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When the Law Is Uncertain

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Introduction

This Article examines the optimal level of tax compliance and the optimal penalty for noncompliance in circumstances in which the tax law is substantively uncertain – that is, when the precise application of the Internal Revenue Code to a particular situation is not clear. In such situations, two interesting questions arise: First, as a normative matter, how certain should a taxpayer be before she relies on a particular interpretation of a substantively uncertain tax rule? That is, if a particular position is not clearly prohibited, but neither is it clearly allowed, under the tax law, what is the appropriate threshold of confidence that the taxpayer ought to have before engaging in the transaction? Second, what penalty regime would give the taxpayer the right incentive with respect to relying on substantively uncertain tax law?

To address this and related questions, the Article makes use of the following hypothetical: Joe Taxpayer (who can be thought of either as an individual investor, a business-owner, or a manager of a corporation) is trying to decide whether to invest, or

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[acknowledgments]

have his company invest, in a particular business transaction. In making this decision, Joe takes into account an array of issues, all of which boil down to one obvious question – how much money will the transaction make net of costs. As part of this analysis, Joe considers the legal consequences of the investment, including the likelihood that the investment might lead to some sort of civil litigation or government enforcement action. Joe evaluates these legal risks and then he weighs them against the expected benefits of the deal. Among the legal risks he contemplates are the possible tax consequences of the transaction.

Now I want to focus the analysis on the tax-planning question. Assume that from Joe's perspective (or that of his company) the investment is worth making *only* if it qualifies for a particular tax treatment. That is, assume the deal makes sense – its overall expected benefits exceed the overall expected costs – only if it qualifies as a “nontaxable transaction” or, alternatively, only if it generates a special tax loss or tax credit that can be used to offset taxes on other income. Thus, the after-tax profitability of the deal turns on the answer to the tax question. Now the problem: Joe's expert tax advisor tells him that, although the special tax treatment he seeks for the transaction is not clearly forbidden under the existing tax laws, neither is it clearly legal. In other words, the law in question, at least as applied to Joe's particular transaction, is uncertain. What should Joe do? What incentive does society want Joe to have in this situation? Put differently, given this reality that the tax law is often uncertain (in terms of how it will be applied *ex post* by the IRS or courts to particular transactions), what is the optimal degree of tax compliance and what is the optimal tax penalty regime?

As it turns out, the answers depend on a number of factors. To see this point, let's first simplify the analysis further by assuming that the only thing Joe cares about, with respect to tax planning anyway, is the expected value of the sum of the possible back taxes (plus interest) and the potential penalty. Joe, in other words, is a rational actor in the traditional economic sense of the term, a true *homo economicus*. Or put more pejoratively, Joe is Holmes's quintessential "bad man."¹ Assume further that, not only is Joe without a conscience, but he faces no informal external sanctions either, such as social norms against tax noncompliance. Either his friends, neighbors, co-workers, and fellow corporate managers are utterly indifferent to Joe's reputation for paying his taxes, or he is indifferent to their opinions. Given all of these simplifying assumptions, Joe's decision whether to engage in the particular transaction in question, and whether to report the transaction on his tax returns in the desired manner, will depend on his ex ante assessment of (a) the probability that the particular tax position in question will be discovered and scrutinized by the IRS, (b) the probability that, if detected, the position would be rejected by the IRS and ultimately a court, and (c) the size of the penalty in the event of both detection and rejection.² Obviously, Joe would not be able to estimate these variables with great precision, but presumably he would give it his best shot, or pay some tax advisor do so. And it seems sensible to assume that Joe would invest in additional information up to the point at which the marginal cost of the additional information equaled the marginal benefit. Again, assuming there is some residual uncertainty even after these investments in information are made, then the question

¹ Oliver Wendall Holmes, Jr., *The Path of the Law*, 10 Harv. L. Rev. 457 (1897) ("If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience.").

² Later in the Article, I relax some of these assumptions and explore the implications for my analysis.

whether the deal is profitable to Joe will depend on this evaluation of uncertain tax law and uncertain tax law enforcement.

That's Joe's perspective. What about society's perspective? What does society want Joe to do when the substantive content of the law can only be estimated?³ Start with the two obvious and extreme positions. First, one could hold the view that Joe should go through with the transaction in question *only if* the tax position that makes the deal attractive – the tax-deferral or the special tax loss or special tax credit or whatever – is *certain* to be upheld by the IRS and the courts. That is, he should adopt the particular interpretation only if he is certain that Congress intended for the preference to apply to the particular type of transaction that he is considering and to the particular class of taxpayers of which he is a member. Alternatively, one could hold the view that, so long as the tax position in question is not clearly and indisputably forbidden by the Internal Revenue Code, the taxpayer should feel free to go for it even if extraneous evidence, or common sense, makes clear that Congress did not have the taxpayer (or his type of transaction) in mind for this particular tax benefit. Obviously, neither of these extreme positions is the right answer. Rather, the right approach will depend on the circumstances. Indeed, this Article contends that, when the substantive tax rules are uncertain of meaning (as applied to a taxpayer's particular situation), the taxpayer should

³ There is an inherent difficulty in specifying what the "right thing to do" is in this context. That is, whether one has a consequentialist or deontological conception of ethical behavior, identifying the proper course of conduct when the substantive law is uncertain is problematic. In general, we might be able to agree that a taxpayer who is operating under conditions of substantive legal uncertainty ought to (and/or should be induced by the law to) take tax positions that are in some sense reasonable – that represent neither abuse of the system nor charity to the government. But specifying what this concept of reasonableness entails is not a simple task, and is beyond the scope of this Article, although I will a bit more about this question as I go along. It will come as no surprise that the analysis in this Article is largely consequentialist in orientation, and as such it conflates the ethical question (i.e., what ought the taxpayer to do, even if she could be certain of going undetected) and the law enforcement question (i.e., what incentives ought the law create with respect to taxpayer behavior).

(and inevitably will) make his decision based on his, or his legal expert's, probabilistic assessment of what the law actually is – or what a court will say that it is. I argue further that the formal penalties for tax underpayment should incorporate and enforce this concept of probabilistic compliance. Interestingly, as the discussion below explains, the existing tax penalties to some extent already take this approach.

Applying the traditional framework of deterrence theory, which I borrow from the tax policy and law-and-economics literatures, the Article reaches a number of novel conclusions regarding optimal level of tax compliance and the optimal tax-compliance penalties when the substantive tax law is uncertain.

One: The optimal level of legal certitude that a taxpayer should have before claiming a substantively uncertain tax benefit will, under a number of assumptions to be specified below, depend on (a) the amount of tax benefit at stake in the particular investment, (b) the size of the potential pre-tax profit from the investment, and (c) the taxpayer's attitude towards risk.

Two: If we assume there is no "detection uncertainty" (that is, if we assume that any legal violation will be detected with certainty), a simple rule of strict liability for back-taxes plus interest with no additional, punitive penalty produces optimal ex ante tax compliance incentives.

Three: If we assume (a) that there is *some* detection uncertainty (that is, a positive-but-less-than-one probability of detection), (b) that there is no upper limit on the amount of the potential ex post penalty that can be imposed on taxpayers who underpay, and (c) that the ex post law-enforcer, either the IRS or court, can accurately determine the ex ante probability of detection for the particular activity in question, then a strict liability rule with a punitive "kicker" achieves optimal ex ante tax-compliance incentives when there is substantive legal uncertainty.

Four: If we assume that taxpayers are risk averse, some form of tax insurance could be used to convert the risk of a large ex post tax liability to a certain payment of the taxpayer's expected tax liability.

Given these conclusions, another interesting question arises. Under what circumstances might a fault-based tax penalty regime be a superior, or least a plausible, alternative to a strict liability regime? What exactly should the fault-standard look like?

How would it be applied by the ex post adjudicator, whether that role is filled by the IRS or a court? What makes these questions especially interesting is that the current tax penalty system in the U.S. for the federal income taxes is a fault-based regime and not a strict liability regime. That is, although the Internal Revenue Code obviously applies a strict liability standard for the underpaid taxes and interest (i.e., the taxpayer owes whatever the courts determine the Code says she owes), but tax *penalties* under the Code are determined on the basis of a fault-based standard. Under current rules, taxpayers can avoid penalties if they can show that they have met what amounts to a reasonableness standard. With respect to the fault-based approach to income tax penalties, the Article reaches the following conclusions:

One: If we maintain all of the traditional assumptions of classical economic analysis, and we assume that there is no upper limit on the size of potential ex post fines for tax avoidance, a fault-based tax penalty is inferior to a strict liability approach, for three reasons: 1) the fault-based regime is more difficult to administer; 2) it encourages taxpayers to over-invest, or invest too often, in legally uncertain tax positions; and 3) the fault-based regime fails to achieve the same degree of rough distributive justice that the strict-liability approach does (with tax insurance).

Two: If, however, we relax some of the traditional economic assumptions (e.g., perfect rationality and the absence of informal social sanctions), and if we assume that there are upper limits on the amount of tax penalties that society can reasonably impose, a case can be made for using a fault-based tax penalty regime not entirely different from the one that is currently in force.

Part I of the Article explains the primary sources of uncertainty in the income tax laws. Part II operationalizes the concept of substantive tax law uncertainty by adopting a probabilistic understanding of substantive law and by describing what I call the “tax compliance continuum.” Part III adopts the assumption of “detection certainty” (i.e., that every tax position gets scrutinized by the IRS) and demonstrates the deterrence benefits of a strict liability tax penalty regime, especially in terms of its ability to induce taxpayers to behave optimally with respect to ex ante legal uncertainty. Part IV introduces the

problem of “detection uncertainty” (known in the tax context colloquially as the “audit lottery”) and shows how, under certain assumptions, the classic Bentham-Becker punitive penalty can induce taxpayers to internalize the expected tax liability associated with substantively uncertain tax positions. Part V explores the role that tax transaction liability insurance, whether privately or publicly provided, could play in such a strict liability tax-penalty regime with a punitive Bentham-Becker penalty. Part VI explains (a) why, under traditional deterrence assumptions and assuming a fully deterring Bentham-Becker penalty, a fault-based tax-penalty regime is inferior to a strict liability regime but (b) why, assuming the Bentham-Becker penalty is unrealistic, a fault-based regime might be second-best optimal.

I. Sources of Tax Law Uncertainty

Before the analysis can get under way, an initial question is why there is substantive tax law uncertainty in the first place. Those with only a passing familiarity with the U.S. tax laws might question the plausibility of the claim that the tax law is rife with uncertainty. After all, the U.S. federal income tax system is among the most detailed and comprehensive legal regimes in the world. Given the thousands of pages of Internal Revenue Code and umpteen-thousands of pages of Treasury Regulations,⁴ the non-expert might be tempted to conclude that precise tax treatment of every conceivable transaction should be gleanable from the existing tax laws, so long as one has the time to read and the expertise to understand the Code or has the resources to hire someone else to do it. Everyone realizes, of course, that the Code is inscrutable to the common man, but surely the tax cognoscenti, whose opinions can be gotten for a price, can find the answers

⁴ The full text of Title 26 of the United States Code is 3,387 pages long. According to the US Government Printing Office, there are 13,458 pages of federal regulations devoted to interpreting that tax laws. <http://www.trygve.com/taxcode.html>

in all of those pages. For two general reasons, however, there is, and likely will always be, considerable uncertainty in the tax laws. The first has to do with the complexity of the laws. The second has to do with unintended gaps or loopholes in the law.

By most accounts, the U.S. federal income tax is *the* paradigmatic system of rules rather than standards.⁵ A taxpayer's tax liability is determined by applying a precise rate schedule to a particular number, which is that taxpayer's taxable income. Sounds simple enough. However, as already mentioned, the number of words in the Internal Revenue Code that must be consulted to determine one's income tax liability is staggering. And the level of specificity and hence the complexity with which the Code defines terms and explains procedures is legendary. Some of this complexity results from Congress's habitual attempts to enact social policy into the tax code, whether it be to subsidize a particular form of investment (such as research and development) or a particular class of taxpayers (such as families or the poor). Another source of complexity is the attempts by Congress and the Treasury Department to close unintended loopholes in the tax laws, discovered further below. Whatever the source, the complexity of the tax rules is a primary source of substantive legal uncertainty. This sort of uncertainty is the primary

⁵ David A. Weisbach, *Formalism in the Tax Law*, 66 U. Chi. L. Rev. 860, 860 (1999) ("The tax law is the paradigmatic system of rules."). According to conventional legal theory, the distinction between rules and standards turns on the degree of ex ante versus ex post specification of the content of the legal norm in question. That is, a rule in this taxonomy is a legal norm whose application to particular situations is precisely and thoroughly specified in advance of the occurrence of the regulated activity in question. With a rule, then, the role of the ex post adjudicator, the agency or court or whoever, is merely to determine what the facts are and which rule is applicable. By contrast, a standard leaves the contents of the legal norm vague such that the ex post adjudicator has greater flexibility, and greater responsibility, in deciding what the precise content of the legal norm is and how to apply it to particular situations after they arise. According to the rules-standards literature, a rule makes sense when (a) the precise application of the legal norm to particular situations is relatively easy to define or identify in advance and (b) when the rule is expected to be applied with great frequency. By contrast, a standard may be preferred when an ex ante determination of the optimal conduct is relatively difficult and when the norm in question will be applied by the ex post adjudicator relatively infrequently. Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L.J. 557, 562 (1992).

reason that so many individual taxpayers either have their returns prepared by professionals or rely on computer programs such as TurboTax for assistance. Every year, as the tax code increases in length and complexity, more taxpayers find it useful to seek expert help to reduce the uncertainty associated with filing their returns.⁶ And complexity-induced uncertainty is a problem that plagues not only unsophisticated individuals but also wealthy individuals and large corporations, who can afford expert legal advice.

A second source of substantive legal uncertainty in the tax law is somewhat less familiar to non-experts, although it is well known among tax lawyers and accountants, and even beginning tax students. Although there are obvious reasons to have numerous detailed tax rules (for example, to set out clearly the tax treatment of the most frequent types of transactions), there is simply no way for Congress or the Treasury Department to anticipate every contingency and provide in advance the precise tax treatment of every conceivable transaction or investment.⁷ The world is just too complex. And even if it were conceivable to “fully specify” the tax code in this extreme sense, doing so would be unreasonable. At some point the increased degree of ex ante precision in the law is outweighed by the cost of figuring out such details in advance and by the loss of flexibility that accompanies ex ante rulemaking. This is the source of the unintended loopholes mentioned above.⁸

⁶ Eric Toder, *Changes In Tax Preparation Methods, 1993-2003*, Tax Notes, May 9, 2005.

⁷ Richard Posner, *Statutory Interpretation*, 50 U. Chi. L. Rev. 800, 811 (1983) (“The basic reason why statutes are so ambiguous in application is not that they are poorly drafted – though many are – and not that the legislators failed to agree on just what they wanted to accomplish in the statute – though often they do fail – but that a statute is necessarily drafted in advance of, and with imperfect appreciation of the problems that will be encountered in, its application.”), citing Edward Levi, *An Introduction to Legal Reasoning* 30-31 (1949).

⁸ An intentional loophole is different. Although for some that term might be oxymoronic (that is, some consider the term loophole to entail a lack of intentionality on the part of the lawmaker), it is also possible

What makes the unintended-loophole problem worse is that taxpayers, at least those who have access to sophisticated legal advice, have a strong incentive to find (some would say, to create where none exists) these loopholes and exploit them to their advantage. And once a loophole is found to work for one taxpayer, there is a natural tendency for others to use it as well. Thus, what starts as a small gap in the tax laws can under the right conditions become a yawning chasm, and the ultimate result can be both inefficiency (because taxpayers alter their investment decisions in the effort to minimize their taxes) and mal-distribution of resources (because the ability to exploit tax loopholes is not evenly or otherwise fairly distributed across taxpayers).⁹ When this process of unintended-loophole discovery and exploitation occurs, it is a virtual necessity that the IRS and the courts be empowered to apply some general anti-abuse “gap filler,” some statutory interpretive standard (in the rules-standards sense of standard) that limits these opportunities. Examples of these anti-avoidance standards in tax law would be the economic substance and sham transaction doctrines. The use of such anti-avoidance standards, however, comes at a cost to the system. That is, the use of ex post anti-avoidance standards increases ex ante substantive legal uncertainty, as taxpayers cannot know for sure in advance where the Service or a court will draw the economic substance or sham transaction line after the fact – just as a driver cannot know for certain where the negligent-driver line will be drawn. But again, the uncertainty created by the existence of anti-avoidance doctrines is in general a good thing, when compared with the alternative of allowing taxpayers to exploit all unintended loopholes with absolute impunity.

to conceive of an intended tax loophole. Thus, it is common to hear people use the term loophole in this way to describe provisions in the tax laws designed to subsidize certain activities.

⁹ Weisbach, *supra* note ___, at 868.

One conclusion that follows from the preceding discussion is that some level of substantive tax-law uncertainty is inevitable. Which is not to say, of course, that Congress and Treasury have no control over the amount, degree, or type of legal uncertainty that exists. Obviously they do. They can invest more or less time in specifying the rules in advance, more or less effort in avoiding unnecessary and confusing complexity. Indeed, there is a large political science literature that explores the question why and under what circumstances legislatures would *intentionally* write vague or ambiguous statutes, whether it be a desire to shift the responsibility of unpopular decisions to enforcement agencies or to courts¹⁰ or the inability to reach a stable legislative consensus on legislative language.¹¹ Moreover, in the tax context in particular, it is possible to conceive of Congress, perhaps with the cooperation of the Treasury Department, actually using the level of legal uncertainty as another tool in their tax enforcement toolbox. That is, if taxpayers are thought to be risk averse, it is not difficult to imagine how strategically increasing tax-law uncertainty, and hence the variance of possible tax outcomes, in some contexts could serve the same function as increasing noncompliance penalties directly.¹² Having said all of that, however, in this Article I focus on legal uncertainty that is unavoidable by lawmakers. Therefore, for most of the Article, I assume that the choice of the appropriate tax penalty and tax

¹⁰ Mark A. Graber, *The Nonmajoritarian Difficulty: Legislative Deference to the Judiciary*, 7 *STUD. AM. POL. DEV.* 35 (1993); Ran Hirschl, *The Political Origins of Judicial Empowerment Through Constitutionalization: Lessons from Four Constitutional Revolutions*, 25 *LAW & SOC. INQUIRY* 91, 104 (2000); and Eli M. Salzberger, *A Positive Analysis of the Doctrine of Separation of Powers, or: Why Do We Have an Independent Judiciary?*, 13 *INT'L REV. L. & ECON.* 349, 361–66 (1993); Peter H. Aranson et al., *A Theory of Legislative Delegation*, 68 *CORNELL L. REV.* 1, 56–62 (1982); and Morris P. Fiorina, *Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?*, 39 *PUB. CHOICE* 33, 46–52 (1982).

¹¹ See, e.g., David B. Spence, *A Public Choice Progressivism, Continued*, 87 *CORNELL L. REV.* 397, 432 (2002).

¹² This possibility was formally demonstrated in Suzanne Scotchmer & Joel Slemrod, *Randomness in Tax Enforcement*, 38 *J. Pub. Econ.* 17 (1989).

liability rule should ignore the effects of the penalty and rule on Congress's decision to increase or decrease the certainty of the laws.

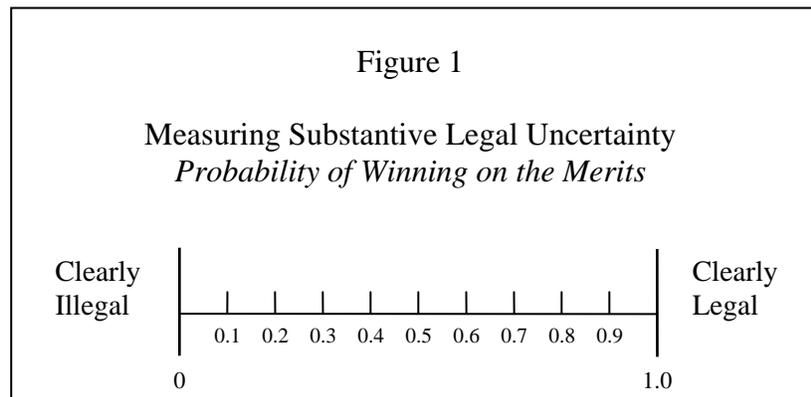
II. A Conception of Uncertain (or Probabilistic) Tax Law: the Tax Compliance Continuum

The next step in the analysis is to provide some functional content to the idea of substantive legal uncertainty. Uncertainty itself is a vague term. Thus, what I mean by legal uncertainty is itself unclear. It could mean this: the law is so vague that I haven't a clue what it purports to prohibit or allow. Beats the heck out of me. Furthermore, the law is so uncertain that I cannot even begin to predict how a court would interpret it, at least not as applied to the facts of my case. Some laws may elicit such an extreme reaction. The analysis of this Article, however, will not provide much help in addressing that sort of profound legal uncertainty. Rather, it will focus on situations in which the law is uncertain, but educated guesses can be made about what the law means and how it will be applied to a given situation.

One way to operationalize this idea is to array the possible range of tax positions (or interpretations of the tax laws) along a continuum according to their probability of success on the merits assuming they are reviewed by a court – that is, assuming the position will be reviewed by a court and the uncertainty will be resolved.¹³ On one extreme end of this continuum lie tax positions that are indisputably *illegal*. The probability that the IRS and a court would uphold such positions if asked to do so is zero. Taking such a position on one's tax return would accurately be characterized as outright

¹³ Thus, one way of resolving the problem of substantive legal uncertainty is to engage in what Michael Abramowicz calls "predictive decisionmaking." Michael Abramowicz, *Predictive Decisionmaking*, 90 Va. L. Rev. 69 (2006).

tax evasion. Indeed, I think that's what people usually mean when they say tax evasion. On the other end of the continuum are tax positions that are clearly legal, in the sense that the probability that the IRS and the courts would sustain them on the merits (if presented with the question) is equal to one. In between these two extreme points are an infinite number of possible tax positions with varying ex ante probabilities of success on the merits. Figure 1 captures the idea of this tax compliance continuum.



What is useful about this continuum is that not only do the two endpoints illustrate the most extreme positions, but the continuum allows a whole range of tax positions to be graded on the basis of their relative “aggressiveness” according to their relative position on the continuum. Thus, as we move from right to left along the continuum in Figure 1, the various tax positions represented by the continuum are becoming increasingly aggressive, in the sense that their probability of being rejected on the merits by court if detected increases.¹⁴

It is easy to conceive of tax positions that would fall on either end of this continuum. On the clearly illegal side are those taxpayers who simply decline to report cash income or intentionally take deductions for expenses that were never incurred.

¹⁴ It is possible that substantive legal uncertainty in many areas of law might usefully be understood in terms of this legal uncertainty continuum. In this Article, I focus exclusively on substantive uncertainty in the tax laws.

Everyone would agree that such behavior constitutes obvious illegal tax evasion.

Obvious tax evasion might also include simply hiding income in illegal foreign accounts. Given the zero or near-zero probability that such positions would be upheld on the merits if detected, the only motivation for taking them is the hope of going undetected. On the other end of the spectrum, there are many tax positions that are clearly legal: a simple business expense deduction or the exclusion of an item this is clearly a gift. There is little dispute that the tax treatment of many transactions is clear and that the answer to many particular tax questions can be known with a high degree of certainty.

What is more interesting, and what I focus on here, are the many tax positions that fall between zero and one in terms of probability of success on the merits. As any tax practitioner or any student in the introductory federal income tax class can tell you, that is the area on the continuum where almost all of the interesting tax questions fall. That is where the action is, whether the issue is corporate, partnership, or individual income taxation. In fact, a reasonable case can be made that the vast majority of the tax issues that end up being decided by a court had, at the time the transaction was planned and carried out, a positive-but-less-than-one probability of success on the merits. Even the most infamous tax-shelter cases, the largely extinct 1970s real-estate-limited-partnership kind as well as the more recent corporate-shelter variety, would doubtless fall somewhere to the right of “clearly illegal” on the continuum. Of course, for most tax-shelter transactions, there would be disagreement about exactly where on the continuum the various shelter transactions fall. But for almost all of them, one could at least imagine using something like the continuum above to assess the relative aggressiveness of the taxpayers’ positions.

Conceiving of the tax compliance decision in such probabilistic, predictive terms will often not comport with reality. Although we may be accustomed to viewing some taxpayers as quintessential rational actors (I have in mind those taxpayers who spend a great deal of time and money to find loopholes in the law), it is quite a different matter to imagine the average individual taxpayer making a probabilistic calculation to determine what the substantive tax law in fact is. And hence this analysis may not apply to the average taxpayer filing out his or her 1040EZ. However, at least for sophisticated taxpayers, by which again I mean taxpayers with sufficient resources and incentives to hire expert legal advisors, such probabilistic estimates are a part of the game.¹⁵ In fact, the tax code and regulations make the application of tax penalties for noncompliance *depend* on such probabilistic predictive assessments. In that sense, the existing tax penalty structure already incorporates something like the tax compliance continuum described above. That is to say, if the Service and the courts determine after the fact that a particular position taken by a taxpayer is wrong — and thus that the taxpayer owes additional taxes — then, the determination of whether the taxpayer must pay additional penalties depends on the Service’s (and, if the case winds up in court, the court’s) ex post assessment of the taxpayer’s ex ante probability of success on the merits.

To get a sense of what this probabilistic predictive analysis of the meaning of an uncertain legal rule might look like, consider an example of a current tax compliance penalty provision. Under existing law, if a taxpayer understates her tax liability (that is,

¹⁵ I do not mean to suggest that there is a large class of taxpayers who are constantly doing probability calculations to determine what the law is with regard to every tax provision. However, with respect to the tax law provisions (a) that are uncertain in application and (b) that can have a significant effect on tax liabilities, many sophisticated taxpayers in fact do such probabilistic calculations — assessing what the Service and a court will likely say the law is — either explicitly or implicitly. And this sort of rational cost-benefit calculation with respect to uncertain tax provisions may be very widespread, insofar as even many individual taxpayers rely on professional tax return preparers, who are presumably incentivized to consider the probabilities of various legal outcomes.

the IRS and courts determine that she took a tax position that was impermissible), she will generally have to pay, in addition to the back taxes and interest, a penalty of 20 percent of the understated tax *unless* she can persuade the IRS or a court ex post that the position in question ex ante had approximately a 40 percent chance or better of prevailing on the merits assuming the issue were reviewed by a court. Such uncertain legal positions are said to have “substantial authority.”¹⁶ Thus, the current taxpayer penalty regime for tax underpayments incorporates a version of the sort of probabilistic predictive assessment that I describe above; and implicit in the whole analysis is the assumption that the substantive tax law itself is uncertain. This definition of substantial authority is not the only example probabilistically assessed tax penalties. Tax penalties can also be avoided if the taxpayer can show that (a) the tax position at issue was disclosed to the IRS, and (b) the position had a “reasonable basis” in the law, and reasonable basis here is understood to mean roughly a 20 percent chance of prevailing on the merits (again, assuming detection). Thus, if you bring your uncertain tax position to the IRS’s

¹⁶ More precisely, the 20 percent substantial understatement penalty will be assessed unless the taxpayer can demonstrate ex post that she ex ante had “substantial authority” for the position. I.R.C. § 6662(d)(2)(B). The official meaning of “substantial authority” found in the Treasury Regulations is maddeningly circular. Treas. Reg. § 1.6662-4(d)(2) (“There is substantial authority for the tax treatment of an item only if the weight of authority supporting such treatment is substantial with respect to the weight of authority supporting contrary treatment.”) The concept of substantial authority is further defined, however, with reference to where it falls on something like the tax compliance continuum in the text above. Thus, substantial authority is understood as an objective test that is “less stringent than the ‘more likely than not’ standard (which is met if there is a greater than 50 percent likelihood that the position will be upheld) and more stringent than the ‘reasonable basis’ standard.”” *Id.* These latter two standards are discussed further in the text immediately below. The actual 40 percent figure is found nowhere in the Code or regulations but often gets tossed around by practitioners and commentators as rough statistical approximation of the idea. See, e.g., Comparison of Joint Committee Staff and Treasury Recommendations Relating to Penalty and Interest Provisions of the Internal Revenue Code, JCX 79-99 (Nov. 15, 1999), p.13, available online at <http://www.house.gov/jct/x-79-99.pdf>.

attention, you are allowed to be somewhat more aggressive, in the sense of taking a position that is a little further to the left on the tax compliance continuum.¹⁷

And there are other examples of the probabilistic reasoning of this sort in the area of tax enforcement. For certain categories of transactions that the IRS has reason to believe are of questionable legitimacy, because of the nature of the transactions or because of the IRS's experience with similar transactions in the past, special rules apply. For example, these transactions must be reported to the IRS; hence the term "reportable" transactions.¹⁸ In addition, to avoid underpayment penalties for such transactions, the taxpayer must be able to show not only that the tax position in question in fact had substantial authority (as defined above) but also that the taxpayer herself reasonably believed the position was "more likely than not" correct. That is, she must have reasonably had the view that the position, in effect, would fall to the right of the mid-point on the tax compliance continuum of Figure 1.¹⁹ As if all these probabilistic standards were not enough, there are also the rules governing tax-preparer penalties. Thus, a tax preparer herself can be penalized for signing a return, or endorsing a tax position, that does not have at least a "realistic possibility of success" standard, which is

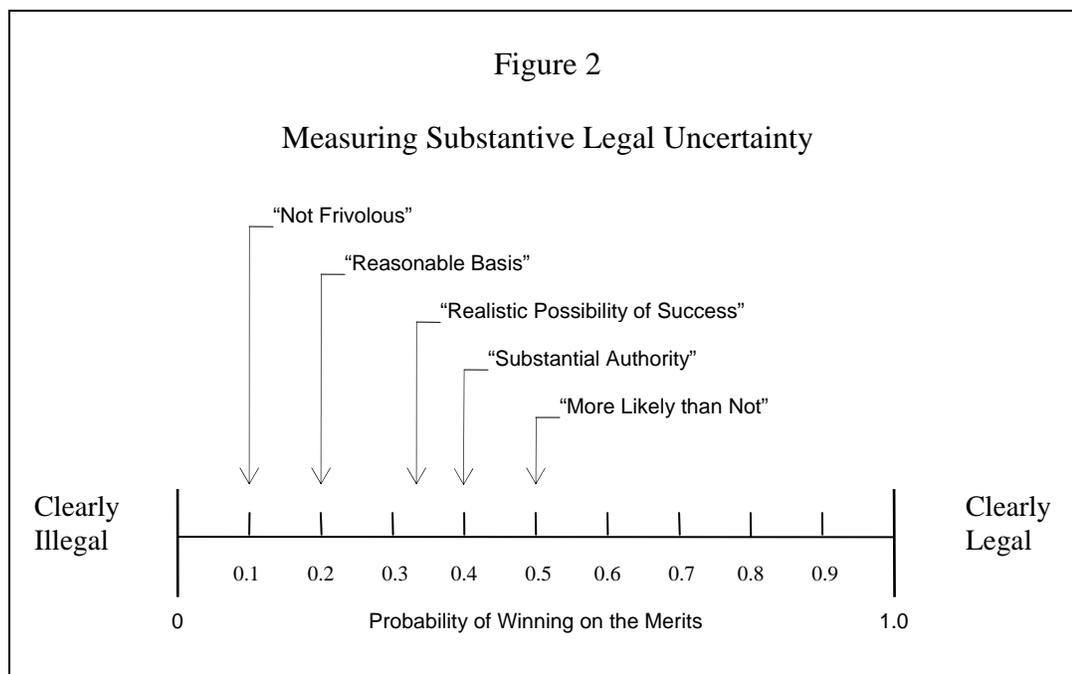
¹⁷ This lower standard, or willingness to waive penalties for relatively aggressive tax positions that are disclosed, does not apply to so-called "tax shelters," defined here as "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(2)(C)(iii). Thus, if your transaction can be characterized as a tax shelter, even if you disclose it to the Service, you incur risk penalties for substantial tax understatements unless you can show that the position had at least a 40 percent chance of winning on the merits. There is also a general exception to any substantial understatement penalty if the taxpayer can demonstrate that she had "reasonable cause" for and acted in "good faith" with respect to the position in question. I.R.C. 6664(d). I will have more to say about this "reasonableness" exception below.

¹⁸ Reportable transactions include, for example, "listed transactions" (which are specific tax avoidance transactions that have been publicly identified by the Service for special scrutiny), "confidential transactions" (which are done under conditions in which the tax advisor has insisted on some sort of confidentiality agreement), transactions that involve "contractual protection" (where the taxpayer has right to a full or partial refund of the tax advisor's fees if the position is not sustained). Treas. Reg. § 1.6011-4(b).

¹⁹ I.R.C. 6664(d).

sometimes quantified to mean at least a 33 percent chance of winning on the merits, assuming detection.²⁰ Alternatively, if the position in question is disclosed to the Service, the preparer can still sign the return and avoid penalties so long as the position is at least not “frivolous,” which some have quantified as something greater than a 10 percent chance of winning on the merits.²¹ Taxpayers themselves also are subject to special penalties for filing frivolous returns, and an even greater penalty (again) for taking positions that are clearly illegal.

If one wanted to array all of these various points along the relative continuum of uncertain tax positions, it would look like this:



²⁰ Treas. Reg. § 1.6694-2(c).

²¹ cites

The point is that all of these various penalties depend not on whether the particular tax position at issue is legal or illegal, but on the position's *ex ante probability of being legal or illegal* as determined either by the IRS, a court, or the taxpayer herself. Later in the Article, I will return to the question whether the above-described penalty scheme, or some modified version of it, can be justified on deterrence grounds. But first let us consider the logically prior questions mentioned in the introduction: what is the socially optimal *ex ante probability-of-winning-on-the-merits* threshold that taxpayers ought to apply in making tax planning decisions? And what tax penalty regime creates the incentives most likely to achieve that result?

III. Strict Tax Liability and the Optimal Merits Probability Threshold

To begin to answer these questions, consider again our friend, Joe Taxpayer. (Or maybe we should call him “Sophisticated Joe,” to capture the idea that either Joe himself or his advisor is both rational with respect to and informed of the relevant law, or lack thereof.) This time, however, we need to include more of the details of the choice Joe faces. Imagine he is considering a single transaction or investment that will (with certainty) produce a pre-tax profit of \$75. Now assume further that there are two and only two possible tax treatments of that transaction: Either it will produce a tax liability of \$100 or it will produce no tax liability at all.²² Thus, the overall profitability of the transaction depends on the ultimate tax consequences; it either produces an after-tax gain of \$75 or an after-tax loss of \$25.²³ The problem, of course, is that Joe does not know

²² All of the numbers as assumed to be discounted to present value.

²³ In effect, I am assuming that even if the transaction has an expected after-tax profit of only one cent, it will be enough to induce Taxpayer to invest. This is obviously an unrealistic assumption, but is useful for purposes of simplicity and does not detract from the overall point of the analysis.

with certainty what the tax consequences will be. This is one of those transactions for which neither Congress nor the Treasury Department has clearly specified the tax treatment. Hence, the best that Joe can do is estimate, or have his lawyer or accountant estimate, the probability that the zero-tax interpretation of the transaction will be upheld if detected and then make his investment decision accordingly.

Let us also assume that the tax-law uncertainty that Joes faces will be resolved only after he has made the investment and only after several years – however long it takes for the IRS to select Joe’s return for audit and either reject or accept the tax position in question, or for the statute of limitations on that return year to run. What this assumption implies also is that Joe cannot, at a reasonable cost or within a reasonable time, get a private letter ruling to resolve the uncertainty before the investment is made. Assume also that, once the transaction is entered into, it cannot reasonably be unwound or reversed should the tax treatment on which the taxpayer relies happen to be struck down. That is, there are no “do-overs.” Rather, in the event the tax position turns out to be wrong, Taxpayer simply has to absorb the extra taxes and penalties, which in this case would again mean that the transaction, from an ex post perspective, would be a net after-tax loser. Relatedly, I assume initially that it is impossible to purchase private insurance against the possibility of an adverse tax decision and, in any event, that Taxpayer is risk neutral (in the sense of being indifferent between two prospects with differing levels of variance but equal expected values). I relax these assumptions below.²⁴

Finally, begging the reader’s indulgence, a few additional assumptions are necessary for the analysis to proceed, and these are assumptions that are common to the

²⁴ The other assumption that is essential to this deterrence analysis is that Taxpayer has sufficient assets to pay whatever tax penalty is assess ex post – that is, Taxpayer is not “judgment proof.”

economic analysis of law. The particular implications of these assumptions will be explored later in the Article. First, recall the assumptions from the introduction that the taxpayer is a rational actor in the traditional sense and cares only about maximizing after-tax returns. These are obviously essential to the deterrence analysis that follows and are customary in the relevant deterrence literatures. Second, it is assumed throughout the Article that the federal tax laws, as ultimately interpreted by a court, represent the will of Congress and are therefore presumptively social-welfare maximizing. This assumption has two components: First, whatever Congress intends for the tax laws to mean is what maximizes social welfare, and this includes both the allocative and distributive consequences of the tax laws. Second, whenever it is unclear what tax treatment Congress intended for a particular transaction, that question is answered definitively and accurately when a court renders a tax decision. Both of these assumptions are obviously unrealistic. We all know how Congress (with the President's help) can and does muck up the tax system. Courts are likewise notorious for getting tax decisions wrong. Nevertheless, to render the deterrence analysis tractable, these assumptions—that courts are always right and Congressional intent is welfare maximizing—are necessary. Moreover, if one is especially troubled by the quality of Congress's tax lawmaking record or by the courts' performance in tax cases, those issues should be addressed directly.²⁵

With that lengthy but necessary set up, we can now begin to isolate the factors that determine what the optimal ex ante tax-compliance incentives would be in Joe

²⁵ I also realize that the vast majority of tax controversies end with a settlement between the IRS and the taxpayer, and thus the courts never get an opportunity in most cases to render a final decision on the merits of most questions of tax law uncertainty. Put differently, in most circumstances, the IRS is the final "ex post adjudicator" of the question of how the tax laws apply to a particular transaction. And this fact introduces further complications to the deterrence analysis. I ignore those complications and assume that either the Service gets it right (and interprets the unclear tax laws consistently with Congressional intent and thus maximization of social welfare) or the Services decision gets reviewed by a court that sets things right.

Taxpayer's situation. This part of the analysis relies on the traditional lens of deterrence theory as it has been developed in the economic analysis of legal rules.²⁶ In that literature, the two most important normative questions are (a) what is the optimal liability rule – e.g., strict liability or some variant of negligence or fault; and (b) what is the optimal level of damages (in the private enforcement context) or the optimal fine (in the public enforcement context).²⁷ Applying this framework, it should be clear, as an initial matter (although it is never expressed this way in the tax compliance literature), that if Joe Taxpayer's position is certain to be scrutinized by the Service (i.e., there is no audit lottery, because the probability of detection is one), the optimal tax liability rule is strict liability, and the optimal fine is simply the amount of additional taxes owed plus an appropriate interest charge to account for the time value of money. This combination will produce the right ex ante compliance incentives and will induce Joe to make the investment described above only if it is efficient to do so.

What's interesting about this conclusion is that such a strict tax liability rule will induce the taxpayer to behave optimally with respect to the question of legal uncertainty; in particular, it will give him the incentive to choose the optimal threshold probability of success on the merits. In the above example, the social-welfare-maximizing choice would be for Joe to make the investment if the probability that the position will be upheld on the merits is greater than 0.25, but not otherwise. Why so? Because for any probability of success on the merits greater than 0.25, the transaction is a positive net-

²⁶ See, e.g., Steven Shavell, *Economic Analysis of Accident Law* (1987); and A. Mitchell Polinsky, *An Introduction to Law and Economics*.

²⁷ For a comprehensive survey of the economic analysis of deterrence in the context of public enforcement of legal rules, see A. Mitchell Polinsky & Steven Shavell, *The Theory of Public Enforcement of Law*, in *Handbook of Law and Economics*, Vol. 1, forthcoming 2007.

present-value investment after taxes, but not otherwise.²⁸ A couple of simple examples illustrate this point: Say the probability of success on the merits for this transaction were 30 percent. In that case, the expected tax cost associated with the investment would be \$70, still less than the pre-tax profit of \$75; hence, the deal, for Joe and for society, is worth pursuing.²⁹ And if the probability-of-success-on-the-merits were 20 percent, the expected tax cost would be \$80, which would make the deal a \$5 loser in after-tax terms.³⁰ Thus, given these numbers, the *optimal merits probability threshold* is 25 percent. This number is entirely an artifact of the arbitrary parameters of the example. But the more general point still holds: Assuming detection certainty (i.e., that every tax issue gets evaluated by a court and thus that all ex ante uncertainty gets resolved ex post), a rule of strict tax liability that requires the taxpayer to pay the additional taxes ex post in the event the Service or a court finds his position to have been wrong will induce him to internalize his ex ante expected tax liability, and this will work whatever numbers we use in the example.

To put the point even more generally, when taxpayers face conditions of legal uncertainty, social welfare is maximized if they make investment decisions on the basis of their best estimate of the ultimate resolution of that uncertainty. To achieve this result, we want to make individuals and firms internalize the expected value of the harm that their decisions might cause – which harm, in this instance, would be the amount of underpaid taxes. This conclusion is consistent with the conventional wisdom in the economic analysis of tort law, where cost-internalization through strict liability is well understood

²⁸ If you know the pre-tax profit of the transaction will be \$75 and you know the potential tax outcomes are either zero or \$100 in taxes, the optimal merits probability threshold can be calculated by solving for x in the following equation: $(x * 0) + ((1-x) * 100) = 75$.

²⁹ The expected tax cost using these numbers is calculated as follows: $(0.3 * 0) + (0.7 * 100) = \70 .

³⁰ $(.2 * 0) + (0.8 * 100) = \80 .

to achieve efficiency in certain settings and under assumptions similar to those made in this Article.³¹ For example, in the products liability context, if a product manufacturer is trying to decide whether to manufacture and sell a particular product (or whether to make a particular safety innovation in an existing product), the existence of a strict liability tort rule induces that company ex ante to take into account the expected harm that its product might cause (or the expected reduction in harm that the safety innovation might yield.)³² In essence, this is what a tax strict liability does as well.

Thus, a regime that makes Joe Taxpayer pay the \$100 in back taxes in the event the Service and courts reject his tax position will induce him to make the social-welfare maximizing ex ante choice regarding when to take advantage of a given legally uncertain tax benefit.³³ It is also worth making two other aspects of this conclusion explicit: First, it highlights the fact that there is no *a priori* correct merits probability threshold apart from what is optimal under the circumstances as described above.³⁴ Second, the optimal merits probability threshold will depend on a number of factors, including: the amount of the potential tax cost (or tax savings) associated with the transaction if the taxpayer loses (or wins), the amount (and the certainty) of the pre-tax profit expected from the transaction, and, if we lower the assumption of risk neutrality, the taxpayer's taste for risk

³¹ Shavell, supra note __.

³² Id.

³³ Henceforth, I ignore the requirement that the award include adequate interest to account for the time value of money. This is a customary assumption in the economic analysis of legal rules. In the real world, of course, the interest charge that the law imposes on taxpayers for tax deficiencies does not precisely equal the rate at which the taxpayer was able to invest those funds. The tax system's failure to calibrate interest charges properly can produce over- or under-deterrence, just as if the amount of taxes owed were over-stated or under-stated.

³⁴ This conclusion is largely a function of the current strong assumptions. That is, I am assuming that the only deterrent here is the formal penalty. Not only is Joe Taxpayer not subject to any informal sanctions from his colleagues or peers for being too aggressive on his tax returns, but he has no conscience either: He does whatever is optimal under the law. Of course, informal sanctions do exist, and most people do have a conscience, and the entire deterrence calculus can change when those facts are admitted. I return to this possibility at the end of the paper.

(though I have assumed risk neutrality to this point). Thus, for example, all else equal, the higher the potential tax cost (or savings) associated the transaction, the higher the minimal threshold probability of success on the merits will be.³⁵ This makes intuitive sense: If the tax aspect of a particular transaction is very large relative to the expected pre-tax profit from that transaction, we want the taxpayer – and the taxpayer himself should want – to be darn sure about the substantive law in question before going forward with the deal. Along the same lines, the relationship between the expected pre-tax profit and the optimal merits probability threshold makes intuitive sense: If the non-tax aspect of a particular deal is large relative to the tax savings, the taxpayer can afford (and society would want him) to be more aggressive in his interpretation of uncertain tax laws.

A number of interesting observations follow from this analysis. First, even if the probability of success on the merits for a given tax position is extremely low, it can be socially optimal for the taxpayer to engage in the transaction and take the questionably legal position, so long as he believes that the expected pre-tax profit from the transaction exceeds the expected tax liability. This is a point that is sufficiently counterintuitive (and interesting) to bear restating in a slightly different way: Socially optimal behavior, in a world with substantive legal uncertainty, can, and often will, include actions that turn out, after the substantive legal uncertainty is resolved, to have been illegal. That is just another way of saying that, whenever there is substantive legal uncertainty, it is not the case that inaction – or declining to interpret the uncertain law in one's favor – is always the best, social-welfare-maximizing approach. In yet other words, where the substantive

³⁵ To see this using my example, imagine that the potential tax outcomes were multiplied by 3 (i.e., either \$300 or zero in taxes). In that case, the threshold probability of success on the merits would be tripled as well (to 0.75). This can be determined by setting the expected profit from the transaction ($\$75$) equal to $(x * 0) + ((1-x) * 300)$ and solving for x .

law is uncertain, conservatism in interpreting the law is not always optimal; to the contrary, sometimes optimality calls for aggressiveness in the face of substantive legal uncertainty.

This conclusion depends *critically* on the probability of detection being one – that is, the complete absence of *detection uncertainty*. If the probability of detection is less than one, this conclusion obviously does not follow, unless there is a penalty large enough to approximate the effect of detection certainty, as will be discussed at some length below. So let me be very clear: I am not advocating a regime that encourages or allows taxpayers to take tax positions that have a very low probability of success on the merits – which is one way of understanding what is normally meant by an “aggressive” tax positions – *unless* we have in place a deterrence regime that either makes detection a certainty or imposes an ex post punitive penalty that has roughly the same ex ante effect as certain detection.

A second interesting observation that flows from the analysis above is that the strict tax liability rule works even for transactions that promise no pre-tax profit, that is, in circumstances in which the tax position in question – i.e., the special deduction or credit or whatever – is what makes the deal potentially profitable. Put differently, strict tax liability produces optimal compliance incentives not only in situations in which the transaction depends on the tax outcome for its overall profitability, but also in situations in which a transaction is expected to produce a pre-tax *loss*. These sorts of transactions are, of course, the source of much debate in the tax literature and are sometimes given pejorative labels such as “abusive tax shelters” or transactions that “lack economic

substance.”³⁶ And yet even for such transactions, if the probability of detection is 100 percent and everyone knows this, a simple strict tax liability rule optimizes taxpayer compliance incentives.

The Joe Taxpayer example can be tweaked slightly to illustrate this last point: Assume now that the transaction is expected to lose \$5 before taxes but promises the possibility of either producing a tax liability of \$50 (for an after-tax loss of \$55) or, perhaps by producing a credit or a loss deduction that can be used to offset taxes from some other source, a net tax savings of \$100 (for an after-tax gain of \$95). Given those possibilities, the break-even or optimal merits probability threshold for Joe’s situation is roughly 0.3; that is, Joe will be willing to engage in the transaction – and, from an efficiency perspective, should be willing to engage in the transaction – if the probability that this position will win on the merits is anything greater than 30 percent, but not otherwise.³⁷ Of course, the precise probability threshold is entirely an artifact of the numbers that I have chosen for the example, but the point is fairly general: Because the strict tax liability rule forces Joe to internalize the ex ante expected value of his ex post tax liability, he will invest in the transaction only if it is optimal to do so, which means he will choose the optimal merits probability threshold, whatever that may be under the circumstances.

IV. The Problem of Detection Uncertainty and the Bentham-Becker Solution

³⁶ Obviously, not all tax transactions that have are expected to have pre-tax losses but post-tax gains are considered abusive tax shelters. For example, some transactions that are designed to exploit explicit tax subsidy provisions in the Code – which we might call “intended loopholes” – fall into this category. One of the biggest issues in the tax shelter literature, arguably the central issue in that debate, is the question how to distinguish the unintended from the intended tax loopholes. For the purposes of this Article, again, I am assuming that the IRS and the courts can figure this out in their ex post evaluations of tax positions.

³⁷ To get this percentage, set $(x * 100) + ((1-x) * (-50))$ equal to -5, and then solve for x.

The preceding analysis assumed, among many other things, that the probability of detection – the combined probability that the taxpayer’s return would be selected for audit and the particular issue in question would be scrutinized – was equal to one. This is an especially fanciful assumption in the tax context, at least with respect to the sort of sophisticated transactions that this Article is focusing on, transactions that involve navigating the intended and unintended loopholes in the Code. For such transactions, the probability of detection is notoriously low. This is true both because the audit rate itself is far less than 100 percent and because, even when a return is audited, there is a good chance such tax positions will go unnoticed by the Service.³⁸ Although no one knows what the precise probability of detection is for any given type of tax position (even the IRS, which does have data on audit rates for different categories of taxpayers and has confidential information about its own enforcement priorities, cannot know what the ultimate detection probability is for a particular tax position), such probability is almost certainly very low for many of the transactions that characterize the zone of substantive legal uncertainty. The result, of course, is that a tax penalty regime of strict liability in which the only penalty is the “harm,” the additional taxes plus interest, woefully underdeters. Thus, with probability of detection significantly below one, unless we assume massive levels of risk aversion, taxpayers have an incentive to engage in transactions (and take tax positions) that are far too aggressive from an overall social welfare

³⁸ According to the most recent IRS statistics, the 2005 audit rates were as follows: all individuals (0.9 percent); individuals with over \$10,000 of income (1.5 percent); individuals with under \$100,000 of income (0.8 percent); all corporations (20 percent); large corporations (those with assets over \$250 million) (44 percent); small businesses (those with assets under \$10 million) (0.8 percent). I.R.S. Data Book (IRS pub. 55B), available on line at <http://www.irs.gov/pub/irs-soi/05db10ex.xls>. Based on research from data from earlier years, it appears that, of those taxpayers who are audited, only a small percentage (as low as 4 percent) are actually penalized. James Andreoni, Brian Erard & Jonathon Feinstein, 37 J. Econ. Lit. 818 (1998). Note that audit rates for individuals are much higher for certain types of errors, such as omitting income that is reported on information returns. Joel Slemrod, Trust in Public Finance p.8 (2002 NBER working paper W9817), available on line at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=330326.

perspective. Indeed, the current problem of the “tax gap” – the difference between the taxes owed and the taxes paid – is almost certainly a result of the fact that the vast majority of taxpayers who underpay their taxes never get caught, and everyone knows that.

The effect of detection uncertainty on taxpayer aggressiveness can easily be illustrated by making a small but important change to the Joe Taxpayer example. Imagine the situation as described in the original example above (i.e., \$75 expected pre-tax profit with a potential tax liability of \$100 or \$0), except that the probability of detection is not 100 percent but is, say, 1 percent. If the fine is then set equal to the amount of back-taxes owed (i.e., the tax analog to the “harm” caused) with no additional penalty, the taxpayer would have an incentive to make the investment in reliance on the tax position in question even if the probability of winning the position on the merits were zero – that is, even if the tax position were clearly illegal.³⁹ Indeed, in the current Joe Taxpayer example, this would be true – Joe would have an incentive to make the investment despite the position’s being unquestionably illegal – for any probability of detection less than 75 percent.⁴⁰ Again, the particular numbers are arbitrary, but the principle is not. The point is quite generalizable and, for that matter, well known among tax practitioners and analysts: the lower the rates of detection, all else equal, the larger the incentive for taxpayers to take aggressive tax positions.⁴¹

³⁹ The expected value of the \$100 in taxes would be \$1, although the probability of winning on the merits if detected is zero; and \$1 is obviously less than the pre-tax profit expected from the transaction.

⁴⁰ This is because the expected pre-tax profit is \$75, so the expected fine would have to be \$75 or greater. If the position is patently illegal, given the potential tax liability of \$100, the expected tax liability will be less than \$75 for any probability of detection less than 75 percent.

⁴¹ The one possible qualification to this observation involves the interaction between formal and informal sanctions. That is, if people are prevented from taking illegal positions by informal norms, either internal ones (conscience) or external ones (reputation), then this relationship between rates of detection and willingness to take aggressive, or clearly illegal, positions may not hold.

The problem of low probabilities of detection is one of the oldest and most thoroughly discussed issues in the entire deterrence literature. At least since Jeremy Bentham, theorists have understood the relationship between the probability of detection, the magnitude of the penalty, and the appropriate level of deterrence.⁴² It was Gary Becker who first formalized the notion in the criminal law context and who further identified the optimal solution to the problem (given certain assumptions to be discussed shortly): to increase the ex post penalty until the potential perpetrator is induced ex ante to act as if the probability of detection were one.⁴³ To be precise, such a Bentham-Becker penalty is calculated by dividing the harm caused by the probability of detection. Thus, if a crime is expected to cause a harm of 100, such that the optimal cost-internalizing sanction would be \$100, but the probability of detection is .01, the optimal fine would be \$10,000 – that is, the amount of the harm – 100 – divided by the probability of detection – 0.01 (Or, if you prefer multiplying, the amount of harm multiplied by the reciprocal of the detection probability). This is so precisely because such a penalty makes the expected value of the fine equal the harm. Thus, in general, so long as (a) the ex post adjudicator can accurately determine both the ex ante probability of detection and the amount of the harm (for purposes of this Article, the actual taxes owed as determined by the adjudicator in resolving the legal uncertainty), (b) taxpayers or their advisors are aware of this fact, and (c) taxpayers have sufficient assets at risk to care about large ex post penalty, then the use of such an ex post penalty regime can create the proper ex ante tax compliance incentives. Indeed, under such a regime, it is *as if* the probability of detection were equal to one and the fine equaled the harm. This same

⁴² Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation*, in 1 *Works of Jeremy Bentham* 1, 86-91 (J. Browning ed. 1843).

⁴³ Gary Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169 (1968).

analysis has been applied to justify punitive damages in tort law and environmental law, among many other areas.⁴⁴ Public finance economists have applied this idea to tax law as well, reaching the conclusion that, under the normal assumptions, the optimal fine for tax underpayments ought to be the amount of tax underpayment divided by the probability of detection.⁴⁵

To see the operation of this idea in the tax context, take the original Joe Taxpayer example but assume a probability of detection of one percent. In such a case, Joe's ex ante compliance incentive would be optimized by applying a strict liability standard that assessed an overall fine – including both the back taxes and penalty – equal to the harm (the additional taxes owed of \$100) multiplied by 100 (i.e., $1/.01$). Thus, in the event the tax position was detected and rejected, Joe would be required to pay not only the underpaid tax, but also a punitive fine (or a “kicker”) of \$9,900.⁴⁶ By adopting a rule that would impose such a fine in the event of an adverse determination, the strict-liability-plus-punitive-kicker rule forces Joe, ex ante, to internalize the expected tax liability associated with the transaction, which, as shown above, leads to the optimal tax compliance incentives even under conditions of legal uncertainty. (Again, this conclusion assumes Joe has at least \$10,000 worth of assets that might be subject to the ex post penalty.) Recall that under the original example, Joe's optimal merits probability threshold was 25 percent. He should only make the investment if he assessed the likelihood of winning on the merits to be greater than 25 percent. Now, if the probability

⁴⁴ See A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Approach*, 111 *Harv. L. Rev.* 869 (1998).

⁴⁵ M. G. Allingham and A. Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 *J. Pub. Econ.* 323-38 (1972).

⁴⁶ Since the optimal total damage payment is determined by harm divided by the probability of detection (h/p), and the optimal punitive award is the amount in excess of the actual harm, the multiplier that can be used to calculate the punitive-kicker part of the award can be written as: $[(1-p)/p] * p$.

of detection were 1 percent rather than 100 percent, but the potential total tax liability were \$10,000 rather than just \$100, Joe would still have an incentive to make the investment (and claim the \$100 tax benefit) only if doing so were socially efficient – that is, only if the 25 percent merits probability were exceeded.

In sum, a strict liability rule with a Bentham-Becker punitive penalty can induce optimal ex ante tax compliance incentives in a world with substantively uncertain tax law and in which taxpayer aggressiveness regularly goes undetected. Applying the strict-liability-with-punitive-kicker regime, however, raises a number of conceptual and practical problems. These are the *ex post unfairness concern*; the *judgment-proof taxpayer problem*; the *over-deterrence problem*; and the *administrability problem*. I discuss the first three in this section and the fourth in the next section. Some but not all of these concerns will apply to both a strict liability and a fault-based regime. All of them are connected with, and even attributable to, the punitive-kicker aspect of the tax-penalty regime proposed in the previous section.

First, even if we assume that taxpayers are perfectly rational and informed (and thus would be optimally deterred by a Bentham-Becker penalty), there is the view that the Bentham-Becker punitive penalty would create a kind of ex post unfairness because of the relationship, or lack of relationship, between the size of the penalty and the magnitude of the offense. In the criminal law context, this complaint against Bentham-Becker penalties is often stated in terms of the punishment being out of proportion to the crime. Thus, for example, if an individual were to break the law and cause a social harm of \$100, a sanction of \$10,000 on that single individual would, on this view, be considered excessive – disproportionate to the crime. The same could be said in the tax

context. If a taxpayer underpays his income by \$100, and the particular mistake has only a 1 percent chance of being detected, it seems intuitively unfair that the 1 person out of 100 who gets caught will have to pay \$10,000 while the other 99 go free. And such an outcome seems especially problematic when the activity in question, from an ex ante perspective, is not clearly illegal – but is only of uncertain legality.

This injustice may be seen as further compounded by the fact that the size of the tax penalties imposed on taxpayers may in many cases reward dishonesty, in the following sense: If the IRS were to concentrate its enforcement efforts on identifying those taxpayers who are most likely to cheat on their taxes (a reasonable strategy), the probability of detection for those taxpayers would increase, relative to the probability of detection of the taxpayers who are not so much the focus of IRS scrutiny. The irony of this approach, however, is that the punitive kicker would correspondingly be *lower* for those relatively dishonest taxpayers (the ones whom the IRS is focusing on) and *higher* for the more honest taxpayers (to whom the Service gives less frequent or intense scrutiny). Thus, if we loosely equate audit rates with detection rates, taxpayers subject to only a 1 percent audit rate because of their historically high levels of compliance would face a potential noncompliance penalty equal to 100 times their tax understatements; whereas the taxpayers subject to a 50 percent audit rate because of their historically low levels of compliance would face a potential penalty of only 2. Of course, audit rates are not necessarily inversely correlated with relative honesty. For example, it may be administratively or politically more feasible to audit certain taxpayers at higher rates than others. But the perception of unfairness could still be a problem.⁴⁷

⁴⁷ One could argue that these ex post unfairness concerns are not present under the assumptions of the examples above, specifically, the assumption of perfectly informed and rational taxpayers. That is, if

Besides the ex post unfairness problems, there is a potential deterrence problem as well. The problem is simple: a rational taxpayer of the sort I have been assuming throughout this analysis (including an assumption of risk neutrality) would ignore the threat of any ex post fine that exceeds the amount of her assets that are available to satisfy a tax judgment. This fact – sometimes called the judgment-proof problem – limits the ability of large ex post fines to produce optimal ex ante compliance incentives. The problem is well known in the deterrence literature, and what it means is that, even with a Bentham-Becker punitive penalty in place, if taxpayers are judgment proof, they will be under-deterred.⁴⁸

Interestingly, there is also an *over*-deterrence concern with the punitive-kicker penalty, although it requires that we assume risk aversion on the part of the taxpayers. Putting aside the judgment-proof problem for the moment, the prospect of large tax penalties in conjunction with a strict liability rule can actually over-deter, that is, induce taxpayers to under-invest in legally uncertain tax positions. The point is simple enough to understand: Risk-averse taxpayers facing a potentially large ex post tax penalty in the event their uncertain tax positions end up losing in court might be deterred from taking

taxpayers are perfectly informed of the merits probability of a particular tax position, perfectly informed of the likelihood of detection, and perfectly informed of the potential Bentham-Becker penalty they face, then no unfairness arises when they freely choose to assume the risk of taking the tax position in question. That is, under these assumptions, when a taxpayer's uncertain position happens to be detected by the IRS and happens to be rejected and the penalty assessed, that would be an example of what Ronald Dworkin calls "option luck." And to allow the taxpayer to bear the consequences of his bad option luck is, on this influential view of distributive justice, entirely appropriate. See generally Ronald Dworkin, "What is Equality? Part 1: Equality of Welfare," *Philosophy and Public Affairs* 10 (1981): 185-245 and "What is Equality? Part 2: Equality of Resources," *Philosophy and Public Affairs* 10 (1981): 283-345. However, insofar as the taxpayer's decision to engage in the uncertain tax position, and hence to subject himself to the risk of a large tax penalty, is influenced by irrationality or incomplete information (and thus the risk is in some sense not freely chosen), we might consider the result a form of bad "brute luck," which Dworkin (and most every egalitarian theorist) would regard as an appropriate grounds for redistributive intervention. Not everyone, not even every philosopher, is prepared to fully embrace this distinction between option luck and brute luck.

⁴⁸ This problem is acknowledged in the standard works on the Bentham-Becker approach to punitive sanctions. See, e.g., Polinsky & Shavell, *Punitive Damages*, supra note ___, at ___.

such positions in the first place – even when taking such positions, although not certain to be upheld on the merits, are well above the efficient merits probability threshold. That is, they would be deterred from making investments that they should make. Thus, for example, when the likelihood of succeeding on the merits for a particular transaction is, say, 40 percent, we know that it would be efficient for the tax to make the investment if the optimal merits probability threshold is less than 40 percent. (In the Joe Taxpayer example above, recall, that threshold was 25 percent.) However, if the taxpayer is risk averse, the possibility of a \$10,000 ex post tax liability might dissuade the taxpayer from going through with even a tax-efficient transaction, that is, even though the expected tax liability would be significantly less than the expected pre-tax profit. In that sense, then, if taxpayers are risk averse, a full punitive-kicker penalty can over-deter and discourage efficient transactions.

Some readers may scoff at this over-deterrence concern. They might say, for example, that, while over-deterrence may be a theoretical possibility, it is a miniscule concern in the real-world of tax enforcement. The much bigger problem, the argument goes, is *under*-deterrence. The whole problem of corporate tax shelters, for example, which has occupied so many pages in *Tax Notes*, *The Wall Street Journal*, and *The New York Times* in recent years, is in essence a problem of under-deterrence. Moreover, the Treasury Department continues to report a substantial federal tax gap of roughly 16 percent – that is, federal tax revenues are estimated to be approximately 16 percent less than they would be if all taxpayers paid what they actually owe.⁴⁹ Thus, one might reasonably ask, how serious can the over-deterrence problem really be? My own view,

⁴⁹ IRS, Understanding the Tax Gap, FS-2005-14, March 2005, available on line at <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>.

based on very little evidence, is that, presently, the over-deterrence problem is probably small, though not non-existent. Even now, I have heard anecdotal accounts of taxpayers who are not willing to engage in certain types of transactions that are tax sensitive because the tax law is too uncertain, and because they cannot get the IRS to issue them a private letter ruling on the issue. But I have no idea how large this problem is. The much more important point is that, even if it were the case that there is presently relatively little over-deterrence under the current tax penalty regime, we obviously do not currently have anything resembling a Bentham-Becker penalty regime. As discussed above, maximum penalties are limited to usually 20 percent, rarely higher than 75 percent, of the underpaid tax. These amounts are obviously far, far less than the penalties that would be the norm under a Bentham-Becker model, which again would be 5, 10, or even 100 *times* the tax underpayment. If such large penalties were authorized, it is reasonable to suppose that it would not be very long before complaints of over-deterrence would dominate the tax news coverage.

V. The Potential Role of (and the Problems with) Tax Liability Insurance

Before we get to the administrability problems with the strict tax liability punitive-kicker regime, consider a possible, at least partial, solution to the ex post unfairness and over-deterrence concerns. These concerns could be reduced if we allowed (and the judgment-proof problem could be reduced if we *required*) taxpayers to purchase insurance against the possibility that a particular tax position on their return might be rejected by the IRS and back-taxes and fines imposed. The insurance would cover the back-taxes, interest, penalties, and perhaps the legal fees as well.⁵⁰ What would the

⁵⁰ Such insurance is not merely a theoretical possibility. There is in fact a small but growing market for this insurance. See Kyle D. Logue, Tax Law Uncertainty and the Role of Tax Insurance, 25 Va. Tax Rev. 339

effect of such insurance be? In theory, assuming actuarially priced insurance, such an innovation would convert the large ex post fines that would threaten taxpayers under the Bentham-Becker kicker regime into something approximating the taxpayer's ex ante expected tax liability. This theoretical result would be as close to the ideal tax treatment of legally uncertain tax transactions as we can get, both from a deterrence perspective and a distributive justice perspective. To see this point, go back to the original example where the efficient merits probability threshold was 25 percent, owing to the \$75 expected pre-tax profit and \$100/\$0 potential tax liability. And assume again that the detection probability for the transaction is 1 percent, such that the optimal punitive penalty is \$9,900, plus the \$100 tax liability. Now imagine that the taxpayer finds a particular transaction that fits this profile and that has a merits probability of 40 percent. Thus, the taxpayer's expected tax liability is \$60.⁵¹ Because his expected after-tax profit is \$15, he should clearly make the investment. Now here's the trick: Assume further that there are 99,999 other taxpayers in the economy taking a similar position, by which I mean a tax position with the same payoff structure as Joe's – i.e., an expected tax liability of \$60. Assume also that *all of these tax positions are uncorrelated with one another*, in the sense that when one uncertain position is resolved by the IRS or a court ex post, that decision has no effect on how the other cases will be resolved.⁵² According to these assumptions, only 1000 of these taxpayers will get audited, 600 of whom will lose their cases and be required to pay the \$100 in taxes plus the \$9,900 Bentham-Becker punitive

(2005), for a description of this types of insurance and the deterrence concerns it can raise. An alternative to commercially provided tax liability insurance would be government provided tax insurance. Private letter rulings can be seen as a form of government provided insurance against substantive uncertainty in the tax law.

⁵¹ $(0.4 * 0) + [(0.6 * \$100)] = \60

⁵² I'll have more to say about this assumption later in the paper, when I introduce the possibility of risk averse taxpayers and the option of tax risk liability insurance.

fine. Again, such a rule produces the right ex ante incentives. The problem, according to the ex post unfairness complaint, is that 600 unlucky souls are required to pay \$10,000 each, while the other 999,400 taxpayers, who are in exactly the same position and who took exactly the same risk, pay nothing. That result could be seen as distributively unjust.

Along comes tax insurance to the rescue. Because each of the 100,000 taxpayers in this example have an expected tax liability of \$60 each – each is taking a 0.006 chance of paying a \$10,000 tax-plus-penalty liability – tax liability insurance, in its idealized form, would allow these taxpayers to shift the risk of a \$10,000 payment to the insurer in exchange for paying the insurer a premium of roughly \$60. If such insurance were provided, then, when the 1000 out of the 100,000 taxpayers were selected for audit, and 600 of those ended up losing their cases, the insurer would pay the \$10,000 total tax liability for each of the 600 unlucky ones.⁵³ In so doing, the insurer would be acting in effect as a private ex ante tax collector, collecting premiums of \$60 from each of the taxpayers in the pool in advance and then eventually paying those premiums over to the government (less an administrative fee).

If it worked, this type of tax insurance could reduce the over-deterrence problem as well as the ex post unfairness (or perceived unfairness) associated with the Bentham-Becker punitive sanction. The over-deterrence problem goes away because the threat of a large ex post fine goes away. The ex post unfairness concern is addressed through the operation of insurance risk pooling. So, unlike the Bentham-Becker penalty without insurance, where \$6,000,000 was spread across 600 taxpayers, here \$6,000,000 is spread

⁵³ The insurer could also cover the litigation costs of all 1000 selected for audit. But we can assume that away for now.

equally among 100,000 taxpayers. Moreover, if we assume that the insurer could set and adjust premiums perfectly to correlate with the expected tax liabilities of its insureds (this is what I meant above by the assumption of actuarially fair insurance), the strict liability rule with a Bentham-Becker penalty would still produce optimal ex ante compliance. Because taxpayers would still ex ante face the expected tax liability associated with the investment, they would be induced to make the efficient decision regarding when to invest in reliance on uncertain tax law.

This rosy picture ignores many complications that might make such tax risk insurance infeasible. But one problem is more fundamental than the others: To the extent the tax insurer is *not* able to classify risks perfectly, there would be a degree of both ex post unfairness and inefficiency. Imagine that the insurer in the example above could not distinguish between a taxpayer who is engaging in a transaction with an expected tax liability of \$60 and a taxpayer who is making an investment with an expected tax liability of \$70 or \$50. To the insurer, these all look the same. If that were true, there would be inefficiency, because taxpayers would not face their own expected tax liability. Some taxpayers who are insured would thus be induced to make investments that are excessively aggressive. For example, a taxpayer might represent to an insurer that it was going to engage in a transaction with an expected tax liability of \$60 and then turn around and, in fact, engage in a transaction with an expected tax liability of \$70. This is a version of the well-known problem of moral hazard that plagues all insurance arrangements to some extent. Likewise, those taxpayers who expected to be engaging in relatively tax-risky transactions (the \$70 expected value transactions) would find the \$60 premium to a bargain and would be disproportionately

likely to purchase insurance. This would force premiums up over time, causing the lower-risk taxpayers on the margin to opt out of buying insurance, thus leaving them uninsured and, again, potentially over-deterred. This is of course the tax-insurance version of adverse selection. When there is variance within insurance risk pools, there is concomitantly cross-subsidization from the low risk to the high risk insureds, which arguably presents an *ex ante* unfairness concern.

Moral hazard, adverse selection, and cross-subsidization occur to some extent in all insurance markets and are not considered *per se* fatal to the enterprise. Insurers generally try to combat these problems in a myriad of ways, not the least of which by engaging in *ex ante* efforts at risk classification and contractual protection. For example, a tax-risk insurer who is approached about covering a particular tax transaction might hire its own tax experts to evaluate the legal merits of the proposed tax treatment. This would help the insurer to decide whether to offer the coverage, at what price, and under what terms. And to mitigate the problem of moral-hazard – that is, the taxpayer who says she is planning a transaction with a \$60 tax risk but then proceeds to do a transaction with a risk of \$70 – the insurer could, in advance of the transaction, require the taxpayer to provide detailed representations regarding the proposed transaction (details suggested by the insurer’s tax experts), and the breach of these representations by the taxpayer would be grounds for the insurer to void the contract. Plus, insurers could use a combination of large deductibles and contractual policy exclusions to try to align reduce moral hazard and adverse selection concerns. Insurers have used these tools for decades in liability and

other insurance markets. And, interestingly, they are beginning to use them now in the small but growing tax risk insurance market.⁵⁴

Another serious problem with tax risk insurance, a problem that potentially confronts all premium-financed insurance arrangements, is the possibility of correlated risks. In the example above I assumed that all 100,000 taxpayers were engaging in transactions that posed the same tax risk but that were uncorrelated with other. Those are the perfect conditions for the insurance risk-spreading mechanism to work. I have already discussed what happens when the risks being insured have different expected values – the problem of insufficiently precise risk classification. But what happens if the tax risks are correlated? If the insurer has not reinsured the risk, and if the correlated risks represent a large fraction of the insurer’s overall book of business, the result can be bankruptcy for the insurer. To see this, change the example so that all of the 100,000 taxpayers are doing precisely the same transaction, or they are doing transactions that turn on exactly the same uncertain legal question, such that if the legal uncertainty is resolved in one case, it gets resolved in all of them, virtually simultaneously. In that case, if those taxpayers were the only risks the insurer covered, and it had no reinsurance and no large surplus of assets, it would not be able to price the policies. It cannot charge just \$60 for the policies, because if a court decides against one of the taxpayers, there would not be sufficient funds to cover all of the claims. The insurer would have \$6 million in premiums, but would need \$100 million, since all 1000 taxpayers selected for audit would lose their cases. Also, the insurer would not be able to charge much more than \$60, because the taxpayer-insureds would not be willing to pay it. Certainly taxpayers would not be willing to pay a premium of \$100 (equal to the taxes they hoped to avoid

⁵⁴ This is in fact what happens with tax transaction liability insurance. See Logue, *supra* note ____.

paying on the transaction), which would be necessary to give the insurer certainty that it would be able to pay the claims when they come in.⁵⁵

This correlated-risk problem is potentially troubling, given that some uncertain tax issues are correlated with each other. This is especially true insofar as taxpayers tend to copy each other's tax transactions. However, the correlated-risk problem seems ultimately unlikely to prevent a tax risk insurance market from arising if a Bentham-Becker punitive-kicker tax penalty regime were adopted. Why? First, there are many different sources of transactional tax-law uncertainty, almost as many as there are sections in the Code. And there would rarely be perfect correlation of risks, even when taxpayers attempt to engage in very similar transactions. Often the tax treatment will turn on highly fact-specific issues that will be peculiar to the particular transaction and particular taxpayer. For that reason, it would be surprising if an insurer could not put together a portfolio of tax-law risks that were relatively diversified, or uncorrelated with each other. Moreover, insurers can, and usually do, reinsure their risks with other, larger insurers that have larger and more diversified portfolios. For the very large insurers, since their tax insurance business would be only a small part of their own portfolio, this diversification function would be performed largely in house.

One complaint that gets lodged against allowing tax risk insurance in the current regulatory climate is that the availability of tax insurance will exacerbate an already existing under-deterrence problem.⁵⁶ The argument is that, given the trivial penalties that currently exist for tax noncompliance, the existence of tax-law uncertainty and taxpayer risk aversion are necessary to prevent the tax gap from increasing dramatically. For that

⁵⁵ This is an example of the much more general insurance problem of correlated risks, which can make insurance markets fail.

⁵⁶ See Logue, *supra* note ___, at ___.

reason, if we allow risk-averse taxpayers to insure their penalties, competition being what it is, insurers will eventually offer coverage for transactions that have zero merits probability, in which case the only risk they would be insuring would be the risk of detection. Put differently, the worst case scenario with respect to tax risk insurance would be insurance for clearly illegal transactions. I agree that this is a concern under the existing penalty structure, and in another Article I have suggested some possible solutions, such as requiring taxpayers who purchase tax risk insurance to report this fact to the service, thus raising the detection risk, and hence the expected tax liability, for such transactions significantly.⁵⁷ This problem of tax shelter insurance, however, would not likely arise – or would be much diminished – under a strict liability penalty regime with a Bentham-Becker punitive penalty. This is so because, if the penalty is set properly, the insurance premium for the transaction will equal the expected tax liability. Which means that, for a transaction with a merits probability of zero, the insurance premium would equal the potential tax liability, making the deal not worth doing for the taxpayer.⁵⁸ Thus, if in our example the merits probability were zero, the insurer would charge the taxpayer a premium of \$100, efficiently deterring the transaction.

An alternative to allowing risk-averse taxpayers to purchase tax liability insurance from commercial insurance companies would be to allow them to purchase such insurance directly from the government. That is, each of the taxpayers in the example above could pay the U.S. Treasury, instead of an insurance company, \$60 and in exchange receive a commitment that the issue in question would not be challenged. We might think of this as something like a private letter ruling, but one for taxpayers are

⁵⁷ Logue, *supra* note __, at __.

⁵⁸ More generally, the liability insurance premium for a clearly illegal activity in a world in which accurately calculated Bentham-Becker penalties are imposed would equal the harm in question.

required to pay the expected tax liability in advance. Perhaps the better analogy would be to a settlement agreement between a taxpayer and the IRS on some issue that the Service has challenged but with respect to which the legal outcome is uncertain. Interestingly, under either approach to dealing with tax law uncertainty – the private insurance approach and the government insurance (or settlement) approach – the key facts are that the taxpayers would face approximately their expected tax liability when making tax-sensitive investment decisions, the government would get the right amount of revenue under the circumstance (\$6 million in our example involving 100,000 taxpayers), and the tax burden for these types of transactions would be allocated fairly across all taxpayers doing the deal (\$60 each). Whether government insurance or private insurance would be the better mechanism for this is beyond the scope of this Article. The essential point to recognize here would be that, under present assumptions, including the assumption of a strict liability rule with an ex post Bentham-Becker fine, either would optimize ex ante compliance and tax decision making under conditions of uncertainty.

The most serious difficulty with any attempt to adopt a full-fledged punitive-kicker tax penalty regime on the Bentham-Becker model is not the ex post injustice or the over-deterrence problems, or the problems of imperfect insurance markets. Rather, the most troubling concern is the administrability of the penalty provision itself. In the analysis thus far, it has been assumed that the ex post adjudicator, the IRS or court, would be able to determine with perfect accuracy not only the correct answer to the tax question at issue but also, for the purpose of calculating the penalty, the *particular* ex ante probability of detection for the *particular* taxpayer and tax issue under scrutiny. Such an assessment is obviously necessary to calculate the precisely correct cost-internalizing

penalty. But making such an assessment, at least with any degree of precision, would be impossible. That impossibility may well be why the current tax penalty regime falls so far short of the Bentham-Becker ideal – with most penalties capped at 20 percent of the underpaid tax. Indeed, some commentators have cited this problem as a reason not even to attempt an ex post punitive penalty approach to dealing with the low-probability-of-protection problem.⁵⁹ Moreover, this problem is connected specifically to the punitive-kicker penalty and therefore would apply whether the tax liability rule in place were strict liability (as I have been discussing thus far) or fault-based (to be taken up below).

I agree that neither the IRS nor any court evaluating the merits of a particular tax position would be able precisely to calculate the ex ante probability that such a position would be detected. Still, some rough approximation might be possible. For example, the ex post adjudicator, whoever it might be, could begin by relying on the publicly available audit rates for various classes of taxpayers.⁶⁰ Such audit rates would almost certainly overstate the probability of detection for many sorts of tax issues that involve substantial legal uncertainty, given that many such issues avoid detection even on audit. But a penalty based on audit rates would come much closer to the Bentham-Becker ideal than the current regime. Further, as a means of increasing the accuracy of the penalty for the taxpayer in question, the adjudicator might be allowed access to the IRS's confidential information regarding audit strategies and audit probabilities. And for still further refinement, the adjudicator could then consider evidence specific to the individual or corporation before it. Moreover, if we are worried about giving this much enforcement

⁵⁹ See, e.g., Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 *Colum. L. Rev.* 569 (2006) (pointing out the difficulty of such an ex post assessment of the ex ante probability of detection).

⁶⁰ See supra note ____.

discretion to the IRS or to the courts – that is, the discretion to determine the size of the ex post tax penalty based on all of these factors – Congress could enact a schedule of punitive fines that would be based on audit rates and that could be somewhat tailored to the class of transaction at issue.

By offering these responses to the administrability problem, I do not mean to be suggesting that this is a concern that should be overlooked or taken lightly. In my view, it is very likely that this concern may be sufficient reason not to adopt such a regime. However, the question is at least worth further study and should get more attention in the literature than it has received.

To summarize the analysis thus far, under the assumptions laid out in Part III above, when the law is substantively uncertain – in the sense that there is a positive-but-less-than-one probability of success on the merits of the tax position at issue – the optimal tax penalty regime would involve a strict liability rule. (Indeed, under present assumptions, a strict liability rule works when the substantive law is certain as well.) The optimal level of penalty, however, depends on the probability of detection. If detection is certain, there is no need for a penalty in excess of the taxes owed plus interest. If detection is uncertain, as it always will be in the cases of interest to the present analysis (ones that involve substantive legal uncertainty), the penalty should approximate the back-taxes owed plus interest divided by the probability of detection. That is the famous Bentham-Becker kicker. Such a regime would induce the taxpayer to make optimal decisions regarding whether and under what circumstances to rely on uncertain tax law. One conclusion made clear by my analysis is that there is no a priori appropriate or efficient merits probability threshold or minimum. Rather, how certain the taxpayer

ought to be about the substantive law before relying on it will depend on a number of factors, including the size of the potential tax consequences and the potential pre-tax profit expected from the investment. If we are concerned about the potential unfairness are over-deterrence effects of very large potential tax penalties – which could be in the neighborhood of 5, 10, even 100 times the underpaid tax – then tax-penalty insurance could be offered, by private insurers or the government. Indeed, if a Bentham-Becker penalty regime were enacted, such an insurance market would likely arise on its own unless prohibited by law, and whether and how to regulate that market would be the questions.

The preceding analysis looked exclusively at a strict liability approach to tax penalties. Under such a regime, when a taxpayer is singled out for enforcement and has a tax position rejected by the adjudicator, not only is she held strictly liable for any additional tax she is found to owe, but she is also automatically liable for the underpayment penalties as well, which penalties ideally (ignoring all of the caveats discussed above) would be set according to the Bentham-Becker formula. The other option, of course, involves some form of fault-based or negligence standard for assessing penalties. Indeed, the fault-based alternative is deserving of special attention, given that the current tax penalty regime employs a fault-based approach. The obvious questions are whether the fault-based approach could, like the strict liability approach, create optimal ex ante tax compliance incentives, and, if so, which regime can do so at lower cost. Relatedly, does the fault-based approach face drawbacks similar to the ones discussed above. In the next section, I explain two fundamental problems with using a fault-based standard for tax penalties, at least if the standard of fault is tied to whether the

taxpayer satisfied the optimal merits probability threshold. Then I explain why, notwithstanding these problems, there is a second-best argument for adopting, or (more accurately) continuing to use, some form of fault-based approach to tax penalties.

VI. Assessing a Fault-Based Tax Penalty Regime

A. Defining the Fault-Based Standard: Applying the Optimal Merits Probability Threshold

If a taxpayer takes a position on her tax return that relies on a substantively uncertain interpretation of the tax laws (that is, the probability of success on the merits is less than one), and the IRS and the courts decide that the taxpayer happens to be wrong, then, as to the assessment of the underpaid taxes plus interest, the rule almost by definition has to be strict liability. That is, if the ex post adjudicator determines that a taxpayer owes more taxes than she paid (recall: we are assuming that the IRS/and courts resolve this uncertainty definitely ex post), then that is that. The taxes must be paid. You cannot get out of paying your taxes simply because the law, ex ante, was uncertain, even if your interpretation of the law was reasonable.⁶¹ This is because, at bottom, the tax law is distributive in nature, and what the adjudicator is resolving is the uncertainty as to what the distributive burden of the tax laws ought to be.⁶² The interesting question is what

⁶¹ Again, this conclusion assumes there are no “do overs” or “unwindings” of tax transactions. For a discussion of the concept of unwindings, see David Hasen, *Unwinding Unwinding* (working paper). If we allowed unwindings, once a taxpayer made an investment in reliance on uncertain tax law and that uncertainty is eventually resolved by the IRS or a court against the taxpayer (i.e., the court says the taxpayer’s position is wrong and he owes more taxes), the taxpayer would be permitted to say “never mind...I didn’t want to do the deal in the first place.” And the whole transaction would be reversed. Of course, such a result would require the acquiescence of the other party to the transaction.

⁶² In that sense, a court’s interpretation of the tax laws is akin to a court’s interpretation of a contract between two parties: If the court interprets the contract to mean that X owes Y another \$100, then that’s what X owes Y. There is no reasonable-interpretation exception to one’s contract obligations. This conclusion does not deny, of course, that there can be settlements in which parties to uncertain contracts will compromise and split the difference, just as there can be settlements between the IRS and taxpayers when the law is uncertain.

about the penalty – the amount imposed on the taxpayer over and above the underpaid tax liability. The analysis to this point has been focusing exclusively on the possibility of imposing such penalties on the basis of strict liability, which is a term and concept borrowed from tort law. The obvious alternative to a strict liability approach to tax penalties is a fault-based approach.

What would an idealized fault-based tax penalty regime under conditions of substantive legal uncertainty look like? At the most general level, the basic idea of a fault-based tax penalty regime can be stated as follows: If the IRS and the court determines that a taxpayer has, in effect, caused “harm” (by taking a tax position that turns out to have been wrong), whether or not the taxpayer will be required to pay a penalty – in addition to the back taxes plus interest that is by assumption owed – will depend on whether the taxpayer’s position was in some sense “reasonable.”⁶³ What is a “reasonable” tax position under conditions of substantive tax law uncertainty is the interesting question. As it turns out, it is also a surprisingly difficult question to answer, even as a conceptual matter. That is to say, although it is simple enough to apply the torts concept of strict liability in the tax context (since strict liability is pretty much the same across all contexts – that is, the offending (or injuring) party is forced to pay the harm she causes plus some additional penalty in cases of detection uncertainty) – the same cannot be said of the negligence standard.

There is in fact a negligence penalty in the income tax.⁶⁴ And the definition of negligence in tax law owes an obvious debt to tort law. The negligence penalty in tax is imposed for any tax underpayment resulting from the taxpayer’s lack of “due care” or her

⁶³ I.R.C. sec. 6662(b).

⁶⁴ I.R.C. sec. 6662(b).

failure to do what “an ordinarily prudent person would do under the circumstances.”⁶⁵ Precisely what due care means in this context is not clear. The Service has ruled that, to avoid this penalty, the taxpayer must take reasonable steps to determine what the law is and then comply with that reasonable understanding; however, they say very little about what constitutes reasonableness. Of course, the same can be said of the due care standard in tort law, where what constitutes a failure of ordinary prudence will typically be determined after the fact by a judge or jury applying an ad hoc analysis that takes into account all of the relevant facts and circumstances. Some conceptual clarity has been brought to the due care standard in torts, with the famous Learned Hand cost-benefit test, but even that presents conceptual difficulties. The Learned Hand rule, announced in U.S. v. Carroll Towing, says that a tort defendant will be found to have been negligent – that is, found to have violated the “due care” standard – if it can be shown that she failed to take some precaution that would have reduced expected accident costs by more than the cost of the additional precaution. Under Hand’s formulation, a party is negligent if the burden of avoiding the accident (B) was less than the product of the probability of the accident (P) and the potential liability resulting from the harm (L), and the party failed to undertake B. Although the Learned Hand standard has been influential among courts and commentators on tort law, it has also generated considerable controversy. For example, some argue that the information that the Learned Hand standard requires is not available to the factfinders who are asked to do the analysis. I will make a similar argument about applying a Learned Hand type standard in the tax penalty context.

⁶⁵ Cite Neely case. The negligence penalty is separate from the substantial understatement penalty. That is, one can take an uncertain tax position that turns out to be wrong but is reasonable (non-negligent), thus avoiding the negligence penalty, but still have to pay the substantial understatement penalty.

But before we get to that criticism, what would a Learned Hand test even look like in the tax context? One possible approach to a Learned Hand type test for penalties – though, as discussed more fully below, not the approach used in Code – would be to apply a version of the optimal merits probability threshold developed in previous Parts of this Article. To see how this would work, imagine that the taxpayer has taken a particular tax position on her return, the position has been scrutinized by the Service, and the position has been found wanting. That is, the Service and the court have determined that the taxpayer is not in fact entitled to the deduction or credit she claimed, or must include some item of income that she excluded, and thus that back taxes and interest are owed. The Service/court would then ask whether the particular tax position in question *ex ante* (at the time the return was filed) had a probability of success on the merits in excess of the optimal merits probability threshold for that particular position, taking into account the expected pre-tax profit and the potential tax consequences for that particular transaction. If so, the taxpayer's position would be considered reasonable, or non-negligent, and no penalties would be assessed. If, however, the *ex post* adjudicator determined that the tax position in question was *ex ante* below the optimal merits probability threshold for that transaction, the taxpayer would be required pay the penalty. In other words, the taxpayer would in that case have taken an unreasonable tax position.⁶⁶

To get a sense of how this probabilistic fault-based standard might be applied, return to the Joe Taxpayer example, with \$75 expected pre-tax profit, a potential tax

⁶⁶ This is of course not the only possible definition of taxpayer due care. For example, due care might just mean that the tax payer has taken reasonable steps to figure out what the law means. On this view, reliance on an expert's advice might be sufficient to avoid penalties. However, the question would remain whether to impose some minimal threshold of probability of success on the merits. That is, surely reliance on legal advice would not excuse a clearly illegal position. Moreover, allowing reliance on expert advice to avoid the negligence penalty would just push the penalty question back one step: what should the standard of care be for the expert in advising a client to take a particular position.

liability of either \$0 or \$100, and a detection probability of 0.01. Thus, for that transaction, the optimal merits probability threshold is 25 percent. That is, it is socially cost-justified for Joe to make the investment if the likelihood of success on the merits is equal to or greater than 25 percent, but not otherwise. Now imagine that Joe, after doing the requisite legal research (or having his lawyer do it), learns that the particular transaction has a 40 percent chance of prevailing if detected, and he makes the investment. However, he happens to get selected for audit and, darn the luck, ultimately loses the case. That means the court says Joe owes another \$100 of tax, which he does (as we are assuming that the courts are never wrong). But does he owe a penalty as well? Not according to our fault standard. Joe made a reasonable (by which I mean, socially cost-justified) bet on the law under the circumstances, the same choice he would have made if detection had been certain and the penalty equal to the harm. Therefore, under this theoretical tax-penalty standard, Joe would owe no penalty. If, however, the probability of success on the merits for the transaction had been, say, 22 percent, and he had made the investment and, again, gotten caught and lost the case, he would have been required to pay the punitive penalty as well – the additional \$9,900. (Deterrence theory tells us that the punitive penalty should be calculated according to the Bentham-Becker formula, even for a fault-based regime.) With such a probabilistic fault-based penalty in place, taxpayers would, under current assumptions, be deterred from taking unreasonably aggressive tax positions under circumstances in which the law is uncertain. This result is analogous to the conclusion reached in the economic analysis of the negligence rule in torts.⁶⁷

⁶⁷ According to that analysis, assuming a world similar to the one I have been assuming in this Article (i.e., perfectly rational actors, no judicial errors, etc.), a negligence standard set at the efficient level of care (that

B. The Problems with a Probabilistic Fault-Based Tax Penalty Regime

Some of the problems with a probabilistic fault-based tax penalty regime are similar to the problems with a fault-based tort regime; some are unique to the tax context. This section discusses those problems. Section ___ below, however, resurrects the case for a modified version of the fault-based standard.

So what's wrong with the above-described idealized form of a fault-based tax penalty regime? The most obvious concern, and ultimately perhaps the most troubling, is the problem of administrability. How is the IRS or a court, looking at a tax position that it has decided lacks merit, supposed to determine the ex ante optimal merits probability threshold for that particular transaction?⁶⁸ We have thus far assumed that courts get everything exactly right when they resolve the tax law uncertainty ex post, but to expect a court to do *this* analysis seems excessively optimistic. And the problem seems more challenging than the problem (discussed earlier) of determining the ex ante probability of detection for the purpose of calculating the appropriate punitive penalty, which again would be required under both the strict liability and fault-based approaches. In assessing ex ante probabilities of detection, at least the court can rely initially on concrete information that is in the hands of the government – i.e., audit rates – as a starting point for the analysis. With the probabilistic fault analysis, however, the ex post adjudicator must determine what the optimal merits probability threshold for this tax transaction is, or, more precisely, what that probability *was* at the time the transaction was entered into.

is, the so-called “due care” standard) would induce potential tortfeasors ex ante to take all reasonable (i.e., cost-justified) steps to minimize the incidence and severity of accidents. The seminal article explaining how a negligence standard in tort can induce optimal levels of “care” is Brown. Shavell, supra note ___, ch. 4 (“Factors Bearing on the Determination of Negligence”); and William M. Landes & Richard A. Posner, *The Economic Structure of Tort Law* ch. 3 (“Strict Liability versus Negligence”).

⁶⁸ Such information cost objections to fault-based liability regimes are commonplace in the economic literature on deterrence. Shavell, supra note __; Landes & Posner, supra note __; Polinsky, supra note ___.

Which means figuring out what the expected pre-tax profit from the deal was expected to be and what the potential tax consequences would have been, as well as making an ex post assessment of the ex ante likelihood that the taxpayer would ultimately (ex post) succeed on the merits. As difficult as this last element of the fault-standard sounds (determining the ex ante probability of success on the merits), it is in fact what the IRS and courts today are asked to do when applying the various understatement penalties under existing law. That is, in cases in which a taxpayer's reporting position is challenged and ultimately overturned by a court, the penalty phase of the analysis requires the court to make an ex post guess of the ex ante strength or weakness of the taxpayer's legal position (literally cast in terms of probability of success on the merits).⁶⁹

Even if a fault-based approach to tax penalties could be made administrable (more on this below), it still may not be superior to the strict liability tax-penalty regime, at least if we continue with our present assumptions. Both types of penalty regimes, by assumption, would entail the ex post analysis of the probability of detection, in order to set the proper Bentham-Becker penalty. However, only the fault-based approach would also require a second costly application of the appropriate merits probability threshold. One possible response to this observation is that, if we return to the standard deterrence assumptions (perfect rationality, no judicial error, etc.), a fault-based approach might be superior because, for game-theoretic reasons, the penalty would never actually have to be imposed. The reason is simple: given the potential liability that the taxpayers face, and given the all-or-nothing nature of the fault standard (that is, if you satisfy it, you avoid all of the penalty – all \$10,000 in our example), taxpayers would have an incentive to be at

⁶⁹ Those penalties, again, are usually 20 percent of the underpaid tax, and sometimes, though rarely, as high as 75 percent. See *supra* note ___ (discussing existing tax penalty regime).

least efficiently conservative, in the sense of only making investments with merits probabilities greater than the efficient threshold that the Service would apply to their conduct. As a result, again for game-theoretic reasons, all taxpayers would have an incentive to satisfy the fault standard, and hence in theory there would be no need for the penalty to be imposed. To put this point differently, under a fault-based tax penalty regime, taxpayers who are taking advantage of uncertain tax rules can, in effect, insure themselves against the risk of a large tax penalty (should the uncertainty be resolved against them) by taking only reasonable tax positions, only positions that fall within the relevant merits probability threshold. Assuming that courts never make mistakes in their ex post penalty assessments, and taxpayers never make mistakes in calculating the relevant ex ante merits probability threshold, the decision only to take reasonable tax positions would be (almost) equivalent to the purchase of tax risk insurance. The result is an increase in social welfare, as risk-averse taxpayers would bear less risk.⁷⁰

Interestingly, in the general economic deterrence literature, this observation – the fault-based system’s ability to reduce risk-bearing because the sanction is never used – is sited as an independent reason, though not necessarily an overwhelming reason, to prefer the fault-based approach over the strict liability approach.⁷¹

Beyond the administrative costs arguments already discussed, there are two fundamental problems with the use of a fault-based tax-penalty standard. The first – the activity-level problem – is well known in the deterrence literature and applies to the use

⁷⁰ Of course, once we allow the possibility of legal errors on the part of the taxpayer or the courts, risk-bearing and the demand for insurance returns. Below I explain why the reasonable-tax-position safe harbor is importantly different from the purchase tax liability insurance.

⁷¹ Polinsky & Shavell, *The Theory of Public Enforcement of Law*, supra note ___, at ___.

of a fault-based standard in any context.⁷² The second – which for lack of a better term I will call the distributional problem – has not previously been discussed and applies only to the use of a fault-based standard in the context of tax penalties.

The activity-level problem is straightforward: To the extent that taxpayers comply with the fault standard, and again assuming courts always get it right, taxpayers can be sure that they will not face a tax penalty. This fact, as mentioned above, reduces the risk that they bear. It also means, however, that they are not forced to internalize the cost of those tax positions that happen to turn out to be wrong – wrong but reasonable. As a result, they will have an incentive to engage in the activity beyond the point at which it is socially cost-justified for them to do so. We can see this point in the example from above. The taxpayer is considering a transaction with an expected pre-tax profit of \$75 and a 60 percent chance of a causing a \$100 tax liability. Under a strict liability approach, he would face an expected tax liability of \$60, either because of the expected ex post fine or because of the ex ante insurance premium. Therefore, the taxpayer would make the investment so long as the \$15 profit from the deal were superior to whatever after-tax profit he could get from some alternative use of the investment, but not otherwise. With the fault-based approach, however, assuming the merits probability is at least greater than 25 percent, the taxpayer's expected after-tax profit from making the investment would be \$75. Thus, he would engage in the transaction so long as there were no other similar investment that produced more than a \$75 after-tax profit. In sum, the taxpayer would be induced to engage in the questionable transaction even when it is not socially cost justified. (For example, he would invest in this transaction even if there were another transaction with an expected after-tax profit of, say, \$70.) More generally,

⁷² Shavell, *supra* note __, at __.

with a fault-based tax penalty regime, there would be an incentive to over-invest, or invest too often, in legally uncertain tax transactions. This problem does not exist with strict liability, where the taxpayers are forced to internalize the expected tax liability associated with their investments. The relative superiority of strict liability over fault-based standards in dealing with activity-level issues on the part of “potential injurers” is well established in the deterrence literature, and the same arguments would seem apply in virtually any deterrence context.⁷³

The distributional problem with a fault-based tax penalty seems to apply uniquely, or at least especially, to the tax context. (And as far as I know, it has never been noticed before.) The problem arises insofar as the fault-based penalty eliminates or reduces the actual imposition of the tax penalties. Recall the observation above that, under ideal circumstances, taxpayers are induced to satisfy whatever threshold of reasonableness is set for them by the courts such that no penalties are assessed. Again, in non-tax areas, this fact is cited as one of the advantages of a fault-based standard, because it means there is no risk-bearing. The difficulty is that, in the tax area, there is a distributional reason

⁷³ Id. A classic example in the torts context illustrating the distinction between care levels and activity levels, and how these variables come out differently under negligence and strict liability, involves driver-pedestrian accidents. Under both a strict liability rule and an idealized negligence rule, drivers will have an incentive to take optimal care when they drive. However, under a negligence rule, drivers will drive too often (or beyond the point at which the next mile driven produces marginal social cost in excess of marginal social benefit), because they will be immune from liability for “unpreventable” accidents. Under a strict liability rule, by contrast, drivers would bear the cost of unpreventable accidents and thus would be induced to take into account those costs when deciding how often or how much to drive. Polinsky, *supra* note __, at __. If we assume further that only drivers (and not pedestrians) can affect the probability or severity of accidents (that is, we assume driver-pedestrian accidents are “unilateral accidents”), then the above analysis suggests that strict liability would be the more efficient liability rule, because it can optimize both care levels and activity levels of potential injurers. If we assume, however, that pedestrians can affect the expected accident costs as well, through care-level investments or changes in their activity levels, then the story gets more complicated. I am assuming for now that the choice of a tax liability rule can only affect the behavior of taxpayers (the potential injurers here) and not Congress or Treasury (acting on behalf of the “injured” fisc).

that we *want* the penalties to be imposed. The failure to impose the penalties actually reduces social welfare, and for distributional reasons, not deterrence reasons.

The best way to illustrate this point is by example. Consider our recurring hypothetical, the one with the 100,000 taxpayers all engaging in a tax transaction with a 60 percent chance of producing a \$100 tax liability, and hence the expected tax liability of \$60 per taxpayer. Hence, the transaction has 40 percent chance of winning on the merits. Under the fault-based standard described above, all of the 100,000 taxpayers would have engaged in this hypothetical transaction because the 40 percent chance of prevailing on the merits would be deemed a “reasonable” position by a court. This is because the 40 percent merits probability surpasses the optimal merits probability threshold for this transaction (which, recall, was 25 percent). According to the assumptions of the example, then, 1000 of those taxpayers would be audited, and 600 of those would lose their cases on the merits. For those 600 taxpayers, then, the fault-based penalty analysis would be applied, and the court would inquire as to the reasonableness of the position taken. As noted, the answer would be yes, the position was reasonable. Thus, *none* of taxpayers would be assessed a penalty. Which means that the total amount of tax revenue collected from these taxpayers for this transaction would be \$60,000 – \$100 of taxes multiplied by 600, the number of taxpayers who were audited and lost their cases. So what’s wrong with this picture?

The problem is that, in terms of probabilistic distributive justice, \$60,000 is approximately \$5.94 million too little to be taxing this group of 100,000 taxpayers who are engaging in a series of transactions that almost certainly are collectively producing an income tax liability of \$6 million. That is to say, if it were feasible and cost-justified to

audit all 100,000 taxpayers who engaged in this transaction, approximately 60,000 of the taxpayers would be found to owe \$100, and the other 40,000 taxpayers, nothing. That is what we meant above when we assumed that the 100,000 transactions in question had a 40 percent chance of prevailing on the merits. Of course, auditing all 100,000 taxpayers is by assumption not feasible. The question therefore is what the tax system can do, in terms of allocating the tax burden consistent with society's distributional values or preferences. The answer may be somewhat surprising: Given that every one of the 100,000 taxpayers engaged in a tax transaction that created an *expected tax liability* of \$60, the best the income tax system can do might be to collect something close to \$6 million from the group, getting \$60 from each of the 100,000, since they are all equal in the eyes of the law with regard to these transactions. That is, as among the 100,000, the principle of horizontal equity would suggest that each should pay \$60 in income taxes for engaging in the transaction in question.⁷⁴ And because a fault-based standard can, for game-theoretic reasons, result in the imposition of no penalties (again, assuming all taxpayers rationally decide to comply with the standard), only the strict liability tax-penalty system (which imposes the penalty on the few audited taxpayers found to owe taxes) would achieve this distributively desirable result. That is, only the strict liability

⁷⁴ The following is a summary of the possible distributive combinations associated with the strict-liability and fault-based approach to tax penalties, using the example in the text. It assumes that a Bentham-Becker penalty regime is in place, but that no penalties are assessed under a fault-based regime, since all taxpayer are induced to meet the threshold standard of reasonableness: 1) *the fault-based approach (with no insurance)*: the 600 taxpayers who are audited and lose pay \$100 each; everyone else – the 400 who are audited and win and the 999,000 who are not audited – pays nothing, for a total of \$60,000 in taxes collected from this group (the other \$5,940,000 would come from other taxpayers); 2) *the strict liability approach (without insurance)*: the 600 taxpayers who are audited and lose pay \$10,000 each; the 400 who are audited and win, and the 999,000 who were not audited, pay nothing, for a total of \$6 million; 3) *the strict liability approach (with insurance)*: each of the 100,000 who engages in the transaction pays \$60, for a total of \$6 million, which gets paid by insurer when 600 taxpayer/insureds are required to pay \$10,000 each; and finally 4) changing the example to allow for a detection probability of one, 100,000 taxpayers get audited and 60,000 are required to pay \$100 in back taxes each (no penalty in that case is necessary), for total of \$6 million.

tax-penalty regime forces taxpayers who make investments in reliance on uncertain (sometimes very uncertain) tax positions to bear the expected income tax liabilities associated with those positions.⁷⁵

Note how this result differs from the result in a non-tax area of law, such as torts, where we do not usually think of the law as being explicitly distributive in nature. If we imagine tort law being primarily about deterring accidents, rather than about trying to achieve a particular distribution of income, we do not care whether the penalties ever get imposed. So long as, say, drivers are encouraged to drive carefully or manufacturers are induced to make safe products, there is no independent reason to require the payment of fines or damages. The victims of accidents caused by reasonably safe driving or reasonably safe products can be compensated much more efficiently through their own first-party insurance companies than through penalties assessed by the government. But tax law is different, or at least that is the conventional wisdom.⁷⁶ Tax law, at least the income tax, is primarily about (a) raising revenue to spend on public goods and (b) allocating the tax burdens in a manner consistent with our society's vision of distributive fairness, whatever that vision happens to be. Hence, when Congress decides that the tax system should collect X dollars from taxpayers who meet a particular description, taxpayers who satisfy certain criteria set out in the law, then failing to collect the tax from

⁷⁵ Whether one believes that the strict tax liability approach, plus the Bentham-Becker penalty, must be accompanied by tax liability insurance to achieve these distributive justice superiority over the fault-based approach will depend largely on whether one is an ex ante or ex post egalitarian. That is, if you think that fairness requires only that each of the 100,000 taxpayers in my example be treated equally only with respect to their ex ante choice, and not the ex post outcomes, then the insurance is not necessary. Each of the 100,000 had the chance to decline to engage in the risky tax position, and if they eventually experience the large Bentham-Becker penalty, that is a function of pure option luck. Again that result assumes perfectly informed voluntary decisionmaking on the part of the taxpayers, which may approximate the real world in cases involving sophisticated taxpayers.

⁷⁶ For an argument that other areas of law besides tax might also be understood as having a distributive component, see Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 Tax L. Rev. 203 (2003).

those individuals means we have to raise the money some other way, such as increasing the national debt or raising rates on everyone. The problem is that either of these latter options produces a distributive result that is different from what Congress intended, different from the social optimum. And these divergences from the optimal distributive outcome represent losses of social welfare to the same extent as do distortions of labor choices caused by various tax rules.⁷⁷

In sum, the main problems with a probabilistic fault-based tax penalty regime are that such a regime (a) is relatively difficult to administer, (b) owing to the activity-level effect, may result in far too many uncertain (albeit “reasonably uncertain”) tax positions being taken, and (c) fails to allocate the tax liabilities associated with those legally uncertain transactions to the group of taxpayers who engaged in them. In its idealized form, the strict liability tax penalty regime – with the Bentham-Becker penalty, accompanied by a tax transaction insurance regime (which could somehow deal with the adverse selection and moral hazard problems) – is able to avoid or at least minimize these problems. That result, however, depends on several key assumptions. It should come as no surprise, therefore, that the best case for using a fault-based tax-penalty builds on the inapplicability of these assumptions in the real world.

C. The Best Case for a Fault-Based Tax Penalty Regime

As mentioned above, and as every tax practitioner knows, the tax-penalty regime currently in effect for the U.S. income tax is a combination of (a) strict liability with respect to back taxes and interest and (b) a fault-based system of sorts for penalties. But what sort of fault-based penalty is it? In fact, as mentioned above, there are several tax

⁷⁷ Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 Nat. Tax J. 1035 (1996).

penalties, all of which require some showing of fault on the part of the taxpayer. There are penalties for tax fraud, where the taxpayer knowingly and intentionally violates a clear tax law.⁷⁸ Again, those penalties do not involve situations of substantive legal uncertainty. Then there is the negligence penalty, where the taxpayer is penalized for failing to do what a reasonable taxpayer would do under the circumstances. Again, it is unclear what would qualify as reasonable in this setting, but the Service has said that it amounts to the sort of mistake that the average taxpayer might make, assuming she has made reasonable efforts to inform herself of the law (whatever that means). Interestingly, the Service has further defined reasonable care to include any tax position that has at least a “reasonable basis” in the law.⁷⁹ Recall that the reasonable basis standard – which is more stringent than non-frivolous and less stringent than substantial authority – is sometimes quantified as approximating 20 percent likelihood of winning on the merits. There is also the substantial understatement penalty, which would apply instead of the negligence penalty to large tax understatements and which has a more stringent fault-based standard: that is, the taxpayer must have more than a reasonable basis; she must have substantial authority for the questionable position. Here the safe harbor or target level of threshold probability is closer to 40 percent. And under current law, this target threshold probability of legal certainty rises (to 50 percent) for certain categories of tax positions, such as so-called “reportable transactions,” that are considered somewhat more questionable because of their nature.

What all of the current fault-based tax penalties have in common, then, are their reliance on targeted threshold merits probabilities. How might such penalty regime be

⁷⁸ I.R.C. sec. 6663.

⁷⁹ Reg. §1.6662-3(b)(1).

justified, given the analysis above that seems to favor a strict liability penalty regime?

Let's begin by recognizing that a full-fledged Bentham-Becker penalty regime across the board to all taxpayers is unrealistic. This is so both because of the ex post unfairness and judgment proof problems of imposing large punitive penalties on the few taxpayers whose tax positions are rejected on audit and because of the imperfections in the tax transaction insurance response. Although it is an interesting theoretical possibility, Congress will never in fact adopt a tax penalty regime that would impose a \$9,900 penalty for a tax underpayment of \$100. Given this fact, we are probably limited to tax penalties that are far lower than the Bentham-Becker ideal, though it is difficult to deny that the normal penalty should be greater than the current 20 percent of the tax underpayments.

If for practical or political reasons we are unlikely ever to have tax penalties that approximate the Bentham-Becker ideal, a reasonably strong argument can be made for using a fault-based approach, of the sort that creates target thresholds of legal certainty. The gist of the idea is simple: If we cannot adopt a regime that would in effect induce taxpayers themselves to identify the optimal merits probability threshold for a given transaction and to make optimal decisions at the margins regarding whether to rely on a particular uncertain tax interpretation or not (which again is what the idealized strict liability regime would do), we should instead choose some arbitrary merits probability threshold – some minimally acceptable target level of legal certainty – and then, through the use of penalties, try to induce everyone at least to meet that standard. Such an all-or-nothing penalty would have the effect of creating relatively strong incentives for taxpayer compliance at least to the extent of the target threshold level of certainty. This is because

the taxpayer by satisfying the targeted threshold level of legal certainty can avoid all penalties; whereas, if she fails to satisfy it and gets caught, she owes the full penalty. This all-or-nothing effect would be especially strong for taxpayers who are risk averse with respect to large tax penalties and there is some uncertainty as to the actual application of the standard by the IRS and the courts.

Does this mean that current law has chosen the optimal target thresholds of legal certainty to serve as triggers for the various penalties? That is, are reasonable basis, realistic possibility of success, substantial authority, and more likely than not the right thresholds? And does the law assign the right legal certainty target for the right types of transactions? That is impossible to say. My own instinct would be, in addition to increasing the magnitude of penalties, it would be useful to increase the threshold target level of certainty for all fault-based penalties to more likely than not, but that is just an instinct. The alternative would be to keep the general shape of the current penalty regime, which imposes a higher certainty threshold for (a) uncertain tax positions that are not disclosed to the service (and hence that have a lower probability of detection) and (b) tax positions that are similar in structure to positions that are known to be especially aggressive, but perhaps to raise the level of certainty required for any type of tax position to avoid penalties.

Conclusion

No matter how hard Congress and the Treasury Department try to specify the precise tax treatment of every conceivable situation, it can't be done. There will always

be gaps in the tax laws. Given this fact, what tax penalty regime will induce taxpayers to make the right choice regarding whether, and under what conditions, to rely on a particular uncertain interpretation of the law? This question is made much more interesting, and problematic, because of a second type of legal uncertainty – that is, detection uncertainty, or the uncertainty as to whether a particular tax position will even be questioned by the enforcement authorities. The combination of these two types of legal uncertainty creates a serious tax enforcement problem.

This Article observes that there is no a priori “right” level of legal certainty that a taxpayer must have before relying on a particular interpretation of uncertain tax laws. Rather, the optimal threshold of substantive legal certainty will depend on the case, specifically on the amount of taxes at stake and the expected pre-tax profit from the transaction in question. The Article contends that, applying the standard assumptions from the economic literature on deterrence, the optimal tax penalty regime would involve (a) a rule of strict liability with respect to taxes owed as well as the penalty, and (b) a penalty calculated on the basis of the famous Bentham-Becker formula, which divides the harm (here, the underpaid tax) by the probability of detection. Such a rule would induce taxpayers to make the optimal ex ante decisions regarding when, and to what extent, to rely on particular interpretations of uncertain tax laws. The Article also explains why, under these same assumptions, a fault-based approach to tax compliance penalties would not work as well, owing to the fault-based approach’s comparatively high administrative costs, its inability to regulate activity levels, and its relatively unattractive distributional consequences (especially if either private or government-provided tax transaction insurance for substantively uncertain positions is allowed and available).

All of these conclusions are based on some pretty strong assumptions. Some of the assumptions, although obviously unrealistic (such as the perfectly rational taxpayer assumption and the infallible IRS/court assumption), do not tend to favor one penalty regime over another. Others, however, may actually affect the comparison. For example, if it simply is not possible, for political or other reasons, to impose large punitive penalties that approximate those suggested by the Bentham-Becker model, then it is not clear that a strict liability regime is superior to a fault-based regime. In that case, a fault approach, with an arbitrarily chosen – and somewhat high – targeted merits probability threshold might induce a higher level of tax compliance than would a strict liability rule, especially if taxpayers are risk averse (and not allowed to insure) and hence would have a tendency to over-comply with the uncertain standard.⁸⁰ Also, if we allow for the possibility of informal sanctions, such as social norms against tax non-compliance, which we have been assuming away, it might be that lower formal penalties would lead to higher informal penalties; and the combination might provide greater overall deterrence than the imposition of a true Bentham-Becker penalty regime.⁸¹

Besides the fact that 20- and 30-percent underpayment penalties are probably too low to get the ex ante compliance incentives right, this Article takes no ultimate position on which tax penalty regime is best. My goal in this Article, rather, has been to set forth a framework for analyzing this question. My own tentative view is that a fault-based tax-penalty standard might work best with most individual taxpayers, but that with corporate

⁸⁰ See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 Va. L. Rev. 965 (1984).

⁸¹ This might be true, for example, if it turned out that formal tax penalties, such as those provided in the Code and enforced by the IRS, had the effect of “crowding out” more informal sanctions for tax noncompliance. Of course, formal and informal penalties do not necessarily have to interact as substitutes; they could also be complements, in which case cutting formal penalties may send the wrong message and actually encourage noncompliance.

taxpayers (and perhaps some wealthy individual taxpayers) a strict liability approach with something approaching Bentham-Becker penalties – and private or government-provided tax transaction insurance – might be worth trying. The other interesting question raised by this Article’s analysis is whether the same questions are raised – such as the question of the optimal merits probability threshold – and the same framework could be applied to any area of law in which the substantive legal standards and rules are uncertain. That question must await another article.