ONE

TAX CHEATING—THE PROBLEM

Our revenue laws as a body might well be entitled, “Acts to promote the corruption of public officials, to suppress honesty and encourage fraud, to set a premium upon perjury and the subornation of perjury, and to divorce the idea of law from the idea of justice.”

—Henry George (1839–1897), Progress and Poverty

Introduction

Emma, an eighty-seven-year-old woman in a wheelchair, is escorted by her daughter Zoe into an Indian tribal casino near Green Bay, Wisconsin. The older woman puts a $20 bill into a quarter slot machine and plays for ten minutes until she wins a $160 jackpot. She cashes in her winnings and the mother and daughter leave to celebrate with a lunch out. The $160 is never reported on the mother’s tax return as required by law. This is one end of the tax cheating continuum. It is the end calling for reform of our laws, however, rather than for heaping moral blame on our citizens. As Justice Oliver Wendell Holmes Jr. observed, “a law which punished conduct which would not be blameworthy in the average member of the community would be too severe for that community to bear.”1 Agreeing with this assessment, Richard Posner writes, “A law is unjust if it is so contrary to dominant public opinion that virtually no one will either obey or enforce it, or if it is so incomprehensible that no one can obey it, or if it is enforced so rarely that people forget about it and it becomes a trap for the unwary.”2 These characteristics describe significant portions of the Tax Code; and, as a result, many casual gamblers like Emma would be surprised to learn they are tax cheaters.

At the other end of the tax cheating continuum are cases involving the infamous, the wealthy, the legendary, and the celebrated. Actor Wesley
Snipes, former Mets pitcher Jerry Koosman, golfer Jim Thorpe, Survivor winner Richard Hatch, country singer Willie Nelson, Leona Helmsley, Spiro Agnew, and Al Capone are examples. Tax cheating is practiced by business leaders as well. On May 7, 2009, for example, the U.S. Department of Justice reported that a jury had convicted four former partners of the international accounting firm of Ernst & Young for promoting highly lucrative but fraudulent tax shelters. The partners were charged with tax evasion, conspiracy, and other crimes relating to these schemes. The tax shelters were designed to help individuals with annual taxable income in excess of $10 million to reduce their income tax bills. The sophistication and intricacy of the devices required the expertise of some of the brightest CPAs and tax attorneys in the country. Acknowledged crime figures have also failed to learn from Al Capone’s mistakes. In 2008 Chicago mob boss Michael “Mickey” Marcello, business associate of Joey “the Clown” Lombardo, was sentenced to 102 months in prison and ordered to pay $65,000 for conspiracy to commit tax fraud.

The serious end of the tax cheating continuum includes ordinary citizens as well. During 2009 the Tax Division of the Department of Justice began prosecuting clients of UBS, one of the world’s leading financial firms, who were aided in hiding their wealth in Swiss bank accounts and failing to disclose this information or to report the resulting income to the IRS. As part of an agreement with the United States government, UBS consented to provide the United States with “the identities of, and account information for, certain U.S. customers of UBS’s cross-border business. UBS also admitted in the agreement, in great detail, how it had conspired to defraud the United States by impeding the IRS.” In this connection, the Tax Division filed a petition in court to enforce an IRS summons issued to UBS to obtain additional names and account information for about fifty-two thousand U.S. taxpayers. In the wake of this news the IRS offered a partial amnesty program (reduced penalties) for tax cheaters who had not reported the income from their offshore accounts. As a result almost fifteen thousand taxpayers turned themselves in during 2009. The success of this program led the IRS in 2011 to offer a “New Offshore Voluntary Disclosure Initiative” for hidden offshore accounts.

In Cheating the Government, Frank Cowell refers to tax cheating as “an intrinsically interesting economic problem with profound implications for the fiscal relationship between government and the citizen.” Tax Cheating

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cheating is not a new problem. The Bible chronicles the disdain felt for tax collectors. Among the ancients, Aristotle offers the following admonition that, while addressed to the law generally, applies as well to a discussion of tax cheating. “In all well-attempered governments there is nothing which should be more jealously maintained than the spirit of obedience to law, more especially in small matters; for transgression creeps in unperceived and at last ruins the state.” Ruining the state, in the context of tax cheating, implies an economic dimension that may exceed Aristotle’s original meaning. But tax cheating, whatever it is ultimately determined to include, is certainly a transgression that may creep in unperceived. More than twenty percent of the nation’s income currently goes unreported, untaxed, or uncollected and the problem has been growing during recent decades.

Tax cheating is not a legal term with a well-defined meaning. It is a popular term used by taxpayers, the news media, politicians, and occasionally an IRS commissioner. In 1984 IRS Commissioner Roscoe Egger asked, “Can we afford any longer a tax system whose very unfairness and complexity invite tax cheating?” Tax cheating is frequently equated with tax evasion, but that is not how I characterize the problem. Tax cheating is broader and includes what the Tax Code and IRS Regulations refer to as “erroneous items.” In this book, I employ tax cheating as an umbrella concept of which tax evasion is one component. The definition of cheating developed here is morally neutral. This neutrality is important because if we are to distinguish instances where cheating is a serious moral infraction from those where cheating is trivial, the definition of cheating should not prejudice the case by smuggling in a moral bias. A similar problem is encountered with many definitions. To allow for both good art and bad art, for example, a definition of art must not itself contain elements of valuation. Likewise, a definition of cheating must allow for a spectrum of moral disapprobation; the moral quality of the cheating will depend ultimately on the moral status of the enterprise being cheated.

The scope of this book is limited to the morality of tax cheating in the context of the current U.S. Internal Revenue Code. It focuses primarily on individual taxpayers, who supply 70 percent of tax revenue to the treasury. While small business and small business corporations are discussed in chapter 2, the topic of tax cheating by large corporations is not addressed, nor the related issue of corporations as responsible moral agents, nor questions about corporate governance. This also is not an economic or political discussion of the ideal form of taxation, though alternatives are mentioned. While these are worthy topics of debate, the scope of this
work is more limited. It is a discussion of the moral duty to comply with the current income tax laws or to disobey these tax laws, or the absence of a moral duty either way. Finally, it is not a treatise of the legitimacy of government or its right to impose taxes.19

Discussions of tax cheating are frequently framed in terms of a distinction between tax avoidance and tax evasion. One economist tells us, “It would be a mistake to blur the boundary between ‘evasion’ and ‘avoidance.’”20 Tax avoidance includes measures undertaken to pay as little tax as legally possible. It involves “changing your behavior so as to reduce your tax liability.”21 Investing in tax-exempt municipal bonds rather than taxable corporate bonds is an example. An often cited defense of tax avoidance is the statement of Justice Learned Hand in his dissenting opinion in Newman, a U.S. Court of Appeals case.

Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.22

To draw attention to the open-ended nature of some tax cheating, I have not framed the problem of tax cheating by employing the distinction between tax avoidance and tax evasion. It may not be, and sometimes is not, clear ahead of time whether a particular transaction, or its characterization on a tax return, is legal or not. For example, ostensibly legal transactions undertaken primarily for tax reasons—meaning there is no independent economic motive except for saving taxes—may be questioned by the IRS and the courts, and labeled tax avoidance schemes or purely tax-motivated transactions.23 When such transactions occur in business they are said to serve no business purpose.24 In such cases, tax avoidance that embraces only the letter of the law and ignores its spirit, may still be illegal and therefore constitute tax cheating. Thus, the complexities of the law and the nuances of interpretation can blur the line between avoidance and evasion. As Goethe observed, “You can’t tell a thief in the dark, when all the cows are black and all the cats are gray.”25

Tax evasion refers to the illegal steps taken to accomplish the goal of minimizing taxes. It is “failing to pay legally due taxes,”26 and is generally associated with fraud and subterfuge. In cases of tax fraud considerations of intention are critical while for negligence (and most tax avoidance)
they are not. In distinguishing tax avoidance from tax evasion a taxpayer's intent may also run afoul of the result achieved. John Dewey generalized this condition in *The Quest for Certainty*. “Judging, planning, choice, no matter how thoroughly conducted, and action no matter how prudently executed, never are the sole determinants of any outcome.” So, to begin this inquiry by accepting the topic under investigation as bifurcated into tax avoidance (legal) and tax evasion (illegal) would be to miss the opportunity to address a central issue in a discussion of tax cheating—the adjoining ground. As Dewey also observed, “To see that a situation requires inquiry is the initial step in inquiry.”

Sociologist Edward Schur observes, “For most individuals, and even for major corporations with high-powered legal and accountancy staffs and advisors, the borderline between legitimate minimizing and illegal manipulation is extremely hazy.” Though there are clear cases of tax avoidance as well as of tax evasion, the fact that there is also a gray battleground of contention in between means that treating the distinction as if it added clarity to the problem of tax cheating is to cut off our chance for refining our understanding from the outset. In *Newman*, the fact that Justice Hand’s above-quoted defense of tax avoidance put him on the losing side of the case—it was his dissenting opinion—shows the importance of addressing the issue of the middle ground.

**Tax Cheating and Morals**

The question of a moral duty to comply with the income tax laws has practical significance for the Treasury and Congress because the decision to obey or disobey a law often comes down to incentives. Penalties, fines, and imprisonment may be disincentives to breaking the law but so may a belief that what the law requires has an ethical foundation. As Benno Torgler points out, “Experiments that consider the interaction between subjects indicate that moral constraint works as a disincentive to evade taxes.” Other researchers tell us, “The identification of underlying moral beliefs and social influences related to [tax] compliance behavior should help policy-makers to create strategies to modify or address these factors.”

Thus, from a public policy perspective, if compliance with the income tax laws is a growing problem, it is important to consider all the available tools for promoting obedience to the Tax Code. If ethical considerations are an incentive for complying with the tax law, the design and implementation of the Internal Revenue Code should take account of how best to
harness this force. Reporting the results of a survey of public opinion on tax evasion, academic researchers found that “individual moral beliefs are highly significant in tax compliance decisions. When tax evasion is seen as a moral issue, individuals are less likely to evade taxes regardless of the tax situation.”32 This should not be surprising given the fact that most people feel a moral obligation to obey the law.33

Morality provides a system of constraints on conduct. John Mackie explains,

> It works by modifying an agent’s view of possible actions, by attaching to them a moral characterization, favourable or adverse, which has prescriptive entailments. . . . It thus brings pressure to bear upon intentions, but in a peculiarly direct way. Moral wrongness is a bit like a penalty, but moral sense . . . attaches it more tightly than any penalty to the wrong act, and discourages such acts more directly than by way of deterrence.34

Though not conclusive, there is evidence in the literature on deterrence that “conscience appeals can be more effective than sanction threats.”35 Abandoning this ally of tax compliance—the dimension encouraged by moral influences—is cutting off one leg of the stool; but this has been Congress’s unwitting strategy since the income tax was introduced in 1913.

The force and authority of conscience, Adam Smith declared, “is, upon all occasions, very great; and it is only by consulting this judge within, that we can ever see what relates to ourselves in its proper shape and dimensions; or that we can ever make any proper comparison between our own interests and those of other people.”36 The ability of lawmakers to rely on help from the consciences of taxpayers to encourage compliance with the law means less need for direct, and often intrusive, deterrence measures. To the extent that Congress continues to ignore this aspect of tax policy, they do so at their own peril. Social psychologist Tom Tyler in Why People Obey the Law explains that “law breaking is viewed both as morally wrong and as a violation of an obligation owed to authorities. . . . If authorities can tap into such feelings, their decisions will be more widely followed.”37 But when legislators are preoccupied with ideological squabbles, amassing campaign reelection funds, and demagoguery, it diminishes the force of obligation felt toward their authority and reduces respect for their laws.
Cheating and Being Cheated

“If you are cheated out of a single dollar by your neighbor,” Henry David Thoreau observed, “you do not rest satisfied with knowing you are cheated, or with saying that you are cheated, or even with petitioning him to pay you your due; but you take effectual steps at once to obtain the full amount, and see to it that you are never cheated again.” The IRS assumes a similar stance: the amount you owe the treasury does not eclipse the fact that you do owe the treasury. While the IRS certainly puts greater effort into collecting larger tax debts, even very small amounts owed to the treasury are taken seriously and actively pursued.

Part of the dynamic inherent in tax cheating results from the fact that, while taxpayers are cheating the tax system of what the law says is its due, many taxpayers also feel they are cheated by the government that takes their money and spends it in ways that often seem hard to justify, or beyond justification. When tax cheating becomes an issue of financial revenge—an eye for an eye—the moral dimension of the problem is clearly exposed.

Tackling any problem is harder when we cannot define the problem’s parameters or even what the terms used to name the problem mean. Tax cheating suffers from such a lack of definition. Although the term cheating is not clearly defined, we know it generally has to do with fairness, with rules—whether stated or implied—with deception and intention, and is often associated with competition and engaged in to garner an advantage. It also is usually taken for granted that cheating means doing something wrong; but, as I argue in chapter 5, this is not necessarily the case.

Tax Fairness

In taxation there are at least two levels of fairness. A 2002 IRS fact sheet discussing its National Research Program states that one of the program’s goals is, “to more effectively catch tax cheating and help ensure everybody pays a fair share.” The dimension of fairness the IRS speaks of in wanting everyone to “pay a fair share” is from its perspective as enforcer of the law. Based on the law’s determination of how much each person should pay, the assessment and collection of tax should be administered fairly and uniformly. The law should be administered without regard to a taxpayer’s race, gender, religious affiliation, sexual orientation, sphere of political influence, relative wealth, and so on. In speaking of tax policy, this was
one of John Stuart Mill’s points when he wrote: “For what reason ought equality to be the rule in matters of taxation? For the reason that it ought to be so in all affairs of government. A government ought to make no distinction of persons or classes in the strength of their claims on it.”

Mill’s other point relates to the nature or substance of the laws. For example, the authors of The Flat Tax argue: “The substantial revenue the government would derive from the flat business tax is the key to the fairness of our tax system.” In such cases, the law’s fairness is questioned in terms of what groups or entities should pay taxes and at what tax rates; that is, consideration is given to factors of distributive justice including the redistribution of wealth, progressive tax rates, fiscal incentives, and the influence of special-interest groups. Designing the underlying system to be fair may result in tax justice at this more basic level. But the “fair share” notion raised at this more fundamental level—that of social philosophy and public policy—though critical, is not the focus of this book, except insofar as the current Internal Revenue Code fails to define our fair share in any articulable way. This failure impacts the administration of the tax, in turn, by undermining the Code’s moral authority. This issue is addressed more fully in chapter 3.

As Mill’s statement illustrates, these two contexts of fairness are distinct and yet easily blended in thought, thereby blurring their identities. It is important to add clarity to discussions of tax policy by seeking a definition of tax cheating as it relates to administration or compliance and by making distinctions explicit about which kind of fairness is under discussion and by drawing out the logical consequences of alternative positions.

The Meaning of Cheating in Tax

According to the U.S. Tax Court, in determining the ordinary usage of words when employed in tax matters, it is appropriate to consult a dictionary. Dictionary definitions are lexical definitions, and while important as historical references, they are only one of numerous kinds of definitions. In the case of cheating, dictionary definitions include the characteristics fraud and deception. Black’s Law Dictionary says cheating necessarily implies a fraudulent intent. If so, without fraudulent intent, an act cannot be cheating. However, as the opening discussion of recreational gambling indicates, this is a more restrictive conception of cheating than intended by the IRS or, in many instances, by the public.
As *cheating* is a term with potential ethical rather than legal import, its ethical dimension must be extracted and examined. In *Moral Thinking*, R.M. Hare says,

The first step that the moral philosopher has to take, in order to help us think better (that is more rationally) about moral questions, is to get to understand the meanings of the words used in asking them; and the second step, which follows directly from the first, is to give an account of the logical properties of the words, and thus of the canons of rational thinking about moral questions.⁴⁶

Some users of the word *cheating* connect it with trickery, fraud, or deception while others take a broader view. In *Lying, Cheating, and Stealing*, for example, Stuart Green specifically excludes deception and covertness from his definition of cheating.⁴⁷ A great deal of tax cheating—referred to as “playing the audit-selection lottery”—requires no attempt to cover one’s tracks but relies on the scant chance of an IRS examination. Just as speeding is widespread among drivers because there are not enough police to catch the majority of offenders, income tax cheating often involves no more than hoping to be among the 99 percent of taxpayers who are not audited. This is why one commentator writes, “To hide unreported income from auditors, taxpayers in some settings must affirmatively falsify routine records, keep multiple sets of books, misclassify transactions, create false documents, and the like. In other situations, taxpayers may be able to simply ‘forget’ to record ‘naturally’ less visible income-generating transactions.”⁴⁸ This indicates that there is a broad spectrum of activity qualifying for the label tax cheating.

In an early tax case heard by the Supreme Court, Justice Holmes said, “A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.”⁴⁹ Definitions that move us past the dictionary are an attempt to point our thinking in a new direction and are called stipulative.⁵⁰ When a dictionary definition is insufficient to capture emerging shades of meaning, as is the case with tax cheating, forging a stipulative definition is appropriate and often helpful. Doing so functions like proposing a new hypothesis to solve a problem in science. The new definition, like the new hypothesis, is tested for adequacy or effectiveness against experience. If the new definition allows us to think more clearly about a problem—making our decisions more grounded—its relative effectiveness is established. Stipulative definitions...
are used by reformers and moral entrepreneurs to help mold changes in public thinking.

But the importance of defining tax cheating goes beyond clarity and understanding. Sociologist Howard Becker tells us that authority is maintained by controlling definitions. “Superordinate groups,” he claims, “maintain their power as much by controlling how people define the world, its components, and its possibilities, as by the use of more primitive forms of control.” Specifically, Becker reports, “control based on the manipulation of definitions and labels works more smoothly and costs less” than more primitive means. “We control people,” says Becker, “by accusing people of deviant acts.” The government’s manipulation of definitions—doublethink in George Orwell’s 1984—is an example of this process. Thus, if those responsible for taxing and collecting taxes can get the upper hand by defining tax cheating in a negative, stigmatizing moral sense—as a form of deviance—their job is made easier. So whether tax cheating is defined as morally indifferent behavior or as an act of moral deviance is more than a matter of semantic quibbling, it has practical consequences for the treasury.

But to effectively utilize the strategy of stigmatizing tax cheaters, current legal restrictions on privacy would have to be loosened, allowing public disclosure of who has cheated, how, and how much. It is unlikely, however, that taxpayers would favor a public registry of tax cheaters as there is, for example, for sex offenders who prey on children. The tension between taxation and privacy is important and is addressed further in chapters 3 and 6. The resolution of this tension may only come from increasing transparency for both the Tax Code and taxpayers.

The wide range of activities combined under the heading of tax cheating makes it difficult, initially, to attack the problem. Former IRS Commissioner Egger said, “Tax cheating is generally regarded [by the public] as a minor infraction, not something shameful or the least bit embarrassing. In some sense, it’s becoming the taxpayer’s revenge against an unfair system.” There is research supporting this view as well as opposing it. One study finds that polls and “current research indicate that Americans no longer value nor feel an ethical duty towards paying their taxes.” These findings contrast sharply with others. In an article entitled “Moral Majority: Most People Disapprove of Any Tax Cheating” the Wall Street Journal reported that 87 percent of one thousand people polled in 1999 believed that tax cheating is always wrong. Prior research reported similar results.
At the core of this apparent divergence may be confusion or disagreement regarding the meaning of tax cheating. Like the terms expedient, ambitious and opportunistic, cheating is frequently used to express moral disapproval; on other occasions, however, its use is morally neutral. In baseball, for example, a shortstop playing out of position in anticipation of the batter's tendency to hit the ball to his left is said to be cheating toward second base, but there is no moral import to this use of the term cheating.

Regardless of this uncertainty about the meaning of cheating, what is clear is that its use to express ethical disapproval is appropriate only in situations where intention is involved and not in situations of inadvertency. For an activity to qualify as cheating, in the morally significant sense, it must be intentional. In the context of taxes, fraud is the most obvious example; a person cannot commit fraud unintentionally. However, at least some, and perhaps most, of what is popularly referred to as tax cheating is either unintentional—often the result of ignorance or confusion—or the taxpayer’s intentions are irrelevant, as when errors are the result of negligence. Tax negligence encompasses errors and omissions caused by not taking the time and effort to fully study, understand, and comply with the tax law.

Difficulties in pinning down the meaning of tax cheating arise in areas where the failure to pay taxes or report income is not strictly intentional, but is the consequence of misunderstanding the requirements of the law or interpreting the law in one’s own favor, though this may involve stretching its spirit. However, as one court explained, “Were simple misreading of the Tax Code a valid defense to tax liability . . . we have no doubt that incompetency in providing accounting services would carry a premium.”

Tax Fraud

In Dante’s Inferno the deepest reaches of hell are reserved for those who commit fraud, and immersion in ice (rather than fire) is their eternal torture. “Since fraud belongs exclusively to man,” Dante writes, “God hates it more and, therefore, far below, the fraudulent are placed and suffer most.” Fraud is broadly understood to include deceptions in many forms. Tax fraud is the most serious form of tax cheating. British philosopher H. L. A. Hart writes, “At any given moment the life of any society which lives by rules, legal or not, is likely to consist in a tension between those who, on the one hand, accept and voluntarily co-operate in maintaining
the rules, and so see their own and other persons’ behaviour in terms of the rules, and those who, on the other hand, reject the rules and attend to them only from the external point of view as a sign of possible punishment.” Research by psychologists provides evidence that most people feel an obligation to obey the law and that the key determinants of this feeling are personal morality and the legitimacy of the law or legal authority. For the rest, attending to the tax law only from an external point of view may lead to tax cheating and in some cases to tax fraud.

While most violent crimes are committed at night by young males, tax crimes are associated with a somewhat older and more diverse demographic, operating in the light of day. Jeremy Bentham, in *Of Laws in General*, wrote that “if it be once determined to place the act in the catalogue of offences it may be necessary to make the punishment which is employed to combat it a severe one: owing for example to the powerfulness of the seducing motive. Instances of this sort are most frequent among offenses against revenue.” In some sense enforcing the tax laws is paramount to enforcing all laws, as the second must be financed by the first.

Enforcing the tax laws is most frequently accomplished through a series of penalties. Most tax penalties are civil and not criminal. Even the significant 75 percent fraud penalty is for a civil offense. Criminal tax fraud is described in the Internal Revenue Code thus:

> Any person [including corporations] who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by the law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned for not more than five years, or both, together with the costs of prosecution.

Though fraud is a general category of tax cheating, specific activities tracked by the IRS include abusive tax schemes, bankruptcy fraud, corporate fraud, employment tax evasion, financial institution fraud, gaming fraud, health care fraud, insurance fraud, money laundering, tax evasion uncovered in narcotics enforcement, public corruption crimes, questionable refunds, telemarketing fraud, and abusive tax return preparation. The Internal Revenue Code also contains sections describing specific criminal offenses including (1) the willful attempt in any manner to evade or defeat any tax, (2) the willful failure to file
a return or pay the tax,\textsuperscript{70} (3) perjury and false statements,\textsuperscript{71} as well as (4) the willful aiding or assisting in the preparation of a false return.\textsuperscript{72} Prison inmates have recently been singled out as perpetrators of tax fraud.\textsuperscript{73} Even the nonprofit sector has not been immune from questionable tax activities.\textsuperscript{74}

In the overall scheme of tax enforcement, the IRS reports only a limited number of criminal tax fraud convictions, due in part to the difficulty of proving a taxpayer’s willful intent. According to the Supreme Court, willfulness means the “voluntary, intentional violation of a known legal duty.”\textsuperscript{75} Numerous defenses are available to deflect the government’s charge of willfulness, including the law’s complexity.\textsuperscript{76} “It is settled,” according to one federal court, that when the law is “vague or highly debatable,” a defendant lacks the requisite intent to violate it.\textsuperscript{77} We will return to the problem of tax complexity in chapter 3.

Total criminal tax fraud investigations initiated for FY2010 were 4,706, with 2,184 convictions and 2,172 taxpayers sentenced. The incarceration rate was 81.5 percent.\textsuperscript{78} Based on these figures—in a country with 300 million citizens and 140 million tax returns filed—we might conclude either that

- not much tax fraud is occurring,
- it is difficult to prove willfulness,
- the IRS is seriously understaffed, or
- the deterrent effect of IRS penalties and the threat of prison time are quite powerful.

Hans Sherrer observes, “In any given year the odds of someone’s being murdered is twenty times greater than that they will be prosecuted and convicted of a tax law violation by the federal government.”\textsuperscript{79} In its publication \textit{War Tax Resistance}, the War Resisters League offers comfort to its supporters: “War tax resistance involves little risk of jail. Since World War II, only about 30 people have been jailed.”\textsuperscript{80} War tax resistance consists of attempting to pay taxes for all governmental functions except defense. In spite of the meager quantity of cases, the Criminal Investigation Division of the IRS is apparently quite adept at seeking out the bigger fish to investigate. A study of almost six hundred criminal prosecutions by the IRS between 2000 and 2004 revealed that the average case involved a misstatement of income—understating income or overstating deductions—of almost $2 million, with almost 90 percent of the cases involving at least $100,000 in misstatements.\textsuperscript{81}
For 2010 the IRS reported 401 criminal investigations initiated against taxpayers who failed to file a tax return. Of that number, 247 were sentenced to federal prison or other modes of incarceration. The incarceration rate was 78.9 percent and the average prison sentence was forty-three months. At a 1993 hearing before the Congressional House Ways and Means Committee, IRS Commissioner Richardson was interrogated by a member of the committee about the scant number of criminal prosecutions for failing to file. The congressman quipped, "If we only have 700 cases completed or being worked on the criminal side and there are 10 million nonfilers, odds are pretty good for a nonfiler." Not mentioned was the fact that the IRS’s statistics on nonfilers includes taxpayers not required to file because their taxable income is below the threshold but also excludes many taxpayers who should file but operate in the cash or shadow economy or otherwise avoid third-party tax reporting such as W-2s and 1099s.

**Penalties and Deterrence**

“The importance of deterrence,” Margaret Levi writes, “is that it persuades taxpayers that others are being compelled to pay their fair share.” Congress has devised a wide array of tax penalties to aid the IRS in its attempts to control how taxpayers behave. This model for encouraging tax compliance is based on simple assumptions about human behavior, rationality, and how people make decisions. In weighting their tax compliance choices, lawmakers presume that taxpayers put various factors on either side of a mental-balance scales, noting the overall impact on the arrow’s position—and deciding whether compliance is outweighed by the interests on the other side of the scales. The amount of a potential tax penalty is assumed to be one of these factors. Overlooked in this legalistic-economic model is the effect of the butcher with the golden thumb. Weighing alternatives is not accomplished in a vacuum but under the influence of a wide range of psychological decision-altering distortions. Dating back to a seminal study of why people in flood-prone regions of the country don’t buy flood insurance, researchers in psychology and economics have addressed numerous flaws in the simplistic view of decision making as purely rational evaluation of alternatives. Most of us do not think like Mr. Spock. Some psychologists claim that “the influence of deterrence on compliance may be overrated.” The study of flood insurance disclosed that “if the chances of an event are sufficiently low, people do not even reflect on its consequences.” For a decade (2001–10)
the average IRS audit rate stood below 1 percent—for many people, not sufficient to prompt reflection on the consequences of tax cheating.

Psychological research on the extrarational influences on our decision processes has burgeoned and its effects now impact thinking in many areas. In this book, for example, several topics relating to these influences are touched on, including availability and subjective probability (chap. 1), intertemporal choice (chap. 3), prospect theory (chap. 6), and adaptation (chap. 8). In spite of this progress in understanding how people make decisions, lawmakers, the majority with legal rather than psychological training, cling to the traditional model of folk psychology, “based mostly on the common perception of unaided intuition.”

It is possible that Congress’s willingness to abandon the moral dimension of tax policy as an ally can be explained by a belief (even if unfounded) in the powerful deterrence force of tax penalties or the threat of prison time, leaving no need to rely on the conscience of taxpayers. But one moral philosopher tells us, “We see a legal penalty as just, as immediately morally appropriate, only if the act to which it is attached is morally wrong.” Thus, if the tax law itself is seen as lacking a supporting
moral foundation—as I argue here—penalties employed to enforce the Tax Code are also forced to accomplish their deterrent effects without the benefit of an ethical dimension.

In a book on IRS practice and procedure, Michael Saltzman reports, “Sanctions for noncompliance [with tax laws] . . . are forms of retribution, of varying degrees of severity ranging from small fines to heavy prison sentences, the threat of which contributes to maintaining compliance with the revenue laws at high levels.”92 Most tax penalties—small fines—are assessed for minor infractions of the law (late filing, late paying); but then general crime statistics reveal that nearly all crimes are “mundane, simple, trivial, easy acts aimed at satisfying desires of the moment.”93 In Spies v. United States, the Supreme Court emphasized the importance of tax penalties:

The United States has relied for the collection of its income tax largely upon the taxpayer’s own disclosures. . . . This system can function successfully only if those within and near taxable income keep and render true accounts. In many ways, taxpayers’ neglect or deceit may prejudice the orderly and punctual administration of the system as well as revenues themselves. Congress has imposed a variety of sanctions for the protection of the system and the revenue.94

Deterrence Theory

Penalties raise revenue but they are also sanctions assumed to act as deterrents, and their deterrent effect has been the subject of study. Researchers discovered that taxpayers are aware of some penalties and their deterrent effect is evidenced by the fact that taxpayers sometimes diversify their tax cheating—a little here, a little there—to minimize the imposition of penalties. In particular, one study found “marked variations in compliance levels across line items [on a tax return] which appear to be systematically related to the difficulty of establishing noncompliance and the penalties for detected noncompliance.”95 It was also found that reminding taxpayers about potential legal sanctions shortly before they file their tax returns results in an increase in the amount of income reported compared to a control group where no such reminder was given.96 And an increase in the number of criminal investigations leading to the incarceration of tax cheaters has also been shown to have a significant effect on voluntary tax compliance.97 These results are consistent with the findings of deterrence theory,
indicating that people avoid illegal behavior because of a fear of social disapproval, the perceived threat of legal punishment, and a moral commitment to the law.  

Sociologist Stephen Pfohl reports that “[f]or deterrence to function effectively as a means of social control, there must be some guarantee that a high percentage of offenders either really will be punished or at least believe that they will be punished.” In *The Psychology of Taxation*, Alan Lewis explains, “The probability of detection, the size of the fine and tax rates may well prove to be among the most important determinants of tax evasion, but even if this is so, the decision to evade tax is based on an individual’s perception of the chance of being caught, the size of the fine and tax rates, not on what they actually are.” Here the IRS may benefit from taxpayers’ subjective miscalculations of their chances of being audited or put in prison, based on the psychological distortion known as *availability*.

“Availability provides a mechanism by which occurrences of extreme utility (or disutility) may appear more likely than they actually are.” Research concludes that people are poor judges of the relative chances of particular kinds of events happening to them. Psychologist Barry Schwartz observes, the availability of news stories on homicide, for example, makes it appear more likely than it is. Because of this, people believe their chances of being murdered equal their chances of dying from a stroke, when in fact death by stroke is eleven times more likely. The more available the kind of event is to a person’s calculation process—the more recent or more vivid the experience—the more likely the event appears. Psychologists Tversky and Kahneman explain, “The impact of seeing a house burning on the subjective probability of such accidents is probably greater than the impact of reading about a fire in the local newspapers. Furthermore, recent occurrences are likely to be relatively more available than earlier occurrences.” In general, “A person is said to employ the availability heuristic whenever he estimates frequency or probability by the ease with which instances or associations could be brought to mind.”

Because of this distortion, a doubling of the audit rate, for example, should result in more than doubling taxpayers’ anxiety, as each audited individual regales family, friends and coworkers with stories of ruthless interrogation, garnished wages, frozen bank accounts, and unrelenting humiliation, producing a rippling effect of consternation. The aversion many people express for an IRS audit may thus distort their perception of its likelihood and increase their compliance. This has been documented
in what is referred to as the spillover effect, where taxpayers report more of their income as the perceived likelihood of an audit increases. One outcome of this effect is that “providing taxpayers with an accurate perception of risks (which is less than they currently fear) could actually increase cheating.” Another researcher concurs, explaining that because “taxpayers tend to overestimate their risk of audit, publicity about very low audit rates may cause an individual taxpayer to maintain a false belief that she is unlikely to be audited.”

We also know that some deterrents can be too threatening, resulting in resistance and even countermeasures. In Sanctions and Social Deviance, criminologist Charles Tittle wrote, “There may be threshold levels as well as levels of diminishing returns for sanction severity and these may vary from person to person and from population to population.” In addition, some penalties (or at least their payment) may even produce the opposite of their intended deterrent effect. Research in trust theory has shown that requiring the payment of fines can release individuals from moral norms otherwise constraining their conduct. Based on this finding, a taxpayer who pays a tax penalty one year may subsequently feel entitled to cheat on his or her next year’s tax return.

Economic Deterrence

As noted, tax penalties are assumed to act as economic deterrents, thereby discouraging tax cheating. But even if we grant the deductive argument that all taxes (including tax penalties) are disincentives, all disincentives are deterrents, and so all taxes are deterrents, this does not answer the question of how effective is a given tax penalty. The Internal Revenue Code contains roughly fifty different income tax–related penalties, ranging from one-half percent interest a month to 100 percent of the tax due. Most of these penalties are unknown to the majority of taxpayers, calling into question their possible deterrent effect. One of the reasons for the emphasis on deductive reasoning in economic debates is the frequent impossibility of conducting relevant large-scale controlled experiments in a functioning economy. This does not mean economists can’t or don’t conduct experiments—they do. However, as Samuelson points out, “It is more difficult to perform experiments in economics than in the laboratory sciences. . . . Economists cannot measure economic variables with the precision that physical scientists can . . . [because] it is difficult to replicate the real economy in a laboratory.” This limitation applies to answering questions about a tax penalty’s power to deter specific kinds of
tax cheating. One study indicated that very high penalty rates, such as 900 percent, do have a marked deterrent effect.\textsuperscript{113} This finding, however, offers little potential benefit for the real world or even for lawmakers. Another study concluded that, “Nonevaders do not need deterrence to keep them from evading” and that for “habitual evaders . . . deterrence does not seem to have any effect.”\textsuperscript{114}

“Unlike physical scientists,” an economics text tells us, “economists rarely have the chance to conduct controlled experiments to validate their models. Instead, economists most often test hypotheses by looking at actual experiences in markets.”\textsuperscript{115} But finding a market reflecting all the complexities of the income tax system is a challenge. The IRS knows there is a problem here. It admits, “Some penalties may be too low under current law to change behavior. Other penalties may be so high that examiners have been unable or unwilling to assert them, particularly when they believe that taxpayers have made inadvertent errors.”\textsuperscript{116} With little empirical evidence to rely on, the amounts set for various tax penalties are arbitrary, simply the outcome of a political process, and often based on the need for revenue as much as for compliance. Here the members of Congress must balance their need to raise revenue against their “need” to get reelected.\textsuperscript{117}

An especially mysterious example of this arbitrariness is the $10,000 penalty imposed on taxpayers who renounce their U.S. citizenship for purposes of avoiding the income and estate tax and then fail to comply with the IRS requirement to file Form 8854 “Expatriation Information Statement.”\textsuperscript{118} While $10,000 may seem significant to the average taxpayer, the deterrent effect of this penalty is aimed at the actions of individuals with more than $2 million net worth who are moving to a tax haven country and turning in their U.S. passports. In light of its dubious deterrent force, we can only hope that the expected revenue gain from this penalty was not earmarked to fund a program of any importance.

\textit{Limiting the Need for Formal Sanctions}

Investigation of the effects of particular deterrents on lawbreaking is notoriously difficult, in part because there is no universal agreement on the causes of crime. One well-known study of crime claims that the supposed causes of illegal behavior—and by implication, therefore, the projected effects of deterrents—are often dependent on the background of the researchers providing the answers. This is an instance of the syndrome: “For a man with a hammer, every problem is a nail.” In their
General Theory of Crime, Gottfredson and Hirschi observe that “for the sociologist, crime is social behavior (when in fact it is the contrary); for the psychologist, crime is learned behavior (when in fact no learning is required); for the biologist, crime is an inherited trait (when in fact crime, like accidents, cannot be inherited); finally, for the economist, crime is economic behavior or labor force participation (when in fact it is uneconomical behavior outside the labor force).”119 On this score Carroll observes, “Attempts to deter noncompliance without understanding the sources and processes of noncompliance are unlikely to provide a satisfactory answer to the problem.”120 Thus, before there can be a sapient answer about the effectiveness of tax penalties as deterrents, we would need an objective, multidisciplinary, empirical investigation, which I have yet to locate.

While the existence of tax penalties may point to areas of tax-cheating concern, the relative effectiveness of these penalties as deterrents remains unknown. Danshera Cords argues that “[m]ore important in deterring tax noncompliance [than penalties] are a taxpayer’s internalized norms regarding the importance of tax compliance.”121 The leg of the enforcement stool represented by the moral belief that tax cheating is wrong—which Congress has chosen to cut off—may therefore be more important to a system requiring self-assessment than penalties and other formal deterrents. But, as I illustrate throughout this book, Congress has inexplicably abandoned the idea that there should be any moral duty to obey the income tax laws.

Tax Penalties—Is the IRS Making it Worse?

Although I will ultimately lay the blame for most tax cheating at the feet of Congress, the IRS contributes in certain ways to aggravating the problem through fomenting a lack of confidence in its ability to do its job well. Public perceptions of the IRS, for example, have been cited as a source of noncompliance. One survey finds that only 58 percent of the public agree that the IRS and its staff are “experienced/knowledgeable,” while 37 percent do not. The findings are the same for perceived trustworthiness (59 percent versus 38 percent). Commenting on these results the author concludes, “There seems to be a problem with a tax system that the majority of the public consider as complicated and unfair.”122 Part of this perception may be related to an uneven handling of tax penalties. Here we find evidence that the IRS is apparently contributing to the kind of unfairness it is primarily charged with enforcing.
The IRS data on civil penalties for 2009 shows that 14 percent of the number (but 53 percent of the amount) of these penalties were abated. This disparity implies that penalties of larger dollar amounts are more likely to be abated than penalties of smaller dollar amounts. For individuals writing bad checks to the treasury 6 percent of the number but 36 percent of the amount was abated, indicating larger bad checks are more likely to be forgiven than smaller ones.

In the context of tax cheating, the apparent inequitable enforcement of the law with regard to abating penalties—larger dollar assessments receiving more favorable treatment in terms of abatement than smaller dollar assessments—raises questions of fairness. This questioning assumes that incurring a larger penalty is a proxy for the relative resources available for paying the penalty. Are larger corporations or wealthier individuals—those capable of triggering larger penalties—really favored in IRS penalty abatements as the numbers seem to imply?

The general rule on abating penalties (“liabilities in respect of a tax”) gives the IRS authority to abate a penalty if it is (1) excessive in amount (2), is assessed after the statute of limitations for collections has expired, or (3) is erroneously or illegally assessed. The bias in favor of abating larger penalties may have different explanations. Perhaps the larger the penalty the more likely the taxpayer is to request abatement. But presumably even a small penalty is a big deal to an impoverished taxpayer. It may also be a matter of who is asking the IRS to back off; that is, the taxpayer with the larger penalty may be politically connected. The question of why the IRS first assesses and then abates the majority of these penalty dollars remains open. If size matters, the affect on the morale of the average taxpayer should not be ignored. And if the abatements are granted for any of the three reasons cited by the Code (excessive amount, assessed too late, or assessed erroneously or illegally) this invites the question of IRS competence and why these larger penalties get assessed in the first place.

According to the author of Tax Compliance and Tax Morality, “The timely filling out of the tax form and the timely paying of the taxes are . . . important compliance determinants for a tax administration.” The majority of IRS tax penalties—more than 50 percent of civil penalty dollars—are assessed against individuals for paying taxes late, failure to make estimated tax payments, or filing returns late, all requirements fundamental to a voluntary tax system. Tellingly, these most frequently assessed penalties are imposed for actions that are the most difficult for a taxpayer to disguise and for which deceit is of little help. Here banking on the audit-selection lottery is of no assistance either. The date of receipt
for a tax payment or a tax return is objectively verifiable either by the postmark or receipt by the IRS, and the IRS tracks 100 percent of these items. ¹²⁹

Since the most common penalties appear to have little to do with tax cheating, though they represent half the civil penalty dollars, their usefulness as a framework for analyzing tax cheating may be limited, though the remainder of the IRS’s arsenal of tax penalties may still serve this purpose. Among the latter the most significant for an understanding of tax cheating may be penalties for negligence and disregard of the rules, a topic addressed in chapter 6.

**Cheating—Specific Characteristics**

A central thread of this book involves reviewing possible meanings of cheating in general, and of tax cheating in particular. In *Lying, Cheating, and Stealing*, Green writes, “Cheating consists of breaking an equitable and fairly enforced rule with the intent to obtain an advantage over some party with whom the rule-breaker is in a cooperative rule-governed relationship.”¹³⁰ He then questions the equitable and fairly enforced criteria in the light of the Internal Revenue Code, and says, “Whether such rules are sufficiently just, however, to allow us to refer to their violation as a form of cheating is a question that cannot be resolved here.”¹³¹

Other studies have addressed the ethical status of tax cheating without specifically tackling the underlying concept of cheating. Most have addressed the broader questions of the ethical responsibility to obey the law or more limited questions such as the morality of tax evasion. ¹³² Leo Martinez, for example, believes that tax evasion is not morally wrong and therefore that any lesser form of tax cheating cannot be immoral either. He concludes that, “As long as taxpayers otherwise intend to obey the law, tax evasion is a morally neutral economic proposition.”¹³³

An Oxford law professor writing early in the last century observed, “Many a rascal takes his way through life without being made to answer for his sins if he takes care not to infringe the prescriptions of the law.”¹³⁴ In coming to understand the meaning of tax cheating it will be necessary to determine whether infringing the prescriptions of the law includes only instances of breaking the strict requirements of the law or whether following the letter but flouting the spirit of the law also qualifies as cheating. As K. D. Deane notes, “To adhere to the letter of the law and to ignore its spirit is often taken as a sign of moral turpitude equal to (if not worse than) that of the straightforward law-breaker.”¹³⁵
Similar threshold questions include: (1) Are the taxpayer's intentions or motives in breaking the law significant in making a determination about tax cheating? (2) Can cheating be unintentional? (3) What about situations in which a taxpayer consciously tries to comply with the law but because of its complexity, fails? In such cases, the IRS may still impose a penalty for negligence, as this does not require establishing the taxpayer's intentions.\(^{136}\) We also need to determine whether the term *cheating*, which typically carries a moral residue, has meaning or significance outside the moral sphere. Can we cheat without violating any moral rules and, alternatively, when we do violate moral rules, is the term *cheating* always applicable? A better understanding of what constitutes tax cheating will open the way to more effective ways of dealing with the problem—or deciding if it is in fact a problem and not, as some believe, a solution to a larger problem.

In the chapters to follow, little else will be said about the IRS's role in promoting or deterring tax cheating, as the IRS is primarily the messenger. Instead, the other players will be scrutinized: the taxpayers, the courts, and the Internal Revenue Code. I will defend the position that it is the Tax Code itself—or rather its author, the Congress—that is most responsible for tax cheating, as it sets the rules. In the process I will refine what is meant by tax cheating and ultimately explain why tax cheating—under the current system—is not a proper target of moral disapproval.