

## TAX IN THE CATHEDRAL: PROPERTY RULES, LIABILITY RULES, AND TAX

*Andrew Blair-Stanek\**

*THE distinction between property rules and liability rules has revolutionized our understanding of many areas of law. But scholars have long assumed that this distinction has no relevance to tax law. This assumption is flatly wrong. Tax law currently uses both property rules and liability rules, and the choice between them has real consequences. When a taxpayer violates a requirement for a favorable tax status, tax law either imposes additional tax proportionate to the harm (a liability rule) or imposes the draconian penalty of taking away the tax status entirely (a property rule). This recognition has three key implications. First, Congress can and should draw on the rich property and liability rule literature to draft better tax legislation and to reform the tax code. Second, novel variations on property and liability rules can be used to rethink the remedies given to the IRS. Third, tax law will enrich the literature on property and liability rules across many other areas of law.*

INTRODUCTION .....	1171
I. REMEDIES IN TAX LAW.....	1175
A. <i>Property Rules and Liability Rules</i> .....	1175
B. <i>Tax Statuses</i> .....	1178
C. <i>Four Examples of Tax Statuses</i> .....	1180
1. <i>Public Charities</i> .....	1181
2. <i>Real Estate Investment Trusts (REITs)</i> .....	1182
3. <i>Tax-Exempt Municipal Bonds</i> .....	1183
4. <i>Qualified Retirement Plans</i> .....	1184
D. <i>Why Taxpayers Violate Requirements</i> .....	1185
E. <i>Tax Status-Loss Is a Property Rule</i> .....	1187

---

\* Assistant Professor of Law, University of Maryland Francis King Carey School of Law. J.D., Yale Law School. I am very grateful for valuable feedback and comments from Anne Alstott, Ian Ayres, Victor Fleischer, David Gamage, David Singh Grewal, Henry Hansmann, Simone Sepe, Noel Brock, Daniel Epps, Nathaniel Gleicher, Megan Hall, Brittan Heller, Daniel Hemel, Connor Raso, Megan Woodford, the Yale Moot Camp participants, and the full law faculties of Tulane, Alabama, Maryland, Wake Forest, Texas, George Washington, San Diego, Illinois, and Virginia.

1170	<i>Virginia Law Review</i>	[Vol. 99:1169
	<i>F. Other Property Rules in Tax Law</i> .....	1191
	<i>G. Liability Rules in Tax Law</i> .....	1192
	II. CHOOSING BETWEEN PROPERTY AND LIABILITY RULES TO PROTECT TAX STATUSES .....	1195
	<i>A. Compliance Expenditures</i> .....	1195
	<i>B. Encouraging Efficient Transactions</i> .....	1198
	1. <i>Allowing Efficient Violations of Requirements by         Setting a “Price”</i> .....	1198
	2. <i>Preventing Ambiguity from Discouraging Efficient         Transactions</i> .....	1199
	<i>C. Deterrence</i> .....	1200
	1. <i>Model of IRS Utility</i> .....	1203
	2. <i>Contrasted with Nuisance Dispute</i> .....	1209
	3. <i>Feedback from Enforcement or Non-Enforcement</i> .....	1211
	<i>D. Improving Taxpayer-IRS Negotiation</i> .....	1211
	1. <i>Encouraging Settlements to Happen</i> .....	1212
	2. <i>More Consistent and Equitable Settlements</i> .....	1212
	<i>E. Biased Liability Amounts</i> .....	1213
	<i>F. Calculation Costs</i> .....	1214
	<i>G. Non-Economic Concerns</i> .....	1216
	<i>H. Definitional Requirements</i> .....	1217
	III. BEYOND PLAIN PROPERTY AND LIABILITY RULES: NEW APPROACHES .....	1217
	<i>A. Liability Rules Tailored to Probability of Detection</i> .....	1218
	<i>B. Pliability Rules</i> .....	1219
	1. <i>Information-Forcing Pliability Rules</i> .....	1220
	2. <i>Pliability Rules Triggered by Financial Crises</i> .....	1220
	<i>C. Why Not Other Property Rules?</i> .....	1222
	<i>D. Rule 4</i> .....	1223
	<i>E. Less Than Zero: The IRS Put-Option</i> .....	1226
	IV. TAX LAW’S CONTRIBUTION TO THE PROPERTY AND LIABILITY RULE SCHOLARSHIP.....	1228
	<i>A. Relaxing Assumption of Constantly Increasing Utility</i> .....	1228
	<i>B. Taker’s Information Costs</i> .....	1230
	<i>C. Liability Rules as “Gentle Nudges”; Property Rules as         “Hard Shoves”</i> .....	1231
	<i>D. Empirical and Experimental Opportunities</i> .....	1232
	CONCLUSION .....	1232

## INTRODUCTION

In a pioneering 1972 article, Guido Calabresi and Douglas Melamed introduced the distinction between “property rules” and “liability rules.”<sup>1</sup> Property-rule remedies like injunctions protect by deterrence, while liability-rule remedies protect by requiring compensation. Property rules and liability rules are “workhorse concepts that permeate every corner of the economic analysis of law.”<sup>2</sup> Scholars have used these concepts to draw insights into areas as diverse as torts, property, contracts, intellectual property, and constitutional law.<sup>3</sup> But the common wisdom has been that tax law relies entirely on liability rules, and that the property and liability rule distinction has no use in tax law. As one leading scholar put it in the *Yale Law Journal*, tax law is the “quintessential liability rule regime.”<sup>4</sup>

This common wisdom is wrong. Tax law uses both property rules and liability rules. The extensive scholarship on property rules and liability rules can and should be used to improve tax law. And tax law can contribute to the broader property and liability rule debate across all areas of law.

Consider briefly the quintessential scenario for property and liability rules: a factory’s pollution harms neighboring residents. Tort law has two basic approaches to protecting the residents’ entitlement to clean air.<sup>5</sup> First, a liability rule requires the factory to pay compensatory dam-

---

<sup>1</sup> Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089 (1972).

<sup>2</sup> Lee Anne Fennell, Adjusting Alienability, 122 Harv. L. Rev. 1403, 1404–05 (2009).

<sup>3</sup> E.g., Richard Craswell, Property Rules and Liability Rules in Unconscionability and Related Doctrines, 60 U. Chi. L. Rev. 1 (1993); Louis Kaplow & Steven Shavell, Property Rules Versus Liability Rules: An Economic Analysis, 109 Harv. L. Rev. 713 (1996); Eugene Kontorovich, Liability Rules for Constitutional Rights: The Case of Mass Detentions, 56 Stan. L. Rev. 755 (2004); Mark A. Lemley & Philip J. Weiser, Should Property or Liability Rules Govern Information?, 85 Tex. L. Rev. 783 (2007).

<sup>4</sup> Carol M. Rose, The Shadow of *The Cathedral*, 106 Yale L.J. 2175, 2197 (1997) (arguing that Louis Kaplow naturally brought pro-liability-rule tendencies to the property- and liability-rule scholarship because he has made major contributions to the study of “that quintessential liability rule regime, tax”).

<sup>5</sup> Calabresi & Melamed, *supra* note 1, at 1092. Calabresi and Melamed discuss a third type of rule, inalienability rules, which forbid selling the entitlement. *Id.* at 1092–93. They recognize, “[i]nalienability rules are thus *quite different* from property and liability rules,” *id.* at 1093 (emphasis added), and therefore treat them separately. *Id.* at 1106. Although inalienability has applications in tax law, these applications will be addressed in a subsequent article.

ages to the residents but allows the pollution to continue.<sup>6</sup> Second, a property rule imposes a much harsher penalty on the factory. Examples of property-rule remedies include injunctions, prison terms, and disgorgement (that is, forcing the factory to disgorge all its profits).<sup>7</sup> Liability rules set a price that compensates residents, so that the factory will pollute only when it is economically efficient; property rules set a penalty so high that the factory should never rationally pollute.

The same dichotomy appears in tax law, most notably in the requirements to qualify for a favorable tax status, such as being a tax-exempt public charity. When a taxpayer violates a requirement for a favorable tax status, tax law has two basic approaches for protecting the government's entitlement to compliance. First, it can increase the taxpayer's taxes by an amount that compensates the government for the harm that violating the requirement caused, such as lost tax revenues, while the taxpayer retains the favorable tax status. This is a liability rule. Second, tax law can strip the taxpayer of the tax status entirely, resulting in a sharp, punitive rise in taxes. This is a high penalty that no taxpayer should rationally incur. Status-loss is a property-rule remedy. It is a form of disgorgement, requiring the taxpayer to disgorge all benefits from the tax status.

An example illustrates the distinction. Consider a university that qualifies as a public charity, which not only makes the university tax exempt, but also allows donors to deduct donations.<sup>8</sup> To qualify for public charity status, the university must satisfy numerous requirements.

One requirement is that public charities must be "operated exclusively" for exempt purposes, such as education.<sup>9</sup> Suppose that the university owns land that it plans one day to use for a dormitory, but that it currently uses for a parking lot that is open to the public and that charges by the hour. The university is no longer "operated exclusively" for exempt purposes, because it is operating a commercial parking lot in addition to being operated for educational purposes. But it does not lose its favorable status as a public charity.<sup>10</sup> Rather, the university must pay a special

---

<sup>6</sup> Calabresi & Melamed, *supra* note 1, at 1092, 1121; e.g., *Boomer v. Atlantic Cement Co.*, 257 N.E.2d 870, 875 (N.Y. 1970) (awarding permanent damages to residents against a nearby cement factory).

<sup>7</sup> See Ian Ayres, *Optional Law: The Structure of Legal Entitlements* 13 (2005).

<sup>8</sup> I.R.C. §§ 501(a), 501(c)(3), 170(a)(1), 170(c)(2) (2006).

<sup>9</sup> *Id.* § 501(c)(3) (listing exempt purposes).

<sup>10</sup> At some point, if too much of the university's operations are unrelated trade or business activities, then it might lose its 501(c)(3) status, but tax law is generally very forgiving on

tax<sup>11</sup> that approximately equals the income tax that a for-profit corporation operating the same parking lot would have paid. The “operated exclusively” requirement is thus protected by a liability rule that compensates the government for the lost tax revenue,<sup>12</sup> thus setting a “price” so that the university can choose whether to violate the “operated exclusively” requirement by operating the parking lot.

But not all tax-status requirements are protected by liability rules. For example, another requirement that the university must meet to be a public charity is that it “not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”<sup>13</sup> Suppose that the university circulated leaflets expressly advocating the defeat of a Member of Congress who opposed public funding for scientific research. In this case, the university has violated the requirement that it not participate or intervene in elections. The law provides that the university entirely loses its status as a public charity.<sup>14</sup> This status-loss means not only that the university must pay tax on *all* of its income,<sup>15</sup> but also that donors cannot deduct their contributions to it.<sup>16</sup> This property-rule remedy sets the penalty so high that no university would rationally incur it.

---

this point. See Treas. Reg. § 1.501(c)(3)-1(e) (2006); Peter Molk, Reforming Nonprofit Exemption Requirements, 17 *Fordham J. Corp. & Fin. L.* 475, 515 & n.189 (2012) (arguing *inter alia* for moving to a pure liability rule for this requirement). See generally Frances R. Hill & Douglas M. Mancino, Taxation of Exempt Organizations ¶ 21.03[1] (2013) (discussing the effect of unrelated business income).

<sup>11</sup> I.R.C. § 511(a) (imposing the unrelated business income tax).

<sup>12</sup> Requiring tax-exempt entities to compensate the government levels the playing field between tax-exempt and for-profit businesses engaged in the same for-profit activity. See S. Rep. No. 81-2375, at 28–29 (1950).

<sup>13</sup> I.R.C. § 501(c)(3).

<sup>14</sup> *Id.* § 501(a), 501(c)(3).

<sup>15</sup> Universities are an example of what Henry Hansmann called “commercial nonprofits,” in that much of their income comes from the provision of a good or service, specifically tuition paid for education. See Henry Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 *Yale L.J.* 54, 59 (1981) (internal quotations omitted). Hansmann notes that many non-profits have substantial net earnings that could be subject to corporate taxation. *Id.* at 56, 58–59. Donations, meanwhile, could be income to a tax-exempt organization just as amounts paid to Tiffany’s for a gift to a third party are income to Tiffany’s. *Id.* at 61–62; see also Boris I. Bittker & George K. Rahdert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 *Yale L.J.* 299, 307–16 (1976) (noting that normal tax principles are inappropriate for taxing non-profits); cf. Hansmann, *supra*, at 59 (arguing that “Bittker and Rahdert overstate the difficulties” in calculating a non-profit’s net income).

<sup>16</sup> I.R.C. § 170(a)(1), (c)(2).

Part I of this Article explains further how imposing status-loss is a property-rule remedy, just as injunctions and disgorgement are property-rule remedies in the common law. It also discusses the central importance of tax statuses throughout tax law, which uses statuses to determine tax rates, tax exemptions, exclusions, deductions, and credits. Tax statuses can apply not only to non-profit entities such as universities, but also to individuals, business entities, properties, transactions, and debts. Although status-loss is the most common property-rule remedy in tax law, Section I.F gives examples of several other property-rule remedies in tax. Section I.G then gives examples of liability rules in tax. In short, Part I conclusively disproves the conventional wisdom that tax law is the “quintessential liability rule regime.”<sup>17</sup>

Scholars have produced a rich literature to guide lawmakers and judges in choosing between property and liability rules in different situations. Part II explores how lawmakers can draw on these scholarly insights to best protect tax-status requirements. For example, liability rules can substantially reduce taxpayers’ compliance costs for requirements that are ambiguous. Liability rules can also encourage economically efficient transactions and improve settlement negotiations between taxpayers and the IRS. Surprisingly, a simple model of IRS utility demonstrates that, in many instances, liability rules do a better job of deterring taxpayers from violating tax-status requirements than draconian property rules. Meanwhile, other considerations identified by scholars, such as calculation costs and biases, may weigh in favor of using property rules in other situations. Congress can and should draft better tax legislation by understanding the property and liability rule distinction.

But tax law can expand beyond plain property and liability rules. Scholars have developed many novel variations, and Part III shows how these innovative remedies can be used to rethink how the IRS protects tax-status requirements. For example, “pliability rules”—where a triggering event switches from one rule (either property or liability) to a second rule (also either property or liability)<sup>18</sup>—can be used for purposes as varied as encouraging taxpayers to disclose information to the IRS or helping taxpayers to survive financial crises. Another example is the “Rule 4” remedy: In the pollution dispute, Rule 4 involves enjoining the polluting factory but requiring the neighboring residents to compensate

---

<sup>17</sup> Rose, *supra* note 4.

<sup>18</sup> See *infra* Section III.B.

the factory for shutting down.<sup>19</sup> In tax law, Rule 4 can be used to protect students when their university violates a requirement for public charity status. Part III also explores several other new IRS remedies drawn from the broader property and liability rule literature.

Recognizing the relevance of the property and liability rule distinction to tax law can inform the broader literature across numerous other areas of law, as Part IV shows. Over the years, applying the distinction to contract law, intellectual property, and constitutional law has enriched the broader debate.<sup>20</sup> Each new area of law has brought new examples (and counterexamples) and unmasked implicit assumptions. Tax law is no different. For example, the IRS will often prefer *not* to get additional money from taxpayers who violate a requirement, because the IRS seeks proportional remedies and responds to political and media pressure.<sup>21</sup> This reveals the assumption implicit throughout the existing literature that parties always prefer to receive more money from the other side. Another contribution tax law can make to the broader literature is as a testing ground for scholars' predictions and novel remedies, as lawmakers constantly seek ways to increase tax revenues while keeping taxpayers happy.

Tax law has both property rules and liability rules. This recognition has concrete implications for tax law, as well as implications for the ongoing scholarly debate about property rules and liability rules in all areas of law.

## I. REMEDIES IN TAX LAW

This Part begins with a brief overview of the rich property and liability rule scholarship, and moves on to give examples of tax statuses used throughout the Article to illustrate remedies in tax law. The Part then demonstrates why taking away a tax status is a property rule. It concludes with examples of property rules and liability rules in tax.

### A. *Property Rules and Liability Rules*

Calabresi and Melamed's seminal 1972 article, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*,<sup>22</sup> which

---

<sup>19</sup> See *infra* Section III.D.

<sup>20</sup> See *infra* notes 344–49.

<sup>21</sup> See *infra* Subsection II.C.1.

<sup>22</sup> Calabresi & Melamed, *supra* note 1.

scholars often simply call “*The Cathedral*,”<sup>23</sup> introduced the distinction between property rules and liability rules. Since then, the distinction has resulted in a flowering of scholarship.<sup>24</sup>

Notably, scholars have generated numerous insights into the relative merits of property and liability rules in different situations.<sup>25</sup> For example, many scholars argue that property rules encourage negotiated efficient resolutions (such as sales), and that liability rules are preferable when high transaction costs make such consensual resolutions difficult.<sup>26</sup> Others have noted, for example, that property rules encourage overinvestment in search costs, because accidentally taking an entitlement incurs draconian punishments.<sup>27</sup>

Scholars have hardly limited themselves to debating the merits of property and liability rules—they have developed entirely new remedies. Calabresi and Melamed themselves started this process in their path-breaking article by recognizing the possibility of a new remedy called

---

<sup>23</sup> E.g., Emily Sherwin, Introduction: Property Rules as Remedies, 106 Yale L.J. 2083, 2084 (1997).

<sup>24</sup> See, e.g., Ayres, *supra* note 7; Ian Ayres & J.M. Balkin, Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond, 106 Yale L.J. 703 (1996); Ian Ayres & Paul M. Goldbart, Optimal Delegation and Decoupling in the Design of Liability Rules, 100 Mich. L. Rev. 1 (2001); Ian Ayres & Eric Talley, Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade, 104 Yale L.J. 1027 (1995); Lee Anne Fennell, Revealing Options, 118 Harv. L. Rev. 1399 (2005); Kaplow & Shavell, *supra* note 3; A. Mitchell Polinsky, Controlling Externalities and Protecting Entitlements: Property Right, Liability Rule, and Tax-Subsidy Approaches, 8 J. Legal Stud. 1 (1979); A. Mitchell Polinsky, Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies, 32 Stan. L. Rev. 1075 (1980); Henry E. Smith, Exclusion and Property Rules in the Law of Nuisance, 90 Va. L. Rev. 965 (2004) [hereinafter Smith, Exclusion]; Henry E. Smith, Property and Property Rules, 79 N.Y.U. L. Rev. 1719 (2004) [hereinafter Smith, Property].

<sup>25</sup> Ayres, *supra* note 7, at 183–200 (discussing the property rule vs. liability rule debate); Ian Ayres & Paul M. Goldbart, Correlated Values in the Theory of Property and Liability Rules, 32 J. Legal Stud. 121, 129–48 (2003) (refuting the argument for property rules when different parties’ values are correlated); Lucian Arye Bebchuk, Property Rights and Liability Rules: The Ex Ante View of the Cathedral, 100 Mich. L. Rev. 601, 619–32 (2001) (considering ex ante incentives created by different rules); Richard A. Epstein, A Clear View of *The Cathedral*: The Dominance of Property Rules, 106 Yale L.J. 2091, 2096 (1997) (arguing that liability rules are rightfully the exception).

<sup>26</sup> Ayres & Balkin, *supra* note 24, at 705–06 & n.9; James E. Krier & Stewart J. Schwab, Property Rules and Liability Rules: The Cathedral in Another Light, 70 N.Y.U. L. Rev. 440, 450–51 (1995) (deeming it a “virtual doctrine” that “[w]hen transaction costs are low, use property rules; when transaction costs are high, use liability rules”).

<sup>27</sup> Stewart E. Sterk, Property Rules, Liability Rules, and Uncertainty About Property Rights, 106 Mich. L. Rev. 1285, 1297 (2008) (building on the work of Thomas W. Merrill, Trespass, Nuisance, and the Costs of Determining Property Rights, 14 J. Legal Stud. 13 (1985)).

“Rule 4” that awards an entitlement to a defendant but protects it with only a liability rule.<sup>28</sup> Subsequent scholars have developed an array of creative new remedies,<sup>29</sup> drawing on seemingly unrelated areas such as option theory.<sup>30</sup>

Professors Louis Kaplow and Steven Shavell made the important observation that property rule and liability rule remedies lie along a *continuum* from zero damages to infinitely high damages.<sup>31</sup> Liability rules set the remedy to compensatory damages, while property rules simply set the remedy much higher up the continuum.<sup>32</sup> In other words, property-rule remedies can be put into dollar terms, and property and liability rules can be viewed as differing only in degree of severity. This observation opened up the entire continuum of possible remedies for discussion. As they observed, “the fully optimal rule may be neither one with extreme damages (that is, a property rule) nor one with damages equal to harm (that is, the conventional liability rule).”<sup>33</sup>

Kaplow and Shavell followed Calabresi and Melamed in drawing their examples from torts and property.<sup>34</sup> Other scholars have fruitfully applied the property and liability rule distinction to numerous other areas, including contract law,<sup>35</sup> constitutional law,<sup>36</sup> and intellectual property.<sup>37</sup> But no one has yet applied the distinction in tax law, with the exception of one fleeting reference by Professor Henry Smith.<sup>38</sup>

Smith proposed an innovative intermediate tax filing status for married couples. A detail of implementing this proposal would be how to recapture benefits that later turned out to be inappropriate. In passing, Smith

---

<sup>28</sup> Calabresi & Melamed, *supra* note 1, at 1116 (calling this a “fourth rule”); Rose, *supra* note 4, at 2178 (their fourth rule is now uniformly called “Rule 4”). Rule 4 is discussed in greater depth *infra* Section III.D.

<sup>29</sup> E.g., Saul Levmore, *Unifying Remedies: Property Rules, Liability Rules and Startling Rules*, 106 *Yale L.J.* 2149, 2156 tbl.2, 2157 tbl.3, 2159 tbl.4, 2163 tbl.5, app. at 2173 (1997) (listing various remedies developed, including origins); Madeline Morris, *The Structure of Entitlements*, 78 *Cornell L. Rev.* 822 (1993).

<sup>30</sup> E.g., Ayres, *supra* note 7, at 5; Morris, *supra* note 29, at 852, 854.

<sup>31</sup> Kaplow & Shavell, *supra* note 24, at 756–57.

<sup>32</sup> *Id.* at 756. Of course, property rules in favor of defendants are the same as zero damages (that is, the bottom of the continuum).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 748–55, 760–62.

<sup>35</sup> E.g., Craswell, *supra* note 3.

<sup>36</sup> E.g., Kontorovich, *supra* note 3.

<sup>37</sup> E.g., Lemley & Weiser, *supra* note 3.

<sup>38</sup> Henry E. Smith, *Intermediate Filing in Household Taxation*, 72 *S. Cal. L. Rev.* 145, 192 (1998).

noted that “the recapture rule could fall anywhere on the continuum from liability rule to property rule.”<sup>39</sup> Unfortunately, Smith did not further investigate the relative merits of using property rules or liability rules for his innovative proposal, let alone for tax law in general. But Smith’s passing reference does reinforce this Article’s basic insight that tax law has not only liability rules, but also property rules and rules falling in between.

### B. Tax Statuses

This Article uses the term “tax status” to refer to the qualification of a taxpayer, a property, or a transaction for particular treatment under the tax laws. Sometimes the tax code actually uses the word “status” to describe what this Article calls a tax status, as with “tax-exempt status.”<sup>40</sup> Sometimes the tax code instead uses the word “qualification,” as, for example, with “qualified retirement plan,”<sup>41</sup> which is a tax status. Other times the tax code simply uses the status’s specific name (for example, “S corporation”<sup>42</sup>) to describe the tax status.

Tax statuses are essential to the working of the tax laws. They determine basic matters such as whether a taxpayer must pay tax, what rates apply, whether a deduction is allowed, whether the taxpayer can take a credit, and how taxable income is calculated. Congress loves adding new tax statuses.<sup>43</sup>

Entities can potentially qualify for a dizzying array of tax statuses, including C corporation,<sup>44</sup> S corporation,<sup>45</sup> partnership,<sup>46</sup> numerous varieties of tax exemption,<sup>47</sup> consolidated group,<sup>48</sup> bank,<sup>49</sup> regulated invest-

---

<sup>39</sup> Id.

<sup>40</sup> E.g., I.R.C. § 501(p) (2006) (“tax-exempt status”); id. § 142(d)(7) (“tax-exempt status”); id. § 62(b)(3)(C) (“marital status”); id. § 150(d)(3) (“status as qualified scholarship funding corporation”); id. § 507 (“private foundation status”).

<sup>41</sup> See id. § 4974(c) (defining “qualified retirement plan” as including various plans under §§ 401, 403, and 408); see also id. §§ 401, 403(a) & (b), 408(a) & (b). For other examples of “qualification” for a status, see, e.g., id. § 953(e)(4) (defining “[q]ualifying insurance company branch”); id. § 48(c)(4)(B) (defining “[q]ualifying small wind turbine”).

<sup>42</sup> See Rev. Proc. 96-30 § 4.04(3), 1996-1 C.B. 696, 704 (“An alternative transaction that will cause the loss of a *favorable special tax status, such as an existing S corporation election*, will ordinarily be viewed as unduly expensive.” (emphasis added)).

<sup>43</sup> See, e.g., *infra* notes 44–74.

<sup>44</sup> I.R.C. §§ 11 & 1361(a)(2).

<sup>45</sup> Id. § 1361(a)(1).

<sup>46</sup> Id. § 761(a) (2006).

<sup>47</sup> E.g., id. § 501(c)(1)–(29).

<sup>48</sup> Id. § 1501.

<sup>49</sup> Id. § 581.

ment company,<sup>50</sup> real estate investment trust,<sup>51</sup> controlled foreign corporation,<sup>52</sup> publicly traded partnership,<sup>53</sup> U.S. real property holding corporation,<sup>54</sup> passive foreign investment company,<sup>55</sup> public utility,<sup>56</sup> and political subdivision of a State.<sup>57</sup> These statuses span business, civil society, and state and local government.

Individuals also may qualify for various tax statuses. Examples include resident alien,<sup>58</sup> head of household,<sup>59</sup> qualifying child,<sup>60</sup> independent contractor,<sup>61</sup> religious minister,<sup>62</sup> and dependent.<sup>63</sup>

Transactions may qualify for tax statuses, with some examples including tax-free corporate reorganizations,<sup>64</sup> various types of prohibited transactions,<sup>65</sup> complete redemptions,<sup>66</sup> and like-kind exchanges.<sup>67</sup> Debts may qualify for statuses, with examples such as qualified education loan,<sup>68</sup> qualified residence acquisition indebtedness,<sup>69</sup> or applicable high yield discount obligation.<sup>70</sup> Property may likewise qualify for statuses, including, for example, tax-exempt municipal bond,<sup>71</sup> qualified low-income housing,<sup>72</sup> regular interest in a real estate mortgage investment conduit,<sup>73</sup> and Section 1256 contract.<sup>74</sup>

---

<sup>50</sup> Id. § 851.

<sup>51</sup> Id. § 856.

<sup>52</sup> Id. § 957.

<sup>53</sup> Id. § 7704.

<sup>54</sup> Id. § 897(c)(2).

<sup>55</sup> Id. § 1297(a).

<sup>56</sup> Id. § 115(1).

<sup>57</sup> Id.

<sup>58</sup> Treas. Reg. §§ 1.871-2, 301.7701(b)-1 (2012).

<sup>59</sup> I.R.C. §§ 2(b), 7703(b).

<sup>60</sup> Id. § 24(c).

<sup>61</sup> Treas. Reg. § 31.3401(c)-1(b).

<sup>62</sup> I.R.C. § 107.

<sup>63</sup> Id. § 152.

<sup>64</sup> Id. § 368(a); see also id. §§ 336(c), 354(a)(1), 361(a), 1032(a) (making reorganizations tax-free to various taxpayers involved in the reorganization).

<sup>65</sup> Id. § 503(b) (prohibited transactions for certain tax-exempt organizations); id. § 857(b)(6)(B)(iii) (prohibited transactions for REITs).

<sup>66</sup> Id. § 302(b)(3).

<sup>67</sup> Id. § 1031.

<sup>68</sup> Id. § 221(d)(1).

<sup>69</sup> Id. § 163(h)(3)(B).

<sup>70</sup> Id. § 163(e)(5).

<sup>71</sup> Id. § 103.

<sup>72</sup> Id. § 42(g)(1).

<sup>73</sup> Id. § 860G(a)(1)-(2).

<sup>74</sup> Id. § 1256(b).

Each tax status involves meeting multiple requirements. In U.S. federal tax law, each requirement is spelled out in the tax code, Treasury regulations, case law, or some combination thereof.

Every status has an equal and opposite status consisting of *not* qualifying. As a matter of nomenclature, this Article uses the term “tax status” to refer to whichever one is favorable (tax-minimizing) for the relevant taxpayer.<sup>75</sup> Therefore, whenever this Article refers to losing a tax status, the loss is always unfavorable for the taxpayer.

U.S. federal tax law’s reliance on statuses is hardly unique. The tax laws of other countries,<sup>76</sup> as well as of many U.S. states and local governments,<sup>77</sup> use tax statuses to organize their tax systems and achieve various policy goals. Tax treaties between countries also rely on tax statuses.<sup>78</sup> Although this Article focuses on U.S. federal tax law, its analysis applies fully to foreign, state, and local tax laws, as well as to tax treaties.

### *C. Four Examples of Tax Statuses*

To illustrate the discussion, this Article focuses on the following four examples of tax statuses in the U.S. tax code.

---

<sup>75</sup> A status that is favorable for a taxpayer at a given time may be unfavorable at a different time or for a different taxpayer. For example, taxpayers sometimes seek to be taxed as corporations, see, e.g., *United States v. Kintner*, 216 F.2d 418, 421 (9th Cir. 1954), while some seek to avoid being taxed as corporations, see, for example, *Morrissey v. Commissioner*, 296 U.S. 344, 348–49 (1935).

<sup>76</sup> E.g., Income Tax Act, R.S.C., 1985, c. 1 (5th Supp.), § 149(1)(e) (Can.) (tax-exempt statuses). Numerous other countries have followed the U.S. in creating a special tax status for real estate investment trusts (“REITs”). Nat’l Ass’n of Real Estate Inv. Trusts, *Frequently Asked Questions About REITs* 28 (2011), available at <http://www.reit.com/portals/0/PDF/2011FAQ.pdf> (listing countries); see 445 Parl. Deb., H.C. (6th ser.) (2006) 369 (U.K.), available at [http://www.publications.parliament.uk/pa/cm200506/cmhansrd/vo060424/debtext/60424-08.htm#60424-08\\_spnew9](http://www.publications.parliament.uk/pa/cm200506/cmhansrd/vo060424/debtext/60424-08.htm#60424-08_spnew9) (statement of Des Browne, Chief Secretary to the Treasury) (explaining the United Kingdom’s adoption of REITs); cf. *infra* Subsection I.C.2 (discussing REITs in U.S. tax law).

<sup>77</sup> See, e.g., Md. Code Ann., Tax-Gen. § 10-724 (LexisNexis 2010) (providing a tax status for property qualifying as an “aquaculture oyster float”).

<sup>78</sup> See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, art. 5, Nov. 6, 2003, T.I.A.S. No. 04,330 (defining “permanent establishment”).

*1. Public Charities*

Examples of public charities include churches, homeless shelters, and private universities.<sup>79</sup> Public charity status comes with two main benefits: The entity itself is generally exempt from taxation,<sup>80</sup> and donors to these organizations can reduce their own taxes by deducting their contributions.<sup>81</sup>

An organization must meet numerous requirements to qualify as a public charity. Many of these requirements generate ambiguity. Most importantly, the organization must be “organized and operated exclusively for religious, charitable, scientific,” or other enumerated purposes.<sup>82</sup> These purposes have generated controversy, such as over the meaning of “charitable.”<sup>83</sup>

Another requirement is that “no part of the net earnings” of the organization may “inure[] to the benefit of any private shareholder or individual.”<sup>84</sup> This requirement raises numerous questions. For example, how much can a charity reward its professional fundraisers?<sup>85</sup> How well can it pay its president?<sup>86</sup>

There are two separate restrictions on public charities’ political involvement. First, no “substantial part” of the organization’s activities can consist of “carrying on propaganda, or otherwise attempting, to in-

---

<sup>79</sup> Richard A. Westin, WG&L Tax Dictionary 568–69 (2002–2003) (defining “public charity” as “a nontechnical term for exempt organizations that are described in [I.R.C.] § 501(c)(3), but which are not private foundations”) (emphasis omitted). Not all organizations qualifying under 501(c)(3) are public charities; some are private foundations. See I.R.C. § 509 (2006) (defining “private foundation”); 5 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶ 100.1.2 (3d ed. 2012).

<sup>80</sup> I.R.C. § 501(a) (2006). In the case of a university that lost its 501(c)(3) status, taxable income would generally consist of gross income such as tuition minus deductions such as professors’ salaries. See *id.* §§ 61, 63.

<sup>81</sup> *Id.* § 170(a), (c)(2).

<sup>82</sup> *Id.* § 501(c)(3). This creates both an organizational test and an operational test. See Bittker & Lokken, *supra* note 79, ¶ 100.2.

<sup>83</sup> *Bob Jones Univ. v. United States*, 461 U.S. 574, 595–96, 605 (1983) (holding that a university’s racial policies made it not qualify as “charitable”); Bittker & Rahdert, *supra* note 15, at 330 (noting that neither Congress nor Treasury nor the IRS have ventured to define “charitable”). See generally Bittker & Lokken, *supra* note 79, ¶ 100.3.2.

<sup>84</sup> I.R.C. § 501(c)(3). See generally Bittker & Lokken, *supra* note 79, ¶ 100.4 (discussing inurement test).

<sup>85</sup> See, e.g., *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1175–76 (7th Cir. 1999).

<sup>86</sup> See Hill & Mancino, *supra* note 10, ¶ 4.03[6].

fluence legislation . . . .”<sup>87</sup> But what is “substantial,” what is “propaganda,” and what is “legislation”? For instance, does this requirement cover attempts to influence executive-branch decisions?<sup>88</sup> Second, public charities must “not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”<sup>89</sup> But, aside from “the publishing or distributing of statements,” it is unclear what “participate” or “intervene” means.<sup>90</sup>

## 2. Real Estate Investment Trusts (REITs)

A real estate investment trust, or REIT (pronounced “reet”), is effectively a mutual fund<sup>91</sup> for real estate.<sup>92</sup> The basic concept of mutual funds and REITs is the same: enabling small investors to buy into a professionally managed, diversified portfolio.<sup>93</sup> While traditional mutual funds invest in a portfolio of stocks and other securities, REITs invest in a portfolio of real estate assets. The 141 REITs traded on the New York Stock Exchange have a total market capitalization of \$461 billion.<sup>94</sup> REITs own a wide variety of real estate assets ranging from warehouses and skyscrapers to mortgage-backed bonds and apartment buildings<sup>95</sup>—including my apartment building.

The key benefit of this status is that REITs are generally exempt from income tax, although the dividends a REIT pays out are fully taxable to its shareholders.<sup>96</sup> Thus, if a REIT owns a building and earns rent, which it pays out to its shareholders, the rent is taxed only once. This treatment

---

<sup>87</sup> I.R.C. § 501(c)(3).

<sup>88</sup> Hill & Mancino, *supra* note 10, ¶ 5.04[4] (discussing the instances when lobbying executive branch officials qualifies as attempting to influence legislation).

<sup>89</sup> I.R.C. § 501(c)(3).

<sup>90</sup> Hill & Mancino, *supra* note 10, ¶ 6.04[1] (“Section 501(c)(3) provides no guidance with respect to the political prohibition.”).

<sup>91</sup> Designation as a mutual fund or “regulated investment company” is another example of a tax status. See I.R.C. § 851.

<sup>92</sup> Michael K. Carnevale et al., *Real Estate Investment Trusts*, in *742 Tax Management A-1* (3d ed. 2012).

<sup>93</sup> H.R. Rep. No. 86-2020, at 3–4 (1960).

<sup>94</sup> Nat’l Ass’n of Real Estate Inv. Trusts, REITWatch, June 2011, at 1, available at <http://returns.reit.com/reitwatch/rw1106.pdf>.

<sup>95</sup> Nat’l Ass’n of Real Estate Inv. Trusts, *Frequently Asked Questions About REITs 2* (2011), available at <http://www.reit.com/portals/0/PDF/2011FAQ.pdf>.

<sup>96</sup> 4 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 99.5.1 (3d ed. 2003).

puts the REIT's shareholders on equal footing with wealthy individuals who can own buildings directly and who are also taxed only once on rent. But losing REIT status is disastrous, causing the REIT to pay the full corporate tax rate,<sup>97</sup> generally for the next five years,<sup>98</sup> with its dividends being taxable a second time to shareholders.

Qualifying for REIT status requires meeting a detailed array of statutory and regulatory requirements. Most of these requirements ensure that REIT status is available only to entities that allow small investors to invest in diversified real estate portfolios. To give a taste of the complexity, the requirements include that the REIT's shares be transferable,<sup>99</sup> that there be at least 100 shareholders,<sup>100</sup> that no five individuals own 50% or more of the stock,<sup>101</sup> that at least 95% of the REIT's gross income come from passive sources like interest,<sup>102</sup> that at least 75% of its gross income be real-estate related, such as rent, mortgage interest, or gain on real estate sales,<sup>103</sup> and that at least 75% of its assets be passive investments.<sup>104</sup>

### *3. Tax-Exempt Municipal Bonds*

Interest on bonds issued by state and local governments (generally called "municipal" bonds) is received tax-free.<sup>105</sup> This is an exception to the general rule that interest is income to the recipient.<sup>106</sup> This exemption allows state and local governments to borrow at lower interest rates.<sup>107</sup> Tax-exempt status for a municipal bond is an example of a tax status that applies to property, not an entity.

Bonds must meet numerous, detailed requirements to qualify for this highly favorable status. Most obviously, they must be issued by a state or local government. But even this seemingly simple requirement has

---

<sup>97</sup> I.R.C. § 856(a)(3) (2006) (requiring that a REIT "(but for the provisions of this part) would be taxable as a domestic corporation").

<sup>98</sup> Id. § 856(g)(3).

<sup>99</sup> Id. § 856(a)(2).

<sup>100</sup> Id. § 856(a)(5).

<sup>101</sup> Id. §§ 856(a)(6), 856(h)(1)(A), 542(a)(2).

<sup>102</sup> Id. § 856(c)(2).

<sup>103</sup> Id. § 856(c)(3).

<sup>104</sup> Id. § 856(c)(4).

<sup>105</sup> Id. § 103; cf. *South Carolina v. Baker*, 485 U.S. 505, 525 (1988) (holding that the U.S. Constitution does not require this tax exemption).

<sup>106</sup> I.R.C. § 61(a)(4).

<sup>107</sup> See 1 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 15.1.1 (3d ed. 1999).

caused controversy over issuers such as volunteer fire departments<sup>108</sup> and agencies created by multistate compact.<sup>109</sup> A host of requirements prevent governments from using their lower borrowing costs for non-governmental purposes.<sup>110</sup> These and the many other requirements involve substantial complexity and uncertainty.<sup>111</sup>

#### 4. Qualified Retirement Plans

Qualified retirement plans, such as pension plans or Section 401(k) plans, bring substantial tax benefits to both employer and employees.<sup>112</sup> The employer gets an immediate (and thus more valuable<sup>113</sup>) deduction for amounts contributed to the plan.<sup>114</sup> The employee defers taxes on contributions, typically until retirement years later.<sup>115</sup> Additionally, investment income on the retirement assets is exempt from tax, and these tax savings compound exponentially, allowing the retirement assets to grow more rapidly.<sup>116</sup>

These significant tax benefits come at the cost of compliance with an extraordinary number of requirements, which commentators have called “an ever-increasing maze of laws, rules, and regulations.”<sup>117</sup> Some requirements are procedural, such as requirements that the trust instrument be written, established in the United States, communicated to employ-

---

<sup>108</sup> See *Seagrave Corp. v. Comm’r*, 38 T.C. 247, 250–51 (1962), superseded by statute, Tax Reform Act of 1986, Pub. L. No. 99-514, § 1301(b), 100 Stat. 2085, 2654 (1986) (codified at I.R.C. § 150(e)).

<sup>109</sup> See *Comm’r v. Shamberg’s Estate*, 144 F.2d 998, 999–1000 (2d Cir. 1944) (divided panel).

<sup>110</sup> E.g., I.R.C. § 103(b)(1) (2006); Bittker & Lokken, *supra* note 107, ¶ 15.2 (discussing history and requirements relating to private activity bonds).

<sup>111</sup> See, e.g., Letter from Kathleen C. McKinney, National Association of Bond Lawyers, to Internal Revenue Serv., Tax Notes Today, June 14, 2010, LEXIS, 2010 TNT 113-93 (suggesting eleven areas relating to tax-exempt bonds where the IRS should make issuing guidance a priority).

<sup>112</sup> See generally Pamela D. Perdue, *Qualified Pension and Profit-Sharing Plans* ¶ 1.02 (2011) (discussing the advantages of maintaining a tax-qualified plan).

<sup>113</sup> See Stephen F. Gertzman, *Federal Tax Accounting* ¶ 1.01[2] (2d ed. 1993 & Supp. 2012).

<sup>114</sup> I.R.C. § 404(a)(1), (5), (6) (2006). See generally Perdue, *supra* note 112, ¶ 1.02[1][a].

<sup>115</sup> See, e.g., I.R.C. §§ 401(k), 501(a). There are still other benefits to the employee, such as tax-free rollovers. *Id.* § 402(c); Perdue, *supra* note 112, ¶ 1.02[2][b].

<sup>116</sup> I.R.C. § 501(a). See generally Perdue, *supra* note 112, ¶ 1.02[1][b], [2][a].

<sup>117</sup> Perdue, *supra* note 112, ¶ 1.01. The primary statute governing plan qualification is the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001–1461 (2006)). The IRS and Department of Labor dually administer ERISA. Perdue, *supra* note 112, ¶ 2.02.

ees, and permanent.<sup>118</sup> Other requirements relate to substance, including requirements for minimum coverage,<sup>119</sup> not discriminating in favor of highly compensated employees,<sup>120</sup> minimum vesting and benefit accrual,<sup>121</sup> minimum distributions,<sup>122</sup> and diversification.<sup>123</sup> Complying with this thicket of requirements has generated plenty of work for law firms.<sup>124</sup>

#### *D. Why Taxpayers Violate Requirements*

The reasons why taxpayers violate requirements can be grouped into four categories: tax law ambiguities, factual changes, ignorance of the tax law, and playing the “audit lottery.”

First, legal ambiguity exists in tax as in all other areas of law. Sometimes no statute, IRS guidance, or case law is on point. Other times, existing law is subject to different reasonable interpretations.<sup>125</sup> For instance, REITs must have at least 75% of their assets invested in specified categories of property,<sup>126</sup> but tax law is unclear as to whether assets used as collateral in common financing transactions count towards the required 75%.<sup>127</sup> Although most practitioners believe they do count,

---

<sup>118</sup> Perdue, *supra* note 112, ¶ 2.04[1].

<sup>119</sup> I.R.C. § 410.

<sup>120</sup> *Id.* § 414(q).

<sup>121</sup> *Id.* § 411.

<sup>122</sup> *Id.* § 401(a)(9).

<sup>123</sup> *Id.* § 401(a)(35).

<sup>124</sup> See, e.g., Employee Benefits, McDermott Will & Emery, <http://www.mwe.com/Employee-Benefits-Pensions> (last visited July 16, 2012).

<sup>125</sup> David Weisbach has discussed line-drawing in otherwise gray areas of tax. David A. Weisbach, An Efficiency Analysis of Line Drawing in the Tax Law, 29 *J. Legal Stud.* 71, 71 (2000); David A. Weisbach, Line Drawing, Doctrine, and Efficiency In The Tax Law, 84 *Cornell L. Rev.* 1627, 1627 (1999). Weisbach’s articles focus on *whether* a line is crossed, while this Article looks at the *result* if a line is crossed.

<sup>126</sup> I.R.C. § 856(c)(4).

<sup>127</sup> The common financing transaction at issue is a sale-repurchase agreement (“repo”) of a mortgage-backed security. In entering a repo, a REIT would sell a mortgage-backed security to a counterparty for cash, but also contract to repurchase the security later at a higher price constituting interest on the sales proceeds. Although repos are generally understood by practitioners to be secured loans for tax purposes, the question is ambiguous. See William W. Chip, Are Repos Really Loans?, 95 *Tax Notes* 1057 (May 13, 2002). If repos are indeed secured loans, the securities used as collateral remain assets of the REIT for the 75% asset test. But if repos are sales, the securities are not assets of the REIT for the duration of the repo, meaning they no longer count towards the 75% test.

many REITs would unexpectedly find themselves in violation of the 75% asset test if the IRS or a court were to decide otherwise.<sup>128</sup>

Second, factual changes—ranging from business exigencies, to compliance with non-tax law,<sup>129</sup> to accidental paperwork failures—can also cause taxpayers to violate requirements. For example, a REIT may generate most of its income from rents, thereby meeting the requirement that at least 75% of a REIT's gross income must come from real-estate sources.<sup>130</sup> But in a recession, some tenants may stop paying rent, causing the percentage of gross income from real-estate sources to fall below the 75% threshold. Similarly, a church's tax-exempt status might be imperiled by a guest preacher's unexpected advocacy of a political candidate. Or, a qualified retirement plan might accidentally misfile paperwork, leading the entire plan to lose its qualification.<sup>131</sup>

Third, ignorance of tax law's requirements is common, which is understandable due to the tax code's extraordinary length and complexity.<sup>132</sup> For example, church leaders may not be aware of the no-campaigning requirement for public charities. A small business owner may not understand the requirements for retirement plan qualification. And a REIT's lawyers and accountants may miss a potential legal issue.

Finally, some taxpayers simply play the "audit lottery," which is taking an incorrect tax position on one's return and hoping the IRS does not audit the return and discover the problem.<sup>133</sup> Like the traditional lottery, the "audit lottery" is a game of chance.<sup>134</sup> A taxpayer playing the "audit

---

<sup>128</sup> See AG Mortgage Investment Trust, Inc., Prospectus, SEC Registration No. 333-172656, at 69 (June 29, 2011), available at <http://www.sec.gov/Archives/edgar/data/1514281/000119312511179374/d424b1.htm>. ("The failure of RMBS subject to repurchase agreements to qualify as real estate assets could adversely affect our ability to qualify as a REIT.")

<sup>129</sup> See, e.g., *Cherry-Burrell Corp. v. United States*, 367 F.2d 669, 677–78 (8th Cir. 1966) (noting that corporate law considerations prevented a taxpayer from meeting status requirements and forgiving the violation based on the statute's purpose).

<sup>130</sup> I.R.C. § 856(c)(3).

<sup>131</sup> See, e.g., *Fazi v. Comm'r*, 102 T.C. 695, 700 (1994).

<sup>132</sup> See Michael J. Graetz, *The U.S. Income Tax 293* (1999) ("[The Internal Revenue Code is] now more than six times longer than Tolstoy's *War and Peace* and considerably harder to parse.")

<sup>133</sup> Richard A. Westin, *WG&L Tax Dictionary 59* (2002–2003) (defining "audit lottery" as "a slang term for the fact that one can take an incorrect tax position on one's *return* and prevail in the sense of not being discovered. The notion is that by doing so, one plays a game of chance, i.e., the audit lottery.")

<sup>134</sup> *Id.*

lottery” may violate a requirement but hope that the IRS will not discover the violation.<sup>135</sup>

None of these four considerations are unique to tax law. For example, an author may potentially infringe another’s copyright due to legal ambiguity about the fair use doctrine. Authors revising their manuscript may accidentally quote another’s work. Authors may be ignorant of copyright law’s requirements, or may simply hope that their infringement goes undiscovered. In copyright and other areas of law, such violations can be remedied by either property rules or liability rules, and the same is true in tax law.

### *E. Tax Status-Loss Is a Property Rule*

Although injunctions are perhaps the quintessential property-rule remedy, disgorgement is also a traditional property-rule remedy.<sup>136</sup> Indeed, the economic consequences of an injunction are nearly identical to those of disgorgement.

Consider a nuisance dispute where a factory increases its profits \$20 million annually by emitting pollution that inflicts \$1 million in annual harm on neighboring residents. A liability rule would require

---

<sup>135</sup> There are various procedural measures to deter such behavior, including penalties and sanctions. E.g., I.R.C. § 6662; 31 C.F.R. §§ 10.50–53 (Circular No. 230) (2007).

<sup>136</sup> Ayres, *supra* note 7, at 13 (“[D]isgorgement and prison terms are traditional property-rule remedies . . . .”); see Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. Pa. L. Rev. 45, 62 (1999); accord Emily Sherwin, *Property, Rules, and Property Rules 22* (Cornell Law Faculty Working Papers No. 26, 2007), available at [http://scholarship.law.cornell.edu/clsops\\_papers/26](http://scholarship.law.cornell.edu/clsops_papers/26) (“A more promising form of property rule is restitution of profits.”). Restitution of profits is disgorgement by definition. Black’s Law Dictionary 536 (9th ed. 2009) (defining “disgorgement” as “[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion”).

Disgorgement is just one type of supracompensatory damages, which scholars recognize as property-rule remedies. See, e.g., Ayres, *supra* note 7, at 83 tbl.5.1 (showing high damages of \$100 as a property rule); *id.* at 147 (“[I]f the damages are greater than \$100 (the highest valuation of any potential defendant), then the plaintiff’s entitlement is property-like in nature.”); Ayres & Talley, *supra* note 24, at 1041 (stating that an entitlement protected by damages higher than any potential taker’s valuation is “property-like” in nature); see also *id.* at 1045 (referring again to “property-like” damages as damages exceeding valuation); Craswell, *supra* note 3, at 4 (noting that “damage measures designed to deter breach rather than merely to compensate the promisee—for example, *in terrorem* penalty clauses or punitive damages” are property rules); Epstein, *supra* note 25, at 2096 (arguing that Roman law’s remedy of giving a plaintiff the right to set liability very high was “an early preference for the property rules”); David D. Haddock et al., *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 Calif. L. Rev. 1, 2 (1990); Smith, *Property*, *supra* note 24, at 1742 (noting that property rules are associated with very high levels of liability and injunctions).

the factory to pay \$1 million in damages each year to the residents, but allow the factory to continue polluting.<sup>137</sup> This \$1 million compensates the residents for taking their entitlement to clean air. But if a court instead issues an injunction against the pollution, the factory will rationally pay the residents any amount up to \$20 million (its profits from polluting) to dissolve the injunction.<sup>138</sup> With an injunction, the residents can force the factory to “disgorge” an amount up to its full profits from the pollution.

Court-ordered disgorgement has the same effect as an injunction. If the factory must disgorge all its profits earned from polluting, it will simply stop polluting, unless it can settle with the residents to pay something less than its full profits.

Tax status-loss is a form of disgorgement, specifically disgorgement of all the tax benefits from the status. For example, suppose that a REIT’s tax status will allow it to save \$20 million in taxes over the next five years, which is the period during which status-loss lasts for a REIT.<sup>139</sup> Moreover, suppose that this REIT violates a requirement that harms the Treasury by \$1 million. A liability-rule remedy might impose \$1 million in additional taxes, and, indeed, several REIT requirements are protected by liability rules.<sup>140</sup> But, by contrast, status-loss forces the REIT to disgorge the full \$20 million in tax benefits, which is a property-rule remedy.<sup>141</sup> Compliance with a requirement protected by status-loss is, as a practical matter, mandated.<sup>142</sup>

---

<sup>137</sup> See *Boomer v. Atlantic Cement Co.*, 257 N.E.2d 870, 873 (1970) (awarding permanent damages to residents against a nearby cement factory).

<sup>138</sup> See Polinsky, *supra* note 24, at 1077 (using this example and referring to this as the “extortion” argument against property-rule protection).

<sup>139</sup> I.R.C. § 856(g)(3).

<sup>140</sup> E.g., *id.* § 857(b)(5) (subjecting REIT to a 100% tax on an amount based on the magnitude of the failure to meet the gross income tests); *id.* § 857(b)(6)(A) (subjecting REIT to 100% tax on prohibited transaction income).

<sup>141</sup> Taking away a tax status may be permanent, as with *id.* § 7704(c)(1)–(2) (publicly traded partnerships), or it may be for a period of years, as with REITs, *id.* § 856(g)(3). The length or permanency of status-loss is irrelevant; the relevant issue for status-loss is the value of all tax benefits lost.

<sup>142</sup> See Henry E. Smith, *Ambiguous Quality Changes from Taxes and Legal Rules*, 67 U. Chi. L. Rev. 647, 661 (2000) (“What we commonly call ‘tax’ laws can often have the effect of *mandating* features of a transaction or activity. For example, the Internal Revenue Code’s provisions on the qualifications for tax-exempt status and for eligibility for deductible charitable contributions have the effect of regulating the form in which charities and some other organizations do business.” (emphasis added)).

A straightforward example demonstrates how tax status-loss has results identical to an injunction. Suppose the IRS got an injunction barring the REIT from calculating its taxes using the favorable REIT rules that save \$20 million in taxes over five years. This injunction would cost the REIT the same \$20 million as status-loss.

The IRS is the entitlement holder under both status-loss and the liability rules currently in the tax code. Specifically, the IRS holds the entitlement to compliance with tax-status requirements.<sup>143</sup> Similarly, in the nuisance example, both an injunction against the factory and damages paid to the residents give the entitlement to the residents, specifically the entitlement to clean air.

When an injunction is a court's only possible remedy for a nuisance like the polluting factory, there are three possible outcomes. Assume, as above, that the factory increases its profits \$20 million by polluting, while the neighbors suffer \$1 million in harm. First, the judge may issue an injunction, and the residents and factory may then negotiate a settlement whereby the factory pays something between \$1 million and \$20 million to the residents to dissolve the injunction. This is the socially optimal outcome because the \$20 million in benefits of the pollution exceed the \$1 million costs to the residents by \$19 million. Second, the judge may issue an injunction, but negotiations between residents and the factory may fail, causing the factory to cease pollution. This failure results in a net loss to society of \$19 million, and much of the property- and liability-rule scholarship considers how to avoid such inefficient outcomes.<sup>144</sup> Third, the judge may decline to issue an injunction altogether, because the costs imposed on the factory vastly exceed the benefits to the residents.<sup>145</sup> This no-remedy outcome often results when only

---

<sup>143</sup> In the two-by-two matrix resulting from Calabresi and Melamed's work, the rows correspond to who gets the entitlement, while the columns correspond to whether the entitlement is protected by a property rule or liability rule. See Ayres, *supra* note 7, at 14 tbl.2.1 (reproducing the matrix). The possibility of giving the entitlement, instead, to the taxpayer, and protecting it with a liability rule (that is, Rule 4) is discussed *infra* Section III.D.

<sup>144</sup> See, e.g., Ayres, *supra* note 7, at 24; Ayres & Talley, *supra* note 24, at 1029–33 (using liability rules to improve bargaining); cf. Calabresi & Melamed, *supra* note 1, at 1107 (noting freeloader issues). Carol Rose notes that such a failure might result either from the costs of bringing together “numerous or indistinctly defined interested parties” or from “the impediments that come *after* bargaining begins, from parties who are close-mouthed, poker-faced, strategically bargaining misanthropes.” Rose, *supra* note 4, at 2184.

<sup>145</sup> This result is what the property- and liability-rule literature calls a “Rule 3,” whereby the factory's right to pollute is protected by a property rule.

property rules are available to decision makers (typically judges), and such remedies are too draconian under the relevant circumstances.<sup>146</sup>

Similarly, there are three possible outcomes when a taxpayer violates a tax-status requirement protected solely by status-loss. First, the IRS and the taxpayer may reach a settlement allowing the taxpayer to keep the status but pay some portion of the status' tax benefit. The vast majority of tax disputes are settled.<sup>147</sup> This outcome is analogous to a court enjoining the factory's pollution, but the factory paying the residents some portion of its profits to dissolve the injunction. Second, negotiations between the IRS and the taxpayer may break down, with the taxpayer losing the tax status entirely. This outcome is analogous to a breakdown in negotiations between the factory and residents to dissolve the injunction. Third, the IRS or a court<sup>148</sup> may see status-loss as too draconian and decline to impose it entirely. This outcome is analogous to a judge refusing to enjoin the factory's pollution.

In sum, when a taxpayer violates a tax-status requirement protected in the tax code or Treasury regulations only by status-loss, there are actually three possible outcomes: a negotiated settlement that allows the taxpayer to keep its status but pay the IRS; the taxpayer's loss of the status; or no remedy at all.

Unless the relevant tax code or Treasury regulation section provides that violating a requirement results in some compensatory additional tax (a liability rule), then the remedy for violation is status-loss (a property rule).<sup>149</sup> In other words, status-loss is the default remedy for violating a requirement, with liability rules applying only when specifically provided.

---

<sup>146</sup> See discussion *infra* note 243 (citing examples of judges avoiding finding violations when that necessitates a draconian property-rule remedy).

<sup>147</sup> Michael I. Saltzman, IRS Practice and Procedure ¶ 9.01 ("In tens of thousands of cases each year, Appeals officers negotiate and in about 85 to 90 percent of the cases settle with taxpayers."). These statistics reflect all types of tax disputes, not just violations of tax-status requirements, but one would expect that similar majorities of violations are settled.

<sup>148</sup> Many tax-status requirements provide sufficient ambiguity for a court to decline to impose status-loss when that is too draconian. See, e.g., *Cherry-Burrell Corp. v. United States*, 367 F.2d 669, 676–77 (8th Cir. 1966) (straining interpretation of tax-free liquidation status to avoid unduly harsh result, at one point commenting the "intendment of the statute should not be thwarted by technical niceties").

<sup>149</sup> See, e.g., *Christy & Swan Profit Sharing Plan v. Comm'r, T.C.M. (RIA)*, No. 2011-62, at 18 (2011) (noting that the "requirements that a plan must satisfy for qualification under section 401(a) must be strictly met," and if not, status is lost).

*F. Other Property Rules in Tax Law*

Status-loss is the most widespread property-rule remedy in federal tax law, but it is not the only one. Jail time is a property-rule remedy,<sup>150</sup> and it is used in tax for serious procedural violations, such as willfully not filing tax returns<sup>151</sup> or threatening physical harm to an IRS agent.<sup>152</sup> Supra-compensatory damages such as punitive damages are also property-rule remedies,<sup>153</sup> and the civil tax fraud penalty fits in this mold.<sup>154</sup>

Congress has occasionally sought to impose taxes modeled on common-law property-rule remedies such as disgorgement.<sup>155</sup> For example, in 1919, Congress passed the Child Labor Tax Law,<sup>156</sup> which required a business employing child labor to pay a tax of one-tenth of its profits. In other words, the government's remedy against employing children was disgorgement of one-tenth of profits. This tax was a property rule, setting a penalty intended to be so high that no taxpayer would employ children. But the Supreme Court struck down this tax in *Bailey v. Drexel Furniture Co.*<sup>157</sup> as exceeding Congress' constitutional taxing power.

The Supreme Court recently distinguished *Drexel Furniture* in *National Federation of Independent Business v. Sebelius*,<sup>158</sup> upholding the individual mandate to purchase health insurance<sup>159</sup> as a "tax on going without health insurance."<sup>160</sup> The Court's rationale was essentially that *Drexel Furniture* involved a property rule, while the individual mandate is a liability rule that compensates for the harm caused by going without health insurance. The Court emphasized that the tax in *Drexel Furniture* "imposed an exceedingly heavy burden,"<sup>161</sup> while the individual man-

---

<sup>150</sup> Ayres, *supra* note 7, at 13.

<sup>151</sup> I.R.C. § 7203 (2006).

<sup>152</sup> *Id.* § 7212(a). Other examples of tax crimes include *id.* § 7201 (willfully attempting to evade or defeat taxes), § 7202 (willful failure to collect or pay over tax), § 7206 (false returns), § 7207 (false documents). See generally 6 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶ 114.9 (2d ed. 2012) (tax-crimes overview).

<sup>153</sup> Smith, *Property*, *supra* note 24, at 1720 ("Such 'property rules' would include injunctions and supra-compensatory damages . . ."); see authorities cited *supra* note 136.

<sup>154</sup> I.R.C. § 6663(a) (penalty of 75% of underpayment).

<sup>155</sup> Ayres, *supra* note 7, at 13 ("[D]isgorgement and prison terms are traditional property-rule remedies . . .").

<sup>156</sup> Pub. L. No. 65-254, 40 Stat. 1057, 1138 (1919).

<sup>157</sup> 259 U.S. 20, 44 (1922).

<sup>158</sup> 132 S. Ct. 2566, 2595–96 (2012).

<sup>159</sup> *Id.* § 5000A(a).

<sup>160</sup> 132 S. Ct. at 2599.

<sup>161</sup> *Id.* at 2595.

date payment will never be more than the cost of insurance.<sup>162</sup> The Court stated, “It may often be a reasonable financial decision to make the [individual mandate] payment rather than purchase insurance, unlike the ‘prohibitory’ financial punishment in *Drexel Furniture*.”<sup>163</sup> In other words, the individual mandate sets a price that allows efficient breach (as do all liability rules), while the child labor tax set a prohibitively high penalty (as do all property rules).<sup>164</sup>

An interesting area for future research is the relationship between Congress’ constitutional taxing power and the property- and liability-rule distinction. This Article does not, however, further consider any constitutional questions.

### G. Liability Rules in Tax Law

Liability rules in tax compensate for harm caused by violating a requirement. There are three types of harm: direct fiscal harm in the form of lost tax revenues; indirect fiscal harm, such as when one taxpayer’s non-compliance encourages others to avoid tax; and non-fiscal harm to third parties or to non-tax policies.<sup>165</sup>

Some liability rules in the tax code are imposed at normal income tax rates, which currently reach a maximum of 39.6% for individuals<sup>166</sup> and 35% for corporations.<sup>167</sup> For example, if a public charity violates the requirement that it be “operated exclusively for religious, charitable, scientific,” or other enumerated purposes,<sup>168</sup> it must pay unrelated business income tax<sup>169</sup> (“UBIT”) at normal corporate income tax rates of up to

---

<sup>162</sup> Id.

<sup>163</sup> Id. at 2595–96.

<sup>164</sup> The Court also relied on the absence of criminal sanctions for failing to pay the individual mandate payment. Id. at 2596. Criminal sanctions are property-rule remedies, so this absence underlines the liability-rule character of the individual mandate.

<sup>165</sup> Pigovian taxes aim to correct market failures such as negative externalities by taxing them. Britt Groosman, Pollution Tax, in 2 Encyclopedia of Law and Economics 2500 (Boudewijn Bouckaert & Gerrit De Gees eds., 2000). Some liability rules for violating tax-status requirements are Pigovian taxes.

<sup>166</sup> American Taxpayer Relief Act of 2012, Pub. L. 112-240, § 101(b)(1), 126 Stat. 2316 (2013).

<sup>167</sup> See I.R.C. § 11 (2006).

<sup>168</sup> Id. § 501(c)(3).

<sup>169</sup> Id. § 511(a)(1), (a)(2)(A). The UBIT is also applied on qualified retirement plans in certain circumstances. Perdue, *supra* note 112, at ¶ 20.02.

35% on all income unrelated to its exempt purpose.<sup>170</sup> If a university opens a parking lot open to the public or invests part of its endowment in a private equity fund,<sup>171</sup> it generally must pay UBIT on the resulting income. Or, if an art museum's gift shop sells souvenirs unrelated to its art collection,<sup>172</sup> it pays UBIT on the sales income. The UBIT compensates the government for the revenue that would be collected if the activity were carried on by a taxable corporation.<sup>173</sup> Similarly, various REIT requirements are protected by 35% liability rules.<sup>174</sup>

An important category of liability rules imposed at normal tax rates applies to tax-free exchanges, such as corporate reorganizations,<sup>175</sup> corporate separations,<sup>176</sup> and like-kind property exchanges.<sup>177</sup> Tax-free exchanges are examples of tax statuses for transactions. All tax-free exchanges have a requirement that "solely" qualified property can be exchanged.<sup>178</sup> But when taxpayers violate this requirement by also exchanging nonqualified property (colorfully called "boot"<sup>179</sup>), the transaction does not lose its tax-free status. Instead, the taxpayer pays tax at normal tax rates on the value of the boot,<sup>180</sup> which is a liability rule.

<sup>170</sup> See Bittker & Rahdert, *supra* note 15, at 316–17 (discussing UBIT's relation to the "operated exclusively for" exempt purposes requirement).

<sup>171</sup> Private equity funds tend to invest using pass-through entities that result in UBIT. See I.R.C. § 512(c)(1); Andrew W. Needham, *Portfolio 735: Private Equity Funds* ¶ VII.A.2 (2d ed. 2010).

<sup>172</sup> See Rev. Rul. 73-105, 1973-1 C.B. 264.

<sup>173</sup> Cf. *supra* note 10 (at some point too much unrelated business income leads to status-loss).

<sup>174</sup> See I.R.C. § 856(c)(7)(C), (g)(5) (violations of asset-composition requirements); id. § 857(b)(4) (dealing in foreclosure property); id. § 860E(e)(6)(A), (B)(i) (certain income from mortgage securitization structures).

<sup>175</sup> Id. §§ 354(a)(1), 368(a)(1).

<sup>176</sup> Id. § 355(a)(1).

<sup>177</sup> Id. § 1031(a).

<sup>178</sup> Id. § 354(a)(1) ("exchanged *solely* for stock or securities" (emphasis added)); id. § 355(a)(1)(A) (requiring that distributing corporation distribute "*solely* stock or securities of a corporation . . . which it controls immediately before the distribution" (emphasis added)); id. § 1031(a)(1) ("if such property is exchanged *solely* for property of like kind" (emphasis added)).

<sup>179</sup> Richard A. Westin, *WG&L Tax Dictionary* 75–76 (2002–2003) (defining "boot" as "a colloquial name for property that is precluded from being transferred by one taxpayer to another tax-free, yet is transferred as part of an otherwise tax-free exchange" (emphasis omitted)).

<sup>180</sup> I.R.C. § 355(c) (for separations that are not reorganizations); id. § 356(a)(1) (for both reorganizations and separations); id. § 1031(b) (for like-kind exchanges).

Other liability rules are imposed at 100% rates,<sup>181</sup> which make sense when violating the requirement is fundamentally inconsistent with the tax status. For example, to ensure that REITs invest primarily in real estate, one requirement is that they receive 75% of their gross income from real-estate investments like rent or mortgage interest.<sup>182</sup> But a REIT that falls below 75% does not lose its status; rather, it generally pays 100% of all taxable income attributable to gross income that falls below the threshold.<sup>183</sup> This compensates the government for a REIT's failure to focus primarily on investing in real estate.

Similarly, tax-exempt municipal bonds have the requirement that the borrowing government must not invest the borrowed money in higher-yielding taxable investments like corporate bonds.<sup>184</sup> Such "arbitrage"—using the tax exemption to borrow low, then investing high, and pocketing the difference—would be a way for the borrowing government to grab tax dollars properly headed to the federal Treasury.<sup>185</sup> When the borrowing government violates this no-arbitrage requirement, the bonds do not lose their status. Rather, the borrowing government simply pays to the federal government 100% of the arbitrage income, thus returning the money.<sup>186</sup>

There are a variety of liability rules in the tax code with other rates, such as various taxes set at 10%,<sup>187</sup> 25%,<sup>188</sup> and 30%<sup>189</sup> for requirement-violations by certain tax-exempt organizations. Still other liability rules impose a flat \$50,000.<sup>190</sup> A promising area for future scholarship is im-

---

<sup>181</sup> Variations in calculating damages to the payee are entirely consistent with a liability rule. For example, some of the nineteenth-century Mill Acts provided for a liability rule with damages for flooding property of 150% of fair-market value. See An Act for the Encouragement of Manufactures, ch. 20, § 3, 1868 N.H. Laws 152, 153, *cited in* *Head v. Amoskeag Mfg. Co.*, 113 U.S. 9, 9 n.1 (1885).

<sup>182</sup> I.R.C. § 856(c)(3).

<sup>183</sup> *Id.* § 857(b)(5). Relief is possible if the violation is "due to reasonable cause and not due to willful neglect" and is properly disclosed. *Id.* § 856(c)(6). As discussed *infra* Section III.A, this is an example of a liability rule.

<sup>184</sup> *Id.* §§ 103(b)(2), 148.

<sup>185</sup> See 1 Bittker & Lokken, *supra* note 107, at ¶ 15.4.1.

<sup>186</sup> I.R.C. § 148(f)(2); Treas. Reg. § 1.148-3 (2011).

<sup>187</sup> I.R.C. § 4941(a) (tax on self-dealing); see also *id.* § 4944 (tax on foundation investments that jeopardize carrying out of exempt purposes).

<sup>188</sup> *Id.* § 4911(a) (tax on excess expenditures to influence legislation).

<sup>189</sup> *Id.* § 4942(a) (tax on failure to distribute income).

<sup>190</sup> E.g., *id.* § 856(g)(5) (certain REIT violations); *id.* § 4959 (501(c)(3) hospital violations).

2013]

*Tax in the Cathedral*

1195

proving the theoretical underpinnings and practical methods for determining compensatory liability-rule amounts in tax.

## II. CHOOSING BETWEEN PROPERTY AND LIABILITY RULES TO PROTECT TAX STATUSES

The preceding Part demonstrated that tax-status requirements may be protected by either property or liability rules. This Part applies the rich property- and liability-rule literature to analyze the relative merits and best uses of each.<sup>191</sup> Each of these considerations elucidates costs and benefits, so one consideration alone will rarely determine the best rule for a particular requirement.

Congress currently makes the decision between liability rules and property rules in tax on a fairly ad hoc basis. Congress might look at perhaps two or three of the considerations raised by the broader property- and liability-rule literature—but it certainly misses most of them. This is not surprising, as several of these considerations are not obvious and took decades to be fleshed out in the broader literature.

This Part should be the first step towards Congress drawing on the considerations from the broader literature to draft better tax laws. And when Congress sets out to reform the tax code, it should use these considerations to see whether it makes sense to move a requirement currently protected by a property rule to a liability rule instead, or vice versa. The considerations in this Part will be useful whenever Congress drafts new tax laws or reforms the existing ones.

### *A. Compliance Expenditures*

Search costs to determine whether doing something would violate someone else's entitlement can be substantial. For example, a landowner who wants to build a new building may hire a surveyor to ensure that it will not encroach onto a neighbor's land, or may hire a real-estate attor-

---

<sup>191</sup> Professor David A. Weisbach, in an excellent article, *Formalism in the Tax Law*, 66 U. Chi. L. Rev. 860 (1999), notes that “[a] discontinuous law, a cliff, may have very different behavioral effects than a continuous law, although one cannot say which will be more efficient without more information.” *Id.* at 873. This Article focuses on how to make such determinations, as liability-rule remedies are a type of continuous law. By contrast, the continuous laws discussed by Weisbach are not liability rules but instead property rules with continuously varying probabilities of being imposed, in that “[a] small change in facts will only change the probability a little, creating a continuous change in the law from an ex ante perspective.” *Id.*

ney to ensure that the building does not violate any easements.<sup>192</sup> As another example, a manufacturer considering a new product may want to hire engineers and patent attorneys to ensure that the product does not infringe on any of a competitor's patents.<sup>193</sup> These search costs can be quite substantial. Indeed, sometimes litigation is the only way to definitively determine the scope of property rights.<sup>194</sup>

Property rules create incentives for higher search-cost expenditures than liability rules do. Building on the work of Professor Thomas Merrill,<sup>195</sup> Professor Stewart Sterk has demonstrated mathematically "that, compared with a liability-rule regime, a property-rule regime creates excessive incentives to search even when search costs are high, the probability of encroachment is relatively low, and the likely harm to the property owner is low."<sup>196</sup> The basic intuition is simple: Possible encroachers have an incentive to spend socially inefficient amounts on searching<sup>197</sup> to avoid even a small possibility of incurring a draconian property rule.

Search costs tend to be low in situations with clear on/off rules, such as the boundary around a parcel of land.<sup>198</sup> Partly as a result, land is often protected by property rules. By contrast, liability rules tend to be better for situations with vague boundaries, as with a manufacturer who must determine whether its new product violates any of a competitor's 2,000 vaguely drafted patents.<sup>199</sup>

There are search costs in tax law, where they are typically called compliance costs. These include expensive accountants and tax lawyers to determine whether contemplated transactions violate ambiguous re-

---

<sup>192</sup> Sterk, *supra* note 27, at 1288.

<sup>193</sup> See Sterk, *supra* note 27, at 1297–99.

<sup>194</sup> Sterk, *supra* note 27, at 1325 (discussing *Drulard v. Le Tourneau*, 593 P.2d 1118 (Or. 1979)); Pandora Media, Inc., Quarterly Report (Form 10-Q), at 49 (Sept. 2, 2011), available at <http://www.sec.gov/Archives/edgar/data/1230276/000119312511239281/d10q.htm> ("Litigation . . . may be necessary in the future to enforce our intellectual property rights . . . and to determine the validity and scope of the proprietary rights of others.").

<sup>195</sup> E.g., Merrill, *supra* note 27.

<sup>196</sup> Sterk, *supra* note 27, at 1304.

<sup>197</sup> The degree of inefficiency created by a property rule is roughly proportional to the search costs to determine encroachment. Sterk, *supra* note 27, at 1318.

<sup>198</sup> See Emily Sherwin, Two- and Three-Dimensional Property Rights, 29 *Ariz. St. L.J.* 1075, 1091 (1997); Smith, Property, *supra* note 24, at 1753–54.

<sup>199</sup> Cf. *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 397 (2006) (Kennedy, J., concurring and joined by three other Justices) (noting that uncertainty in legal boundaries of patents should be considered in deciding between injunction and damages to protect the patent).

quirements.<sup>200</sup> They also include internal controls to ensure factual changes do not cause violations. For example, REITs retain tax counsel to determine whether potential investments will qualify under the various asset and income tests, while also maintaining internal systems to monitor value and income fluctuations.<sup>201</sup> State and local governments use written procedures and outside auditors to ensure that their bonds continue to be tax-exempt.<sup>202</sup> And some churches are, as one commentator noted, “always looking over their shoulder, for fear that *any* political activity will place them in violation of the [Tax] Code and at risk of losing their tax-exempt status.”<sup>203</sup> Such constant self-monitoring wastes time.

If a requirement is protected by a property rule, with potentially draconian status-loss as the remedy, taxpayers rationally lavish money on compliance costs to avoid violating it. A liability rule, by contrast, leads to lower compliance costs.

Compliance costs always weigh in favor of liability rules in tax. The only question is how much they weigh towards liability rules for a particular requirement. When the law around a requirement is clear and the relevant facts are fully within the taxpayer’s control, compliance costs are low and provide little advantage for liability rules over status-loss.<sup>204</sup> That situation is akin to the on/off clarity provided by land boundaries. But when the law is unclear or the relevant facts can fluctuate outside the taxpayer’s control, compliance costs are high, weighing towards liability rules.<sup>205</sup>

---

<sup>200</sup> Cf. Sterk, *supra* note 27, at 1297 (providing an example of real-property search cost of hiring a lawyer to ascertain the extent of an easement).

<sup>201</sup> For instance, one of the various REIT asset tests, I.R.C. § 856(c)(4)(B)(iii)(II) (2006), requires that to qualify as a REIT, “the trust [cannot] hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer.” I.R.S. Priv. Ltr. Rul. 9237022 (June 12, 1992) demonstrates how factual changes outside a REIT’s control can cause unwitting violations of this test.

<sup>202</sup> See Shamik Trivedi, *Written Procedures Critical to Post-Issuance Compliance*, *Bond Attorneys Say*, 133 *Tax Notes* 293 (Oct. 17, 2011).

<sup>203</sup> Steffen N. Johnson, *Of Politics and Pulpits: A First Amendment Analysis of IRS Restrictions on the Political Activities of Religious Organizations*, 42 *B.C. L. Rev.* 875, 899 (2001).

<sup>204</sup> Cf. Sterk, *supra* note 27, at 1318 (explaining that search costs are less of an argument for jettisoning property rules when search costs are low).

<sup>205</sup> Cf. Smith, *Property*, *supra* note 24, at 1754 (noting that liability rules may be better for high-stakes borderline disputes).

Congress should identify the requirements currently protected by status-loss that create particularly high compliance costs and move to liability rules. Such a move makes the economic “pie” bigger, while compensating the government when violations happen.

### *B. Encouraging Efficient Transactions*

Property rules can discourage taxpayers from engaging in some economically efficient transactions that they would otherwise engage in if a liability rule were used. The following two Subsections illustrate the two basic circumstances where liability rules can encourage economically efficient transactions.

#### *1. Allowing Efficient Violations of Requirements by Setting a “Price”*

In contract law, liability-rule protection dominates, giving promisors incentives to intentionally breach contracts when doing so is economically efficient.<sup>206</sup> Liability rules thus make the economic “pie” bigger, while ensuring that the promisee is compensated for the breach.<sup>207</sup> Similarly, using liability rules to protect tax-status requirements may make sense in the many instances when violating a requirement is economically efficient. Liability rules in tax make the economic “pie” bigger, while ensuring that the government is no worse off.

The unrelated business income tax (UBIT) discussed earlier is a perfect example.<sup>208</sup> Whenever a public charity’s activities violate the requirement that it be “operated exclusively” for an exempt purpose,<sup>209</sup> the UBIT collects the same tax revenues that would be generated if a for-profit corporation had undertaken the activities. This liability rule allows public charities to participate in ventures that make the “pie” bigger by minimizing transaction costs or taking advantage of synergies with their exempt activities. For example, the UBIT allows university endowments to invest directly in business ventures resulting from faculty innovations, and it allows art-museum gift shops to sell non-art souvenirs.<sup>210</sup> It allows

---

<sup>206</sup> See Ayres, *supra* note 7, at 12.

<sup>207</sup> *Id.* at 11–12.

<sup>208</sup> See *supra* notes 168–73.

<sup>209</sup> I.R.C. § 501(c)(3) (2006).

<sup>210</sup> See *supra* note 172 and accompanying text.

senior centers to sell senior-friendly appliances<sup>211</sup> and allows youth centers to offer miniature golf courses.<sup>212</sup>

Such efficient breaches would generally not occur if the relevant requirements were protected by property rules, which aim to deter any violation by setting damages much higher than the harm to the government. Congress should consider using a liability rule whenever breaching a requirement can make the “pie” bigger.

## 2. Preventing Ambiguity from Discouraging Efficient Transactions

The previous Subsection observed that liability rules encourage efficient breach of *clear* requirements. This Subsection argues that liability rules also encourage efficient transactions where it is *unclear* whether a transaction violates a requirement.

Taxpayers will take an action that arguably violates a tax-status requirement whenever the expected non-tax benefit<sup>213</sup> exceeds the expected tax cost, which is the probability that the action violates a requirement, multiplied by the penalty for violation. Status-loss is a high penalty, meaning that the expected tax cost of an action will be so high that few actions have sufficient non-tax benefit to be worthwhile under this cost-benefit analysis. The beneficial actions that taxpayers do not take because of these risks are deadweight losses to society. By contrast, a liability rule sets the penalty equal to the government’s harm, so the expected tax cost equals expected harm to the government. Thus, a liability rule causes taxpayers to properly balance their non-tax benefit against the expected harm to the government.

A straightforward hypothetical illustrates this advantage of liability rules over property rules. Suppose a REIT expects to get \$50 million in tax benefits from qualifying as a REIT over the next five years. (REIT status-loss generally remains effective for five years.<sup>214</sup>) The REIT is considering an economically efficient asset sale that would generate \$1

---

<sup>211</sup> Rev. Rul. 81-62, 1981-1 C.B. 355 (providing an example where a senior-citizen center had UBIT on income from selling heavy-duty appliances, which “generally spares aged persons only an infrequent inconvenience”).

<sup>212</sup> Rev. Rul. 79-361, 1979-2 C.B. 237 (providing an example where a charitable organization providing for the welfare of young people was subject to UBIT on income from operating a miniature golf course).

<sup>213</sup> Of course there may be non-tax costs as well. For simplicity, non-tax costs are assumed to have already been subtracted from non-tax benefits.

<sup>214</sup> I.R.C. § 856(g)(3).

million in profit, but which has a 20% chance<sup>215</sup> of being a prohibited transaction.<sup>216</sup> If prohibited transactions resulted in status-loss, the expected tax cost of the sale would be \$10 million (that is, 20% of \$50 million), vastly exceeding the \$1 million in benefit. The economically efficient sale will not occur.

But, in actual fact, REIT prohibited transactions incur a liability rule, specifically a 100% excise tax on the net income from the prohibited transaction.<sup>217</sup> The expected tax cost is therefore only \$200,000 (that is, 20% of \$1 million). Because this is less than the \$1 million in benefits from the sale, the sale will occur, to society's benefit. In this way, whenever a requirement potentially generates ambiguity, moving from status-loss to a liability rule prevents the ambiguity from generating a deadweight loss. This provides another reason for Congress to move to liability rules for ambiguous requirements.<sup>218</sup>

The detriment from using status-loss to protect ambiguous requirements is not limited to purely economic matters. Samuel Brunson has observed that the ambiguous no-political-participation requirement—which is protected by status-loss—often causes a charity to “restrict its behavior more than the tax law requires, and miss the chance to do some things that are permissible and would further its exempt purpose.”<sup>219</sup> Such missed chances would be minimized by instead using a liability rule.

### C. Deterrence

Property rules are, by definition, intended to deter violations by setting a high penalty.<sup>220</sup> This Section argues—counterintuitively—that status-loss may actually be *less* effective in deterring violations than a liability rule in many circumstances. Status-loss is often a draconian remedy, and the IRS hesitates to impose it.

---

<sup>215</sup> See Weisbach, *supra* note 191, at 873 (stating that when contemplating a transaction, “the taxpayer only knows probabilities”).

<sup>216</sup> See I.R.C. § 857(b)(6). Whether a sale is a prohibited transaction depends on the highly ambiguous determination of whether the property being sold is “inventory.” See *id.* § 1221.

<sup>217</sup> *Id.* § 857(b)(6)(A).

<sup>218</sup> See *supra* Section II.A (discussing how liability rules substantially reduce compliance costs for ambiguous requirements).

<sup>219</sup> Samuel D. Brunson, *Reigning in Charities: Using an Intermediate Penalty to Enforce the Campaigning Prohibition*, 8 *Pitt. Tax Rev.* 125, 155 (2011).

<sup>220</sup> See Ayres, *supra* note 7, at 13 (“Property rules protect entitlements by trying to *deter* others from taking.”); Calabresi & Melamed, *supra* note 1, at 1092.

Consider the All Saints Church investigation. Two days before the 2004 presidential election, the sermon delivered at All Saints was “If Jesus Debated Senator Kerry and President Bush,” which critiqued President Bush for the war in Iraq and inaction on poverty.<sup>221</sup> The next day, the *Los Angeles Times* ran a front-page story discussing the sermon,<sup>222</sup> and the IRS soon issued a summons requesting information relevant to the sermon and All Saints Church’s tax-exempt status as a public charity.<sup>223</sup> The church refused even to comply with the summons,<sup>224</sup> and the IRS ultimately imposed no remedy at all.<sup>225</sup>

The All Saints Church investigation neatly exemplifies the problems of protecting a requirement solely with status-loss. The IRS has taken away a church’s status only once,<sup>226</sup> with a church that ran full-page newspaper ads in 1992 specifically advocating Bill Clinton’s defeat.<sup>227</sup> In a less egregious case, such as the sermon at All Saints Church, taking away public charity status would be a disproportionate remedy. Status-loss would also bring public-relations and political costs to the IRS vastly outweighing any benefit from increased tax revenue. The IRS’s mere investigation provoked a stern letter to the IRS from the congressman representing All Saints Church’s district.<sup>228</sup> The letter suggested a con-

---

<sup>221</sup> George F. Regas, Rector Emeritus, All Saints Church, *If Jesus Debated Senator Kerry and President Bush*, *Tax Notes Today*, Oct. 31, 2004, LEXIS, 2005 TNT 215-27.

<sup>222</sup> Josh Getlin, *The Race for the White House: Pulpits Ring with Election Messages*, *L.A. Times*, Nov. 1, 2004, at A1.

<sup>223</sup> Summons from Internal Revenue Service, Tax Exempt and Government Entities Division, to All Saints Church, *Tax Notes Today*, June 9, 2005, LEXIS, 2005 TNT 228-16.

<sup>224</sup> Stephanie Strom, *I.R.S. Inquiry Into Sermon Is Challenged by Church*, *N.Y. Times*, Sept. 22, 2006, at A15. This forced the IRS either to request a court to enforce the summons, or to abandon the case.

<sup>225</sup> Letter from Marsha A. Ramirez, Director, Exempt Organization Examinations, to Marcus S. Owens, Attorney for All Saints *Tax Notes Today*, Sept. 10, 2007, LEXIS, 2007 TNT 186-24.

<sup>226</sup> Benjamin Vaughn, Note, *The High Cost of Free Exercise: All Saints, The Service, and Section 501(c)(3)*, 61 *Tax Law.* 981, 993 (2008); see IRS, 2006 Political Activities Compliance Initiative at 5 (2007), available at [http://www.irs.gov/pub/irs-tege/2006paci\\_report\\_5-30-07.pdf](http://www.irs.gov/pub/irs-tege/2006paci_report_5-30-07.pdf) (suggesting zero churches had final or proposed status-revocations).

<sup>227</sup> *Branch Ministries v. Rossotti*, 211 F.3d 137, 145 (D.C. Cir. 2000) (upholding the IRS revocation of the church’s tax exempt status; rejecting numerous First Amendment and statutory arguments), *aff’g*, 40 F. Supp. 2d 15, 16 (D.D.C. 1999); cf. Vaughn E. James, *Reaping Where They Have Not Sowed: Have American Churches Failed to Satisfy the Requirements for the Religious Tax Exemption?*, 43 *Cath. Law.* 29, 47 (2004) (“[T]he Service and the courts have not stringently enforced [section 501(c)(3)’s lobbying and campaigning] limitations . . .”).

<sup>228</sup> See Letter of Rep. Adam B. Schiff to Mark W. Everson, Commissioner of Internal Revenue, and John W. Snow, Secretary of the Treasury (Nov. 15, 2005), *in* Summons from

gressional inquiry might be warranted.<sup>229</sup> Actually imposing status-loss on All Saints would have created severe headaches for the IRS.

This problem with protecting a requirement solely with status-loss is hardly limited to churches, as shown by the example of Care Investment Trust, a REIT that had its initial public offering (IPO) in 2007.<sup>230</sup> One of the requirements for REIT qualification is having shares that are “transferable.”<sup>231</sup> But Care Investment Trust had its IPO with over 36% of its shares subject to lock-up agreements,<sup>232</sup> meaning the REIT failed the “transferable” requirement.<sup>233</sup>

This requirement—just like the requirement that public charities not intervene in politics—is protected only by status-loss. The IRS could strip the REIT of its status or do nothing.<sup>234</sup> The IRS did nothing, and Care Investment Trust suffered no consequences from its blatant violation. Taking away the status of a publicly traded REIT such as Care Investment Trust would severely impact its shareholders, many (or all) of whom would contact their congressperson. The status-loss would make the financial press. And the National Association of Real Estate Invest-

---

Internal Revenue Service, Tax Exempt and Government Entities Division, to All Saints Church, Tax Notes Today, June 9, 2005, LEXIS, 2005 TNT 226-32.

<sup>229</sup> *Id.*

<sup>230</sup> See Care Investment Trust Inc., Prospectus, SEC Registration No. 333-141634 (June 22, 2007), available at <http://www.sec.gov/Archives/edgar/data/1393726/000095013607004365/file1.htm> [hereinafter “CIT Prospectus”].

<sup>231</sup> I.R.C. § 856(a)(2) (2006) (requiring “the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest”).

<sup>232</sup> CIT Prospectus, *supra* note 230, at cover page (“CIT Group, through our Manager and CIT Holding, will own approximately 36.1% of our outstanding common stock.”); *id.* at 13 (chart of ownership); *id.* at 110 (describing the extremely complete lock-up that the CIT Group agreed to with the underwriters to prevent transferability).

<sup>233</sup> Case law and IRS guidance had interpreted the “transferable” requirement leniently, to allow some small percentage of the stock to be locked up for purposes like employee stock options and underwriting. Specifically, the transferable requirement was leniently interpreted to require that only “substantially all” of the stock be transferable. *Zuckman v. United States*, 524 F.2d 729, 742 (Ct. Cl. 1975); I.R.S. Priv. Ltr. Rul. 9534022 (May 31, 1995) (stating “a small percentage of the stock” was not transferable); I.R.S. Priv. Ltr. Rul. 9747034 (Aug. 25, 1997) (“a small percentage of the stock”); I.R.S. Priv. Ltr. Rul. 9613018 (Dec. 27, 1995); I.R.S. Priv. Ltr. Rul. 9440026 (July 11, 1994) (“a small percentage of the stock”). “Substantially all” generally means 90%, but may mean as little as 80% or 70% in unusual situations. See Rev. Proc. 95-10, 1995-1 C.B. 504. But Care Investment Trust fell very far short of any of these, with only 63.9% of its shares being transferable. See *supra* note 232.

<sup>234</sup> The IRS does have the power to impose a \$50,000 fine on Care Investment Trust if the violation is “due to reasonable cause and not due to willful neglect.” I.R.C. § 856(g)(5). This fine is negligible compared to the IPO’s \$225 million value. Moreover, it is doubtful that such a clear violation would be “due to reasonable cause.”

ment Trusts (NAREIT), the REIT trade organization,<sup>235</sup> would bring political pressure on the IRS to reverse itself.

### *1. Model of IRS Utility*

This Subsection builds a simple model of the IRS's utility that attempts to explain the IRS's behavior in cases such as All Saints Church and Care Investment Trust. The utility functions used in this model are ultimately only examples, but they demonstrate why status-loss may often provide a less effective deterrent than a liability rule.

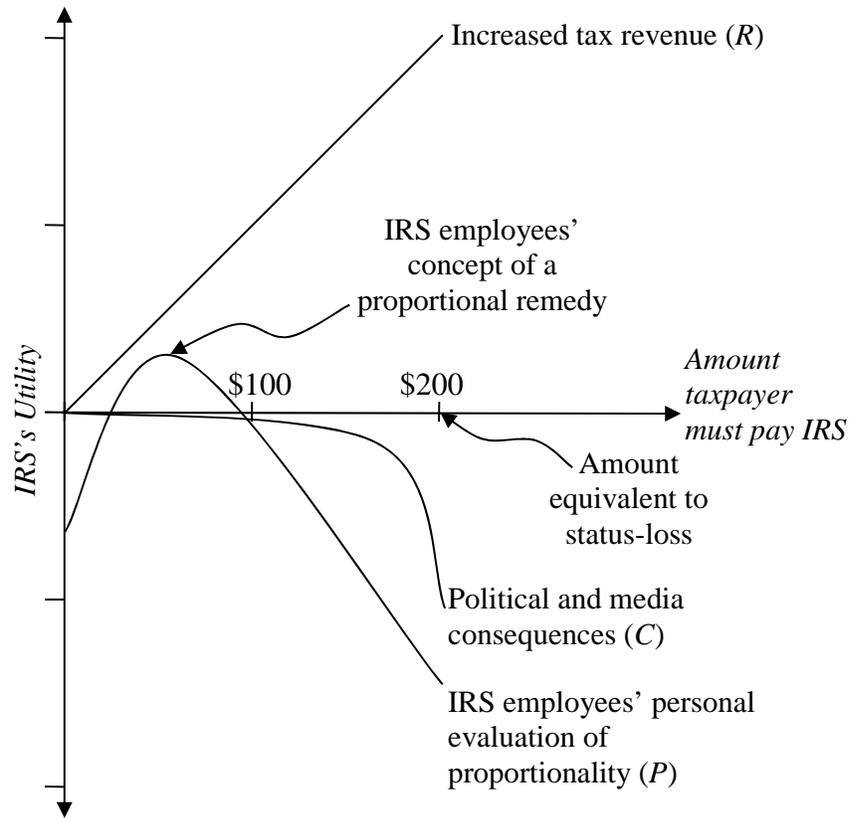
Assume that the taxpayer, who has violated a requirement, derives total value of \$200 from the tax status.<sup>236</sup> During negotiations on the proper remedy for the violation, there is a range of settlement amounts the taxpayer could reach with the IRS—anywhere from \$0 up to \$200. If the IRS demanded \$200 or more, the taxpayer would rationally abandon the status. In other words, \$200 is the precise equivalent to the taxpayer of status-loss.

Three factors contribute to the IRS's utility (specifically, the utility of IRS employees, such as agents, attorneys, and supervisors) as a function of the amount the IRS requires the taxpayer to pay in order to retain its status: utility *R* from collecting the additional revenue; utility *P* corresponding to the IRS employees' sense of the proportionality of the remedy to the gravity of the violation; and utility *C* consisting of pressure from Congress, executive-branch political appointees, and the media from having imposed the remedy. Examples of these three curves are below.

---

<sup>235</sup> NAREIT frequently lobbies the IRS regarding REIT tax qualification matters. See, e.g., NAREIT, 2011–2012 Guidance Priority List Recommendations, Tax Notes Today, May 26, 2011, LEXIS, 2011 TNT 109-25; Letter from NAREIT to Treasury and IRS, Tax Notes Today, Feb. 3, 2011, LEXIS, 2011 TNT 38-21.

<sup>236</sup> Total value includes both direct and indirect tax benefits. For example, in the case of a public charity, total value from the status would include: (1) direct financial benefits from not paying income taxes; *plus* (2) the donations it receives because donors can deduct donations from their own tax returns; *plus* (3) intangible benefits from the government's recognition of not having a profit motive.

**Figure 1: Components of IRS's Utility**

$R$ , for revenue, is simple. The IRS is a revenue-collection agency, and increased revenue generates increased utility.<sup>237</sup>

$P$  takes the shape it does because IRS employees, like all humans, have a natural sense of proportionality.<sup>238</sup> When a taxpayer who violates

<sup>237</sup> Potentially  $R$  would reflect declining marginal utility from each additional dollar collected. But the IRS collects from such a vast number of taxpayers that this decline is irrelevant to any individual taxpayer. Hence  $R$  can be assumed to be a straight line.

<sup>238</sup> See Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norms Problem*, 67 U. Chi. L. Rev. 607, 612 fig.2 (2000) (reflecting a nearly identical function  $P$ , representing utility as a function of severity of remedy); *id.* at 612 n.5 (gathering citations for experimental research from social sciences justifying the notion that humans have an intuitive sense of proportionality).

a requirement pays only \$0, this result is inequitable, undermines compliance, and hence gives the IRS negative utility. As the remedy increases, the IRS's utility becomes positive and increases until it reaches its peak at the remedy that the IRS views as proportional to the violation. This peak will be further to the right for graver violations, and further to the left for more minor violations. Beyond this peak, higher remedies become increasingly disproportionate, decreasing IRS utility, which eventually becomes negative.<sup>239</sup> By the time the remedy reaches \$200 (the equivalent of status-loss), utility is strongly negative. Status-loss is tax law's equivalent of a forfeiture, which is generally recognized as being abhorrent or, at a minimum, highly distasteful.<sup>240</sup> Status-loss is particularly draconian when imposed for minor violations.<sup>241</sup>

Several factors backstop the IRS's desire for proportionality. Many IRS employees plan to eventually move to law or accounting firms, giving an incentive to avoid reputations for being unduly harsh to taxpayers (for example, "when A was at IRS she was responsible for actually revoking a REIT's status," or "B extracted a massive settlement from a pension when he was at IRS"). Additionally, the harsher the penalty the IRS is seeking, the greater the likelihood that a judge or jury<sup>242</sup> will find wiggle room to avoid imposing any penalty at all,<sup>243</sup> undermining tax

<sup>239</sup> One practitioner has observed:

[IRS District] Counsel's position is that the importance of litigation to the administration of the tax law is not measured by the amount of taxes collected through litigation, but rather by the effect that a position taken by the IRS in litigation has on the shape and development of the tax law. Accordingly, it is Counsel's position that the position taken in a case must be one that is reasonable on the facts in the case *and* one which makes the maximum contribution to a sound tax system.

Charles W. Hall, *IRS Controversies at Audit and Beyond*, William & Mary Annual Tax Conference Paper 210, at 29 (Dec. 1, 1990), available at <http://scholarship.law.wm.edu/tax/210>.

<sup>240</sup> *People v. Ranger Ins. Co.*, 78 Cal. Rptr. 2d 763, 765 (Cal. Ct. App. 1998) ("Because the law abhors forfeitures, these statutes are to be strictly construed . . ."); *Fifty States Mgmt. Co. v. Pioneer Auto Parks, Inc.*, 389 N.E.2d 113, 116 (1979) ("[E]quity abhors forfeitures.").

<sup>241</sup> *Perdue*, supra note 112, ¶ 19.02[2][a] (stating "in view of the complexities of the qualification rules, disqualification often seemed a *draconian* response to many relatively minor violations" (emphasis added)).

<sup>242</sup> Tax refund suits brought in district court may be tried to a jury. 28 U.S.C. § 2402 (citing 28 U.S.C. § 1346(a)(1)) (2006); see also Saltzman, supra note 147, ¶ 1.05[2][a].

<sup>243</sup> See, e.g., *Cherry-Burrell Corp. v. United States*, 367 F.2d 669 (8th Cir. 1966) (Blackmun, J.) (forgiving clear violation of requirement based on statute's "purpose"). Professor Kontorovich notes a similar trend in constitutional law, where only property-rule remedies are typically available to judges to vindicate constitutional rights. Kontorovich, supra note 3, at 780. In many instances where there has been a constitutional violation but where a

administration and creating IRS-unfavorable precedent. For example, a determined court certainly would have had wiggle room to avoid finding that the All Saints Church sermon violated the ambiguous no-political-participation requirement.<sup>244</sup>

C, the third of the three factors in this model, reflects the congressional, political-appointee, and media pressure that comes with increasingly harsh remedies.<sup>245</sup> Although no empirical data exists on requirement violations in particular, there have been studies testing whether Congress and executive-branch political appointees impact IRS behavior on easy-to-measure audit rates.<sup>246</sup> These studies demonstrate that audit rates are lower in districts of members of the Senate and House committees that oversee the IRS, as well as in presidential-election swing states. Congresspersons regularly intervene with the IRS on behalf of constituents and donors, and some congresspersons even advertise on their websites that they can help constituents who have “problems” with the IRS.<sup>247</sup> A taxpayer at risk of status-loss or of paying a disproportionately large settlement to the IRS would be well advised to contact their congressperson. Recall that the congressperson representing All Saints Church’s district wrote a stern letter to the IRS.<sup>248</sup> The media also plays a role: Past media accounts of IRS “horror stories” have led to congressional hear-

---

property-rule remedy would be too drastic, Kontorovich observes that courts have contorted themselves to avoid finding a constitutional violation. *Id.* at 780–86.

<sup>244</sup> See Letter from All Saints Church’s Attorney to IRS, *Tax Notes Today*, Oct. 11, 2005 LEXIS 2005 TNT 215-13 (summarizing legal arguments).

<sup>245</sup> Cf. Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 *Yale L.J.* 1165, 1167 (1993) (noting that the IRS and Treasury are not immune from political pressures or interest group influence).

<sup>246</sup> William J. Hunter & Michael A. Nelson, *Tax Enforcement: A Public Choice Perspective*, 82 *Pub. Choice* 53, 54 (1995); Marilyn Young et al. *The Political Economy of the IRS*, 13 *Econ. & Pol.* 201, 202 (2001); see also Eugenia Froedge Toma & Mark Toma, *A Congressional Control Model of Treasury Revenue Collection*, 53 *S. Econ. J.* 141, 149 (1986) (using time series data to demonstrate that tax-collection appropriations move in opposite directions from higher marginal tax rates).

<sup>247</sup> Young et al., *supra* note 246, at 204. An interesting question, well outside the scope of this Article, is the degree to which the IRS and Congress engage in Coasean bargaining over a particular taxpayer’s treatment. For example, in return for not imposing status-loss on a favored donor to a Member of the House Ways & Means Committee, the IRS might get a desired tweak to the tax code. A further interesting question is whether status-loss or liability rules better facilitate Coasean bargaining (if any) between the IRS and Congress.

<sup>248</sup> Letter of Rep. Adam B. Schiff, *supra* note 228.

2013]

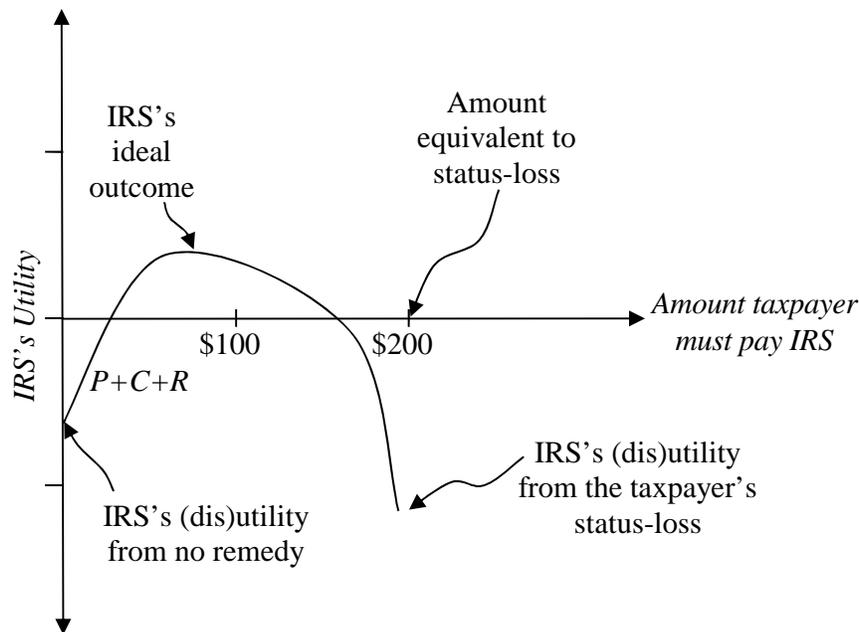
*Tax in the Cathedral*

1207

ings and legislation aimed to curtail IRS powers and practices.<sup>249</sup> As a result,  $C$ , the utility from political and media harm generally<sup>250</sup> starts at zero for a \$0 penalty, and goes down from there. The closer the penalty gets to status-loss, the greater the grist for complaints to congresspersons and the media, causing  $C$  to decline more rapidly.<sup>251</sup>

The utility functions  $R$  (revenue),  $P$  (proportionality), and  $C$  (political and media pressure) in Figure 1 are, as noted earlier, just examples. Adding all three together yields an example of the IRS's total utility function, depicted below in Figure 2:

**Figure 2: IRS's Total Utility**



<sup>249</sup> See, e.g., Creighton R. Meland, Jr., Note, Omnibus Taxpayers' Bill of Rights Act: Taxpayers' Remedy or Political Placebo?, 86 Mich. L. Rev. 1787, 1787-88 (1988) (contending that taxpayer horror stories led to the passage of IRS-restraining legislation).

<sup>250</sup> The  $C$  curve depicted here is an example intended to reflect most cases, and could be markedly different. For example, the  $C$  curve might even be increasing if Congress or the media were calling for the IRS to punish a perceived abuse.

<sup>251</sup> Additionally, the IRS often will not know the precise value of the tax status to the taxpayer (assumed here to be \$200), which is the penalty at which the taxpayer rationally abandons the status. This uncertainty makes  $C$  decline even faster as it approaches the approximate value of the tax status.

This figure demonstrates graphically why, in many cases, including All Saints Church and Care Investment Trust, status-loss is less effective in deterring a violation than a liability rule. Due to the downward slope in  $P$  (proportionality) and  $C$  (political and media pressure), the IRS's utility is higher at \$0 (no remedy) than at \$200 (which is equivalent to status-loss). In these circumstances, the threat of status-loss is not credible and fails to deter.

When a tax status is protected solely by a property rule, the IRS faces an unpleasant dilemma if it cannot reach a settlement with the taxpayer: It can let the violation go entirely unpunished, or it can take away the status. In such situations, a leading treatise likens the IRS to "a prosecutor who can win conviction only by persuading a jury to impose the *death penalty*; the prosecutor is reluctant to prosecute where the penalty is obviously excessive."<sup>252</sup> When the IRS's only option is status-loss, it often imposes no remedy at all.<sup>253</sup>

By contrast, liability rules require the taxpayer to compensate the government for harm from the violation. As a result, liability-rule penalties are proportional to the harm and are at or near the peak of  $P$  (the proportionality utility curve). Moreover, it is hard for politicians or the media to get worked up about a penalty that merely compensates the government, meaning  $C$  is not terribly negative. All told, a liability rule will generally be at or close to the amount that maximizes the IRS's total utility, making it quite credible that the IRS will impose the liability rule on a taxpayer who violates a requirement. In this way, liability rules may provide *some* deterrence while status-loss provides *none*.

Would All Saints Church and Care Investment Trust have been as cavalier if the requirements at issue had been protected by liability rules? Probably not.

Status-loss is even less credible when it would harm third parties.<sup>254</sup> Imposing status-loss on a university would harm students by reducing

---

<sup>252</sup> Bittker & Lokken, *supra* note 107, ¶ 15.1 (emphasis added) (discussing the result of violating tax-exempt municipal bond requirements protected solely by status-loss).

<sup>253</sup> In some cases, the IRS may be willing to suffer the lower utility of status-loss with respect to one taxpayer if that increases utility across all taxpayers. For example, by taking away one taxpayer's status, the IRS may find that it has credibility to negotiate intermediate penalties that maximize its utility with the next 100 taxpayers. See, e.g., *Fazi v. Comm'r*, 102 T.C. 695, 706 (1994) (ruling that a qualified retirement plan lost its status).

<sup>254</sup> Courts have long considered third parties' interests in deciding between property rules and liability rules. For example, in *Madison v. Ducktown Sulphur, Copper & Iron Co.*, cited in Calabresi and Melamed's path-breaking article, *supra* note 1, at 1120 n.60, the owners of

the university's economic resources. Status-loss for a homeless shelter would reduce resources available to help the homeless. Additionally, donors would lose the deductibility of their donations.<sup>255</sup> Status-loss for a REIT would harm its shareholders. Status-loss for a retirement plan diminishes workers' retirement assets and leads them to have higher current tax bills.<sup>256</sup> Anecdotal evidence confirms that the IRS avoids status-loss that harms third parties. For example, the head IRS official in charge of auditing qualified retirement plans recently told the audience at an ABA event that the IRS is "very passionate about keeping qualified plans qualified."<sup>257</sup>

When third parties would be harmed, *P* (proportionality utility) is even more negative at the point of status-loss, because the third parties exacerbate the lack of proportionality. Similarly, *C* (political and media pressure) is even more negative as the harmed third parties complain to their congresspersons and the media. As a result, when status-loss harms third parties, the IRS's total utility from imposing status-loss is even more negative, and status-loss is even less credible as a deterrent.

## 2. *Contrasted with Nuisance Dispute*

How is it that status-loss can ever deter violations less than a liability rule? The answer lies in the IRS's utility curve compared to a normal private litigant's utility curve.

Consider the nuisance scenario where a factory's pollution harms a neighboring resident. Assume that the factory's utility from the polluting activity is \$200, while the neighbor's utility in having pollution-free air is only \$50. Figure 3 below illustrates the neighbor's utility on the vertical axis, as a function of the factory's damages (either court ordered or in a settlement) on the horizontal axis. Just like Figure 2 earlier, this figure graphs utility as a function of amount paid. But the function's shape is very different.

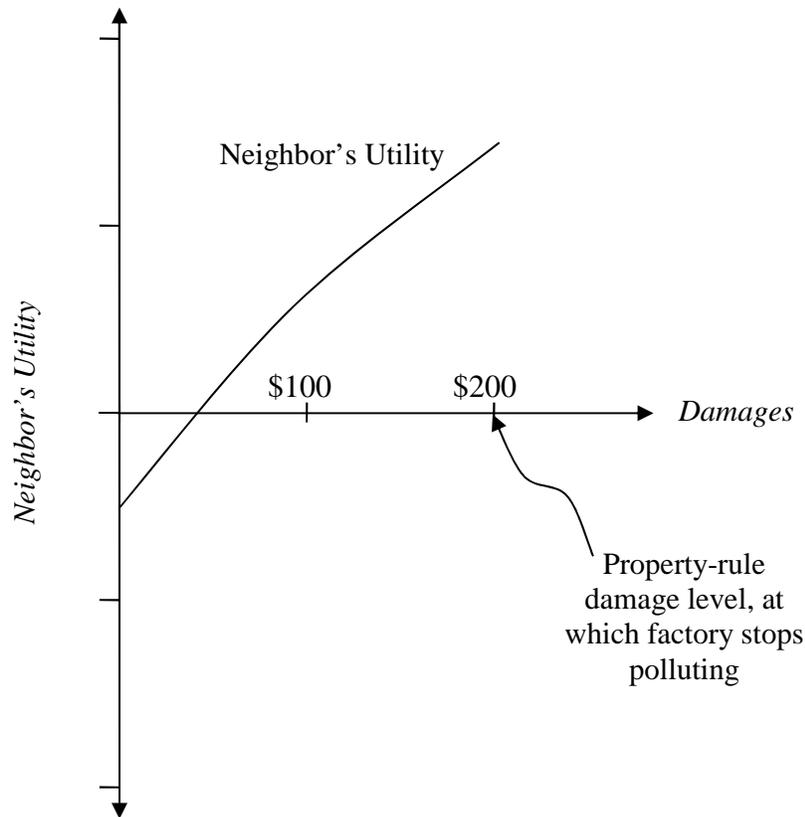
---

land worth \$1,000 sought an injunction (property-rule protection) against a mining operation that was a nuisance but employed over a thousand workers and brought substantial revenue to the locality. 83 S.W. 658, 660 (Tenn. 1904). But the court awarded only damages (a liability rule), relying heavily on the interests of the third parties that would be affected. *Id.* at 666 (asking rhetorically whether the court should issue an injunction that would "destroy half of the taxable values of a county, and drive more than 10,000 people from their homes").

<sup>255</sup> I.R.C. § 170 (2006).

<sup>256</sup> See generally Perdue, *supra* note 112, ¶ 19.02.

<sup>257</sup> Matthew Dalton & Shamik Trivedi, *Employee Plan Compliance Remains in IRS Sights, Official Says*, 132 Tax Notes 797, 798 (Aug. 22, 2011).

**Figure 3: Nuisance**

The higher the damages paid to the neighbor, the more utility the neighbor receives.<sup>258</sup> In other words, an extra dollar from the factory always increases the neighbor's utility. If the neighbor can obtain an injunction or disgorgement of the factory's profits (\$200), the neighbor will rationally do so.

By contrast, back in Figure 2, the IRS's utility as a function of the amount paid by the taxpayer increases, reaches a maximum, and then decreases. The IRS has considerations other than just maximizing revenue, including political and media pressure and proportionality.

<sup>258</sup> The slight curve in the utility function in Figure 3 reflects the diminishing marginal utility of money to the resident. The degree of decline in marginal utility varies from person to person.

### *3. Feedback from Enforcement or Non-Enforcement*

Professor Dan Kahan notes that when decision makers see a particular rule being enforced by other decision makers, they are more likely to enforce it themselves.<sup>259</sup> Conversely, when decision makers see a rule not being enforced, they are less likely to enforce it themselves.<sup>260</sup> This explains why remedies seen as draconian (which he calls “hard shoves”) are not enforced: Decision makers shy away from enforcing the rule, which further discourages other decision makers from enforcing it.<sup>261</sup> By contrast, remedies only slightly above a proportionate response (which he calls “gentle nudges”) are more likely to be enforced, allowing a general increase in enforcement over time. Examples of areas where “gentle nudges” successfully increased enforcement over time include antismoking regulations<sup>262</sup> and sexual harassment.<sup>263</sup>

Kahan’s basic insight likely applies to IRS employees as well. When IRS employees see their colleagues imposing no remedy for violations where the only remedy is status-loss, they may become more likely to do the same. Status-loss is a “hard shove” towards compliance,<sup>264</sup> and often fails to promote compliance because IRS employees see it as too draconian.

#### *D. Improving Taxpayer-IRS Negotiation*

When the IRS audits a taxpayer and discovers a gray area, the result in most cases is a settlement for some percentage of the potential taxes at stake.<sup>265</sup> This Section considers how liability rules can facilitate equitable settlements after violations of tax-status requirements have occurred.

---

<sup>259</sup> Kahan, *supra* note 238, at 613.

<sup>260</sup> *Id.*

<sup>261</sup> See *id.* at 616–17.

<sup>262</sup> *Id.* at 625–28.

<sup>263</sup> *Id.* at 634–40.

<sup>264</sup> Professor Samuel D. Brunson has observed that status-loss as a remedy for the no-campaigning requirement for public charities is a “hard shove.” Brunson, *supra* note 219, at 152. In its place, Brunson forcefully advocates an “intermediate penalty that gently nudges” public charities towards compliance. *Id.* at 169; see also *id.* at 159–68. This “intermediate penalty” is a liability-rule remedy, although Brunson does not identify it as such.

<sup>265</sup> Saltzman, *supra* note 147, ¶ 9.01 (“Appeals officers negotiate and in about 85 to 90 percent of the cases settle with taxpayers.”); *id.* ¶¶ 9.07–9.09.

### 1. *Encouraging Settlements to Happen*

Scholars have identified numerous reasons why liability rules may encourage negotiated solutions better than property rules, which exacerbate the problems created by “close-mouthed, pokerfaced, strategically bargaining” parties.<sup>266</sup> Many of liability rules’ negotiation benefits come from providing an intermediate value as a starting point for negotiation, thereby curtailing strategic bargaining and transaction costs. These benefits apply in tax law.

But the considerations (discussed in Section II.C above) that can make status-loss fail to deter violations from happening in the first place also worsen the scope for taxpayers to strategically bargain after the violation has occurred. The IRS’s hesitation to impose status-loss allows a taxpayer to “play chicken”<sup>267</sup> with the IRS by walking away from its last offer and daring the IRS to impose status-loss—or impose no remedy at all.

By contrast, liability rules are more proportionate and generate less political or media blowback. The IRS rarely hesitates to impose them. Protecting requirements with liability rules severely constrains taxpayers’ ability to “play chicken” or otherwise bargain strategically.

### 2. *More Consistent and Equitable Settlements*

When status-loss is the only remedy and negotiations *do* succeed in producing a settlement, similarly situated taxpayers may get much different settlements. Different taxpayers will have different IRS employees handling their cases. Some IRS employees will be much better negotiators than others, capturing much different portions of the wide negotiating range between \$0 and status-loss. Moreover, different IRS employees may have different concepts of a proportional remedy,<sup>268</sup> leading to different negotiating postures and different settlements.

---

<sup>266</sup> Rose, *supra* note 4, at 2184; see also *Walgreen Co. v. Sara Creek Prop. Co.*, 966 F.2d 273, 278 (7th Cir. 1992) (Posner, J.) (holding that property rules can “create[] a huge bargaining range” and “given such a bargaining range, [negotiations] might well be protracted and costly”); Ayres, *supra* note 7, at chs. 9 & 10; Ayres & Talley, *supra* note 24, at 1032–33.

<sup>267</sup> Cf. Ayres & Madison, *supra* note 136, at 62 (“By allowing the defendant to credibly threaten inefficient performance, disgorgement remedies may allow the defendant to bargain to pay substantially less.”). The fundamental differences between the IRS and the parties discussed in Ayres & Madison are discussed *infra* note 347.

<sup>268</sup> The most proportional remedy is the peak of the utility curve *P* discussed above in Subsection II.C.1.

Perhaps most troublingly, IRS employee negotiating postures will also be influenced by the political and media pressure that a taxpayer (and third parties like a REIT's shareholders or a church's parishioners) can bring to bear on the IRS.<sup>269</sup> As a result, wealthy and well-connected taxpayers will, on average, be able to negotiate more favorable settlements.

A liability-rule formula is set *ex ante*, before taxpayers know whether they will violate the requirement. This minimizes the opportunity for the wealthy and well connected to influence the formula through lobbying or public relations.<sup>270</sup> By contrast, when the negotiations are left wide-open by protecting a requirement with status-loss, the wealthy and well-connected can bring their political and media pressure to bear *ex post* to ensure the IRS negotiates a more lenient settlement. Liability rules thus minimize the role that a particular taxpayer's political or media influence plays in the settlement amount.

By having universal application, liability rules also minimize the impact that individual IRS employees' senses of proportionality have on the settlement. And, because they narrow the bargaining range, and because the IRS rarely hesitates to impose them, liability rules also minimize the impact of individual IRS employees' negotiating skill. In sum, Congress should recognize that liability rules lead to more consistent, fairer settlements than status-loss.

#### *E. Biased Liability Amounts*

Scholars have recognized that the benefits of liability rules dissipate if liability amounts are biased, being on average too high or too low.<sup>271</sup> Professor Henry Smith has observed that if liability rules are systematically set too low, then entitlements will be violated opportunistically even when doing so is economically inefficient.<sup>272</sup>

This same problem exists in tax law. As Professor David Weisbach has noted more generally, "Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take ad-

---

<sup>269</sup> Such pressure corresponds to the utility curve *C* discussed above in Subsection II.C.1. The shape of *C* influences the shape of the IRS's total utility curve, which in turn determines the IRS's negotiating posture.

<sup>270</sup> Cf. Ayres, *Optional Law*, *supra* note 7, at 199 (arguing that institutional considerations such as greater trust for different decision makers may influence the decision between property and liability rules).

<sup>271</sup> See, e.g., *id.* at 197; Kaplow & Shavell, *supra* note 3, at 730–32.

<sup>272</sup> Smith, *Property*, *supra* note 24, at 1743.

vantage of them.”<sup>273</sup> If the liability-rule amount is set below the level of harm the violation causes, then taxpayers may inefficiently violate the requirement through tax planning or negligence.

For example, the tax code imposes a flat \$50,000 addition to tax for certain REIT violations, regardless of harm to the Treasury or tax administration.<sup>274</sup> The average publicly traded REIT has a market capitalization of over \$2.5 billion,<sup>275</sup> meaning that this liability rule is almost certainly biased too low.

The possibility of bias in liability rules should weigh in favor of status-loss whenever Congress cannot be confident that the liability-rule formula is not biased too low. When liability rules are used, the formulas need to be carefully crafted. As a backstop, when Congress provides for liability rules, it should consider giving the IRS express rulemaking authority to fix any biases that emerge in the formulas.<sup>276</sup>

#### *F. Calculation Costs*

Scholars have observed that liability rules entail calculation costs (also called “assessment costs”) that property rules do not, thus weighing in favor of property rules.<sup>277</sup> For example, using a liability rule to protect residents’ entitlement to unpolluted air requires a court to calculate the harm caused by pollution. Using a liability rule to remedy the loss of someone’s arm in a car crash requires calculating the value of the arm and the time spent recuperating. Such calculations often involve costly expert testimony, attorney time, juror time, and court time, all of which are calculation costs. By contrast, an injunction requires little or no calculation costs.

In tax law as well, calculation costs can weigh against liability rules. Taxpayers, potentially the IRS, and even courts must calculate liability-rule amounts. As a closely related matter, putting liability-rule formulas into tax law requires making the tax code or Treasury regulations longer

---

<sup>273</sup> Weisbach, *supra* note 191, at 869.

<sup>274</sup> I.R.C. § 856(g)(5) (2006). The legislative history does not indicate why a flat fine was chosen. H.R. Rep. No. 108-755 (2004) (Conf. Rep.).

<sup>275</sup> See NAREIT, *supra* note 95, at 3.

<sup>276</sup> The “Rule 6” option discussed *infra* Section III.E and anti-abuse liability rule discussed *infra* Section III.A can also act as backstops, allowing the IRS to threaten status-loss in place of biased liability rules.

<sup>277</sup> Krier & Schwab, *supra* note 26, at 457–59; Smith, Property, *supra* note 24, at 1720. But see Ayres, *supra* note 7, at 189 (responding to Krier & Schwab’s assessment costs criticism of liability rules).

and more complex. Such concerns weigh towards status-loss instead of liability rules.

But tax law also provides unique opportunities for minimizing calculation costs, because liability-rule tax formulas can be based entirely on variables already quantified for accounting or tax purposes.<sup>278</sup> For example, one REIT requirement is that a REIT must have at least 100 shareholders.<sup>279</sup> This requirement is currently protected by status-loss. But a liability rule could be set to 1% of gross income for each shareholder below 100. A REIT with only 99 shareholders would thus pay 1% of its gross income. A REIT with only 98 shareholders would pay 2% of its gross income, and so on. Once the violation of the requirement is known, computing the liability amount is straightforward.

Tax is full of opportunities for similar easily calculated liability-rule formulas.<sup>280</sup> In the broader property and liability rule debate, Professors Kaplow and Shavell have noted that using such formulas to determine liability amounts (provided they are unbiased) harnesses many of the benefits of liability rules, while minimizing calculation costs.<sup>281</sup>

By contrast, it would be very difficult to craft a universally applicable formula for calculating the harm from polluted air or from losing an arm. Even if lawmakers could agree on such a formula, few of the inputs would already be quantified. In this way, tax law may provide opportunities to minimize liability-rule calculation costs not present in other areas of law.<sup>282</sup>

---

<sup>278</sup> Cf. Brunson, *supra* note 219, at 159–62 (proposing a penalty formula for public charities' political participation that involves several inputs that would not be previously calculated, thus failing to take advantage of tax law's potential calculation-cost advantages).

<sup>279</sup> I.R.C. § 856(a)(5).

<sup>280</sup> As an analogous example, consider the requirement for S-corporation status that no shareholders be nonresident aliens. *Id.* § 1361(b)(1)(C). If a shareholder accidentally becomes a nonresident alien, the current remedy is status-loss, which is disastrous for all shareholders. See *id.* § 1361(b)(3)(C) & (D). But a liability rule could simply impose a 100% tax on the foreign shareholder's pro-rata share of earnings, putting the burden on the taxpayer who is the lowest-cost avoider of the violation.

<sup>281</sup> Kaplow & Shavell, *supra* note 3, at 732.

<sup>282</sup> Tax law avoids calculation costs in additional ways. In many non-tax areas, there are multiple entitlement holders, such as when a polluting factory harms thousands of neighboring residents. Splitting up liability-rule amounts between multiple claimants can entail substantial calculation costs. By contrast, tax law has only one entitlement holder (the government) and thus avoids such calculation costs.

Counterintuitively, in some instances status-loss may even involve more calculation costs than a liability rule.<sup>283</sup> For example, taking away the tax-exempt status of a public charity requires an organization that had not previously recorded income and deductions to calculate those amounts. Moreover, as Professors Bittker and Rahdert have noted, calculating the income of many public charities would require addressing novel tax issues, such as whether donations are income.<sup>284</sup> Indeed, status-loss is less like an injunction, which requires few (if any) calculations, and more like disgorgement, a property-rule remedy that can require complicated calculations.<sup>285</sup>

In sum, liability rules in tax can result in substantial calculation costs, which can weigh against using them. But in many instances the calculation costs imposed by status-loss can also be nontrivial. Moreover, Congress can and should minimize liability rules' calculation costs by using straightforward formulas that draw on inputs that have already been quantified for accounting or tax purposes.

### *G. Non-Economic Concerns*

The considerations discussed above for deciding between property and liability rules relate primarily to maximizing economic efficiency. But scholars have identified noneconomic concerns that have a role to play in deciding between property and liability rules. For instance, Professor Margaret Jane Radin suggests that some belongings (for example, family heirlooms) are sufficiently tied up in their owners' "personhood" that they should be protected by property rules, even if liability rules were more economically efficient.<sup>286</sup> Similar noneconomic considera-

---

<sup>283</sup> Ayres, *supra* note 7, at 197 (noting that the administrative costs of liability rules in some instances may be lower than those of property rules). Another issue is that negotiating settlements that avoid status-loss may also incur significant calculation costs. Consider for example the IRS's extraordinarily calculation-heavy process for negotiating settlements with taxpayers who violate qualified retirement plan requirements protected by status-loss. Rev. Proc. 08-50, 2008-35 I.R.B. 464, § 1.03 (overview), § 5.01(5) (defining "Maximum Payment Amount"), 14.01(1)-(2) (using a multifactor test for "[d]etermination of sanction").

<sup>284</sup> Contributions could be either gross income or non-taxable contributions to capital. See Bittker & Rahdert, *supra* note 15, at 307-09, 313-14. But see Hansmann, *supra* note 15, at 59 (arguing that Bittker and Rahdert overstate the difficulties in calculating a nonprofit's net income).

<sup>285</sup> For example, for a factory to disgorge profits it makes from polluting, accountants must sort out the costs and revenues related to the polluting from those unrelated to the polluting.

<sup>286</sup> Margaret Jane Radin, *Property and Personhood*, 34 *Stan. L. Rev.* 957, 984-88, 1005-06 (1982).

2013]

*Tax in the Cathedral*

1217

tions, based on fundamental values, have a role in deciding whether to use a property rule or a liability rule to protect a tax-status requirement.

For example, whenever Congress protects a requirement for tax-exempt municipal bonds with status-loss, compliance is effectively mandated for state and local governments. Federalism may thus weigh in favor of protecting municipal-bond requirements with liability rules.

As another example, some would argue that the requirement that churches and other public charities not intervene in political campaigns should be protected by a property rule, reflecting a fundamental concern that civil society and religion should be kept out of the political sphere. But others might argue that the official recognition conferred by public charity status is part of the “personhood” of many organizations—particularly volunteer-driven public charities—and that liability rules are preferable, to minimize personhood deprivations.

A general theory of noneconomic considerations in tax law is beyond the scope of this Article. Some considerations weigh towards property rules, while others weigh towards liability rules. This is a promising area for future scholarship.

#### *H. Definitional Requirements*

Some requirements must be protected by status-loss for the tax status to be workable. For example, one REIT requirement is that it be a “corporation, trust, or association.”<sup>287</sup> This requirement must be protected by status-loss, since being an entity is an essential assumption of being a REIT; an individual being a REIT would be unworkable. Similarly, another REIT requirement is notifying the IRS that it elects REIT status.<sup>288</sup> This requirement must also be protected by status-loss to make the status administrable. No matter the benefits of liability rules, some core requirements must be protected by status-loss.

### III. BEYOND PLAIN PROPERTY AND LIABILITY RULES: NEW APPROACHES

Part II above drew on the property and liability-rule literature to identify considerations for Congress and other lawmakers to weigh in deciding whether a tax-status requirement should be protected by a property rule or a liability rule. Now, Part III goes further, outlining just a few of

---

<sup>287</sup> I.R.C. § 856(a) (2006).

<sup>288</sup> Id. § 856(c)(1); Treas. Reg. § 1.856-2(b) (1981); I.R.S. Form 1120-REIT (2012) (filing this form acts as the election).

the many novel tax-law remedies made possible by applying the property- and liability-rule scholarship to tax.

*A. Liability Rules Tailored to Probability of Detection*

Optimal deterrence is generally achieved by multiplying the harm to be deterred by a damage multiplier equal to one divided by the probability of detection.<sup>289</sup> For example, if a tort causes \$1 million in harm but has only a one-in-three probability of detection, damages should be set to \$3 million whenever the tort is detected.

Neither a liability rule nor status-loss will achieve optimal deterrence. Liability-rule penalties simply equal the harm, without the damage multiplier. Meanwhile, status-loss has no tailoring whatsoever for either the harm or the probability of detection. Often status-loss will impose a penalty vastly above the amount that results in optimal deterrence.<sup>290</sup>

Instead, optimal deterrence can be achieved using “risk-adjusted” liability rules, generally consisting of the “pure” liability-rule amount that compensates for the harm, times an optimal multiplier based on the probability of detection by the IRS. For example, suppose that a taxpayer violates a requirement, causing \$1 million in harm to the government, but that the probability of detection is only one-in-three. The taxpayer should owe \$3 million to the IRS if detected. This rule provides more optimal deterrence than either pure liability rules or status-loss.<sup>291</sup> It

---

<sup>289</sup> The idea of this sort of damage multiplier can be traced back at least two centuries. See Cesare Bonesana Beccaria, *An Essay on Crimes and Punishments* (M. De Voltaire trans., Albany, W.C. Little 1872) (1759); Jeremy Bentham, *A Theory of Legislation* (R. Hildreth trans., Boston, Weeks, Jordan, & Co. 1840); see also Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169, 184 (1968); Richard Craswell, *Damage Multipliers in Market Relationships*, 25 *J. Legal Stud.* 463, 463 (1996) (discussing the idea’s origins). The deterrence literature has been fruitfully applied by scholars to tax law. See, e.g., James Andreoni et al., *Tax Compliance*, 36 *J. Econ. Literature* 818, 823-24 (1998); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 *Colum. L. Rev.* 569, 576 (2006). Scholars have identified various upwards or downwards adjustments that may be appropriate to the 1-divided-by-probability-of-detection multiplier. See Craswell, *supra* at 465-78 (reviewing literature on adjustments).

<sup>290</sup> In rare circumstances (for example, low-value tax statuses or huge multipliers), it may be less.

<sup>291</sup> Professor Raskolnikov points out that the low probability of detection common in tax may result in risk-adjusted multipliers that are high, making the IRS hesitant to impose them, much as the IRS may hesitate to impose status-loss. Raskolnikov, *supra* note 289, at 597 n.117; see also *supra* Subsection II.C.1. But the IRS is still more likely to impose high risk-adjusted liability rules than status-loss, which is even more draconian. Risk-adjusted liability

builds on Kaplow and Shavell's observation that "the fully optimal rule may be neither one with extreme damages (that is, a property rule) nor one with damages equal to harm (that is, the conventional liability rule)."<sup>292</sup>

### *B. Pliability Rules*

Pliability rules are a straightforward but powerful extension of the property and liability rule concept. The term "pliability rule" was introduced by Professors Abraham Bell and Gideon Parchomovsky.<sup>293</sup> A "pliability rule" has three elements: "[1] a first stage rule (either property or liability), [2] a triggering event causing a shift between stages, and [3] a second stage rule," also either a property rule or a liability rule.<sup>294</sup>

One pliability rule is known to all first-year tort students, set out in the venerable tort cases *Ploof v. Putnam*<sup>295</sup> and *Vincent v. Lake Erie Transportation Co.*<sup>296</sup> A dock owner is normally allowed to exclude unwelcome boats, which is a property rule. But necessity, such as a dangerous storm, triggers a shift to a liability rule. During a storm, a boater seeking shelter is entitled to temporarily use the dock (per *Ploof*),<sup>297</sup> but must compensate the dock owner for any resulting damages (per *Vincent*).<sup>298</sup> Pliability rules optimally deploy property and liability rules in the face of changed circumstances, such as emergencies.<sup>299</sup>

Currently, tax law rarely uses pliability rules.<sup>300</sup> The next two Subsections give two examples of pliability rules that Congress could enact.

---

rules are preferable to status-loss for deterring violations not only because they provide optimal deterrence, but also because it is more credible that the IRS will impose them.

<sup>292</sup> Kaplow & Shavell, *supra* note 3, at 756.

<sup>293</sup> Abraham Bell & Gideon Parchomovsky, Pliability Rules, 101 Mich. L. Rev. 1, 5 (2002).

<sup>294</sup> *Id.* at 65.

<sup>295</sup> 71 A. 188, 188-89 (Vt. 1908) (holding that plaintiff ship owner could sue defendant dock owner for unmooring them from dock where they had moored during storm); Restatement (Second) of Torts §§ 262, 262 cmt. d, 263, 263 cmt. d (1965) (discussing doctrine of necessity).

<sup>296</sup> 124 N.W. 221, 221-22 (Minn. 1910) (holding that a ship owner who took advantage of the *Ploof* rule during a storm was liable to the dock owner for any damages caused by the boat); Bell & Parchomovsky, *supra* note 293, at 51 n.180 (discussing *Vincent*).

<sup>297</sup> 71 A. at 189.

<sup>298</sup> 124 N.W. at 222.

<sup>299</sup> Bell & Parchomovsky, *supra* note 293, at 67.

<sup>300</sup> One (rare) example of pliability rules in tax protects violations of certain REIT requirements relating to asset composition. The requirements are protected by status-loss, with a trigger to a 35% liability rule, I.R.C. § 856(c)(7)(C) (2006), if: the failure was "due to rea-

### 1. Information-Forcing Pliability Rules

The following pliability rule could be used to optimally protect an ambiguous tax-status requirement. Initially, violations would incur the risk-adjusted liability rule (discussed above in Section III.A) that is adjusted upward by a multiplier reflecting the risk that the IRS would not detect the violation. The triggering mechanism would be the taxpayer disclosing on its tax return that it had possibly violated the requirement. This disclosure would trigger protecting the requirement with a plain liability rule (without the multiplier).

This pliability rule completely addresses the objection to liability rules that they encourage playing the “audit lottery.” The taxpayer gets the plain liability rule only if the arguable violation is disclosed to the IRS.<sup>301</sup> Otherwise, the taxpayer is subject to the higher risk-adjusted liability rule that reflects the probability of going undetected by the IRS.

Even better, the IRS gets timely information on which requirements taxpayers are violating or finding ambiguous, rather than haphazardly finding a fraction of violations years later on audit. Rules creating incentives for timely information disclosure generally encourage socially efficient resolutions.<sup>302</sup> The IRS can use information gathered with this pliability rule to focus on providing guidance clarifying the ambiguous requirements actually causing problems for taxpayers.<sup>303</sup>

### 2. Pliability Rules Triggered by Financial Crises

Temporary financial distress can make it impossible for taxpayers to comply over the short run with some tax-status requirements. Tax law

---

sonable cause and not due to willful neglect”; the REIT files with the IRS a “description of each asset that causes” a failure; and the REIT disposes of the asset. *Id.* § 856(c)(7)(A)(i)-(iii).

<sup>301</sup> Congress and the IRS have been broadly moving over the past decade towards requiring more disclosure from taxpayers, and this proposed pliability rule fits into this trend. One notable recent step by the IRS is requiring many companies to disclose many uncertain tax positions (UTPs). See Uncertain Tax Position Statement, I.R.S. Form 1120 Schedule UTP (2012); I.R.S., Instructions for Schedule UTP (Form 1120) (2012). This Article’s proposed liability rule provides substantive incentives for disclosure that correspond to optimal deterrence from playing the “audit lottery,” whereas Schedule UTP is purely procedural and only applies to a subset of taxpayers.

<sup>302</sup> See Sterk, *supra* note 27, at 1295.

<sup>303</sup> See Saltzman, *supra* note 147, ¶ 3.01 (laying out the numerous ways the IRS provides guidance to taxpayers).

can then compound this temporary financial distress with status-loss, which deepens the financial distress and potentially leads to bankruptcy.

During the 2008 financial crisis, Congress and the IRS took several ad hoc, temporary steps to remove the threat of status-loss, to ensure that tax law did not worsen the crisis. For example, Congress gave the Treasury power, whenever “appropriate in light of distressed conditions in the debt capital markets,”<sup>304</sup> to suspend rules that would result in status-loss for already-distressed debt.<sup>305</sup> As another example, the IRS issued guidance moving the requirement that REITs distribute earnings<sup>306</sup> from being protected by status-loss to a liability rule.<sup>307</sup> This temporary change allowed REITs to conserve cash, helping many to survive the liquidity shortage at the heart of the financial crisis.

A better long-run approach would be to move to pliability rules triggered by financial distress.<sup>308</sup> A requirement may currently be protected by status-loss that would worsen a taxpayer’s financial distress. If Congress is reluctant to move permanently to a liability rule, then it should at least use a pliability rule that shifts to a liability rule whenever the Treasury declares distressed market conditions.<sup>309</sup>

---

<sup>304</sup> I.R.C. § 163(e)(5)(F)(iii).

<sup>305</sup> The relevant tax status was for a debt obligation not being an “applicable high yield discount obligation.” Id. § 163(e)(5). (Recall from the text accompanying supra note 75 that not being in an unfavorable tax status is a favorable tax status.) See generally Viva Hammer, *Taxation of High-Yield Debt—Beware the End of the Reprieve*, 2009 Tax Notes 1095, 1109 (Sept. 14, 2009) (discussing the background of the suspension and arguing for continuing it).

<sup>306</sup> I.R.C. § 857(a)(1) (requiring that ninety percent of the REIT’s income, with certain adjustments, be distributed each year).

<sup>307</sup> Rev. Proc. 10-12, 2010-3 I.R.B. 302, amplifying and superseding Rev. Proc. 09-15, 2009-4 I.R.B. 356, amplifying and superseding Rev. Proc. 08-68, 2008-52 I.R.B. 1373. These revenue procedures, applicable for tax years from 2008 to 2011, allow REITs to easily meet the distribution requirements of § 857(a)(1) by distributing stock (that is, not cash) that is taxable to shareholders in proportion to how much stock the REIT had to distribute, which is equal to the REIT’s shortfall in complying with the requirement. This is a liability rule.

<sup>308</sup> Cf. Kontorovich, supra note 3, at 760 (arguing for pliability rules providing property-rule protection most of the time but moving to liability rules to protect constitutional rights in times of emergency).

<sup>309</sup> See, e.g., I.R.S. Notice 10-11, 2010-4 I.R.B. 326 (finding by the Treasury of continuing “distressed conditions in the debt capital markets”). Requiring an express Treasury declaration avoids opportunistic taxpayer behavior, which is consistent with Smith’s observation that, “when liability rules are used, as in . . . the law of necessity, they are often hedged about with conditions and restrictions . . .” Smith, *Property*, supra note 24, at 1723.

In tort law, *Ploof v. Putnam*<sup>310</sup> and *Vincent v. Lake Erie Transportation Co.*<sup>311</sup> established that a storm shifts a dock owner's entitlement from a property rule to a liability rule, helping boaters.<sup>312</sup> It makes sense that a financial crisis should similarly shift tax-status requirements from status-loss to a liability rule, helping taxpayers weather the storm.

### C. Why Not Other Property Rules?

The common law employs many property-rule remedies: injunctions, jail time, disgorgement, and other supracompensatory damages. Status-loss is a type of disgorgement. As discussed earlier in Section I.F, tax law also uses several other property-rule remedies, such as jail time and supracompensatory damages, for serious procedural violations.

But status-loss is the only property-rule remedy currently used for violations of tax-status requirements.<sup>313</sup> Why not use other property-rule remedies, such as injunctions, for violations?

Forward-looking, consensual injunctions in particular could play a constructive role in administering tax statuses.<sup>314</sup> Currently, the IRS and a taxpayer who violated a requirement can negotiate only over money, up to and including status-loss. But Congress should amend the tax code<sup>315</sup> to authorize the IRS and a taxpayer to enter into a settlement whereby the taxpayer retains its tax status, in exchange for consenting to the entry of an injunction against future violations of the requirement.<sup>316</sup>

---

<sup>310</sup> 71 A. 188 (Vt. 1908).

<sup>311</sup> 124 N.W. 221 (Minn. 1910).

<sup>312</sup> See supra notes 295-99 and accompanying text.

<sup>313</sup> The federal tax code has apparently only a single provision, I.R.C. § 7409, allowing injunctions against violating tax-status requirements. When a public charity "flagrantly" violates the requirement against political expenditures, § 7409 allows the IRS to seek an injunction to enjoin it "from further making political expenditures and for such other relief as may be appropriate to ensure that the assets of such organization are preserved for charitable or other purposes specified in section 501(c)(3)." I.R.C. § 7409(a)(1) (2006). This provision appears never to have been used, likely because it requires an extraordinary personal determination by the Commissioner of Internal Revenue. *Id.* § 7409(a)(2)(B); Treas. Reg. § 301.7409-1(b) (1995).

<sup>314</sup> Currently, injunctions play a limited procedural role in tax administration, such as in enjoining tax return preparers who engage in fraudulent or inappropriate behavior. I.R.C. § 7407.

<sup>315</sup> The best section to amend would likely be I.R.C. § 7121, relating to closing agreements that resolve tax disputes. See *Id.* § 7121.

<sup>316</sup> The taxpayer could potentially also pay money, although presumably less than without the injunction.

Consensual injunctions would have several benefits. First, if the violation occurred because of the requirement's ambiguity, an injunction could clarify what specific steps the taxpayer must take (or avoid taking) to comply in the future. Second, injunctions would avoid harming innocent third parties. For example, if a homeless shelter violated a requirement and reached a monetary settlement with the IRS, the shelter would have fewer economic resources to help the homeless. By contrast, an injunction would preserve the shelter's resources. Similarly, injunctions could protect the workers in a retirement plan that violated a requirement or the shareholders in a REIT that violated a requirement.

#### *D. Rule 4*

In their path-breaking article, Calabresi and Melamed recognized that all remedies can be classified as either liability rules or property rules, and that the initial entitlement can go to either side (for example, either to a polluting factory or to a neighboring resident).<sup>317</sup> Their description can be visualized as a two-by-two matrix, with rows corresponding to which side gets the initial entitlement, and columns corresponding to whether the initial entitlement is protected by a property rule or a liability rule. Of the four boxes in the two-by-two matrix, one box corresponds to a property rule stopping the nuisance (called Rule 1). A second box corresponds to giving liability-rule damages to the neighbor, but allowing the nuisance to continue (called Rule 2). And a third box corresponds to giving the factory a property-rule right to pollute without interference or damages (called Rule 3). But the fourth box does not correspond to any traditional remedy. The remedy that fits in this box has been dubbed "Rule 4":

	Property Rule	Liability Rule
<b>Resident</b> Has Initial Entitlement	Rule 1: Injunction against pollution	Rule 2: Damages from pollution
<b>Polluter</b> Has Initial Entitlement	Rule 3: Factory allowed to pollute freely	<i>Rule 4</i>

Calabresi and Melamed recognized that this "Rule 4" was a viable remedy: The resident could force the polluter to cease polluting, but the

---

<sup>317</sup> Calabresi & Melamed, *supra* note 1, at 1115–16.

resident would be liable to the polluter for damages that compensate it for shutting down.<sup>318</sup>

As fate would have it, simultaneously with Calabresi and Melamed's article, the Arizona Supreme Court developed a Rule 4 remedy to handle a real-life nuisance dispute in *Spur Industries, Inc. v. Del E. Webb Development Co.*<sup>319</sup> The defendant owned a cattle feedlot that had started operation when the surrounding area was agricultural. But the plaintiff, a real-estate developer, later purchased nearby land and began developing it into a residential area. As the development got closer to the cattle feedlot, the developer ran into "sales resistance . . . so great that the parcels were difficult if not impossible to sell"<sup>320</sup> as a result of "flies and the odor"<sup>321</sup> from the feedlot.

The developer sued the feedlot owner to permanently enjoin this public nuisance, and the trial court granted the injunction. The Arizona Supreme Court upheld this injunction—with the unusual modification that the developer had to pay the feedlot owner damages to compensate it for shutting down its operations.<sup>322</sup>

The court gave two primary reasons for this novel remedy. First, the feedlot owner was blameless, having had "no indication [at the time the feedlot started] that a new city would spring up, full-blown, alongside the feeding operation and that the developer of that city would ask the court to order [the feedlot owner] to move because of the new city."<sup>323</sup> Thus, the equities favored granting the initial entitlement to the feedlot owner. Second, the "proper and legitimate regard of the courts for the rights and interests of the public,"<sup>324</sup> particularly the residents of the developer's new neighborhood, favored shutting down the feedlot. The court clearly felt an obligation to protect the interest of the residents, who were largely innocent third parties.<sup>325</sup> Rule 4 was the equitable and economically efficient resolution.

---

<sup>318</sup> Id. at 1116. The possibility of a Rule 4 had been previously discussed by Professor James Atwood. James R. Atwood, Note, An Economic Analysis of Land Use Conflicts, 21 Stan. L. Rev. 293, 315 (1969); see also Guido Calabresi, Remarks: The Simple Virtues of the Cathedral, 106 Yale L.J. 2201, 2204 (1997) (acknowledging Atwood's discussion).

<sup>319</sup> 494 P.2d 700, 708 (Ariz. 1972).

<sup>320</sup> Id. at 704.

<sup>321</sup> Id. at 705.

<sup>322</sup> Id. at 708.

<sup>323</sup> Id. at 707–08.

<sup>324</sup> Id. at 708.

<sup>325</sup> Id. at 705 ("It is noted, however, that neither the citizens of Sun City nor Youngtown are represented in this lawsuit and the suit is solely between Del E. Webb Development

Rule 4 can be used in tax law for much the same reasons—to make the remedy’s burden fall most equitably and most efficiently on the least-cost avoider. In tax law, Rule 4 imposes status-loss (equivalent to the injunction stopping the feedlot operations in *Spur*), but forgives the entire increase in taxes that otherwise results from the status-loss (equivalent to the damages in *Spur* that the developer owed to the feedlot owner).<sup>326</sup> With respect to the taxpayer, Rule 4 is a complete wash, because the tax status is lost, but the IRS forgives the resulting liability. Yet third parties who derive tax benefits from the tax status *are* impacted.

For example, Rule 4 can be applied to a qualified retirement plan. Recall that employers receive a deduction for contributions to their workers’ retirement plans.<sup>327</sup> This tax benefit to the employer is separate from the tax benefit that the plan trust itself receives from the tax status. If an employer erroneously causes a plan to lose its qualification, a Rule 4 remedy would be to cause the plan trust itself to lose its tax status, but to forgive the resulting taxes on the trust. This is a wash with respect to the trust, thus preserving the assets for the retirement of workers (who are innocent third parties akin to the residents in *Spur*). But the employer loses the benefit of its tax deduction. This Rule 4 remedy imposes the burden on the employer,<sup>328</sup> who is the least-cost avoider of a violation.

Professor Samuel Brunson has proposed what is, in effect, a Rule 4 remedy for public charities’ violations of the no-political-participation requirement.<sup>329</sup> He proposes that, when a public charity violates that requirement, the public charity be allowed to maintain its status, but that a

---

Company and Spur Industries, Inc.”); *id.* at 707 (“Were [the developer] the only party injured, we would feel justified in holding that the doctrine of ‘coming to the nuisance’ would have been a bar to the relief . . .”).

<sup>326</sup> In the analogy between tax-status violations and the nuisance in *Spur*, the IRS is analogous to the developer, and the taxpayer with the tax status is analogous to the feedlot owner. Just as the feedlot owner’s flies and odors harmed the developer’s land, so too the taxpayer’s violation caused harm. Meanwhile, third parties, such as workers participating in a qualified retirement plan or recipients of charity from a public charity, are akin to the residents in *Spur* who had bought houses from the developer and whom the court felt an obligation to protect. See *supra* note 325 and accompanying text.

<sup>327</sup> I.R.C. § 404(a)(1), 404(a)(5), 404(a)(6) (2006). See generally *Perdue*, *supra* note 112, ¶ 1.02[1][a]; *supra* Subsection I.C.4.

<sup>328</sup> Because the employer loses the deduction for contributions over affected years, the workers do not have income from the contributions. I.R.C. § 83(h). But workers do lose some tax benefits if the plan becomes disqualified. See *id.* § 402(c); *Perdue*, *supra* note 112, ¶ 1.02[2][b]. A Rule 4 remedy can simply be tweaked to allow workers to keep such benefits.

<sup>329</sup> Brunson, *supra* note 219, at 159–68.

percentage<sup>330</sup> of its donors' contributions be denied deductibility. Brunson's innovative remedy protects the charity's beneficiaries (for example, students at a university or the homeless in a church-run shelter), while getting compensation for the government from donors, who are generally well situated to monitor the charity and prevent it from violating the requirement.

*E. Less Than Zero: The IRS Put-Option*

The discovery of Rule 4 suggested the possibility of other, previously undiscovered remedies. One fascinating source of new remedies comes from the recognition that traditional liability rules are effectively call options.<sup>331</sup>

Call options give their holder the option (but not the obligation) to purchase an entitlement at a fixed price. A \$25 call option on IBM stock allows the option's holder to buy IBM stock for \$25, which makes sense if the stock is later above \$25. But the holder need not exercise the option. Similarly, a traditional liability rule protecting residents from a polluting factory gives the factory a call option to buy the right to pollute from the residents for a court-determined price (that is, damages). But the factory need not exercise this option, because it can simply stop polluting, which makes sense if stopping is cheaper than the court-determined price.

While call options are options to *buy* at a fixed price, put options are options to *sell* at a fixed price. For example, a \$25 put option on IBM stock allows the option's holder to sell IBM stock for \$25, which makes sense if the stock is later below \$25. But the holder need not exercise the option. Scholars recognized that if traditional liability rules are call options, then there could be alternative liability rules that are put options.<sup>332</sup> For example, neighboring residents could be given a put option for their entitlement to clean air: They could have the right to enjoin the pollution, plus the option to force the factory to buy the right to pollute for a

---

<sup>330</sup> The percentage would be calculated by a formula reflecting the expenditures involved or the size of the audience reached. *Id.* at 159–62.

<sup>331</sup> See, e.g., Ayres, *supra* note 7, 14–18; Ian Ayres, *Protecting Property with Puts*, 32 *Val. U. L. Rev.* 793, 794–95 (1998); Krier & Schwab, *supra* note 26, at 443; Levmore, *supra* note 29, at 2159; Morris, *supra* note 29, at 852.

<sup>332</sup> Ayres & Talley, *supra* note 24, at 1062; see also Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 557–59 (5th ed. 1996) (discussing put-call parity).

court-determined price (that is, damages).<sup>333</sup> In other words, residents could choose between an injunction and court-determined damages.

This put-option liability rule is even more beneficial for the residents—and harsher for the factory—than the corresponding property rule. Options can have substantial value, even when it is not yet clear whether exercising them will ultimately make sense.<sup>334</sup> The put-option liability rule gives the residents the value of being able to enjoin the factory, *plus* the value of the option to sell for court-determined damages if that turns out to be more favorable.<sup>335</sup> Conversely, the factory bears the detriment of being enjoined, *minus* the possibility of being forced to pay damages. Professor Ian Ayres has observed that protecting the residents with a property rule leaves the factory with zero value, but that the put-option liability rule leaves the factory with “less than zero.”<sup>336</sup> Additionally, this remedy causes the factory’s payoff to have greater variability, which means more risk.<sup>337</sup> Assuming the factory is risk averse, this risk leaves the factory worse off.

If Congress really wants to crack down on violations of a particular requirement, it can give the IRS a put-option liability rule.<sup>338</sup> If a taxpayer violates the requirement, the IRS could choose between imposing status-loss and imposing a liability rule.<sup>339</sup> Just as in the example with the polluting factory, this put-option remedy maximizes the IRS’s expected outcome<sup>340</sup> and leaves the taxpayer with “less than zero.”<sup>341</sup> It guarantees

---

<sup>333</sup> Ayres, *supra* note 7, at 15–16 (calling this remedy Rule 6, but also recognizing the varied names given to this remedy).

<sup>334</sup> *Id.* at 1–3.

<sup>335</sup> Ayres, *supra* note 7, at 17–21; Krier & Schwab, *supra* note 26, at 473; Levmore, *supra* note 29, at 2163; Morris, *supra* note 24, at 855–56; Rose, *supra* note 4, at 2178–79.

<sup>336</sup> Ayres, *supra* note 7, at 17.

<sup>337</sup> See *id.* at 26 (“[A]n option . . . tends to increase the variance in the non-option holder’s payoff.”).

<sup>338</sup> This remedy is what Ayres calls Rule 6. *Id.* at 15. Tax law could also have a remedy giving the put-option to the taxpayer, what Ayres calls Rule 5. *Id.* But it is unpalatable to give a favorable option to a taxpayer who violates a requirement.

<sup>339</sup> A variant of this remedy would statutorily specify factors the IRS must consider in deciding between status-loss and the liability rule, allowing courts to review the IRS’s decision (for example, for abuse of discretion). This variant converges towards being a liability rule, while splitting the authority for exercising the put option between the IRS and the courts.

<sup>340</sup> Additionally, the IRS’s interest in sound tax administration and ability to observe trends in taxpayers’ actions may make it a “better chooser” of the remedy. Cf. Ayres, *supra* note 7, at 26 (listing factors that make one side a “better chooser”).

<sup>341</sup> *Id.* at 17.

that the taxpayer will, at a minimum, pay a compensatory amount, and potentially will suffer draconian status-loss.

Some may object that giving the IRS the option to choose its remedy contravenes the principle that similarly situated taxpayers should be treated equally.<sup>342</sup> But that makes this approach perfect for seriously cracking down on violations. Most taxpayers crave certainty, and protecting a requirement with a put-option liability rule increases variability for any taxpayer that violates the requirement.

#### IV. TAX LAW'S CONTRIBUTION TO THE PROPERTY AND LIABILITY RULE SCHOLARSHIP

The previous Part looked at novel remedies the broader property and liability rule scholarship could contribute to tax law. This Part looks at how tax law can enrich the broader property- and liability-rule scholarship.

Calabresi and Melamed's path-breaking article focused almost entirely on remedies in torts and property law.<sup>343</sup> Contracts scholars advanced the property- and liability-rule scholarship by bringing contract law's focus on bargaining and information disclosure.<sup>344</sup> Still others have advanced the literature by considering examples from intellectual property<sup>345</sup> and constitutional law.<sup>346</sup> Each new area has provided new examples and new insights on the relative merits of different rules and has unmasked underlying assumptions. Tax is no different.

##### *A. Relaxing Assumption of Constantly Increasing Utility*

The model of IRS utility derived above in Subsection II.C.1 to explain why the IRS often fails to impose status-loss unmarks an implicit assumption throughout the existing property- and liability-rule scholar-

---

<sup>342</sup> See Bittker & Lokken, *supra* note 107, ¶ 3.1.4 (discussing horizontal equity, the principle that similarly situated taxpayers should be treated equally).

<sup>343</sup> Calabresi & Melamed, *supra* note 1. Their article opened with the sentence: "Only rarely are Property and Torts approached from a unified perspective." *Id.* at 1089.

<sup>344</sup> Rose, *supra* note 4, at 2197 (noting the contributions of the "eminent contracts scholars" Ayres and Talley to the property- and liability-rule literature).

<sup>345</sup> See, e.g., Lemley & Weiser, *supra* note 3, at 784; Sterk, *supra* note 192, at 1327–33.

<sup>346</sup> See, e.g., Kontorovich, *supra* note 3, at 764.

ship. All existing scholarship assumes that a party's utility increases with each additional dollar of value received (or not paid out).<sup>347</sup>

But this assumption often does not apply to the IRS, which is influenced not only by revenues but also by concern for proportionality and for avoiding negative scrutiny from congresspersons and the media. In such instances, beyond a certain level, the IRS's utility actually *declines* for each dollar it receives from the opposing party (the taxpayer), as can be seen in the decline in the curve in Figure 2 in Subsection II.C.1.<sup>348</sup>

The IRS is almost certainly not the only party to have declining utility for additional dollars received beyond a certain point. Many government agencies impose remedies on regulated parties, either directly with fees and fines, or indirectly through mandates to take certain actions. These remedies can range from compensatory liability rules up to property rules. Beyond a certain point, agencies may face the same proportionality, political, and media concerns that lead the IRS to have declining utility—as well as the same problems with deterrence and negotiation. This is a promising area for future research (indeed, this Article will hopefully encourage scholars to apply the property- and liability-rule framework to other agency-dominated areas of law).

Many private actors are also subject to political, media, and similar pressures. For example, a real-estate developer suing a polluting factory may be subject to similar pressures. High damages might lead the factory to lay off workers, who are also voters, making it harder for the developer to get local permits in the future. In this situation, the developer might have declining utility for additional money extracted from the fac-

---

<sup>347</sup> Ayres and Madison discuss an important but different situation: entitlement holders who receive less value from specific performance (a property rule) than from compensatory damages (a liability rule). Ayres & Madison, *supra* note 136, at 61. This situation can incentivize strategic threats, such as requiring specific performance, even if that is economically inefficient. But Ayres and Madison still assume throughout that all parties will always attempt to maximize the dollar value they receive (or minimize the dollar value they lose). By contrast, the IRS will often prefer to receive less money from taxpayers.

The difference between the IRS and the parties in Ayres and Madison's analysis is demonstrated by moving \$1 down from a full property-rule remedy. If Ayres and Madison's plaintiff had the choice between (a) getting specific performance or (b) getting specific performance but having to pay the defendant \$1, the plaintiff would choose (a). But, as Figure 2 in Subsection II.C.1 shows, if the IRS has the choice between (a) imposing the status-loss amount or (b) imposing the status-loss amount minus \$1, it will choose (b) in many circumstances. That is the essence of declining utility from each dollar.

<sup>348</sup> See Subsection II.C.1.

tory. This is another promising area for future research, possibly with implications for understanding land-use patterns.

### *B. Taker's Information Costs*

Smith argues that property rules give entitlement holders better incentives to invest in information about their entitlement.<sup>349</sup> Investments in information are crucial to economic efficiency, entrepreneurship, and innovation.<sup>350</sup>

For example, assume that Blackacre has always been used to grow wheat, and that its fair market value reflects its wheat-producing capacity.<sup>351</sup> Blackacre's owner *O* invests in information about whether Blackacre's soil, weather, and altitude allow for growing crops more profitable than wheat. Assume that *O* succeeds, discovering that barley is more profitable than wheat for Blackacre. If *O* is protected by a property rule, *O* can capture all the profits from this discovery. These profits are *O*'s incentive to invest in information. But if *O* is protected only by a liability rule, then a taker *T* could force *O* to sell Blackacre for a court-determined price, and *T* could grow barley and reap the profits.<sup>352</sup> Liability rules thus undermine *O*'s incentive to invest in information about the best crops to grow on Blackacre.<sup>353</sup>

But tax law reveals that information-cost considerations sometimes weigh *against* property rules. Recall that the IRS holds the entitlement to be free of requirement violations,<sup>354</sup> just as *O* held the entitlement to Blackacre. Meanwhile, the taxpayer is the non-entitlement holder, just

---

<sup>349</sup> Smith, Property, *supra* note 24, at 1748.

<sup>350</sup> *Id.* at 1724–25 (citing Frank H. Knight, Risk, Uncertainty and Profit 19–21, 197–232 (1921)).

<sup>351</sup> Cf. Smith, Property, *supra* note 24, at 1729–30 (using the example of a future tourist attraction on Blackacre).

<sup>352</sup> *O* could attempt to persuade the court that Blackacre's value should be based on its ability to grow barley. But convincing courts of speculative future values is difficult and might require expensive expert testimony and litigation. See *id.* at 1729.

<sup>353</sup> Cf. *id.* at 1730 (making same point with respect to future tourist attraction on Blackacre).

<sup>354</sup> See Section I.E. The entitlement could theoretically be given to either the IRS or the taxpayer, but tax law virtually always assigns the entitlement to the IRS, with the only question being whether the IRS's entitlement is protected by a property or liability rule. Similarly, the entitlement to use Blackacre could theoretically be assigned to either the owner *O* or the taker *T*, but property law virtually always assigns it to the owner, with the only question being whether a property or liability rule protects the owner's entitlement.

like the taker *T* in the example above.<sup>355</sup> Yet we want *taxpayers* to invest in information about uses of their tax status. For example, public charities may develop innovative mechanisms for helping charitable recipients, or a REIT may develop new financing structures for avoiding home foreclosures. Innovative uses of tax statuses run a higher likelihood of violating unclear or ambiguous tax-status requirements.<sup>356</sup> Protecting requirements with status-loss can deter innovative uses of the tax status, decreasing the incentive to invest in information about the socially beneficial uses of the status.<sup>357</sup>

Thus, information costs can weigh towards liability rules in tax law. The same will be true in any area of law where an innovation runs the risk of incurring a draconian property rule. This is another promising area for future research.

*C. Liability Rules as “Gentle Nudges”; Property Rules as “Hard Shoves”*

Kahan has argued that “gentle nudges,” slightly above what decision makers see as a proportionate remedy, often better promote compliance norms than draconian “hard shoves” that decision makers hesitate to impose, thus making other decision makers also hesitate to impose them.<sup>358</sup> This Article argued above in Subsection II.C.3 that liability rules for requirement violations may better promote compliance norms than status-loss, which IRS employees may view as draconian.

Kahan’s insight applies to the broader property- and liability-rule literature. Liability rules aim to compensate the entitlement holder, and therefore often correlate with what most decision makers see as a proportionate remedy. Liability rules may be akin to “gentle nudges” that protect entitlement holders better than property rules, which are “hard shoves.”

---

<sup>355</sup> See discussion supra note 354.

<sup>356</sup> See, e.g., discussion supra notes 127–28 and accompanying text (noting uncertainty about whether a common financing transaction causes violations of REIT asset tests).

<sup>357</sup> The IRS expressly refuses to provide guidance on many ambiguous areas. See Rev. Proc. 11-3, 2011-1 I.R.B. 111.

<sup>358</sup> Kahan, supra note 238, at 608.

*D. Empirical and Experimental Opportunities*

Although scholars have developed numerous insights on when to use property or liability rules, as well as some novel remedies, few have been applied in practice. Common-law judges are inherently reluctant to use new or untested remedies, and remedies are typically determined on a facts-and-circumstances basis by individual judges and have little precedential value.<sup>359</sup>

By contrast, tax law is a much more promising area for applying the property- and liability-rule scholarship, for several reasons. First, tax law is largely statutory. Unlike judges, legislative bodies have repeatedly demonstrated a willingness to enact innovative, even quirky, new tax proposals from scholars and others.<sup>360</sup> Second, any government that has the power to tax can benefit from this scholarship. State or foreign tax laws provide as good a testing ground as U.S. federal tax law. Third, all lawmakers have a strong incentive to implement innovations that can increase tax revenues while improving efficiency for taxpayers.

## CONCLUSION

This Article has demonstrated that tax law has both property rules and liability rules, and that this framework can improve tax law. When deciding between property and liability rules, Congress currently does not look at anywhere near all of the considerations that the property- and liability-rule literature has developed. This should change. By drawing on this literature, Congress could better understand the often-subtle costs and benefits of the two rules—leading to better tax legislation. And by looking to the novel remedies that have sprung out of the property- and liability-rule literature, Congress could expand the range of remedies that it gives to the IRS.

This Article certainly does not identify all the ways the property- and liability-rule distinction can be applied to tax law. Fully exploring the

---

<sup>359</sup> Sherwin, *supra* note 23, at 2085 (“[J]udicial practice strongly favors case-by-case decisionmaking under loosely defined standards.”); Sherwin, *supra* note 136, at 19 (“To the extent that future courts treat prior decisions as examples or rules of thumb, prior decisions do not establish property rules.”).

<sup>360</sup> See, e.g., Reuven S. Avi-Yonah, *Enforcing Dividend Withholding on Derivatives*, 121 *Tax Notes* 747 (Nov. 10, 2008) (proposing a reform that became law in 2010 with the enactment of I.R.C. § 871(l)); Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 *Ind. L.J.* 539, 583 (2006) (proposing a reform that became law in 2008 with the enactment of I.R.C. § 6045(g)).

2013]

*Tax in the Cathedral*

1233

benefits of this framework for tax law will take other articles and other scholars. The broader property- and liability-rule literature is an area of continuing ferment and debate.<sup>361</sup> Scholars will identify new considerations weighing in favor of property rules or liability rules, and they will develop more novel remedies. Recognizing that tax law has both property and liability rules will allow these insights to be used to improve tax. Meanwhile, examples and insights from tax will contribute back to this broader ferment and debate, across many other areas of law.

---

<sup>361</sup> Ayres, *supra* note 7, at 183–200 (discussing the debate).