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Tax Penalties and Tax Compliance

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ARTICLE

TAX PENALTIES AND TAX COMPLIANCE

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This Article examines the relationship between tax penalties and tax compliance. Conventional accounts, drawing from deterrence theory and norms theory, assume that the relationship is purely instrumental—that the function of tax penalties is solely to promote tax compliance. This Article identifies another aspect of the relationship that generally has been overlooked by the existing literature: the function of tax penalties in defining tax compliance. Tax penalties determine the standards of conduct that satisfy a taxpayer's obligations to the government; they distinguish compliant taxpayers from non-compliant taxpayers. This Article argues that tax compliance in a self-assessment system should require the taxpayer to report her tax liabilities only on the basis of legal positions that she reasonably and in good faith believes to be correct. But the accuracy penalties provided under current law set much lower standards of conduct. In the case of a non-abusive transaction, current law allows the taxpayer to base her self-assessment on a position having as little as a one-in-five chance in prevailing. For an abusive transaction, the taxpayer only needs a reasonable belief that her position is more likely than not to prevail. The Article describes reformed standards of conduct for taxpayers, tax practitioners, and government officials that define tax compliance more appropriately for a self-assessment system.

I. Introduction

Why does government impose penalties on those who do not pay taxes? Taxation, however legitimate, constitutes a forced extraction of wealth: why then does government extract one amount from those who pay in the first instance but a larger amount from those who do not? The conventional answer is that a penalty promotes compliance. But even if one reasonably takes it as given that government wants taxpayers to comply with their tax obligations, this simply raises the further question why government would expect tax penalties to promote compliance. After all, if a taxpayer does not comply with an obligation to pay a tax, it is not immediately obvious that the imposition of a tax penalty—in effect, a second tax—will cause her to pay both the tax and the penalty.

The justification for tax penalties would appear to turn on what motivates taxpayers to comply with their tax obligations. The existing literature presents competing models in response to that question. The standard deter-

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rence model holds that taxpayers comply with their tax obligations to avoid legal sanctions (such as penalties and incarceration) whenever those sanctions are expected to be more costly than compliance.[1] The norms model maintains that many taxpayers satisfy their tax obligations because they want to adhere to specific social or personal norms, such as reciprocating the cooperation of others or respecting legitimate obligations.[2] Neither model accounts adequately for taxpayer compliance, and, to complicate matters, the two models suggest different roles for tax penalties. The deterrence model, following the familiar economic analysis of punishment, implies that tax penalties should be severe enough that taxpayers expect the costs of noncompliance to exceed the costs of compliance. That argues for a substantial increase in expected tax penalties over those set out in current law. The norms model, by contrast, implies that harsh tax penalties may undermine compliance—for example, by signaling that many taxpayers shirk their obligations or by crowding out personal commitments to comply. The model argues for deemphasizing tax penalties in favor of other government actions that enhance trust in government and respect for legal obligations.

The questions of why taxpayers comply and how tax penalties should be structured to promote compliance have taken on immediate policy importance over the last several years as legislators and tax administrators have rediscovered the "tax gap," the difference between what taxpayers actually owe and what taxpayers actually pay.[3] Current estimates put the annual tax gap at $345 billion.[4] This imposing figure has raised a bipartisan ruckus among lawmakers eager to reduce the federal budget deficit without having to cast difficult votes to increase taxes, reform entitlement programs, or decrease discretionary spending. It appears hardly relevant that the other side of the tax gap is a robust taxpayer compliance rate of about eighty-five percent[5] or that, because of enforcement costs, optimal tax administration almost certainly would permit an appreciable level of taxpayer non-

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[1] *See infra* Part III.A.

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

[3] *See generally* Internal Revenue Serv., U.S. Dep't of the Treasury, Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance (2007). There, the government defines the tax gap as "the aggregate amount of true tax liability imposed by law for a given tax year that is not paid voluntarily and timely." *Id.* at 6 (emphasis omitted).

[4] Off. of Tax Pol'y, U.S. Dep't of the Treasury, A Comprehensive Strategy for Reducing the Tax Gap 5 (2006). The number falls to $290 billion once administrative enforcement and collection efforts are taken into account. *Id.* The tax gap has been a recurring theme of tax policy. The latest round of interest was triggered by the publication in 2005 of new tax-gap figures for tax year 2001; these updated figures from the late 1980s. *See* Press Release, Internal Revenue Serv., New IRS Study Provides Preliminary Tax Gap Estimate IR-2005-38 (Mar. 29, 2005), *available at* http://www.irs.gov/newsroom/article/0,,ID=137247,00.HTML. The 2005 preliminary figures were finalized in 2006. *See* Off. of Tax Pol'y, *supra*, at 5.

[5] The government puts the compliance rate between 83.7% (when late payments and government enforcement actions are not taken into account) and 86.3% (when late payments and government enforcement actions are taken into account). Off. of Tax Pol'y, *supra* note 4, at 5.

compliance.[6] Policymakers regard the tax gap as a pressing problem, and they respond in part by ratcheting up penalties.[7]

The increased attention to tax penalties raises the potential for legislative mischief. In fairness, the two competing models of taxpayer compliance—the deterrence model and the norms model—pull policymakers in different directions on penalty reform. There is, however, an absolutely crucial function of tax penalties that the legal and economic literatures generally have failed to recognize: the fundamental role of tax penalties in *defining* tax compliance. Our self-assessment tax system looks to taxpayers in the first instance to determine their own tax liabilities. Tax penalties set boundaries around the conduct that constitutes compliance with this duty of self-assessment so that taxpayers who want to comply—whether to avoid legal sanctions or to satisfy social or personal norms—will know how to do so.

This definitional function of tax penalties implies that a primary consideration in structuring penalties should be to conform the standards of conduct set by the penalties to the basic objectives of the self-assessment tax system. But policymakers consistently have failed to account for this. Current penalties set forth multiple standards of conduct, none of which coheres with the policy commitment to the self-assessment tax system. Academics too have failed to account for the dual relationship of tax penalties and tax compliance. In both the legal and economic literatures, analysis of tax compliance focuses almost exclusively on the familiar instrumental function of tax penalties with little or no attention to the definitional function. Consequently, most proposals for penalty reform would impose inappropriate standards of conduct on taxpayers.

The analysis of this Article yields three principal conclusions. First, in addition to their instrumental function of promoting tax compliance, tax penalties serve the critical, transparent, but generally overlooked function of defining tax compliance. This definitional function should be the starting point for penalty reform: before one can figure out how to promote compliance, one must first determine what conduct will count as compliance. Second, in a self-assessment system, the concept of tax compliance that tax penalties define should consist of nothing less and nothing more than the taxpayer's best effort to assess her tax liabilities correctly. Third, consistent with this concept of tax compliance, current tax penalties should be revised to impose standards of conduct on taxpayers, tax practitioners, and government officials that are generally higher than those imposed by current law. The argument for these conclusions proceeds as follows. Part II provides a

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[6] *See* A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LITERATURE 45, 70 (2000) ("Optimal enforcement tends to be characterized by some degree of underdeterrence relative to first-best behavior, because allowing some underdeterrence conserves enforcement resources.").

[7] *See, e.g.*, American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 812, 818–19, 118 Stat. 1418, 1577–80, 1584–85 (codified at I.R.C. § 6662A (2006)) (enacting higher penalties for abusive transactions).

brief overview of the relevant tax penalties under current law. Part III explores the two functions of tax penalties: the instrumental function generally recognized by the conventional deterrence and norms models and the definitional function generally overlooked by the existing literature. Part IV sets out the case for reforming current tax penalties. The discussion there shows where the instrumental and definitional functions described in Part III converge on penalty reform, where they diverge on penalty reform, and why the definitional function should be the first consideration.

II. Overview of Tax Penalties

The federal income tax imposes three basic obligations on the taxpayer: to assess her own tax liability, to file a tax return reporting that liability, and to pay that liability when due.[8] A complex scheme of civil and criminal penalties stands behind those obligations.[9] The tax code provides, for example, penalties for failure to file a tax return[10] and penalties (and interest charges) for failure to pay a tax liability when it is due.[11] The taxpayer's duties to file and to pay are straightforward, and the operation of the associated penalties is not problematic.[12] By contrast, the taxpayer's duty of self-assessment is as obscure and controversial as the substantive tax law. The penalty that grounds that duty—referred to here as the "accuracy penalty"—presents difficult problems of interpretation and administration; it is the prin-

[8] *See* Off. of Tax Pol'y, Dep't of the Treasury, Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code 18 (1999) [hereinafter Treasury Study]; Commissioner's Executive Task Force on Civil Penalties, Internal Revenue Serv., Report on Civil Tax Penalties 1 (1989) [hereinafter Commissioner's Task Force Report].

[9] The Treasury Department reported in 1999 that the tax law "presently contains over 100 civil and criminal penalties." Treasury Study, *supra* note 8, at 19. Additionally, there are many provisions in the tax code, such as the excise tax on large "golden parachute" payments to corporate managers, that function as penalties without being denoted as such. *See, e.g.*, I.R.C. § 4980B(C) (tax on group health plans that fail to provide "COBRA" coverage to former plan participants); § 4999 (tax on "excess parachute payment"). The arguments for and against considering these provisions to be penalties are discussed in Treasury Study, *supra* note 8, at 13–14. For a skeptical analysis of such provisions, see Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. Rev. 343 (1989).

[10] I.R.C. § 6651(a)(1) (civil penalty for failure to file return); § 7203 (criminal penalty for willful failure to file return).

[11] *Id.* § 6651(a)(2) (civil penalty for failure to pay tax shown as due on return); § 6651(a)(3) (civil penalty for failure to pay tax required to be shown as due, but not shown as due, on return); § 7203 (criminal penalty for willful failure to pay tax).

[12] The fact that those penalties are mechanically straightforward does not imply that they could not be improved as a policy matter. *See, e.g.*, Treasury Study, supra note 8, at 59–74; Staff of the Joint Committee on Taxation, Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters) 123–28 (1999) [hereinafter Joint Committee Study].

cipal focus of this Article.[13] Further, the taxpayer's duty of self-assessment necessarily implicates the actions of tax practitioners who assist the taxpayer and government officials who administer the tax code. Analysis of the accuracy penalty therefore must include analysis of the corresponding penalties applicable to those parties. This Part sets out the standards of conduct and the penalties imposed on taxpayers, tax practitioners, and government officials—all within the context of the taxpayer's duty to assess her own tax liability.

A. *Standards of Conduct and Penalties for Taxpayers*

At the threshold, the taxpayer's duty of self-assessment flatly precludes the taxpayer lying on her tax return. If the taxpayer does lie about her tax liability, she exposes herself to a civil fraud penalty equal to seventy-five percent of her fraudulent underpayment[14] and possible criminal sanctions.[15] But the self-assessment duty entails more than merely avoiding dishonesty; it also requires some level of accuracy. That presents difficulties when the application of the tax law is uncertain. In those cases, the standards of conduct required of the taxpayer are determined by the accuracy penalty. The penalty distinguishes between transactions that do and do not have the potential for tax abuse.

1. *Non-Abusive Transactions*

A non-abusive transaction is any transaction other than one that, because of its potential for tax abuse, constitutes either a "reportable transaction"[16] or a "tax shelter."[17] For a non-abusive transaction involving a "substantial understatement of income tax,"[18] the accuracy penalty equals twenty percent of the understatement.[19] Thus, if a taxpayer has understated

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[13] The penalties set out in I.R.C. §§ 6662 and 6662A are technically labeled "accuracy-related" penalties. For ease of reference, this Article refers to those penalties, collectively, as the "accuracy penalty."

[14] I.R.C. § 6663(a) (2006).

[15] *See, e.g.*, I.R.C. § 7207.

[16] As used here, the term "reportable transaction" means any transaction covered by I.R.C. § 6662A—that is, either a reportable transaction described in § 6707A(c)(1) or a listed transaction described in § 6707A(c)(2). *See infra* Part II.A.2.

[17] As used here, the term "tax shelter" means any transaction described in I.R.C. § 6662(d)(2)(C)(iii). *See infra* Part II.A.2.

[18] An "understatement" of tax is the difference between the tax required to be shown on the taxpayer's return and the tax actually shown on her return, and the understatement is "substantial" if it exceeds a designated threshold. For most taxpayers, the threshold is the greater of $5,000 or one-tenth of the tax required to be shown on the return. I.R.C. § 6662(d). In the case of most corporations, the threshold is $10,000,000 or, if less, the greater of $10,000 or one-tenth of the tax required to be shown on the taxpayer's return. *Id.* No accuracy penalty applies for an understatement that does not meet the designated substantiality threshold.

[19] I.R.C. § 6662(b)(2). The taxpayer may also owe interest for late payment of the tax. *See* § 6601.

her taxes by $100,000 and she incurs the accuracy penalty, her liability to the government for the tax and penalty will total $120,000.[20] The statutory conditions for imposing the accuracy penalty, however, are very forgiving. Even if a taxpayer has substantially understated her tax liability, she will not incur the accuracy penalty if her understatement is attributable either to a disclosed legal position that has a "reasonable basis" or to a non-disclosed legal position that has "substantial authority."[21]

Consider first the defense for an understatement attributable to a disclosed position having a reasonable basis. The disclosure requirement is mechanical; the taxpayer must simply include the proper factual information on the proper form filed with her return.[22] To have a reasonable basis, the taxpayer's legal position must be stronger than "frivolous" or "patently improper," but it need not be correct or even likely correct.[23] As interpreted by both the government and the practicing bar, a taxpayer has a reasonable basis if her position stands just a one-in-five chance of prevailing on the merits.[24] Thus, in deciding to exclude an item from gross income or to claim a deduction where there is legal uncertainty, the taxpayer will incur no accuracy penalty if there is even a twenty-percent chance that a court will uphold the exclusion or deduction and if she makes proper disclosure to the government on her return. She may know that the legal uncertainty on the matter is very significant. She may in fact believe—and her tax advisors may have counseled her—that the law plainly favors the government. However, even her sincere belief that her position would likely lose in court is beside the point. To defeat the accuracy penalty, all she needs beyond disclosure is a one-in-five chance of winning.

Alternatively, the taxpayer can avoid the accuracy penalty without making any disclosure to the government if her legal position has substantial authority. This approach has the obvious attraction for the taxpayer of not

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[20] *See* I.R.C. § 6662(a) (2006). A similar penalty attaches (in an equal or greater amount) to certain misstatements concerning the value of assets and liabilities and to negligence or disregard of rules or regulations. *See* § 6662(b)(1), (3)-(5). The penalty for valuation misstatements arises only in specific contexts (such as misstating pension liabilities). *See generally* Richard J. Wood, *Accuracy-Related Penalties: A Question of Values*, 76 Iowa L. Rev. 309 (1991). The penalty for negligence or disregard of rules or regulations sets a low standard of taxpayer conduct: to incur this penalty, the taxpayer must have failed "to make a reasonable attempt to comply" with the tax law or to have engaged in "careless, reckless, or intentional disregard" of the tax law. I.R.C. § 6662(c); *see also* Treasury Study, *supra* note 8, at 100. Similarly, a separate penalty for making "frivolous" submissions to the government sets a low standard of conduct. *See* I.R.C. § 6702.

[21] I.R.C. § 6662(d)(2)(B). The taxpayer may also defeat the penalty if she has "reasonable cause" for the understatement and acts "in good faith." § 6664(c)(1). This generally looks to the taxpayer's effort to assess her tax liability properly and potentially excuses an "honest misunderstanding of . . . law." Treas. Reg. § 1.6664-4(b)(1) (2008). The reasonable-basis and substantial-authority standards generally are more favorable to the taxpayer than the reasonable-cause-and-good-faith standard; the latter is discussed in Part II.A.2, *infra*.

[22] *See* Treas. Reg. §§ 1.6662-4(e)–(f).

[23] *See* Treas. Reg. § 1.6662-3(b)(3).

[24] *See* Joint Committee Study, *supra* note 12, at 160.

increasing the chance that the government will scrutinize her return. The substantial-authority standard requires that the weight of the legal authority for her position be "substantial" relative to the weight of the legal authority against her position.[25] For practical purposes, the substantial-authority standard requires that the taxpayer have about a two-in-five chance of prevailing in litigation on the merits.[26] Again, the fact that the taxpayer may have a sincerely held belief that her position will likely lose in court is irrelevant in determining that her position is supported by substantial authority and therefore protected from the accuracy penalty.

2. *Potentially Abusive Transactions*

The accuracy penalty sets a higher standard of conduct for a taxpayer engaging in a potentially abusive transaction. These transactions divide into three categories: tax shelters, disclosed reportable transactions, and non-disclosed reportable transactions. The first two categories are subject to one standard; the third category is subject to a higher standard, although the higher standard effectively attaches only to the taxpayer's failure to disclose the underlying transaction.[27]

a. *Tax Shelters and Disclosed Reportable Transactions*

A taxpayer is subject to the accuracy penalty for any substantial understatement of income tax attributable to a tax shelter.[28] For this purpose, a "tax shelter" is any entity, plan, or arrangement having the avoidance or evasion of income tax as a "significant purpose."[29] The accuracy penalty in the case of a tax shelter is twenty percent of the understatement, but the only defense available is acting with reasonable cause and in good faith.[30] This defense depends on all relevant facts and circumstances, the most important of which is the "extent of the taxpayer's effort to assess the taxpayer's proper tax liability."[31] The taxpayer establishes reasonable cause and good faith if she shows both that she had substantial authority for her position and that she reasonably believed that her position was more likely than not correct.[32] The first component, substantial authority, is the same as before: the taxpayer must have a forty-percent chance of prevailing in litigation on the

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[25] Treas. Reg. § 1.6662-4(d)(3)(i).

[26] *See* Joint Committee Study, *supra* note 12, at 160.

[27] Michael Graetz suggested this point.

[28] The standard here for "substantial understatement" is the same as that in the case of a non-abusive transaction. *See supra* note 18.

[29] I.R.C. § 6662(d)(2)(C)(iii) (2006).

[30] I.R.C. § 6664(c)(1). The taxpayer cannot assert either the substantial-authority or the reasonable-basis defense available for non-abusive transactions. § 6662(d)(2)(C)(i). However, as shown below, the existence of substantial authority for the taxpayer's position is a component of the reasonable-cause-and-good-faith defense.

[31] Treas. Reg. § 1.6664-4(b)(1) (2008).

[32] Treas. Reg. § 1.6664-4(f).

merits.[33] The second component, a reasonable belief that her position is more likely than not correct, requires that the taxpayer reasonably believe that her position has a greater than fifty-percent chance of prevailing in litigation on the merits.[34]

The twenty-percent accuracy penalty also applies when a taxpayer engages in a reportable transaction that she discloses to the government.[35] A "reportable transaction" is a transaction that the government specifically identifies as involving tax avoidance or evasion or as having potential for tax avoidance or evasion.[36] As in the case of a tax shelter, the taxpayer's sole defense in the case of a disclosed reportable transaction is reasonable cause and good faith.[37] Again, the taxpayer will establish reasonable cause and good faith if her tax position is supported by substantial authority and if she reasonably believes that the position is more likely than not correct.[38]

b. Non-Disclosed Reportable Transactions

In the case of a non-disclosed reportable transaction, the accuracy penalty applies on a strict-liability basis.[39] The penalty equals thirty percent of the taxpayer's reportable transaction understatement.[40] The taxpayer with such an understatement cannot assert any defense to the penalty.[41] Thus, even if the taxpayer sincerely believes that her position is correct, she will incur the thirty-percent penalty if the position fails on the merits. The taxpayer triggers this strict-liability standard simply by failing to disclose a reportable transaction.

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[33] *See* Joint Committee Study, *supra* note 12, at 160.

[34] *See id.* at 150. The Financial Accounting Standards Board has adopted the more-likely-than-not standard as the basis for requiring corporations to recognize tax effects for purposes of their financial statements. *See* Financial Accounting Standards Board, FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes (2006).

[35] I.R.C. § 6662A (2006). The penalty equals twenty percent of the taxpayer's "reportable transaction understatement." § 6662A(a). This understatement is, roughly, the amount of understated tax attributable to the reportable transaction. § 6662A(b)(1). There is no substantiality threshold for this penalty. § 6662A.

[36] More precisely, the accuracy penalty under I.R.C. § 6662A applies to any "listed transaction" and to any "reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax." § 6662A(b)(2). A "listed transaction" is a "reportable transaction" that is the same as or substantially similar to a transaction specifically identified by the government as a tax-avoidance transaction. §§ 6662A(d), 6707A(c)(2). A "reportable transaction" is a transaction for which the government requires disclosure because it is "of a type" that the government "determines as having a potential for tax avoidance or evasion." §§ 6662A(d), 6707A(c)(1). Thus, the penalty under § 6662A potentially applies to any listed transaction and to any other reportable transaction if (in addition to its potential for tax avoidance or evasion) the reportable transaction has a "significant purpose" of avoiding or evading federal income tax.

[37] I.R.C. § 6664(d) (2006).

[38] *Id.*

[39] I.R.C. §§ 6662A, 6664(d).

[40] I.R.C. § 6662A(c).

[41] I.R.C. § 6664(d).

These standards of conduct imposed on the taxpayer by the accuracy penalty are summarized in Table 1.

TABLE 1: STANDARDS OF CONDUCT UNDER THE ACCURACY PENALTY

Transaction Type	Standard of Taxpayer Conduct
Non-abusive, disclosed	20% chance of winning on merits ("reasonable basis")
Non-abusive, non-disclosed	40% chance of winning on merits ("substantial authority")
Tax shelter	40% chance of winning on merits plus a reasonable belief of a greater than 50% chance of winning on merits ("substantial authority" plus "reasonable belief that more likely than not")
Reportable, disclosed	40% chance of winning on merits plus a reasonable belief of a greater than 50% chance of winning on merits ("substantial authority" plus "reasonable belief that more likely than not")
Reportable, non-disclosed	Strict liability

B. Standards of Conduct and Penalties for Tax Practitioners

Many taxpayers rely on tax practitioners, including attorneys and accountants, in assessing and reporting their tax liabilities. Current law imposes standards of conduct, supported by penalties, on these practitioners. The standards and penalties divide into three broad categories of practitioner activity: providing advice, preparing returns, and promoting transactions.[42]

1. Tax Advisors

One of the principal functions of a tax practitioner is to advise the taxpayer about the application of the tax law to her circumstances. The standards of conduct imposed on the tax advisor are set out in a set of government regulations known as "Circular 230."[43] Circular 230 provides

[42] The focus in this Part, like the focus throughout this Article, is on the assessment and reporting of tax liabilities. For this reason, the important function of the tax practitioner as the taxpayer's advocate in audit and litigation and the penalties applicable to the practitioner in that capacity are ignored.

[43] 31 C.F.R. §§ 10.0–10.93 (2007). Standards promulgated by practitioner organizations (such as the bar and accountant organizations) also apply to the conduct of tax advisors in many cases. However, those standards generally do not provide specific rules for tax advisors *qua* tax advisors. For a discussion of the applicable bar standards, see Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 626–33 (2006). For criticism of how those standards have been applied to lawyers rendering tax advice, see Gwen Thayer Handelman, *Constraining Aggressive Return Advice*, 9 VA. TAX REV. 77, 80–89, 93–96 (1989). For a discussion of the applica-

both generally applicable and specific standards for rendering certain types of written tax advice. The government may sanction a tax advisor who violates these standards by disbarring or suspending the advisor from practice before the Internal Revenue Service ("IRS") or by censuring or fining the advisor.[44]

The general standards include broad requirements of candor, diligence, and good conduct,[45] but they impose no specific duty to advise the taxpayer about the strength of a position that the taxpayer takes on a particular issue. The two general rules that bear specifically on providing tax advice set relatively low standards of conduct. First, if the tax advisor provides written advice to a taxpayer, the advisor must meet certain minimum standards aimed at ensuring the integrity of the advice.[46] Second, if the tax advisor knows that the taxpayer has not complied with the tax law or has made an error or omission in any document prepared under the tax law, the advisor must advise the taxpayer of the fact and consequences of the non-compliance, error, or omission.[47]

Higher standards apply when the tax advisor provides the taxpayer with written advice that constitutes a "covered opinion," which includes advice about a transaction that presents a particular potential for tax abuse and advice about a tax shelter that the taxpayer will rely on for purposes of the accuracy penalty.[48] These standards generally require that the tax advisor develop the relevant facts, apply the tax law to the facts, and state a conclusion as to the likelihood that the taxpayer will prevail on the merits for each issue addressed by the opinion.[49] If the advisor is unable to conclude that the taxpayer is more likely than not to prevail on the merits (that is, that the taxpayer has a greater than fifty-percent likelihood of winning in litigation), the opinion must indicate both that fact and the fact that the opinion cannot be used by the taxpayer in defense against the accuracy penalty.[50]

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ble standards in the accounting profession, see Harold S. Peckron, *Watchdogs That Failed to Bark: Standards of Tax Review After Enron*, 5 FLA. TAX REV. 851, 867–69 (2002).

[44] 31 C.F.R. § 10.50 (2007).

[45] *See, e.g.*, 31 C.F.R. § 10.20 (providing documents and certain other information to the government); § 10.22 (exercising due diligence); § 10.27 (not charging "an unconscionable fee"); § 10.29 (avoiding conflicts of interest); § 10.28 (providing documents and certain other information to the taxpayer); § 10.51 (not engaging in incompetent or disreputable conduct).

[46] 31 C.F.R. § 10.37. More specifically, the advisor may not base the advice on unreasonable factual or legal assumptions, may not unreasonably rely on representations, statements, findings, or agreements, must consider all relevant facts that the advisor knows or should know, and must not take into account the possibility that the taxpayer's return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement. *Id.*

[47] 31 C.F.R. § 10.21.

[48] 31 C.F.R. § 10.35.

[49] *Id.*

[50] *Id*; *see also* Beale, *supra* note 43, at 583, 618–26.

2. *Tax Return Preparers*

The tax code imposes a standard of conduct on a tax return preparer that tracks the standard imposed on the taxpayer herself.[51] As revised in 2008, the penalty applies to a tax return preparer for any understatement of the taxpayer's liability attributable to a disclosed position for which there was no reasonable basis or to an undisclosed position for which there was no substantial authority.[52] This standard is consistent with the standard imposed on the taxpayer under the accuracy penalty for non-abusive transactions. The return preparer penalty also applies to an understatement on the taxpayer's return if the underlying transaction was a tax shelter or a reportable transaction, there was not substantial authority for the taxpayer's position, and it was not reasonable to believe that the taxpayer's position was more likely than not to prevail on the merits.[53] This is consistent with the standard imposed on the taxpayer for tax shelters and disclosed reportable transactions.

3. *Promoters*

Tax advisors and return preparers provide services to taxpayers on an individualized basis. Other practitioners, whether or not members of a profession, also potentially affect how taxpayers comply with their tax obligations by providing more generalized services. Most commonly, these practitioners are promoters of transactions or investment products; they range from financial institutions selling tax-qualified retirement plans to investment banks and financial advisors selling corporate and individual tax shelters. A promoter penalty, equal to the smaller of $1,000 and the promoter's fee, covers anyone who organizes or sells an interest in an entity, plan, or arrangement but only if she makes a statement about the tax benefits of the entity, plan, or arrangement that she "knows or has reason to know is false or fraudulent as to any material matter."[54] Thus, the penalty sanctions

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[51] The term "income tax return preparer" is defined generally to include anyone who prepares a return or refund claim or a "substantial portion" of a return or refund claim for compensation. I.R.C. § 7701(a)(36) (2006). As interpreted by the government, this definition encompasses advice provided to a taxpayer about the potential treatment of a transaction on her return. *See* Treas. Reg. § 301.7701-15 (2008). Thus, the distinction between a tax return preparer and a non-preparer tax advisor can be elusive.

[52] *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3880 (2008) (to be codified at I.R.C. § 6694(a)(2)(A)-(B)).

[53] I.R.C. § 6694(a)(2)(C). The return preparer can assert as a defense that there was reasonable cause for the understatement and that the preparer acted in good faith. *See* § 6694(a)(3). Return preparers face additional statutory penalties. *See, e.g.*, § 6694(b) (a penalty for any understatement on the taxpayer's return if the return preparer's conduct constituted a willful attempt to understate the liability or a reckless or intentional disregard of the law); § 6695 (penalties for acts such as failing to sign the taxpayer's return and failing to provide a copy of the return to the taxpayer); § 6701 (a penalty on aiding, assisting, procuring, or advising with respect to an understatement of tax liability); § 6713 (a penalty for disclosing taxpayer information).

[54] I.R.C. § 6700(a).

only outright lying about the tax benefits of the promoter's transaction or product.

C. Standards of Conduct and Penalties for Government Officials

Although government officials plainly have an important role in the assessment of a taxpayer's liabilities, the tax law imposes very little accountability on those officials for inaccurate assertions of liability for taxes and penalties. The only specific check against government officials is a statutory provision permitting the award of costs to a taxpayer who prevails in an administrative or judicial tax dispute with the government.[55] However, those costs may be awarded only if the position taken by the government in the dispute was not "substantially justified."[56] That standard requires nothing more than that the government have a one-in-five chance of prevailing on the merits—the same low standard applicable under the accuracy penalty to a taxpayer who discloses a non-abusive transaction.[57]

III. The Dual Function of Tax Penalties

Tax penalties serve two functions. First, they serve the instrumental function of promoting tax compliance. This is widely recognized in the legal and economics literatures, although there is little consensus about how penalties promote compliance beyond the basic point that different penalty structures may affect compliance differently. Second, tax penalties serve the function of defining tax compliance. This definitional function has been generally ignored by the legal and economic literatures, but it is absolutely fundamental. The policy commitment to a self-assessment tax system implies a particular conception of tax compliance, and the penalties for taxpayers, tax practitioners, and government officials should transcribe that conception into appropriate standards of conduct. If tax penalties set out the wrong conception of tax compliance, those penalties—even if well designed for instrumental purposes—will not induce conduct that conforms to the right conception of tax compliance. The wrong target remains the wrong target, no matter how expert the marksmanship.

This Part examines both the instrumental and the definitional functions of tax penalties. Subpart A discusses the two competing models of tax penal-

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[55] I.R.C. § 7430. There are, of course, more general prohibitions on misconduct by government officials set forth in government ethics rules and, to the extent the officials are members of a professional organization (such as the bar), in the rules of that organization. For a discussion of standards, not backed by specific sanctions, for government officials in determining what issues to pursue against taxpayers, see Richard Lavoie, *Analyzing the Schizoid Agency: Achieving the Proper Balance in Enforcing the Internal Revenue Code*, 23 Akron Tax J. 1 (2008) (discussing standards set forth in Revenue Procedure 64-22).

[56] I.R.C. § 7430(c)(4)(B)(i) (2006).

[57] *Compare* 26 C.F.R. § 301.7430-5(c) (2008) *with* I.R.C. § 6662(d)(2)(B) *and* Joint Committee Study, *supra* note 12, at 160.

ties as instruments for promoting tax compliance, considers the specific penalty reform implications of the two models, and identifies certain of their limitations and shortcomings. Both models generally assume that the considerations they set out are sufficient for guiding tax penalty reform, but that assumption is simply wrong. Subpart B considers the definitional function of tax penalties. Subpart C considers the relationship between the instrumental function and the definitional function.

A. The Instrumental Function of Tax Penalties

Most analysis of the instrumental function of tax penalties begins with the reasonable supposition that, because penalties promote tax compliance, penalty reform requires an understanding of what motivates taxpayers to comply with their tax obligations. That immediately presents a puzzle: taxpayers generally pay their taxes, and conventional economic analysis cannot account for that fact.[58] All the fury in Congress over the tax gap obscures the point that most taxpayers pay "most of their taxes most of the time," and many pay all their taxes all the time.[59] Although the estimated $345 billion tax gap is significant, the overall compliance rate is about eighty-five percent.[60] The fact that taxpayers in a self-assessment system voluntarily remit about eighty-five percent of the amount required by law indicates that taxpayer compliance is robust.

While policymakers wring their hands over how to collect the remaining fifteen percent of tax liabilities without turning the republic into a police state,[61] academics have struggled to account for the high percentage that taxpayers already pay. The extensive but still unsettled literature coalesces around two principal models of taxpayer compliance: a deterrence model and a norms model. Neither of these explanations has managed to account fully and persuasively for the high level of observed taxpayer compliance,[62] and they both entail dubious prescriptions for tax penalty reform.

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[58] *See* James Alm, Isabel Sanchez & Ana de Juan, *Economic and Noneconomic Factors in Tax Compliance*, 48 KYKLOS 3 (1995).

[59] *Id.*

[60] The terms "tax compliance" and "compliance" are defined more precisely in Part III.B. For purposes of this Part III.A, the use of those terms is provisional and should be understood roughly as a taxpayer paying the tax she owes at the time she owes it.

[61] *See, e.g.*, Lori Montgomery, *Narrowing Tax Gap Called "Unrealistic": Paulson's Comments Anger Democrats,* WASH. POST, Apr. 19, 2007, at D3.

[62] As Joel Slemrod notes, "there is still much dispute about the proper conceptual model to use in addressing" tax compliance. Joel Slemrod, *Introduction* to WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT 1, 2 (Joel Slemrod ed., 1992).

1. The Deterrence Model

The deterrence model draws directly from Gary Becker's economic analysis of punishment for criminal conduct.[63] Becker's analysis is normative; his purpose is to determine optimal punishments by setting a wrongdoer's expected costs equal to the wrongdoer's expected benefits.[64] Becker models expected costs as a function of both the severity of the punishment potentially imposed on the wrongdoer and the probability of punishment.[65] That implies that the level of punishment and the probability of punishment generally are substitutes.[66] If all else is held constant, a less severe punishment with a higher probability of imposition can yield the same expected costs to the wrongdoer—and, therefore, the same level of deterrence—as a more severe punishment with a lower probability of imposition.

Becker's general model (which he thought applicable to a broad range of wrongdoing, from traffic violations to murder[67]) has been adapted specifically for the problem of tax evasion by Michael Allingham and Agnar Sandmo.[68] Allingham and Sandmo analyze evasion by considering the taxpayer's decision of how much income to report on her tax return while treating both the taxpayer's income and the government's enforcement strategy as exogenous.[69] They argue that the taxpayer will evade tax to the extent that the benefit of evasion (the amount of tax not paid) exceeds the product of the total amount she would have to pay if her evasion were detected (the tax plus any penalty) and the probability of detection.[70] Again, this implies that penalties and probabilities can be traded off in deterring tax evasion: if, for example, a desired level of deterrence could be achieved with a fifty-percent probability of the taxpayer incurring a penalty equal to forty percent of the amount evaded, the same level of deterrence could be achieved with a twenty-five-percent probability of the taxpayer incurring an eighty-percent

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[63] *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968). For criticism of Becker's analysis, see, e.g., Nicholas Stern, *On the Economic Theory of Policy Towards Crime*, *in* Economic Models of Criminal Behavior 123 (J.M. Heineke ed., 1978).

[64] Becker, *supra* note 63, at 170, 176.

[65] *Id.* at 177.

[66] *Id.* at 177–84.

[67] *Id.* at 170.

[68] Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Econ. 323 (1972); *see also* Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 J. Pub. Econ. 201 (1974).

[69] Allingham & Sandmo, *supra* note 68, at 323–24. In focusing on the taxpayer's deliberate underreporting of income, Allingham and Sandmo follow the familiar but elusive distinction between tax evasion (illegal non-reporting of income or non-payment of taxes) and tax avoidance (legal structuring of conduct to avoid incurring tax obligations). Not too much should be made of the distinction, however: in the end, the difference between non-compliance that is avoidance and non-compliance that is evasion really is nothing more than the difference between resolving an issue against the government under conditions of greater or lesser legal uncertainty.

[70] *Id.* at 326.

penalty or a one-hundred-percent probability of the taxpayer incurring a twenty-percent penalty.[71]

The subsequent literature has extended the Allingham-Sandmo analysis to include adverse effects on the taxpayer's reputation as expected costs,[72] to differentiate between individual and corporate taxpayers,[73] to treat government detection and enforcement activity as endogenous,[74] and to apply to tax avoidance,[75] among other refinements.[76] Throughout all the permutations, the basic proposition of the model is that a taxpayer reports and remits her tax liabilities to the extent that—and only to the extent that—her expected costs of non-compliance exceed her expected benefits of non-compliance.

Tax penalties obviously are central to the deterrence model: they provide the mechanism for imposing higher costs on non-compliant taxpayers. The deterrence model therefore implies that accuracy penalties should be high and that, at least on certain interpretations of the model, taxpayers should have strict liability for those penalties. Kyle Logue makes the case clearly.[77] In examining taxpayer compliance under conditions of legal uncer-

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[71] *See id.* at 330.

[72] *See, e.g.*, James P.F. Gordon, *Individual Morality and Reputation Costs as Deterrents to Tax Evasion*, 33 Eur. Econ. Rev. 797 (1989).

[73] *See, e.g.*, Keith J. Crocker & Joel Slemrod, *Corporate Tax Evasion with Agency Costs*, 89 J. Pub. Econ. 1593 (2005); Massimo Marrelli & Riccardo Martina, *Tax Evasion and Strategic Behaviour of the Firms*, 37 J. Pub. Econ. 55 (1988); Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations*, *in* Why People Pay Taxes, *supra* note 62, at 125.

[74] *See* Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J.L. Econ. & Org. 1 (1986). This refinement complicates the implications of the deterrence model considerably. *See* James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. Econ. Literature 818, 841–43 (1998).

[75] *See, e.g.*, Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 Va. Tax Rev. 241 (2007); Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 Handbook of Public Economics 1423, 1436–38 (Alan J. Auerbach & Martin Feldstein eds., 2002). As a general proposition, the economic literature has tended to focus on tax evasion, and the legal literature has tended to focus on tax avoidance. There are, of course, counterexamples. *See, e.g.*, Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1454 n.1 (2003).

[76] *See, e.g.*, Andreoni et al., *supra* note 74 (describing numerous extensions and refinements of the Allingham-Sandmo analysis); Agnar Sandmo, *The Theory of Tax Evasion: A Retrospective View*, 58 Nat'l Tax J. 643 (2005) (same); Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. Econ. Persp. 25 (2007) (same).

[77] Logue, *supra* note 75; *see also* David P. Hariton, *Response to 'Old "Brine" in New Bottles' (New Brine in Old Bottles)*, 55 Tax L. Rev. 397, 399 (2002) (arguing for strict-liability penalty for abusive transactions); Michael L. Schler, *Ten More Truths about Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 Tax L. Rev. 325, 362 (2002) (same); Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, *in* Tax and Corporate Governance 229 (Wolfgang Schön ed., 2008) (arguing for strict-liability standards); Slemrod, *supra* note 76, at 43 ("[A] government concerned with maximizing the expected utility of a representative citizen will want to set the penalty for detected crimes as high as possible, so that even with a low resource cost of enforcement, the overall expected deterrent effect will be large."). *But see* Sarah Lawsky, *Probably? Understanding the Law's Uncertainty* 27 (GWU Legal Studies, Research Paper No. 422, 2008) (arguing that "fault-based penalties are not necessarily inconsistent with, and in fact may be required by, marginal deterrence theory"). Without arguing for strict liability, Alex

tainty, Logue posits a rational but amoral taxpayer.[78] He argues that the optimal level of compliance will be achieved by setting the penalty on non-compliance to equal the quotient of the "harm" from non-compliance (the understated tax liability) over the ex ante probability of detection, and by imposing strict liability for that penalty.[79] Strict liability forces the taxpayer, when considering a transaction for which the tax treatment is uncertain, to internalize the full cost of the harm from non-compliance.[80] That, in turn, causes the taxpayer to proceed with the transaction only where the post-tax return, discounted for the possibility of the taxpayer losing on the tax issue, remains positive.[81]

However, policymakers would be mistaken to attempt tax penalty reform by simply adopting the implications of the deterrence model. There are significant limitations to the model, and there are good reasons to be hesitant about its policy prescriptions. Most importantly, the model fails to explain the current high level of actual taxpayer compliance.[82] Assuming that a non-compliant taxpayer does not engage in criminal misconduct, the largest penalty that she can expect is a seventy-five-percent fraud penalty;[83] more likely, the penalty would only be a twenty-percent or thirty-percent accuracy penalty.[84] The general probability that the government will detect the taxpayer's non-compliance is low; the government audits fewer than two percent of the tax returns filed each year by individuals.[85] Assuming a

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Raskolnikov suggests the desirability of increasing probabilities of detection. Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 Colum. L. Rev. 569 (2006); *see also* Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of* Long Term Capital Holding v. United States, 3 Berkeley Bus. L.J. 381 (2006) (arguing for an increase in probability of detection through greater government enforcement activity).

[78] Logue, *supra* note 75, at 244–45, 247–51.

[79] *Id.* at 266–68. The "penalty" in Logue's formulation includes both the understated taxes and the additional amount representing what current law would call the accuracy penalty. *Id.* at 267. Logue's argument is a particular application of the general analysis of punitive damages. *See* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869, 887–96 (1998) (demonstrating that, where there is some probability that injurer will escape liability, "total damages imposed on an injurer should equal the harm multiplied by the reciprocal of the probability that the injurer will be found liable when he ought to be"). Logue does not argue that this conclusion holds under all conditions, and he notes that, when his assumptions are relaxed, there is a basis for preferring a fault-based penalty regime. Logue, *supra* note 75, at 290–93. In fact, the policy choice between strict liability and fault-based standards may be quite complicated. *See* Polinsky & Shavell, *supra* note 6, at 50–56, 70.

[80] *See* Logue, *supra* note 75, at 267, 278–79. Relatedly, if there were "detection certainty" in every case, no penalty would be necessary to cause the taxpayers to internalize this cost. *Id.* at 261.

[81] *See id.* at 267–68.

[82] *See, e.g.*, Andreoni et al., *supra* note 74, at 819; Raskolnikov, *supra* note 77, at 577; Sandmo, *supra* note 76, at 649–50.

[83] I.R.C. § 6663 (2006).

[84] I.R.C. §§ 6662, 6662A.

[85] U.S. Gen. Accounting Office, IRS' Audit and Criminal Enforcement Rates for Individual Taxpayers Across the Country 3 (1998). In 2007, the government audited only 1.03% of individual tax returns and only 0.66% of business tax returns. Internal Revenue Serv., Fiscal Year 2007 IRS Enforcement and Service Statistics 3, 6 (2007), *avail-*

maximum penalty of seventy-five percent and an average detection rate of two percent,[86] a taxpayer's expected cost of avoiding a $100 tax liability would be only $3.50—an amount far less than the $100 expected cost of paying the tax liability up front.[87] Assuming a maximum penalty of twenty percent and the same rate of detection, the taxpayer's expected cost of avoiding a $100 tax liability would be only $2.40.[88] If the deterrence model were correct—that is, if taxpayers comply with their tax obligations only to avoid penalties that make non-compliance more costly than compliance—taxpayers generally would not pay all the taxes they owe.[89] The deterrence model thus substantially under-predicts taxpayer compliance.[90]

It is possible that taxpayers so overestimate the likelihood of detection by the government that even the modest penalty levels under current law yield expected costs more likely to deter non-compliance.[91] But this seems

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able at http://www.irs.gov/pub/irs-news/irs_enforcement_and_service_tables_fy_2007.pdf. Of course, selection of a return for audit by no means ensures that the government will detect every position on the return that potentially merits an adjustment to tax or a tax penalty. In fiscal year 1995, only 4.1% of audited taxpayers—already a very small percentage of total returns—"received any penalty for fraud, negligence, false withholding, failure to report tips, or other miscellaneous infractions." Andreoni et al., *supra* note 74, at 821; *see also* James S. Eustice, *Abusive Corporate Tax Shelters: Old 'Brine' in New Bottles*, 55 TAX L. REV. 135, 160–61 (2002) (arguing for greater enforcement of existing accuracy penalty).

[86] The two-percent rate, derived from the overall audit rate, is used only for illustration. In fact, the detection rate varies with different types of tax return items. For example, if a taxpayer fails to report as income all or part of the taxable compensation reported by her employer on Form W-2, the detection rate would be much higher—approaching one hundred percent in certain cases.

[87] The expected cost of non-compliance under these assumptions is straightforward: $100 (tax liability) + $75 (tax penalty) = $175 (total potential liability); $175 x 0.02 (probability of detection) = $3.50 (expected cost of non-compliance).

[88] The calculation here is: $100 (tax liability) + $20 (tax penalty) = $120 (total potential liability); $120 x 0.02 (probability of detection) = $2.40 (expected cost of non-compliance).

[89] *Cf.* Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355, 358 (1985) (arguing that, in cases of legal uncertainty, the deterrence theory suggests that "throughout the 1970s *no one* should have paid the taxes they owed" (emphasis in original)).

[90] Andreoni et al., *supra* note 74, at 855 ("The most significant discrepancy that has been documented between the standard economic model of compliance and real-world compliance behavior is that the theoretical model greatly over-predicts noncompliance.").

[91] *See, e.g.*, James Alm, Gary H. McClelland & William D. Schulze, *Why Do People Pay Taxes?*, 48 J. PUB. ECON. 21, 24 (1992); Andreoni et al., *supra* note 74, at 844 ("[S]urvey results suggest that people greatly overestimate the probability of an IRS audit."); Sandmo, *supra* note 76, at 649; John T. Scholz & Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 J. AM. POL. SCI. 490, 491 (1995). Still, the effects of audit rates on compliance are uncertain. Some have found that "higher probabilities of taxpayer audits and larger numbers of notices sent to taxpayers . . . are associated with higher levels of voluntary compliance by taxpayers." Ann D. Witte & Diane F. Woodbury, *The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax*, 38 NAT'L TAX J. 1, 7 (1985); *see also* Alm et al., *supra* note 58, at 12. By contrast, in a "controlled experiment" conducted by the Minnesota Department of Revenue, letters sent by the government to taxpayers indicating that their next returns would be "closely examined" appear to have caused compliance to increase among low- and moderate-income taxpayers but to decrease among high-income taxpayers. Joel Slemrod, Marsha Blumenthal & Charles Christian, *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. PUB. ECON. 455, 456–57 (2001); *see also* STEPHEN COLEMAN,

unlikely. In the case of the seventy-five-percent penalty for fraud, the taxpayer would have to assume a better than one-in-two chance of detection for the model to yield an accurate compliance prediction.[92] In the case of the twenty-percent penalty, the taxpayer would have to assume a better than a four-in-five chance of detection.[93] With published audit rates of less than two percent, one would have to posit general paranoia among taxpayers to rescue the model on this basis.[94]

Predictions under the deterrence model might be more satisfactory if expected costs were increased by reputational harm and similar non-pecuniary costs,[95] but this also presents problems. Taxpayer information—including even the existence of an audit—remains confidential up to the point that the taxpayer and the government take their dispute to adjudication.[96] Criminal tax prosecutions are rare,[97] and civil tax disputes can always be settled

THE MINNESOTA INCOME TAX COMPLIANCE EXPERIMENT: STATE TAX RESULTS 10–16 (1996), *available at* http://mpra.ub.uni-muenchen.de/4827/.

[92] For the expected cost of non-compliance to be the same as the expected cost of compliance, the probability of detection would have to be 57.15 percent: $100 (tax liability) + $75 (tax penalty) = $175 (total potential liability); $175 x 0.5715 (probability of detection) = $100 (expected cost of non-compliance).

[93] For the expected cost of non-compliance to be the same as the expected cost of compliance, the probability of detection would have to be 83.34 percent: $100 (tax liability) + $20 (tax penalty) = $120 (total potential liability); $120 x 0.8334 (probability of detection) = $100 (expected cost of non-compliance).

[94] Taxpayer compliance is lowest for income types that are subject neither to "withholding [nor] third-party information reporting." INTERNAL REVENUE SERV., *supra* note 85, at 12; *see also* Robert A. Kagan, *On the Visibility of Income Tax Law Violations*, *in* 2 TAXPAYER COMPLIANCE, VOLUME 2: SOCIAL SCIENCE PERSPECTIVES 76–125 (Jeffrey A. Roth & John T. Scholz eds., 1989); Slemrod, *supra* note 76, at 39. This certainly provides some support for the deterrence model, Slemrod, *supra* note 76, at 37, 45, but still leaves unexplained why there is significant compliance for such income. *See* INTERNAL REVENUE SERV., *supra* note 3, at 12 (indicating compliance rate of over forty percent for such income). Slemrod argues that the high compliance rates associated with wages and salaries reflect the very high likelihood of detection for a taxpayer who underreports that type of income and that this vindicates the deterrence model. *Id.* at 39; *see also* Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. KAN. L. REV. 971, 974 (2003). But that argument is not fully satisfactory. Taxpayers with readily observable items, such as wages and salaries, can shift their non-compliance efforts to less observable items, such as deductions, credits, and income not subject to reporting or withholding. So, for example, a taxpayer with both wage and non-wage income could increase non-compliance on the non-wage side to compensate for forgone non-compliance on the wage side; alternatively, the taxpayer could overstate deductions or credits. Although reporting and withholding on specific items decrease opportunities for non-compliance, they do not eliminate those opportunities altogether.

[95] *See, e.g.*, Gordon, *supra* note 72, at 8; *see also* 1 TAXPAYER COMPLIANCE: AN AGENDA FOR RESEARCH 7–8 (Jeffrey A. Roth et al. eds., 1989); Harold G. Grasmick & Wilbur J. Scott, *Tax Evasion and Mechanisms of Social Control: A Comparison with Grand and Petty Theft*, 2 J. ECON. PSYCH. 213, 227 (1982). Non-reputational but still non-pecuniary costs, such as "anxiety, guilt or a reduction in self-image" attributable to an "honesty characteristic," Gordon, *supra* note 72, at 798–99, are considered in the discussion of the norms model in Part III.A.2, *infra*.

[96] I.R.C. § 6103 (2006).

[97] U.S. GEN. ACCOUNTING OFF., *supra* note 85, at 4. In a nation of 300 million people, the government recommended only 1,423 criminal tax prosecutions in 2007. *Id.* at 10.

confidentially prior to litigation.[98] The likelihood of suffering involuntary reputational harm for non-compliance is, if anything, even more remote than the likelihood of paying penalties.[99]

A substantial part of the deterrence model's weakness derives from its narrow view of taxpayer motivation. The model assumes that tax-compliance decisions are made by rational taxpayers who simply compare expected benefits to expected costs.[100] But that fails to conform to general intuitions about taxpayer motivations or to reflect evidence from the social sciences about the importance of other motivations for legal compliance.[101] Consider two polar cases. At one pole, certain taxpayers no doubt comply with their tax obligations simply for the sake of complying; they are unmoved by penalty threats because, for them, obeying the law is an end in itself.[102] At the other pole, certain taxpayers no doubt would refuse to comply with their tax obligations even if non-compliance were made very costly.[103] Between the simple cases of taxpayers who always comply and taxpayers who never comply, there are no doubt many taxpayers with rich and complex motiva-

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[98] That is, the taxpayer who wants to avoid adverse personal publicity could always pay the full amount demanded by the government.

[99] The deterrence model also makes the dubious assumption that a taxpayer can determine the expected cost of non-compliance. This would require her to know both the terms of the applicable penalties and the probability that those penalties will be imposed in her case. The first point is plausible in the case of a sophisticated taxpayer, but the second point is not plausible in any case. The probability that a penalty will be imposed on a taxpayer is itself a "cumulative probability" of various detection, enforcement, and litigation outcomes—with only the general audit rate available as a fixed datum. Raskolnikov, *supra* note 77, at 581. These include the probabilities "that an offense will be detected; that it will be selected for prosecution; that the government will prevail at trial on the substantive issue, decide to seek a penalty and convince a court to impose it; that the judgments favoring the government will survive appeals; and, finally, that the government will actually collect the penalty from the taxpayer." *Id.* Many taxpayers presumably use the published audit rate, which is very low, as a rough approximation of the actual probability that a penalty would be imposed.

[100] *See, e.g.*, Commission on Taxpayer Compliance, American Bar Association, *Report and Recommendations on Taxpayer Compliance*, 41 TAX LAW. 329, 348–49 (1987) (criticizing deterrence model for embodying "an overly narrow view of taxpayers as purely rational calculators who evaluate the potential costs and benefits of noncompliance in making their tax decisions").

[101] *See infra* Part III.A.2; *see also* Alm et al., *supra* note 58, at 15 ("[E]xplaining tax compliance requires recognizing the myriad factors that motivate individual behavior, factors that go much beyond the standard economics-of-crime approach . . . ."); Andreoni et al., *supra* note 74, at 819 ("Economists are just beginning to grapple with the findings from other social sciences that could explain the observed compliance levels, such as a household's sense of moral or social obligation to pay its taxes.").

[102] *See, e.g.*, TOM R. TYLER, WHY PEOPLE OBEY THE LAW (2006); *cf.* Graetz et al., *supra* note 74, at 7 (identifying taxpayers who are "habitual compliers").

[103] One need not think only of tax protestors here. In the early 1980s, Raymond Hunthausen, the Roman Catholic Archbishop of Seattle, announced that he would stop paying one-half his federal tax liability to protest the federal government's military spending. *Checking Up on 'Dutch'*, TIME, Nov. 28, 1983; Joseph Sobran, *Bishop in the Doghouse*, NAT'L REV., Dec. 19, 1986, at 28. He actively sought publicity for his non-compliance. Indeed, he certainly understood that his action could have its intended effect only to the extent that both the public and the government were aware that he was refusing to comply with his tax obligations for purposes of dissent.

tions for compliance and non-compliance; but the deterrence model generally assumes the richness and complexity away.[104]

Finally, the implications of the deterrence model for penalty reform give pause.[105] The model clearly implies that either penalty levels or probabilities of detection (or a combination, given the substitutability of the two) should be raised to high levels. If a rough probability of detection were set at twenty-five percent (which is more than ten times the general audit rate of two percent), the accuracy penalty would have to be raised to 300% in order to make the expected cost of non-compliance equal to the expected benefit of non-compliance.[106] There is good reason to suppose that a penalty of that magnitude would be unacceptable on political (and likely other) grounds.[107] The current penalty for civil tax fraud is only seventy-five percent, and the most recent legislative increase in the accuracy penalty raised the stakes by only ten percentage points.[108]

If, instead, existing penalty levels are taken as given, government could increase the probability of imposing the penalties. However, this likely would require very intrusive detection efforts and extremely aggressive and costly enforcement. Government could, for example, undertake to audit four out of every five tax returns and commit to conducting those audits as thoroughly as possible. In so doing, the probability of penalty imposition would increase, perhaps enough to make the twenty-percent accuracy penalty a meaningful deterrent. But it seems likely that few legislators would be will-

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[104] *Compare* Slemrod & Yitzhaki, *supra* note 75, at 1446 ("In the typical economic model, . . . there are no honest or dishonest individuals, only utility-maximizers; thus, this distinction can be introduced only artificially by simply positing that some individuals do not pursue tax evasion."), *with* Dick J. Hessing, Henk Elffers, Henry S.J. Robben & Paul Webley, *Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies*, *in* Why People Pay Taxes, *supra* note 62, at 291, 304 (positing three groups of taxpayers—"taxpayers who never evade taxes[;] . . . taxpayers who will try to evade now and then; and . . . taxpayers who will often try to evade"—and arguing that deterrence is not needed for the first group and is ineffective for the second and third groups).

[105] The discussion here considers only the penalty levels and probabilities of detection implied by the deterrence model. *See, e.g.*, Joint Committee Study, *supra* note 12, at 34–35. The standard of taxpayer conduct—which, as Logue, *supra* note 75, and Shaviro, *supra* note 77, argue, should be strict liability—is considered in Part IV.A, *infra*.

[106] If the taxpayer did not report $100 of income and faced a twenty-five percent chance of being made to pay the $100 of income and a $300 penalty, the expected cost to the taxpayer of not reporting the $100 would be $100 [0.25 x ($100 + $300)], which is equal to the expected cost of reporting the $100 in the first instance.

[107] As Graetz and Wilde put the point: "[t]hat an economic model analyzing the expected utility calculation of a would-be tax evader recommends large increases in the applicable sanction in light of the very low probability of its application quickly becomes irrelevant as a policy matter. . . . [L]ife imprisonment is simply not within the feasible set of punishments for tax evasion." Graetz & Wilde, *supra* note 89, at 358.

[108] American Jobs Creation Act of 2006, Pub. L. 108-357, § 812(a) (2006) (codified at I.R.C. § 6662A (2006)) (raising the accuracy penalty in the case of non-disclosed reportable transactions).

ing to allocate the necessary resources to the IRS and that fewer still would find that degree of government intrusiveness to be tolerable.[109]

2. *The Norms Model*

The norms model maintains that a substantial number of taxpayers comply with their tax obligations through adherence to social or personal norms.[110] The model positions itself as a complement to the deterrence model: it accepts that the deterrence model accounts for some taxpayer compliance, but it argues that the compliance left unexplained by the deterrence model can be attributed to standards of conduct imposed on taxpayers by others or by themselves. Consider social norms first.[111] The argument here is not that a taxpayer complies with her tax obligations because she fears formal sanctions (such as tax penalties) potentially imposed by the government; rather, she complies because she follows social norms, and she wants to avoid informal sanctions potentially imposed by other taxpayers.[112] The model points in particular to social norms of reciprocal cooperation and trust as drivers of tax compliance.[113] For example, taxpayers may comply as a way

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[109] Raskolnikov's proposal for a "self-adjusting" penalty, intended to increase the likelihood of the government detecting tax avoidance, helps illustrate the counterintuitive policy implications of the deterrence model. He argues that taxpayers who attempt to avoid taxes often do so by concealing improperly claimed items (such as deductions and credits) among properly claimed items of the same type. He therefore proposes a penalty that would be calculated as a percentage not of the *improperly* claimed item but of the *properly* claimed item. Raskolnikov, *supra* note 77, at 599–605. Assume, for example, that taxpayer A improperly claims $100 of charitable deductions and properly claims $200 of charitable deductions; assume that taxpayer B also improperly claims $100 of charitable deductions but has no properly claimed charitable deductions. In that case, taxpayer A—but not taxpayer B—would incur Raskolnikov's self-adjusting penalty. In other words, Raskolnikov's proposal effectively burdens the combination of compliance and non-compliance more heavily than it burdens non-compliance alone. For any given level of non-compliance, the self-adjusting penalty increases as the taxpayer's *compliance* increases.

[110] *See generally* Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 Fla. Tax Rev. 599, 612–17 (2007).

[111] For general discussions of social norms, see Robert C. Ellickson, Order Without Law: How Neighbors Settle Disputes (1991); Edna Ullmann-Margalit, The Emergence of Norms (1977); Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 Va. L. Rev. 1577 (2000); Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. Legal Stud. 537 (1998); Lawrence Lessig, *The New Chicago School*, 27 J. Legal Stud. 661 (1998); Cass R. Sunstein, *Social Norms and Social Roles*, 96 Colum. L. Rev. 903 (1996). For an argument that social norms can support taxpayer non-compliance, see Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. Chi. L. Rev. 601 (2007).

[112] *See, e.g.,* 1 Taxpayer Compliance: An Agenda for Research, *supra* note 95, at 73; Kornhauser, *supra* note 110, at 612–17; Slemrod, *supra* note 76, at 39.

[113] *See* Lars P. Feld & Bruno S. Frey, Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation (2005) [hereinafter Psychological Tax Contract]; Bruno S. Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 J. Comp. Econ. 136 (2007); Lederman, *supra* note 75, at 1476–1517; John T. Scholz & Mark Lubell, *Adaptive Political Attitudes: Duty, Trust, and Fear as Monitors of Tax Policy*, 42 Am. J. Pol. Sci. 903 (1998); John T. Scholz & Mark Lubell, *Trust and Taxpaying: Testing the Heuristic Approach to Collective Action*, 42 Am. J. Pol. Sci.

of inducing or reciprocating the compliance of other taxpayers.[114] The argument is similar as to personal norms. A taxpayer who values integrity, honesty, and the benefits of citizenship may feel guilt, shame, or similar emotions if she does not meet her tax obligations.[115] These personal norms may depend on whether she regards her tax obligations as legitimate. That, in turn, may depend on whether she sees legal actors, such as government tax officials, satisfying basic concerns of procedural justice such as "neutrality, lack of bias, honesty, efforts to be fair, politeness, and respect for citizens' rights."[116]

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398 (1998) [hereinafter *Trust and Taxpaying*]; Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, *in* WHY PEOPLE PAY TAXES, *supra* note 62, at 225–26; M.W. Spicer & S.B. Lundstedt, *Understanding Tax Evasion*, 31 PUB. FIN. 295 (1976). On norms of cooperation and reciprocity more generally, see Jon Elster, THE CEMENT OF SOCIETY: A STUDY OF SOCIAL ORDER 97-151, 186–214 (1989); Cristina Bicchieri, *Norms of Cooperation*, 100 ETHICS 838 (1990); Ernst Fehr & Simon Gächter, *Fairness and Retaliation: The Economics of Reciprocity*, 14 J. ECON. PERSP. 159 (2000); Mark Lubell & John T. Scholz, *Cooperation, Reciprocity, and the Collective-Action Heuristic*, 45 AM. J. POL. SCI. 160 (2001); Elinor Ostrom, *Collective Action and the Evolution of Social Norms*, 14 J. ECON. PERSP. 137 (2000).

[114] Dan Kahan's account is representative. *See* Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71 (2003) [hereinafter *Logic of Reciprocity*]. He argues that individuals generally approach collective-action problems, such as tax compliance, as reciprocal cooperators rather than as free riders. *Id.* at 71. That is, "[w]hen they perceive that others are behaving cooperatively, individuals are moved by honor, altruism, and like dispositions to contribute to public goods even without the inducement of material incentives." *Id.* But when "they perceive that others are shirking or otherwise taking advantage of them, individuals are moved by resentment and pride to withhold their own cooperation and even to engage in personally costly forms of retaliation." *Id.* Tax compliance, then, is a cooperative norm providing an equilibrium solution for the problematic funding of public goods: a taxpayer pays her taxes in order to reciprocate the compliance of other taxpayers, to induce the compliance of other taxpayers, or both. If she knows that other taxpayers are refusing to comply, she will not feel constrained by the norm to continue her own compliance. *See also* Dan M. Kahan, *Reciprocity, Collective Action, and Community Policing*, 90 CAL. L. REV. 1513, 1514, 1519–20 (2002) [hereinafter *Reciprocity, Collective Action, and Community Policing*]; Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. REV. 333, 340–44 (2001).

[115] *See, e.g.*, PSYCHOLOGICAL TAX CONTRACT, *supra* note 113; Lars P. Feld & Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, 3 ECON. GOV. 87 (2000); Bruno S. Frey & Lars P. Feld, *Deterrence and Morale in Taxation: An Empirical Analysis* (CESifo Working Paper No. 760 2002) [hereinafter *Deterrence and Morale in Taxation*]; Frey & Torgler, *supra* note 113; Kornhauser, *supra* note 110, at 612–17; Richard D. Schwartz & Sonya Orleans, *On Legal Sanctions*, 14 U. CHI. L. REV. 274 (1967); Young-dahl Song & Tinsley E. Yarbrough, *Tax Ethics and Taxpayer Attitudes: A Survey*, 38 PUB. ADMIN. REV. 442 (1978). Recently, the literature has begun to use the vague term "tax morale" to describe an individual taxpayer's intrinsic willingness to comply with her tax obligations. *See* Frey & Feld, *supra*, at 6; Frey & Torgler, *supra* note 113, at 140; Kornhauser, *supra* note 110, at 601. The term, however, is also used more expansively to include both social and personal norms. Kornhauser, *supra* note 110, at 606–07.

[116] TYLER, *supra* note 102, at 7; *cf.* Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. (forthcoming 2008). A separate strand of the norms literature suggests that taxpayers comply to the extent that they perceive the terms of their exchange with the government—paying taxes on the one hand and receiving public goods on the other—to be fair. *See, e.g.*, Massimo Bordignon, *A Fairness Approach to Income Tax Evasion*, 52 J. PUB. ECON. 345 (1993); Spicer & Lundstedt, *supra* note 113, at 296. That line of analysis generally makes the highly implausible assumptions that "the taxpayer can compute the 'fair' terms of trade" be-

The norms model implies that government should supplement tax penalties with other mechanisms aimed at inducing and reinforcing norms-based compliance. Tax penalties remain necessary under the model for two reasons. First, the norms model assumes that certain taxpayers will not follow tax-compliance norms, and those taxpayers must be deterred by the threat of legal sanctions. Second, taxpayers who do follow such norms must be assured that non-compliant taxpayers will be sanctioned; otherwise, the tax-compliance norms may atrophy.[117] But government must find a delicate balance because heavy reliance on penalties may crowd out norms.[118] This implies that government must somehow devise "appropriately tailored" penalties "aimed specifically" at taxpayers who ignore tax-compliance norms.[119] Penalty reform under the norms model, then, would make tax penalties both narrower and stronger: narrower because they must target only recalcitrant, norm-defying taxpayers and stronger because, under the deterrence model, existing penalties are too low to provide an effective deterrent.

With respect to taxpayers who follow tax-compliance norms, the objective of government should be different.[120] Government should aim, for example, to cultivate trust among taxpayers that their compliance will not be exploited by other taxpayers.[121] This may include publicizing the fact that most taxpayers comply with their tax obligations[122] and not publicizing criminal tax prosecutions.[123] Government also should emphasize procedural justice: officials responsible for enforcing tax laws should deal with taxpayers

tween herself and the government and that the taxpayer believes that she has accurate perceptions of the extent to which other taxpayers comply. Bordignon, *supra*, at 346, 350–51; *see also* JOINT COMMITTEE STUDY, *supra* note 12, at 32 n.67 (arguing that the benefits of government services are too diffuse for individuals to directly correlate them with paying their taxes). Additionally, this analysis struggles to account for compliance with redistributive taxes. *Deterrence and Morale in Taxation*, *supra* note 115, at 13–14.

[117] *See Deterrence and Morale in Taxation*, *supra* note 115, at 11; Lederman, *supra* note 75, at 1470–77.

[118] *Deterrence and Morale in Taxation*, *supra* note 115, at 7 (arguing that "authoritarian" government approach may "crowd out" compliance based on tax morale but that a "respectful" government approach may "crowd in" such compliance); *see also* Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043, 1050–52 (1997); Ostrom, *supra* note 113, at 147. *But see* Lederman, *supra* note 75, at 1499. On the other hand, it may be that such norms actually ground the deterrence effects of tax penalties. *See* Scholz & Pinney, *supra* note 91, at 491. If so, scaling back tax penalties may have undesirable effects under both the deterrence and the norms models.

[119] *Logic of Reciprocity*, *supra* note 114, at 79; *see also* Lederman, *supra* note 75, at 1514.

[120] For an extended discussion of the policy implications of the norms-based model, see Kornhauser, *supra* note 110, at 626–40.

[121] *See Logic of Reciprocity*, *supra* note 114, at 76.

[122] *Id.* at 83. Experimental evidence, however, suggests that such measures have only minor effects on taxpayer compliance. *See, e.g.*, Marsha Blumenthal, Charles Christian & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125 (2001); *see also* Coleman, *supra* note 91, at 18, 25. *But see* Schwartz & Orleans, *supra* note 115, at 295, 299.

[123] *Logic of Reciprocity*, *supra* note 114, at 83; *see also* Schwartz & Orleans, *supra* note 115, at 291, 300; Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance, in* WHY PEOPLE PAY TAXES, *supra* note 62, at 195.

openly and fairly, without bias or predisposition; and government should "give taxpayers the benefit of the doubt when it finds a mistake, by sanctioning small violations more mildly, and by sanctioning large . . . violations more heavily."[124]

There are, however, problems both with the policy implications of the norms model and with the model itself. Government, the model implies, should direct separate enforcement strategies at separate groups of taxpayers—targeting deterrence-based penalties at taxpayers who do not follow tax-compliance norms and norm-enhancing measures at taxpayers who do. But that makes a critical move that the norms model has yet to justify: the move from establishing the existence of different taxpayer *motivations* to establishing the existence of different taxpayer *types*. The former does not necessarily imply the latter.[125] An individual may defy tax-compliance norms, but that hardly implies that she disregards all social or personal norms, including those that support compliance with other legal obligations.[126] A taxpayer may even be motivated by deterrence as to some of her tax obligations but by norms as to other tax obligations; or she may have different motivations as to different items within the four corners of a single tax return. More subtly, it may well be that a taxpayer's motivations are mixed as to almost every point of tax compliance and non-compliance; that is, it may be that some combination of deterrence and norms is necessary for her to comply on any particular tax issue, with neither alone being sufficient.[127]

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[124] Edward J. McCaffery & Joel Slemrod, *Toward an Agenda for Behavioral Public Finance* 20 (CLEO Research Paper No. C04-22, 2004) (describing policy recommendations of "tax morale" literature). Australia attempted to implement such an approach for its tax system. *See generally* Taxing Democracy: Understanding Tax Avoidance and Evasion (Valerie Braithwaite ed., 2003).

[125] *But see* Graetz et al., *supra* note 74, at 7 (distinguishing between "strategic noncompliers" and "habitual compliers"); Alex Raskolnikov, *Beyond Deterrence: Targeting Tax Enforcement with a Penalty Default*, 109 Colum. L. Rev. (forthcoming 2009) (distinguishing between "reciprocators" and "gamers"); Michael Wenzel, *The Multiplicity of Taxpayer Identities and Their Implications for Tax Ethics*, 29 Law & Pol'y 31 (2007) (providing empirical evidence for links between posited taxpayer "identities" and "tax ethics").

[126] *See, e.g.*, Russell Hardin, *Law and Social Norms in the Large*, 86 Va. L. Rev. 1821, 1822 (2000) ("[O]ne might argue that people are able to compartmentalize their behaviors and that I might be cooperative in some contexts and not in others. So I might always take the trouble to vote, I might always remember to repay small debts, and I might be invariably generous in my dealings with others—but I might shade my taxes. This is surely a correct view of our complexity much of the time.").

[127] *See, e.g.*, 1 Taxpayer Compliance: An Agenda for Research, *supra* note 95, at 5 ("Research to date tends to support tax administrators' long-held conjectures that financial incentives, social sanctions, and moral commitment may all affect taxpayer compliance . . . ."); Raskolnikov, *supra* note 77, at 579 (recognizing that taxpayers consider "various factors" in making compliance decisions); *see also* Ostrom, *supra* note 113, at 138. *But see* Alm et al., *supra* note 58, at 15 ("There are individuals who always cheat and those who always comply, some who maximize expected utility, others who overweight low probabilities, individuals who respond in different ways to changes in their tax burdens, some who are at times cooperative and at other times free-riders, and many who are guided in some way by social norms."); Hessing et al., *supra* note 104, at 304 (positing separate taxpayer types).

The policy prescriptions of the norms model elide these nuances; they take it as given that certain taxpayers respond to tax-compliance norms but that other taxpayers respond to deterrence.[128] The norms model, then, assumes that the only implementation question is how to tailor different government strategies to different groups of taxpayers: harsh tax penalties appropriate for taxpayers who respond only to deterrence should not be aimed at taxpayers who respond to tax-compliance norms because the harsh penalties will undercut the norms and crowd out compliance; measures intended to enhance taxpayer trust should not be aimed at taxpayers who respond only to deterrence because those measures will signal easy opportunities for avoidance and evasion. But if most (or even many) taxpayers in fact have mixed and complicated motivations for compliance, the policy approaches recommended by the norms model seem as likely to undermine tax compliance as to support it.

Apart from its policy implications, there are fundamental problems with the norms model itself. Application of the rich literature on social norms to tax compliance encounters the basic difficulty that, unlike other activities that can be regulated through social norms, tax compliance and tax noncompliance are private matters that third parties, other than government officials, simply cannot observe. Individuals complete their tax returns privately (with or without the help of a tax-return preparer, although the information provided to the preparer is also confidential[129]), and taxpayers file their returns subject to strict confidentiality laws that prohibit government officials from disclosing taxpayer information.[130] With the exception of those who hold or seek high public office, very few taxpayers make their returns available for public review.

But a social norm generally presupposes observability by third parties because it "represents a pattern of behavior that is judged in a similar way by others and that is sustained in part by social approval or disapproval."[131] A social norm of trust among reciprocal cooperators, for example, requires "face-to-face assurance,"[132] which makes the insightful trust and reciprocity

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[128] *See* Lederman, *supra* note 75, at 1500.

[129] I.R.C. § 6713 (2006).

[130] I.R.C. § 6103.

[131] Alm et al., *supra* note 58, at 6; *see also* Fehr & Gächter, *supra* note 113, at 166 (defining a social norm as "a behavioral regularity; that is . . . based on a socially shared belief of how one ought to behave; which triggers . . . the enforcement of the prescribed behavior by informal social sanctions"); Sunstein, *supra* note 111, at 915 ("[S]ocial norms are enforced through social sanctions . . . .").

[132] *Logic of Reciprocity*, *supra* note 114, at 76; *see also id.* at 72 (noting the "tendency of observable cooperation to generate reciprocal cooperation"); Bicchieri, *supra* note 113, at 846 ("Defection should be expected in all those circumstances in which an individual is anonymous . . . ."); Fehr & Gächter, *supra* note 113, at 164 ("[T]he impact of negative reciprocity changes radically if subjects are given the opportunity to observe the contributions of others, and to punish those who do not contribute."); Ostrom, *supra* note 113, at 140 ("Face-to-face communication in a public good game . . . produces substantial increases in cooperation . . . ."); Sunstein, *supra* note 111, at 945 ("[A]gents are willing to cooperate, and hence to

literature a very poor fit for explaining tax compliance.[133] A social norm requires social sanctions, and social sanctions require that others be able to observe the relevant behavior. If an individual fails every week to put her recycling bin in front of her house, her neighbors can observe that and impose on her whatever social sanctions a recycling norm might entail. However, if the same individual every year fails to report a portion of her income or claims excessive deductions, no one will be in any position to impose any kind of social sanction on her. That no taxpayer can observe the compliance or non-compliance of any other taxpayer should imply skepticism about claims that tax compliance depends on social norms.[134]

One could argue that what matters in the context of tax compliance is whether taxpayers *perceive* that other taxpayers generally do or do not comply with their tax obligations.[135] Arguably, a social norm such as reciprocal cooperation might be sustainable on the basis of what the taxpayer believes

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solve collective action problems without coercion, if most people are seen as cooperators . . . .").

[133] *See Trust and Taxpaying*, *supra* note 113, at 408 ("Theoretically, respect should have little direct effect on compliance because noncompliers can prevent others from knowing they were cheating, since the IRS is forbidden by law from publicizing an individual's audit results even when they find noncompliance."). Reciprocal cooperation—which is simply not plausible as among taxpayers—may be plausible as between a taxpayer and the government. *See, e.g.*, Slemrod, *supra* note 76, at 40; Smith, *supra* note 113, at 227 ("The reciprocity and legitimacy arguments both lead to the proposition that tax authorities' responsive, respectful, and fair treatment of taxpayers tends to foster respect for and cooperation with the tax system."). That is, if a taxpayer believes that the government treats her fairly and appropriately, she may be inclined to reciprocate to the government through tax compliance.

[134] This is not to suggest that there is not a social norm against criminal tax fraud or that there cannot be social sanctions imposed on taxpayers who commit such fraud. Undoubtedly, if one were convicted of such a crime, one could expect informal social sanctions along with formal legal sanctions. But prosecutions for criminal tax fraud are rare. U.S. GEN. ACCOUNTING OFF., *supra* note 85, at 4. Actual criminal activity is thus at the outer edge of tax noncompliance, and it would be a mistake to think that the possibility of social sanctions for a criminal tax fraud conviction meaningfully informs much taxpayer conduct—particularly in cases where the substantive law is uncertain. *But see* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1789 (2000) (arguing that criminal tax conviction "signals" one's "type" to third parties). For criticisms of Posner's argument, see Hardin, *supra* note 126; Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's* Law and Social Norms, 36 U. RICH. L. REV. 367 (2002). Perhaps the most remarkable aspect of Kahan's criticism, which focuses on the non-observability of tax compliance, is that Kahan seems entirely unaware of the serious problem that non-observability presents for his own attempt to apply reciprocity theory to tax compliance.

[135] *See, e.g.*, Frey & Torgler, *supra* note 113, at 137 ("[T]he more other taxpayers are perceived to be honest, the more willing individuals are to pay their own taxes."); *id.* at 153 ("An individual taxpayer is influenced strongly by his perception of the behavior of other taxpayers."); *Logic of Reciprocity*, *supra* note 114, at 74 ("[T]he willingness of individuals to make costly contributions to collective goods is highly conditional on their perception that others are willing to do so."); *Reciprocity, Collective Action, and Community Policing*, *supra* note 114, at 1520 ("[M]ost taxpayers behave like moral and emotional reciprocators: in deciding whether to pay their taxes in full, they are more influenced by their perception that others are or are not complying than they are by the material costs and benefits of evasion."); Michael Wenzel, *Misperceptions of Social Norms about Tax Compliance: From Theory to Intervention*, 26 J. ECON. PSYCH. 862 (2005) (studying effects of taxpayer perceptions of social tax-compliance norms on taxpayer behavior).

about the conduct of other taxpayers. If information provided by the government about overall compliance levels and anecdotal accounts from relatives, friends, and acquaintances lead a taxpayer to believe that most taxpayers comply most of the time, reciprocal cooperation might hold even in the absence of "face-to-face assurance."[136] That move, however, does nothing to change the fact that, no matter what the taxpayer believes about other taxpayers, no one can impose a social sanction against her for not complying with her tax obligations. At best, it suggests that there may be social norms regarding "cheap talk" among taxpayers: perhaps it is important in certain social circles to insist that one always pays all one's taxes or, in other circles, to insist that one often takes aggressive tax positions. But a social norm governing what taxpayers say about their tax compliance is very different from a social norm that governs whether taxpayers actually comply.[137]

The norms model also argues that taxpayer compliance involves personal norms, and here it stands on firmer ground. On this argument, the basis for compliance is internal rather than external: what matters are the individual taxpayer's personal convictions about duty, honesty, and citizenship. Her own compliance does not depend on whether she can observe others complying or whether others can observe her complying; rather, her motivations are "intrinsic," such as a general desire on her part to honor her legitimate legal obligations.[138] But, at this point, the explanation for taxpayer compliance essentially becomes a black box.[139] To argue that "something inside"

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[136] *See, e.g.*, Spicer & Lundstedt, *supra* note 113, at 297 ("[O]ne may reasonably argue that if a taxpayer knows many people in groups important to him who evade taxes, then his commitment to the social norm of tax compliance will be weaker.").

[137] Consider this formulation from the research literature: "An analysis that compared the impact of various information sources on taxpayers . . . found that social influence (specifically, *perceived* attitudes toward noncompliance of the individuals with whom the taxpayer *discussed* taxes) had by far the strongest impact on the taxpayer's *commitment* and compliance." Marco R. Steenbergen, Kathleen M. McGraw & John T. Scholz, *Taxpayer Adaptation to the 1986 Tax Reform Act: Do New Tax Laws Affect the Way Taxpayers Think about Taxes?*, *in* WHY PEOPLE PAY TAXES, *supra* note 62, at 9, 13 (emphasis added). A taxpayer's self-reported "commitment" to comply, based on the attitudes that she has "perceived" among other taxpayers with whom she has "discussed" taxes, is not even remotely informative. If there is a social norm at work there, it is simply a norm of cheap talk. A taxpayer can say just about anything to other taxpayers about what she has done or intends to do with respect to her taxes; none of it is observable or verifiable.

[138] The question of what constitutes a "legitimate" legal obligation is, of course, vague. *See, e.g.*, TYLER, *supra* note 102, at 161 (describing legitimacy as "the belief that one ought to obey the law"); Alan Hyde, *The Concept of Legitimation in the Sociology of Law*, 1983 WIS. L. REV. 379 (1983); Kidder & McEwen, *supra* note 109, at 52–53 (asserting that, despite criticisms, "legitimacy is viewed by most social scientists as one of the fundamental glues that holds societies together"); Craig A. McEwen & Richard J. Maiman, *In Search of Legitimacy: Toward an Empirical Analysis*, 8 LAW & POL'Y 257 (1986). *But see* 1 TAXPAYER COMPLIANCE: AN AGENDA FOR RESEARCH, *supra* note 95, at 8 ("Not surprisingly, survey research has consistently found that taxpayers who report high moral commitment to obey tax laws are unlikely to report cheating on their taxes. However, it is not clear whether this pattern reflects actual behavior or merely a desire to report behavior that is consistent with one's proclaimed attitudes.").

[139] With no apparent irony or self-consciousness, two researchers on "tax morale" flatly note that "no objective or observable measure of tax compliance is available." Frey & Torgler,

the taxpayer causes her to comply with her tax obligations is simply to return to the original question—the question that neither deterrence nor social norms could satisfactorily answer. It may well be that the taxpayer's sense of duty or respect for the law is an important determinant of her compliance. In that case, however, it is unclear whether tax compliance presents any concerns distinct from legal compliance generally. More importantly, it suggests genuine limitations on government's ability to base tax penalty reform on the instrumental function of tax penalties: without knowing what is inside the black box of intrinsic motivations, it is difficult for government to reform tax penalties specifically for the purpose of promoting tax compliance.

B. The Definitional Function of Tax Penalties

The instrumental function of tax penalties is well recognized in the tax-compliance literature. The questions of why taxpayers comply and how penalties should be structured to promote compliance remain unsettled and controversial, but the general point that tax penalties encourage tax compliance is accepted. By contrast, the literature has overlooked a more basic function of tax penalties—the function of *defining* tax compliance. The federal income tax is highly indeterminate, and economic transactions of even modest sophistication regularly encounter uncertainty about the correct interpretation and application of the substantive tax law. In cases of legal uncertainty—and they are the rule, not the exception—tax penalties establish the standards of conduct that determine whether taxpayers have complied with their tax obligations. The current system of penalties, however, establishes standards that fundamentally conflict with the policy commitment to a self-assessment tax system. In short, existing tax penalties fail to define tax compliance appropriately.[140]

supra note 113, at 141. The recent trend of attributing taxpayer compliance to "tax morale" and then defining "tax morale" as the taxpayer's "willingness to pay . . . taxes," *see* Frey & Feld, *supra* note 115, at 6, is emblematic of the problem: the explanation of why taxpayers comply with their tax obligations has zeroed in on indeterminate "intrinsic" factors that make taxpayers willing to pay their taxes.

[140] The definitional function of tax penalties can be associated with the descriptive side of legal expressivism. Elizabeth Anderson and Richard Pildes argue that, "[a]t the most general level, expressive theories tell actors—whether individuals, associations, or the State—to act in ways that express appropriate attitudes toward various substantive values." Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. Pa. L. Rev. 1503, 1504 (2000). As applied to law, expressive theories specifically evaluate the conduct of government and government officials as set forth in law and in actions taken under the authority of law. *Id.* at 1511–12. But this overtly normative side of legal expressivism tends to eclipse its interesting and important descriptive side: before legal expressivism can evaluate the attitudes expressed by government action, it must first establish what it is that governmental action expresses. Joel Feinberg's famous account of the expressive function of punishment illustrates the distinction. *See* Bernard E. Harcourt, *Joel Feinberg on Crime and Punishment: Exploring the Relationship Between* The Moral Limits of the Criminal Law *and* The Expressive Function of Punishment, 5 Buff. Crim. L. Rev. 145, 157 (2001). So does Lessig's distinction between "contestable" and "not contestable" social meanings. *See* Lawrence Lessig, *The New Chicago School*, 27 J. Legal Stud. 661, 682–85 (1998). The descrip-

1. How Tax Penalties Define Tax Compliance

Tax penalties define tax compliance; more precisely, the legal conditions that preclude the imposition of tax penalties on a taxpayer define the standards of conduct that constitute compliance with the taxpayer's obligations.[141] The argument for that conclusion is very straightforward. The tax law establishes that a taxpayer who has not complied with her obligations has satisfied the legal conditions for imposition of a tax penalty.[142] It necessarily follows that a taxpayer who has not satisfied the legal conditions for imposition of a tax penalty has complied with her tax obligations.[143] Tax penalties mark off the boundaries of tax compliance.[144]

The difficulty here is that, as shown in Part II, the existing accuracy penalty generally imposes very low standards of conduct on taxpayers when the law is uncertain. For non-abusive transactions, the accuracy penalty requires that the taxpayer have only a forty-percent chance of winning on the merits if she does not disclose her position and only a twenty-percent chance of winning on the merits if she does disclose her position.[145] This means that, as long as the taxpayer meets the forty-percent or twenty-percent threshold (whichever applies), the taxpayer is not subject to the accuracy penalty even if she sincerely believes that her position likely will lose in court. In such a case, the accuracy penalty defines tax compliance as a self-assessment of tax liabilities based on a legal position that is likely wrong but not too likely

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tive side of legal expressivism is essentially interpretive and, as such, is open to the familiar difficulties and challenges that attend any interpretive exercise. *See, e.g.*, Anderson & Pildes, *supra*, at 1513, 1524–25. For other general discussions about legal expressivism, see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. Pa. L. Rev. 1363 (2000); Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. Chi. L. Rev. 943 (1995); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. Pa. L. Rev. 2021 (1996).

[141] This would not include, for example, the discretion of government officials not to impose a penalty in a case that satisfied the legal conditions for imposition of the penalty. Thus, if the taxpayer's conduct legally would justify imposition of a penalty but a government official decides not to impose the penalty, the taxpayer has not complied with her tax obligations.

[142] See the discussion of the accuracy penalty in Part II.A, *supra*.

[143] The second statement is simply the contrapositive of the first statement, and the two statements have the same truth value. To put it slightly more formally: Let C stand for the proposition "the taxpayer has not complied with her tax obligations," and let P stand for the proposition "the taxpayer has satisfied the conditions for imposition of a tax penalty." Positive law establishes the truth of the following statement (S): $\sim C \rightarrow P$. The contrapositive of (S) must also be true; that is, it necessarily follows that: $\sim P \rightarrow C$.

[144] At times, the government has expressed this view. *See, e.g.*, Commissioner's Task Force Report, *supra* note 8, at III-1 (asserting that tax penalties accomplish the "setting and validation of standards of behavior"); *id.* at VIII-8 (asserting that penalties "define, as a civil matter, what constitutes an adequately 'correct' return"); Treasury Study, *supra* note 8, at 36 n.99 (quoting Internal Revenue Serv., IRS Penalty Handbook § 20.1.1.2 (2008) as stating that "penalties encourage voluntary compliance by [*inter alia*] 'defining standards of compliant behavior'"); Joint Committee Study, *supra* note 12, at 31 ("Penalties for the failure to comply with laws serve to establish and validate the standards of behavior set forth by the tax laws themselves . . . ."). One might identify this aspect of tax penalties with what Matthew Adler would call the "prescriptive meaning" of law. *See* Adler, *supra* note 140, at 1396–97.

[145] *See supra* Part II.A.1–2.

wrong—or what could be called a "good enough but wrong" legal position. The standard is only a little better in the case of tax shelters and disclosed reportable transactions. In those cases, the taxpayer must have both a forty-percent chance of winning on the merits and a reasonable belief that she has a greater than fifty-percent chance of winning on the merits.[146] Here, then, compliance requires a self-assessment based on a legal position that the taxpayer reasonably believes will win, if only barely. In the case of a non-disclosed reportable transaction, the standard is actually much higher: there, tax compliance consists of nothing less than a correct self-assessment.[147] Thus, the accuracy penalty defines tax compliance as taxpayer conduct that ranges from taking absolutely correct positions to taking positions that have an eighty-percent chance of being wrong.

As a policy matter, the government rejects the idea that tax compliance could include the low standards of conduct permitted under the accuracy penalty. In its formal report on the tax gap, the IRS insists that a taxpayer is compliant only if she meets her obligations to assess her tax liability correctly, to report that liability on her return, and to pay the liability on time and without compulsion.[148] Non-compliance, the government argues, occurs when the taxpayer does not pay her "true tax liability,"[149] which the government defines as follows: "[t]rue tax liability for any given taxpayer means the amount of tax that would be determined for the tax year in question if all relevant aspects of the tax law were correctly applied to all of the relevant facts of that taxpayer's situation."[150] In the view of the IRS, then, "tax compliance" requires that the taxpayer make a correct assessment of her tax liability with all legal uncertainties resolved correctly.

The government's understanding of tax compliance probably would draw broad but not universal support among legislators, other policymakers, practitioners, and academics; and it does accord with general intuitions about what it means to comply with the law.[151] Much of the practicing bar agrees with the government's definition: a commission of the American Bar Association asserts that tax compliance "is the timely filing and reporting of required tax information, the *correct* self-assessment of income taxes owed, and the timely payment of those taxes without enforcement action."[152] But,

[146] *See id.*

[147] *See id.* Again, however, the strict-liability standard effectively attaches to the failure to disclose, since a lower standard applies in the case of a disclosed reportable transaction.

[148] Internal Revenue Serv., *supra* note 3, at 6.

[149] *Id.*

[150] *Id.*

[151] *But see* 1 Taxpayer Compliance: An Agenda for Research, *supra* note 95, at 21–22 (defining "compliance" generally as requiring that the taxpayer file a return that "accurately report[s] tax liability in accordance with the Internal Revenue Code, regulations, and court decisions applicable at the time the return is filed" but excluding any case in which "fully informed neutral experts may disagree about how the law should be applied"—that is, excluding any case involving legal uncertainty).

[152] Commission on Taxpayer Compliance, *supra* note 100, at 338 (emphasis added).

with or without the concurrence of the bar, the government's understanding misstates current law. The tax law provides no basis for distinguishing between the conduct of different taxpayers other than through the imposition or non-imposition of a tax penalty. Two identically situated taxpayers—one who reports and pays her "true tax liability" with her return and one who pays her "true tax liability" only after the government audits her return and asserts a deficiency—stand on equal footing unless they are made to pay different amounts by reason of a tax penalty.

Consider the point with a concrete example. Taxpayer, *M*, engages in a non-abusive transaction during Year X that involves a point of uncertainty in the tax law. The transaction produces a tax liability of either $50,000 or $0. She cannot say for certain which answer is correct. Her tax advisors tell her that the point is genuinely in doubt; they advise her that, if she reports $0 of tax liability from the transaction, there is a sixty-percent chance that she will lose in litigation. A second taxpayer, *N*, engages in the same transaction in Year X and mulls over the same advice about the legal uncertainty. Right up to the point when they complete their tax returns, *M* and *N* are identically situated. *M* decides to report and pay the $50,000 tax liability with her return; she then files a refund claim in which she asserts $0 in tax liability from the transaction. The government denies the refund claim. *M* pursues the matter through litigation and loses on the merits in court. *N*, by contrast, decides not to report or pay the $50,000 tax liability with his return. When the government audits his return and asserts a $50,000 tax deficiency, he seeks judicial review of the government's position. *N* loses on the merits in court. *N* then pays the $50,000 deficiency and the applicable interest charge.[153] The government determines that, because there was a forty-percent chance that *N* would prevail on the merits when he filed his return, his case does not satisfy the legal conditions for imposing the accuracy penalty.

The law provides no basis for distinguishing between the compliance status of *M* and the compliance status of *N*; and the law treats them precisely the same. *M* is no better off than *N* for having paid her taxes with her return, and *N* is no better off than *M* for having paid his taxes only after the government asserted a deficiency. *M* paid $50,000 with her Year X tax return; after losing her refund litigation, her account with the government is even. *N* paid $50,000 sometime after filing his Year X tax return plus interest to make the government whole for the late payment; after losing his deficiency litigation, his account with the government is even as well. *N* and *M* stand in exactly the same position both before and after filing their tax returns. It cannot be that *M* has complied with the law but *N* has not if they both ultimately pay the same amount to the government despite taking diametrically opposite

[153] Assume that the interest rate charged to *N* for paying his $50,000 tax liability after filing his return reflects a market interest rate.

positions on their tax returns. If *M* has complied with her tax obligations, so has *N*.[154]

Thus, the government's insistence that tax compliance requires a *correct* self-assessment of the taxpayer's liability with the *correct* resolution of legal uncertainty does not describe the law as it stands today. The differentiation between non-compliance and compliance is provided through the imposition of penalties, and, except in the case of abusive transactions, penalties cannot be imposed as long as the taxpayer has a good-enough-but-wrong legal position. An incorrect self-assessment of taxes when the law is uncertain simply is not sufficient grounds, in those cases, for determining that the taxpayer is non-compliant.

2. *How Tax Penalties Should Define Tax Compliance*

"The United States," Justice Jackson observed, "has a system of taxation by confession."[155] Since the early days of the federal income tax, Congress has required taxpayers to assess and report their own tax liabilities. In so doing, it specifically rejected the model used by other nations under which the government, rather than the taxpayer, assesses liabilities.[156] That basic policy decision places self-assessment at the center of tax compliance; and that, in turn implies standards of conduct markedly different from the standards imposed by the current system of tax penalties. As the Staff of the Joint Committee on Taxation noted, the standards required under the existing accuracy penalty "are so low [that] they provide little incentive for taxpayers to determine the appropriate tax treatment" on their returns.[157]

The policy commitment to taxpayer self-assessment is striking. The federal government collects more than $1 trillion each year through the federal income tax, and those collections are premised on the notion that, for the most part, taxpayers will determine how much they owe and will remit those amounts to the government. Although the government backs up the duty of self-assessment with penalties, criminal sanctions, and forcible collection procedures, the government starts from the assumption that taxpayers will turn over roughly ten percent of gross domestic product without actual com-

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[154] This is not to argue that the definitional function of tax penalties is the only potential vehicle for the law to define tax compliance. It would be possible for the law to distinguish between tax compliance and tax non-compliance through other mechanisms. For example, the government could include *M* on a public list of taxpayers who did not pay their "true tax liabilities" until after audit and thereby identify *M* as non-compliant. But, under current law, tax penalties provide the distinction between compliant and non-compliant taxpayers.

[155] United States v. Kahriger, 345 U.S. 22, 36 (1953) (Jackson, J., concurring). More prosaically: "A fundamental assumption of the self-assessment system of taxation in the United States . . . is that taxpayers will come forward with a periodic accounting of their tax situation, in prescribed formats, and by statutory due dates." COMMISSIONER'S TASK FORCE REPORT, *supra* note 8, at VI-1.

[156] COMMISSIONER'S TASK FORCE REPORT, *supra* note 8, at VI-29 to VI-30.

[157] JOINT COMMITTEE STUDY, *supra* note 12, at 148.

pulsion.[158] Other systems of taxation do not provide for nearly that level of taxpayer participation in assessing the amounts owed. Local property taxes levied throughout the United States, for example, do not require or even permit taxpayers to assess their own liabilities; instead, local governments make the assessments and simply demand payment from taxpayers.[159] Similarly, employment taxes, such as those financing entitlement programs, generally do not allow taxpayer self-assessments. But the single largest source of federal government revenue, the income tax,[160] looks to taxpayers to assess and report their liabilities. Along with state income taxes (many of which are modeled on the federal income tax), the federal income tax is an outlier in the scope of responsibilities it entrusts to taxpayers.

For present purposes, the policy commitment to self-assessment is taken as a given. Presumably, that commitment rests on a judgment that, for an income tax, a self-assessment system is much less costly to administer than a system of government assessments.[161] The income tax has a very broad scope, and it reaches virtually every economic transaction in which taxpayers participate. This implies sharp informational asymmetries between taxpayers and the government: taxpayers have much more information about their economic transactions than the government does. To allocate the costs of assessment in the first instance to taxpayers should be more efficient, even if self-assessment entails selective review and re-assessment by the government. That efficiency justification implies that tax compliance requires honest and accurate self-assessments by taxpayers. The lower administrative costs realizable through a system of self-assessment would be lost if taxpayers were permitted to make dishonest or inaccurate assessments of their tax liabilities.

Consider, for example, the likely results if government had to treat each taxpayer's self-assessment as presumptively incorrect and audited every return to determine correct tax liabilities. A system in which taxpayers spend resources to assess their taxes incorrectly and the government then spends resources to re-assess the taxes actually owed would forfeit all the cost savings of a self-assessment system. It likely would be even more costly than a system in which taxpayers made no self-assessments at all.

The policy commitment to self-assessment might also be justified by reference to principles of political self-determination. One could argue that legal obligations imposed on citizens in a representative democratic state effectively constitute legal obligations that citizens impose on themselves

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[158] Sonya Hoo & Eric Toder, *The U.S. Tax Burden Is Low Relative to Other OECD Countries*, 111 Tax Notes 695 (2006).

[159] Of course, taxpayers have a right to challenge the assessments.

[160] Letter from Peter R. Orszag, Dir. of the Cong. Budget Office, to Senator Kent Conrad, at Table 1 (May 18, 2007), *available at* http://www.cbo.gov/ftpdocs/81xx/doc8116/05-18-TaxRevenues.pdf.

[161] Commissioner's Task Force Report, *supra* note 8, at II-1 (arguing that a self-assessment system is likely to be more "efficient" and "accurate" than a system of government assessment).

and that government should, to some extent, trust citizens to meet those obligations. This justification for taxpayer self-assessment actually seems weaker than the efficiency justification for the simple reason that tax systems in the United States become less trusting of citizens the closer one gets to actual democracy. At one pole, the federal government—in which any one citizen has very little say—allows self-assessment for the federal income tax. At the other pole, local governments—in which individual citizens have relatively more say—do not dare to trust taxpayers with self-assessment of their property taxes. Even so, this political justification also implies that tax compliance requires honest and accurate self-assessments. If the underlying notion is that government should trust taxpayers to meet the tax obligations they have imposed on themselves through legitimate processes of representative government, that trust could not be meaningful unless taxpayers were expected to meet those obligations honestly and accurately.

Thus, the policy commitment to a self-assessment tax system demands that tax compliance be defined to require honest and accurate self-assessments by taxpayers. Because tax penalties define compliance through the standards of conduct they set for taxpayers, tax penalties should impose these requirements of honesty and accuracy. But, as shown above, the current system of tax penalties for the most part only requires that taxpayers be able to justify their reported self-assessments with good-enough-but-wrong legal positions.

C. The Relationship between the Instrumental and Definitional Functions

In sum, tax penalties serve two distinct but intertwined functions: they promote tax compliance, but they also define tax compliance. By focusing exclusively on the instrumental function, the tax-compliance literature generally has assumed that the starting point for tax penalty reform is to resolve the question of why taxpayers comply. The underlying intuition is that, because tax penalties promote tax compliance, policymakers cannot fashion a sensible and effective penalty regime without first understanding what motivates taxpayers to satisfy their obligations. That, in turn, leads to the competing claims of the deterrence model and the norms model. Neither model has given a full and satisfactory account of tax compliance, and each pulls policymakers in a different direction on penalty reform. Under the deterrence model, tax penalties promote compliance by providing the sanctions that form the basis for deterrence, and the model therefore implies that current penalties should be made much stronger across the board. Under the norms models, tax penalties promote compliance by backstopping, but not crowding out tax-compliance norms. This model also implies that current penalties should be strengthened, but it insists that those strengthened penalties should be directed narrowly at taxpayers who do not respond to tax-compliance norms.

Tax penalties, however, also serve the more basic function of defining tax compliance. By distinguishing among the consequences that apply to different taxpayers, tax penalties determine the standards of taxpayer conduct that constitute compliance and non-compliance, including for the great many cases in which the substantive tax law presents ambiguity, indeterminacy, or other uncertainty. In effect, tax penalties, in their definitional function, set the compliance target toward which tax penalties, in their instrumental function, direct taxpayer conduct. This function is perhaps so fundamental that policymakers have taken it for granted. But, in doing so, policymakers have allowed the definitional function of tax penalties to go seriously awry. The current accuracy penalty marks off a definition of tax compliance that is simply inconsistent with the underlying and long-standing policy commitment to a self-assessment tax system.

Thus, responsible tax penalty reform requires proper consideration of both the instrumental function and the definitional function of tax penalties, but the definitional function is more fundamental. Even if one could resolve the competing claims of the deterrence model and the norms model to arrive at a system of tax penalties that would be highly effective in promoting tax compliance, those efforts would be pointless if the conception of tax compliance being promoted were itself the wrong conception. The appropriate standards of conduct must come first; the mechanisms for effectively promoting the appropriate standards can then follow.

IV. Reforming Tax Penalties

This Part sets out the case for tax penalty reform under the definitional function. The objective is to get the definitional function right—that is, to describe in general terms a penalty standard that properly defines tax compliance for a self-assessment tax system. The discussion covers the penalties and standards of conduct for taxpayers, tax practitioners, and government officials. Points where the reform implications of the definitional function and the instrumental function converge are noted. However, at points where those implications diverge, the discussion here gives initial priority to the definitional function. The outcome is a penalty standard that both captures the policy commitment to taxpayer self-assessment and provides the starting point for further penalty reform.

The discussion here does not yield a fully specified system of tax penalties. Any such system would have to take into account both the definitional and the instrumental functions of tax penalties, and the inquiry here centers on the definitional function. Thus, the general penalty standard described here would require further refinement upon consideration of all relevant instrumental aspects. It may be, for example, that the accuracy penalty described here should be set at a very high level (perhaps more than fifty percent) for sophisticated corporate taxpayers but at a much lower level (perhaps no more than the existing twenty percent) for individual taxpayers. It may be that the disclosure requirement described here would need refinement to ensure that taxpayers do not have incentives for too much or too little disclosure. These and other instrumental implications merit close and sustained consideration as a project for future research. Again, the immediate objective is to describe a penalty standard that properly fulfills the important but overlooked definitional function and to demonstrate how much that standard differs both from current law and from prominent reform proposals.[162]

A. *Standards of Conduct for Taxpayers*

The current accuracy penalty establishes inappropriate standards of taxpayer conduct. A reformed penalty should set a standard that coheres with the policy commitment to a self-assessment tax system. That generally implies that taxpayers should be held to higher standards.

1. *Inadequacy of the Existing Standards*

As outlined in Part II, the accuracy penalty imposes four separate standards of conduct on taxpayers when they take positions under conditions of legal uncertainty: the reasonable-basis standard, which requires a twenty-percent chance of winning on the merits; the substantial-authority standard, which requires a forty-percent chance of winning; the reasonable-cause-and-good-faith standard, which requires both a forty-percent chance of winning and a reasonable belief that there is a greater than fifty-percent chance of winning; and the strict-liability standard.[163] The first three are fault-based; the fourth is not. None captures the appropriate standard of conduct for a self-assessment tax system.

Consider first the reasonable-basis and substantial-authority standards for non-abusive transactions. These standards do not require the taxpayer to assess and report her tax liabilities based on a *correct* application of the law; they do not even require her to assess and report based on a *likely correct* application of the law. Instead, the taxpayer avoids the accuracy penalty entirely—which is to say, she complies with her tax obligations—if she assesses and reports her tax liabilities on the basis of a good-enough-but-wrong legal position. Indeed, she faces no accuracy penalty even if she sincerely believes that her position is likely to be the wrong position. A good-enough-but-wrong position shields her from the accuracy penalty and en-

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[162] Additionally, the discussion in this Part effectively treats both government policy and the conduct of government officials in implementing that policy as exogenous. A more fully specified system of tax penalties should treat those factors as endogenous. *See, e.g.*, Graetz et al., *supra* note 74, at 4–5.

[163] *See supra* Part II.A.1.

sures her the same outcome that she would have from taking the correct legal position.[164]

Congress had reasons for enacting these misguided standards, however difficult those reasons may be to defend.[165] The reasonable-basis standard loosely tracks the standard for court filings by litigants. The underlying notion appears to be that, as long as the taxpayer discloses the relevant facts of her transaction to the government, she may assert a mere litigating position on her tax return.[166] But the analogy is misplaced. A pleading or a brief filed by a litigant in a contested proceeding is all but certain to be reviewed closely by the litigant's adversary and, assuming the matter reaches adjudication on the merits, by an impartial decision-maker. By contrast, a tax return filed in a self-assessment tax system is treated by the government as presumptively accurate and is highly unlikely to be reviewed by anyone.[167] The policy decision to maintain a self-assessment system trades routine govern-

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[164] The jurat required on the taxpayer's return does not change this conclusion. The taxpayer's signature on her tax return verifies, under penalties of perjury, that "to the best of [her] knowledge and belief, [the return is] true, correct, and complete." *See* IRS Form 1040 (2007). The jurat is backed by a criminal sanction which applies if the taxpayer who signs the jurat "does not believe [the return] to be true and correct as to every material matter." *See* I.R.C. § 7206(1) (2006). This merely prevents the taxpayer from taking a position that she knows to be wrong. It does not prevent her from taking a position that she thinks is likely wrong—even very likely wrong—but that is not so wrong that it flunks the reasonable-basis or substantial-authority standard. *See* Cheek v. United States, 498 U.S. 192 (1991) (good faith misunderstanding of tax law not a violation of known legal duty); United States v. Pomponio, 429 U.S. 10 (1976) ("willfully" element of section 7206(1) requires violation of known legal duty). The same legal uncertainty that puts her tax position in play for purposes of the reasonable-basis or substantial-authority standard ensures that she does not violate the jurat.

[165] One point on which the enactment of these standards can be defended is that, under prior law, the only potentially applicable penalties for inaccurate taxpayer self-assessments were the negligence and fraud penalties. As Michael Asimow argued at the time, this created a large unregulated area. Michael Asimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 UCLA L. Rev. 637, 652 (1976) ("Between careless inaccuracies and quasi-criminality lies an immense middle ground: an endless array of cases involving reckless or intentional overstatement of deductions or understatement of income which lack the flagrancy necessary for imposition of the fraud penalty."). For a contrary view, see Richard C. Stark, *A Principled Approach to Collection and Accuracy-Related Penalties*, 91 Tax Notes 115, 135 (2001) (arguing that prior law "generally accorded well with the objectives of penalties and their proper place in tax administration"). The fact that the reasonable-basis and substantial-authority standards helped to fill the large gap between negligence and fraud does not imply, however, that they filled it adequately.

[166] *See* Treasury Study, *supra* note 8, at 97 ("A reasonable basis standard essentially treats taxpayers and the IRS as adversaries and permits taxpayers to take what is essentially a litigating position on their tax return."). As originally enacted in 1982, this defense mandated only disclosure of the taxpayer's position. The requirement that the disclosed position have a reasonable basis was added by Congress in section 13251 of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103–66, 107 Stat. 531 (codified at I.R.C. § 6662(2)(B)(ii)(II) (2006)). For the historical development of the penalties on taxpayer conduct through 1989, see Commissioner's Task Force Report, *supra* note 8, at V-1 to V–53. For the historical development of these penalties from 1989 through 1999, see Treasury Study, *supra* note 8, at 25–32.

[167] Joint Committee Study, *supra* note 12, at 162 ("[T]he position on the tax return is assumed to be correct under present law and the risk of challenge by the IRS to that assumption is low.").

ment scrutiny of tax returns off against low administrative costs, but it justifies that trade-off by requiring accurate self-assessment and reporting. The reasonable-basis standard directly undermines that justification: it gives the taxpayer the full benefit of asserting a highly aggressive position on her return—one that has as much as an eighty-percent chance of losing on the merits—with only a negligible chance that anyone will push back from the government side.[168] In a self-assessment system, a tax return cannot be treated as simply an argument made in an adversarial proceeding. It must be taken for what the self-assessment system assumes it to be—a correct determination of tax liability.

The legislative rationale for the substantial-authority standard is hardly more defensible. Congress enacted the standard in 1982, specifically rejecting a proposed requirement that the taxpayer's position be "more likely than not" to prevail.[169] The Conference Committee disingenuously implied that the only alternative to the substantial-authority standard was strict liability[170] and that the substantial-authority standard would distinguish taxpayers who took "highly aggressive" positions from those "who endeavor in good faith to fairly self-assess."[171] Substantial authority, however, protects even taxpayers who do not "endeavor in good faith to fairly self-assess" because it requires that their positions have only a forty-percent chance of winning on the merits. Put differently, it allows taxpayers to resolve legal uncertainty

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[168] *See* Treasury Study, *supra* note 8, at 106 (arguing that "litigating standards" for the accuracy penalty are improper "in light of the practical limitations on the IRS's ability to audit returns and reliance of the tax system on the self-reporting of taxpayers and policing function of tax practitioners."); Commissioner's Task Force Report, *supra* note 8, at VIII-10 to VIII–11 ("[A] simple litigating standard does not adequately protect the self-assessment objective . . . ."); Lee A. Sheppard, *What are Penalties For?*, 85 Tax Notes 709, 709 (1999) ("A tax return is not adversarial. A return is an attested document. It is signed by the taxpayer and the preparer under penalties of perjury. It is not an opening offer. It is not a submission in an adversarial proceeding."). The same criticism has been made of tax practitioners. *See, e.g.*, Handelman, *supra* note 43, at 89–93; Loren D. Prescott, Jr., *Challenging the Adversarial Approach to Taxpayer Representation*, 30 Loy. L.A. L. Rev. 693, 705–41 (1997).

[169] The Senate Finance Committee had sent to the Senate floor a bill that required the taxpayer to have "a subjective belief that [her] treatment [of an item] was more likely than not to be sustained if the issue were challenged and litigated." S. Rep. No. 97–494, at 273 (1982). The change to the substantial-authority standard was made by floor amendment. *See* 128 Cong. Rec. 17,220–27 (1982) (floor amendment of Senator Armstrong (R-CO)). Senator Armstrong's remarks in support of the amendment flatly indicate that he sought the lower standard at the behest of the American Institute of Certified Public Accountants, an interest group representing the accounting industry. *See id.* at 17,224. Notably, one of Senator Armstrong's co-sponsors on the amendment to weaken the standard of taxpayer conduct was Senator Baucus (D-MT), *see id.* at 17,220, who presently leads the legislative crusade against the tax gap. *See, e.g.*, News Release, Senate Fin. Comm., Hearing Statement of Senator Max Baucus (D-Mont.) Regarding the Administration's Plan for Reducing the Tax Gap (Apr. 18, 2007), *available at* http://www.senate.gov/~finance/press/Bpress/2007press/prb041807b.pdf.

[170] The Conference Committee reported that it had rejected "an absolute standard that a taxpayer may take a position on a return only if, in fact, the position reflects the correct treatment of the item because, in some circumstances, tax advisors may be unable to reach so definitive a conclusion." H.R. Rep. No. 97-760, at 575 (1982). This, of course, conflated the more-likely-than-not standard with the strict-liability standard.

[171] *Id.*

against the government as long as they have no more than a sixty-percent chance of losing. As Senator Grassley (R-IA) argued, the substantial-authority standard allows "taxpayers to report taxable transactions in ways they believe to be incorrect . . . ."[172] Taking such positions is very different from "endeavor[ing] in good faith to fairly self-assess."[173] Thus, Congress was wrong to settle on the substantial-authority standard in 1982, and the Treasury Department was wrong when it recommended to Congress in 1999 that the substantial-authority standard continue to apply for purposes of the accuracy penalty.[174]

The reasonable-basis and substantial-authority standards fail as well on the instrumental function of tax penalties. Consider first how they play out under the deterrence model. A taxpayer who has a reasonable basis for a disclosed position or substantial authority for a non-disclosed position generally will resolve legal uncertainty in her own favor because the expected return from taking a good-enough-but-wrong position will exceed the expected return from taking the correct position. To see this concretely, assume that a taxpayer with a thirty-five-percent marginal tax rate faces legal uncertainty on whether a $1,000,000 receipt from a non-abusive transaction constitutes income. Assume that she has been advised that there is substantial authority for excluding the $1,000,000 from income, that there is only a forty-percent chance that the exclusion would be sustained on the merits, and that the better legal answer therefore is to include the $1,000,000 in income. She has two options. Including the $1,000,000 in income will cost her $350,000. Excluding the $1,000,000, even with the expectation that she will concede the issue if the government raises it on audit, will cost her some amount less than $350,000; specifically, it will cost her $350,000, discounted by the probability that the government will examine her return and assert that the $1,000,000 receipt constitutes income.[175] If that probability is assumed to be twenty-five percent, her expected cost of relying on the substantial-authority position to exclude the receipt will be only $87,500. Excluding the receipt plainly has greater economic value than including it, even

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[172] 128 CONG. REC. 17,225 (1982).

[173] For additional discussion of the development of the substantial-authority standard in Congress and in the case law, see Merrill Glenn Jones II, Note, Osteen v. Commissioner*: In Search of a Workable Test for Substantial Authority in "All or Nothing" Substantial Understatement Penalty Cases*, 31 WAKE FOREST L. REV. 1185, 1201–07 (1996).

[174] *See* TREASURY STUDY, *supra* note 8, at 108. More specifically, the Treasury Department recommended that, for non-abusive transactions, the standard of taxpayer conduct for non-disclosed positions should continue to be the substantial-authority standard, and the standard of conduct for disclosed positions should be a "realistic possibility of success." *Id.* The realistic-possibility-of-success standard requires at least a one-in-three chance of prevailing on the merits. *Id.* at 103. By contrast, the Staff of the Joint Committee on Taxation recommended that the substantial-authority standard replace the reasonable-basis standard for disclosed positions on non-abusive transactions. *See* JOINT COMMITTEE STUDY, *supra* note 12, at 5, 162–64.

[175] This assumes a fair rate of interest.

though it is likely the wrong answer and even though she believes it is likely the wrong answer.[176]

The literature on the deterrence model argues that the expected penalties under current law are too low; it recommends increasing nominal penalties, increasing the probability of penalty imposition, or both. But, even if the deterrence model accurately accounts for tax compliance, those recommendations are misplaced as long as tax penalties continue to define tax compliance improperly. In the example above, the taxpayer's expected penalties could be increased many times over without changing the result. As long as tax penalties define compliance down to the low standards of reasonable basis and substantial authority, even strikingly high expected penalties will not cause the taxpayer to prefer the correct position over a good-enough-but-wrong position. It is not the low expected penalty that gives the taxpayer the wrong incentive; it is the impunity conferred by the reasonable-basis and substantial-authority standards. Without the proper definition of tax compliance in place, no level of expected penalty will induce a taxpayer to meet the standard of conduct assumed by a self-assessment system.[177]

Consider now the implications of these standards under the norms model. The norms model posits that taxpayers comply with their tax obligations to satisfy social or personal norms, but it does not suggest that such norms lead taxpayers to do more than what the law requires. Under these standards, all that the law requires is that taxpayers have a good-enough-but-wrong legal position in support of their likely inaccurate self-assessments. In fact, the substantial-authority and reasonable-basis standards could be construed as expressions of government indifference toward inaccurate self-assessments that fall within their parameters. The mere existence of the

[176] The same result applies even if she decides to litigate the treatment of the $1,000,000 receipt. In that case, including the $1,000,000 receipt in income has an expected cost of $210,000 (ignoring litigation expenses): she would include the amount on her return, pay the $350,000 tax, and file a refund suit that would have an expected return of $140,000 (forty percent of $350,000). Excluding the $1,000,000 receipt has an expected cost (again, ignoring litigation expenses) of $210,000 discounted by the probability that the government will examine her return, assert that the $1,000,000 constitutes income, and litigate against her. If that probability is twenty-five percent, her expected cost of excluding the receipt is only $52,500. Both these examples assume, of course, that the taxpayer correctly judges the ex ante likelihood of prevailing on the merits. Setting optimal sanctions under the deterrence model becomes significantly more difficult if that assumption does not hold. *See generally* Louis Kaplow, *Optimal Deterrence, Uninformed Individuals, and Acquiring Information about Whether Acts Are Subject to Sanctions*, 6 J.L. Econ. & Org. 93 (1990).

[177] Additionally, the fact that an incorrect legal position backed by substantial authority or a reasonable basis can have greater economic value than the correct legal position encourages the taxpayer to invest resources in identifying such an incorrect position. If the expected tax savings from the inaccurate assessment are sufficient, she can pay for tax advice that provides her with a legal justification for inaccurate assessment and reporting. Viewed from the perspective of the deterrence model, then, the current accuracy penalty produces results that are the opposite of what they should be. Rather than encouraging taxpayers to invest in assessing and reporting their tax liabilities correctly, the substantial-authority and reasonable-basis standards encourage taxpayers to invest in determining the best legal argument for assessing and reporting their tax liabilities incorrectly.

reasonable-basis and substantial-authority standards implies that no taxpayer should be expected to follow the correct answer or even the likely correct answer when the taxpayer identifies legal uncertainty. If the taxpayer has a twenty-percent chance of winning on the merits and is honest enough to disclose the relevant facts of the underlying transaction to the government, she has the satisfaction of knowing that she has done everything asked of her. If she has a forty-percent chance of winning, she need not even disclose anything about the transaction to have that satisfaction. By setting the standards of conduct so low, government signals that it does not expect even honest, diligent, compliance-minded taxpayers to assess their tax liabilities on the basis of anything stronger than a good-enough-but-wrong legal position. There is no reason to think that social or personal norms would set the bar of tax compliance any higher than the government has set it.

The accuracy penalty imposes higher standards of conduct on taxpayers engaging in potentially abusive transactions. For tax shelters and disclosed reportable transactions, the standard is reasonable-cause-and-good-faith; this requires the taxpayer to have both a forty-percent chance of winning and a reasonable belief that she has a greater than fifty-percent chance of winning.[178] The standard requires that the taxpayer believe that her self-assessment is likely correct, and in that respect, it improves on the standards that apply for non-abusive transactions. However, the reasonable-cause-and-good-faith standard still permits the taxpayer to resolve significant levels of legal uncertainty in her own favor. When she reasonably believes that the legal considerations are almost in equipoise—fifty-one percent in her favor and forty-nine percent in the government's favor—the reasonable-cause-and-good-faith standard treats her as complying with her tax obligations.

The policy commitment to a self-assessment tax system—with its de facto presumption that the taxpayer's return is correct—generally requires a higher level of legal certainty when the taxpayer decides to resolve an issue in her own favor.[179] Self-assessment is justified in large part by the significant informational asymmetries between the taxpayer and the government. One of those asymmetries is that it is the taxpayer, not the government, who knows which aspects of her tax return rest on certain positions and which rest on uncertain positions. A standard that allows the taxpayer to allocate to the government the risk of her incorrect assessment in a close case—which

[178] *See supra* Part II.A.2.

[179] For analyses concluding that the more-likely-than-not standard is adequate, *see, e.g.*, Joint Committee Study, *supra* note 12, at 5, 161–62 (recommending more-likely-than-not standard for undisclosed positions); Beale, *supra* note 43, at 593 (arguing that taxpayers and advisors should be subject to a more-likely-than-not standard). A 1989 penalty study by a government task force arrived at odd recommendations on this point. On the one hand, it insisted that taxpayers should report on the basis of positions that were "probably correct." *See* Commissioner's Task Force Report, *supra* note 8, at VIII-13. On the other hand, it defined "probably correct" down to a forty-five percent chance of winning on the merits and effectively equated it with the substantial-authority standard. *See id.* at VIII-39. These jumbled recommendations may have reflected inconsistent views among members of the task force.

is the effect of the reasonable-cause-and-good-faith standard—excuses her from any obligation to narrow the legal uncertainty.

Narrowing that uncertainty, if possible, is important. Although "relatively small" legal uncertainty may lead to undesirable "overcompliance" with taxpayer obligations, "[v]ery broad uncertainty . . . is more likely to lead to undercompliance."[180] It is the taxpayer, not the government, who stands in a better position to eliminate or reduce the range of legal uncertainty in applying the tax law to her circumstances. At a minimum, the taxpayer who takes a position believing that it just satisfies a more-likely-than-not standard should be required to disclose the fact and extent of the underlying legal uncertainty. That way, the government is alerted that the position identified in the taxpayer's disclosure is uncertain, and it can pursue resolution of the uncertainty if it believes the issue is important.

It is important to this point that the law provides the taxpayer with mechanisms for addressing legal uncertainty both before and after filing her return. The taxpayer can obtain advice from a tax practitioner. She also can seek government review of a legal question before filing her return—in fact, before even engaging in a transaction—by requesting a "letter ruling" from the IRS.[181] If granted, the ruling binds the government on the tax issue that it addresses.[182] After filing her return, the taxpayer can pursue an administrative refund claim with the government.[183] If she is dissatisfied with the disposition of her claim, she can undertake refund litigation in federal court.[184] These mechanisms belie the customary objection among tax practitioners that "many situations arise where it is simply not possible . . . to conclude that *any* position is more likely than not correct."[185] In such cases, the appropriate action for the taxpayer is to resolve the doubt in favor of the government—which protects her from the accuracy penalty—and then, if she wants, to pursue resolution of the legal uncertainty after filing her return. Just as it is less costly for the taxpayer, rather than the government, to assess the taxpayer's liabilities in the first place, so too is it less costly for the taxpayer, rather than the government, to identify the positions on her return

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[180] Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. Econ. & Org. 279, 280 (1986); *see also* John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 Va. L. Rev. 965 (1984).

[181] *See* 26 C.F.R. § 601.201(a)(2) (2008); *see also* Beale, *supra* note 43, at 641–42. Some taxpayers purchase third-party insurance for the desired tax effects of their transactions. *See generally* Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 Va. Tax Rev. 339 (2005).

[182] 26 C.F.R. § 601.201(l) (2008).

[183] 26 C.F.R. § 301.6402–03.

[184] I.R.C. § 7422 (2006); *see also* Beale, *supra* note 43, at 638–39 n.209 (arguing that requiring "taxpayers to test aggressive theories in suits for refunds seems appropriate").

[185] Letter from the A.B.A. Section of Taxation to Senator Max Baucus, Chairman, S. Comm. on Fin., and Senator Charles Grassley, Ranking Member, S. Comm. on Fin. 2 (Nov. 15, 2007) (on file with author), *available at* http://ippubs.bna.com/ip/BNA/DER.NSF/c7ab0d5fa31060838525660500534lf4/852564530074ae98852573960017c4ab?OpenDocument [hereinafter Letter from the American Bar Ass'n Section of Taxation] (emphasis added).

that involve substantial legal uncertainty and, when reasonable to do so, to address the uncertainty.[186]

That does not imply, however, that the taxpayer should be strictly liable for the accuracy penalty. Academics have argued for a strict-liability accuracy penalty on the general ground that it would improve deterrence.[187] But strict liability goes too far. The strict-liability standard defines tax compliance as an absolute requirement to assess and report the correct tax liability. It flatly rules any good faith mistake or misinterpretation by the taxpayer out of bounds for tax compliance, and it implies that tax compliance requires the taxpayer either to arrive at the correct outcome on every issue or to resolve all doubts in favor of the government. Even the taxpayer's best efforts to comply will be penalized if it turns out that she has taken the wrong position.[188]

Those outcomes are not consistent with the policy commitment to a self-assessment system. A self-assessment system looks in the first instance to taxpayers to determine their own tax liabilities and to report those liabilities to the government. But taxpayers who must make those determinations under a strict-liability standard will understand that even their best efforts to reach the right results are inadequate. Strict liability undermines the assumption that government can trust taxpayers to assess their own taxes with integrity and that taxpayers can trust government to review those self-assessments with integrity.[189]

A strict-liability standard also undermines the efficiency justification for self-assessment. Although a fault-based standard can be more costly to apply than strict liability insofar as it requires individualized determinations about whether the fault-based standard has been met, strict liability can be more costly overall because the enforcement and collection of penalties itself is costly, and the strict-liability standard implies enforcement and collection for every act of non-compliance.[190] Additionally, strict liability for the accuracy penalty may drive more tax issues into litigation on the underlying

[186] Of course, lower-income taxpayers (to the extent they have positive tax liability) generally should not be required to expend resources to resolve questions of legal uncertainty. Under a better system of tax administration, the government would provide pre-filing assistance to lower-income taxpayers or such taxpayers would be relieved entirely from the obligation to file returns. *See, e.g.*, Michael J. Graetz, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States (2007).

[187] *See, e.g.*, Logue, *supra* note 75; Shaviro, *supra* note 77.

[188] *See, e.g.*, Lawsky, *supra* note 77, at 33, 36.

[189] Even a government task force has expressed concern that a strict-liability standard might undermine the self-assessment system. *See* Commissioner's Task Force Report, *supra* note 8, at VIII-36 ("The Task Force was concerned that regularly penalizing taxpayers . . . would be considered unfair, would destroy the moral and ethical connotations of the penalty, and would ultimately undermine the standard of behavior. Thus, the Task Force rejected a strict liability penalty.").

[190] *See* Polinsky & Shavell, *supra* note 6, at 52, 56, 70. If the government applied a strict-liability standard on a selective basis (that is, imposing liability on some, but not all, taxpayers who satisfy the legal conditions for liability), the government would incur costs of making individualized determinations about when to impose or not to impose liability.

merits, yielding back some of the efficiency gains of having a self-assessment system in the first place. The standard could even cause self-assessment to unravel altogether if taxpayers—who might accept the high costs imposed on them by a requirement to do their best in self-assessing their taxes—reject the much higher costs imposed on them by an absolute requirement that they arrive at the correct tax result, with no margin for error.[191]

2. *The Standard Required for a Self-Assessment System*

The policy commitment to a self-assessment tax system implies a standard of taxpayer conduct more stringent than the three existing fault-based standards but not as unforgiving as the strict-liability standard. The decision to administer the income tax through self-assessment reflects a judgment that taxpayers have superior information about their economic transactions and can determine their tax liabilities at lower cost than the government. It also reflects a judgment that, on the whole, taxpayers can be trusted to assess and report their tax liabilities with minimal reassessment by the government. Both those judgments are undermined by any definition of tax compliance that does not require the taxpayer to make her best efforts to arrive at the correct determination of her tax liability. Accordingly, the accuracy penalty should apply to any understatement of the taxpayer's tax liability attributable to a position that she does not reasonably and in good faith believe to be correct.

Under this standard, the tax return filed by the taxpayer must reflect her reasonable, good faith belief that the tax she has assessed and reported on that return is correct. As part of this obligation, the taxpayer must try to resolve legal uncertainties. In some cases, she will be able to determine in reasonable good faith that she would be correct to resolve the uncertainty in her favor. When she cannot, she should resolve the uncertainty in the government's favor. Alternatively, if she believes in reasonable good faith that the arguments in her favor are more likely than not to prevail, she can resolve the uncertainty in her own favor as long as she discloses and describes the uncertainty on her return. That disclosure would both describe the underlying transaction and the taxpayer's legal analysis of why she believes her claimed tax treatment is more likely than not correct. By discharging those obligations, the taxpayer will file a tax return with the government that represents her best effort to make an accurate self-assessment of her tax liability and to apprise the government of points where the law that bears on her tax liability remains uncertain.

This standard demands more of the taxpayer than the existing fault-based standards. A good-enough-but-wrong position is not adequate. Even a more-likely-than-not position does not protect the taxpayer under this stan-

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[191] This last point was suggested by George Yin.

dard for an undisclosed position. A position that the taxpayer believes is barely likely to win is not necessarily a position that the taxpayer reasonably and in good faith believes to be correct. At the very least, a nearly even chance of prevailing or losing suggests that the taxpayer should undertake further inquiry to determine whether the legal uncertainty can be resolved. If the taxpayer reasonably and in good faith believes that the legal question is very close but tilts in her favor, she demonstrates her good faith by disclosing and describing the legal uncertainty on her return. In that way, she does not pass off a position with a bare likelihood of being right as though it were a position on which there could be no reasonable disagreement.

This penalty standard does not amount to strict liability. The tax law is ambiguous and indeterminate, and tax returns are intricate and often difficult documents. Careful, diligent, and reasonable taxpayers make both factual and legal mistakes in completing their returns, and the government cannot fairly hold them to a standard that penalizes them without regard to their good faith efforts to reach the right answers. By the same token, this standard, in contrast to the existing fault-based standards, is not reducible to a purely probabilistic calculation about winning on the merits. The ultimate inquiry for the government in imposing the accuracy penalty under this standard and for a court in determining whether to uphold the penalty is not the ex ante odds that the taxpayer will win or lose on a position that she reports in her own favor. Rather, the inquiry is whether the taxpayer invests the resources, effort, and integrity assumed by a self-assessment tax system to be appropriate for arriving at her correct tax liability. That inquiry necessarily is both subjective and objective: it must take account of (and make allowances for) the taxpayer's abilities, resources, and sophistication; but it must also hold the taxpayer to an objective standard of reasonableness. A taxpayer with no particular financial sophistication who does not have the resources to consult a tax advisor or seek an advance ruling from the government might reasonably and in good faith mistakenly claim an exclusion or deduction that a sophisticated taxpayer with resources should not. Yet certain exclusions and deductions would lie beyond the boundaries of reasonableness for any taxpayer.[192]

Finally, this standard does not distinguish among transactions by their potential for tax abuse as the existing accuracy penalty does. The labels contrived by current law—such as "tax shelter" and "reportable transaction"—suggest that taxpayers should be held to higher standards of conduct only when they engage in suspect transactions. Instead, a conception of tax compliance thick enough and robust enough for a self-assessment system requires taxpayers to satisfy a higher standard of conduct in all cases. Whether the taxpayer's self-assessment and reporting of her tax liabilities fall short of the standard should be determined by how the taxpayer applies the law to

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[192] *See, e.g.*, INTERNAL REVENUE SERV., THE TRUTH ABOUT FRIVOLOUS TAX ARGUMENTS (2007), *available at* http://www.irs.gov/pub/irs-utl/friv_tax.pdf.

her transaction rather than how the government happens to label it. Of course, the more aggressively a transaction is structured, the more difficult it will be for the taxpayer to establish that she reasonably and in good faith believed a self-assessment in her own favor was correct.[193]

B. Standards of Conduct for Tax Practitioners

The penalties under current law for tax practitioners also provide inappropriate standards of conduct. As outlined in Part II, current law separates tax practitioners into three categories—advisors, return preparers, and promoters—and imposes separate standards of conduct on each. In none of these cases does current law hold practitioners to the standard of conduct appropriate for a tax system organized around the principle of taxpayer self-assessment.

The variation in the current penalty standards for tax practitioners is striking. At one extreme, a promoter can be penalized only if she makes materially "false or fraudulent" statements about the tax benefits of the transaction or product that she promotes.[194] The standard of conduct is simply not to lie. At the other extreme, a practitioner who is a return preparer can be penalized if a position on the taxpayer's return involving a tax shelter or a reportable transaction is not supported by substantial authority and a reasonable belief that the position is more likely than not to prevail.[195] In between these extremes, advisors are subject to the standards of Circular 230, which generally require candor, diligence, and good conduct but do not prohibit the advisor from giving favorable advice on weak legal positions (except in the case of certain transactions having the potential for tax abuse).[196] These standards are inconsistent with the policy commitment to a

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[193] The standard is fault-based, and it requires a subjective inquiry about the taxpayer as well as an objective inquiry about the reasonableness of the taxpayer's beliefs. Those points suggest that the standard will be costly to administer. Certainly, the decision whether to impose the accuracy penalty under this standard and the decision whether to uphold imposition of the penalty will be more costly than they would be for an objective strict-liability standard, even if the total costs attributable to a strict-liability standard are higher—because, for example, it provokes more litigation about the merits of the underlying tax positions. However, it is not clear at all that the administration of the standard suggested in the text would be more costly than the administration of the current accuracy penalty, which requires determinations of the classification of the underlying transaction (for example, whether it is an abusive transaction and, if so, whether it is a tax shelter or a reportable transaction), the ex ante probability of winning (twenty percent, forty percent, or greater than fifty percent), and (in certain cases) the taxpayer's subjective belief about the ex ante probability of winning. Still, as noted above, the details of the penalties under this standard will require refinement under the instrumentalist function.

[194] *See supra* Part II.B.3.

[195] *See supra* Part II.B.2.

[196] *See supra* Part II.B.1. The Circular 230 rules for opinions on potentially abusive transactions have been soundly and thoughtfully criticized. *See* Deborah H. Schenk, *The Circular 230 Amendments: Time to Throw Them Out and Start Over*, 110 Tax Notes 1311 (2006). However, some criticisms are more than a bit overdone. *See, e.g.*, Juan F. Vasquez, Jr. & Jaime Vasquez, *Section 10.35(b)(4)(ii) of Circular 230 Is Invalid (But Just in Case It Is Valid, Please*

self-assessment tax system. In such a system, the penalties for tax practitioners should impose a standard of conduct that dovetails with the standard for taxpayers. Whether they act as advisors, return preparers, or promoters, the role of tax practitioners is ancillary to that of the taxpayer; if the object of the taxpayer's conduct is to assess and report accurately, the object of the practitioner's conduct should be to assist in correct assessments and reporting.[197]

All the practitioner standards under current law fall short of this target. The standard for promoters—that they refrain from lying about the tax benefits of a transaction or product—is remarkably low. The no-lying standard allows a promoter to make statements and representations about the tax consequences of a transaction that, if relied on by the taxpayer in determining her tax liability, would cause the taxpayer to incur the accuracy penalty. That obviously increases self-assessment costs for the taxpayer. In most cases, the promoter understands the transaction better than the taxpayer does, yet the low standard of conduct allows the promoter to provide the taxpayer with useless or simply bad information. This moves the taxpayer's compliance efforts backward: she must expend additional resources to evaluate any legal conclusions asserted by the promoter to determine whether she can reasonably and in good faith treat them as correct.

The existing standards for tax advisors are also misguided. With an overriding duty to make her best efforts at the correct self-assessment of her tax liability, the taxpayer relies on the tax advisor to help her evaluate the strength of various possible legal positions and to resolve or narrow legal uncertainties that bear on those positions. But the current standards for tax advisors generally do not require that the advisor counsel the taxpayer about the standard that applies to the taxpayer's self-assessment and do not require that the advisor indicate whether positions that the taxpayer might take on her return meet that standard. The standard of conduct for advising the taxpayer in writing on a potentially abusive transaction improves on the general standards but still applies to only one aspect of the advisory relationship. To support the taxpayer's own duties in a self-assessment system, the standards should require that, for any advice provided to the taxpayer, the advisor must judge the strength of the taxpayer's possible positions, advise the taxpayer of those conclusions, and indicate how those conclusions compare to the taxpayer's own obligations as defined by the accuracy penalty.

Note that You Cannot Rely on this Article to Avoid the Imposition of Penalties), 7 Hous. Bus. & Tax L.J. 293 (2007).

[197] By contrast, efforts to use tax practitioners as a bulwark against non-compliance by driving a wedge between tax practitioners and taxpayers should be considered with great skepticism. *Compare* David M. Schizer, *Enlisting the Tax Bar*, 59 Tax L. Rev. 331 (2006) (demonstrating deficiencies in such approaches), *with* Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 Yale J. on Reg. 77 (2006) (advocating such approaches), *and* Richard Lavoie, *Deputizing the Gunslingers: Co-Opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 Va. Tax Rev. 43, 73–98 (2001) (same).

The standards for return preparers present the same problem. These standards are the same low standards that apply to the taxpayer: for a non-abusive transaction, the position need only have a twenty-percent chance of winning (if disclosed) or a forty-percent chance of winning (if not disclosed), so a good-enough-but-wrong position is sufficient; for a tax shelter or a reportable transaction, there need only be a forty-percent chance of winning and a reasonable belief of a greater than fifty-percent chance of winning. For the same reasons that these standards are insufficient in the case of the taxpayer,[198] they are insufficient in the case of the return preparer.

In short, the standards of conduct for tax practitioners should support compliance by taxpayers. Whether practitioners sell transactions, provide advice, or prepare returns, they should be held to the same standard that applies to taxpayers. Promoters, advisors, and return preparers should not be legally justified in making statements, rendering opinions, or taking return positions unless the taxpayer herself would be justified in self-assessing and reporting her tax liabilities on the same basis. Any mismatch in standards can only weaken taxpayer compliance. Thus, a promoter should be subject to penalty for making a statement about the tax effects of a transaction or product unless the promoter reasonably and in good faith believes the statement to be correct; an advisor should be subject to penalty for providing a favorable opinion on a legal position unless the advisor reasonably and in good faith believes that position to be correct; and a return preparer should be subject to penalty for any understatement on the taxpayer's return based on a disclosed position that does not meet the more-likely-than-not standard or a non-disclosed position that the return preparer does not reasonably and in good faith believe to be correct.[199]

C. Standards of Conduct for Government Officials

A self-assessment tax system also should impose high standards of conduct on the officials charged with administering the tax law. For government legitimately to require that taxpayers make their best efforts to self-assess and report their tax liabilities accurately, taxpayers must be able to expect reciprocal treatment from government. This implies that government officials should be accountable for improperly challenging substantive positions taken by taxpayers and for improperly asserting penalties against them or against tax practitioners.

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[198] *See supra* Part IV.A.1.

[199] *Cf.* Matthew C. Ames, *Formal Opinion 352: Professional Integrity and the Tax Audit Lottery*, 1 Geo. J. Legal Ethics 411, 429–30 (1987) (arguing that the standard of conduct for tax advisors and return preparers should be one of "substantial[ ] certain[ty]"). Others have suggested lower practitioner standards. *See, e.g.*, Handelman, *supra* note 43, at 103 (proposing, as standard for return preparers, that any non-disclosed position taken on tax return be "supported" by at least one legal "authority"); Jay A. Soled, *Third-Party Civil Tax Penalties and Professional Standards*, 2004 Wis. L. Rev. 1611, 1650–53 (proposing a more-likely-than-not standard for tax practitioners).

The standard set by current law is far too low. Government must pay taxpayer costs when it takes an unjustified position, but the threshold for payment requires the government's position to fall below a twenty-percent chance of winning on the merits.[200] This standard presumably rests on the assumption that the government's re-assessment of the taxpayer's tax liabilities and the government's assertion of accuracy penalties is nothing more than a litigating position. Thus, all the government needs is a good-enough-but-wrong legal position to avoid sanction. Again, the litigation analogy is misplaced. The government's re-assessment of the taxpayer's liabilities mirrors in point and purpose the taxpayer's self-assessment of her own liabilities. The objective in both cases is to determine the taxpayer's correct tax liability; that objective must control the conduct of government officials in any assertion of taxpayer or tax practitioner liability made during audit or in litigation.[201]

The re-assessment of the taxpayer's liabilities made by the government is certain to be salient to the taxpayer; it effectively occupies the same posture vis à vis the taxpayer that a disclosed position on the taxpayer's return occupies vis à vis the government. Therefore, the standard that should apply to re-assessment by the government is the same more-likely-than-not standard that should apply to the taxpayer when the taxpayer makes disclosure on her return.[202] In other words, a government official should be subject to sanctions when she asserts tax or penalty liability against a taxpayer or a tax practitioner based on a position that the government official does not reasonably and in good faith believe to have a greater than fifty-percent chance of prevailing on the merits.

That said, sanctions on government officials present particular operational problems. Even if such penalties properly define the standards of conduct for government officials, they may fail on the instrumental function. As Daryl Levinson has argued, government likely does not internalize costs in the same way that private individuals and organizations do.[203] This aspect of penalty reform requires attention: imposing a standard of conduct on government officials that tracks the standards properly imposed on taxpayers and tax practitioners is important, but applying a sanction mechanism that will give government officials the proper incentives to conform their conduct to that standard is much more difficult. In particular, the sanction mechanism must be seen by taxpayers and tax practitioners as credible and effective so that compliance with their own high standard of conduct does not unravel.

It may be that, as the Staff of the Joint Committee on Taxation has recommended, detailed publication by the government about how often it

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[200] *See supra* Part II.C.

[201] *Cf.* Joint Committee Study, *supra* note 12, at 169 (recommending that standards of conduct for government officials be "similar" to standards of conduct for tax practitioners).

[202] *See supra* Part IV.A.2.

[203] Daryl Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. Chi. L. Rev. 345, 345 (2000).

must make payments of costs to taxpayers and how large those payments are would facilitate congressional oversight of the conduct of government officials.[204] But just as individual officials seem unlikely to internalize the effect of paying the taxpayer's costs out of the fisc, so too they seem unlikely to internalize the effects of possible adverse publicity and increased legislative scrutiny resulting from publication of those payments. To be meaningful—and to be understood by taxpayers and tax practitioners as meaningful—sanctions against government officials for failing to meet the standards of conduct required of them must affect the tenure and promotion of those officials. If government officials know that non-compliance with the applicable standards of conduct will adversely affect their prospects for remaining in government service and advancing to positions of higher responsibility and better compensation, they are considerably more likely to take those standards seriously in their dealings with taxpayers and tax practitioners.[205] Still, the potential for over-deterring government officials would need to be considered carefully; making government officials too cautious about challenging taxpayer self-assessments might cause tax administration to unravel from the other side.

V. Conclusion

This Article has examined the relationship between tax penalties and tax compliance. The legal and economics literatures conventionally assume that the relationship is purely instrumental: the function of tax penalties is solely to support tax compliance. On this understanding of the relationship, the robust tax compliance observed in the United States presents a deep and persistent puzzle. The deterrence model, which assumes that taxpayers are amoral, rational actors, cannot match the weak expected penalties of current law to the high levels of taxpayer compliance. The norms model, which supplements the deterrence story by appealing to social and personal tax-compliance norms, does little more than posit a black box of taxpayer motivations. Still, these two models no doubt account for an appreciable level of taxpayer compliance, even if they do not account for all of it. There is good reason, then, to take note of the deficiencies that these models identify in the existing penalty structures.

This Article has identified and examined another aspect of the relationship between tax penalties and tax compliance—one that generally has been overlooked by the existing literature. Tax penalties not only support tax compliance, they also define it. Tax penalties determine the standards of conduct that the law imposes on taxpayers; they distinguish compliant taxpayers from non-compliant taxpayers. Importantly, the idea of tax compliance in a

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[204] *See* Joint Committee Study, *supra* note 12, at 171.

[205] It seems that such a system of sanctions could be administered more effectively by an inspector general than by the IRS itself.

self-assessment system can consist only in the taxpayer making her best efforts to assess and report her correct tax liabilities. The policy commitment to a self-assessment tax system assumes that taxpayers can and should be trusted to make correct assessments and reports to the government; otherwise, the efficiency and political justifications for having a self-assessment system crumble. But the penalties provided under current law generally set much lower standards of conduct. In the case of non-abusive transactions, current law only requires that the taxpayer base her self-assessment on a good-enough-but-wrong legal position. Even for most abusive transactions, the taxpayer only needs a reasonable belief that her position is more likely than not to prevail.

Both the definitional and the instrumental functions of tax penalties unambiguously imply that existing penalties should be reformed. Because the definitional function is the more basic of the two, it must be the first consideration. Properly defining tax compliance for a self-assessment system requires that taxpayers be held to a standard of assessing and reporting their liabilities only on the basis of legal positions that they reasonably and in good faith believe to be correct. This high standard demands that taxpayers fulfill their obligations with the overriding objective of accuracy. It specifically rejects the treatment of the tax return as a litigating document, yet it also rejects the unforgiving standard of strict liability for taxpayer error. Positions disclosed by taxpayers on their returns should at least satisfy the more-likely-than-not standard.

Additionally, the standard of conduct for tax practitioners should reflect the standard of conduct for taxpayers. Whether they serve as advisors, return preparers, or promoters of transactions, the conduct of practitioners should support the taxpayer's compliance with her obligation to assess and report correctly. Similarly, government officials who review and reassess a taxpayer's self-assessment should be required to act under the same standard that applies to taxpayers for disclosed positions. Because current law fails to impose these standards of conduct, reform is needed for the standards applicable both to tax practitioners and to government officials (although, as noted, the instrumental implications of reform to the standards for government officials require particular attention).

The penalty reform considerations presented by the deterrence and norms models of tax compliance remain important. A system of tax penalties that properly defines tax compliance but that does not effectively promote that compliance will have largely symbolic value. On the other hand, a system of tax penalties that effectively promotes taxpayer conduct not measuring up to the proper idea of tax compliance is pointless. Both aspects of tax penalty reform are necessary, and responsible reform ultimately must account for both the definitional and instrumental functions. Between the two, however, the definitional function is logically and practically the initial step; reforming penalties to define the proper idea of tax compliance should be the first, but not the last, concern of legislative action.