The Case Against Strategic Tax Law Uncertainty

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LEIGH OSOFSKY*

I. INTRODUCTION

Treasury and the IRS face a formidable task. Together, they are charged with administering the morass that is the U.S. tax law. In fulfilling this duty, they face constant pressure regarding the amount and nature of guidance that they should issue to taxpayers. When making these decisions, tax administrators have to take into account a variety of considerations, including the cost of issuing guidance, the limited tax administrator resources available to do so, and the likelihood that taxpayers will exploit the guidance that is issued.

Against this backdrop of ongoing angst regarding release of tax guidance, an important idea has surfaced in the tax compliance literature. Prominent tax compliance scholars have argued that the strategic use of tax law uncertainty may cause taxpayers to report higher tax liability. Strategic tax law uncertainty, in this context, means strategically

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1 IRC § 7805 (tasking the Secretary of the Treasury with “prescrib[ing] all needful rules and regulations”), § 7803 (allowing delegation to the Service).

2 Taxpayers and their advisors serve as a major source of pressure. See, e.g., ABA Members Seek More Guidance on Codification of Economic Substance Doctrine (Jan. 18, 2011), 2011 TNT 12-13, Jan. 18, 2011, available in LEXIS, Tax Analysts File, for one of many taxpayer demands for more guidance about the codified economic substance doctrine. The economic substance doctrine is discussed at text accompanying notes 98-112.

3 See letter from Douglas Shulman, IRS Comm'r, to Max Baucus, Chairman, Senate Fin. Comm. (Nov. 5, 2010), reprinted in Shulman Warns of Challenges for IRS of Delayed AMT Patch, 2010 TNT 217-23, Nov. 10, 2010, available in LEXIS, Tax Analysts File (discussing the “strain” on the Service’s “limited resources, which have been tapped on numerous occasions over the last three years to implement tax legislation”).

4 See, e.g., Suzanne Scotchmer & Joel Slemrod, Randomness in Tax Enforcement, 38 J. Pub. Econ. 17, 17 (1989) (“When there is tax evasion, increased randomness about how much taxable income an auditor would assess generally leads to higher reported income and more revenue.”); Suzanne Scotchmer, The Effect of Tax Advisors on Tax Compliance, in 2 Taxpayer Compliance 182, 187 (Jeffrey A. Roth, John T. Scholz & Ann D. Witte eds., 1989) (“[T]he imperfectly informed risk averse taxpayer bears involuntary risk, unlike the
withholding tax law guidance, so that taxpayers have less certainty regarding their tax liability. Scholars who provide support for strategic uncertainty posit two responses to its use: (1) Risk-averse taxpayers may dislike the involuntary risk imposed by more uncertain tax law and therefore may report higher tax liability to minimize the risk. (2) Taxpayers who believe that the IRS will audit more under increased uncertainty may report higher tax liability to avoid the perceived higher chance of audit. These theories suggest that tax administrators could use uncertainty as another tool in the tax compliance arsenal. By strategically holding back on guidance for taxpayers with underreporting opportunities, tax administrators could reduce taxpayers’ inclinations to take overly aggressive, or even evasive, reporting positions. As a result, tax administrators could increase revenue by reducing underreporting.

While these theories have strong economic appeal, this Article counsels against their acceptance. In contrast to the support for stra-

perfectly informed taxpayer, who has the option of avoiding all risk. The risk averse taxpayer may cope with involuntary risk by reporting conservatively.”); Woon-Oh Jung, Tax Reporting Game Under Uncertain Tax Laws and Asymmetric Information, 37 Econ. Letters 323, 324 (1991) (setting forth game-theory model, which concludes that “in general an increase in uncertainty induces conservative reporting (i.e., reporting of a higher amount), and enhances the expected revenue of the agency”); David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 250 (2002) (citing Scotchmer and Slemrod model for proposition that “uncertainty creates incentives for taxpayers to report higher amounts on their tax returns,” but also noting some potential objections, including that taxpayers may be able to capture the majority of the bargaining surplus under uncertainty); Marsha Blumenthal & Charles Christian, Tax Preparers, in The Crisis in Tax Administration 201, 205 (Henry J. Aaron & Joel Slemrod eds., 2004) (“If taxpayers are averse to the risk of an audit, they report more income as their uncertainty rises.”); Kyle D. Logue, Optimal Tax Compliance and Penalties When the Law Is Uncertain, 27 Va. Tax Rev. 241, 250-51 (2007) (“[I]f 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.”). Compare Mark P. Gergen, Uncertainty and Tax Enforcement: A Case for Moderate Fault-Based Penalties, 64 Tax L. Rev. 453 (2011) (analyzing how penalties can create risk for risk-averse taxpayers given a stagnant amount of uncertainty).

5 For the remainder of the Article, the term “strategic uncertainty” is used to convey the concept of strategically withholding tax law guidance.

6 A possibility not examined in the literature is that simply making taxpayers more cognizant of the existing level of tax law uncertainty, without strategically withholding guidance, may have the same impact. This method may be subject to less concern about fairness. Fairness concerns are discussed further in Section II.D.

7 See Logue, note 4, at 250-51 for such a suggestion.

9 For a discussion of the difference between aggressive tax positions (also often characterized as “tax avoidance”) and evasion, see Agnar Sandmo, The Theory of Tax Evasion: A Retrospective View, 58 Nat'l Tax J. 643, 645 (2005) (describing “tax evasion” as “a violation of the law” and “tax avoidance” as “within the legal framework of the tax law”). In this scheme, an aggressive position is one that is unlikely, but possible, under current law, whereas tax evasion is clear failure to abide by existing tax law.
tegic uncertainty in the literature, I argue that this move may have perverse effects on taxpayer reporting and may lower, rather than raise, revenue. This argument relies on fundamental features of the tax compliance framework, which could create significant problems with translating the theory behind strategic uncertainty into less underreporting. As a result, this Article cautions against reliance on strategic uncertainty as a tax compliance tool.

In so doing, this Article does not advocate tax law certainty at all times at any cost. Rather, the Article seeks to undermine an increasingly ingrained strain of thought, which provides support for strategic uncertainty as a revenue-raising tax compliance tool. More generally, the Article cautions against the difficulties of relying upon simplified economic models regarding taxpayer incentives when making policy decisions for the complex real-world tax compliance framework.

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10 This Article focuses on features of the tax compliance framework that exist across different taxpaying contexts, such as business versus individuals. The Article also incorporates generalized empirical evidence regarding taxpayer reactions to uncertainty based on actual tax return data, to the extent such empirical evidence is available. For a discussion of the limitations that the IRS places on the release of its tax compliance data, see Steven Klepper & Daniel Nagin, The Anatomy of Tax Evasion, 5 J.L. Econ. & Org. 1, 2 (1989). Future projects may expand on the analysis in this Article by examining at a more fine-grained level the impact of uncertainty in different taxpaying contexts and by developing additional empirical evidence regarding the impact of uncertainty on taxpayer behavior, potentially through experiments, which would be sensitive to the fundamental features of the tax compliance framework set forth in this Article.

11 Further discussion of some reasons why tax law uncertainty may, at times, be necessary or desirable can be found in Section II.A.

12 In recent years, behavioral law and economics has questioned many of the neoclassical economic assumptions that have been integrated into law and economics. While various behavioral modifications to economic principles can be re-envisioned as actually following from classical economic assumptions, doing so is often a tortured and unconvincing process. See, e.g., Richard A. Posner, Economic Analysis of Law 18 (7th ed. 2007) (explaining that "[h]yperbolic discounting may be explicable by positing that the 'individual' is actually a succession of separate selves, 'time sharing' the same body."). It is more straightforward to accept that people often exhibit behavioral deviations from the rational choice theory that underlies law and economics analysis. See Frank Cowell, Carrots and Sticks in Enforcement, in The Crisis in Tax Administration, note 4, at 239 ("The expected utility (EU) paradigm may be good as a device for simplified model building, but it may miss important nuances about people's preferences in the face of uncertainty."). When evaluating a policy in the abstract, conventional law and economics wisdom may helpfully develop a theory of how completely rational utility-maximizing individuals should respond. See Posner, supra, at 16 (emphasizing that economics produces theories, not descriptions). If, however, behavioral study suggests that people will systematically respond to the policy differently than economic theory predicts, optimal policymaking dictates incorporation of this information into a decision regarding whether and how to adopt the policy. See Christine Jolls, Cass R. Sunstein & Richard H. Thaler, A Behavioral Approach to Law and Economics, 50 Stan L. Rev. 1471, 1544-45 (providing example where the government should take into account consumers' failure to heed warnings in evaluating the costs and benefits of installing a safety device); Edward J. McCaffrey & Jonathan Baron, Thinking About Tax, 12 Psychol. Pub. Pol'y & L. 106, 109 (2006) ("If people really do think in ways
This Article sets forth three reasons to doubt the utility of strategic uncertainty as a tax compliance tool designed to raise revenue by reducing underreporting. First, strategic uncertainty may cause taxpayers to perceive ambiguity, rather than risk, regarding particular tax issues. Ambiguity is a particular form of uncertainty, in which taxpayers face uncertainty regarding the probability of obtaining a tax outcome. Taxpayers may have divergent reactions to increased ambiguity, whereby taxpayers with a low chance of success on the merits would be more likely to claim tax benefits, whereas taxpayers with a high chance of success on the merits would have the opposite inclination. As a result, the impact of strategic uncertainty on revenue becomes unclear. Additionally, increased aggressiveness by taxpayers with a low chance of success on the merits, offset by more conservative behavior by already conservative taxpayers, would be an undesirable reaction to a tax compliance tool designed to raise revenue by reducing aggressive and evasive tax positions.

Second, the likelihood of monetary tax penalties applying actually declines as uncertainty increases. Historical analysis indicates that the decreasing likelihood of the imposition of penalties as uncertainty increases is a deeply-rooted feature of the tax penalty system and is unlikely to change. Tax penalties should cause taxpayers to avoid taking a chance by reporting less than they owe, hoping to elude detection and thereby reduce their total tax costs. As a result, the decline in monetary tax penalties as uncertainty increases should significantly reduce taxpayers’ incentives to report more tax liability in response to strategic uncertainty and may cause taxpayers to report less. Additionally, while more empirical work remains to be done regarding noneconomic incentives to pay taxes under uncertainty, the likely reduction of such noneconomic incentives in response to strategic uncertainty may compound the effects of the increasingly low likelihood of monetary tax penalties as uncertainty increases.

Third, taxpayers should not have strong tactical reasons to increase tax liability reporting in response to strategic uncertainty and, instead, may have the opposite incentives. While taxpayers may take into account the Service’s incentives in deciding how much tax liability to report, the IRS’s ability to capitalize on broad-based strategic uncertainty would require higher audit rates, a prospect that taxpayers should be unlikely to find credible. Even if taxpayers believe that the...
IRS could audit more as uncertainty increased, taxpayers' incentives to engage in negotiation posturing and an increasing tendency to rely on professional tax return preparers might cause taxpayers to report less, rather than more, tax liability in response to strategic uncertainty.

The remainder of this Article proceeds as follows: Part II sets forth the emergence of the notion of strategic uncertainty as a tax compliance tool. The next Part offers three reasons why this concept does not withstand analysis: (1) Taxpayers' potentially divergent responses to ambiguity may undermine the efficacy of strategic uncertainty. (2) The decrease in tax penalties as uncertainty increases should impact tax liability reporting incentives. (3) Tactical reasons may cause taxpayers to report less, rather than more, tax liability in response to strategic uncertainty. Part IV concludes.

II. THE EMERGENCE OF STRATEGIC UNCERTAINTY

A. Tax Law Uncertainty Generally

Understanding proposals for strategic uncertainty requires an understanding of tax law uncertainty generally. Tax law uncertainty, in this context, means any type of tax law question that a taxpayer cannot definitively resolve based on the available tax law authority. To many, it may seem anathema not only to require the average, individual taxpayer to pay taxes to the government, but then also to subject her to uncertainty regarding her tax liability. Indeed, the tax system mirrors this impulse. The average taxpayer with a simple tax situation, such as receipt of only wage and interest income, does not experience significant legal uncertainty regarding tax liability.\(^{13}\) Tax liability in such cases is generally not only clear, and likely to remain clear even given a drastic increase in tax law uncertainty, but also subject to third-party information reporting, which alerts the IRS as to the amount of tax owed.

\(^{13}\) This is not to say that taxpayers with relatively simple tax situations do not face significant actual or perceived compliance complexity and therefore substantial out-of-pocket and anxiety costs in assessing and paying their tax liabilities. Joseph Bankman details how the vast majority of taxpayers with only wage and interest income, and who do not itemize, still perceive the income tax to be complex. Even for taxpayers who are subject to negligible tax law uncertainty, the experience of filing a tax return can be anxiety-provoking, as a result of difficulty in determining which forms need to be filed and how to fill out the information on each form. Joseph Bankman, Simple Filing for Average Citizens: The California ReadyReturn, 107 Tax Notes 1431, 1431 (June 13, 2005). For a more general definition of compliance complexity as "the problems faced by the taxpayer in keeping records, choosing forms, making necessary calculations, and so on," see David F. Bradford, Untangling the Income Tax 266-67 (1999); see also Gerald H. Goldberg, Comment, in The Crisis in Tax Administration, note 4, at 140.
As is well known to tax experts but perhaps much less well known to nontax experts, taxpayers with more complicated tax profiles regularly have to deal with tax law uncertainty. For these taxpayers, uncertainty abounds throughout the tax law, often increasing in proportion to the complexity of the taxpayer's tax profile. The question for these taxpayers is not whether uncertainty exists, but rather to what degree.

There are a number of sources of tax law uncertainty. Prevalent use of standards in the tax law may leave taxpayers unsure of the application of a standard to a particular set of facts. Tax rules often also create uncertainty. Incredibly complex tax rules may have small but gaping holes, leaving application of the rule uncertain.

Tax administrators can, and do, play a significant role in either reducing, or failing to reduce, the level of tax law uncertainty. Different tax questions can have different degrees of uncertainty. As a result,

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14 The tax law uncertainty literature in recent years has repeatedly recognized this point. See, e.g., Kyle D. Logue, Tax Law Uncertainty and the Role of Tax Insurance, 25 Va. Tax Rev. 339, 363 (2005) ("That there can be significant substantive legal uncertainty in the tax laws may come as a surprise to nonexperts in the field."); Yehonatan Givati, Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings, 29 Va. Tax Rev. 137, 138 (2009) ("Tax Law is ambiguous in many cases. Different interpretations of the law are often possible, resulting in substantially different tax consequences.").

15 Examples of such standards include fundamental tax concepts such as the "ordinary and necessary" standard applicable to deductions, IRC § 162(a), and the "business purpose" standard applicable to corporate reorganizations, Gregory v. Helvering, 293 U.S. 465 (1935).

16 While legal uncertainty has been viewed as "a measure of the extent to which a legal command is standard-like," Louis Kaplow, General Characteristics of Rules, in 5 Encyclopedia of Law & Economics: The Economics of Crime and Litigation 502, 513 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), both rules and standards may leave content unspecified in advance. See Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557, 584 (1992). For example, § 751 (d)(3) categorizes certain partnership items as "inventory items" where they would be inventory items if held by a distributee partner. Application of this rule is uncertain, however, as a result of conceptual difficulties in application. (How is one to know, for example, whether property, now deemed to be held by the distributee partner, is held by such partner in a business or nonbusiness capacity?)

17 Section 382 of the Code provides a good example of this phenomenon. This section is designed to place limits on the amount of net operating losses a company can use after an ownership change. Despite its dizzyingly length and complexity, the government, until recently, has failed to issue any meaningful guidance on how taxpayers should apply certain statutory rules. For example, in determining whether an ownership change has occurred, § 382(l)(3)(C) dictates that "any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account." Taxpayers historically have had little idea what this meant. For one particularly complicated and still seemingly unworkable formulation of the meaning of the statute, see Mark R. Hoffenberg, Owner Shifts and Fluctuations in Value: A Theory of Relativity (Mar. 21, 2005), 2005 TNT 54-29, Mar. 22, 2005, available in LEXIS, Tax Analysts File. As a result of this complexity, the IRS recently released guidance that provides taxpayers a range of possibilities, but still no definitive answers, regarding the meaning of § 382(l)(3)(C). Notice 2010-49, 2010-27 I.R.B. 1.
tax administrators can often decrease the amount of uncertainty that taxpayers face. As guidance regarding the likely outcome of a tax question becomes clearer, uncertainty decreases. On the other hand, tax administrators can increase uncertainty by providing less regulatory or administrative guidance or making such guidance less clear, issuing fewer actions on decision,\(^{18}\) refusing to issue advance rulings on tax questions,\(^{19}\) limiting the disclosure of advance rulings provided to taxpayers, or forgoing litigation of unclear tax issues.\(^{20}\) While courts could try to fill some of the void by making clear pronouncements when a tax case comes before them, their circumscribed role would not allow them to fill the dearth caused by materially reduced administrator guidance.\(^{21}\) Tax administrators regularly utilize a wide range of guidance, such as regulations, revenue rulings and procedures, notices, and a variety of internal rulings and documents as well as even less formal announcements. Such guidance is a huge part of the tax landscape, and taxpayers and advisors take the issuance of even informal guidance very seriously.\(^{22}\)

While Congress sometimes mandates that tax administrators issue particular regulations,\(^{23}\) for the most part tax administrators have sig-

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\(^{18}\) Actions on decision are statements as to the Service’s future litigation position regarding a court decision. IRS, Actions on Decision (AOD), http://www.irs.gov/app/picklist/list/actionsOnDecisions.html (last visited Apr. 8, 2011). Because of multiple fora in which to litigate a tax question, a tax issue is far from decided even when a court rules on the issue. As a result, the Service’s release of an Action on Decision may be very important to reduce uncertainty regarding an issue. A taxpayer may litigate a federal tax issue in the United States Tax Court, the United States District Court, or the United States Court of Federal Claims. David B. Porter, Where Can You Litigate Your Federal Tax Case, 98 Tax Notes 558, 558 (Jan. 27, 2003). While the Tax Court tries to apply the tax law consistently throughout the country, the Golsen rule requires the Tax Court to follow a squarely-on-point Court of Appeals decision where appeal lies to that court. Golsen v. Commissioner, 54 T.C. 742, 757 (1970). Appeal lies to the United States Court of Appeals for the circuit in which the taxpayer resides. Porter, supra, at 558. District courts are bound by the Court of Appeals for the circuit in which the district court is located and the Supreme Court. Id. at 559. Appeal from the United States Court of Federal Claims lies with the Court of Appeals for the Federal Circuit. Id.


\(^{21}\) Moreover, as discussed further at note 125 and accompanying text, courts have shown great reluctance to impose penalties when the tax law is uncertain. As a result, courts contribute to the impetus to report less as tax law uncertainty increases.


\(^{23}\) See, e.g., § 332(d)(4) (“The Secretary shall provide such regulations as appropriate to prevent the abuse of this subsection. . . .”).
significant discretion regarding what guidance to issue. In making decisions whether to issue guidance and what type to issue, tax administrators often face significant public pressure. In responding to such pressure, administrators have to consider how the guidance may be used and, potentially, abused by taxpayers. In this context, the issuance or failure to issue guidance becomes an important tax administration tool, about which tax administrators have to make decisions on a daily basis.

Tax administrators may want to leave, or even increase, uncertainties in the tax law for a number of reasons. Most simply, they may leave uncertainties in the law due to the cost of elimination. Reducing uncertainty to zero in all cases clearly is not feasible from a cost-benefit perspective. Take § 162 as an example. It provides that taxpayers may deduct all ordinary and necessary business expenses. While tax administrators theoretically could list every conceivable expense in every possible situation and indicate whether or not such expense would be an ordinary and necessary business expense, doing so would clearly have rapidly declining marginal returns.

24 Even when Congress explicitly states that “[t]he Secretary shall prescribe regulations that . . .” tax administrators often fail to issue the required regulations. For an interesting discussion of this issue, see Phillip Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 Tax Law. 413, 415 (2003).

25 The recent public furor over Treasury’s refusal to issue guidance regarding codification of the economic substance doctrine, discussed further at Subsection III.B.2, is a good example of such pressure.

26 See Martin J. McMahon Jr., Living with the Codified Economic Substance Doctrine, 128 Tax Notes 731, 750 (Aug. 16, 2010) (“Certainty requires detailed rules. And detailed rules breed more detailed rules, in a never-ending spiral, as taxpayers and their advisers devise transactions designed to exploit anomalies in the rules resulting in tax benefits vastly disproportionate to any economic benefit that might be realized from the transaction.”).

27 A recent meeting of the ABA Tax Section provides a representative example of how essential even tax administrators’ informal guidance is to the tax law landscape and how frequently administrators must decide whether or not to issue guidance as part of administration. At the meeting, Lee Kelley, IRS Deputy Associate Chief Counsel (Corporate) indicated the IRS position as to a number of complex corporate reorganization, spinoff, and acquisition questions. In response to one of the questions, Kelley elaborated on the IRS’s thinking with respect to a recent private letter ruling issued by the Service. Eric Solomon, Ernst & Young, noted that “there’s a lot of law being made through the PLR process” and that, even though taxpayers technically cannot rely on such guidance, “[w]e all know private letter rulings give taxpayers insight as to the IRS thinking on issues.” At the same meeting, William Alexander, IRS Associate Chief Counsel (Corporate) demurred regarding requests for guidance as to another set of corporate tax questions, indicating that the question is “probably not a likely candidate for regulatory guidance in the fairly near term.” Amy S. Elliott, IRS Will Follow 50-Year-Old Revenue Ruling in Reorg Letter Rulings, Official Says (Jan. 24, 2011), 2011 TNT 16-2, Jan. 25, 2011, available in LEXIS, Tax Analysts File.

28 On the other hand, eliminating uncertainty would not always be costly to tax administrators, at least in terms of the cost of creating guidance. Sometimes, for example, tax administrators have existing, clearly defined internal guidance that would eliminate uncer-
Tax administrators also may intentionally engage in “line-blurring,” leaving uncertainties in the law or increasing uncertainty out of a belief that doing so will dissuade taxpayers from engaging in undesirable tax planning. Under this theory, risk-averse taxpayers may believe that, as a result of uncertainty, they have to engage in even more extensive tax planning in order to get the desired tax result. If this planning gets too costly, the taxpayers may abandon the tax planning transaction altogether.\textsuperscript{29}

tainty, at least as to the administrators’ own interpretation of the law. There would be no cost in promulgating the guidance, as it already exists, and yet tax administrators, for various strategic reasons, may wish to keep the guidance secret. A history of ample litigation shows tax administrators’ refusal to reveal internal guidance on the application of the tax law. See, e.g., Tax Analysts and Advocates v. IRS, 505 F.2d 350 (D.C. Cir. 1974); Taxation with Representation Fund v. IRS, 485 F. Supp. 263 (D.D.C. 1980); Tax Analysts v. IRS, 117 F.3d 607 (D.C. Cir. 1997). The tax press has repeatedly voiced the opinion that the Service intentionally keeps secret its application of the tax laws. Christopher E. Bergin, Transparency Is a Two-Way Street, 126 Tax Notes 677 (Feb. 1, 2010) (“For almost 40 years Tax Analysts has worked to force the IRS to disclose to taxpayers how it applies the tax laws to them. The IRS has fought ferociously to keep its secret law just that: secret.”). Recently, tax lawyers have lamented the secret nature of advance pricing agreements, which are issued in the context of transfer pricing disputes but which the Service does not publicly release. See Richard C. Stark, Hartman E. Blanchard Jr. & Saul Mezei, Consistency, Sunshine, Privacy, Secret Law, and the APA Program, 130 Tax Notes 655, 656 (Feb. 7, 2011) (“The substance of these APAs could establish key categories of facts and data, agreed approaches to interpreting them, and acceptable methodologies for assigning arm’s-length returns to functions such as manufacturing and distribution in these and other industries . . . . There are statutory limitations on what information could be released, but the IRS has stopped far short of those limitations by choosing as a practical matter to release virtually no substantive information concerning completed APAs.”).

\textsuperscript{29} For a discussion of the use of uncertainty for this purpose, see Daniel Shaviro, Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters, in Tax and Corporate Governance 229, 241-42 (Wolfgang Schön ed., 2008). While a full discussion of this potential use of uncertainty is outside the scope of this Article, it merits a bit of elaboration. While many commentators accept line-blurring as a good reason for uncertainty, it also suffers serious problems. First, taxpayers may prefer uncertainty, over a clear rule that proscribes the tax planning scheme. To the extent that taxpayers exhibit uncertainty-seeking, taxpayers may engage in more, rather than less, aggressive tax planning as uncertainty increases. Whether taxpayers exhibit uncertainty-seeking would depend on whether they believed that the desired tax result would have been disallowed under clear law. If so, taxpayers may prefer uncertainty and be more willing to take aggressive positions as uncertainty increases. Additionally, uncertainty is not only costly to taxpayers engaging in aggressive, undesirable tax planning schemes, it is also costly to those engaging in business transactions that are not motivated by tax planning purposes. Take, as an example, the wash sales rule, a friction put in place to prevent taxpayers from selling loss property and immediately thereafter repurchasing the same property. The rule generally disallows losses claimed to have been sustained from the sale of stock or securities if, within thirty days of such sale, the taxpayer acquires identical stock or securities. IRC § 1091. Ideally, this rule should target and deter taxpayers who are selling stock only to repurchase it, but not burden taxpayers engaging in real divestment of stock. The wash sales rule is a reasonable friction from a design perspective if it sorts taxpayers actually intending to engage in wash sales and those who are not. That is, the wash sales rule works, at least from a sorting perspective, if a taxpayer who repurchases within thirty days likely was engaged in a tax planning scheme, whereas a taxpayer who waited longer than
Strategic uncertainty is distinct from line-blurring uncertainty and that attributable to cost savings. Strategic uncertainty exists if tax administrators leave or increase unnecessary uncertainties in the tax law in order to raise revenue by reducing aggressive or evasive tax return positions. This type of uncertainty does not mean skewing the law in a direction disadvantageous to the taxpayer, for example, by only issuing negative guidance. Rather, strategic uncertainty requires simply holding back on guidance, which would include both positive and negative guidance. The theory is that the decreased certainty itself, rather than any change in the direction of the law, may serve as a type of compliance tool, which could cause taxpayers to report more of the tax liability that they owe. It is this type of uncertainty that has gained increasing support in the tax compliance literature, and therefore may be gaining traction with tax administrators besieged with guidance decisions. As a result, the remainder of this Article addresses only strategic uncertainty.

B. Economic Tax Compliance Models

Scholars root their support for strategic uncertainty in economic models of taxpayers' decisions about how much tax liability to report. The classic economic model is the Allingham-Sandmo ("A-S") model. The A-S model applied Gary Becker's work regarding economic analysis of crime and punishment to tax evasion, or the understatement of tax known to be owed. The A-S model assumed that a taxpayer has two choices: stating the actual tax owed, or understating this amount, which will result in a penalty if the tax authorities detect the understatement. Relative to stating the actual amount of tax owed, the taxpayer will be better off if he understates the tax and the authorities do not detect the understatement, but worse off if he understates the tax and the authorities detect the understatement and a
penalty applies.\textsuperscript{34} Formally stated, a taxpayer will understate tax to the extent that the benefit of the understatement exceeds the amount of the understated tax plus the penalty for evasion and the applicable interest, multiplied by the probability of detection.\textsuperscript{35}

Economic work since the A-S model has expanded on and sometimes diverged from the model.\textsuperscript{36} One such development was an interactive conception of taxpayer reporting, in which taxpayers engage in tactical reporting techniques in order to avoid an audit.\textsuperscript{37} In a variety of circumstances, these models have illustrated how taxpayers often will respond by reporting tax liability tactically, if they believe the IRS is auditing tactically. Taxpayers appear to exhibit some examples of this behavior, at least at very basic levels, such as by avoiding tax reporting techniques believed to raise "red flags" that trigger audits.\textsuperscript{38}

\section*{C. How the Government Could Use Strategic Uncertainty to Increase Revenue by Reducing Underreporting}

Scholars supporting strategic uncertainty as a tax compliance tool rely on two main arguments. First, some scholars rely on arguments about risk aversion to posit that strategic uncertainty may cause risk-averse taxpayers\textsuperscript{39} to report more tax liability ("risk-averse" model).\textsuperscript{40} This argument fundamentally relies on the A-S model of taxpayer re-

\textsuperscript{34} Id.
\textsuperscript{35} Id.
\textsuperscript{36} For a useful discussion of developments since the A-S model, see James Andreoni, Brian Erard & Jonathan Feinstein, Tax Compliance, 36 J. Econ. Literature 818 (1998).
\textsuperscript{37} For a classic example of such modeling, see Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement, 2 J.L. Econ. & Org. 1, 7 (1986).
\textsuperscript{38} For a discussion of this issue and a proposed fix, see Alex Raskolnikov, Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty, 106 Colum. L. Rev. 569 (2006).
\textsuperscript{39} Determining whether taxpayers are risk averse may depend on the type of taxpayer. A standard assumption is that individuals are often risk averse. Logue, note 14, at 370. More debatable is whether firms are risk averse. Logue notes a number of reasons why publicly traded corporations may be risk averse. For example, corporate managers (and tax directors) may be risk averse as to certain tax consequences, even if loyal agents would act in a risk-neutral manner. Id. at 371. Others suggest that corporations may not be quite so risk averse as to an undesirable substantive tax law interpretation, at least after factoring in the low audit rate. Joseph Bankman, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775, 1776 (June 21, 1999); David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Colum. L. Rev. 1312, 1317 n.10 (2001) (discussing same).
\textsuperscript{40} See, e.g., James Alm, Betty Jackson & Michael McKee, Institutional Uncertainty and Taxpayer Compliance, 82 Am. Econ. Rev. 1018, 1018 (1992); Blumenthal & Christian, note 5, at 205; Logue, note 16, at 374; Scotchmer & Slemrod, note 5, at 19-24; Scotchmer, note 4, at 187. David Weisbach also suggests that increased uncertainty may increase revenue, but in so doing he focuses on the asymmetry between a penalty that applies for underpayments but not overpayments and does not (at least explicitly) focus on the role of risk with re-
porting behavior, in which taxpayers weigh the potential gain from underreporting against the potential cost from being audited and having to pay a penalty plus interest. The risk-averse model expands on the A-S model by examining the interaction between taxpayers' reporting decisions and uncertain tax law. When tax law is clear and taxpayers are making a decision whether to under-report, they take a risky gamble that pays off in the event that taxpayers are not audited.\(^4\) In the A-S model, however, taxpayers know the total extent of the risk, because they know the actual amount of tax they should pay and therefore the total tax liability adjustment and penalty they will be subject to, should they under-report and face audit. Tax law uncertainty imposes additional, and involuntary, risk on the taxpayer.\(^4\) Taxpayers now face not only a risk regarding the possibility of audit, but also a risk regarding the tax liability they face if audited. The risk-averse model posits that this additional risk, and its covariance with the risk of audit, may serve the same role as a noncompliance penalty, thereby raising revenue by reducing aggressive and evasive reporting.

Second, interactive models suggest that taxpayers may have an incentive to reduce under-reporting in response to strategic uncertainty, as long as taxpayers believe that the IRS will audit more as a result of the greater amount of uncertainty. The Service may wish to audit more in response to strategic uncertainty if greater uncertainty creates the possibility of a higher equilibrium benefit from auditing.\(^4\) Under interactive models, taxpayers respond to IRS audit incentives.\(^4\) As a result, if taxpayers believe that the Service holds these beliefs about higher equilibrium benefit from auditing under greater uncertainty, then they may believe the Service will audit more frequently in response to strategic uncertainty. Taxpayers may respond by reporting higher tax liability in order to avoid a higher perceived chance of audit and resulting costs including tax liability adjustments, penalties, and

\(^{41}\) Alm et. al., note 40, at 1018.
\(^{42}\) Id.; Scotchmer & Slemrod, note 4, at 23.
\(^{43}\) Logue, note 4, at 250-51.
\(^{44}\) Paul J. Beck & Woon-Oh Jung, Taxpayers' Reporting Decisions and Auditing Under Information Asymmetry, 64 Acct. Rev. 468, 479 (1989) (suggesting this may be the case). Beck and Jung note, however, that if penalties become nontransferable, taxpayer reporting will become more aggressive than in the case of transferable penalties. Id. at 479-81.
\(^{45}\) For examples of such modeling, see id.; Graetz et al., note 37.
resource and opportunity costs that result from responding to an audit.  

D. Fairness Objections to Strategic Uncertainty

An initial objection to strategic uncertainty may be that it seems fundamentally unfair. In other words, simply as a matter of fairness, tax administrators should not be able to create or leave unnecessary uncertainties in the tax law. According to this perspective, whether or not strategic uncertainty works as contemplated by the tax compliance literature is beside the point.

Evaluating whether strategic uncertainty works, however, remains crucial notwithstanding potential objections about whether it is fair. First, while the principal aim of this Article is to examine whether strategic uncertainty works rather than whether it is fair, at least some notions of whether strategic uncertainty is fair may turn critically on whether it works. Taxpayers engage in vastly different reporting practices, which largely correspond to their under-reporting opportunities. Less than 1% of wage income is under-reported. On the other hand, taxpayers under-report an almost unbelievable 57% of nonfarm sole-proprietor income and 72% of farm income. As a result, taxpayers with only wage income bear a disproportionately large percentage of tax liability, relative to taxpayers with business or farm income, as well as relative to larger businesses, which also have significant under-reporting opportunities. Assuming that, in creating the tax law, Congress believed it was fairly allocating the tax burden across taxpayers, the misallocation itself may be a significant form of unfairness.

Since strategic uncertainty is not likely to affect taxpayers subject to only wage and interest income, even given a drastic increase in tax law uncertainty, its primary effect would be on those taxpayers who have the greatest under-reporting opportunities. If strategic uncertainty did increase tax liability reporting among the taxpayers currently engaged in significant under-reporting, then strategic uncertainty might bolster rather than undermine fair tax allocation. Imagine a business taxpayer taking deductions that she either knows or strongly suspects that she is not entitled to take. Taking the deductions would reduce her tax burden relative to a taxpayer with only wage income. If strate-

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46 A number of interactive models suggest this result. Beck and Jung analyze the issue in the context of discrete tax outcomes. Beck & Jung, note 44, at 473. Jung analyzes this issue in the context of continuous tax outcomes. Jung, note 4, at 323.


48 Id.

49 See text accompanying notes 13-14 for a discussion of this point.
gic uncertainty caused the business taxpayer to report more of the tax liability that she owes, the relative tax burden allocation between the two taxpayers might be fairer. On the other hand, if strategic uncertainty reduced tax reporting by the segment of taxpayers already significantly under-reporting, such as this business taxpayer, then it could worsen the unfair tax allocation that already exists. Determining whether and how strategic uncertainty works, then, may be essential to a discussion of fair tax administration.

Moreover, even if the use of strategic uncertainty was unfair or violated other normative principles, to the extent that tax administrators nevertheless rely upon it under a mistaken belief that it works, debunking this notion would be an important means of reversing policy. As a result, even considering broader objections to the idea of strategic uncertainty, it remains critical to determine whether this approach would actually raise revenue by decreasing aggressive or evasive reporting positions of taxpayers with under-reporting opportunities.

III. DEBUNKING THE CASE FOR STRATEGIC UNCERTAINTY

In contrast to the support for strategic uncertainty in the tax compliance literature, I offer three reasons why strategic uncertainty may not raise revenue by reducing under-reporting.

A. Taxpayers May Exhibit Perversely Divergent Ambiguity-Seeking and Aversion

Taxpayers may not fear increased risk as a result of reduced guidance, in the manner contemplated by economic arguments in support of strategic uncertainty. Rather, taxpayers may experience ambiguity in response to strategic uncertainty. Taxpayers may have perversely divergent reactions to ambiguity, which would both place in doubt the impact of strategic uncertainty on revenue and undermine its efficacy as a tool designed to reduce aggressive or evasive reporting.

The risk-averse model relies on a theory of how uncertainty may cause risk-averse taxpayers to fear an increase in risk, as characterized by an increase in variance. One simple example of how uncertainty could increase variance is by increasing the dispersion of potential tax liabilities, while holding the mean tax liability constant. Imagine that a taxpayer faces a 50% chance of a tax liability being $100 or a 50% chance of a tax liability being $500. If greater uncertainty caused the taxpayer to face, instead, a 50% chance of the tax liability being zero

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50 See, e.g., Logue, note 4, at 250-51 (discussing risk averse taxpayers’ reactions to increased variance under uncertainty); Scotchmer & Slemrod, note 4, at 25-27 (focusing on risk).
or a 50% chance of the tax liability being $600, then the variance of
potential tax liabilities has increased and the risk has increased. Es-
sential to this analysis is that risk exists when taxpayers face known
probabilities of particular outcomes. Risk may increase as the poten-
tial outcomes (or their percentage likelihoods) change, but in any
event the probability of the potential outcomes remains known.

Strategic uncertainty, however, often would have the effect of sim-
ply making taxpayers less sure of the probability of a given tax out-
come. Lack of certainty regarding the probability of a particular
outcome is a particular type of uncertainty, referred to as ambiguity.
For example, as famously characterized by Daniel Ellsberg, a person
faces ambiguity when betting on the color of a ball that will be drawn
from an urn, if she knows that the urn contains 100 balls, which are
either black or red, but she does not know the percentages of either.51
This situation is distinct from knowing that the urn contains fifty black
balls and fifty red balls. The latter case presents risk; the former
presents ambiguity.

In many cases, if tax administrators strategically withhold tax gui-
dance, taxpayers would experience increased ambiguity, not risk, re-
arding particular tax outcomes.52 An example of how strategic
uncertainty may increase ambiguity exists with the application of
§ 351 to transfers of property to a corporation. Absent special treat-
ment, the transfer of property to a corporation in exchange for stock
in the corporation is a realization event for the transferor subject to
income recognition.53 Section 351 provides a special exception to in-
come recognition in the case of property contributions, as long as cer-
tain requirements are met (namely that the transferors control the
corporation immediately after the exchange).54 A fair amount of un-
certainty exists regarding the meaning of the “control immediately af-
ter the exchange” requirement.55 Many taxpayers likely experience
such uncertainty, and would experience increased uncertainty, as a
lack of confidence in the likelihood of being entitled to § 351 treat-
ment, or a state of ambiguity regarding entitlement to the tax benefit.

The reaction of taxpayers who perceive ambiguity in response to
strategic uncertainty is crucial in evaluating that uncertainty. While

51 Daniel Ellsberg, Risk, Ambiguity, and the Savage Axioms, 75 Q.J. Econ. 643, 650-61
(1961).
52 See Lawsky, note 20, at 1066-73, for comprehensive discussion of this point.
53 IRC § 1001.
54 IRC § 351(a).
55 See David R. Tillinghast & Denise G. Paully, The Effect of the Collateral Issuance of
Stock or Securities on the “Control” Requirement of Section 351, 37 Tax L. Rev. 251, 252
(1982) (noting that the immediately-after-the-exchange requirement has been extensively
litigated and discussed over the years).

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experimental evidence regarding taxpayer responses to ambiguity about the entitlement to favorable tax positions is limited, some evidence suggests that taxpayers exhibit divergent responses to such ambiguity. Taxpayers who believe that they have a high percentage likelihood of obtaining a favorable tax position (such as nonrecognition treatment under § 351) may be ambiguity-averse because they like their chances of getting the favorable tax position. As a result, they may be more likely to claim entitlement to the favorable tax position when certainty exists regarding those chances but less likely to claim entitlement to the favorable tax position when ambiguity exists regarding the chances. On the other hand, taxpayers who believe they have a low percentage likelihood of obtaining a favorable tax position may be ambiguity-seeking. These taxpayers, who view their chances of success as low under certain tax law, may welcome the chance to take a gamble when the likelihood of disallowance of the favorable tax position becomes less certain. As a result, these taxpayers may be more likely to claim a favorable tax position in response to strategic uncertainty.

In one notable experiment regarding taxpayers' likelihood of claiming a tax deduction, taxpayers exhibited both ambiguity-seeking and ambiguity aversion regarding the probability of detection and penalties. Specifically, in the experiment, subjects had to decide whether to take a tax deduction. Subjects received information that, while most accountants believed the deduction was perfectly legal, the Service spot-checks returns for the deduction and if the Service screened a return and found the deduction, the Service would disallow it and the taxpayer potentially would have to pay a penalty on the disallowed deduction. Subjects received a prompt from a tax accountant indicating the probability estimate that the Service would spot-check their return and a probability estimate of the penalty that the Service would impose if it disallowed the deduction. Additionally, the subjects received disclaimers by the tax accountant regarding the level of confidence in the probability of detection and penalty estimates. Disclaimers either indicated uncertainty regarding the probability estimates through statements that the accountant was "very unsure and

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57 Casey & Scholz, note 56, at 369-75.

58 Id. at 371.
hesitate[d] to guess” or indicated certainty regarding the estimates by
describing them as “exact.”

The experiment revealed ambiguity-seeking when the taxpayer
faced unfavorable estimates regarding the probability of detection and
penalties and ambiguity aversion when the taxpayer faced favorable
estimates regarding the probability of detection and penalties. When the estimated probability of detection was high, subjects were
more likely to take the deduction if the estimate was vague. When
the estimated probability of detection was low, subjects were more
likely to take the deduction if the estimate was precise. The experi-
ment found the same results for the penalty estimates. When the
penalty estimate was high, subjects were more likely to take the de-
duction if the estimate was vague. When the penalty estimate was
low, subjects were more likely to take the deduction if the estimate
was precise.

More data is needed to determine how and when taxpayers exhibit
these divergent tendencies. Nonetheless, some anecdotal evidence
from the partnership anti-abuse regulation also suggests that taxpay-
ers exhibit a mixture of tax law ambiguity aversion and seeking.
Moreover, in this context, taxpayers’ divergent tendencies seemed to
correspond to a high or low perceived chance of success on the merits,
respectively.

The partnership anti-abuse regulation, released in 1994, provides
that the Commissioner can recast a partnership transaction for federal
tax purposes “if a partnership is formed or availed of with a principal
purpose to reduce substantially the present value of the partners’ ag-
gregate federal tax liability in a manner inconsistent with the intent of
subchapter K.” The regulation, even as finalized, is repeatedly and
self-consciously equivocal. For example, under the regulation, the fac-
tors set forth to determine “[w]hether a partnership was formed or
availed of with a principal purpose to reduce substantially the present
value of the partners’ aggregate federal tax liability in a manner inconsis-
tent with the intent of subchapter K . . . may be indicative, but do
not necessarily establish, that a partnership was used in such a man-
ner.” The regulation warns further that “[t]hese factors are illustra-

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59 Id.
60 Id. at 373.
61 Id.
62 Id.
63 Id. at 374.
64 Id.
65 Id. at 371-75.
66 Reg. § 1.701-2(b). Subchapter K sets forth the partnership taxation rules.
67 Reg. § 1.701-2(c).
tive only, and therefore may not be the only factors taken into account in making the determination."68 Additionally, "[t]he presence or absence of any factor described . . . does not create a presumption that a partnership was (or was not) used in such a manner."69 This regulation seemed almost designed to undermine any sense of certainty, including the probability of running afoul of the regulation. Taxpayers' reactions, therefore, can seemingly be reasonably characterized, at least in part, as a reaction to ambiguity.

The tax bar responded to the introduction of the regulation by decrying the ambiguity it engendered.70 For example, the Office of Chief Counsel for Advocacy of the U.S. Small Business Administration complained,

"[I]t is one thing to expect tax practitioners to judge the tax ramifications of business transactions based on an [sic] reasonable ascertainable standard elucidated by the Service. It is quite another to require these practitioners to render an opinion based on a standard which the Service has not yet adequately articulated in its regulations."

Notably, practitioners seemed particularly concerned about the impact of the anti-abuse regulation on positions that the tax law historically clearly protected. For example, critics of the regulation questioned whether the regulation would impact seemingly well-established tax treatments such as special allocations of depreciation.72 While perhaps such questions were merely rhetoric designed to attack the regulation as an extreme overreach by the government, which

68 Id.
69 Id.
72 Letter from Joseph Bankman, Stanford Law Sch., to Internal Revenue Service (July 1, 1994), reprinted in Stanford Professor Rebuts Criticism of Partnership Antiabuse Reg., 94 TNT 140-33, July 20, 1994, available in LEXIS, Tax Analysts File (disagreeing with a critic who argues that the regulations will cast doubt on special allocations of depreciation).
would place into doubt the most sanctified tax law transactions,\textsuperscript{73} these strongly-voiced concerns regarding run-of-the-mill transactions were in striking contrast to the more muted criticisms against the regulation by well-known aggressive partnership tax lawyers.\textsuperscript{74} To the extent that the tax bar's seemingly unfounded concern about protecting longstanding tax benefits was sincere, it may be an example of ambiguity aversion when the probability of desired tax treatment disallowance is low. At the same time, this aversion seemed to have been matched by ambiguity-seeking by taxpayers with a perceived low chance of success on the merits.

This example illustrates how strategic uncertainty may often cause taxpayers to experience increased ambiguity. Moreover, taxpayer reactions to ambiguity are likely to be mixed, and, as a result, the impact of strategic uncertainty on revenue becomes unclear. Additionally, if strategic uncertainty indeed causes taxpayers with a low perceived chance of success on the merits to become more aggressive in claiming entitlement to tax benefits, while having the opposite effect on taxpayers with a perceived high chance of success on the merits, then the impact on tax compliance would be perverse; these divergent responses would undermine strategic uncertainty's efficacy as a tool designed to raise revenue by reducing aggressive or evasive reporting.

\textbf{B. Penalties Decrease as Uncertainty Increases}

A second reason why strategic uncertainty may not raise revenue in the manner contemplated by the tax compliance literature is because the prospect of tax penalties declines as tax law uncertainty increases. Under the current tax penalty structure, as uncertainty increases, tax penalties are less likely to apply. Moreover, as an historical approach reveals, the inverse relationship between uncertainty and penalty likelihood is deeply rooted in fundamental notions of the nature of tax penalties and appears unlikely to change.\textsuperscript{75} This relationship is an important reason to doubt the utility of strategic uncertainty as a tax compliance tool. As a result of the decreasing operation of tax penalties as tax law uncertainty increases, taxpayers should have less impe-

\textsuperscript{73} Bankman suggests this may have been the case. \textit{Id.}


\textsuperscript{75} The recent enactment of a strict liability penalty for transactions that lack economic substance has the potential to be a significant deviation from penalty operation under uncertainty. For the reasons discussed further in Subsection III.B.2, however, it seems likely that, in the long run, the penalty will be confined to the tax shelter context, which would be consistent with the general operation of penalties under uncertainty. See notes 104-12 and accompanying text for further discussion of this issue.
to report more tax liability and, instead, may have strong reasons to report less tax liability in response to strategic uncertainty. Moreover, noneconomic incentives to report tax liability may magnify this result. Potential nontax penalties, such as financial reporting concerns, do not appear to change the penalty calculus.

1. Monetary Penalties

Economic models depend on monetary penalties as the principal reason why taxpayers report tax liability rather than taking a chance and under-reporting, hoping not to be audited. As a result, if monetary penalties decrease in response to strategic uncertainty, then an important impetus to report tax liability should decrease as well. As detailed below, unlike in a straightforward A-S model, in which the taxpayer is assumed to be under-reporting, or “evading,” tax known to be owed, as tax law uncertainty increases, the taxpayer’s tax obligation becomes less clear. As this tax obligation becomes less clear, a monetary tax penalty becomes less likely to apply under the current tax penalty structure. As a result, taxpayers should have a decreasing impetus to report more tax liability as uncertainty increases, and may have the opposite incentive.

Accuracy penalties are the primary monetary penalties that apply in cases of tax law uncertainty. If an accuracy penalty applies, a penalty equal to $75\%$ of the underpayment attributable to fraud also potentially applies to erroneous reports of tax liability. IRC § 6663(a). Fraud is “actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing.” Estate of Temple v. Commissioner, 67 T.C. 143, 159 (1976) (quoting Mitchell v. Commissioner, 118 F.2d 308, 310 (5th Cir. 1941)). This level of scienter will not exist if

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76 See Scotchmer, note 4, at 184 (“Most of the tax compliance literature written by economists presumes that taxpayers have no commitment to honesty and report income only to the extent that reporting is in their utility-maximizing interest. The primary means of persuasion is threat of penalty.”).

77 See, e.g., Agnar Sandmo, The Theory of Tax Evasion: A Retrospective View, 58 Nat’l Tax J. 643, 645 (2005) (discussing both how the A-S model applies in the context of evasion and how, in contrast, “it is hard to imagine that a penalty will be imposed on the basis of transactions that are truthfully reported”).

78 Increased uncertainty and decreased likelihood of penalties have opposite effects. At least under an economic model, the former would increase variance, while the latter would decrease variance. The net impact would depend on the relationship between the increase in uncertainty and the decrease in penalties. While difficult to show that penalties decrease faster than uncertainty increases, the important point is that we simply do not know whether strategic uncertainty would increase variance, after taking into account the decline in penalty likelihood. Moreover, the decreased operation of tax penalties under uncertainty should undermine taxpayers’ incentives to report higher tax liability, relative to robust operation of tax penalties under uncertainty. As a result, we have reason to doubt whether strategic uncertainty would actually cause taxpayers to report higher tax liability, and we have some reason to believe that taxpayers may have the opposite reporting incentives. I thank David Weisbach and Sarah Lawsky for exploring this point with me.

79 A fraud penalty equal to $75\%$ of the underpayment attributable to fraud also potentially applies to erroneous reports of tax liability. IRC § 6663(a). Fraud is “actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing.” Estate of Temple v. Commissioner, 67 T.C. 143, 159 (1976) (quoting Mitchell v. Commissioner, 118 F.2d 308, 310 (5th Cir. 1941)). This level of scienter will not exist if
ality of 20% of the portion of the underpayment attributable to the accuracy penalty is imposed. The first accuracy penalty is negligence or disregard of rules or regulations. Negligence means "any failure to make a reasonable attempt to comply with the provisions of this title," and "the term 'disregard' includes any careless, reckless, or intentional disregard." Even if a taxpayer takes a position contrary to a revenue ruling or IRS notice, the taxpayer "has not disregarded the ruling or notice if the contrary possibility has a realistic position of being sustained on its merits." In this case, even though the government has issued a direct position on a tax issue, if contrary authority creates uncertainty about the viability of the government's position, no penalty applies. Where no controlling authority dictates the result, a taxpayer is unlikely to have failed to make a "reasonable attempt to comply with" the Code or "careless[ly], reckless[ly], or intentional[ly] disregarded" it.

While the Code imposes a number of accuracy penalties designed to operate in a more strict liability fashion, these penalties generally apply only in limited contexts and have high understatement thresholds (which impliedly indicate fault). They also have occasional, additional pervasive fault-based carveouts. The substantial understatement penalty applies more broadly for any understatement that exceeds a given threshold, but this penalty, too, has significant fault-based carveouts. As uncertainty increases, a taxpayer has an in-

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80 IRC § 6662(a). This penalty is increased to 40% in the case of a gross valuation misstatement. IRC § 6662(h).
81 IRC § 6662(c).
82 Reg. § 1.6662-3(b)(2).
83 IRC § 6662(c).
84 There are penalties for substantial valuation misstatements, substantial overstatement of pension liabilities, and substantial estate or gift tax valuation understatements. IRC § 6662(b). These penalties are limited, respectively, to situations in which: (1) the value or adjusted basis of property claimed on a tax return is 150% or more of the correct valuation or adjusted basis or a § 482 valuation misstatement exists that exceeds certain specified thresholds, (2) actuarial determination of pension liabilities is 200% or more of the correct amount of such liabilities, or (3) the value of any estate or gift tax property is 65% or less than the correct valuation. IRC § 6662(e), (f), (h).
85 The § 482 penalty, for example, is subject to a number of exclusions if the taxpayer used a "reasonable" method for determining a transfer price. IRC § 6662(e)(3)(B).
86 This penalty applies to an understatement of income tax for a taxable year that "exceeds the greater of (i) 10 percent of the tax required to be shown on the return for the taxable year, or (ii) $5,000." IRC § 6662(d)(1)(A). In the case of corporations, a substantial understatement of income tax exists if the understatement for a taxable year "exceeds the lesser of (i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (ii) $10,000,000." IRC § 6662(d)(1)(B). The seemingly strict liability operation of the penalty above the threshold is substantially undermined by built-in reductions of the penalty in various circumstances. Understatements are reduced

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creasingly low bar to meet in order to apply one of the fault-based carveouts. The regulations specifically contemplate this result, indicating that "[t]here may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision."87

The penalty defenses make application of a penalty even less likely in a case of tax law uncertainty. Most notably, an omnibus defense applies in the case of all the accuracy-related penalties.88 Under this defense, "[n]o penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to" the underpayment.89 "[A]n honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and edu-

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87 Reg. § 1.6662-4(d)(3)(ii).

88 Some limited exceptions apply. This defense may not apply in certain cases to substantial or gross valuation overstatements with respect to charitable deduction property. IRC § 6664(c)(2). The reasonable cause exception will apply, however, in these cases if "(A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and (B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property." IRC § 6664(c)(2)(A), (B).

89 Reg. § 1.6664-4(a). This is a facts and circumstances determination and "[g]enerally the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Reg. § 1.6664-4(b).
tion of the taxpayer” may indicate reasonable cause and good faith. Since uncertainty allows a taxpayer to claim an honest misunderstanding of the law, the omnibus defense often will eliminate penalties that would otherwise apply.

2. Tax Shelter Penalties

One caveat to the above discussion applies. For limited transactions, the likelihood of monetary tax penalties does not decrease to the same extent when tax law uncertainty increases. These are highly engineered transactions designed to produce tax advantages not intended by the law, often referred to as “tax shelters.” The existence of these tax shelter penalties, however, should not change taxpayers’ general reporting incentives outside of the tax shelter context. Additionally, even for tax shelter transactions, taxpayers are particularly unlikely to respond to strategic uncertainty by reporting more tax liability, because the very creation of these transactions is dependent on the hope of winning the audit lottery and never being examined.

The penalty provisions are harsher and less forgiving when the taxpayer appears to have strategically engineered into an abusive tax reduction transaction, as with a tax shelter. The substantial understatement penalty cannot be reduced as a result of disclosure and reasonable basis or substantial authority if the understatement is attributable to a tax shelter. Section 6662A applies an accuracy penalty of 20% (or 30% in the case of failure to meet disclosure rules) to reportable transaction understatements. While the reasonable cause exception generally applies to this penalty, it does not apply unless the taxpayer adequately discloses the transaction, substantial authority exists, and the taxpayer reasonably believes that its treatment was proper. Additionally, a corporation can take into account its legal justification under the reasonable cause defense for tax shelter items

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90 Id.
91 Additionally, the negligence penalty will not apply if a return position has a reasonable basis. Reg. § 1.6662-3(b)(1). A disregard penalty will not apply if the return position had a reasonable basis and the taxpayer adequately disclosed the position on the return. Reg. § 1.6662-3(a).
92 This “dual nature” of monetary tax penalties, whereby penalties apply when the law is clear and to tax shelters regardless of the level of uncertainty, merits future examination.
93 IRC § 6622(d)(2)(B), (C).
94 These are understatements attributable to transactions that taxpayers must disclose on their tax returns because they are potential tax shelter transactions. IRC § 6707A. This penalty generally applies in lieu of the IRC § 6662(a) penalties. See IRC § 6662A(e)(1)(B).
95 IRC § 6664(d).
only if substantial authority exists and the corporation reasonably believed that the treatment was more likely than not proper.\textsuperscript{96}

Recently, as part of the Health Care and Education Reconciliation Act of 2010, Congress strengthened the harsher application of penalties to tax shelter transactions even under uncertainty.\textsuperscript{97} The Act codified the economic substance doctrine, which previously had been an important judicial tool to disallow the tax benefits from tax shelter transactions.\textsuperscript{98} Specifically, § 7701(o) of the Code now provides that, when the economic substance doctrine is relevant, a transaction will have economic substance only if the transaction meaningfully changes the taxpayer's economic position and the taxpayer has a substantial business purpose for entering into the transaction.\textsuperscript{99}

Additionally, the Act added a new accuracy penalty for transactions lacking economic substance. The penalty is 20\% of the underpayment of tax, or 40\% if the transaction is not disclosed.\textsuperscript{100} Finally, the Act eliminated the reasonable cause exception for non-economic substance transactions, including reportable transaction understatements attributable to one or more non-economic substance transactions.\textsuperscript{101}

Even though the economic substance doctrine has always been used as a judicial tool to attack tax shelters, tax advisors have worried that this codification may extend strict liability penalties beyond the tax shelter context. In the wake of economic substance codification, in a manner reminiscent of the enactment of the partnership anti-abuse rule, taxpayers have voiced strong concern that economic substance codification and the associated strict liability penalty could apply not only to tax shelters, but also routine tax transactions. In support of this concern, taxpayers have cited not only the indeterminacy of the economic substance doctrine itself,\textsuperscript{102} but also the fact that the eco-

\textsuperscript{96} Reg. § 1.6664-4(f).
\textsuperscript{98} For a recent discussion of the economic substance doctrine and related issues, see Leandra Lederman, W(h)ither Economic Substance?, 95 Iowa L. Rev. 389 (2010).
\textsuperscript{99} Taxpayers may not use federal tax reduction to prove either the objective or subjective prong of the economic substance doctrine.
\textsuperscript{100} IRC § 6662(i).
\textsuperscript{101} !IRC § 6664(c)(2).
\textsuperscript{102} Taxpayers and their advisors have urged that codification could place in jeopardy sacrosanct tax planning. As examples, tax advisors have argued that the doctrine could disallow the sale of loss property, such as a pool of mortgages, for a different pool of mortgages if the purpose of the sale was to recognize a tax loss. Letter from Mark Silverman & Amanda Pedvin Varma, Steptoe & Johnson, to Michael F. Mundaca, Ass't Sec'y (Tax Pol'y), Treas. Dep't (July 7, 2010), reprinted in Firm Seeks Guidance on Economic Substance Doctrine, 2010 TNT 130-11, July 8, 2010, available in LEXIS, Tax Analysts File. Tax advisors cite this example because the Supreme Court famously held in an important tax case that taxpayers could recognize a loss under these exact facts. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991).
economic substance penalty applies to “[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance . . . or failing to meet the requirements of any similar rule of law.”

Taxpayers’ concerns, while understandable, seem an over-reaction that will subside over time. Economic substance codification likely will not expand the reach of the doctrine, or robust penalty application under uncertain tax law, outside the tax shelter context. As an initial matter, Congress made sure to indicate that codification does not change the decision about when to apply the economic substance doctrine. The statute merely provides a definition for the economic substance doctrine “[i]n the case of any transaction to which the economic substance doctrine is relevant.” As a result, codification should not be an impetus for the doctrine, or the new accompanying strict liability penalty, being applied outside the tax shelter context in which the economic substance doctrine historically has been used.

The reaction of government officials to taxpayers’ concerns bolsters the conclusion that codification should not expand application of the economic substance doctrine (or the accompanying strict liability penalty) outside of the tax shelter context. As was the case with the partnership anti-abuse rule, government officials have rushed to defend the codified economic substance doctrine by indicating that it was meant to apply and will be applied only to abusive transactions, not ordinary tax planning. Treasury has suggested that the penalty should potentially only apply in “appropriate cases.” Treasury Deputy Tax Legislation Counsel Bryon Christensen indicated that Service officials are “sensitive to the fact that what they do out of the gate affects both the value of the economic substance doctrine as an antiabuse rule going forward” and whether the Service actually will be able to assert

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103 IRC § 6662(b)(6).
104 IRC § 7701(o).
105 Jeremiah Coder, Government Hopes to Alleviate Some Uncertainty on Economic Substance, Treasury Official Says (May 12, 2010), 2010 TNT 92-1, May 13, 2010, available in LEXIS, Tax Analysts File. In so doing, Treasury was acknowledging the suggestion of Monte A. Jackel, PricewaterhouseCoopers LLP, that the penalty should only apply in “appropriate cases.” Id. Among other preconditions to penalty application, Jackel had suggested that the penalty should only apply after the Service considered (1) “the taxpayer’s effort to assess its proper tax liability under the statutory economic substance doctrine in a manner similar to reg. section 1.6664-4(b)(1),” (2) the taxpayer’s statement of facts and law and any legal opinion as occurs under reg. § 1.6664-4(c)(1), (f) (except that a “more likely than not” opinion should not be required), (3) “the novelty of the issue,” and (4) “the published precedent under the economic substance doctrine as applied to the facts of the taxpayer’s case.” Monte A. Jackel, Dawn of a New Era: Congress Codifies Economic Substance, 127 Tax Notes 289, 295 (Apr. 19, 2010). Jackel’s preconditions to penalty application would obliterate any suggestion that the penalty had actually eliminated, or even seemingly chipped away at, the reasonable cause exception for non-economic substance transactions.
the penalty in a strict liability fashion.\textsuperscript{106} As a result, Treasury officials have indicated that they will establish “clear procedures” to make sure that revenue agents apply the economic substance penalty only within the limited context intended.\textsuperscript{107} Government officials have pointedly affirmed that, other than applying a strict liability penalty, “nothing has really changed,\textsuperscript{108} that “the new law is not transformative,”\textsuperscript{109} and that “codification should have a minimal practical impact.”\textsuperscript{110} The Large Business and International Division (LB&I) has recently gone a long way toward making good on these assurances, with a new directive that clearly limits application of the economic substance penalty. The directive requires examiners to walk through four steps prior to determining that an economic substance penalty is appropriate. The steps make clear that the penalty is appropriate in extraordinary, tax shelter type of contexts, not with ordinary tax planning. Additionally, the directive explicitly states that, until further guidance is issued, the penalty will apply only to the economic substance doctrine, not any other “similar rule of law.”\textsuperscript{111} While only time will tell for certain, it seems very likely that actual application of the codified doctrine will indicate the clear limitation of the doctrine to the tax shelter context.\textsuperscript{112}


\textsuperscript{112} In the context of the partnership anti-abuse rule, taxpayers initially voiced very similar concerns about the unfair uncertainty placed on taxpayers and the likely negative impact on garden-variety partnership transactions. See text accompanying notes 66-74. Though Treasury and IRS officials repeatedly tried to reassure taxpayers that the application of the anti-abuse rule would be limited, the Service ultimately had to quell the uproar with an announcement that agents seeking to apply the rule would have to get approval from the National Office. Announcement 94-87, 1994-27 I.R.B. 124 (July 5). LB&I released a similar directive in the context of the economic substance penalty. See LMSB-20-0910-024 (Sept. 14, 2010), available at http://www.irs.gov/pub/foia/ig/lmsb/lmsb-20-0910-024.pdf (requiring review and approval by Director of Field operations prior to proposal of economic substance penalty).
As a result, economic substance codification, at present, is best seen as yet another example of the harsher penalty application specifically for abusive, or tax shelter transactions. It should not change the inverse relationship between uncertainty and penalty likelihood outside of the tax shelter context.

Moreover, strategic uncertainty should not even induce taxpayers who have engaged in tax shelter transactions to report more tax liability as a means of reducing potential penalties from the shelter transactions. Tax shelters produce vast tax savings for the taxpayers engaging in them. Garden-variety tax shelters can produce losses for tax purposes in excess of half a billion dollars, while imposing only relatively immaterial economic costs on tax shelter participants. Importantly, tax shelters are highly engineered transactions that would not be engaged in if not for the potentially extremely desirable tax outcomes flowing from such transactions. As a result, once taxpayers have entered into tax shelter transactions, they are going to report the trans-

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At least in the context of the partnership anti-abuse rule, this Announcement basically sounded the death knell for any widespread application of the rule. See Noel B. Cunningham & James R. Repetti, Textualism and Tax Shelters, 24 Va. Tax Rev. 1, 59 (2004) (describing how “[t]he vitriolic outcry of the tax bar against the regulations, coupled with the Service’s statement that its agents will not assert the regulations without the approval of the National Office, left the lasting impression that the regulations were not valid”). While the economic substance penalty stands on much firmer ground than the partnership anti-abuse rule because Congress itself enacted the economic substance penalty, the parallels between the objections to the partnership anti-abuse rule and the current objections to the economic substance penalty nonetheless reveal that it will have to withstand similar intense pressure from taxpayers designed to limit its application.

The end result appears likely to be a relatively circumscribed economic substance penalty, not a doctrine that applies to routine tax planning transactions. Even tax advisors who have painted the most dire scenarios about possible application of the economic substance penalty have intimated that any widespread application would likely be very short lived. See Monte A. Jackel, Letter to the Editor, (June 14, 2010), 2010 TNT 114-4, June 15, 2010, available in LEXIS, Tax Analysts File.

Similarly, even the most vehement objectors to the partnership anti-abuse regulation believed that it would likely “be overturned if employed with malice, or with unsound reasoning, or senseless disregard for the substantive nature of a particular transaction or set of transactions.” Kip Dellinger, The Internal Revenue Service’s Power Grab (June 27, 1994), 94 TNT 128-37, July 1, 1994, available in LEXIS, Tax Analysts File. The implication is that that government simply will not or cannot sustain application of a strict liability penalty as a general matter under uncertainty; notwithstanding the broadly worded nature of the economic substance doctrine, a strict liability penalty under this doctrine can only be applied in the context of tax shelters.

Black and Decker Corporation claimed a $560 million capital loss on its tax shelter transaction, which involved incorporation of a subsidiary with $561 million accompanied by the subsidiary’s assumption of $560 million of contingent liabilities, followed by sale of the subsidiary for $1 million. Black & Decker Corp. v. United States, 436 F.3d 431, 432 (4th Cir. 2006).
actions in a manner that is likely to result in the desired tax outcome.\textsuperscript{114}

Obtaining the extremely desirable tax outcomes afforded by tax shelters requires taking an aggressive reporting position, notwithstanding the potential application of penalties for doing so. Given the large amount of revenue at stake and the questionable reliance on tax provisions in a manner unintended by Congress, taxpayers engaging in tax shelter transactions know that, if detected, the IRS will almost certainly disallow the results. While taxpayers can fight the disallowance, once the Service detects the shelter, the taxpayer has lost most of the battle.\textsuperscript{115} As a result, once taxpayers engage in a tax shelter transaction, they not only take the advantageous reporting position they hope to gain by engaging in the tax shelter transaction, but also try to bury the evidence of it in a voluminous and often confusing tax return, hoping it will never see the light of day.\textsuperscript{116}

The risk of a penalty is therefore unlikely to cause tax shelter participants to abandon their claimed tax shelter benefits on their return after having decided to engage in such transactions. The tax shelter context, then, does not change the general conclusion that, under the current monetary penalty system, taxpayers should be less likely to report more, and may instead have reason to report less, tax liability from completed tax transactions in response to strategic uncertainty.

3. Will Monetary Penalties Change?

One possible response to the discussion regarding the monetary tax penalty system is that, if tax penalties do not currently work as necessary to induce greater tax liability reporting under uncertainty, perhaps we should change them. A move to a strict liability system of monetary tax penalties would provide risk-averse taxpayers operating within an economic framework of reporting stronger reason to report more tax liability in response to strategic uncertainty.

This argument does not adequately appreciate the low likelihood of moving to a strict liability system, and therefore the doubtful utility of strategic uncertainty as a means of increasing revenue by reducing under-reporting. Understanding why it is unlikely that the United

\textsuperscript{114} See note 29 for a discussion of some of the arguments for and against using uncertainty to impact decisions about whether and how to structure transactions.

\textsuperscript{115} Bankman, note 39, at 1782 (indicating tax shelter purchasers' reliance on audit lottery).

States would broadly adopt a strict liability regime requires a historical and contextual understanding of the nature of tax penalties.

Modern tax penalties have been fault-based since their inception. This scheme reflects a deeply-held belief that penalties should not penalize taxpayers who could not understand their tax law obligations. As early as 1921, Senator Reed explained,

"I have been informed by people in the collector's office in Kansas City that there are hundreds of these cases where men come in and are willing to pay the tax, and have forgotten it for a day or two, and find a penalty stuck on them, and they simply go out mad and cursing the whole Government. It is very natural. I think we ought to get away from irritation where we can. I think if you keep on imposing such penalties and heavy taxes, everybody is going to hate the Government anyhow. . . . These people have not read this law. If they did read it, they could not understand it. It applies to millions of people to whom it is a hopeless muddle, and they forget, and then get stuck 5 per cent. It is harsh. It would be harsh in any law."

Animated by this sentiment, the penalties have remained fundamentally unchanged and fault-based over the history of the Code. Government bodies have continually linked this deep-seated commitment to fault to the same sentiment expressed by Senator Reed. As described most succinctly by the Commissioner's Executive Task Force on Civil Penalties in 1989, "regularly penalizing taxpayers . . . would be considered unfair, would destroy the moral and ethical connotations of the penalty, and would ultimately undermine the standard of behavior." As a result, the Commissioner's Executive Task Force believed that penalties should only apply when taxpayers have "an understanding of [their tax] obligations and they have everything they need to be able to comply."

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117 The first modern penalties arrived with the Federal Revenue Act of 1918, which applied a negligence penalty at a rate of 5% and a fraud penalty at a rate of 50%. Federal Revenue Act of 1918, Pub. L. No. 254, ch. 18, § 250(b), 40 Stat. 1057, 1083. The Act provided that "if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement." Id.

118 An Act to Reduce and Equalize Taxation, to Amend and Simplify The Revenue Act of 1918, and for Other Purposes: Hearing on H.R. 8245 Before the S. Comm. on Finance, 67th Cong. 99 (1921) (statement of Sen. Reed).


120 Id. at IV-1.
The major thrust of penalty changes since the inception of penalties has been to ensure that penalties apply when taxpayers engage in tax shelters or particularly aggressive efforts to reduce their tax liability. This tactic is entirely consistent with a strong commitment to protecting taxpayers who are honestly trying to pay the tax liability they owe, and therefore supports the general commitment to decreased likelihood of penalties in response to strategic uncertainty. As Dan Kahan has explained, targeting taxpayers who are clearly dedicated to shirking their taxpaying duties is an important complement to protecting taxpayers who do not exhibit such tendencies.\textsuperscript{121}

The most significant and widespread penalty change since the inception of modern penalties, the substantial understatement penalty, was prompted by concern about tax shelters.\textsuperscript{122} Congress made sure to apply fault-based carveouts for this penalty, explaining that “taxpayers who take highly aggressive filing positions are penalized while those who endeavor in good faith to fairly self-assess are not penalized,” and additionally providing a waiver for reasonable cause and good faith (which later became the omnibus defense).\textsuperscript{123} Most of the remaining changes in the history of tax penalties have been narrowly directed at particularly abusive, or tax shelter transactions, such as the increasingly stringent application of the substantial understatement penalty to tax shelters, the addition of the § 6662A penalty to reportable transactions, and economic substance codification.\textsuperscript{124}

Courts’ application of the current penalty provisions also indicates a strong commitment to the same fault-based principles. A review of case law reveals that the accuracy penalties operate in two primary circumstances: when the tax obligation is clear or when the taxpayer was actively trying to game the system and potentially take unfair advantage of uncertainties, as in a tax shelter. The first category is by far


\textsuperscript{124} See Subsection III.B.2 for reasons why economic substance codification is likely to be limited to the tax shelter context and not a paradigm shift in penalty application under uncertainty. Minor changes have been made to penalties outside the tax shelter context. For example, prior to 1993 neither the substantial understatement penalty nor the negligence penalty applied to disclosed tax positions that were not frivolous. H.R. Rep. No. 103-111, at 753-55 (1993). In 1993, this standard was changed to the current “reasonable basis” standard. Id. at 754.
the most prevalent application of the accuracy penalties. Examples abound of courts upholding accuracy penalties as a result of seemingly flagrant violations of clear tax law obligations (including failure to meet substantiation requirements). Presumably, the Service finds it substantially easier to assess and prove an accuracy penalty rather than a fraud penalty, even when the circumstances may support the latter.

The second category is a much less significant but still sizeable number of cases in which penalties are applied in tax shelter or non-economic substance cases, even if the governing law is not entirely clear. This category reflects both the underlying tax law's harsher application of penalties in tax shelter transactions, and the at times seemingly independent commitment of the courts to apply penalties for these transactions. It is the rare case that upholds an accuracy penalty

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125 See, e.g., Scott v. Commissioner, 352 Fed. App'x. 468, 469 (2d Cir. 2009) (taxpayer reported zero wages when he earned $61,072 and his only defense was a "specious" argument that he was not an employee and that his income did not constitute wages); Akers v. Commissioner, 326 Fed. App'x. 593 (2d Cir. 2009) (taxpayer clearly failed to meet substantiation requirements for deductions); Randall v. Commissioner, 2007 WL 4269061, at *1 (10th Cir. 2007) (taxpayer failed to include income that was included on 1099s); Sadberry v. Commissioner, 153 Fed. App'x. 336, 343 (5th Cir. 2005) ("any cursory reading" of the Form 1040 instructions precluded taxpayer's position and his status as an attorney obviated reasonable cause for failure to comply with the instructions); Jackson v. Commissioner, 50 Fed. App'x. 701, 704 (6th Cir. 2002) (taxpayer took deductions without any documentation); Toberman v. Commissioner, 294 F.3d 985, 990 (8th Cir. 2002) (taxpayer failed to provide any records to substantiate net operating loss carryforwards and did not explain absence of records); Barmes v. Commissioner, No. 01-3517, 2002 WL 652089 (9th Cir. 2002) (taxpayers' position was frivolous); Sykes v. Commissioner, 99 T.C.M. (CCCH) 12 (2010) (taxpayers submitted no evidence that would defend against the penalty and they failed to keep adequate books and records that would substantiate the item); Koziej v. Commissioner, T.C. Summ. Op. 2010-41 (2010) (taxpayer failed to report claimed receipt of loan payments as income); Elverson v. Commissioner, T.C. Summ. Op. 2010-36 (2010) (taxpayer did not produce records to substantiate deductions and Tax Court disbelieved that they existed); Chow v. Commissioner, 99 T.C.M. (CCCH) 1193 (2010) (taxpayers' positions directly violated applicable tax law or were not substantiated); Conway v. Commissioner, T.C. Summ. Op. 2010-27 (2010) (taxpayer claimed that she did not have to report rental income received by her son in direct violation of bedrock Lucas v. Earl precedent); Robert v. Commissioner, 99 T.C.M. (CCCH) 1159 (2010) (taxpayer's positions were without substance and had no support in case law); Prough v. Commissioner, 99 T.C.M. (CCCH) 1093 (2010) (taxpayers received direct instructions in conflict with the tax positions they took); Royster v. Commissioner, 99 T.C.M. (CCCH) 1077 (2010) (failure to substantiate).


127 In Long Term Capital Holdings, the district court made the seemingly categorical statement, "Since the Court has found that the OTC transaction is devoid of objective economic substance and subjective business purpose, Long Term has not and cannot cite authority, much less substantial authority, for the proposition that a taxpayer may claim
penalty in non-abusive circumstances when the tax law is not clear.\textsuperscript{128} It is more common for courts to craft judicial exceptions to penalties to ensure that they cannot apply under uncertainty, in a manner that seems to go beyond even what the Code and regulations require.\textsuperscript{129}

The case law and the courts' sentiments expressed therein\textsuperscript{130} thereby confirm the fundamental conception of monetary tax penalties as punishments for known or likely wrongdoing. This conception of monetary penalties appears unlikely to change, reducing the utility of strategic uncertainty as a means of increasing revenue.

4. Taxpayers' Awareness of Monetary Penalties

An additional objection to the analysis regarding monetary tax penalties and strategic uncertainty is that what matters is whether taxpayers think penalties operate under uncertainty, not whether they actually do. If taxpayers think that monetary penalties operate robustly under uncertainty, then taxpayers may have much stronger reason to increase tax liability reporting in response to strategic uncertainty, even though they would not, were they well-informed.\textsuperscript{131}

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\textsuperscript{128} See, e.g., Green v. Commissioner, 507 F.3d 857, 869, 872 (5th Cir. 2007) (substantial understatement penalty upheld when taxpayer excluded payments from settlement, even though language relating to the settlement was “less than clear”); Estate of True v. Commissioner, 390 F.3d 1210, 1245 (10th Cir. 2004) (upheld penalties when taxpayers relied on buy-sell agreements to set values notwithstanding that “the parties present comparatively persuasive arguments in support of their relative positions”).

\textsuperscript{129} William Drennan points to “a string of judicial exceptions” to prevent the application of penalties when faced with uncertainty. William A. Drennan, Strict Liability and Tax Penalties, 62 Okla. L. Rev. 1, 20 (2009). Exemplifying this phenomenon is the doctrine of first impression embraced by the Tax Court as well as the courts of appeal. See, e.g., Mitchell v. Commissioner, 79 T.C.M. (CCH) 1954 (2000) (refusing to uphold substantial understatement penalty applied to a factual issue because the case was one of first impression “involving the unclear application of an amendment to the Internal Revenue Code”).

\textsuperscript{130} The Second Circuit displayed characteristic anathema to penalty application under uncertainty when it warned that “the government's bald claim that the taxpayer did not exercise due care” when the tax law was unclear was “little short of reprehensible.” Holmes v. United States, 85 F.3d 956, 963 n.7 (2d. Cir. 1996).

\textsuperscript{131} Recently, Joshua Blank and Daniel Levin have provided interesting data indicating that the government manipulates the release of tax enforcement information to influence taxpayers' perceptions of penalties and audit rate. Joshua D. Blank & Daniel Z. Levin, When Is Tax Enforcement Publicized?, 30 Va. Tax Rev. 1, 4-5 (2010). The government tends to reveal information about criminal and civil injunctions regarding tax fraud, which is accompanied by severe penalties. Id. at 8. This form of manipulation would seem to provide taxpayers little information about the nature of tax penalties when the tax law is uncertain.
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As a result, perhaps strategic uncertainty could increase revenue by reducing under-reporting, even absent actual robust application of penalties under uncertainty.

Several responses to this objection are in order. First, the models that posit that strategic uncertainty may increase revenue rely on assumptions of both highly rational and highly informed taxpayers. Specifically, under the risk-averse model, taxpayers would have to appreciate the greater risk imposed by uncertain tax law and the ability to mitigate the risk by higher tax reporting. Under the interactive model, taxpayers would have to be able to analyze how the Service might react to greater tax law uncertainty and respond accordingly.

If we are to apply these assumptions, then applying the lesser assumption that taxpayers have an understanding of how tax penalties operate seems reasonable. The application of penalties under uncertainty is clear from publicly available statutes and regulations. As a result, tax administrators should not adopt strategic uncertainty as a compliance tool based on an assumption of hyper-rational and informed taxpayer behavior without an accompanying assumption that taxpayers will understand the operation of the penalty provisions under uncertainty.

Additionally, some empirical evidence supports the notion that taxpayers do believe that there is some incentive to report less tax liability as uncertainty increases. Steven Klepper and Daniel Nagin obtained access to taxpayer reporting data through the Taxpayer Compliance Measurement Program ("TCMP") to conduct studies regarding taxpayer reporting when tax law is uncertain. Klepper and Nagin characterized this uncertainty (or in their terms "ambiguous" tax items) based on whether or not a tax issue required a valuation, which they viewed as inherently susceptible to dispute, and based on how many revenue rulings the Service had issued with respect to a tax question. The Service issues revenue rulings to eliminate uncertainty regarding how the tax law applies in specific factual situa-

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132 Information regarding actual taxpayer reporting behavior is very difficult to obtain. The most reliable source of information comes from the TCMP, which was a program in which the IRS conducted intensive audits of randomly selected taxpayers during various tax years between 1963 and 1988. Robert E. Brown & Mark J. Mazur, The National Research Program: Measuring Taxpayer Compliance Comprehensively, 51 U. Kan. L. Rev. 1255, 1261-62 (2003). The program, which was designed to develop information about taxpayer compliance and sharpen IRS audit selection formulas and techniques, was discontinued due to a variety of factors including general discontent with the IRS. Id. at 1262-63. The Service has strictly restricted access to TCMP data, limiting the empirical observations that can be made regarding taxpayer compliance under a variety of circumstances. See, e.g., Raskolnikov, note 38, at 590 (describing the “extreme secrecy” of the Service with respect to TCMP data).

133 Klepper & Nagin, note 10, at 13.
Klepper and Nagin measured the number of revenue rulings for particular tax items from the year of the tax return and the two subsequent years, to capture the uncertainty which existed at the time of tax return filing. While not a perfect measure of tax law uncertainty, the methodology produced an interesting conclusion. Klepper and Nagin found a significant positive correlation between the ambiguity of an item and noncompliance.

While these results do not isolate the impact of monetary tax penalties under uncertainty on reporting behavior, the results are at least consistent with taxpayers actually being affected by monetary tax penalty operation under uncertainty. Given the importance of monetary tax penalties as an incentive in taxpayers' reporting decisions, penalties are likely to be at least a partial explanation for the Klepper and Nagin results. As a result, while it may be difficult to say with certainty what taxpayers' beliefs are about monetary tax penalty operation under uncertainty, the actual operation of monetary tax penalties under uncertainty, combined with indications that taxpayers act consistently with this operation, counsels against adoption of strategic uncertainty as a means of raising revenue.

5. Noneconomic Incentives

In addition to responding to monetary tax penalties, taxpayers respond to noneconomic incentives to report tax liability. While pure economic models of taxpayer reporting behavior do not consider the impact of noneconomic incentives, scholars in an increasingly vast literature have posited that some sort of norms, duties, compulsions,
or other noneconomic incentives partially must cause taxpayers to pay taxes.\textsuperscript{139} These noneconomic incentives are often seen as a complement to the economic models.\textsuperscript{140} The operation of these noneconomic incentives in response to strategic uncertainty may provide taxpayers even greater reason to report less, rather than more, tax liability as tax law uncertainty increases.

While little consensus exists regarding exactly how noneconomic incentives influence taxpayer reporting,\textsuperscript{141} they clearly influence reporting to some extent.\textsuperscript{142} These mechanisms may include a desire to return the government’s cooperation, a desire to reciprocate the tax-paying of one’s fellow citizens, a more general duty to obey the law, or some combination thereof. For example, Dennis Ventry suggests that taxpayer behavior responds to the fairness of government processes.\textsuperscript{143} Dan Kahan posits that a taxpayer is a “moral and emotional reciprocator,” who pays taxes out of some sense of guilt or shame if others are believed to be paying taxes, but reciprocates perceived failure to pay taxes with failure to pay in order to avoid feeling like a “sucker.”\textsuperscript{144} Michael Doran suggests that perhaps the firmest taxpaying norm is the desire to honor “legitimate legal obligations.”\textsuperscript{145}

Little work has been done regarding the impact of uncertainty on these mechanisms.\textsuperscript{146} Strategic uncertainty, however, likely reduces taxpayers’ noneconomic incentives to pay taxes.\textsuperscript{147} To the extent that

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\item Doran, note 86, at 131-32 (describing the norms model as complementing the deterrence model).
\item For an erudite summary of the various norms or factors that may impact taxpayer reporting accompanied by a critical appraisal of whether the norms literature can help improve compliance, see id. at 131-38.
\item See Raskolnikov, note 139, at 695-96 (noting that “it is beyond doubt” that the deterrence model based on fines and audit rate “fails to describe the behavior of many individuals” since “numerous taxpayers comply with tax law even though they have a clear opportunity to evade or avoid their obligations”). Scholars fundamentally base this conclusion on the surprisingly high rate of voluntary compliance (The Office of Tax Policy recently estimated voluntary compliance as being between 83.7% and 86.3%) given the low audit and monetary penalty rates. Off. of Tax Pol’y, Treasury Dep’t, A Comprehensive Strategy for Reducing the Tax Gap 5 (2006), available at http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf
\item Dennis J. Ventry, Cooperative Tax Regulation, 41 Conn. L. Rev. 431, 439 (2008).
\item Kahan, note 121, at 81.
\item Doran, note 86, at 137.
\item See Gergen, note 4, at 421.
\item For a similar view, see Yuval Feldman & Doron Teichman, Are All Legal Probabilities Created Equal?, 84 N.Y.U. L. Rev. 980, 1012-13 (2009) (pointing to nondeterrence theories of compliance and explaining that “the use of legal uncertainty as a revenue-en-
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taxpayers pay taxes because of a desire to cooperate with the government, strategically increasing uncertainty may be seen as an uncooperative act by the government, resulting in less cooperation by taxpayers. In this regard, taxpayers may view high levels of tax law uncertainty as fundamentally unfair and may respond by shirking their taxpaying obligations to a greater extent. To the extent that taxpayers pay taxes as a result of a desire to reciprocate one's fellow citizens' taxpaying, strategic uncertainty may place into doubt other citizens' reporting decisions and thereby reduce a taxpayer's taxpaying reciprocation. To the extent that taxpayers pay taxes as a result of a duty to obey the law, making the law less clear may reduce certainty regarding the taxpayer's commitment and thereby undermine such commitment.

The reduced operation of these noneconomic incentives to pay taxes in response to strategic uncertainty would magnify the impact of monetary tax penalties on reporting. As a result, a reduced likelihood of tax penalties, potentially combined with the reduced operation of noneconomic incentives to pay taxes, may provide taxpayers with impetus to report less, rather than more, tax liability in response to strategic uncertainty.


Notwithstanding the reduced operation of tax penalties (and, potentially, noneconomic incentives to report tax liability), if nontax financial reporting costs induce taxpayers to report higher tax liability on
their tax returns as uncertainty increases, then taxpayers may still report higher tax liability on their tax returns in response to strategic uncertainty. Recently promulgated nontax financial reporting rules, backed by a new tax reporting regime, do impose new and potentially significant costs on taxpayers. Nevertheless, these rules should not cause taxpayers to report higher tax liability on their tax returns in response to strategic uncertainty.

In 2006, the Financial Accounting Standards Board ("FASB") changed the landscape of accounting for uncertain tax positions by issuing Financial Interpretive Statement 48 ("FIN 48").\textsuperscript{151} FIN 48's purpose is to ensure that companies with financial statements subject to FASB rules comparably account for uncertain tax positions on their financial statements.\textsuperscript{152} FIN 48 creates a two-step process to evaluate tax positions for financial statement purposes. In the first step (the "recognition step"), the company must evaluate the technical merits of the tax position and determine whether the position is more likely than not to be sustained (the "more likely than not" standard).\textsuperscript{153} If a position is more likely than not to be sustained, then, in the second step, the company must determine the largest amount of the tax benefit from the position that has a greater than 50% likelihood of being realized upon settlement.\textsuperscript{154} The company must create a reserve on the financial statement for tax benefits that fail either part of this two-part test.\textsuperscript{155}

The Service has recently instituted a new set of reporting requirements designed to capitalize on FIN 48. The Service now requires certain corporations that file audited financial statements and that meet certain asset thresholds to file a schedule of uncertain tax positions ("Schedule UTP") with their tax returns, providing a concise summary of the uncertain tax positions on the tax return and ranking them from highest to lowest reserve amounts.\textsuperscript{156} Uncertain positions, for this purpose, are positions for which the corporation has recorded a reserve on audited financial statements, or for which the corporation did not record a reserve because it expects to litigate (and win) the position.\textsuperscript{157} The Service has indicated that, while it will not immedi-

\textsuperscript{152} Id. at Summary.
\textsuperscript{153} Id.
\textsuperscript{154} Id.
\textsuperscript{155} Id. The taxpayer need not set up a reserve if it expects to litigate (and win) the issue. Id. at 11.
\textsuperscript{156} See IRS, 2010 1120 Instructions 1, 3, 4 (2010); Announcement 2010-75, 2010-41 I.R.B. 428, 429 (Oct. 12).
\textsuperscript{157} IRS, note 156, at 2.
ately propose adjustments based on a taxpayer’s Schedule UTP, it will rely upon Schedule UTP to focus its audit resources. The combination of FIN 48 and Schedule UTP increases costs on taxpayers. Specifically, prior to FIN 48/Schedule UTP, taxpayers with audited financial statements had a much greater ability to take aggressive tax positions, which were unlikely to be sustained, and claim the benefits of such positions for financial accounting purposes. Taxpayers could rely on the audit lottery to hopefully prevent the issues from seeing the light of day, thereby permanently ensconcing the tax reduction. Under FIN 48/Schedule UTP, if a company with audited financial statements wants to take a tax position with a very low likelihood of success, it should have to place a reserve on its financial statements for such position, thereby reducing the strength of its financial statements. The company would also have to notify the Service of the position on Schedule UTP, presumably attracting audit attention and increasing the likelihood of disallowance.


159 See, e.g., Announcement 2010-9, 2010-7 I.R.B. 408, 409 (Jan. 26) (indicating that the new disclosure will allow the Service to focus its resources on uncertain positions of sufficient magnitude); Jeremiah Coder, Shulman Announces Proposal for Reporting Uncertain Tax Positions (Jan. 26, 2010), 2010 TNT 17-2, Jan. 27, 2010, available in LEXIS, Tax Analysts File (“The IRS believes that better and more complete information regarding the nature and materiality of a company’s uncertain tax positions will cut down on the time it takes to both find an issue and complete the audit . . . .”).

160 Other alternatives are possible. Since the disclosure obligation keys off of reserves for financial accounting purposes, practitioners have warned that the UTP Schedule will merely cause taxpayers to take more aggressive financial accounting positions. See, e.g., Jeremiah Coder, Wilkins Discusses Need for Uncertain Tax Position Reporting (Mar. 2, 2010), 2010 TNT 41-2, Mar. 3, 2010, available in LEXIS, Tax Analysts File (quoting Phillip A. Pillar of Greenberg Traurig LLP stating that the Schedule UTP may have the ironic result of reducing the number of uncertain tax positions for financial accounting purposes). Alternatively, taxpayers could simply have disparate responses to the reporting regimes, whereby conservative taxpayers have a strong incentive to disclose positions, thereby diverting audit resources toward conservative taxpayers. At the same time, more aggressive taxpayers’ uncertain (and undisclosed) positions could be less likely to be examined. Some empirical evidence exists that supports this concern. Alexander Edwards, Allison Koester, and Terry Shelvin examined the S&P index during the three days surrounding the release of the Schedule UTP announcement. Alexander Edwards, Allison Koester & Terry Shelvin, Examining Investor Reaction to IRS Announcement 2010-09, 127 Tax Notes 669, 671 (May 10, 2010). They found that stock prices generally did not respond to the release, indicating that stockholders did not believe it would impact tax compliance or tax costs. Id. at 673. They found no significant relationship between firms with large uncertain tax positions for financial accounting positions and stock price surrounding the announcement. Id. at 671-72. They did find a significant but negative relationship between stock prices and current effective tax rates, indicating that firms with low effective tax rates (likely resulting from aggressive positions) favorably viewed the announcement. Id. at 672-73. They hy-
Even though these reporting rules increase the costs of taking an uncertain tax position,\(^{161}\) increasing uncertainty under the new reporting regime should not cause taxpayers to report higher tax liability on their tax returns. It is easiest to understand this proposition by way of example. Imagine two different taxpayers, \(A\) and \(B\). Prior to imposition of strategic uncertainty, \(A\) believed that she had a 40\% chance of being able to claim entitlement to a particular tax benefit. \(B\) believed that she had a 60\% chance of being entitled to the tax benefit. Additionally, \(B\) determined that the amounts and probabilities of the possible estimated tax benefit outcomes are as follows:

<table>
<thead>
<tr>
<th>Possible Estimated Outcome</th>
<th>Individual Probability of Occurring (%)</th>
<th>Cumulative Probability of Occurring (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$75</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>50</td>
<td>50</td>
<td>75</td>
</tr>
<tr>
<td>25</td>
<td>25</td>
<td>100</td>
</tr>
</tbody>
</table>

Under FIN 48, the reserve requirements would be as follows. Since \(A\)'s position does not meet the more-likely-than-not standard, \(A\) would not be entitled to recognize a tax benefit for financial reporting purposes, and therefore would be required to create a reserve for the entire tax position. Since \(B\)'s position meets the more-likely-than-not threshold and $50 is the largest amount that is greater than 50\% likely of being realized upon settlement, \(B\) would be entitled to recognize a tax benefit of $50 and would have to create a reserve for the remaining amount.\(^{162}\)

Now imagine that tax administrators rely on strategic uncertainty. As a result, taxpayers have less guidance but do not face guidance skewed in one direction or the other. Simply withholding guidance without skewing it in one direction or another should not clearly change the result under either the recognition or measurement step of FIN 48. As a result, taxpayers may not experience different FIN 48 or Schedule UTP results as a result of strategic uncertainty.

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\(^{161}\) An uncertain tax position, for this purpose, would be any tax position that does not meet the more-likely-than-not standard or any portion of a tax benefit that does not have a greater than 50\% likelihood of being realized on settlement. In this regard, the term "uncertain tax position," adopted by both FIN 48 and Schedule UTP, is really a misnomer. The more accurate description should be "unlikely tax position."

\(^{162}\) See FIN 48, note 151, at 16-17, for examples of this calculation.
As to the recognition step, A and B may experience ambiguity regarding the percentage chance of being entitled to the benefit. That is, with less guidance, but without guidance skewed in either direction, A and B may maintain that, if pressed, they would still have 40% and 60% respective chances of being entitled to their tax benefits, but may simply be less confident in these precise measures. If this is the case, then A still does not get to recognize any benefit for financial reporting purposes, the same conclusion as existed without strategic uncertainty. B may be able to claim that, although not sure, her best guess is still that she has a 60% chance of being entitled to the tax benefit. As a result, she may still proceed to the measurement step.

At the measurement step, B may perceive that strategic uncertainty has increased the range of potential outcomes. For example, it is possible that under strategic uncertainty, without making B better or worse off, a greater range of potential outcomes exists. So, B may now determine that the amounts and probabilities of the possible estimated tax benefit outcomes are as follows:

<table>
<thead>
<tr>
<th>Possible Estimated Outcome</th>
<th>Individual Probability of Occurring (%)</th>
<th>Cumulative Probability of Occurring (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>75</td>
<td>20</td>
<td>40</td>
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<td>50</td>
<td>20</td>
<td>60</td>
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<tr>
<td>25</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>0</td>
<td>20</td>
<td>100</td>
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</tbody>
</table>

In this case, since $50 is still the largest amount that is greater than 50% likely of being realized upon settlement, B would still be entitled to recognize a tax benefit of $50. In short, because strategic uncertainty would have merely decreased clarity without skewing expected tax liability one way or another, B would have a plausible claim to end up with the same tax benefit for financial reporting purposes as under less uncertainty. A would remain disentitled to claim the tax benefit in either case. As a result, strategic uncertainty would not impose greater financial reporting costs on either taxpayer.

Even if B felt disentitled to claim the same tax benefit for financial reporting purposes as prior to the strategic uncertainty, B may still take the position on its tax return. Imagine that B simply could not convince the company's auditor that B should still meet the more-likely-than-not threshold. For example, imagine that tax administra-
tors hold back almost entirely on guidance regarding a particular issue. In this case, an auditor may conclude that the lack of guidance forecloses coming to a more-likely-than-not decision that \( B \) is entitled to the benefit. Even in this case, \( B \) would still have significant reason to take the position on its tax return. As discussed previously, given the uncertainty in this case, \( B \) would be unlikely to suffer a penalty. Additionally, if \( B \) ultimately settles the issue in \( B \)'s favor with the IRS, or if the statute of limitations period for the position simply closes without adjustment by the Service, then \( B \) can then also take the benefit for financial statement purposes.\(^{163}\)

In sum, while recently enacted FIN 48 and Schedule UTP increase costs on companies, the introduction of strategic uncertainty would not necessarily dictate a more disadvantageous financial reporting result under the new reporting regime and should not significantly skew taxpayers' tax return reporting incentives. As a result, the FIN 48/Schedule UTP regime should not serve as a nontax penalty that would induce higher tax liability reporting on tax returns in response to strategic uncertainty. Rather, as a result of reduced tax penalties and, potentially, noneconomic incentives to report tax liability, taxpayers should have lower impetus to report more tax liability in response to strategic uncertainty and may have impetus to report less tax liability instead.

C. Tactical Factors May Cause Strategic Uncertainty to Decrease Rather than Increase Revenue

A third reason why strategic uncertainty may not increase revenue by reducing under-reporting is because tactical factors may weigh against increased tax liability reporting and may instead have the opposite result. Interactive models of taxpayer reporting suggest that taxpayers may have an incentive to report more of the tax liability that they owe in response to strategic uncertainty if they believed that the Service would increase audits as a result of a perceived greater benefit from auditing under greater uncertainty. Taxpayers would respond by reporting more tax liability to avoid the higher chance of audit.

While this argument has some appeal, other tactical factors may cause the opposite effect. Specifically, limitations on the Service's audit abilities, negotiating opportunities afforded by greater tax law uncertainty, and the influence of professional tax return preparers may cause taxpayers to report less, rather than more, tax liability in response to strategic uncertainty. Tactical factors therefore cast doubt

\(^{163}\) FIN 48, note 151, at 3.
on the ability of strategic uncertainty to raise revenue by reducing underreporting.

1. Audit Rate

In order for taxpayers to report more tax liability in response to strategic uncertainty under an interactive model, taxpayers would have to believe that greater tax law uncertainty increased the possibility of audit. Practical constraints on the IRS, however, make it very unlikely that the audit rate would increase in response to the level of tax law uncertainty. These limitations should dampen taxpayers' incentives to report more of the tax liability that they owe under an interactive model in response to strategic uncertainty.

Interactive models often assume that the Service chooses an audit rate that maximizes revenue collection, given the various tax enforcement parameters. If an aspect of the tax enforcement system changes, then the assumption is that the Service is free to change its audit rate in order to capitalize on the new auditing incentives.

The introduction of a binding budget constraint can, at times, have a drastic impact on the predictions of these models. In the context of strategic uncertainty, budgetary and political constraints on the IRS are likely to limit the Service's ability to tailor the audit rate to levels of uncertainty. Strong evidence suggests that the Service faces political and budget constraints that dictate the audit rate. As an initial matter, the audit rate is notoriously extremely low, with audit rates currently as low as 1.03% for individuals. As commentators have noted, little political will exists for increasing the audit rate, even in circumstances in which taxpayers are clearly evading tax. This is unlikely to increase in response to greater tax law uncertainty.

Numerous examples illustrate Congress' resistance to increasing the IRS's tax enforcement budget, even when doing so would directly and easily raise revenue. For example, recently the Service has outsourced collection of small tax debts to private companies even when hiring

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164 See, e.g., Beck & Jung, note 44, at 478 (discussing higher audit probability).
165 In the taxpayer reporting model with discrete tax outcomes set forth by Graetz, Reinganum, and Wilde, for example, introduction of a binding budget constraint resulted in the prediction of total noncompliance by strategic taxpayers who had high income. Graetz et al., note 37, at 25.
167 Raskolnikov, note 139, at 716 ("If decades of stagnant or falling audit rates suggest anything, it is that a substantial increase in audit coverage is highly unlikely.").
168 See Joseph Bankman, Eight Truths About Collecting Taxes from the Cash Economy, 117 Tax Notes 506, 516 (Oct. 29, 2007) (discussing lack of political support for audit expansion).
more revenue officers to do the same job would raise substantially more revenue at substantially lower cost.\textsuperscript{169} Indeed, even though Congress was aware of the greater revenue-raising potential from hiring more revenue officers to collect small tax debts, Congress refused to provide the funding necessary to allow the IRS to do the collections itself.\textsuperscript{170}

The lesson is that the Service already has very strong incentives to increase its enforcement efforts, including the audit rate, and yet political and budget constraints prevent realization of these incentives.\textsuperscript{171} The introduction of strategic uncertainty is not likely to overcome those barriers. As a result, fear of a higher audit rate becomes an unlikely impetus for taxpayers to increase their tax liability reporting.\textsuperscript{172}

2. \textit{Negotiation Tactics}

Even if strategic uncertainty caused taxpayers to fear an increasing chance of audit, the impact on taxpayer reporting is unclear. Increasing the fear of audit through strategic uncertainty may cause taxpayers to report less, rather than more, tax liability. The reason is because the increased chance of audit triggers two counterbalancing factors: the desire to report more tax liability to avoid the greater chance of audit and the desire to report less tax liability in order to influence the final outcome in case an audit actually occurs. Using strategic uncertainty as the impetus for greater perceived chance of audit may cause the latter factor to dominate, and therefore may cause reported tax liability to decrease.

\textsuperscript{169} See David Cay Johnston, I.R.S. Enlists Outside Help in Collecting Delinquent Taxes, Despite the Higher Costs, N.Y. Times, Aug. 20, 2006, at A12 (reporting that “[t]he private debt collection program is expected to bring in $1.4 billion over 10 years, with the collection agencies keeping about $330 million of that, or 22 to 24 cents on the dollar,” whereas “[b]y hiring more revenue officers, the I.R.S. could collect more than $9 billion each year and spend only $296 million—or about three cents on the dollar”).

\textsuperscript{170} Id.

\textsuperscript{171} Service officials have repeatedly voiced a desire for more enforcement resources. For example, when discussing the 2001 tax gap estimate, Commissioner Mark Everson pressed for more enforcement resources, arguing that “over a quarter-trillion dollars . . . is way too much money to leave on the table.” Stephen Joyce, 2001 Tax Gap Found to Exceed $310 Billion; Everson Uses Research to Press for Funding, Daily Tax Rep. (BNA), Mar. 30, 2005, at G-11.

\textsuperscript{172} The Service’s stated intention of using Schedule UTP to focus its audit resources on existing uncertainties is distinct from the ability of the Service to increase the audit rate generally in response to generally increased uncertainty. If the government strategically increased uncertainty across the Code, then taxpayers would have to believe that the Service could generally increase the audit rate in order to believe that the higher level of uncertainty would mean a higher chance of audit.
The key intuition here is that perceived increased audit probability not only encourages taxpayers to report more tax liability in order to avoid the chance of audit, but also encourages taxpayers to report less tax liability to influence the ultimate outcome should an audit occur. By reporting a low amount of tax liability, taxpayers may influence the ultimate outcome should an audit occur because of a psychological phenomenon called the “anchoring effect.” Under the anchoring effect, negotiators are heavily influenced by the first proposal in a negotiation. As a result, a taxpayer may report low tax liability on a tax return in case an audit occurs, in hopes of lowering the ultimate amount of taxes the Service ultimately asserts that the taxpayer owes.

An interesting controlled experiment conducted in Minnesota suggests this potential result. In this experiment, a group of taxpayers received a letter warning that their tax returns would be “closely examined.” While low- and middle-income taxpayers who received this letter reported a small amount more tax liability in relation to their prior year's tax report, relative to control taxpayers who did not receive the letter, high-income taxpayers reported substantially less tax liability in relation to their prior year's tax report, relative to those who did not receive the letter. A hypothesis suggested by these findings was that the high-income taxpayers, promised a searching audit, may have believed that they could influence the ultimate audit outcome by initially reporting lower tax liability.

The incentive to report less tax liability as an anchoring tactic makes significantly more sense as tax law uncertainty increases. While taxpayers who are certain of their tax liabilities may imagine that the Service cannot detect all evasion, and thus some benefit may exist from reporting lower tax liability to start audit adjustments from a lower point, the downside from understating tax liability known to be owed is clear from a tactical perspective. If the Service does catch

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173 Cognitive psychologists Amon Tversky and Daniel Kahneman identified the anchoring effect in the 1970's, as an important heuristic principle that affects judgments and decision making. Amos Tversky & Daniel Kahneman, Judgment Under Uncertainty: Heuristics and Biases, 185 Sci. 1124, 1128-30 (1974).

174 An oft-cited use of the anchoring effect is car dealerships' pricing of cars above the likely sales price in order to anchor the negotiations. In a meta-analysis of studies measuring the impact of the anchoring effect in negotiations, Dan Orr and Chris Guthrie found that “anchoring has a powerful impact on negotiation outcomes.” Dan Orr & Chris Guthrie, Anchoring, Information, Expertise, and Negotiation: New Insights from Meta-Analysis, 21 Ohio St. J. on Disp. Resol. 597, 598 (2006).


176 Id. at 482.

177 See id. (suggesting that the high-income taxpayers in the Minnesota experiment may have thought as much).
clear tax evasion on audit, the taxpayer will have little room to negotiate with the Service. The taxpayer would be branded a tax evader in the eyes of the auditing agent who has discretion over the rest of the return, as well as in the eyes of potential appeals officers or judges who might review other aspects of the tax return. Additionally, the Code codifies this distrust of taxpayers who are clearly caught hiding tax liability by subjecting such taxpayers to more searching audit review. Taxpayers who fail to report a substantial item on their return entirely or engage in fraudulent under-reporting are subject to an extended statute of limitations of six years, or indefinitely, respectively, as compared to a normal statute of limitations of three years. These extended statutes of limitations allow the auditor to subject the taxpayer to an unusual amount of scrutiny, for a lengthy period of time. As a result, while reporting lower tax liability may influence the outcome on audit, under-reporting carries serious risks and may not be as beneficial when the tax law is clear.

Under tax law uncertainty, on the other hand, the taxpayer faces much less strategic downside from reporting less tax liability, and instead may experience much upside as a negotiation tactic. As a result, as uncertainty increases, taxpayers may be much more likely to report low tax liability, in order to improve their starting position and negotiation posturing should the taxpayer end up being audited. If the Service questions a low tax liability report, but the report remains within the confines of the tax law, the Service has little leverage to demand a higher payment. Absent an ultimate decision by a court, the resolution of any tax issue subject to uncertainty merely becomes a matter of negotiation between the Service and the taxpayer. Whether the Service ultimately can capture a significant amount of this bargaining surplus or not, the taxpayer still has much to gain by reporting as low as possible within the confines of uncertainty.

Importantly, by engaging in this strategy, as long as the taxpayer's position is not identified as a tax shelter, the taxpayer has little rea-

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178 The case law discussed above at Subsection III.D.3 indicates that the Service and courts are willing to make income adjustments and apply penalties for known violations of tax law.
179 IRC § 6501.
180 David Weisbach suggests the taxpayers may be able to capture the majority of this surplus. Weisbach, note 4, at 250-51.
181 As explained previously in Subsection III.D.2, the U.S. tax system has developed a different perception of tax shelters than non-shelter planning, even though tax shelters are arguably subject to legal uncertainty, such as whether and when benefits achieved through literal interpretations of the law are subject to disallowance as a result of broader standards. As explained in Section III.D.2, tax shelter participants do not get benefits that accompany most tax planning under uncertainty, including low likelihood of penalties. In the context of strategic interaction with the Service, finding a tax shelter is likely to cause the Service to examine the tax return intensively. Indeed, the Service generally has a po-
son to fear being branded a tax cheat whose entire return (and potentially returns from prior years) must be examined intensively in response to low reporting. Indeed, as long as the taxpayer provides the Service a clue as to the item in question and does not engage in fraud, an extended statute of limitations will not apply for the tax year. For example, if a taxpayer receives nonmonetary compensation from an employer and under-reports the value of the compensation on the income tax return, relative to the assessed value on audit, the taxpayer is not subject to the extended statute of limitations because reporting the item (even while under-reporting the value) apprised the Service of the item in question.\textsuperscript{182} Reporting less tax liability becomes more attractive as a negotiation tactic in case an audit actually occurs as uncertainty increases. The result may be less, rather than more, reported tax liability in response to strategic uncertainty. As a result, even if taxpayers perceived a higher audit rate under strategic uncertainty, the result still may be less, rather than more, tax reporting.

3. \textit{Professional Tax Return Preparers}

The involvement of professional tax return preparers may compound the response of reporting less, rather than more, tax liability in response to strategic uncertainty.\textsuperscript{183} Researchers have posited two

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{182} IRC § 6501(e)(1)(A)(ii); Colony, Inc. v. Commissioner, 357 U.S. 28 (1958) (indicating that an entire item must be omitted for the six-year substantial omission statute of limitations to apply).
  \item \textsuperscript{183} This discussion focuses on paid preparers, who remain by far the greatest source of tax return preparation. Internal Revenue Service, Return Preparer Review (Dec. 2009), 2010 TNT 2-62, Jan. 4, 2010, available in LEXIS, Tax Analysts File [hereinafter Return Preparer Review]. While taxpayers currently rely on tax preparation software to prepare only a minority of tax returns, its use is clearly on the rise. Interestingly, however, the impact of tax preparation software on compliance remains a very understudied question. See, e.g., Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, Cash Businesses and Tax Evasion, 20 Stan. L. & Pol’y Rev. 37, 55 n.60 (2009) (“leav[ing] open the question of whether technology has caused cheating to decrease over time”). Notably, in its recent study of return preparers, the Service both acknowledged the increasing role that tax preparation software plays and yet noted that “there have been few studies completed on the quality and accuracy of tax preparation software” and, as a result, “no consensus” exists.
\end{itemize}
\end{footnotesize}
main reasons why taxpayers seek the assistance of professional tax return preparers (including attorneys, accountants, and other return preparers such as bookkeepers or national tax services). The first reason is to obtain advice when the tax law is uncertain. The second is a desire not to spend time on tax preparation. These reasons are generally consistent with studies repeatedly finding that taxpayers with self-employment income and taxpayers who are required to file more forms and schedules have an increasing likelihood of using professional tax return preparers to prepare their tax returns. While uncertainty can impact even a simple return, the impact is almost certainly more pervasive as a tax return becomes more intricate. As a result, taxpayers with more complicated returns are likely affected by uncertainty to a greater degree, at least partially explaining their greater use of tax return preparer services. Indeed, Klepper, Mazur, and Nagin found in a study using TCMP data that tax returns prepared by professional tax return preparers tended to face a disproportionate amount of tax law uncertainty.

In accordance with taxpayers' tendencies to seek tax return preparer services when tax law is uncertain, strategic uncertainty may cause taxpayers to seek out a greater amount of advice from professional tax return preparers. The increased use of professional tax return preparers in response to strategic uncertainty may have a compounding effect. Empirical studies of TCMP data have revealed that the use of professional tax return preparers is correlated with lower reporting for uncertain tax items. In their study regarding taxpayer reporting under uncertainty, Klepper and Nagin found that professional tax return preparers contributed to more aggressive reporting by taxpayers on ambiguous tax issues, counterbalanced by their tendency to induce greater compliance with legally unambiguous tax questions. Other studies have linked professional tax return

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184 "Whether enhanced regulation of the tax preparation software industry is necessary." Return Preparer Review, supra, at 39. As the use of tax preparation software continues to increase, its impact on compliance will become increasingly important. Future research should focus on this growing facet of tax compliance.

185 See, e.g., Charles W. Christian, Sanjay Gupta & Suming Lin, Determinants of Tax Preparer Usage: Evidence from Panel Data, 46 Nat'l Tax J. 487, 499 (1993) (both concluding as much and cataloguing other studies that have reached the same findings).


187 Steven Klepper & Daniel Nagin, The Role of Tax Preparers, 22 Pol. Sci. 167, 168 (1989). Klepper, Mazur, and Nagin later formalized these findings, concluding that "strong support" existed for professional tax return preparers being "on the one hand, guardians against unequivocal breaches of the legal code and, on the other hand, exploiters of legally ambiguous features of the tax code to the advantage of the taxpayer." Klepper et al., note 186, at 207.
preparers (particularly lawyers and CPAs) with a greater amount of noncompliance generally.\textsuperscript{188}

The penalties facing professional tax return preparers support their tendency to encourage aggressive reporting in response to strategic uncertainty. Professional tax return preparers are liable for their own monetary penalties for tax liability understatements, and these penalties self-consciously track taxpayers' accuracy penalties.\textsuperscript{189} Professional tax return preparers are liable for a penalty equal to the greater of $1,000 or 50\% of the income derived by the preparer from a return with respect to any underpayments on the return, unless the position was disclosed and had a reasonable cause or was not disclosed and had substantial authority.\textsuperscript{190} Just as for taxpayers, a higher standard of conduct applies with tax shelters and reportable transactions, for which the preparer can avoid the penalty only if it was reasonable to believe that the position would more likely than not be sustained.\textsuperscript{191} Importantly, also just like with taxpayer penalties, no penalty applies if the understatement on the return had reasonable cause and the preparer acted in good faith.\textsuperscript{192}

The striking parallels between this monetary penalty regime and the monetary penalty regime applicable to taxpayers means that professional tax return preparers have decreased personal incentives to encourage taxpayers to report more tax liability in response to strategic uncertainty. One prominent practitioner noted that "practitioners are likely . . . to interpret [tax law] . . . ambiguities in favor of the taxpayer."\textsuperscript{193} Survey evidence has confirmed this inclination, indicating that the vast majority of CPAs and lawyers avow that they will resolve in favor of their client all questionable items that have a reasonable basis.\textsuperscript{194}

Moreover, experimental research has revealed that taxpayers often cede decisional authority about the aggressiveness of tax reporting to professional tax return preparers. Peggy Hite and Gary McGill found that only 25\% of randomly selected taxpayers had ever been asked by

\textsuperscript{189} For purposes of these penalties, a "tax return preparer" is "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax . . . or any claim for refund of tax". IRC § 7701(a)(36)(A).
\textsuperscript{190} IRC § 6694(a).
\textsuperscript{191} IRC § 6694(a)(2)(C).
\textsuperscript{192} IRC § 6694(a)(3). A tax preparer penalty will apply if an understatement is due to a willful attempt to understate tax liability or a reckless or strategic disregard of rules or regulations. This is akin to the taxpayer fraud penalties. IRC § 6694(b). Circular 230 also places requirements on practitioners who provide "covered opinions" to taxpayers. See Circular 230, 31 C.F.R. § 10.35 (2010).
\textsuperscript{193} Gerald W. Padwe, Commentary, in Crisis in Tax Administration, note 5, at 224.
\textsuperscript{194} Erard, note 188, at 167 (citing IRS survey).
their professional tax return preparers what position the taxpayer would like to take with respect to a debatable deduction. Significantly, the taxpayers in the study only tended to agree slightly that professional tax return preparers should ask the client regarding whether to report a questionable item on a tax return. While 45% of taxpayers agreed that professional tax return preparers should ask taxpayers about reporting of questionable items, 17% of taxpayers were undecided and 38% disagreed. According to Hite and McGill, "[t]he implication of these responses is that taxpayers do not want to make their own tax reporting decisions." Recent IRS studies have reached similar conclusions, finding that 94% of taxpayers who use professional tax return preparers generally follow their advice.

As a result, to the extent that professional tax return preparers tend to exploit uncertainty to report less tax liability, the increased use of professional tax return preparers could have an important impact on reporting decisions. Strategic uncertainty may provide the professional tax return preparers who taxpayers may increasingly employ more ample ground for exploitation of uncertain tax law. The larger professional tax return preparer involvement, combined with more uncertain law, may result in more aggressive tax reporting. This final reaction is consistent with those sketched earlier in the Article. Rather than causing more tax liability reporting, tactical factors, including potential increased use of professional tax return preparers, may cause taxpayers to report less tax liability in response to strategic uncertainty, which may thereby undermine, rather than help, efforts to raise revenue by reducing tax liability underreporting.

IV. CONCLUSION

This Article has set forth three reasons why strategic uncertainty may not raise revenue by reducing aggressive or evasive tax positions. Instead, this Article counsels that strategic uncertainty may have perverse effects on taxpayer compliance and may reduce revenue.

First, strategic uncertainty would often cause taxpayers to perceive ambiguity regarding tax outcomes. Taxpayers are likely to vary in their responses to such ambiguity, and these responses may undermine the efficacy of strategic uncertainty as a tax compliance tool.

Second, tax penalties decline as uncertainty increases. The decreasing operation of tax penalties as uncertainty increases is deeply rooted

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196 Id.
197 Id.
in the conception of tax penalties and should significantly decrease taxpayers’ incentives to report more tax liability in response to strategic uncertainty. Instead, taxpayers may report less tax liability.

Finally, tactical factors bolster the case against strategic uncertainty because a combination of tactical factors, including doubts about the Service’s ability to increase its audit rate, negotiation tactics, and the role of professional tax return preparers, may result in less, rather than more, aggressive tax positions in response to strategic uncertainty.

As alluring as strategic uncertainty may be to tax administrators both besieged with decisions about when to issue guidance and tasked with improving taxpayer compliance, they should be mindful of the significant problems with translating strategic uncertainty into higher tax reporting. Relying on strategic uncertainty as a tax compliance tool would be misguided, given the realities of the tax compliance framework.