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# FORCING COOPERATION: A STRATEGY FOR IMPROVING TAX COMPLIANCE

*Rachelle Y. Holmes**

*The current U.S. deterrence-based tax enforcement regime is failing. Despite the continual passage of new penalties and reporting requirements, large businesses remain able to keep their income out of the reach of the federal treasury. While the Internal Revenue Service (IRS) has struggled with the decreasing effectiveness of its enforcement efforts, jurisdictions, such as Australia, have been able to achieve increased compliance rates as a result of transitioning to a cooperative tax model. This type of regime focuses on resolving emerging taxpayer issues in real-time, providing taxpayers with helpful, readily available guidance, and creating positive incentives for compliant taxpayers, such as the ability to book tax benefits more quickly and with lower compliance costs.*

*This Article argues for an adoption of a cooperative tax regime in the U.S., and more importantly proposes a framework for its implementation. Because many businesses are already able to successfully game the current system, they may be reluctant to voluntarily cooperate with the IRS based on the mere expectation of cooperation-based benefits. In order to combat this resistance, this Article argues that the IRS will have to delineate sharper compliance choices for taxpayers by broadening the spectrum of applicable compliance standards.*

*This Article proposes that the IRS implement a system in which non-cooperation is met with strict liability and heightened compliance standards, while cooperation is rewarded with expanded pre-filing programs, decreased liability standards, and lower compliance costs. When faced with these two choices, most taxpayers should, over time,*

* Assistant Professor of Law, George Mason University School of Law. The author would like to thank Adam Rosenzweig and Caroline Mala Corbin for their insightful comments. This Article has also benefited from helpful feedback from Alex Raskolnikov on a preliminary draft. The author would also like to thank the participants of the Henry G. Manne Faculty Forum and the Robert A. Levy Fellows Workshop in Law & Liberty, who provided extraordinarily thoughtful suggestions. Research assistance from Rachel Askman is gratefully acknowledged.

*choose to cooperate. Those who do not, however, will be met with more targeted enforcement. By widening the gap between the two enforcement regimes, taxpayers will be forced to signal their cooperative intentions to the IRS, which the IRS can then dynamically use this information to make its post-filing efforts more effective and "force" more taxpayers onto the path of cooperation.*

## INTRODUCTION

Large business entities (LBEs)[1] and the Internal Revenue Service (IRS or Service) are locked in an ongoing battle over revenue. In this tax war, savvy LBEs facing daunting competition from their global counterparts are responding aggressively by minimizing all undue costs, including the money they willingly hand over to the federal government.[2] Although tactical implementations among LBEs do vary, most strive to adeptly navigate the gray line between patently impermissible "tax evasion" and questionable "tax avoidance"[3] by exploiting weaknesses in the tax law while complying with the black letter rules directly on point.[4] On the opposing side of the field is the IRS, which can rightfully be categorized as the underdog because it is at a systematic disadvantage to the LBEs. The U.S. tax system relies heavily on the self-reporting of transactions through the filing of tax returns. LBEs are able to report their transactions as aggressively as they deem feasible. The IRS, through audits, is then assigned with the daunting task of auditing the returns, discovering and assessing any offending transactions, and ultimately fighting with the LBEs about the proper amount of taxes owed. Often understaffed and outwitted, IRS

1. As referred to herein, LBEs include corporations and pass-through entities with $250 million or more in gross assets.

2. Many global competitors have the advantage of being located in low- or no-tax jurisdictions. The U.S. corporate tax system is increasingly perceived, both domestically and abroad, as being disadvantaged in many respects, including its relatively high statutory corporate tax rates and unduly complex tax provisions. *See generally Compliance Concerns Relative to Large and Mid-Size Businesses: Hearing Before the S. Comm. On Finance*, 109th Congress 1 (2006) (Written Testimony of Mark Everson, Commissioner of Internal Revenue) [hereinafter Everson Compliance Report] ("[LBE] taxpayers are sophisticated, well-capitalized, well-organized, and adept at planning. Particularly in the case of public companies, they are driven to show high after-tax profitability to shareholders in a very competitive and complex economic environment. They have the resources and willingness to aggressively defend and contest tax positions.").

3. As referred to herein, "tax evasion" is an impermissible failure to comply with the tax laws, which can result in potentially large penalties and criminal sanctions. "Tax avoidance" is the legal, but IRS-disapproved, minimization or elimination of taxes through structures which often exploit loopholes and other weaknesses in the law. Although not illegal, many tax avoidance transactions would be challenged or disrupted by the IRS if discovered. *See generally* Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 124 n.69 (2009) (explaining the "familiar but elusive distinction" between tax avoidance and tax evasion).

4. Former IRS Commissioner Mark Everson noted that as "the Code continues to expand, becoming more complex and challenging to administer, [LBEs] are able to utilize every available resource to explore opportunities to reduce their tax liability by using the most intricate and complicated Code provisions . . . ." *Offshore Abuses: The Enablers, the Tools, and Offshore Secrecy: Hearing Before the S. Comm. Homeland Sec. & Gov't Affairs' Permanent Subcomm. on Investigations*, 109th Cong. 2 (2006) (Testimony of Mark Everson, Comm'r of Internal Revenue Serv.). *See also* Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusion of Tax Simplification*, 94 TAX NOTES TODAY 249-75 (1994) (noting there is no shortage of methods by which taxpayers can engage in tax avoidance schemes).

agents have resorted to using every penalty, sanction, procedural tactic, threat, and common law doctrine available in their arsenal to capture the elusive LBE income base for the U.S. Treasury chest.[5]

Not surprisingly, both sides of this game have developed enormous amounts of mistrust and resentment towards their opponent as they try to defend their diametrically opposed economic interests. After all, the stakes of this battle are extremely high. The proliferation of sophisticated evasion techniques and aggressively structured tax products results in billions of dollars in lost tax revenue each year to the U.S. fisc.[6] Not only is there no shortage of methods by which taxpayers can engage in tax avoidance and evasion transactions, but also LBEs and their advisors have become particularly masterful at masking these transactions from detection by IRS agents, who would undoubtedly shut them down if discovered. The U.S. Treasury and many practitioners agree this phenomenon has created a crisis of sorts in the U.S. tax system and is responsible for the escalating feelings of distrust and suspicion among LBEs and the IRS.[7]

Congress and the IRS have employed a number of measures to curtail this trend. In particular, a command-and-control deterrence-based approach has dominated their reform efforts and has resulted in a heightened focus on augmenting sanctions and penalties.[8] These

5. *See generally* David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 335–36 (2006) (describing the Service's uphill enforcement battle). *See also infra* notes 105–108 and accompanying text (enumerating recent rules and regulations aimed at procuring taxpayer compliance).

6. It is estimated that the U.S. corporate tax gap, that is the amount of revenue the U.S. estimates it should receive from corporations less the amount of revenue it voluntarily and timely collects, is approximately $30 billion. Everson Compliance Report, *supra* note 2, at 2 ("The National Research Program (NRP) results provided last February estimate the underreporting non-compliance by larger corporations in 2001 to be $25 billion. The estimate for all corporations is $30 billion."). The IRS estimated "that abusive corporate tax shelters contributed $10 to $15 billion of the $30 billion in unreported . . . corporate income taxes." James Bickley, *CRS Updates Report on Proposals to Narrow Tax Gap*, 2009 TAX NOTES TODAY 145-26 (2009).

7. Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221, 230 (2000); *see also* Allen Kenney, *Tax Enforcement Makes GAO's 2005 List of High-Risk Areas*, 106 TAX NOTES 531, 531 (2005) ("'Given the broad declines in IRS's enforcement workforce, IRS's decreased ability to follow up on suspected noncompliance, the emergence of sophisticated evasion concerns, and the unknown effect of these trends on voluntary compliance, IRS is challenged on virtually all fronts in attempting to ensure that taxpayers fulfill their obligations . . . .'" (quoting Government Accountability Office report)).

8. Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 LAW & POL'Y 3, 4 (2007) (noting the current U.S. tax administration has a "command-and-control operational system to accomplish their mission of catching 'the scoundrels' who do not pay their tax"). The deterrence doctrine can be traced back to the classic work of Jeremy Bentham. JEREMY BENTHAM, PRINCIPLES OF PENAL LAW (1788), *reprinted in* 1 THE WORKS OF JEREMY BENTHAM 365 (William Tait ed., 1859). The basic premise of his classic utilitarian theory of crime is that people are rational actors who behave in a manner that will maximize their expected utility. In other words, individuals assess opportunities and risks and disobey the law when the anticipated fine and probability of being caught are small in

deterrence-based tactics are not yielding their desired results, primarily because detection and penalty rates cannot realistically exist at levels that will meaningfully deter wrongdoing.[9] As a result, notwithstanding the onslaught of new fines and penalties, LBEs still are able to consistently keep their income out of the reach of the fisc.[10]

As an alternative to the government's current approach, this Article argues for the adoption of a cooperative, as opposed to deterrence-based, tax regime,[11] and proposes a framework for its implementation. In a recent article, Alex Raskolnikov suggested that the IRS use information-forcing mechanisms to reveal taxpayer motives in order to enable a more efficient targeting of tax enforcement efforts.[12] His intuition of separating so-called "gamers" from "non-gamers" for enforcement purposes can also be used to induce non-cooperating LBE taxpayers to become cooperators by applying a dynamic sorting mechanism to the pre-filing process. In particular, this Article argues that by making strict liability the default for LBE taxpayers and simultaneously opening up access to pre-filing resolution programs, the IRS will be able to jump start the transition of the current command-and-control regime into a cooperative one.

A cooperative model of tax regulation has the potential to provide a better foundation for taxpayer compliance, not only in the immediate

relation to the profits to be made through non-compliance. Becker expanded on this model by arguing that authorities needed to find an appropriate balance between increasing sanctions and increasing detection rates to make compliance behavior the rational economic choice. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). For criticism of Becker's analysis, see, for example, Nicholas Stern, *On the Economic Theory of Policy Towards Crime*, *in* ECONOMIC MODELS OF CRIMINAL BEHAVIOR 123 (J. M. Heineke ed., 1978).

9. *See generally* Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 582 (2006). This is true even with respect to LBEs that are under continuous audit.

10. *See supra* note 6 and accompanying text.

11. In recent years, more scholars have begun to recognize the benefits of, and have begun to push for, a movement towards more cooperative tax regulation. *See generally* Braithwaite, *supra* note 8, at 4; Dennis Ventry, *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 436 (2008); Jenny Job et al., *Culture Change in Three Taxation Administrations: From Command-and-Control to Responsive Regulation*, 29 LAW & POL'Y 84 (2007). Hallmarks of a cooperative regime include: (i) rewarding cooperation and compliance; (ii) allowing taxpayers to obtain certainty on tax issues on a real-time basis; (iii) advocating taxpayer assistance, rather than abuse; (iv) sanctioning small violations mildly and serious violations heavily; and (v) enhancing penalties for the non-cooperative. *Id.*; Edward J. McCaffery & Joel Slemrod, *Toward an Agenda for Behavioral Public Finance* 20 (CLEO Research Paper No. C04-22, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=590201 (describing policy recommendations of "tax morale" literature).

12. Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009). *See also* Lawrence Zelenak, Tax *Enforcement for Gamers: High Penalties or Strict Disclosure Rules?*, 109 COLUM. L. REV. SIDEBAR 55 (2009) (critiquing Raskolnikov's proposal).

future, but going forward as well.[13] Although penalties and fines still need to exist as a baseline level for enforcement, the purely adversarial nature of command-and-control tax regulation fosters increased resentment and mistrust by taxpayers, which ultimately results in greater resistance and non-compliance.[14] A cooperative tax regime can be superior to an adversity-based one because it can cultivate an environment where otherwise resistant taxpayers and tax regulators are willing to "trade secrecy for certainty."[15] This type of cooperative model will allow taxpayers to obtain certainty with respect to their tax positions pre-filing and thus allow them to book tax benefits immediately for financial accounting purposes.[16] It will also make them subject to fewer resource-consuming post-filing challenges, audits, and adjustments. At the same time, if a taxpayer is willing to have an ongoing transparent dialogue with government agents, the IRS will be better positioned to identify emerging compliance issues and risks, and more effectively allocate its limited resources.[17] Thus, from both a present-day and long-term perspective, cooperative tax regulation can yield superior benefits to the current deterrence-based regime for both taxpayers and tax regulators.[18]

13. Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71, 83–84 (2003) (suggesting that governments should encourage reciprocal compliance behavior by emphasizing other taxpayers' compliance rather than the possibility of audit); Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, *in* WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT 193, 214 (Joel Slemrod ed., 1992) ("Increased enforcement efforts [in the area of tax compliance] might result in a perverse indirect increase in future noncompliance if the enforcement mechanism reveals to the affected taxpayer (and associates) that it is relatively easy to get away with evasion."); TOM R. TYLER, WHY PEOPLE OBEY THE LAW (2006) (finding that people are more likely to comply voluntarily with laws when they perceive that those laws are enforced through fair procedures).

14. Kristina Murphy, *Enforcing Tax Compliance: To Punish or Persuade?*, 38 ECON. ANALYSIS & POL'Y 112, 128 (2008) (study of 652 tax offenders in Australia suggested that "in order to prevent possible re-offending after an enforcement experience, regulators should aim to adopt enforcement procedures that emphasize reintegration and the fair treatment of offenders"); Marsha Blumenthal, Charles Christian & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125 (2001); Doreen McBarnet, *When Compliance is Not the Solution but the Problem: From Changes in Law to Changes in Attitude*, *in* TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 229 (Valerie Braithwaite ed., 2003) [hereinafter McBarnet, TAXING DEMOCRACY].

15. For instance, taxpayers desirous of certainty with respect to uncertain tax items would be willing to get input from the IRS on the tax treatment of their transactions pre-filing in order to book the purported tax benefit for accounting purposes, even though the IRS may not have otherwise detected the transaction in audit. *See* Ventry, *supra* note 11, at 436.

16. *See infra* Part III.A (discussing the new financial accounting regulations).

17. *See* Ventry, *supra* note 11, at 436.

18. In fact, Australia, which also was suffering high levels of noncompliance, completely overhauled its deterrence-based regime and replaced it with a cooperative-based model. Even taking into account the significant cultural and administrative difficulties that were encountered as a result of

Even if a cooperative tax regime is superior to a contentious one, the question remains: Given their long history of mistrust, how can the IRS and taxpayers transition into such a relationship? In this tax game, the players have a deeply rooted antagonistic posture towards each other. Although greater gains for both sides may realistically be achieved through cooperation, neither side is willing to give up any ground based on their justified suspicion as to the other side's motives. Because taxpayers are currently on the winning side of the war, they have very little incentive to abandon their current strategies with the IRS. As long as the money and resources they spend to develop innovative tax avoidance structures outweigh the present value of any potential penalties and fines that may be levied upon detection, most taxpayers will continue their status quo.[19] Some scholars have suggested that encouraging taxpayer participation in the regulatory process and offering rewards such as tax rebates to compliers can help transition taxpayers to a more cooperative model.[20] Others have focused on the need for changing the attitudes and cultures of the regulators.[21] This Article, however, argues that in order to effectively spur a transition to a cooperative regime, the IRS will have to first make a decisive move that will significantly change the playing field for LBEs.

Part I of this Article discusses the failures of the current deterrence-based tax compliance model. Part II provides an overview of the Service's ad hoc attempts at cooperative regulation, which focus on pre-filing resolutions of taxpayer issues. Part III argues that a comprehensive cooperative approach to tax regulation would be beneficial to both taxpayers and the IRS. It further analyzes Australia's conversion into cooperative tax regulation as a potential model for an effective approach. Part IV outlines how the United States should work towards forcing a comprehensive cooperative regulation regime for LBEs by combining a heightened liability standard with expanded pre-filing resolution programs. It also explores challenges that the IRS may face and acknowledges ancillary consequences that may ensue as a

this drastic change in culture, initial reports have demonstrated substantial improvements in collections and compliance. For a fuller discussion of Australia's reform, see *infra* Part III.E.

19. It is worthwhile to note, however, that some LBEs, even when on the right side of the law, have backed away from some strategies for fear of public shaming that may be associated with tax avoidance schemes. *See, e.g.* Michael Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863 (2004) (discussing ways in which Congress has resorted to shaming practices in order to discourage undesirable taxpayer behaviors, such as banning corporations who have moved their tax residence offshore from entering into certain U.S. government contracts).

20. Ventry, *supra* note 11, at 436.

21. Job et al., *supra* note 11, at 86; Sagit Leviner, *A New Era of Tax Enforcement: From 'Big Stick' to Responsive Regulation*, 42 U. MICH J.L. REFORM 381, 382 (2009).

result of the proposed forced cooperative model.

## I. FAILURES OF THE TRADITIONAL DETERRENCE MODEL

Direct enforcement is often the cheapest and most effective way to deter wrongdoing and is the quintessential strategy for enforcing legal norms.[22] However, when dealing with LBEs in the current tax regime, direct enforcement efforts that rely on the traditional deterrence model do not work. Low detection rates, combined with inadequate penalties, and enormous information asymmetries, leave the IRS at a vast disadvantage in attempts to restrain taxpayers from taking overly aggressive or abusive positions on their tax returns. Not only is the deterrence model unable to function to effectively prevent taxpayer wrongdoing (i.e. penalties and detection rates cannot realistically be made high enough to outweigh expected tax benefits), but also a model based strictly on deterrence does not fully explain the existing levels of compliance among LBE taxpayers given the relatively low penalty and detection rates.[23] Moreover, the iron-gloved regulatory approach associated with the penalty and audit regimes fosters an environment of mistrust and perpetrates an antagonistic relationship between LBEs and the Service.

From a purely logistical standpoint, the IRS cannot feasibly review the majority of the nearly 10 million business returns it receives each year.[24] As a result, audit rates, and ergo opportunities for misconduct detection, are invariably low, leaving taxpayers often happy to play the so called "audit lottery."[25] This is true even with respect to non-*de*

22. Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 56 (1986).

23. This is in part due to the secondary information reporting that the IRS is able to get from LBEs, which makes a large portion of their earnings known to the IRS. There is some level of compliance, however, that may be more linked to norm or other social based models. *See generally* Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599, 612–17 (2007). *See also* Raskolnikov, *supra* note 12, at 696–97 (citing the non-exhaustive list of alternative "nonrational" explanations to include being guided by a sense of duty, complying out of habit, and reflecting perceptions of fairness of the tax burden); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1794–98 (2000) (positing that the effects of the negative signals that noncompliance may bring to the evading taxpayer can add significant weight to the cost–benefit analysis calculation); James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. ECON. LIT. 818, 819, 841–43 (1998); Agnar Sandmo, *The Theory of Tax Evasion: A Retrospective View*, 58 NAT'L TAX J. 643, 649–50 (2005).

24. INTERNAL REVENUE SERV., FISCAL YEAR 2009 ENFORCEMENT RESULTS (2010) [hereinafter IRS FY 2009 RESULTS], *available at* www.irs.gov/pub/irs-drop/fy_2009_enforcement_results.pdf. Business returns include small and large corporation returns and subchapter S and partnership pass through returns. *Id.* at 4.

25. *See generally* Raskolnikov, *supra* note 9, at 582.

*minimis* corporate taxpayers. In fact the audit rate for corporations with $250 million or more in assets, which account for more than 75% of total corporate tax revenue, was just over 25% in the 2009 fiscal year.[26] Thus, although a select number of top-income corporations are under continuous audit, nearly three-quarters of corporate LBEs go unaudited each year. As indicated in Figure 1 below, the audit rate for corporate LBEs has been dropping dramatically over the past five years, and is significantly down from the 44% rate in the 2005 fiscal year. Even among the largest of these corporations—those with assets of $5 billion or more—the audit rate has declined 17% over the last two years, from 78% in 2007 to 64% in 2009.[27] Although some of this reduction is due to a strategic shift in audit resources to large pass-through entities, which comprise an ever-growing segment of business tax filers, much of the reduction is due to stretched and shrinking IRS resources.[28]

**Figure 1**

**IRS Audits of Corporations with $250M or More in Assets**[29]

| | No. of Returns | No. of Audits | % Audited |
|---|---|---|---|
| **FY 2005** | 11,018 | 4,859 | 44.1% |
| **FY 2006** | 12,148 | 4,276 | 35.2% |
| **FY 2007** | 12,588 | 3,424 | 27.2% |
| **FY 2008** | 13,336 | 3,654 | 27.4% |
| **FY 2009** | 14,673 | 3,771 | 25.7% |

Even if the IRS does audit a taxpayer's return, the auditors may not have the time or requisite experience to intuit what particular transactions the taxpayer has in fact engaged in, or what areas of the return require more in-depth probing. For example, the typical tax return of a large multinational taxpayer can be thousands of pages long.[30] The filings for large pass-thru entities can be even more

26. IRS FY 2009 Results, *supra* note 24; Internal Revenue Serv., U.S. Dep't of the Treasury, No. 4198 (7-2010), 2010 Tax Statistics (2010), *available at* http://www.irs.gov/pub/irs-soi/10taxstatscard.pdf; Syracuse Univ., IRS Face-to-Face Audits of Federal Income Tax Returns Filed by Corporations, http://trac.syr.edu/tracirs/trends/v15/corporations.html (last visited June 13, 2011).

27. Syracuse Univ., Despite Rising Deficits, IRS Audits of the Largest and Richest Corporations Decline, http://trac.syr.edu/tracirs/newfindings/v15/#table4 (last visited June 13, 2011).

28. *See, e.g.*, Michael Joe, *IRS Enforcement Revenue Slips in Fiscal 2008*, 2008 TAX NOTES TODAY 247-51.

29. IRS FY 2009 RESULTS, *supra* note 24. The IRS fiscal year runs from October 1 through September 30.

30. *IRS Releases Tax Season Statistics on Business Return Filings*, 2007 TAX NOTES TODAY 71-

complex. Field agents, understandably, may have significant difficulty detecting wrongdoing by the taxpayer. Not only is the sheer volume of information daunting, but questionable tax positions can be hidden among or lumped in with other non-controversial items.[31] Taxpayers even intentionally throw the auditors off the trail by adding unnecessary entities or elements to their transactions in order to disguise abusive or questionable items they may have on the return.[32] As such, even if the IRS were able to achieve a 100% audit rate for all LBEs, the ability for auditors to discover and collect revenues from offending transactions is significantly compromised and insufficient to meaningfully deter wrongdoing.

When taxpayers are able to rely, not only on low detection rates, but also on penalty defenses and low government detection and enforcement success as well, the *ex ante* calculus of whether to enter into an aggressive transaction can heavily favor pushing the envelope as far as possible. First, even if the questionable transaction is detected, reasonable basis and good faith defenses are available with respect to non-tax shelter transactions, which may bar the imposition of any penalties.[33] Furthermore, even if penalties are imposed, the actual penalty level will be low relative to the detection risk. Indeed, given a detection rate of 26%, penalties would need to be increased dramatically in order for the expected economic value of the taxpayer's tax benefit to be low enough to deter them from entering into the transaction.[34]

Assuming that a non-compliant LBE does not engage in criminal misconduct, the largest penalty that it can expect is a 75% fraud penalty.[35] More likely, however, the penalty would only be a 20% or 40% accuracy penalty.[36] Assuming a maximum penalty of 75% and an average detection rate equal to the audit rate of 26%, a taxpayer's expected cost of avoiding a $100 tax liability would be only $45.50—an amount equal to less than half of the $100 expected cost of paying the tax liability up front with the initial return. Assuming a more realistic maximum penalty of 20% and a detection rate equal to half the audit rate

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13.

31. *See* Raskolnikov, *supra* note 9, at 572.

32. *See* Schizer, *supra* note 5, at 331.

33. *See infra* Part IV.A.1.

34. Doran, *supra* note 3, at 126–27; Ventry, *supra* note 11, at 439–40.

35. I.R.C. § 6663(a) (2006). The IRS has the burden of proving fraud by clear and convincing evidence. *Id.* § 6663(b).

36. Taxpayers engaged in non-reportable or non-tax shelter transactions are generally subject to a 20% accuracy-related penalty on underpayments of tax that are due to negligence or disregard of the rules or to understatements that are "substantial." I.R.C. § 6662(b)(1) (West 2010). The penalty increases to 40% if the underpayment is the result of a gross valuation misstatement. *Id.* § 6662(h)(1).

(i.e., misconduct is detected by an IRS audit 50% of the time), the taxpayer's expected cost of avoiding a $100 tax liability would be only $15.60. Accordingly, in order for the deterrence model to be effective even under the most stringent assumptions, taxpayers would need to be subject to penalties in excess of 285%.[37] Inarguably, penalties at this level would not be politically feasible because notwithstanding the deterrent effects, public and political perception remains that tax penalties should approximately correlate to the severity of the offense which is being penalized.[38]

Additionally, while the deterrence model surely accounts for some baseline level of LBE taxpayer compliance, it does not adequately explain a great portion of it. If the deterrence model was solely responsible for guiding LBE behavior, LBEs generally would only pay a fraction of the total taxes they owe.[39] Other controls, however, such as withholding and independent reporting obligations (e.g., those made to the Securities and Exchange Commission), are in place. Thus, with respect to a significant portion of LBE income, the compliance rate is high because secondary or backup information controls are in place to help restrain taxpayer misbehavior. However, at any given income level, the actual amount of tax liability due can vary greatly. Therefore, a large part of the tax gap with respect to LBEs does not hinge on hiding income per se, but rather on the way in which the taxpayer's income is manipulated and reported for tax purposes. As discussed above, the IRS agents must navigate thousands of pages of data in order to untangle or reverse engineer an LBE's transaction reporting and ultimately deduce a "proper" tax liability figure.[40] This can be a daunting or even impossible task for the resource-restrained government. Accordingly, a more cooperative model in which the IRS could gain insight pre-filing as to the manner and methods by which LBE taxpayers are reporting transactions, should significantly improve compliance statistics.

37. Assumes a 75% penalty rate and 26% detection rate.

38. Indeed, numerous criticisms have already been raised regarding the IRS's disproportionate level of penalties, including the stacking of penalties that can now occur when taxpayers are engaged in listed or tax haven transactions. Stuart M. Lewis, *White Paper on Tax Penalty Reform*, 2009 TAX NOTES TODAY 75-25. Moreover, in June of 2009, Congress asked the IRS to suspend its enforcement of the harsh § 6707A $200,000 strict liability penalty for nondisclosure, believing that it was too punitive and excessive with respect to the small-business owners against whom it was being assessed. The IRS complied and acknowledged that in many cases the penalty was disproportionate to the tax savings. Douglas Shulman, *Letter by IRS Commissioner Douglas Shulman*, 2009 TAX NOTES TODAY 128-15.

39. Doran, *supra* note 3, 126–27.

40. *See supra* notes 30–32 and accompanying text.

## II. TESTING THE WATERS: IRS ATTEMPTS AT COOPERATIVE REGULATION

The concept of cooperative regulation is not entirely foreign to the IRS. For a long time, the IRS has worked with taxpayers to resolve certain issues, pre-filing through the private letter ruling (PLR) process. During the last decade, several additional pre-filing programs, most notably the pre-filing agreement (PFA) program and the Compliance Assurance Program (CAP), have been put in place, which require significant levels of taxpayer–IRS cooperation.[41] These programs, although undoubtedly steps in the right direction, are currently too limited in scope and application as they comprise only a small part of the otherwise command-and-control centered regulatory tax regime. Furthermore, as implemented these initiatives do not truly embrace certain hallmarks of cooperative regulation, such as responsiveness, inclusiveness, and trust.

### *A. Private Letter Rulings*

Through the PLR process, a taxpayer desiring a written ruling from the IRS regarding the tax status or effects of its transactions before filing a return can submit a written inquiry and fee of up to $14,000 to the IRS Associate Chief Counsel Office.[42] PLRs are then issued at the discretion of the Service when they are deemed "appropriate in the interest of sound tax administration."[43] The IRS will interpret and apply the applicable tax laws to the specific taxpayer's set of facts.[44] Within twenty-one days after a PLR request has been made, an IRS official will meet with the taxpayer to inform him, if possible, whether the eventual ruling will be favorable or adverse.[45] Once the process is complete, a PLR is then issued and is authoritative with respect to that specific taxpayer, assuming it adheres to the proposed form of transaction and

41. In 2001, the IRS also piloted the Fast Track Settlement (FTS) process, which is a non-binding negotiation process between the taxpayer and revenue Agents or the Team Manager with the assistance of an Appeals Official acting as a neutral third party. IRS Notice 2001-67, 2001-2 C.B. 544 (establishing pilot FTS program); Rev. Proc. 2003-40, 2003-1 C.B. 1044 (setting forth the procedures for FTS). One of the most significant objectives of FTS is reducing the time it takes to resolve a dispute. In many cases, the IRS has achieved this objective of appreciably shortening the time frame; given the specified time limitation of 120 days from start to finish, in many cases taxpayers and the IRS have cut two years or more from the resolution time. Pamela F. Olson & David B. Robison, *Recently Developed IRS Audit and Dispute Resolution Techniques*, *in* TAX LAW & PRACTICE 841, 865 (PLI Tax Law & Estate Planning Series, Course Handbook Series No. 855, 2008).

42. Rev. Proc. 2010-1, § 2.01, app. A, 2010-1 I.R.B 1.

43. *Id.* § 2.01.

44. *Id.*

45. *Id.* § 8.02.

there are no material changes in law.[46] All PLRs are then published in redacted form and often serve as helpful guidance for other taxpayers, although only the original taxpayer is entitled to rely on the ruling.[47]

There are significant limitations on the types of issues the IRS will address through the PLR process. It will not issue letters where the determination requested is primarily one of fact.[48] It will also not issue a determination on the tax effect of a hypothetical or indefinite future transaction.[49] Thus, the IRS generally issues a PLR on a proposed transaction or on a completed transaction if the ruling request is submitted before the return is filed for the year in which the transaction is completed.[50] PLRs are also not issued with respect to any transaction having a major purpose of reducing taxes.[51] The IRS generally will not issue a PLR if the applicable law is unclear or unknown.[52] If the issue cannot be readily resolved through the straightforward application of the taxpayer's facts to the tax statutes, regulations, or other published guidance, generally no ruling will be issued.[53] In addition to these limitations, the IRS has developed an extensive list of topics for which they will not issue PLRs, including international issues.[54]

Because of these limitations, many LBEs are unable to fully maximize the potential afforded by the PLR process. LBEs generally employ sophisticated in-house personnel who are able to handle straightforward applications of existing law to facts. Pre-filing guidance would be most useful to LBEs in situations where the applicable law is unclear. Additionally, most LBEs are multinational and the exclusion of most international issues also significantly limits the utility of the PLR process. The reluctance of the IRS to tackle the more intricate issues relevant to LBEs has garnered criticism.[55] In addition, the number of PLRs issued by the Service has dropped from over 5,000 in 1980 to a

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46. *Id.* § 11.01–.03.

47. *Id.* § 11.02; I.R.C. § 6110(k)(3) (West 2010).

48. Treas. Reg. § 601.201(s)(2) (as amended in 2002).

49. *Id.* § 601.201(d)(2); Rev. Proc. 2010-1, § 6.12, 2010-1 I.R.B. 1.

50. Rev. Proc. 2010-1, § 5.01, 2010-1 I.R.B. 1. Furthermore, the IRS will issue PLRs in all cases when a prospective transaction is required by law to have a determination as to the tax consequences, such as I.R.C. § 367 exchanges. Treas. Reg. § 601.201(d)(3).

51. Treas. Reg. § 601.201(s)(2).

52. Rev. Proc. 2010-1, § 5.14, 2010-1 I.R.B. 1.

53. *Id.* § 6.09.

54. Treas. Reg. § 601.201(d)(2); Rev. Proc. 2010-1, § 6.02, 2010-1 I.R.B. 1. In certain situations, however, the IRS may issue a ruling in an area that it has said it would not ordinarily issue one if there are unique and compelling reasons to do so. Rev. Proc. 2010-7, § 2.01, 2010-1 I.R.B. 231.

55. *See, e.g.*, Michael Desmond, *Resolution of Financial Products Tax Controversies*, *in* TAX LAW & PRACTICE 257, at 261 (PLI Tax Law & Estate Planning Series, Course Handbook Series No. 860, 2009) (noting the scarcity of meaningful rulings in the financial products area).

little under 2,000 in 2009.[56] A large portion of these rulings do not in fact address substantive tax issues, but rather involve mundane taxpayer requests to change accounting methods, obtain extensions, make election modifications, or confirm qualification for tax-free transactions.[57]

In addition to these PLR limitations, the publication of the decisions is also a hurdle for LBEs. Although PLRs are redacted to preserve anonymity when they are published, they still provide a detailed description of the facts giving rise to the ruling.[58] This can be critical because LBEs engage in many sensitive or proprietary transactions with respect to which disclosure to the public, and in particular to their competitors, would be untenable.

Thus, while the PLR process provides a potentially valuable resource for LBEs and the IRS to resolve taxpayer issues pre-filing, the limitations on the scope of issues involved and the public nature of the process often make it a less than ideal solution for LBEs. As a result, these restrictions are stifling the Service's ability to get in front of, versus merely reacting to, ongoing transactional and reporting issues that taxpayers are facing. Unfortunately, similar deficiencies exist with the Service's more recently implemented PFA and CAP programs.

### *B. Pre-Filing Agreements*

In 2000, the IRS started an alternative, pre-examination compliance tool for Large and Midsize Business (LMSB) taxpayers known as the PFA program.[59] The LMSB Division serves corporations, subchapter S corporations, and partnerships with assets greater than $10 million.[60] The PFA program is available to all LMSB taxpayers who have qualifying issues they would like resolved prior to filing their tax returns.[61] Tax practitioners have hailed the use of PFAs as "superbly efficient and beneficial for both taxpayers and the Service,"[62] and a representative of the American Institute of Certified Public Accountants

56. Results yielded from search for PLRs issued during 1980 and 2009 on RIA/Checkpoint database.

57. *Id*.

58. Rev. Proc. 2010-1, § 11.02, 2010-1 I.R.B. 1.

59. Rev. Proc. 2001-22, 2001-1 C.B. 745. On December 24, 2008, the IRS released Rev. Proc. 2009-14, which effectively made permanent some minor tweaks made to the program in 2007 (in Rev. Proc. 2007-17) and some major changes made to the program in 2005 (in Rev. Proc. 2005-12). Rev. Proc. 2009-14, 2009-3 I.R.B. 324.

60. IRS, Large & Mid-Size Business Division At-a-Glance, http://www.irs.gov/irs/article/0,,id=96387,00.html (last visited Mar. 28, 2011).

61. Rev. Proc. 2009-14, § 3.01, 2009-3 I.R.B. 324.

62. Amy S. Elliott, *Practitioners Praise Prefiling Agreement Program,* 2009 TAX NOTES TODAY 45-2.

(AICPA) noted that it has "been a win-win both for the companies and for the IRS, because it saves a lot on resources from both ends."[63] Even though many taxpayers and practitioners support the concept of the PFA program, many criticize its less than ideal implementation. In particular, critics blame the Service's narrow program scope, conservative implementation, heavy-handed Chief Counsel oversight, and aggressive fee structure as significant detractors from the program's potential benefits.[64]

### 1. Scope and Implementation

As a threshold matter, to qualify for the PFA program a taxpayer's request must relate to a transaction that is already complete and for which the related return has not been filed.[65] PFAs cannot be used to determine the tax treatment of prospective or future transactions or events.[66] Moreover, PFAs are only used for issues that require either: (1) a determination of facts or the application of well-established law to known facts; or (2) an agreement as to the methodology used by a taxpayer to determine the appropriate amount of an item of income, allowance, deduction, or credit.[67] In addition, the PFA process is only available with respect to a limited number of international issues.[68]

For both domestic and international related issues, the Service may, in its sole discretion, refuse to address an issue in a PFA based on considerations of sound tax administration, and the program requires LMSB to consult with the Office of Chief Counsel before any decision is made to proceed with the taxpayer's request for a PFA.[69] The Office of Chief Counsel's involvement has been a source of contention for many taxpayers who feel that the Chief Counsel refuses many PFA requests because they improperly infringe on its office's territory.[70] Whatever the reasoning, as demonstrated in Figure 2 below, the IRS has indeed exercised its broad discretion to refuse PFA requests by rejecting almost 35% of all applications.

63. *Id.* (quoting Benson S. Goldstein, a technical manager at AICPA).

64. *Id.*

65. Rev. Proc. 2009-14, § 1.02, 2009-3 I.R.B. 324.

66. *Id.*

67. *Id.* § 3.03(1), (2).

68. *Id.* § 3.06.

69. *Id.* §§ 3.05, 3.06.

70. *Id.* § 3.06. *See also* Elliott, *supra* note 62, at 45-2 (citing both Daniel J. Wiles, a tax attorney with PricewaterhouseCoopers and former lawyer in the Chief Counsel's office, and Mike Dolan, director in KPMG's Washington National Tax Practice, as blaming the lack of Chief Counsel concurrence as the reason that many of their PFA applications are not being accepted).

**Figure 2**

**IRS Pre-Filing Agreements**[71]

| | Received | Accepted | Closed with Agreement |
|---|---|---|---|
| **CY 2000** | 19 | 12 | 7 |
| **CY 2001** | 26 | 18 | 5 |
| **CY 2002** | 44 | 25 | 12 |
| **CY 2003** | 42 | 29 | 18 |
| **CY 2004** | 38 | 22 | 27 |
| **CY 2005** | 53 | 29 | 19 |
| **CY 2006** | 46 | 37 | 27 |
| **CY 2007** | 29 | 20 | 20 |
| **CY 2008** | 32 | 20 | 19 |
| **CY 2009** | 28 | 21 | 15 |
| **Total** | **357** | **233** | **169** |

Similar to the PLR process, one of the frustrations that the tax community has with the existing PFA program is that the IRS is reluctant to address any "real issues," the type of which many sophisticated LBE taxpayers would like resolved prior to filing.[72] Not only do the present terms of the PFA limit their scope to the application of well-settled law to known facts (a situation for which a PFA may have only limited utility to an LBE), but the Service has also refused otherwise eligible PFA issues because they were considered too "controversial" in nature.[73] This reluctance to tackle difficult issues severely limits the program's utility to LBE taxpayers, particularly those with well-staffed, sophisticated lawyers who are able to conduct difficult analysis in areas where the law is well-settled. One of the major benefits of the program, discussed further below in Part III.A, is that taxpayers will be able to get certainty prior to filing, which not only saves them money on penalty protection opinions and post-filing audit compliance costs, but also allows them to book tax benefits immediately, rather than creating reserves, under the Financial Accounting Standard Board's

71. For the original statistics, see Pre-Fillment Agreement Program, http://www.irs.gov/businesses/article/0,,id=102667,00.html (last visited Mar. 28, 2011).

72. Elliott, *supra* note 62, at 45-2 (quoting Daniel J. Wiles, a tax attorney with PricewaterhouseCoopers).

73. *Id.*

(FASB) Interpretation No. 48 (FIN 48).[74] Despite the purported potential benefits of this program, the IRS has accepted an average of less than twenty-four PFA applications each year.[75]

### 2. The Fee

In addition to the limited number of issues the IRS seems willing to address through the PFA process, another reason the number of actual applications is so low (an average of just over thirty-five per year) is that there is a $50,000 user fee to participate in the PFA program.[76] The justification for this fee is that even though the program saves the Service money in the long-run, it is in fact a quite resource-intensive endeavor in the short-term.[77] Prior to 2007, the IRS used a sliding scale mechanism to calculate the fee, with the highest amount charged being $10,000. This jump in fees has purportedly turned away many midmarket LMSB taxpayers from the PFA program. This assertion is consistent with the sudden drop-off in applications, illustrated in Figure 2 above, which occurred in 2007.[78] In addition, because all PFAs do not result in a resolution (as of 2009, over a quarter of PFAs have failed to result in a final agreement), smaller LMSB taxpayers may be even more hesitant to invest a significant amount of capital upfront with no assurances that the process will ultimately work out. Thus, under the current PFA structure, the IRS has in place a program with significant upside potential, but that offers pre-filing resolutions for less complex issues that are of limited interest to larger taxpayers, at fee levels that only larger taxpayers may be willing to bear.

### *C. Compliance Assurance Program*

In December 2005, as a follow up to the PFA program, which provides pre-filing resolution on an issue-by-issue basis, the IRS announced CAP, which allows pre-filing reviews of multiple taxpayer

74. FIN. ACCOUNTING STANDARDS BD., FASB INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES: AN INTERPRETATION OF FASB STATEMENT NO. 109, NO. 281-B (2006) [hereinafter FASB INTERPRETATION NO. 48], *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820931560&blobheader=application/pdf.

75. *See supra* Figure 2.

76. Rev. Proc. 2009-14, § 10.02, 2009-3 I.R.B. 324.

77. Elliott, *supra* note 62, at 45.

78. Although, as discussed infra in Part IV.C, some of the drop off may be due to more taxpayers moving into the CAP program.

issues at a time.[79] CAP is a significant cooperation-based initiative in which select large business taxpayers undergo "real-time" audits by working closely with assigned IRS personnel such that taxpayers can have certainty on all material issues prior to filing their tax returns. As outlined in the CAP pilot announcement, the Service requires taxpayers enrolled in the program to engage in "extensive cooperation," which includes "full disclosure of information concerning their completed business transactions and their proposed return treatment of all material issues."[80] In return, successful participants in the program can minimize or eliminate the need for any post-filing examinations or adjustments.[81] CAP has received primarily positive reviews during its inaugural years.[82] However, the program has drawn criticism due to its limited availability to only a handful of select taxpayers, its extensive administrative demands, its time delays, and its sometimes antagonistic implementations.[83]

### 1. The CAP Process

When a taxpayer enters CAP, the Service will assign it an "Account Coordinator."[84] The Account Coordinator serves as the primary point of contact with the Service for issue resolution. The Account Coordinator reviews the taxpayer's audit history and prior tax issues and becomes familiar with relevant industry trends and current business practices of the taxpayer.[85] During the initial stages of CAP, the Account Coordinator works directly with the taxpayer to review business transactions, assess risk, identify compliance issues, and provide compliance guidance. During the review and examination of the taxpayer's compliance items, the Account Coordinator consults with Service specialists, appeals personnel, and Chief Counsel advisors.[86]

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79. I.R.S. Ann. 2005-87, 2005-2 C.B. 1144 (Dec. 12, 2005).

80. *Id.*

81. *Id.*

82. *See, e.g.,* Jeremiah Coder, *The Future of the CAP Program*, 2010 TAX NOTES TODAY 55-3 ("IRS officials have touted the successes of the program and reported 'overwhelmingly high' customer satisfaction with the process.").

83. *Id.*

84. I.R.S. Ann. 2005-87, 2005-2 C.B. 1144 (Dec. 12, 2005).

85. *Id.* A standardized memorandum of understanding (MOU), which sets the ground rules for CAP, must be executed between each participating taxpayer and the assigned Account Coordinator. The MOU defines specific objectives for the program, sets parameters for the disclosure of information, describes the methods of communication, and serves as a statement of the parties' commitment to good-faith participation in CAP. Failure to comply with the terms of the MOU may result in removal of the taxpayer from the program. *Id.*

86. *Id.*

CAP taxpayers that resolve all material issues with the Account Coordinator will be assured, prior to the filing of the tax return, that the IRS will accept their tax return, assuming it is filed consistent with all agreed-to resolutions, and that no post-filing examination will be required.[87] If all material issues cannot be resolved prior to the filing of the return, the program will identify the remaining items that need to be resolved through the traditional examination processes.[88] The taxpayer will retain access to all available appeal rights with respect to any traditional examination that is conducted.[89] CAP operates on a year-to-year basis and gives no promise of reducing or eliminating audit activity in future years.[90] However, the number of CAP taxpayers that remain in the program as repeat participants is steadily increasing.[91]

### 2. Who Is in CAP?

CAP began as a pilot program with just seventeen hand-selected taxpayers, all of which asked to continue in the program for future cycles.[92] Today, there are nearly one hundred total taxpayers involved in CAP.[93] Almost all of these participants are Coordinated Industry Case (CIC) taxpayers, which means that they are large corporations from specified industries that meet a composite of various quantitative benchmarks (e.g., gross assets of at least $500 million; gross receipts of at least $1 billion; foreign assets of at least $250 million) and are regularly audited by LMSB examination teams.[94]

A current significant limitation of CAP is that it is an invitation-only program and is not open to all taxpayers. Only those companies that historically have exhibited a "high level of tax compliance behavior" are invited to participate in the program.[95] Practitioners have complained that entry into the program needs to be greatly expanded and objective criteria for selection should be established.[96] In order to counteract any

87. *Id.*

88. *Id.*

89. *Id.*

90. Philip Tatarowicz et al., Internal Revenue Serv. Advisory Council, *Large and Mid-Size Business Subgroup Report* (Nov. 19, 2008) [hereinafter *LMSB Subgroup Report*], *available at* http://www.irs.gov/taxpros/article/0,,id=188491,00.html#_Toc213566359.

91. *Id.*

92. Pamela F. Olson and David B. Robison, *Recently Developed IRS Audit and Dispute Resolution Techniques*, *in* TAX LAW & PRACTICE 841, at 847 (PLI Tax Law & Estate Planning Series, Course Handbook Series 855, 2008).

93. *LMSB Subgroup Report*, *supra* note 90.

94. *Id.*

95. *Id.*

96. Coder, *supra* note 82.

perceived favoritisms, as the CAP program transitions out of its pilot phase and demand escalates, a less subjective process will undoubtedly need to be put in place.

### 3. The CAP Report Card

Overall, CAP participants have indicated that the ability to determine certainty in their tax reporting and focus on current issues are the key reasons they want to continue in the program.[97] However, there have been a number of criticisms, particularly relating to actions of CAP exam teams. Many of these concerns were brought forth in recent interviews done by Tax Analysts with practitioners working with taxpayer clients that are involved in CAP.[98] Not surprisingly, almost none of the practitioners interviewed would do so on the record for fear of potential adverse consequences for their clients.[99]

Among the complaints lodged is an overall concern about the continued antagonistic attitude of CAP participants from the IRS side, including an undue focus on administrative procedures rather than results. As noted by one practitioner: "Some CAP exam teams have not embraced the concept behind the program and are still treating a CAP exam like a traditional audit, issuing comprehensive [information document requests] and such."[100] Similarly, another practitioner confessed that CAP "can be a very intrusive process, with the IRS exam team digging into issues that may not be necessary."[101] Other exam teams have acted in ways that are so antithetical to the philosophy of CAP that the participating taxpayers "have considered CAP to be oppressive, without the expected sharing leading to a limited focus."[102] Thus, in order to sustain on-going interest in CAP, the IRS will need to ensure that its personnel buys into and demonstrates the cooperative spirit that CAP is intended to foster.

97. Olson & Robison, *supra* note 92, at 899.

98. Coder, *supra* note 82.

99. *Id.*

100. *Id.* (the same practitioner also noting that "here is a frustration that the increased compliance burden from reportable transaction reporting, Schedule M-3, and e-filing has done nothing to streamline the examination process").

101. *Id.*

102. *Id.*

## III. BENEFITS OF A COOPERATIVE APPROACH

The current regime of fines, penalties, and post-filing audits has yielded no measurable improvement in tax compliance among large corporations.[103] Indeed, over the past decade, although the statutory rate has not changed, the effective corporate tax rate has declined, and the general atmosphere of taxpayer–government hostility has risen with each passing year.[104] As sophisticated taxpayers continue to out-maneuver the under-staffed government, Congress and the IRS have repeatedly responded by instituting new, and more rigorous, deterrence-focused penalties and reporting requirements in an effort to stem the tide of taxpayer non-compliance. These response tactics have targeted taxpayers and tax advisors alike, and include increasing the penalties applicable to tax shelters,[105] strengthening tax return preparer liability,[106] greatly expanding the ethical rules governing tax practice,[107] and forcing increased reporting and disclosure.[108]

While the United States has continually struggled to make its command-and-control regime adequately capture the income of LBEs, in other jurisdictions, such as Australia, purposeful moves towards cooperative regulation have actually yielded increased voluntary

103. *See generally* Thomas Barthold, *Testimony of the Chief of Staff of the Joint Committee on Taxation Thomas A. Barthold Before the Select Revenue Measures Subcommittee of the House Committee on Ways and Means Hearing on Taxes as Part of the Federal Budget*, 2010 TAX NOTES TODAY 56-47 (noting that over the years the percentage of corporate income tax revenues has declined).

104. *Id.*

105. *See* I.R.C. § 6700(a)(1)(B)(2)(B) (2006) (raising the shelter organizer penalty for a false statement from $1,000 to 50% of gross income derived from the activity); I.R.C. § 6707 (2006) (increasing the penalty for failure to register a tax shelter transaction from $500 to $50,000 for reportable transactions other than listed transactions and up to 75% of gross income derived from the activity for listed transactions); I.R.C. § 6707A (West 2010) (creating a new taxpayer penalty for failure to disclose a reportable transaction); I.R.C. § 6708 (2006) (establishing a new penalty which replaced the $50 penalty for failure to maintain investor lists under § 6112 with a $10,000 per day penalty for failure to turn over information upon request from the IRS); I.R.C. § 6662A (West 2010) (creating a new taxpayer 20% understatement penalty for reportable transactions, increased to 30% if not disclosed).

106. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3880 (codified at I.R.C. § 6694(a)(2)(A)–(B)).

107. Treasury Dep't Circular No. 230, 31 C.F.R. §§ 10.0-10.93 (2007). *See, e.g.*, Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75,839, 75,844 (Dec. 20, 2004).

108. *See, e.g.*, I.R.C. §§ 6111-12, 6662A, 6707, 6707A. *See also Treasury and IRS Issue Revised Tax Form for Corporate Tax Returns*, 2004 TAX NOTES TODAY 131-16 (noting that the IRS instituted a book-tax reconciliation initiative which requires large corporations to file Schedule M-3, which is used to reconcile their financial accounting net income to their taxable income and as an investigative tool for ferreting out tax shelters). *See also* I.R.S. Ann. 2010-9, 2010-7 I.R.B. 408 (Jan. 26, 2010) (announcing a new proposal that would require corporations with more than $10 million in assets to report the maximum exposure they have for each "uncertain tax positions," which primarily include those positions for which a tax reserve must be established under FIN 48, on a new schedule to be filed with their annual tax returns).

compliance rates.[109] Such initiatives have focused on getting ahead of, instead of responding, to emerging taxpayer issues, providing taxpayers with helpful, readily available advice, assuring non-adversarial, respectful treatment during audits, and creating positive incentives for compliant taxpayers.[110] A shift towards a cooperative tax regime in the United States could likewise yield significant benefits, including greater accounting benefits for taxpayers, heightened awareness of tax compliance norms, and decreased compliance costs for taxpayers and the government.

### *A. Certainty Yields Benefits for FIN 48*

A traditional post-filing examination of a taxpayer's return takes an average of fifty-two months to close. This is an extraordinarily long time for a taxpayer to wait to gain certainty on their tax filing positions. While in the past, this lag time for "closing the books" may have been more palatable, recent accounting regulations have made LBEs subject to FASB much less tolerable of contingent tax liabilities.

Under FIN 48, FASB now prohibits a company from booking a tax benefit unless the tax position will more likely than not be sustained on its merits.[111] Thus, in preparing financial statements, a company must analyze each tax position and determine whether it meets the more likely than not standard. If a position is unable to meet this threshold, the company cannot book the benefit until the uncertainty is resolved, and must disclose the position by showing a liability for the unrecognized tax benefit.[112] A benefit failing the standard can only be subsequently booked on the financial statements if the position is favorably resolved with the IRS.[113]

109. *See, e.g.*, Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 LAW & POL'Y 102, 106–08 (2007) (arguing that respectful treatment by tax authorities leads to higher compliance, "particularly in [Swiss] cantons using referendums and initiatives in political decision-making"); Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, *in* WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT 223, 246 (Joel Slemrod ed., 1992) (concluding from data that "responsive service and procedural fairness are positive incentives that affect normative commitments to tax compliance").

110. *Id.* *See also* Michael Wenzel, *Tax Compliance and the Psychology of Justice: Mapping the Field*, *in* TAXING DEMOCRACY, *supra* note 14, at 55 (reporting studies showing that taxpayers value access to, and provision of, information by the Australian Tax Office).

111. FASB INTERPRETATION NO. 48, *supra* note 74, ¶ 6 ("The more-likely-than-not recognition threshold is a positive assertion that an enterprise believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date.").

112. *Id.* ¶ 5.

113. *Id.* ¶ 3. A company may also subsequently book the benefits if there is a law change which

Thus, under a cooperative approach, where a majority of major taxpayer issues can be resolved pre-filing,[114] the benefits of immediate certainty are concrete.[115] Taxpayers will be able to immediately book a tax benefit on their financial statements, without reserve, if a favorable determination on the issue is made during either the PFA or CAP process.[116] The PFA process provides credible evidence of the value of certainty to LBEs because taxpayers have been willing to pay $50,000 in order to determine the outcome of a tax transaction in real-time rather than waiting two or more years for a final determination.[117]

### *B. Lower Compliance and Enforcement Costs*

Pre-filing certainty of outcomes not only allows taxpayers to avoid booking tax reserves, but it also saves both taxpayers and the IRS the expenditure of significant amounts of time and money in anticipation of, preparing for, and in the process of post-filing battle. IRS enforcement costs, which have steadily increased over the past five years, include the costs of conducting post-filing audits, contests, and litigation.[118] The total number of IRS collection and enforcement personnel necessary to execute these functions has grown 11% since 2005.[119]

Likewise, LBEs spend millions of dollars annually complying with and subsequently defending their reporting positions with respect to the tax laws.[120] The overwhelming complexity of the tax rules can result in extremely high compliance costs for LBE taxpayers, even if they are

pushes the likelihood of success over the 50% threshold or the statute of limitations applicable to the position lapses such that no further adjustments can be made. *Id.*

114. For example, a CAP case only takes an average of 6.3 months to close. Sam Young, *Current Information Key to Good Tax Administration, IRS Official Says*, 2008 TAX NOTES TODAY 211-8.

115. *See* I.R.S. Ann. 2005-87, 2005-2 C.B. 1144 ("CAP will allow taxpayers to better manage tax reserves and ensure more precise reporting of earnings on financial statements."). *See also* Elliott, *supra* note 62, at 45.

116. Olson & Robison, *supra* note 92, at 865.

117. Rev. Proc. 2009-14, § 10.02, 2009-3 I.R.B. 324.

118. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., REPT. NO 2010-30-066, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2009 (2010) [hereinafter TIGT FY2009 COMPLIANCE REPORT].

119. *Id.*

120. For example, Jim Owens, Chairman and CEO of Caterpillar, Inc., stated that "tax makes a substantial difference in U.S. competitiveness," and he specifically was troubled by the complexity of a tax system that results in Caterpillar spending $40 million annually on tax planning, preparation, and filing. James W. Owens, Chairman & CEO, Caterpillar, Inc., Panelist at Secretary Henry M. Paulson's Conference on U.S. Business Tax Competitiveness (July 26, 2007). In addition, Mobil Oil reported that completing and filing its 1993 federal income tax return cost $10 million and that the return was 6,300 pages long. *See* Dennis R. Lassila & L. Murphy Smith, *Tax Complexity and Compliance Costs of U.S. Multinational Corporations*, 10 ADVANCES IN INT'L ACCT. 207, 209 (1997).

merely trying to comply with—and not manipulate—the laws.[121] The U.S. tax system is estimated to impose a hidden compliance cost on all taxpayers of over $260 billion each year.[122] This does not include the countless dollars spent by LBEs on tax planning in and around these rules, which may include pricy penalty protection opinions issued by their outside tax counsel. National Taxpayers Union estimates that the cost for compliance by corporations is almost $160 billion, which comprises over 50% of corporate income taxes collected in FY 2008.[123] To be sure, although many dollars are spent in mere efforts to comply with the laws, additional costs borne by LBEs are done so based on the *ex ante* calculus of weighing incremental tax planning costs against the anticipated tax savings. Nevertheless, even LBEs would be willing to trade a slightly higher effective tax rate to the extent they could realize a commiserate decrease in tax compliance costs. Even if the net tax costs remained unchanged as a result of a cooperative regime (i.e., the decrease in compliance costs exactly offset the increase in taxes paid), LBEs would still realize the additional benefits of increased certainty and the ability to allocate post-filing compliance time to more productive efforts.

Accordingly, if the IRS and LBEs are able to work through a majority of their unresolved issues pre-filing, significant cost and time savings could accrue to both sides. As noted by the IRS: “Taxpayers and the Service often resolve issues more effectively and efficiently through a pre-filing examination than a post-filing examination, because the taxpayer and the Service have more timely access to the records and personnel that are relevant to the issues.”[124] These pre-filing procedures thus benefit both taxpayers and the government by improving the quality of tax compliance while reducing costs, burdens, and delays. The IRS recently conducted a time and cost expenditure analysis with respect to its PFA program, and found that on average, the Service benefited from an estimated 80% cost savings compared with resolving the same issue

121. Lassila & Smith, *supra* note 120, at 209–10.

122. J. SCOTT MOODY ET AL., TAX FOUND., SPECIAL REPORT: THE RISING COST OF COMPLYING WITH THE FEDERAL INCOME TAX 1 (2005), *available at* http://www.taxfoundation.org/files/sr138.pdf. This creates an extraordinary amount of social waste and also can result in lower profits for LBEs, higher prices of goods and services for customers, and decreased amounts of capital available for domestic and foreign investment. Robert J. Peroni et al., *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103, 105–06 (2003).

123. David Keating, *A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens*, NAT'L TAXPAYERS UNION: POLICY PAPERS, Apr. 15, 2009, at 5, *available at* http://www.ntu.org/assets/pdf/policy-papers/pp_ntu_126.pdf (calculated using estimates of the total paperwork burden for corporate income taxes multiplied by the hourly wage for tax accountants).

124. Elliott, *supra* note 62.

post-filing.[125] Similarly, taxpayers experienced an average estimated 60% cost savings from the program.[126] These cost reductions are substantial and support the tangible benefits that can accrue on both sides from increased cooperation. Even if these savings estimates do not reflect all of the real costs that will be associated with a more widespread change in processes, they demonstrate the savings that can be achieved through a more cooperative approach that focuses on pre-filing resolutions.

### *C. Institutional Knowledge Gains from Increased Transparency*

Cooperative regulation can also help the IRS gain institutional knowledge which will help it become more efficient in performing its existing regulatory duties, such as drafting regulations, issuing timely guidance, and enforcing taxpayer compliance. One of the biggest obstacles to effective enforcement at the IRS is the vast information asymmetry that often exists between taxpayers and the Service.[127] There are certainly intermediaries and other agencies that have their own withholding and disclosure duties and serve as a backstop to the Service's otherwise self-reporting system.[128] Nevertheless, taxpayers largely control the flow of information to the IRS. If the taxpayer has critical information that the IRS wants to know, they are typically the only party in the position to provide it. This is particularly problematic because tax results can turn on even the smallest of facts, and accurate, complete information is often necessary to calculate a taxpayer's "true" tax liability.

Today, a large bulk of the Service's knowledge regarding taxpayer behaviors is gleaned from post-filing reviews of taxpayer returns. Unfortunately, taxpayers know where to hide items on their tax returns

125. *Id. See also Prepared Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City*, 2010 TAX NOTES TODAY 17-15 ("Today, we spend up to 25 percent of our time in a large corporate audit searching for issues rather than having a straightforward discussion with the taxpayer about the issues. It would add efficiency to the process if we had access to more complete information earlier in the process regarding the nature and materiality of a taxpayer's uncertain tax positions.").

126. Elliott, *supra* note 62.

127. *See generally* Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted*, 78 FORDHAM L. REV. 1733, 1734 (2010) ("One aspect of the problem is that the taxpayer knows the facts regarding the relevant transactions he or she engaged in during the tax year—or at least has ready access to that information. The government is forced to obtain that information after the fact, either from the taxpayer or from third parties.").

128. *See, e.g.*, I.R.C. § 1441 (2006) (requiring tax to be withheld at source on interest, dividends, and other fixed or determinable annual or periodical U.S. source income paid to foreign persons); FASB INTERPRETATION NO. 48, *supra* note 74.

and how to befuddle the IRS examiners.[129] Field agents may have an almost impossible time trying to reverse-engineer complex transactions that involve multiple entities, jurisdictions, and flows of income and deductions. Initiatives such as the PFA and CAP programs, however, which require a certain amount of real-time collaboration with IRS officials, will allow the Service to become aware of and respond more quickly to emerging issues which they may not otherwise have known about or become aware of. This will facilitate the government's transition from a primarily reactive to a primarily responsive regulatory posture.[130]

Greater institutional knowledge can significantly improve the effectiveness of the IRS in its dealings with taxpayers. If certain tax planning techniques or structures are on the rise and the IRS becomes aware of them during the course of its pre-filing efforts with cooperating taxpayers, it will then be better equipped to address any tax treatment uncertainties in a responsive, rather than reactionary way. Making the Service's institutional knowledge more current with respect to emerging tax issues will enable it to take any number of responsive actions. These actions may include working directly with affected taxpayers in real-time to determine the most appropriate tax treatment, issuing clarifying or preemptive guidance to the extent the applicable law is unclear, or educating field agents of more pertinent issues to be focused on during taxpayer examinations. As a regulating body, the IRS can only improve its enforcement efforts if it is more aware of what its regulatees are actually doing.

### *D. Heightened Awareness of Tax Compliance Norms*

Although the Service's increased knowledge may increase its power as a regulator, an LBE's pre-filing collaboration with the IRS does not have to result in a "heads we win, tails you lose" game with the Service. Active communication between taxpayers and tax authorities can be a crucial component to forging a shared understanding of tax compliance

129. *See generally* Raskolnikov, *supra* note 9, at 582; Schizer, *supra* note 5, at 335 (noting that complex tax structures can be arranged to "have extraneous pieces that are included solely to befuddle auditors" and when "[f]acing a large and complicated return, auditors try to intuit what questions to ask, without really knowing where the bodies are buried").

130. As noted by Daniel Shaviro, "[t]here are simply too many fault lines in the existing income tax laws and too many clever people laboring behind closed doors to find new ways to exploit these fault lines for after-the-fact prospective responses to be adequate." DANIEL SHAVIRO, CORPORATE TAX SHELTERS IN A GLOBAL ECONOMY: WHY THEY ARE A PROBLEM AND WHAT WE CAN DO ABOUT IT 23 (2004).

norms and can yield benefits to both sides.[131]

Ambiguity in either the applicability or content of the law can cause difficulties for LBEs and the Service alike in terms of increased time and money spent, even in attempts to merely comply with (as opposed to game) the tax system. Ambiguity is not uncommon in today's ever-changing environment where legitimate transactions are becoming increasingly globalized and investment technologies are becoming more sophisticated. It is impossible for the existing tax rules to stay in complete lockstep with the evolving landscape, and there will often be lag time between the emergence of new market technologies and the tax law that will govern them.

Having a meeting of the minds between taxpayers and IRS officials as these issues arise, however, can help ameliorate these effects. Absent such dialogue, the parties "may have different and genuinely held understandings of a rule's meaning, and may each consider theirs the correct and clear" application of the law.[132] Active communication between the parties can identify a shared compliance norm and clarify what is expected of each participant. Moreover, understanding the opposing party's point of view and decision-making processes can help forge a better understanding of not only where the law is, but also how the law should evolve.

### *E. Lessons from Down Under: The Australian Experience*

In 1997, the Australian Taxation Office (ATO) developed a cooperative compliance model in consultation with its Cash Economy Taskforce.[133] Built on core goals such as understanding taxpayer behavior, building a cooperative relationship with the taxpayer community, and encouraging support and compliance, the model put in place several normative goals, including: (1) advocating taxpayer assistance, rather than abuse, when taxpayers make mistakes through

131. McBarnet, TAXING DEMOCRACY, *supra* note 14, at 276.

132. Sol Picciotto, *Constructing Compliance: Game Playing, Tax Law, and the Regulatory State*, 29 LAW & POL'Y 11, 12 (2007). *See also* McBarnet, TAXING DEMOCRACY, *supra* note 14, at 276 (observing whether a taxpayer "does what is asked of him or her is not always visible," and "whether or not a person interprets the request in accordance with its intent is sometimes far from certain").

133. New Zealand has also moved towards a cooperative approach. In 2001, the newly appointed New Zealand Inland Revenue Commissioner through the department's strategic document "The Way Forward," and in 2002 with a training program for operative staff. "The Way Forward" outlined four strategic strands: (1) streamline and simplify tax processes; (2) create an environment which promotes compliance; (3) enhance staff capability; and (4) enhance the administration of social policy business. A compliance model, adapted from the ATO compliance model, formalized the department's ideas for moving from a traditional deterrence-based approach to a more responsive regulatory system. Job et al., *supra* note 11, at 91.

ignorance or poor financial planning and are prepared to come forward with full disclosure; (2) providing assistance to "put things right and move on" if taxpayers are prepared to be cooperative when anomalies are spotted; and (3) dedicating resources to focus persistent and consistent attention on the difficult cases and the "big fish," not the "low hanging fruit."[134] To fulfill these goals, Australian revenue agents were instructed to abandon their previously contentious ways and adopt a softer, more cooperative approach with taxpayers.[135] In fact, the principles of responsive regulation were incorporated into corporate plans, training packages for newcomers to the ATO, staff performance assessments, recruitment selection criteria, legislation, and in the day-to-day operations of the field staff.[136]

The ATO compliance model relies on the idea that taxpayers' beliefs, values, and attitudes concerning the tax administration lead them to adopt a particular stance towards the tax administration.[137] Depending on the taxpayers' beliefs, the tax administration uses various techniques to achieve taxpayer cooperation. The model resembles a pyramid in which it is assumed that most taxpayers are cooperative and are therefore at the bottom.[138] The tax administration initially appeals to the social responsibility of the taxpayer and aims to cultivate the taxpayer's good citizenship, trust, and alliance without the use of punitive measures that could undermine the taxpayer's goodwill and intrinsic motivation to comply.[139] If the taxpayer does not comply, then the tax administration moves proportionally higher on the pyramid and uses more authoritarian means of enforcement, regulation, and punitive consequences. However, the administration is also forgiving. As soon as the taxpayer chooses cooperation, the tax administration will gradually move down the pyramid, de-escalating enforcement and regulation.[140] Therefore, the taxpayer views the tax administration as cooperative unless they refuse to comply, and then more command-and-control techniques are used. The belief is that a system which is responsive to the attitudes of the specific taxpayer will more adequately reign in non-compliant taxpayers, while sparing the compliant taxpayers from unnecessary tension with and fear of the tax administration.

To be sure, Australia's transition has not been easy. Within the ATO,

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134. *Id.* at 90.

135. *See* Raskolnikov, *supra* note 12, at 737.

136. Job et al., *supra* note 11, at 90.

137. Leviner, *supra* note 21, at 410.

138. *Id.* at 423.

139. *Id.* at 422.

140. *Id.*

the new model created significant organizational barriers. ATO is a large bureaucracy, with about 19,000 people on staff split into twelve divisions dispersed throughout the country.[141] Many of the staff, particularly those individuals that had been with the ATO for a long time and were entrenched in the old culture, had difficulty adjusting to the new system.[142] Obstacles faced by ATO included difficulties in infiltrating the new vision across the entire agency and getting the staff to adjust to their new tasks in the new system.[143] Indeed some staff members in certain positions believed that their jobs were being compromised by the new regime and were reluctant to follow the changes.[144] These cultural and workforce adjustments were particularly hard given the historically anti-innovative culture of the ATO.[145]

However, initial results indicate that the difficulties have been well worth the benefits which have accrued under the cooperative regime. According to the ATO, these benefits have been significant. For example, the ATO has realized increases in revenue collections and decreases in deductions and losses claimed by high-net worth individual taxpayers.[146] It claims to also have achieved significant results in terms of increased revenue in dealing with transfer pricing issues.[147] Every Aus$1 million dollars spent by the ATO resulted in over Aus$1 billion extra tax collected.[148] The ATO believes these outcomes are even more meaningful because they are related to highly sophisticated taxpayers, most of whom historically have been able to choose how much tax they wanted to pay because of their high capacity to use tax avoidance mechanisms that were relatively safe from ATO enforcement and surveillance activity.[149]

While at first blush these results may seem extraordinary, they have come as a result of years of comprehensive and painstaking efforts to overhaul the entire model and culture of taxation in Australia. Considerable resources are needed to transform a tax system. Entrenchment difficulties with respect to enforcement attitudes and systems would be at least as arduous in the United States, if not more so. Additionally, because the Australian system is still fairly new, there is

141. Jenny Job & David Honaker, *Short-Term Experience with Responsive Regulation in the Australian Taxation Office*, *in* TAXING DEMOCRACY, *supra* note 14, at 118–20.

142. *Id.*

143. *Id.* at 118–20.

144. *Id.* at 120–23.

145. *Id.*

146. JOHN BRAITHWAITE, MARKETS IN VICE, MARKETS IN VIRTUE (2005).

147. *Id.* at 95.

148. *Id.*

149. *Id.*

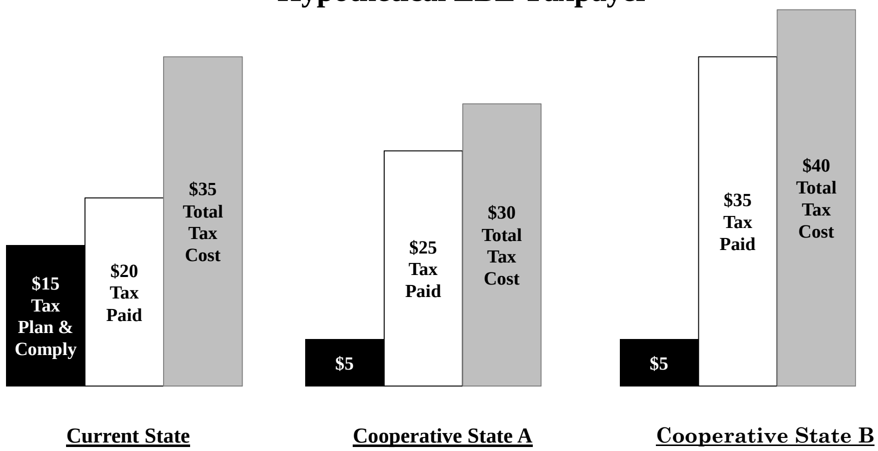
no firm statistical data to highlight which of tools and reform measures best encourage compliance. Nevertheless, the ATO reform has thus far demonstrated that the potential for sustained, improved taxpayer compliance is real and is worthy of serious examination in the U.S. tax regime.

## IV. FORCING COOPERATION

If the Service wanted to leverage Australia's seemingly successful experiment and try to realize the benefits of a cooperative regulatory approach, how could it shift the U.S. taxing culture away from its current deterrence-based paradigm? A long-standing mistrust has settled in between LBEs and the government, making such a transition difficult to implement. Moreover, although internal cultural and resource challenges at the Service may also hinder transition, the attitudes and behaviors of the LBEs may pose the most difficult hurdle to overcome.

Because many LBEs believe that they are defeating the IRS in the tax war, they may not have the incentive to move into a cooperation-based program without a clear impetus to do so. In this regard, this Article argues that a fundamental change must be made to the current LBE compliance calculus. Although LBEs are aware of the benefits they may achieve through a cooperative regime, including certainty and potentially lower compliance costs, they may not be willing to make a move that could potentially put them in a worse economic position. As illustrated in Figure 3 below, LBEs could be unsure as to whether they would end up in cooperative state A, in which the new regime would enable them to reap the expected benefits of cooperation because the uptick in actual taxes paid to the U.S. fisc would be outweighed by lower tax planning and compliance costs, or cooperative state B, in which the IRS would take advantage of its more open access to taxpayer information to significantly augment tax liabilities.

**Figure 3**[150]
**Hypothetical LBE Taxpayer**




Given many LBEs' past dealings with the IRS, they may have no reason to trust that the IRS would not use any tools at their disposal to drive up their ultimate tax costs. Under the current tax regime, many LBEs are hesitant to pursue pre-filing resolutions, even when they have the opportunity and incentives to do so. Notwithstanding their growing needs for certainty in reporting positions, LBEs seem reluctant to bring to the attention of the IRS transactions with uncertain tax consequences which may not otherwise be noticed upon audit because the risk of negative IRS interference is too high.[151] Therefore, because the IRS may have a hard time getting LBEs to buy into a new cooperative strategy, they will likely have to meaningfully change tax compliance norms.

In this regard, the IRS will likely have to delineate sharper compliance choices for taxpayers by broadening the spectrum of applicable compliance standards. Similar to the strategy employed by the ATO, the system should be designed such that non-cooperation would be met with larger "sticks," such as heightened penalties, while full cooperation would be met with juicier "carrots," such as expanded

150. This graph is illustrative only. The black bar represents the taxpayer's total tax planning and compliance costs. The white bar represents the total amount of tax paid to the U.S. government. The gray bar represents the sum of the black and white bars, which equals the taxpayer's total tax cost.

151. Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 137 (2009) (finding "[t]he strategic disadvantages of applying for an advance ruling usually outweigh the strategic advantages of such a request" in part because application for advance rulings dramatically increase the probability of IRS inspection and detection of otherwise borderline transactions which may not be detected upon audit).

pre-filing programs, lower penalty rates, and lower compliance costs.[152] When faced with the two options, rational LBE taxpayers should, over time, end up on the side of cooperation. Moreover, by widening the gap between the two enforcement regimes, taxpayers would be forced to signal their cooperative intentions to the IRS. If successfully implemented, the Service could then dynamically use this signaling information to make its post-filing efforts more effective and "force" more taxpayers onto the path of cooperation.

### *A. Higher Penalty and Legality Standards*

In order to change the status quo in a way that will induce taxpayers to participate in the Service's expanded pre-filing programs, the liability and legality standards for LBEs will need to be raised. Under the present system, taxpayers are faced with relatively low penalty rates that are subject to easily invoked defenses.[153] This Article proposes that all LBE taxpayers who are eligible for pre-filing assistance through the CAP and PFA programs be subject to a strict liability standard. Moreover, the actual standard of legality, and thereby the benchmark for penalties, should also be raised to "more likely than not," regardless of whether the position is disclosed on the return. When faced with the reality of certain penalties if they "get it wrong," LBE taxpayers should respond by increasing their efforts to "get it right." This assurance can be achieved by working with the IRS pre-filing in order to resolve all material questions related to their returns. If taxpayers do choose to go it alone, they should be less aggressive in their reporting positions in order to avoid being assessed penalties. In either case, compliance among LBE taxpayers should increase.

#### 1. Current Penalty Regime

Taxpayers engaged in non-reportable or non-tax-shelter transactions are generally subject to a 20% accuracy-related penalty on underpayments of tax that are due to negligence or disregard of the rules

152. *See generally* Ventry, *supra* note 11, at 436 (also supporting the use of "sweeter carrots and sharper sticks").

153. I.R.C. § 6662(d)(2)(B) (West 2010). In addition, penalties can be avoided if the taxpayer can show that they acted with reasonable cause and in good faith with respect to their underpayment. I.R.C. § 6664(c)(1) (West 2010). The taxpayer has the burden of proof regarding reasonable cause and good faith and this exception is generally geared towards taxpayers having honest misunderstandings of law or who make inadvertent computational or transcription errors. Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003).

or to understatements that are "substantial."[154] The penalty increases to 40% if the underpayment is the result of a gross valuation misstatement.[155] These penalties, however, generally can be avoided with respect to an undisclosed position if the taxpayer has "substantial authority" or with respect to a disclosed position if it has a "reasonable basis."[156] The penalty rate is increased to 40% if the taxpayer fails to adequately disclose the relevant facts affecting the tax treatment in the return.[157] Thus, if a taxpayer properly discloses his position, he will not be subject to the accuracy-related penalty so long as he has a reasonable basis for his reporting position.[158] This reasonable basis standard has been interpreted by the government and the practicing tax bar to equate to a tax reporting position that has just a 20% chance of prevailing on the merits.[159] Accordingly, as long as a taxpayer files a *de minimis* amount of factual information with his return, he can make his tax payments based on positions that have only a one-in-five chance of being the correct position.

If a taxpayer does not disclose his position related to the understatement, then penalties will be assessed if the position cannot be supported by substantial authority.[160] Substantial authority is established if "the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary

154. I.R.C. § 6662(b)(1)–(5). For corporate taxpayers an understatement is substantial if the amount of the understatement exceeds the lesser of (a) 10% of the tax required to be shown on the return for that tax year (or $10,000 if that is greater), or (b) $10 million. *Id.* § 6662(d)(1)(B). A taxpayer will have to reach a higher standard of certainty with respect to his disclosed positions to avoid penalties with respect to his tax understatements if the underlying transactions are "reportable transactions" or "tax shelters." In these cases, the 20% penalty is not imposed if the position is properly disclosed, is backed by substantial authority, and the taxpayer reasonably believes that his tax treatment is more likely than not the proper treatment (i.e., greater than 50%). I.R.C. § 6664(d)(2). If the disclosure is not provided, the penalty will be raised to 30% and the reasonable belief defense, discussed below, will not be available. I.R.C. § 6662A(c) (West 2010).

155. I.R.C. § 6662(h)(1). In addition, for underpayments attributable to transactions entered into after March 30, 2010, a 20% penalty applies to an underpayment attributable to any 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. *Id.* § 6662(b)(6).

156. *See supra* note 154 and accompanying text.

157. I.R.C. § 6662(i)(1).

158. *Id.* § 6662(d)(2)(B)(ii). A taxpayer properly discloses his position if he files a completed Form 8275 or 8275-R with his return. Treas. Reg. §§ 1.6662-4(f); Rev. Proc. 2010-15, 2010-7 I.R.B. 404.

159. STAFF ON THE JOINT COMM. ON TAXATION, STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) 152 (Comm. Print 1999) [hereinafter JOINT COMMITTEE PENALTY STUDY].

160. I.R.C. § 6662(d)(2)(B)(i).

treatment."[161] This position has been interpreted as requiring a taxpayer to have about a 40% chance of prevailing on the merits.[162]

Both the accuracy related and substantial understatement penalties can be avoided, however, if the taxpayer can show that he acted with reasonable cause and in good faith with respect to his underpayment.[163] In all cases, the taxpayer has the burden of proof regarding reasonable cause and good faith, and the most important factor is the extent of the taxpayer's efforts to ascertain its true tax liability.[164] In this regard, a taxpayer may rely on professional advice, including an opinion of counsel, so long as such reliance was reasonable and the taxpayer acted in good faith.[165]

### 2. Moving to Strict Liability and Higher Reporting Standard

Because the current regime allows LBEs to easily escape penalties as long as they have a reasonable basis for their reporting position and they rely on a tax advisor, LBEs are able to consistently underpay their true tax liability. According to the IRS, the true tax liability of a taxpayer is "the amount of tax that would be determined for the tax year in question if all relevant aspects of the tax law were *correctly* applied to all of the relevant facts of that taxpayer's situation."[166] Non-compliance purportedly occurs when the taxpayer does not pay her true tax liability voluntarily and timely.[167] Presumably, to be correct, a position must have at least a greater than 50% chance of being sustained on its merits, or in other words, more likely than not to be sustained on its merits.

If this is the standard of tax legality as perceived by the government, then it is difficult to reconcile this correctness standard with the standards applicable to taxpayers to avoid penalties on their tax returns,

161. Treas. Reg. § 1.6662-4(d)(3).

162. *See* JOINT COMMITTEE PENALTY STUDY, *supra* note 159, at 152.

163. I.R.C. § 6664(c)(1) (West 2010).

164. Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003).

165. *Id.* A taxpayer's reliance on a tax opinion would not be reasonable, for example, to the extent the opinion did not properly take into account all of the taxpayer's relevant facts and circumstances. *Id.* § 1.6664-4(c)(1)(i). The tax advisor's opinion may not be relied upon to establish the reasonable belief of a taxpayer, however, if the tax advisor is a disqualified tax advisor. I.R.C. § 6664(d)(3)(B) (providing that an advisor is disqualified if it is (i) a material advisor or compensated by the material advisor, (ii) has a contingency fee based on the intended tax benefits of the transaction at issue, or (iii) has a disqualified financial interest in the transaction). The opinion must also not rely on any unreasonable assumptions or the invalidity of a regulation. Treas. Reg. § 1.6664-4(c)(1)(ii), (iii). *See also* I.R.C. § 6664(d)(3)(B)(iii).

166. *See generally* INTERNAL REVENUE SERV. & U.S. DEP'T OF THE TREASURY, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 6 (2007) (emphasis added).

167. *Id.*

which only require the reporting of a disclosed return position that has a one-in-five chance of succeeding on its merits.[168] Even if an LBE's reporting position is later challenged by IRS officials, in the worst case scenario the taxpayer's treatment will be disallowed, and they will have to return the tax benefit to the IRS with appropriate interest.[169] Other than possibly making it difficult to book a tax benefit for accounting purposes, this makes the *ex ante* risk of taxpayer aggression (at least down to the 20% reasonable basis threshold) near zero. Accordingly, under the current penalty regime, a taxpayer is under no duty to report items on his tax return, with or without any additional disclosures, in a manner he believes reflects the correct amount of tax he should pay under the applicable tax rules and regulations.

If LBEs only need to have a 20% confidence level in their reporting positions, it is not surprising that they are not taking more advantage of the pre-filing resolution programs currently offered by the Service. Taxpayers would need another overriding concern to seek pre-filing assistance, such as the booking of tax benefits for financial accounting reporting purposes because they should otherwise be able to achieve the meager required reporting standard without IRS input. Accordingly, in order to move LBEs into these cooperative programs, the liability standards should be raised.

In particular, LBEs should be subject to a strict liability standard with respect to: (1) all of their return positions if they are eligible to participate in CAP; and (2) all transactions which are eligible for resolution through the PFA process.[170] If the LBE underreports, its tax liability in either of these situations, then penalties should be enforced regardless of reasonableness, good faith, or disclosure, if their reporting positions are not more likely than not the correct position.[171] LBE taxpayers are sophisticated enough to be held responsible for calculating

168. *See supra* note 159 and accompanying text.

169. I.R.C. §§ 6601, 6621(a)(2) (2006).

170. While a transaction's eligibility for PFA resolution should trigger the strict liability standard, imposing that requirement on PLR eligible transactions may not be equitable, particularly with respect to sensitive or proprietary transactions. Even though the opinions are redacted, a full statement of facts, including details of the transaction structure, are included. If the issue at hand does not implicate privacy concerns, however, a heightened standard for PLR eligible issues may also be warranted.

171. The disclosure distinction should not bear on the assessment of penalties because many LBEs are adept at reporting positions in such a way where the probability of detection is not meaningfully increased. *See generally* Ventry, *supra* note 11, at 451–52 (supporting the imposition of no-fault penalties to reduce the gamesmanship of the current soft penalty regime); Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters* 45 (N.Y. Univ. Sch. of Law & Econ. Research Paper Series Working Paper No. 07-05, 2007), *available at* http://ssrn.com/abstract=955354 (stating that "no-fault" penalties should not even be controversial because of taxpayers gaming of uncertainty in the law).

their actual tax liabilities, particularly when assistance is available, without violating any equity or fairness principles.[172] Indeed, many LBEs are already subject to the more likely than not standard for their reporting of tax positions under FASB and already have to analyze each of their material tax positions and determine whether they meet this standard.[173] Accordingly, if a taxpayer has the option of seeking pre-filing resolution of an uncertain tax position, they should be strictly liable for penalties if they choose to forgo assistance and fail to correctly report their tax liability.

### *B. Sweetening the Benefits of Cooperation*

While non-cooperators should be subject to more stringent enforcement, cooperators should be rewarded with more favorable rules and other benefits. If LBEs choose to seek pre-filing assistance rather than be subject to strict liability, then the Service needs to have procedures and controls in place which ensure that they are met with respect and non-adversarial assistance. If the IRS continues to employ a heavy handed, mistrustful, and threatening "gotcha" enforcement attitude, then LBEs, even in the face of strict liability, may choose to take their chances and go it alone. They would be legitimately concerned as to what the IRS would do with open access to their tax-related records. Rather, as soon as a taxpayer signals that they are willing to be cooperators, the IRS needs to meet them halfway and work towards a cooperative resolution. Moreover, in order to keep LBEs on the cooperative path, a proven record of cooperation and compliance should be further rewarded.

#### 1. Expansion of Pre-Filing Assistance

In order to be able to truly capitalize on the benefits of cooperative regulation, it is important for LBEs to be able to get certainty with

172. The bar and tax regulators have clung to standards below the 50% level based on two misguided premises: (i) it is impossible to correctly determine one's tax liability in all situations; and (ii) the tax return is an adversarial document. *See* Rachelle Holmes, *The Tax Lawyer as Gatekeeper*, 49 U. LOUISVILLE L. REV. 185, 212–17 (2010). Moreover, LBEs can take advantage of tax risk or indemnity insurance policies which protect them for disallowed tax benefits. *See* Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV., 339, 387–95 (2006).

173. FASB INTERPRETATION NO. 48, *supra* note 74, ¶ 6 ("The more-likely-than-not recognition threshold is a positive assertion that an enterprise believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date.").

respect to as many of their material tax issues as possible before filing the return. As outlined above, however, the current PLR, PFA, and CAP programs only capture a very small portion of LBE taxpayers. PLRs are only issued under certain conditions and the results are publicly disclosed, albeit on a no-names basis. In addition, the IRS only takes on a limited number of PFAs each year.[174] CAP is a by-invitation-only program with only one hundred participants.[175] Accordingly, these programs would have to be expanded well beyond their present scope in order to maximize the potential payoffs of the responsive regulation model. In addition, informal ad hoc advice should be more readily available and perhaps even serve as a reasonable defense to the strict liability standard.

With just over 20,000 total enforcement officers and agents,[176] the IRS cannot realistically open up CAP to all of its roughly 20,000 LBE taxpayers.[177] It would have to roll out the program gradually. Initial expansion among public companies makes the most sense because these companies are already involved in real-time assessments of their outstanding material tax issues in order to comply with their quarterly FIN 48 reporting requirements. It also makes sense to transition resources that are currently being used for post-filing audits to pre-filing resolutions. Eventually, however, CAP should be available to as many of the top quartile of LBE taxpayers as possible or whatever number the IRS determines constitutes a majority of its LBE tax revenues. Broad availability is particularly important if the Service wants to capitalize on the sorting and signaling benefits provided by an opt-in cooperative regime, discussed below in Part IV.C. For those taxpayers for which CAP is not feasible or practical, PFAs and PLRs should be made more widely available. The IRS should lift many of the limitations it currently has in place, including restrictions on international transactions and controversial questions of law, and allow taxpayers to have a quick and cooperative means for which to settle one-off tax issues pre-filing.

Outside of the official pre-filing avenues, pre-filing communication with the IRS can be counterproductive, as unofficial or informal IRS

174. *See supra* Figure 2.

175. *See supra* notes 92–95 and accompanying text.

176. IRS FY 2009 RESULTS, *supra* note 24.

177. This number is an estimate based on the number of tax returns filed by C corporations, partnerships, and S corporations with reported assets of $250 million or greater (14,673, 4,375 and 660, respectively). *Id.* (reporting FY 2009 return numbers for C corporations); TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, FILING CHARACTERISTICS AND EXAMINATION RESULTS FOR PARTNERSHIPS AND S CORPORATIONS, REF. NO. 2006-30-114 (2006), *available at* http://www.treas.gov/tigta/auditreports/2006reports/200630114fr.html#fig2 (reporting processing year 2006 return numbers for partnerships and S corporations).

advice is not binding on the IRS or its representatives, even when it is erroneous.[178] IRS agents often give informal oral or written advice to taxpayers in an effort to help taxpayers understand the Service's viewpoint on a question. However, the utility of this advice is severely limited because it does not represent an official ruling, and the IRS is able to change its position if it is beneficial for it to do so. Thus, taxpayers have been warned that they should rely on this kind of informal advice "at [their] peril."[179] If the Service wants to enter into a cooperative compliance regime, however, then it will not only need to make the availability of informal advice more widespread, but also increase taxpayers' ability to rely on that advice.[180]

### 2. Preferred Review Status

The cost and resources required to participate in ongoing real-time audits with the IRS is not trivial. As such, taxpayers may not be willing to enter CAP if the payoff for the dedication of extensive resources does not extend beyond a single filing cycle. Moreover, as CAP participants go through several tax filing cycles, they should develop a good understanding of the Service's expected tax compliance norms. Similarly, the IRS should have gained significant insight into the taxpayers' filing habits and practices. As a result, it may be appropriate at some point (e.g., after five years of participation without any significant issues) to consider implementing a multi-year preferred compliance program, including a potential moratorium on standard audit activity.[181] Taxpayers could instead have shorter, more focused reviews of their returns, and preferential access to the PFA and PLR processes on an as-needed basis. These taxpayers should also be able to have increased access to informal ad hoc advice that will be able to assist them in gaining certainty pre-filing and shield them from strict liability.[182]

Notwithstanding the potential negative political perception of relaxed

178. *See, e.g.*, Clarke v. Comm'r, 68 T.C.M. (CCH) 398 (1994); Ferreira v. Comm'r, T.C. Summary Op. 2001-167. Moreover, the IRS is not stopped from later correcting errors of law that it makes in advice to taxpayers. *See, e.g.*, Demirjian v. Comm'r, 457 F.2d 1 (3d. Cir. 1972), *aff'g* 54 T.C. 1691 (1970) (where taxpayer claimed detrimental reliance on a letter from the district director).

179. United Block Co. v. Helvering, 123 F.2d 704 (2d Cir. 1941).

180. For example, it may be able to for a rebuttable presumption against the imposition of penalties.

181. *LMSB Subgroup Report*, *supra* note 90.

182. A LBEs former CAP Account Coordinator, for example, may be able to provide this type of assistance in a relatively cost effective manner because of his or her in-depth familiarity with the taxpayer's filing history.

oversight of the cooperative LBEs, moving proven compliant taxpayers into a more lenient process, at least for a predetermined number of years, will allow the IRS to free up significant resources and bring new taxpayers into the CAP system.[183] In addition, some kind of fail-safe mechanism could be put in place which would only extend a taxpayer's preferred status grace period to the extent that no material issues come up during subsequent spot reviews. This would help keep taxpayers from taking advantage of their relaxed oversight and give the IRS a mechanism by which they can bring offending taxpayers back into pre-CAP status if necessary.

### *C. The Sorting Effect*

Changing to a strict default penalty level for LBE taxpayers, while contemporaneously expanding pre-filing assistance, will have the effect of providing a sorting mechanism for two kinds of taxpayers: cooperators and non-cooperators.[184] Cooperators, or those who elect to opt-in to CAP or have issues resolved under the other pre-filing programs, will signal that they are willing to be open and transparent with the IRS in order to gain certainty with respect to their tax filing positions. It is likely that these taxpayers are ones that either already lean towards the more conservative side of the tax evasion/tax avoidance line, or are willing to forgo future aggressive planning activities in order to reap the economic benefits of cooperation.[185] Non-cooperators, on the other hand, are much less likely to elect into CAP or use the other pre-filing cooperative mechanisms. It is more likely that these taxpayers are either pursuing tax avoidance strategies in a way that will be looked at unfavorably by the IRS or their general distrust for the IRS is so high that they believe that any type of cooperation that requires transparency will lead to a disproportionate increase in their tax liabilities. Even with respect to the latter type of taxpayer, however, this level of mistrust is likely to be higher if the taxpayer is a more aggressive filer. As such, non-cooperators will send a general signal that they have "something to hide."[186]

Anecdotal evidence suggests that sorting on a smaller scale is already

183. *See generally* Ventry, *supra* note 11, at 436 (noting a benefit of cooperative regulation is the ability to better allocate post-filing enforcement resources).

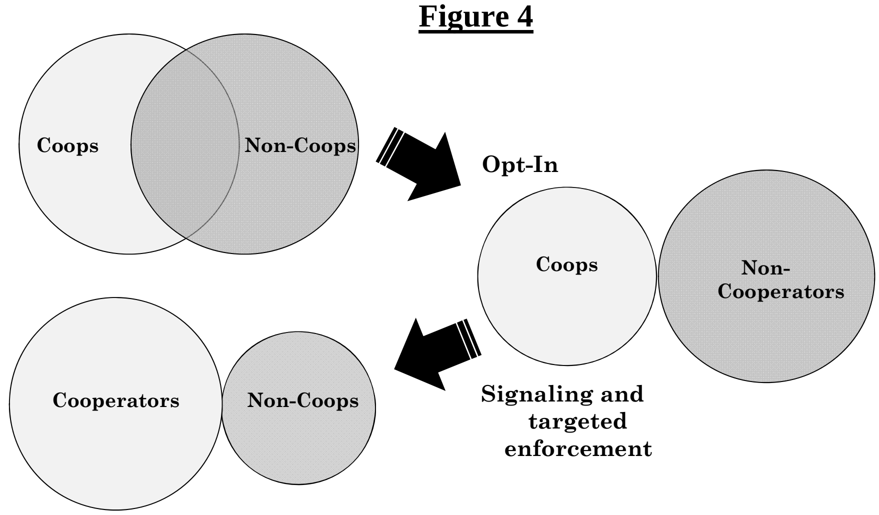
184. This distinction will be akin to the categories of "gamers" and "non-gamers" put forth by Alex Raskolnikov. *See* Raskolnikov, *supra* note 12, at 689.

185. It is assumed that the CAP IRS agents' abilities will be sufficiently respected such that the cooperators are in fact largely transparent in their disclosures with the Service.

186. Nanci S. Palmintere et al., *Session 10: Risk of Controversy with the Tax Authorities*, 85 TAXES 137, 163 (2007).

occurring. The IRS believes that one reason for the drop in PFAs in recent years, as illustrated in Figure 2 above, is because some of the very same taxpayers who would have come in for PFAs in prior years are now involved in the CAP program.[187] This is a logical assertion because both programs involve real-time reviews of taxpayer issues (PFA addressing single and CAP addressing multiple issues) and require a posture of transparency and cooperation with the IRS. This suggests that there is a distinct set of taxpayers who are eager cooperators (i.e., are willing to cooperate in the absence of any added pressure to do so). If, as is suggested, CAP is expanded to be an opt-in regime for a larger subset of LBE filers, sorting on a greater scale should occur. This sorting mechanism could be particularly robust with respect to large LBEs already under continuous post-filing audit if the IRS gives those taxpayers the option to move some of its post-filing personnel resources to work with the taxpayer on its pre-filing issues. Cooperators should sign up, while non-cooperators should resist.[188] The IRS can then use these signals being sent by LBEs to force even greater cooperation and compliance. This is illustrated below in Figure 4.

**Figure 4**




187. Elliott, *supra* note 62, at 45-2 ("There's a sense that some of our CAP taxpayers are the very same taxpayers that would have come in for prefiling agreements. It's possible that, absent CAP, we would be seeing different prefiling agreement numbers today." (quoting Cheryl Claybough, director of pre-filing and technical guidance in LMSB)).

188. Raskolnikov, *supra* note 12, at 738 ("[I]mproved taxpayer assistance is likely not only to facilitate the separation of gamers from the rest, but to increase compliance among non-gamers as well.").

An expansion of CAP should improve the overall effectiveness of post-filing audits in three meaningful ways. First, as more LBEs opt-in to CAP, fewer companies will require time-consuming post-filing audits. The majority of LBEs participating in CAP should reach agreement on all material issues such that no or limited post-filing reviews are needed. Second, because of the sorting that is accomplished by CAP, the post-filing audit efforts that are expended by the Service will be focused on those institutions which have signaled that they may have something to hide. Assuming that largely compliant taxpayers will choose to opt-in, resources currently directed at would-be cooperators will be able to be directed towards non-cooperators.

Lastly, an expanded CAP should help increase post-filing audit detection rates. A significant stumbling block with respect to LBE audits now is that the IRS has trouble identifying areas of non-compliance on the return. As discussed above, field agents must sift through thousands of pages of information, in which taxpayers may have tried to intentionally obscure the presence of any wrongdoing.[189] Under the proposed cooperative regime, however, non-cooperators should find their aggressive positions being discovered more often on audit. Service agents will have the advantage of possessing real-time information learned from cooperators, which should make it significantly easier to identify current areas of compliance concern and newly developed structured tax transactions. Even if the cooperators are on the whole less aggressive than non-cooperators, the IRS will still learn valuable information because sometimes the mere existence of a certain type of transaction or market technology is beneficial to enforcement efforts, even if the specific cooperative taxpayer at hand has not decided to take the most aggressive reporting position. It is also possible that certain cooperator LBEs may strategically choose to propose new aggressively reported transactions to CAP or PFA agents in order to ensure equal tax treatment with non-cooperators. If the IRS signs off on a particular strategy then they, along with their competitors, will be able to book the tax benefits. On the other hand, if the Service shoots down the tax treatment, the IRS may then issue preemptive guidance which will prevent their non-cooperator competitors from taking the benefits as well.

Ultimately, more effective auditing should move non-cooperators more in line with cooperators. Eventually, the rewards of cooperation (i.e., immediate certainty, no strict liability, and decreased planning and compliance costs) should outweigh the shrinking benefits of evasion and

189. *See supra* notes 30–32 and accompanying text.

gamesmanship. This should cause more former non-cooperators to opt-in. As more non-cooperators opt-in, a super-sorting function will begin to occur as the last non-cooperators to hold out will most likely be the LBEs with the most to hide. As this number decreases, IRS efforts can be adjusted to increasingly target these entities until they too are forced to cooperate.

### *D. Challenges and Consequences of a Cooperative Compliance Model*

#### 1. A Necessary Change in Culture

Both IRS personnel and taxpayers are entrenched in their respective antagonistic postures. Shifting to a cooperative model may be procedurally and psychologically difficult to implement. Taxpayers may legitimately fear that any revelation of their tax plans pre-filing may result in harsh scrutiny and disproportionately high tax liabilities. As discussed above, current CAP participants have already complained that the Service has not embraced the cooperative spirit of the program and have been very antagonistic, intrusive, and oppressive.[190] However, under a cooperative model, not only should the IRS cultivate trust among taxpayers, but it should also deal with taxpayers openly and honestly and "give taxpayers the benefit of the doubt when it finds a mistake, by sanctioning small violations more mildly, and by sanctioning large . . . violations more heavily."[191] A cooperative tax regime will be unsustainable if the IRS cannot evolve out of its adversarial posture.

Like the ATO, which had significant difficulties in changing its large bureaucratic organizational structure to support its new cooperative model,[192] the IRS has over 16,000 employees all over the country engaged in various agency enforcement and compliance tasks.[193] Getting all of these employees, or at least the ones dealing with LBEs, to buy into a new culture of cooperation and accommodation will likely be very difficult. Many of the IRS personnel have been submerged in a deterrent environment pitting them directly against taxpayers for the entirety of their careers. Extensive training and cultural rehabilitation would be necessary in order to change their mindsets and dispositions.[194]

190. Coder, *supra* note 82, at 55-3.

191. McCaffery & Slemrod, *supra* note 11, at 20 (describing policy recommendations of "tax morale" literature).

192. *See generally* Job & Honaker, *supra* note 141.

193. TIGT FY2009 COMPLIANCE REPORT, *supra* note 118.

194. *See* INTERNAL REVENUE SERV., OVERSIGHT BD., ANNUAL REPORT TO CONGRESS: 2009, at 53 (2010), *available at* http://www.treas.gov/irsob/reports/2010/IRSOB%20Annual%20Report%

### 2. The Need for More Elite IRS Talent

Under a cooperative tax regime, the IRS will need more top talent. In order for any pre-filing assistance, in the form of CAP, PFAs, or PLRS to be worthwhile and not result in a disproportionate decrease in government revenue, the IRS personnel will need to be sophisticated enough to work through complex tax issues with the LBEs on equal footing.[195] That is, even if the LBEs are fully transparent and forthcoming with the government during these processes, the IRS personnel involved in making the ultimate agreed-to determinations must be able to fully comprehend the intricacies of the transactions at issue and the ramifications their decisions may have beyond the immediate taxpayer's return. To the extent that LBEs feel like they can get one over on the Service agents brought in under CAP, they are likely to revert to non-cooperative, clandestine behaviors under the guise of full transparency. Such a scenario would put the government in an even worse position than it is currently in because under the CAP and PFA agreements, it will be more difficult to go back and unwind or penalize taxpayers unless egregious violations are found.

Thus, not only will the IRS need more bodies to execute a comprehensive responsive regulatory system, but many of those bodies will ideally need to consist of some of the nation's top legal minds. While salary competitions between the government, law firms, and LBEs would almost undoubtedly disfavor the government, Congress should be mindful of the real cost savings that can be achieved by implementing this approach and be willing to re-allocate some of the capture into efforts to procure more elite tax talent.

### 3. Other Issues

In addition to cultural changes, the IRS will have to deal with other challenges such as budgeting limitations and guarding against corruption. First, because it is more difficult to quantify results in CAP compared with the traditional audit process, allocating resources will pose a challenge for the government. The IRS has historically been limited in resources and funds even when workload increases.[196] In order to get the funding necessary to meaningfully expand the pre-filing

202009.pdf (recounting a panel discussion in which it was acknowledged that "to change an organizational culture takes a very long time and a committed leadership over a period of years").

195. *See generally* Schizer, *supra* note 5 (exploring ways in which the Service can upgrade its tax talent).

196. *See generally* Ventry, *supra* note 11, at 456.

programs, it will be necessary to convince the budget makers of the long-term benefits.[197]

Second, to the extent individual IRS personnel are given latitude in dealing with individual taxpayers through the pre-filing resolution programs, it is important to protect against corruption and agency capture, which can increase when authority is devolved in a system with high levels of discretion.[198] While it is important to balance the need for consistent decision-making and equity against the considerations of individual taxpayer circumstances, disparate treatment by IRS agents among taxpayers can undermine the integrity of the cooperative system.

## CONCLUSION

There is an old proverb that you can catch more flies with honey than with vinegar. The government and the IRS, however, have continued to use increasingly harsh methods to procure taxpayer compliance. The failures of the Service's current deterrence-based model and the success of Australia's cooperative transformation should prompt the government to seriously consider instituting a more friendly tax regime. Although the cultural and psychological barriers that exist for both LBEs and the IRS as a result of their long-lasting adversarial postures towards each other are significant, the rewards of a successfully implemented cooperative regime should make the costs and pains of transition worthwhile.

Once a cooperative compliance norm is established, both sides should be able to realize greater benefits than they do under the existing deterrence model. Although many LBEs may not willingly buy into the new accommodative system, they can be induced to do so. This Article proposes a framework for helping induce and transition LBEs and the IRS into a new cooperative compliance era. The multi-faceted approach will not only help reduce uncertainty and the compliance costs of taxpayers, but also augment IRS enforcement efforts by providing a dynamic sorting mechanism that enables them to better target non-cooperators. Although the implementation of this cooperative model would be an extreme undertaking, it has become increasingly clear that the IRS can no longer afford to continue with the status quo if it intends

197. This is more challenging with the "pay as you go" norms employed by lawmakers, which are designed to ensure that the cost of any government spending increase or tax cut is offset by a simultaneous equal spending cut or tax increase.

198. *See, e.g.*, Job et al., *supra* note 11, at 92; *see also* Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1565 (1992) (defining the capture hypothesis).

to use the corporate tax base as a significant source of income going forward.