, as defined in this Article, include the formal and informal rules governing interactions between taxpayers and the IRS. For example, the IRS follows certain practices and procedures in conducting taxpayer examinations.[15] Similarly, the appeals process includes the taxpayer's right to appeal decisions of the U.S. Tax Court,[16] as well as the right to representation and to informal conferences with IRS Appeals Office personnel.[17] Finally, the Code provides rules for taxpayer privacy, including the general rule of confidentiality for returns and return information.[18]

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[9] *E.g.*, I.R.C. § 6012 (individual returns); *id.* §§ 6151–6161 (payment of tax).

[10] Examples include the procedures for the issuance of a notice of deficiency by the IRS and taxpayer petitions to the Tax Court in I.R.C. §§ 6212–6213.

[11] I.R.C. §§ 6601–6751.

[12] *E.g.*, §§ 6041–6050Y (third-party reporting).

[13] *See, e.g.*, §§ 6211–6334 (assessment and collection of tax by the IRS); *id.* §§ 6501–6532 (statutes of limitations limiting both the time for the IRS to make assessments and for taxpayers to claim a tax refund); *id.* §§ 7201–7217 (criminal and other offenses); *id.* §§ 7421–7525 (judicial proceedings).

[14] The structure of the Code reflects this basic distinction: Subtitles A through E contain the substantive rules for calculating tax liabilities under different tax instruments. *E.g*., I.R.C. §§ 1–1563 (income taxes); *id.* §§ 2001–2801 (estate and gift tax); *id.* §§ 4001–5000C (excise taxes). Subtitle F of the Code, in contrast, contains the statutory rules of tax "Procedure and Administration." I.R.C. §§ 6001–7874. In some cases, procedural rules are included within the substantive provisions in Subtitles A through E. *See, e.g.*, *infra* notes 249–51 and accompanying text (discussing the consequences for reckless or fraudulent Earned Income Tax Credit claims, which are included within the substantive provision providing for the calculation of the Earned Income Tax Credit).

[15] *See* IRS, Internal Rev. Manual 4.10, Examination of Returns (2016), https://www.irs.gov/irm/part4/irm_04-010-003 (describing practices to be used by the IRS in conducting taxpayer examinations).

[16] I.R.C. § 7481.

[17] *See, e.g.*, IRS, Catalog No. 46074I, Your Appeal Rights and How to Prepare a Protest if You Don't Agree (2019), https://www.irs.gov/pub/irs-pdf/p5.pdf.

[18] I.R.C. § 6103(a).

Means-based adjustments are a defining feature of many substantive tax rules. For example, the federal income tax follows a progressive rate schedule, whereby taxpayers with higher incomes generally pay tax at higher rates.[19] The tax procedure rules, in contrast, typically apply the same to all taxpayers, without adjustment for the taxpayer's income or other measures of her ability to pay. For example, all taxpayers face the same civil tax penalty rates and interest rates on underreporting and underpayments, can raise the same defenses against penalties, and benefit from the same statutes of limitations for IRS assessments.[20]

Under progressive tax procedure, these rules would instead vary depending on the taxpayer's income. For example, a high-income taxpayer would face higher tax penalty rates, longer periods where the IRS could assess tax deficiencies, and higher standards for claiming defenses against penalties.

Progressive tax procedure offers specific advantages that could improve the administration of the tax system. It could address the unique challenges from high-end tax noncompliance, equalize the effect of the tax procedure rules for taxpayers in different economic circumstances,[21] and narrow the gap between the substantive tax law's prescriptions and the taxes paid by high-income taxpayers.[22] It could also operate as a complement to the current system of activity-based rules and proposals to increase IRS enforcement, while avoiding the disadvantages of exclusive reliance on these alternative responses. Finally, progressive tax procedure could improve tax morale, which could in turn reinforce norms of tax compliance and support for substantive progressive tax reform.[23]

This Article also explains why progressive tax procedure should be designed with an exception for low-value underpayments. This

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[19] *See infra* note 28 and accompanying text.

[20] *See, e.g.*, I.R.C. § 6662 (underpayment penalties); *id.* § 6501 (limitation on assessments); *id.* § 6664(c) (reasonable cause defense). *See infra* Section III.B for discussion of the general absence of means-based adjustments in the tax procedure rules.

[21] *See infra* Section II.B.1.

[22] This Article does not address the separate question of when noncompliance may be a desirable social outcome and assumes that the substantive tax rules in fact represent the socially desirable or optimal tax system. Achieving full tax compliance may not be optimal and additional enforcement or other measures to close the tax gap may not be desirable if they impose additional costs that outweigh the benefits from the additional revenue raised. *See infra* notes 92–95 and accompanying text. In general, however, policymakers should pursue tax policy through adjustments to the substantive tax rules rather than through their selective enforcement. Furthermore, it is almost certainly the case that reducing the amount of taxes underpaid by the highest-income taxpayers through more effective enforcement, which is the specific focus of this Article, would be a desirable social outcome. *See infra* Section I.A.2.

[23] *See infra* Section II.B.3.

exception would alleviate the risk of excessive IRS scrutiny or unduly burdensome rules for less serious offenses, and, instead, would restrict means-based adjustments to cases of significant noncompliance.[24]

After developing the normative case for progressive tax procedure, the Article illustrates its possible application in three specific areas: accuracy-related tax penalties, the reasonable cause defense, and the statute of limitations. These applications illuminate the basic design choices in implementing progressive tax procedure, including the types of rules that should be adjusted and the methods for designing these adjustments.

Each of these categories of tax procedure rules could vary with a taxpayer's taxable income. For one example, taxpayers with greater taxable income could be subject to higher penalty rates for understatement and fraud that vary according to their taxable income. Current law imposes an "accuracy-related" penalty of 20% on underpayments resulting from negligence or disregard of rules or regulations, substantial understatements of income tax, and in certain other cases.[25] Under current law, a taxpayer subject to this penalty with a $50,000 underpayment would face an additional $10,000 penalty,[26] regardless of her taxable income. Under progressive tax procedure, in contrast, this penalty rate would increase for high-income taxpayers. For example, a taxpayer with $2 million or more of taxable income and an underpayment of $50,000 could be subject to an accuracy-related penalty of 30%. In this case, the taxpayer would instead face a penalty of $15,000 on the underpayment.[27]

The remainder of this Article proceeds as follows. Part I describes tax noncompliance by high-income taxpayers and its consequences in the context of a progressive tax system. This Part also reviews basic models of taxpayer compliance, proposals to increase compliance, and the predominant activity-based approach to high-end tax noncompliance under current law. Part II presents the case for progressive tax procedure. This discussion describes the limitations of activity-based rules as a response to noncompliance and the advantages of means-based adjustments to the tax procedure rules for high-income taxpayers. Part III describes design considerations in imple-

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24 *See infra* Section II.C; *infra* note 264 and accompanying text.

25 I.R.C. § 6662(a).

26 $50,000 underpayment * 20% = $10,000. *Id*. This calculation sets aside additional possible payments due, such as interest on underpayments. *See* I.R.C. § 6601. The rules for interest charges on late payments of tax liabilities can be understood as compensating the government for the taxpayer's use of its funds, much like private party interest compensates a bank for the borrower's use of its loan proceeds.

27 $50,000 underpayment * 30% = $15,000. For further discussion of this example and other possible applications of progressive tax procedure, see *infra* Section III.B.

menting progressive tax procedure and illustrates its possible application to several categories of tax procedure rules.

I
Tax Noncompliance at the Top

Discussion of progressive taxation in the United States generally focuses on the structure of the substantive tax law, such as the marginal rates, income brackets, deductions, and credits under the federal income tax.[28] A comprehensive analysis of the progressivity of the tax system, however, should also consider the ability of taxpayers in different economic circumstances to avoid their obligations to comply with the tax law.[29] While difficult to quantify, one recent study estimates that tax noncompliance by the top 1% of earners alone accounts for 30% of the tax gap,[30] and that the total tax gap will reach $600 billion in 2020 and $7.5 trillion over the following decade.[31]

This Part first explains the particular reasons why policymakers should be concerned with addressing high-end noncompliance, notwithstanding the fact that noncompliance by lower-income taxpayers can also result in lost tax revenues. The discussion then outlines the advantages of high-income taxpayers that enable tax noncompliance, describes proposals in the prior literature to improve compliance, and explains how current law generally adopts an activity-based approach

[28] *See, e.g.*, Michael J. Graetz, Deborah H. Schenk & Anne L. Alstott, Federal Income Taxation: Principles and Policies 24 (8th ed. 2018) ("The income tax is progressive in that the rate of tax applied to an individual's income increases as income increases.").

[29] *See* Joel Slemrod & Jon Bakija, Taxing Ourselves: A Citizen's Guide to the Debate over Taxes 256 (5th ed. 2017) ("[E]vasion makes it difficult to achieve whatever degree of progressivity we deem to be consistent with vertical equity."); *infra* Section I.A.1; *see also* Leandra Lederman, *The IRS, Politics, and Income Inequality*, 150 Tax Notes 1329, 1333 (2016) (describing how inadequate enforcement in a progressive tax system can instead increase inequality).

[30] Charles O. Rossotti, Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: A Comprehensive Approach*, 169 Tax Notes Fed. 1467, 1468 (2020) (based on data in Jason DeBacker, Bradley Heim, Anh Tran & Alexander Yuskavage, *Tax Noncompliance and Measures of Income Inequality*, 166 Tax Notes Fed. 1103 (2020)); *see also* Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 63 Nat'l Tax J. 397, 406 tbl.3 (2010) (estimating based on 2001 data that noncompliance by the top 0.5% of earners alone resulted in an annual federal revenue loss of at least $50 billion during the time period studied); Jesse Eisinger & Paul Kiel, *Gutting the IRS: The IRS Tried to Take on the Ultrawealthy. It Didn't Go Well*, ProPublica (Apr. 5, 2019, 5:00 AM), https://www.propublica.org/article/ultrawealthy-taxes-irs-internal-revenue-service-global-high-wealth-audits ("The top 0.5 percent in income account for fully a fifth of all the underreported income, according to a 2010 study by the IRS' Andrew Johns and the University of Michigan's Joel Slemrod. Adjusted for inflation, that's more than $50 billion each year in unpaid taxes."); *infra* notes 35–37 and accompanying text.

[31] Rossotti et al., *supra* note 30, at 1471 tbl.2.

to high-end tax noncompliance by targeting the specific activities that indicate or enable noncompliance.

A. High-End Noncompliance and Progressive Taxation

This Section describes data on the distribution of noncompliance, its consequences in a progressive tax system, and how high-income taxpayers benefit from unique opportunities to avoid and evade tax obligations.

1. The Distribution of Noncompliance

Taxpayers across the income distribution engage in noncompliance through various strategies, all of which have the effect of reducing tax revenues.[32] The IRS estimates that tax noncompliance—from nonfiling, underreporting, and underpayment—resulted in a gross tax gap of approximately $441 billion for tax years 2011 to 2013. Of this amount, only an estimated $60 billion was collected through enforcement and other late payments, resulting in a net tax gap of approximately $381 billion for this period.[33]

Studies suggest that tax noncompliance may disproportionately benefit the wealthiest taxpayers and thereby may reduce the overall progressivity of the tax system.[34] That is, because of this noncompliance, the effective distribution of tax burdens is likely less progressive than what would be implied by the substantive progressive tax rules.

For example, IRS economist Andrew Johns and Professor Joel Slemrod found that, for the 2001 tax year, the proportion of misreported income (as a percentage of taxpayers' actual income) increased with the taxpayer's income level and peaked among taxpayers in the 99.0 to 99.5 percentile.[35] They found for that year an overall misreporting percentage of 15.2% for taxpayers with actual income above $100,000 but of only 7%—less than half this amount—for taxpayers below this income level.[36]

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32 *See, e.g.*, *infra* notes 50–51, 60 and accompanying text (describing strategies available to lower-income taxpayers).

33 Barry W. Johnson & Peter J. Rose, IRS, Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011–2013, at 7, 8 fig.1 (2019) [hereinafter IRS Tax Gap Estimates 2011–2013], https://www.irs.gov/pub/irs-pdf/p1415.pdf.

34 *See* Slemrod & Bakija, *supra* note 29, at 256.

35 Johns & Slemrod, *supra* note 30; *see also* William G. Gale & Aaron Krupkin, *How Big Is the Problem of Tax Evasion?*, Brookings: Up Front (Apr. 9, 2019), https://www.brookings.edu/blog/up-front/2019/04/09/how-big-is-the-problem-of-tax-evasion (noting that "[t]hose in the top 1 percent accounted for 28 percent of tax evasion but 18 percent of income").

36 Johns & Slemrod, *supra* note 30, at 404–05; *see also* Slemrod & Bakija, *supra* note 29, at 256.

These findings indicate a significantly higher underreporting rate—both in absolute terms *and* as a proportion of income—among higher-income taxpayers. In fact, the findings imply that high-end noncompliance has a unique role in undermining progressivity, since under the progressive rate schedule tax liabilities generally rise with a taxpayer's income.[37] As a result, even if higher-income taxpayers underreported their income at the same rate as other taxpayers, this high-end noncompliance would still result in a proportionally higher rate of noncompliance at the top, when measured in terms of underreported tax liabilities rather than underreported income.[38]

More recently, Professors Natasha Sarin and Lawrence Summers estimated that the IRS 2001–2013 tax gap data also suggests that higher-income taxpayers underreport at significantly higher levels, and consequently that the tax gap disproportionately benefits high-income taxpayers.[39] They estimated that the average underreporting percentage for taxpayers with $10 million in income or more is 13.9%, or more than five times the average 2.6% underreporting percentage they estimated for taxpayers with income under $200,000.[40]

These studies may actually *underestimate* the degree of noncompliance at the top of the distribution. First, the IRS tax gap estimates may understate the degree of noncompliance for certain taxpayers and activities, and the IRS does not even provide estimates for some areas of the tax gap, such as unpaid tax liabilities attributable to income earned from illegal activity.[41] Other studies also have estimated that noncompliance rates may be even higher at the very top of

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37 That is, every dollar of income that is not reported by a higher-bracket taxpayer represents a greater tax liability saved.

38 Because of the progressive rate schedule, a lower-income taxpayer who underreports income may be more likely to shift into a lower top marginal rate bracket. In this case a lower-income taxpayer could realize a greater proportional reduction in their taxes paid than would a higher-income taxpayer who underreports their income at the same rate but who remains in the same top rate bracket. In this case, however, noncompliance by the high-income taxpayer would still result in a larger unpaid tax liability for every dollar of underreported income, to the extent the underreported income would otherwise be taxed at higher marginal rates.

39 Sarin & Summers, *supra* note 6, at 1100–02.

40 *Id.* at 1101 tbl.1. Sarin and Summers arrive at these estimates by multiplying the share of each income category earned by lower- and higher-income taxpayers by the misreporting percentages estimated by the IRS for income in that category. *Id.*

41 *See* U.S. GOV'T ACCOUNTABILITY OFF., TAX GAP: IRS NEEDS SPECIFIC GOALS AND STRATEGIES FOR IMPROVING COMPLIANCE 3, 17–20 (2017), https://www.gao.gov/assets/690/688067.pdf (noting that the IRS does not have sufficient information to produce estimates regarding certain areas of the tax gap); Eric Toder, *What is the Tax Gap?*, 117 TAX NOTES 367, 368 (2007) (describing lack of information in IRS estimates of the tax gap regarding tax noncompliance attributable to illegal income, such as drug dealing and illegal gambling).

the income distribution. Economists Emmanuel Saez and Gabriel Zucman find that the fraction of taxes owed but unpaid rises dramatically at the top of the income distribution, from approximately 10% for taxpayers below the 90th percentile to nearly 25% for the very highest earners.[42]

2. *Noncompliance and Progressivity*

The studies estimating the distribution of noncompliance described above do not necessarily suggest that rates of noncompliance rise continuously with a taxpayer's income. It could be, for example, that noncompliance generally rises with income but peaks at a level below the very top of the income distribution.[43] Furthermore, taxpayers within each income group will vary in their levels of compliance, depending upon their individual motivations and tax avoidance opportunities.[44]

The principles underlying progressive taxation, however, imply that policymakers should be uniquely concerned with high-end noncompliance in all events, holding constant the magnitude of noncompliance at different income levels. Progressive taxation in the substantive tax law is most commonly justified under a principle of declining marginal utility, whereby aggregate social welfare may be maximized by taxing higher-income taxpayers at higher average rates.[45] In this framework, collecting one marginal dollar of revenue from a high-income taxpayer will, *ceteris paribus*,[46] result in relatively lower social welfare cost, as compared to collecting the marginal dollar of revenue from a lower-income taxpayer.[47] For the same reason, one marginal dollar of revenue collected by reducing noncompliance by a high-income taxpayer will, *ceteris paribus*, result in a

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42 Emmanuel Saez & Gabriel Zucman, The Triumph of Injustice: How the Rich Dodge Taxes and How to Make Them Pay 60–61 (2019).

43 For example, the Johns and Slemrod study of 2001 tax data found that "the ratio of aggregate misreported income to true income generally increases with income, although it peaks among taxpayers with adjusted gross income in the 99.0 to 99.5 percentile." Johns & Slemrod, *supra* note 30, at 397. Of course, it may also be that noncompliance rates are even higher at the top of the income distribution. *See supra* note 42 and accompanying text.

44 *See infra* Sections I.A.3 and I.B.1.

45 *See* Louis Kaplow, The Theory of Taxation and Public Economics 47 (2008) (arguing that progressive redistribution schemes may be justified, despite potential behavioral distortions, because of the principle of declining marginal utility).

46 That is, holding constant the costs of taxation to both the taxpayers and the government, including from enforcement and administration of the tax law.

47 *See* Kaplow, *supra* note 45, at 47 (illustrating how the social welfare gains from redistribution under an assumption of declining marginal utility could justify "extremely high" efficiency costs from taxation).

larger social welfare gain than would collecting a marginal dollar of revenue by reducing noncompliance by a lower-income taxpayer.

This effect has two implications, both of which suggest that policymakers should be uniquely concerned with the problem of high-end noncompliance in a progressive tax system. First, the general principle of declining marginal utility of income offers an independent reason why policymakers seeking to maximize social welfare should focus on reducing noncompliance at the top of the income distribution, regardless of the magnitude of noncompliance at different income levels.[48] For the same reason, when determining enforcement priorities policymakers should take into consideration which taxpayers are engaging in the noncompliance—and their location within the income distribution—and not just which enforcement efforts will yield the greatest amount of revenue at the lowest cost to the government and taxpayers.[49]

3. *Opportunities for High-End Noncompliance*

High-end taxpayers benefit from unique opportunities to avoid complying with tax obligations that are not available to lower-income taxpayers. These opportunities may partially explain the findings on the distribution of noncompliance described above in Section I.A.1.

Avoidance Opportunities. Both low-end and high-end taxpayers have opportunities to avoid and evade their taxes—or to claim undue benefits from the tax system—through noncompliance. For example, some lower-income taxpayers may claim the Earned Income Tax Credit inappropriately, which could result in additional redistribution to this lower-income group of taxpayers.[50] Similarly, workers and small business owners with moderate incomes who earn cash may be

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[48] This analysis will depend on the shape of the social welfare function and the relative marginal utility of income to taxpayers at different income levels. *See* KAPLOW, *supra* note 45, at 48–50. In the case where marginal utility at the top of the income distribution approaches zero, then the only relevant consideration for policymakers would be choosing rules designed to maximize the amount of revenue generated from these taxpayers. *See, e.g.*, Emmanuel Saez & Gabriel Zucman, *Progressive Wealth Taxation* 47 (BPEA Conference Drafts, Sept. 5–6, 2019) ("For economists who believe in utilitarianism and decreasing returns to consumption, it is natural to assume that the marginal utility of billionaires' wealth is close to zero. As a result, revenue considerations—and consequences on the rest of the economy—should be the only relevant issue from a normative perspective.").

[49] *See, e.g.*, *infra* note 60 and accompanying text (describing why the IRS may favor auditing lower-income taxpayers because it is often cheaper than auditing high-income taxpayers).

[50] *See infra* note 60 and accompanying text.

able to underreport these amounts, with a lower chance that the IRS will detect this noncompliance.[51]

Several factors explain why high-income taxpayers can more readily engage in certain forms of noncompliance, however, and why these activities likely undermine the distribution of tax revenues prescribed by the progressive schedule in the substantive tax law.

First, many high-income taxpayers have opportunities to underreport their taxes that do not exist for lower-income taxpayers.[52] For a simple example, as a result of the 2017 tax legislation, a wealthy individual could use a wholly owned Subchapter C corporation to earn income taxed at the new 21% corporate tax rate rather than at the 40.8% top marginal income tax rate on individuals[53] by having the corporation retain its earnings and not pay a dividend.[54] The IRS would not uncover the potentially abusive tax strategy without auditing the corporation's tax return and investigating the reason for the corporation's retention of earnings.[55]

High-income taxpayers can also take advantage of complex business structures and transactions to engage in abusive tax avoidance and tax evasion, such as through the use of pass-through entities (such as Subchapter S corporations), tax-indifferent parties (such as trusts and tax-exempt entities) and non-U.S. entities.[56] Commissioner of Internal Revenue Charles P. Rettig explains that the most complex types of tax returns are those of higher-income taxpayers, which often

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[51] *See, e.g.*, IRS Tax Gap Estimates 2011–2013, *supra* note 33, at 18 (describing the lower compliance rates for cash income that is not subject to information reporting).

[52] *See, e.g.*, Gale & Krupkin, *supra* note 35 (describing how higher-income taxpayers are more likely to earn income from capital, which can allow for unique tax evasion opportunities). In contrast, wage earners subject to withholding and earning more "visible" forms of income generally have fewer opportunities for noncompliance. *Id.*

[53] *See* I.R.C. § 1(a)–(d), (j) (top marginal rates); *id.* § 1411 (investment income tax surcharge); *id.* §§ 3101(b), 3111(b) (Medicare surtaxes).

[54] For discussion of potential abusive retention strategies, see David Kamin, David Gamage, Ari Glogower, Rebecca Kysar, Darien Shanske, Reuven Avi-Yonah, Lily Batchelder, J. Clifton Fleming, Daniel Hemel, Mitchell Kane, David Miller, Daniel Shaviro & Manoj Viswanathan, *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 Minn. L. Rev. 1439, 1451–52 (2019); Cory J. Stigile, *Now I Am a C Corp: What About the Accumulated Earnings Tax?*, 163 Tax Notes 421 (2019). Anti-abuse rules—such as the accumulated earnings tax in § 531 and the personal holding company tax in § 541—may prevent the simplest strategies for retaining earnings in a corporation to avoid individual-level taxes, but would have limited effect in addressing more complex structures. *See* Ari Glogower & David Kamin, *The Progressivity Ratchet*, 104 Minn. L. Rev. 1499, 1515–16 (2020).

[55] *See* IRS, Internal Rev. Manual 4.10.13.2.3, Holding or Investment Company (2015), https://www.irs.gov/irm/part4/irm_04-010-013#idm140227035904816 (noting that, to subject a corporation to the personal holding company tax, a tax examiner must be able to set forth a basis for this conclusion); I.R.C. §§ 531, 532(a) (accumulated earnings tax rules).

[56] *See supra* note 54 and accompanying text.

involve "cash intensive businesses, transfer pricing, executive compensation, research and development credits, cryptocurrencies, partnerships and flow through entities, micro captives, offshore transactions, and syndicated conservation easements."[57]

High-income taxpayers also have more opportunities to avoid tax by hiding assets abroad, often through the use of offshore shell companies.[58] High-income taxpayers often also benefit from the absence of information reporting and withholding, a procedural advantage that is not available to lower-income taxpayers earning salaries or wages. Tax compliance rates correlate closely with the "visibility" of different categories of income, with the highest compliance rates for income subject to both information reporting and withholding, such as the wages and salaries earned by employees.[59] Because of this "visibility gap," the IRS can often detect noncompliance by many lower-income taxpayers at a lower administrative cost, whereas the less visible forms of noncompliance by wealthy taxpayers may be significantly more costly to detect.[60] For example, according to IRS statistics, the misreporting rate for wages and salaries—which is subject to information reporting and withholding—is only about 1%.[61] By contrast, the mis-

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57 Letter from Charles P. Rettig, IRS Comm'r, to Sen. Ron Wyden (D-OR) 2 (Sept. 6, 2019) [hereinafter Rettig IRS Letter], https://www.documentcloud.org/documents/6430680-Document-2019-9-6-Treasury-Letter-to-Wyden-RE.html.

58 ZUCMAN, *supra* note 2, at 44 (noting that shell corporations and offshore trusts "add a layer of opacity between financial wealth and its true owners"); *see* SAEZ & ZUCMAN, *supra* note 42, at 63–65. Offshore tax avoidance presents a global challenge for tax enforcement, although different jurisdictions use different tax systems and enforcement strategies. Recent research by Professors Annette Alstadsæter, Niels Johannesen, and Gabriel Zucman found that offshore tax evasion is concentrated among the very wealthy, at least in their dataset consisting of wealth records in Scandinavia. Annette Alstadsæter, Niels Johannesen & Gabriel Zucman, *Tax Evasion and Inequality*, 109 AM. ECON. REV. 2073, 2074 (2019). They estimate that the top 0.01% of taxpayers in the study "evades about 25 percent of its tax liability by concealing assets and investment income abroad." *Id.*

59 *See* IRS TAX GAP ESTIMATES 2011–2013, *supra* note 33, at 3, 13, 14 fig.3.

60 For example, in a 2019 letter to Senator Ron Wyden (D-OR), IRS Commissioner Charles Rettig explained why the IRS might favor audits of low-income taxpayers claiming the EITC over audits of wealthier and higher-income taxpayers. Rettig IRS Letter, *supra* note 57, at 4. Rettig explained that more complex returns, including those by high-income and high-wealth taxpayers, generally require significantly more costly "face-to-face examinations." *Id.* at 1–2; *see also* William Hoffman, *IRS Exams Focus on EITC Claims, Not Poor, Inspector General Says*, 164 TAX NOTES FED. 2344 (2019) (quoting Treasury Inspector General for Tax Administration J. Russell George as stating: "[T]here is no question that more low-income people are being examined than upper-income people."); Paul Kiel, *IRS: Sorry, but It's Just Easier and Cheaper to Audit the Poor*, PROPUBLICA (Oct. 2, 2:47 PM), https://www.propublica.org/article/irs-sorry-but-its-just-easier-and-cheaper-to-audit-the-poor.

61 *See* Gale & Krupkin, *supra* note 35; IRS TAX GAP ESTIMATES 2011–2013, *supra* note 33, at 14 fig.3.

reporting rates for net capital gains and partnership income—which are disproportionately earned by higher-income taxpayers—are 21% and 11%, respectively.[62] Professors Lily Batchelder and David Kamin calculate that, in 2016, wage income accounted for only 10% of the reported income of the top 0.001% of taxpayers, but consisted of 80% of the reported income of the bottom 95% of taxpayers.[63]

Finally, high-end taxpayers simply have more money at stake—because of both their higher levels of income and applicable tax rates—which could justify greater expenditures on noncompliance.[64] These taxpayers also have more financial resources to pay for more sophisticated forms of avoidance and noncompliance[65] and may have more complicated forms of taxable income and investments that may be easier to hide or underreport, or that are subject to more complex tax treatment.[66]

Audit Rates. Taxpayers at varying income levels also face different chances that the IRS will enforce the tax rules, detect noncompliance, and successfully recover unpaid tax liabilities. Historically, the IRS has audited high-income taxpayers at higher rates, which might suggest that tax enforcement efforts disproportionately target the top of the income distribution.[67]

In 2018, however, the IRS's audit rate of taxpayers in the highest income group reached its lowest point in years, despite reports of continued global tax evasion through offshore structures and other abusive tax strategies.[68] From 2017 to 2018, the IRS's audit rate of households with adjusted gross income between $5 million and $10

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62 *See* IRS Tax Gap Estimates 2011–2013, *supra* note 33, at 20 tbl.5.

63 Lily Batchelder & David Kamin, *Policy Options for Taxing the Rich*, *in* Maintaining the Strength of American Capitalism 200, 203 (Aspen Econ. Strategy Grp. ed. 2019), https://economicstrategygroup.org/wp-content/uploads/2019/12/Maintaining-the-Strength-of-American-Capialism-Policy-Options-for-Taxing-the-Rich.pdf.

64 For example, in 2019 the maximum amount of the EITC that could be claimed by a lower-income taxpayer is only $6,557, which would operate as a ceiling on the amount a lower-income taxpayer would spend in tax planning or other strategies to improperly claim the credit. *See* I.R.C. § 32(a)–(b).

65 *See* Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 Nat'l Tax J. 345, 345–46 (1985) (describing the planning costs that enable tax evasion).

66 *See* Grant Richardson, *Determinants of Tax Evasion: A Cross-Country Investigation*, 15 J. Int'l Acct. Auditing & Tax'n 150, 151 (2006) (finding that "complexity is the most important determinant of tax evasion").

67 For example, in fiscal year 2018 the IRS audited 0.69% of individual returns with adjusted gross income between $1 and $25,000 and 6.66% of returns with adjusted gross income of $10 million or more. 2018 IRS Data Book 27 tbl.9b (2019), https://www.irs.gov/pub/irs-prior/p55b—2019.pdf.

68 *See, e.g.*, *id.*; *see also* Ashlea Ebeling, *IRS Audit Rate on the Rich Collapses*, Forbes (May 20, 2019, 5:33 PM), https://www.forbes.com/sites/ashleaebeling/2019/05/20/irs-audit-rate-on-the-rich-collapses (noting that the IRS's 2018 audit rate was the lowest since 2002).

million dropped from 7.95% to 4.21%, and its audit rate of households with adjusted gross income between $1 million and $5 million dropped from 3.52% to 2.21%.[69] By contrast, the audit rate on households with adjusted gross income between $50,000 and $75,000 *increased* slightly from 0.48% to 0.54%.[70]

Following the IRS's announcement of the 2018 audit rates, journalists in the mainstream press highlighted the steep decline in IRS examinations of high-income households with headlines such as *IRS Audit Rate on the Rich Collapses*[71] and *The IRS Barely Bothered to Audit Superrich People Last Year*.[72] Many commentators attributed the drop in audit rates to IRS funding cuts over the past decade, as the agency has not been able to hire or retain enough revenue agents with the expertise necessary to review high-income taxpayers' returns.[73] Some commentators have also noted that the audit rates among high earners now equals the audit rate on some subgroups of low-income taxpayers.[74]

Procedural Advantages. Finally, even if the IRS can detect noncompliance by high-income taxpayers, it may not be able to recover the applicable tax liabilities and penalties due. High-end taxpayers have greater resources to spend on sophisticated tax advisors and representation in disputes with the IRS and upon procedural steps such as negotiations and appeals.[75] These procedural advantages reduce

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[69] 2018 IRS DATA BOOK, *supra* note 67, at 27; 2017 IRS DATA BOOK 27 tbl.9b (2018), https://www.irs.gov/pub/irs-soi/17databk.pdf.

[70] 2018 IRS DATA BOOK, *supra* note 67, at 27.

[71] Ebeling, *supra* note 68.

[72] Eric Levitz, *The IRS Barely Bothered to Audit Superrich People Last Year*, N.Y. MAG. INTELLIGENCER (May 20, 2019), https://nymag.com/intelligencer/2019/05/the-irs-barely-bothered-to-audit-super-rich-people-last-year.html.

[73] *See, e.g.*, Richard Rubin, *IRS Audit Rate Drops Again as It Examines Fewer High-Income Households*, WALL ST. J. (May 20, 2019, 2:52 PM), https://www.wsj.com/articles/irs-audit-rate-drops-again-as-it-examines-fewer-high-income-households-11558363990; Rachel Sandler, *Why Are the Superrich Getting Audited Less?*, FORBES (May 21, 2019, 4:39 PM), https://www.forbes.com/sites/rachelsandler/2019/05/21/why-are-the-super-rich-getting-audited-less.

[74] Paul Kiel, *It's Getting Worse: The IRS Now Audits Poor Americans at About the Same Rate as the Top 1%*, PROPUBLICA (May 30, 2019, 10:16 AM), https://www.propublica.org/article/irs-now-audits-poor-americans-at-about-the-same-rate-as-the-top-1-percent (finding that the audit rate on the top 1% of earners, as a whole, approximately equals the audit rate for low-income earners claiming the Earned Income Tax Credit).

[75] *See* Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 581 (2006) ("The probability of punishment is a cumulative probability: that an offense will be detected; that it will be selected for prosecution; that the government will prevail at trial on the substantive issue, decide to seek a penalty and convince a court to impose it; that the judgments favoring the government will survive appeals; and, finally, that the government will actually collect the penalty from a taxpayer.").

the amount of taxes and penalties that the IRS ultimately recovers as a result of enforcement actions against high-income taxpayers.[76]

Recent reports illustrate this uphill battle that the IRS faces when attempting to audit and challenge the tax positions of high-income taxpayers. In 2018, *ProPublica* interviewed over fifty current and former IRS employees and issued a series of reports describing the IRS's attempts to increase enforcement against ultra-wealthy taxpayers.[77] As the report details, the IRS's Global High Wealth Industry Group—a task force assigned to the tax returns of the wealthiest taxpayers—reduced the scale of its audits following lobbying by targeted taxpayers.[78] According to one report, the IRS only audited twelve to eighteen wealthy taxpayers in the Group's first year.[79] Even in the limited number of audits of the wealthiest taxpayers by the IRS, the Treasury Inspector General for Tax Administration (TIGTA) found that in over 40% of the cases, the IRS did not assess any additional tax liability.[80] A subsequent report by TIGTA found that the IRS's audits of wealthy taxpayers had become less comprehensive and that, in several cases, the IRS allowed their delinquent outstanding tax liabilities to expire.[81] As Richard Schickel, a former IRS agent, commented in 2019, "This is a great time for not being compliant with paying taxes."[82]

As described in greater detail below, higher-income taxpayers are also more likely to derive the greatest benefit from current tax procedure rules, which in turn can reduce their chances of paying a tax liability even if their noncompliance is detected. For example, high-income taxpayers are more likely to rely on sophisticated tax advisors, which also enables these taxpayers to take greater advantage of the

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76 *See, e.g.*, Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. Legis. 111, 157 (2009) (describing the insufficient standards for legal advisors in fostering taxpayer compliance).

77 *See, e.g.*, Eisinger & Kiel, *supra* note 30.

78 *Id*.

79 *See Few Millionaires Audited by IRS Global High Wealth Group*, Transactional Records Access Clearinghouse (Apr. 10, 2012), https://trac.syr.edu/tracirs/newfindings/v17.

80 Treasury Inspector Gen. for Tax Admin., Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers 15 (2015), https://www.treasury.gov/tigta/auditreports/2015reports/201530078fr.pdf.

81 *See* Treasury Inspector Gen. for Tax Admin., Prioritization of Collection Cases Is Inconsistent and Systematic Enforcement Actions Are Limited for Inactive Cases 7, 19 (2017), https://www.treasury.gov/tigta/auditreports/2017reports/201730069fr.pdf.

82 Paul Kiel, Jesse Eisinger & ProPublica, *The Golden Age of Rich People Not Paying Their Taxes*, Atlantic (Dec. 11, 2018), https://www.theatlantic.com/politics/archive/2018/12/rich-people-are-getting-away-not-paying-their-taxes/577798.

"reasonable cause" defense to penalties.[83] Similarly, high-income taxpayers tend to have more complex transactions that can take more time for the IRS to detect and are thereby more likely to be able to take advantage of the statute of limitations, which limits the time for the IRS to assess and collect tax liabilities.[84]

B. Factors in Tax Compliance

1. Models of Tax Compliance

In a basic model, a taxpayer who is only concerned with their financial outcome would comply with tax obligations whenever the expected after-tax outcome from complying exceeds the expected outcome from not complying (and potentially getting caught and facing a penalty in addition to the tax).[85] The expected outcome from not complying, in turn, depends upon both the chance that the noncompliance will be detected as well as size of the potential penalty.[86]

For example, consider *Taxpayer A*, a taxpayer who is only concerned with their financial outcome from compliance and noncompliance, with $1,000 of pretax income and facing a $200 tax liability.[87] If the chance that the IRS detects noncompliance and successfully imposes a penalty is 10% and the penalty rate is 50% of the tax underpayment, the expected value of noncompliance would be $970,[88] which is greater than the $800 *Taxpayer A* will have after-tax if she complies. This simple example illustrates that a combination of high penalty rates and chances of detection would be necessary to induce compliance for a taxpayer making the decision on this basis alone.[89]

The basic model of tax compliance mirrors the classic "Becker-Bentham fine" model, where the deterrent effect of any legal sanction depends on the chance of detection and the size of the sanction if the

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83 I.R.C. § 6664(c); *see infra* Section III.B.2.

84 I.R.C. § 6501; *see infra* Section III.B.3.

85 *See* Sarah B. Lawsky, *Modeling Uncertainty in Tax Law*, 65 STAN. L. REV. 241, 249–53 (2013) (detailing a general model of tax evasion, factoring in audit probabilities).

86 *Id.* at 249–50. That is, the taxpayer will comply when $I - T > p(I - T - F) + (1 - p)(I)$, where (I) is the taxpayer's pretax income, (T) is the potential tax liability the taxpayer is considering whether to avoid through noncompliance, (p) is the probability that noncompliance will be detected, and (F) is the amount of the additional fine if the noncompliance is detected. *Id.* at 250.

87 Assume, for this example, that *Taxpayer A*'s income would be taxed at a 20% rate.

88 0.1(1,000 – 200 – 100) + 0.9(1,000).

89 *See* Lawsky, *supra* note 85, at 252. Of course, taxpayers may decide to comply for other reasons that are not reflected in this simple model. *See id.* For a discussion of other explanations of why taxpayers may comply with the tax law, see *infra* notes 104–10 and accompanying text.

offense is detected and the sanction is in fact imposed.[90] These two deterrence models fundamentally diverge, however, in one critical respect. In the case of legal offenses, the deterrent effect from sanctions and the detection rate should be set to only preserve efficient offenses, where the benefit to the offender exceeds the social costs resulting from the activity.[91] Professor Alex Raskolnikov observes that in the case of tax noncompliance, however, any degree of noncompliance can instead be understood to result in a net social loss.[92]

Of course, improving tax compliance through deterrence and enforcement can also impose additional costs on both the government and taxpayers. These costs may include additional administrative burdens on the government, as well as a variety of possible costs imposed on taxpayers, including the costs of compliance, behavioral changes, or even the psychic costs from enforcement and penalties.[93] As a result, adjustments to tax penalties and other tax procedure rules may not be desirable, if such rules impose costs on the government and taxpayers that outweigh the social benefit from raising additional revenue by narrowing the tax gap.[94] Further, at a certain point, policymakers may be able to raise more revenue from high-end taxpayers—

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90 *See* Jeremy Bentham, The Theory of Legislation 325 (C.K. Ogden ed., Richard Hildreth trans., Routledge & Kegan Paul Ltd. 1931) (1802) (proposing that the "evil of the punishment must be made to exceed the advantage of the offence"); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968); *see also* A. Mitchell Polinsky, An Introduction to Law and Economics 79–90 (4th ed. 2011) (engaging in a broad analysis of optimal deterrence and fines). In this case, policymakers can minimize administrative costs by increasing the sanction rather than the chance of detection, since the latter requires additional government spending and the former does not. *Id.* at 82–83.

91 *See* Polinsky, *supra* note 90, at 80.

92 Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 Cornell L. Rev. 523, 531–36 (2013); *see also id.* at 536 ("[T]he basic law and economics approach . . . is well suited for activities that are socially desirable at some level. . . . The optimal response to taxation is no response."). Raskolnikov argues that the case of tax noncompliance may be more appropriately analogized to the case of nonconsensual transfers or theft, which results in a gain to one party and a loss to the other, plus socially wasteful transfer costs. *Id.* at 534. This framework assumes, critically, that the substantive tax rules (and all the compliance rules they entail) in fact represent the socially desirable or optimal tax system. *Id.* at 574–75 ("If corporate tax is not part of the optimal tax system . . . the optimal taxpayer response to corporate tax is to evade it.").

93 *See* Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF Staff Papers 172, 173 (1996) ("[E]xcess burdens, administrative costs, and compliance costs are all components of what we shall refer to as the social costs of taxation: the costs incurred by society in the process of transferring purchasing power from the taxpayers to the government.").

94 *See* Michael Keen & Joel Slemrod, *Optimal Tax Administration*, 152 J. Pub. Econ. 133, 134 (2017) ("The welfare impact of administrative interventions thus cannot be inferred simply from associated changes in the compliance gap. Given too the costs of implementing such interventions, for both governments and taxpayers, it is clear that . . . the optimal compliance gap is not zero.").

at a lower social cost—by increasing rates in the substantive tax law rather than through increased enforcement and administration.[95]

Scholars have also described extensions of the basic model of taxpayer compliance. One extension would also account for taxpayers' risk aversion by evaluating the expected utility from compliance or noncompliance, rather than the expected dollar return. In this case, under an assumption of declining marginal utility of income, a taxpayer may experience more utility loss from monetary losses and less corresponding utility gains from additional income.[96]

Returning to the same example above, a common assumption in the literature would represent the taxpayer's utility function as the natural log of their income.[97] In this case, using the facts above, the taxpayer's expected utility from compliance would be approximately 6.68[98] and expected utility from noncompliance would be approximately 6.87.[99] The hypothetical taxpayer making a decision on this basis alone would still not comply, notwithstanding the fact that risk aversion would lead them to value potential losses more heavily than potential gains of equal value. In general, however, the effect of risk aversion in the expected utility model would induce taxpayers to comply at lower penalty and detection rates than under the simple expected value model. This example also illustrates that the detection and penalty rates would still need to be significant to effectively deter noncompliance under the expected utility model.

Some scholars argue that the basic model does not accurately predict levels of taxpayer compliance and that taxpayers do not necessarily make compliance decisions based on the penalty rate and chance of detection.[100] Economists Joel Slemrod and Christian Gillitzer respond, however, that this "dismissive" approach to the basic model understates the "varying rates of the chance of detection"

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95 *See id.* at 133 (posing a basic choice for policymakers, of whether it is better "to raise an additional dollar of revenue by increasing statutory tax rates or by strengthening tax administration so as to improve compliance").

96 In this case, adjusting the formula described *supra* in note 86 and accompanying text to reflect expected utility rather than the expected dollar return, the taxpayer will comply when $U(I - T) > pU(I - T - F) + (1 - p)U(I)$, where $U(x)$ represents the taxpayer's utility function. *See* Lawsky, *supra* note 85, at 254–57.

97 *See id.* at 255 ("[A] taxpayer's utility function is often taken to be the natural log of the taxpayer's income, probably because natural log is an easy function to work with and represents a person who has declining marginal utility, a popular assumption.").

98 $ln(1{,}000 - 200)$.

99 $0.1ln(1{,}000 - 200 - 100) + 0.9ln(1{,}000)$.

100 *See* Lars P. Feld & Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, 3 ECON. GOVERNANCE 87, 88 (2002) (arguing that "expected punishment is rarely statistically significant and, if it is, the effect is of quite a small magnitude").

in the model.[101] They argue that, once chances of detection are taken into account, levels of compliance for different forms of income are "absolutely consistent with the deterrent model."[102]

Even if taxpayers do respond in part to penalty and detection rates, the basic model still only offers a partial explanation for why taxpayers may comply with tax obligations.[103] Taxpayers may be also motivated by other factors including moral values, social norms or community attitudes, and "perceptions of and attitudes towards evasion."[104]

For example, scholars have studied tax morale, "the intrinsic motivation to pay taxes."[105] Numerous studies have shown a correlation between tax morale and tax compliance,[106] and countries with low tax morale tend to experience higher rates of tax noncompliance.[107] For instance, Italy and Greece are often described as countries with both low tax morale and high levels of tax avoidance and evasion.[108]

Tax morale depends on a number of factors and varies from jurisdiction to jurisdiction. A public perception that some taxpayers are avoiding their tax responsibilities may decrease tax morale among

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101 Joel Slemrod & Christian Gillitzer, Tax Systems 43 (2013); *see also* Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. Econ. Persp. 25, 39 (2007) ("[T]he low average audit coverage rate vastly understates the chances that the average dollar of unreported net income would be detected.").

102 Slemrod & Gillitzer, *supra* note 101, at 43.

103 Slemrod and Gillitzer argue that these other taxpayer motivations should be understood as additional factors in compliance, rather than as alternatives to the basic model. *Id.*

104 Steven M. Sheffrin, Tax Fairness and Folk Justice 161 (2013); *see* Doran, *supra* note 76, at 131–38 (describing the social norms model of taxpayer compliance).

105 Bruno S. Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 J. Comp. Econ. 136, 140 (2007). *See generally* Bruno S. Frey & Lars P. Feld, *Deterrence and Morale in Taxation: An Empirical Analysis* (CESifo, Working Paper No. 760, 2002), https://www.ifo.de/DocDL/760.pdf (assessing tax morale by examining the relationship between tax officials and taxpayers); Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 Fla. Tax Rev. 599 (2007) (discussing the literature on tax morale and providing recommendations for the IRS on how to improve tax compliance).

106 *See* Benno Torgler, Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis 64–78 (2007); Sheffrin, *supra* note 104, at 169, 178–80.

107 *See, e.g.*, Erzo F.P. Luttmer & Monica Singhal, *Tax Morale*, 28 J. Econ. Persp. 149 (2014) (highlighting studies on tax morale and compliance that utilize data from around the world); Org. for Econ. Co-operation & Dev., What Drives Tax Morale? 2 (2013), https://www.oecd.org/ctp/tax-global/what-drives-tax-morale.pdf.

108 *See* James Surowiecki, *Dodger Mania*, New Yorker (July 4, 2011), https://www.newyorker.com/magazine/2011/07/11/dodger-mania (discussing tax morale in Greece); Josef Hien, *Tax Evasion in Italy: A God-Given Right?*, *in* Sven H. Steinmo, The Leap of Faith: The Fiscal Foundations of Successful Government in Europe and America ch.4 (2018) (discussing levels of tax noncompliance among Italian citizens).

other taxpayers.[109] Studies have also shown that progressive tax systems may correlate with higher levels of tax morale.[110]

2. *Proposals to Increase Compliance*

Scholars and policymakers have proposed a variety of reforms to increase taxpayer compliance based on the models of taxpayer behavior described above. A number of proposals in the literature would focus on the structure of civil tax penalties, while others would expand information-reporting requirements in order to increase the probability of detection.

Increasing Tax Penalties. As described above, tax penalties primarily serve a deterrent effect. For example, civil penalties for failing to report or pay taxes[111] reduce the expected benefit from noncompliance. In a report to Congress on tax penalties, the Treasury identified the deterrence function as the primary purpose of the civil tax penalty rules:

> Penalties may raise revenue collaterally but this should not be a deliberate objective of penalty design and doing so can create perverse incentives. Rather, the penalty regime should raise revenue by encouraging taxpayers to remit the appropriate amount of tax in the proper fashion. Thus, although it is appropriate to consider the cost to the government associated with noncompliance in designing penalties, fostering compliance and deterring noncompliance should be the overriding goals.[112]

Scholars and policymakers have recognized that higher penalties could more effectively deter noncompliance,[113] but also that penalty and noncompliance detection rates would need to be significantly higher than under current law and practice in order to achieve the

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[109] *See* Frey & Torgler, *supra* note 105, at 136 (finding "a high correlation between perceived tax evasion and tax morale").

[110] *See, e.g.*, Philipp Doerrenberg & Andreas Peichl, *Progressive Taxation and Tax Morale*, 155 PUB. CHOICE 293 (2013).

[111] *See, e.g.*, I.R.C. § 6651 (imposing penalties for failure to file tax return or pay tax); *id.* § 6662 (imposing accuracy-related penalties on underpayments of taxes); *id.* § 6663 (imposing penalties for underpayments of taxes due to fraud).

[112] DEP'T OF THE TREASURY, OFF. OF TAX POL'Y, REPORT TO THE CONGRESS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 36 (1999), https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Penalty-Interest-Provisions-1999.pdf. For additional discussion of varying rationale underlying tax penalties, see Alex Raskolnikov, *Six Degrees of Graduation: Law and Economics of Variable Sanctions*, 43 FLA. STATE U. L. REV. 1015 (2016).

[113] *See, e.g.*, Lawsky, *supra* note 85, at 248–56 (describing models of how penalties could deter taxpayers from underpaying taxes and the potential limitations of more modest penalties in achieving this desired deterrence effect).

deterrence effect that would be suggested by analogy to the optimal Becker-Bentham fine.[114]

As an alternative to a comprehensive increase in penalty rates, Professor Alex Raskolnikov has proposed a "self-adjusting" tax penalty, where taxpayers who report an illegitimate deduction on the same line on the tax return as a legitimate deduction would be subject to a tax penalty that is based not on the amount of the illegitimate deduction item, but instead on the amount of the legitimate deduction item.[115] The objective of this proposal is to increase the expected cost of noncompliance for taxpayers who attempt to avoid tax liability by concealing abusive tax positions from the IRS.[116] Professor Kyle Logue has offered another extrapolation of the Bentham-Becker fine by proposing strict liability tax penalties equal to the taxpayer's underpaid tax divided by the probability that the IRS would detect the taxpayer's noncompliance ex ante.[117] Other tax scholars have offered additional proposals for increasing or reforming civil tax penalties.[118]

These proposals have expanded debate and understanding among tax scholars and economists, but they have not been implemented by the federal or state governments.[119] Despite the appeal of these proposals under different models of compliance, legislators appear to face political economy and other constraints in implementing the steep

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[114] *See, e.g.*, *id.* at 257 ("[T]he probability of detection and rate of penalties are so low that, in fact, the expected utility model would predict compliance only if individuals were extremely risk averse, far more so than any research would suggest they actually are."). The highest civil penalty rate currently in the Code, which is only imposed in cases of fraud, is 75% of the underpayment. I.R.C. § 6663(a). Other scholars have argued that the basic deterrence model may be relevant, however, since in many cases the chance of detection is significantly higher than audit rates would suggest. *See, e.g.*, Slemrod, *supra* note 101, at 39 ("[T]he low average audit coverage rate vastly understates the chances that the average dollar of unreported net income would be detected.").

[115] *See* Raskolnikov, *supra* note 75, at 599–605.

[116] *See id.*

[117] Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 Va. Tax Rev. 339, 351–52 (2005). Logue's work builds on the Becker-Bentham fine, described *supra* note 90.

[118] *See, e.g.*, Michael Asimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 UCLA L. Rev. 637 (1976) (arguing for the adoption of the Administrative Conference of the United States' proposals in Recommendation 75-7); William A. Drennan, *Strict Liability and Tax Penalties*, 62 Okla. L. Rev. 1 (2009) (proposing a strict-liability penalty system); Mark P. Gergen, *Uncertainty and Tax Enforcement: A Case for Moderate Fault-Based Penalties*, 64 Tax L. Rev. 453 (2011) (proposing a fault-based penalty); Jay A. Soled, *Third-Party Civil Tax Penalties and Professional Standards*, 2004 Wis. L. Rev. 1611 (2004) (proposing reforms for professional standards and third-party civil tax penalties); Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. Rev. 343 (1989) (arguing that Congress should only enact new tax penalties when it can demonstrate the advantages of such penalty provisions over direct sanctions).

[119] *See* Raskolnikov, *supra* note 92, at 573–80 (discussing "[t]he disconnect between the optimal tax theory and the actual tax system").

penalty increases necessary to effectively discourage noncompliance by all taxpayers.[120]

Increasing Detection. Scholars have also argued that policymakers should focus on increasing detection of high-end tax noncompliance. The primary options that have received attention in the literature are expanded information reporting and increased funding for IRS enforcement.

As tax compliance is highly correlated with levels of information reporting and withholding, scholars have advocated for increased information reporting rules, many of which would affect high-income taxpayers.[121] For example, Professors Mitchell Gans and Jay Soled proposed that when a nonspousal donee receives a gift that exceeds the gift tax annual exclusion, the donee would be required to file an information return with the IRS.[122] Professor Kathleen DeLaney Thomas has proposed that small businesses, which can be owned or conducted by high-income taxpayers, would be subject to tax collection on a presumptive basis by imputing income to these taxpayers based on external factors rather than self-reporting.[123] Professor Lederman has also advocated for basis reporting by brokers of securities[124] (a proposal which was subsequently enacted).[125]

Scholars have also focused on the correlation between detection rates and IRS funding. Professors Lily Batchelder and David Kamin have noted that when the IRS attempts to audit high-income taxpayers, it often "does not have the resources to correctly identify their

120 *See* Doran, *supra* note 76, at 130 (arguing that it is unlikely that sufficiently large penalties would "be acceptable on political . . . grounds" while significantly increasing audit rates and enforcement would face similar resistance to "government intrusiveness"); Slemrod, *supra* note 101, at 43 ("The harsher the penalty, the more damage a corrupt administrator could inflict and, in the case of an honest mistake, the more capricious the system. . . . [W]ith harsher penalties, courts may be more reluctant to find the taxpayer guilty of evasion, so that one practical consequence may be fewer penalties imposed.").

121 When taxpayers are subject to information reporting and withholding at the source, the tax compliance rate is approximately 99%. When taxpayers are subject to information reporting only, the rate is approximately 93%. When taxpayers are subject to neither information reporting nor withholding, the IRS estimates that the rate is as low as 37%. *IRS Oversight: Treasury Inspector General for Tax Administration: Testimony Before the H. Comm. on Appropriations, Subcomm. on Appropriations, and Gen. Gov't*, 116th Cong. 8 (2019) (testimony of Hon. J. Russell George, Treasury Inspector Gen. for Tax Admin.), https://www.treasury.gov/tigta/congress/congress_09262019.pdf.

122 Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. Rev. 759, 792 (2007).

123 *See* Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 Tax L. Rev. 111, 147 (2013).

124 Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 Fordham L. Rev. 1733, 1742–44 (2010).

125 *See Cost Basis Reporting FAQs*, IRS (last updated Feb. 20, 2020), https://www.irs.gov/businesses/small-businesses-self-employed/cost-basis-reporting-faqs.

tax liability."[126] In response, scholars such as Professor Lederman have argued that Congress should increase funding of IRS enforcement resources, since "if the tax laws are not adequately enforced, the net effect of a progressive tax system may be to *increase* income inequality."[127] Recognizing the bleak prospects for significantly increased IRS funding, Professors Jonathan Forman and Roberta Mann have proposed measures to increase the enforcement impact of limited resources.[128]

Current law only partially reflects the recommendations of these scholars to improve IRS detection and enforcement. While wage earners are subject to information reporting and withholding, high-end taxpayers are not subject to either information reporting or withholding on many forms of income.[129] In addition, IRS funding has continued to decline, falling by nearly 20% in inflation-adjusted dollars from 2010 to 2018.[130]

C. Activity-Based Rules

In general, policymakers have not embraced the comprehensive changes to tax penalty rates, enforcement infrastructure, or modes of statutory interpretation proposed in the prior literature.[131] Rather, policymakers have generally applied the principles described above in more narrow circumstances, through what this Article terms "activity-based rules," which adjust the rules of tax procedure in cases where the taxpayer engages in specific activities that may correlate with or enable noncompliance.

For example, the Code imposes higher civil tax penalties and additional disclosure obligations that apply when taxpayers engage in certain transactions or tax strategies. The Code also empowers the IRS to scrutinize these activities by mandating disclosure of certain information by tax advisors, foreign financial institutions, and other third parties. This Subpart describes several examples of the Code's activity-based approach to tax avoidance and evasion.

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126 Batchelder & Kamin, *supra* note 63, at 7.

127 Lederman, *supra* note 29, at 1333.

128 Jonathan Barry Forman & Roberta F. Mann, *Making the Internal Revenue Service Work*, 17 Fla. Tax Rev. 725, 781–815 (2015) (proposing a range of administrative and congressional actions to improve tax enforcement).

129 *See, e.g.*, IRS Tax Gap Estimates 2011–2013, *supra* note 33, at 18 (noting that wages are subject to substantial reporting and withholding requirements, unlike income from partnerships, S corporations, capital gains, rent, and royalties).

130 Emily Horton, *2018 Funding Bill Falls Short for the IRS*, Ctr. on Budget & Pol'y Priorities (Mar. 23, 2018, 10:30 AM), https://www.cbpp.org/blog/2018-funding-bill-falls-short-for-the-irs.

131 *See supra* Section I.B.

Reportable Transactions. Current law targets taxpayers' use of "reportable transactions"[132]—potentially abusive tax shelter strategies—through special disclosure and tax penalty rules. Reportable transactions include "listed transactions" and those that are "substantially similar,"[133] which are tax strategies that the IRS will challenge if taxpayers have used them to claim tax benefits.[134] Reportable transactions also contain more general categories of activities, such as situations where tax advisors require taxpayers to keep tax advice confidential or where taxpayers claim large tax losses.[135] If taxpayers engage in any reportable transaction, they must file a special disclosure form with the IRS's Office of Tax Shelter Analysis.[136] The form serves as a red flag, increasing the IRS's ability to detect the transaction and potential noncompliance. In addition, taxpayers' advisors must also file a disclosure statement, which describes the reportable transactions on which they have provided advice in exchange for a minimum fee.[137] If the IRS determines that the taxpayer has used a reportable transaction to reduce tax liability, the taxpayer may be subject to a special 20% tax shelter penalty.[138]

Offshore Bank Accounts. Other activity-based rules address the use of offshore bank accounts to evade U.S. tax liability. For decades, high-end taxpayers would divert income to banks, trusts, and other entities in non-U.S. countries without paying U.S. tax on this income and then would withdraw their funds through wire transfers, credit cards, and other methods.[139] Historically, the IRS could not deter this

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132 *See* Treas. Reg. § 1.6011-4 (taxpayer disclosure requirements).

133 Treas. Reg. § 1.6011-4(b)(2). The IRS maintains the list of abusive tax shelters on its website. *See* IRS, *Recognized Abusive and Listed Transactions* (last updated Dec. 30, 2020), https://www.irs.gov/businesses/corporations/listed-transactions.

134 For specific examples of listed transactions, see, for example, IRS Notice 2017-10, 2017-4 I.R.B. 544 (syndicated conservation easement transactions); IRS Notice 2004-30, 2004-1 C.B. 828 (S-corporation transactions where taxable income is shifted to a tax-exempt entity); IRS Notice 2001-45, 2001-2 C.B. 129 (transactions where the taxpayer attempts to inflate basis of stock through complex redemption transactions).

135 The threshold for a large tax loss is $2 million in the case of individuals. Treas. Reg. § 1.6011-4(b)(5)(D).

136 *See* IRS, INSTRUCTIONS FOR FORM 8886 (2019), https://www.irs.gov/pub/irs-pdf/i8886.pdf.

137 Treas. Reg. § 301.6111-3(d)(1), (e). The minimum fee in cases involving listed transactions and transactions of interest is $10,000 where the advisee is an individual. Treas. Reg. § 301.6111-3(b)(3)(i)(B). In all other cases, the minimum fee is $50,000 where the advisee is an individual. Treas. Reg. § 301.6111-3(b)(3)(i)(A).

138 I.R.C. § 6662A(a).

139 *See supra* notes 58–60 and accompanying text; *see also* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 110TH CONG., TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 3 (Staff Rep. 2008); STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 108TH CONG., TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS AND SECRECY 1 (Majority & Minority Staff Rep. 2006); Mark Hosenball & Evan Thomas,

activity because of the bank secrecy rules in non-U.S. jurisdictions such as Switzerland.[140]

Following the U.S. government's deferred prosecution agreement with UBS, in which UBS conceded that it had facilitated tax evasion by thousands of taxpayers through foreign shell corporations that would open offshore accounts at UBS,[141] the U.S. government took an aggressive approach against offshore tax evasion. Enacted in 2010, the Foreign Account Tax Compliance Act (FATCA) requires foreign financial institutions to report to the IRS identifying information and account balance information regarding U.S. account holders.[142] Non-complying financial institutions are subject to a 30% withholding tax on certain U.S.-source payments.[143] Through these rules, FATCA has increased the IRS's ability to detect offshore tax evasion by U.S. taxpayers.[144]

Around this time, the U.S. government also pursued a number of high-profile criminal tax enforcement actions against high-income and wealthy taxpayers who held offshore bank accounts and failed to pay income tax liability or file required disclosure forms. From 2009 through 2018, the IRS entered into settlement agreements with over fifty thousand U.S. taxpayers who participated in its Offshore Voluntary Disclosure Program.[145] Under this program, taxpayers who disclosed their offshore bank accounts to the IRS avoided criminal prosecution in exchange for paying a penalty equal to a percentage of

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Cracking the Vault, NEWSWEEK, Mar. 23, 2009, at 32; Joshua D. Blank & Ruth Mason, *Exporting FATCA*, 142 TAX NOTES 1245 (2014).

140 *See* Bradley J. Bondi, *Don't Tread on Me: Has the United States Government's Quest for Customer Records from UBS Sounded the Death Knell for Swiss Bank Secrecy Laws?*, 30 NW. J. INT'L L. & BUS. 1 (2010) (describing Swiss bank secrecy rules).

141 *See* Press Release, Dep't of Just., *UBS Enters into Deferred Prosecution Agreement* (Feb. 18, 2009), https://www.justice.gov/opa/pr/ubs-enters-deferred-prosecution-agreement.

142 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 501, 124 Stat. 71, 97–99 (2010).

143 These payments include U.S.-source interest and dividends and gross proceeds from the sale of assets that generate U.S. dividends and interest. I.R.C. §§ 1471(a), (c), 1473(1).

144 For discussion of FATCA's impact, see Blank & Mason, *supra* note 139, at 1247; Shu-Yi Oei, *The Offshore Tax Enforcement Dragnet*, 67 EMORY L.J. 655 (2018); J. Richard Harvey Jr., *Offshore Accounts: Insider's Summary of FATCA and Its Potential Future*, 57 VILL. L. REV. 471 (2012); J. Richard Harvey Jr., *FATCA—A Report from the Front Lines*, 136 TAX NOTES 713 (2012); Leandra Lederman, *The Use of Voluntary Disclosure Initiatives in the Battle Against Offshore Tax Evasion*, 57 VILL. L. REV. 499 (2012); Young Ran (Christine) Kim, *Considering "Citizenship Taxation": In Defense of FATCA*, 20 FLA. TAX REV. 335 (2017).

145 *See* DEP'T OF TREASURY, CONTROL NO. LB&I-09-1118-014, MEMORANDUM FOR DIVISION COMMISSIONERS (2018); *IRS: Offshore Voluntary Compliance Program to End Sept. 28*, IRS (Sept. 4, 2018), https://www.irs.gov/newsroom/irs-offshore-voluntary-compliance-program-to-end-sept-28.

their unreported accounts and filing several years of amended tax returns.[146]

Today, taxpayers who hold offshore bank accounts must file several disclosure forms—including IRS Form 8938 (Statement of Specified Foreign Financial Assets)[147] and Report of Foreign Bank and Financial Accounts (FBAR)[148]—or face significant monetary penalties and the possibility of criminal prosecution.[149]

Non-Economic Substance Transactions. The law also increases tax penalties for activities that possess more general tax avoidance indicia, such as transactions where a court or the IRS applies the "economic substance" doctrine. These increased penalties may be understood as a more generally defined activity-based rule.

Historically, courts would investigate whether a taxpayer's transaction possessed economic substance by inquiring whether the transaction served a non-tax business purpose and meaningfully improved the taxpayer's economic position, aside from the transaction's potential tax benefits.[150] In 2010, following several inconsistent judicial decisions involving tax shelter transactions,[151] Congress codified the

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146 *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2012*, IRS (Jan. 21, 2020), https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012.

147 Internal Revenue Serv., Dep't of the Treasury, Form 8938, Statement of Specified Foreign Financial Assets (2020).

148 31 U.S.C. § 5314; Dep't of the Treasury, Report of Foreign Bank and Financial Accounts (FBAR) (2020), https://www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar.

149 31 U.S.C. § 5322. For additional discussion, see Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates & Gifts, ¶ 65.6.4 (2020) (detailing civil and criminal penalty amounts for violations of FBAR requirements); Miriam L. Fisher & Brian C. McManus, *The Top Ten FBAR Mistakes—And How to Fix Them*, 28 J. Tax'n & Regul. Fin. Inst. 5 (2015); Oei, *supra* note 144, at 671.

150 *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 247–48 (3d Cir. 1998) (applying economic substance doctrine). This judicial anti-abuse standard originated in *Gregory v. Helvering*, in which the Supreme Court held that the transaction at issue lacked a nontax business purpose and was inconsistent with Congress's intent underlying the relevant statutes. 293 U.S. 465, 469–70 (1935); *see also* Knetsch v. United States, 364 U.S. 361, 366 (1960) (disallowing deduction for payments lacking economic substance to an insurance company). For background on the judicial economic substance doctrine, see Leandra Lederman, *W(h)ither Economic Substance?*, 95 Iowa L. Rev. 389, 402–16 (2010); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. Rev. 195, 197 (2001); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 Tax L. Rev. 215, 228–29 (2002).

151 *See, e.g.*, Long Term Cap. Holdings v. United States, 330 F. Supp. 2d 122, 171–74, 186–87 (D. Conn. 2004) (requiring both expectation of economic profit and a non-tax-related business purpose); Rice's Toyota World v. Comm'r, 752 F.2d 89, 91–92 (4th Cir. 1985) (requiring either expectation of economic profit or a non-tax-related business purpose); Coltec Indus. v. United States, 62 Fed. Cl. 716, 756 (2004), *vacated*, 454 F.3d 1340 (Fed. Cir. 2006) (holding application of economic substance doctrine to be an unconstitutional violation of separation of powers). For further discussion, see Terrence R.

economic substance doctrine.[152] Under the statute, courts that choose to apply the economic substance doctrine must treat a transaction as possessing economic substance if it changes the taxpayer's economic position in a meaningful way, apart from tax effects, and if the taxpayer has a substantial purpose, apart from tax reasons, for entering into the transaction.[153]

In order to deter taxpayers from engaging in abusive tax avoidance, Congress also enacted a new 20% civil tax penalty that applies whenever the taxpayer is found to owe taxes as a result of the application of the economic substance doctrine or "any similar rule of law."[154] As discussed in Part III, this tax penalty applies on a strict liability basis; taxpayers are not permitted to rely upon "reasonable cause and good faith," or other statutory defenses, in order to defend against it.[155]

Non-Disclosure. Finally, current law imposes penalties on taxpayers who fail to disclose potentially abusive transactions to the IRS. Complex tax shelters—which may also involve other parties and entities in the United States and other jurisdictions—are difficult for the IRS to detect from the face of a taxpayer's return.[156] To address this challenge, Congress enacted in 2004 tax penalties for taxpayers and advisors who fail to disclose to the IRS their participation in reportable transactions.[157] The penalty for failing to report participation in a

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Chorvat, *Tax Shelters, Dutch Books, and the Fundamental Theorem of Asset Pricing*, 26 VA. TAX REV. 859, 874–75 (2007) (describing inconsistent application of economic substance doctrine); David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1, 3 (2003) ("[C]ourts . . . have been struggling to apply a coherent standard of scrutiny."); Lederman, *supra* note 150, at 391 ("Courts do not apply the [economic substance] doctrine consistently . . . ."); McMahon, Jr., *supra* note 150, at 195 (describing differences between judicial anti-abuse doctrines as "fairly gossamer").

152 I.R.C. § 7701(o).

153 *Id*. Commentators have argued that several features of the codified doctrine do not change the ability of courts to engage in their own style of tax shelter analysis. *See, e.g.*, Joshua D. Blank & Nancy C. Staudt, *Corporate Shams*, 87 N.Y.U. L. REV. 1641, 1656–57 (2012); David Hariton, *Has Codification Changed the Economic Substance Doctrine?*, 2 COLUM. J. TAX L. 1, 3 (2019) ("[C]odification has almost no substantive effect."); Richard M. Lipton, *'Codification' of the Economic Substance Doctrine—Much Ado About Nothing?*, 112 J. TAX'N 325, 333 (2010) ("[I]t would seem that little has changed concerning the manner in which the economic substance doctrine will be applied to transactions.").

154 I.R.C. § 6662(a), (b)(6).

155 *See infra* note 309 and accompanying text.

156 *See* Sheryl Stratton, *Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS*, 100 TAX NOTES 456, 456–57 (2003); Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1632 (2009) (noting that overdisclosure has led to difficulties in identifying abusive transactions).

157 *See* STAFF OF JOINT COMM. ON TAX'N, 108TH CONG., DESCRIPTION OF H.R. 4520, THE "AMERICAN JOBS CREATION ACT OF 2004" 150 (2004) (discussing the new penalties).

listed transaction for individual taxpayers is $100,000[158] and the penalty for failing to disclose any other reportable transaction is $10,000.[159] In addition, taxpayers subject to either a 20% reportable transaction understatement penalty or the 20% non-economic substance penalty face an increased penalty in each case where they did not disclose the transaction to the IRS.[160] Taxpayers' advisors can be subject to nondisclosure penalties as well. For example, an advisor who fails to file a disclosure statement regarding a listed transaction is subject to a monetary penalty equal to the greater of $200,000 or 50% of the gross income from providing advice regarding the transaction.[161]

As each of these examples illustrates, the government often attempts to deter abusive tax avoidance and evasion by targeting taxpayers' transactions or activities, which may be defined narrowly or broadly. If the taxpayer engages in the triggering activity, the taxpayer will face increased civil tax and criminal tax penalties and probability of detection through direct and third-party disclosure obligations. Section II.A considers the limitations of this approach as a response to high-end tax noncompliance.

II
The Case for Progressive Tax Procedure

This Part presents the case for progressive tax procedure: means-based adjustments to the tax procedure rules for high-income taxpayers. Progressive tax procedure could complement the other possible approaches of activity-based rules and increased tax enforcement, while avoiding the significant limitations of exclusive reliance on these responses. Progressive tax procedure could also equalize the effect of the tax procedure rules for taxpayers in varying economic circumstances and could address the particular concerns with high-end noncompliance and its consequences for the progressive tax system. Finally, the current tax procedure rules already implement means-based adjustments in many instances. As a result, the approach proposed in this Article represents a rationalization and extension of—rather than a departure from—principles already embedded in current law.

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158 I.R.C. § 6707A(b)(2)(A).

159 I.R.C. § 6707A(b)(2)(B). These civil tax penalties apply "without regard to whether the transaction ultimately results in an understatement of tax." H.R. Rep. No. 108-755, at 596 (2004) (Conf. Rep.).

160 I.R.C. §§ 6662A(c), 6662(b)(6), (i)(1).

161 I.R.C. § 6707(b)(2).

A. *Limitations of Activity-Based Rules*

As described above, the "activity-based" rules in current law adjust the applicable tax procedure rules based on characteristics of the taxpayer's activities.[162] Some rules adjust based on the culpability of the activity. For example, the penalty rate for underpayments resulting from fraud is greater than the penalty rate for underpayments resulting from negligence or "disregard of rules or regulations."[163] Other rules adjust based on the activity's role in enabling noncompliance. For example, taxpayers with assets held abroad may be subject to third-party reporting requirements under FATCA and even face criminal prosecution.[164] Taxpayers also face additional disclosure requirements and potential penalties when engaging in certain "listed" or "reportable" transactions.[165]

These activity-based rules can improve tax enforcement and administration by targeting the activities which can enable or correlate with noncompliance. For example, the FATCA and FBAR rules impose greater compliance obligations on taxpayers engaging in activities where the IRS may have more difficulty detecting noncompliance.[166] Activity-based rules can also have the effect of increasing enforcement for high-income taxpayers, to the extent that this subset of taxpayers tends to engage in the activities subject to the adjusted rules.[167]

Activity-based rules also face limitations, however, when used to increase deterrence and enforcement for high-income taxpayers. As a result, these rules should be considered a beneficial, but incomplete, response to high-end noncompliance. The remainder of this Section describes the primary limitations of activity-based rules as a response to high-end tax noncompliance.

1. *High-End Avoidance of Activity-Based Rules*

Due to the elasticity of tax planning, high-income taxpayers may be able to simply change the form of their activities to avoid those targeted by activity-based rules. For example, high-income taxpayers, and their sophisticated advisors, often avoid engaging in the activity

[162] *See supra* Section I.C.
[163] I.R.C. §§ 6662(a)–(b), 6663(a).
[164] *See supra* notes 142–49 and accompanying text.
[165] *See supra* notes 132–38 and accompanying text.
[166] *See, e.g.*, Kim, *supra* note 144, at 359–62 (describing the advantages of the FATCA and FBAR rules in combating offshore tax evasion).
[167] For example, FATCA targets an activity—holding assets offshore—which may enable noncompliance by high-income and wealthy taxpayers in particular. *See supra* notes 58–60 and accompanying text.

specified as abusive by the IRS, such as a "listed transaction" or "transaction of interest."[168] For instance, when the IRS announced its intention to challenge strategies such as BOSS (bond and option sales strategy),[169] CARDS (custom adjustable rate debt structure),[170] and contingent liability[171] tax shelter strategies in the early 2000s, taxpayers responded by shifting quickly to other tax avoidance tactics.[172] Taxpayers can focus on tax positions that do not fall into the specific categories that would lead to additional tax shelter penalties.[173] As commentators have noted, high-income taxpayers "tend not to steamroll tax laws; they employ complex, highly refined strategies that seek to stretch the tax code to their advantage."[174]

Similarly, taxpayers may avoid offshore disclosure requirements by shifting their assets to other investments which also facilitate evasion.[175] Of course, policymakers can implement new activity-based rules to address changes in taxpayer behavior. As described below, however, this approach leaves policymakers in the challenging position of constantly responding to new noncompliance strategies as they arise.

2. *Greater Burdens on Lower-Income Taxpayers*

By focusing solely on specific activities rather than the actors, activity-based rules can also impose the highest burdens on lower-income taxpayers engaging in the activities and subject to these rules. These lower-income taxpayers engaging in the targeted activities may bear proportionally higher compliance burdens or have less ability to contest penalties or other consequences. High-income taxpayers, on the other hand, may be able to avoid or mitigate the effect of these activity-based rules. This upside-down effect of many activity-based

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168 *See* Blank, *supra* note 156, at 1638; Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1950 (2005) (describing cat-and-mouse tax shelter games between the IRS and taxpayers).

169 I.R.S. Notice 99-59, 1999-52 I.R.B. 761.

170 I.R.S. Notice 2002-21, 2002-1 C.B. 730.

171 I.R.S. Notice 2001-17, 2001-1 C.B. 730.

172 For discussion, see Chirelstein & Zelenak, *supra* note 168.

173 *See id.*; U.S. DEP'T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 5 (July 1999); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999).

174 Eisinger & Kiel, *supra* note 30.

175 *See generally, e.g.*, Omri Marian, *Are Cryptocurrencies* Super *Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38, 38 (2013) [hereinafter Marian, *Cryptocurrencies*] (describing how cryptocurrencies "could replace tax havens as the weapon-of-choice for tax-evaders"); Omri Marian, *Blockchain Havens and the Need for Their Internationally-Coordinated Regulation*, 20 N.C. J.L. & TECH. 529, 529 (2019) ("[T]he unique nature of blockchain-based technology—most importantly, decentralization and temper resistance—makes such traditional anti-tax haven policies ineffective in the blockchain context.").

rules results from the imperfect correlation between the activities and actors of greatest concern. Furthermore, policymakers may not be able to effectively target these rules—and to isolate the cases of high-end noncompliance—by reference to the activities alone.

For example, Professor Shu-Yi Oei has described the regressive consequences of the IRS's Offshore Voluntary Disclosure Program, which often resulted in the highest relative penalties for participating taxpayers with relatively small account balances.[176] In contrast, higher-income taxpayers were able in many cases to mitigate the burdens from these activity-based rules.[177] More generally, any activity-based rule can have the effect of imposing the greatest relative burden on the lowest-income taxpayers engaging in the activity by imposing the same consequences for all taxpayers engaging in the activity.

3. *Reactive, Not Preemptive*

Activity-based rules all share a common additional limitation that is related to those described above. Policymakers generally introduce these activity-based rules in reaction to abusive activities undertaken by taxpayers. Introducing these rules preemptively, in contrast, would require policymakers to anticipate the specific activities that taxpayers will engage in that will enable noncompliance.

Reactive activity-based rules often invite taxpayers to simply shift their behavior to other activities that are not covered by these rules. For one example, the IRS rules for "listed transactions" only cover specific transactions that the Treasury has identified as abusive,[178] but this list does not preemptively target unanticipated new transactions. Similarly, the FATCA and FBAR rules[179] address one activity taxpayers use to hide assets—holding them in foreign accounts—but these rules may simply encourage taxpayers to hide assets through other activities, such as holding cryptocurrency.[180]

Narrowly drafted activity-based rules invite sophisticated taxpayers to simply find new activities. On the other hand, policymakers cannot easily draft activity-based responses broadly in order to antici-

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176 Oei, *supra* note 144, at 702–03.

177 *See, e.g.*, *id.* at 708–09 (describing how "major offenders" may not have been "sufficiently sanctioned" under the OVDPs, even as the programs imposed "costs" on other actors). For example, the National Taxpayer Advocate found that "in the 2009 OVDP, the median offshore penalty paid by those with the smallest accounts . . . was almost six times the median unreported tax liability, while for those with the largest accounts, it was only about three times the unreported tax." *Id.* at 703 (citing Nat'l Taxpayer Advocate, 1 Annual Report to Congress 86 (2014)).

178 *See supra* notes 132–38 and accompanying text.

179 *See supra* notes 142–49 and accompanying text.

180 *See* Marian, *Cryptocurrencies*, *supra* note 175.

pate all possible abusive activities. In this case, broadly drafted activity-based rules can inadvertently penalize or unduly burden activities or taxpayers that should not be prioritized as targets for enforcement.[181]

B. Advantages of Means-Based Tax Procedure Rules

Means-based adjustments to the tax procedure rules offer a different approach to the problems of high-end noncompliance. These adjustments can equalize the effect of the tax procedure rules for taxpayers in different economic circumstances. Means-based adjustments can also complement the alternative approaches of activity-based rules and increasing tax enforcement while avoiding the limitations of relying exclusively on these responses to address tax noncompliance.

1. Addressing High-End Noncompliance

Means-based adjustments can equalize the effect of the tax procedure rules for taxpayers in varying economic circumstances and account for the greater social cost resulting from high-end noncompliance in a progressive tax system.

Of course, some tax procedure rules that apply equally to all taxpayers—such as a "flat rate" penalty applied to a taxpayer's underpayment—can already impose a higher burden on higher-income taxpayers in the presence of a progressive rate schedule. For illustration, assume that taxpayers underreport the same proportion of their actual income, and assume a simplified progressive tax schedule which taxes the first $1,000 of income at a 20% rate and additional income at a 40% rate. Also assume that all taxpayers face the same 20% accuracy-related penalty for underreporting of income.[182]

Assume again *Taxpayer A* described above[183]—with $1,000 of pretax income and a potential $200 tax liability—underreports her income by $100, or 10% of her total pretax income, resulting in a $20 tax underpayment.[184] If *Taxpayer A* is caught and subject to an

[181] *See, e.g.*, Amy S. Elliott, *Practitioners Blast Economic Substance Guidance*, 128 TAX NOTES 1212 (2010) (describing practitioner concerns that the codified economic substance doctrine and related penalty could be applied too broadly to penalize non-abusive transactions). In this case, policymakers and courts may react to an overbroad activity-based rule by simply declining to apply the rule or by preserving their own discretion, which can undermine the impact of codifying the rule in the first instance. *See, e.g.*, *supra* note 153 (describing the limited substantive impact resulting from the codification of the economic substance doctrine).

[182] *Cf.* I.R.C. § 6662(a) (applying a penalty equal to 20% of the portion of the underpayment to which the section applies).

[183] *See supra* notes 87–88 and accompanying text.

[184] The $100 of income underreported that would have been taxed at a 20% rate.

accuracy-related tax penalty, she will pay an additional $4 penalty,[185] which is 0.4% of her total income.[186] Now assume *Taxpayer B* has $100,000 of actual income and underreports $10,000 (also 10%) of her income, for a tax underpayment of $4,000.[187] If *Taxpayer B* is caught and subject to an accuracy-related penalty, she will pay an additional $800 penalty,[188] which is 0.8% of her total income.[189] Both in absolute dollar terms and when measured as a percentage of each taxpayer's total income, *Taxpayer B* would pay a penalty that is twice the amount paid by *Taxpayer A*.

The discussion that follows explains why means-based adjustments to tax procedure rules would still be desirable in this case, notwithstanding the fact that generally applicable rules (such as a "flat rate" penalty) can result in proportionally higher burdens on higher-income taxpayers in the presence of a progressive rate schedule.

Most critically, as described above, the design of tax procedure rules such as penalties should not be assessed ex post in the case where they end up being applied (as in the example immediately above), but ex ante in order to analyze the deterrent effect.[190] The discussion that follows consequently describes the cases where means-based adjustments can equalize the ex ante deterrent effects of the tax procedure rules and why these adjustments may also be desirable in light of the greater net social costs of noncompliance by higher-income taxpayers.

Equalizing the Deterrent Effect. As described above, tax procedure rules that may be characterized as remedies for wrongdoing serve a primary function of deterring noncompliance. For example, the risk of penalties for underreporting can influence a taxpayer's expected benefit from noncompliance and therefore her decision whether to comply with the tax rules.[191] In this case, the taxpayer's decision may depend, in addition to other factors, on both the chance that the IRS detects the noncompliance as well as the possible fines or penalties the IRS may impose if it detects the noncompliance.[192]

In an expected utility model, a rational taxpayer would account for the expected utility they will derive from complying and not complying, rather than simply the expected monetary outcome of their

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185 20% of the $20 underpayment.

186 $4 ÷ $1,000.

187 The $10,000 of income underreported that would have been taxed at a 40% rate, since *Taxpayer B* is in the higher 40% tax bracket.

188 20% of the $4,000 underpayment.

189 $800 ÷ $100,000.

190 *See supra* note 112 and accompanying text.

191 *See supra* notes 85–89 and accompanying text.

192 *See id.*

decision.[193] In general, penalties have a modestly higher deterrent effect in an expected utility model than they do in an expected monetary outcome model,[194] since a taxpayer with declining marginal utility experiences lesser utility gains from an additional dollar of income, as compared to the utility loss they would experience from losing the same dollar amount of income.[195]

This deterrent effect from risk aversion can have less effect, however, for taxpayers at the top of the income distribution, depending on the shape of the assumed utility curve.[196] Under the assumption of declining marginal utility of income, a taxpayer with lower income will experience steep utility losses as their income declines, whereas a higher-income taxpayer will not experience the same utility loss from a commensurate decline in their income.[197]

For a simple example, assume again *Taxpayer A* has $1,000 of income and *Taxpayer B* has $100,000 of income, and each again underreports 10% of her income. Also assume each taxpayer's utility curve is represented by the natural log of her income,[198] each faces a fixed-amount $250 penalty if the noncompliance is detected, and the chance that the IRS successfully detects the noncompliance and imposes the penalty is 40%. Also assume again the first $1,000 of income is taxed at a 20% rate, and any additional income is taxed at a 40% rate.

In this case, *Taxpayer A* would have greater expected utility from compliance than from noncompliance.[199] *Taxpayer B*, in contrast, would still have greater expected utility from noncompliance than from compliance, when facing the same penalty amount and chances

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193 *See supra* notes 96–99 and accompanying text. As described above, the basic model likely provides only a partial explanation for why taxpayers comply with tax obligations. For a discussion of the possible limitations of the basic model, defenses of the model in the literature, and other factors in compliance, see *supra* notes 100–10 and accompanying text.

194 *See supra* note 88 and accompanying text.

195 *See supra* notes 96–99 and accompanying text.

196 *See* Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1423, 1431 (Alan J. Auerbach & Martin Feldstein eds., 2002) ("Regardless of whether the penalty depends on the tax understatement or income understatement, more risk-averse individuals will, *ceteris paribus*, evade less. Individuals with higher income will evade more as long as absolute risk aversion is decreasing; whether higher-income individuals will evade more, as a fraction of income, depends on relative risk aversion.").

197 *See* HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 179–80 (10th ed., 2014).

198 *See supra* notes 97–99 and accompanying text.

199 *Taxpayer A* would have an expected after-tax return of $800 from compliance, for an expected utility of approximately 6.68. *Taxpayer A* would have an expected utility of only approximately 6.67 from noncompliance, calculated as $.4ln(1{,}000 - 200 - 250) + .6ln(1{,}000)$.

of detection as *Taxpayer A* faces.[200] This different outcome results from two effects: (1) the fact that the fixed amount penalty represents a proportionally smaller amount as compared to *Taxpayer B*'s potential savings from noncompliance, and (2) the fact that *Taxpayer B* is at a higher location on the utility curve than *Taxpayer A*, and therefore experiences a lower disincentive effect from risk aversion for local changes in income. In this case, a significantly higher fixed-amount penalty would be necessary to equalize the deterrent effect of the penalty between the two taxpayers.

The case for higher penalties for higher-income taxpayers to equalize their deterrent effect—on the basis of differences in risk aversion alone—is more nuanced for penalties determined as a percentage of the tax underpayment, such as the accuracy- and fraud-related penalties under current law. Professors Joel Slemrod and Shlomo Yitzhaki observe that, in principle, higher tax rates—such as in a progressive rate schedule—can increase the deterrent effect of underpayment-based penalties,[201] while others have described how this model conflicts with empirical work finding increasing evasion at higher tax rates.[202] In this case, the effect of penalty rates for lower- and higher-income taxpayers will depend on the interaction of the varying rates and income levels in the progressive rate schedule, and on changes in taxpayers' risk aversion at these varying levels.

In the case of all tax penalties—whether fixed-amount or determined as a percentage of the underpayment—means-based adjustment for higher-income taxpayers would also be justified in the basic model to the extent that the other variable in the model—the chance of detection and enforcement—is lower for higher-income taxpayers. The chance of detection will depend on a range of factors, including the nature of the taxpayer's income and income-generating activities.[203] As described above, however, many high-income taxpayers can take advantage of sophisticated tax avoidance strategies that reduce

200 *Taxpayer B* would have an expected after-tax return of $60,200 from compliance, for an expected utility of approximately 11. *Taxpayer B* would have an expected utility of approximately 11.31 from noncompliance, calculated as $.4ln(100{,}000 - 39{,}800 - 250) + .6ln(1{,}000)$.

201 *See* Slemrod & Yitzhaki, *supra* note 196, at 1430 ("This is an important change, because it means that the tax rate has no effect on the terms of the tax evasion gamble; as t rises, the reward from a successful understatement of a dollar rises, but the cost of a detected understatement rises proportionally.").

202 *See* Fabrizio Balassone & Philip Jones, *Tax Evasion and Tax Rate: Properties of a Penalty Structure*, 26 Pub. Fin. Rev. 270, 274 (1998); Feld & Frey, *supra* note 100, at 88 ("[A]n increase in the tax rate has a theoretically ambiguous effect in most models . . . yet both experimental, as well as econometric, research consistently finds that higher tax rates are associated with greater evasion.").

203 *See supra* Section I.A.3.

their chance of detection that are not available to lower-income taxpayers.[204] The basic model would not only take account of the chance of detection, however, but also the chance that the IRS would succeed in enforcing a penalty even if the noncompliance is detected.[205] As described above, high-income taxpayers may also have more resources and procedural advantages that can allow them to avoid or reduce the imposition of penalties even if their noncompliance is detected.[206]

For example, consider again *Taxpayer A* with $1,000 of pretax income and *Taxpayer B* with $100,000 in pretax income, facing the same fixed-amount or underpayment base penalty. In each case, if *Taxpayer B* has a lower risk that the IRS will detect the noncompliance and enforce the penalty (as compared to *Taxpayer A*'s risk), then a higher penalty would be required for *Taxpayer B* to achieve the same deterrent effect between the two taxpayers.

The Social Costs of Noncompliance. Means-based adjustments to the tax procedure rules for high-income taxpayers would also be justified on account of the different social costs of noncompliance for taxpayers in different economic circumstances. As described above, policymakers should not implement any and all measures to eliminate the compliance gap, if these measures impose costs on the government and taxpayers that do not justify the additional revenue raised.[207] This framework suggests a ceiling to the additional compliance burdens and deterrents that may be desirable to introduce to the tax procedure rules.

At the same time, each dollar of noncompliance at the top of the income distribution entails a greater social welfare cost than does a dollar of noncompliance by a lower-income taxpayer.[208] For the same reason, higher costs of taxation at the top of the distribution may be justified on account of the higher social welfare gains from revenue paid by higher-income taxpayers.[209]

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204 *See supra* Section I.A.3.

205 *See supra* notes 75, 90 and accompanying text.

206 *See supra* notes 75–82 and accompanying text.

207 *See supra* notes 93–95 and accompanying text.

208 *See supra* notes 46–47 and accompanying text.

209 *See supra* note 47 and accompanying text. As described above, if these costs borne by high-income taxpayers are negligible compared to the welfare gains from redistribution of the tax revenue raised, then the optimal tax rate on these taxpayers would be the revenue-maximizing rate. *See, e.g.*, Saez & Zucman, *supra* note 48, at 47–48 (describing the normative case for taxing the wealthiest taxpayers at the revenue-maximizing rate). Of course, other costs imposed on high-end taxpayers—such as psychic costs from the fear of IRS enforcement—may entail greater welfare loss than purely monetary costs.

This same framework has similar implications for balancing the costs and benefits from enforcement rules and noncompliance. Enforcement rules can impose additional costs on high-end taxpayers, such as the costs from additional compliance, behavioral changes, or the psychic disutility from fearing higher penalties or sanctions.[210] In this case, means-based adjustments to the tax procedure rules that impose greater costs on high-income taxpayers may be similarly warranted on account of the greater social benefit from reducing noncompliance at the top of the income distribution. It is also likely that the current tax procedure rules impose costs on high-income taxpayers that are significantly below the optimal ceiling.[211]

Two additional considerations should mitigate the concern that means-based adjustments to tax procedure rules would in fact impose significant additional costs on high-income taxpayers. First, in many cases, higher-income taxpayers with more economic resources will benefit from greater economy of scale when fulfilling compliance obligations or negotiating with the IRS.[212] Furthermore, progressive tax procedure could be designed to deter noncompliance while also minimizing additional costs on high-income taxpayers in all events.[213]

2. *Complement to Activity-Based Rules and Increased Enforcement*

Means-based adjustments to the tax procedure rules can also complement the two approaches to high-end noncompliance in the prior literature and in current law—activity-based rules and proposals for increasing enforcement—while avoiding the limitations of exclusive reliance on these responses alone.

Unlike activity-based rules, means-based adjustments can tailor the rules of tax procedure to address the problems of high-end non-

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210 *See supra* notes 93–94 and accompanying text.

211 That is, as many commentators have argued, significant additional revenue could be raised from the wealthiest taxpayers through even modest increases in enforcement that would not impose significant additional costs on taxpayers. *See, e.g.*, Sarin & Summers, *supra* note 6, at 1104–05 (describing how increasing audits of high-income individuals could "substantially increase tax collections" notwithstanding the higher cost of conducting these audits); *see also* Keen & Slemrod, *supra* note 94, at 137 ("[A] higher value of either of the key elasticities strengthens the case for raising additional revenue by spending additional resources on enforcement rather than by raising tax rates: a higher enforcement elasticity does so because administrative measures are then more productive of revenue, and a higher elasticity of taxable income does so because it means a higher welfare cost of a rate increase.").

212 Put differently, it may not be cost-effective for low-income taxpayers to engage tax accountants and tax lawyers, whereas high-income taxpayers routinely rely on these external advisors.

213 That is, rules designed as ex ante deterrents, such as increased penalties, would not necessarily impose greater compliance burdens on high-income taxpayers to the same degree as would requiring ongoing obligations such as increased information reporting.

compliance in particular, which imposes the greatest social costs. Unlike activity-based rules, means-based adjustments can also avoid imposing relatively higher burdens on lower-income taxpayers subject to the rules while allowing higher-income taxpayers to mitigate the effect of these activity-based rules.[214]

The Limits of Increasing Enforcement. Means-based adjustments to the tax procedure rules also offer advantages over simply increasing enforcement of higher-income taxpayers. While ensuring adequate budgetary resources for the IRS is a necessary precondition for effective tax enforcement, this approach alone is unlikely to be successful in deterring high-end tax noncompliance without accompanying means-based adjustments to the tax procedure rules.

First, means-based adjustments to the tax procedure rules can increase compliance while minimizing the costs to both the taxpayers and the government from reliance on increased enforcement alone. In the basic Becker-Bentham fine model described above, the government can reduce overall costs by increasing either sanctions or the chance of detection.[215] Means-based adjustments could increase deterrence of high-end noncompliance without entailing additional government costs of increased enforcement. For example, higher penalty rates or disclosure obligations for high-income taxpayers can reduce the ex ante expected value from noncompliance without the need for more government expenditures on administration and enforcement.

Means-based adjustments to the tax procedure rules are also likely more sustainable and effective than increasing the IRS's tax enforcement resources alone. First, increasing the IRS's budgetary resources is not reliable as an exclusive strategy for increasing enforcement against high-end taxpayers. Congress's budget allocations vary from one administration to another and, as recent history has shown, can enter periods of steady decline.[216] Means-based adjustments to the tax procedure rules do not require annual approval and, thus, can be more durable. For example, the several means-based adjustments to the tax procedure rules under current law were introduced decades ago and have not been subject to the same changes and fluctuation as the IRS's annual budget allocation.[217]

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214 *See supra* Sections II.A.1–2.

215 *See supra* note 90 and accompanying text; *see also* Keen & Slemrod, *supra* note 94, at 137 (describing how raising revenue by improving compliance can be more efficient than raising revenue through higher taxes, in a case of lower marginal administration or compliance costs).

216 *See infra* note 291 and accompanying text.

217 *See, e.g.*, I.R.C. §§ 7430(c)(4)(A)(ii), 7491(a)(2), 6404(h).

Without explicit direction from Congress to target high-end noncompliance, the IRS may also use increased funding to target activities where tax enforcement, including collection, is easier. IRS officials have suggested publicly in the past that correspondence audits regarding specific tax deductions and tax credits are appealing from a simple cost-benefit perspective. For example, in 2019, Commissioner of Internal Revenue Rettig addressed the disparity between relative audit rates of recipients of the Earned Income Tax Credit (low-income taxpayers) and high-end taxpayers, commenting that the "IRS cannot simply shift examination resources from single issue correspondence audits to more complex higher income audits because of employee experience and skillset."[218]

The Advantages of a Layered Approach. Progressive tax procedure should be considered a complement to—rather than a substitute for—activity-based rules and increasing enforcement. Each of the three responses in isolation is unlikely to offer a comprehensive solution to the complex challenge of deferring tax noncompliance. When employed together, however, these tools offer a more comprehensive approach and a more versatile mix of responses available to tax administrators. Finally, when used together, these rules may achieve the greatest effect in targeting the behavior of highest concern to the tax system. For example, layering means-based adjustments upon the current framework of activity-based rules could target heightened deterrence measures on particular cases of noncompliance of unique social concern: high-income taxpayers engaged in activities that tend to enable noncompliance.[219]

3. *Improving Tax Morale*

The tax procedure rules—and the substantive values and norms these rules express—also serve a broader function in influencing tax morale and public perceptions of the tax system.[220] Scholars and policymakers have long recognized how the administration of the tax system affects taxpayer morale and how taxpayer morale in turn affects compliance with the substantive tax rules. For example, the 2018 National Taxpayer Advocate Report suggested that voluntary compliance depends less on the traditional deterrence models and more critically on taxpayers' "faith and trust in the fairness of the tax

218 Rettig IRS Letter, *supra* note 57, at 4.

219 For illustrations of how means-based adjustments could layer upon the current system of activity-based rules to realize the benefits of both systems, see *infra* notes 290, 350–51 and accompanying text.

220 *See supra* notes 105–06 and accompanying text.

system."[221] As described above, studies have found that a perception that taxpayers are evading their taxes can reduce tax morale, and therefore discourage compliance among other taxpayers.[222] For example, Professor Benno Torgler found that, when individuals believe that they know or have heard about other taxpayers who engage in tax avoidance and evasion without being detected by the taxing authority, they report lower tax morale than others.[223]

Progressive tax procedure could further this goal of fostering public faith and trust in the fairness of the tax system by countering the perception that high-income taxpayers have unfair or undue advantages that enable tax evasion and by adjusting the tax rules to counteract high-income taxpayers' preexisting advantages.

Progressive tax procedure would also provide a salient and easily comprehensible assurance that high-income taxpayers do not enjoy special advantages in tax compliance.[224] Progressive tax procedure could have a more significant effect on tax morale if it can yield observable evidence that high-income taxpayers are in fact affected by the means-based adjustments.[225] In this case, progressive tax procedure could strengthen tax morale by positively affecting taxpayer per-

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[221] 1 Nat'l Taxpayer Advocate, 2018 Annual Report to Congress 117 (2019), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/07/ARC18_Volume1.pdf.

[222] *See supra* note 109 and accompanying text.

[223] Benno Torgler, *Tax Morale, Trust and Corruption: Empirical Evidence from Transition Countries* 11–12, 18, 20–21 (Ctr. for Rsch. in Econ., Mgmt. & the Arts (CREMA), Working Paper No. 2004-05, 2004) (finding through a cross-country empirical analysis that tax morale significantly increases with trust of the legal system and decreases with perceived corruption); Benno Torgler & Friedrich Schneider, *What Shapes Attitudes Toward Paying Taxes? Evidence from Multicultural European Countries*, 88 Soc. Sci. Q. 443, 465 (2007) (finding the same effect in a within-country empirical analysis).

[224] For discussions of the role of salience and perceptions of fairness in tax compliance, see Slemrod, *supra* note 101; Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 40 Loy. U. Chi. L.J. 483, 507 n.114 (2009) ("There is a positive correlation between tax compliance and the perceived fairness of the tax system."); Jan-Emmanuel De Neve, Clement Imbert, Johannes Spinnewijn, Teodora Tsankova & Maarten Luts, *How to Improve Compliance? Evidence from Population-Wide Experiments in Belgium* 28 (Saïd Bus. Sch., Working Paper No. 2019-07, 2019) ("Simplifying communication by the tax administration consistently improves tax compliance.").

[225] For discussion of the role of evidence on public perceptions of tax administration, see Joshua D. Blank, *In Defense of Individual Tax Privacy*, 61 Emory L.J. 265, 288–90 (2011) (discussing the power of specific tax-enforcement examples on taxpayers' perceptions); Alan H. Plumley, IRS, The Determinants of Individual Income Tax Compliance 36 (1996) ("[T]he most important influence that these [tax-evasion] convictions have on the general population may be to satisfy the typical taxpayer that criminals are not going scott-free, thus encouraging him to pay his 'fair share.'"); *see also, e.g.*, Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance*, 35 Pub. Fin. Rev. 500, 502 (2007) (finding that IRS criminal investigations measurably increase voluntary tax compliance, and spillover revenue benefit from audits and criminal investigations is approximately 95%).

ceptions of the government's tax enforcement capabilities and priorities.

Taxpayer morale and public trust in the efficacy of the tax procedure rules may also influence public support for substantive progressive tax reforms. A perception that high-income taxpayers can evade paying new or higher progressive taxes may discourage public support for their enactment. For example, in early 2019 Senator Elizabeth Warren proposed a new wealth tax on the richest taxpayers, in order to increase the progressivity of the tax system and to raise funds for government programs.[226] A prominent line of criticism in the public debate that followed focused on the possibility that high-income taxpayers would simply find ways to avoid the new tax.[227] Countering these objections through progressive tax procedure could, in turn, foster a perception that these substantive progressive reforms would be feasible and effective.

C. *Potential Disadvantages of Means-Based Adjustments*

Means-based adjustments to tax procedure rules would also pose potential disadvantages or concerns. In many cases, these considerations may be mitigated through particular methods of implementing and designing these adjustments.

Treating High-Income Taxpayers Differently. The core premise of progressive taxation is to treat higher-income taxpayers differently than lower-income taxpayers by taxing their income at higher rates.[228] Means-based adjustments to the tax procedure rules would extend this principle further, by treating high-income taxpayers differently under other tax rules. This differential treatment, however, might be viewed to violate principles of equal treatment under the law and procedural fairness.[229]

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[226] *See* Press Release, Sen. Elizabeth Warren (D-MA), Senator Warren Unveils Proposal to Tax Wealth of Ultra-Rich Americans (Jan. 24, 2019), https://www.warren.senate.gov/newsroom/press-releases/senator-warren-unveils-proposal-to-tax-wealth-of-ultra-rich-americans (describing proposal for a tax of 2% on net wealth above $50 million and 3% on net wealth above $1 billion in order to fund investments benefitting middle-class households). Senator Bernie Sanders has proposed a similarly structured tax on wealth. *See Tax on Extreme Wealth*, Bernie Sanders, https://berniesanders.com/issues/tax-extreme-wealth (last visited Apr. 18, 2021).

[227] *See, e.g.*, Neil Irwin, *Elizabeth Warren Wants a Wealth Tax. How Would That Even Work?*, N.Y. Times: TheUpshot (Feb. 18, 2019), https://www.nytimes.com/2019/02/18/upshot/warren-wealth-tax.html (describing the challenges of avoidance and evasion which could limit the revenue effects from the proposed wealth tax).

[228] *See supra* note 28 and accompanying text.

[229] Professors Larry May and Paul Morrow, for example, describe the principle of procedural fairness, in general terms, as "a consideration independent of the substantive issue or result of a procedure," which requires "not allowing decisions to be made to the

Progressive tax procedure could be designed to mitigate this concern. First, progressive tax procedure could be limited to particular tax procedure rules that do not directly implicate core prerequisites of access to justice. For example, adjustments should not be made to the core procedural rules ensuring a taxpayer's right to contest claims and to appeal judgments.[230] On the other hand, progressive tax procedure may be more appropriate for other tax procedure rules, such as remedies for wrongdoing, and particularly in cases where such rules offer undue advantages to higher-income taxpayers. In these cases, progressive tax procedure could simply equalize the application of the rules rather than impose greater burdens on higher-income taxpayers.[231]

Concern with treating higher-income taxpayers differently could also be mitigated by narrowing the types of consequences that can be adjusted through means-based adjustments. For example, it may be considered inappropriate to subject higher-income taxpayers to different rules that could lead to criminal sanctions. Many jurisdictions, however, have adopted systems that increase monetary fines and sanctions for higher-income taxpayers.[232] These monetary adjustments

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basis of irrelevant, unique characteristics of a person." Larry May & Paul Morrow, *Introduction* to PROCEDURAL JUSTICE, at xiii (Larry May & Paul Morrow eds., 2012).

[230] *See, e.g.*, I.R.C. § 6212 (notice of deficiency); *id.* § 6213 (petitions to U.S. Tax Court).

[231] *See supra* Section II.B.1 (describing how means-based adjustments can equalize the impact of the tax procedure rules to taxpayers in varying circumstances).

[232] A number of jurisdictions have experimented with "variable fines" or "day fines" for criminal and civil offenses that vary with the offenders' income. For prior works evaluating these regimes and their potential adoption in the United States, see generally Beth A. Colgan, *Graduating Economic Sanctions According to Ability to Pay*, 103 IOWA L. REV. 53 (2017); Gary M. Friedman, Comment, *The West German Day-Fine System: A Possibility for the United States?*, 50 U. CHI. L. REV. 281 (1983); Sally T. Hillsman, *Fines and Day Fines*, 12 CRIME & JUST. 49 (1990); Alec Schierenbeck, *The Constitutionality of Income-Based Fines*, 85 U. CHI. L. REV. 1869, 1876–79 (2018) (describing the advantages of income-based adjustments to fines in the criminal justice system). For a prominent recent example, Finland's penal code provides for a system of day fines calculated as a fraction of the offender's average annual income, reduced by an exemption amount for basic consumption needs. Sakosta, muuntorangaistuksesta ja rikesakosta [Fine, Conversion Sentence and Summary Penal Fee] (30.4 1999/550), https://finlex.fi/fi/laki/ajantasa/1889/18890039001, *translated in* Criminal Code of Finland Ch. 2a (Fin. Ministry of Just.), https://finlex.fi/en/laki/kaannokset/1889/en18890039_20150766.pdf. This system has garnered public attention in recent years for resulting in large speeding tickets on high-income drivers, in some cases exceeding the equivalent of $100,000. *See* Suzanne Daley, *Speeding in Finland Can Cost a Fortune, if You Already Have One*, N.Y. TIMES (Apr. 25, 2015), https://www.nytimes.com/2015/04/26/world/europe/speeding-in-finland-can-cost-a-fortune-if-you-already-have-one.html; Joe Pinsker, *Finland, Home of the $103,000 Speeding Ticket*, ATLANTIC (Mar. 12, 2015), https://www.theatlantic.com/business/archive/2015/03/finland-home-of-the-103000-speeding-ticket/387484.

could equalize the deterrent effect of the sanction for taxpayers in varying economic circumstances.[233]

More generally, progressive tax procedure may be understood as an extension of principles already embedded in current law, rather than a radical departure from it. As described in Section II.D. below, the tax procedure rules already treat taxpayers differently based on their economic circumstances, in cases where these adjustments do not implicate core concerns of equal access to procedural justice.

Finally, as described in Section III.A below, progressive tax procedure could be designed with a deficiency-based threshold. This limitation would ensure that high-income taxpayers engaging in minor acts of noncompliance would still benefit from the same generally applicable tax procedure rules and would reserve the means-based adjustments for the cases of greater social concern in a progressive tax system: large tax deficiencies owed by higher-income taxpayers.

Granting More Power to the IRS. Progressive tax procedure may also be viewed as inviting greater scrutiny of higher-income taxpayers, or granting more power and discretion to IRS agents in their interactions with them.[234] Of course, other proposals—such as calls for increased enforcement for high-income taxpayers—could encounter a similar concern.[235] More generally, all of these approaches would deliberately adjust the balance of power between tax administrators and taxpayers in order to increase deterrence of high-end noncompliance.

Progressive tax procedure, however, would only provide additional enforcement tools to tax administrators in narrow and limited circumstances. IRS agents negotiating with high-income taxpayers would still be bound by statutory and other procedural protections afforded to taxpayers.

Additional Tax Liabilities for High-Income Taxpayers. Progressive tax procedure could also have the effect of increasing total tax liabilities for high-income taxpayers. For example, a high-income tax-

[233] *See, e.g.*, Friedman, *supra* note 232, at 286 (describing how the West German day-fine system was designed “to effect an equal impact on all offenders”); Hillsman, *supra* note 232, at 54 (contrasting the American fixed-fine regimes against European contexts where fines can be adjusted “not only in relation to the severity of the offense but also to the means of the offender”).

[234] *See* Slemrod, *supra* note 101, at 43 (describing the possible adverse effects of giving too much discretion to tax administrators, and cautioning that “[t]he harsher the penalty, the more damage a corrupt administrator could inflict and, in the case of an honest mistake, the more capricious the system”).

[235] For example, this same concern could be raised with regard to the proposal by Professors Sarin and Summers to increase IRS enforcement of high-income taxpayers. Sarin & Summers, *supra* note 6.

payer who does not comply and is subject to a higher penalty rate could end up paying more than a lower-income taxpayer with a similar deficiency, or than a taxpayer with the same income who simply complies with the tax law. This result should be considered an ancillary possible effect of progressive tax procedure, however, rather than its primary purpose. The purpose of progressive tax procedure—like the purpose of penalties and other procedural rules in general[236]—is not to impose additional substantive tax burdens ex post on taxpayers. Rather, progressive tax procedure should be designed to deter acts of noncompliance ex ante, and thereby to narrow the gap between what high-income taxpayers report and pay and their tax liabilities proscribed by the substantive progressive tax rules.

D. Means-Based Adjustments in Tax Procedure Today

The current tax procedure rules generally do not distinguish among taxpayers on the basis of their economic circumstances. For example, all taxpayers face the same penalty rates on underpayments and failures to file returns,[237] the same interest rates on underpayments,[238] and the same statute of limitations for IRS assessments.[239]

In certain cases, however, the tax procedure rules already incorporate means-based adjustments—typically to benefit lower-income taxpayers in certain circumstances. In other cases—though even less frequently—the tax procedure rules also impose additional requirements or burdens on higher-income taxpayers.

The current rules of tax procedure include instances of means-based adjustments but implement these adjustments in particular cases, rather than systemically and consistently. The current tax procedure rules also include many features which have the effect of imposing *additional* burdens on lower-income taxpayers—which may be understood as regressive and a backwards application of the same principles underlying progressive tax procedure.

1. High-End Adjustments in Current Law

One group of statutory tax procedure rules explicitly includes means-based adjustments to impose additional burdens on wealthier taxpayers. These provisions all refer to the same net wealth test used for a general fee-shifting provision in the 1980 Equal Access to Justice

236 *See supra* note 112 and accompanying text.

237 *See* I.R.C. § 6651 (delinquency penalties); *id.* § 6662 (accuracy-related penalties); *id.* § 6663 (civil fraud penalties).

238 *See* I.R.C. § 6601.

239 *See* I.R.C. § 6501.

Act.[240] In order to qualify for fee-shifting as a "party" under this rule, the individual must—in addition to satisfying other requirements—have net assets of $2 million or less.[241] A series of statutory tax procedure rules consequently incorporate this same net asset test in order to determine eligibility for fee shifting in certain tax disputes,[242] judicial review of a failure by the IRS to abate interest charges,[243] award of attorney's fees in cases of unauthorized inspection or disclosure of taxpayer information,[244] burden of proof shifting in tax proceedings,[245] and waiver of a penalty for failure to deposit employment taxes.[246] All of these examples follow the same principles of progressive tax procedure: adjustments to the tax procedure rules that disallow statutory procedural benefits for high-end taxpayers.

2. *Low-End Adjustments in Current Law*

More commonly, the tax procedure rules offer special allowances or benefits for lower-income taxpayers. These adjustments have the same effect, however, of varying the tax procedure rules based on the taxpayer's means.

For example, the Code provides for special informal Tax Court proceedings for "S cases" involving disputes of $50,000 or less.[247] These informal proceedings are not explicitly limited to lower-income taxpayers. As such, this program may be understood as an adjustment based on factors which strongly correlate with a taxpayer's means, rather than an explicit means-based adjustment to the applicable rules on the basis of the taxpayer's economic circumstances. Nonetheless, the availability of these proceedings will tend to benefit lower-income taxpayers to the extent they are more likely to have smaller amounts in dispute with the IRS.[248]

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240 28 U.S.C. § 2412. For more detail on these examples, see Steve R. Johnson, A Modest Proposal to Improve Tax Compliance: Curbing Penalty-Protection Opinions, 53–59 (July 18, 2013) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1285282.

241 28 U.S.C. § 2412(d)(2)(B).

242 I.R.C. § 7430(c)(4)(A)(ii).

243 I.R.C. § 6404(e)(1).

244 I.R.C. § 7431(c)(3).

245 I.R.C. § 7491(a)(2)(C).

246 I.R.C. § 6656(c)(1).

247 I.R.C. § 7463; *see also Tax Court Rules*, U.S. TAX CT., https://www.ustaxcourt.gov/rules.html (last visited Feb. 8, 2021) (providing "Small Tax Case Rules" for disputes involving amounts of $50,000 or less).

248 *See* Carlton M. Smith, *Does the Tax Court's Use of Its* Golsen *Rule in Unappealable Small Tax Cases Hurt the Poor?*, 11 J. TAX PRAC. & PROC. 35, 35 (2009) ("S cases do not always involve poor or middle-class people and are not always brought *pro se*, but probably the vast majority of S cases fall into those categories.").

Other tax procedure rules, however, can explicitly impose proportionally greater burdens on lower-income taxpayers. These rules can be understood as adjustments to treat lower-income taxpayers worse—rather than more favorably—than higher-income taxpayers.

For example, a low-income taxpayer who recklessly claims the Earned Income Tax Credit can be disqualified from claiming the credit for the following two years, and a taxpayer who fraudulently claims the credit can be disqualified for the following decade.[249] These harsh consequences will only impact lower-income taxpayers who could otherwise claim the credit in those subsequent years and can result in penalty amounts—expressed as a percentage of the amount of underpayment—far in excess of those imposed on reckless or fraudulent activity by higher-income taxpayers.[250] Even tax procedure rules ostensibly designed to benefit lower-income taxpayers can also entail procedural disadvantages. For example, a taxpayer cannot appeal a decision from an S case in the United States Tax Court.[251]

3. *Inconsistent Application*

The means-based adjustments in the current tax procedure reflect the same principles behind progressive tax procedure. These adjustments can account for taxpayers' varying economic circumstances and can equalize the effect of the tax procedure rules for different groups of taxpayers. The current tax procedure rules only include these adjustments in narrow circumstances, and not as part of a systematic and consistent approach. Furthermore, some of these rules have the precisely opposite effect of imposing even greater burdens on the lowest-income taxpayers.

In this respect, progressive tax procedure may be understood as an extension and rationalization of rules currently in the tax law,

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249 I.R.C. § 32(k)(1).

250 For example, as described *supra* in note 64, in 2019 the maximum amount of the EITC that could be claimed by a lower-income taxpayer is $6,557, which could be claimed by a joint filing taxpayer with more than two qualifying children and earned income of up to $24,820. I.R.C. § 32(a)–(c); Joint Comm. on Tax'n, JCX-9-19, Overview of the Federal Tax System as in Effect for 2019, at 9–10 (2019). If a taxpayer with this profile is found to have recklessly claimed the EITC in Year 1, and would have otherwise qualified for the credit in Years 2 and 3 but cannot claim the credit in those years because of the reckless claim in Year 1, the effective penalty amount would be 200% of the reckless claim and more than 50% of the taxpayer's entire annual earned income ($13,000 / $24,820). In contrast, as described *supra* in note 114, the highest explicit penalty rate in the Tax Code is the 75% penalty for fraud under I.R.C. § 6663(a).

251 I.R.C. § 7463(b). Low-income taxpayers may also encounter other procedural disadvantages in S cases. *See generally* Smith, *supra* note 248, at 36 (describing how the *Golsen* rule—whereby the applicable circuit court precedent applies in Tax Court cases in the jurisdiction—could disadvantage low-income taxpayers in S cases).

rather than as a fundamentally new direction. Progressive tax procedure could allow for a more methodical and systematic application of these principles already embedded in current law.

III
Progressive Tax Procedure in Practice

Progressive tax procedure could promote a more equitable and effective tax system by deterring high-end tax noncompliance and addressing resource imbalances between high-end taxpayers and the IRS. This Part offers concrete guidance to policymakers who seek to implement means-based adjustments to the tax procedure rules. It presents key design features that policymakers should consider when assessing proposed adjustments to tax procedure rules and illustrates several possible applications of progressive tax procedure. These examples reveal additional considerations of which policymakers should be aware when implementing progressive tax procedure.

A. Design Considerations

Policymakers should consider several factors when designing progressive tax procedure: the tax procedure rule to be adjusted, the base for the adjustment, the need to prevent undue scrutiny of low-value underpayments, and the administrability of the rule by the taxing authority.

Choice of Tax Procedure Rule. Progressive tax procedure may not be desirable for all tax procedure rules. This model would be most appropriate in the case of tax procedure rules that serve a deterrence function or that govern the collection of tax liability by the IRS, such as civil tax penalties or the statute of limitations. Progressive tax procedure would be less appropriate for tax procedure rules that serve other functions. For example, means-based adjustments may not be warranted in the case of the rules governing interest charges on underpayments, which instead serve a compensatory function.[252]

As described above, progressive tax procedure would also not be appropriate for tax procedure rules that implicate core principles of access to justice, such as the taxpayer right to appeal[253] or in the cases of criminal or other severe nonmonetary sanctions.[254]

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[252] *See supra* note 26. That is, higher interest rates on underpayments owed by high-income taxpayers would not be justified if these taxpayers' deferred tax payments did not result in greater proportional revenue loss to the government.

[253] *See supra* notes 15–18 and accompanying text.

[254] *See supra* note 232 and accompanying text.

Progressive tax procedure would be most appropriate in the case of rules that have different effects for taxpayers in varying economic circumstances and in cases where the means-based adjustments could counteract these effects. In each case, policymakers should compare the likely effects of the proposed adjustments with the current law's impact on high-income taxpayers' behavior.

Base for Adjustment. Policymakers should next determine the base that will be used to determine whether a means-based adjustment applies. Means-based adjustments could be linked to a number of different base options, such as income or wealth, or a combination thereof.

One option could be to match the base for triggering the means-based adjustment to the base for the underlying substantive tax rule. For example, if a tax penalty relates to an underpayment of income tax liability,[255] then the means-based adjustment to this tax penalty could be triggered when a taxpayer's taxable income meets a threshold amount. This matching approach is simple and administrable. It also parallels provisions in current law, such as the application of special graduated income tax rates on dividends and capital gains that only arise when taxpayers' taxable income reaches a specified amount.[256] To prevent avoidance of these adjustments and to smooth out the effects of irregular income, policymakers could also base the adjustment on an average of a taxpayer's income over a period of prior years.

An income-based adjustment may also be more desirable than a delinquency- or underpayment-based adjustment. A taxpayer's annual taxable income may provide a more accurate reflection of a taxpayer's economic circumstances than the size of a delinquent tax liability or a tax deficiency in a single tax year. A low-income taxpayer can become delinquent in paying a growing outstanding tax liability, especially when taking into account late-payment and late-filing penalties and interest on underpayments.[257] Similarly, a taxpayer could report a large tax liability in a single tax year even though the taxpayer normally has low taxable income from wages and other sources.[258]

[255] *See, e.g.*, I.R.C. § 6662(a) (describing a tax penalty equaling "20 percent of the portion of the underpayment to which this section applies").

[256] *See, e.g.*, I.R.C. § 1(h)(1), (11) (setting schedules for tax rates on net capital gain and qualified dividend income).

[257] *See, e.g.*, *I Can't Pay My Taxes*, TAXPAYER ADVOC. SERV., https://www.taxpayeradvocate.irs.gov/get-help/paying-taxes/cant-pay-my-taxes (last visited Feb. 13, 2021) ("The IRS also charges daily interest on unpaid tax bills, so the longer you wait, the more interest you'll owe.").

[258] For example, a lower-income taxpayer may receive a large taxable payment from settling a lawsuit. *See* I.R.C. § 104(a) (flush language) (providing that emotional distress

Income is not the only possible base that could trigger means-based adjustments. Another approach could be to adjust tax procedure rules, such as tax penalties, based on the taxpayer's wealth. Scholars have argued that a taxpayer's wealth—or a combination of income and wealth—may yield a more accurate measure of relative economic circumstances than income alone.[259] In this case, means-based adjustments to the tax procedure rules could apply if the taxpayer holds assets that have aggregate value in excess of a set threshold. If the purpose of means-based adjustments is to deter high-end tax noncompliance more generally, beyond a focus on high-income taxpayers alone, then adjustments based on the value of taxpayers' assets could also be appealing to policymakers.

Despite its intuitive appeal, the possibility of using a taxpayer's wealth to trigger means-based adjustments may be less feasible under current law. First, high-end taxpayers could respond to the possibility of means-based adjustments to tax procedure rules as a result of crossing an asset value threshold by challenging the IRS's valuation of their assets. Disputes over valuation of assets, such as land, closely-held corporate stock, and artwork, often consume significant time and resources from the IRS.[260] In estate and gift tax disputes, the core issues frequently involve questions of valuation.[261]

Policymakers would also need to decide whether the measurement of asset value should reflect liabilities, or not. If so, many wealthy individuals may be able to avoid application of the means-based adjustments by encumbering their assets with debt (including debt owed to entities owned by the taxpayer).

Last, unlike taxable income, taxpayers do not currently report their wealth to the IRS in order to calculate tax liabilities. By contrast, taxpayers calculate and report their taxable income on their annual

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does not constitute a physical injury, such that damages for emotional distress may be subject to tax).

259 *See, e.g.*, Ari Glogower, *Taxing Inequality*, 93 N.Y.U. L. Rev. 1421, 1467–83 (2018) (describing how wealth and income can be incorporated into a combined tax base measuring relative economic spending power).

260 *See* IRS, Internal Rev. Manual 4.25.12, Valuation Assistance (2020), https://www.irs.gov/irm/part4/irm_04-025-012 (describing asset valuation challenges).

261 *See, e.g.*, Michael Cohn, *Whitney Houston's Estate Strikes $2M Tax Deal with IRS*, Acct. Today (Jan. 5, 2018, 3:01 PM) https://www.accountingtoday.com/news/whitney-houstons-estate-strikes-2m-tax-settlement-with-irs (describing valuation dispute between the IRS and the estate of Whitney Houston); Kelly Phillips Erb, *Michael Jackson's Estate to IRS: Beat It*, Forbes (Aug. 21, 2013, 11:38 AM), https://www.forbes.com/sites/kellyphillipserb/2013/08/21/michael-jacksons-estate-to-irs-beat-it (describing valuation dispute between the IRS and the estate of Michael Jackson); *see also* Mitchell M. Gans, Bridget J. Crawford & Jonathan G. Blattmachr, *The Estate Tax Fundamentals of Celebrity and Control*, 118 Yale L.J. Pocket Part 50 (2008) (arguing that celebrities must retain post-death control over their estates to ensure the proper functioning of the estate tax).

tax return and, for many taxpayers, their employers and financial institutions submit corresponding information reports to the IRS.[262]

A wealth-based adjustment may be more feasible, however, if future policymakers were to implement a federal wealth tax.[263] In this case, a wealth-based adjustment could rely upon the infrastructure and methods developed to implement and administer the substantive wealth tax.

Low-Value Underpayments. Targeting means-based adjustments to high-income taxpayers—as an actor-based approach—could also subject high-income taxpayers to unduly burdensome tax procedure rules for relatively minor offenses. For instance, a high-income taxpayer who omits a low-value item of income from her tax return, or who fails to report a small part of a larger item of income, could face increased tax penalties or other changes to tax procedure rules simply as a result of her general economic status.

Progressive tax procedure addresses cases of significant noncompliance by high-income taxpayers. Minor offenses, even when committed by high-income taxpayers, do not pose the same threats to the progressive tax system and do not warrant the same adjustments to the tax procedure rules. Policymakers could address the potential for overburdening smaller offenses with less significant consequences for tax progressivity by creating an exception for low-value amounts of understatements of income or underpayments of income tax. For example, many of the tax penalty rules calculate the amount of the penalty by applying a rate to the taxpayer's underpayment of income tax.[264] Policymakers could include an exception from means-adjusted tax penalty rules when the amount of a taxpayer's underpayments for the year fall below a particular dollar value. This type of exception would avoid unduly burdensome adjustments to the tax procedure rules in cases of minor offenses.

Administrability by the Taxing Authority. Finally, policymakers should evaluate the taxing authority's capacity to implement any proposed means-based adjustment. As discussed earlier, an adjustment that is triggered by the taxpayer's taxable income is likely more administrable than one triggered by the taxpayer's wealth—at least given the current structure of the tax system. Further, if a means-

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262 *See* I.R.C. §§ 6011–6012 (return filing requirements).

263 For a description of Senators Warren and Sanders's wealth tax proposals, see *supra* note 226 and accompanying text. For discussion of possible constitutional constraints on a federal wealth tax, and why a court could find it constitutional, see generally Ari Glogower, *A Constitutional Wealth Tax*, 118 MICH. L. REV. 717 (2020).

264 *See, e.g.*, I.R.C. § 6662(a) (20% of accuracy-related underpayments); *id.* § 6663(a) (75% of fraud-related underpayments).

based adjustment, such as an increase in civil tax penalties, is excessive, high-end taxpayers may choose to litigate rather than enter into settlement agreements with the IRS.[265] An increase in tax litigation with high-end taxpayers could consume valuable tax enforcement resources and, from the perspective of the IRS, introduce the risk that a court could side with the taxpayer in high-profile, publicly visible litigation.[266]

B. Three Applications

The purpose of progressive tax procedure is not to generate additional tax revenue beyond that required by substantive tax rules nor to impose different overall tax burdens on groups of taxpayers based on their economic circumstances. Rather, the objective is to disincentivize abusive tax avoidance and tax evasion by high-end taxpayers by increasing the expected cost of tax noncompliance in the minds of these taxpayers. While it is unlikely that any proposed means-based adjustment would precisely equalize deterrence of tax noncompliance for all taxpayers, this Article argues more generally that some level of adjustment could effectively increase the expected costs for high-end taxpayers in particular.

This Subpart provides several possible applications of means-based adjustments in three areas of tax procedure: civil tax penalties, reasonable cause defenses to certain civil tax penalties, and the statute of limitations on assessment. These examples illustrate how policymakers could introduce means-based adjustments to the tax procedure rules based on the characteristics of the actor (the high-end taxpayer) rather than exclusively based on the presence of a specific activity (a potentially abusive tax strategy). These examples also address additional concerns or considerations that may be present in each particular context.

These examples all introduce means-based adjustments for taxpayers with adjusted gross income of $2 million or more[267] and pro-

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265 For a general overview of dispute procedures, see I.R.C. § 6213 (procedures for Tax Court litigation) and I.R.C. § 7422 (procedures for civil actions for tax refund).

266 *See, e.g.*, Compaq Comput. Corp. v. Comm'r, 277 F.3d 778, 780, 788 (5th Cir. 2001) (overturning a Tax Court judgment which penalized the taxpayer for violating § 6662 through deficiencies and accuracy-related negligence); IES Indus., Inc. v. United States, 253 F.3d 350, 351, 356 (8th Cir. 2001) (reversing in part a lower-court judgment against the taxpayer asserting a sham transaction); United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1017, 1020 (11th Cir. 2001) (reversing a tax court decision and finding economic substance in the challenged transaction).

267 In this case, these adjustments would only affect approximately the top 0.1% of households. *See* ROBERT BELLAFIORE, TAX FOUNDATION FISCAL FACT NO. 622, SUMMARY OF THE LATEST FEDERAL INCOME TAX DATA, 2018 UPDATE, at 11 tbl.7 (2018),

vide an exception for taxpayers with aggregate underpayments for the year of less than $50,000.[268] Of course, policymakers could calibrate these levels based on the desired reach and revenue effect of progressive tax procedure.

1. *Tax Penalties*

As sophisticated tax avoidance and evasion strategies frequently escape IRS detection and challenge, the expected costs of tax noncompliance are often inadequate to deter high-income taxpayers from pursuing them. Compared to taxpayers whose income consists solely of wages, high-income taxpayers can often avoid or evade tax liabilities by using strategies that are more difficult for the IRS to detect.[269] These strategies include the use of tax haven entities, closely held corporations, pass-through entities such as Subchapter S corporations, in-kind wealth transfers, and, most recently, cryptocurrency.[270] Given the obstacles that the IRS faces in detecting and challenging these strategies, current tax penalties are too low to deter high-end taxpayers under either the expected value or expected utility models.[271]

The Code contains over one hundred separate civil tax penalties, which consist of both percentage-based tax penalties and fixed-amount penalties.[272] Percentage-based tax penalties calculate penalty amounts as a percentage of the tax underpayment. Accuracy-related tax penalties, for instance, require individuals who underpay their taxes through particular types of misconduct—such as negligence or disregard of rules and regulations—to pay an additional tax penalty equal to 20% of the underpayment of tax liability.[273] Fixed-amount penalties, on the other hand, require taxpayers to pay a fixed-dollar amount when they engage in specific activities. Individuals are subject

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https://files.taxfoundation.org/20181113134559/Summary-of-the-Latest-Federal-Income-Tax-Data-2018-Update-FF-622.pdf (finding an adjusted gross income threshold of approximately $2.1 million for the top 0.1% of earners in 2016).

268 The Code already uses this amount as the threshold for a low-value underpayment in other contexts. *See, e.g.*, I.R.C. § 7345 (passport revocation for tax delinquencies above $50,000, among other conditions); *id.* § 7463 (codifying separate dispute procedures involving delinquencies not exceeding $50,000).

269 *See, e.g.*, Press Release, Richard Neal, Chairman, H.R. Ways & Means Comm., Neal Opening Statement at Hearing on Understanding the Tax Gap and Taxpayer Noncompliance (May 9, 2019), https://waysandmeans.house.gov/media-center/press-releases/neal-opening-statement-hearing-understanding-tax-gap-and-taxpayer ("[H]igh-income taxpayers have the most opportunity to engage in tax avoidance planning.").

270 See, for instance, the strategies described in Kamin et al., *supra* note 54.

271 *See supra* notes 111–14 and accompanying text.

272 *See generally* I.R.C. §§ 6651–6702.

273 I.R.C. § 6662.

to fixed-dollar tax penalties, for instance, when they file frivolous tax returns[274] or false statements regarding tax withholdings.[275]

Policymakers could implement progressive tax procedure in this area through means-based adjustments to the percentage-based and fixed-amount penalties based on the taxpayer's income. For a simple illustration, instead of the 20% civil tax penalty on underpayments for acts specified in section 6662(b),[276] Congress could revise this statute to provide that: taxpayers with taxable income below $2 million would still incur accuracy-related tax penalties at a rate of 20% of the underpayment; taxpayers with taxable income of $2 million or more, but below $5 million, would incur these penalties at a rate of 30%; and taxpayers with taxable income of $5 million or more would incur these penalties at a rate of 40%. To address concerns regarding excessive IRS scrutiny of high-income taxpayers' low-value underpayments based on a taxpayer's economic status discussed earlier,[277] Congress could exempt taxpayers with an aggregate underpayment for the year of less than $50,000.

Assume, for example, a taxpayer with income of $15 million underpaid tax by $4 million by pursuing a tax avoidance strategy involving the special pass-through deduction under section 199A,[278] and the taxpayer incurred the applicable accuracy-related tax penalty. Under this new penalty structure, the taxpayer would pay a tax penalty of $1.6 million[279] rather than $800,000.[280]

Similarly, Congress could also increase flat-dollar tax penalties based on taxpayers' taxable income. For example, for taxpayers with taxable income of $2 million or more, Congress could increase the tax penalty for failing to file a reportable transaction form[281] from $10,000 to $50,000 or the tax penalty for filing a frivolous tax return[282] from $5,000 to $25,000. Again, this model could similarly allow an exception for taxpayers with an aggregate underpayment for the year of less than $50,000.

These examples are not exhaustive—policymakers could introduce means-based adjustments to any or all of the dozens of civil tax

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274 I.R.C. § 6702(a) ($5,000 penalty).

275 I.R.C. § 6682 ($500 penalty).

276 I.R.C. § 6662(b) (imposing a penalty for negligence, substantial understatement of income tax, and other acts).

277 *See supra* Section II.C and note 264 and accompanying text.

278 I.R.C. § 6662(a), (d)(1)(C) (20% penalty if understatement of income exceeds the greater of $5,000 or 5% of tax required to be reported).

279 40% of $4 million.

280 20% of $4 million.

281 I.R.C. § 6707A(b)(2)(B).

282 I.R.C. § 6702(a).

penalties under current law.[283] Further, if policymakers desire more measured application of means-based adjustments, they could refine the simple examples above by introducing a graduated-dollar penalty or percentage penalty schedules, similar to the schedule that applies to the calculation of tax liability for dividends and net capital gains under current law.[284]

Rather than focusing solely on a specific activity, these means-based adjustments to civil tax penalties would apply to all high-income taxpayers with underpayments above the threshold amount. Current law frequently deploys an activity-based approach to tax enforcement by increasing the tax penalty for certain types of tax shelter transactions and offenses. As discussed earlier, the civil tax penalty rules include tax shelter penalties that apply when taxpayers participate in an abusive tax strategy that is designated as a "listed transaction" or "reportable transaction"[285] or fail to file a required reportable transaction form.[286]

Means-based adjustments to the civil tax penalty rules, in contrast, would apply to the actor—the high-income taxpayer. With these adjustments in place, high-income taxpayers would still be subject to increased tax penalties[287] even if they were able to circumvent tax shelter tax penalties, such as the reportable transaction[288] or nondisclosed listed transaction penalties.[289] In addition, policymakers could apply means-based adjustments to *both* the activity and the actor by introducing even greater increases to the tax shelter tax penalties for high-end taxpayers. For example, in the case of high-income taxpayers, policymakers could increase the nondisclosed noneconomic substance transactions penalty from 40% to 50%.[290]

By adjusting means-based civil tax penalties to the actor rather than solely to the activity, Congress could also signal to all high-income taxpayers that their costs of tax noncompliance in general have increased. As described above, the IRS's ability to audit high-end taxpayers has declined over the last decade due to significant budget reductions and the complexity of the tax positions of high-end

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[283] *See generally* I.R.C. §§ 6651–6702.

[284] I.R.C. § 1(h)(1), (11) (tax rates on net capital gain and qualified dividend income).

[285] I.R.C. § 6662A(a) (20% tax penalty).

[286] I.R.C. § 6707A(b)(2)(B) (additional $10,000 tax penalty).

[287] For example, they would be subject to a 30% penalty instead of 20% penalty in the case of accuracy-related penalties, as described above in the example.

[288] I.R.C. § 6662A(a).

[289] I.R.C. § 6707A(b)(2)(B).

[290] I.R.C. § 6662(i)(1).

taxpayers.[291] Means-based adjustments to the civil tax penalty rules would serve to counterbalance the IRS's resource challenges that hinder its ability to detect tax noncompliance by high-income taxpayers.

Means-based civil tax penalties could also bolster tax morale by providing salient signals that the government is treating high-end taxpayers differently in order to deter tax noncompliance.[292] Under current law, there are subtle variances between the treatment of high-income and low-income taxpayers, such as how the IRS views an individual's education and professional background when determining whether to allow the reasonable cause defense to civil tax penalties.[293] These exceptions are not generally apparent to the public and are easily overshadowed by vivid news reports of the IRS's meager tax enforcement against the richest taxpayers, such as *ProPublica*'s 2018 exposé on this topic.[294] Means-based civil tax penalties, on the other hand, would allow the government to make its renewed focus on high-end taxpayers explicit and salient.

A potential concern raised by means-based civil tax penalty adjustments is that they could cause the IRS to focus disproportionately on high-end taxpayers and shift its attention away from other taxpayers. Under the example of means-based adjustments described above, an IRS agent could assess a 30% or even 40% accuracy tax penalty by auditing and challenging the tax positions of a high-end taxpayer compared to a 20% accuracy tax penalty for all other taxpayers. The means-based penalty structure could create too much of an incentive for the IRS to audit high-end taxpayers compared to others, allowing tax noncompliance by middle- and low-income taxpayers to flourish.

While means-based adjustments to the civil tax penalty rules could induce some shift in the IRS's focus away from lower-income noncompliance, it is not likely the IRS would dramatically shift its resource allocations. The IRS assigns its agents to different audit units

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[291] *See supra* notes 126–30, 218 and accompanying text; *see also* Paul Kiel & Jesse Eisinger, *Gutting the IRS: How the IRS Was Gutted*, ProPublica (Dec. 11, 2018, 5:00 AM), https://www.propublica.org/article/how-the-irs-was-gutted; Taxpayer Advoc. Serv., Special Rep. to Congress, Earned Income Tax Credit: Making the EITC Work for Taxpayers and the Government 9 n.37 (2019) (describing $2 billion IRS budget decline, in inflation-adjusted dollars, from 2010 to 2018).

[292] *See supra* Section II.B.3.

[293] Treas. Reg. § 1.6664-4(b)(1) (indicating that a taxpayer's reasonable cause defense is evaluated in light of the taxpayer's "experience, knowledge, and education"). For further discussion of this defense, see *infra* Section III.B.2.

[294] Eisinger & Kiel, *supra* note 30.

based on the complexity of the returns.[295] Revenue agents, the most experienced IRS examiners, are assigned to complex tax returns of high-income taxpayers, which often involve pass-through entities, offshore transactions, and cryptocurrency.[296] Revenue agents undergo rigorous training and must have several years of work experience before reviewing these returns.[297] Without significantly increased funding from Congress, it would be difficult for the IRS to shift enforcement resources from correspondence examinations involving relatively simple deficiencies, such as reported taxable income that does not match information reports, to audits of high-income taxpayers.[298] Further, if high-income taxpayers or their advisors perceive that the IRS may increase scrutiny of their tax positions in order to collect additional revenue, this perception (even if inaccurate) would only serve to increase deterrence of high-end tax noncompliance.

2. *Reasonable Cause Defense*

Civil tax penalties often fail to deter high-end tax noncompliance not only due to their low rates or probability of application, but also as a result of the availability of taxpayer defenses. As discussed earlier, the accuracy-related tax penalties apply to any underpayment that is attributable to specified acts such as negligence, disregard of rules or regulations, and substantial understatements.[299] Under current law, however, all taxpayers may rely on the statutory "reasonable cause and good faith" defense to defend against the application of these penalties (the so-called "omnibus defense").[300] Rather than focusing solely on the specific tax laws at issue in the tax controversy, this defense allows a taxpayer to present information about their personal attributes, including "experience, knowledge, and education," in order to show that the claimed tax position was reasonable.[301] A taxpayer can also satisfy the reasonable cause standard by showing that she reasonably relied in good faith on advice from a professional tax advisor regarding the treatment of a tax position.[302] To qualify for this exception, the advice must consider all pertinent facts and circum-

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[295] Rettig IRS Letter, *supra* note 57, at 2, 4; IRS, INTERNAL REV. MANUAL 4.1.1, PLANNING, MONITORING, AND COORDINATION (2020), https://www.irs.gov/irm/part4/irm_04-001-001r#idm140507379437840 (instructing IRS employees about the factors the agency considers in assigning staff).

[296] *See* Rettig IRS Letter, *supra* note 57, at 2.

[297] *See id.*

[298] *See id.* at 4.

[299] *See supra* note 25 and accompanying text.

[300] I.R.C. § 6664(c).

[301] Treas. Reg. § 1.6664-4(b).

[302] Treas. Reg. § 1.6664-4(c).

stances and not be based on unreasonable assumptions.[303] In addition, the IRS will apply a facts-and-circumstances analysis, focusing on whether the taxpayer's position was reasonable in light of the taxpayer's experience, knowledge, and education.[304]

The reasonable cause defense—particularly the reliance on opinion and advice exception—has long played a central role in tax planning by high-end taxpayers.[305] In the late 1970s and early 1980s, in thousands of tax shelter cases, high-income taxpayers actively sought written tax opinions as a means of avoiding tax penalties.[306] Twenty years later, throughout the corporate tax shelter boom of the late 1990s, corporate taxpayers paid hefty sums for standard form written opinions, many of which included questionable legal conclusions.[307] While the era of mass-marketed tax shelters has subsided, high-income individual taxpayers still often seek written opinions from professional tax advisors, which present varying levels of confidence, in order to take advantage of the reasonable cause defense.[308]

The law currently adopts an activity-based approach by restricting taxpayers from relying upon the reasonable cause defense when they have engaged in certain potentially abusive transactions. For example, taxpayers may not assert the defense against accuracy-related tax penalties resulting from transactions that lack "economic

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303 Treas. Reg. § 1.6664-4(c)(1)(i), (ii).

304 Treas. Reg. § 1.6664-4(c)(1).

305 *See* Doran, *supra* note 76, at 117–18; Drennan, *supra* note 118, at 17–18 & nn.80–81; Rachelle Y. Holmes, *The Tax Lawyer as Gatekeeper*, 49 U. Louisville L. Rev. 185, 204–05 (2010); Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 Tax L. Rev. 489, 510–11 (2010); Raskolnikov, *supra* note 75, at 619.

306 *See generally* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 Yale J. on Regul. 77 (2006) (describing the role of lawyers in the development of tax shelters); Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 Am. U. L. Rev. 267, 272 (2008) (same); Dennis J. Ventry, Jr., *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, 111 Tax Notes 823, 825 & n.18 (2006) ("Tax departments began generating huge profits from fees for opinion letters costing as much as $1 million per opinion, which were sold multiple times to different clients with little or no additional work.").

307 *See* Tanina Rostain & Milton C. Regan, Jr., Confidence Games: Lawyers, Accountants, and the Tax Shelter Industry 218–36 (2014) (identifying several lawyers and firms known for questionable opinions designed to justify tax shelters); Bankman, *supra* note 173, at 1782 (describing the role of legal opinions in the development of tax shelters); U.S. Dep't of Treasury, *supra* note 173, at x ("The ABA believes that many corporate tax shelters and supporting opinions are based upon dubious factual settings.").

308 *See* Emily Cauble, *Accessible Reliable Tax Advice*, 51 U. Mich. J.L. Reform 589, 591 (2017); Heather M. Field, *Tax Lawyers as Tax Insurance*, 60 Wm. & Mary L. Rev. 2111, 2122 (2019); Robert W. Wood, *Why Tax Opinions Are Valuable*, Forbes (Jan. 18, 2011, 9:12 AM), https://www.forbes.com/sites/robertwood/2011/01/18/why-tax-opinions-are-valuable.

substance" as defined in the Code.[309] Similarly, in some cases a taxpayer may not assert the reasonable cause defense for certain tax shelter penalties if he fails to disclose participation in an abusive tax strategy, such as in a listed transaction.[310]

Under the actor-based approach of progressive tax procedure, policymakers could also prevent high-income taxpayers from asserting the reasonable cause defense against any accuracy-related tax penalties. For example, policymakers could revise the law to provide that in the case of individual taxpayers with taxable income of $2 million or more, the reasonable cause and good faith defense of section 6664 would not be available to prevent the application of accuracy-related tax penalties and tax shelter accuracy-related tax penalties.[311] Again, to counter the possible motivation of IRS agents to challenge low-value tax positions of high-end taxpayers, policymakers could allow an exception to this adjustment for taxpayers with aggregate underpayment for the year of less than $50,000.

This adjustment would prevent high-income taxpayers from defending against these tax penalties by showing "reliance on opinion or advice," such as the written opinion of a tax lawyer or accountant.[312] More generally, this adjustment would allow the IRS to avoid the obligation to consider more general facts and circumstances when applying accuracy-related tax penalties.[313]

While means-based adjustments would prevent high-end taxpayers from asserting the reasonable cause defense, including through reliance on tax opinions or advice, critical aspects of the current tax penalty structure would remain in place. High-end taxpayers could still defend against certain accuracy-related tax penalties using defenses other than the reasonable cause and good faith defense.[314] For example, the law provides taxpayers with possible defenses other than the reasonable cause defense in the case of an accuracy-related

309 I.R.C. § 6664(c)(2); *see also supra* notes 150–55 and accompanying text (describing the economic substance doctrine and its limitations).

310 I.R.C. § 6664(d)(3).

311 Of course, any income threshold will create a "cliff effect," where taxpayers with income close to the threshold may be subject to significantly different treatment, depending upon whether their income reaches the threshold. For discussion of cliff effects in the tax law, see Manoj Viswanathan, *The Hidden Costs of Cliff Effects in the Internal Revenue Code*, 164 U. PA. L. REV. 931 (2016). These effects are not relevant for high-income taxpayers with income significantly higher than the threshold.

312 Treas. Reg. § 1.6664-4(c).

313 Treas. Reg. § 1.6664-4(c)(1).

314 While the reasonable cause defense is available for the accuracy-related tax penalties (§ 6662) and civil fraud tax penalties (§ 6663), as discussed *infra* notes 326–28 and accompanying text, there are additional potential statutory and administrative defenses to these penalties.

tax penalty resulting from a substantial understatement.[315] In this case, a high-end taxpayer would still be permitted to assert a "substantial authority" defense by arguing that the weight of authorities supporting the tax treatment are substantial compared to contrary authorities.[316]

Progressive tax procedure suggests a broader but also more properly tailored approach to the reasonable cause defense than under current law. Taxpayers are currently prevented from asserting the reasonable cause defense against accuracy-related tax penalties only in certain circumstances, such as non-disclosed listed transactions.[317] In contrast, the proposal would prevent all high-income taxpayers from asserting the reasonable cause defenses, irrespective of whether their tax position is a non-disclosed listed transaction or any other specific transaction.[318]

The adjustments to the reasonable cause penalty defense under progressive tax procedure would also depart in critical respects from prior approaches in the tax law literature. Professor Steve Johnson, for example, has argued that Congress should not allow wealthy taxpayers to assert the "reliance on opinion or advice" exception to defend against accuracy-related tax penalties.[319] The approach under progressive tax procedure, in contrast, is simultaneously broader and more tailored than this prior proposal. First, the adjustment would prevent high-end taxpayers from asserting the entire reasonable cause defense against tax penalties, not just the reliance on opinion or advice exception.[320] That is, the adjustment under progressive tax procedure would also prevent high-income taxpayers from arguing that general facts and circumstances, including knowledge of the taxpayer and honest misunderstanding of fact or law, as a tax penalty defense. At the same time, the exception for low-value underpayments could preserve a high-income taxpayer's ability to raise the defense in cases of more minor offenses. Finally, the adjustment to the reasonable

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315 I.R.C. § 6662(d).

316 I.R.C. § 6662(d)(2)(B)(i).

317 *Id.*

318 *Id.*

319 Johnson, *supra* note 240, at 60. For other proposed reforms to this defense that do not explicitly adjust on the basis of a taxpayer's wealth, see Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. Corp. L. 219, 264 (2004); Jeremiah Coder, *Achieving Meaningful Civil Tax Penalty Reform and Making It Stick*, 27 Akron Tax J. 153, 178 (2012); Drennan, *supra* note 118, at 35; Calvin H. Johnson, *Ending Reliance on Tax Opinions of the Taxpayer's Own Lawyer*, 141 Tax Notes 947, 961 (2013); Michelle M. Kwon, *Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors with Conflicts of Interest*, 67 Tax Law. 403, 443–49 (2014).

320 *See supra* notes 309–13 and accompanying text.

cause defense under progressive tax procedure would be implemented as part of a systematic program of adjustments to the tax procedure rules in general designed to address high-end noncompliance, rather than as a unique and isolated rule change.

Means-based adjustments to reasonable cause defenses would enhance deterrence by increasing the expected value of tax penalties. While the dollar value of the IRS's initial asserted tax penalties against high-income individuals can be substantial, the IRS often settles these cases without imposing the tax penalties.[321] For instance, according to public reports, in 2016 the IRS claimed that an auto-parts magnate, Georg Schaeffler, owed taxes and penalties of approximately $1.2 billion as a result of the restructuring of billions of dollars in debt.[322] In 2019, news reports noted that the IRS ultimately withdrew its tax penalty assertions and accepted a payment of tens of millions rather than the original $1.2 billion deficiency.[323] Under progressive tax procedure, high-income taxpayers would not be entitled to claim the reasonable cause defense to contest any accuracy-related tax penalty—even if their tax strategies fall outside of the current non-reasonable cause defense categories. Such a change to the tax controversy landscape would likely increase the government's ability to deter high-end noncompliance generally and strengthen the IRS's bargaining power in settlement negotiations.

These adjustments could combat perceptions by taxpayers that the IRS does not apply sanctions against high-end taxpayers due to weaknesses in tax enforcement. By reforming the reasonable cause defense according to the taxpayer's income, legislators could frame the change as shutting down a "tax penalty loophole" for high-income taxpayers. This framing could allow policymakers to argue credibly that the IRS may no longer permit high-income taxpayers, who can afford to pay for a written tax opinion from a lawyer or accountant, to use this advice as a penalty waiver. Legislators could also note that one of the most common tax penalty defenses, the reasonable cause defense, would now be available only to middle- and low-income taxpayers. These adjustments could thus improve taxpayers' perceptions of the fairness of the tax system, a shift which could enhance tax morale and tax compliance.[324]

One possible concern with this approach is that, without the reasonable cause defense, high-income taxpayers could be forced to face tax penalties in situations where the tax treatment is uncertain ex

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321 *See, e.g.*, Eisinger & Kiel, *supra* note 30.

322 *Id.*

323 *Id.*

324 *See supra* Section II.B.3.

ante. For example, consider a high-income taxpayer who desires to participate in a debt modification and who would like to take the legal position that the modification does not result in cancellation of indebtedness because there are conflicting authorities on this particular issue.[325] She may be concerned that if she claims the tax position, she could be subject to an accuracy-related tax penalty without being able to assert the reasonable cause defense. In this case, some might argue that the denial of the reasonable cause defense imposes either excessive tax penalties on the taxpayer—if she pursues the restructuring and is subject to a penalty—or opportunity costs, if she decides not to pursue it at all because of the increased penalty risk.

A response to this potential concern is that, under the proposal, the high-income taxpayer would not be without any penalty defenses. If the IRS asserted an accuracy-related tax penalty due to a "substantial understatement," for example, the taxpayer could still present a "substantial authority" defense, arguing that the weight of supporting authorities is substantial compared to the weight of contrary authorities.[326] The taxpayer could also defend against this penalty by disclosing to the IRS a "reasonable basis"—that the tax position is reasonably based on certain authorities, such as provisions of the Code, legislative history, regulations, or tax treaties, among others.[327] In contrast to the reasonable cause defense, which considers the personal attributes and actions of the taxpayer (such as reliance on a professional tax advisor), the reasonable basis defense and the substantial authority defenses depend upon substantive analysis of the applicable tax law in the Code, regulations, and other legal authorities.[328] Elevating the importance of these defenses would also force the high-income taxpayer to articulate the legal arguments for the claimed tax position directly.

More generally, some might argue that disallowing a reasonable cause defense could invade the attorney-client relationship for high-income taxpayers and their advisors. Some may argue that the change would disincentivize high-end taxpayers from seeking legal advice regarding transactions and strategies where the tax treatment is ambiguous. Critics of the tax penalty for non-economic substance

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[325] *See* Treas. Reg. § 1.1001-3 (detailing the complex rules regarding the modification of debt instruments).

[326] I.R.C. § 6662(d)(2)(B)(i).

[327] Treas. Reg. § 1.6662-3(b)(3).

[328] *See supra* note 301 and accompanying text.

transactions,[329] which applies on a strict liability basis,[330] made similar arguments when Congress enacted the law in 2010.[331]

Means-based adjustments, however, would not prevent taxpayers from seeking legal counsel regarding any tax issue or the tax treatment of any proposed transaction. The only restriction created by means-based adjustments is that high-end taxpayers could not rely on legal advice to avoid accuracy-related tax penalties. If taxpayers have questions regarding whether a tax position is consistent with the tax law, they could still seek advice from a tax lawyer or accountant before claiming the tax position. The absence of the reliance on opinion and advice exception may alter taxpayers' willingness to engage in abusive tax strategies, but this result would be a socially desirable outcome.

3. *Statute of Limitations*

The statute of limitations on additional assessment of tax liability also inhibits deterrence of high-end tax noncompliance. The default statute of limitations begins on the date that a taxpayer files a tax return and continues to run for three years from this date.[332] A primary purpose of the statute of limitations is to require the IRS to review taxpayers' returns, and supporting documents and other material, in a timely manner and to create closure for the taxpayer for actions that have occurred in the past.[333] While the statute of limitations is a source of procedural fairness, it is also an obstacle for the IRS. The IRS must assess additional tax or, at least, issue a notice of deficiency before the clock stops ticking.

Current law provides activity-based adjustments in this area as well and extends the statute of limitations when taxpayers commit specific acts or abuses. If a taxpayer's return reflects a "substantial omission," where an amount of income is improperly omitted from

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329 I.R.C. § 6662(b)(6).

330 *See* I.R.C. § 6664(c)(2) (providing that the reasonable cause defense does not apply to transactions lacking economic substance).

331 *See, e.g.*, Clinton Stretch, Matthew Lay & John Galotto, *Economic Substance and Strict Liability Do Not Mix*, 113 Tax Notes 1357, 1361 (2009) (arguing that a strict liability standard will create uncertainty and deter beneficial investment); Am. Inst. of Certified Pub. Accts., Report on Civil Tax Penalties: The Need for Reform 9–11 (2009) ("The lack of a reasonable cause or waiver provision in penalties involving complex determinations is particularly troubling."). For additional criticism of the codified economic substance doctrine, see Kathleen DeLaney Thomas, *The Case Against a Strict Liability Economic Substance Penalty*, 13 U. Pa. J. Bus. L. 445 (2011). *See also* Lederman, *supra* note 150.

332 I.R.C. § 6501(a).

333 *See* Michael I. Saltzman & Leslie Book, IRS Practice and Procedure ¶ 5.01 (2d ed. 2020).

gross income and that amount is greater than 25% of the gross income stated on the return, then the statute of limitations is doubled from three years to six years.[334] If the taxpayer fails to file a reportable transaction disclosure form for a listed transaction, even if the transaction becomes a listed transaction after the taxpayer has participated in it, the statute of limitations does not close until after the taxpayer or her advisor provides the required information.[335] Last, if the taxpayer files a fraudulent return, or no return at all, the statute of limitations never closes.[336]

The statute of limitations diminishes the IRS's ability to deter high-end taxpayers from engaging in complex, potentially abusive tax strategies. Once the statute of limitations clock runs out, the IRS cannot restart it and assess additional tax liability. Notable examples of transactions where an expired statute of limitations prevented the IRS from pursuing tax deficiencies include several high-profile controversies involving overstatement of basis,[337] such as *United States v. Home Concrete & Supply, LLC*,[338] which the U.S. Supreme Court decided in the taxpayer's favor. As IRS officials have reported, high-end tax avoidance is among the most challenging types for the IRS to detect, as higher-income taxpayers can use more complex strategies and may involve multiple entities in different jurisdictions.[339] High-end taxpayers who claim questionable tax positions are aware that time may run out before the IRS detects them.[340] As one tax advisor has explained, when he informs his clients that statutes of limitations have expired, "we high-five them."[341]

If the IRS detects a potentially improper tax position toward the end of the applicable statute of limitations period, the IRS often requests that the taxpayer grant the IRS an extension.[342] In most cases, taxpayers grant the IRS the extension rather than encourage its

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334 I.R.C. § 6501(e).

335 I.R.C. § 6501(c)(10).

336 I.R.C. § 6501(c)(1), (2).

337 *See, e.g.*, Beard v. Comm'r, T.C.M. 2009-184 (2009), *rev'd*, 633 F.3d 616 (7th Cir. 2011), *cert. granted and vacated*, 566 U.S. 971 (2012); Bakersfield Energy Partners, LP v. Comm'r, 568 F.3d 767, 768 (9th Cir. 2009); *cf.* Salman Ranch Ltd. v. Comm'r, 647 F.3d 929, 943 (10th Cir. 2011) (rejecting petitioner's argument that statute of limitations had lapsed).

338 566 U.S. 478 (2012).

339 *See* Rettig IRS Letter, *supra* note 57, at 2.

340 *See, e.g.*, Kiel & Eisinger, *supra* note 291; *see also Statute of Limitations: When Taxpayers Can Tell the IRS, "You Snooze, You Lose.*," Barnes L. LLP (May 7, 2016), https://www.barneslawllp.com/blog/statute-limitations-taxpayers-can-tell-irs-snooze-lose.

341 Kiel & Eisinger, *supra* note 291.

342 IRS, Catalog No. 46890Q, Extending the Tax Assessment Period (2017), https://www.irs.gov/pub/irs-pdf/p1035.pdf.

agents to issue an aggressive notice of deficiency quickly.[343] But even in these situations, high-end taxpayers retain negotiation leverage due to the very existence of the initial time limit. High-income taxpayers often agree to a conditional waiver, where they reach agreement with the IRS over the end date[344] and the specific issues that the IRS may continue to review during the extension period.[345] For this reason, tax advisors who specialize in working with high-income taxpayers have commented that "it is almost always preferred to sign a limited extension with a specified expiration date . . . rather than an indefinite extension . . . ."[346] In some extreme cases, high-end taxpayers refuse to grant the waiver. In the reported 2012 audit of Georg Schaeffler over a $5 billion deficiency, for instance, the taxpayer allegedly threatened to refuse to grant the IRS an extension.[347]

Instead of extending the statute of limitations based solely on specific acts or offenses, policymakers could also extend the statute of limitations based on the taxpayer's income. For example, in the case of any individual taxpayer with taxable income of $2 million or more, policymakers could revise the default review period in which the IRS could assess additional tax liability to six years—instead of the three years under current law[348]—from the filing of the taxpayer's return. All other taxpayers would still face the default three-year statute of limitations. As in the prior examples, the adjustment could include an exception for taxpayers with an aggregate underpayment of less than $50,000 so that high-income taxpayers with smaller underpayments would still benefit from the default statute of limitations rules under current law.[349]

Policymakers can also layer this means-based adjustment atop the law's current activity-based adjustments for particularly abusive transactions, such as substantial omissions,[350] by extending the time for review in the case of high-income taxpayers from six years under current law[351] to nine years. All other taxpayers would remain subject to

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343 *Id.* ("If you choose not to sign the consent, we will take steps that will allow us to assess any tax we determine to be due.").

344 For example, this date could be six months from the date of the waiver.

345 *See, e.g.*, Joe Marchbein, *Consent to Extend the Statute of Limitation*, TAX ADVISER (June 30, 2009), https://www.thetaxadviser.com/issues/2009/jul/consenttoextendthestatuteoflimitation.html; Charles P. Rettig, *Tax Practitioners Guidebook: Picking Up Table Scraps*, 114 TAX NOTES 1007, 1010 (2007).

346 Rettig, *supra* note 345, at 1010.

347 Eisinger & Kiel, *supra* note 30.

348 I.R.C. § 6501(a).

349 For discussion of potential cliff effects resulting from the low-value underpayment threshold, see *supra* notes 311–13.

350 I.R.C. § 6501(e).

351 *Id.*

the six-year statute of limitations for substantial omissions. A key objective should be to increase the statute of limitations for high-end taxpayers while retaining the features of current law for all other taxpayers. These examples are illustrative, and policymakers could calibrate the degree of the time period adjustments to balance the competing considerations of providing closure for past offenses and allowing sufficient time for the IRS to make assessments.

This actor-based approach to the statute of limitations could enhance deterrence of high-end abusive tax planning and tax evasion and could counter taxpayer strategies to avoid assessments by taking advantage of shorter statute of limitation periods. High-income taxpayers, and their advisors, value the limitations on the ability of the IRS to review their tax returns and assess additional tax. In most cases, they avoid participating in listed transactions, but if they do, they are aware that failing to file the required disclosure form can keep the statute of limitations open.[352] When the tax shelter disclosure rules first took effect, the IRS reported that aggressive taxpayers attempted to file inadequate disclosure forms in order to avoid penalties and start the statute of limitations.[353] Especially in the case of gifts by high-end taxpayers, tax advisors emphasize the importance of filing a gift tax return in order to limit the IRS's time for review.[354] Implicit in some of this advice is that, if the clock starts ticking, the IRS may not identify a potential deficiency before time runs out.[355]

By increasing the time for review, this adjustment would also alert high-income taxpayers that the chance of IRS detection of abusive tax positions has increased. Even if policymakers did not apply other means-based adjustments to tax penalties or to tax penalty defenses,[356] this change would increase the probability of detection and, as a result, the expected costs of high-end tax noncompliance.

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352 *See, e.g.*, Linda Z. Swartz & Jean Marie Bertrand, Cadwalader LLP, To Disclose or Not to Disclose: Tax Shelters, Penalties, and Circular 230 in 2015, at 5–6 & n.17 (2015), https://www.cadwalader.com/uploads/books/d09bc22416d46ea1af862b33ebf77de8.pdf (advising corporate clients regarding the disclosure requirements and statute of limitations).

353 *See, e.g.*, Blank, *supra* note 156, at 1667; *see also* Michael Kosnitzky, *Protective Filings for Hedge Funds After the Jobs Act*, 109 Tax Notes 817, 817 (2005) (describing inadequate protective filings made by hedge funds).

354 *See, e.g.*, Anthony Vittiello, James R. Grimaldi, Mark Sklarz & Seth Cohen, *Gift Tax Returns & IRS Examination*, CPA J. (Jan. 2017), https://www.cpajournal.com/2017/01/21/gift-tax-returns-irs-examination; Jay A. Soled, Paul L. Caron, Charles Davenport & Richard Schmalbeck, *Rethinking the Penalty for the Failure to File Gift Tax Returns*, 141 Tax Notes 757, 759 n.28 (2013) ("[N]oncompliant taxpayers always risk a future audit.").

355 *See* Vittiello et al., *supra* note 354 ("[T]ake advantage of the adequate disclosure statute of limitations . . . .").

356 *See supra* Sections III.B.1–2.

Adjustments to the statute of limitations through progressive tax procedure would counter public perceptions that the IRS does not challenge abusive tax planning as a result of expired time limits. For example, in 2018, the *New York Times* published a lengthy report on tax planning by members of President Trump's family and the Trump Organization.[357] The reporters characterized several of the tax positions, involving property valuations and transactions between related parties, as "dubious tax schemes," "tax dodges," and "overt fraud."[358] In addition, the reporters noted that the IRS would be unlikely to review the returns for the years covered in the story, some dating to the 1960s and 1970s, because "the acts happened too long ago and are past the statute of limitations."[359] Whether or not the allegations in the report are accurate, dozens of other news sources highlighted the impact of the statute of limitations on further investigation by the IRS.[360] Means-based adjustments would empower the government to signal to all taxpayers that it now possesses an enhanced tax enforcement tool—time itself—which it can deploy in its review of the tax returns of high-end taxpayers.

A potential concern raised by the proposed adjustment is that it could be perceived as depriving high-end taxpayers of procedural fairness and equal treatment under the law.[361] An extended statute of limitations increases the potential that any high-end taxpayer, even one who is compliant with the tax law, could face potentially intrusive audits that stretch several years in the past. Not only would these taxpayers be exposed to the potential for greater IRS assertions of tax

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357 *See* Barstow et al., *supra* note 4.

358 *Id.*

359 *Id.*

360 *See, e.g.*, Michael Collins, *IRS Unlikely to Pursue Tax Fraud Allegations Against Donald Trump and Family, Experts Say*, USA Today (Oct. 3, 2018, 9:50 PM), https://www.usatoday.com/story/news/politics/2018/10/03/trump-taxes-irs-unlikely-probe-fraud-claims-detailed-newspaper/1515405002; Irina Ivanova, *Trump Likely Couldn't Be Prosecuted for Tax Fraud – Even if the Times Report Is True*, CBS News (Oct. 3, 2018, 7:57 PM), https://www.cbsnews.com/news/trump-couldnt-be-prosecuted-for-tax-fraud-even-if-what-the-new-york-times-reported-is-true; Claudia Koerner, *New York Officials Are "Vigorously" Reviewing a Report That Trump Committed Tax Fraud*, BuzzFeed News (Oct. 3, 2018, 5:50 PM), https://www.buzzfeednews.com/article/claudiakoerner/trump-taxes-investigation; Bess Levin, *"Beyond the Law": Should Trump's Tax Chicanery Land Him in the Clink?*, Vanity Fair (Oct. 3, 2018), https://www.vanityfair.com/news/2018/10/beyond-the-law-should-trumps-tax-chicanery-land-him-in-the-clink; Annie McDonough, *Why Hasn't New York Charged Donald Trump for Tax Fraud?*, City & State N.Y. (May 9, 2019), https://www.cityandstateny.com/articles/policy/criminal-justice/why-hasnt-new-york-charged-donald-trump-with-tax-fraud.html.

361 That is, this adjustment could be understood as affecting a rule that is more similar to a core procedural rule ensuring equal process and access to justice. *See supra* notes 253–54 and accompanying text.

deficiencies than other taxpayers, but they would also be subject to increased compliance burdens, including record keeping and documentation.[362] By applying different review periods to different groups of taxpayers, this proposal could face criticism that it subjects certain taxpayers to increased scrutiny based on economic status rather than potential culpability.

This possible concern may be mitigated by a number of considerations. Of course, the small-underpayment exemption would only limit these adjustments to significant cases of abuse. Statutes of limitation afford taxpayers closure, but also do not implicate core aspects of access to justice in the same manner as a right to appeal.

More generally, differential treatment of high-income taxpayers may also be justified in this case on account of their access to different tax planning and detection avoidance opportunities. That is, this adjustment would be designed to equalize the effect of the tax procedure rules, rather than to make them less equal. As described above, the business affairs of many high-income taxpayers are more complex and difficult for the IRS to review than those of taxpayers whose income consists largely of wages.[363] High-income taxpayers also present a greater resource mismatch with the IRS, in terms of participation of tax accountants and lawyers in planning, than other taxpayers.[364] Recognizing such differences, Congress has already applied net worth requirements to taxpayers in other tax procedure rules, such as provisions that govern taxpayers' ability to shift the burden of proof in civil tax controversies to the IRS.[365] Different statute of limitations periods based on taxable income are in line with these other means-based adjustments. By taking into account differences between groups of taxpayers through varying statutory review periods, the IRS may ultimately apply more equitable enforcement of the tax law against these taxpayers in practice.

Conclusion

High-end tax noncompliance undermines the progressivity of the tax law and poses an obstacle for future progressive reforms. Policymakers concerned with preserving a progressive tax system will need

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[362] *See How Long Should I Keep Records?*, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/how-long-should-i-keep-records (last updated Sept. 29, 2020); Bob Carlson, *How Long Should You Keep Tax Returns? Longer Than You Think*, Forbes (July 9, 2018, 3:14 PM), https://www.forbes.com/sites/bobcarlson/2018/07/09/how-long-should-you-keep-tax-returns-longer-than-you-think.

[363] *See* Rettig IRS Letter, *supra* note 57, at 2, 4.

[364] *Id*.

[365] I.R.C. § 7491(a)(2).

to address this challenge and the first order effects of noncompliance on the distribution of tax burdens. Professor Joel Slemrod observed:

> [I]t is impossible to understand the true impact of a country's tax system by looking only at the tax base and the tax rates applied to that base. A critical intermediating factor is how the tax law is administrated and enforced.[366]

This Article has offered a new way for policymakers to address the problem of noncompliance by high-income taxpayers. The proposed system of "progressive tax procedure"—means-based adjustments to the tax procedure rules as they apply to high-income taxpayers—would more effectively deter high-end tax noncompliance than the law's current focus on specific potentially abusive activities. In presenting this new approach, this Article has made three primary contributions.

First, this Article has presented a normative case for means-based adjustments to the tax procedure rules. Means-based adjustments would enhance the core functions of certain tax procedure rules, such as the deterrent function of civil tax penalties, when they apply to high-end taxpayers. In achieving deterrence of high-end tax noncompliance, means-based adjustments could also improve taxpayer morale and lead to increased tax compliance by all taxpayers.

Second, this Article has revealed previously unexamined general limitations of the current statutory and regulatory responses to the problem of abusive tax planning and tax evasion, by introducing the concept of "activity-based rules." These rules currently target specific transactions or activities, such as participation in listed transactions or the use of offshore bank accounts, and high-income taxpayers—and their sophisticated advisors—often circumvent these activity-based rules.

Finally, this Article has provided a framework for implementing progressive tax procedure and illustrated how it can be designed through three representative examples. These examples illustrate how progressive tax procedure could be implemented in three areas of law at the heart of the government's deterrence efforts in tax enforcement: civil tax penalties, the reasonable cause defense, and the statute of limitations.

This Article has introduced progressive tax procedure as a general approach to reforming the tax procedure rules, but it has only examined some potential applications. Policymakers can implement progressive tax procedure in other areas of tax procedure as well. Pro-

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366 Joel Slemrod, *Why People Pay Taxes: Introduction*, *in* WHY PEOPLE PAY TAXES 1 (Joel Slemrod ed., 1992).

gressive tax procedure has broad potential application, at both the federal and state levels, and across multiple tax instruments. As a result, the analysis and application presented in this Article are relevant to tax scholars, legislators and other tax policymakers, and federal and state tax administrators.