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"Progressive Tax Procedure."

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Vanderbilt Hall – 202
Time: 4:00 – 5:50 p.m.
Week 14

**SCHEDULE FOR FALL 2019 NYU TAX POLICY COLLOQUIUM**
(All sessions meet from 4:00-5:50 pm in Vanderbilt 202, NYU Law School)

1. Tuesday, September 3 – Lily Batchelder, NYU Law School.
2. Tuesday, September 10 – Eric Zwick, University of Chicago Booth School of Business.
3. Tuesday, September 17 – Diane Schanzenbach, Northwestern University School of Education and Social Policy.
4. Tuesday, September 24 – Li Liu, International Monetary Fund.
5. Tuesday, October 1 – Daniel Shaviro, NYU Law School.
6. Tuesday, October 8 – Katherine Pratt, Loyola Law School Los Angeles.
7. Tuesday, October 15 – Zachary Liscow, Yale Law School.
8. Tuesday, October 22 – Diane Ring, Boston College Law School.
9. Tuesday, October 29 – John Friedman, Brown University Economics Department.
10. Tuesday, November 5 – Marc Fleurbaey, Princeton University, Woodrow Wilson School.
11. Tuesday, November 12 – Stacie LaPlante, University of Wisconsin-Madison, Wisconsin School of Business.
12. Tuesday, November 19 – Joseph Bankman, Stanford Law School.
13. Tuesday, November 26 – Deborah Paul, Wachtell, Lipton, Rosen, and Katz.
14. Tuesday, December 3 – Joshua Blank, University of California, Irvine Law School, and Ari Glogower, The Ohio State University, Moritz College of Law.

# PROGRESSIVE TAX PROCEDURE

Joshua D. Blank[*] & Ari Glogower[**]

*Abusive tax avoidance and tax evasion by high-income and wealthy 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 rules targeting the specific strategies that enable tax avoidance and evasion by these taxpayers. For example, taxpayers who engage in certain tax shelter transactions or hold assets abroad face additional compliance obligations and potential tax penalties.*

*This Article presents the case for "progressive tax procedure"—means-based adjustments to the tax procedure rules for high-income and wealthy taxpayers. In contrast to the activity-based rules in current law, progressive tax procedure would tailor rules to the characteristics of the actors rather than their activities. Instead of focusing exclusively on specific potentially abusive activities, such as "reportable transactions," progressive tax procedure would adjust tax procedure rules based on the taxpayer's income or net assets. For example, a high-income taxpayer would face higher tax penalty rates or longer periods where the IRS could assess tax deficiencies.*

*Progressive tax procedure could improve upon the current system of activity-based rules to more effectively deter noncompliance by high-end taxpayers and counter the resource mismatch between these taxpayers and the IRS. Most critically, it could narrow the gap between the substantive tax law's prescriptions and the actual tax paid by high-end taxpayers. While progressive tax procedure would be especially desirable when policymakers pursue progressive tax reforms, it would be beneficial regardless of the progressivity of the underlying substantive tax law.*

*After developing the normative case for progressive tax procedure, the Article illustrates examples of means-based adjustments 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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We are grateful to [ ] for thoughtful suggestions and comments on prior drafts. All errors are our own.

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## I. INTRODUCTION

Abusive tax avoidance and tax evasion by high-income and wealthy taxpayers pose unique threats to the tax system.[1] These strategies undermine the 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 high-profile example, a 2018 *New York Times* exposé on the tax affairs of some members of the Trump family provoked public concern that 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 have the desired effect of raising more revenue from high-end taxpayers.[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 responses targeting the specific strategies that enable tax avoidance and evasion by these taxpayers. For example, taxpayers who engage in certain

[1] Of course, 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 strategies that do not comply with the substantive law, but not legal avoidance opportunities allowed by the substantive 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. For a more detailed description of the abusive tax avoidance and evasions opportunities available to high-end taxpayers, see *infra* Part II.A.

[5] For more discussion of the effect of noncompliance on progressive revenue collection, see *infra* Part II.A.

[6] *See generally, e.g,* Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential*, TAX NOTES FEDERAL 1099 (Nov. 18, 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* note 30 and accompanying text.

tax shelter transactions or who hold assets abroad face additional compliance obligations and potential tax penalties.[7]

This Article presents the case for "progressive tax procedure"— means-based adjustments to the tax procedure rules for high-income and wealthy taxpayers. In contrast to the activity-based rules in current law, progressive tax procedure would tailor rules to the characteristics of the actors rather than their activities. Instead of focusing exclusively on specific potentially abusive activities, such as "reportable transactions," progressive tax procedure would adjust tax procedure rules based on the taxpayer's income or net assets. Progressive tax procedure, we argue, could improve upon the current system of activity-based rules to more effectively deter noncompliance by high-end taxpayers and counter the resource mismatch between these taxpayers and the IRS. Most critically, it could narrow the gap between the substantive tax law's prescriptions and the actual tax paid by high-end taxpayers.[8] While progressive tax procedure would be especially desirable when policymakers pursue progressive tax reforms, it would be beneficial regardless of the progressivity of the underlying substantive tax law.

Tax procedure rules govern tax compliance and administration, including taxpayers' obligations to file returns correctly and on time, the IRS's ability to review and assess the reported tax liability,[9] civil tax penalties and interest on underpayments,[10] and reporting requirements of taxpayers and third parties, among other items.[11] Each of these rules can be distinguished from "substantive" tax rules, which determine tax liabilities under various tax instruments by taxing a defined base at an applicable rate schedule.

Unlike the substantive tax rules—which typically follow progressive schedules[12]—the tax procedure rules generally apply using the same penalty rates, time periods and other features for all taxpayers, without adjustment for their income or other external indicia of their ability to pay. All

[7] For discussion of these activity-based rules, see *infra* Part III.C.

[8] This Article does not address the separate question of whether noncompliance may be a desirable social outcome, and assumes that the substantive tax rules in fact represent the socially desirable or optimal tax system. *See infra* note 77. Additional enforcement or other measures to close the tax gap may also not be desirable, if they impose additional costs that outweigh the benefits from the additional revenue raised. *See infra* note 110 and accompanying text.

[9] For example, the procedures for the issuance of a notice of deficiency and petitions to the Tax Court in I.R.C. §§ 6212-6213.

[10] E.g. I.R.C §§ 6651-6651, 6662-6663 (penalties), § 6041-6050Y (third-party reporting).

[11] E.g. I.R.C. § 6012 (individual returns); §§ 6041-6045B (third party returns).

[12] *See supra* note [ ].

taxpayers, for example, face the same civil tax penalty and interest rates on underreporting and underpayments, and the IRS is subject to the same statutes of limitations for all taxpayers, irrespective of their income or wealth.[13]

Under progressive tax procedure, these rules would instead vary depending on the taxpayer's income or wealth. 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. The current activity-based rules in the tax law focus on particular activities or transactions that enable or indicate noncompliance. Progressive tax procedure would instead focus on the characteristics of the actors, and thereby address the general advantages available to high-end taxpayers in the tax administration system.

Tax procedure covers a broad set of rules with varying functions. Some tax procedure rules have a "deterrent" function by encouraging taxpayers to comply with the tax laws. For instance, the civil penalties for failure to file returns or pay taxes,[14] for accuracy-related underpayments,[15] and for fraud[16] encourage compliance by increasing a taxpayer's expected cost from noncompliance.[17] Other tax procedure rules have a "compensatory" function. The rules for interest charges on late payments of tax liabilities,[18] for example, 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). Other tax procedure rules—such as the statutes of limitations and the taxpayer appeal rights—advance general goals of procedural fairness, similar to in other areas of procedural law.[19] Tax procedure rules may also be understood as having an explicit "revenue raising" function, since they can increase the final tax burden paid by taxpayer's subject to these rules.[20] Finally, some tax

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[13] *See, e.g.*, IRS § 6662 (underpayment penalties); § 6501 (limitation on assessments); *see also infra* Part III.A.1 (defining the full scope of tax procedure rules).

[14] I.R.C. § 6651.

[15] I.R.C. § 6662.

[16] I.R.C. § 6663.

[17] See, e.g., Sarah Lawsky, *Modeling Uncertainty in Tax Law*, 65 STAN. L. REV. 241, 24-253 (2013); *see also infra* Part III.A.2.

[18] I.R.C. §§ 6601, 6621.

[19] *See infra* notes [ ] and accompanying text.

[20] That is, tax procedure rules may be understood as having a function similar to that of the substantive tax law in raising additional revenue, beyond the amounts necessary to deter noncompliance or to compensate the government for additional enforcement costs. *See infra* notes [ ] and accompanying text.

procedure rules have an "expressive" function in signaling the standards for taxpayer compliance and for fair treatment in tax administration.[21]

The case for means-based adjustments to the tax procedure rules will vary depending on nature and function of the rule subject to the adjustment. Means-based adjustments to rules serving a deterrent function—such as penalties for underpayments—can account for the challenges of detection and enforcement for high-income taxpayers, their differences in risk aversion, and perceptional harm to the tax administration system that could result from imposing harsher consequences for noncompliance on all taxpayers.[22] Means-based adjustments can also advance the expressive function of the tax procedure rules, by signaling that high-income taxpayer do not enjoy special benefits in their interactions with the tax compliance system, nor special opportunities to avoid their tax compliance obligations.[23] More generally, means-based adjustments can improve tax morale and perceptions of fairness, which can in turn affect taxpayer compliance and public support for progressive reforms.[24]

The purpose of progressive tax procedure is not simply to impose additional burdens on high-end taxpayers, solely because of their greater income or wealth. Rather, progressive tax procedure can equalize the impact of tax procedure rules across taxpayers in varying economic circumstances. In this respect, progressive tax procedure can promote more equal treatment, rather than differential treatment, by tailoring the rules to relevant characteristics of the taxpayer.[25]

After developing the normative case for means-based adjustments to the tax procedure rules, the Article illustrates possible applications of means-based adjustments 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 means-based adjustments, including the types of rules that should be adjusted and the methods for designing these adjustments.

Each of these tax procedure rules could vary with a taxpayer's taxable income or net assets. For one example, taxpayers with greater taxable income or net assets could be subject to higher penalty rates for understatement and fraud that vary according to their taxable income or net assets. Current law imposes an "accuracy-related" penalty of 20% on

[21] *See infra* notes [ ] and accompanying text.

[22] *See infra* notes 251-268 and accompanying text.

[23] *See infra* notes 278-279 and accompanying text.

[24] *See infra* Part III.D.2.

[25] *See infra* Part III.B (describing other contexts where means-based adjustments to legal rules can have the effect of equalizing their impact for individuals in different economic circumstances).

underpayments resulting from negligence or disregard of rules or regulations, substantial understatements of income tax and in certain other cases.[26] A taxpayer subject to this penalty with a $10,000 underpayment would face an additional $2,000 penalty,[27] regardless of taxable income or wealth. A means-based adjustment to this penalty could increase the percentage of the underpayment that high-end taxpayers would be required to pay as a tax penalty. For example, taxpayers with $5 million or more of taxable income or $10 million or more of net assets could be subject to an accuracy related penalty of 30%. In this case, the taxpayer would instead face a penalty of $3,000 on the underpayment.

The remainder of this Article proceeds as follows. Part II describes tax noncompliance by high-income and wealthy taxpayers, scholars' proposals for increasing deterrence and the government's activity-based approach to high-end tax noncompliance under current law. Part III presents the limitations of activity-based rules in the current law, general context on the theory of means-based adjustments to legal rules, the current state of means-based adjustments in the tax procedure rules, and the normative case for more systematic adoption of these adjustments through progressive tax procedure. Part IV describes design considerations for implementing means-based adjustments to the tax procedure rules and illustrates their possible application to several categories of rules.

## II. 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 as the legislators intended.

As this Part shows, high-income and wealthy taxpayers enjoy unique opportunities to avoid and evade tax obligations and face decreasing chances of being audited or challenged by taxing authorities.[29] In 2018, the IRS's audit rate of taxpayers in the highest income group reached its lowest

[26] I.R.C. § 6662(a).

[27] Setting aside additional possible payments due, such as interest on underpayments. I.R.C. § 6601.

[28] *See* I.R.C. § 1(a)-(d), (j); MICHAEL J. GRAETZ, DEBORAH H. SCHENK & ANNE 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 rate increases.").

[29] *See infra* notes [ ]-[ ] and accompanying text.

point in years, despite reports of continued global tax evasion through the offshore structures and other abusive tax strategies.[30] While difficult to quantify, at least one study has estimated that tax noncompliance by taxpayers with the highest income (the top 0.5%) results in an annual loss to the United States of at least $50 billion each year.[31]

The following discussion outlines the advantages of wealthy and high-income taxpayers that enable tax noncompliance, describes scholars' proposals for increasing deterrence of tax noncompliance generally and explains how current law adopts an activity-based approach to high-end tax noncompliance by focusing on specific potentially abusive activities.

### *A. High-end Tax Avoidance and Evasion*

This Subpart describes the ways in which high-end taxpayers avoid and evade tax liabilities, the low probability of government detection and the resource imbalance between high-end taxpayers and the IRS.

*Opportunities for Tax Noncompliance.* Both low-end and high-end taxpayers have opportunities to avoid and evade their taxes—or receive 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.[32] Studies suggest, however, that overall tax noncompliance may disproportionately benefit the wealthiest taxpayers, and thereby may reduce the overall progressivity of the tax system.[33] 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

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[30] *See, e.g.*, INT. REV. SERV., 2018 IRS DATA BOOK 27, *available at* https://www.irs.gov/pub/irs-soi/18databk.pdf; *see also* Ashlea Ebeling, *IRS Audit Rate on the Rich Collapses*, Forbes.com, May 20, 2019, *infra* notes 53-60 and accompanying text.

[31] Andrew Johns & Joel Slemrod, *The Distribution of Income Tax Noncompliance*, 63 NAT'L TAX J. 397, 397-98 (2010). For discussion, *see* Jesse Eisinger & Paul Kiel, *Gutting the IRS: The IRS Tried to Take on the Ultrawealthy. It Didn't Go Well*, ProPublica, Apr. 5, 2019, *available at* https://www.propublica.org/article/ultrawealthy-taxes-irs-internal-revenue-service-global-high-wealth-audits; *See also infra* notes 34-37 and accompanying text.

[32] See *infra* note [ ] and accompanying text.

[33] 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.").

fraction of actual income) increased with the taxpayer's income level, and peaked among taxpayers in the 99.0 to 99.5 percentile.[34] They found for that year an overall misreporting percentage of 15.2% for taxpayers with true income above $100,000 but less than half this amount (7.2%) for taxpayers below this income level.[35] Professors Natasha Sarin and Lawrence Summers estimated that recent IRS data suggests that higher income taxpayers underreport a significantly higher levels, and consequently the "tax gap" disproportionately benefits high-income taxpayers.[36]

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 an even stronger effect on the progressivity of tax revenue collection, since under the progressive rate schedule, tax liabilities generally rise with a taxpayer's income.[37]

Several factors explain why high-end taxpayers are more likely to benefit from abusive tax avoidance and noncompliance, and why these activities likely undermine the distribution of tax revenues prescribed by the progressive schedule in the substantive tax law.

First, high-end taxpayers have opportunities to underreport their taxes that do not exist for low-end taxpayers.[38] For simple example, as a result of the 2017 tax legislation, a wealthy individual can use a wholly-owned Subchapter C corporation as a device for earning income at the new 21% corporate tax rate rather than at the 40.8% top marginal income tax rate on individuals (including the net-investment income tax) by having the corporation retain its earnings and not pay a dividend.[39] In this case, the

[34] Johns & Slemrod, *supra* note 31; *The Distribution of Income Tax Noncompliance*, 63 NAT'L TAX J. 397, 397-98 (2010); *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/.

[35] *Id.* at 404-405; *See also* SLEMROD & BAKIJA, *supra* note 33, at 256.

[36] Sarin & Summers, *supra* note 6, at 1100-1102 (estimating that the average underreporting percentage for taxpayers with $10 million in income or more is 13.9%, or more than 5 times the 2.6% estimated for taxpayers with income under $200,000).

[37] That is, every $1 of tax that is not reported by a higher-bracket taxpayer represents a greater tax liability saved.

[38] *See, e.g.*, Gale & Krupkin, *supra* note 34 (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.

[39] For discussion of potential abusive retention strategies, *see* Cory J. Stigile, *Now I Am a C Corp: What About the Accumulated Earnings Tax?*, TAX NOTES, Apr. 15, 2019; David Kamin, et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439, 1451-52 (2019).

individual taxpayer would not pay tax on any income.[40] 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.[41]

Examples of abusive tax avoidance and tax evasion possibilities become more complex as they involve pass-through entities (such as Subchapter S corporations), tax-indifferent parties (such as trusts and tax-exempt entities) and non-U.S. entities. As Charles P. Rettig, Commissioner of Internal Revenue has explained, the most complex types of tax returns are those of high-end taxpayers, which often 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."[42] Recent research by Professors Annette Alstadsæter, Niels Johannesen, and Gabriel Zucman has found that offshore tax evasion is concentrated among the very wealthy, at least in their dataset consisting of wealth records in Scandinavia.[43] According to their study, they estimate that the top .01 percent of taxpayers in the study "evades about 25 percent of its tax liability by concealing assets and investment income abroad."[44]

Second, high-end taxpayers also benefit from the absence of information reporting and withholding, a procedural advantage that is not available to taxpayers with less income. 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.[45] 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.[46] For example, according to IRS

[40] *Id*.

[41] *See* Int. Rev. Serv., Internal Rev. Manual 4.10.13.2.3; I.R.C. §§ 531; 532(a).

[42] Letter from IRS Commissioner Charles P. Rettig to Senator Ron Wyden, Sept. 6, 2019, *available at* https://www.documentcloud.org/documents/6430680-Document-2019-9-6-Treasury-Letter-to-Wyden-RE.html.

[43] Annette Alstadsæter, Niels Johannesen, and Gabriel Zucman, *Tax Evasion and Inequality*, 109 AMER. ECON. REV. 2073 (2019).

[44] *Id*.

[45] *See* Dept. of Treasury, Pub. 1415, FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2011-2013, at 3, 13, 14 fig. 3 (Sept. 2019), https://www.irs.gov/pub/irs-soi/p1415.pdf.

[46] 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. Letter from Charles T. Rettig, IRS Commissioner, to Sen. Ron Wyden, (Sept. 6, 2019),

statistics, this misreporting rate for wages and salaries, which is subject to information reporting and withholding, is only about 1%.[47] By contrast, the misreporting rate for net capital gain income and partnership income, two common sources of income of high-end taxpayers, is 21% and 14%, respectively.[48] As Professors Lily Batchelder and David Kamin have calculated, in 2016, wage income accounted for only 10% of the reported income of the top .001% of taxpayers, but consisted of 80% of the reported income of the bottom 95% of taxpayers.[49]

Last, high-end taxpayers simply have more money at stake—potentially because of both their higher levels of income and applicable tax rates—which could justify greater expenditures on noncompliance.[50] These taxpayers also have more financial resources to pay for more sophisticated forms of avoidance and noncompliance,[51] and may have more complicated forms of taxable income and investments which may be easier to hide or underreport, or that are subject to more complex tax treatment.[52]

*Odds of Detection*. Taxpayers at varying income levels 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

https://www.finance.senate.gov/download/090619-treasury-letter-to-wyden-re-eitc. 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 Said*, TAX NOTES TODAY FEDERAL, September 27, 2019 (quoting Treasury Inspector General for Tax Administration J. Russel George as stating: "…there 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.

47 *See* Gale & Krupkin, *supra* note 34; Int. Rev. Serv., Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011-2013, Publication 1415 (2019).

48 *See id*.

49 Lily L. Batchelder & David Kamin, *Taxing the Rich: Issues and Options*, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3452274 (Sept. 18, 2019).

50 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 in turn serve as a ceiling on the amount a lower-income taxpayer would spend in tax planning or other strategies to improperly claim the credit. I.R.C. § 32(a)-(b).

51 *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).

52 *See* Grant Richardson, *Determinants of tax evasion: A cross-country investigation*, 15 J. INT'L ACCOUNTING AUDITING & TAX'N 150, 151 (2006) (finding that complexity is "the most important determinant of tax evasion").

enforcement efforts disproportionately target the top of the income distribution.[53]

According to recent IRS statistics, however, from 2017 to 2018, the IRS's audits of households with adjusted gross income between $5 million and $10 million dropped from 7.95% to 4.21% and between $1 million and $5 million dropped from 3.52% to 2.21%.[54] 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%.[55]

During the days following the IRS's announcement of the 2018 audit rates, journalists in the mainstream press highlighted the plunge in IRS examinations of high-income households with headlines such as *IRS Audit Rate On The Rich Collapses*[56] and *The IRS Barely Bothered to Audit Superrich People Last Year*.[57] Many commentators attributed the drop in audit rates to cuts to IRS funding over the past decade, as the agency has not been able to hire or retain enough Revenue Agents who have expertise necessary to review high-end taxpayers' returns.[58] Some commentators have also noted that this trend indicates that the audit rates among high earners now equals the audit rate on some subgroups of low-income taxpayers.[59]

*Resource Imbalance*. 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 expend on sophisticated tax advisors and representation in disputes with the

[53] For example, in fiscal year 2018 the IRS audited .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. IRS, DATA BOOK, 2018, PUB. 55B, at 27 tbl. 9b (May 2019), https://www.irs.gov/pub/irs-soi/18databk.pdf.

[54] INT. REV. SERV., 2018 IRS DATA BOOK 27, *available at* https://www.irs.gov/pub/irs-soi/18databk.pdf .

[55] *Id*.

[56] Ashlea Ebeling, *IRS Audit Rate on the Rich Collapses*, Forbes.com, May 20, 2019.

[57] Eric Levitz, *The IRS Barely Bothered to Audit Superrich People Last Year*, NEW YORK MAG., May 20, 2019.

[58] *See, e.g.*, Rachel Sandler, *Why Are The Superrich Getting Audited Less?*, Forbes.com, May 21, 2019; Richard Rubin, *IRS Audit Rate Drops Again as It Examines Fewer High-Income Households*, WALL ST. J., May 20, 2019.

[59] Paul Kiel, *It's Getting Worse: The IRS Now Audits Poor Americans at About the Same Rate as the Top 1%*, PROPUBLICA (May 30, 2016), 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).

IRS, and upon procedural steps such as negotiations and appeals.[60] These procedural advantages reduce the amount of taxes and penalties that the IRS ultimately recovers as a result of enforcement actions against high-income taxpayers.[61]

Recent reports illustrate the uphill battle that the IRS faces when attempting to audit and challenge the tax positions of high-end taxpayers. In 2018, *ProPublica* interviewed over 50 current and former IRS employees and issued a series of reports describing the IRS's attempts to increase enforcement against ultra-wealthy taxpayers.[62] 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.[63] According to one report, the IRS only audited 12 to 18 wealthy taxpayers in its first year.[64] 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.[65] Subsequent reports 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.[66] As Richard Schickel, a former IRS agent, commented in 2019, "This is a great time for not being compliant with paying taxes."[67]

[60] *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 an 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.").

[61] *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.)

[62] Eisinger & Kiel, *supra* note 31.

[63] *Id*.

[64] Transactional Records Access Clearinghouse (TRAC), Few Millionaires Audited by IRS Global High-wealth Group, Apr. 10, 2012, *available at* https://trac.syr.edu/tracirs/newfindings/v17/.

[65] Treas. Insp. Gen. for Tax Admin., *Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-end Taxpayers*, Sept. 18, 2015.

[66] Treas. Insp. Gen. for Tax Admin., *Prioritization of Collection Cases Is Inconsistent and Systematic Enforcement Actions Are Limited for Inactive Cases*, Sept. 25, 2017.

[67] Eisinger & Kiel, *supra* note 31.

*B. Models of Deterrence*

Tax scholars have proposed a variety of models for increasing deterrence of tax noncompliance, including by high-end taxpayers. A number of proposals in the literature would focus on the structure of civil tax penalties. Others would apply information-reporting and other approaches in order to increase the probability of detection. And some would reform the anti-abuse rules that courts and the IRS apply in order to reduce the ability of high-end taxpayers to avoid their application. These different approaches to enhancing deterrence, and the government's responses under current law, are described below.

*Increasing Tax Penalties*. When evaluating options for increasing deterrence of tax noncompliance by high end-taxpayers, the first tools that scholars and policymakers generally consider are tax penalties. For example, civil penalties for failing to report or pay taxes[68] reduce the expected benefit from noncompliance. In a report to Congress on tax penalties the Internal Revenue Code, 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.[69]

The prior literature examines the efficacy of the penalty rules in deterring noncompliance.[70] In a basic model, a taxpayer would comply with tax obligations whenever the expected value resulting from an adverse outcome (getting caught and facing a penalty in addition to the tax) exceeds the expected benefit from noncompliance.[71] The expected value of the adverse outcome, in turn depends upon both the chance that the noncompliance will

[68] *See, e.g.*, I.R.C. § 6651, §§ 6662-6663.

[69] TREASURY DEP'T. OFFICE OF TAX POLICY, REPORT TO 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.

[70] *See*, e.g., Sarah Lawsky, *Modeling Uncertainty in Tax Law*, 65 STAN L. REV. 241, 248-256 (2013) (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).

[71] Lawsky, *supra*, at 249-53.

be detected as well as size of the potential penalty.[72]

For example, consider *Taxpayer A*, a rational taxpayer who is only concerned with their financial outcome from compliance and noncompliance, with $100 of pretax income and facing a $20 tax liability. If the chance the IRS detects noncompliance and imposes a penalty is 10% and the penalty rate is 50% of the underpayment, the expected value of noncompliance would be $97,[73] which is greater than the $80 the taxpayer will have after-tax if they comply. 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.[74]

The deterrent effects from penalties operates similarly in the cases of both tax noncompliance and other legal offenses,[75] where a sanction discourages undesirable social behavior. These two situations fundamentally diverge 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 costs resulting from the activity.[76] Professor Alex Raskolnikov observes that, in the case of tax noncompliance however, any degree of noncompliance results in a net social loss.[77]

Professor Sarah Lawsky describes a more complex rational actor model, which would also account for taxpayers' risk aversion, by

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[72] *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 probably that noncompliance will be detected, and ($F$) is the amount of the fine if the noncompliance is detected. *Id.* at 250.

[73] 0.1(100 – 20 – 10) +0 .9(100).

[74] *See* Lawsky, *supra* note 70, at 252. Of course, taxpayers may decide to comply for other reasons that are not reflected in this simple model. *See id*. For discussion of other explanation of why taxpayers may comply with the tax law, *see, e.g.*, See Doran, *supra* note 61, at 131-38 (describing the social norms model of taxpayer compliance).

[75] *See infra* III.B.2.

[76] *See infra* notes 193-195 and accompanying text.

[77] Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 531-536 (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 in fact represent the socially desirable or optimal tax system. *Id.* at 575-76 ("If corporate tax is not part of the optimal tax system . . . the optimal taxpayer response to corporate tax is to evade it.").

evaluating the expected utility from compliance or noncompliance, rather than the expect 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.[78]

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.[79] In this case, using the facts above, the taxpayer's expected utility from compliance would be approximately 4.38[80] and expected utility from noncompliance would be approximately 4.57.[81] 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. Nonetheless, 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, however, that the detection and penalty rates would still need to be significant to effectively deter noncompliance.

Scholars and policymakers have noted this core problem with rational actor models: current penalty and noncompliance detection rates would need to be significantly higher than the current levels under the Code and administrative enforcement practices in order to effectively deter noncompliance.[82] Civil tax penalties under current law are far too low to achieve the deterrence effects of the classic Bentham-Becker fine, where the fine equals the harm divided by the probability that the harm would be detected *ex ante*.[83] As an alternative, 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 are 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

[78] In this case, adjusting the formula described *supra* note [ ] to reflect expected utility rather than the expected dollar return would yield, 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,* at 254-57. Professor Lawsky introduces an additional model which also accounts for a taxpayer's attitudes towards uncertainty. *Id.* at 257-66.

[79] *See id.* at 255.

[80] $ln(100\text{-}20)$.

[81] $0.1ln(100 - 20 - 10) + 0.9ln(100)$.

[82] *See, e.g.* Lawsky, *supra,* at 257 ("[T] the 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).

[83] *See supra* note 193 and accompanying text.

legitimate deduction item.[84] Professor Kyle Logue has offered another extrapolation of the Bentham-Becker fine by introducing a proposal for strict liability tax penalties that would be equal to the taxpayer's underpaid tax divided by the probability that the IRS would detect the taxpayer's noncompliance *ex ante*.[85] Other tax scholars have offered additional proposals for increasing or reforming civil tax penalties.[86]

While these proposals have expanded debate and understanding among tax scholars and economists, they have not been implemented by the federal or state governments.[87] Despite the appeal of these proposals under different models of compliance, legislators appear to face political economy constraints in implementing the steep penalty increases necessary to effectively discourage noncompliance by all taxpayers.[88]

*Increasing Detection.* In addition to proposals to increase or reform tax penalties, 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-end taxpayers. [89] For example, Professors Mitchell Gans and Jay Soled, have

[84] *See generally* Raskolnikov, *supra* note 60.

[85] 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 Bentham-Becker fine. *See generally* JEREMY BENTHAM, THE THEORY OF LEGISLATION 325 (C.K. Ogden ed., Richard Hildreth trans., Routledge & Kegan Paul Ltd. 1931) (1802); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

[86] *See, e.g.*, Michael Asimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 UCLA L. REV. 637 (1975) (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 (2010) (proposing a fault-based penalty); Jay Soled, *Third-Party Civil Tax Penalties and Professional Standards,* 2004 WIS. L. REV. 1611 (2004); Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

[87] *See* Raskolnikov, *supra* note 77, at 573-80 (discussing "[t]he disconnect between the optimal tax theory and the actual tax system").

[88] *See* Doran, *supra* note 61, 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").

[89] 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%. And, by contrast, when

proposed that when a non-spousal donee receives a gift that exceeds the gift tax annual exclusion, the donee would be required to file an information return with the IRS.[90] Professor Kathleen DeLaney Thomas has proposed that small business, which could be owned or conducted by high-end 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.[91] And Professor Lederman has advocated for basis reporting by brokers of securities[92] (a proposal which was subsequently enacted).[93]

In addition, scholars have noted that detection rates and IRS funding are linked. Professors Lily Batchelder and David Kamin have noted that when the IRS attempts to audit high-end taxpayers, it often "does not have the resources to correctly identify their tax liability."[94] In response, scholars such as Professor Lederman have argued that Congress should increase funding of IRS enforcement resources due to the fact as "inadequate enforcement of a progressive tax system may actually increase income inequality."[95] Recognizing the bleak prospects for significantly increased IRS funding, Professors Jonathan Forman and Roberta Mann have offered a number of proposals to IRS officials for maximizing the enforcement impact of limited resources.[96]

Current law only partially reflects the recommendations of these scholars regarding IRS detection. While wage earners are subject to information reporting and withholding, high-end taxpayers engage are not subject to either information reporting or withholding on many forms of

taxpayers are subject to neither information reporting nor withholding, the IRS estimates that the rate is as low as 37%. Testimony of Hon. J. Russell George, Treasury Inspector General for Tax Administration, Committee on Ways and Means, U.S. House of Representatives, May 9, 2019.

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

[91] Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX L. REV. 111 (2013).

[92] Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1742 (2010).

[93] *See* Int. Rev. Serv., *Cost Basis FAQs for Form 1040 filers*, *available at* https://www.irs.gov/businesses/small-businesses-self-employed/cost-basis-reporting-faqs.

[94] Batchelder & Kamin, *supra* note 49.

[95] Leandra Lederman, *The IRS, Politics and Income Inequality*, TAX NOTES, Mar. 14, 2016.

[96] Jonathan Barry Forman & Roberta F. Mann, *Making the Internal Revenue Service Work*, 10 FL. TAX REV. 725 (2015).

income.[97] In addition, IRS funding has continued to decline, falling by nearly 20% in inflation-adjusted dollars from 2010 to 2018.[98]

*Reforming Anti-abuse Rules.* In addition to increasing tax penalties or the probability of detection, scholars have also critiqued the anti-abuse rules that judges, and by extension, the IRS, use to address abusive tax shelters. If these tools were stronger, they argue, the IRS would be able to more effectively deter various forms of tax noncompliance, including by high-end taxpayers.

Under the judicial economic substance doctrine, prior to codification in 2010, courts would ask whether a taxpayer's transaction possessed a non-tax business purpose and meaningfully improved the corporation's economic position, aside from reducing its tax liability.[99] Scholars have criticized this approach as focusing too much on the intent of the taxpayer rather than that of the legislators who drafted the relevant statutes.[100] Professors Shannon Weeks McCormack,[101] Leandra Lederman[102] and Martin McMahon,[103] for example, have argued that the economic substance doctrine should focus on the purpose of the underlying tax laws rather than the taxpayers' business purpose for a transaction. Similarly, Professors Marvin Chirelstein and Lawrence Zelenak have offered a proposal that would apply objective standards and not require courts to analyze a

[97] *See* Testimony of Hon. J. Russell George, *supra* note 89.

[98] Emily Horton, *2018 Funding Bill Falls Short for the IRS*, Center on Budget and Policy Priorities, Mar. 23, 2018.

[99] *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, 364 U.S. at 366. For background, *see* Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 402-416 (2010); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 195 (2001); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 228–29 (2002).

[100] *See* Lederman, *supra* note 99, at 389 (criticizing courts' focus on taxpayer intent); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 715 (arguing against intent-based anti-abuse standards); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 94 TAX NOTES 511, 518 (2002) (criticizing application of economic substance doctrine).

[101] *See* McCormack, *supra* note 100, at 720–31.

[102] Lederman, *supra* note 99, at 389.

[103] *See* McMahon, *supra* note 99, at 1017 ("Supreme Court jurisprudence supports the application of a 'purposive activity' test...").

taxpayer's business motivation for pursuing particular transactions.[104] Professor David Weisbach has praised broad anti-abuse rules, such as the proposals offered by these tax scholars, for their role in creating uncertainty in the tax shelter market, which, he argues, also has the benefit of "forcing taxpayers to be more conservative than they would be if they had clear boundaries."[105]

While the Code now contains a codified economic substance rule, the statute retains the focus on taxpayers' intent.[106] Under the statute, enacted in 2010, courts 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.[107] Commentators have observed that several features of the codified doctrine do not change the ability of courts to engage in their own style of tax shelter analysis.[108]

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Of course, improving deterrence and enforcement can 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.[109] As a result, adjustments to tax penalties and other tax procedure rules may not be desirable, if such rules impose greater costs on the government and taxpayers that outweigh the social benefit from raising additional revenue by narrowing the tax gap.[110] Further, at a certain

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[104] Marvin Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1953-55 (2005).

[105] David A. Weisbach, *Disrupting the Market for Tax Planning*, 26 VA. TAX REV. 971 (2007).

[106] I.R.C. § 7701(o).

[107] *Id*.

[108] *See, e.g.*, Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. REV. 1641, 1656 (2012); David Hariton, *Has Codification Changed the Economic Substance Doctrine?*, 2 COLUM. J. TAX L. TAX MATTERS 5 (2011) ("[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).

[109] *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.").

[110] *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

point policymakers may be able to raise more revenue from high-end taxpayers—at a lower social cost—by increasing rates in the substantive tax law rather than through increased enforcement and administration.[111]

*C. Activity-based Rules*

Rather than embracing the comprehensive changes to tax penalty rates, enforcement infrastructure or modes of statutory interpretation offered in the prior literature,[112] the government has instead adopted targeted deterrence approaches to specific potentially abusive activities. The tax law contains increased civil tax penalties and disclosure obligations that apply when taxpayers engage in certain specifically designated transactions or tax strategies. In addition, it 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 activity-based approach to tax avoidance and evasion.

*Reportable Transactions*. Current law targets taxpayers' use of "reportable transactions"[113]—potentially abusive tax shelter strategies—through special disclosure and tax penalty rules. Reportable transactions include "listed transactions" and "substantially similar transactions,"[114] which are tax strategies that the IRS will challenge if taxpayers have used them to claim tax benefits. Specific examples of listed transactions are syndicated conservation easement transactions,[115] S-corporation transactions where taxable income is shifted to a tax-exempt entity[116] and transactions where the taxpayer attempts to inflate basis of stock through complex redemption transactions,[117] among many others. Reportable transactions also contain more general categories, such as situations where tax advisors require taxpayers to keep tax advice confidential or where taxpayers claim large tax losses ($2 million in the case of individuals).[118] If

costs of implementing such interventions, for both governments and taxpayers, it is clear that . . . the optimal compliance gap is not zero.").

[111] *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.").

[112] *See supra* notes [ ] – [ ] and accompanying text.

[113] Treas. Reg. § 1.6011-4 (taxpayer disclosure requirements).

[114] Treas. Reg. § 1.6011-4(b)(2). The IRS maintains the list of abusive tax shelters on its website. *See* Int. Rev Serv., Recognized Abusive and Listed Transactions, https://www.irs.gov/businesses/corporations/listed-transactions.

[115] I.R.S. Notice 2017-10, 2017-4 I.R.B. 544.

[116] I.R.S. Notice 2004-30, 2004-1 C.B. 828.

[117] I.R.S. Notice 2001-45, 2001-2 C.B. 129.

[118] Treas. Reg. § 1.6011-4(b)(5).

taxpayers engage in any reportable transaction, they must file a special disclosure form with the IRS's Office of Tax Shelter Analysis.[119] The form serves as a red flag, increasing the IRS's ability to detect the transaction. 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.[120] 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.[121]

*Offshore Bank Accounts*. Another specific activity that results in targeted reporting requirements and potential tax and criminal penalties is 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 liability on this income and then would withdraw their funds through wire transfers, credit cards and other methods.[122] Historically, the IRS could not deter this activity as a result of the bank secrecy rules of non-U.S. jurisdictions, such as Switzerland.[123]

Following the U.S. government's deferred prosecution agreement with UBS, in which conceded that it had facilitated tax evasion by thousands of taxpayers through foreign shell corporations that would open offshore accounts at UBS, the U.S. government took an aggressive approach against offshore tax evasion.[124] Enacted in 2010, the Foreign Account Tax Compliance Act (FATCA) requires foreign financial institutions to report identifying information and account balance information regarding account

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[119] *See* Int. Rev. Serv., Instructions for Form 8886 (Rev. Aug. 2017).

[120] 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. Id. § 301.6111-3(b)(3)(i)(A).

[121] I.R.C. § 6662A(a).

[122] For discussion, *see* STAFF OF THE HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, 110TH CONG., TAX HAVEN BANKS AND U.S. TAX COMPLIANCE, at 3 (2008); PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, 108TH CONG., TAX HAVEN ABUSES: THE ENABLERS, THE TOOLS AND SECRECY, at 1 (2006); Mark Hosenball and Evan Thomas, *Cracking the Vault*, NEWSWEEK, Mar. 23, 2009, at 32; Joshua D. Blank & Ruth Mason, *Exporting FATCA*, 142 TAX NOTES1245 (2014).

[123] *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).

[124] *See, e.g.*, Hiring Incentives to Restore Employment Act, P.L. 111-147, section 501, 124 Stat. 71 (2010).

holders that are U.S. persons, to the IRS.[125] If these financial institutions do not comply with FATCA's requirements, foreign financial institutions are subject to a 30 percent withholding tax on certain U.S.-source payments, including U.S.-source interest and dividends, and gross proceeds from the sale of assets that generate U.S. dividends and interest.[126] The impact of FATCA has been to increase the IRS's ability to detect offshore tax evasion by U.S. taxpayers.[127]

Around this time the U.S. government also pursued a number of high-profile criminal tax enforcement actions against high-end taxpayers who held offshore bank accounts and who 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.[128] 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 their unreported accounts and filing several years of amended tax returns.[129]

Today, taxpayers who hold offshore bank accounts must file several disclosure forms, such as IRS Form 8938 (Statement of Specified Foreign Financial Assets)[130] and Report of Foreign Bank and Financial Accounts (FBAR),[131] or face significant monetary penalties, including the possibility of criminal prosecution.[132]

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[125] *Id*.

[126] I.R.C. §§ 1471(a), (c); 1473(1).

[127] For discussion, *see* Blank & Mason, *supra* note 122; 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).

[128] *See* Dep't of the Treas., Memorandum for Division Commissioners Re Updated Voluntary Disclosure Practice, Nov. 20, 2018, *available at* https://www.irs.gov/pub/foia/ig/spder/lbi-09-1118-014.pdf; Prepared Remarks of IRS Commissioner Doug Shulman, IR-2011-55 (discussing voluntary disclosure program); Int. Rev. Serv, Offshore Voluntary Compliance Program to end Sept. 28, IR-2018-176 (Sept. 4, 2018).

[129] *See*, Int. Rev. Serv., Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2012.

[130] I.R.S. Form 8938 (Statement of Specified Foreign Financial Assets) (2018).

[131] 31 U.S.C. §5314; Dep't of the Treas., TD F 90-22.1 (Report of Foreign Bank and Financial Accounts (2012).

[132] 31 U.S.C. §5322. For additional discussion¸ *see* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS, ¶65.5.8 *Reporting Bank*

*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.[133] As described above, in 2010, Congress enacted legislation that created a uniform economic substance standard that courts must apply in cases where they find the doctrine to be applicable.[134] In order to deter taxpayers from engaging in abusive tax avoidance, Congress also enacted a special 20% civil tax penalty that applies whenever the taxpayer is found to owe tax liability as a result of the application of the economic substance doctrine or "any similar rule of law."[135] The IRS may assert this penalty following an audit without pursuing further litigation.[136] As discussed further in Part IV, taxpayers are not permitted to rely upon "reasonable cause" to defend against this tax penalty.[137]

*Non-Disclosure*. Finally, current law imposes penalties on taxpayers who fail to disclose potentially abusive transactions to the IRS. Complex tax shelters—which may involve not just the individual taxpayer, but also other parties and entities in the U.S. and other jurisdictions—are difficult for the IRS to detect from the face of a taxpayer's return.[138] To address this difficulty and increase deterrence, in 2004, Congress enacted tax penalties for taxpayers and advisors who fail to disclose to the IRS their participation in reportable transactions.[139] The penalty for failing to report participation in a listed transaction for individual taxpayers is $100,000[140] and the penalty for failing to disclose any other reportable transaction is $10,000.[141] These civil tax penalties apply "without regard to whether the transaction

*and Foreign Financial Accounts* (2018); Miriam L. Fisher & Brian C. McManus, *The Top Ten FBAR Mistakes—And How to Fix Them*, 28 J. OF TAX'N & REG. OF FIN. INST. 5 (2015); Oei, *supra* note 127 at 671.

[133] *See supra* note [ ] and accompanying text.

[134] *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–68 (codified at I.R.C. § 7701(o)).

[135] I.R.C. § 6662(d)(6).

[136] *See* I.R.S., Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (2018), available at *http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties.*

[137] *See infra* notes [ ] – [ ] and accompanying text.

[138] For discussion, *see* Sheryl Stratton, *Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS*, 100 TAX NOTES 1246, 1246–47 (2003); Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629 (2009).

[139] *See* STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF H.R. 4520, THE "AMERICAN JOBS CREATION ACT OF 2004" 150 (Comm. Print 2004) (discussing new penalties).

[140] I.R.C. § 6707A(b)(2)(A).

[141] I.R.C. § 6707A(b)(1)(A).

ultimately results in an understatement of tax."[142] In addition, taxpayers who are 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.[143] Taxpayers' advisors can be subject to non-disclosure 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.[144]

As each of these examples illustrates, the government often attempts to deter abusive tax avoidance and evasion by targeting specific transactions or activities. 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. Part III considers the limitations of this approach to deterring high-end tax noncompliance.

## III. The Case for Progressive Tax Procedure

### *A. Limitations of Activity-based Responses*

As described above, the "activity-based" responses in current law adjust the applicable tax procedure rules based on characteristics of the taxpayer's activities.[145] 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." [146] 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 in prior years could participate in offshore voluntary disclosure programs to avoid prosecution.[147] Taxpayers also face additional disclosure requirements and potential penalties when engaging in certain "listed" or "reportable" transactions.[148]

These activity-based rules can improve tax enforcement and administration by targeting the activities which can enable or correlate with

[142] H.R. Rep. No. 108-755, at 373 (2004) (Conf. Rep.).
[143] I.R.C. §§ 6662A(c); 6662(b)(6, (i)(1).
[144] I.R.C. § 6707(b)(2).
[145] *See supra* Part II.C.
[146] I.R.C. §§ 6662(a)-(b), 6663(a).
[147] *See supra* notes [ ] and accompanying text.
[148] *See supra* notes [ ] and accompanying text.

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.[149] Activity-based rules can also have the effect of increasing enforcement for high-end taxpayers, to the extent that this subset of taxpayers tends engage in the activities subject to the adjusted rules.[150]

Activity-based rules also face limitations when used to increase deterrence and enforcement for high-end taxpayers. As a result, these rules should be considered a beneficial but incomplete response to deterring high-end noncompliance.

First, due to the elasticity of tax planning, high-end taxpayers may be able to simply change the form of their activities to avoid those targeted by activity-based rules. For example, high-end taxpayers, and their sophisticated advisors, often avoid engaging in the activity specified as abusive by the IRS, such as a listed transaction or "substantially similar" tax strategy.[151] Instead, they seek out tax positions that do not fall into categories that would lead to the additional tax shelter penalties.[152] As commentators have noted regarding high-end taxpayers, "[s]uch taxpayers tend not to steamroll tax laws; they employ complex, highly refined strategies that seek to stretch the tax code to their advantage."[153]

Similarly, taxpayers may avoid offshore disclosure requirements by shifting their assets to other investments which also facilitate evasion.[154] Of course, policymakers can implement new activity-based rules to address changes in taxpayer behavior. This approach, however, leaves policymakers

[149] *See, e.g.,* Young Ran (Christine)Kim, *Considering "Citizenship Taxation:" In Defense of FATCA*, 20 FLA. TAX. REV. 335, 359-362 (2017) (describing the advantages of the FATCA and FBAR rules in combating offshore tax evasion).

[150] *See supra* notes [ ] and accompanying text.

[151] *See* Chirelstein & Zelenak, *supra* note 104, at 1950 (describing cat-and-mouse tax shelter game between the IRS and taxpayers); Joshua D. Blank, *Overcoming Overdisclosure*, 56 UCLA L. REV. 1629 (2009).

[152] *See* Chirelstein & Zelenak, *supra* note 104; U.S. Department of Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals (July 1999); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999).

[153] Jesse Eisinger & Paul Kiel, *Gutting the IRS: The IRS Tried to Take on the Ultrawealthy. It Didn't Go Well*, ProPublica, Apr. 5, 2019, *available at* https://www.propublica.org/article/ultrawealthy-taxes-irs-internal-revenue-service-global-high-wealth-audits.

[154] *See generally, e.g.,* Omri Marian, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38 (2013) (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 (2019).

in the challenging position of constantly responding to new noncompliance strategies as they arise.

Activity-based rules—by focusing on the nature of the activities rather than the actors—can also impose the highest burdens on lower-income taxpayers subject to these rules. High-end taxpayers, on the other hand, may be able to avoid or mitigate these burdens. For example, Professor Shu-Yi Oei has described the regressive consequences of IRS's Offshore Voluntary Disclosure Program, which often resulted in the highest relative penalties for participating taxpayers with relatively small account balances.[155] In contrast, high-end taxpayers have more resources which can mitigate the burdens from these activity-based rules.[156] More generally, in the case of any activity-based rule, these rules will often impose the greatest relative burden on the lowest-income taxpayers engaging in these activities.

This second limitation also points to a third limitation of activity-based rules: their lower salience and expressive value. These rules may tend to indirectly target high-end taxpayers—to the extent the activities correlate with higher income or wealth—but do not do so explicitly. As a result, these rules obscure the expressive signal that they are targeted to the high end and could be more vulnerable to the objection that the rules target the wrong taxpayers. For example, critiques of the FATCA, FBAR and other offshore disclosure rules typically focus on the burdens they impose on lower-income taxpayers and nonculpable taxpayers,[157] which can obscure the rules' impacts in preventing high-end tax avoidance.

### *B. Means-Based Adjustments in General*

Means-based adjustments can be a feature of both tax and other non-tax legal regimes. Before considering the case for progressive tax procedure, this Subpart briefly reviews the role of mean-based adjustments in other areas of law, including progressivity in the substantive tax law. This discussion illustrates basic principles of when means-based adjustments to legal rules may and may not be desirable. The consideration of means-based adjustments in these other contexts offers critical insights for the case of progressive tax procedure presented in the succeeding Parts.

[155] Shu-Yi Oei, *The Offshore Tax Enforcement Dragnet*, 67 EMORY L.J. 655, 702-404 (2018). [citing taxpayer advocate reports]

[156] *See, e.g., id.* at 708-09 (describing how "major offenders" may not have been "adequately punished" under the OVDPs, even as the programs imposed "high costs" on other actors.") [examples from advocate report, general advantages in Part II above]

[157] *See* Oei, *supra* note 155, at 694-709.

*1. Progressive Taxation*

Progressive income taxation is typically defined as the relationship between a taxpayer's income and income tax rate.[158] In the case of the progressive federal income tax, for example, a taxpayer with a greater base of taxable income generally pays tax on this income at higher rates.[159] As such, substantive progressive taxation can be considered a "means-based" adjustment to the calculation of tax liabilities.

*Justifications*. Progressive income taxation has historically been justified under variations of the "ability to pay" principle, with income serving as the relevant measure of ability to pay.[160] Progressive income taxation can equalize the marginal sacrifice among taxpayers, on an assumption of declining marginal utility of income.[161] In this case, treating taxpayers differently in terms of their applicable tax rates can in fact treat taxpayers more equally, in terms of their sacrifice or utility loss from taxation. This same principle of declining marginal utility justifies progressive taxation in a welfarist analysis, where the welfare benefits from redistribution through progressive taxation are weighed against the potential costs of taxation.[162]

Political scientists Kenneth Scheve and David Stasavage offer a somewhat different justification for progressive taxation than the common ability-to-pay rationale, but which is premised on the same principle that

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[158] *See* Donald W. Kiever, *Progressivity, measures of*, in THE ENCYCLOPEDIA OF TAXATION & TAX POLICY 304, 304-305 (2d ed., Joseph J. Cordes et. al., eds 2005) ("A tax is progressive if the ratio of taxes to income rises as income increases . . .").

[159] *See* I.R.C. § 1(a)-(d), (j); MICHAEL J. GRAETZ, DEBORAH H. SCHENK & ANNE 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 rate increases.").

[160] *See, e.g,* Richard A. Musgrave, *Fairness in Taxation*, in THE ENCYCLOPEDIA OF TAXATION & TAX POLICY, *supra* note 158, at 136-7; SLEMROD & BAKIJA, *supra* note 33, at 94 ("According to the ability-to-pay principle, tax burdens should be related to . . . ability to bear a sacrifice of material well-being that a tax burden entails."). Progressive taxation may also be justified in limited circumstances under the "benefit theory," where tax liabilities should reflect the prices taxpayers should pay for benefits received from the government. *See* Musgrave, *supra*, at 135. Under this view, progressivity would only be justified to the extent higher income taxpayers receive proportionally greater benefits. *See* EDWIN R.A. SELIGMAN, PROGRESSIVE TAXATION IN THEORY AND PRACTICE 83 (1894).

[161] *See* Musgrave, *supra*, at 135-36.

[162] *See* Joel Slemrod, *Introduction* to TAX PROGRESSIVITY AND INCOME INEQUALITY 1, 1–3 (Joel Slemrod ed., 1996) ("The modern approach to evaluating progressivity focuses on the trade-off between the potential social benefit of a more equal distribution . . . and the economic costs caused by . . . high marginal tax rates . . . .").

differential taxation can in fact treat taxpayers more equally in other respects. Scheve and Stasavage argue that "the most politically powerful claims in favor of progressive taxation" are motivated by a "compensatory theory," rather than a theory grounded in the ability to pay principle.[163] This compensatory theory would justify progressive taxation to compensate for other privileges or advantages the state affords the wealthy.[164] They suggest that the compensatory theory may be applied broadly to justify progressive taxation to compensate for any circumstance "where the state fails to treat citizens as equals."[165]

Progressive taxation can serve an important role in raising tax revenues fairly and mitigating economic inequality. In the coming years, the federal government may also need to increase taxes on the rich in the years to come through additional progressive reforms, in order to address revenue needs and economic inequality. Economic inequality can cause social and political harms,[166] which may be ameliorated in turn through progressive taxation.[167] Reforms that would increase the progressivity of the tax system by raising taxes on the wealthy could also raise revenue to fund the deficit and government spending.[168]

*Design Considerations.* These basic principles imply a series of design considerations in implementing a progressive tax.

First, a progressive tax that distinguishes among taxpayers on the basis of their income need not tax an income base. Other tax instruments may also have a progressive effect, even when progressivity is measured according to its traditional definition as a relationship between tax liabilities and income. For example, the estate tax may have the progressive effect of imposing a greater tax burden on higher incomes, as long as the size of

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[163] KENNETH SCHEVE & DAVID STASAVAGE, TAXING THE RICH: A HISTORY OF FISCAL FAIRNESS IN THE UNITED STATES AND EUROPE 32 (2016).

[164] *Id.*. Scheve & Stasavage distinguish this theory from the benefit theory described *supra* note 160 on the grounds that the latter theory only pertains to the provision of public goods and does not envision using taxation more broadly to compensate for the effect of other taxes or government interventions. *Id.*

[165] *Id.* at 37.

[166] For a summary of these harms, including social, political and economic costs from excessive wealth concentration, see Ari Glogower, *Taxing Inequality*, 93 N.Y.U. L. REV. 1421, 1441-43, 1445-47 (2018).

[167] *See, e.g.*, Emmanuel Saez & Gabriel Zucman, *Progressive Wealth Taxation* 37 (BPEA Conference Drafts, Sept. 5-6, 2019), https://www.brookings.edu/wp-content/uploads/2019/09/Saez-Zucman_conference-draft.pdf (estimating how a federal wealth tax would reduce wealth concentration).

[168] *See, e.g.*, Curry, *supra* note [ ] (describing progressive tax reform proposals currently advanced by policymakers "to address income inequality and to use as pay-fors for ambitious domestic spending proposals").

estates tends to correlate with income.[169] Similarly, a progressive consumption tax may be designed to impose a proportionally greater tax burden on high-income taxpayers, through graduated rates on spending, a credit system or an exemption for goods purchased by lower income households.[170]

Second, the design of a progressive tax instrument will also depend on the choice of the relevant measure of ability to pay, or more broadly on the basis for comparing taxpayers' varying economic circumstances. As described above, "income" may be viewed as the most desirable measure of economic capacity, and therefore the most desirable basis for progressive taxation.[171] Even the term "income," however, may be defined in different ways, with corresponding implications for progressive income tax design.[172] Other measures of a taxpayer's economic circumstances, beyond their income alone, may also be a more appropriate basis for comparing taxpayers in a progressive tax system.[173] For example, a progressive tax on wealth or a combined base of both income and wealth may be justified to account for the role of both wealth and income as factors in taxpayers' relative economic circumstances.[174] Similarly, the estate and gift tax rules may be justified on the premise that larger estates and inheritances should

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[169] *See, e.g,* Leonard E. Burman, Greg Leiserson & Jeffrey Rohaly, *Revenue and Distributional Effects of the Thompson Tax Plan*, 118 TAX NOTES 193, 207 (Jan. 7, 2008) (describing how repealing the estate tax would be regressive, once translated into effective tax cuts for taxpayers as a percentage of their income).

[170] *See, e.g,* Eric Toder & Kim Rueben, *Should We Eliminate Taxation of Capital Income?*, in TAXING CAPITAL INCOME 89, 104-122 (Henry J. Aaron, Leonard E. Burman & C. Eugene Seeurle, eds., 2007); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); *see also infra* note [ ] and accompanying text.

[171] *See* Musgrave, *supra* note 160, at 136 ("In order to implement ability-to-pay taxation, an index is needed by which to measure 'ability.' That index has traditionally thought of in terms of income, with income seen to provide the best measure of economic capacity.").

[172] *See* John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253, 259–74 (2018) (describing different possible definitions of income and their implications for tax design); *id.* at 266 ("Ultimately, 'income' is whatever society wants it to be in order to achieve a result that the democracy believes to be appropriate and just."); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 45 (1990);

[173] *See, e.g.,* RICHARD SCHMALBECK, LAWRENCE ZELENAK & SARAH B. LAWSKY, FEDERAL INCOME TAXATION 17 (5th ed. 2018) ("It is not self-evident, however, that income is the best measure of ability to pay . . . . perhaps a wealth tax would be a better choice than an income tax.").

[174] *See* Glogower, *supra* note 166, at 1467-83 (describing how wealth and income can be incorporated into a combined tax base measuring relative economic spending power).

be progressively taxed, to address the unique advantages taxpayers receive from intergenerational wealth transfers.[175]

Last, progressive taxation may be designed to address different concerns at different points along the economic distribution. Progressive adjustments at the low-end of the economic distribution may alleviate the tax burden—or provide economic benefits—for taxpayers with limited economic resources. For example, Milton Friedman advocated for only a minimal degree of progressive taxation through a "negative income tax," in order to alleviate poverty at the lowest end of the income distribution, but a flat rate of tax for other taxpayers.[176] Similarly, the standard deduction may be understood as exempting a minimum level of income from taxation,[177] and the earned income tax credit as providing additional economic support to low-income workers.[178] In contrast, progressive taxation to increase tax burdens on the wealthy can address the particular social concerns with concentrated wealth at the top of the economic distribution.[179]

The variations of progressive taxation described above may differ on the proper basis for redistribution and the method of implementation, but all share a core similarity. In all of these cases, progressivity may be understood as a rule of "substantive progressivity," whereby a taxpayer's liability under a particular tax instrument varies with some measure of their economic circumstances or ability to pay. Each of these substantive instruments implements progressivity through adjustments to different factors—such as the rate schedule, deductions, credit or exemptions—used in calculating the taxpayer's substantive tax liability under the instrument.

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[175] *See generally, e.g.*, Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1 (2009).

[176] See MILTON FRIEDMAN, CAPITALISM AND FREEDOM 176, 190-195 (40th anniversary ed. 2002) (advocating for a minimal degree of progressivity at the low end of the income distribution, and a flat rate of tax for other taxpayers, through a "negative income tax" that would allow for a standard deduction amount and a refund for taxpayers with "negative income" as a result of the deduction).

[177] *See* EDWIN R.A. SELIGMAN, PROGRESSIVE TAXATION IN THEORY AND PRACTICE 80–81, 129–30, 159–61 (Baltimore, Am. Econ. Ass'n 1894) (describing early justifications for a progressive tax that exempts a threshold amount of income necessary for subsistence); *see also* Ari Glogower & Clint Wallace, *Shades of Basic Income*, in SHARING THE GAINS OF THE GLOBAL ECONOMY: PROCEEDINGS OF THE NEW YORK UNIVERSITY 70TH ANNUAL CONFERENCE ON LABOR 6* (2018) (describing the rationale for the standard deduction and personal exemption in the federal income tax).

[178] *See* MARGOT L. CRANDALL-HOLLICK, CONG. RES. SERV., THE EARNED INCOME TAX CREDIT (EITC): A BRIEF LEGISLATIVE HISTORY 2 (CRS Report 7-5700, Mar. 20, 2018), https://fas.org/sgp/crs/misc/R44825.pdf (describing the origins of the EITC as an alternative to the negative income tax with similar economic effects).

[179] *See, e.g.*, Joseph Bankman & Daniel Shaviro, *Piketty in America: A Tale of Two Literatures*, 68 TAX L. REV. 453, 453 (2015) ("Rising high-end wealth concentration is one of the central issues of our time.").

As described in greater detail in Part IV below, progressive tax procedure would, in contrast, introduce progressive adjustments to other tax rules that are not factors used in calculating the taxpayers' substantive tax liability under a particular tax instrument.

For the reasons described above, progressive substantive tax instruments may not have the desired effect of raising revenues according to a particular progressive schedule, to the extent taxpayers can avoid paying the nominal "sticker price" of their tax labilities.[180] More generally, the different tax avoidance opportunities available to different groups of taxpayers likely alters the actual distribution of tax burdens contemplated by the substantive progressive tax rules.[181]

*2. Means-Based Fines*

Similar principles to those underlying progressive taxation may also justify means-based adjustments to other nontax legal rules. A number of jurisdictions have experimented with "variable fines" or "day fines" for criminal and civil offenses that vary with the offenders' income.[182] For 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.[183] 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.[184]

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[180] *See supra* Part II.B.

[181] *See, e.g.,* Leandra Lederman & Ted Sichelman, *Enforcement as Substance in Tax Compliance*, 70 WASH. & LEE L. REV. 1679, 1684-85 (2013) (describing how policymakers can adjust the substantive effect of the tax law by "fostering less than 100% compliance"); *supra* notes 34-37 and accompanying text (describing the distributional effects of tax noncompliance).

[182] 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 (20107); 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) [Hereinafter *Fines and Day Fines*]; Alec Schierenbeck, *The Constitutionality of Income-Based Fines*, 85 U. CHI. L. REV. 1869, 1876-79 (2018) (describing the benefits of income-based adjustments to fines in the criminal justice system).

[183] Finland Penal Code, Chapter 2a, http://www.finlex.fi/fi/laki/ajantasa/1889/18890039001.

[184] *See* Suzanne Daley, *Speeding in Finland Can Cost a Fortune, if You Already Have One*, N.Y. TIMES, Apr. 26, 2015, at A12; Joe Pinkser, *Finland, Home of the $103,000 Speeding Ticket*, THE ATLANTIC, March 12, 2015, https://www.theatlantic.com/business/archive/2015/03/finland-home-of-the-103000-speeding-ticket/387484/;

Day fines and similar systems first arose in the criminal justice system as an alternative to incarceration or rehabilitation programs.[185] They solved a problem for reformers favoring monetary fines over forms of punishment. On the one hand, monetary fines could reduce expenditures in the justice system and avoid the stigmatization and social harms from incarceration.[186] A system that imposed the same monetary fines on all offenders, however, would have the effect of imposing a lighter sentence on higher-income offenders, who could pay the fine more easily. By adjusting the fines in accordance with the offender's income, day fine systems allowed reformers to equalize the effect of the sanction for offenders in varying economic circumstances.[187]

Advocates of day fines justify these adjustments for reasons similar to those justifying progressive taxation as described above. Day fines could equalize the utility loss from monetary fines imposed on offenders with varying incomes, and thereby also equalize the deterrent effect of the sanction.[188] For example, a means-based speeding fine can deter low and high-income drivers from speeding to the same degree.[189] In addition to more effectively deterring undesirable behavior at different income levels, these means-based adjustments could also raise additional revenue that could be used for other social spending.[190] Finally, the unequal treatment of offenders with varying income—as measured by their varying fines paid—could in fact resulting in *more* equal treatment—as measured by their utility loss resulting from the same offenses—and counter other advantages that wealthy may have in their interactions with the criminal justice system.[191]

[185] For a general history of day fines, *see* Hillsman, *Fines and Day Fines, supra* note 182, at 77-78; *see also* Friedman, *supra* note 182, at 281 (describing the origins of the West German day fine system in the 1960s as an alternative to incarceration).

[186] *See* Friedman, *supra* note 182, at 285 (describing the concern of West German reformers that "short-term imprisonment, rather than facilitating the offender's return to noncriminal activity upon release, breaks whatever positive ties the offender has to society . . . "); Hillsman, *Fines and Day Fines*, *supra* note 182, at 50 (describing how criminal fines do not "undermine the offender's ties to family and community" and "can be financially self-sustaining and provide revenue for related social purposes …").

[187] *See, e.g.*, Friedman, *supra* note 182, at 286 (describing how the West German day-fine system was designed "to effect an equal impact on all offenders"); Hillsman, *Fines and Day Fines*, *supra* note 182, at 54.

[188] Schierenbeck, *supra* note 182, at 1876-77.

[189] See Pinsker, *supra* note 184.

[190] Schierenbeck, *supra*, at 1879.

[191] *See* Friedman, *supra* note 182, at 286 ("The . . . method of adjustment could also serve to effect equality of justice, for without such adjustment it is not possible to ensure that fines have the same proportionate impact on affluent and poor offenders."); Schierenbeck, *supra* note 182, at 1870-71 ("A system that tailors fines according to income . . . would help ensure that every person experiences a proportional penalty when she runs afoul of the law.").

Means-based adjustments to fines and sanctions, however, would not be warranted under a basic analysis developed in the law and economics literature.[192] Under this framework, the expected value of the fine should be set equal to the cost the offense imposes on others, including the harm of the offense and any costs of enforcement.[193] Fines set higher than this amount would be inefficient, since they would deter activity where the benefit to the offender exceeds the costs to others.[194] For the same reason, the offender's economic circumstances would not be relevant in determining the amount of the fine.[195] Policymakers can consequently minimize enforcement costs while still maintaining the optimal fine amount, by reducing the chance of detection while increasing the fine if an offender is caught.[196]

These two paradigms reflect a key difference. Means-based fines may be justified when the purpose of the fine is to deter the undesirable behavior by all offenders equally, regardless of the varying benefits offenders may derive from the offense. Fines set at the harm imposed on others may be desirable, in contrast, when policymakers only seek to deter inefficient offenses, but not to foreclose the activity entirely.[197]

### *3. Redistribution Through Legal Rules*

According to one view in the literature, means-based adjustments to fines and penalties may not be desirable, if the purpose of these adjustments is redistribution from a high-ability offender to the government or to lower-ability victims. Professors Louis Kaplow and Steven Shavell argue that redistribution through legal rules should be left to the income tax rules alone,[198] since redistribution through other legal rules will only compound the distortive effects of the redistributive policy.[199]

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[192] *See, e.g.,* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 79-90 (4th ed. 2011); Gary S. Becker, *Crime and Punishment: An Economic Approach,* 76 J. POL. ECON. 169 (1968).

[193] POLINSKY, *supra*, at 80; Becker, *supra,* at 192.

[194] POLINSKY, *supra*, at 80.

[195] Becker, *supra*, at 195 ("If the goal is to minimize the social loss of income from offenses . . . then fines should depend on the total harm done by the offenders, and not directly on their income . . . .").

[196] POLINSKY, *supra*, at 81-83. For example, if the social harm from speeding is $100, policymakers can set a fine with an expected value of $100 through either a $100 fine and sufficient enforcement to catch all offenders, or a $1000 fine with less costly enforcement that only catches 10% of offenders.

[197] *See* Raskolnikov, *supra* note 77, at 531-32.

[198] *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income,* 23, J. LEGAL STUD. 667 (1994).

[199] Kaplow & Shavell, *supra,* at 667-68.

Kaplow and Shavell offer the example of an efficient strict liability rule for injuries—building off the framework described above[200]—which requires injurers to pay a fine equal to the harm they cause.[201] If policymakers subsequently introduce a means-based adjustment to this fine, by imposing a proportionally higher fine on higher-income offenders, then this rule will have the effect of both over-deterring the behavior subject to the fine (beyond the efficient level) and also burdening the offender's income.[202] The same redistributive goal can be achieved at a lower efficiency cost, by simply increasing the progressive rate of tax on the offender's income instead.[203]

This narrow argument, however, would still allow for means-based adjustments to nontax legal rules in many circumstances. First, this argument presumes a "first-best" world in which the optimal degree of efficient redistribution can in fact be achieved through income taxation alone.[204] It may be more desirable to redistribute through a combination of legal rules, if the aggregate distortions resulting from these adjustments would be less than the distortions resulting from redistribution through the income tax alone.[205] Other legal rules may also be able to account for non-income characteristics that the tax system cannot easily redistribute.[206]

More generally, this view would only pertain to means-based adjustments to legal rules if the purpose of the adjustment is in fact to achieve additional redistribution, beyond the amount contemplated by the background legal rules. Means-based adjustments to legal rules could, however, also advance other goals besides redistribution. For example, as in the case of day fines discussed above, these adjustments could improve the deterrence to socially undesirable activity.[207] Means-based adjustments to

[200] *Supra* note 193 and accompanying text.

[201] Kaplow & Shavell, *supra*, at 669.

[202] *Id.* at 669-671.

[203] *Id.* at 671-74.

[204] *See generally* R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956).

[205] *Cf.* David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355 (2015) (arguing that redistribution through multiple tax instruments may be desirable to minimize the particular distortive effects of redistribution through any particular instrument).

[206] See Zachary Liscow, Note, *Reducing Inequality on the Cheap: When Legal Rule Design Should Incorporate Equity as Well as Efficiency*, 123 YALE L. J. 2478 (2014); see also Tomer Blumkin & Yoram Margalioth, *On the Limits of Redistributive Taxation: Establishing a Case for Equity-Informed Legal Rules*, 25 VA. TAX REV. 1, 18 (2005) (legal rules that can account for "non income based measures of equality").

[207] That is, as described above in Part II.B, day fines may have a primary goal of deterring misbehavior, rather than a primary goal of raising revenue from wealthy offenders.

legal rules can also satisfy substantive values of distributional fairness throughout the legal system.[208]

*C. Tax Procedure in Current Law*

*1. What is Tax Procedure?*

Tax procedure rules—as the term is used in this Article—are the statutory and administrative provisions governing taxpayers' obligations to comply with the tax law and how the IRS administers the tax system. These rules may all be distinguished from the "substantive" rules governing the calculation of tax liabilities due under each tax instrument.

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, such as the Income Tax,[209] the Estate and Gift Tax,[210] and excise taxes.[211] Subtitle F of the Code, in contrast, contains the statutory rules of tax "Procedure and Administration."[212] Among other provisions, this subtitle includes the rules governing return filing and information reporting by taxpayers and third parties,[213] payment of tax,[214] assessment and collection of tax by the IRS,[215] statutes of limitations limiting both the time for the IRS to make assessments and for taxpayers to

[208] For example, Professor Zachary Liscow has argued that individuals may have "category-specific" moral commitments that would necessitate incorporating distributional considerations across the legal system. *See* Zachary Liscow, *The Dilemma of Moral Commitments in Addressing Inequality* (manuscript at 4) (on file with authors) ("For example, many may actually be willing to pay through a smaller pie to distribute health care instead of cash."). Professors Tomer Blumkin and Yoram Margalioth have similarly argued that legal rules should account for distribution when the form of redistribution has "intrinsic value" or where the "efficient" legal rule would itself generate the inequity. Blumkin & Margalioth, *supra*, at 15, 19-20 ("For example, in certain cases people might find redistribution through the tax and transfer system distasteful, and have a preference for redistribution through legal rules.").

[209] I.R.C. § 1 et seq.

[210] I.R.C. § 2001 et seq.

[211] I.R.C. § 4001 et seq.; § 5001 et seq.

[212] I.R.C. § 6001 et seq. In some cases, procedural rules are included within the substantive provisions in Subtitles A through E. *See, e.g.*, the consequences for reckless or fraudulent Earned Income Tax Credit claims discussed *infra* notes 247-248 and accompanying text, which are included within the substantive provision providing for the calculation of the Earned Income Tax Credit.

[213] I.R.C. §§ 6001- 6115 (Chapter 61).

[214] I.R.C. §§ 6161 – 6111 (Chapter 62).

[215] I.R.C. §§ 6211 – 6334 (Chapters 63-64).

claim a tax refund,[216] interest and civil penalties,[217] criminal and other offenses,[218] and judicial proceedings.[219]

Beyond these statutory provisions, the tax procedure rules—as the term is 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.[220] Similarly, the appeals process includes the formal right to appeal decisions of the Tax Court,[221] as well as the right to representation and to informal conferences with Appeals Office personnel.[222] Finally, the Code provides rules for taxpayer privacy, including the general rule of confidentiality for returns and return information.[223]

Under this broad definition, the tax procedure rules can be understood to overlap with a variety of general categories of legal rules with varying functions. Some tax procedure rules (within this Article's broad definition of the term) can be understood as examples of legal remedies, or, defined broadly, sanctions imposed for violations or offenses.[224] In the context of the private law, remedies are typically understood to serve two primary functions: deterrence of wrongdoing and compensation for the plaintiff.[225] Similarly, in the context of the tax procedure rules, these rules can deter noncompliance[226] and compensate the government for specific costs arising from the taxpayer's noncompliance.[227] Other tax procedure rules function similarly to the general category of "procedural" rules in the law, with a function of ensuring due process and procedural fairness.[228] Finally, tax procedure rules also perform an "expressive function" in signaling

[216] I.R.C. §§ 6501-6532 (Chapter 66).

[217] I.R.C. §§ 6601-6751 (Chapters 67-68).

[218] I.R.C. §§ 7201- 7217 (Chapter 75).

[219] I.R.C. §§ 7421-7525 (Chapter 76).

[220] *See* I.R.M. 4.10 Examining Process, https://www.irs.gov/irm/part4/irm_04-010-003.

[221] I.R.C. § 7481.

[222] *See, e.g.*, the procedures outlined in IRS PUB. 5, Rev. 01-1999, YOUR APPEAL RIGHTS AND HOW TO PREPARE A PROTEST IF YOU DON'T AGREE, https://www.irs.gov/pub/irs-pdf/p5.pdf

[223] I.R.C. § 6103(a).

[224] *See generally* Samuel Bray, *Remedies*, in OXFORD HANDBOOK OF NEW PRIVATE LAW (Andrew Gold et all, eds., forthcoming 2019); *infra* notes [ ] and accompanying text.

[225] Bray, *supra*, at 3*.

[226] *See supra* Part II.B.

[227] [discussion of interest charges as compensation]

[228] *See infra* notes [ ]and accompanying text.

substantive values in tax administration, and the standards for compliance and fair treatment in the tax system.[229]

*2. Means-Based Adjustments in Tax Procedure Today*

In contrast to the explicitly progressive structure of the primary substantive tax instruments—such as the individual income tax and the estate tax—the tax procedure rules generally operate the same for all taxpayers, with no adjustments to account for their economic varying circumstances.[230] The rules do allow for means-based adjustments for lower income taxpayers to a degree, through special relief procedures for lower-income taxpayers in some cases.[231] Unlike in the case of the substantive tax rules, however, these tax procedure rules generally do not provide commensurate adjustments for high-income taxpayers, and only benefit low income taxpayers in unique and narrow circumstances.[232] The current tax procedure rules also include many features which have the effect of imposing *additional* burdens on lower-income taxpayers—which many be understood as means-based adjustments which impose additional burdens on taxpayers with fewer means.[233]

The statutory 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,[234] the same interest rates on underpayments,[235] and the same statute of limitations for IRS assessments.[236] In this respect, these tax procedure rules may be analogized in one sense to "flat taxes" or "head taxes" in the substantive tax law.[237]

[229] *See infra* notes [ ] and accompanying text.

[230] In some limited cases, the tax procedure rules do explicitly provide for progressive adjustments. *See infra* notes 238-244 and accompanying text.

[231] *See infra* notes 245-246 and accompanying text.

[232] *See id.*

[233] *See infra* notes 247-248 and accompanying text.

[234] I.R.C. §§ 6651, 6662-6663.

[235] I.R.C. § 6601.

[236] I.R.C. § 6501.

[237] The appropriateness of this analogy depends on the relevant definition of progressivity discussed *supra* Part III.B. A tax procedure rule that applies equally to all taxpayers would not be progressive, if a progressive rule is simply understood as a rule that adjusts in some manner on the basis of the taxpayer's income or other measure of ability to pay. A tax procedure rule that applies equally to all taxpayers could still be progressive (or regressive) according to the traditional definition of progressivity, to the extent that it had the effect of increasing (or decreasing) the effective rate of tax on taxpayers in certain income groups.

One narrow group of statutory tax procedure rules do explicitly adjust for taxpayers in different economic circumstances. These provision all refer to the same net wealth test used for a general fee shifting provision in the 1980 Equal Access to Justice Act.[238] 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.[239] 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,[240] judicial review of a failure by the IRS to abate interest charges,[241] award of attorney's fees in cases of unauthorized inspection or disclosure of taxpayer information,[242] burden of proof shifting in tax proceedings,[243] and waiver of a penalty for failure to deposit employment taxes.[244]

In other cases, some formal and informal special procedures for resolving tax disputes may be understood as cases of means-based adjustments, to the extent they may tend to benefit low-income taxpayers in particular. For example, the Code provides for special informal Tax Court proceedings for "S cases" involving disputes of $50,000 or less.[245] These informal proceedings are not explicitly limited to lower-income taxpayers. As such, this program may be understood as distinct from rules which explicitly provide for a means-based adjustment to the applicable rules on the basis of the taxpayer's economic circumstances, rather than on the basis of other indicia which may tend to correlate with a taxpayer's means. 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.[246]

Other tax procedure rules can impose proportionally greater burdens on lower-income taxpayers. For example, a low-income taxpayer who recklessly claims the Earned Income Tax Credit can be disqualified from

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[238] 26 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* (2008), https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=624258.

[239] 26 U.S.C. § 2412(d)(2)(B).

[240] *See* I.R.C. § 7430(c)(4)(A)(ii).

[241] *See* I.R.C. § 6404(e)(1).

[242] *See* I.R.C. § 7431(c)(3).

[243] *See* I.R.C. § 7491(a)(2)(C).

[244] *See* I.R.C. § 6656(c)(1).

[245] I.RC. § 7463; *See also* Tax Court Rules 170-175; I.R.M. 31.5.3.2 (07-04-2012), https://www.irs.gov/irm/part35/irm_35-001-003.

[246] 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 PRACTICE & PROCEDURE 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.").

claiming the credit for the following two years, and a taxpayer who fraudulently claims the credit can be disqualified for the following decade.[247] These harsh consequences will only impact lower-income taxpayers who could otherwise claim the credit in those subsequent years, and 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.[248] Even tax procedure rules 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 U.S. Tax Court.[249]

In sum, the current tax procedure rules only provide for means-based adjustments in narrow circumstances. Even in these limited cases the rules typically only provide limited benefits to lower income taxpayers, rather than accounting for the additional advantages enjoyed by higher income taxpayers. In the most cases, however, the tax procedure rules apply equally to all taxpayers, regardless of their economic circumstances, and some even have the regressive effect of disproportionately disadvantaging lower-income taxpayers.

### *D. Why Progressive Tax Procedure?*

In contrast to the inconsistent approach in current law, legislators and policymakers should consider systematic adoption of means-based adjustments to the tax procedure rules for high end taxpayers. Progressive tax procedure could improve upon the current system of activity-based rules to more effectively deter noncompliance by high-end taxpayers and counter the resource mismatch between these taxpayers and the IRS. Most

[247] I.R.C. § 32(k)(1).

[248] For example, as described above *supra* note [ ], 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); *see also* JOINT COMMITTEE ON TAX'N, OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2019 (Mar. 20, 2019), https://www.jct.gov/publications.html?func=startdown&id=5172. If a taxpayer with this profile is found to have recklessly claimed the EITC in Year 1, and would have 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* note [ ], the highest explicit penalty rate in the Tax Code is the 75% penalty for fraud under I.R.C. §6663(a).

[249] I.R.C. § 7463(b). Low income taxpayers may also encounter other procedural disadvantages in S cases. *See generally*, Smith, *supra* note [ ] (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.).

critically, it could narrow the gap between the substantive tax law's prescriptions and the actual tax paid by high-end taxpayers. Progressive tax procedure can also improve taxpayer morale and public trust in the tax system, which can in turn affect taxpayer compliance and public support for progressive tax reforms.

*1. Advancing the Functions of Tax Procedure*

As described above, the general category of tax procedure rules encompasses a diverse set of rules with varying functions. At the same time, these rules all share a common role in facilitating the collection of tax revenues in accordance through the substantive tax rules. As such, the case for means-based adjustments to the tax procedure rules—and the most desirable form these adjustments may take—will vary based on the nature and function of the rule in question, and these adjustments may be more or less desirable for different categories of tax procedure rules serving these different functions.

Despite these differences, the formal and systematic adoption of means-based adjustments to the tax procedure rules for high-end taxpayers could advance the rules' core functions of deterring noncompliance and enabling the collection of tax liabilities due.[250] Progressive tax procedure can also strengthen the expressive signal of the tax procedure rules, and counter a perception that these rules afford special advantages to high-end taxpayers.

The discussion that follows considers the particular circumstances when means-based adjustments for high-end taxpayers can advance these primary functions of the tax procedure rules. Most critically, progressive tax procedure can equalize the effect of the tax procedure rules across taxpayers in varying economic circumstances.

*Deterring Noncompliance.* 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 decision whether to comply with the tax rules, and their expected benefit from noncompliance.[251] 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.[252]

[250] Means-based adjustments to tax procedure rules serving other functions may not be desirable. [example of interest charges on underpayments]

[251] *See supra* notes [ ] and accompanying text.

[252] *See supra* notes [ ] and accompanying text.

Of course, Congress can increase the deterrent effect of tax procedure rules such as penalties for noncompliance by simply raising the penalty rates for all taxpayers. Means-based adjustments to these tax procedure rules for taxpayers at the top of the economic distribution in particular, however, may be desirable for three distinct reasons.

First, means-based adjustments to these tax procedure rules can correct for the fact that taxpayers at different locations on a utility curve may be more or less risk-averse with respect to local changes in income. As described above, in an expected utility model, a rational taxpayer will account for the expected utility they will derive from complying and not complying, rather than simply the expected outcome of their decision in monetary terms.[253] This model modestly increases the deterrent effect of penalties, to the extent that a taxpayer with declining marginal utility experiences lesser utility gains from an additional dollar amount of income, as compared to the amount of utility loss they would experience from losing the same dollar amount of income.[254]

This deterrent effect from risk aversion may have less effect, however, for taxpayers at the top of the income distribution, depending on the shape of the assumed utility curve. For example, under the traditional assumption of declining marginal utility, 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.[255] As a result, the effect of penalties will have less deterrent effect for the higher income taxpayers, if all taxpayers experience the same penalty rate regardless of their income.[256]

To illustrate the varying effect of the deterrence from risk aversion for taxpayers at different, income levels—and therefore at different points in the utility curve—consider again the example of *Taxpayer A* described in Part II.B above, with $100 of pretax income and a potential $20 tax liability, and the utility curve represented by the natural log of the taxpayer's income.[257] If the IRS achieves a 60% detection rate and imposes

[253] *See supra* notes [ ] and accompanying text.

[254] *See id.*

[255] *See* HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 179-80 (10th ed., 2014).

[256] *See* Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration,* in 3 HANDBOOK OF PUBLIC ECONOMICS 1423, (Auerbach & 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."). [note models and empirical studies on effect of higher rates on evasion incentive]

[257] *See supra* notes 79-81 and accompanying text.

a penalty rate of 60% for noncompliance, then *Taxpayer A* would have greater expected utility from compliance than from noncompliance.[258]

Consider now a second taxpayer, *Taxpayer B*, facing the same potential tax liability, detection rate and penalty rate. The only difference between the two taxpayers is that *Taxpayer B* has $10,000 in pretax income rather than $100.[259] Because *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—they would still have a greater expected utility from noncompliance than from compliance.[260]

Policymakers could counter this reduced deterrent effect from risk aversion for high-income taxpayers, by increasing their applicable penalty rate. On the facts in the example immediately above, a penalty rate of 67% would be necessary to deter *Taxpayer B* from noncompliance, while under the same conditions only a 56% penalty rate is necessary to deter the lower-income *Taxpayer A* from noncompliance.[261]

Means-based adjustment to tax penalty rates in the rational actor model may also be justified to the extent that the other variable in the model—the

[258] That is, *Taxpayer A* would have an expected dollar return of $80 from compliance, for an expected utility of approximately 4.38 (assuming again that the taxpayer's utility function is defined as the natural log of their after-tax income). *Taxpayer A* would have an expected utility of only approximately 4.37 from noncompliance, calculated as $.6ln(100 – 20 – 12) + .4ln(100)$.

[259] Of course, in the real world a higher income taxpayer is likely to also have a correspondingly higher potential tax liability that they could save through noncompliance. This simplified example is meant to isolate and illustrate the varying effect of the noncompliance disincentive from risk aversion for taxpayers at different locations on the utility curve, but who are otherwise similarly situated.

[260] *Taxpayer B* would have an expected dollar return of $9,980 from compliance, for an expected utility of approximately 9.208338, but would have an expected utility of approximately 9.208417 from noncompliance, calculated as $.6ln(10,000 – 20 – 12) + .4ln(10,000)$. The assumption that the utility curve is represented as the natural log of the taxpayer's income yields the modest—though nonetheless—illustrative results presented above. This modest effect would be even more pronounced, however under different possible assumptions of the taxpayer's utility curve. For example, if the taxpayer's first dollars of income represent significant utility gains (that is, the curve is initially steeper) and additional dollars of income after a certain level yield virtually no utility gains (that is, the curve flattens to a greater degree at higher levels), then the deterrence effect from risk aversion would be even greater at lower income levels, but would decline further at high-income levels.

[261] At a 56% penalty rate, *Taxpayer A*, would have an expected utility of approximately 4.38 from noncompliance, calculated as $.6ln(100 – 20 – 11.2) + .4ln(100)$, which would be less than the expected utility of approximately 4.382 from compliance. At a 67% penalty rate, *Taxpayer B* would have an expected utility of approximately 9.208333 from noncompliance, calculated as $.6ln(10,000 – 20 – 13.4) + .4ln(10,000)$, which would be less than the expected utility of 9.208338 from compliance.

chance of detection and enforcement—is lower for higher income taxpayers. The chance of detection will depend on the range of factors, including the source of the taxpayer's income.[262] As described above, however, many high-income taxpayers can take advantage of sophisticated tax avoidance strategies that reduce their chance of detection which are not available to lower income taxpayers.[263] The rational actor 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.[264] 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.[265]

For example, consider again *Taxpayer A* with $100 of pretax income and *Taxpayer B* with $10,000 in pretax income, facing the same $20 tax liability. Assume, however, that *Taxpayer A*'s chance that the IRS will detect noncompliance and successfully impose a penalty is 60%, while *Taxpayer B's* chance is 55%.[266] In this case, while the 56% penalty rate would be necessary to deter *Taxpayer* A from noncompliance, now a 82% penalty rate would be necessary to similarly deter *Taxpayer B*.[267] This example also illustrates the compound effect of both the differences in risk aversion at different locations on the utility curve and variations in chances of detection and penalty enforcement, which can both result in higher penalty rates necessary to deter noncompliance by high-income taxpayers.

The numbers used in these examples also illustrate the core limitation of the rational actors deterrence models that is described in the prior literature: These models imply that penalty rates and chances of detection would need to be significantly higher than under current law to have an effective deterrent effect (independent of the other possible reasons that a taxpayer might comply with the tax laws).[268]

This consideration leads to the third justification for means-based adjustments to tax procedure rules serving a deterrence function. As

[262] *See supra* note [ ] and accompanying text.

[263] *See supra* Part II.A.

[264] *See supra* note [ ] and accompanying text.

[265] *See supra* note [ ] and accompanying text.

[266] For example, assume that *Taxpayer A* earns wage income subject to information reporting and withholding, while *Taxpayer B* earns business income that is not subject to these requirements.

[267] At a 82% penalty rate, *Taxpayer B* would have an expected utility of approximately 9.208334 from noncompliance, calculated as $.55ln(10{,}000 - 20 - 16.4) + .45ln(10{,}000)$, which would be less than the expected utility of 9.208338 from compliance.

[268] *See supra* note [ ] and accompanying text.

described above, significantly increasing penalties for all taxpayers may face political constraints and create a perception that Congress imposes unduly harsh or intrusive sanctions for noncompliance.[269] Limiting the adjustments resulting in larger penalties to the wealthiest taxpayers can allow Congress to more effectively deter noncompliance by this subset of taxpayers without necessitating similarly large penalties on other taxpayers. Targeting higher penalties to higher income taxpayers could thereby mitigate public objection that could result from extending higher penalties to all taxpayers.

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.[270] This framework suggests a ceiling to the additional compliance burdens and deterrents it may be desirable to introduce to the tax procedure rules.

This Article does not suggest exactly where this ceiling may be reached, or what might be the optimal magnitude of the means-based adjustments to the tax procedure rules might be. Rather, this Article argues that some degree of adjustment is likely desirable for high-end taxpayers.

A number of considerations suggest why some degree of means-based adjustments to the tax procedure rules could improve compliance and narrow the tax gap while without exceeding this ceiling fixed by the costs of administration and enforcement. First, with respect to the government's administrative costs, means-based adjustments can increase revenue collection while reducing the government's costs. For example, higher penalty rates or disclosure obligations for high-end taxpayers can reduce the *ex ante* expected value from noncompliance without the need for more government expenditures on administration and enforcement. In this respect, means-based adjustments can minimize administrative costs in the same manner as described in Becker's general deterrence model.[271]

Progressive tax procedure could also impose more costs high-end taxpayers, such as the costs from additional compliance, behavioral changes, or the psychic disutility from fearing higher penalties.[272] A number of considerations also suggest why these costs may not outweigh the benefits of reasonable means-based adjustments to the tax procedure rules.

[269] *See supra* note [ ] and accompanying text.

[270] *See supra* notes 109-111 and accompanying text.

[271] *See supra* notes [ ] and accompanying text; *see also* Keen & Slemrod, *infra* note 276 (describing how raising revenue through enforcement can be more efficient than raising revenue through higher taxes, in a case of lower administrative costs of enforcement).

[272] *See supra* notes [ ] and accompanying text.

First, it is likely that the current tax procedure rules impose costs on high-income taxpayers are significantly below the optimal limit.[273] At the same time, progressive tax procedure can remedy the costs imbalance under the current approach of activity-based rules, which can impose relatively higher costs on lower income taxpayers.[274] Furthermore, depending on the shape of the policymaker's social welfare function, the benefits of redistribution through progressive taxation of high-end taxpayers may significantly outweigh the welfare loss from certain costs imposed on these taxpayers.[275] Finally, it is unlikely that policymakers can more efficiently raise more revenue from high-end taxpayers from simply raising tax rates, given that higher tax rates will induce more tax avoidance responses, which can be discouraged through progressive tax procedure.[276]

*Expressive Function.* The tax procedure rules also serve an expressive function, by signaling substantive norms and values governing taxpayer compliance and interactions between taxpayers and the IRS.[277] In this case, progressive tax procedure can further this expressive function by signaling that high-income taxpayer do not enjoy special benefits in their interactions with the tax compliance system, nor special opportunities to avoid their tax compliance obligations.

Tax procedure rules that are perceived as unduly harsh or simply unfair to taxpayers can also undermine this expressive function, by fostering a perception that the IRS has undue procedural advantages in their

[273] *See supra* Parts II.A-B. [in general current rules don't impose significant costs on the highest income taxpayers, particularly proportional to the revenue additional rules could raise]

[274] *See supra* Part III.A.

[275] If these costs borne high-end taxpayers are negligible compared to the welfare gains from redistribution of tax revenue raised, then the optimal tax rate on these taxpayers would be the revenue-maximizing rate. *See, e.g.,* Saez & Zucman, *supra* note 167, at 46 (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 costs in the form of reduced resources available for consumption.

[276] *See* Keen & Slemrod, *supra* note 110, 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 costs of a rate increase. Lower (marginal) administration or compliance costs also favor enforcement measures, as does a higher statutory tax rate.").

[277] *See supra* notes [ ] and accompanying text.

interactions with taxpayers.[278] Progressive tax procedure can reconcile these competing considerations by framing adjustments to the rules for high-income taxpayers as necessary to counteract the advantages afforded by their wealth, rather than as simply additional penalties on a particular subset of taxpayers. In this respect, means-based adjustments to the tax procedure rules can be understood as adjustment necessary to treat taxpayers equally in more fundamental respects, in the same fashion as means-based adjustments to the substantive tax rules.[279]

*2. Improving Tax Morale*

The tax procedure rules—and the substantive value and norms these rules express—serve a broader function in influencing tax morale and perceptions of the tax system.[280] Tax morale, the "intrinsic motivation" of individuals to cooperate with the government by paying taxes, depends on a number of factors and varies from jurisdiction to jurisdiction.[281] Numerous studies have shown a strong correlation between tax morale and tax compliance.[282] Countries with low tax morale appear to experience higher rates of tax noncompliance.[283] For instance, Italy and Greece are often described countries with low tax morale, where tax avoidance or evasion is high.[284] Studies have also shown that progressive tax systems correlate with high levels of tax morale.[285]

This dynamic suggests a deeper relationship between the tax procedure rules and the substantive tax rules. The tax procedure rules do not simply

[278] *See, e.g., supra* note [ ] and accompanying text.

[279] *See supra* notes 163-165 and accompanying text.

[280] *See generally* Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599 (2007).

[281] Bruno S. Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 J. COMP. ECON. 136, 140 (2007) (finding "a high correlation between perceived tax evasion and tax morale").

[282] For discussion, *see* BENNO TORGLER, TAX COMPLIANCE AND TAX MORALE: A THEORETICAL AND EMPIRICAL ANALYSIS 64–77 (2007).

[283] *See, e.g.,* Erzo F.P. Luttmer and Monica Signhal, *Tax Morale*, 28 J. OF ECON. PERSP. 149 (2014); Organization for Economic Co-operation and Development, *What drives tax morale?*, OECD (2013), *available at* https://www.oecd.org/ctp/tax-global/what-drives-tax-morale.pdf.

[284] *See* James Surowiecki, *Dodger Mania*, NEW YORKER, July 11 & 18, 2011, at 38 (discussing tax morale in Greece); Josef Hein, *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 (2018). (discussing levels of tax noncompliance among Italian citizens).

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

serve an instrumental and auxiliary role in administering and effectuating the substantive tax rules. Rather, the tax procedure rules shape perceptions of the administration of the tax system, which in turn influence taxpayer compliance with the substantive tax rules—even among taxpayers who are not directly affected by the tax procedure rules—and may also influence public support for substantive progressive tax reforms.

First, the tax procedure rules likely influence taxpayer compliance with the substantive tax rules, even among taxpayers who are not directly affected by these rules. 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 that taxpayers must "have faith and trust in the fairness of the tax system."[286] Progressive tax procedure can 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, and by limiting adjustments that may disadvantage taxpayers to those necessary to counteract high-income taxpayers' preexisting advantages.

Second, taxpayer morale and public trust in the efficacy of the tax procedure rules may also influence public support for substantive progressive tax reforms. In particular, a perception that high-income taxpayers can simply avoid paying new or higher progressive taxes may discourage public support for their enactment. For example, in early 2019 Senator Elizabeth Warren (D-MA) proposed a new wealth tax on the wealthiest taxpayers, in order to increase the progressivity of the tax system and to raise funds for government programs.[287] 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.[288]

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[286] IRS TAXPAYER ADVOCATE SERVICE, 2018 ANNUAL REPORT TO CONGRESS, Vol. 1, at 117 (Feb. 2019), https://taxpayeradvocate.irs.gov/Media/Default/Documents/2018-ARC/ARC18_Volume1.pdf.

[287] *See* Press Release, Elizabeth Warren, Senator, *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).

[288] *See. e.g,* Neil Irwin, *Elizabeth Warren Wants a Wealth Tax. How Would That Even Work?*, NEW YORK 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).

Countering these objections through progressive tax procedure can in turn foster a perception that these substantive progressive reforms would be feasible and effective.

## IV. PROGRESSIVE TAX PROCEDURE IN PRACTICE

Progressive tax procedure could promote more equitable and effective administration of the tax system by deterring high-end abusive tax planning and noncompliance and by addressing resource imbalances between high-end taxpayers and the IRS. This Part offers guidance to policymakers who seek to implement means-based adjustments to the tax procedure rules. It describes key design features that policymakers should consider when assessing proposed adjustments to tax procedure rules, presents several concrete applications of means-based adjustments and, last, describes the potential viability of progressive tax procedure across the political spectrum.

### *A. Design Considerations*

When introducing means-based adjustments to any tax procedure rule, policymakers should consider several design factors: the tax procedure rule to be adjusted; the base for the adjustment; the distributional location of the adjustment; the administrability of the adjustment by the taxing authority; and the potential impact of the adjustment on tax morale.

*Choice of Tax Procedure Rule*. Policymakers should start by articulating their objective in making changes to the tax procedure rules. Once policymakers have identified their purpose clearly, they should select the procedural rule that should be adjusted. Some rules, such as tax penalties, primarily serve a deterrent and expressive function, while others, such as those governing interest charges on underpayments, serve a compensatory function.[289] Next, policymakers should consider whether the adjustment would advance one or more of the core functions of the chosen procedural rule, specifically with respect to high-end taxpayers. For example, policymakers should consider whether a proposal to impose a high civil tax penalty rate based on taxable income would apply primarily to high-end taxpayers or, alternatively, to all taxpayers, including low-income taxpayers. In each case, policymakers should compare the likely effects of the proposed adjustments with the current law's impact on high-

[289] *See infra* notes [ ] – [ ] and accompanying text. For additional discussion of varying rationale underlying tax penalties, *see* Alex Raskolnikov, *Six Degrees of Graduation: Law and Economics of Variable Sanctions*, 43 FLA. ST. U. L. REV. 1015 (2015).

end taxpayers' behavior as well as public perceptions of the IRS's enforcement of the tax law against high-income and wealthy taxpayers.

*Base for Adjustment.* Once policymakers have selected the specific tax procedure rule to adjust, they should next determine the base that will be used to determine whether the means-based adjustment applies. Means-based adjustments could be linked to a number of different base options, such as income, wealth, consumption, or some combination of all three.

One design approach 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 understatement of income tax liability,[290] then the means-based adjustment to this tax penalty could be triggered when a taxpayer meets a threshold amount of income. This matching approach is simple and administrable. It also parallels 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.[291]

Proposals that are triggered when a taxpayer's annual taxable income crosses a threshold amount are, at least nominally, targeted at high-end taxpayers. A taxpayer's annual taxable income may provide a more accurate reflection of a taxpayer's economic circumstances than, for instance, 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.[292] Similarly, a taxpayer could report a large tax liability in a single tax year (for example, by receiving a large taxable payment from settling a lawsuit),[293] even though the taxpayer normally has low taxable income from wages and other sources.

However, the measure of the taxpayer's ability to pay used in the substantive tax law, such as income, may not be the most desirable exclusive base for a particular means-based adjustment. For instance, if the purpose of the means-based adjustment is deterrence of high-end tax noncompliance, then it could be more desirable to adjust tax penalties based on the taxpayer's net assets *or* taxable income. While this dual approach would be more complex than a base that looks to taxable income alone, it

[290] *See, e.g.*, I.R.C. § 6662(b)(2) (substantial understatement of income tax).

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

[292] *See, e.g.*, Taxpayer Advocate Service, IRS, *I can't pay my taxes*, *available at* https://taxpayeradvocate.irs.gov/get-help/i-can-t-pay-my-taxes ("The IRS also charges daily interest on unpaid tax bills, so the longer you wait, the more interest you'll owe").

[293] *See, e.g.*, I.R.C. § 104(a) (flush language) (exception for damages for emotional distress from exclusion of physical injuries).

would better reflect the taxpayer's ability to seek tax advice from accountants and other advisors and to engage in tax strategies that are complex and difficult for the IRS to detect.

*Distributional Location of Adjustment.* Policymakers must decide whether to introduce progressivity by increasing the burden of certain rules on high-end taxpayers or by reducing their burden on low-income taxpayers. It may be most desirable to implement means-based adjustments for the highest-income taxpayers, on account of their unique tax avoidance opportunities, procedural advantages, and the size of their tax liabilities at stake. Alternatively, adjustments at the bottom end of the income distribution may be more desirable to alleviate onerous consequences and regressive effects for noncompliance among taxpayers with lesser means.

*Administrability by the Taxing Authority.* Policymakers should also evaluate the taxing authority's capacity to implement any proposed means-based adjustment. An adjustment that is triggered by the taxpayer's taxable income may be more administrable than one triggered by the taxpayer's net assets. Taxpayers calculate and report their taxable income on their annual tax returns and, for many taxpayers, their employers and financial institutions submit corresponding information reports to the IRS.[294] In contrast, a means-based adjustment tied to net asset value would require the IRS to seek this information from taxpayers directly as individuals do not calculate their net asset values for tax purposes regularly. And just as the IRS devotes considerable attention to valuation disputes in the estate and gift tax context,[295] it could find itself in a similar position in the case of adjustments linked to taxpayers' net assets. Further, if a means-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.[296] 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.[297]

*Tax Morale.* Finally, policymakers should consider the effects of each proposed means-based adjustment to the tax procedure rules on tax

[294] I.R.C. §§ 6011, 6012 (return filing requirements).

[295] *See, e.g.*, Michael Cohn, *Court hears IRS dispute over value of Michael Jackson estate*, ACC'TING TODAY, Feb. 8, 2017 (describing estate tax valuation controversy).

[296] I.R.C. § 6213 (procedures for Tax Court litigation), § 7422 (procedures for civil actions for tax refunds).

[297] See, e.g., *Compaq v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003) (involving transaction of American Home Products); *IES Industries, Inc. v. U.S.*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

morale.[298] One independent variable that appears to affect tax morale is the knowledge that the government is enforcing the tax law, particularly with respect to wealthy taxpayers. Benno Torgler, among other scholars, have 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.[299] In response to this concern, government officials in the United States have explained that one reason it publicizes its tax enforcement of individuals who have engaged in tax fraud is to bolster confidence among compliant taxpayers that "the system is fair."[300]

While forecasting whether a particular proposal would bolster tax morale would be challenging, policymakers could start by examining two features of any proposed means-based adjustment. First, policymakers could first consider whether the means-based adjustment is one that most taxpayers would be able to comprehend and understand as applying specifically to high-end taxpayers.[301] In other words, policymakers could consider whether the government can explain clearly that the change to the tax procedure rule is specifically targeted to high-end taxpayers. Second, policymakers could consider whether the proposed adjustment would result in observable evidence that high-end taxpayers are indeed affected by the means-based adjustment.[302] If either or both of these features are present, the means-based adjustment could strengthen tax morale by positively

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[298] *See* notes [ ] – [ ] and accompanying text.

[299] Benno Torgler, *Tax Morale, Trust and Corruption: Empirical Evidence from Transition Countries*, Center for Research in Economics, Management and the Arts (CREMA), Working Paper, no. 2004-05 (2004); Benno Torgler & Friedrich Schneider, *What Shapes Attitudes Toward Paying Taxes? Evidence from Multicultural European Countries*, 88 SOC. SCI. Q. 443, 444 (2007).

[300] Jeremiah Coder, *Conversations: Eileen Mayer*, 116 TAX NOTES 738, 740 (2007) (*quoting* then-Chief of the IRS Criminal Investigation Division, Eileen Mayer).

[301] *See* Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSP. 25 (2007); Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 40 LOY. U. CHI. L. J. 483, 507, n. 114 ("There is a positive correlation between tax compliance and the perceived fairness of the tax system"); Jan-Emmanuel De Neve, et al., *How to Improve Compliance? Evidence from Population-wide Experiments in Belgium*, 2019, *available at* https://www.povertyactionlab.org/sites/default/files/publications/How-to-Improve-Tax-Compliance_DeNeve-et.al_April2019.pdf ("simplifying communication by the tax administration consistently improves tax compliance").

[302] For discussion, *see* Joshua D. Blank, *In Defense of Individual Tax Privacy*, 61 EMORY L.J. 265, 288-290 (2011) (discussing power of specific examples on taxpayers' perceptions); ALAN H. PLUMLEY, IRS, CATALOG. NO. 22555A, THE DETERMINANTS OF INDIVIDUAL INCOME TAX COMPLIANCE 36 (1996); See, e.g., Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance*, 35 PUB. FIN. REV. 500, 502 (2007).

affecting taxpayer perceptions of the government's tax enforcement capabilities.

*B. Application*

The purpose of making means-based adjustments to the tax procedure rules is not to generate additional tax revenue or 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, some degree of adjustment could effectively increase the expected costs for high-end taxpayers in particular.

This Subpart provides several concrete examples 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. In each case, it shows how policymakers could introduce means-based adjustments to the tax procedure rule 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).

*1. Tax Penalties*

As sophisticated tax avoidance and evasion strategies frequently escape IRS detection and challenge, the expected costs of tax noncompliance are inadequate to deter high-end taxpayers from pursuing them. Compared to taxpayers whose income consists solely of wages, high-end taxpayers can avoid or evade tax liabilities by using strategies that are more difficult for the IRS to detect.[303] 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.[304] 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.[305]

[303] *See* Testimony of Hon. J. Russell George, Treasury Inspector General for Tax Administration, Committee on Ways and Means, U.S. House of Representatives, May 9, 2019 ("High-end taxpayers have the most opportunity to engage in tax avoidance planning.")

[304] *See id*.

[305] *See supra* notes [ ] – [ ] and accompanying text.

The Internal Revenue Code contains over one hundred separate civil tax penalties, which consist of percentage tax penalties and flat tax penalties.[306] Percentage tax penalties cause taxpayers to pay a penalty equal to a percentage of their underpayment of tax. Accuracy-related tax penalties, for instance, require individuals who underpay their taxes through particular types of misconduct—such as negligence, disregard of rules and regulations—to pay an additional tax penalty equal to 20% of their required underpayment of tax liability.[307] Flat tax penalties, on the other hand, require taxpayers to pay a dollar amount when they engage in specific events. Individuals are subject to flat dollar tax penalties, for instance, when they file frivolous tax returns ($5,000),[308] file false statements regarding tax withholdings ($500)[309] or fail to file reportable transaction forms ($10,000).[310]

In contrast to current law, legislators could introduce means-based adjustments to the civil tax penalty rates and dollar amounts based on taxpayers' taxable income or net assets. For a simple illustration, instead of the 20% civil tax penalty on underpayments for acts specified in Section 6662(b),[311] Congress could revise this statute to provide that: taxpayers who have taxable income of up to $5 million or net assets of up to $10 million would incur accuracy-related tax penalties at a rate of 20% of the underpayment; taxpayers with taxable income of $5 million or more or net assets of $10 million or more would incur these penalties at a rate of 30%; and taxpayers with taxable income of $10 million or more or net assets of $20 million or more would incur these penalties at a rate of 40%. Under this structure, if a taxpayer with taxable income of $15 million underpaid tax of $4 million by pursuing a tax avoidance strategy involving the special pass-through deduction under Section 199A,[312] and if the taxpayer incurred the applicable accuracy-related tax penalty, the taxpayer would pay a tax penalty of $1.6 million (40% of $4 million) rather than $800,000 (20% of $4 million).

Similarly, Congress could also increase flat dollar tax penalties based on taxpayers' taxable income. For example, for taxpayers with taxable income of $5 million or more or net assets of $10 million or more, Congress could increase the tax penalty for failing to file a reportable transaction

[306] *See generally* I.R.C. §§ 6651–6702.
[307] I.R.C. § 6662.
[308] I.R.C. § 6702(a).
[309] I.R.C. § 6682.
[310] I.R.C. § 6707A(b)(2)(B).
[311] I.R.C. § 6662(b).
[312] I.R.C. § 6662(d)(1)(C).

form[313] from $10,000 to $50,000 or the tax penalty for filing a frivolous tax return[314] from $5,000 to $25,000.

These examples are certainly not exhaustive—legislators could introduce means-based adjustments to any or all of the dozens of civil tax penalties under current law.[315] Further, if legislators desire more measured application of means-based adjustments, they could refine the simple examples above by introducing 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).[316]

Rather than focusing solely on a specific activity, these means-based adjustments to civil tax penalties would apply to all high-end taxpayers. 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" (20% tax penalty)[317] or fail to file a required reportable transaction form (additional $10,000 tax penalty).[318]

Means-based adjustments to the civil tax penalty rules, in contrast, would apply to the actor—the high-end taxpayer. With these adjustments in place, high-end taxpayers would still be subject to increased tax penalties (*e.g.*, 30% penalty instead of 20% penalty in the case of accuracy-related penalties[319]) even though they could still attempt to circumvent tax shelter tax penalties, such as the reportable transaction[320] or nondisclosed listed transaction penalties[321]). 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 (*e.g.*, 50% penalty instead of 40% penalty in the case of nondisclosed noneconomic substance transactions[322]).

By implementing means-based civil tax penalties to the actor rather than solely to the activity, Congress could also signal to all high-end taxpayers that the costs of tax noncompliance in general have increased.

[313] I.R.C. § 6707A(B)(2)(b).
[314] I.R.C. § 6702(a).
[315] *See generally* I.R.C. §§ 6651–6702.
[316] I.R.C. §§ 1(h)(1), (11) (tax rates on net capital gain and qualified dividend income).
[317] I.R.C. § 6662A(a).
[318] I.R.C. § 6707A(B)(2)(b).
[319] *See supra* notes [ ] – [ ] and accompanying text.
[320] I.R.C. § 6662A(a).
[321] I.R.C. § 6707A(B)(2)(b).
[322] I.R.C. § 6707A(B)(2)(b).

Over the last decade, the IRS's ability to audit high-end taxpayers has declined due to significant budget reductions and the complexity of the tax positions of high-end taxpayers.[323] In September 2019, Charles Rettig, Commissioner of Internal Revenue, addressed the disparity between relative audit rates of recipients of the Earned Income Tax Credit (low-income taxpayers) and high-end taxpayers, commenting that "IRS cannot simply shift examination resources from single issue correspondence audits to more complex higher income audits because of employee experience and skillset."[324] Means-based adjustments to the civil tax penalty rules would serve to counterbalance the IRS's resource challenges related to detecting tax noncompliance by high-end taxpayers.

Means-based civil tax penalties could also enable the government to bolster tax morale by providing clear evidence that it is treating high-end taxpayers differently in order to deter tax noncompliance. Under current law, there are subtle variances between the treatment of high-end 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.[325] 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.[326] 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. Such a change in the structure of tax penalties could enhance taxpayers' confidence in the government's ability to enforce the tax law effectively by deterring those with the greatest resources and access to sophisticated advisors from avoiding and evading their tax liabilities.[327]

Opponents of means-based civil tax penalties might criticize this approach by arguing that it would cause the IRS to disproportionately focus on high-end taxpayer and shift 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

[323] For discussion, *see* Paul Kiel and Jesse Eisinger, *How the IRS Was Gutted*, ProPublica.org, Dec. 11, 2018, *available at* https://www.propublica.org/article/how-the-irs-was-gutted; National Taxpayer Advocate, 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).

[324] Letter from IRS Commissioner Charles P. Rettig to Senator Ron Wyden, Sept. 6, 2019, *available at* https://www.documentcloud.org/documents/6430680-Document-2019-9-6-Treasury-Letter-to-Wyden-RE.html.

[325] Treas. Reg. § 1.6664-4(b)(1).

[326] Eisinger & Kiel, *supra* note 31.

[327] *See supra* notes [ ] – [ ] and accompanying text.

challenging the tax positions of a high-end taxpayer compared to a 20% accuracy tax penalty for all other taxpayers. Opponents may argue that 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 would alter tax penalty payments by some high-end taxpayers, this objection is unpersuasive. The IRS assigns its agents to different audit units based on the complexity of the returns.[328] Revenue Agents, the most experienced IRS examiners, are assigned to complex tax returns of individuals, those filed by high-end taxpayers, which often involve pass-through entities, offshore transactions and cryptocurrency.[329] Revenue Agents undergo rigorous training and must have several years of work experience before reviewing these returns.[330] 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-end taxpayers.[331] Further, if high-end taxpayers or their advisors perceive that the IRS may increase scrutiny of high-end taxpayers in order to collect additional revenue, this (likely inaccurate) perception 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.[332] 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").[333] If the taxpayer invokes this defense, she can 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

[328] *See* Rettig, *supra* note [ ]; Int. Rev. Serv, Internal Rev. Manual 4.1.1.1.6 (Oct. 25, 2017).

[329] *See* Rettig, *supra* note [ ].

[330] *See id*.

[331] *See id.*

[332] *See supra* notes [ ] – [ ] and accompanying text.

[333] I.R.C. § 6664(c).

tax position.[334] To qualify for this exception, the advice must consider all pertinent facts and circumstances and not be based on unreasonable assumptions.[335] 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.[336]

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.[337] In the late 1970's and early 1980's, in thousands of tax shelter cases, high-end taxpayers actively sought written tax opinions as a means of avoiding tax penalties.[338] Twenty years later, throughout the corporate tax shelter boom of the late 1990s, corporate taxpayers paid hefty sums for standard for written opinions, many of which included questionable legal conclusions.[339] While the era of mass-marketed tax shelters has subsided, high-end individual taxpayers still seek written opinions from professional tax advisors, which present varying levels of confidence, in order to take advantage of the reasonable cause defense.[340]

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

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[334] Treas. Reg. § 1.6664-4(c).

[335] Treas. Reg. §§ 1.6664-4(c)(1)(i), (ii).

[336] Treas. Reg. § 1.6664-4(c)(1).

[337] For discussion, *see* Doran, *supra* note 61; William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 35 (2009); Rachelle Y. Holmes, *The Tax Lawyer as Gatekeeper*, 49 U. LOUISVILLE L. REV. 185, 204 (2010); Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489 (2010); Raskolnikov, *supra* note 60, at 619; Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

[338] *See* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77 (2006); Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 AM. U. L. REV. 267 (2008); Dennis J. Ventry, Jr., *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, 111 TAX NOTES 823 (2006); Donald Arthur Winslow, *Tax Penalties—"They Shoot Dogs, Don't They"*, 43 FLA. L. REV. 811, 823 (1990);

[339] *See* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999); TANINA ROSTAIN & MILTON C. REGAN, JR., CONFIDENCE GAMES: LAWYERS, ACCOUNTANTS AND THE TAX SHELTER INDUSTRY (2014); U.S. Department of Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999).

[340] *See* Emily Cauble, *Accessible Reliance Tax Advice*, 51 U. MICH. J.L. REF. 589 (2017); Heather M. Field, *Tax Lawyers as Tax Insurance*, 60 WILLIAM & MARY L. REV. 2111, 2122 (2019); Robert W. Wood, *Why Tax Opinions Are Valuable*, Forbes.com, Jan 18, 2011.

from transactions that lack "economic substance" as defined in the Code.[341] Similarly, if a taxpayer fails to disclose participation in an abusive tax strategy, such as a listed transaction, the taxpayer may not assert the reasonable cause defense regarding certain tax shelter penalties.[342]

Departing from this approach, Congress could prevent all high-end taxpayers from asserting the reasonable cause defense against any accuracy-related tax penalties. For example, Congress could revise the law to provide that in the case of individual taxpayers with taxable income of $5 million or more or net assets of $10 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. The effect of this revision would be that high-end taxpayers could no longer defend against these tax penalties by showing "reliance on opinion or advice," such as the written opinion of a tax lawyer or accountant.[343] More generally, this revision would prevent the IRS from considering more general facts and circumstances when applying accuracy-related tax penalties.[344]

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 attempt to defend against certain accuracy-related tax penalties using defenses other than the reasonable cause and good faith defense. For example, the law provides taxpayers with possible defenses other than the reasonable cause defense in the case of an accuracy-related tax penalty resulting from a substantial understatement.[345] 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.[346] In addition, all taxpayers, not only high-end taxpayers, would still be restricted from asserting the reasonable cause defense in tax controversies involving tax penalties related to non-economic substance transactions[347] and non-disclosed reportable transactions.[348]

This Article's approach is broader than prior efforts to reform civil tax penalty defenses. Current law prevents taxpayers from asserting the

[341] I.R.C. § 6664(c)(2).
[342] I.R.C. § 6664(d)(3).
[343] Treas. Reg. § 1.6664-4(c).
[344] Treas. Reg. § 1.6664-4(c)(1).
[345] I.R.C. § 6662(d).
[346] I.R.C. § 6662(d)(2)(B)(i).
[347] I.R.C. § 6664(c)(2).
[348] I.R.C. § 6664(d)(3).

reasonable cause defense against accuracy-related tax penalties only in certain circumstances, such as non-disclosed listed transactions.[349] In contrast, the proposal would prevent all high-end taxpayers from asserting the reasonable cause defenses, irrespective of whether their tax position is a non-disclosed listed transaction or any other specific transaction.[350]

The proposal is also consistent with, but more wide-reaching than, penalty defense proposals offered by other scholars. 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.[351] Our approach is consistent with, yet broader than, proposals by Johnson and others in that it would prevent high-end taxpayers from asserting the entire reasonable cause defense against tax penalties, not just the reliance on opinion or advice exception.[352] That is, our means-based adjustments would also prevent high-end 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. Further, while other scholars have addressed the weaknesses of the civil tax penalty structure in general, our proposal is an illustration of our new theoretical framework that policymakers should focus on actors rather than solely target specific activities.

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-end individuals can be substantial, the IRS often settles these cases without imposing the tax penalties.[353] 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.[354] In 2019, news reports noted that the IRS ultimately withdrew its tax penalty assertions and accepted a

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[349] *Id*.

[350] *Id*.

[351] Johnson, *supra* note 238. *See also* 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 (2003); Jeremiah Coder, *Achieving Meaningful Civil Tax Penalty Reform and Making It Stick*, 27 AKRON TAX J. 153, 178 (2012); William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1, 35 (2009); Calvin H. Johnson, *Ending Reliance on Opinions of the Taxpayer's Own* Lawyer, 141 TAX NOTES 947 (2013); Michelle M. Kwon, *Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors with Conflicts of Interest*, 67 TAX LAW. 403 (2014); Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989);

[352] *See supra* notes [ ] – [ ] and accompanying text.

[353] *See, e.g.,* Eisinger & Kiel, *supra* note 31.

[354] *Id*.

payment of tens of millions rather than the original $1.2 billion deficiency.[355] Under means-based adjustments, high-end taxpayers would not be entitled to point to 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 tax noncompliance generally and strengthen the IRS's bargaining power in settlement negotiations.

The government could utilize means-based adjustments to 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 claim that the change shut down a "tax penalty loophole" for high-end taxpayers. This framing could allow policymakers to argue credibly that the IRS may no longer permit high-end 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.[356]

Opponents may argue that without the reasonable cause defense, high-end taxpayers could be forced to face tax penalties in situations where the tax treatment is not clear *ex ante*. For example, consider a high-end 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. 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. Whether she pursues the restructuring and is subject to a penalty or she decides not to pursue it at all, opponents of the proposal would likely assert that it would impose excessive tax penalties or, alternatively, burdens such as opportunity cost, on this high-end taxpayer.

A response to this criticism is that, under the proposal, the high-end 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

[355] *Id*.
[356] *See supra* notes [ ] – [ ] and accompanying text.

the weight of contrary authorities.[357] 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.[358] These defenses are more closely tied to language in the Code, regulations, rulings and other legal authorities than the reasonable cause defense. They would also force the high-end taxpayer to articulate the legal arguments for the claimed tax position directly.

More generally, opponents of this proposal could also object that it would invade the attorney-client relationship for high-end taxpayers and their advisors. They 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 transaction,[359] which applies on a strict liability basis,[360] made similar arguments when Congress enacted the law in 2010.[361]

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 would be a socially desirable outcome.

### *3. Statute of Limitations*

Another procedural rule that inhibits deterrence of high-end tax noncompliance is the statute of limitations on additional assessment of tax liability. The default statute of limitations begins on the date that a taxpayer

[357] I.R.C. § 6662(d)(2)(B)(i).

[358] Treas. Reg. § 1.6664-4(b)(3).

[359] I.R.C. § 6662(b)(6).

[360] I.R.C. § 6662(c)(2).

[361] *See, e.g.*, Clinton Stretch, Matthew Lay, and John Galotto, *Economic Substance and Strict Liability Do Not Mix*, 113 TAX NOTES 1357 (June 15, 2009); American Institute of Certified Public Accountants, *Report on Civil Tax Penalties: The Need for Reform*, Aug. 28, 2009; 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); Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389 (2010).

files a tax return and continues to run for three years from this date.[362] 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.[363] While the statute of limitations is a source of procedural fairness, it is also an obstacle for the IRS. Like a basketball player facing a shot clock, the IRS must assess additional tax, or at least issue a notice of deficiency, before the clock stops ticking.

Current law 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 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.[364] 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 it, the statute of limitations does not close until the taxpayer files the required form.[365] Last, if the taxpayer files a fraudulent return, or no return at all, the statute of limitations never closes.[366]

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,[367] such as *United States v. Home Concrete & Supply, LLC*,[368] 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 the strategies are complex and can involve multiple entities in different jurisdictions.[369] High-end taxpayers who claim questionable tax positions are aware that time may run

[362] I.R.C. § 6501(a).

[363] *See* MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE 5 (2d ed. 2019).

[364] I.R.C. § 6501(e).

[365] I.R.C. § 6501(c)(10).

[366] I.R.C. §§ 6501(c)(1), (2).

[367] *See*, *e.g.*, Beard, TC Memo 2009-184; Bakersfield Energy Partners, LP v. Commissioner, 568 F.3d 767 (2009); Salman Ranch Ltd. v. Commissioner,. 647 F.3d 929, (10th Cir. 2011).

[368] SCt, 132 SCt 1836 (2012).

[369] *See* Letter from IRS Commissioner Charles P. Rettig to Senator Ron Wyden, *supra* note [ ].

out before the IRS detects them.[370] As one tax advisor has explained, when he informs his clients that statutes of limitations have expired, "we high-five them."[371]

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.[372] In most cases, taxpayers grant the IRS the extension rather than encourage its agents to issue an aggressive notice of deficiency quickly.[373] But even in these situations, high-end taxpayers retain negotiation leverage due to the very existence of the initial time limit. High-end taxpayers often agree to a conditional waiver, where they reach agreement with the IRS over the end date (*e.g.*, six months from the date of the waiver) and the specific issues that the IRS may continue to review during the extension period.[374] For this reason, tax advisors who specialize in working with high-end taxpayers have commented that "it is almost always preferred to sign a limited extension with a specified expiration date…rather than an indefinite extension."[375] 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.[376]

Instead of extending the statute of limitations based solely on specific acts or offenses, Congress could also extend the statute of limitations based on the income or assets of the taxpayer. For example, in the case of any individual taxpayer with taxable income of $5 million or more or net assets of $10 million or more, Congress could revise the default review period in which the IRS could assess addition tax liability to six years, instead of three years,[377] from the filing of the taxpayer's return. All other taxpayers would still face the default three-year statute of limitations. Congress could also retain the law's treatment of particularly abusive transactions, such as substantial omissions,[378] by extending the time for review in the case of

[370] *See, e.g.*, Eisinger & Kiel, *supra* note 31; Barnes Law LLP, *Statute of Limitations: When Taxpayers Can Tell the IRS, "You Snooze, You Lose."*, May 7, 2016.

[371] *Id*.

[372] Int. Rev. Serv., Extending the Tax Assessment Period, Publication 1035.

[373] *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.")

[374] *See, e.g.*, Joe Marchbein, *Consent to Extend the Statute of Limitation*, THE TAX ADVISER, July 1, 2009; Charles P. Rettig, *Tax Practitioners Guidebook: Picking Up Table Scraps*, TAX NOTES, Mar. 12, 2007.

[375] Rettig, *supra* note [ ].

[376] Eisinger & Kiel, *supra* note 31.

[377] I.R.C. § 6501(a).

[378] I.R.C. § 6501(e).

high-end taxpayers from six years under current law[379] to nine years. All other taxpayers would remain subject to 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. Of course, each of these time periods, and the triggering thresholds, could be adjusted.

An actor-based approach to the statute of limitations could enhance deterrence of high-end abusive tax planning and tax evasion. High-end 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.[380] 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.[381] 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.[382] 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.[383] By increasing the time for review, this proposal would alert high-end taxpayers that the chance of IRS detection of abusive tax positions has increased. Even if Congress does not apply means-based adjustments to tax penalties or the tax penalty defenses,[384] this change would increase the probability of detection and, as a result, the expected costs of high-end tax noncompliance.

Means-based adjustments to the statute of limitations 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

[379] *Id*.

[380] *See, e.g.*, Linda Z. Swartz, *To Disclose or Not To Disclose: Tax Shelters, Penalties and Circular 230 in 2015*, Cadwalader LLP, 2015, available at https://www.cadwalader.com/uploads/books/d09bc22416d46ea1af862b33ebf77de8.pdf.

[381] *See, e.g.*, George Jones, *Treasury Advisor Explains "Transactions of Interest" Disclosure Regulations Designed to Give IRS Flexibility*, CCH TAX Group (Aug. 31, 2007); Michael Kosnitzky, *Protective Filings for Hedge Funds After the Jobs Act*, 109 TAX NOTES 817 (2005). For further discussion, see Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629 (2009).

[382] *See, e.g.*, Anthony Vittiello, et al., *Gift Tax Returns & IRS Examination*, THE CPA JOURNAL, Jan. 2017; Jay A. Soled, et al., *Rethinking the Penalty for the Failure to File Gift Tax Returns*, TAX NOTES, Nov. 18, 2013.

[383] *See* Vittiello, *supra* note [ ] ("take advantage of the adequate disclosure statute of limitations".

[384] *See supra* notes [ ] – [ ] and accompanying text.

Trump's family and the Trump organization.[385] 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."[386] 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."[387] 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.[388] Means-based adjustments would empower the government to signal to all taxpayers that it now possesses an enhanced tax enforcement tool—time itself—which can deploy in its review of the tax returns of high-end taxpayers.

Opponents of this proposal would likely object that it deprives high-end taxpayers of procedural fairness and equal treatment under the law. 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 deficiencies than other taxpayers, but they would also be subject to increased compliance burdens, including record keeping and documentation.[389] 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.

A response to this objection is that as high-end taxpayers have access to different tax planning and detection avoidance opportunities than other taxpayers, differential treatment on the basis of taxable income or net assets is justified. As has been discussed, the business affairs of many high-end

[385] David Barstow, Susanne Craig and Russ Buettner, *Trump Engaged in Suspect Tax Schemes as He Reaped Riches From His Father*, N.Y. TIMES, Oct. 2, 2018.

[386] *Id*.

[387] *Id*.

[388] *See, e.g.*, Bess Levin, *"Beyond the Law": Should Trump's Tax Chicanery Land Him in the Clink?*, VANITY FAIR, Oct. 3, 2018; Michael Collins, *IRS unlikely to pursue tax fraud allegations against Donald Trump and family, experts say*, USA Today, Oct. 3, 2018; Irina Ivanova, *Trump likely couldn't be prosecuted for tax fraud – even if the Times report is true*, cbsnews.com, Oct. 3, 2018; *New York Officials Are "Vigorously" Reviewing A Report That Trump Committed Tax Fraud*, buzzfeednews.com, Oct. 3, 2018; Annie McDonough, *Why hasn't New York charged Donald Trump for tax fraud?*, City&State NewYork, May 9, 2019;

[389] Int. Rev. Serv., *How long should I keep records?*, *available at* https://www.irs.gov/businesses/small-businesses-self-employed/how-long-should-i-keep-records; Bob Carlson, *How Long Should You Keep Tax Returns? Longer Than You Think*, Forbes.com, Jul. 9, 2018.

taxpayers are more complex and difficult for the IRS to review than those of taxpayers whose income consists largely of wages.[390] Further, high-end taxpayers present a greater resource mismatch with the IRS, in terms of participation of tax accountants and lawyers in planning, than other taxpayers.[391] 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.[392] Different statute of limitations periods based on taxable income or net assets 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.

### *C. The Politics of Progressive Tax Procedure*

In addition to enhancing deterrence of high-end tax noncompliance, means-based adjustments to tax procedure rules may be more politically feasible than alternative tax enforcement approaches. Legislators pursuing means-based adjustments to tax procedure rules should argue that the purpose of these changes is not to raise additional revenue, as is the case with proposals to increase marginal tax rates or eliminate certain tax deductions.[393] Instead, they should characterize means-based adjustments as a way to encourage compliance with the tax law by high-end taxpayers and strengthen the IRS's ability to enforce the tax law. They should note that Congress has previously addressed differences between high-end taxpayers and other taxpayers by applying net worth limits to various tax procedure rules, such as rules that address recovery of fees and costs from the IRS,[394] the shift of the burden of proof in civil tax controversies[395] and abatement of interest on underpayment.[396] Proponents of means-based adjustments should argue that Congress also enacted the prior changes to address

[390] *See* Letter from IRS Commissioner Charles P. Rettig to Senator Ron Wyden, *supra* note [ ].

[391] *Id*.

[392] I.R.C. § 7491(a)(2).

[393] *See, e.g.,* Kevin Kelleher, *Alexandria Ocasio-Cortez Suggests a Return to 70% Tax Rate on the Super Wealthy to Help Fund Green New Deal*, Fortune.com, Jan. 4, 2019 (describing proposal by Rep. Alexandria Ocasio-Cortez, D-NY, to introduce 70% top marginal tax rate to fund Green New Deal).

[394] I.R.C. § 7430(c)(4)(A)(ii).

[395] I.R.C. § 7491(a)(2).

[396] I.R.C. § 6404(h).

enforcement-related differences between types of taxpayers rather than to raise additional revenue.

Proponents of progressive taxation should seek means-based adjustments to tax procedure rules in order to support progressivity of the underlying substantive tax law. On its face, the current federal income tax is progressive, as it includes graduated marginal tax brackets and rates.[397] As this Article has shown, however, some high-end taxpayers not only pursue strategies that enable them to reduce or evade their tax obligations, but they also circumvent the law's activity-based approach to abusive tax avoidance and evasion.[398] If high-end taxpayers are able to avoid and evade tax liability without significant consequence, as the latest tax gap studies suggest, then the law is not as progressive as its substantive legal rules suggest. Proponents of means-based adjustments might consider distilling Professor Joel Slemrod's analysis into a simple talking point:

> [I]t is impossible to understand the true impact of a county'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.[399]

Any legislator who desires progressive taxation—whether by maintaining the current system of graduated income tax rates, introducing marginal tax rates aimed at ultra-high-income taxpayers or introducing additional taxes, such as wealth taxes[400]—should support changes to tax procedure that address features of the actor, the high-end taxpayer, rather than that focus solely on potentially abusive activity.

Even opponents of progressive taxation should embrace means-based adjustments to tax procedure rules. Imagine a legislator who desires a true proportional tax system, such as a flat tax with no zero bracket, where everyone is subject to same percentage rate on taxable income, rather than a progressive income tax system.[401] If this system were adopted and high-end taxpayers could design abusive tax avoidance structures that minimized

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[397] I.R.C. § 1(j)(2).

[398] *See supra* notes [ ] – [ ] and accompanying text.

[399] Joel Slemrod, *Why People Pay Taxes: Introduction*, *in* JOEL SLEMROD, WHY PEOPLE PAY TAXES 1 (1992).

[400] *See, e.g.,* Elizabeth Warren, Ultra-Millionaire Tax, *available at* https://elizabethwarren.com/ultra-millionaire-tax/ (last visited Nov. 9, 2019); Bernie Sanders, Tax on Extreme Wealth, *available at* https://berniesanders.com/issues/tax-extreme-wealth/ (last visited Nov. 9, 2019).

[401] For general description, *see* Kyle Pomerleau, *What Are Flat Taxes?*, Tax Foundation, May 19, 2015, *available at* https://taxfoundation.org/what-are-flat-taxes/ (last visited, Nov. 9, 2019); ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (1995).

their tax base, the tax system would not, in reality, be flat. Instead, increased time for IRS review and other tailored changes to tax procedure rules could deter abusive tax avoidance and tax aggressiveness by high-end taxpayers. With means-based adjustments to tax procedure rules, even proponents of non-progressive taxation could attempt to attain a tax system that operates in practice in ways that are closer to the intended effects of the substantive tax law.

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.[402] Means-based adjustments to the tax procedure rules do not require annual approval and, thus, are more long-lasting. 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 types of changes and fluctuation as the IRS's annual budget allocation.[403]

Second, without explicit direction from Congress, the IRS may use increased funding to target activities where tax enforcement, including collection, is easier. As IRS official have commented publicly in the past, correspondence audits regarding specific tax deductions and tax credits are the most efficient use of the IRS's enforcement resources.[404]

Last, without incorporating an actor-based approach to the tax procedure rules, the IRS may still face difficulty in enforcing the tax law against high-end taxpayers, even with greater budgetary resources. Changes to the tax procedure rules that apply to the actor, the high-income taxpayer, can more effectively increase the expected cost of abusive tax avoidance and tax evasion for high-end taxpayers than the law's current exclusive use of activity-based anti-abuse rules. While ensuring adequate budgetary resources for the IRS is a necessary precondition for effective tax enforcement, without accompanying mean-based adjustments to the tax procedure rules, this approach is unlikely to be successful in deterring high-end tax noncompliance.

[402] *See supra* note 323 and accompanying text.

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

[404] *See* Letter from IRS Commissioner Charles P. Rettig to Senator Ron Wyden, *supra* note [ ].

## V. CONCLUSION

This Article has offered a new approach to the problem of abusive tax planning and tax evasion by high-end taxpayers. It has argued that "progressive tax procedure"—means-based adjustments to the tax procedure rules as they apply to high-income and wealthy taxpayers—would more effectively deter high-end tax noncompliance than the law's current exclusive focus on specific potentially abusive activities. In presenting this new approach, this Article has made four primary contributions.

First, this Article has presented a normative case for means-based adjustments to the tax procedure rules. Means-based adjustments, this Article has contended, 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 enhance taxpayer morale and lead to increased tax compliance by all taxpayers.

Second, this Article has revealed previously unexamined limitations of the current statutory and regulatory responses to the problem of abusive tax planning and tax evasion. It has shown how the law currently targets specific transactions or activities, such as participation in listed transactions or the use of off-shore bank accounts, and how high-end taxpayers, and their sophisticated advisors, often circumvent activity-focused responses.

Third, in contrast to current law, this Article has argued that legislators should apply means-based adjustments to the tax procedure rules by reforming these rules to take into account taxpayers' income and wealth. The Article has applied this concept to several concrete examples that are at the heart of the government's deterrence efforts in tax enforcement: civil tax penalties; the reasonable cause defense; and the statute of limitations.

Last, this Article has argued that means-based adjustments to tax procedure rules may be more politically feasible than other approaches to strengthening tax enforcements. As the purpose of progressive tax procedure is to encourage compliance with the tax law by high-end taxpayers and to enhance the IRS's enforcement capabilities, proponents of progressive taxation, proportionate taxation or any other type of distributional structure should support means-based adjustments to the tax procedure rules.

While this Article has only examined a few potential applications, there are many other tax procedure rules where legislators could consider applying means-based adjustments. The concept of progressive tax procedure has broad application, at both the federal and state levels. As a result, the analysis and application presented in this Article is relevant to legislators and other tax policymakers, scholars of both tax law and progressivity, and federal and state tax administrators.