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## ARTICLE

### COLLATERAL COMPLIANCE

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*As most of us are aware, noncompliance with the tax law can lead to tax penalties, which almost always take the form of monetary sanctions. But noncompliance with the tax law can have other consequences as well. Collateral sanctions for tax noncompliance—which apply on top of traditional tax penalties to revoke or deny government-provided benefits—increasingly apply to individuals who have failed to obey the tax law. They range from denial of hunting permits to suspension of driver’s licenses to revocation of passports. Further, as the recent Supreme Court case *Kawashima v. Holder* demonstrates, some individuals who are subject to tax penalties for committing tax offenses involving “fraud or deceit” may even face deportation from the United States.*

*When analyzing sanctions as incentives for tax compliance, tax scholars have focused almost exclusively on the design and implementation of monetary penalties. This Article, in contrast, introduces the collateral tax sanction as a new form of tax penalty that does not require noncompliant taxpayers to pay the government money and that does not require a taxing authority to implement it. Drawing on behavioral research and experiments in the tax context and other areas, I argue that collateral tax sanctions can promote voluntary tax compliance more effectively than the threat of additional monetary tax penalties, especially if governments increase public awareness of these sanctions. Governments should therefore embrace collateral tax sanctions as a means of tax enforcement, and taxing authorities should publicize them affirmatively.*

*After considering the effects of collateral tax sanctions under the predominant theories of voluntary compliance, I propose principles that governments should consider when designing collateral tax sanctions. These principles suggest, for example, that initiatives to revoke driver’s licenses or professional licenses from individuals who fail to file tax returns or pay outstanding taxes would likely promote tax compliance. However, whether the sanction of deportation for tax offenses involving fraud or deceit will have positive compliance effects is far less certain. Finally, I suggest how taxing authorities should publicize these sanctions to foster voluntary compliance.*

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## INTRODUCTION

Tucked in the corner of one of the dozens of strip malls along Ventura Boulevard in California’s San Fernando Valley, the Japanese restaurant Cho Cho San serves spicy tuna rolls, shrimp tempura, and a menu of other entrées favored by the American palate.<sup>1</sup> Its owners, Akio and Fusako Kawashima, arrived in the United States in 1982 in search of opportunity, and through hard work and good fortune, established the profitable restaurant chain.<sup>2</sup> Their business success, however, did not extend to their dealings with the Internal Revenue Service (IRS). In 1997, IRS agents determined that the couple underpaid taxes on their restaurant income by

<sup>1</sup> *Locations*, CHO CHO SAN, <http://chochosan.com/loc/html> (last visited Feb. 21, 2014); *Menu*, CHO CHO SAN, <http://www.chochosan.com/menu.html> (last visited Feb. 21, 2014).

<sup>2</sup> Brief for Petitioners at 3, *Kawashima v. Holder*, 132 S. Ct. 1166 (2012) (No. 10-577); see also Teresa Rochester, *Thousand Oaks Family at Heart of Supreme Court Deportation Case*, VENTURA COUNTY STAR (Feb. 28, 2012), <http://www.vcstar.com/news/2012/feb/28/thousand-oaks-family-at-heart-of-us-supreme> (describing the couple’s years in the United States).

nearly a quarter of a million dollars over several years.<sup>3</sup> Rather than face a criminal trial, Mr. Kawashima pleaded guilty to willfully making a false tax return, and Mrs. Kawashima pleaded guilty to aiding and assisting the preparation of a false tax return.<sup>4</sup> The Kawashimas agreed to pay back the taxes owed plus tax penalties and interest and were sentenced to four months in prison.<sup>5</sup> Almost three years later, after reestablishing themselves as “exemplary” members of their community,<sup>6</sup> the Kawashimas received an unexpected notice from the immigration authorities.<sup>7</sup> As a result of their prior guilty pleas in their tax case, they faced deportation to their native country of Japan and the prospect of leaving their children and American lives behind.<sup>8</sup>

The story of *Kawashima v. Holder*,<sup>9</sup> decided by the United States Supreme Court in 2012, illustrates a curious chain of events. After incurring a tax penalty and prison time, the taxpayers faced the *additional* sanction of deportation as a result of the *same* tax offense. Criminal law scholars refer to such additional sanctions as the “collateral consequences” of criminal convictions.<sup>10</sup> For example, a convicted individual may be prohibited from holding certain public or private sector employment<sup>11</sup> or from serving on juries<sup>12</sup> following a prison sentence. I describe the Kawashimas’ added sanction here as a “collateral tax sanction.” The sanction applied on top of monetary tax penalties and prison sentences, revoked a privilege provided

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<sup>3</sup> See Brief for Petitioners, *supra* note 2, at 3-4 (“[T]he total actual tax loss was \$245,126.”).

<sup>4</sup> *Id.*; Opening Brief for Petitioners at 6, *Kawashima v. Gonzales*, 503 F.3d 997 (9th Cir. 2007) (No. 04-74313).

<sup>5</sup> Opening Brief for Petitioners, *supra* note 4, at 6.

<sup>6</sup> Opening Brief for Petitioners at 18, *Kawashima v. Gonzales*, 503 F.3d 997 (9th Cir. 2007) (No. 05-74408) (quoting retired Deputy Sheriff Steven Smith).

<sup>7</sup> *Id.* at 11.

<sup>8</sup> *Id.*

<sup>9</sup> 132 S. Ct. 1166 (2012).

<sup>10</sup> For a small sampling of the literature on collateral consequences, see Gabriel J. Chin, *Race, the War on Drugs, and the Collateral Consequences of Criminal Conviction*, 6 J. GENDER RACE & JUST. 253 (2002); Kathleen M. Olivares et al., *The Collateral Consequences of a Felony Conviction: A National Study of State Legal Codes 10 Years Later*, FED. PROBATION, Sept. 1996, at 10; Michael Pinard, *Collateral Consequences of Criminal Convictions: Confronting Issues of Race and Dignity*, 85 N.Y.U. L. REV. 457 (2010); Michael Pinard, *An Integrated Perspective on the Collateral Consequences of Criminal Convictions and Reentry Issues Faced by Formerly Incarcerated Individuals*, 86 B.U. L. REV. 623 (2006); Michael Pinard & Anthony C. Thompson, *Offender Reentry and the Collateral Consequences of Criminal Convictions: An Introduction*, 30 N.Y.U. REV. L. & SOC. CHANGE 585 (2006).

<sup>11</sup> See, e.g., N.Y. STATE BAR ASS’N, RE-ENTRY AND REINTEGRATION: THE ROAD TO PUBLIC SAFETY 18-19 (2006) (describing employment obstacles faced by convicted felons).

<sup>12</sup> See, e.g., Brian C. Kalt, *The Exclusion of Felons from Jury Service*, 53 AM. U. L. REV. 65, 131-42 (2003) (criticizing statutes that ban felons from serving on juries as penologically unjustified).

by the government instead of requiring additional monetary payment, and was imposed by an agency other than the taxing authority.

It may appear unusual to tax practitioners and tax scholars that the Kawashimas' additional, nonmonetary sanction for tax noncompliance was levied by an agency other than the IRS. However, collateral tax sanctions are increasingly used in other contexts. In recent years, federal agencies and state governments have started to apply collateral tax sanctions to combat tax delinquency, an offense that occurs when a taxpayer fails to pay an established tax liability in a timely manner. For example, under current and proposed federal rules, failure to pay taxes owed may result not only in civil and criminal tax penalties,<sup>13</sup> but also in loss of ability to apply for Federal Housing Authority (FHA) mortgages,<sup>14</sup> enter into contracts with the federal government,<sup>15</sup> and hold a United States passport.<sup>16</sup> Likewise, several states suspend driver's licenses and vehicle registrations,<sup>17</sup> revoke law and other professional licenses,<sup>18</sup> and deny hunting and gaming permits<sup>19</sup> to residents who fail to satisfy their tax obligations. Criminal law scholars have written

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<sup>13</sup> See generally I.R.C. §§ 6651–6725 (2006 & Supp. V 2012) (prescribing civil tax penalties); I.R.C. §§ 7201–7217 (2006 & Supp. V 2012) (prescribing criminal tax penalties).

<sup>14</sup> See U.S. DEP'T OF HOUS. & URBAN DEV., HOUSING HANDBOOK NO. 4155.1, MORTGAGE CREDIT ANALYSIS FOR MORTGAGE INSURANCE ON ONE- TO FOUR-UNIT MORTGAGE LOANS 4.A.2.F (2011), available at <http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4155.1/41551HSGH.pdf> (deeming a borrower ineligible for an FHA mortgage until a delinquent federal tax debt is resolved).

<sup>15</sup> Consolidated and Further Continuing Appropriations Act, 2012, § 527, Pub. L. No. 112-55, 125 Stat. 552, 636 (2011).

<sup>16</sup> See Moving Ahead for Progress in the 21st Century Act, S. 1813, 112th Cong. § 40304 (2012) (proposing passport revocation or denial for a “seriously delinquent tax debt”); see generally U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-272, FEDERAL TAX COLLECTION: POTENTIAL FOR USING PASSPORT ISSUANCE TO INCREASE COLLECTION OF UNPAID TAXES 17 (2011), available at <http://www.gao.gov/new.items/d11272.pdf> (“Congress may wish . . . to enable and require the Secretary of State to screen and prevent individuals who owe federal taxes from receiving passports . . .”).

<sup>17</sup> See, e.g., *California to Tax Scofflaws: Pay Up Or Lose Your Driver's (or CPA) License*, ACCOUNTINGWEB (Sept. 20, 2011), <http://www.accountingweb.com/topic/tax/california-tax-scofflaws-pay-or-lose-your-drivers-license> (describing California's driver's license suspension program). See generally Jay A. Soled, *Using Driving Privilege to Solve States' Fiscal Crises*, 60 STATE TAX NOTES 841, 841-42 (2011) (arguing in favor of suspending driver's licenses for residents who are not current on their tax payments).

<sup>18</sup> See, e.g., MINN. STAT. § 270C.72(1) (2012) (mandating the revocation of a professional license if the license holder owes delinquent taxes); WIS. STAT. § 73.0301(1)(d)(11), (2)(b)(1)(a) (2012) (mandating the revocation of a law license if a license holder is liable for delinquent taxes).

<sup>19</sup> See, e.g., *Hunting Licenses*, LA. DEP'T OF WILDLIFE & FISHERIES, <http://www.wlf.louisiana.gov/licenses/hunting-licenses> (last visited Feb. 21, 2014) (requiring license applicants to have filed a state income tax return and complied with state income tax regulations).

dozens of articles on the collateral consequences of criminal convictions.<sup>20</sup> Yet tax scholars have virtually ignored similar consequences in the taxation context.

Instead, when analyzing sanctions as incentives for tax compliance, tax scholars have focused almost exclusively on the design and implementation of monetary tax penalties.<sup>21</sup> This Article, in contrast, introduces the collateral tax sanction as a new form of tax penalty that neither requires noncompliant taxpayers to pay the government money nor requires the taxing authority to apply it. To explore this overlooked aspect of tax enforcement, this Article considers several questions: Why do collateral tax sanctions appear to encourage individuals to pay their tax debts where monetary tax penalties have failed? Could collateral tax sanctions influence individuals' tax compliance decisions in areas other than the payment of outstanding tax liabilities? And how, if at all, should taxing authorities, as opposed to other government agencies, publicize the existence of collateral tax sanctions? Drawing on behavioral research and experiments in the tax context and other areas, I argue that collateral tax sanctions can promote voluntary tax compliance more effectively than the threat of additional monetary tax penalties, especially if governments increase public awareness of these sanctions. I conclude that governments should embrace collateral tax sanctions as a means of tax enforcement and that taxing authorities should publicize them affirmatively.

To begin this investigation, I examine differences between collateral tax sanctions and traditional monetary tax penalties. I also consider the significance of these differences in light of potential tax compliance motivations presented in the tax literature.<sup>22</sup> I find that collateral tax sanctions possess several unique features that traditional monetary tax penalties lack. Several features, I argue, enable collateral tax sanctions to encourage voluntary compliance more effectively than traditional monetary tax penalties.

First, collateral tax sanctions are more salient than traditional monetary tax penalties, thus enabling them to exploit powerful cognitive biases.<sup>23</sup> The

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<sup>20</sup> See, e.g., *supra* note 10.

<sup>21</sup> See, e.g., Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 122-45 (2009) (discussing current tax penalties' role in defining tax compliance); Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 257-63 (2007) (proposing strict-liability tax penalties); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 580-605 (2006) (criticizing civil tax penalties' design and proposing alternatives).

<sup>22</sup> See *infra* Section II.B.

<sup>23</sup> See generally RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 25 (rev. ed. 2009) (noting that salience is closely related to the availability bias); Joshua D. Blank, *In Defense of Individual Tax Privacy*, 61

salience of collateral tax sanctions can, in turn, create greater deterrence than traditional monetary tax penalties. Second, by targeting specific government benefits and services for which individuals have developed feelings of entitlement, collateral tax sanctions provoke individuals' loss aversion biases. This bias leads to a desire to avoid incurring losses (as compared to acquiring gains) and the endowment effect.<sup>24</sup> Third, certain collateral tax sanctions can result in greater indirect economic costs than monetary tax penalties, particularly with respect to individuals with a greater ability to pay. These indirect costs may cause collateral tax sanctions to induce compliance from wealthy taxpayers more effectively than monetary tax penalties.<sup>25</sup> Fourth, certain collateral tax sanctions emit negative reputational signals<sup>26</sup> by forcing individuals to reveal to others that they have failed to pay their taxes.<sup>27</sup> Fifth, the observability of many collateral tax sanctions, as opposed to monetary tax penalties applied behind the curtain of taxpayer privacy,<sup>28</sup> can bolster confidence among taxpayers motivated by feelings of reciprocity.<sup>29</sup> Last, when collateral tax sanctions require taxpayers to forfeit specific government benefits rather than money,

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EMORY L.J. 265, 287-322 (2011) (describing the effects of salience and cognitive biases on individuals' tax compliance decisions); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420 (1999) (detailing how companies manipulate the market by using salience to exploit consumers' psychological traits); Edward J. McCaffery, *Cognitive Theory and Tax*, 41 UCLA L. REV. 1861, 1876 (1994) (noting the "disproportionate [cognitive] impact of salient or vivid information"); Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REG. 253, 261-63 (2011) (discussing salience in "th[e] sense of prominence or visibility" with regard to hidden taxes); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases* (describing loss aversion bias, wherein an individual's "response to losses is more extreme than the response to gains"), in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 3, 11-14 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982).

<sup>24</sup> See Daniel Kahneman et al., *The Endowment Effect, Loss Aversion, and Status Quo Bias*, J. ECON. PERSP., Winter 1991, at 193-94, 197-203 (explaining that the endowment effect causes individuals to "demand much more to give up an object than they would be willing to pay to acquire it" and describing the different psychological effects of losses versus gains); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions* (describing loss aversion bias, wherein an individual's "response to losses is more extreme than the response to gains"), in RATIONAL CHOICE: THE CONTRAST BETWEEN ECONOMICS AND PSYCHOLOGY 64, 74-75 (Robin M. Hogarth & Melvin W. Reder eds., 1987).

<sup>25</sup> See *infra* subsection II.B.3.

<sup>26</sup> See Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1786-91 (2000) (arguing that an individual complies with the tax law to avoid sending a signal to others that he is a "bad type").

<sup>27</sup> See *infra* subsection II.B.4.

<sup>28</sup> I.R.C. § 6103(a) (2006).

<sup>29</sup> See *infra* subsection II.B.5.



they promote the perception that tax dollars fund critical government services and thus that tax compliance is a duty of citizenship.<sup>30</sup>

After considering the compliance benefits of collateral tax sanctions and potential drawbacks under the predominant theories of voluntary compliance, I propose guiding principles that governments should consider when designing collateral tax sanctions.<sup>31</sup> Specifically, I argue that collateral tax sanctions are most effective as a means of promoting tax compliance where (1) the tax offense results from a violation of a tax rule, not a tax standard; (2) the taxing authority, as opposed to another government agency, determines that a taxpayer has committed the tax offense; and (3) the collateral tax sanction is proportionate to the tax offense.

I then apply this proposed framework to determine whether a variety of specific tax offenses, including offenses *other* than nonpayment of taxes, should subject offenders to collateral tax sanctions. These examples suggest that initiatives to revoke professional licenses from individuals who have failed to file their tax returns would likely promote voluntary compliance.<sup>32</sup> However, whether the threat of deportation as punishment for tax offenses “involving fraud or deceit,” such as the collateral tax sanction at issue in *Kawashima*, will have positive effects on voluntary compliance is far less certain.<sup>33</sup> In addition, I consider the role that the taxing authority should play in publicizing collateral tax sanctions.<sup>34</sup>

The remainder of this Article proceeds as follows. Part I introduces the concept of collateral tax sanctions and illustrates their current application. Part II investigates why collateral tax sanctions can promote individual tax compliance more effectively than additional monetary tax penalties. Part III proposes principles that governments should consider when designing collateral tax sanctions and addresses publicity strategies that taxing authorities should adopt. Finally, the Conclusion argues that taxing authorities should embrace collateral tax sanctions as a means of tax enforcement.

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<sup>30</sup> See Richard M. Bird, *Tax Challenges Facing Developing Countries* 19-20 (Inst. for Int’l Bus., Working Paper No. 9, 2008), available at <http://ssrn.com/id=1114084> (discussing the importance of linking expenditure with revenue decisions); *Your 2012 Federal Tax Receipt*, WHITE HOUSE, <http://www.whitehouse.gov/2012tax-receipt> (last visited Feb. 21, 2014) (allowing taxpayers to see a detailed allocation of individual tax payments to government programs and services).

<sup>31</sup> See Section III.A.

<sup>32</sup> See *infra* Section III.B.

<sup>33</sup> See *infra* subsection III.B.3.

<sup>34</sup> See *infra* Section III.C.

## I. THE RISE OF COLLATERAL TAX SANCTIONS

If you ask most people what will happen to them if they fail to pay their taxes, they will probably respond with one or more of the following: audits, tax penalties, or maybe even prison. While these are familiar possibilities to much of the population,<sup>35</sup> a host of additional sanctions that are administered by agencies *other* than the taxing authority may also apply. Unlike traditional tax penalties that require noncompliant taxpayers to pay money to the taxing authority, collateral tax sanctions require noncompliant taxpayers to forfeit a nonmonetary government benefit or service. Both the federal and state governments are increasingly using non-tax agencies to deploy collateral tax sanctions to combat tax noncompliance. This Part briefly describes existing traditional monetary tax penalties and the tax law scholarship that addresses them. It then introduces the contrasting model of collateral tax sanctions and provides examples of their use at the federal and state levels. Finally, it outlines several important questions that collateral tax sanctions raise for both tax scholars and policymakers.

### A. Monetary Tax Penalties

Tax noncompliance is a major problem in the United States. A government's "tax gap" is the difference between the amount of taxes that taxpayers should pay and the amount that they actually pay voluntarily and on time.<sup>36</sup> At the federal level alone, the latest estimate of the United States' gross annual tax gap is approximately \$450 billion,<sup>37</sup> though many critics of the U.S. Treasury's method of estimating the tax gap have argued that it is likely far greater.<sup>38</sup> The majority of this amount (approximately \$376 billion) results from taxpayers failing to report their full tax liability on a timely filed return, otherwise referred to as "underreporting."<sup>39</sup> While underreporting is typically the primary focus of tax scholars and policymakers, taxpayers' failure to pay their established tax liability—otherwise referred to as "underpayment" or "tax delinquency"<sup>40</sup>—represents a substantial portion

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<sup>35</sup> For a discussion of popular perceptions of formal tax penalties, see Blank, *supra* note 23, at 299. See generally Lawrence Zelenak, *Six Decades of the Federal Income Tax in Sitcoms*, 117 TAX NOTES 1265 (2007).

<sup>36</sup> OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5-6 (2006).

<sup>37</sup> IRS, TAX GAP "MAP": TAX YEAR 2006 (2011), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_map\\_2006.pdf](http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf).

<sup>38</sup> See, e.g., Eric Toder, *What is the Tax Gap?*, 117 TAX NOTES 367 (2007) (describing weaknesses in the current tax gap methodology).

<sup>39</sup> IRS, *supra* note 37.

<sup>40</sup> *Id.*

(approximately \$46 billion) of the annual federal gross tax gap.<sup>41</sup> For these noncompliant taxpayers, there is no dispute that they owe a certain amount of tax liability; they just do not pay. Additionally, every year, hundreds of thousands of taxpayers, owing approximately \$28 billion in federal taxes in the aggregate, simply fail to file federal tax returns at all.<sup>42</sup>

Governments most commonly respond to the existence of tax noncompliance with tax penalties. Governments rely on tax penalties to promote voluntary compliance with the tax law by deterring noncompliant taxpayers and by bolstering confidence in compliant taxpayers that the government punishes tax abuse.<sup>43</sup> In most cases, governments turn to civil tax penalties, which require taxpayers to pay additional money to the taxing authority, as a way to prevent and reduce tax noncompliance. Governments also threaten to subject taxpayers to criminal tax penalties in the case of tax fraud, but they rarely impose extreme penalties such as the loss of liberty (i.e., prison) on noncompliant taxpayers.<sup>44</sup> At the federal level, the Internal Revenue Code (IRC) contains over one hundred separate civil monetary tax penalties,<sup>45</sup> and the IRS regularly applies many of these penalties. State tax systems often conform to the federal tax system and also impose a myriad of civil tax penalties on taxpayers in addition to the tax liability owed.<sup>46</sup> Generally, monetary tax penalties are either percentage tax penalties or flat tax penalties.

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> See, e.g., Mark E. Matthews, *New IRS Publicity Strategy*, U.S. ATT'YS' BULL., July 2001, at 15; see also Blank, *supra* note 23, at 293.

<sup>44</sup> The number of criminal prosecutions that the federal government pursues each year, for example, represents a miniscule percentage of tax returns filed and is dwarfed by the number of civil tax penalties that the IRS imposes. In 2009, the federal government authorized the prosecution of 1210 criminal tax cases. TAX DIV., U.S. DEP'T OF JUSTICE, FY 2011 CONGRESSIONAL BUDGET 25 (2010), available at <http://www.justice.gov/jmd/2011justification/pdf/fy11-tax-justification.pdf>. This number represents 0.00086% of the total individual tax returns filed in 2009. See IRS, ALL RETURNS: NUMBER OF RETURNS, BY AGE, MARITAL STATUS, AND SIZE OF ADJUSTED GROSS INCOME, available at <http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income> (see heading "Individual Tax Returns Filed and Sources of Income," then subheading "All Returns: Number of Returns," and click "2009") (last updated Aug. 12, 2013) (showing that 140,494,127 individual tax returns were filed in 2009).

<sup>45</sup> See generally I.R.C. §§ 6651–6702 (2006 & Supp. V 2012).

<sup>46</sup> See, e.g., STATE OF CAL. FRANCHISE TAX BD., PENALTY REFERENCE CHART (2012), available at <https://www.ftb.ca.gov/forms/misc/1024.pdf> (listing federal tax penalties and their corresponding California counterparts).

### 1. Percentage Tax Penalties

Monetary tax penalties that consist of a portion of the taxpayers' underpayment of tax liability can be described as "percentage tax penalties." Some of the most commonly known percentage tax penalties include delinquency penalties, whereby taxpayers who fail to pay their taxes on time owe an additional penalty equal to up to 25% of their tax liability;<sup>47</sup> accuracy penalties, whereby taxpayers who underpay their taxes through various acts, such as negligence, owe an additional tax penalty equal to 20% of their tax liability;<sup>48</sup> and civil fraud penalties, whereby taxpayers who intentionally underpay their taxes owe an additional penalty equal to 75% of their tax liability.<sup>49</sup> At the federal level, percentage tax penalties are the tax penalties that the IRS applies most frequently.<sup>50</sup>

### 2. Flat Tax Penalties

The alternative form of monetary tax penalties that appears regularly in the tax law are "flat tax penalties," which simply consist of a stated dollar amount that taxpayers must pay for every occurrence of a specified offense. For example, the federal tax law includes flat tax penalties such as \$50,000 for every instance of failing to file a return or submit required information relating to "reportable transactions";<sup>51</sup> \$1 per day for each day that a taxpayer fails to file a notification of change of status of a pension plan;<sup>52</sup> and \$500 for every instance of providing a false statement regarding tax withholdings.<sup>53</sup>

Under the classic rational actor model, taxpayers weigh the expected benefit of claiming a particular tax position (i.e., the tax savings discounted by the probability that the IRS will detect the position) against the expected cost of claiming the tax position (i.e., monetary tax penalties and interest discounted by the probability that the IRS will not detect the position).<sup>54</sup> Several tax scholars have argued that the current low rates of

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<sup>47</sup> I.R.C. § 6651(a)(1)-(2).

<sup>48</sup> I.R.C. § 6662.

<sup>49</sup> I.R.C. § 6663.

<sup>50</sup> In 2012, for example, there were over 17 million instances where the IRS assessed civil delinquency tax penalties on taxpayers who failed to pay their outstanding tax penalties in a timely manner, resulting in the collection of over \$5.6 billion in monetary tax penalties alone. See IRS, 2012 DATA BOOK 42 (2012), available at <http://www.irs.gov/pub/irs-soi/12datbk.pdf>.

<sup>51</sup> I.R.C. § 6707A.

<sup>52</sup> I.R.C. § 6652(d)(2).

<sup>53</sup> I.R.C. § 6682.

<sup>54</sup> See James Andreoni et al., *Tax Compliance*, 36 J. ECON. LITERATURE 818, 819 (1998) (noting that economists traditionally model tax cheating "as if it were adding one more risky asset to a household's portfolio").

detection—the audit rate for individual taxpayers hovers just over one percent—cause monetary tax penalties, by themselves, to be a weak deterrent against tax noncompliance for rational taxpayers.<sup>55</sup> Further, civil tax penalty rules often allow taxpayers to claim specified defenses, such as “reasonable cause” or reliance on “substantial authority,” that enable them to escape the imposition of these penalties.<sup>56</sup> Despite the low probability that the IRS will ultimately subject most noncompliant taxpayers to monetary tax penalties, Congress has rarely raised the nominal amount of these monetary tax penalties, except in cases of specific highly publicized threats.<sup>57</sup>

The limited ability of existing monetary tax penalties to deter tax non-compliance has led many tax scholars to propose a variety of alternative approaches. Alex Raskolnikov, for instance, has proposed a “self-adjusting tax penalty” whereby taxpayers who report an illegitimate deduction on the same line of the tax return as a legitimate deduction (which would often mask the illegitimate deduction) would be subject to a monetary tax penalty that is based not on the value of the illegitimate deduction, but rather on the value of the legitimate deduction.<sup>58</sup> Similarly, Kyle Logue has extrapolated from the classic Bentham–Becker fine a proposal for a strict-liability monetary tax penalty that would be equal to the taxpayer’s underpaid tax divided by the probability that the taxpayer’s noncompliance would be detected *ex ante*.<sup>59</sup> As an alternative to adjusting the magnitude of monetary tax penalties themselves, Eric Zolt has argued that Congress should subject its enactment of tax penalties to the same type of reporting procedures that apply to tax expenditures in order to justify the use of this instrument to shape taxpayer behavior.<sup>60</sup> Other tax scholars, such as Steven Johnson, have argued that the effectiveness of monetary tax penalties could be improved if

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<sup>55</sup> See, e.g., Doran, *supra* note 21, at 126–28; Logue, *supra* note 21, at 264–71; Raskolnikov, *supra* note 21, at 581.

<sup>56</sup> Treas. Reg. § 1.6662-4(d) (2011); Treas. Reg. § 1.6664-4 (2011).

<sup>57</sup> See generally 1 STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, at 37 (Comm. Print 1999).

<sup>58</sup> Raskolnikov, *supra* note 21, at 601.

<sup>59</sup> Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 351–52 (2005). Logue’s work builds on the Bentham–Becker fine. See generally JEREMY BENTHAM, THE THEORY OF LEGISLATION 325 (C.K. Ogden ed., Richard Hildreth trans., Harcourt, Brace & Co. 1931) (1802); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

<sup>60</sup> Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

courts revisit their approach to statutory interpretation of those penalties.<sup>61</sup> And many other tax scholars have offered a variety of approaches to reform monetary tax penalties.<sup>62</sup> While these alternative proposals have enriched and advanced the tax compliance scholarship, federal and state governments have not adopted them when designing monetary tax penalties.<sup>63</sup>

### B. Collateral Tax Sanctions

Tax scholars who have analyzed tax penalties have focused their attention almost exclusively on the role of monetary tax penalties in promoting voluntary compliance. However, noncompliant taxpayers also face a growing number of penalties that cause them to forfeit something *other* than money when they engage in certain acts of tax noncompliance. These nonmonetary sanctions apply to individuals who commit tax offenses, yet they are applied by non-tax agencies at both the federal and state levels. Because these nonmonetary sanctions apply *in addition to* the monetary tax penalties that taxpayers face when they commit tax offenses, the nonmonetary sanctions resemble the collateral consequences that convicted individuals face in addition to their criminal sentences. Drawing on this concept, I describe these nonmonetary sanctions as “collateral tax sanctions.” This Section offers a brief description of collateral consequences in the criminal context, provides a formal definition of collateral tax sanctions, and offers several examples of collateral tax sanctions that have been proposed or applied by federal and state non-tax agencies.

#### 1. Collateral Consequences in the Criminal Context

Criminal lawyers describe collateral consequences as the indirect penalties, restrictions, and legal “disabilities” that an individual faces after being

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<sup>61</sup> Steve R. Johnson, *The Canon that Tax Penalties Should Be Strictly Construed*, 3 NEV. L.J. 495 (2003).

<sup>62</sup> See, e.g., Michael Asimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 UCLA L. REV. 637 (1975) (arguing for the adoption of the Administrative Conference of the United States' proposals in Recommendation 75-7); William A. Drennan, *Strict Liability and Tax Penalties*, 62 OKLA. L. REV. 1 (2009) (proposing a strict-liability penalty system); Mark P. Gergen, *Uncertainty and Tax Enforcement: A Case for Moderate Fault-Based Penalties*, 64 TAX L. REV. 453 (2010) (proposing a fault-based penalty); Jay Soled, *Third-Party Civil Tax Penalties and Professional Standards*, 2004 WIS. L. REV. 1611 (proposing that the civil tax penalty structure for third parties be reformed to mirror the three-tier civil tax penalty structure that applies to all taxpayers).

<sup>63</sup> See Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523, 573-80 (discussing “[t]he disconnect between the optimal tax theory and the actual tax system”).

formally sanctioned for committing a criminal offense.<sup>64</sup> Regardless of the specific type, collateral consequences apply on top of the formal sanction that an offender receives after being convicted.

The most common examples of collateral consequences stem from criminal convictions.<sup>65</sup> The federal government alone revokes dozens of benefits and opportunities from individuals who are convicted of certain felony and misdemeanor offenses.<sup>66</sup> For example, when an individual is convicted of a felony drug offense, he may receive a prison sentence (a formal sanction), but upon release from prison, he may also be denied admission to public housing (a collateral consequence).<sup>67</sup> And as a result of federal rules and regulations, he may also, for varying periods of time, forfeit the ability to serve on a federal grand or petit jury,<sup>68</sup> hold a passport,<sup>69</sup> enlist in any branch of the military,<sup>70</sup> receive a commercial motor vehicle license,<sup>71</sup> serve in certain leadership roles in a labor organization,<sup>72</sup> work as a federal law enforcement officer,<sup>73</sup> register as a commodities dealer,<sup>74</sup> work for a hospice without undergoing a criminal background check,<sup>75</sup> serve as a foster or adoptive parent,<sup>76</sup> qualify for certain federal higher education grants or loans,<sup>77</sup> receive federal benefits,<sup>78</sup> and obtain or sell firearms,<sup>79</sup> among many other consequences.<sup>80</sup> State agencies may also impose their own additional restrictions upon an individual convicted of a federal drug offense, such as by suspending his driver's license.<sup>81</sup>

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<sup>64</sup> U.S. DEP'T OF JUSTICE, FEDERAL STATUTES IMPOSING COLLATERAL CONSEQUENCES UPON CONVICTION (2000), available at [http://www.justice.gov/pardon/collateral\\_consequences.pdf](http://www.justice.gov/pardon/collateral_consequences.pdf).

<sup>65</sup> See *id.* at 1-12 (discussing the collateral consequences of convictions of federal crimes).

<sup>66</sup> *Id.*

<sup>67</sup> 42 U.S.C. § 13661(a) (2006).

<sup>68</sup> 28 U.S.C. § 1865(b)(5) (2006).

<sup>69</sup> 22 U.S.C. § 2714 (2012).

<sup>70</sup> 10 U.S.C. § 504(a) (2012).

<sup>71</sup> 49 U.S.C. § 31310 (2006).

<sup>72</sup> 29 U.S.C. § 504(a) (2006).

<sup>73</sup> 5 U.S.C. § 7371 (2012).

<sup>74</sup> 46 U.S.C. § 7503(b)(1) (2006).

<sup>75</sup> 42 C.F.R. § 418.114(d)(1) (2013).

<sup>76</sup> 42 U.S.C. § 671(a)(20)(A)(ii) (2006 & Supp. V 2012).

<sup>77</sup> 20 U.S.C. § 1091(r) (2012).

<sup>78</sup> 21 U.S.C. § 862 (2012).

<sup>79</sup> 18 U.S.C. § 922(g)(1) (2012).

<sup>80</sup> For a comprehensive list of collateral consequences, see AM. BAR ASS'N COMM'N ON EFFECTIVE CRIMINAL SANCTIONS & THE PUBLIC DEFENDER SERV. FOR D.C., INTERNAL EXILE: COLLATERAL CONSEQUENCES OF CONVICTIONS IN FEDERAL LAWS AND REGULATIONS (2009), available at <http://www.pdsdc.org/Resources/Publication/Collateral%20Consequences%20of%20Conviction%20in%20Federal%20Laws%20and%20Regulations.pdf>.

<sup>81</sup> See, e.g., N.Y. VEH. & TRAF. LAW § 510(2)(b)(v) (McKinney 2011 & Supp. 2013) (instituting a six-month suspension on licenses of drivers convicted of a drug-related offense).

Many commentators have argued that the proliferation of collateral consequences to felonies and misdemeanors should be reconsidered.<sup>82</sup> The consensus is that the accumulation of collateral consequences that apply under current federal and state law is detrimental to convicted individuals, their families, and the rest of society.<sup>83</sup> Government officials, advocacy groups, and scholars have proposed a range of reforms to the criminal justice system that endeavor to reduce the adverse effects of collateral consequences of criminal convictions.<sup>84</sup>

## 2. Collateral Tax Sanctions Defined

The discussion of collateral consequences has centered entirely on the extrajudicial effects of convictions for felony criminal offenses such as drug possession and distribution, illegal weapons possession, robbery, rape,

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<sup>82</sup> See *supra* note 10.

<sup>83</sup> The primary objections of those who oppose the current state of collateral consequences can be grouped into two overarching categories. The first principle objection is that these consequences present an unjustifiable obstacle for convicted individuals seeking reentry into the community following their convictions. Critics argue that, by preventing certain convicted individuals from residing in public housing or participating in civic engagement (such as voting or serving on juries), collateral consequences alienate those individuals from others. See, e.g., Deborah N. Archer & Kele S. Williams, *Making America "The Land of Second Chances": Restoring Socioeconomic Rights for Ex-Offenders*, 30 N.Y.U. REV. L. & SOC. CHANGE 527, 544-45 (2006) (illustrating the cumulative burdens of collateral consequences that prevent ex-offenders from obtaining an education, earning a living, or finding a stable home); Anthony C. Thompson, *Navigating the Hidden Obstacles to Ex-Offender Reentry*, 45 B.C. L. REV. 255, 273 (2004) ("These social exclusions . . . quite effectively relegate ex-offenders to the margins of legitimate society, stigmatizing them and further highlighting their separation from law-abiding members of society.")

The second principle objection is that defendants lack adequate notice of collateral consequences when entering into plea agreements with prosecutors. Many commentators have noted that discussion of the potential collateral consequences rarely occurs among defendants, their lawyers, and prosecutors before defendants enter a guilty plea. See, e.g., Pinard & Thompson, *supra* note 10, at 590-93 ("Currently, court rules do not require that either a trial judge or defense attorney explain the collateral consequences of a guilty plea to the defendant."); Priscilla Budeiri, Comment, *Collateral Consequences of Guilty Pleas in the Federal Criminal Justice System*, 16 HARV. C.R.-C.L. L. REV. 157, 190-91 (1981) (explaining that Rule 11 of the Federal Rules of Criminal Procedure has been read to not require that a defendant be informed of the collateral consequences of pleading guilty).

<sup>84</sup> For example, during his 2004 State of the Union address, President George W. Bush proposed, and Congress subsequently enacted, the allocation of \$300 million in federal grants to organizations that provide employment assistance, substance abuse treatment, or housing to individuals upon their release from incarceration. President George W. Bush, State of the Union Address Before a Joint Session of the Congress (Jan. 20, 2004), in H. DOC. NO. 108-44, at 9 (Jan. 23, 2005). On April 9, 2008, President George W. Bush signed the Second Chance Act of 2007, which authorized grants to government agencies and nonprofit groups to provide reentry assistance to convicted individuals. Pub. L. 110-199, 122 Stat. 657 (2008) (codified as amended at 42 U.S.C. § 17501 (Supp. V 2012)).



assault, and other violent crimes. Yet, collateral consequences occur in other legal settings, including tax noncompliance. The imposition of collateral sanctions for tax noncompliance has begun to grow in recent years under federal, state, and local law.

Collateral tax sanctions are additional penalties that occur outside of the tax system. For example, imagine that if you failed to pay your taxes on time, your local board of elections would prohibit you from voting in any federal, state, or local election.<sup>85</sup> In this hypothetical, when you eventually pay your tax liability, you will likely owe a formal tax penalty in the form of a delinquency tax penalty. But, in addition to this formal tax penalty, you will also face a collateral tax sanction because you will forfeit your right to vote.

Collateral tax sanctions, as I define them, possess three primary characteristics: (1) they rescind or deny a government benefit or privilege from a noncompliant taxpayer rather than require the noncompliant taxpayer to pay money to the government; (2) they are enforced by an agency other than the taxing authority; and (3) they apply in addition to the formal tax penalty, typically a monetary tax penalty, that a taxpayer incurs as a result of his tax offense. These characteristics mirror the features of nearly all of the non-tax collateral consequences described above, such as restrictions on the right of certain convicted individuals to serve on juries or qualify for public housing. Applying this definition to the voting example, the revocation of the right to vote as a result of an outstanding state tax bill is a collateral tax sanction because it (1) revokes a government benefit, the right to vote, rather than imposing a monetary penalty; (2) applies in addition to the tax delinquency penalty, a formal tax penalty; and (3) results from an action by the board of elections, a government agency other than the taxing authority.

Collateral tax sanctions are akin to tax expenditures, except that they operate in reverse. Tax expenditures refer to tax credits, deductions, exemptions, and other mechanisms that the taxing authority administers in order to achieve a non-tax-revenue-related, public policy objective.<sup>86</sup> As one example out of many,<sup>87</sup> the federal government encourages individuals to

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<sup>85</sup> The deprivation of voting rights may raise constitutional concerns. *See Hill v. Stone*, 421 U.S. 289, 300 (1975) (striking down a restriction of the franchise to only those who had submitted their property for taxation); *Cipriano v. City of Houma*, 395 U.S. 701, 702 (1969) (striking down a requirement that voters in a general bond election be “property taxpayers”).

<sup>86</sup> *See* STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 3 (1985) (“[Tax incentives or subsidies] represent government spending for favored activities or groups, effected through the tax system rather than direct grants, loans, or other forms of government assistance.”).

<sup>87</sup> *See* U.S. GOV’T ACCOUNTABILITY OFFICE, *GAO-05-690, GOVERNMENT PERFORMANCE AND ACCOUNTABILITY: TAX EXPENDITURES REPRESENT A SUBSTANTIAL*

support charities by allowing tax-deductible contributions to a number of qualifying charitable organizations.<sup>88</sup> The IRS must monitor these deductions to ensure that they comply with the relevant statutory provisions. Collateral tax sanctions, by contrast, require agencies *other* than the taxing authority, such as the board of elections in the example above, to participate in tax enforcement by rescinding or denying a government benefit as a result of an individual's tax noncompliance.

### 3. Examples

With this definition in hand, it is possible to identify collateral tax sanctions. Below are several illustrations of collateral tax sanctions that have been proposed or enacted by the federal government and by state and local governments.

#### a. *Federal Examples*

##### i. Passports

Each year, the U.S. Department of State issues hundreds of thousands of passports to U.S. citizens who, collectively, owe the federal government billions of dollars in unpaid taxes.<sup>89</sup> In 2012, the U.S. Senate passed a measure designed to encourage tax-delinquent individuals to pay their outstanding tax bills.<sup>90</sup> Under the legislation, the State Department would be required to deny a request for a new passport or renewal of an existing passport from any individual owing more than \$50,000 in "seriously delinquent" tax debt—tax debt for which the IRS has filed a notice of federal tax lien.<sup>91</sup> Additionally, the State Department would be authorized to revoke the outstanding passport of any individual owing this amount of tax who attempts to reenter the United States.<sup>92</sup>

The announcement of the passport denial proposal generated heated public debate. Opponents argued that denying passports to tax-delinquent individuals would violate due process rights by restricting an individual's

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COMMITMENT AND NEED TO BE REEXAMINED 4 (2005) ("Between 1974 and 2004, tax expenditures doubled in number from 67 to 146 . . .").

<sup>88</sup> I.R.C. § 170(a)(1) (2006).

<sup>89</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-272, FEDERAL TAX COLLECTION: POTENTIAL FOR USING PASSPORT ISSUANCE TO INCREASE COLLECTION OF UNPAID TAXES 4 (2011) (noting that, as of September 2008, the State Department had issued passports to 224,000 individuals who collectively owed \$5.8 billion in unpaid taxes).

<sup>90</sup> Moving Ahead for Progress in the 21st Century Act, S. 1813, 112th Cong., § 40304 (2012).

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

ability to travel based on a nonjudicial determination of tax liability.<sup>93</sup> Sponsors of the legislation estimated that, if enacted, the proposal would raise over \$740 million in tax revenue over a ten-year period.<sup>94</sup> While the passport denial provision was passed by the U.S. Senate in 2012, it has not been adopted by the U.S. House of Representatives.<sup>95</sup>

## ii. Residency

In *Kawashima v. Holder*, the U.S. Supreme Court addressed another collateral tax sanction with significant implications for lawful permanent residents in the United States who may have engaged in certain abusive tax activities. Two lawful permanent residents, Akio and Fusako Kawashima, failed to pay nearly \$250,000 in taxes attributable to their Japanese restaurants.<sup>96</sup> In 1997, Mr. Kawashima pleaded guilty to willfully filing a false tax return, a felony under section 7206(1) of the IRC.<sup>97</sup> Mrs. Kawashima pleaded guilty to aiding and assisting the preparation of a false tax return under section 7206(2) of the IRC.<sup>98</sup> In addition to civil tax penalties, the Kawashimas each received a four-month prison sentence.<sup>99</sup> Mr. Kawashima additionally received one year of supervised release.<sup>100</sup>

In August 2000, three years after entering their guilty pleas and serving their prison sentences, federal immigration officials determined that the Kawashimas should be deported back to Japan as a result of committing an “aggravated felony” under the Immigration and Nationality Act.<sup>101</sup> Specifically, the statute provides that an aggravated felony includes an offense that “(i) involves fraud or deceit in which the loss to the victim or victims exceeds \$10,000; or (ii) is described in section 7201 of title 26 (relating to tax evasion) in which the revenue loss to the Government exceeds \$10,000.”<sup>102</sup>

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<sup>93</sup> See, e.g., Robert W. Wood, *Forget Travel If You Owe the IRS*, FORBES (Apr. 7, 2012), <http://www.forbes.com/sites/robertwood/2012/04/07/forget-travel-if-you-owe-the-irs> (noting that the “idea seems pretty extreme” and has been attacked as “potentially unconstitutional”).

<sup>94</sup> Press Release, U.S. Senate Comm. on Fin., Baucus Unveils Chairman’s Mark to Fund Highway Bill, Create Infrastructure Jobs (Feb. 3, 2012), <http://www.finance.senate.gov/newsroom/chairman/release/?id=4f035bct-14e2-4bea-8dob-7e578fa5bfbf>.

<sup>95</sup> The measure was reintroduced in the U.S. Senate on July 30, 2012, but as of the date of publication of this Article, has not been enacted. See Veterans Jobs Corps Act of 2012, S. 3457, 112th Cong. (2012) (proposing grant of power to the Secretary of State for “action with respect to denial, revocation, or limitation of passports”).

<sup>96</sup> Brief for Respondent at 5, *Kawashima*, 132 S. Ct. 1166 (No. 10-577).

<sup>97</sup> *Id.* at 5-6.

<sup>98</sup> *Id.* at 6.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 7-8.

<sup>102</sup> 8 U.S.C. § 1101(a)(43)(M)(i)-(ii) (2012).

While the Kawashimas did not plead guilty to tax evasion under section 7201 of the IRC,<sup>103</sup> the immigration authorities held that they had committed an act involving fraud or deceit which imposed a loss of more than \$10,000 on a “victim”—the federal government itself—because they willfully filed false tax returns.<sup>104</sup>

The U.S. Supreme Court upheld the Kawashimas’ deportation in a 6–3 decision in 2012, holding that the willful filing of a false tax return necessarily involves “fraud or deceit” under the aggravated felony statute.<sup>105</sup> Whether the federal immigration authorities will expand the use of the collateral tax sanction of deportation following this decision remains to be seen.

### iii. Housing Assistance

Since the Great Depression, low-income individuals have received access to funds to purchase a home by obtaining a mortgage that is insured by the Federal Housing Administration (FHA).<sup>106</sup> Unlike conventional mortgages, an FHA-insured loan is a low-payment obligation that requires a very low down payment from the borrower.<sup>107</sup> This federal program has offered housing assistance to millions of Americans. Under current law, however, if an individual is delinquent in paying any federal taxes or has been subject to a tax lien by the federal government, the individual may not participate in the FHA loan program until entering into a written repayment plan with the IRS.<sup>108</sup> Denial of this federal benefit applies in addition to any formal tax penalties and is applied by the U.S. Department of Housing and Urban Development. The proliferation of third-party advisors who specialize in helping FHA loan applicants enter into tax repayment programs and petition to have tax liens removed indicates the effectiveness of this collateral tax sanction.<sup>109</sup>

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<sup>103</sup> Brief for Petitioners, *supra* note 2, at 4.

<sup>104</sup> *Id.* at 4–5.

<sup>105</sup> *Kawashima v. Holder*, 132 S. Ct. 1166, 1173 (2012).

<sup>106</sup> *Let FHA Loans Help You*, U.S. DEP’T OF HOUS. & URBAN DEV., <http://portal.hud.gov/hudportal/HUD?src=/buying/loans> (last visited Feb. 21, 2014).

<sup>107</sup> *Id.*

<sup>108</sup> See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-592, TAX DEBTORS HAVE RECEIVED FHA MORTGAGE INSURANCE AND FIRST-TIME HOMEBUYER CREDITS 11-12 (2012), available at <http://www.gao.gov/assets/600/591174.pdf>. Following the publication of this report, the Department of Housing and Urban Development committed to develop a policy with the IRS to ensure that it would properly identify tax delinquents. *Id.* at 27.

<sup>109</sup> See, e.g., Dan Green, *FHA Mortgages: Common Questions from Borrowers with Bad Credit*, MORTGAGE REPORTS (June 9, 2013), <http://themortgagereports.com/11633/fha-mortgages-qa-for-borrowers-with-derogatory-credit>; *Frequently Asked Questions About the FHA Loan Program*,

#### iv. Government Contracts and Employment

Individuals and businesses that desire to enter into valuable contracts with the federal government may be prevented from doing so if they have failed to comply with certain tax rules. In 2011, the Government Accountability Office revealed that 3700 federal contractors who received economic stimulus funds during the Obama Administration collectively owed nearly \$760 million in outstanding federal tax liabilities.<sup>110</sup> In response, Congress enacted legislation that bars the award of a government contract worth more than \$5 million unless the service provider can certify that it has filed all federal tax returns during the prior three years, has not been convicted of a tax crime, and does not owe any outstanding federal tax debt.<sup>111</sup>

In addition, in 2012, the U.S. House of Representatives passed legislation that would deny federal employment to tax-delinquent individuals. Under the legislation, all federal agencies would be required to deny employment to any individual with a “serious” federal tax delinquency and to terminate any existing federal employee who is “seriously” tax delinquent.<sup>112</sup> The legislation defines tax delinquency as serious whenever the IRS has filed a Notice of Federal Tax Lien with respect to the tax debt, regardless of the amount of the obligation.<sup>113</sup> As the sponsor of this legislation has explained, “Employees who consciously ignore the channels and processes in place to fulfill their tax obligations must be held accountable.”<sup>114</sup> This provision was not passed by Congress, but despite the failure to enact, third-party attorneys have already offered advice to federal employees

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LIFESTYLE MORTGAGE.COM, <http://www.lifestyle-mortgage.com/fha/faq.shtml> (last visited Feb. 21, 2014) (providing advice to those with federal tax liens).

<sup>110</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-485, THOUSANDS OF RECOVERY ACT CONTRACT AND GRANT RECIPIENTS OWE HUNDREDS OF MILLIONS IN FEDERAL TAXES 7 (2011), available at <http://www.gao.gov/assets/320/317844.pdf>.

<sup>111</sup> Consolidated and Further Continuing Appropriations Act of 2012, § 527, Pub. L. No. 112-55, 125 Stat 636 (2011).

<sup>112</sup> The Federal Employee Tax Accountability Act of 2011, H.R. 828, 112th Cong., § 2(a) (2012).

<sup>113</sup> *Id.*

<sup>114</sup> Press Release, Chaffetz Sponsored Federal Employee Tax Accountability Act Passes House (July 31, 2012), <http://chaffetz.house.gov/press-release/chaffetz-sponsored-federal-employee-tax-accountability-act-passes-house> (quoting Congressman Jason Chaffetz (R-Utah)); see also Richard Simon, *House Votes to Fire Tax-Delinquent Federal Workers*, L.A. TIMES (Aug. 1, 2012), <http://articles.latimes.com/2012/aug/01/nation/la-na-pn-house-vote-tax-delinquents-20120731> (noting the views of both proponents and opponents).

regarding ways in which they could enter into repayment programs and offers-in-compromise to avoid the collateral tax sanction of job termination.<sup>115</sup>

b. *State and Local Examples*

i. Driver's Licenses and Vehicle Registration

Several states have created policies that revoke one of the most significant state benefits—the license to drive. In 2011, California enacted legislation that requires the Franchise Tax Board to make available a list of the five hundred taxpayers who owe the most in income taxes and the five hundred taxpayers who owe the most in sales and use taxes.<sup>116</sup> The Department of Motor Vehicles can suspend the licenses of those appearing on that list; the license suspension remains in effect until the taxpayer has made arrangements to satisfy the outstanding tax liability.<sup>117</sup> Other states that also revoke tax-delinquent residents' driver's licenses and/or vehicle registration include New York,<sup>118</sup> Massachusetts,<sup>119</sup> Maryland<sup>120</sup> and South Carolina.<sup>121</sup> The collateral tax sanction of revoking driver's licenses from tax-delinquent individuals has flourished because states have found that it is effective. For example, when New York Governor Andrew Cuomo announced in 2013 that New York would adopt the measure, his office estimated that it would raise over \$26 million in tax collections in a single year.<sup>122</sup>

Similarly, several states deny vehicle-registration renewal to individuals who are delinquent in paying a variety of state and local taxes.<sup>123</sup> For

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<sup>115</sup> See, e.g., Eileen Ambrose, *Lawmakers Aim Crackdown on Federally Employed Tax Scofflaws*, BALT. SUN (Sept. 14, 2012), [http://articles.baltimoresun.com/2012-09-14/news/bs-md-federal-tax-scofflaws-20120912\\_1\\_tax-scofflaws-tax-gap-federal-taxes](http://articles.baltimoresun.com/2012-09-14/news/bs-md-federal-tax-scofflaws-20120912_1_tax-scofflaws-tax-gap-federal-taxes).

<sup>116</sup> CAL. REV. & TAX §§ 7063, 19195 (2012).

<sup>117</sup> CAL. VEH. CODE § 34623.1 (2012); see also Nannette Miranda, *Perea Targets Delinquent Taxpayers' Licenses to Drive*, ABC LOCAL KSFN (June 8, 2011), <http://abclocal.go.com/kfsn/story?section=news/state&id=8179463> (reporting on the implementation of California's collateral enforcement policy).

<sup>118</sup> N.Y. VEH. & TRAF. LAW §§ 510(4-a), 511(7) (2001).

<sup>119</sup> MASS. GEN. LAWS ch. 60A, § 2A (2012).

<sup>120</sup> MD. CODE ANN. TRANSP. § 13-406 (LexisNexis 2012) (preventing vehicle registration if not all fees are paid).

<sup>121</sup> S.C. CODE ANN. § 12-37-2740 (West, Westlaw 2013 through 2013 Reg. Sess.) (suspending the driver's license of an individual who fails to pay the personal property tax on their vehicle).

<sup>122</sup> Press Release, Office of the Governor of N.Y., Governor Cuomo Announces Initiative to Suspend Driver Licenses of Tax Delinquents Who Owe More than \$10,000 in Back Taxes (Aug. 5, 2013), <http://www.governor.ny.gov/press/08052013Tax-Delinquents>.

<sup>123</sup> See, e.g., CONN. GEN. STAT., § 14-33 (West 2006); R.I. GEN. LAWS § 31-3-6 (2006); S.C. CODE ANN. § 12-37-2740 (suspending the vehicle registration of an individual who fails to pay the personal property tax on their vehicle).

example, many municipalities in Rhode Island impose an annual “car tax” based on the value of automobiles owned by residents.<sup>124</sup> If an individual is delinquent in paying the car tax on any of his cars, the Rhode Island Department of Motor Vehicles blocks the renewal of vehicle registration for *all* cars that he owns.<sup>125</sup> Not only does the individual owe the original car tax and formal delinquency tax penalties, but the individual may also lose the use of the car that was subject to the tax and any other cars that he owns as well.<sup>126</sup>

## ii. Professional Licenses

Many states condition the grants of various professional licenses held by individuals and businesses on compliance with state and even federal tax laws. Like all collateral tax sanctions, they revoke a government benefit—the license to engage in a particular profession—in addition to formal tax penalties that may result from tax noncompliance. Physicians and lawyers are often subject to such scrutiny by licensing boards.

When considering whether to grant or renew medical licenses, state medical licensing boards often consider tax compliance as a factor relevant to the question of whether a physician possesses sufficient moral character to uphold professional standards. In Minnesota, for instance, if the state taxing authority informs the medical licensing board that a physician is delinquent in paying taxes, civil tax penalties, or interest, or has simply failed to file tax returns at all, the medical licensing board may deny or suspend the physician’s license.<sup>127</sup>

In the same vein, many state bars might consider certain instances of tax noncompliance to be acts of “moral turpitude” that may justify denial or

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<sup>124</sup> R.I. GEN. LAWS § 31-3-6 (2006).

<sup>125</sup> *Id.*

<sup>126</sup> In 2010, Rhode Island reduced the exemption for the car tax, causing thousands of Rhode Island residents to receive notices from the Department of Motor Vehicles threatening the denial of vehicle registration for all of their cars. See Ted Nesi, *Nearly Half of RI Communities Eliminate Car Tax Exemption*, WPRI.COM (Aug. 16, 2011), <http://blogs.wpri.com/2011/08/16/nearly-half-of-ri-communities-eliminate-car-tax-exemption> (discussing how Rhode Island reduced the exemption for the car tax, prompting the Department of Motor Vehicles to issue notices threatening to deny vehicle registration to thousands of Rhode Island residents, for all of their cars).

<sup>127</sup> See MINN. STAT. § 270C.72 (2012) (mandating the revocation of an individual’s medical license if he owes taxes, penalties, or interest and the taxing authority notifies the medical licensing board); MO. REV. STAT. § 324.010 (2012) (same); VT. STAT. ANN. tit. 32, § 3113(f) (West, Westlaw through 2013–2014 General Assemb. First Sess.) (same). For further discussion, see Arthur H. Coleman, *Suspension of Medical License for Tax Evasion*, 55 J. NAT’L MED. ASS’N 255 (1963).

suspension of a license to practice law.<sup>128</sup> For example, in 2011, a prominent New York attorney pleaded guilty to two counts of failing to file U.S. income tax returns for 2004 and 2006 and two counts of willfully failing to pay income taxes in 2005 and 2007.<sup>129</sup> He paid formal tax penalties and was sentenced to twenty-eight months' incarceration, followed by one year of supervised release.<sup>130</sup> In addition to incurring these formal tax penalties, the disciplinary committee of the New York Bar suspended the attorney's law license, even though his willful failure to file tax returns was a misdemeanor offense and involved federal, not state, tax returns.<sup>131</sup>

### iii. Liquor Licenses

When restaurant owners fail to pay established tax liability, the state agency responsible for issuing liquor licenses may suspend the restaurant's license to serve alcoholic beverages to customers.<sup>132</sup> The responsible agency often publicly posts a notice of suspension or revocation of a restaurant's liquor license at the entrance of the restaurant.<sup>133</sup> As a result of this sanction, not only will the restaurant owner face formal tax penalties for his failure to pay outstanding tax liabilities, but, without a liquor license, the restaurant may also lose significant business income.<sup>134</sup>

### iv. Recreational Licenses

Several states and municipalities suspend recreational and entertainment licenses—such as hunting and fishing licenses—of individuals who are delinquent in paying state and local taxes.

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<sup>128</sup> See, e.g., RULES OF PROC. OF THE STATE BAR OF CAL., tit. IV, std. 1.4(c)(ii) (revoking law license for acts of moral turpitude, including failure to pay taxes).

<sup>129</sup> *Matter of O'Brien*, 946 N.Y.S.2d 174 (App. Div. 2012).

<sup>130</sup> *Id.* at 2.

<sup>131</sup> *Id.* at 3.

<sup>132</sup> See, e.g., MINN. STAT. § 270C.725 (2012) (describing how all businesses with licenses to sell liquor, beer, or wine must be placed on a tax delinquency list if they owe state taxes).

<sup>133</sup> See, e.g., Angela Swartz, *Cafe Is Left Dry Following Liquor License Suspension*, CAL. AGGIE (Nov. 14, 2011), <http://www.theaggie.org/2011/11/14/cafe-is-left-dry-following-liquor-license-suspension> (discussing how the California Department of Alcohol Beverage Control posted a "Notice of Suspension" sign in the window of 3rd & U Cafe, located near the University of California-Davis campus, because the restaurant owners owed outstanding tax liability).

<sup>134</sup> As one disappointed student commented in response to the closing of the 3rd & U Cafe, "For me it sucks . . . . Alcohol is a huge part of their business." *Id.*



Whether the target is deer, bass, or even alligators,<sup>135</sup> recreational hunting and fishing in Louisiana—the “Sportsman’s Paradise”<sup>136</sup>—is often described as a “way of life.”<sup>137</sup> Since 2004, however, if a Louisiana resident owes over \$500 in state taxes, the Louisiana Department of Wildlife and Fisheries will suspend all hunting and fishing licenses held by that individual and will deny requests for renewal until the individual has satisfied the outstanding tax liability.<sup>138</sup> Despite initial controversy over the measure, Louisiana state officials have reported that this license suspension program has significantly enhanced its ability to settle outstanding tax debts.<sup>139</sup>

Finally, some state and local governments have barred tax noncompliant individuals from participating in entertainment activities. In Minnesota, the annual state fair boasts attendance rates that are among the highest of such events in the United States.<sup>140</sup> In keeping with its description as the “Great Minnesota Get-Together,”<sup>141</sup> the fair includes carnival rides and live music<sup>142</sup> in addition to educational booths, such as one offering attendees the opportunity to “milk” a fiberglass cow<sup>143</sup> or witness a live animal birth.<sup>144</sup> While the state fair is an annual community ritual, if an individual owes

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<sup>135</sup> See LA. DEP’T OF WILDLIFE & FISHERIES, ALLIGATOR HUNTING LICENSE APPLICATION FORM, available at <http://www.wlf.louisiana.gov/wildlife/alligator-hunting> (follow “Hunter Application” link).

<sup>136</sup> This slogan appears on Louisiana license plates. See, e.g., LA. REV. STAT. ANN. § 47:463A(3)(c) (West, Westlaw through 2013 Reg. Sess.) (directing the Secretary of the Department of Public Safety and Corrections to issue to all pick-up trucks license plates containing the slogan).

<sup>137</sup> James A. Robichaux, *Gator Hunting Is Way of Life for Some*, STMARYNOW (Sept. 7, 2012), <http://www.banner-tribune.com/gator-hunting-way-life-some> (discussing the cultural prominence of alligator hunting).

<sup>138</sup> LA. REV. STAT. ANN. § 47:296.3 (West, Westlaw through 2013 Reg. Sess.).

<sup>139</sup> See *Suspension, Revocation, Denial of Licenses Now in Effect*, TAX TOPICS, Apr. 2004, at 1 (describing the initial results of the hunting license revocation program).

<sup>140</sup> See *State Fair—Goers Get on the Stick, Nearly Set Attendance Record in 2012*, STARTRIBUNE (Sept. 4, 2012), <http://www.startribune.com/local/168479726.html> (noting that the twelve-day fair drew 1.78 million individuals in 2012).

<sup>141</sup> *The Great Minnesota Get-Together (Minnesota State Fair)*, LIBR. CONGRESS, <http://lcweb2.loc.gov/diglib/legacies/MN/200003190.html> (last visited Feb. 21, 2014).

<sup>142</sup> *2012 Adventure Park, Attractions & More*, MINN. ST. FAIR, [http://www.mnstatefair.org/entertainment/adventure\\_park.html](http://www.mnstatefair.org/entertainment/adventure_park.html) (last visited Feb. 21, 2014).

<sup>143</sup> *Little Farm Hands*, MINN. ST. FAIR, [http://www.mnstatefair.org/entertainment/ag\\_exhibits/lfh.html](http://www.mnstatefair.org/entertainment/ag_exhibits/lfh.html) (last visited Feb. 21, 2014).

<sup>144</sup> See *2013 CHS Miracle of Birth Center*, MINN. ST. FAIR, [http://www.mnstatefair.org/entertainment/ag\\_exhibits/chs\\_mob.html](http://www.mnstatefair.org/entertainment/ag_exhibits/chs_mob.html) (last visited Feb. 21, 2014) (describing the exhibit as the “birthplace of nearly 200 calves, lambs, goats and piglets during the 12 days of the Minnesota State Fair”).

more than \$500 in Minnesota state taxes or has not filed state tax returns, he will not be permitted to operate a concession, ride, or booth at the fair.<sup>145</sup>

### C. *Unanswered Questions*

As this discussion reveals, both the federal and state governments have started to apply collateral tax sanctions by suspending numerous government benefits and services from taxpayers who have failed to follow the tax law, especially in the aftermath of the recent economic downturn. Yet, even if we accept that the collateral tax sanctions described above have resulted, or are expected to result, in more effective tax collection than the use of traditional monetary tax penalties alone, this new form of tax penalty raises several unanswered questions.

First, why do collateral tax sanctions encourage noncompliant taxpayers, particularly those who are delinquent in paying outstanding tax liability, to comply where using monetary tax penalties failed? While the media has shined some light on the use of collateral tax sanctions, no scholar has analyzed the reasons why these sanctions are effective, either by considering their behavioral effects or performing original experimental research. Scholars of tax compliance, who have devoted significant attention to the relationship between monetary tax penalties and tax compliance,<sup>146</sup> should also seek to develop an understanding of the effect of collateral tax sanctions on individual taxpayer compliance.

Second, why have legislators largely restricted the use of collateral tax sanctions to the offense of tax delinquency as opposed to other tax offenses? Federal and state collateral tax sanctions that apply today focus almost exclusively on a taxpayer's failure to pay established outstanding tax liability. In some cases, such as the proposed legislation that revokes passports from tax delinquent individuals, the collateral tax sanction will not apply to the taxpayer unless the IRS has filed a lien against the taxpayer's property.<sup>147</sup> Is it possible that collateral tax sanctions could apply effectively to tax offenses *other* than tax delinquency?

Third, do collateral tax sanctions raise the same fairness concerns as the collateral consequences that occur in the criminal context? Criminal law scholars have criticized the spread of collateral sanctions, such as rules that prevent convicted felons from holding particular types of employment

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<sup>145</sup> MINN. STAT. ANN. § 270C.72, subd. 2(c) (West 2012).

<sup>146</sup> See *supra* Section I.A. (analyzing theories and practical implications of tax penalty provisions).

<sup>147</sup> Moving Ahead for Progress in the 21st Century Act, S. 1813, 112th Cong. § 40304 (2012).

following the completion of their prison sentences.<sup>148</sup> They have argued that collateral consequences apply without adequate notice to the defendants<sup>149</sup> and even represent a form of double jeopardy.<sup>150</sup> Do collateral tax sanctions, such as state rules that revoke tax delinquents' driver's licenses, raise these fairness concerns as well? If so, what is the effect on taxpayer behavior and how might governments redesign offending collateral tax sanctions to alleviate the concerns?

Fourth, why have taxing authorities, such as the IRS and state departments of revenue, not publicized the existence of collateral tax sanctions? At the federal level, for example, neither the IRS website nor the tax forms that individuals complete every April contain information about the possibility that certain types of tax noncompliance may result in deportation from the United States for noncitizens. They also fail to explain that noncompliance may result in the suspension of medical or law licenses by state licensing agencies.<sup>151</sup> Further, surveys of taxpayer attitudes do not reveal collateral tax sanctions as one of the motivations for why individuals file their tax returns each year.<sup>152</sup> There may be reasons for the lack of publicity of collateral tax sanctions by taxing authorities, but they have not been articulated thus far.

These are just a few of the many questions that the rise of collateral tax sanctions provokes. The remainder of this Article addresses these questions and others as it investigates the proper role and scope of collateral tax sanctions as a means of tax enforcement.

## II. WHY COLLATERAL TAX SANCTIONS PROMOTE COMPLIANCE

As the previous discussion illustrates, several states and the federal government are actively considering the use of collateral tax sanctions as a result of their apparent effectiveness at combating tax delinquency.<sup>153</sup> State officials have reported that collateral tax sanctions that are currently in effect, such as measures that revoke driver's licenses, have resulted in

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<sup>148</sup> See *supra* note 83 (discussing the need to provide ex-offenders genuine, full citizenship upon reentry, including socioeconomic rights that decrease the burden on ex-offenders and their families).

<sup>149</sup> See *id.*

<sup>150</sup> See *id.*

<sup>151</sup> See IRS, FORM 1040 INSTRUCTIONS 2013, available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

<sup>152</sup> See, e.g., IRS OVERSIGHT BD., 2011 TAXPAYER ATTITUDE SURVEY 5 (2012), <http://www.treasury.gov/irsob/reports/2012/IRSOB-Taxpayer%20Attitude%20survey%202012.pdf>.

<sup>153</sup> See *supra* subsection I.B.3.b.

significant tax collections.<sup>154</sup> Federal measures that are pending legislative approval, such as the proposed revocation of passports from tax delinquents, are projected to enable the government to collect hundreds of millions of dollars in outstanding taxes.<sup>155</sup> Despite the growing popularity of collateral tax sanctions among federal and state government officials, sponsors of these sanctions have yet to offer a coherent theoretical or empirical basis to explain why collateral tax sanctions appear to encourage noncompliant taxpayers to pay taxes owed where traditional monetary tax penalties had failed to provoke this response. Before we can determine whether governments should deploy collateral tax sanctions, and in what contexts, we must examine possible reasons for their apparent effectiveness.

In this Part, I argue that collateral tax sanctions possess features that traditional monetary tax penalties lack and that these unique features are likely to cause collateral tax sanctions to be more effective than traditional monetary tax penalties. In situations where taxpayers have failed to respond to monetary tax penalties resulting from their tax noncompliance, collateral tax sanctions, whether they involve the revocation of a recreational or professional license, are more likely to induce compliance. In making this claim, I consider behavioral and experimental research in the tax compliance and other related contexts. While this Article does not present the results of original experimental research, future studies could examine the effects of specific types of collateral tax sanctions on taxpayers who possess particular characteristics. After presenting arguments for why collateral tax sanctions offer tax enforcement benefits that traditional monetary tax penalties do not, I consider whether and how collateral tax sanctions should be applied to tax offenses other than tax delinquency.

#### A. *Why Do People Pay Taxes?*

In the United States, most people pay their taxes. According to the latest statistics released by the federal government, approximately 83% of all tax dollars owed to the federal government is paid correctly and in a timely manner each year.<sup>156</sup> In light of the complexity of the federal tax law and its reliance on individual taxpayers to correctly self-assess and report income,

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<sup>154</sup> *Id.*

<sup>155</sup> *See supra* note 94 and accompanying text.

<sup>156</sup> IRS, TAX YEAR 2006 TAX GAP ESTIMATE—SUMMARY OF ESTIMATION METHODS 1 (2012), available at [www.irs.gov/pub/newsroom/summary\\_of\\_methods\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/summary_of_methods_tax_gap_2006.pdf) (noting a voluntary compliance rate of 83.1% in 2006).

government officials, commentators, and scholars have lauded this compliance rate as high.<sup>157</sup>

The other side of the voluntary compliance coin is the gross federal tax gap, which is the amount of true tax liability that is not paid on time each year. According to the most recent government reports, this amount is \$450 billion, or approximately 17% of federal taxes owed.<sup>158</sup> Noncompliance by individual taxpayers (as opposed to corporations or other entities) represents the largest component (\$296 billion) of the gross federal tax gap.<sup>159</sup> And within the federal tax gap, certain forms of tax compliance occur at levels far lower than the overall voluntary compliance rate, such as reporting of income by small business owners who are not subject to information reporting or withholding.<sup>160</sup>

There is no single answer to the question of why some individuals comply with the tax law while others do not.<sup>161</sup> Over the past several decades, legal scholars and economists have offered a number of theories to explain why individual taxpayers are motivated to comply with the tax law—reasons other than rules that require mandatory withholding of tax liability by third parties. Some of the most prominent of these possible motivations of compliance include fear of sanctions,<sup>162</sup> the perception that others are reciprocating one's tax compliance,<sup>163</sup> a desire to avoid the negative signal of

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<sup>157</sup> See, e.g., IRS, REDUCING THE FEDERAL TAX GAP (2007), available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf) (“The overall compliance rate achieved under the United States revenue system is quite high.”); Doran, *supra* note 21, at 123 (characterizing the federal taxpayer compliance rate of approximately 85% as “robust”).

<sup>158</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, SOURCES OF NONCOMPLIANCE AND STRATEGIES TO REDUCE IT 4 (2012), available at <http://www.gao.gov/assets/600/590215.pdf>.

<sup>159</sup> *Id.*

<sup>160</sup> Only 44% of income that is subject to little or no information reporting, such as cash income, rents, royalties, and farm income, is properly reported and paid to the federal government each year. *Id.* at 6 fig.1. By contrast, 99% of income that is subject to third-party information reporting and withholding rules, such as wages, is properly reported and paid. *Id.*

<sup>161</sup> See, e.g., Joel Slemrod, *Introduction to WHY PEOPLE PAY TAXES: TAX COMPLIANCE AND ENFORCEMENT 1* (Joel Slemrod, ed., 1992) (discussing why it is important that tax policymakers know what drives tax compliance and how that information can be supplied by cross-disciplinary literature).

<sup>162</sup> See, e.g., Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 209 (1968); Raskolnikov, *supra* note 21, at 571 (describing deterrence theory).

<sup>163</sup> See Ernst Fehr & Simon Gächter, *Reciprocity and Economics: The Economic Implications of Homo Reciprocans*, 42 EUR. ECON. REV. 845, 845-46 (1998); Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71, 71 (2003).

tax noncompliance,<sup>164</sup> and the belief that payment of taxes is a duty of citizenship.<sup>165</sup>

In addition to these theories of individual tax compliance, tax scholars have observed that cognitive biases and heuristics also influence individuals' decisions.<sup>166</sup> As a general matter, these biases cause people to draw incorrect conclusions based on memorable events, anchor themselves to initial values, overvalue losses, and exhibit other seemingly irrational tendencies.<sup>167</sup> Several tax scholars have explored the ways that cognitive biases can influence individuals' tax planning and compliance decisions.<sup>168</sup>

### B. *Collateral Tax Sanctions and Motivations of Compliance*

To illustrate the tax administration dilemma that many states and the federal government face, consider the following scenario: a wealthy individual owes the government \$400,000 in undisputed state taxes. The individual has incurred significant monetary tax penalties and interest as a result of this outstanding tax liability. While the taxing authority has attempted to contact this individual repeatedly, he simply refuses to respond, let alone pay any of his outstanding tax liability. Even after the taxing authority obtains liens on the individual's property, he still refuses to pay. Now the state government has a choice. It can continue to apply monetary tax penalties against this individual or, alternatively, it can threaten this individual with a collateral tax sanction.

In this Section, I investigate how current collateral tax sanctions by the federal and state governments, which primarily have targeted the offense of tax delinquency, promote tax compliance among individuals. In conducting this analysis, I contrast the use of collateral tax sanctions in addition to monetary tax penalties with the exclusive use of monetary tax penalties, taking into account the perceived major motivations for tax compliance and

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<sup>164</sup> See Posner, *supra* note 26, at 1789 (applying signaling model to tax compliance).

<sup>165</sup> See, e.g., John T. Scholz, *Contractual Compliance and the Federal Income Tax System*, 13 WASH. U. J.L. & POL'Y 139, 189 (2003) (describing the empirical support for the duty-of-citizenship model of tax compliance).

<sup>166</sup> See generally THALER & SUNSTEIN, *supra* note 23; McCaffery, *supra* note 23; Tversky & Kahneman, *supra* note 23.

<sup>167</sup> See, e.g., Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 667 (1999) (describing how economic actors present information to exploit individuals' cognitive biases); Howard Latin, "Good" Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. REV. 1193 (1994) (arguing that certain product warnings exploit individuals' cognitive biases); Tversky & Kahneman, *supra* note 23, at 14-18 (describing the availability and anchoring biases).

<sup>168</sup> See, e.g., Blank, *supra* note 23 (exploring how various cognitive biases affect taxpayer decisions); McCaffery, *supra* note 23; Schenk, *supra* note 23.

individuals' well-known cognitive biases. My analysis reveals that collateral tax sanctions possess several unique characteristics that make them more likely to encourage noncompliant taxpayers, including those such as the individual described above, to begin to cooperate with the taxing authority.

1. Collateral Tax Sanctions Are More Salient than Monetary Tax Penalties

One explanation for the efficacy of collateral tax sanctions as a deterrent against continued tax noncompliance is that their features cause them to be more salient than traditional monetary penalties. The salience bias generally leads individuals to pay greater attention to information that is prominent rather than that which is hidden.<sup>169</sup> For example, an individual is often more affected by witnessing a violent car accident in person than by reading anonymous statistics regarding car accidents in the newspaper. Similarly, scholars have noted that the effect of a particular tax on an individual's purchasing decisions can increase with the salience of the tax.<sup>170</sup> This matters because deterrence theorists posit that some individuals act rationally when deciding whether to engage in tax avoidance or evasion.<sup>171</sup> The salience of collateral tax sanctions, compared to that of traditional monetary tax penalties, likely causes people to assign greater weight to collateral tax sanctions than to traditional monetary tax penalties when calculating the cost of tax noncompliance.

When individuals owe monetary tax penalties as a result of their failure to report tax liability properly or pay outstanding tax liabilities, they may consider the tax penalties as indistinguishable from the overall tax bill. Because both tax liability and tax penalties are monetary, they are likely fungible in some taxpayers' minds. The government inadvertently promotes

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<sup>169</sup> For a general explanation of the salience bias, see Cass R. Sunstein, *What's Available? Social Influences and Behavioral Economics*, 97 NW. U. L. REV. 1295, 1301 (2003). See also Tversky & Kahneman, *supra* note 23, at 11 (hypothesizing that salience affects the "retrievability of instances" when individuals assess the probability of an event or engage in other cognitive exercises).

<sup>170</sup> See, e.g., Raj Chetty et al., *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145, 1145-47 (2009) (finding that the prominence of sales tax information on price tags affects consumer purchasing choices); Richard L. Ott & David M. Andrus, *The Effect of Personal Property Taxes on Consumer Vehicle-Purchasing Decisions: A Partitioned Price/Mental Accounting Theory Analysis*, 28 PUB. FIN. REV. 134, 149-50 (2000) (finding that individual consumers do not properly take into account vehicle property taxes when purchasing automobiles).

<sup>171</sup> See BENTHAM, *supra* note 59, at 325; Becker, *supra* note 162, at 176 ("Some persons become 'criminals,' therefore, not because their basic motivation differs from that of other persons, but because their benefits and costs differ."); Raskolnikov, *supra* note 21, at 576 (explaining the theory that when "rational utility-maximizers" decide to evade taxes, they take into account the expected cost of punishment).

this conflation. For example, when describing the collection of delinquent taxes, many state and local governments inform their residents that the tax assessor collects “taxes, including penalties and interest.”<sup>172</sup> Similarly, in its instructions to taxpayers regarding installment agreements and offers in compromise, the IRS refers to tax liabilities as “taxes, including penalties and interest.”<sup>173</sup> Taxing authorities therefore describe tax penalties as part of the tax liability itself rather than as separate punitive payments. The threat of additional monetary penalties is unlikely to be salient enough to motivate individuals who have ignored outstanding tax liabilities to comply.

Tax liens are also not effective collection mechanisms for many taxpayers, particularly wealthy individuals. One might ask, for instance, why the sanctions proposed by the passport revocation legislation apply only after the taxing authority has filed a tax lien against the taxpayer.<sup>174</sup> A tax lien alerts future purchasers of the taxpayer’s property and the taxpayer’s creditors that the government holds a claim against the property.<sup>175</sup> Imagine that a wealthy individual owns three houses and the IRS (only knowing about one of them) files a Notice of Federal Tax Lien only where one of the houses is located. The filing of the lien may have no effect on the other two houses.<sup>176</sup> In addition, if the taxpayer has no plans to sell the house that is subject to the tax lien, he may allow the lien to remain without suffering a serious consequence.<sup>177</sup> Tax liens adversely affect individuals’ credit scores, but wealthy individuals may not rely on borrowing from third-party lenders. Finally, if the property is already encumbered with mortgages, the IRS might not seek to foreclose on a house subject to a tax lien because, after the other creditors are satisfied, the IRS would collect little from the foreclosure

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<sup>172</sup> See, e.g., IND. CODE § 6-1.1-23-1(d) (2008); MONT. CODE ANN. § 39-51-1304(1) (2013).

<sup>173</sup> See IRS, FORM 433-D, INSTALLMENT AGREEMENT (2012) (“This agreement will remain in effect until your liabilities (*including penalties and interest*) are paid in full . . . .”); IRS, FORM 656 BOOKLET, OFFER IN COMPROMISE 3 (2012) (“If your offer is defaulted, all compromised tax debts, including penalties and interest, will be reinstated.”).

<sup>174</sup> See *supra* subsection I.B.3.a.i.

<sup>175</sup> See I.R.C. § 6321 (2006); *Understanding a Federal Tax Lien*, IRS (Nov. 6, 2013), <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Understanding-a-Federal-Tax-Lien>.

<sup>176</sup> See I.R.C. § 6323(f) (describing the place for the filing of a tax lien on real property).

<sup>177</sup> See, e.g., Marc Lifsher & Scott Wilson, *California Tax Delinquents List Includes Notable Names*, L.A. TIMES (Apr. 14, 2012), <http://articles.latimes.com/2012/apr/14/business/la-fi-tax-deadbeats-20120414> (listing millionaires who have ignored multi-million dollar state tax liens dating back to 1995).



proceedings.<sup>178</sup> Indeed, the IRS files millions of tax liens each year without recovering the outstanding tax liabilities.<sup>179</sup>

Collateral tax sanctions, by contrast, target conspicuous privileges and services and, as a result, likely evoke stronger psychological reactions from individual taxpayers facing them. Several collateral tax sanctions—such as those which cause an individual to lose a driver’s license, forfeit a passport, or face deportation hearings—threaten the loss of crucial benefits. In turn, proposals of such collateral tax sanctions tend to receive significant publicity. For example, the Senate’s 2011 proposal to rescind or deny tax delinquent individuals’ passports has been the focus of hundreds of media reports.<sup>180</sup> As a result, it is possible that individuals have an easier time imagining the consequences of losing one of these privileges than simply owing additional money.

In addition to increased publicity, collateral tax sanctions affect salient government benefits that individuals value highly. Many of these benefits serve a mix of personal and business purposes. For example, a driver’s license enables many individuals to drive to work where they can earn a paycheck, and to children’s little league baseball games, or to a friend’s birthday party. For this reason, many consider the driver’s license to be one of the most valuable benefits that they receive from their state government.<sup>181</sup> As one court noted when considering driving-while-intoxicated charges, “The fact remains that today the very livelihood of a man and his family may depend upon his [driver’s] license.”<sup>182</sup> For some individuals, the high personal value of the government benefits at stake likely causes them to assign greater weight to collateral tax sanctions than to monetary tax penalties, thereby increasing their deterrent effect.

Last, not only are collateral tax sanctions more salient than monetary tax penalties, but they are often administered by government agencies that are more salient than the taxing authority. According to the IRS, nearly sixty percent of taxpayers in the United States use tax preparers or software to file their annual tax returns and do not interact with the IRS beyond

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<sup>178</sup> See I.R.C. § 7403 (2006) (outlining foreclosure proceedings against properties with government liens). Some preexisting liens on a property may take priority over a tax lien filed by the IRS. IRS, INTERNAL REVENUE MANUAL 5.17.2.6 (2012).

<sup>179</sup> See IRS, IRS DATA BOOK 2011, 41 (2012) (reporting that 2,138,606 federal tax liens were filed in fiscal years 2010 and 2011).

<sup>180</sup> A search on LexisNexis’s ALL News Database for “passport” and “tax” and “deny” and “delinquent” between January 1, 2011, and September 24, 2012, yielded 22 different articles. A similar Google search yielded 1390 articles.

<sup>181</sup> See, e.g., *Bechler v. Parsekian*, 176 A.2d 470, 479 (N.J. 1961) (“[I]n today’s society a license to operate an automobile may be of vital significance and value to the licensee . . .”).

<sup>182</sup> *Parsekian v. Cresse*, 183 A.2d 426, 430 (N.J. Super. Ct. App. Div. 1962).

writing a check.<sup>183</sup> Collateral tax sanctions, on the other hand, force individuals to answer for their tax noncompliance directly by facing another government agency. Some of these agencies, such as the department of motor vehicles, have a reputation for being bound by strict rules and procedures.<sup>184</sup> For example, in New Jersey, to receive a driver's license, an individual must submit multiple specific identification documents<sup>185</sup> and even refrain from excessive smiling when being photographed.<sup>186</sup> If individuals are aware that they will forfeit a government benefit, such as a driver's license, as a result of tax delinquency or other tax offenses, they might fear that the agency that enforces the sanction will be even less flexible than the taxing authority in correcting errors or compromising.

## 2. Collateral Tax Sanctions Provoke Loss Aversion and the Endowment Effect

Another explanation for why collateral tax sanctions are effective deterrents against tax noncompliance compared to additional monetary tax penalties is that they trigger loss aversion and the endowment effect, two significant, related cognitive biases of individual taxpayers.

When individuals are forced to choose between two options—one that will lead them to gain some item and another that will cause them to lose an item they already possess—individuals have difficulty choosing to experience the loss.<sup>187</sup> Their strong distaste for losses leads to the endowment effect, which causes them to develop attachments to items they own and a reluctance to part with them.<sup>188</sup> These two biases lead individuals to resist attempts by others to take their property, whether or not they are compensated.

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<sup>183</sup> See *SOI Tax Stats—Tax Stats at a Glance*, IRS, <http://www.irs.gov/uac/SOI-Tax-Stats-Tax-Stats-at-a-Glance> (last updated Jan. 24, 2014) (showing that fifty-six percent of individual tax returns were filed with assistance from a paid preparer in the 2011 tax year).

<sup>184</sup> See, e.g., REAL ID Act of 2005, § 202, Pub. L. 109-13, 119 Stat. 302, 312-15 (2005) (creating numerous requirements for identifications issued by state motor vehicles departments).

<sup>185</sup> See, e.g., *6 Point ID Verification*, ST. N.J. MOTOR VEHICLE COMMISSION (Dec. 16, 2013), <http://www.state.nj.us/mvc/Licenses/6PointID.htm> (describing that New Jersey citizens wishing to obtain a license must pass a “6 Point ID Verification”).

<sup>186</sup> See Harry Bradford, *New Jersey Bans Smiling In Driver's License Photos*, HUFFINGTON POST (Sept. 24, 2012), [http://www.huffingtonpost.com/2012/09/24/new-jersey-bans-smiling-drivers-license\\_n\\_1909773.html](http://www.huffingtonpost.com/2012/09/24/new-jersey-bans-smiling-drivers-license_n_1909773.html) (quoting a Department of Motor Vehicles' spokesman as stating that the Department will “allow small smiles but ‘I-won-the-lottery-type’ grins aren't acceptable” when having a license picture taken).

<sup>187</sup> See Kahneman et al., *supra* note 24, at 194 (giving an overview of behavioral studies on the endowment effect); Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 44 (1980) (explaining the role of opportunity costs in the endowment effect).

<sup>188</sup> See Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1342 (1990) (describing the

Many experiments have demonstrated that individuals are averse to losing things they hold. In one of the most famous studies by Daniel Kahneman, Jack Knetsch, and Richard Thaler, subjects were told that they were buyers or sellers.<sup>189</sup> The sellers were given Simon Fraser University coffee mugs, and the buyers were not given anything.<sup>190</sup> When the buyers were asked to state the price at which they would purchase the coffee mug from the sellers, they reported an average price of \$2.87.<sup>191</sup> The sellers, on the other hand, reported that they would be willing to sell the very same mugs to the buyers for an average price of \$7.12.<sup>192</sup> In another similar study, subjects were told that they would receive coffee mugs and were asked to speculate on the price at which they would be willing to sell the mugs.<sup>193</sup> The subjects then received the actual mugs and were asked the same question.<sup>194</sup> Once they held the mugs in their hands and “owned” them, they reported an average minimum selling price that was significantly higher than their original reported price.<sup>195</sup> These and several other similar experiments reveal that individuals consider the experience of parting with property to be roughly twice as painful as gaining property of the same value.<sup>196</sup>

Individuals do not experience loss aversion in all transactions. For some individuals, it is possible that traditional monetary tax penalties do not induce strong loss aversion or endowment effects, especially if they are not applied at very high rates. As the founding researchers in this area have stated, “Buyers do not value the money spent on normal purchases as a loss,

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“instant endowment effect”, which causes subjects to increase their valuation of certain goods as soon as they receive them).

<sup>189</sup> Kahneman et al., *supra* note 24, at 195-96.

<sup>190</sup> *Id.*

<sup>191</sup> *Id.*

<sup>192</sup> *Id.*

<sup>193</sup> George Loewenstein & Daniel Adler, *A Bias in the Prediction of Tastes*, 105 *ECON. J.* 929, 931-32 (1995).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> Kahneman et al., *supra* note 24, at 199. This result is consistent with prospect theory. See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263, 278-79 (1979) (explaining that individuals are risk-averse when facing gains and risk-seeking when facing losses). Several experiments have demonstrated the applicability of prospect theory to individual tax compliance. See, e.g., Henk Elffers & Dick J. Hessing, *Influencing the Prospects of Tax Evasion*, 18 *J. ECON. PSYCHOL.* 289, 291 (1997); Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 *TAX L. REV.* (forthcoming 2014), available at <http://ssrn.com/id=2316233> (offering a proposal to impose presumptive collection on small business owners that would cause them to expect tax refunds); Gideon Yaniv, *Tax Compliance and Advance Tax Payments: A Prospect Theory Analysis*, 52 *NAT'L TAX J.* 753, 761 (1999) (finding that sufficiently high advance tax payments induce compliance because individuals are risk-averse when approaching tax refunds).

so long as the price of the good is not thought to be unusually high.”<sup>197</sup> Others have stated the same principal using different terms, such as that loss aversion does not occur in “routine transactions”<sup>198</sup> and that individuals do not experience loss aversion when they spend money “as intended.”<sup>199</sup> Applying these findings to taxation, habitually delinquent or otherwise noncompliant taxpayers likely do not consider monetary tax penalties as significant losses. When an individual deliberately decides not to pay outstanding taxes on time or fails to pay the appropriate amount of estimated federal tax payments each quarter, he usually knows that he will incur additional monetary tax penalties and interest.<sup>200</sup> These individuals probably consider such monetary tax penalties to be like any other payment that they intend to make during the year and, as a result, do not change their behavior in response to the threat of the monetary tax penalties.

On the other hand, individuals likely experience greater loss aversion when faced with the threat of collateral tax sanctions that would cause them to forfeit salient government benefits and services. Collateral tax sanctions serve as more effective deterrents than traditional monetary tax penalties because many individuals are highly averse to the thought of having to sacrifice a license or benefit, such as the right to travel freely, apply for a subsidized federal loan, or engage in a recreational activity like hunting or fishing. Unlike money that an individual allocates to the payment of monetary tax penalties, these government benefits and services can be considered “entitlements” in the minds of individual taxpayers, items that are similar to any other property they hold. For instance, news reports regarding collateral tax sanctions often use the terms “lose” or “forfeit” when discussing these sanctions, further stimulating individuals’ loss aversion biases.<sup>201</sup>

People also associate personal experiences and even emotional feelings with government benefits and privileges that are the subject of collateral tax sanctions. For example, some lawyers have significant personal feelings regarding their law licenses because they recall the costs, monetary and otherwise, of going to law school and taking the bar exam. Of course, this

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<sup>197</sup> Kahneman et al., *supra* note 24, at 200 n.3.; *see also* Nathan Novemsky & Daniel Kahneman, *The Boundaries of Loss Aversion*, 42 J. MARKETING RES. 119 (2005).

<sup>198</sup> Novemsky & Kahneman, *supra* note 197, at 119.

<sup>199</sup> *Id.* (“A key idea is that exchange goods that are given up ‘as intended’ do not exhibit loss aversion.”)

<sup>200</sup> *See* IRS, PUBLICATION 505, TAX WITHHOLDING AND ESTIMATED TAX 13 (2013), available at <http://www.irs.gov/pub/irs-pdf/p505.pdf> (describing estimated tax payment requirements and related tax penalties).

<sup>201</sup> *See, e.g., State Gets License to Keep Tax Cheats Off Road*, BOSTON HER., July 11, 2008 (“Don’t pay your taxes, and you will lose your driver’s license.”); *California to Tax Scofflaws*, *supra* note 17.

particular license enables lawyers to earn a living. Yet even lawyers who do not practice continue to pay annual dues and make annual payments to client protection funds because they do not want to forfeit their law licenses.<sup>202</sup> Whether collateral tax sanctions cause lawyers to think about the value of their law licenses, individuals to recall their experiences in receiving their first driver's licenses, or noncitizen residents to remember satisfying the requirements for a green card, these sanctions can result in strong loss-aversion effects. For many individuals, these licenses and benefits have a personal history, whereas individual dollars used to pay monetary tax penalties do not.

Further, collateral tax sanctions threaten to revoke benefits and services that cannot be replaced. An individual can pursue a number of different options, such as borrowing or increasing work hours, to replace the dollars spent on monetary tax penalties. But unlike monetary instruments, there is no private market for items such as passports, driver's licenses, liquor licenses, or many of the other government benefits and services that are the subject of collateral tax sanctions.<sup>203</sup> Because individuals cannot spend money or engage in other activities to replace those benefits and services if they are forced to forfeit them, the loss-aversion and endowment effects of collateral tax sanctions cause some people to attempt to avoid losing these items. In the face of collateral tax sanctions, the easiest way for individuals to avoid revocation of those benefits and services is to comply with the tax law.

### 3. Certain Collateral Tax Sanctions Can Impose Greater Economic Costs than Monetary Tax Penalties

While collateral tax sanctions do not impose an explicit monetary fine on noncompliant taxpayers, they can still result in indirect economic costs. These indirect costs differ significantly from the types of economic costs imposed by traditional monetary tax penalties. Particularly with respect to wealthy taxpayers, certain collateral tax sanctions have a much greater potential ability to approximate the deterrence effects of the classic Bentham–Becker fine (in which the fine equals the harm divided by the probability that the harm would be detected *ex ante*) than the monetary tax penalties that legislators are typically capable of enacting.<sup>204</sup>

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<sup>202</sup> See, e.g., N.J. CT. R. 1:28-2(a) (requiring all law license holders in New Jersey to make annual contributions to a client protection fund in order to maintain their law licenses).

<sup>203</sup> This statement refers to markets for legal, rather than counterfeit, licenses.

<sup>204</sup> See *supra* note 13-19 and accompanying text.

Monetary tax penalties, whether they are percentage or flat tax penalties,<sup>205</sup> are bound by relatively low statutory limits. For example, taxpayers are subject to a penalty equal to 0.5% of the net tax shown on the taxpayer's tax return for each month (or fraction of a month) that they fail to timely pay their tax liability.<sup>206</sup> The total amount of the tax penalty is capped at 25% of the taxpayer's tax liability.<sup>207</sup> The total amount of this particular tax penalty, thus, is limited. Even though the taxpayer will continue to owe interest to the federal government as he fails to pay the outstanding liability, the interest rate is also subject to a statutory limit.<sup>208</sup> Rational taxpayers who weigh costs and benefits can easily calculate the economic cost of tax penalties. As has been discussed, in most cases, the nominal amounts of these penalties are relatively low compared to the tax liability and are even lower when a taxpayer discounts them to take into account the probability that the taxing authority will be unable to compel payment.<sup>209</sup>

By contrast, certain collateral tax sanctions can result in indirect economic costs that are greater than most traditional monetary tax penalties. For example, a taxpayer who fails to pay an outstanding tax liability and consequently forfeits her professional license, such as a medical or law license, for a period of time will also lose income unless she attempts to practice her profession illegally. Rational taxpayers likely assume that the cost of certain collateral tax sanctions, such as loss of a professional license, is high. This type of collateral tax sanction would result in lost income during the suspension, future lost income from clients who choose other providers, and transactional expenses related to seeking reinstatement of the license from the non-tax agency. Some rational taxpayers might even overvalue the amount of these indirect economic costs compared to the simple valuation of explicit monetary tax penalties. One response to the question of why collateral tax sanctions promote voluntary compliance more effectively than traditional monetary tax penalties, thus, could be that they threaten to impose a high and uncertain economic cost on taxpayers that outweighs the potential benefits of continued tax noncompliance.

The indirect economic cost of collateral tax sanctions offers two deterrence benefits that traditional monetary tax penalties do not. First, certain collateral tax sanctions are more progressive than traditional monetary tax penalties in that their indirect economic cost is tied to the individual

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<sup>205</sup> See *supra* Section I.A.

<sup>206</sup> I.R.C. § 6651(a)(2) (2006).

<sup>207</sup> *Id.*

<sup>208</sup> *Id.* § 6621(a)(2) (2006) (defining the underpayment rate as the sum of the federal short-term rate plus three percentage points).

<sup>209</sup> See *supra* notes 54-57 and accompanying text.

characteristics of the noncompliant taxpayer, particularly the taxpayer's ability to pay. When governments enact monetary tax penalties, they attempt, in part, to set the penalty amounts at levels that are significant enough to achieve deterrence. But this process only enables the government to consider amounts that will achieve general levels of deterrence across the population. By imposing economic costs that vary from taxpayer to taxpayer depending on their individual characteristics, on the other hand, collateral tax sanctions enable the government to create targeted sanctions that impose meaningful economic costs on taxpayers with different abilities to pay.

Consider an example: A monetary tax penalty for filing a frivolous tax return under current law is a flat amount of \$5000 for every taxpayer, regardless of the taxpayer's personal attributes, such as annual income or wealth.<sup>210</sup> A collateral tax sanction that revokes a taxpayer's professional license for a similar offense, on the other hand, would impose an economic cost that is directly tied to the individual's income. If the individual who incurs this collateral tax sanction is an orthopedic surgeon who earns \$40,000 a month,<sup>211</sup> for example, the revocation of her professional license for two months would result in at least \$80,000 of lost income. Even if we ignore the behavioral effects of collateral tax sanctions described earlier and apply the rational-actor model of taxpayer behavior, the collateral tax sanction in this example would be more likely to encourage the taxpayer to pay than the monetary tax penalty.

As this illustration shows, certain collateral tax sanctions can impose a heavier economic burden on individuals who have a greater ability to pay. In this example, the potential indirect economic cost of the collateral tax sanction is \$80,000 compared to the \$5000 economic cost of the monetary tax penalty; therefore, the value of the collateral tax sanction is much closer to the Bentham-Becker fine than the monetary tax penalty.<sup>212</sup> The indirect cost of collateral tax sanctions is unique compared to the cost of monetary tax penalties—it depends on the taxpayer's individual characteristics rather than on an assumption by the government regarding the level of the penalty needed to achieve general deterrence. Where the flat monetary tax penalty for filing a frivolous tax return described above applies equally to all taxpayers, irrespective of their income or wealth, a collateral tax sanction

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<sup>210</sup> I.R.C. § 6702(a) (2006).

<sup>211</sup> The national median salary for an orthopedic surgeon was more than \$515,000 in 2012. SULLIVAN COTTER & ASSOCS., INC., PHYSICIAN COMPENSATION: WHERE THE MARKET IS GOING (2013), available at [https://www.eiseverywhere.com/file\\_uploads/5f5dedc5323d81d666261a4e9a6436bf\\_2013\\_AMGA\\_Presentation\\_CFO\\_3-13-13\\_to\\_AMGA\\_Print.pdf](https://www.eiseverywhere.com/file_uploads/5f5dedc5323d81d666261a4e9a6436bf_2013_AMGA_Presentation_CFO_3-13-13_to_AMGA_Print.pdf).

<sup>212</sup> See *supra* note 59 and accompanying text. I thank David Schizer and Deborah Schenk for helpful discussion of this point.

can result in an indirect economic burden that is directly tied to an individual's earning capacity (in the case of loss of a professional license) or choice of leisure activities (in the case of loss of a recreational license). The progressive nature of certain collateral tax sanctions, thus, can induce voluntary compliance from wealthy taxpayers who do not respond to the threat of monetary tax penalties under current law.

In addition, the indirect economic cost of certain collateral tax sanctions can be greater than the maximum value of traditional tax penalties that legislators can enact as a political matter. One could reasonably deduce from the argument above that the federal and state governments could achieve the results of collateral tax sanctions with monetary tax penalties by simply increasing the nominal value of the monetary tax penalties by an amount equal to the indirect economic costs of the collateral tax sanctions. Legislators, however, rarely alter the nominal value of monetary tax penalties, in part because of the political consequences such action would have.<sup>213</sup> As the Joint Committee on Taxation reported in 1998, Congress often faces "pressures to set enforcement at levels lower than would be most appropriate."<sup>214</sup> One reason for the political infeasibility of raising the explicit amounts of monetary tax penalties is that legislators do not want to create rules that are overly punitive to taxpayers. For example, Congress capped the penalty for failure to pay tax liability (to 25% of the tax liability) because of the need to "avoid the buildup of financial burdens on delinquent taxpayers to the point where such additional burdens act as a barrier to resolution."<sup>215</sup> In contrast, many of the collateral tax sanctions described above, such as the revocation of driver's licenses from tax delinquent individuals, have been sponsored by legislators of both political parties and have received public support as well.<sup>216</sup>

#### 4. Certain Collateral Tax Sanctions Emit Negative Signals

While collateral tax sanctions deter tax noncompliance by some individuals who respond positively to the threat of penalties and punishment, they can also influence the behavior of individuals who fear the negative reputational signals that the sanctions convey to others. The signaling effect of

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<sup>213</sup> For a discussion of how setting penalty amounts in an enforcement regime can pose difficult issues for the government, see 1 STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 57, at 37; Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489, 530 (2011) (discussing the relative stability of tax penalties).

<sup>214</sup> 1 STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 57, at 36.

<sup>215</sup> U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 58 (1999), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/intpenal.pdf>.

<sup>216</sup> See *supra* subsection I.B.3.



certain collateral tax sanctions is a feature that traditional monetary tax penalties typically do not possess. In order to avoid these collateral tax sanctions and their accompanying negative reputational signals, some individuals would likely feel compelled to properly report and pay their tax liabilities.

Signals are costly actions that individuals undertake in order to provide information to other individuals.<sup>217</sup> When a professor wears a suit and tie to class, he might do so in part to signal to his students that he possesses knowledge, professionalism, discipline, or other characteristics. This signal provides two types of information: direct information (he is wearing a suit and tie) and indirect information (he is professional). According to the signaling model, individuals engage in cooperative relationships with other individuals that take the form of a repeated prisoner's dilemma.<sup>218</sup> Because people want to engage in as many of these cooperative relationships as possible, they must find ways to signal to others that they are "good types" who will not try to take advantage of them.<sup>219</sup>

In the tax context, proponents of the signaling theory, most notably Eric Posner, have argued that tax compliance serves as a signal that an individual is a good type who can be trusted.<sup>220</sup> Conversely, tax noncompliance is a signal that an individual will cheat others just as he has cheated the government.<sup>221</sup> According to this theory, a possible explanation for high rates of voluntary compliance in a self-assessment tax system is that most individuals do not want to signal to others that they are bad types.<sup>222</sup>

The signaling model as an explanation for why people pay taxes has been subject to harsh criticism in both social norms and tax law scholarship.<sup>223</sup> The primary objection is that, unlike other types of signals, such as wearing suits and ties, acts of tax compliance and noncompliance usually cannot be observed by other individuals.<sup>224</sup> Tax return information is

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<sup>217</sup> See Posner, *supra* note 26, at 1787.

<sup>218</sup> *Id.* at 1786-88.

<sup>219</sup> *Id.* at 1786-90.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.* at 1818-19.

<sup>223</sup> See, e.g., Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367, 368-69 (2002) (proposing a theory of "moral and emotional" reciprocity as more accurate than Posner's economic signaling model); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1476 n.122 (2003) ("[T]he signaling theory has fundamental problems."); Richard H. McAdams, *Signaling Discount Rates: Law, Norms, and Economic Methodology*, 110 YALE L.J. 625, 688 (2001) (book review) (criticizing Posner's model for its failure to examine motivations for signaling).

<sup>224</sup> See Kahan, *supra* note 223, at 378 ("[W]hether a person is complying with her tax obligations *can't* be observed by members of the public generally.").

specifically protected by taxpayer privacy rules that prevent individuals from seeing others' tax returns, including whether they were audited by the taxing authority or required to pay monetary tax penalties.<sup>225</sup> Few individuals reveal their tax return information voluntarily to others.<sup>226</sup> In defending his signaling theory, even Eric Posner himself appears to ultimately agree that his theory has somewhat limited application to tax compliance.<sup>227</sup>

In contrast to traditional monetary tax penalties, which taxpayers pay during settlement with the taxing authority behind the curtain of taxpayer privacy, certain collateral tax sanctions indeed produce observable negative signals. As I describe below, these signals can result in significant adverse professional and personal consequences, which effectively deter acts of tax noncompliance.

a. *Professional Signals*

Individuals who hold positions of trust, such as lawyers and physicians, may fear not only the potential suspensions of their licenses that can result from failing to comply with the tax law, but may also fear the reputational damage from such suspensions. For example, if a physician's medical license is temporarily suspended for failing to file tax returns for several years, a potential patient may learn of the suspension and the underlying offense and conclude that he will not be able to trust the physician to reach accurate and timely medical treatment decisions. Not only will the physician owe tax penalties and interest on her delinquent tax liability—as well as suffer financial losses during the period when she cannot practice medicine—but also future patients might learn of her medical license suspension. If the physician were subject solely to monetary tax penalties, however, it is unlikely that the potential patient would ever learn about the tax offenses, due to tax-privacy protections. Especially in the online era, once the physician's license is suspended, potential patients can easily discover this information through their own research.<sup>228</sup>

In addition, collateral tax sanctions can lead some potential clients and business associates to incorrectly assume that the sanctioned individual committed an act even *more* serious than tax noncompliance. For example, if

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<sup>225</sup> I.R.C. § 6103 (a)(b)(2) (2006).

<sup>226</sup> See Kahan, *supra* note 223, at 379 (“[T]here is in fact no such norm of spontaneous tax disclosure in our society.”).

<sup>227</sup> Eric A. Posner, *The Signaling Model of Social Norms: Further Thoughts*, 36 U. RICH. L. REV. 465, 468 (2002) (conceding that tax privacy limits signaling effects).

<sup>228</sup> See, e.g., HEALTHGRADES, <http://www.healthgrades.com> (last visited Feb. 21, 2014) (indexing contact information and user reviews for doctors by geographic location).

a lawyer receives a collateral tax sanction for failing to file tax returns and loses his law license, a potential client can learn of the suspension but not its cause. The client might assume that it was due to any number of offenses beyond tax noncompliance, such as commingling a client's funds with the lawyer's own personal account or even engaging in the use of illegal narcotics.<sup>229</sup> Similarly, a notice of a suspended liquor license in the window of a restaurant whose owners have failed to pay state taxes may cause potential customers to wonder whether the restaurant engaged in any number of offenses, ranging from serving minors to selling altered alcohol.<sup>230</sup> The far-reaching and uncertain nature of the negative signals of collateral tax sanctions thus can further deter some individuals from failing to properly report and pay their taxes.

b. *Personal Signals*

Certain collateral tax sanctions can also cause individuals to reveal tax noncompliance to their personal associates. If an individual's tax delinquency causes him to lose the use of his driver's license for a period of time, he could be forced to reveal his failure to pay his taxes to others. As a result of the driver's license suspension, for instance, an individual might need to ask for assistance from friends and family members in order to travel to work, complete household errands, and transport his children to and from after-school activities.<sup>231</sup> This individual could feel compelled to admit his tax noncompliance to his friends and family members rather than allow his personal associates to speculate as to whether he committed a more dangerous act, such as driving recklessly or while intoxicated. As long as an individual fears adverse reactions from personal associates, or at least is embarrassed that he will have to reveal his tax noncompliance to them, the potential negative signals of certain collateral tax sanctions can, in the individual's mind, overshadow the benefits of tax noncompliance.

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<sup>229</sup> See, e.g., *Disciplinary Actions from the Most Recent Journal*, N.C. ST. BAR, <http://www.ncbar.com/discipline> (last visited Feb. 21, 2014).

<sup>230</sup> These are just a few of the potential reasons that might explain suspension of a restaurant's liquor license. See generally CITY OF BOULDER, FIN. DEP'T, TAX & LICENSE DIV., BEVERAGES LICENSING AUTHORITY PENALTY SCHEDULE (last updated Jan. 5, 2011), available at [https://www-static.bouldercolorado.gov/docs/Violations\\_and\\_penalties-1-201307221353.pdf](https://www-static.bouldercolorado.gov/docs/Violations_and_penalties-1-201307221353.pdf).

<sup>231</sup> See *supra* notes 181-182 and accompanying text.

### 5. Collateral Tax Sanctions Bolster Confidence Among Taxpayers Motivated by Feelings of Reciprocity

Collateral tax sanctions are more likely than monetary tax penalties to promote compliance by individuals who pay their taxes because they believe that other taxpayers are doing so as well—in effect, reciprocating their good behavior.<sup>232</sup> Reciprocity theory hypothesizes that individuals are inclined to pay their taxes only if they believe that other individuals are reciprocating their compliant behavior.<sup>233</sup> For “reciprocator” taxpayers, it is essential that the government appears to detect and punish freeriders—individuals who fail to comply with the tax system.<sup>234</sup> The federal government’s strategic publicity of its own tax enforcement actions, for example, reveals that its officials are well aware of the basic concept of reciprocity theory.<sup>235</sup> One former head of the U.S. Department of Justice Tax Division has commented, “People who pay what the law requires deserve the assurance that those who don’t, and those who promote or facilitate tax evasion, will not get away with it.”<sup>236</sup> For several reasons, collateral tax sanctions can enable the government to provide this assurance more effectively than the threat of monetary penalties or strategic publicity of its tax enforcement efforts.

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<sup>232</sup> The application of the reciprocity theory to tax compliance derives from several studies. See BEHAVIOURAL INSIGHTS TEAM, ANNUAL UPDATE 2011-2012, available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/83719/Behavioural-Insights-Team-Annual-Update-2011-12\\_0.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/83719/Behavioural-Insights-Team-Annual-Update-2011-12_0.pdf) (reporting reciprocity experiments that encouraged individuals to pay outstanding tax liabilities); STEPHEN COLEMAN, MINN. DEP’T OF REVENUE, THE MINNESOTA INCOME TAX COMPLIANCE EXPERIMENT: STATE TAX RESULTS (1996) (exploring the effectiveness of various strategies designed to improve voluntary compliance with the Minnesota individual income tax); Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance (2): A Field-Experiment 2* (Austl. Nat’l Univ. Ctr. for Tax Sys. Integrity, Working Paper No. 8, 2001) (finding that tax compliance is linked to taxpayer perceptions of various social norms).

<sup>233</sup> See Fehr & Gächter, *supra* note 163; Kahan, *supra* note 223.

<sup>234</sup> See Kahan, *supra* note 223, at 368 (“The reciprocity theory holds that individuals in collective action settings behave not like rational wealth maximizers but rather like moral and emotional reciprocators.”).

<sup>235</sup> See HERBERT GINTIS, GAME THEORY EVOLVING 255 (2000) (noting that “public-spirited contributors want to retaliate against free-riders, and the only way available to them . . . is by not contributing themselves”). Several studies have demonstrated that individuals reduce their compliance with the law if they perceive that others are cheating. See James Andreoni, *Cooperation in Public-Goods Experiments: Kindness or Confusion?*, 85 AM. ECON. REV. 891 (1995) (exploring the motives underpinning charitable giving); Joyce Berg et al., *Trust, Reciprocity, and Social History*, 10 GAMES & ECON. BEHAV. 122, 122-38 (1995) (finding that subjects take others’ “inappropriate behavior” into account when making their own decisions).

<sup>236</sup> Press Release, U.S. Dep’t of Justice, Justice Department and Internal Revenue Service Highlight Tax Enforcement Results (Apr. 3, 2007), <http://www.justice.gov/tax/txdvo7216.htm>.

a. *Publicity*

Collateral tax sanctions generate significant amounts of media attention. For example, California's enactment of the driver's license revocation provision in 2011,<sup>237</sup> the U.S. Senate's debate over the revocation of passports in 2012,<sup>238</sup> and the Louisiana legislation that empowered the state to rescind hunting licenses from tax delinquent individuals<sup>239</sup> were featured in dozens of stories in newspapers, radio and television reports, and blog posts. This media attention is attributable to the high salience of the government benefits and services that collateral tax sanctions confiscate and the controversy that often surrounds the enactment of these measures. Further, because federal and state legislatures rarely implement dramatic changes to the monetary tax-penalty structure,<sup>240</sup> the introduction of collateral tax sanctions presents an opportunity for journalists to write entertaining and digestible news stories about tax developments. This heightened media coverage can thus cause reciprocator taxpayers to develop the perception that the government is focused on preventing tax noncompliance.

b. *Observability*

Collateral tax sanctions can also strengthen feelings of reciprocity by causing the public to observe specific examples of the government's success in detecting and punishing tax-noncompliant individuals. Under federal and state law, tax-return information is protected by broad taxpayer privacy rules.<sup>241</sup> As a result of these protections, the general public cannot determine whether a particular taxpayer has been audited or required to pay a monetary tax penalty. Even tax liens are not easily observable because individuals must search court records to discover them, and with the exception of celebrities, the media does not report on most individuals' tax liens.<sup>242</sup> Scholars have argued that the "non-observability" of the compliance or noncompliance of other taxpayers poses a "serious problem" to attempts to apply reciprocity theory to taxpayer behavior.<sup>243</sup>

Collateral tax sanctions, however, can force some noncompliant taxpayers who have been caught and punished to appear in front of the curtain of

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<sup>237</sup> See *supra* notes 116-17 and accompanying text.

<sup>238</sup> See *supra* subsection I.B.3.a.i.

<sup>239</sup> See *supra* subsection I.B.3.b.iv.

<sup>240</sup> See Osofsky, *supra* note 213 (exploring the connection between tax law certainty and taxpayer compliance).

<sup>241</sup> See I.R.C. § 6103(a) (2006); see also FLA. STAT. ANN. § 213.053(6) (West 2013).

<sup>242</sup> See, e.g., Lifsher & Wilson, *supra* note 177 (describing various celebrity tax liens).

<sup>243</sup> Doran, *supra* note 21, at 136 n.134.

taxpayer privacy. For example, the owner of a restaurant would feel confident about the government's tax enforcement capabilities if he were to observe a forfeiture-of-liquor-license sign in the window of one of his competitors who failed to pay its outstanding tax liability. Likewise, when a physician learns that a fellow doctor has forfeited his medical license as a result of engaging in tax evasion, he would feel that few of his colleagues would likely be willing to engage in similar acts, given the significance of the resulting penalty. Collateral tax sanctions thus can provide reciprocator taxpayers with specific examples of the government's tax enforcement successes, whereas the use of monetary tax penalties results in anonymous and therefore much less memorable tax-enforcement statistics.<sup>244</sup>

c. *Peer Group Examples*

In addition to generating specific examples, collateral tax sanctions can also apply to members of a reciprocator taxpayer's peer group. As tax compliance scholars have noted, the cooperative behavior posited by reciprocity theory most likely occurs when an individual believes that "other members of one's in-group" are cooperating as well.<sup>245</sup>

The media often publicizes instances where an individual taxpayer receives a criminal sanction for failing to comply with the tax law.<sup>246</sup> As the federal government wins nearly all criminal tax cases, it attempts to maximize this publicity by prosecuting high-profile individuals where possible and by timing these prosecutions and guilty pleas to coincide with time periods when individuals are focused on preparing their individual tax returns.<sup>247</sup> During the 2006 criminal trial of Wesley Snipes, for instance, the public learned that the movie star had filed millions of dollars in fraudulent refund claims, adopted the "861 position" (a tax protester argument) and even signed fabricated tax return forms.<sup>248</sup> While Snipes was ultimately convicted

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<sup>244</sup> For a further discussion of the power of specific examples, see Blank, *supra* note 23, at 288-90.

<sup>245</sup> LYNN STOUT, CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE 145 (2011); see also Susan C. Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 U. CONN. L. REV. 675, 697-98 (2012) (discussing the relationship between peer group dynamics and tax enforcement efforts).

<sup>246</sup> See Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance*, 35 PUB. FIN. REV. 500, 502 (2007) (finding that the media plays a large role in the dissemination of stories on tax enforcement, thereby increasing tax compliance); Robert M. Melia, *Is the Pen Mightier than the Audit?*, 34 TAX NOTES 1309, 1310-11 & n.3 (1987) (same).

<sup>247</sup> See Blank, *supra* note 23, at 316-17 (discussing the media's role in taxpayer compliance).

<sup>248</sup> See United States' Sentencing Memorandum, *United States v. Snipes*, 2008 WL 6124556 (M.D. Fla. Apr. 14, 2008) (No. 06-22-Oc-10GRJ) (describing Snipes's thirty-six-month prison term).

for willfully failing to file tax returns,<sup>249</sup> it is possible that some reciprocator taxpayers viewed his conviction as an indication that only extreme acts of tax evasion committed by tax protestors are the types of offenses that result in detection and prosecution by the taxing authorities.

Because collateral tax sanctions result in specific examples of enforcement and can affect a diverse group of taxpayers, however, they can further increase reciprocator taxpayers' confidence in the government's ability to ensure that their peers are paying their fair share of taxes. For example, when a prominent attorney at a New York City law firm forfeited his law license in 2012 as a result of his failure to file tax returns or pay taxes for several years,<sup>250</sup> he appeared in a public court and the press covered his story extensively.<sup>251</sup> Upon hearing this news, another New York City law firm partner, who has dutifully filed her tax returns in the dozens of jurisdictions in which her firm conducts business, may have felt relief that she has not acted like a "chump" by engaging in burdensome tax return preparation and making sizeable tax payments while her colleagues at other firms, or even the same firm, simply ignored their tax obligations.<sup>252</sup>

For reciprocator taxpayers, observable punishments for tax delinquency are especially important. If reciprocator taxpayers perceive that the taxing authority is not capable of detecting blatant acts of tax delinquency, they may doubt whether the authority possesses the ability to attack far more sophisticated forms of tax avoidance and evasion. By generating media attention and, in some cases, exposing specific tax offenders who have been detected and punished, collateral tax sanctions can more effectively preserve or enhance reciprocator taxpayers' beliefs that the government is capable of controlling the growth of tax noncompliance than traditional monetary tax penalties.

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<sup>249</sup> See *Wesley Snipes Gets 3 Years for Not Filing Tax Returns*, N.Y. TIMES, Apr. 25, 2008, at C3 (describing Snipes's sentence for noncompliance).

<sup>250</sup> *In re O'Brien*, 946 N.Y.S.2d 174 (N.Y. App. Div. 2012).

<sup>251</sup> See, e.g., Bob Van Voris, *Ex-Sullivan & Cromwell Lawyer Gets 28 Months for Tax Crime*, BLOOMBERG (Jan. 11, 2012), <http://www.bloomberg.com/news/2012-01-11/ex-sullivan-cromwell-lawyer-gets-28-months-for-tax-crime-2-.html>.

<sup>252</sup> See Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1487 (2003) (citing Janet Novack, *Are You a Chump?*, FORBES, Mar. 5, 2001, at 125).

## 6. Collateral Tax Sanctions Reinforce Tax Compliance as a Duty of Citizenship

A final oft-discussed motivation of individual tax compliance is that some individuals feel that paying taxes is an important duty of citizenship.<sup>253</sup> As Justice Oliver Wendell Holmes famously proclaimed, “I like to pay taxes. With them I buy civilization.”<sup>254</sup> The growing use of collateral tax sanctions may thus have positive impacts on tax compliance by individuals who feel a similar patriotic obligation to pay their taxes.

Scholars have long argued that the government can preserve, and perhaps even improve, tax compliance among patriotic taxpayers by convincing them that their tax dollars provide valuable government benefits and services. As economist Richard Bird has phrased this objective, an “essential institutional feature” of tax administration is the government’s demonstration of clear “expenditure–revenue links” between tax payments and the services and benefits they fund.<sup>255</sup> Numerous studies have confirmed that, as taxpayers increasingly perceive that the government is using their tax dollars to provide public goods, their willingness to cooperate with the state and to pay their taxes out of a duty of citizenship—often described as “tax morale”—rises as well.<sup>256</sup>

The challenge is that the link between tax revenues and government expenditures is not always apparent to taxpayers. As a result, several scholars have offered proposals that would increase positive publicity of the government benefits and services that tax dollars provide. For example, Yair Listokin and David Schizer have argued that the government should “trumpet” its use of taxpayer dollars in “signs about ‘your tax dollars at work’” and “in press releases from politicians about benefits secured for

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<sup>253</sup> See James Alm & Benno Torgler, *Culture Differences and Tax Morale in the United States and in Europe*, 27 J. ECON. PSYCHOL. 224, 228-29 (2006) (arguing that taxpayers’ willingness to pay taxes increases as they perceive that the state provides public goods); John T. Scholz, *Contractual Compliance: Tax Institutions and Tax Morale in the U.S.* (describing the concept of “tax morale”), in TAX EVASION, TRUST AND STATE CAPACITIES 51 (Nicolas Hayoz & Simon Hug eds., 2007); Benno Torgler & Friedrich Schneider, *What Shapes Attitudes Toward Paying Taxes? Evidence from Multicultural European Countries*, 88 SOC. SCI. Q. 443, 444 (2007) (citing studies linking “tax morale” to decreased tax evasion).

<sup>254</sup> FELIX FRANKFURTER, MR. JUSTICE HOLMES AND THE SUPREME COURT 42-43 (1938) (quoting Oliver Wendell Holmes).

<sup>255</sup> Richard M. Bird, *Evaluating Public Expenditures: Does It Matter How They Are Financed?*, in FISCAL MANAGEMENT 83, 95-96 (Anwar Shah ed., 2005).

<sup>256</sup> See, e.g., Ronald G. Cummings et al., *Effects of Tax Morale on Tax Compliance: Experimental and Survey Evidence* 4 (Leitner Program in Int’l & Comparative Political Econ., Working Paper No. 2005-22, 2005), available at <http://www.yale.edu/leitner/resources/docs/botswana.pdf> (arguing that tax compliance increases with the perception that the government is “providing valued goods and services with the revenues”).



constituents,” just as charitable organizations rely heavily on the use of print and electronic media to inform their donors and potential donors of the specific initiatives that their contributions support.<sup>257</sup> Similarly, Joshua Rosenberg has argued that the government should produce advertisements featuring projects and services such as “[b]rief shots of hospitals, schools, roads, jetfighters, people eating wholesome food, taking safe drugs, etc.” to enhance positive associations toward tax payments.<sup>258</sup> Outside the United States, several national governments have deployed television and radio advertisements similar to these proposals.<sup>259</sup>

Collateral tax sanctions offer another approach for enhancing tax morale. By rescinding benefits and services from individuals who have failed to pay their outstanding tax liabilities, the government can maintain and strengthen the public perception that tax dollars indeed fund critical benefits and services. As a result of the high salience of collateral tax sanctions and their implication of the loss-aversion bias, individuals are likely to pay greater attention to the possibility of losing those benefits than to the government’s positive publicity of benefits and services that citizens already enjoy and are not in immediate danger of losing.

Collateral tax sanctions establish explicit links between tax payments and concrete government benefits and services, and can do so even more effectively than positive publicity campaigns. Even if the federal government publicizes its improvements to the interstate highway system or its assistance to home mortgage borrowers, for example, some individuals may be skeptical that their tax dollars actually contributed to those efforts. By revoking an individual’s driver’s or recreational hunting license, on the other hand, a state government can cause its residents to perceive taxes as payments that fund structurally sound roads and safe, well-maintained hunting grounds. Likewise, if the federal government enacts legislation that would revoke passports from tax delinquents, it can remind individuals that their tax dollars pay for protections that the U.S. government and its embassies

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<sup>257</sup> Yair Listokin & David M. Schizer, *I Like To Pay Taxes: Taxpayer Support for Government Spending and the Efficiency of the Tax System*, 66 TAX L. REV. 179, 194 (2013).

<sup>258</sup> Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 229 (1996) (footnote omitted).

<sup>259</sup> The Canada Revenue Agency, for example, has used television advertising as a way to discourage people from paying contractors under the table. See, e.g., *Get It in Writing! Before You Build or Renovate...*, CAN. REVENUE AGENCY (June 16, 2010), <http://www.cra-arc.gc.ca/ndrgrnd/wtchvd-eng.html>. South Africa has also used television commercials to achieve the types of linkages described above. In one video, the tagline at the end of the ad is “THANK YOU SOUTH AFRICA: Your Tax Is Touching Lives.” See SARS TV, *A Second Chance*, YOUTUBE (Nov. 22, 2012), <http://www.youtube.com/watch?v=iM9iLCxpVxs&feature=share&list=PL2cgdzQm93yo2h5CoYlywDXBfotE3QMR8>.

provide when Americans travel abroad.<sup>260</sup> Collateral tax sanctions thus essentially encourage individuals to view their taxes as “user fees” that they pay in exchange for commonly used benefits and services.

Another advantage of collateral tax sanctions is that they can enhance expenditure–revenue links in the minds of individual taxpayers without provoking contradictory messages that often surround positive publicity campaigns. As advocates of the positive publicity approach, such as Listokin and Schizer, acknowledge, when the government publicizes its programs, political opponents of the incumbent party often criticize the effort as an act of credit-claiming.<sup>261</sup> For example, when the U.S. Department of Labor advertised its new “green jobs” training programs in 2009, opponents of the Obama Administration publicly dismissed the publicity effort as a political use of taxpayer dollars that did not “pass the basic sniff test.”<sup>262</sup> These conflicting characterizations may have muted the value of the new program for many taxpayers. Collateral tax sanctions do not create similar opportunities for politicians to accuse each other of attempting to publicize specific government benefits or programs. Instead of requiring government officials to “trumpet”<sup>263</sup> specific government benefits and services, collateral tax sanctions simply take these benefits and services away from individuals who do not pay for them.

### C. Drawbacks

Collateral tax sanctions encourage the proper reporting and payment of tax liability by individuals who are influenced by different, often overlapping, motivations of compliance, yet they also present several potential drawbacks. These are discussed below.

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<sup>260</sup> See, e.g., U.S. DEP’T OF STATE, U.S. PASSPORT CARD FREQUENTLY ASKED QUESTIONS, available at [http://travel.state.gov/passport/ppt\\_card/ppt\\_card\\_3921.html](http://travel.state.gov/passport/ppt_card/ppt_card_3921.html) (last visited Feb. 21, 2014) (explaining that the cost of the U.S. passport card is based on the “cost of providing consular services” to U.S. passport holders).

<sup>261</sup> Listokin & Schizer, *supra* note 257, at 194.

<sup>262</sup> See Judson Berger, *Labor Department Spent \$500G in Stimulus on Green-Job Ad Blitz of Olbermann, Maddow*, FOXNEWS (Aug. 22, 2012), <http://www.foxnews.com/politics/2012/08/22/labor-department-spent-500g-in-stimulus-funds-on-ads-during-olbermann-maddow> (quoting Rep. Jason Chaffetz (R-Utah)).

<sup>263</sup> See Listokin & Schizer, *supra* note 257, at 194.

### 1. Spillover Effects

A significant drawback of certain collateral tax sanctions is that, by revoking government privileges and benefits, they impose spillover effects on parties other than noncompliant taxpayers.<sup>264</sup>

Consider a few illustrations of the people and activities that several of the collateral tax sanctions described above affect. When an individual forfeits her driver's license as a result of failing to pay her established tax liability, for example, she loses the ability to drive herself to professional and personal activities. But the driver's license revocation can also adversely affect her children and other family members who rely on her for transportation. Further, depending on the individual's occupation, her employer may incur costs, such as having to hire a more expensive temporary employee. Monetary tax penalties, on the other hand, are borne more directly by the individual who committed the initial tax offense because they do not affect government benefits upon which individuals other than the noncompliant taxpayer rely.

The potential spillover effects of collateral tax sanctions increase as the scope and application of these sanctions grow. If collateral tax sanctions such as revocation of professional licenses apply to common tax reporting errors or mistakes, they could result in substantial social costs. In light of the spillover effects, governments should be cautious when considering applying collateral tax sanctions to tax offenses that are committed by many individuals.

### 2. Brute Deterrence

Another possible harmful effect of collateral tax sanctions is that taxpayers may view some of these measures as illegitimate acts of brute deterrence<sup>265</sup> by the government. This reaction can occur especially in instances where individuals do not feel that the government enforces collateral tax sanctions with the same due process that it metes out when applying other penalties. A consequence of this perception is that some individuals could reduce, rather than increase, their tax compliance.

If people do not consider the law or legal institutions to be legitimate, they can choose not to obey the law. Based on findings in several social

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<sup>264</sup> For a general discussion of these effects, see Daniel B. Kelly, *Strategic Spillovers*, 111 COLUM. L. REV. 1641, 1642-47 (2011).

<sup>265</sup> See Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire?* (noting that taxpayers who read reports regarding the "tax gap" were less likely to comply), in *WHY PEOPLE PAY TAXES*, *supra* note 161, at 211-14.

psychology studies, Tom Tyler has argued that individuals comply with the law because “[w]hen authorities are viewed as legitimate, their actions are more likely to be seen as fair.”<sup>266</sup> For instance, one study of individuals’ reactions to police behavior found that, if individuals perceive that the police are applying the law fairly, they will yield to police authority and will cooperate with them when necessary.<sup>267</sup> Another study found that individuals’ belief that the government acts in a procedurally fair manner corresponds with a sizeable increase in individuals’ likelihood to cooperate with various government agencies, including the taxing authority.<sup>268</sup> Though few studies of this theory have been conducted specifically in the tax context,<sup>269</sup> if individuals feel that the government’s tax enforcement efforts are not fair, they may react in a manner consistent with the findings in these studies.

Certain collateral tax sanctions could appear illegitimate to some individuals. Such a perception could develop if individuals believe that a particular collateral tax sanction is directly at odds with a related tax administration objective of the government. For example, individuals who have failed to pay their taxes could object to a rule that forces them to forfeit their driver’s license because the effect of this policy will be to deprive them of the ability to earn income necessary to repay their tax liabilities.<sup>270</sup> Individuals could also view a collateral tax sanction as illegitimate if it imposes an excessive personal hardship, including its spillover effects. Finally, some individuals could feel that certain collateral tax sanctions are illegitimate if they apply without due process of law.

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<sup>266</sup> TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 107 (2006); *see also* Tom R. Tyler, *Procedural Justice, Legitimacy, and the Effective Rule of Law*, 30 *CRIME & JUST.* 283, 291 (2003) (highlighting the negative impact that a decline in “trust and confidence” in the legal system has on compliance with the law); Tom R. Tyler, *Psychological Perspectives on Legitimacy and Legitimation*, 57 *ANN. REV. PSYCHOL.* 375 (2006) (discussing the effects of perceptions of legitimacy on deference to authority).

<sup>267</sup> Jason Sunshine & Tom R. Tyler, *The Role of Procedural Justice and Legitimacy in Shaping Public Support for Policing*, 37 *LAW & SOC’Y REV.* 513, 524 (2003) (“[T]he legitimacy of the police is based on how well they perform, whether they effectively sanction rule-breakers, and/or whether police services are distributed fairly across society.”).

<sup>268</sup> Margaret Levi et al., *Conceptualizing Legitimacy, Measuring Legitimizing Beliefs*, 53 *AM. BEHAV. SCIENTIST* 354, 366 (2009).

<sup>269</sup> *See* Kathleen M. McGraw & John T. Scholz, *Appeals to Civic Virtue Versus Attention to Self-Interest: Effects on Tax Compliance*, 25 *LAW & SOC’Y REV.* 471, 494 (1991) (finding that normative appeals may have some effects on tax attitudes); Richard D. Schwartz & Sonya Orleans, *On Legal Sanctions*, 34 *U. CHI. L. REV.* 274, 295 (1967) (finding normative appeals to have greater influence on tax compliance than deterrence factors).

<sup>270</sup> *See* ASSEMBLY COMM. ON REVENUE & TAXATION, 2011-2012 REGULAR SESSION, BILL ANALYSIS, AB1424, 4 (2011) (stating that revocation of an individual’s driver’s license will reduce his ability to earn income).

How might individuals who harbor such feelings of illegitimacy respond to collateral tax sanctions? One possibility is that, consistent with Tyler's legitimacy research, some individuals could respond to hefty collateral tax sanctions by making greater efforts to escape detection by the taxing authorities rather than by cooperating at all.<sup>271</sup> Some could respond by shifting business operations into the black market, where the government lacks the ability to monitor whether they even owe tax liability, let alone whether they have paid it in a timely manner.

### 3. Horizontal Equity

Taxpayers might also perceive that the government is acting unfairly if it applies collateral tax sanctions in a way that violates the principle of horizontal equity.<sup>272</sup> Though the question of whether the concept of horizontal equity should play a role in the design of tax policy is surely debatable,<sup>273</sup> many taxpayers feel that taxpayers who are similarly situated should be taxed in the same manner.<sup>274</sup> Applying this concept to the tax enforcement context, policymakers aim to subject individuals who commit the same tax offenses to the same tax penalties.<sup>275</sup> As the discussion above reveals, collateral tax sanctions can result in significant noneconomic costs and indirect economic costs.<sup>276</sup> For example, individuals who commit the tax offense of tax delinquency and forfeit their professional licenses as a result of a collateral tax sanction will incur significant costs, which have both economic and noneconomic features, whereas individuals who do not hold the specified professional licenses and commit the same tax offense will only incur the significantly less costly monetary tax penalty. As will be discussed, governments can proactively respond to the horizontal equity concern by

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<sup>271</sup> See sources cited *supra* note 266.

<sup>272</sup> For further discussion, see R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45-47 (1967).

<sup>273</sup> See, e.g., Peter J. Lambert & Shlomo Yitzhaki, *Equity, Equality and Welfare*, 39 EUR. ECON. REV. 674, 674-75 (1995) (comparing horizontal and vertical equity in the context of tax policy); Daniel N. Shavero, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393 (1993) (criticizing horizontal equity). *But see* Brian Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323, 1366-67 (2008) (defending horizontal equity as having independent meaning as a default rule in favor of existing arrangements).

<sup>274</sup> See JOINT COMM. ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 26 (Comm. Print 2001) (discussing the importance of "perceived horizontal equity").

<sup>275</sup> See, e.g., U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 406 (1984), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/tres84v2C20.pdf> (criticizing tax penalties that "undermine horizontal equity").

<sup>276</sup> See *supra* subsection II.B.3.

designing collateral tax sanctions that are not restricted to a narrowly defined group of individuals, but that apply to a broader segment of the taxpayer population.<sup>277</sup>

#### 4. Tax Privacy

Collateral tax sanctions also raise tax privacy concerns that traditional monetary tax penalties do not. A potential drawback of collateral tax sanctions is that they could cause individuals to fear that government agencies and officials other than the taxing authority will gain access to their personal tax return information.<sup>278</sup> Even though taxing authorities regularly share tax return information with other government agencies as a result of a large number of statutory exceptions to taxpayer confidentiality,<sup>279</sup> providing other agencies with access to individuals' tax return information could result in abuse.<sup>280</sup> These abuses could potentially involve the inappropriate use of personal tax return information by officials other than the employees of the taxing authority or the improper revocation of government benefits and services by non-tax agencies that attempt to apply collateral tax sanctions.<sup>281</sup>

Regardless of whether the perception is accurate, if individuals believe that collateral tax sanctions reduce their tax privacy protections, they could respond in ways that negatively affect the taxing authority's ability to administer and enforce the tax law. If individuals believe that collateral tax sanctions will allow non-tax agencies to gain access to their tax returns, they might limit the information that they reveal to the taxing authority.<sup>282</sup> Further, individuals could feel that the sharing of tax return information

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<sup>277</sup> See *infra* note 329 and accompanying text.

<sup>278</sup> Commentators have long argued that taxpayers will not cooperate with the taxing authority unless, as former Treasury Secretary Andrew Mellon famously stated, they trust that their personal tax information "stops with the government." 1 U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON SCOPE AND USE OF TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS 18-19 (2000) (attributing the quote to Andrew Mellon); see also Blank, *supra* note 23 at 280-82.

<sup>279</sup> I.R.C. § 6103(c)-(o) (2006).

<sup>280</sup> See, e.g., CAL. FRANCHISE TAX BD., THE DELINQUENT TAXPAYER ACCOUNTABILITY ACT (2012) (describing a variety of abuse concerns regarding driver's license revocations); Jacoba Urist, *No Taxes, No Travel: Why the IRS Wants the Right to Seize Your Passport*, THE ATLANTIC (Apr. 17, 2012), <http://www.theatlantic.com/business/archive/2012/04/no-taxes-no-travel-why-the-irs-wants-the-right-to-seize-your-passport/255940> (quoting Daniel Shaviro as stating that passport revocation from tax delinquents could "be misused, say, to harass specific individuals whom government officials dislike").

<sup>281</sup> See *id.*

<sup>282</sup> The IRS itself has articulated this view. IRS, DISCLOSURE & PRIVACY LAW REFERENCE GUIDE 1-17 ("By the single act of filing a tax return, a record is created and also a trust."). For further discussion, see Blank, *supra* note 23, at 280-82.

with other agencies is illegitimate or unfair, especially if the other agency applies harsh collateral tax sanctions in an inconsistent and unpredictable manner. In response, they might reduce their individual tax compliance.<sup>283</sup>

Although these reactions could occur if individuals believe that collateral tax sanctions enable non-tax agencies to gain broad access to their individual tax returns, these reactions are not justified in the case of many existing collateral tax sanctions. In the case of existing collateral tax sanctions, non-tax agencies receive narrowly tailored and limited personal tax information of individuals directly from the taxing authority, such as a list of individuals who owe outstanding tax liabilities exceeding a certain threshold.<sup>284</sup> Nonetheless, because individuals place significant trust in the government when they submit detailed personal information on their tax returns, government officials should not ignore the potential tax privacy concerns that certain types of collateral tax sanctions raise.

### 5. Observability

Finally, the observability of some collateral tax sanctions is a feature that may strengthen tax compliance among certain individuals. If these sanctions are applied too broadly, however, observability could instead reduce tax compliance. If the government applies collateral tax sanctions that result in observable effects, such as individuals' losses of professional licenses, to common tax offenses or to tax offenses that meet a low dollar threshold, many individuals could incur these sanctions. For individuals who are motivated by feelings of reciprocity,<sup>285</sup> the frequent imposition of observable collateral tax sanctions could lead them to perceive that many individuals have engaged in tax noncompliance. A possible reaction from these reciprocator taxpayers could be to reduce their own compliance. Additionally, if the government applies collateral tax sanctions too frequently, the negative signal of tax noncompliance would likely become muted.<sup>286</sup> If most individuals lose their professional licenses temporarily as a result of a common tax offense, individuals' fear of emitting this particular signal would decrease. Government officials, consequently, should consider the potential adverse effects of observability, along with each of the other drawbacks discussed

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<sup>283</sup> See Levi et al., *supra* note 268, at 359.

<sup>284</sup> For example, in California, the Department of Motor Vehicles revokes the driver's licenses of individuals who appear on lists that it receives directly from the taxing authority. CAL. VEH. CODE § 34623.1 (2012).

<sup>285</sup> See *supra* subsection II.B.5.

<sup>286</sup> See Posner, *supra* note 26, at 1790 ("Stigma arises only when a behavior or its detection is rare.").

above, when deciding whether to deploy collateral tax sanctions as a means of enforcement.

### III. WHEN SHOULD COLLATERAL TAX SANCTIONS APPLY?

When should governments apply collateral tax sanctions? While the previous discussion illustrates that collateral tax sanctions possess features that enable them to encourage tax compliance more effectively than the threat of additional monetary tax penalties, it also reveals that collateral tax sanctions present several significant drawbacks.<sup>287</sup> If governments do not address these drawbacks, their use of collateral tax sanctions could be detrimental to their tax enforcement efforts.

In light of the foregoing analysis of the competing benefits and detriments, governments are in need of guidance regarding how they should apply collateral tax sanctions to maximize their positive impact on compliance. This Part proposes guiding principles for the design and implementation of collateral tax sanctions, applies these principles to specific examples, and, finally, outlines publicity strategies for taxing authorities.

#### A. Proposed Principles

Below are three guiding principles that I propose governments should consider when crafting collateral tax sanctions.

##### 1. Tax Offense Is a Violation of a Tax Rule, Not a Tax Standard

Collateral tax sanctions should apply when the underlying tax offense represents a violation of a tax rule, not a tax standard. A tax rule is clear, specific guidance that dictates *ex ante* whether a taxpayer is required to engage, or prohibited from engaging, in a particular action.<sup>288</sup> For example, the requirement that individual taxpayers file their annual federal income tax returns on or before April 15th is a tax rule.<sup>289</sup> A tax standard, by contrast, consists of general guidelines regarding particular conduct.<sup>290</sup> The

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<sup>287</sup> See *supra* Section II.C.

<sup>288</sup> See Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 543-44 (2009) (distinguishing *ex ante* tax rules from *ex post* tax standards); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1993) (“[T]he only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act.” (emphasis omitted)).

<sup>289</sup> I.R.C. § 6072(a) (2006).

<sup>290</sup> See Blank, *supra* note 288, at 543; Kaplow, *supra* note 288, at 560.



only way to determine with absolute certainty whether a taxpayer has violated a tax standard is by receiving an ex post judgment from an adjudicator such as a court.<sup>291</sup> For instance, the requirement that a taxpayer's transaction possess "economic substance"<sup>292</sup> is a tax standard because it is not possible to know with absolute certainty whether the transaction satisfies this requirement until a judge reviews it.<sup>293</sup> For several reasons, collateral tax sanctions should promote tax compliance more effectively and avoid many of the potential drawbacks described above if they apply to situations where taxpayers violate tax rules rather than tax standards.

First, without clear advance notice, the threat of collateral tax sanctions is unlikely to serve as an effective deterrent for taxpayers who are influenced by their fear of sanctions. A collateral tax sanction that results from violation of an explicit tax rule, like the requirement that taxpayers pay established tax liability by a specific date, is easier for the government to publicize with clear communication than one that results from a violation of a more ambiguous tax standard, such as a requirement that taxpayers not claim tax positions that reflect "negligence" or "disregard of rules and regulations."<sup>294</sup>

Further, a collateral tax sanction would affect fewer taxpayers if it applies to violations of a tax rule rather than violations of a tax standard. Compared to tax rules, tax standards are ambiguous. A state government, for instance, could create a rule that provides that any physician who engages in a transaction that is an abusive tax shelter must forfeit his medical license. The dilemma created by this provision is that taxpayers might not be able to predict with certainty whether a particular transaction indeed lacks economic substance until an audit, and possibly a trial, occurs. If the loss of a medical license in this example were to apply to situations where taxpayers had engaged in abusive tax shelters, the result could be the emergence of many observable instances of tax noncompliance. And without a definition of "tax shelter," it is unclear whether collateral tax sanctions would even be capable of reducing their occurrence.<sup>295</sup> Increased observability

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<sup>291</sup> See Blank, *supra* note 288, at 543.

<sup>292</sup> See, e.g., *ACM P'ship v. Comm'r*, 157 F.3d 231, 247-48 (3d Cir. 1998) (applying an objective economic substance analysis to a taxpayer transaction). For a discussion of the development of the economic substance doctrine, see generally Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 402-16 (arguing that the modern economic substance doctrine should be abandoned in favor of a direct inquiry into congressional intent).

<sup>293</sup> See Joshua D. Blank & Nancy Staudt, *Corporate Shams*, 87 N.Y.U. L. REV. 1641, 1650-51 (2012) (describing the ex post nature of economic substance doctrine).

<sup>294</sup> I.R.C. § 6662(b)(1).

<sup>295</sup> See, e.g., Calvin H. Johnson, *What's a Tax Shelter?*, 68 TAX NOTES 879, 879 (1995) (commenting that there is "no consensus definition of a 'tax shelter' in the law"). The Code contains a

of tax noncompliance poses risks under both the reciprocity and signaling models of tax compliance.<sup>296</sup>

A final reason to restrict the use of collateral tax sanctions to violations of tax rules is that individuals may be less willing to enter settlements with the taxing authority in tax controversies if their admission of committing a tax offense will result in the revocation of a significant government benefit or service.<sup>297</sup> If a state government, for instance, required individuals who negligently underpaid their taxes to forfeit their driver's licenses for a specified period of time, individuals facing this sanction may be unwilling to settle the tax controversy with the taxing authority. As a result of the magnitude of the potential collateral tax sanction, they would likely argue their cases in front of judges, who would decide whether they violated the negligence tax standard, rather than accept the taxing authority's charge. If the driver's license suspension in this example instead resulted from a violation of a clear tax rule, such as the requirement to pay an established outstanding tax liability on time, those individuals may instead decide to settle the matter and face the collateral tax sanction because he would consider his chances of succeeding in court to be low.

## 2. Tax Offense Should Be Defined by Tax Law and Identified by the Taxing Authority

Collateral tax sanctions that result from a tax offense that the tax law defines and that a taxing authority identifies are likely to enhance tax compliance objectives more effectively than those that stem from definitions contained in non-tax statutes and that are applied by non-tax agencies. Non-tax agencies have the authority to revoke government benefits as a result of tax offenses, which are defined in their own governing statutory or administrative law, rather than the tax law.<sup>298</sup> These agencies can apply different, broader definitions of tax offenses than the taxing authority as a result of special qualifications relating to the specific benefits that these agencies

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general definition of tax shelter as a transaction that possesses a "significant purpose of . . . avoidance or evasion of Federal income tax." I.R.C. § 6662(d)(2)(C) (2006).

<sup>296</sup> See *supra* subsection II.C.5.

<sup>297</sup> The IRS Appeals Division settles approximately eighty-five percent of all tax controversies. B. John Williams, Jr., Chief Counsel, IRS, Resolving Tax Shelters: By Settlement or Litigation, Address Before the Chicago Bar Association Federal Taxation Committee 8 (Feb. 25, 2003), available at <http://www.irs.gov/pub/irs-utl/shelters-feb25.pdf>.

<sup>298</sup> See, e.g., 8 U.S.C. § 1101(a)(43)(M)(i) (2012) (defining tax offenses in a U.S. Code section governing aliens and nationality); see also C.O. Lamp, *Tax, Turpitude, and a Technical Test for Disbarment*, 17 DRAKE L. REV. 94, 101-06 (1967) (describing confusion among state bars as to which tax offenses constitute moral turpitude).

provide. Further, the government could affirmatively allow non-tax agencies to describe and detect abusive tax activities, rather than merely revoke government benefits due to tax noncompliance.<sup>299</sup> For example, if current tax privacy rules were altered,<sup>300</sup> Congress could empower the Department of State to issue regulations defining tax offenses that result in the suspension of a U.S. passport and to identify instances where those offenses occur. For several reasons, however, such measures are unlikely to maximize the compliance benefits of collateral tax sanctions.

The taxing authority has limited ability to deter tax noncompliance through advance publicity of collateral tax sanctions that result from laws other than the tax law and that are identified by other agencies. Extending the hypothetical from above, if the Department of State were authorized to apply its own definition of tax noncompliance when determining whether to revoke an individual's passport, officials in this agency would develop their own internal standards for determining when certain acts of tax noncompliance merit revocation. Without coordination between agencies, IRS officials may not be aware of these standards, at least not in such depth that they would be capable of warning taxpayers *ex ante* of the potential collateral tax sanction of passport removal as a result of uncertain tax offenses.

Further, if a collateral tax sanction results from a non-tax agency's definition and identification of a tax offense, taxpayers might feel that the non-tax agency lacks the expertise necessary to make this determination. While officials in non-tax agencies are certainly capable of reading the existing tax law when reviewing an individual's tax returns, they may have little understanding of the case law, administrative rulings, or policy rationales that are necessary for an informed application of the tax law to particular facts.

### 3. The Collateral Tax Sanction Should Be Proportionate to the Tax Offense

Finally, when the government applies a collateral tax sanction, the benefit or service that it revokes from an individual should have a proportionate relationship to the magnitude of the tax offense that triggers the sanction. Proportionality is frequently raised as a goal of punishment design for

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<sup>299</sup> Such an argument might be made in the interest of efficiency and reduction of bureaucratic waste. *See, e.g.*, Mark Landler & Annie Lowrey, *Obama Bid to Cut the Government Tests Congress*, N.Y. TIMES, Jan. 14, 2012, at A1 (quoting President Obama as calling on Congress to grant him authority to propose mergers of government agencies, which Congress would then approve or reject).

<sup>300</sup> Federal law currently allows for limited sharing of individual tax return information between the IRS and other agencies, including state taxing authorities. I.R.C. § 6103(a), (c), (o) (2006).

equity or constitutional reasons.<sup>301</sup> One could argue, for instance, that simply as a matter of fundamental fairness, the government should not suspend a benefit as a result of tax noncompliance if this act would be disproportionate to the underlying tax offense. An overarching objective of designing any collateral tax sanction thus should be to ensure that the resulting sanction represents just desert for the offender. Yet in addition to the general normative objective that tax penalties should be fair, governments should also consider the potential relationship between proportionality and compliance. As this final principle illustrates, disproportionate collateral tax sanctions could have detrimental effects on individuals' tax compliance decisions and the government's ability to administer the tax law efficiently.

Collateral tax sanctions should satisfy a proportionality principle in order to maintain individuals' willingness to cooperate with the taxing authority. Many people intuitively support the biblical mandate of *lex talionis*, commonly referred to as "eye for eye, tooth for tooth."<sup>302</sup> Criminal law theorists, such as Paul Robinson and John Darley, have argued that if the government deviates from this principle by applying disproportionate sanctions, it will weaken the law's "moral credibility," which in turn may "undercut its ability to help in the creation and internalization of norms and its power to gain compliance by its moral authority."<sup>303</sup> Although this theory of penalty design has been subject to criticism,<sup>304</sup> it has also been supported by several empirical studies that report that individuals reduce their compliance with the law in response to the government's application of disproportionate sanctions for offenses ranging from tax noncompliance<sup>305</sup> to possession and

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<sup>301</sup> If a civil fine or forfeiture represents a punitive rather than remedial measure, it may be limited by the Excessive Fines Clause of the Eighth Amendment. See *Austin v. United States*, 509 U.S. 602 (1993). For discussion, see Nancy J. King, *Portioning Punishment: Constitutional Limits on Successive and Excessive Penalties*, 144 U. PA. L. REV. 101, 108-12 (1995) (discussing proportionality under the Eighth Amendment); and Alice Ristroph, *Proportionality as a Principle of Limited Government*, 55 DUKE L.J. 263, 292-314 (2005) (same).

<sup>302</sup> *Exodus* 21:23-25.

<sup>303</sup> Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. U. L. REV. 453, 478, 482 (1997); see also PAUL H. ROBINSON, *DISTRIBUTIVE PRINCIPLES OF CRIMINAL LAW: WHO SHOULD BE PUNISHED AND HOW MUCH?* (2008); Paul H. Robinson et al., *The Disutility of Injustice*, 85 N.Y.U. L. REV. 1940 (2010); Paul H. Robinson & John M. Darley, *Intuitions of Justice: Implications for Criminal Law and Justice Policy*, 81 S. CAL. L. REV. 1 (2007).

<sup>304</sup> See, e.g., Adam J. Kolber, *How to Improve Empirical Desert*, 75 BROOK. L. REV. 433, 441-48 (2009) (criticizing theorists such as Robinson and Darley for cherry-picking certain moral intuitions, but ignoring others, in making their arguments); Christopher Slobogin, *Some Hypotheses About Empirical Desert*, 42 ARIZ. ST. L.J. 1189 (2011) (asserting that Robinson's work on empirical desert could use further empirical support).

<sup>305</sup> Karyl A. Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data* (finding that when subjects perceive tax law to be unfair as a result of friends' excessive

use of marijuana.<sup>306</sup> Though predictions of taxpayers' responses to the government's use of disproportionate collateral tax sanctions may not hold true for all individuals, in light of the existing empirical and theoretical support, governments should consider proportionality when determining which benefits and privileges to revoke, and for what length of time, in response to specific tax offenses.

The difficult question, of course, is when individuals would perceive a collateral tax sanction to be disproportionate to the underlying tax offense. The U.S. Supreme Court has decided several cases that address the constitutionality of disproportionate criminal sanctions<sup>307</sup> and civil forfeitures.<sup>308</sup> In *United States v. Bajakajian*,<sup>309</sup> Hosep Bajakajian attempted to board a plane from Los Angeles to Cyprus while carrying \$357,144 in cash, but was stopped by U. S. customs officials.<sup>310</sup> Bajakajian was charged with failing to declare his removal of more than \$10,000 in cash from the United States.<sup>311</sup> Even though the maximum criminal fine was \$5000, the government sought to force Bajakajian to forfeit the entire \$357,144 because Bajakajian provided misleading answers regarding the reasons for his transport of the cash.<sup>312</sup> The Supreme Court held that this sanction represented a violation of the Excessive Fines Clause of the Eighth Amendment because it was "grossly disproportional to the gravity of [Bajakajian's] offense."<sup>313</sup>

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payment of taxes in response to IRS demands, they report a lower willingness to comply with the tax law in the future), in *WHY PEOPLE PAY TAXES*, *supra* note 161, at 259; *see also* John T. Scholz & Mark Lubell, *Trust and Taxpaying: Testing the Heuristic Approach to Collective Action*, 42 AM. J. POL. SCI. 398, 408 (1998) (finding that individuals' trust in government increases willingness to comply with the tax law).

<sup>306</sup> Herbert Jacob, *Deterrent Effects of Formal and Informal Sanctions*, 2 L. & POL'Y Q. 61, 64-67, 72 (1980) (reporting that only thirty-six percent of subjects who viewed marijuana bans as unfair refrained from using the substance); *see also* Robinson et al., *supra* note 303, at 2001-04 (finding that individuals who are disillusioned by the unfairness of the criminal justice system are less willing to cooperate with police).

<sup>307</sup> *See, e.g.*, *Solem v. Helm* 463 U.S. 277, 290-92 (1983) (introducing a three-part test for finding whether a criminal sanction is disproportionate to the crime and therefore in violation of the Eighth Amendment's prohibition against cruel and unusual punishment).

<sup>308</sup> *See* *United States v. Bajakajian*, 524 U.S. 321 (1998); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996) (finding that excessively high punitive damages violate the Due Process Clause).

<sup>309</sup> 524 U.S. 321.

<sup>310</sup> *Id.* at 325.

<sup>311</sup> *Id.*

<sup>312</sup> *Id.*

<sup>313</sup> *Id.* at 324. In response to this decision, Congress amended the forfeiture statute. *See* 18 U.S.C. § 983(g) (2012) (introducing a proportionality standard).

While my analysis is not focused on the potential constitutionality of collateral tax sanctions,<sup>314</sup> taxpayers likely consider some of the same factors as judges do when forming a view of whether a particular penalty is disproportionate to the offense. For example, they may weigh the magnitude of the harm caused by the tax offense against the severity of the collateral tax sanction. To conduct this analysis, we may ask several questions: Is the tax offense similar to other offenses that result in the same sanction? What is the harm that results from the tax offense? What is the maximum formal tax sanction, civil or criminal, that an individual could face as a result of committing this particular tax offense? While the application of this analysis will not offer precise measurements, these factors provide a roadmap for determining whether individuals would likely perceive a collateral tax sanction as lacking proportionality.

### B. *Beyond Tax Delinquency?*

Many of the collateral tax sanctions that apply to tax delinquency satisfy the three principles that I have proposed.<sup>315</sup> As a result, the compliance benefits of those sanctions likely outweigh their potential detriments to individuals' willingness to obey the tax law and cooperate with the taxing authority.

Consider, for example, California's policy of suspending driver's licenses from the five hundred taxpayers who owe the greatest amount of income taxes and the five hundred taxpayers who owe the greatest amount of sales and use taxes.<sup>316</sup> As I argued previously, this sanction possesses characteristics that would have a positive impact on individuals affected by different, often overlapping, tax compliance motivations.<sup>317</sup> But would it satisfy the three principles outlined above or instead result in some of the drawbacks of collateral tax sanctions? First, California revokes driver's licenses as a result of a violation of an explicit tax rule—the requirement to pay established tax liability by a specified date.<sup>318</sup> Second, this offense results from a violation

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<sup>314</sup> While an examination of the constitutionality of each collateral tax sanction is beyond the scope of this Article, it is possible that some sanctions would likely be deemed remedial, even though they also serve a deterrence purpose. *See, e.g.,* *Kvitka v. Bd. of Registration in Med.*, 551 N.E.2d 915, 918 n.4 (Mass. 1990) (holding that the revocation of a physician's professional license for unlawfully dispensing controlled substances is remedial rather than punitive); *see also* *State v. Young*, 530 N.W.2d 269, 278 (Neb. Ct. App. 1995) (holding that the purpose of a driver's license revocation is to protect the public).

<sup>315</sup> *See supra* Section III.A.

<sup>316</sup> CAL. REV. & TAX CODE §§ 7063, 19195 (2012); CAL. VEH. CODE § 34623.1 (2012).

<sup>317</sup> *See supra* note 180-86 and accompanying text.

<sup>318</sup> CAL. VEH. CODE § 34623.1 (2012).

of California's tax laws and the California taxing authority provides a list of the names of the top tax delinquents to the Department of Motor Vehicles.<sup>319</sup> Third, it is unlikely that taxpayers consider this sanction to be disproportionate to the underlying tax offense. The individuals subject to this collateral tax sanction are not significantly different from individuals who lose their driving privileges for other reasons, such as failing to attend a driver's education program or simply forgetting to renew their outstanding license. The harm to the state imposed by the individuals on this list (the worst offenders) may amount to millions of dollars of unpaid tax liability,<sup>320</sup> and until each offender pays the outstanding tax liability or enters into an installment payment plan, the harm is ongoing. Finally, the sanction is not excessively severe compared to other sanctions that could apply to this offense, such as levies on property.<sup>321</sup> This sanction will likely produce its intended compliance benefits without generating significant adverse effects.

Could governments apply collateral tax sanctions to address offenses *other* than tax delinquency? To consider this question, this Section applies the three guiding principles described above to several hypothetical collateral tax sanctions. The objective of this Section is not to provide an exhaustive list of new collateral tax sanctions, but rather to illustrate how policymakers should apply the proposed principles when deciding whether to adopt a particular sanction.

### 1. Nonfiling and Professional Licenses

The failure to file tax returns, as opposed to the failure to pay outstanding taxes, causes taxing authorities to face significant difficulty in calculating and collecting taxes. In California, for example, more than 800,000 residents who were required to file state tax returns ignored their obligation in 2009, resulting in an estimated \$650 million of unpaid tax liability, or 10% of California's state tax gap.<sup>322</sup> At the federal level, at least \$28 billion of tax revenue goes uncollected each year due to nonfiling.<sup>323</sup> While many states have enacted collateral tax sanctions that revoke benefits and services from

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<sup>319</sup> CAL. REV. & TAX CODE §§ 7063, 19195 (2012).

<sup>320</sup> See Miranda, *supra* note 117.

<sup>321</sup> See CAL. STATE BD. OF EQUALIZATION, COLLECTION PROCEDURES (2009), available at [www.boe.ca.gov/pdf/pub54.pdf](http://www.boe.ca.gov/pdf/pub54.pdf) (describing the levy process for deficient taxpayers' real or personal property).

<sup>322</sup> *More Background on the Tax Gap*, CAL. FRANCHISE TAX BOARD, [https://www.ftb.ca.gov/Tax\\_Gap/background.shtml](https://www.ftb.ca.gov/Tax_Gap/background.shtml) (last visited Feb. 21, 2014).

<sup>323</sup> IRS, *supra* note 37.

individuals who fail to pay their established tax liability, they have not developed similar sanctions that specifically apply to individuals who have failed to file tax returns.

To address the problem of tax return nonfiling, a state government could suspend or deny *any* professional license issued by a state agency in that state if (1) the individual who holds or seeks the license has failed to file personal state tax returns for the past two consecutive years and (2) the individual had a legal obligation to do so. The sanction would apply, until the individual files those outstanding tax returns and would apply in addition to any monetary tax penalties and interest owed to the taxing authority as a result of the failure to file. This proposal expands the scope of existing collateral tax sanctions by targeting nonfiling of tax returns, rather than just nonpayment of taxes. It also alleviates some of the horizontal equity concerns regarding collateral tax sanctions that were discussed above, where a narrowly defined group of tax-delinquent individuals, such as physicians and lawyers, incur greater tax sanctions than other noncompliant taxpayers by forfeiting their licenses to practice their professions. In contrast, this proposal would apply not only to lawyers and physicians but also to many other professionals such as pharmacists, electricians, psychologists, and building contractors.<sup>324</sup>

Considering the multiple motivations of compliance, this proposal could reduce instances of nonfiling among individuals who hold professional licenses. The threat of revocation of a professional license, which could result in significant loss of future income, should serve as an effective deterrent against the failure to file. This sanction should also have a positive influence on individuals who work in professions where tax noncompliance carries a stigma and might therefore cause them to lose the trust of their patients, customers, or clients. The sanction would encourage these individuals to file their tax returns so that they would not be forced to explain the reasons for their temporary license suspension. And for aspiring professionals who do not yet hold a license, this policy could instill in them an understanding of their legal obligation to comply with the tax law.

In addition to its potential compliance benefits, this policy avoids potential drawbacks of collateral tax sanctions because it satisfies each of the three proposed principles.

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<sup>324</sup> See, e.g., Types of Licenses, WASH. ST. DEP'T OF LICENSING, <http://www.dol.wa.gov/business/professionals.html> (last visited Feb. 21, 2014).



a. *Tax Rule*

The requirement to file a tax return is an explicit tax rule, not a tax standard. As long as a taxpayer meets the threshold income requirement, there is no ambiguity regarding whether the taxpayer must take a specific action. In almost all cases, the taxpayer can make a determination *ex ante* that he is required to file a return and does not need to receive a formal judicial opinion or administrative ruling.<sup>325</sup> The taxing authority and the licensing agencies can clearly communicate the policy that individuals who fail to meet the explicit tax rule requiring timely filing of tax returns will forfeit their ability to practice their professions legally.

b. *Tax Law and Taxing Authority*

The revocation of a professional license under this policy occurs as a result of a violation of a tax rule contained in the tax law—the requirement to file returns.<sup>326</sup> To ensure that the taxing authority makes the determination that an individual has failed to file tax returns for two years, the taxing authority could provide a list to each licensing agency in the state of all taxpayers who have, according to the taxing authority’s records, failed to file tax returns in that time frame. This arrangement would avoid creating the perception that licensing agencies are launching their own independent investigations of individuals’ tax returns. It is also consistent with the approach that many states currently use when empowering non-tax agencies to revoke licenses from individuals who have failed to pay outstanding taxes in excess of certain threshold amounts.

c. *Proportionality*

Individuals would likely consider the revocation and denial of professional licenses as a proportionate sanction for the failure to file tax returns for two years. The tax offense of failing to file a tax return is certainly comparable, if not significantly greater than, other offenses that also result in the revocation of a professional license. Under this proposal, for example, lawyers who fail to file tax returns for two years would forfeit their law license until they file their outstanding tax returns, just as lawyers who fail

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<sup>325</sup> See Kaplow, *supra* note 288, at 560 (defining a rule as “entail[ing] an advance determination of what conduct is permissible, leaving only factual issues for the adjudicator”).

<sup>326</sup> See, e.g., *Do I Need to File?*, CAL. FRANCHISE TAX BOARD, <https://www.ftb.ca.gov/individuals/fileRtn/index.shtml> (last visited Feb. 21, 2014) (providing a chart that individuals can use to determine whether they must file a California income tax return).

to pay their outstanding tax liabilities would also lose that same privilege.<sup>327</sup> The potential harm to the government from an individual's failure to file a tax return is significant, as the government expends resources to attempt to determine the individual's income or, alternatively, has little ability to detect the individual's failure to pay taxes on significant amounts of income. Individuals may not consider the sanction to be excessively severe, given that if the criminal tax law were applied instead, individuals who deliberately fail to file their tax returns could be subject to far greater tax penalties, including prison sentences.<sup>328</sup>

## 2. Household Employment Taxes and FDIC Insurance

Most individuals who pay household employees do not comply with the household employment tax rules. Under federal law, individuals who pay at least \$1900 per year to a household employee, such as a nanny, health aide, or housekeeper, are required to withhold Social Security and Medicare<sup>329</sup> taxes from the employee's wages and to pay an employer's share of these taxes, plus federal unemployment insurance taxes.<sup>330</sup> The household employer is required to complete a form with her annual personal tax return<sup>331</sup> and remit these taxes to the IRS, along with additional information regarding the wages paid to the employee. Compliance with these rules is notoriously low.<sup>332</sup> According to one recent study, the household employment tax

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<sup>327</sup> See *supra* notes 128-131 and accompanying text.

<sup>328</sup> See, e.g., U.S. Dep't of Justice, Press Release, Ohio Insurance Salesman Sentenced to 37 Months in Prison for Tax Evasion (Oct. 16, 2012), <http://www.justice.gov/opa/pr/2012/October/12-tax-1247.html>.

<sup>329</sup> See I.R.C. § 3101 (2006 & Supp. V 2012) (requiring employers to withhold 6.2% from their employees' wages for Social Security and 1.45% for Medicare); I.R.C. § 3111 (2006 & Supp. V 2012) (requiring the employer to pay 6.2% of the paid wages for Social Security and 1.45% for Medicare); IRS, PUBLICATION 926, HOUSEHOLD EMPLOYER'S TAX GUIDE (2014), available at <http://www.irs.gov/pub/irs-pdf/p926.pdf>.

<sup>330</sup> See I.R.C. §§ 3301, 3306(b)(1) (2006 & Supp. V 2012) (imposing a 6% rate on the first \$7000 of an employee's wages).

<sup>331</sup> IRS., SCHEDULE H (FORM 1040), HOUSEHOLD EMPLOYMENT TAXES (2013), available at <http://www.irs.gov/pub/irs-pdf/f1040sh.pdf>.

<sup>332</sup> See, e.g., David Cay Johnston, *Nanny Tax Evasion Grows Bigger and Bigger*, 128 TAX NOTES 783 (2010) (noting that in 1995 two million households employed legal domestic help, but only a quarter of them filed a Schedule H to report and pay the payroll taxes of their workers).

noncompliance rate may be as high as seventy percent,<sup>333</sup> resulting in a tax revenue loss of at least \$15 billion annually.<sup>334</sup>

One possible resolution to this problem is for the federal government to enact legislation providing that, if the IRS determines that an individual has paid a household employee at least \$30,000 in wages during the year and has not paid all required household employment taxes, the individual will forfeit Federal Deposit Insurance Corporation (FDIC) coverage on all personal bank accounts until the end of the calendar year following the year of detection by the IRS. In addition, the individual must pay civil penalties for the underpayment of taxes. The FDIC provides free insurance to individuals of up to \$250,000 for deposits in a qualifying bank; the coverage amount may be expanded significantly if the individual is married or if other conditions are met.<sup>335</sup> This proposal could be modified to increase the threshold wage amount or the insurance suspension period depending upon the number of years of noncompliance.

This particular collateral tax sanction may raise awareness of household employment tax obligations and induce cooperation in an area where noncompliance is high. FDIC coverage is a salient government benefit for individuals who hold liquid savings in bank accounts, especially in times of uncertainty regarding the financial viability of banking institutions.<sup>336</sup> Many of the individuals who would be subject to this proposal—which again requires them to pay employees at least \$30,000 in wages per year—likely hold funds in bank accounts in addition to their other investments. For some of these individuals, the thought of forfeiting FDIC coverage, even for one year, may provide significant motivation to comply with the household employment tax rules.<sup>337</sup> Under the example above, if an employer loses FDIC coverage and one of the banks holding her personal funds were to fail by the end of 2013, he would receive no protection from the federal government.

The next inquiry is whether, despite the theoretical compliance benefits, this proposal would implicate some of the potential negative effects of

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<sup>333</sup> See Catherine B. Haskins, *Household Employer Payroll Tax Evasion: An Exploration Based on IRS Data and on Interviews with Employers and Domestic Workers* 119 (Feb. 2010) (unpublished Ph.D. dissertation, Univ. of Mass. Amherst), available at [http://scholarworks.umass.edu/open\\_access\\_dissertations/163](http://scholarworks.umass.edu/open_access_dissertations/163).

<sup>334</sup> See IRS, *TAX GAP FOR TAX YEAR 2006*, at 2 (2012), available at [http://www.irs.gov/pub/newsroom/overview\\_tax\\_gap\\_2006.pdf](http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf).

<sup>335</sup> 12 U.S.C. § 1821(a)(1)(E) (2012) (increasing the standard maximum deposit insurance amount to \$250,000 as of March 2010).

<sup>336</sup> See *BANK FAILURES IN BRIEF: 2013, FED. DEPOSIT INS. CORP.* (Jan. 10, 2014), <http://www.fdic.gov/bank/historical/bank/2008> (describing twenty-four bank failures in 2013).

<sup>337</sup> See subsection II.B.2.

collateral tax sanctions. As the analysis below demonstrates, the FDIC collateral tax sanction may satisfy only some of the proposed guiding principles.

a. *Tax Rule*

At first blush, the failure to pay household employment taxes seems to be a violation of an explicit tax rule. The IRC states that individuals who pay wages to household employees in excess of a specified amount (\$1900) must pay the required taxes.<sup>338</sup> Upon closer inspection, however, an individual may not know with certainty whether the IRS would characterize a particular service provider, such as a gardener or driver, as an “employee” for tax purposes until the IRS, or possibly a court, reviews the relevant facts.<sup>339</sup> According to the IRS, a worker is an employee if the service recipient controls not only the type of services that the worker provides, but also the manner in which the worker provides them.<sup>340</sup> Whether the requisite “control” element is present, however, is not necessarily apparent *ex ante*. A possible consequence of imposing such a salient collateral tax sanction is that when individuals face household employment challenges from the IRS, they may be less willing to settle the controversy and pay the resulting monetary tax penalties than if the collateral tax sanction were not in effect.<sup>341</sup>

b. *Tax Law and Taxing Authority*

The proposed FDIC collateral tax sanction would result from the application of federal tax law and a determination by the IRS. If the proposed sanction were adopted, federal tax privacy rules would need to be amended to allow the IRS to provide the FDIC with both the list of specified individuals who have failed to pay all required household employment taxes and the length of their insurance coverage suspension periods. As the IRS would be permitted by statute to share only this discrete information with the FDIC, individuals’ concerns that the introduction of this collateral tax

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<sup>338</sup> See I.R.C. § 3102(a) (2006); Cost-of-Living Increase and Other Determinations for 2012, 76 Fed. Reg. 66,111, 66,112 (Oct. 25, 2011) (setting forth threshold wage amounts).

<sup>339</sup> See, e.g., I.R.C. § 3121(b) (2006 & Supp. V 2012) (defining “employment”); *Independent Contractor (Self-Employed) or Employee?*, IRS (Nov. 5, 2013), <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee> (explaining the difference between independent contractors and employees).

<sup>340</sup> PUBLICATION 926, *supra* note 329, at 2 (defining “household employee”).

<sup>341</sup> See *supra* note 297 and accompanying text.

sanction could lead to abuse of discretion by a non-tax agency should be allayed.

c. *Proportionality*

Individuals would likely view the proposed FDIC collateral tax sanction as proportionate for several reasons. First, as this sanction would be the only instance in which individuals would forfeit FDIC insurance, a fact which should make the sanction all the more salient, individuals would not compare the offense of nonpayment of home-employment tax to other offenses that result in the same sanction. Second, the government could argue that the nonpayment of this tax results in significant harm. When household employers disregard these rules, not only do they contribute to the federal tax gap, but they also prevent the IRS from detecting and taxing household employees. In addition, the widespread nature of the problem drives up the wage that a compliant individual must pay to a household employee if she is one of the few taxpayers who withhold and remit the required taxes.<sup>342</sup> Last, assuming that the IRS publicizes the collateral tax sanction effectively, individuals may not view it as excessively severe. This sanction is certainly not greater in value than the potential criminal tax sanctions that could apply in the case of intentional nonpayment of the taxes.<sup>343</sup>

This proposal provides an example of a collateral tax sanction that may represent a violation of a tax standard rather than a tax rule, but still satisfies the other two principles. How should governments decide whether to pursue such collateral tax sanctions as means of tax enforcement? To answer this question, we can consider specific elements of the proposed sanction that relate to the justifications for the tax rule principle. If the FDIC collateral tax sanction implicates a tax standard rather than a tax rule because the definition of “employee” is not clear, it is possible that some individuals may not settle disputes involving this issue with the IRS. This concern, however is likely alleviated by the fact that some individuals who would be subject to this sanction may be unwilling to reveal publicly that they have failed to report wages and pay required taxes for their household employees. As many nominees for cabinet positions have demonstrated, others may perceive the failure to pay household employment taxes to be a

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<sup>342</sup> For a discussion of a New York law designed to protect payment of overtime for domestic employees, see Mona Simpson, Op-Ed., *Pay Your Nanny on the Books*, N.Y. TIMES, July 2, 2010, at A25.

<sup>343</sup> See, e.g., *Examples of Employment Tax Fraud Investigations—Fiscal Year 2012*, IRS (Sept. 17, 2013), <http://www.irs.gov/uac/Examples-of-Employment-Tax-Fraud-Investigations-Fiscal-Year2012> (describing criminal cases of federal-employment-tax evasion).

negative signal of lack of integrity or competence, or both.<sup>344</sup> Consequently, these individuals may still choose to settle the dispute and forfeit their FDIC coverage privately rather than to reveal the nonpayment in litigation publicly.

### 3. “Fraud and Deceit” Tax Offenses and Deportation

Would the federal government increase tax compliance by deporting lawful permanent residents who willfully mislead a taxing authority? As previously discussed, the U.S. Supreme Court in *Kawashima v. Holder* upheld the deportation of two lawful permanent residents who had previously pleaded guilty to willfully filing false tax returns.<sup>345</sup> Though the Immigration and Nationality Act specifically designates tax evasion as an offense under section 7201 of the IRC and as an “aggravated felony” that can result in automatic deportation,<sup>346</sup> Akio and Fusako Kawashima argued that this provision did not apply to them because they pleaded guilty to a lesser offense.<sup>347</sup> The Court rejected this argument by finding that the Act’s reference in a separate provision to an offense that constitutes “fraud or deceit” and results in a loss of more than \$10,000 to the victim implicitly includes tax offenses.<sup>348</sup> Specifically, the Court held that for purposes of federal immigration law, the words “fraud and deceit” encompass tax offenses that involve willfulness and false statements, even though the federal tax law often does not specify that fraud is an element of these offenses.<sup>349</sup>

As one option, the federal government could attempt to incorporate the *Kawashima* holding into its existing deportation policies. A potential collateral tax sanction could be an affirmative policy by the U.S. Immigration and Customs Enforcement to treat as an aggravated felony any criminal conviction of a lawful permanent resident for any tax offense that involves willfulness and false statements and tax liability of more than \$10,000. These tax offenses could involve the willful delivery of false information to the taxing authority, as was the case in *Kawashima*, but they could also include other tax offenses at the federal, state, and local levels.

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<sup>344</sup> See, e.g., Claudia Wallis, *The Lessons of Nannygate*, TIME, Feb. 22, 1993, at 76 (describing the tax troubles of President Clinton’s nominees for Attorney General in 1993, Kimba Wood and Zoe Baird).

<sup>345</sup> *Id.* at 1168.

<sup>346</sup> 8 U.S.C. § 1101(a)(43)(M)(ii) (2012).

<sup>347</sup> See Brief for Petitioners, *supra* note 2, at 12.

<sup>348</sup> *Kawashima v. Holder*, 132 S. Ct. 1166 (2012).

<sup>349</sup> *Id.* at 1173.

Finally, the immigration authorities could apply this sanction to any past criminal convictions as well, as current law does not include a statute of limitations on the identification of aggravated felonies.<sup>350</sup>

Proponents of this policy might argue that it would not only help ensure that only citizens with good moral character retain lawful permanent resident status,<sup>351</sup> but that it would also increase tax compliance. For a lawful permanent resident, there is no government benefit more salient than a Green Card.<sup>352</sup> This benefit enables individuals to live in the United States, attain employment and, possibly, receive naturalized citizenship.<sup>353</sup> A primary objective of applying the holding in *Kawashima*, supporters would likely argue, is to encourage individuals who are motivated by the fear of sanctions to report and pay their tax liabilities properly. In theory, if federal immigration authorities threaten to strip this treasured benefit from lawful permanent residents who engage, or have engaged, in criminal tax offenses involving willful and false statements, some lawful permanent residents could respond by not engaging in any acts of tax noncompliance.

Though this collateral tax sanction might cause some lawful permanent residents to respond positively, it might also result in adverse effects that could, in turn, weaken overall compliance. Accordingly, this policy fails all three of the guiding principles that I have argued governments should consider when designing collateral tax sanctions.

a. *Tax Rule*

In considering whether the presence of willful and false statements in a criminal tax offense sufficiently qualified as an act of fraud or deceit under the immigration laws, the *Kawashima* Court created an extremely broad tax standard, not a narrowly tailored tax rule. As Justice Ginsburg commented in her dissent, many tax crimes of varying magnitude involve false statements or misleading conduct.<sup>354</sup> Such offenses could include the delivery of a false Form W-2 to an employee,<sup>355</sup> the failure to truthfully collect and pay

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<sup>350</sup> See 8 U.S.C. § 1227(a)(2)(A)(iii) (2012) (“Any alien who is convicted of an aggravated felony at any time after admission is deportable.”).

<sup>351</sup> See 8 U.S.C. § 1427(a) (2012) (describing the importance of “good moral character” for the purposes of naturalization).

<sup>352</sup> For a description of the benefits of a Green Card, see *Green Card*, U.S. CITIZENSHIP & IMMIGRATION SERVICES, <http://www.uscis.gov/greencard> (last updated May 13, 2011).

<sup>353</sup> *Id.*

<sup>354</sup> See *Kawashima*, 132 S. Ct. at 1176 (Ginsburg, J., dissenting); Brief for Amicus Curiae Johnnie M. Walters in Support of Petitioners 12-18, *Kawashima*, 132 S. Ct. 1166 (No. 10-577) (arguing that including “all willful” and “false tax crimes” is too broad).

<sup>355</sup> I.R.C. § 7204 (2006) (imposing a fine of up to \$1000 for such an offense).

over taxes,<sup>356</sup> the submission of false documents to the taxing authority, providing false documents,<sup>357</sup> and many others. The *Kawashima* standard could also apply to misdemeanor offenses, such as the willful failure to file a tax return.<sup>358</sup> This standard could also, theoretically, apply to any state or local criminal tax offense that involves willfulness and false statements. In California, for instance, it is a misdemeanor to provide false information when requesting a property assessment reduction.<sup>359</sup> In light of *Kawashima*, it is not apparent which offenses may result in deportation.

An immediate consequence of the breadth of the *Kawashima* standard is that the IRS may lack the ability to publicize the specific types of tax offenses that result in deportation. As it is not clear which tax offenses lead to deportation after *Kawashima*, the IRS would have little ability to warn lawful permanent residents that particular types of tax offenses can lead not only to formal tax penalties, but also to deportation as well. Alternatively, if lawful permanent residents perceive that this collateral tax sanction could apply to any type of tax offense, some might overreact by adopting only the most conservative tax positions possible (such as by claiming the standard deduction rather than itemized deductions).<sup>360</sup> The adverse effect of such caution is that the IRS may not accurately assess individuals' incomes and that individuals may not take advantage of social programs that are enacted as tax expenditures.

Another implication of *Kawashima* is that lawful permanent residents who face criminal tax charges, whether felonies or misdemeanors, might refuse to enter guilty pleas if they fear that the immigration authorities will one day characterize these convictions as aggravated felonies. In the wake of *Kawashima*, lawful permanent residents could certainly react this way when charged with willfully filing false tax returns. But given the ambiguous meaning of the standard and the immigration authority's ability to detect aggravated felonies without a statute of limitations, lawful permanent residents could display a similar response in *any* criminal tax case. Increased litigation would not only result in the diversion of tax enforcement resources away from other important tax enforcement functions, but also, given its public nature, could cause taxpayers to view the government as disproportionately prosecuting lawful permanent residents for tax offenses compared to other types of offenders and offenses.

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<sup>356</sup> I.R.C. § 7202 (imposing a fine of up to \$10,000 for such an offense).

<sup>357</sup> I.R.C. § 7207 (imposing a fine of up to \$10,000 for such an offense).

<sup>358</sup> I.R.C. § 7203 (imposing a fine of up to \$25,000 for such an offense).

<sup>359</sup> See CAL. REV. & TAX CODE § 1610.4 (discussed in Brief for Amicus Curiae Johnnie M. Walters, *supra* note 354).

<sup>360</sup> See I.R.C. § 63(c) (2006 & Supp. V 2012) (defining the standard deduction).



b. *Tax Law and Taxing Authority*

In applying this collateral tax sanction, immigration officials search public records for instances in which lawful permanent residents violated federal or state criminal tax laws. But the determination as to whether these offenses involve “fraud or deceit” sufficient to result in deportation is dependent upon immigration officials’ own interpretation of the Immigration and Nationality Act.<sup>361</sup> Unlike the other collateral tax sanctions discussed thus far, such as those where the taxing authority provided a list of individuals who have committed specific tax offenses to the non-tax agency,<sup>362</sup> this particular collateral tax sanction results from an offense that a non-tax agency identifies on its own.

This feature could muddle the government’s attempt to increase compliance through publicizing the collateral tax sanction of deportation. Taxpayers, including lawful permanent residents, often learn about potential tax penalties from the IRS at the time they make decisions ranging from whether to report particular types of income to whether to file tax returns.<sup>363</sup> If IRS officials cannot accurately describe the tax offenses that lead to deportation under the aggravated felony statute because they do not know how the U.S. Immigration and Customs Enforcement will determine whether a particular tax offense merits this sanction, they will have little ability to influence individuals’ tax reporting decisions at the time they make them. The immigration authority’s separate interpretation of whether a particular offense constitutes fraud also conflicts with the IRS’s own public statements regarding what it views as fraud under the tax law. As a former IRS Commissioner has commented, “[T]he criminal tax laws do not treat crimes involving the ‘willful’ provision of ‘false’ information as interchangeable and synonymous with those involving ‘fraud or deceit’ under the immigration laws.”<sup>364</sup>

c. *Proportionality*

If immigration officials actively apply *Kawashima*, some individuals might perceive the collateral tax sanction of deportation to be disproportionate to the underlying tax offense. This reaction will likely occur if

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<sup>361</sup> 8 U.S.C. § 1101(a)(43) (2012) (defining “aggravated felony”).

<sup>362</sup> See, e.g., CAL. VEH. CODE § 34623.1 (2012) (using a list of tax delinquents provided by the State Board of Equalization or the Franchise Tax Board to determine driver’s license suspension).

<sup>363</sup> See generally Joshua D. Blank & Daniel Z. Levin, *When Is Tax Enforcement Publicized?*, 30 VA. TAX REV. 1, 4-5 (2010) (explaining the increase in tax enforcement press releases during tax filing season).

<sup>364</sup> Brief for Amicus Curiae Johnnie M. Walters, *supra* note 354, at 2.

officials apply this policy retroactively to lawful permanent residents who pleaded guilty to tax offenses involving false statements and willfulness, but that were lesser than tax evasion, prior to the Supreme Court's decision in *Kawashima*.

An initial reason why individuals would likely view the sanction as disproportionate to the underlying tax offense is that this particular sanction is often levied upon far more harmful offenses. For example, under the Immigration and Nationality Act, aggravated felonies include murder,<sup>365</sup> rape,<sup>366</sup> sexual abuse of a minor,<sup>367</sup> and illicit trafficking of controlled substances.<sup>368</sup> Individuals may not view the types of tax offenses potentially implicated by *Kawashima*—which could include misdemeanor tax offenses, such as willful failure to file a tax return—as crimes as grave as the non-tax related aggravated felonies. Further, offenses that involve physical violence or reckless disregard for the safety of others, such as driving while intoxicated,<sup>369</sup> are *not* considered to be aggravated felonies, while potentially minor criminal tax offenses may be considered to be aggravated felonies that could result in deportation.

Though some tax offenses involving willfulness and false statements prevent the taxing authority from collecting substantial tax liabilities, others result in significantly less harm, especially when compared to the harms that result from some of the violent aggravated felonies described above. The monetary threshold for a fraud and deceit tax offense that can result in deportation is \$10,000.<sup>370</sup> For example, if a lawful permanent resident is convicted of filing a series of Form W-2s that contain false information and result in \$3000 of lost tax revenue each year for a period of four years, this individual could face deportation for committing an aggravated felony.<sup>371</sup>

Individuals might also view the sanction of deportation for tax offenses involving willful and false statements as excessively severe when compared to the maximum civil and criminal penalties for many of these tax offenses.

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<sup>365</sup> 8 U.S.C. § 1101(a)(43)(A) (2012).

<sup>366</sup> *Id.*

<sup>367</sup> *Id.*

<sup>368</sup> *Id.* § 1101(a)(43)(B).

<sup>369</sup> See, e.g., *Kawashima v. Holder*, 132 S. Ct. 1166, 1180 n.2 (2012) (Ginsburg, J., dissenting) (citing *Leocal v. Ashcroft*, 543 U.S. 1 (2004), and inquiring why a tax offense can result in deportation when more serious crimes do not); see also *Dalton v. Ashcroft*, 257 F.3d 200, 202 (2d Cir. 2001) (holding that felony convictions for driving while intoxicated do not constitute aggravated felonies).

<sup>370</sup> 8 U.S.C. § 1101(a)(43)(M)(ii).

<sup>371</sup> In this example, the total loss to the “victim,” the federal government, would be \$12,000. For further discussion, see Brief for Amicus Curiae Johnnie M. Walters, *supra* note 354, at 15-16 (explaining that the threshold in 8 U.S.C. § 1101 is not hard to meet in many jurisdictions).

As described above, some criminal tax offenses involving willful and false statements may result in a monetary fine. For example, in Ohio, the criminal offense of knowingly filing a false municipal tax return results in a \$250 fine.<sup>372</sup> The additional sanction of deportation for this offense would likely appear to be vastly disproportionate to many individuals. But even for tax offenses that result in prison sentences, such as willfully filing a false tax return, the sanction of deportation may appear to be disproportionate. Some argue that deportation for an aggravated felony—a sanction that may cause an individual to separate from his children, forfeit a business, and face a permanent ban against reentering the United States—is a punishment that is even *more* severe than prison, regardless of the length of the sentence.<sup>373</sup>

How would individuals respond if the government enforced *Kawashima* in a manner that they viewed as lacking proportionality? As scholars have predicted in other contexts, some lawful permanent residents might perceive the government's use of a disproportionate sanction for a vaguely defined tax offense as lacking legitimacy.<sup>374</sup> One recent study has found that when people think that police officers target certain racial or religious groups disproportionately, they believe that the law lacks legitimacy.<sup>375</sup> Similarly, if individuals perceive the deportation of individuals who have committed tax offenses involving willful and false statements—some of which may have occurred *prior* to *Kawashima*—as illegitimate, they might reduce their cooperation with the taxing authority. Some lawful permanent residents could fail to report income or items that they believe the taxing authority may not detect, such as cash income or, for wealthy individuals, offshore bank accounts in their home countries.<sup>376</sup> Rather than risk facing a collateral tax sanction that they perceive as illegitimate, these individuals might take the minimum action necessary, such as simply filing a personal

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<sup>372</sup> Brief for Amicus Curiae Johnnie M. Walters, *supra* note 354, at 15 (discussing COLUMBUS, OHIO CODE § 361.31(a) (2009)).

<sup>373</sup> See, e.g., *Ng Fung Ho v. White*, 259 U.S. 276, 284 (1922) (describing deportation as depriving an individual of “all that makes life worth living”).

<sup>374</sup> See *supra* notes 267, 305 and accompanying text.

<sup>375</sup> Aziz Z. Huq et al., *Why Does the Public Cooperate With Law Enforcement?*, 17 PSYCHOL. PUB. POL'Y & L. 419, 429 (2011) (stating that police targeting of Muslim Americans after September 11, 2001, increased perceptions of a lack of police legitimacy by both Muslim Americans and Non-Muslim Americans).

<sup>376</sup> See *Second Special Voluntary Disclosure Initiative Opens*, IRS (Feb. 8, 2011), <http://www.irs.gov/newsroom/article/0,,id=235695,00.html> (describing the 2011 offshore Voluntary Disclosure Initiative, which encourages those with hidden assets in offshore accounts to become current with their taxes).

tax return, to satisfy an immigration court that they have attempted to comply with the tax law.

As this discussion demonstrates, the government's active application of *Kawashima* to individuals who have committed criminal tax offenses involving willful and false statements would likely produce mixed results. Some lawful permanent residents might believe that they are required by law to abide by heightened standards of moral conduct and, as a result, they may adhere to the letter of the law, including the tax law. These individuals would respond to the immigration authority's active application of *Kawashima* by continuing to correctly report and pay their tax liabilities, and, as described above, would even forego tax credits and deductions to which they are entitled. Others, however, could refuse to enter into plea agreements in criminal tax cases and may even limit the information that they reveal to the taxing authorities in their tax returns. As a result, it is far from certain whether the use of the collateral tax sanction of deportation for fraud and deceit tax offenses will result in net tax-compliance benefits.

### C. *Publicity by Taxing Authorities*

Many of the positive effects of collateral tax sanctions discussed in this Article will occur only if taxpayers are aware of these measures. Existing collateral tax sanctions currently receive publicity, but not as a result of direct communication from taxing authorities. Taxpayers learn about the existence of collateral tax sanctions from other sources, and often *after* they have already engaged in tax noncompliance. In its publications and on its website, for example, the IRS does not discuss the risk of lawyers and doctors forfeiting their professional licenses in their respective states if they engage in abusive tax activities.<sup>377</sup> Taxing authorities should play a more active role in publicizing these sanctions, specifically when they satisfy the guiding principles described above. This Section outlines approaches that taxing authorities could adopt to publicize collateral tax sanctions effectively.

#### 1. Strategic Publicity

In contrast with their currently passive stances, taxing authorities should publicize the threat of collateral tax sanctions strategically, during encounters and at times when this information is likely to have its maximum impact on taxpayers' perceptions and beliefs. Taxing authorities should

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<sup>377</sup> See, e.g., IRS, PUBLICATION NO. 334, TAX GUIDE FOR SMALL BUSINESSES (2013), available at <http://www.irs.gov/pub/irs-pdf/p334.pdf>; IRS, PUBLICATION NO. 587, BUSINESS USE OF YOUR HOME (2013), available at <http://www.irs.gov/pub/irs-pdf/p587.pdf>.

pursue this approach in their direct and indirect communications with taxpayers.

Taxing authorities often directly communicate with noncompliant taxpayers when they send them notices requesting that they pay their outstanding tax liabilities. In these notices, they do not inform taxpayers of the collateral tax sanctions that may await them if they continue to ignore their outstanding tax obligations. For instance, under current law, when the IRS sends a Notice of Federal Tax Lien to taxpayers, it states the amount of their outstanding tax liability, and informs them that the IRS may seek to attach a lien to their property and warns that they will continue to accrue monetary tax penalties and interest.<sup>378</sup> The IRS does not, however, describe the collateral tax sanctions that may occur in addition to these consequences.<sup>379</sup> A more effective form of direct communication would be for the IRS to describe in this notice not only the additional monetary tax penalties and interest that taxpayers may accrue if they continue to ignore their obligations, but also the government benefits that these individuals may sacrifice—such as a U.S. passport,<sup>380</sup> qualification for an FHA loan,<sup>381</sup> or the right to enter into contracts with the federal government.<sup>382</sup>

But even before taxpayers become delinquent on their taxes, taxing authorities should publicize the potential application of collateral tax sanctions during those periods of the year when taxpayers are most focused on their tax reporting and payment obligations. The federal government already appears to deliberately increase publicity of its tax enforcement actions, including criminal tax cases, during this period by issuing a disproportionate number of tax enforcement press releases and announcements compared with the rest of the year.<sup>383</sup> Strategic publicity could have positive effects on individuals' perceptions of the taxing authority's enforcement capabilities and, ultimately, on compliance.<sup>384</sup> Similarly, taxing authorities should issue public announcements regarding potential collateral tax sanctions during

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<sup>378</sup> See IRS, FORM 668(Y)(C), NOTICE OF FEDERAL TAX LIEN (1999); *Understanding a Federal Tax Lien*, IRS (July 5, 2013), <http://www.irs.gov/Businesses/Small-Businesses-%26-Self-Employed/Understanding-a-Federal-Tax-Lien>.

<sup>379</sup> See *supra* note 378.

<sup>380</sup> See *supra* subsection I.B.3.a.i.

<sup>381</sup> See *supra* subsection I.B.3.a.iii.

<sup>382</sup> See *supra* subsection I.B.3.a.iv.

<sup>383</sup> See Blank & Levin, *supra* note 363, at 17 (finding that from April 1 to Tax Day, the government issued 128% more tax enforcement press releases per week than during the rest of the year).

<sup>384</sup> For further discussion, see Blank, *supra* note 23, at 318-26 (examining how strategic publicity may enhance individual taxpayer compliance under both the deterrence and reciprocity models of taxpayer behavior).

this period. Such strategic publicity is especially important if the collateral tax sanction stems from individuals' tax reporting decisions, such as the proposed FDIC collateral tax sanction for household-employment-tax evasion.<sup>385</sup> Individuals who learn of the collateral tax sanctions during the weeks leading up to Tax Day may, for example, revise their decision to omit their household employees and ignore their related tax obligations. But even if collateral tax sanctions would relate only to nonpayment, rather than underreporting, taxing authorities should nonetheless attempt to publicize these sanctions during this period. Moreover, for individuals whose motivation to comply with the tax law stems from feelings of reciprocity, this publicity would assure them that the most blatant form of tax avoidance—the simple refusal to pay—does not go undetected or unpunished.<sup>386</sup>

## 2. Specificity

When taxing authorities publicize collateral tax sanctions, they should describe with specificity the tax offenses and the resulting denial or revocation of benefits. Due to the salient nature of the benefits at stake,<sup>387</sup> confusion among taxpayers and resentment toward the taxing authorities may result if taxing authorities fail to describe the potential collateral tax sanctions clearly.

Taxing authorities should actively publicize collateral tax sanctions, in part, because officials of non-tax agencies may not possess sufficient expertise in the tax law to describe these sanctions accurately to the general public. For instance, the Louisiana license statutes provide that an individual's hunting or fishing license will be revoked only if the individual owes a final assessment "in excess of five hundred dollars of individual income tax."<sup>388</sup> Yet, the Louisiana Department of Wildlife and Fisheries website—a source that is much more likely to be accessed by individuals than are the statutes—states that an individual may not receive a hunting or fishing license unless the individual can demonstrate that, during the previous twelve months, "he has filed a Louisiana state income tax return *and has complied with state income tax laws and regulations*."<sup>389</sup> Even though the law in Louisiana clearly applies only to the offense of tax delinquency, the plain English description of the law appears to expand its scope significantly. Under the Department of Wildlife and Fisheries' interpretation of the

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<sup>385</sup> See *supra* subsection III.B.2.

<sup>386</sup> See *supra* subsection II.B.5.

<sup>387</sup> See *supra* subsection II.B.1.

<sup>388</sup> LA. REV. STAT. § 47:296.3 (West, Westlaw through 2013 Reg. Sess.).

<sup>389</sup> See *Hunting Licenses*, *supra* note 19 (emphasis added).

statute, individuals might perceive that failing to pay a small amount of tax or filing late returns will force them to forfeit their hunting licenses. One consequence of such a broad description of the law is that individuals could perceive that it is disproportionate to the offense and may, in response, reduce their cooperation with the taxing authority (since this is the agency that identifies the offenses that ultimately lead to license revocation). By actively explaining the specific tax offenses that may result in collateral tax sanctions, the taxing authority may prevent mischaracterizations of the law and the perception that it enlists other agencies to enforce unfair measures.

In addition, taxing authorities should explicitly publicize the limits of the application of collateral tax sanctions. For instance, in California, a state with a population of nearly 38 million individuals, the collateral tax sanctions that suspend driver's licenses or deny their renewal affects only 1000 tax delinquents, some of whom owe as much as \$10.5 million in outstanding state taxes.<sup>390</sup> Likewise, at the federal level, the proposed passport legislation would only apply to individuals who have failed to pay more than \$50,000 in federal taxes.<sup>391</sup> By publicizing such limits, the taxing authority would further protect itself from accusations that it is enforcing a disproportionate sanction. Such charges are not merely hypothetical; they have been levied in the past. In March 2011, when the Senate passed the passport provision, commentators expressed sentiments similar to those of one talk radio host, who exclaimed that the law would empower the IRS to "arbitrarily" direct the Department of State to revoke an individual's passport.<sup>392</sup> With a more active public role, taxing authorities could preempt such inaccurate reports.

Even if the taxing authority publicizes these limits, due to the high salience of these sanctions, some individuals will likely assume that collateral tax sanctions have greater application than they actually do under the law. For example, though the individual audit rate is approximately 1%, several studies of individual taxpayers' beliefs have shown that individuals estimate that audit rates are as high as 48%<sup>393</sup> and that more than 60% of individuals

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<sup>390</sup> See Lifsher & Wilson, *supra* note 177 (describing the \$10.5 million tax debt of Halsey M. Minor, founder of CNET.com).

<sup>391</sup> Moving Ahead for Progress in the 21st Century Act, S. 1813, 112th Cong., § 40304 (2012); see also text accompanying *supra* note 90.

<sup>392</sup> See Eric Blair, *Keeping the Slaves on the Plantation: Senate Says No Passport If You Owe Taxes*, ACTIVIST POST (Apr. 5, 2012), <http://www.activistpost.com/2012/04/keeping-slaves-on-plantation-senate.html> ("[The IRS] can arbitrarily determine any figure they wish to impose on a citizen without much recourse for the accused.")

<sup>393</sup> John T. Scholz & Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 AM. J. POL. SCI. 490, 497-99 (1995); see also Harold G. Grasmick & Wilbur J. Scott, *Tax Evasion and Mechanisms of Social Control: A Comparison with Grand and Petty Theft*, 2

report that their fear of being audited has an influence on their decision of whether to pay taxes.<sup>394</sup> But as long as the taxing authority clearly states the specific limits of collateral tax sanctions (just as the IRS explicitly describes the true 1% audit rate on its website),<sup>395</sup> it would resist accusations that it has attempted to achieve tax compliance through misleading communications.

### 3. Results

When publicizing a particular collateral tax sanction that has been in effect for some time, taxing authorities should provide data regarding the effectiveness of the measure. As discussed earlier, nearly every collateral tax sanction will result in spillover effects upon other individuals, such as the children of tax delinquent individuals who must rely on someone else for transportation during the individual's driver's license forfeiture or the patients of tax delinquent physicians who must seek alternative care during their physicians' medical license suspensions. A consequence of such spillover effects is that taxpayers could perceive the collateral tax sanction as unjustified in light of the underlying tax offense. The taxing authority can partially quell this concern by including, in its public statements regarding collateral tax sanctions, statistics that reinforce the message that these sanctions are effective. For example, as California's driver's license suspension program only applies to the top 500 income tax delinquents and the top 500 sales and use tax delinquents, state officials could emphasize to the public that many individuals are removed from these lists each year as they make arrangements to satisfy their outstanding tax liabilities.<sup>396</sup>

In addition to mitigating perceptions that the government has enacted overly harsh sanctions, this type of message would also have a positive effect on taxpayers affected by two specific motivations of compliance. For

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J. ECON. PSYCHOL. 213, 222 (1982) (offering evidence that 37.9% of individuals surveyed believed they would get caught if they engaged in tax evasion).

<sup>394</sup> See IRS OVERSIGHT BD., *supra* note 152, at 5 (examining the effects that various factors have on individuals' willingness to comply with U.S. tax law).

<sup>395</sup> See IRS, FISCAL YEAR 2012 ENFORCEMENT AND SERVICE RESULTS (2012), available at <http://www.irs.gov/pub/irs-news/FY%202012%20enforcement%20and%20service%20results-%20Media.pdf> (demonstrating that the IRS audit rate for the years 2006 to 2012 has hovered consistently around one percent).

<sup>396</sup> States that have attempted to publicly shame tax delinquents by using online websites have also released public statements regarding the efficacy of these measures. See, e.g., Steven Walters, *Taxpayer List Scares Up Cash*, MILWAUKEE J. SENTINEL, May 30, 2006, at 3B (reporting decreases in the number of names on Wisconsin's delinquent taxpayer list); see also Blank, *supra* note 288, at 552 (discussing various proposals to use public shaming in order to combat corporate tax abuse).



reciprocator taxpayers,<sup>397</sup> statements from the taxing authority that individuals change their behavior in response to collateral tax sanctions would confirm their belief that the government effectively deters tax noncompliance. For taxpayers who fear sanctions that would make their failure to obey the tax law observable by others—such as suspension of a professional license—an announcement that such collateral tax sanctions are effective in forcing others to file their returns could lead these taxpayers to perceive that the negative signal of tax noncompliance is rare, and thus strong.

#### 4. When Drawbacks Outweigh Benefits

On occasion, legislatures will enact collateral tax sanctions that fail all of the principles proposed above, creating significant drawbacks that may outweigh many of the potential compliance benefits of the sanctions. The deportation of lawful permanent residents who have committed a criminal tax offense involving willful and false statements<sup>398</sup> is an illustration of such a collateral tax sanction. In cases like these, the taxing authority should not actively publicize the collateral tax sanction. As I have argued, the taxing authority will be ill-equipped to describe accurately a collateral tax sanction that stems from a standard that is subject to the interpretation of another agency.<sup>399</sup> Further, if the taxing authority publicizes this collateral tax sanction, such as deportation for tax offenses involving willfulness and false statements, individuals who perceive it to be disproportionate or unfair may direct their backlash at the taxing authority. Some might even suspect that the taxing authority works in concert with the non-tax agency to identify tax offenses that would allow the non-tax agency to subject the taxpayer to a harsh collateral tax sanction, such as deportation. In these cases, it is best for the taxing authorities to refrain from attempting to enhance compliance by publicizing the collateral tax sanction.

#### CONCLUSION

This Article has offered a comprehensive analysis of an alternative approach to reducing tax noncompliance that can be deployed by federal, state, and local governments—collateral tax sanctions. As I have argued, collateral tax sanctions can promote voluntary tax compliance more effectively than the threat of additional monetary tax penalties, especially if governments increase public awareness of these sanctions.

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<sup>397</sup> See *supra* subsection II.B.5.

<sup>398</sup> See *supra* subsection III.B.3.

<sup>399</sup> See *supra* subsection III.A.2.

Several unique aspects of collateral tax sanctions can encourage individuals to report and pay their tax liabilities properly. First, collateral tax sanctions are more salient than traditional monetary tax penalties, which can lead to greater deterrence than traditional monetary tax penalties. Second, collateral tax sanctions provoke individuals' loss-aversion biases and the endowment effect by targeting specific government benefits for which individuals have developed feelings of entitlement. Third, certain collateral tax sanctions can result in greater indirect economic costs than monetary tax penalties, particularly for individuals with greater abilities to pay. Fourth, the negative reputational signals of certain collateral tax sanctions can deter some individuals from engaging in tax noncompliance. Fifth, many collateral tax sanctions are observable, causing them to bolster confidence among taxpayers motivated by feelings of reciprocity. Finally, collateral tax sanctions can promote tax compliance as a duty of citizenship by clearly linking tax payments with valued government services.

After considering the potential drawbacks that can result from existing or potential collateral tax sanctions, this Article has proposed a set of guiding principles that governments should consider when designing a collateral tax sanction to promote tax compliance. Under these principles, collateral tax sanctions are most effective as a means of encouraging compliance where (1) the tax offense results from a violation of a tax rule, not a tax standard; (2) the sanction results from a tax offense that the tax law defines and that a taxing authority identifies; and (3) the collateral tax sanction is proportionate to the underlying tax offense. When these principles are satisfied, taxing authorities should actively publicize collateral tax sanctions in coordination with existing efforts to inform taxpayers of potential civil and criminal tax penalties.

As tax scholars, policymakers, and lawyers are well aware, the tax law serves multiple purposes and often bears the burden of implementing social programs and policies that are unrelated to its core functions. Collateral tax sanctions, by contrast, require non-tax agencies and taxing authorities to share the responsibility of encouraging individuals to satisfy their obligations under the tax law. Governments in search of tax revenue should seize this opportunity.