Introduction

Tax enforcement against the rich in the United States is in crisis. Consider the following examples:

- In December 2022, the House of Representatives Committee on Ways & Means released six years' of President Donald J. Trump's federal income tax returns to the public.[1] An accompanying report found a host of potentially abusive tax positions on these returns, but also that the IRS had failed to adequately challenge, or in some cases to even audit, the returns. The report found that the IRS agents had only audited one of Trump's returns while he was president. When the IRS did audit Trump, its agents were quickly overwhelmed with his complex tax dealings, which involved hundreds of "flow-through returns" filed by tiers of entities.[2] In fact, in some cases, the IRS agents appeared to have simply deferred to Trump's advisors, noting that he had used a professional accounting firm and counsel to prepare his returns.[3] One senator commented that wealthy and high-income taxpayers like Trump are "more likely to get struck by lightning than have [their] hundreds of partnerships audited."[4]
- In May 2021, the Treasury Department released a proposal that would have empowered the IRS to observe more information about the financial activities of taxpayers, especially the rich.[5] Under the proposal, banks and other financial institutions would report to the IRS information on business and personal accounts, including banking, loan, and investment accounts, with exceptions for those with low gross cash flow and fair market value. According to the Treasury, the purpose of the measure was to enable the IRS to "better target enforcement activities" by "increasing scrutiny of wealthy evaders."[6] Despite these arguments, the proposal faced a backlash from legislators, taxpayers, and financial institutions. Opponents warned that the proposal would introduce a new "surveillance state" and lead to an "outrageous and blatant" violation of privacy.[7] Ultimately, Congress did not take up the reform.[8]

- In August 2022, after years of pleas by the IRS, Congress passed, and President Biden signed, legislation providing nearly $80 billion of new funding to the agency.[9] IRS officials stated that they would use part of this funding to increase its tax enforcement against "high-dollar noncompliance," especially by focusing on the returns of "high-income and high-wealth individuals."[10] However, when Republicans gained majority control of the House in the 2022 midterm election, they quickly threatened to repeal the legislation. In June 2023, as part of the perennial debt-ceiling negotiations, Congress and the president agreed to reduce the IRS's annual appropriations by $10 billion in each of the next two fiscal years.[11] The IRS itself acknowledged that the increased tax-enforcement funding, including the portion it would use to increase tax enforcement against the rich, was uncertain.[12]

These three different events all illustrate a pressing challenge for the US tax system. Not only do many high-income and wealthy taxpayers pursue complex strategies and transactions that enable them to engage in abusive tax avoidance and evasion, but also the IRS often has greater difficulty enforcing the tax law against them. High-end taxpayers account for a disproportionate share of the total US tax revenue lost from tax noncompliance. According to one recent study, tax noncompliance by the top 1% of taxpayers alone costs the federal government approximately $175 billion of lost tax revenue each year, or nearly $2 trillion over a decade.[13] As one particularly costly example of this phenomenon, economist Gabriel Zucman highlights the role of "tax havens" in facilitating global tax evasion by wealthy taxpayers.[14] He estimates that unreported foreign accounts resulted in approximately $35 billion in lost revenues in 2014 alone.[15]

This noncompliance also contributes to the low overall effective rates of tax paid by many high-end taxpayers. In 2021, ProPublica, a nonprofit news organization, released otherwise confidential details of tax returns of multibillionaires, including Elon Musk, Michael Bloomberg, Mark Zuckerberg, Bill Gates, Warren Buffet, and Rupert Murdoch. The report showed that in many years, they paid little, if any, federal income tax.[16] During the period when many of these returns were filed, from 2011 to 2018, the IRS audit rate of millionaires plummeted by 80%.[17] For instance, from 2017 to 2018, the IRS's audit rate of households with adjusted gross income between $5 million and $10 million dropped from 7.95% to 4.21%, and its audit rate of households with adjusted gross income between $1 million and $5 million dropped from 3.52% to 2.21%.[18]

Designing and administering rules that prevent aggressive and abusive tax avoidance by the rich is not easy. IRS officials have repeatedly stated that their agency is committed to "enforcing tax laws in a manner that is fair and impartial."[19] But what should the government do when high-income and wealthy taxpayers are subject to the same tax rules that apply to everyone else, but somehow are able to achieve very

different tax outcomes? How can the government design rules and policies that address tax noncompliance by the rich in a manner that is fair, impartial, and, importantly, effective?

To combat tax noncompliance and underenforcement involving high-end taxpayers, policymakers usually adopt two familiar approaches. The first approach is to seek to bolster the IRS's funding so that the agency can improve and increase enforcement. Congress took this step in 2022 when it passed the historic $80 billion investment in the IRS described above, through the enactment of the Inflation Reduction Act.[20] But this approach is unpredictable and unstable, especially as political control of Congress changes. When the IRS does seek to increase its enforcement of the tax law, political opponents often accuse the agency of using heavy-handed tactics to invade taxpayers' privacy or even to settle political scores. More importantly for this book, increased IRS funding also does not change the underlying tax rules that often benefit high-end taxpayers, including in their interactions with the IRS.

The second response is to design rules that target specific activities that may enable tax noncompliance by the rich. When it comes to the structure of the tax law, Congress has responded to the problem of tax noncompliance through what can be described as "activity-based rules." These rules target specific activities that enable or signal tax noncompliance. Under an activity-based approach, when taxpayers participate in a particular activity, they may be subject to different tax administration and compliance requirements, such as increased information reporting requirements and potential penalties.[21] While these activity-based rules play an important role in the tax system, they can also target the *wrong* taxpayers while the rich escape their reach. Further, the IRS faces administrative law hurdles in implementing activity-based rules, which have grown in recent years as the agency has faced increased judicial scrutiny in light of legal challenges from high-end taxpayers and their attorneys.[22]

This book shows why these two traditional approaches are not enough to combat the problem of tax noncompliance by the rich. Both IRS enforcement and activity-based rules can only achieve so much in dealings with sophisticated taxpayers. In contrast to these traditional approaches, this book proposes a new legal response to address the long-standing dilemma of tax noncompliance by the rich: a system of means adjustments to the tax compliance rules.

Under current law, the tax compliance rules, ranging from filing tax returns to responding to audit letters to paying tax penalties, apply in the same way to all taxpayers, regardless of their income or wealth. For example, every taxpayer faces the same civil tax penalty rates and interest rates on underreporting and underpayments. All of them, regardless of their income level or wealth, can also raise the same defenses against penalties, and benefit from the same statutes of limitations for IRS assessments.

In contrast to current law, we argue that Congress and the IRS should adopt a new approach to the tax compliance rules, and adjust certain rules based on

taxpayers' means, such as their income and wealth, in order to level the playing field between the rich and everyone else. Under our approach, high-end taxpayers would face higher tax penalty rates, longer periods where the IRS could assess tax deficiencies, and higher standards for claiming defenses against penalties, among many other means-adjusted rules. Rather than focusing solely on regulating specific activities, such as a particular abusive tax strategy, we propose that the government should also account for a taxpayer's means in the design of the tax compliance rules.

The problem of tax noncompliance by the rich is as old as the United States tax system itself. Despite waves of tax reform throughout the country's history, lawmakers have struggled to design tax systems that can tax the rich progressively. In the 1800s, rich taxpayers undermined the collection of general property taxes by state and local tax authorities by holding intangible financial assets, including stocks bonds, and other instruments that were harder to tax.[23] When taxing jurisdictions relied instead on indirect taxes that were not as easily avoidable – such as excises and tariffs – it soon became clear that these taxes, in fact, placed higher burdens on lower-income consumers. In the early 1900s, progressive reformers advocating for a national income tax faced the frequent objection that rich taxpayers would simply avoid the new tax by manipulating how their income is measured.[24]

While the public release of the Trump tax returns in 2022 drew denouncement of the IRS's failure to audit and challenge wealthy and high-income taxpayers, this critique also is not new. In the mid-1800s in the United States, during the Civil War period, individual tax returns were open to public inspection. In fact, in 1865, the *New York Times* regularly published a front-page feature titled *Our Internal Revenue*, which listed the income tax liabilities of prominent New Yorkers.[25] A July 8, 1865 feature, for example, listed the tax liabilities of rich and famous citizens such as William B. Astor ($1.3 million), Cornelius Vanderbilt ($576,551) and Samuel Lord ($183,630).[26]

During this period, reporters noted that many tax collection districts in New York, and the United States in general, were behind in enforcing the tax law, especially against wealthy and powerful taxpayers. In one 1865 column, *Times* reporters chronicled their own discovery of unchallenged taxpayer abuses, such as one tax return where "a person returned his income at $11,000, when his books revealed the delightful figuring of $80,000 to his credit," among many other "wonderful frauds" that were only "discernable to the close observer."[27] The reporters argued that this was "partly because the investigation of frauds and 'insufficiencies' occupied time which should have been otherwise employed, but to a very great degree it was due to the lack of brain and physique in the officers themselves – brain with which to comprehend the mysteries of the law, physique with which to drive work and workmen and secure results."[28]

Public disclosure of this information fell out of favor for a period of time, only to return in 1924, when the *Times* published lists of wealthy individuals who had paid no tax at all. The editors dubbed this list of citizens the "non-taxables" and questioned why they had not been investigated for "suspicious" tax positions.[29]

This book offers a new approach to addressing the persistent problem of tax noncompliance at the top. Before describing how our new approach to tax compliance would work, we should pause to define some key terms.

First, what do we mean by "rich" taxpayers? In this book, we focus on the taxpayers at the very highest income and wealth levels, who often have unique advantages to avoid paying their taxes under the current rules. For example, we will describe how taxpayers in the top 0.1% of the income distribution have very different opportunities to avoid or evade taxes than even other high-income taxpayers, such as those in the top 10% of earners. Throughout the book, we refer to high-income and high-wealth taxpayers as "high-end" taxpayers.

Second, what do we mean by the "tax compliance rules"? In this context, these rules govern critical aspects of not only taxpayers' obligations to report and remit federal taxes but also those governing the federal government's administration and enforcement of these obligations. These rules include taxpayers' obligations to file returns correctly and on time, the IRS's ability to review and assess reported tax liabilities, civil tax penalties and interest on underpayments, and reporting requirements of taxpayers and third parties, among other items. Beyond these statutory provisions, the tax compliance rules include the formal and informal rules governing interactions between taxpayers and the IRS. For example, the IRS follows certain practices in conducting taxpayer examinations. Similarly, the appeals procedures govern the taxpayer's right to appeal decisions of the US Tax Court, as well as the right to representation and to informal conferences with IRS Appeals Office personnel.

Unlike the current tax compliance rules, our proposed means-adjusted tax rules would vary depending upon a measure of taxpayers' income or wealth, just like the graduated individual tax rate schedule and other features of our progressive federal tax system.

For example, with means-adjusted tax penalty rules, high-end taxpayers could be subject to higher penalty rates for understatements and fraud that vary according to their income. Current law imposes an "accuracy-related" penalty of 20% on underpayments resulting from either negligence or the taxpayer's disregard of rules or regulations, as well as from substantial understatements of income tax and certain other cases.[30] This 20% penalty applies to all taxpayers, irrespective of their income or wealth. Under means-adjusted tax compliance rules, on the other hand, this penalty rate would increase for high-end taxpayers. For illustration, a taxpayer with $5 million or more of adjusted gross income in the taxable year could be subject to an accuracy-related penalty of 40% rather than 20%.[31]

For another example, consider the defenses that taxpayers can use to avoid federal civil tax penalties. Under current law, all taxpayers can rely on a "reasonable cause and good faith" defense, which they can satisfy by showing that a tax advisor provided them with a written opinion on which they reasonably relied. As many high-end taxpayers and their advisors know, the tax opinion can effectively serve as a

tax penalty shield. Here too, the law adopts an activity-based approach and denies this defense of reliance on an advisor for certain transactions, such as for transactions that lack "economic substance." Well-advised taxpayers can still use the defense, as long as they can avoid this economic substance exception. A system of means-adjusted tax compliance rules, in contrast, could prevent high-end taxpayers from taking advantage of this defense – and from avoiding activity-based limitations – irrespective of the specific activity in which they engaged.

The statute of limitations is yet another area where the policymakers could introduce means adjustments. By limiting the number of years during which a tax noncompliance investigation can take place, this statute of limitations restricts the IRS's ability to assess additional tax against taxpayers.[32] High-end taxpayers often enjoy a strategic advantage as a result of this rule, including by engaging in structuring that may be hard for the IRS to detect and challenge before the clock runs out. Under the current default rule, the IRS must assess additional tax within three years from the time a taxpayer files the tax return. In this case as well, current law adopts an activity-based approach. For example, the period is doubled to six years where the return reflects a "substantial omission" of gross income.[33] Under means-adjusted tax compliance rules, the length of the statute of limitations could also vary with a taxpayer's income or wealth. For example, the default rule could increase to six years for taxpayers with income and underpayments above the threshold levels and to nine years in the case of a statutory substantial omission.

We argue that adjusting the tax compliance rules for high-end taxpayers offers several advantages that could improve the administration of the tax system:

1. This approach can equalize the effect of tax compliance rules for taxpayers at varying income levels. These adjustments can counter the specific advantages many high-end taxpayers have under the current rules, including their greater access to complex tax-avoidance strategies and sophisticated legal counsel. For example, higher penalty rates for high-income taxpayers can improve their deterrent effect and account for these taxpayers' lower chance of detection.
2. Means adjustments would redress the limitations of activity-based responses to tax noncompliance. With a system of means-adjusted tax compliance rules, sophisticated taxpayers could not, for instance, simply restructure their transactions to avoid a tax information reporting obligation.
3. Means adjustments would address the unique effects of high-end non-compliance in a progressive tax system, where the dollars of revenue lost from noncompliance at the top represents a greater social cost than the dollars lost from noncompliance lower on the income distribution.
4. Means-adjusted tax compliance rules can be more efficient than relying exclusively on increasing IRS audits and enforcement, which can be costly and limited in effect.

5. Means adjustments can improve tax morale, which is the intrinsic willingness of individuals to pay taxes and comply with their tax return reporting and filing obligations. Some studies find that the perception that the government is enforcing the tax law and that other taxpayers are compliant can affect tax morale for other taxpayers.

Importantly, policymakers should *not* introduce means adjustments to punish or burden rich taxpayers. Rather, they should use these adjustments to improve the administration of the tax system and to enable the collection of taxes that are already owed. In pursuing this goal, it is possible that a system of means-adjusted tax compliance rules could also impose additional burdens on high-end taxpayers. For example, a high-end taxpayer who does not comply and is subject to a higher penalty rate could end up paying more than a lower-income taxpayer with a similar deficiency, or than a taxpayer with the same income who simply complies with the tax law. This outcome should only be considered an ancillary effect of means adjustments, rather than their primary purpose. The purpose of means-adjusted tax compliance rules – like the purpose of penalties and other procedural rules in general – is not to impose additional substantive tax burdens ex post on taxpayers. Rather, means-adjusted tax compliance rules should be designed to deter acts of noncompliance ex ante, and thereby narrow the gap between what high-end taxpayers report and pay and their tax liabilities prescribed by the substantive progressive tax rules.

The tax compliance rules should also not subject high-end taxpayers to unwarranted scrutiny or harassment, and no one should have to face onerous legal burdens just because they have more wealth. The tax compliance rules must preserve basic procedural protections for all taxpayers in their interactions with the IRS. They should also not subject high-end taxpayers to unnecessarily burdensome procedures and penalties for minor offenses. Even when committed by high-income taxpayers, minor tax offenses do not pose the same threats to the tax system as do major ones, and therefore do not warrant the same adjustments to the tax compliance rules. As this book describes, policymakers could address the potential for overburdening smaller offenses by creating an exception for low-value amounts of understatements of income or underpayments of income tax. For example, policymakers could include an exception from means-adjusted tax penalty rules when the amount of a taxpayer's underpayments for the year fall below a particular dollar value.

In addition to presenting the practical advantages of means-adjusted tax compliance rules, we also offer a broader normative case for why policymakers should make these adjustments.[34] Prior academic work in legal theory and in public finance considers the question of when it is appropriate, or not, for the law to subject taxpayers at different income levels to different legal rules. We explain how these debates can inform the design of the tax compliance rules, and also what the case of the tax compliance rules can teach us about these broader questions for legal theory.

In the case of tax compliance, these adjustments can be designed not to penalize one group of taxpayers through different legal rules, but rather to better tailor these rules for taxpayers in different economic circumstances, and to thereby improve the operation of the tax system. Similarly, we explain how means adjustments can be made in a manner that is consistent with constitutional principles of due process and equal protection.

Introducing formal means adjustments to the tax compliance rules would also address important equity concerns. In recent years, the lack of IRS enforcement against high-end taxpayers has been striking when compared to the IRS audits of the poor. In 2021, for example, low-income taxpayers were over five times as likely to be audited by the IRS as other taxpayers.[35] Many of these taxpayers claim the federal Earned Income Tax Credit (EITC), a program designed to replace traditional welfare that is administered through the tax system.[36] When questioned regarding the IRS's focus on taxpayers who claim this credit, the then IRS Commissioner Charles Rettig commented that "EITC correspondence audits are the most efficient use of available IRS examination resources with the average time to complete the audit of 5 hours per return."[37] His response to congressional inquiries regarding this issue suggested that, compared to the tax returns of high-end taxpayers, tax audits involving the EITC and low-income taxpayers are often simply easier for the IRS to conduct than audits of high-income and wealthy taxpayers.

In 2023, in its strategic operating plan, the IRS stated that it would address inequities in tax enforcement and devote more resources to prevent high-end tax noncompliance.[38] That same year, IRS Commissioner Daniel Werfel also commented that the IRS would reevaluate the agency's approach to selecting returns for audit and consider changes to its methodology, which would include exploring the impact of "optimizing on broader issues rather than focusing on EITC overclaims."[39] As we describe, means adjustments to the tax compliance rules could assist these IRS initiatives to improve equity in tax enforcement. These adjustments would increase the potential tax revenue from pursuing audits of high-end taxpayers, and would help the IRS enforce the tax law more evenly across income levels.

After outlining the advantages of means adjustments to the tax compliance rules and their theoretical dimensions, we offer a practical guide for policymakers who may seek to implement these adjustments. We take a deep dive into the structure of the current tax compliance rules and explain how high-end taxpayers can often take advantage of these rules, as well as how they can be improved through means adjustments. This guide offers options for designing the adjustments and explains when they would and would not be suitable. We also consider the roles of both Congress and the IRS in making these adjustments. We then offer analysis of how these adjustments could be implemented in four critical areas of tax compliance: (1) civil tax penalties; (2) statutory and regulatory defenses to civil tax penalties; (3) statutes of limitation and restrictions on assessment; and (4) tax information

reporting rules. These examples highlight what we argue are the essential components of effective adjustments while allowing policymakers flexibility in choosing the thresholds of income, wealth, and other indications of means that may trigger them.

The book develops its analysis and proposals as follows. We begin in Chapter 1, *Tax Noncompliance at the Top*, by describing the consequences of high-end tax noncompliance and their impact on the progressive tax system. As this chapter explains, high-end taxpayers have more money at stake and greater opportunities for tax noncompliance than other taxpayers. In Chapter 2, *How the Tax System Addresses Noncompliance*, we describe the basic models of taxpayer compliance in the tax literature – including the behavioral effects of deterrence and detection – and general considerations in balancing the costs and benefits of tax enforcement in order to achieve the optimal level of tax compliance. The chapter then describes the conventional policy and scholarly responses to high-end noncompliance as well as the limitations of these responses. Chapter 3, *Means-Adjusted Tax Compliance: A New Approach*, presents a novel approach to the problem of high-end tax noncompliance: a system of means adjustments to the tax compliance rules governing critical aspects of tax administration and enforcement. In Chapter 4, *When Are Means Adjustments Fair and Efficient?*, we address two areas of legal theory – the "double distortion" principle and the "generality" principle – that consider when means adjustments to legal rules may not be desirable.

We then transition from theory to implementation in Chapter 5, *From Theory to Legal Design*, where we describe general design considerations that policymakers should adopt when implementing our approach, based on the theoretical analysis we developed in earlier chapters. In Chapter 6, *Tax Penalties*, we describe how Congress should enact means-adjusted civil tax penalties to attack abusive tax avoidance and tax evasion by high-end taxpayers. Following up on this proposal and analysis, Chapter 7, *Tax Advice*, proposes that policymakers should revise current law to prevent high-end taxpayers from asserting the reasonable cause defense against any accuracy-related tax penalties. In Chapter 8, *The Statute of Limitations*, we propose means adjustments to the statute of limitations, which limits the period of time in which the IRS can assess taxes. In Chapter 9, *Tax Information Reporting*, we show how the government's activity-based approach to tax information reporting often allows high-end taxpayers to engage in noncompliance with the tax law, while most other taxpayers are subject to significant automatic IRS review. In Chapter 10, *Closing the Tax Information Gap*, we propose means-adjusted reforms to tax information reporting as an additional tool to address high-end noncompliance. This chapter proposes a series of means adjustments to the information reporting rules for high-end taxpayers, including an annual wealth reporting form and increased information reporting by banks and financial institutions.

The costs of high-end tax noncompliance are significant and far-reaching. Lost tax revenue means higher taxes for everyone else, a ballooning national debt, and less money for critical public investments such as in infrastructure, education, and healthcare. Further, tax noncompliance by high-end taxpayers undermines progressive taxation, one of the defining features of the federal US tax system, since these taxpayers have the greatest ability to pay taxes. Tax noncompliance by the rich can also reduce tax morale by fostering a perception that taxes are only "for the little people."[40] Tax noncompliance also makes it harder for legislators to improve the tax system through new reforms that can raise needed revenue and advance fairness.

This book does not offer a complete solution to the problems of high-end noncompliance but shows how the tax compliance rules can be redesigned to help narrow the tax gap at the top. Economist Joel Slemrod once noted that "it is impossible to understand the true impact of a country's tax system by looking only at the tax base and the tax rates applied to that base ... [a] critical intermediating factor is how the tax law is administrated and enforced."[41] This book takes a new look at this crucial insight by highlighting how high-income and wealthy taxpayers can often take advantage of our current tax compliance rules and how means adjustments to these rules can help to stop them.

NOTES

1 HOUSE COMM. ON WAYS & MEANS, REPORT ON THE INTERNAL REVENUE SERVICE'S MANDATORY AUDIT PROGRAM UNDER THE PRIOR ADMINISTRATION (2017–2020) (Dec. 20, 2022). *See* Presidential Tax Returns archive hosted by Tax Analysts. For copies of President Donald J. Trump's 2015–2020 US federal income tax returns, see *Presidential Tax Returns*, TAX NOTES, https://www.taxnotes.com/presidential-tax-returns.

2 *See* JOINT COMM. ON TAXATION, REPORT TO THE HOUSE COMMITTEE ON WAYS & MEANS, CHAIRMAN RICHARD NEAL 21 (Dec. 15, 2022).

3 HOUSE COMM. ON WAYS & MEANS, *supra* note 1, at 21.

4 Press Release, *US Senate Committee on Finance, Wyden Statement on Ways & Means Investigation of Presidential Audit Program* (Dec. 21, 2022).

5 *See* U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 88–90 (2021).

6 U.S. DEP'T OF THE TREASURY, THE AMERICAN FAMILIES PLAN TAX COMPLIANCE AGENDA 2 (May 2021).

7 Press Release, *House Comm. on Ways & Means, Ways & Means Republicans Introduce Bill Prohibiting Biden's Invasive IRS Bank Surveillance Plan* (Oct. 15, 2021).

8 *See, e.g.*, Sarah Kolinovsky & Trish Turner, *Biden Admin Backs Down on Tracking Bank Accounts with over $600 Annual Transactions*, ABC NEWS (Oct. 19, 2021, 4:37 PM).

9 Pub. L. 117-169, 136 Stat. 1818.

10 IRS, INTERNAL REVENUE SERVICE INFLATION REDUCTION ACT STRATEGIC OPERATING PLAN, FY 2023–2031 (2023).