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Tax Compliance and Norm Formation Under High-Penalty Regimes

Susan C Morse

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TAX COMPLIANCE AND NORM FORMATION UNDER HIGH-PENALTY REGIMES

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Susan C. Morse*

ABSTRACT

Skepticism about the potential of moral appeals relating to tax compliance -- for example, as applied to large groups of individual taxpayers outside a wartime context -- has resulted in the absence of a theory about how salient government communication can further tax compliance. This Article fills that gap. It provides a comprehensive theory of tax compliance and norm formation under high-penalty regimes from the starting point of a non-compliance norm.

The theory explains the roles of and mutually reinforcing relationships between the compliance mechanisms of deterrence, separation and reputation signaling. The success of these mechanisms depends on the presence of all three of taxpayer perception of penalty imposition, taxpayer perception of detection efficacy, and an absence of close substitutes. Either government enforcement or a reputation market can provide taxpayer perception of penalty imposition and detection efficacy. The Article offers the U.S. requirement of self-reporting of offshore bank account information as an example of a potentially effective high-penalty regime founded on aggressive and creative government enforcement efforts.

The theory also defines an appropriate role for expressive law in advancing tax compliance. This role has relevance, at least, when resources have been committed and government enforcement is not practical. The theory suggests that using law to define good-reputation indicators and trigger compliance mechanisms (including deterrence and separation as well as signaling) has particular promise when applied to reputation-sensitive taxpayers such as large intermediaries. The Article identifies four expressive law tax compliance tactics: reputation referencing, salience, management targeting, and incrementalism. It illustrates the expressive law portion of the theory with the example of a recently passed law that would require non-U.S. banks to identify U.S. account holders or face withholding on certain U.S. source income.

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INTRODUCTION

Scholars disagree about how the government can influence compliance with the law, including tax compliance. Under a view that takes seriously the assumption that taxpayers are rational economic decisionmakers, the government can do so mainly by increasing or enforcing penalties. This view has its roots in the theory of deterrence. The government may also provide opportunities for compliant taxpayers to self-identify as such. This can separate compliant from noncompliant taxpayers, boosting government's ability to tailor enforcement solutions to each.

Under another view, the government's statements and actions have an expressive function and can provide content for compliance norms enforced by informal sanctions. This view connects to the idea of reputational signaling. In the tax context, the use of expressive law lacks broad support and the connection between expressive law and deterrence has not yet been explored.

This Article provides a theory of tax compliance under high-penalty regimes. The theory accommodates both the strict rational economic actor view and the expressive law view, explains the roles of and mutually reinforcing relationships between deterrence, separation and signaling, and defines an appropriate role for expressive law in advancing tax compliance. The Article uses the example of offshore accounts to illustrate the theory.

Parts I, II and III of this paper set forth an analytic framework for analyzing high-penalty tax regimes where there is no strong pre-existing compliance norm. Part I outlines the compliance mechanisms of deterrence, separation and signaling and describes their mutually reinforcing relationships. Part II argues that three supports are necessary for a high-penalty regime to successfully implement one or more of these compliance mechanisms. Taxpayers should perceive that they actually face material penalties for noncompliance, they should believe that the government has an effective mechanism for detecting noncompliers who attempt to masquerade as compliers, and they should lack close-substitute choices not subject to penalties. Either government enforcement or a reputational market can provide perceived penalties and detection of masquerading noncompliers.

Part III theorizes the problem presented where government enforcement cannot provide the supports of perceived penalties and masquerading noncomplier detection. It argues that an expressive law strategy may be capable of generating a tax compliance norm that then can support a self-reinforcing reputation signaling compliance mechanism. This strategy has particular promise when applied to large tax intermediaries that are reputation-sensitive, participate in a robust reputation market, and have the opportunity to publicly signal their tax compliance behavior.

Parts IV, V and VI use the problem of offshore account information asymmetry to illustrate the analytic framework developed in Parts I, II and III. Part IV explains that some U.S. persons transfer funds to financial accounts outside the U.S. and fail to include related items in their reported taxable income. Part IV also describes how the multinational OECD organization used an expressive law strategy in this context to persuade countries to take certain steps toward information exchange and transparency and remove themselves from the so-called tax haven "blacklist."

Part V applies this analytic framework to the Report of Foreign Bank and Financial Accounts ("FBAR") requirements that oblige U.S. taxpayers to disclose their offshore account information to the U.S. government. It argues that government enforcement can provide the three supports necessary for the FBAR system to function as an effective high-penalty regime. Key elements include the government's thoughtful publicity of successful audits and its persuasive anchoring on willfulness-based penalties despite the uncertain applicability of such penalties under the Cheek standard.

Part V applies the same analytic framework to the Foreign Account Tax Compliance Act ("FATCA"), which will require foreign financial intermediaries, such as foreign banks, to automatically report U.S. account holders' ownership of offshore accounts. Noncompliance with FATCA requirements carries high potential penalties, but the U.S. does not have the power to audit banks to ensure that noncompliers do not masquerade as compliers. As a result, FATCA, unlike FBAR, is not that promising as a high penalty regime founded on government-enforced supports. But FATCA may find success if policymakers use an expressive law norm development strategy. In particular, the immediate goal of the U.S. policymakers implementing FATCA should be to persuade non-U.S. banks that compliance with FATCA is a mark of good reputation and thus launch a reputation signaling compliance mechanism.

I. COMPLIANCE MECHANISMS OF HIGH-PENALTY REGIMES

A. Assumptions

1. Pre-existing noncompliance norm

I am interested in this Article in situations in which a high-penalty regime faces a pre-existing norm of noncompliance. In the case of tax compliance, it is often true in cases of interest that a noncompliance norm exists. U.S. taxpayers have a high rate of income tax compliance,[1] but it does not follow that U.S. taxpayers have strong voluntary compliance norms. Most U.S. taxpayers have no choice about their compliance: their taxable income is automatically withheld upon or at least automatically reported to the government.[2] The difficult compliance questions relate to taxpayers who have the ability to evade tax. This category includes cash business owners and the group that I focus on in Parts IV, V and VI of this Article, holders of offshore financial accounts. For these taxpayers, tax evasion is commonplace and the norm is at a noncompliance equilibrium.

In addition to having practical importance, pre-existing noncompliance norms provide an analytically attractive starting point. The pre-existing noncompliance norm provides a low compliance baseline[3] and so the enactment or increased enforcement of a high-penalty regime might have a material positive effect on compliance. It would be more difficult to theorize about a high-penalty regime applied to, say, individual wages, because the tax compliance rate for such income already approaches 100%.

2. Legal certainty

I also mean here to analyze situations where the law is clear, as I believe it largely is in the offshore account example I use to illustrate the theory developed in this Article.[4] Introducing legal uncertainty

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[1] In 2001, the U.S. compliance rate was about 84% when measured as the ratio of the tax paid voluntarily and on time to the total tax due. *See* U.S. DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (Sept. 26, 2006) (giving gross tax gap and net tax gap figures).

[2] *See, e.g.*, Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL'Y REV. 37, 39 (2009) (explaining that income source is the most important determinant of tax compliance).

[3] For example, Schedule C small-business taxpayers have a noncompliance rate of about 50%. *See id.*

[4] Various questions related to FATCA, including the scope of the financial

complicates the analysis, for example by raising the possibility that actions taken by governments or others may affect taxpayers' understanding of the degree of certainty of a certain legal result. There is a lively debate about the impact of legal uncertainty on tax law design and tax compliance,[5] but I do not mean to engage it here.

3. High penalties

This Article focuses on high-penalty regimes because such regimes are prominent relative to, for example, the interest and time-based penalty regimes generally applicable to underpayments of tax. By high penalties I mean either criminal penalties or punitively high civil penalties that could exceed the amount of tax due several times over. Each of the compliance mechanisms I describe relies on perceptions of the regime and therefore it is important that the rules have qualities that make them noticeable and salient. Regimes that feature less severe penalties might also succeed in achieving the prominence necessary to trigger the compliance mechanisms that I describe, but consideration of that possibility falls outside the scope of this Article.

4. "Taxpayers" here includes tax intermediaries

Tax law imposes requirements not only on taxpayers, but also on tax intermediaries who must report items to the government and/or withhold tax. Requiring third parties to report or withhold is a variety of gatekeeper regulation.[6] As Leandra Lederman has argued, a third-party strategy, including a tax reporting or withholding requirement, is

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institutions subject to its requirements and the details of its due diligence rules, are uncertain because they await guidance. However, my interest in FATCA centers on the paradigm case where the law plainly applies and its disclose-or-withhold mechanics are clear. FATCA, like wage withholding and interest, dividend and gross proceeds reporting, must feature extremely clear rules, computer-programmable by intermediary banks, if it is to operate successfully. [Problem: close substitutes point includes an element of uncertainty.]

[5] *See, e.g.*, Mark P. Gergen, *Uncertainty and Tax Enforcement: A Case for Modest Fault-Based Penalties*, ___ TAX L. REV. [page 2, and/or Part V] (2011) (arguing that legal uncertainty can cause high penalties to over-deter tax noncompliance among risk-averse taxpayers, while not sufficiently deterring risk-neutral taxpayers); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1074 (2009) (summarizing conclusions drawn from the "subjectivist" view that legal uncertainty relates to taxpayers' beliefs about uncertainty); Kyle Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX. REV. 241, 293-96 (2007) (analyzing strict liability and fault-based tax penalty structures assuming legal uncertainty).

[6] *See* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53 (1986) (introducing the gatekeeper regulation concept).

particularly useful if the third party's reputational, financial or other interests are aligned with the government's interest in enforcement.[7]

This paper considers the application of high-penalty regimes to tax intermediaries as well as to taxpayers themselves. In some cases, tax intermediaries' compliance behavior is more visible than taxpayers'. Also, tax compliance may provide a stronger positive reputational signal in the case of tax intermediaries. Accordingly, the expressive law strategy described in Part III and illustrated in Part VI has particular relevance when applied to intermediaries.

B. Deterrence, Separation and Signaling

High penalties can increase compliance in several ways. One mechanism is deterrence. The hypothetical fully rational taxpayer decides whether to evade tax by comparing the amount of saved tax to the penalties for cheating weighted by the chance that the evasion will be detected.[8] Risk aversion modifies this analysis, adding a compliance bias to the fully rational model.[9] Reputational concerns also modify the cost-benefit calculus.[10]

As Alex Raskolnikov has observed, high penalties can also prompt self-identification by compliant taxpayers. Self-identification separates taxpayers into compliant and non-compliant groups that the government can observe and apply different regimes to. The idea is that compliant taxpayers may be more inclined to self-identify if they know that failing to do so subjects them to the possibility of high penalties,[11] whether

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[7] *See* Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted*, 78 FORD. L. REV. 1733, 1739-41 (2010) (hereinafter Lederman, *Reducing Information Gaps*) (listing factors that support a successful information reporting strategy, including arm's length parties with the capacity to perform the reporting tasks and the absence of "alternative arrangements"); Leandra Lederman, *Statutory Speed Bumps: The Role Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 734-741 (2007) (outlining reasons for tax authorities to suspect the quality of the check third parties may provide).

[8] *See* Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323-38 (1972).

[9] *See id.*

[10] *See, e.g.*, Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audi Perceptions in Tax Compliance*, 49 PUB. FIN. 70 (1994) (theorizing the impact of possible shame on tax compliance decisions); James P. P. Gordon, *Individual Morality and Reputation Costs as Deterrents to Tax Evasion*, 33 EUR. ECON. REV. 797 (1989) (modeling tax behavior to include both an honesty trait and reputation cost).

[11] *See* Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689, 704-05 (2009) (describing

imposed by the government or the reputation market.

As Eric Posner has explained, tax compliance can also serve as a reputation signal. For example, taxpayers' peers may interpret a compliance choice to connote a reputation-enhancing quality such as trustworthiness or good citizenship.[12] Signaling connects to deterrence, as suggested above and explored more fully below, because a rational actor who chooses to provide a compliance signal may be deterred by the reputational penalties produced by noncompliance or encouraged to self-identify by the superior reputational benefits that result. This dynamic changes, and signaling becomes more powerful, with a decreasing proportion of evaders relative to compliers.[13] In other words, signaling has a virtuous circle quality, which is that as more people signal compliance as a positive reputation signal, the positive reputation signal grows in strength.[14]

I distinguish here between, on one hand, reputation; and, on the other hand, other warm glow effects such as patriotism or the satisfaction of contributing to worthy public goods.[15] I mean only to consider in this

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the separation function of penalties).

[12] *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1789 (2000) (arguing that people may comply with tax laws to avoid the negative signal that would result if they were audited and "revealed . . . to be a bad type").

[13] *See, e.g.*, Gordon, *supra* note 10, at 801 (describing a reputation cost that rises with "the proportion of the population who are believed to consider evasion to be morally wrong"); Christian Traxler, *Social Norms and Conditional Cooperative Behavior*, 26 EUR. J. POL. ECON. 89 (2010) (articulating a similar idea).

[14] Robert Cooter describes this phenomenon as an equilibrium shift from less compliance to more compliance as more people comply and cause others to comply by "punish[ing] wrongdoers by informal means." Robert Cooter, *Expressive Law and Economics*, 27 J. LEG. STUD. 585, 593 (1996). Alex Geisinger and Michael Ashley Stein have theorized a similar virtuous circle quality in international norm development. *See* Alex Geisinger & Michael Ashley Stein, *A Theory of Expressive International Law*, 60 VAND. L.R. 77, 118 (2007) ("As other States are guided by the norm, certainty that a particular behavior is norm-congruent increases, with a corresponding increase in the esteem a State would expect from acting in accordance with the norm.").

[15] *Compare* Robert B. Cialdini, *Social Motivations to Comply: Norms, Values and Principles*, *in* TAXPAYER COMPLIANCE: SOCIAL PERSPECTIVES 209 (Jeffrey A. Roth & John T. Scholz, eds., 1989) (suggesting a commitment and consistency link between overarching norms like patriotism or honesty and tax compliance) *and* Marjorie E. Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, 121 TAX NOTES 737, 740–44 (Nov. 10, 2008) (recommending public education and media tactics to connect tax payment and public goods) *with* Susan Cleary Morse, *Using Salience and Influence to*

Article reputation among one's peers, clients, and other contacts. Confining the purpose of tax compliance signaling to reputation is consistent with Eric Posner's understanding of signaling.[16]

But I do not think that signaling is only important because of the existence of private information. Instead, signaling has a second potential virtuous circle quality. It can strengthen the compliance behavior of the very individual who signals, through the commitment consistency heuristic which induces individuals to act consistently with past acts and statements[17] and avoid questions about "one's reputation for consistency, a highly valued asset in our economic culture."[18] Nothing limits the operation of commitment consistency so as to drive behavior to gather around negative instead of positive norms. Commitment consistency should reinforce the compliance behavior of a taxpayer who self-identifies as compliant under a signaling mechanism.

Yet effective signaling requires the existence of a compliance norm of some kind. Absent such a norm, a visible compliance choice cannot serve as a good-reputation proxy.[19] In this Article I assume that the pre-existing norm is a noncompliance norm. This means that some other

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Narrow the Tax Gap, 40 LOY. U. CHI. L. J. 483, 505-06 (2009) (arguing that small group norms among similar taxpayers have a clearer link to tax compliance than large-group or national norms).

[16] *See* Posner, *supra* note 12, at 1788.

[17] *See, e.g.*, ROBERT CIALDINI, INFLUENCE: SCIENCE AND PRACTICE 61-90 (4th ed. 2001) (detailing results of commitment consistency studies); Dan M. Kahan, *Social Influence, Social Meaning and Deterrence*, 83 VA. L. REV. 349, 358-59 (1997) (noting that the desire to avoid cognitive dissonance motivates individuals to conform their behavior).

[18] Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)* 144, 151, *in* BEHAVIORAL LAW AND ECONOMICS (Cass Sunstein ed. 2000). *See* Dan Simon, *A Third View of the Black Box: Cognitive Coherence in Legal Decisionmaking*, 71 U. CHI. L. REV. 511, 522 (2004) ("The central feature of constraint satisfaction mechanisms is that the mental model will reconfigure itself until the constraints settle at a point of maximal coherence."); *see also* Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective*, 93 GEO. L. J. 1, 72 (2004) (arguing that individuals are not aware of the influence that commitment or other heuristics exert over their decisionmaking).

[19] *See, e.g.*, James Alm & Michael McKee, *Tax Compliance as a Coordination Game*, 54 J. ECON. BEHAV. & ORG. 297 (2004) (noting that taxpayer communication regarding planned noncompliance increases noncompliance and describing ways in which audit policy can discourage noncompliance cooperation); Kahan, *supra* note 17, at 365 (1997) (arguing that individuals decide whether or not to commit crimes in large part based on their perception of others' criminal behavior); Posner, *supra* note 12, at 1788 ("[S]ocial norms describe equilibrium signaling.").

mechanism, such as enforcement-based penalties and detection or an expressive norm-building mechanism, must generate a compliance norm before signaling can effectively incent tax compliance.

Extracting an effective signal from a merely announced law faces the additional problem of confidentiality in the tax context. Because tax compliance is not necessarily a public act, taxpayers are not generally forced to show whether or not they comply with an unenforced law.[20] This distinguishes tax compliance from an unenforced law relating to, say, water conservation in residential landscaping, where signaling whether or not one follows the law is usually inevitable.

In some circumstances, however, tax compliance is a public act. For example, the "taxpayer" category considered here includes tax intermediaries, such as banks and other third-party reporting and/or withholding agents. Third-party reporting and/or withholding by such intermediaries is observed by large groups – including the intermediary's clients and other institutions in the withholding agent chain – and should therefore have greater potential to support a reputation signal.

C. How Deterrence, Separation and Signaling Interact

The deterrence, separation and signaling mechanisms interact and can reinforce each other. As described below, relationships exist between deterrence and separation, deterrence and signaling, and separation and signaling. In each case, causality runs in both directions.

Consider first the relationship between deterrence and separation. The premise of deterrence is that it can transform non-compliant taxpayers into compliant taxpayers. I am not speaking of an inherent or exogenous quality of a compliant nature or personality, but rather of exhibited taxpayer behavior. Under a deterrence theory, taxpayers' compliance behavior is fluid, not exogenous.

Since the purpose of deterrence is to persuade some non-compliers to act as compliers, it can expand the group that wishes to self-identify as compliant to obtain the benefits of a compliance-appropriate government regime under the separation mechanism. Separation can also reinforce deterrence because it can require the revelation of information that makes it easier for the government to carry out its enforcement program, for example to audit taxpayers who have self-declared as compliant to

[20] Eric Posner describes the possible negative signal that may result from tax noncompliance as arising from the possibility that a taxpayer would be audited. *See* Posner, *supra* note 12, at 1789. But such a negative signal is highly unlikely to be imposed given taxpayer confidentiality and the ability to settle tax claims with the government.

ensure that they are in fact complying.

Deterrence can also strengthen signaling. Recall that effective signaling requires the existence of a compliance norm. Successful deterrence, by pushing taxpayers into the compliant group, tends to make compliance a more dominant behavior, thus increasing the chance that it will be understood to connote good reputation.[21] In the other direction, signaling influences deterrence by changing the individual utility curve referenced by a taxpayer when making a decision as to whether to evade tax. If compliance brings reputational benefits, the tax evasion calculus, which compares the amount of saved tax to the risk-adjusted penalty for cheating, changes. In particular, the reputational benefit of advertising compliance adds to the list of factors that incents tax compliance.

Separation, or compliant taxpayers' self-identification to the government, supports signaling in a different way. The key here is commitment consistency.[22] Taxpayers' self-identification is at least a quasi-public declaration about their compliance values, and after such a declaration taxpayers will be more likely to internalize such compliance as consistent with their view of themselves and with their desire to demonstrate their good reputation.

Separation also may strengthen signaling because the act of self-identification to the government as a compliant taxpayer can serve as a strong reputational signal. The more effective that self-identification is as a signaling mechanism, therefore, the more likely a taxpayer will be willing to self-identify as compliant for purposes of the separation mechanism.

In the other direction, signaling changes the separation dynamic by altering the menu of choices presented to taxpayers. Signaling makes it

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[21] A related theory is that peer-to-peer influences induce others to comply, perhaps achieving a "tipping point" that produces a new, more compliant equilibrium. Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 VA. L. REV. 1577, 1587 (2000). Empirical and experimental research supports the conclusion that compliance norms can evolve over time depending on the compliance decisions of other taxpayers with whom the taxpayer identifies or communicates. *See* James Alm, Gary H. McClelland & William D. Schulze, *Changing the Social Norm of Tax Compliance by Voting*, 52 KYKLOS 141, 153, 161 (reporting increased compliance if experimental subjects were permitted to communicate about their compliance decisions); Michael Wenzel, *Motivation or Rationalisation? Causal Relations Between Ethics, Norms and Tax Compliance*, 46 J. ECON. PSYCHOL. 491, 504-05 (2005) (reporting longitudinal study results indicating that group norms affect personal ethics when a taxpayer identifies with the group).

[22] *See supra* notes 17 and 18 (discussing commitment consistency).

more attractive to self-identify as compliant because self-identifying causes a different, and better, reputation market result that is separate from the government's promise to treat compliers and noncompliers differently.

D. Set Aside Crowding Out.

High penalties may have the potential to crowd out compliant behavior as well as serving the compliance-enhancing functions of deterrence, separation and signaling.[23] They may commoditize and thereby undermine previous social norms of compliance.[24] Or they may be interpreted by a compliant taxpayer as a defecting move in the previously reciprocal tit-for-tat compliance relationship the taxpayer had built with the government.[25] One solution to the problem of crowding out is to apply and articulate different penalties proportional to the severity of different offenses, and to also publicize rewards, such as better taxpayer service, offered to compliers.[26] This Article will focus, however, on penalties only, not rewards, and it sets aside the possibility of crowding out in an effort to streamline the analysis.

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[23] *See, e.g.*, Eric Fleisig-Greene, *Law's War With Conscience: The Psychological Limits of Enforcement*, 2007 B.Y.U. L. Rev. 1203, 1222, 1233-1235 (2007) (arguing that law can have an adverse impact on previously existing positive norms and citing one empirical study suggesting that taxpayers who received letters notifying them of a likely audit reported less income than other taxpayers).

[24] *See, e.g.*, Marjorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers, in* 2 NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 151, 164 (2008) (arguing that a commodified exchange view of taxation can "crow[d] out positive normative influences on [compliance] behavior" and prompt taxpayers to believe that the government is not fair); Marjorie Kornhauser, *Tax Compliance and the Education of John (and) Jane Q. Taxpayer*, TAX NOTES 737, 739 & n.21 (Nov. 10, 2008) (noting the importance of procedural fairness and reciprocal trust for compliant taxpayers).

[25] *See* Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action and the Law*, 102 MICH. L. REV. 71, 83-84 (2003) (noting the inconsistency of audit threats with a reciprocal compliance relationship).

[26] *See* Morse, supra note 15, at 510-512 (arguing for penalties and rewards commensurate with taxpayer behavior). This idea of government-taxpayer reciprocity is distinguishable from the idea of taxpayer-taxpayer reciprocity connected to the common provision of public goods. *See* Sagit Leviner, *An Overview: A New Era of Tax Enforcement—From "Big Stick" to Responsive Regulation*, 2 REG. & GOVERNANCE 360, 365 (2008); Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 436 (2009).

II. THREE SUPPORTS OF HIGH-PENALTY REGIMES

A high-penalty regime can produce the mutually reinforcing mechanisms of deterrence, separation and signaling described in Part I. But achieving these results requires the three supports of penalty credibility, the perception that the non-compliers who masquerade as compliers will be detected, and the absence of close substitutes. In the cases of penalty credibility and masquerading noncomplier detection, government enforcement and/or a robust reputation market can provide the supports.

A. Penalty Credibility

Penalty credibility based on government enforcement depends on more than the penalties as stated in the statute books. A gap often exists between a de jure penalty and a de facto penalty policy. Various reasons may be responsible for this gap between an on-the-books penalty and its enforcement in practice. These may include litigation risk management;[27] internal agency politics, such as a desire to stick to prior practice or avoid adversarial relationships with regulatees;[28] national politics, including the goal of avoiding backlash legislation that could curb the agency's power or resources in response to an excessively tough public image;[29] and international politics, including a reluctance to upset foreign governments by pushing U.S. policies that appear harsh and

[27] *See, e.g.*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION 44-47 (1992) (arguing that an agency that threatens serious punishments may be "vulnerable to a litigious firm determined to shatter its myth of invincibility").

[28] For example, although the IRS has broad statutory powers to summon documents, *see* I.R.C. § 7602; and the Supreme Court has vindicated its authority to use these powers to summon tax accrual workpapers prepared by accountants, *see* United States v. Arthur Young, 465 U.S. 805, 816 (1984), the IRS has historically followed a "policy of restraint" under which it will only seek workpapers "to obtain collateral sources of data, not to fish for new issues." Thomas J. Monks, *Your Papers, Please: Requests for FIN 48 Workpapers*, 125 TAX NOTES 901, at nn. 72-75 (Oct. 28, 2009). This restraint may stem from habit as well as from a desire to dodge litigation risks, limit exposure to restrictive statutory changes, and/or avoid souring relationships with taxpayers. For a summary of recent developments in the area of tax accrual workpapers and a view that they can never constitute protected work product, *see* Dennis J. Ventry Jr., *A Primer on Tax Work Product for Federal Courts*, TAX NOTES 875 (May 18, 2009).

[29] *See* Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1, 79 (2004) (describing the public perception of an overzealous IRS that led to the passage of a statute curtailing the agency's power).

unilateral.[30]

A conceptually distinct – and more important[31] – gap also often exists between a de jure penalty and taxpayers' perception of a de facto penalty policy. Taxpayers' internal perception of the likelihood of penalty imposition drives their compliance decisions and hence this perception is the real key to this element of a successful high-penalty strategy.[32] Elements that influence this perception include how the agency actually imposes penalties; whether it says it will impose penalties; and how information about penalty imposition and rhetoric is made public and, separately, publicized.

If affected taxpayers perceive that the reputation market is well-supplied with information and able to impose reputational sanctions, credible reputation penalties can also support compliance. One kind of reputational penalty consists of the stigma that may attach if a taxpayer is audited and charged with tax evasion.[33] In many cases, taxpayers' actual compliance behavior is confidential and not visible and so the possibility of public litigation provides the main possible reputational feedback loop. Its power is limited because audit, let alone litigation, is a remote and unlikely possibility.

But sometimes taxpayers' compliance behavior is immediately visible. For example, tax intermediaries (included in my definition of taxpayers for purposes of this Article) execute third-party tax reporting tasks that are clearly visible to their clients. Partners and S corporation shareholders can observe entities' tax compliance behavior. Politicians who disclose their tax returns publicly also have visible tax compliance behavior. If a robust reputation market can observe tax compliance behavior, and if the market gives taxpayers reputation demerits for tax noncompliance, the reputation market provides credible penalties that support compliance for reputation-sensitive taxpayers.

B. Detection and Information Strategies

As Alex Raskolnikov has persuasively argued, a key task in tax administration is to identify noncompliers who masquerade as

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[30] *Cf.* JOSEPH S. NYE, JR., SOFT POWER 63-65 (2004) (connecting "unilateral" approach to American foreign policy and "decline of America's attractiveness abroad").

[31] *See, e.g.*, AYRES & BRAITHWAITE, *supra* note 27, at 44-47 (identifying that regulatees' perception of an agency's "invincibility" as a key factor).

[32] *Cf.* Lawsky, *supra* note 5, at 1041-42 (making a parallel point about the importance of taxpayers' beliefs about the law's certainty).

[33] *See* Posner, *supra* note 12, at 1789.

compliers.[34] This point is highly relevant to a high-penalty regime, whether the high penalty is intended to serve only the separation purpose that Raskolnikov identified in the context of menu-based regulatory penalty default structures or whether the high penalty also functions as a deterrent and/or signal. The deterrence function will also be frustrated if noncompliers can hide behind a mask of compliance. Signaling will be weaker as well if masked noncompliance is a known workaround, for the workaround can serve as a competing signal.

In focusing here in this detection and information strategies point on the identification of noncompliers masquerading as compliers, I do not mean to dismiss the more general goal of discovering and penalizing noncompliers. But the place for that goal is in the consideration in Part II.A, above, of whether taxpayers perceive penalties as credible possibilities. Assuming that they do, and that they self-identify as compliers, the necessity of detection and information strategies to determine whether they are telling the truth is a separate and important component of an effective high-penalty strategy. Either the government or a reputation market may detect masked noncompliance.

For the government, one way that information filing can improve detection is through its interaction with audit policy. In simplest form, regulatees who identify themselves as compliers may be subject to more frequent or more thorough audit.[35] Larger populations of regulatees require an audit selection strategy that identifies compliance filers who are more likely to be in fact noncompliant. Part of this can be based solely on the compliance information provided by regulatees, as they can be sorted based on statistical information about the likelihood of compliance by regulatees who meet certain descriptive characteristics. This works only if those characteristics are available in information provided to the regulating agency and it works best if the data are provided in a form that allows automatic information searching.

A different audit selection strategy may be available if there are

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[34] *See* Raskolnikov, *supra* note 11, at 724-728 (exploring several ways to increase the likelihood of detection in the compliance group).

[35] This may be a sufficient strategy for a small population of regulatees, if it is possible to craft the audit approach in a way that does not interfere with the goal of rewarding compliant taxpayers with better service. The IRS's Compliance Assurance Program, or CAP, for large corporate taxpayers is an example of an attempt to craft this kind of service-oriented audit strategy. *See* I.R.S. Announcement 2005-87, 2005-50 I.R.B. 1144 (anticipating government-taxpayer cooperation in the CAP early issue resolution program); CLIFF JERNIGAN, CORPORATE TAX AUDIT SURVIVAL: A VIEW OF THE IRS THROUGH CORPORATE INSIDER EYES 76-77 (2005) (explaining that the IRS invited taxpayers with a "history of honest dealings" to participate in CAP).

alternative sources of information about regulatees. Third party reporting is the most prevalent in tax administration, but other "non-tax documentation" sources[36] – book-tax balance sheet differences provide one example – might also be used. Strategies here go beyond sorting based on a statistical model built from taxpayer-provided data. Instead, the regulator may analyze different sources of data to check whether they match and/or to feed a richer statistical model of the likelihood of compliance. Because of the importance of interactions between alternative sources of data and the taxpayer-provided information that signals compliance, careful design of the reporting required by compliant taxpayers will increase the chance of success for a high-penalty regime.

A reputational market might also police the possibility of masquerading noncompliers. For example, in the case of third-party intermediaries or partnership and S corporations, the clients or equity owners who receive reports have a non-tax financial interest in ensuring that the reports comprehensively list all income items. The omission of some items might suggest that the value of the account or equity interest is not accurately stated in the records of the intermediary or entity, or that the inaccuracy of the reports is a symptom of a broader mismanagement or agency cost problem. In the case of politicians who disclose their tax returns, adverse political interests and the media generally have ample incentive to discover and publicize discrepancies between tax returns and underlying facts.

C. No Close Substitutes

Like any other kind of rule, the operation of a high penalty regime will also be affected by the ability of taxpayers to avoid the whole scheme by making choices that are sufficiently close substitutes for the penalized behavior.[37] The success of a high penalty for a particular infraction requires the absence of sufficiently close substitutes for the penalized action. The penalty will be less effective if the taxpayer can make choices that achieve the goal of tax evasion without incurring a penalty.[38]

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[36] Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 U.C.L.A. L. REV. 1629, 1685-86 (2009).

[37] *See* Lederman, *Reducing Information Gaps*, *supra* note 7, at 1740-41 (arguing that the absence of "alternative arrangements" increases the likelihood of success of an information reporting provision).

[38] The close substitute problem is magnified by the fact that specific penalties typically attach to narrowly described behavior as a matter of statute or administrative guidance. Legislative and administrative process reasons may often be responsible for the existence of specific penalties. In the legislature, the importance of salient scapegoat narratives in the process, the ability of interest groups to influence the scope of penalties in a way that excludes them, and the

David Weisbach has conceptualized the idea of minimizing close substitutes for a taxed activity as the goal of minimizing the "marginal efficiency cost function," which is lower if fewer behavioral distortions result from the imposition of a tax.[39] David Schizer has categorized the factors that may determine whether a particular "friction" prevents taxpayers from planning around a particular rule. Schizer notes that strong and not-malleable frictions, which may come in the form of business choice preferences, technology limitations, and legal and accounting costs, can hinder or prevent the development of close substitutes.[40] The absence of close substitutes or, almost equivalently, the existence of strong and inflexible frictions, is key to the success of a high penalty strategy.

D. All Three Supports Needed

All three of the supports – taxpayer perception of penalties, taxpayer perception of detection of masquerading noncompliers, and an absence of close substitutes – are essential to the success of the compliance mechanisms of deterrence, separation and/or signaling under a high-penalty regime. In the case of deterrence, the perceived (not actual) likelihood of penalty and detection are the inputs into the calculus of the expected benefits and burdens of tax evasion, and a close-substitute activity will prompt a choice that avoids the calculus altogether. The absence of any of the three provides a loophole that can ruin the whole deterrence project. For example, a very high likelihood of penalty imposition cannot effectively deter if there is a zero probability of detection of non-compliers who falsely present themselves as compliers or the presence of a costless close substitute.

Penalty credibility, detection and close substitutes relate to separation in a similar way to the way in which they relate to deterrence. A

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proceduralist nature of the legislative process as "a complex set of hurdles that proponents of a new policy must overcome before their bill becomes law," WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, LEGISLATION AND STATUTORY INTERPRETATION 70 (2d ed. 2006), all tend to support the development of narrow rather than broad penalties.

[39] *See* David Weisbach, *Line Drawing, Doctrine and Efficiency in the Tax Law*, 84 CORN. L. REV. 1627, 1665-1668 (1999) (defining marginal efficiency cost of funds as the ratio between the revenue from a tax change with no behavioral distortion and the actual (presumably lower but still positive) revenue including the impact of behavioral effects).

[40] *See* David Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1323-34 (noting the strength and malleability properties of frictions and listing different possible sources of frictions including business, technology and legal constraints).

taxpayer's decision as to whether to identify as a complier is shaped by the perceived benefits and burdens of the compliance and non-compliance regimes, while a close substitute option eliminates the necessity of choosing from the government's menu. So long as taxpayers require a penalty incentive before they will take the trouble to self-identify as compliant, all three enforcement factors are also essential to the success of a separation goal.

A robust reputation market, as well as government enforcement action, can provide the supports of penalty credibility and masquerading noncomplier detection for the compliance mechanisms of deterrence and separation. In the case of signaling, these reputation supports are central to the compliance project. Taxpayers must perceive that the reputation market will impose penalties for noncompliance, and that the market can detect masquerading noncompliers, in order for a signaling compliance mechanism to succeed. Taxpayers do not necessarily need to believe that the government will penalize them for noncompliance, or detect noncompliers who pretend to masquerade as compliers, in order for the signaling mechanism to work. The desired outcome under the signaling goal is not mediated by the government, but rather by the reputational market populated by, for example, the taxpayer's peers and clients.

But government enforcement is still relevant to signaling. If government enforcement causes more taxpayers to comply, compliance becomes a more dominant behavior and so more likely to connote good reputation. In addition, self-identifying as compliant for whatever reason, including reasons relating solely to concerns about government enforcement, should make a taxpayer more likely to in fact behave in a compliant way and associate compliance with good reputation, because of the behavioral tendency toward commitment consistency.[41]

A close substitute can singlehandedly derail a signaling goal even if the reputational market is working well. The reason is that the close substitute behavior may become the norm that everyone gathers around. Regardless of the quality of enforcement of high penalties for prohibited behavior, a close substitute can function as a competing signal that undermines the signaling power of the enacted and enforced law, so long as the close substitute is sufficiently well known. Regulatees may gather around the workaround as an indicator of clever as well as sufficiently compliant behavior rather than around the law as enacted, just as motorists informally agree that driving ten miles above the speed limit is close enough.

[41] *See supra* notes 17-18 and accompanying text (discussing commitment consistency).

III. AN EXPRESSIVE LAW THEORY OF HIGH-PENALTY REGIMES

A. Plan B: Expressive Law

Part II above described how the three supports of credible penalties, credible detection policy, and lack of close substitutes can bring about tax compliance through the mechanisms of deterrence, separation and/or signaling under a high-penalty regime. Effective government enforcement is one route to credible penalties and credible detection policy. But what if effective government enforcement is not possible? In the starting-point scenario that this paper considers – specifically, where there is no pre-existing norm of tax compliance – advertising tax compliance carries few initial reputational benefits and signaling has little force. In other words, the reputation market cannot provide credible penalties and detection policy. At least, it cannot do so until a norm of tax compliance is created. This is where expressive law comes in.[42]

There may be circumstances where government must choose between an enforced high-penalty strategy and an expressive law approach. Resource constraints or a situation where both strategies were available, but one is not compatible with the other, might force such a choice. But I do not here advance any criteria for such a choice. Rather I have in mind a simpler situation, where the government has already committed resources to a high-penalty regime and where it cannot construct the penalty and detection supports with enforcement (for example, because of a lack of jurisdiction). In this case, at least, it should consider the use of an expressive law Plan B.

[42] *See* Cooter, *supra* note 14, at 607 ("Law provides an instrument for changing social norms by expressing commitments."); Posner, *supra* note 12, at 1798-99 (observing that the government is a player in the norm creation game and can send signals that affect taxpayer behavior); Cass Sunstein, *Legal Interference with Private Preferences*, 53 U. CHI. L. REV. 1129, 1137-38 (1986) (explaining that law helps to determine preferences and exploring related democratic theory problems). It is not necessary here to argue that government expressions about the law must have moral content; it is enough to conceive of expressive law as an instrumental tool that can alter social norms, although one would expect a correspondence between the morality of a government expression and the morality of the resulting social norm. *See* Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363, 1497 (2000) (arguing that "the the proper methodology for assessing governmental speech is scientific, not moral" although a "moral framework" is necessary in order to evaluate the results of government speech).

B. Reputation-Sensitive Tax Evaders

The idea of targeting an expressive law strategy at an apparently determined noncomplier may seem silly. For example, the offshore account holders or bank secrecy-focused non-U.S. banks that I discuss in Parts IV, V and VI have historically not complied with U.S. requirements to disclose the existence of U.S.-held non-U.S. bank accounts. Existing accounts of expressive law might categorize such taxpayers or intermediaries as "dedicated cheaters."[43] Alex Raskolnikov calls this the "gamer" category, and endeavors to find a way to ensure that a taxpayer's true gamer nature is revealed by a separation mechanism so that, among other things, more draconian penalties may be applied to this group.[44] Eric Posner concludes that signaling strategies will not work as applied to "people in deviant communities," because tax compliance lacks salience as a reputational strategy or because "people already have a low opinion of that . . . person."[45]

These analyses suggest that expressive law strategies are futile as applied to determined evaders. How could expressive law and norm development affect a taxpayer who views the tax law as a game and does not care about his reputation? The answer lies in the fact that a key assumption is incorrect. In particular, it is possible that a historically committed tax evader cares quite a bit about reputation, and this possibility opens the door for an expressive law strategy.

In a situation where there is a tax noncompliance norm, an evader who cares about reputation suffers no reputational blow from failing to comply with applicable tax requirements and may even experience an improvement in reputation from a failure to comply. The cash business situation provides an example. If a store owner evades taxes, and all of his small-business friends do likewise, the tax-evading store owner may experience camaraderie or respect for a particularly clever evasion strategy, rather than a blow to reputation.[46] The offshore account situation explored further below in Parts IV, V and VI provides other examples: the U.S. individual with a Swiss bank account might be seen by her peers as rich, clever, cosmopolitan; and the Swiss bank that found a dodgy way around a requirement to disclose U.S. account holders might be seen as offering excellent, personalized client service while respecting its longstanding national bank secrecy tradition.

If a historically committed tax evader cares about reputation, and it is

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[43] Kahan, *supra* note 25, at 84.

[44] Raskolnikov, *supra* note 11, at 691.

[45] Posner, *supra* note 12, at 1795.

[46] *See* Morse, Karlinsky & Bankman, *supra* note 2, at 65-66 (describing tax noncompliance behavior of small businesses as consistent with group norms).

possible to build a norm that recasts tax compliance, not tax noncompliance, as the reputation-enhancing behavior, then the reputation-sensitive historic tax evader might start to experience reputation benefits from signaling consistency with the new tax compliance norm. This appears to have happened recently in the tax haven context, where efforts to brand tax havens as nefarious have apparently produced countries' efforts to signal their compliance with a new norm involving at least some commitment to information exchange and transparency. Part IV.B discusses this story in more detail.

C. Norm Entrepreneurship and Tax Compliance

1. Norm building in the tax context

Building a norm – by which I mean, following Robert Ellickson, a "rule supported by a pattern of informal sanctions"[47] – requires some kind of communication about it. A normative expressive law strategy has been described as a "[c]onversation [that] establishes a public space of meanings and shared understandings between the speaker and addressee."[48] Law can express moral principles, such as race equality or animal rights.[49] It can also express a solution to a collective action problem,[50] which has been called the "least controversial case for the expressive function of law."[51] A law might provide a focal point for cooperative decisionmaking, for example by requiring cars to drive on one side of the road.[52] Or a law might provide an honorable excuse for individuals to avoid mutually destructive activity, for example by prohibiting individuals convicted of dueling from holding public office.[53]

Moral expressive law strategies do not have a large following when

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[47] Robert Ellickson, *Law and Economics Discusses Social Norms*, 12 J. LEG. STUD. 537, 549 n. 58 (1998).

[48] Elizabeth Anderson & Richard Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503, 1574 (2000).

[49] *See* Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2043-44 (1996) (discussing connection between public norms and private norm entrepreneurs).

[50] *See, e.g.*, Cooter, *supra* note 14, at 607 (describing norm development as a way to accomplish a Pareto self-improvement through cooperation); Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1654-58 (2000) (describing expressive law as a way to solve coordination games); Eric A. Posner, *Law, Economics & Inefficient Norms*, 144 U. PA. L. REV. 1697, 1729-36 (1996) (considering ways in which the government could foster the replacement of inefficient group norms with efficient norms).

[51] Sunstein, *supra* note 49, at 2033.

[52] *See* McAdams, *supra* note 50, at 1667 (giving driving example).

[53] *See* Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. Chi. L. Rev. 943, 968-72 (1995) (giving dueling example).

it comes to the problem of tax compliance. Exhorting large groups of individual taxpayers to pay their taxes because it is the right thing to do may have met historical success in the extreme context of wartime crisis, which provides an opportunity for messages with unparalleled salience as well as consensus with respect to public goods[54] and reciprocity.[55] But outside that context few seem to consider a normative approach to tax compliance a very promising strategy. Available empirical evidence is sparse and mixed.[56]

Tax compliance might seem to be a classic collective action problem. Presumably taxpayers comply only because they know that others will also comply, so that the funding of public goods will be a collective exercise. But in many cases of interest taxpayers do not experience tax compliance as a collective action problem.

First, the collective action problem likely lacks salience for stakeholders in the tax compliance case because the public benefit produced by better tax compliance -- a marginal improvement to the public finance system -- is confusing, remote and somewhat boring. It is cognitively difficult for taxpayers to appreciate this marginal public benefit. Related research investigating the relationship between tax compliance and perceived government legitimacy or trust in government reaches inconsistent results regarding whether these factors are positively correlated with tax compliance.[57]

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[54] *See* Carolyn Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685 (1989).

[55] *See* STEVEN A. BANK, KIRK J. STARK & JOSEPH J. THORNDIKE, WAR AND TAXES (2008).

[56] *See, e.g*. Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125, 130–34 (2001) (reporting small positive but not statistically significant improvements in tax compliance for taxpayers who received letters either stating that nearly all Minnesota taxpayers were compliant or listing certain public benefits paid for by tax revenues).

[57] *Compare* TAXPAYER COMPLIANCE: AN AGENDA FOR RESEARCH 126 (Jeffrey A. Roth, John T. Scholz & Ann Dryden Witte, eds., 1989) (reporting little correlation between perceived government legitimacy and tax compliance); Marjorie Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, TAX NOTES 737, 738 (Nov. 10, 2008) (noting pervasive and historic "anti-tax schema" in American culture) *with* Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSP. 25, 40 (2007) (citing survey evidence of a correlation between disapproval of tax evasion and declared trust in government, but noting that such survey results could reflect rationalizations of pre-existing compliance decisions); James Alm, Betty R. Jackson & Michael McKee, *Fiscal Exchange, Collective Decision Institutions and Tax Compliance*, 22 J. ECON. BEHAV. & ORG. 285 (1993).

Second, the decisions of noncompliant taxpayers to shift their compliance behavior and start to comply may not result in a net benefit to the taxpayers who change their behavior, and thus the situation does not fit the classic definition of a collective action problem. Most U.S. taxpayers have no choice about their compliance: their taxable income is automatically withheld upon or at least automatically reported to the government. The difficult compliance questions relate to taxpayers who have the opportunity to evade tax and have historically done so. Thus the public benefits of increased compliance (e.g., lower overall tax rates)[58] would be spread over all taxpayers, not just those whose compliance increases -- and the vast majority of U.S. taxpayers have no choice but to comply.

Moral appeals and collective action solutions targeted at the taxpayer population in general may lack promise in the tax compliance context. But the connection between expressive law and potential reputation benefits may nevertheless be exploited. It is important to distinguish here between normative language aimed at large groups of individual taxpayers and normative rhetoric that engages smaller groups of larger taxpayers, including tax intermediaries. In the individual taxpayer situation – although I do not think the experiment has been run with enough energy and creativity to reject it out of hand – normative rhetoric is less promising because it lacks the support of a strong reputation signaling mechanism. This is because individual reputation is mediated by small-group norms that can be difficult for the government to penetrate,[59] and because usually no one observes individuals' tax compliance behavior.[60] Large tax intermediaries, however, typically must defend their reputation in a larger national or global market, and their compliance behavior is typically visible. Such intermediaries are thus a good candidate for reputation signaling.

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[58] Various kinds of public benefits are possible, including lower enforcement expenditures; less tax planning deadweight loss; and greater economic productivity due to better allocation of resources. *See generally* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES (4th ed. 2008).

[59] *See* Morse, *supra* note 15, at 505-06 (arguing that small group norms among similar taxpayers have a clearer link to tax compliance than large-group or national norms). As Lynn Stout has explained in the course of exploring the relationship between law and conscience, the several evolutionary biology explanations for "prosocial" behavior support the conclusion that "altruistic cooperation tends to occur only with *other members of one's in-group*." The in-group concept, although "plastic," might not easily encompass the whole citizenry absent a moment of national war or other crisis. LYNN STOUT, CULTIVATING CONSCIENCE 144-47 (2010).

[60] *See* Posner, *supra* note 12, at 1788.

The government's expressive law task is to persuade some taxpayers to internalize a new tax compliance norm and act as private norm entrepreneurs within the context of a reputation market. The informal sanctions of such a market can provide the credible penalty and credible detection supports needed for a successful signaling strategy. Moreover, signaling has virtuous-circle capacity to self-reinforce. First, the more taxpayers comply, the stronger the positive reputation signal and the stronger the incentive to other taxpayers to comply as well. Second, taxpayers who comply to reap reputation benefits should experience a commitment consistency attachment to compliance behavior.[61]

The question of how a norm is internalized is thorny and interesting but not crucial to the analysis here. It is possible that a private norm entrepreneur could support a government expressive law strategy for completely rational reasons, for example because the actor recognizes a promising branding opportunity offered by developing the norm as a positive reputational signal and then sending the signal.[62] A rational path could feature collective action among a subset of previously noncompliant taxpayers who find that all of them will gain from cooperation, even though the complete group of noncompliant taxpayers might not experience a net gain from compliance.

It is also possible for a private norm entrepreneur to be motivated by some higher ideal, such as the morality of paying taxes, or the idea of honesty, even though inconsistent with its own self-interest, so that the norm is born outside the bounds of the rational actor model.[63] But immediately the norm becomes a preference, say for tax compliance, and it is possible to conceptualize that preference within the bounds of the rational actor model.[64] The norm could also quickly support positive reputation signaling, which also falls within the bounds of a rational actor model.

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[61] *See supra* Part I.B.

[62] *See* Alex Geisinger, *A Belief Change Theory of Expressive Law*, 88 IOWA L. REV. 35, 42-43 (2002) (noting the debate over whether norms are internalized in the course of individuals' pursuit of rational interests).

[63] *See id.*

[64] *See id*. The argument is that it is a false dichotomy to separate the normative exercise sharply from a rational actor model. One's taste for fairness, for example, might affect the utility curve referenced when making "rational" decisions. *Cf.* LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 45 (2008) (comparing different social welfare functions derived from different philosophical outlooks).

2. Norm-building tactics: reputation referencing, salience, management targeting, and incrementalism

The promise of a strategy of normative rhetoric and conversation, at least in the tax compliance context, does not turn on whether the internalization mechanism is rational or not. The goal is to stimulate signaling, or informal reputational sanctions, for the violation of the norm. Whatever message the government uses should reference reputation, demonstrate high salience and provide opportunities for taxpayers to show their commitment to the norm. The fact that the articulation of the norm needs to reference reputation probably means that the language will have a moral tone. But this does not mean that the internalization mechanism is moral rather than rationally self-interested.

In addition, if directed at organizations, such as large tax intermediaries, an expressive law strategy should target the people at the top. This is because group norms within a business organization are heavily influenced by the views of leaders of the organization.[65] Group members tend to defer to information offered by others instead of forming their own opinions, especially when the person who offers of information is a peer or supervisor.[66] Donald Langevoort gives the example of large corporations' tendency to develop optimism biases that lead to overcommitment and overbidding for assets,[67] but nothing prevents this organizational behavior tendency from reinforcing compliance norms in addition to overly aggressive norms.

Tax compliance measures aimed at large enterprises present some of the same problems as the regulation of large enterprises in generally. Corporations, for example, may act only through the individuals that comprise them, but these individuals are strongly incented to conform to corporate hierarchical example, which is typically formed at least in part by the corporation's profit motive. Corporate employees may "not become as purely self-interested as Economic Man, [but] may at least behave like his second cousin, Corporation Man."[68] But the strength of the corporate hierarchy can also be turned to good use by a government

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[65] *See, e.g.*, JAMES G. MARCH & HERBERT A. SIMON, ORGANIZATIONS 99-100 (2d ed. 1993) (noting that disproportionate weight may be accorded to norms held by senior group members).

[66] *See* Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962, 1012-13 (2005) (describing "polarization" process and "cascades").

[67] *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 131, 139-40 (1997) (noting that corporations themselves "develop belief systems" and can amplify "optimism bias").

[68] STOUT, *supra* note 59, at 169.

moves that manage to insert compliance into the hierarchical example and message. Elsewhere I have argued that Sarbanes-Oxley managed to do this in a way that contributed significantly to the general demise of the corporate tax shelter business that had flourished in the 1990s.[69] Sarbanes-Oxley and other regulatory movements have in the last decade or so produced the "proliferation" of Chief Compliance Officers at large firms.[70] It is these individuals, among others, who should be targeted by the FATCA implementation project.

Finally, an expressive law strategy may lend itself to incrementalism. The idea is that once a norm gains a toehold, reputational signaling may strengthen it through the virtuous circles described above. A stronger norm should cause more and more firms to engage in reputational signaling, and their engagement with the norm can facilitate the ability to import it into different contexts.

IV. AN EXAMPLE: OFFSHORE ACCOUNT INFORMATION ASYMMETRY

A. The Problem

In the remainder of this paper, I use the example of offshore accounts to illustrate both the compliance support factors outlined in Part II and the expressive law theory described in Part III. Part V contends that the Report of Foreign Bank and Financial Reports, or FBAR, reporting requirements applicable to U.S. taxpayers who hold offshore accounts can be successful based in large part on supports of credible penalties and masquerading noncomplier detection provided by government enforcement. Part VI will argue that government enforcement cannot provide the supports of credible penalties and detection necessary to make a success out of the Foreign Account Tax Compliance Act, or FATCA, which imposes information disclosure rules on non-U.S. financial institutions for accounts owned by U.S. holders. Instead, FATCA requires the application of the expressive law theory described in Part III. Accordingly, an introduction to the problems raised by U.S. taxpayers who own financial accounts outside the U.S. is in order.

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[69] *See* Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Compliance Norm*, 75 FORD. L. REV. 961, 984 (2006) (arguing that concerns among top executives about liability and adverse publicity under Sarbanes-Oxley and tax shelter-related litigation increased the tax compliance of corporations).

[70] Wikipedia cites Scott Cohen of the trade publication *Compliance Week* as dating the broad CCO movement to a 2002 speech by SEC commissioner Cynthia Glassman. *Chief Compliance Officer*, WIKIPEDIA, http://en.wikipedia.org/wiki/Chief_compliance_officer (last visited Apr. 29, 2011).

A 2002 Treasury report estimated that there were about 1 million offshore accounts held by U.S. persons and that less than 20% of foreign bank account reports, or FBARs,[71] were duly filed as required annually.[72] One estimate suggests that these accounts might contain in the neighborhood of $1.5 trillion.[73] The tax collection shortfall resulting from the failure to pay tax on the income from the 80% of offshore accounts that historically went unreported might have amounted to as much as $50 billion annually.[74] However, the number of FBAR filings

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[71] Part V below discusses FBARs in more detail.

[72] *See* SEC'Y OF TREAS., A REPORT TO CONGRESS IN ACCORDANCE WITH § 361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 6 (noting that the IRS estimated the number of foreign bank accounts at 1 million and the number of annual FBAR filings at about 180,000). The IRS has reported that 322,414 FBARs were filed in 2007. *See* IR 2008-79. Without more information about the number of offshore accounts, which may have increased, the frequency with which one FBAR filer listed more than one account or more than one FBAR filer reported one account and so forth, better estimates are difficult to produce.

[73] *See* Avi-Yonah Statement, *supra* note 74, at 3 (deducing U.S. residents' holdings from broader Boston Consulting Group estimate). *See also* RONEN PALAN, RICHARD MURPHY & CHRISTIAN CHAVAGNEUX, TAX HAVENS: HOW GLOBALIZATION REALLY WORKS 62-63 (2010) (citing similar estimates).

[74] *See* Martin Sullivan, *U.S. Citizens Hide Hundreds of Billions in Cayman Accounts*, 103 TAX NOTES 956 (May 24, 2004) (citing $70 billion estimate); *Hearing on Issues Involving Banking Secrecy Practices and Wealthy American Taxpayers*, 111th Cong., 1st Sess. (Mar. 31, 2009) (statement of Reuven S. Avi-Yonah) [hereinafter Avi-Yonah Statement] (assembling various estimates of cash and securities deposits offshore and translating those figures into an estimate of approximately $50 billion in unpaid U.S. federal income tax annually). The Avi-Yonah calculation includes the assumption that the accounts earn a 10% return. *See id.*

The overall 2001 tax gap estimates were based on National Research Program (NRP) audit studies. *See* Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 367, 370-74 (Oct. 22, 2007) (describing NRP estimation methodology). The cited estimates of offshore account noncompliance derive from independent estimates of the size of offshore accounts held by U.S. individual taxpayers, and according to one report "it is doubtful that the $345 billion estimate includes the entire international tax gap." TREAS. INSPECTOR GEN'L FOR TAX ADMIN., A COMBINATION OF LEGISLATIVE ACTIONS AND INCREASED IRS CAPABILITY AND CAPACITY ARE REQUIRED TO REDUCE THE MULTI-BILLION DOLLAR U.S. INTERNATIONAL TAX GAP (Jan. 27, 2009), *available at* http://www.treas.gov/tigta/iereports/2009reports/2009IER001fr.html. Despite the different methodology and incomplete overlap, comparing the $350 billion measure of overall noncompliance to the $50 billion estimate of offshore account noncompliance should give an idea of the general size of the tax gap problem and relative importance of its components, as intended. At least, it does not underestimate the problem.

has increased. In 2004, taxpayers filed 217,699 FBARs and in 2009 534,043.[75]

The IRS has said that account holders come from "all walks" of (relatively wealthy) life.[76] One official has been reported as saying that of 50,000 accounts targeted by the UBS subpoena discussed below[77] – which requested all accounts with U.S. connections at a certain bank, without any filtering mechanism as to size or otherwise – a few thousand were enormous accounts of tens or hundreds of millions of dollars, and the vast majority smaller, less than ten million dollars.

Offshore account holders include heirs, immigrants and expatriates with some personal connection to the location of their offshore account.[78] Account holders who lack any non-U.S. connection may have various reasons for opening the account including misguided acceptance of an unscrupulous planner's advice,[79] or nontax asset protection, as well as determined and conscious tax evasion. And determined tax evaders may have legal or illegal sources for their deposited funds, tax-paid or not.

Offshore account noncompliance presents a problem of information asymmetry, rather than an issue of legal uncertainty. It is perfectly clear that U.S. citizens and residents must pay U.S. tax on their worldwide

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[75] *See* TREAS. INSPECTOR GEN'L FOR TAX ADMIN., NEW LEGISLATION COULD AFFECT FILERS OF THE REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS, BUT POTENTIAL ISSUES ARE BEING ADDRESSED (Sept. 29, 2010).

[76] *See* IR 2003-95 (July 30, 2003) ("People from all walks of life applied for the [2003 voluntary disclosure] program, including lawyers, dentists, business executives, estate heirs and numerous other occupations.").

[77] *See infra* Part V.B.1.

[78] *See* Jeremiah Coder, *IRS Extends Offshore Voluntary Disclosure Deadline*, 124 TAX NOTES 1297 (Sept. 28, 2009) (reporting practitioner report of inquiries from "immigrants or their children who created accounts before coming to the United States"). *Cf.* Fred Feingold, *Further Guidance Needed on Who Must Report Foreign Accounts*, 123 TAX NOTES 1023 (May 25, 2009) (arguing that many FBAR nonfilers fail to file due to ignorance of the requirement).

[79] At a Senate committee hearing in 2002, for example, lawmakers heard testimony from an orthopedic surgeon and federal inmate. He had gotten into financial trouble, refused the offers of several tax protestor promoters, and then entered into a offshore "business trust" arrangement supported by "legal opinions and letters from several attorneys." He thought things were legal, he claimed, until he discovered that the trust routed funds from Utah to the Isle of Man and then to Austria and provided false receipts for the funds. He stated that he was attempting to extricate himself from the situation when he was found out. *Transcript of Hearing on Schemes, Scams and Cons, Part II: The IRS Strikes Back,* 107th Cong., 2d Sess. (Apr. 11, 2002) 16-22 (statement of Dr. Daniel Bullock).

income, including income that accrues to an offshore account.[80] The challenge is to make or persuade offshore account holders – and/or the foreign banks where they do business – disclose the relevant information.

B. OECD's Expressive Law Harmful Tax Project

1. The OECD's project

In the 1990s, the Organization for Economic Cooperation and Development, or OECD, decided to study the problem of harmful tax competition. The developed nations who make up the OECD's membership generally have, on balance, an interest in more robust residence-based taxation.[81] The harmful tax competition project (later renamed "harmful tax practices" project")[82] initially aimed at both low-tax regimes applicable to active, business income and secrecy regimes that permitted the hiding of passive investment income.[83] But the first goal of "stopping tax havens from 'poaching' mobile capital" fell out, reportedly as a result of the objections of tax havens and others including

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[80] A U.S. citizen or resident alien may exclude certain income earned abroad from the performance of services, but this foreign earned income exclusion does not exempt investment income from U.S. tax. *See* I.R.C. § 911. One of the requirements for the foreign earned income exclusion is that the individual demonstrate his or her substantial foreign presence abroad by meeting either the bona fide residence test or the 330-day test. *See* I.R.C. § 911(d). Such a taxpayer may also be able to reduce his or her U.S. tax by the amount of foreign taxes paid, but must record the foreign tax credit claim on the tax forms submitted to the U.S. government. *See* I.R.C. § 901 (providing for foreign tax credit election); I.R.S., FORM 1116 (enabling foreign tax credit election); I.R.S., FORM 1116 INSTRUCTIONS at 1 (explaining that in certain circumstances a taxpayer with "passive category income" only may claim a foreign tax credit on line 47 of From 1040 without filing Form 1116). In most offshore account situations, in any case, there is no foreign tax to credit.

[81] Thirty-four developed countries make up the membership of the OECD. These nations are concentrated in Europe but also include Australia, Canada, Japan and the United States. *See* www.oecd.org. Some criticize what they describe as the inappropriate meddling of the OECD in the affairs of tax haven countries, often less developed than the members of the OECD. Vaughn James, *Twenty-First Century Pirates of the Caribbean: How the OECD Robbed Fourteen CARICOM Countries of Their Tax and Economic Sovereignty*, 34 U. MIAMI INTER-AM. L. REV. 1 (2002).

[82] *See* J.C. SHARMAN, HAVENS IN A STORM: THE STRUGGLE FOR GLOBAL TAX REGULATION 88-89 (2006) (describing the retreat from the controversial implication that "competition" could be harmful).

[83] *See* Alex Easson, *Harmful Tax Competition: An Evaluation of the OECD Initiative*, ___ TAX NOTES INT'L 1037, 1038 (June 7, 2004) (describing 1998 report). Secrecy as well as low taxes is widely recognized as a tax haven badge. *See* PALAN, MURPHY & CHAVAGNEUX, *supra* note 73, at 33-35.

the U.S. and some Commonwealth nations.[84] The most prominent feature of the remaining passive investment income portion of the project was the use of a tax haven blacklist, first published in draft form in 2000.[85] This was the main tool used to incite "tax havens" to move towards more information reporting, and less bank secrecy.

The OECD and its member states were not about to use force to reduce bank secrecy. Even if the days of gunboat diplomacy are not over, this project, headed by the expert technocratic and consensus-building OECD, was not a situation that would provoke its use.[86] Nor did the OECD offer tax havens a monetary side payment.[87] Moreover, the "defensive measures" promised by the OECD for countries on the list were not particularly threatening for havens singled out for helping residents of high-tax OECD countries hide passive investment income. Reduced foreign tax credits, for example, would not affect such tax benefits. Some other provisions, such as requiring information reporting, imposing withholding taxes, or enhancing audit activity or applicable penalties for investments in tax havens, had more relevance but faced very significant implementation obstacles, including the necessity of coordinating national tax legislation among OECD members, addressing jurisdictional limitations to enforce any requirements placed on offshore banks, and gathering the offshore information necessary to support an audit and enforcement strategy.[88]

This was not a situation where government-enforced penalties and detection would likely produce successful deterrence, separation and/or signaling compliance mechanism. Instead, the endeavor evolved into an

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[84] SHARMAN, *supra* note 82, at 74.

[85] *See* OECD, PROJECT ON HARMFUL TAX PRACTICES, 2000 PROGRESS REPORT.

[86] *See* SHARMAN, *supra* note 82, at 53-55 (describing the "military non-option").

[87] *Compare* Timothy V. Addison, *Shooting Blanks: The War on Tax Havens*, 16 IND. J. GLOB. LEG. STUD. 703, 723-24 (recommending a side payment to tax havens to align tax compliance incentives).

[88] *See* OECD, *supra* note 85, at ¶35. *See* SHARMAN, *supra* note 82, at 59-61 (describing tax havens' successful attempts to convince some OECD members that sanctions would violate sovereignty). The situation nicely fits Anne-Marie Slaughter's understanding of horizontal and vertical international networks of regulators. Although the individual nations that are OECD members possess "hard power" to enforce, fine, imprison and so forth, there is no mechanism available for the OECD to force the member nations to take such action. Indeed, there would be not necessarily be any such mechanism even if the OECD had "formal legal authority" over the member states. Instead the network that is the OECD must rely on soft power: "information, persuasion, socialization." ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 168 (2004).

expressive law project, undertaken by a small group of countries,[89] to persuade governments to signal their opposition to tax evasion. The result – tax havens' agreement to enter into lukewarm tax information exchange agreements -- may appear to represent defeat for the OECD when measured against the initial ambitious goals of stopping tax competition for mobile active investment capital and achieving automatic information exchange for passive investments.[90] But when viewed as a piece of an incremental global information reporting project, the fact that the OECD persuaded previously secretive jurisdictions to acknowledge that other nations' tax evasion concerns could trump client confidentiality counts as a battle triumph.[91]

2. Reputation referencing, salience, management targeting and incrementalism.

The OECD's harmful tax practices project thus stands as an example of a successful expressive law strategy that worked by triggering reputation signaling. The endeavor worked partly because its targets –

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[89] The harmful tax competition project is thus consistent with Robert Keohane's observation that small groups may form international regimes (defined broadly and including "principles, norms, rules and procedures") to further their shared interests but perhaps at the expense of other international actors, such as other nations. *See* ROBERT KEOHANE, AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY 59, 79 (1984).

[90] The model OECD tax information exchange agreement only requires governments to disclose information only upon request – not automatically -- and requires the requesting government to provide considerable information about the targeted taxpayer. *See* OECD, AGREEMENT ON EXCHANGE OF INFORMATION ON TAX MATTERS, Article 5 (200_). It is not yet clear how the provisions will work in practice. *See* Maria Flavia Ambrosanio & Maria Serena Caroppo, *Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms*, 53 CAN. TAX J. 685 (2005) (explaining certain workarounds).

[91] *See* SHARMAN, *supra* note 82, at 152-53 (noting the failure of the initiative's original broad goals but the possible success of the "scaled-back project"). The modest success was remarkable also because of the backdrop of a historic reluctance to enforce other countries' tax laws *See* William S. Dodge, *Breaking the Public Law Taboo*, 43 HARV. INT'L L. J. 161, 170-77, 202-06 (2002) (giving history of "revenue rule" refusal to enforce other countries' tax laws and absence of mutual collection assistance provisions from tax treaties). In 2005, the Supreme Court restricted the application of the revenue rule when it held in a 5-4 decision that a scheme to evade Canadian excise taxes qualified as fraud under U.S. law and hence could support a wire fraud conviction. *See* Pasquantino v. United States, 544 U.S. 349, 356, 364 (2005) (concluding that Canada's right to excise taxes counts as property and that the revenue rule does not bar prosecution "by a domestic sovereign acting pursuant to authority conferred by a criminal statute").

tax haven governments – are and were extremely reputation sensitive.[92] It also worked because, despite various missteps and course changes, it was effectively implemented. It referenced reputation; used high-salience communication techniques and gave targeted governments clear opportunities to show their commitment to the norm; targeted people at the top of governments; and modified its initial, too-broad approach to a winnable incremental strategy.

The OECD led with normatively loaded language by targeting "harmful tax competition."[93] At first, the message lacked salience because the lists of factors and considerations used to define this idea made it difficult to understand and apply, particularly in the context of tax regimes applicable to active business income. But the salience goal was rescued by the use of a "tax haven" blacklist, which both changed and simplified the message.[94] As it turned out, the countries proposed for the list were mostly small passive income havens, such as Gibraltar, St. Lucia and the Turks and Caicos,[95] rather than developing countries seeking to attract foreign direct investment with tax holidays and other incentives. Now the message was clear – good banks don't lie -- and as Luxembourg and Switzerland recognized, it plainly targeted bank secrecy.

The list gave the targeted countries an opportunity to provide a clear, positive reputation signal – removing themselves from the blacklist. To avoid being listed, a country had to (1) evidence a willingness to exchange information (on request, not automatically) with OECD countries who wished to do so and (2) ensure that its account holdings were sufficiently transparent, so that its supervising government had access to beneficial owner information.[96] The information exchange portion of this commitment had a further level of salience, as it could involve signing tax information exchange agreements ("TIEAs") for which the OECD provided a model.[97] And OECD meetings provided a

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[92] *See* SHARMAN, *supra* note 82, at 107-114 (explaining the importance of reputation to tax haven countries based on an extensive series of interviews and other corroborating information).

[93] *See* Arthur Cockfield, *Protecting Taxpayer Privacy Rights Under Enhanced Cross-Border Tax Information Exchange: Toward a Multilateral Taxpayer Bill of Rights*, 42 U.B.C. L. Rev. 421, 428-29 (summarizing OECD's harmful tax competition project); Adam Rosenzweig, *Why Are There Tax Havens?*, 52 WM & MARY L. REV. 923, 928 (2010) (suggesting that tax havens have been "singled out by institutions such as the OECD and G20 as the root cause of many of the fiscal shortfalls plaguing the governments of the world").

[94] *See* Easson, *supra* note 83, at 1042.

[95] *See id.*

[96] *See id.* at 1045-1046.

[97] *See* Geisinger & Stein, *supra* note 14, at 119 (discussing treaty ratification

perfect opportunity to put pressure on senior decisionmakers in each country.[98]

Finally, the OECD's process was incremental. It began in 1996 and 1998 with the articulation of harmful tax competition as a problem in a vague manner difficult to disagree with. It moved in 2000 to the publication of a draft tax haven listing of 35 countries, which could remove themselves from by promising to eliminate their harmful tax practices before a deadline that was then extended three times. In April 2002 there were only seven countries left and in 2004 only five.[99] Subsequently, under the auspices of the OECD's follow-on project of encouraging information exchange (though only on receipt of a fairly detailed request), dozens of bilateral tax information exchange agreements have been entered into by countries historically known as tax havens.[100]

Reputation signaling explains why low-tax countries took pains to avoid the OECD blacklist.[101] There is also evidence that the reputation signaling foothold gained by the tax competition project had self-reinforcing qualities that prompted countries that had supported the OECD project to favor disclosure over bank secrecy more generally. Arguably the project has caused a "good banks don't lie" norm to become pervasive and powerful as a signaling touchstone. One indication of this virtuous cycle effect is the Swiss government's eventual decision to stretch the Swiss bank secrecy laws perhaps to their breaking point[102] in order to permit the disclosure of U.S. account holder

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and, separately, observed treaty compliance as signals of conformity to a prevailing international norm).

[98] *Cf.* SHARMAN, *supra* note 82, at 99-100 (explaining that tax haven states were brought into the OECD consensus-building process as "participating partners").

[99] *See id.*

[100] *See* Charles Gnaedinger, *OECD Tax Official Calls G-20 Summit an "Outstanding Success*", 2009 TNT 186-5 (Sept. 28, 2009), *available at* LEXIS, TNT library (reporting the execution of ninety tax information exchange agreements and the amendment of sixty tax treaties and the launch of the OECD Global Forum on Transparency and Exchange of Information, formed to conduct peer reviews of the implementation of the agreements).

[101] *See* SHARMAN, *supra* note 82, at 101 (arguing that the entire issue for tax havens was reputational); *see also* KEOHANE, *supra* note 89, at 105 ("noting that, "under conditions of uncertainty and decentralization," "a good reputation makes it easier for a government to enter into advantageous international agreements.").

[102] *See* Bradley J. Bondi, *Don't Tread On Me: Has the United States Government's Quest for Customer Records from UBS Sounded the Death Knell for Swiss Bank Secrecy Laws?*, 30 N.W. J. INT'L L. & BUS. 1, 3-6, 18-19 (2009) (describing historic Swiss commitment to bank secrecy and connection to Swiss

names in UBS case, as discussed below,[103] and enter into a TIEA-based information exchange treaty protocol with the U.S.[104]

This does not mean that the countries that repealed bank secrecy laws will definitely renounce their bank secrecy practices. The OECD's TIEA model, for example, only removes the shield of bank secrecy to require the disclosure of taxpayer information when the requesting country has provided a detailed request naming the taxpayer. TIEAs accordingly might not increase information flow in any material way.[105]

Commentators have labeled putative tax haven countries' responses to the OECD project "ritualistic" and "superficial," for example, and noted that more "savvy" countries capitulated more rapidly to OECD demands, perhaps because they more quickly came to the conclusion that there was not much substance in them.[106] But even if this is true, the fact that countries took steps to avoid the blacklist provides an excellent example of stakeholders taking actions for clearly reputational reasons. Once they have done so, the groundwork is laid for a successful high-penalty regime founded on deterrence, separation and signaling, reinforced by commitment consistency, and enforced by the reputational market.

V. THE FBAR AS AN ENFORCED HIGH-PENALTY REGIME

A. The FBAR

National efforts also currently attempt to address the problem of offshore accounts. So-called FBAR reporting is one tool available to the U.S. government. Under a regulation promulgated under the Bank Secrecy Act,[107] U.S. owners of offshore accounts must annually file

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legal rule that tax evasion is a civil, not criminal, offense and attributing Switzerland's disclosure decisions in part to the decisions of other countries to amend bank secrecy rules in favor of the OECD's model of sharing tax information relating to fraud in other countries upon receipt of a detailed request).

[103] *See infra* text accompanying notes 129-132 (describing UBS account holder disclosure saga).

[104] *See* Michael McIntyre, *How to End the Charade of Information Exchange*, ___ TAX NOTES 695, 696 (calling the protocol "painful" for Switzerland, despite low expectations for significant resulting information exchange).

[105] *See supra* note 90 (describing model TIEA).

[106] *See* PALAN, MURPHY & CHAVAGNEUX, *supra* note 73, at 205-07, 215.

[107] *See* 31 U.S.C. § 5314. Section 5314 was enacted in 1982. *See* Pub. L.

Reports of Foreign Banks and Financial Accounts, or FBARs, with respect to their non-U.S. holdings. This requirement links to the individual income tax return through Line 7 of Form 1040, Schedule B, which requires a taxpayer to specify whether he or she "had an interest in or a signature or other authority over a financial account in a foreign country."[108] In addition, recently enacted I.R.C. § 6038D – a "shadow FBAR" provision – imposes similar self-reporting requirements.[109] Section 6038D is important to the government's offshore account audit strategy, as discussed in Part V.B.2 below.

Despite the characterization of the Bank Secrecy Act as an anti-money-laundering statute,[110] there are at least three partially overlapping reasons for its provisions, including the FBAR requirements. First, the depositor may have illegally obtained the funds that go into an account. Second, the depositor, whether or not he or she has obtained the funds

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97-258, Sept. 13, 1982, 96 Stat. 997; 31 C.F.R. § 103.24 ("Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form"). *See generally* Bank Secrecy Act of 1970 ("BSA"), Pub. L. No. 91-508, 84 Stat. 114 (1970) (codified as amended at 12 U.S.C. §§ 1829b & 1951-59 and 31 U.S.C. 5311-5332). *See generally* STEVEN MARK LEVY, FEDERAL MONEY LAUNDERING REGULATION: BANKING, CORPORATE AND SECURITIES COMPLIANCE § 3.02[B] (2003 & Supp. 2009) (explaining that Title I of the BSA, codified in the 12 U.S.C. sections, requires banks to maintain certain records and that Title II, codified in the 31 U.S.C. sections, requires certain reporting of "secret foreign bank transactions").

[108] I.R.S. Form 1040, Schedule B, Line 7.

[109] *See* I.R.C. § 6038D. The provision is effective for tax years beginning after the date of enactment, March 18, 2010. *See* P.L. 111-147 § 511(c). *See also infra* TIGTA SEPTEMBER 2010 REPORT, *supra* note 75 (contrasting § 6038D and FBAR requirements). This paper focuses on the banking-law-based FBAR requirement rather than the § 6038D requirement because FBAR reporting more clearly fits the high-penalty model that I am concerned with in this paper, at least as long as a willfulness-based penalty is a credible possibility. The basic § 6038D penalty is $10,000, increasing to a maximum of $50,000 after notification by the Secretary. *See* I.R.C. § 6038D(d) (providing $50,000 maximum for "any failure," presumably meaning a limit for each annual failure to file). Another provision increases substantial underpayment penalty for "any transaction involving a foreign financial asset" from 20% to 40%. *See* I.R.C. § 6662(b)(6). But these penalties do not approach the size of FBAR penalties such as the 50% of account value willful civil penalty and the possibility of imprisonment. *See infra* note 121.

[110] *See* LEVY, *supra* note 107, at § 3.02 ("The grande dame of money laundering regulation is the statute commonly known as the Bank Secrecy Act of 1970.").

illegally, may not have properly paid taxes with respect to them. Third, the depositor may fail to pay taxes on the income from the accounts.[111] The second and third issues are tax enforcement concerns. The Financial Crimes Enforcement Network, or FinCEN, division of the Treasury had enforcement responsibility for FBAR compliance until 2003, when enforcement authority was transferred to the IRS under a Memorandum of Understanding.[112]

The FBAR regulations are broad. They require "every person subject to the jurisdiction of the United States . . . having a financial interest in, or signature or other authority over, a bank, securities or other financial account" to file a report.[113] Under a de minimis rule, a report is required if the aggregate value of the financial accounts exceeds $10,000 at any time during the calendar year. The form instructions give more specifics, but retain the broad character of the regulatory requirements, both with respect to the definition of persons required to report[114] and with respect to the definition of accounts required to be reported.[115] Filings are required of entities such as corporations, partnerships and trusts[116] and with respect to holdings in or through corporations,

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[111] The legislative history of the 1970 enactment of the Bank Secrecy Act includes a concern for these tax evasion issues. Swiss bank accounts are not a recent phenomenon. "One of the most damaging effects of an American's use of secret foreign financial facilities is its undermining of the fairness of our tax laws. Secret foreign financial facilities, particularly in Switzerland, are available only to the wealthy. To open a secret Swiss account normally requires a substantial deposit, but such an account offers a convenient means of evading U.S. taxes. . . . [I]t is grossly unfair to leave the secret foreign bank account open as a convenient avenue of tax evasion." H.R.Rep. No. 91-975, *reprinted in* 1970 U.S.C.C.A.N. 4394, 4397-98 (1970).

[112] *See* IRS News Release 2003-48; 31 C.F.R. § 103.56(g). *See also* NYSBA July 17, 2009 Letter, *supra* note 117, at text accompanying notes 6-7 (describing delegation of authority).

[113] 31 C.F.R. § 103.24.

[114] The definition of a person subject to the jurisdiction of the United States is narrowed in the form instructions to "a citizen or resident of the United States, or a person in or doing business in the United States." Instructions to TD F 90-22.1 [hereinafter FBAR Instructions] at 6. See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATE & GIFTS ¶ 65.5.8, *available at* Lawrence Lokken, *The Big, Bad FBAR: Reporting Foreign Bank Accounts to the U.S. IRS* 2-4 (2009), *available at* http://ssrn.com/abstract=1429744 (describing persons required to report and interpretation of doing business language). Proposed regulations and other guidance also narrow FBAR filing requirements somewhat. *See infra* notes 117 & 119.

[115] *See* FBAR Instructions, *supra* note 114, at 6 (defining financial account).

[116] An entity account may be required to be reported because of a U.S. person's financial interest in or signatory authority over such account. *See* FBAR Instructions at 6-7 (describing financial interest and signatory authority rules); BITTKER & LOKKEN, *supra* note 114, at 65.5.8.4 and 65.5.8.5 (same). Various

partnerships, trusts or other entities.[117] Taxpayers must report information that should be readily available to them: the existence and size of an offshore account.[118] The focus here is on the core requirement to report bank accounts financially owned by individual U.S. taxpayers directly or through a corporation or other entity over which the U.S. owner has signatory authority.[119]

There are several civil and criminal statutory penalties specified for FBAR violations.[120] This Article focuses on the civil willful violation penalty, which equals the greater of $100,000 or 50 percent of the balance in the account "at the time of the violation."[121] This is a huge

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other requirements to report ownership in and transactions with foreign entities also exist. *See* I.R.S. Forms 5471, 5472, 3520-A, 8865.

[117] Recent government comments and guidance have expanded practitioners' previous understanding of the breadth of the financial account definition. *See* FBAR Instructions at 6 (providing that financial accounts "generally also encompass any accounts in which the assets are held in commingled funds"); *see also* Letter from New York State Bar Association to Neal S. Wolin, Deputy Secretary, Department of the Treasury, et al. (July 17, 2009), *available at* LEXIS, TNT library, 2009 TNT 137-13, [hereinafter NYSBA July 17, 2009 Letter] at text accompanying notes 13-22 (charging that a "flurry" of informal guidance and media comments indicating that holders of accounts in commingled funds such as non-U.S. hedge funds or private equity funds presented a "tension" with earlier guidance and took practitioners by surprise). Proposed regulations, however, "reserve the treatment of investment companies other than mutual funds or similar pooled funds" despite some concerns about the possible use of entities such as hedge funds for tax evasion. *See* Financial Crimes Enforcement Network: Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, 75 Fed. Reg. 8844, 8846 (proposed Feb. 26, 2010) (to be codified at 31 C.F.R. Part 103). *See also* Notice 2009-62, 2009-35 I.R.B. 260 (requesting comments on various FBAR filing requirements).

[118] The FBAR form requires the reporting of the maximum amount in the account during the year reported. *See* Treasury Department Form TD F 90.22-1 (rev. Oct. 2008).

[119] Proposed regulations and other guidance would not disturb the FBAR filing requirement in this paradigm case. *See* Financial Crimes Enforcement Network: Amendment to the Bank Secrecy Act Regulations – Reports of Foreign Financial Accounts, 75 Fed. Reg. 8844 (proposed Feb. 26, 2010) (to be codified at 31 C.F.R. Part 103); Notice 2010-23 (providing administrative relief for FBAR filing requirements such as for certain signatories without financial interest in the account); Announcement 2010-16 (suspending FBAR filing requirement for certain non-U.S. persons).

[120] There is also a voluminous list of possible penalties for tax evasion and other offenses that may be linked to failure to file an FBAR. *See* IRS, Voluntary Disclosure Questions and Answers, available at www.irs.gov/newsroom/article/0,,id=210027,00.html, Q&A 14 and 15 (listing possible civil and criminal penalties).

[121] *See* 31 U.S.C. § 5321(a)(5) (specifying willful civil penalty). *See* also 31 U.S.C. § 5321(a)(5)(B) (specifying $10,000 civil penalty with reasonable cause

potential penalty, and significantly more than before the statute was amended in 2004.[122]

B. Applying the High-Penalty Analytical Framework to the FBAR

1. Penalty credibility

Part II argued that penalty credibility is one factor necessary to support the success of a high-penalty regime as a deterrence, separation and/or signaling mechanism. In the case of the FBAR, the government has done a good job so far of establishing the credibility of government-enforced penalties in the minds of taxpayers. Government efforts to articulate and publicize applicable penalties crystallized in litigation relating to accounts at Swiss bank UBS and in the administration of the 2009 FBAR voluntary disclosure program. In particular, the government's strategy has leveraged availability bias and persuaded taxpayers of the likelihood of imposition of large civil penalties despite legal uncertainty. The government now faces the task of maintaining momentum.

Leveraging availability bias. In 2007, acting on information provided by ex-employee Bradley Birkenfeld,[123] the Tax Division of the Department of Justice launched a criminal fraud investigation of UBS. The key to the case was the deliberately designed UBS process for working around the "qualified intermediary," or QI, agreement that UBS had entered into with the U.S. government.[124] The main thrust of the QI

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exception); 31 U.S.C. § 5322(a) and (b) (specifying criminal penalties including imprisonment). *See generally* BITTKER & LOKKEN, *supra* note 114, at 65.5.8.7 (summarizing penalties).

[122] The legislative history indicates that the increased penalty responded to Treasury's reporting of widespread disregard for the FBAR filing requirement. *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 377-38 (2005) (proving explanation for § 821 of the Act, codified at 31 U.S.C. § 5321 of the Code.

[123] Starting in 2007, a U.S. native and UBS banker named Bradley Birkenfeld channeled evidence to the government of serious misconduct at the Swiss bank. He informed on the elaborate James-Bond-worthy secrecy practices in the cross-border private banking division at UBS, for example "say[ing] he once transported diamonds, bought with client money abroad, into the United States in a tube of toothpaste." Evan Thomas & Mark Hosenball, *Cracking the Vault*, NEWSWEEK (Mar. 23, 2009). Birkenfeld pled guilty in June 2008 to conspiring to help wealthy American Igor Olenicoff evade taxes, *see* Lynnley Browning, *U.S. Said to Expand Tax Inquiry*, N.Y. TIMES, (Dec. 1, 2008), and in August 2009 received a 40-month prison sentence, *see* Joanna Chung, *Former UBS Banker Given Prison Term*, FIN. TIMES (Aug. 22, 2009).

[124] Over 5000 foreign banks, such as UBS, Credit Suisse and Deutsche Bank, have signed qualified intermediary agreements with the U.S. *See* Letter from

agreement was to permit UBS and other participating banks to forward non-U.S. client information to U.S. withholding agents in summary form and still obtain statutory withholding exemptions or lower treaty-based withholding rates on the payments of U.S. source investment income to non-U.S. persons. [125] But the QI agreement also included a less-than-airtight provision that required UBS to disclose U.S. account holders to the U.S. government,[126] and it was this provision that UBS helped clients to deliberately plan around.[127] The criminal case ended with a $780

New York State Bar Association to Sen. Max Baucus et al. (Sept. 10, 2009) *available at* LEXIS, TNT library, 2009 TNT 175-67, [hereinafter NYSBA Sept. 10, 2009 Letter]. The alternative is nonqualified intermediary, or NQI treatment, which requires the submission of beneficial owner information for each specific account to avoid U.S. withholding on U.S. source payments of investment income such as interest and dividends. *See generally* Treas. Regs. §§ 1.1441-1 et. seq. (containing QI and NQI documentation and withholding rules. Importantly, there is no presumption of U.S. status for purposes of backup withholding with respect to gross security sale proceeds. *See* Treas. Regs. 1.6049-5(d)(3)(ii) (providing that withholding on gross proceeds is not required for payment to a non-U.S. intermediary unless the payer has actual knowledge that a nonexempt U.S. person is the beneficial owner of the payment).

[125] *See* Rev. Proc. 2000-12, 2000-1 C.B. 387 (outlining model QI agreement). Prior to the adoption of these nonresident withholding rules, the U.S. had little assurance that the rules for reducing rates on U.S. source investment income payments to non-U.S. investors were properly enforced. *See* Susan C. Morse & Stephen E. Shay, *Qualified Intermediary Status: A New U.S. Withholding Role for Foreign Financial Institutions Under Final U.S. Withholding Regulations*, 27 TAX MGM'T INT'L J. 331, 332-33 (1998) (noting that the regulations require foreign financial institutions to provide information about "foreign status, eligibility for treaty benefits, and qualification for other statutory withholding tax exemptions such as those applicable to effectively connected income and foreign government or international organization status" and "plac[e] the burden of investigating beneficial ownership on QIs rather than on U.S. custodians"). *See also* REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW 27, 28, 68-78 (2008) (outlining exceptions to the default 30% U.S. withholding tax on U.S.-source investment income).

[126] A compromise struck in the model QI agreement, in deference to bank secrecy rules, does not flatly require QIs to disclose the identity of their U.S. clients. Instead, it describes the option of reconciling the existence of a U.S. account holder with bank secrecy laws by excluding U.S. securities or other assets that generate U.S.-source reportable payments from the U.S. client's account. *See* Rev. Proc. 2000-12, 2000 C.B. 387 § 6.02 ("If QI is prohibited by law, including by contract, from disclosing to a withholding agent . . . the account holder's name . . . then QI must (i) request . . . the authority to make such a disclosure; (ii) request . . . the authority to sell any assets that generate . . . reportable payments or (iii) request that the account holder disclose himself.").

[127] UBS apparently recommended to U.S. clients that they hold accounts through a nominee blocker corporation in a tax haven or that they take advantage of the fact that the qualified intermediary reporting rules only applied to assets that generated U.S. source income by moving U.S. account holders out of assets

million fine and a deferred prosecution agreement in February 2009.[128]

The IRS then submitted a request for enforcement of a broad subpoena to disclose the names of over 50,000 U.S. clients of UBS. In August 2009, after the intervention of the Swiss government as amicus in the case and top-level negotiations, the civil case settled under an agreement requiring UBS to disclose over 4000 names through the information exchange provisions of the U.S.-Switzerland treaty.[129] After considerable debate, the Swiss parliament approved the agreement in the June 2010.[130] As of August 2010, the I.R.S. had received information about 2000 UBS clients.[131] Meanwhile, the U.S. government ran a voluntary disclosure program aimed at offshore account holders, which resulted in 15,000 applications by October 2009.[132]

The Justice Department used the UBS case to support the criminal prosecution of a number of offshore account holders, and it obtained a number of plea bargains,[133] which then supported well-executed availability-bias-based publicity.[134] The publicity was not supported by

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that produced U.S. source income, perhaps trading in U.S. treasuries for British gilts. . *See, e.g.* UBS, QUALIFIED INTERMEDIARY SYSTEM: U.S. WITHHOLDING TAX ON DIVIDENDS AND INTEREST INCOME FROM U.S. SECURITIES 1 (Oct. 2004) ("A QI has to ensure that *US Persons* . . . either declare themselves to the US tax authorities . . . or are no longer permitted to invest in US securities.").

[128] *See* Lynnley Browning, *U.S. Reports Agreement With UBS in Tax Case*, N.Y. Times at B3 (Aug. 13, 2009) (noting earlier resolution of criminal case against UBS).

[129] *See id.* (reporting civil case settlement).

[130] *See* Lynnley Browning, *Swiss Approve Deal for UBS to Reveal U.S. Clients Suspected of Tax Evasion*, N.Y. TIMES (June 17, 2010). This followed a decision by the Swiss Federal Administrative Court that the failure to file a W-9 with UBS for transmission to the U.S. tax authorities did not constitute "tax fraud and the like" and therefore did not meet a requirement under a 1996 treaty for an exception to bank secrecy protection. *See* Daniel Pruzin, *Switzerland for Now to Hand Over Data on Only 250 Secret Accounts with UBS*, BNA TAX MANAGEMENT WEEKLY REPORT 144-45 (Feb. 1, 2010).

[131] *See* Lynnley Browning, *I.R.S. to Drop Suit Against UBS Over Tax Havens*, N.Y. TIMES (Aug. 26, 2010).

[132] *See* Marie Sapirie, *New Era of Enforcement Follows UBS Saga*, 59 TAX NOTES INT'L 501 (Aug. 16, 2010) (noting 14,700 disclosures under the program).

[133] *See* Part II.E *infra*.

[134] The 2009 program followed the offshore credit card initiative of 2002-2003, which sought information about from payment processors such as MasterCard and Visa. *See* Rev. Proc. 2003-11, 2003-1 C.B. 311 (announcing offshore initiative directed in part at credit cards). It culminated in only 10 or so prosecuted cases, plus settled cases that did not get publicized. *See* Heather Bennett, *IRS Offshore Compliance Initiative Collects $170M*, 102 TAX NOTES 713 (Feb. 9, 2004) (reporting that the initiative collected 1300 applications and $170 million). It was considered a limited success. *See, e.g.*, JOINT COMMITTEE

huge numbers of convicted taxpayers. As of October 12, 2009, only seven individual clients and a handful of advisors had submitted plea bargains in connection with the UBS case and the 2009 voluntary disclosure effort. But their stories were well covered by national media and presented a salient story of average rich people getting caught.

A central purpose of audit and compliance publicity is to increase taxpayers' or tax preparers' perception of the risk of detection.[135] These efforts should leverage the well-established cognitive availability bias, which prompts us to estimate the "likelihood of an event on the basis of how quickly instances or other associations come to mind."[136] Studies support the existence of an "indirect" audit effect related to taxpayers' decisions to comply because they hear news of others getting caught.[137]

ON TAXATION, TAX COMPLIANCE AND ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES 48-49 (Mar. 30, 2009) (hereinafter JCT 2009 OFFSHORE ACCOUNT REPORT) (reporting the view that the lack of parallel enforcement actions and publicity limited the success of the 2003 program). In general the 2002-2003 initiative did not face a bank secrecy obstacle, since it targeted U.S. payment processors. *See, e.g.*, Dorsey v. United States, 2004-1 U.S.T.C. ¶ 50,164 (D. Md. 2004) (refusing to quash summons under § 7602; bank secrecy issue not raised).

[135] *See, e.g.*, James Andreoni et al., *Tax Compliance*, 36 J. ECON. LIT. 818, 846 (1998) (summarizing tax compliance studies associating a high subjective probability of detection with significantly higher compliance rates).

[136] Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective on the Human Animal*, 93 GEO. L. J. 1, 39-41 (2004) (quoting SUSAN T. FISKE & SHELLEY E. TAYLOR, SOCIAL COGNITION 384 (2d ed. 1991)). *See generally* Edward J. McCaffery & Joel Slemrod, *Toward an Agenda for Behavioral Public Finance, in* BEHAVIORAL PUBLIC FINANCE (Edward J. McCaffery & Joel Slemrod eds., 2006).

[137] *See, e.g.*, James Alm, Betty R. Jackson & Michael McKee, *Getting the Word Out: Enforcement Information Dissemination and Compliance Behavior* 93 J. PUB. ECON. 392, 401 (2009) (reporting results of laboratory study showing that subject-to-subject messaging about audit outcomes significantly affects compliance decisions and also showing different responses to different combinations of government information); Jeffrey Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance*, 35 PUB. FIN. REV. 500, 516, 518 (2007) (concluding from a longitudinal study of state segmented data that audits and criminal investigation activities significantly influence compliance behavior). *See also* James Alm & Mohammad Yunus, *Spatiality and Persistence in U.S. Individual Income Tax Compliance*, 57 NAT'L TAX J. 101, 121 (2009) (finding correlation between geographic residence and evasion behavior). Estimates of the ratio between the dollars brought in because of other taxpayers' compliance compared to the additional collections resulting from the audit itself are in the range of 11 or 15:1. *See* ALAN H. PLUMLEY, I.R. PUBFLICATION 1916: THE DETERMINANTS OF INDIVIDUAL INCOME TAX COMPLIANCE: ESTIMATING THE IMPACTS OF TAX POLICY, ENFORCEMENT, AND IRS RESPONSIVENESS 35 (1996) (estimating the indirect audit effect at 11.6 times

Associations come more quickly to mind if the stories are familiar,[138] so a publicity strategy should effectively communicate to taxpayers that people like them get caught by the IRS or settle with the IRS because of a fear of being caught.[139] The 2008-2010 plea bargain publicity does a nice job of this kind of availability bias-based communication. Some of the taxpayers in the news for tax evasion through offshore accounts are Forbes-400 rich.[140] But featured taxpayers also include Steven Michael Rubinstein, a Florida accountant with a UBS account allegedly worth "at least $6 million;"[141] Robert Moran, Florida resident whose company builds and rents yachts and the alleged owner of an account containing

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the direct audit effect); Dubin, *supra*, at 519 (reporting result of 15.1:1 under simulation doubling audit rates).

[138] *See* SUSAN T. FISKE & SHELLEY E. TAYLOR, SOCIAL COGNITION 270-71 (1984) (noting "retrieval biases," "strength of association biases" and ease of imagining events); Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 163, 163 *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman, Paul Slovic & Amos Tversky, eds., 1982). ("Life-long experience has taught us that instances of large classes are recalled better and faster than instances of less frequent classes, that likely occurrences are easier to imagine than unlikely ones, and that associative connections are strengthened when two events frequently co-occur.") *See also* Ronald Chen & Jon Hanson, *Categorically Based: The Influence of Knowledge Structures on Law and Legal Theory*, 77 S. CAL. L. REV. 1106, 1179 (2004) ("[C]ues that are prominent or catch our attention are more likely to activate associated categories and schemas.").

[139] *See* Morse, *supra* note 15, at 510 ("[An audit] publicity campaign featuring more typical taxpayers would have more salience.").

[140] *See* Joanna Chung & Haig Simoniam, *Former UBS Employee Charged With Helping Billionaire Evade Tax*, FIN. TIMES, May 14, 2008 (noting the December 2008 guilty plea of real estate magnate Igor Olenicoff, who agreed to pay $52 million in back taxes related to "income earned on about $200 million of assets kept offshore"); *see also* Lynnley Browning, *Suicide Victim May Have Hidden Millions Abroad*, N.Y. TIMES, Sept. 15, 2009, at B1 (reporting that the government had begun to build a criminal tax evasion case involving as much as $100 million in back taxes against Finn Caspersen before his death).

See, e.g., Lynnley Browning, *UBS Executive Indicted in U.S. Inquiry*, N.Y. TIMES, Nov. 12, 2008, at B9 (reporting indictment of Raoul Weil, who led the cross-border private banking division at UBS and mentioning the indictment of Bradley Birkenfeld, a UBS banker); Lynnley Browning, *U.S. Indicts Two in Switzerland on Tax Charges*, N.Y. Times, Aug. 21, 2009 (reporting indictment of NZB Swiss bank executive Hansruedi Schumacher and Swiss lawyer Matthias Rickenbach).

[141] *See, e.g.*, Lynnley Browning, *Florida Man, a UBS Client, Pleads Guilty to Tax Fraud*, N.Y. TIMES, June 26, 2009, at __ (reporting Rubinstein guilty plea); Lynnley Browning, *First Client from U.S. Is Arrested in UBS Case*, Apr. 3, 2009 (reporting Rubinstein arrest).

"at least $3.7 million,"[142] and Jeffrey Chernick, a New York resident who runs a toy company and concealed "more than $8 million."[143] They include Juergen Homann of Saddle River, New Jersey who runs a chemical company and allegedly concealed "about $6.1 million in assets,"[144] John McCarthy, a Malibu businessman whose account allegedly held "more than $1 million,"[145] and Roberto Cittadini, a retired Boeing sales manager who pled guilty to "hiding nearly $2 million."[146]

These are not small numbers, but they are also not among the largest accounts out there. Of the 52,000 UBS clients on the original summons list, one description put the number of "ultrawealthy" taxpayers with accounts worth "tens to hundreds of millions of dollars" at several thousand and suggested that the government would focus its attention there.[147] Yet that is not where all the action has been. At least one report suggested that word on the street while the voluntary disclosure program was pending was that smaller UBS clients were included on the list selected for disclosure.[148]

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[142] *See* Lynnley Browning, *UBS Client Pleads Guilty in Tax Case*, N.Y. TIMES, Apr. 15, 2009 (reporting Moran guilty plea).

[143] *See* Lynnley Browning, *Inquiry Widens as UBS Client Pleads Guilty*, N.Y. TIMES, July 29, 2009 (reporting Chernick guilty plea).

[144] *See* Samantha Henry, *UBS Client Pleads Guilty to Hiding Assets*, ASSOCIATED PRESS, Sept. 26, 2009 (reporting Homann guilty plea).

[145] *See* David Voreacos & Carlyn Kolker, *UBS Client to Admit Failure to Report Swiss Account to IRS*, BLOOMBERG, Aug. 15, 2009 (reporting anticipated McCarthy guilty plea).

[146] *See* Kim Dixon, *Ex-Boeing Manager Pleads Guilty in UBS Tax Case*, Reuters, Oct. 5, 2009.

[147] Lynnley Browning, *Settlement Anticipated in UBS Case*, N.Y. TIMES, June 22, 2009 (reporting the description of a government official).

[148] *See* Laura Saunders, *IRS Extends Deadline to Declare Foreign Accounts*, WALL ST. J., Sept. 22, 2009, (reporting "no discernible pattern as to which customers were selected" for required disclosure under UBS settlement and repeating on practitioner's comment that "'[s]everal of our clients with 'plain vanilla' accounts well under $1 million have gotten these letters.'"). The U.S. John Doe summons request did not discriminate based on the size of the account. *See* Memorandum in Support of Ex Parte Petition for Leave to Serve John Doe Summons at 5, *In re Tax Liabilities of John Does* (S.D. Fla. No. 08-21864) (June 30, 2008) (describing John Doe class as any U.S. taxpayer with "signature or other authority . . . with respect to any financial accounts," except for taxpayers who had supplied UBS with Forms W-9 and been subject to Form 1099 reporting). However, since the description of account selection criteria under the summons settlement is not yet available, it is difficult to tell whether targeting a range of accounts was an intentional strategy. *See* Lee Sheppard, *Now What? Dealing With UBS Account Disclosures*, __ TAX NOTES 847, 850 (Aug. 31, 2009) (speculating that the U.S. targeted large accounts and accounts with particularly creative planning).

Voluntary disclosure penalty sticks despite legal uncertainty. The government chose a high monetary penalty benchmark for the special offshore account voluntary disclosure program. In particular, it took the civil willfulness penalty equal to 50 percent of the account balance for each annual failure to file,[149] as its starting point. In addition to requiring taxpayers to file returns going back six years and pay all back taxes, interest, and either accuracy or delinquency penalties,[150] participants in the FBAR voluntary disclosure program were subjected to a maximum penalty of 20 percent of the account balance for the year (of the six years covered) with the highest balance.[151] And the government apparently intends to apply it across the board. For example, the government declined to recognize a distinction between business accounts and savings and investment accounts,[152] and an anticipated reduction to a five percent penalty apparently meant to apply to inherited accounts is reportedly never granted.[153] In February 2011, the government announced a second FBAR-targeted voluntary disclosure program that

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[149] *See* 31 U.S.C. § 5321(a)(5) (providing for a penalty of the greater of $100,000 or 50 percent of the balance in the account at the time of the violation). Prior to 2004, the maximum penalty for a willful violation was the *lesser* of $100,000 or the account balance at the time of violation. *See* BITTKER & LOKKEN, *supra* note 114.

[150] *See id.*; IRS, Voluntary Disclosures: Questions and Answers*, supra* note 120, at Q&A 22 (giving penalty example). Delinquency penalties for failure to file and failure to pay are typically calculated as a percentage of the tax due per month of failure to file or pay, up to a maximum of 25 percent each. *See* I.R.C. § 6651. The accuracy penalty equals 20 percent of certain underpayments including an underpayment attributable to negligence, disregard of rules or regulations, a substantial underpayment or other misconduct. *See* I.R.C. § 6662. *See generally* LEANDRA LEDERMAN & STEPHEN W. MAZZA, TAX CONTROVERSIES: PRACTICE AND PROCEDURE § 12.02 (3d ed. 2009).

[151] *See* Memorandum from Linda E. Stiff, Deputy IRS Commissioner for Services and Enforcement, to Commissioner, Large and Mid-Size Business Division and Commissioner, Small Business/Self-Employed Division (March 23, 2009), available at www.irs.gov/pub/newsroom/memorandum_authorizing_penalty_framework.pdf (setting forth settlement terms). State taxes and penalties may also apply.

[152] *See* IRS, Voluntary Disclosure: Questions and Answers, *supra* note 120, at Q&A 32.

[153] In guidance, the IRS stated that a 5% penalty might apply to accounts that the taxpayer "did not open or cause . . . to be opened, [where] there has been no activity . . . during the period the account . . . was controlled by the taxpayer, and . . . all applicable U.S. taxes have been paid on the funds [deposited] in the accounts." Memorandum from Linda E. Stiff, *supra* note 151, at 2. An inherited account, for example, might fit these criteria. However, practitioners report that as a practical matter taxpayers cannot persuade the government to apply only a 5% penalty. *See, e.g.*, Remarks of Frank Agostino, Kathryn Keneally & Bryan Skarlatos, The Prosecution and Defense of Offshore Bank Accounts, *supra* note 185.

used a 25-percent-of-account value fine for most accounts and added a 12.5 percent penalty for smaller accounts whose value did not exceed $75,000 in any covered year.[154] Accompanying guidance explicitly stated that the 25% penalty would not be subject to negotiation or the discretion of IRS personnel.[155]

Remarkably, the government managed to establish 20%, and then 25%, of the account value as a credible penalty – in other words, it successfully publicized that penalty level in its program, and voluntarily disclosing taxpayers accepted it as a benchmark -- despite legal uncertainty about how a court would apply the willfulness standard in the offshore account situation, particularly for failures to file before news about the UBS case began to emerge. Under the Supreme Court's Cheek case, "willful" violation of a legal duty to file a tax form generally requires that the defendant know of the legal duty.[156] It is conceivable, given the historic lack of publicity and enforcement about the FBAR filing requirements, that a defendant might be able to show a lack of willfulness.[157] There is one circuit case decided under the Cheek standard that rejected an "ostrich" defense theory in an FBAR filing case, but it involved egregious facts.[158]

Maintaining momentum. For a typical offshore account holder, continued news about indictments and plea bargains of the merely very wealthy, rather than the Forbes 400, has salience and taps effectively into availability bias. The IRS should publicize different kinds of taxpayers that have gotten caught to the extent it legally can.[159] The government's

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[154] See Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 Deadline, IR 2001-14 (Feb. 8, 2011).

[155] *See* IRS, IRS, Voluntary Disclosure: Questions and Answers, *supra* note 120, at Q&A 50 (providing however that the assessed penalties would not exceed the maximum penalties that would be assessed under law outside the voluntary disclosure initiative).

[156] *See* Cheek v. United States, 498 U.S. 192, 201-02 (1991) (considering case involving alleged willful failure to file a federal income tax return).

[157] *See, e.g.*, Fred Feingold, *Further Guidance Needed on Who Must Report Foreign Accounts*, 123 TAX NOTES 1023 (May 25, 2009) (arguing that many FBAR nonfilers fail to file due to ignorance of the requirement).

[158] *See* United States v. Sturman, 951 F.2d 1466, 1476-77 (6th Cir. 1991) (holding that actions taken to conceal assets from the government, including the use of different corporations to transfer funds, together with admitted "knowledge of and failure to answer a question concerning signature authority at foreign banks on Schedule B of his income tax return" "provid[ed] a sufficient basis to establish willfulness on the part of the defendant").

[159] Publicizing taxpayers who have been caught is likely more important that publicizing the audit rate or the compliance rate, both of which draw mixed results in terms of their ability to promote additional compliance. Taxpayers may interpret the audit rate as communicating that audit activity exists or

apparent focus on marshaling simple and easily decided (or plea bargained) charges makes sense, as does its emphasis on continuing its prosecution, plea bargain and publicity program[160] and in covering banks other than UBS.[161] The government appears aware of the need to broaden the net beyond UBS and has instituted criminal proceedings against another large bank, HSBC, and at least two of its clients,[162] as well as against Credit Suisse bankers.[163]

On the heels of the 2011 announcement of the follow-on voluntary disclosure program came news that the U.S. offshore account investigations now also targeted Asian and Israeli banks. These targets

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communicating that an audit is too unlikely to worry about. *Cf.* Alm, Jackson & McKee, *supra* note 137, at 401 (noting conflicting results for "official" publication of audit information in laboratory study). The IRS does publish audit rates, though it keeps the factors that affect its audit selection mechanism secret.

The typically cited problem with publicizing the compliance rate, as opposed to quietly disclosing it, is that taxpayers can interpret the figure as meaning "a clever minority cheats" instead of "most people pay their taxes." In one real-life experiment, Minnesota taxpayers received a letter from the Minnesota Department of Revenue stating that nearly all taxpayers – ninety-three percent – were compliant. Increased compliance, measured by reference to actual tax returns filed, was not statistically significant for those who received the letter. The possibility that the audience will self-identify with or aspire to be part of the "clever minority" makes this a risky strategy. *See* Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125, 135 (stating that a statement of high compliance "may be interpreted to mean that the revenue department is unable to detect cheating").

[160] *See* BNA, TAX MG'T WEEKLY REPORT at 100 (Jan. 25, 2010) (noting 150 ongoing offshore account criminal investigations and that "hundreds of taxpayers are still coming in under IRS's basic procedures for voluntary disclosure"). Plea bargain publicity has continued to emerge, and continues to feature the average wealthy. *See, e.g.*, Lynnley Browning, *UBS Client Pleads Guilty to Tax Fraud*, N.Y. TIMES (Apr. 12, 2010) (reporting guilty plea of Harry Abrahamsen of Oradell, New Jersey, whose UBS account was allegedly financed by claiming $1.3 million in inflated expenses – which would have produced a tax benefit of perhaps approximately $500,000).

[161] *See* Sheppard, supra note 148, at 850 (suggesting that the IRS should pursue and publicize 50 UBS cases and 20 from other banks).

[162] *See* Lynnley Browning, *U.S. Widens Tax Inquiry Into HSBC*, N.Y. TIMES (July 9, 2010) (reporting criminal investigation of London-based HSBC and two of its client); David D. Stewart, *U.S. Offshore Enforcement Likely to Focus on Asia, Practitioners Say*, TAX NOTES, Apr. 2, 2010, available at LEXIS, TNT library, 2010 TNT 64-1 (reporting on David Rosenbloom and Scott Michel's efforts to warn the financial industry in Hong Kong and Singapore of the likelihood of UBS-like investigations in Asia).

[163] *See* Kara Scannell & Haig Simonian, *U.S. Probe Into Tax Evasion Widens*, FIN. TIMES (Feb. 27, 2011).

presumably emerged from information provided by taxpayers about offshore accounts on FBAR forms submitted under the 2009 voluntary disclosure program.[164] Some observers expect the government to pursue increasingly harsh penalties.

The IRS is fortunate in this case that various media outlets are following this story closely, because Section 6103 of the Code, which prohibits the IRS from disclosing confidential taxpayer "return information,"[165] limits the government's direct publicity efforts.[166] The enumerated exceptions in the statute do not even include explicit permission for the I.R.S. to publicize return information that has already been disclosed publicly, whether through a posted lien, civil or criminal litigation, taxpayer discussion of the case in a public forum, or otherwise,[167] although in light of the case law[168] the IRS has gotten

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[164] *See* Scannell & Simonian, *supra* note 163.

[165] I.R.C. § 6103. The statute defines "return information" very broadly and it includes "any information developed or obtained by the IRS during the course of an audit or investigation of the taxpayer, as well as the mere fact that the taxpayer's return has been or is being audited or investigated." Stephen W. Mazza, *Taxpayer Privacy and Tax Compliance*, 51 KAN. L. REV. 1065, 1091 (2003). A series of exceptions permits disclosure of return information in certain specific circumstances, which include several third-party disclosure permissions necessary to effective administration. For example, the I.R.S. may disclose information in connection with judicial proceedings, *see, e.g.*, I.R.C. § 6103(h)(4), and under certain circumstances to obtain relevant information, *see* I.R.C. § 6103 (k)(6), or put an interested party on notice, *see, e.g.*, 6103(e).

[166] *See, e.g.*, I.R.C. § 6103(b)(1) (permitting disclosures to the general public when it publicizes "data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer"); I.R.C. § 6103(k)(1) (allowing disclosure "to permit inspection of any accepted offer-in-compromise under section 7122").

[167] *See, e.g.*, Mazza, *supra* note 165, at 1121 ("The IRS's current efforts to communicate strong and meaningful deterrence messages are hampered by the lack of an exception in section 6103 permitting disclosure of return information to criminal tax proceedings.").

[168] The circuit courts have divided into three camps. The Ninth and Sixth Circuits have adopted a "public records" exception that permits the IRS to publicize taxpayer information that has been disclosed in litigation, including in an indictment or other filing that precedes a final determination. *See* Rowley v. United States, 76 F.3d 796, 801 (1996) (holding valid IRS disclosure of taxpayers' names and tax deficiency in an advertisement for the sale of property under tax lien despite the later release of the lien due to improper notice); Schrambling v. United States, 937 F.2d 1485, 1488-89 (1991) (concluding that the filing of a tax lien destroyed confidentiality); Lampert v. United States, 854 F.2d 335, 338 (1988) (focusing on press releases relating to charges and final resolutions and declining to use a "strict, technical reading of the statute" because such a reading would "defeat the purposes of the statute"), *cert. denied*, 490 U.S. 1034 (1989). The Fourth Circuit adopts the technical statutory reading rejected

comfortable with the strategy of posting basic press releases, or links to such releases, on its website.[169] Categorical publicity or fictional advertising are also options open to the IRS under current law.[170]

2. Detection and information strategies

A key possible weakness in a high penalty regime is the possibility that taxpayers who wish to game the system may pretend to be compliers.[171] Excellent audit of FBAR filers is therefore essential, as is publicity of successful audit. The availability of data and the nature of the FBAR filing group as a small population with established publicity

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by the Ninth Circuit and holds that no disclosure of return information is permitted regardless of the public disclosure of such information elsewhere. *See* Mallas v. United States, 993 F.2d 1111, 1120-21 (1993) (finding a violation of Section 6103 under a strict statutory reading and on facts including the disclosure of more facts than appeared in the court opinion, which was subsequently unanimously reversed by an *en banc* Fourth Circuit decision). The Fifth, Seventh and Tenth Circuits have adopted forms of an "immediate source" exception, which permits disclosure if the IRS in fact drew the relevant information from court or other public proceedings and not from inside agency information. *See* Thomas v. United States, 890 F.2d 18, 21 (7th Cir. 1989) (noting that Section 6103 "is not a prohibition of any kind against the disclosure of opinions of the Tax Court"); *see also* Rice v. United States, 166 F.3d 1088 (10th Cir. 1999) (finding no Section 6103 violation where IRS press official had obtained press release information from public findings and trial and sentencing proceedings); Johnson v. Sawyer, 120 F.3d 1307, 1325-26 (1997) (finding a violation of Section 6103 where information disclosed by IRS employee "came either from Johnson's return file or from information 'in [the IRS employee's] head'"). *See generally* Mazza, *supra* note 165, at 1105-14, 1121-22 (analyzing case law and related cases in other contexts considering when public disclosure diminishes privacy rights and describing and evaluating Joint Committee and Treasury recommendations "which essentially adopt the Ninth Circuit's public records exception").

[169] *See* IRS, Offshore Tax Avoidance and IRS Compliance Efforts, http://www.irs.gov/newsroom/article/0,,id=110092,00.html (last visited Oct. 12, 2009).

[170] Joshua Blank and Daniel Levin have recently shown that the federal government appears to pursue a strategic publicity strategy by issuing a significantly higher volume of press releases during the weeks before April 15. *See* Joshua D. Blank and Daniel Z. Levin, *When is Tax Enforcement Publicized*, 30 VA. TAX REV. 1, 4 (2010). In a related article, Blank argues that taxpayer privacy appropriately allows the government to select what information may be disclosed, thus facilitating the manipulation of taxpayers' perceptions of enforcement. *See* Joshua D. Blank, *In Defense of Taxpayer Privacy*, 61 EMORY L. J. ___ (forthcoming 2011).

[171] *See* Raskolknikov, *supra* note 11, at 724 (noting that very high compliance regime penalties will induce gamers, particularly aggressive gamers, to try to hide behind the compliance regime).

avenues can shape the detection strategy in the case of the FBAR.

In the short term, audit filters must derive from statistical models containing the information on FBAR filings themselves. The good news is that the taxpayers targeted by the FBAR filing requirement are not an enormous group – perhaps one or two million. The actual audit rate, for wealthier taxpayers – 6.42% for fiscal year 2009 for taxpayers with income in excess of $1 million – exceeds substantially the 1.03% rate for individual taxpayers on average.[172] And the IRS has formed a special group to coordinate offshore account examinations for high-net-worth individuals.[173] The small size and high net worth characteristics of the target population also facilitate effective publicity of the likelihood that non-compliers masquerading as compliers will be caught. In fact, the government has a proven publicity strategy: the distribution of press releases that national and international newspapers then report on.

The bad news is that the IRS is constrained by the fact that the FBAR is a creature of banking law. Because taxpayer information is confidential, "when the IRS is operating solely on its designated authority . . . while enforcing FBAR provisions, it is precluded from using tax return or tax return information or information systems derived from that information."[174] The shadow FBAR filing required under § 6038D of the Internal Revenue Code is intended to solve this problem. The IRS can develop a program to automatically match § 6038D data with other tax return information.[175]

The possible future availability of third-party data should shape the way in which the government collects FBAR and § 6038D data now. In particular, data fields should be standardized for FBAR and FATCA filings.[176] And they should be simple, especially given the global nature of a successful information-reporting project in this area, which features different information technology challenges and different legal constraints. The essential contents of an FBAR or § 6038D form filed on

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[172] *See* INTERNAL REVENUE SERVICE, FISCAL YEAR 2009 ENFORCEMENT RESULTS 2, 3, *available at* http://www.irs.gov/newsroom/article/0,,id=217442,00.html.

[173] *See* David D. Stewart, *New IRS Group to Examine Wealthier Individuals Using Offshore Arrangements for Evasion*, TAX NOTES (Sept. 2, 2009) *available at* LEXIS, TNT library, 2009 TNT-168-1.

[174] TIGTA September 2010 Report, *supra* note 75.

[175] *See id.*

[176] Robert Foley of State Street Bank has suggested that taxpayers at least be able to elect electronic filing, citing in part the ability of the IRS to more effectively use electronically submitted data. *See* email from Robert J. Foley to Notice Comments (Aug. 27, 2009), *available at* LEXIS:TNT library, 2009 TNT 173-19 or Doc. 2009-20081).

behalf of an individual can be reduced to four information fields: taxpayer identity, which should often reduce to a TIN; the identity of the financial institution at which the account is held; the maximum value of the account for the year; and the account number.[177]

Even if electronic filing – which would require statutory authorization[178] – is not yet feasible, assigning numeric codes for these fields would facilitate data entry and sorting based on paper source documents. For example, foreign financial institutions should have identification numbers to be used on FBAR and other filings.[179] Without these simplification and automation measures, the government may face a situation where it has gobs of paper FBAR information about taxpayers and does not know what to do with it.[180]

3. The close substitute of quiet disclosure

As Part II.C discussed, the problem of close substitutes can also bar a high-penalty regime from achieving its deterrence, separation and/or signaling goals. This is an issue for the FBAR filing requirement. The possibility of a "quiet disclosure" option may exist as a close substitute alternative to voluntary disclosure.

"Quiet disclosure" is the practice of simply filing amended tax returns for the years in question.[181] It is not endorsed by any

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[177] Boxes 3-13 capture the identity of the individual taxpayer; box 15 asks for the maximum value of the account during the year; box 18 asks for the account number or other designation; and boxes 17 and 19-23 identify the foreign financial institution. *See* Treasury Department Form TD F 90-22.1.

[178] I.R.C. § 6011(e) generally specifies the Secretary's ability to require electronic filing. As amended, it gives broad authority to require financial institutions to file returns relating to withholding tax for which the institution is liable under §§ 1461 or 1474(a). It is possible that Section 6011(e) may not limit the ability to require individuals to submit FBARs electronically, as FBARs are not tax returns (so long as there is no parallel restriction under banking law) but it may not be prudent to take that risk.

[179] The applicable regulation delegates to the Secretary of the Treasury the authority to prescribe the information that must be listed on the form. 31 C.F.R. § 103.24 (a). Others have proposed uniform numbering. *See, e.g.*, William L. Burke, *Tax Information Reporting and Compliance in the Cross-Border Context*, 27 VA. TAX REV. 399, 411 (2007).

[180] *Cf.* Blank, *supra* note 36, at 1632 (describing the problem of overdisclosure under tax shelter disclosure rules).

[181] *See* Treas. Regs. § 1.451-1(a) ("If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due."); LEDERMAN & MAZZA, *supra* note 150, at [71-72] (describing generally amended return practice).

government guidance, in contrast to official "voluntary disclosure," which is described in the Internal Revenue Manual.[182] Voluntary disclosure includes a list of conditions – and features an undertaking by the IRS to consider the fact of disclosure when deciding whether to forward a case to the Justice Department for criminal prosecution, such as for tax evasion. In practice, it is generally thought that voluntary disclosure bars criminal prosecution.[183]

Even though quiet disclosure is not officially endorsed,[184] it is a fairly well established practice,[185] and taxpayers' expectation that quiet disclosure offers at least some protection against criminal prosecution is also entrenched.[186] This presents a problem for the integrity of the high-penalty FBAR rules, because the voluntary disclosure option does not subject the taxpayer to the significant willful-failure-to-file-derived penalties that the IRS has applied to voluntarily disclosing taxpayers. The quiet disclosure option weakens the ability of the high-penalty FBAR regime to serve its deterrence, separation and signaling functions.

The deterrence power of the FBAR, grounded in taxpayers' comparison of the risks and rewards of filing and not filing, depends on taxpayers' belief that failure to file the FBAR will lead to the government imposing penalties. The no-penalty quiet disclosure option suggests that there is little cost to failing to file the form initially, and that the taxpayer may wait to see whether the government's seems to have the ability to discover his or her offshore accounts by other means.

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[182] *See* INTERNAL REVENUE MANUAL § ____ (describing voluntary disclosure guidance).

[183] *See, e.g.*, Letter from Stuart E. Abrams et al. to The Honorable Douglas H. Shulman, Commissioner of Internal Revenue & John DiCicco, Esq., Acting Assistant Attorney General, Department of Justice, Tax Division 2 (Mar. 30, 2010) (asserting that to maintain consistency with taxpayer and practitioner expectations, the government should ensure that taxpayers who attempt voluntary disclosure in "good faith" are not prosecuted, even if their disclosures are technically late).

[184] *See* SALTZMAN & BOOK at ¶¶ 12.07[3][d] & [e] (distinguishing quiet disclosure from voluntary disclosure and noting disadvantages such as the waiver of Fifth Amendment protection and the possibility of an additional violation if the amended returns are incorrect).

[185] Remarks of Frank Agostino at The Prosecution and Defense of Offshore Bank Accounts, ABA Tax Section Teleconference & Live Audio Webcast (Mar. 3, 2010) (describing long-standing "quiet disclosure" approach based on private practice experience in Hackensack New Jersey).

[186] *Cf.* LAWRENCE R. JONES, JR., DEALING WITH THE IRS COLLECTION DIVISION § 1412, at 235-26 (1995) (stating that a taxpayer has a very limited chance of criminal prosecution if failure to file is corrected by filing tax returns and recommending the resolution of "all questionable items on the delinquent tax return . . . in favor of the IRS" to minimize the risk of fraud charges).

If the government does, then quiet disclosure is an easy solution.[187]

The separation goal of a high-penalty system is similarly undermined by the quiet disclosure option. Compliant taxpayers might choose up-front compliance, by filing the FBAR, or delayed compliance, through quiet disclosure. The quiet disclosure option does not clearly identify compliant taxpayers in the way that filing an FBAR does, and therefore makes it more difficult for the government to target taxpayer service or tailored detection strategies to the compliance group. The signaling potential of the high-penalty FBAR system is also muffled by the availability of quiet disclosure, because quiet disclosure constitutes a competing signal around which taxpayers may gather instead.

To permit FBAR reporting to function as a high-penalty regime that promotes deterrence, separation and signaling, this quiet disclosure close substitute should be removed. The government has taken the first step toward doing so, by saying in its guidance that it will not respect quiet disclosure – in contrast to voluntary disclosure -- as a reason to refrain from criminal prosecution in the offshore account context.[188] But as with other elements of a high-penalty regime, taxpayers' perception is what counts. So the plan for eliminating a quiet disclosure option should include appropriate, availability-bias-motivated publicity, such as publicity of taxpayers subject to significant penalties despite efforts at quiet disclosure.

C. FBAR Reporting as a Successful High-Penalty Regime

The recent enforcement of the FBAR rules has established a good starting point, due to taxpayer perception of government enforcement, to serve the high-penalty purposes of deterrence, separation and signaling. Tax administrators should continue to work to increase taxpayers' perception of the credibility of the penalties specified under the FBAR system, by expanding the reach of their criminal and civil investigations to other banks and by continuing to publicize cases where taxpayers failed to file FBARs and got caught. The government should develop its FBAR audit strategy, with help from the shadow FBAR requirements of § 6038D, and publicize its ability to detect noncompliant taxpayers attempting to masquerade as compliant taxpayers by filing incomplete

[187] Of course, the taxpayer's willingness to choose the quiet disclosure option instead of the voluntary disclosure option with its more explicit commitment to avoid a criminal prosecution recommendation depends in part on the taxpayer's risk aversion.

[188] *See* I.R.S., Voluntary Disclosure Questions and Answers*, supra* note 120, at Q & A 10 ("Those taxpayers making 'quiet' disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.").

FBARs. Finally, it should also eliminate the close substitute option of quiet disclosure as a remedy for the failure to file an FBAR in the future.

VI. AN EXPRESSIVE LAW FATCA STRATEGY

A. What FATCA Is

The Foreign Account Tax Compliance Act, or FATCA, requires non-U.S. financial institutions to tell the U.S. government about their U.S. account holders.[189] FATCA applies to certain payments made on or after January 1, 2013, to "foreign financial institutions."[190] Unless the institution – and each of its affiliates -- has entered into an agreement with the Secretary under which it agrees to obtain and report information about U.S. account holders and submit to "verification and due diligence procedures,"[191] 30% withholding applies to U.S.-source portfolio income streams and gross proceeds from the sale of certain securities, regardless of whether those payments are made to U.S. or non-U.S. accounts.[192] If the foreign financial institution has entered into such an agreement, 30% withholding applies only to accounts held by "recalcitrant account holders" who refuse to provide information necessary to ascertain whether they are U.S. persons and/or do not waive bank secrecy law

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[189] I refer to the statute, codified at I.R.C. §§ 1471-1474 or Chapter 4 of the Code, as "FATCA" although it was not codified as such. The law was proposed in the 2010 Greenbook as a modification to the qualified intermediare (QI) and nonqualfied intermediary (NQI) rules applicable to payments of U.S.-source investment income to non-U.S. persons. *See* TREASURY DEPARTMENT, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 41-45 (May 2009). Bills proposing to enact a "Foreign Account Tax Compliance Act" followed in late 2009, *see, e.g.*, H.R. 3933 (111th Cong., 1st Sess.), and legislation passed as part of a larger jobs-oriented tax package in March 2010. *See* P.L. 111-147 § 501.

[190] *See* I.R.C. § 1471 (describing rules applicable to payments to foreign financial institutions). Withholding may also apply to payments to other foreign entities. *See* I.R.C. § 1472.

[191] *See* I.R.C. § 1471(b)(1) (describing agreement requirements); § 1471(e) (requiring that all affiliates of a financial institution enter into the requisite agreement in order for payments to the financial institution to escape withholding)

[192] *See* I.R.C. § 1471(a) (applying 30% tax to any "withholdable payment" to a "foreign financial institution"); § 1473(1) (defining "withholdable payment"). The withholding penalty applies to payments of U.S.-source interest, dividends, rents, royalties and other payments of passive or investment income. It also applies – unlike penalty withholding rules under the qualified intermediary regime -- to "gross proceeds from the sale or other disposition of property of a type which can produce interest or dividends from sources within the United States." *See* I.R.C. § 1473(1)(A). It does not apply to amounts connected with a U.S. trade or business. *See* I.R.C. § 1473(1)(B).

obstacles to the disclosure of their identity consistent with FATCA.[193] The law gives the Treasury broad discretion to craft appropriate agreements and exceptions.[194]

FATCA builds on the precedent of the negotiated development of the model qualified intermediary, or QI, agreement, which implemented the rules permitting non-U.S. QI banks to forward non-U.S. client information to the U.S. on a summary basis to obtain reduced rates of withholding on U.S. source payments.[195] Starting in 1998, the IRS negotiated with bank trade associations, primarily in Europe, to draft the Model QI Agreement.[196] The bank associations extracted some favorable provisions, including permission to rely on existing know-your-customer, or KYC, procedures[197] and the provisions described above[198] that were interpreted by banks to permit the retention of keep U.S. account holders if they divested non-U.S. assets or invested through a foreign corporate blocker.[199]

FATCA applies to every bank that holds U.S. securities, not just those that prefer QI to NQI status. The New York State Bar Association has pointed out, for example, that "there are no QIs in a number of countries that represent significant sources of inbound investment to the

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[193] I.R.C. §§ 1471(b)(1)(D), (d)(6).

[194] Some statutory language is quite specific. *See, e.g.*, § 1471(c) (requiring the name, address, and TIN of each U.S. account holder, the account number, the account balance of value and gross receipts and gross withdrawals). But discretion is sprinkled throughout the statute and in particular in § 1471(b)(2)(A), which provides broad authority to the Treasury Secretary to "deem" financial institutions to meet requirements so long as Secretary-prescribed "procedures" and "requirements" are met.

[195] *See supra* notes 124-125 (citing Model QI agreement). The government so far has emphasized its openness to foreign banks' input and its willingness to listen to their concerns with respect to FATCA. *See, e.g.*, Kristen A. Parillo, *IRS, Treasury Aim for Release of FATCA Guidance in Stages, Official Says*, Tax Notes (Apr. 30, 2010) ("[I]t's helpful for institutions to provide submissions and give us comments telling us what they already do and help us understand what assurance those measures provide.") (quoting Treasury attorney-advisor Itai Grinberg).

[196] *See* Susan C. Morse & Stephen E. Shay, *Qualified Intermediary Status, Act II: Notice 99-8 and the Role of a Qualified Intermediary*, 28 TAX MGM'T INT'L J. 259, 259-60 (1999) (describing process of collecting comments from foreign banks before proposing QI agreement). *Cf.* Marnin J. Michaels et al., *Nine Months of Working With the QI Agreement: What Has the IRS Wrought?*, 11 J. INT'L TAX'N 4 (2000).

[197] *See* Morse & Shay, *supra* note 196, at 262 (describing typical practice of one country's bank association guiding KYC rules to IRS approval).

[198] *See supra* notes 71-72 (describing provisions relating to the disclosure of U.S. holders' identity).

[199] *See supra* note 127.

United States, including China, Brazil and Mexico"[200] as well as New Zealand;[201] there are reportedly "very few [QIs] in Japan."[202]

B. Applying the High-Penalty Analytic Framework to FATCA

It appears at first glance that for any foreign financial institution with clients who hold investments in U.S. securities, FATCA's withholding penalty is so onerous that it simply must be avoided at all costs. Thirty percent withholding on gross proceeds! That would lose customers fast. It exceeds any penalty typically prescribed for U.S. banks required to report to U.S. customers.[203]

But, in fact, the U.S. government is not – and should not be -- generally prepared to impose this withholding tax. Significant international relations problems and capital market disruptions could result if it did, as the U.S. government recognizes.[204] Consider with respect to the first point the intervention of Secretary of State Hillary Clinton to help resolve the UBS disclosure case[205] and with respect to the second point the many-layered provisions of the standardized agreement used by derivative traders designed to ensure that holders of derivatives will not see their return changed by an unexpected withholding tax.[206] Broadly enforced penalties are just not credible.

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[200] *Id.* at [21].

[201] *See id.* at [18].

[202] *Id.*

[203] No withholding requirement applies to usual-course bank and financial account reporting to U.S. account holders within the U.S. *See* Lily Kahng, *Investment Income Withholding in the United States and Germany*, 10 FLA. TAX REV. 315, 324-26 (noting the absence of investment income withholding in the U.S.). Withholding is only required if an account holder repeatedly fails to pay taxes on income reported from an account. *See* Treas. Regs. § 1.6041-1 et seq. (explaining "B notices").

[204] *Cf.* David D. Stewart, *IRS Taking 'Process-Oriented' Approach to FATCA, Official Says*, TAX NOTES (Apr. 27, 2010), available at LEXIS, TNT library, 2010 TNT 80-1 (quoting IRS Associate Chief Counsel Steven Musher as saying that the goal was the "least burden consistent with the compliance goals"). [add more here]

[205] *Clinton Says Agreement in Principle With UBS*, REUTERS (July 31, 2009) (reporting Hillary Clinton's announcement of a litigation settlement agreement and her related meeting with the Swiss foreign minister), available at http://www.reuters.com/article/idUSN3142328120090731.

[206] *See* INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, MASTER AGREEMENT (1992). Part 2 of the Schedule to the ISDA Master Agreement executed in connection with specific transactions generally includes a representation that no withholding will be due on payments under the derivative agreement, based on representations about the residence of the recipient and the delivery of certain documentation.

In addition, jurisdictional limitations constrain the ability of the United States to detect noncompliant banks that masquerade as compliant banks.[207] The U.S. may develop audit selection models, but may not be able to apply them directly. In the companion qualified intermediary context, audit responsibility is generally delegated to a third-party auditor, frequently a large accounting firm or an affiliate of such a firm.[208] Historic jurisdictional limitations now memorialized in the QI agreement prevent the IRS from directly accessing the financial institution's records to perform a direct audit.

It is unclear whether the question of close substitutes presents a problem. Foreign banks have three options under FATCA: disclose, withhold, or divest U.S. assets. The withholding penalty does not apply if a foreign bank divests all U.S. assets and invests solely in non-U.S. securities, for in this situation no withholdable payments to the divested foreign bank – whether paid directly from a US withholding agent or through other foreign financial institutions – would exist. The success of Chapter 4 thus depends on the stickiness of global investment in U.S. securities. Widespread investment in U.S. government debt and other U.S. securities throughout the world suggests that non-U.S. banks will have a sufficient incentive to negotiate with the U.S. The banks are not entirely without an alternative, though, and on the margin some banks might make a divestiture decision, which could impact U.S. capital markets.

There may also be other substitute strategies available under the statute. The approach of entering into an agreement but accepting withholding tax imposition on "recalcitrant account holders" provides one possibility.[209] Depending on regulatory guidance, a foreign bank might be able to enter into an agreement with the U.S. Treasury, but steer all recalcitrant account holders (presumably all U.S.) toward investment exclusively in non-U.S. securities. Under this approach, non-U.S. account holders and U.S. account holders willing to have their names disclosed could retain their investments in U.S. securities; only

[207] Historically, U.S. jurisdiction over non-U.S. banks for the purpose of discovering information about U.S. tax evasion or other criminal activity allegedly facilitated by such banks has been based on the physical nexus of a U.S. representative office. *See, e.g.*, Bank of Nova Scotia (1982) (referenced in Palan, Murphy, Chavagneux at 198); UBS civil and criminal case; credit card subpoena case from 1990s. *See also* Burke, *supra* note 179, at 421-22, 436 (articulating jurisdictional barriers to solving cross-border compliance problem).

[208] *See* Rev. Proc. 2000-12, 2000-1 C.B. 387 § 10 (detailing external audit procedures).

[209] I.R.C. § 1471(b)(1)(D) (imposing withholding requirement with respect to "recalcitrant account holders"); *id.* § 1471(d)(6) (defining same).

recalcitrant account holders would be required to divest.

The U.S. government cannot remove the substitute of divestiture from the menu of options available to non-U.S. banks, but this may not be fatal to FATCA's strategy. The reason is that divestiture is costly; U.S. securities remain attractive investments for various reasons. The substitute exists, but it may not qualify as a sufficiently close substitute.

C. Administering FATCA With Expressive Law in Mind

Since FATCA does not work as a high-penalty regime within the bounds of the rational actor model, and since the U.S. government has already committed resources to the administration of FATCA, it makes sense to consider an expressive law strategy. The idea is to create a norm that prompts reputation-based signaling. If a robust reputation market supports the perceptions that noncompliance carries reputational penalties and that masquerading noncompliers will be detected, then the signaling mechanism can make the high-penalty FATCA regime a success even in the absence of government enforcement.

Accordingly, the government should follow an expressive law strategy that includes the factors outlined above: reputation referencing, salience, management targeting and incrementalism.[210] It should articulate the norm in a way that references reputation. It should maximize the salience of the norm and provide opportunities for targeted tax intermediaries to publicly show their commitment to the norm. Since the audience consists of large enterprises, the government should target the people at the top, in particular the top compliance officers that most firms now include in their executive management team. Finally, it should embrace incrementalism, because signaling can trigger self-reinforcing virtuous circles that should make it easier to expand the application of the regime once the underlying norm has gained a foothold.[211]

A relevant model for reputational signaling in the third-party reporting context is the Form 1099 reporting regime applicable to U.S. financial institutions. The statute books include both high monetary penalties – up to 10% of the aggregate amount of the items required to be reported correctly for intentional disregard[212] – and criminal penalties[213]

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[210] *See supra* Part III.C.

[211] Signaling can produce virtuous circles because a more widely accepted norm is a stronger norm and also because signaling should trigger a commitment consistency effect that strengthens the compliance behavior of the signaler. *See supra* Part I.B.

[212] *See* I.R.C. § 6721(d) (providing intentional disregard penalty of 10% of amount required to be reported for requirements including the reporting of

for failure to file information returns such as the annual submission of 1099 forms informing investors of the amount of dividends, interest, gross proceeds and other payments.[214] But these penalties are almost never applied, particularly to large financial institutions. So why do such firms uniformly comply with the reporting requirements?

One possibility is that these firms are subject to regular audit and so believe that the penalties will be applied if they fail to report. But another possibility is that large firms are risk averse with respect to their reputations and their client relationships, so that the possible revelation of a failure to report would carry an enormous penalty only partly contained within the statute and augmented by factors such as the likely public relations problems resulting from the necessity of, for example, sending corrected, late information returns to clients. Another related reputational idea is that the action of reporting carries with it an important signaling message about the reputation of the reporting firm: we're a good bank, our records are accurate, we tell the truth by January 31 every year.

The example of U.S. banks – as well as the experience of signing up foreign banks as qualified intermediaries – suggests that non-U.S. banks do have significant reputational interests that a signaling strategy can tap into. And in fact there is plenty of reputational content and salience in the norm that FATCA administrators wish to advocate. As the OECD's harmful tax competition project rested on the idea that "tax havens are bad," or that "good banks don't lie," so FATCA is saying that "good banks tell the truth." The trouble, of course, is that the existing bank secrecy-based norm among many non-U.S. banks is more like, "good banks keep their clients' secrets."[215]

The recognition that they face the task of replacing a non-U.S. bank

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interest and dividends under § 6041 and penalty of 5% of such amount for requirements including the reporting of gross proceeds under § 6045). A maximum annual penalty per person of $250,000 is imposed for an uncorrected failure to file an information return that is not excused under a reasonable cause standard. *See* I.R.C. §§ 6721(a) & (b), 6724(a).

[213] *See* I.R.C. § 7203 (providing misdemeanor characterization for failure to file information return and prescribing penalties including up to one year's imprisonment); *cf.* Pappas v. United States, 216 F.2d 515, 518-19 (10th Cir. 1954) (sustaining jury conviction under § 7203 predecessor of partners who failed to supply required balance sheet and other information on partnership return despite maintaining careful "cash count" and other records).

[214] *See* I.R.C. §§ 6041 et seq.

[215] *See, e.g.*, Bondi, *supra* note 102, at 3-6 (describing historic Swiss commitment to bank secrecy and connection to Swiss legal rule that tax evasion is a civil, not criminal, offense).

secrecy norm with the FATCA truth-telling norm should motivate U.S. tax administrators to find all the help they can get from non-U.S. governments and non-U.S. organizations as they try to communicate the FATCA norm and its connection to reputation. This is so particularly because the U.S. has only recently taken the initiative in the project of increasing tax haven transparency; European countries had previously carried the project, particularly during the Bush II administration when the U.S. government refused to participate in the OECD project.[216]

Any country whose residents have significant offshore account holdings has strong fiscal reasons to support the norm that good banks tell the truth (and the related tax principle of residence-based income taxation for individuals) and they therefore make up a subgroup for whom the norm would represent a collective action solution.[217] The OECD experience with the harmful tax practices project suggests that other countries might cooperate in communicating the new norm. Other nations' efforts to find out about their own residents' offshore account holdings, such as by demanding disclosure of offshore credit card accounts,[218] purchasing data from ex-bank employees,[219] entering into tax information exchange agreements,[220] provide examples of actions that support the norm that FATCA administrators are attempting to generate. Likewise, U.S. acquiescence to requests from other countries, including Mexico, asking the U.S. to disclose information about their residents or citizens would support the FATCA norm.[221]

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[216] *See* PALAN, MURPHY & CHAVAGNEUX, *supra* note 73, at 8, 217-218 (describing U.S. with

[217] *See* KEOHANE, *supra* note 89, at 79 (noting that governments may form agreements on international regimes in situations that involve "shared interests" and "dense policy spaces;" SLAUGHTER, *supra* note 88, at 172-77 (exploring different models of international regulatory convergence supported by horizontal and cross-border networks of regulators).

[218] *See* PALAN, MURPHY & CHAVAGNEUX, *supra* note 73, at 83 (describing UK order to Barclays to disclose offshore credit card information in 2006), *id.* at 231 (describing various countries' attempts "to collect revenue lost to tax havens").

[219] *See, e.g.*, PALAN, MURPHY & CHAVAGNEUX, *supra* note 73, at 239-41 (describing "[t]he Liechtenstein debacle"); *The Liechtenstein Connection*, DER SPEIGEL (Feb. 16, 2008) (reporting on German government's acquisition of data about Liechtenstein accounts held by "as many as 900 wealthy Germans – many of them well-known").

[220] *China Signs TIEA With Argentina*, CHINA BRIEFING (Dec. 21, 2010), *available at* http://www.china-briefing.com/news/2010/12/16/china-signs-tiea-with-argentina.html (reporting China's TIEAs with Argentina, the Bahamas, British Virgin Islands, Isle of Man, Guernsey, Jersey Island and Bermuda).

[221] *See* McIntyre, *supra* note 104, at 697-98 (expressing "guarded optimism" on the future of information exchange based in part on the Mexican request for U.S. bank data); Kevin Preslan, Turnabout is Fair Play: The U.S.

One question facing the U.S. is whether it would accept, as an alternative to FATCA, an approach like the Swiss-proposed solution reportedly named "Project Rubik," which calls for the imposition by the Swiss government of withholding taxes on undisclosed accounts and the remittance of the taxes to the governments of the accounts' beneficial owners' residence or citizenship.[222] A similar confidentiality-preserving approach has been used, for example, in an agreement struck between Switzerland and the UK.[223] As with FATCA, the question is whether Project Rubik would deliver the perception that penalties will be enforced, the perception that masquerading noncompliers will be detected, and an absence of close substitutes. Also as with FATCA, the resident countries lack jurisdiction over the information-holding banks, so a reputation market is necessary to provide penalties for noncompliance and detection of masquerating compliers. Project Rubik would rely only a reputation market of government and, presumably, other intermediary banks' perception of different banks' compliance;[224] it would not attempt to harness a reputation market of clients' perception of different banks. This is not necessarily a weakness; it might be that a more focused message about reputation would be possible if the audience were narrower, for example. But the analysis is somewhat different.

The FATCA administration strategy must also include opportunities for non-U.S. banks and other foreign financial intermediaries to signal their compliance with the norm. The statute itself offers two such signaling mechanisms – entry into an agreement between the U.S. government and a foreign financial institution,[225] and annual reporting of the required information.[226] These mechanisms will be stronger signaling devices if they are public and simple. Thus the banks who have agreements with the government might be publicly listed on the IRS website, and the reporting form should be as streamlined as possible. Appendix I provides an example of how such a streamlined form might look.

Response to Mexico's Request for Bank Account Information ([March 3,]2011) (unpublished manuscript, on file with the author) (describing Mexico's information request and the U.S. failure to respond, and recommending that the U.S. comply with the request).

[222] *See* Niels Jense, *How to Kill the Scapegoat: Addressing Offshore Tax Evasion With a Special View to Switzerland*, 63 VAND. L. REV. 1823, 1852-55 (2010).

[223] *See* Vanessa Houlder, *Britons Face Tax on Secret Funds*, FIN. TIMES, May 3, 2011, at 7.

[224] This is because measures would have to be implemented to ensure only one tier of withholding.

[225] *See* I.R.C. § 1471(b).

[226] *See* I.R.C. § 1471(c).

Because FATCA seeks to influence the reputation signaling behavior of large institutions, its administration should take into account the organizational behavior features of large institutions, as discussed above.[227] The penalty for failing to agree or report as required under FATCA does not target top managers, but instead provides for withholding on particular payments made to accounts. Yet reputation signaling strategies could target top management, for example by gathering them at public events related to the development of FATCA guidance or the signing of FATCA agreements or by including information about the top management of a particular firm in publicity about compliance or noncompliance with FATCA.

Finally, the promise of an incremental expressive law strategy should inform the details of FATCA implementation. The idea is to start with the lightest, least intrusive interpretation possible consistent with the regulatory goals. The U.S. wants a norm that a lot of non-U.S. banks will agree with. After they have agreed with it, the U.S. can expand its application. This path would resemble the connection between the ten-year-old QI/NQI rules, directed at payments of U.S. source income to offshore accounts held by non-U.S. residents, and FATCA's attempt to institute automatic reporting for offshore accounts held by U.S. residents. Since non-U.S. banks are used to giving some information to the U.S. tax system under the QI/NQI system, the idea of providing more information under FATCA is not as distasteful.

For example, one issue under current regulatory guidance is granting exemptions from FATCA for certain classes of institutions or accounts. Exemptions may be granted, for example, by classifying an entity as a deemed-compliant foreign financial institution or as an excepted non-foreign financial entity. The U.S. has already extended exemptions to insurance companies (except with respect to whole life policies) and is considering various other exemptions, such as for non-U.S. pension funds and mutual funds barred by local employee benefits or U.S. securities regulations from soliciting investors in the U.S.[228] Another issue is the application of FATCA to relatively small accounts held in non-bank-secrecy jurisdictions.[229]

The goal of articulating the least burdensome policy possible consistent with the norm that good banks tell the truth suggests that

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[227] *See supra* notes 65-67.

[228] *See* Notice 2010-60.

[229] *See* Richard M. Lipton & Marnin J. Michaels, *Getting Ready for FATCA – A Practical Approach*, 114 J. TAX'N 89, 98 (2011) (identifying small-account retail banking in non-secrecy jurisdictions as problematic in part because know-your-customer rules are less strict for such accounts).

exemptions should be fairly broadly granted. There are, however, two caveats. First, granting exemptions raises the possibility of a close-substitutes problem. Second, if regulated financial institutions perceive a lack of equity in their treatment versus the treatment of other institutions, they may be less willing to perceive the norm as fair. One solution to these problems is to reserve on and postpone, rather than definitively exempting, various categories of financial institutions. This is similar to the approach taken in the administration of the nonresident withholding regulations that became effective in 2000: the qualified intermediary rules, targeted at large foreign banks, came first; the rules applicable to withholding foreign partnerships and withholding foreign trusts came later.

FATCA guidance must also provide due diligence guidelines for foreign financial institutions to determine whether an account is held by a U.S. person. The existing Notice does not always require a foreign financial institution to obtain U.S. withholding forms (which would be a significant departure from current practice), but it alters the usual withholding agent rule that one may rely facially on information provided by a payee[230] by requiring further investigation if due diligence suggests a U.S. link. Such a link might be indicated by various bits of information, such as a U.S. address listed in almost any connection with the account.[231] If this due diligence indicates U.S. status, the foreign financial institution must either obtain a W-9 and comply with reporting requirements, or obtain a W-8BEN or more persuasive-than-usually-required documentary evidence, or withhold. There is a difference in the due diligence standards for new and existing accounts: for the former, all collected information must be reviewed; for the latter, only electronically searchable information must be considered.[232]

These due diligence rules execute the idea of incremental regulation nicely. The softer diligence requirement for existing accounts has drawn fire,[233] and the ability to use non-U.S. documentary evidence to prove non-U.S. status (in the absence of U.S. due diligence red flags) is not as

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[230] *Cf.* International Lotto Fund v. Va. State Lottery Dep't, 800 F. Supp. 337, 342 (E.D. Va. 1992) ("The role of a withholding agent is ministerial in nature. . . . The agent is not granted the discretion by the I.R.S. to conduct an audit-like inquiry upon submission of a properly completed Form 1001.").

[231] The Notice refers to "documentation suggesting that account holders are U.S. residents or U.S. citizens; a U.S. correspondence or residence address; U.S. place of birth for an account holder; 'in care of,' 'hold mail' or 'PO Box' address; power of attorney or signatory authority granted to someone with U.S. status; standing instructions to transfer funds to an account maintained in the U.S. or per directions from a U.S. address." *See* Notice 2010-60.

[232] *See* Notice 2010-60.

[233] *See* Sheppard

stringent as some would like. But the more understanding approach is consistent with the idea that the U.S. wants to persuade banks to tell it what they know in a minimally invasive way, rather than that the U.S. will require mountains of paper-based historical diligence and sweeping changes to the way every account at a non-U.S. bank is opened in the future. Good banks tell the truth. Good banks should not spend vast resources on unnecessary paperwork.

Developing FATCA's reporting system will necessarily involve decisions about cooperation and compromise. The QI experience provides good examples of this. In particular, it resulted in compromise agreements to permit reliance on know-your-customer rules to determine account owner identity and to permit bank secrecy workarounds as alternatives to divulging U.S. account owner identities. The know-your-customer rules are shaped by concerns about ferreting out crimes such as money laundering and may not reliably distinguish accounts held, for example, through shell companies. This bank secrecy workaround provided an entry point to a number of avoidance strategies used by UBS and other banks to conceal U.S. clients' identities or move them to accounts without U.S. securities.[234] But it also encouraged many non-U.S. banks to go along with the QI program, which in turn laid the groundwork for FATCA.

Similar questions regarding appropriate compromises will come up in the negotiation of the implementation of FATCA. Viewing the problem through the expressive law lens makes compromise more attractive, assuming that compromise is necessary to gain foothold acceptance of the norm by countries and/or financial institutions and that it does not open up a close substitute avenue. In many cases it may be possible to reserve issues of compromise for re-examination, for example by putting a sunset on some categorical exceptions. Although leaving the door open for re-examination may compromise the goal of giving taxpayers certain expectations, it is a sensible way to pursue the dual aims of norm development and a well-functioning global reporting system.

CONCLUSION

For the compliance mechanisms of deterrence, separation and/or signaling to succeed, a high-penalty regime should feature the three supports of persuasive penalties; an effective mechanism for detecting noncompliers who attempt to masquerade as compliers; and a lack of close-substitute choices. The FBAR reporting regime could include all

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[234] *See supra* notes 124-127 and accompanying text (discussing the QI program and its interaction with the UBS case).

of these features, based on government enforcement. Publicity and audit efforts have enhanced and can continue to enhance taxpayers' perception of the likelihood of penalty imposition and noncompliance detection, and it is possible to remove the problematic close substitute of quiet disclosure on a prospective basis.

If government enforcement cannot provide these three supports for a high-penalty regime, it is sometimes possible for a robust reputational market to do so. At the starting point of a historic noncompliance norm, reputational signaling lacks effect, but the government may succeed, through an expressive law strategy, in generating a norm that can then support reputational signaling. FATCA provides an example of a situation appropriate for an expressive law strategy.

The U.S. tax administrators enforcing FATCA should articulate a norm with reputational content; one likely subtext is "good banks tell the truth." FATCA administrators should seek the endorsement of other countries of this norm instead of the existing norm of bank secrecy, and avoid obfuscating the norm with extra paperwork. They should also recognize the goal of persuading the top management of non-U.S. banks that adherence to the new norm is a good reputation signal, and should make the exercise of giving that signal as simple and salient as possible. And they should compromise where necessary – ideally reserving on the possibility of later expansion – in order to progress the goal of norm development.

APPENDIX A: DRAFT FATCA REPORTING FORM

Form ____ (Under I.R.C. §1471(c)(1) Year ended 12/31/____)					
Name of Foreign Financial Institution (FFI) Making Report		FFI Address		FFI ___-Assigned Identifying Number	
US account holders[235]	TIN	Name	Address	Account number	Maximum annual account balance
1					
2					
3					
4					
5					

This form provides a name, address and TIN; the account number; and account value for every account held by a "specified U.S. person" or a "United States owned foreign entity," as required by statute,[236] but leaves off "gross receipts and gross withdrawals," which the Secretary has explicit discretion to waive.[237] The government could require the form to be filed electronically, but if that is not appealing the use of numeric codes for each field, including assigned identification numbers for each financial institution, would facilitate data entry and sorting.[238]

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[235] Defined as "specified United States persons" and "substantial United States owners of United States owned foreign entities," consistent with the statute. *See* I.R.C. § 1471(c)(1)(A).

[236] *See* I.R.C. § 1471(c)(1)(A), (B), (C).

[237] *See* I.R.C. § 1471(c)(1)(D).

[238] *See* I.R.C. § 6011(e)(4).