CONTEMPTUOUS TAX REPORTING*

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The use of self-reporting and self-assessment principles in the collection of corporate income tax means that companies are not subject to administrative tax assessment and ex-ante examination of tax positions taken, but rather to infrequent ex-post examination of tax returns submitted by their managers. Thus, while acting as the government's agents for the purpose of assessing corporate taxes, managers can engage in contemptuous self-reporting that involves knowingly reporting tax positions that do not conform to the tax code and prevailing tax doctrines.

According to estimates provided by Congress, U.S. companies will enjoy more than $25 billion dollars of R&D incentives in 2019 and 2020. The majority thereof will come from self-reported R&D credits claimed on companies' tax returns. While being one of the most expensive tax expenditures claimed by corporations in the federal budget, this article argues that R&D tax incentives provide a prominent example of contemptuous tax reporting in which managers knowingly take positions that contradict prevailing tax doctrines.

This article presents a novel conceptualization of contemptuous tax reporting along with empirical findings that point to the tremendous loss of tax revenues resulting from such abusive tax behavior by S&P 500 companies. Moreover, the article overcomes the challenges existing scholars face when empirically analyzing corporate tax behavior as a single homogenous phenomenon even though, normatively speaking, it encompasses both legal tax avoidance and illegal tax evasion.

Following the analysis of additional empirical findings, showing a significant positive correlation between R&D expenditures and contemptuous tax reporting, this article further contributes by proposing measures for minimizing contemptuous tax reporting with respect to inflated or intentionally miscategorized R&D expenditures.

INTRODUCTION

December 2017 provided many stressful moments not only for the Trump administration, struggling to pass the Tax Cuts and Jobs Act of 2017 in both Houses before Christmas, but also for many prominent companies engaged in research and development (R&D) activities. Although a consensus prevailed in both Houses supporting a big cut in the federal corporate tax rate, many other details of the tax reform bill were not yet settled. Thus, when the tax bill finally reached the Senate, in an effort to reduce the bill's overall cost,[1] Republican senators overturned the House[2] and retained the corporate Alternative Minimum

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1. *See Estimated Revenue Effects of H.R. 1, The "Tax Cuts And Jobs Act," Scheduled for Markup by the Committee On Ways And Means On November 6, 2017*, JOINT COMM. TAXATION (Nov. 2, 2017), https://www.jct.gov/publications.html?func=startdown&id=5026 (estimated revenue effect of the (then) proposed "Tax Cuts and Jobs Act").

2. *The Tax Cuts and Jobs Act: Policy Highlights*, HOUSE. COMM. WAYS & MEANS, https://republicans-waysandmeansforms.house.gov/uploadedfiles/12.15_tcja_policy_highlights.pdf

Tax (AMT) thus unintentionally terminating the biggest tax break for R&D.[3] Generally speaking, the AMT sets a limit on the extent to which taxpayers—corporations and individuals—can use deductions and credits to reduce their overall tax liability. It does so by requiring taxpayers to calculate a standard tax, in which regular tax breaks and marginal rates apply, and an AMT, which omits many deductions and credits while using alternative and generally lower tax rates. If the standard calculation results in a lower liability than the AMT, the taxpayer must pay the higher AMT. While the House's version of the tax bill repealed the AMT for corporations,[4] Republicans' last-minute amendments to the Senate's version of the bill preserved the corporate AMT (at its original tax rate of twenty percent).[5] It thereby made the R&D credit and other politically-popular tax breaks, de facto, worthless: claiming the R&D credit under the (then) Senate's proposed (standard) corporate rate of twenty percent would cause the unrepealed corporate AMT of twenty percent to kick-in.[6] As accurately described by one reporter: "Companies can either take no deductions, and pay a [twenty] percent rate [under the proposed reduced standard rate]—or take lots of deductions . . . and [still] pay a [twenty] percent rate [because of the unrepealed AMT]."[7]

[https://perma.cc/58FB-LMEL] (summarizing the House of Representative's bill changes, among them - "Eliminates the Corporate Alternative Minimum Tax").

3. *See* Ed Crooks, *Republican Reforms Threaten Corporate Tax Credits*, FIN. TIMES (Dec. 4, 2017), https://www.ft.com/content/9372cabe-d91c-11e7-a039-c64b1c09b482; Richard Rubin, *Passage of Senate Tax Bill Puts R&D Tax Credit in Doubt — Update*, FOX BUS. (Dec. 3, 2017), https://www.foxbusiness.com/features/passage-of-senate-tax-bill-puts-rd-tax-credit-in-doubt-update [https://perma.cc/4S2W-CXM6]; Eric Levitz, *The Senate GOP Accidentally Killed Some of Its Donors' Favorite Tax Breaks*, NEW YORK MAG. (Dec. 4, 2017), http://nymag.com/intelligencer/2017/12/senate-gop-accidentally-killed-all-corporate-tax-deductions.html [https://perma.cc/JGV9-QLKZ].

4. Larry Light, *GOP Tax Bills Curbs Impact of Hatred AMT*, CBSNEWS (Dec. 20, 2017), https://www.cbsnews.com/news/gop-tax-bill-curbs-impact-of-hated-amt/
[https://perma.cc/R9XW-EDJA].

5. Richard Rubin, *Passage of Senate Tax Bill Puts R&D Tax Credit in Doubt*, WALL STREET J. (Dec. 4, 2017), https://www.wsj.com/articles/passage-of-senate-tax-bill-puts-r-d-tax-credit-in-doubt-1512328243.

6. Before corporate tax was reduced by the Tax Cuts and Jobs Act of 2017, the corporate AMT of twenty percent was rarely applicable to business filers, who end up paying a lower effective rate than the "regular" thirty-five percent rate by claiming breaks that aren't affected by the AMT. However, once the regular rate proposed was twenty percent, the overhaul could have driven many companies into the AMT, forcing them to lose some of their breaks in the process. The biggest consequence could have been the loss of the R&D credit, often claimed by manufacturers, technology firms and pharmaceutical companies, *see* Rubin*, supra* note 3.

7. Levitz, *supra* note 3.

Once the dust settled and the implications of maintaining the corporate AMT on the usability of R&D credits were understood by politicians,[8] it was elegantly repealed in the joint House-Senate committee thus allowing companies to continue to enjoy the R&D credit to its full-extent without any limitations imposed by the AMT.[9] However, as this article points out, removing the AMT threat to R&D credits also perpetuates one of the most prominent instances of contemptuous tax behavior by corporations—self-reporting of R&D-based tax positions that contravene prevailing tax doctrines.

According to estimates provided by Congress,[10] U.S. corporations are expected to receive more than $25 billion dollars in R&D tax incentives in 2019 and 2020. The majority thereof are expected to result from the R&D credit, allowing companies to reduce tax bills by an amount equal to fourteen or twenty percent[11] of their current year Qualified Research Expenditures (QREs).[12] Accordingly, 2018 Apple Inc.'s commitment to contribute over $350 billion to the US economy over a period of five years[13] will result in a fourteen or twenty percent tax refund of all such amounts spent on R&D activities.

Due to the enormous financial benefits it holds, along with incentivizing U.S. companies to increase spending on R&D,[14] the current R&D tax regime sets the stage for companies to treat non-R&D business expenditures contemptuously, e.g., categorizing operation managers' salaries as QREs entitled to credit, thereby artificially

8. *See, e.g.*, Rubin*, supra* note 3.

9. *Tax Cuts and Jobs Act: A Comparison for Large Businesses and International Taxpayers*, (Sept. 11, 2019), https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-a-comparison-for-large-businesses-and-international-taxpayers [https://perma.cc/2XC2-PTWA].

10. *Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020*, JOINT COMM. TAXATION 29 (Jan. 30, 2017), https://www.jct.gov/publications.html?func=startdown&id=4971.

11. I.R.C. §§ 41(a), (c)(4)(a) (2012) (defining the research credit as twenty percent exceeding a pre-determined base amount, or fourteen percent of current year QRE exceeding fifty percent of the preceding three years average QRE).

12. § 41(d)(1) (defines "qualified research"); *see also United States v. McFerrin*, 570 F.3d 672, 676 (5th Cir. 2009) ("Qualified research" has four separate and independent requirements: (1) the expenses must be of the type deductible under I.R.C. § 174; (2) the research must be undertaken 'for the purpose of discovering information . . . which is technological in nature;' (3) the application of that information must be 'intended to be useful in the development of a new or improved business component of the taxpayer;' and (4) substantially all of the research activities must 'constitute elements of a process of experimentation.').

13. *Apple Accelerates US Investment and Job Creation*, APPLE, INC. (Jan. 17, 2018), https://www.apple.com/newsroom/2018/01/apple-accelerates-us-investment-and-job-creation/ [https://perma.cc/NT4P-89G3].

14. Andrew C. Chang, *Tax Policy Endogeneity: Evidence from R&D Tax Credits*, 27 ECON. INNOVATION & NEW TECH. 810 (2018) (quantifying and estimating the impact of R&D tax incentives on R&D expenditures at the U.S. state level).

inflating entitlement to R&D tax credit. A number of tax cases litigated in recent years involved such practices.[15] For example, in *Shami v. Commissioner of Internal Revenue*,[16] Farouk Systems, Inc. (FSI), a Houston-based company that develops and manufactures hair care and cosmetic products, was found to be over-claiming more than two million dollars of R&D credits in the company's self-reported tax returns.[17] The tax court's ruling, affirmed on appeal by the Fifth Circuit, rejected FSI's self-reporting of more than thirty million dollars—paid to the chairman of FSI's board and the company's CEO[18]—as R&D expenditures entitled to a credit.[19]

In the last few years, legal scholars have questioned the validity of and justifications for the current R&D tax incentives regime,[20] including the actual role such incentives play in inducing and increasing

15. *See, e.g.*, *CRA Holdings US, Inc. v. United States*, No. 15-CV-239W(F), 2017 U.S. Dist. LEXIS 11068 (W.D.N.Y. Jan. 26, 2017) (claiming an initial tax refund action for 6,100 R&D projects, a national environmental engineering firm's number of projects for which the refund was requested was reduced at trial to 159 R&D projects); *United States v. Quebe*, 321 F.R.D. 303, 305–08 (S.D. Ohio 2017) (granting IRS's motion to compel regarding details about the foundation of the defendant's assertion that they are entitled to the research tax credit); *Suder v. Comm'r*, 109 T.C.M. (CHH) 354 (2014) (finding that eleven of the twelve projects discussed satisfy the four-part test for qualified research; however, finding that the compensation for a ninety percent owner of the company, Mr. Suder, to be unreasonable under section 174(e)).

16. *Shami v. Comm'r*, 741 F.3d 560 (5th Cir. 2014).

17. *Id.* at 564 ("The QREs allegedly incurred by FSI enabled it to claim a § 41 credit of $1,072,170 in 2003, $749,460 in 2004, and $261,315 in 2005. The Commissioner subsequently served notices of deficiency on each Petitioner, challenging the entirety of the credit claimed by FSI.").

18. *Id.* ("Although FSI claimed that dozens of its employees engaged in qualified research each year, the bulk of its wage QREs came from the salaries of two FSI employees: Farouk Shami and John McCall. Together, their wages accounted for over eighty percent of the wage QREs FSI claimed in 2003, 2004, and 2005. Shami served as chairman of FSI's board of directors in each of these years and was FSI's president and CEO in 2003. McCall held the title of co-chairman of FSI's board of directors in 2003 and 2004. Neither Shami nor McCall has any formal education or training in chemistry or engineering.").

19. *Id.* at 565, 574.

20. *See also* Jacob Nussim & Anat Sorek, *Theorizing Tax Incentives for Innovation,* 36 VA. TAX REV. 25, 49 (2017) ("[C]ast[ing] serious doubts on the social desirability of existing practices of promoting innovation through tax incentives, and explain[ing] why non-tax cash-transfers are most likely socially superior."); Stephen E. Shay, et al., *R&D Tax Incentives: Growth Panacea or Budget Trojan Horse*, 69 TAX L. REV. 419, 422 (2016) (calling for a thorough reexamination of the U.S. R&D tax incentive regime); William Natbony, *The Tax Incentives for Research and Development: An Analysis and a Proposal*, 76 GEO. L.J. 347, 350 (1987) (arguing that the actual effects of § 174 and § 41 do not meet the congressional desires of incentivizing new products through § 174 and incentivizing increased R&D by existing businesses through § 41).

local R&D expenditures.[21] While this article draws attention to additional and not-yet-discussed flaws of the existing R&D incentives regime, that is, the contemptuous use of R&D tax incentives in self-reporting, the argument this article makes is broader. It argues that cases like *Shami*, in which a company knowingly over-claimed R&D credits by adopting a position that the company CEO's salary can be considered an expense related to R&D although he spends little time on actual R&D activities,[22] truly represent a much broader phenomenon. When filing corporate tax returns, managers take advantage of the tax system's underlying collection infrastructure, that is, the reliance on taxpayers to self-assess and self-report taxes due, and knowingly file tax returns that contain legal positions that correspond frivolously or not at all to the tax code and prevailing tax doctrines ("contemptuous tax reporting").[23] In this respect, contemptuous tax reporting is different than simple false reporting (regulated by § 7206 and other sections under the Internal Revenue Code (IRC).[24] Contemptuous reporting involves managers reporting the tax results of a deal, or any other business transaction, by implementing in the report a tax interpretation of the code which they know to be inconsistent with prevailing tax doctrines, but has nevertheless not yet been positively ruled against. In this respect, while the interpretation adopted by managers presents a possibly-valid legal argument (and therefore does not fall into the category of false interpretations), if (and when) it were subject to a decision—e.g., by the court and according to prevailing tax doctrines—managers know it would be voided. Nevertheless, and although managers know the positions are expected to be voided if and when scrutinized, due to various reasons discussed below, managers file corporate tax returns while taking such *de jure* invalid tax positions.[25]

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21. *See, e.g.*, Chang, *supra* note 14, at 281.

22. *Compare Shami v. Comm'r*, 741 F.3d 560, 564 (5th Cir. 2014) (noting that the salaries of FSI's president and cochairman of the board of directors, neither of whom had "any formal education or training in chemistry or engineering," amount to eighty percent of the QREs FSI claimed in 2003, 2004, and 2005), with *Suder v. Comm'r*, 108 T.C.M. (CHH) 354 (2014) ("During the years at issue Mr. Suder served as the chief executive officer (CEO) of ESI. However, he did not perform the typical duties of a CEO. He spent most of his time brainstorming ideas for new products and ways to improve existing products.").

23. *See infra* note 50 and accompanying text.

24. *See generally,* Phyllis Horn Epstein, *Office and Owner Liability for Corporate Tax*, CORP. BUS. TAX'N MONTHLY (May 2012) (reviewing different sections under the tax code that can result in a personal liability for managers and shareholders due to tax issues).

25. One could argue that as long as a legal argument regarding the tax code has not been invalidated by a positive legal action, e.g., a judgment, a taxpayer is free to follow that argument ("tax-argument"), and possibly become subject to additional

Due to a number of reasons, contemptuous tax reporting by corporations has not yet received the full attention it deserves. As elaborated in the beginning of the next section, among these reasons is a gap between the normative legal discourse on tax avoidance, as described in the legal literature, and the descriptive-empirical corporate tax discourse, as described in and conducted by the financial (accounting) literature. As a result of this thus-far unmitigated gap, tax researchers have been modeling corporate tax behavior by aggregating all tax-avoidance conduct engaged in by management[26] and uniformly measuring it using one-dimensional financial parameters. The problem with this predominant research approach is that it overlooks the normative-legal differences between the various actions taken by managers to avoid tax. For example, a manager can reduce a corporation's tax by performing a "tax inversion," that is, relocating the corporation's legal domicile and business center from its current state to a state with a lower corporate tax rate, a reincorporation action which, although driven only by the purpose of reducing corporate tax,[27] is in conformity with tax doctrine. However, managers can also reduce defacto tax payments by falsely understating the corporation's taxable income when submitting its annual tax return. This distinction between

fines if the tax-argument is found to be frivolous or unsupported (e.g., according to IRC §§ 6660, 6702 (2012)). *See also Summary of Preparer Penalties under Title 26*, (last updated Aug. 6, 2019), https://www.irs.gov/tax-professionals/summary-of-preparer-penalties-under-title-26 [https://perma.cc/ALN9-BDV6] (last updated Aug. 6, 2019). Nevertheless, one should further assume that the taxpayer following the tax-argument believes in the validity of the as-yet undecided argument; if this were not so, the taxpayer would be abusing the current tax collection system. As further discussed in this article, collecting income taxes in the US, and specifically the use of self-reporting, relies on taxpayers' participation in fulfilling the role of the state in assessing the tax and hence, assumes they follow only valid tax-arguments. If taxpayers follow tax-arguments they admit are not valid but nevertheless follow because they are able to do so in a self-reporting regime, then they contemptuously breach their collection duty. "There is legal compulsion, to be sure, but basically the Government depends upon the good faith and integrity of each potential taxpayer to disclose honestly all information relevant to tax liability." *United States v. Bisceglia*, 420 U.S. 141, 145 (1975).

26. *Cf.* Michelle Hanlon & Shane Heitzman, *A Review of Tax Research*, 50 J. ACCT. & ECON. 127 (2010) (providing an extensive literature review of corporate tax research).

27. *See* Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1233 (2008) ("[T]ax-motivated corporate locational decisions can lead to an efficiency cost to the extent that corporations are steered into suboptimal legal regimes from a corporate law standpoint."); Wolfgang Schön, *Playing Different Games? Regulatory Competition in Tax and Company Law Compared*, 42 COMMON MKT. L. REV. 331 (2005) (discussing the problem arising in light of the possibility of corporate re-organization in the European Internal Market through cross-border reincorporation); Jens Dammann, *A New Approach to Corporate Choice of Law*, 38 VAND. J. TRANSNAT'L L. 51, 54 (2005) ("[A]llowing corporations to choose the applicable state law in their articles of incorporation" in lieu of applying the state of incorporation doctrine).

perfectly legal tax inversion and illegal interpretation of taxable income is lost when all conduct across the spectrum are uniformly measured—as in many cases has been done by existing corporate tax research—using a single dimension tax parameter, e.g., the effect on a corporation's Effective Tax Rate (ETR).[28] Moreover, as further discussed in the article, due to accounting rules currently followed by publicly traded US corporations,[29] financial tax parameters disclosed to investors, such as the tax expenses reported in a company's profit and loss statement or a company's ETR, are ill-affected by certain types of tax avoidance. Some actions taken by managers, among them, contemptuous tax reporting, affect disclosed tax parameters, making it appear as if the tax were paid in full. As a result, a misperception is created under which companies involved in contemptuous tax reporting are viewed according to their financial statements prepared for investors, *ceteris paribus,* as paying higher taxes than those not engaged in such contemptuous tax reporting. Taking contemptuous tax reporting into consideration when analyzing corporate tax behavior, also suggested by this article, overcomes this misperception.

This article introduces the concept of *contemptuous tax reporting* into the legal discourse of corporate tax avoidance and argues that it is a unique tax behavior that should be differentiated from other corporate tax avoidance activities. The article also introduces into the legal discourse a financial analysis that provides information regarding the degree of legitimacy—defined by the degree of a manager's obedience to prevailing tax doctrine—involved in a corporation's tax behavior. Thus, while existing empirical research has been limiting legal discourse to the measurement of *actus reus* involved in corporate tax behavior, that is, it provided legal scholars with quantitative information about the overall tax avoided by managers without any differentiation between legitimate and non-legitimate actions, this article introduces into the discourse the concept of contemptuous tax reporting and thereby facilitates a measurement of the *mens rea* involved in managers' tax avoidance actions. That is, it provides information about the amount of corporate tax avoided by managers knowing the positions taken are inconsistent with prevailing tax doctrines.

While investigating the contemptuous tax behavior of publicly traded corporations, this article integrates theoretical, empirical and

28. The ETR, a financial parameter commonly used when analyzing corporate tax behavior, represents the ratio of a company's overall tax liability to its pre-tax income. *See infra* note 92 and accompanying text.

29. Publicly traded European corporations are required to apply very similar rules in their financial reports for financial years starting on or after January 1, 2019. *See* 2018 O.J. (L 265) 3, 5–6.

normative components in a discussion which proceeds as follows: Section II discusses tax contemptuousness—what constitutes contemptuous tax reporting and how its appearance is influenced by tax collection through self-reporting rather than active governmental assessment of taxes due. It is then argued, in Section III, that mainstream financial parameters used in contemporary corporate tax discourse do not convey information about contemptuous tax reporting, thus, inter alia preventing proper treatment thereof. Moreover, it is argued that in the analysis of corporations' tax behavior, contemptuous reporting distorts commonly used financial tax parameters thus providing an inaccurate and occasionally inflated view of the actual corporate tax burden. Section IV presents a novel empirical analysis of contemptuous tax reporting including the magnitude of such tax behavior and the tremendous tax loss it creates when practiced by S&P 500 companies. Furthermore, a multi-year analysis of disclosures made by S&P 500 companies shows a significant and positive correlation between R&D expenditures reported by S&P 500 companies and contemptuous tax behavior, thus pointing to R&D expenditures as an empirically indicated generator of contemptuous reporting. Section VI proposes curbing over-reporting of R&D expenditures by preventing companies from reporting R&D expenditures on their tax return unless expenditures were also treated as such in the company's financial statement reported to investors. It thereby suggests implementation of a more general approach to minimizing contemptuous tax reporting, by pegging returns' parameters affected by managers' contemptuous interpretations to other reports made by management. It would thereby subject managers' return positions—resulting in tax recognition of R&D expenditures and alike—to additional ex ante scrutiny by other non-IRS parties. Section VII concludes.

I. EVASION, AVOIDANCE AND CONTEMPTUOUS TAX REPORTING

A principle legal distinction between "tax evasion" and "tax avoidance" has long existed in legal tax discourse.[30] Tax evasion

30. *See, e.g.*, David Weisbach, *Corporate Tax Avoidance*, National Tax Association Proceedings, 96 Ann. Conf., 1 (2003) https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1137&context=law_and_economics [https://perma.cc/GBA9-4JDQ] ("Most studies of tax avoidance and evasion are written as if we knew what these terms meant, and the problem is analyzing the various incentives to engage in these activities."). Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1423, 1428 (Alan Auerbach & Martin Feldstein, eds., 2002) (ascribing the distinction between evasion and avoidance to Judge Oliver Wendell Holmes in *Bullen v. Wisconsin*, 240 U.S. 625, 630 (1916)); *Fraud on the Law—The Doctrine of Evasion* 42

involves taxpayers avoiding the payment of actual tax owed by not complying with the law and by breaching it, for example, by sheltering income in a foreign bank account and not reporting it to the IRS.[31] In contrast, tax avoidance refers to practices in which means are used by taxpayers to reduce their taxes, but which, nonetheless, conform to the law and hence, do not constitute a breach.[32] An example of avoidance would be establishing an offshore company to buy a product's Intellectual Property (IP) thereby legally diverting some portions of the product's future income to a low-tax territory via royalty payments for the use of the IP. Both tax evasion and avoidance result in less tax being paid by the taxpayer than Congress intended.[33] Nevertheless, evasion involves unlawfulness while avoidance involves lawful conduct.[34] Following this principal distinction, the Supreme Court has long stated that one might avoid a tax but may not evade it.[35]

Following the long-standing dichotomous legal distinction between "evasion" and "avoidance,"[36] legal thought has gone on to indicate degrees of legitimacy in taxpayers' actions. Overall, it treats tax evasion/avoidance as a spectrum of behaviors with different levels of normativity extending from evasion on the one end, to avoidance on the other.[37] Meanwhile, for research purposes, empirical corporate tax

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COLUM. L. REV. 1015, 1016 n. 7 (1942) (saying "the distinction apparently stems from *United States v. Isham*, 84 U.S. 496 (1873)").

31. *See* Weisbach, *supra* note 30, at 9.

32. For early discussions of the distinction between evasion and avoidance, see William Cogger, *Tax Avoidance v. Tax Evasion* 15 TAX MAG. 518 (1937) (reviewing avoidance/evasion cases from the nineteenth century to the early twentieth); Angell B. Montgomery, *Tax Evasion and Tax Avoidance*, 38 COLUM. L. REV. 80, 80–81, 86, 91–92 (1938).

33. *See, e.g.*, Joshua D. Blank, Reconsidering Corporate Tax Privacy, 11 N.Y.U. J.L. & BUS. 31, 37 (2014) ("Corporate tax aggressiveness occurs where corporations use complex transactions that appear to comply with the literal text of the Internal Revenue Code to obtain valuable tax benefits that Congress did not intend."). *See also* Judith Freedman, *Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament*, 123 L. REV. Q. 53 (2007) (examining the problem of ascertaining the intention of the legislature in tax cases).

34. *See also* Slemrod & Yitzhaki, *supra* note 30, at 1428 (defining "avoidance" as "efforts to reduce one's tax liability without altering one's consumption basket").

35. *United States v. Isham*, 84 U. S. 496 (1873) *cited in* Cogger, *supra* note 32, at 518. *See also* Judith Freedman, *The Anatomy of Tax Avoidance Counteraction: Abuse of Law in a Tax Context at Member State and European Union Level*, *in* PROHIBITION OF ABUSE OF LAW: A NEW GENERAL PRINCIPLE OF EU LAW 365, 370 (Rita de la Feria & Stefan Vogenauer eds., 2011) (discussing the difficulties of abuse and avoidance encountered in the area of taxation).

36. Montgomery, *supra* note 32.

37. *See, e.g.*, BEYOND BOUNDARIES: DEVELOPING APPROACHES TO TAX AVOIDANCE AND TAX RISK MANAGEMENT, 1–2 (Judith Freedman ed., 2008) (a collection of articles discussing the challenge of regulating tax avoidance) ("[T]here is

literature, developed mainly by finance and accounting researchers, blurred that normative difference when it—mainly due to empirical-pragmatic reasons, including the desire for an objective standard of measurement[38]—applied a uniform measurement to all managers' actions that result in de facto reduced taxes. It refers to all of them—evasion, avoidance and all the points in-between—as "tax avoidance."

Considering one prominent example—in their oft-cited and comprehensive review of financial tax research—Hanlon & Heitzman acknowledge that "tax avoidance represents a continuum of tax planning strategies where something like municipal bond investments are at one end (lower explicit tax, perfectly legal), then terms such as 'noncompliance,' 'evasion,' 'aggressiveness,' and 'sheltering' would be closer to the other end of the continuum."[39]

Nevertheless, due to pragmatic reasons, the definition set by the authors for the discussion of empirical research of corporate tax behavior blurs that normative distinction.

> "We define tax avoidance broadly as the reduction of explicit taxes. This definition . . . reflects all transactions that have any effect on the firm's explicit tax liability . . . [t]his definition does not distinguish between real activities that are tax favored, avoidance activities specifically undertaken to reduce taxes, and targeted tax benefits from lobbying activities."[40]

Using such a broad definition results in the uniform measurement of corporate behaviors that differ fundamentally in normative—and therefore legal—terms. This empirical approach, implemented by contemporary corporate tax research, creates a real challenge for legal researchers and policymakers interested in distinguishing between corporate tax reductions that result from non-legitimate tax behaviors, which should be deterred, and legitimate tax selections made by taxpayers which should be allowed (e.g., whether to incorporate as a company and be taxed according to a C-corporation regime or establish a partnership and be taxed as a "pass through.")

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another set of boundaries that is of major significance in any discussion of taxation: this consists of the boundary between illegal evasion and 'legal' avoidance and the boundary between what is sometimes termed 'acceptable' and 'unacceptable' avoidance. . . . A precise boundary is clearly impossible and even undesirable, given that any such boundary would be an instant target for tax 'planning' activity.").

38. *See, e.g.*, Hanlon & Heitzman *supra* note 26, at 137 ("If tax avoidance represents a continuum of tax planning strategies . . . [h]owever, much like art, the degree of aggressiveness (beauty) is in the eye of the beholder; different people will often have different opinions about the aggressiveness of a transaction.").

39. *Id.* at 137.

40. *Id.*

In this respect, contemptuous tax reporting, as further argued below, represents a non-legitimate tax behavior, which therefore should be distinguished from other avoidance actions taken by managers.

A. Assessing the Tax

"Taxes are what we pay for [a] civilized society."[41] Nonetheless, enacting a federal tax code and setting treasury regulations are not sufficient in order to have funds streaming into the Treasury.[42] Codes and regulations must be applied in accordance with each taxpayer's individual factual circumstances. The process in which tax legislation and the resulting tax liability is fixed to the specific taxpayer's circumstances is known as "assessment."[43] The liability established in the assessment phase must be reported and paid; in other words, the tax must be "collected." Income and profit tax are assessed and collected in the US and in many other countries around the world[44] mainly by requiring taxpayers[45] to file annual tax returns accompanied by a check or a refund request to the tax authority ("self-reporting").[46] While having prominent systemic advantages, self-reporting levies a burden on taxpayers who are required to self-implement the tax code on their own individual factual circumstances. Practically speaking, many taxpayers follow online tax guides and use tax software to complete their returns; others pay a tax advisor to help them file or, in the case of large corporations, employ full-time professionals, supervised by the management, to handle the corporation's taxes. In all cases, under a self-reporting regime, application of the tax code to taxpayers' factual circumstances is controlled by the filing taxpayer and not by a government assessment officer. Therefore, taxpayers' self-assessment is

41. *Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, Jr., J., dissenting). The phrase, including the word "a," is also engraved on the IRS building in Washington DC.

42. Slemrod, *supra* note 30, at 1426 (noting that avoidance, evasion and administration are central, not peripheral, concepts in public finance).

43. IRS, Procedures for Assessment of Tax § 35.9.2.1 (2004), https://www.irs.gov/irm/part35/irm_35-009-002 [https://perma.cc/VC22-78LF].

44. *See* OECD, COMPARATIVE INFORMATION ON OECD AND OTHER ADVANCED AND EMERGING ECONOMIES, 302–03 (Forum on Tax Administration, Centre for Tax Policy and Administration, OECD, 2013), https://read.oecd-ilibrary.org/taxation/tax-administration-2013_9789264200814-en#page305 [https://perma.cc/34DQ-KPUN].

45. *See* 26 U.S.C. § 6012(a) 2018 (requiring corporations to submit tax returns on income).

46. *See* Curtis J. Berger, *Voluntary Self-Assessment - The Unwilling Extraction of Taxpayer Information*, 42 U. PITT. L. REV. 759, 760 (1981) (describing the duties taxpayers must perform, and the Service's powers to enforce those duties).

not subject to ex-ante governmental scrutiny but rather, subject to occasional ex-post audits.[47]

B. Opportunistic Tax Reporting

Applying a generalized legal tax code, and especially a long and complicated one such as the U.S. tax code, to a taxpayer's unique circumstances is not always straightforward. Occasionally, application results in more than one possible interpretation of the code's relevance to the specific taxpayer's circumstances. Thus, taxpayers sometimes face a number of possible interpretations ("tax positions") from which they need to choose.[48] Faced with several tax positions,[49] taxpayers might opportunistically choose, ex-post*,* their most favorable tax positions and report accordingly.[50] Furthermore, taxpayers might invest resources, i.e., incur additional Coasean transaction costs,[51] in reshaping their position's legal condition ex-ante*,* without affecting their position's economic substance, in order to achieve a favorable tax result.[52] When taxpayers incur such additional transaction costs only to

47. *See* NICHOLAS BARR, SIMON JAMES & ALAN PREST, SELF-ASSESSMENT FOR INCOME TAX 34, 3–4 (1977) (defining self-assessment for personal income tax as the taxpayer being responsible for calculation of total income, total tax-free income, total taxable income, and total taxes due; verification activities are carried out by the tax administration only on a sample of tax returns).

48. *See* Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 137 (2009).

49. *See* Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance,* 25 VA. TAX REV. 339, 339 (2005) (discussing a tax risk insurance policy that provides coverage against the risk that the Service will disallow a taxpayer-insured's tax treatment of a particular transaction).

50. *See* Shu-Yi Oei & Diane M. Ring, *Can Sharing Be Taxed*, 93 WASH. U. L. REV. 989, 989, 1028 (2016) (discussing sharing businesses, and how such businesses opportunistically pick the more favorable regulatory interpretation if there is ambiguity regarding which rule applies or whether a rule applies).

51. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390–91 (1937) (presenting a theory of the firm that is based on transaction costs; coordinated production does not rely on prices separately established in endless open market negotiations; among other things, the firm as a vehicle to lower "[t]he costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market . . . .").

52. *See* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 230 (2010) (defining regulatory arbitrage as "the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment"); *see also* Jordan Barry, See Also Response, *On Regulatory Arbitrage*, 89 TEX. L. REV. 69, 73–75 (2011) (commenting on Fleischer's regulatory arbitrage analysis); Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227–28 (1997) (explaining the concept of regulatory arbitrage); Lynn A. Stout, *Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial*

create an opportunity to reduce their tax liability, they are said to have taken advantage of tax arbitrage.[53] Tax arbitrage, and more generally, regulatory arbitrage, appears whenever the structure of a deal (a business transaction) can be manipulated "to take advantage of a gap between the economic substance of a transaction and its regulatory treatment."[54] Tax arbitrages are presumed to be practiced by most rational taxpayers whenever the resulting tax savings is higher than the additional required transaction costs needed to make the arbitrage available to the taxpayer, making the reshaping of the deal generally profitable for the taxpayer.[55] Acting opportunistically by selecting ex-post between a number of available tax positions,[56] or by incurring additional transaction costs to make a favorable tax position available, concludes with the taxpayer reporting that is in line with the code.[57] Hence, to whatever extent these behaviors might be considered "opportunistic," the resultant reporting is still in conformity with prevailing tax doctrine. Although the taxpayer might end up with a favorable tax position only by "taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision"[58] or, by incurring additional transaction costs to make such positions available (tax arbitrage), the final position taken is an available tax position ("conformant tax reporting"). Thus, a taxpayer might act opportunistically; however, her behavior, i.e., her tax report, is still in conformity with prevailing tax doctrine.

C. Opportunistic Reporting versus Contemptuous Reporting

As compared with these two types of opportunistic yet conformant tax reporting, taxpayers can also engage in non-conformant tax reporting. That is, a taxpayer can resolve a tax dilemma by taking a

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Markets, 21 J. CORP. L. 53, 55 (1995) (discussing the relationship between regulatory arbitrage and increased use of financial derivatives).

53. *See* Stout, *supra* note 52.

54. Fleischer, *supra* note 52, at 230; *see also* Partnoy, *supra* note 52, at 227 (suggesting a narrower definition for regulatory arbitrage).

55. *But see* Fleischer, *supra* note 52, at 252 (defining five constraints—legal constraints, Coasean transaction costs, professional constraints, ethical constraints, and political constraints—that limit the use of regulatory arbitrage).

56. *See, e.g.*, Oei, *supra* note 50.

57. Fleischer, *supra* note 52, at 229 ("[T]he most effective techniques are more pernicious, crafted by lawyers to meet the letter of the law while undermining its spirit, successful only until the government discovers and closes the loophole."). *See also* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239, 241–43 (1984) (explaining lawyers' contributions in balancing transaction costs and regulatory costs).

58. Fleischer, *supra* note 52, at 229.

legal position that does not correspond to her specific situation, nevertheless such specific application has not yet been positively ruled against (or, denied by an IRS interpretation). This third type of tax behavior, i.e., the resolution of a tax dilemma by knowingly taking a legal position that its application in the specific case (or at all . . .) does not follow prevailing tax doctrine, goes beyond mere opportunism and is nevertheless factually reportable because the assessment, i.e., the fixture of a factual transaction to its appropriate tax result, is made by taxpayers themselves; accordingly, managers have the discretion how to report the transaction.

In this respect, when managers choose to report a position, they know to be inconsistent—as tested against prevailing tax doctrines—with a company's factual circumstances, managers' reporting involves an abuse of the responsibility given to corporate taxpayers to self-report their taxes,[59] and is, accordingly, termed "contemptuous."[60]

It is worth spending a few more words on the nature and definition of contemptuous tax reporting: As mentioned, contemptuous reporting is defined as the knowingly filing of tax returns that contain legal positions that correspond frivolously or not at all to the tax code and prevailing tax doctrines.[61] A "litmus paper" that can identify such a legal position taken by a company is the court—if asked to determine whether the position reported is a valid one or not. Therefore, we can further define contemptuous reporting as the reporting of positions which, if were challenged by the IRS and litigated by the parties in the tax court (and even up to the Supreme court), would have been denied by the court, i.e., ruled against, resulting with additional tax being paid by the taxpayer.

All-in-all, the ability of taxpayers to contemptuously report tax positions is a direct result of taxpayers' control over the assessment. Where tax is assessed and collected by the government,[62] opportunistic yet conformant positions can prevail, but not positions that do not

59. Edward Yorio, *Federal Income Tax Rulemaking: An Economic Approach*, 51 FORDHAM L. REV. 1, 47 (1982) ("A central feature of the federal income tax system is that it relies primarily on self-assessment and voluntary compliance by taxpayers. Although taxes must be withheld on certain forms of income, each taxpayer essentially determines his own tax liability."); *United States v. Bisceglia*, 420 U.S. 141, 141 (1975) ("The Government depends upon the good faith and integrity of each potential taxpayer . . . .").

60. *See* Tricia S. Jones, *Emotional Communication in Conflict: Essence and Impact*, *in* THE LANGUAGE OF CONFLICT AND RESOLUTION 81, 96 (William F. Eadie & Paul E. Nelson eds., 2001) (defining "contemptuous behavior" as a challenge to the legitimacy of the other as a subject deserving respect).

61. *See supra* note 23 and accompanying text.

62. For example, by withholding taxes, then requesting taxpayers entitled to reductions to submit refund requests which are fully scrutinized by the tax authority before approved.

conform to tax doctrine. Thus, an assessment officer conducting an assessment could not object to an opportunistic interpretation just because it results in reduced tax, as long as it conforms to the doctrine. Such an officer could and would object to a contemptuous interpretation that does not correspond to prevailing tax doctrine. However, once there is no administrative ex-ante examination of positions taken, contemptuous reporting is curbed only by the low-probability risk of being discovered in an ex-post tax audit. Most recent statistics published by the IRS indicate the IRS audited only one percent of corporate income tax returns (excluding S corporation returns).[63] Knowing the low probability of being audited, managers decide to report contemptuously, putting money on the highly likely scenario that the corporation will not be audited and even if audited, that the contemptuous position taken would not be discovered; ergo, playing the "tax lottery," betting that the position taken will never be challenged by the IRS.[64]

In theory, taxpayers are deterred from playing the tax lottery by high penalties levied on those returns audited and found to include frivolous reporting positions that result in underestimated tax liability.[65] Thus, theoretically, an equilibrium point composed of audit rate and punishment level (interest, fines, etc.) should exist so as to deter managers from playing the tax lottery.[66] However, as the data shows,[67] each year publicly traded companies adopt billions of dollars worth of contemptuous positions; that is, positions the companies report on while knowing they do not conform to prevailing tax doctrine and if they were audited, would result in additional tax payments. These findings suggest that even if such an equilibrium point were to theoretically exist,[68] the system is not there now. Either the fraction of such

63. *See* IRS Data Book, INTERNAL REVENUE SERVICE, 21, (2017), https://www.irs.gov/pub/irs-soi/17databk.pdf [https://perma.cc/83H6-FM4B] (reporting a 0.5 percent overall rate of returns audited) [hereinafter IRS Data Book].

64. *See* Slemrod, *supra* note 30, at 1428–31.

65. *See, e.g.*, IRC §§ 6662, 6702, 7206; *see also* IRS, *Summary of Preparer Penalties Under Title 26*, https://www.irs.gov/tax-professionals/summary-of-preparer-penalties-under-title-26 [https://perma.cc/KGD6-RAYM].

66. *See* Slemrod, *supra* note 30, at 1433 (discussing different models regarding the equilibrium).

67. *See infra* Section. IV.A. (discussing the empirical study of contemptuous reporting by S&P 500 companies).

68. *See* Slemrod, *supra* note 30, at 1436, 1464 (reviewing theoretical models that integrate avoidance and evasion into the overall decision problem faced by individuals, and introduces a general theory of optimal tax systems in which tax rates and bases are chosen simultaneously with the administrative and enforcement regimes).

taxpayers' returns audited by the IRS is not high enough or the sanction is not high enough, or both.[69]

D. Self-Reporting

At this point, it should be noted that throughout history, different methods were implemented for collecting taxes. For example, at the beginning of the 17th century,[70] the British government was firmly wedded to the idea that the government should contract with private agents, known as "tax farmers," to effectively assess and collect taxes due.[71] Thus, taxes at that time, mainly composed of custom duties and property taxes, were actively collected by syndicates of businessmen who acted as privatized active assessment officers.[72] Moreover, tax assessment was akin to a judgment, creating an obligation for the taxpayer to pay and a correlative right for the collector, as representing the sovereign, to collect the assessed amount.[73] Collection of taxes was based on ex-ante assessment by the government or its representative; inter-alia, the taxpayer's only remedy against erroneous assessment was to sue for an ex-post refund, but only after paying the tax as initially assessed.[74]

However, when the constitutionality of the income tax was clearly established by the Sixteenth Amendment in 1913, Congress adopted a

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69. *See* Jacob Nussim & Avraham D. Tabbach, *Deterrence and Avoidance*, 29 INT'L REV. L. & ECON. 314 (2009) (arguing that increasing punishment or enforcement efforts does not necessarily deter criminal activity and may actually trigger increased crime if avoidance is possible).

70. Robert Ashton, *Revenue Farming Under the Early Stuarts*, 8 ECO. HIST. REV. 310, 310 (1956); Metin M. Cosgel & Thomas J. Miceli, *Tax Collection in History*, 37 PUB. FIN. REV. 399, 415–16 (2009) (arguing that a combination of factors, including stronger bureaucracies and more sophisticated production and exchange, increased the cost of measuring the tax base and revenue and lowered the cost of measuring the collectors' effort, hence creating a trend after the seventeenth century toward greater use of wage contracts in tax collection).

71. Ashton, *supra* note 70, at 311, 320; *see also* Eugenia Froedge Toma & Mark Toma, *Tax Collection with Agency Costs: Private Contracting or Government Bureaucrats?*, 59 ECONOMICA 107, 107 (1992) (developing a "theoretical framework for determining when a welfare-maximizing government should choose tax farmers over bureaucratic tax collectors"); Cosgel, *supra* note 70, at 399 (examining a variety of tax collection methods that have been employed throughout history).

72. Ashton, *supra* note 70; Cosgel, *supra* note 70, at 402 (discussing how the syndicates paid an annual rent to the Crown in return for the right to run a semi-privatized collection mechanism and to appropriate taxes due to themselves).

73. *See* Boris I. Bittker & Kenneth M. Kaufman, *Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code,* 82 YALE. L.J. 51, 56 (1972) (discussing common law origin of tax assessment).

74. *Id.*

very different approach for collection the new income tax.[75] Section 2 of the Revenue Act of 1913 declared, "Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his total net income from all sources . . ."[76] Thus, instead of applying a government-based collection system, such that allows minimal discretion to taxpayers, Congress chose to "empower" taxpayers with the authority to self-report their tax liabilities under the new income tax.[77] Instead of hiring additional assessment officers to be employed by the government for the purpose of assessing individual taxpayers, the U.S. Postal Service was recruited for the task of conveying self-assessed tax returns.[78]

As the U.S. has been implementing a self-reporting regime for income tax collection since the 1910s,[79] over the years, legal scholars have pointed to a number of justifications for preferring such a tax collection system in which taxpayers perform assessment and face potential ex-post scrutiny, over any alternative version of an administrative-assessment system that would apply ex-ante scrutiny on taxpayers' reporting.[80] First, self-reporting systems are believed to be more cost-efficient in achieving accurate tax collection.[81] It is cheaper for taxpayers to gather the information required for accurate assessment of their income than for the revenue authority to collect the data (e.g., by sending assessment officers to the taxpayer). Second, self-reporting allows citizens to actively and directly participate in a fundamental democratic obligation of their citizenship—paying taxes.[82] The citizen is

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75. *See* EDWIN R. A. SELIGMAN, THE INCOME TAX – A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD, v-vi (1911) (discussing a survey of tax collection practices from around the world conducted with the objective of proposing what sort of method best fits the U.S.'s new income tax).

76. Revenue Act of 1913, § 2(A).

77. *Id.*

78. *Id.*

79. *Id.*; *see also* Andrew Okello, *Managing Income Tax Compliance Through Self-Assessment*, IMF Working Papers 14/41, 12 (2014) ("Canada and the United States first implemented self-assessment in the 1910s, followed by Japan in 1947 . . . .") https://www.imf.org/external/pubs/ft/wp/2014/wp1441.pdf [https://perma.cc/G6BY-J665].

80. *See* Edward Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1256 (1985); Yorio, *supra* note 59, at 47. *Compare* Simon James, *Self-Assessment for Income Tax*, 1994 BRITISH TAX REV. 204 [hereinafter James Self-Assessment] *and* Simon James, *Correspondence*, 1995 BRITISH TAX REV. 206 (advocating a U.K. transfer to self-assessment) [hereinafter James Correspondence], *with* Cedric Sandford, *Self-Assessment for Income – Another View*, 1994 BRITISH TAX REV. 674 (objecting to a U.K. transfer to self-assessment, arguing constitutional reasons will cause it not to work in the U.K.).

81. *See* James Correspondence, *supra* note 80, at 208.

82. *Id.*

not only required to comply with and pay a tax liability determined for him by the government, but also to participate in calculating the liability through self-reporting.[83] In addition, as compared to administrative-assessment, self-assessment is believed to be less intrusive and inquisitorial[84] and is believed to reduce clashes between the government and the citizen (without losing too much revenue due to fraud in the process).[85]

Nevertheless, these arguments are valid as long as taxpayers cooperate and play by the rules.[86] However, if taxpayers intentionally act contrary to prevailing tax doctrines, the rationale justifying self-reporting is seriously harmed. For instance, the information-efficiency justification is voided: We may be saving money on assessment officers' salaries but losing tax revenues. This is also true for the justification of enhancing positive and active participation of citizens in tax collection when/if democratic participation becomes abusive. And, if taxpayers abuse the discretion they have in a self-reporting regime, the potential for clashes increases.

That said, scholars have also pointed to the role tax collection played in U.S. history as affecting Congress's decision to adopt the self-reporting mechanism for collection of the (new) American income tax.[87] In this respect, historical reasoning (rather than sound policy) can explain current circumstances. According to King's College London Professor Ann Mumford, a direct link exists between the role taxes played in the battle of the Colonies against Great Britain, and the implementation of self-assessment and self-reporting principles in the contemporary U.S. tax system.[88]

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83. Yorio, *supra* note 59, at 47 ("A political asset of a self-assessment system is that citizens in a democracy participate directly in what is a fundamental, albeit onerous, duty of citizenship.").

84. *See* Nicholas Barr, Simon James & Alan Prest, SELF-ASSESSMENT FOR INCOME TAX 3–4, 130–53 (1977) (summarizing and discussing the pros and cons of self-assessment for personal income tax).

85. OECD, COMPARATIVE INFORMATION ON OECD AND OTHER ADVANCED AND EMERGING ECONOMIES, at 303 (Forum on Tax Administration, Centre for Tax Policy and Administration, OECD, 2013), https://read.oecd-ilibrary.org/taxation/tax-administration-2013_9789264200814-en#page305 [https://perma.cc/AJA2-DFVT].

86. Berger, *supra* note 46, at 759 ("Our collective honesty . . . provides the essential lubricant for the revenue-reaping machine. Without it, our government would not have the means to operate[,]"referring to *United States v. Bisceglia*, 420 U.S. 141 (1975)).

87. Ann Mumford, *Self-Assessment for Income Tax: The Relevance of Historical and Constitutional Difference*, BRITISH TAX REV. 120, 122–23 (1996).

88. *See, e.g.*, ANN MUMFORD, TAXATION CULTURE: TOWARDS A THEORY OF TAX COLLECTION LAW 18 (2002) (discussing self-assessment, while comparing the U.S. and the U.K., and arguing that the U.S. decision to adopt self-reporting is explained based on cultural backgrounds and clashes with England); Mumford, *supra* note 87, at 123 ("The United States constitution's opening words—'We, the people . . .'—reflect[s]

American historical explanation aside, the general assumption that taxpayers play by the rules, or can at least be effectively deterred from disobeying them, as well as recognition of the systemic advantages of self-reporting, have been leading more and more countries around the world to follow the U.S. and adopt self-reporting in lieu of administrative-assessment for the purpose of tax collection.[89] As the Organisation for Economic Co-Operation and Development (OECD) data show, following a global expansion during the last thirty years,[90] today more than half of OECD countries apply self-reporting principles for the purpose of collecting personal income tax and more than two-thirds for collecting corporate income tax.[91] However, if taxpayers, or in the case of corporations, their managers, are not effectively deterred from using self-reporting to contemptuously self-report their taxes, the shift towards self-reporting means a shift towards more problematic and less effective collection of taxes.

II. THE INFORMATION GAP REGARDING CONTEMPTUOUS TAX REPORTING

A key parameter in the debate preceding President Trump's 2017 corporate tax reform was the low effective tax rate (ETR) reported by publicly traded corporations.[92] The ETR represents the ratio of a company's overall tax liability to its pre-tax income.[93] The year preceding the reform, companies such as Intel and Google (Alphabet Inc.) reported effective tax rates as low as 20.3 percent[94] and nineteen percent[95] (respectively), well below the then statutory federal corporate

a different view of the sovereign and hence the taxing authority, from the British view, and that is reflected in self-assessment as a mechanism . . . . The American constitution embodies toleration by the people (within limits) of a taxing power held by each other.").

89. *See* Okello, *supra* note 79.

90. *Id.*

91. OECD, *supra* note 85.

92. *See, e.g.*, Patricia Cohen, *Profitable Companies, No Taxes: Here's How They Did It*, N. Y. TIMES (Mar. 9, 2017), https://www.nytimes.com/2017/03/09/business/economy/corporate-tax-report.html [https://perma.cc/DW8T-JT8C]; Christopher Helman, *What America's Biggest Companies Pay in Taxes*, FORBES (Apr. 18, 2017, 1:40 AM), https://www.forbes.com/sites/christopherhelman/2017/04/18/what-americas-biggest-companies-pay-in-taxes/#7c46020c2f51 [https://perma.cc/4AKF-DGMP].

93. *See* Cohen, *supra* note 92.

94. Intel, Inc., Annual Report (Form 10-K) (For Fiscal Year Ending Dec. 31, 2016) at 41, https://www.sec.gov/Archives/edgar/data/50863/000005086317000012/a10kdocument12312016q4.htm [https://perma.cc/R4XB-CM6P].

95. Alphabet Inc. (Google, Inc.), Annual Report (Form 10-K) (For Fiscal Year Ending Dec. 31, 2016) at 23,

tax of thirty-five percent.[96] Such reports have led the financial press to compare big corporations' low ETR rates with the much (then) higher statutory tax rate,[97]suggesting companies do not pay their fair share.[98]

In a similar fashion to the discussion critical of companies' low ETR, legal researchers[99] have pointed to another phenomenon: Companies reporting high pre-tax income on their annual financial statements—prepared for investors according to financial accounting standards[100]—while simultaneously stating a much lower taxable income on their corporate tax returns filed with the IRS.[101] Among other things, the gap between the high income reported to investors (known as "book income") and the much lower income reported to the IRS (known as "tax income") has caused legal scholars to suggest aligning investor-reporting with tax-reporting, thereby curtailing aggressive[102] tax behavior intended to lower tax income due to the effect it will have on book income.[103]

While ETR and the gap between book income and tax income—book-tax difference, or "BTD"—have taken center stage in past discussions of changes required in the corporate tax regime,[104] these

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https://www.sec.gov/Archives/edgar/data/1652044/000165204417000008/goog10-kq42016.htm [https://perma.cc/5W36-H585].

96. Cohen, *supra* note 92.

97. *Id.*; Helman, *supra* note 92.

98. Cohen, *supra* note 92.

99. *See*, *e.g.*, Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 475 (2009) (proposing a simple and uniform percentile adjustment on financial accounting income); Mihir A. Desai, *The Degradation of Reported Corporate Profits*, 19 J. ECON. PERSP. 171, 190 (2005) (suggesting beginning with accounting-based measures of income and then identifying exceptions); Celia Whitaker, *Bridging the Book-Tax Accounting Gap*, 115 YALE L.J. 680, 683 (2005) (advocating a system of near-total book-tax conformity that uses financial income — as reported to investors — as the starting point for taxable income); Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax GAAP*, 2001 COLUM. BUS. L. REV. 539, 544–58 (describing the initial appeal of using the book income of public corporations as their tax base under the comprehensive approach, and its shortcomings); Gil B. Manzon & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175 (2002) (exploring the magnitude and source of differences between book and taxable income).

100. *See generally* Israel Klein, *The Gap in the Perception of the GAAP*, 54 AM. BUS. L.J. 581, 594–603 (2017) (reviewing accounting norms and their prescribers).

101. Blank, *supra* note 33; *see also* IRS, ABOUT FORM 1120, U.S. CORPORATION INCOME TAX RETURN (2019), https://www.irs.gov/forms-pubs/about-form-1120 [https://perma.cc/FU37-Z3D5].

102. *See, e.g.*, Blank, *supra* note 33.

103. *See infra* Section IV.A.

104. See, *e.g.*, TREASURY DEP'T, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS, at 84 (1999), 1999 TNT 127–12, July 2, 1999, https://www.treasury.gov/resource-center/tax-

two tax parameters do not convey information about a company's contemptuous tax behavior. Furthermore, because of changes in the disclosure rules (accounting principles)[105] governing the effect contemptuous reporting has on a company's financial report,[106] ETR and BTD although being extremely popular when discussing corporate tax policy, have now become a distorted prism through which corporate tax behavior is viewed. Hence, the section that follows introduces an alternative analysis to ETR and BTD and provides a financial measure of a company's contemptuous tax behavior.

A. The Information Gap

Financial tax parameters,[107] such as a company's ETR[108] or BTD,[109] routinely used in legal[110] and finance[111] articles, are calculated based on a company's reported tax expenses as disclosed in its financial statements.[112] Although being an easily accessible parameter, the use of

policy/Documents/Report-Corporate-Tax-Shelters-1999.pdf [https://perma.cc/9899-9J2Z]. For a discussion of the Treasury report, see Terry Shevlin, *Corporate Tax Shelters and Book-Tax Differences*, 55 TAX L. REV. 427, 427 (2002) (discussing a Treasury report that indicated a growing spread between book and taxable income, which the Treasury interpreted as being possibly due to growing corporate tax shelter activity).

105. *See* Israel Klein, *A Change in Accounting, A Change in Law*, 42 DEL. J. CORP. L. 51 (2017) (discussing the impact changes in accounting standards has on fiscal and regulatory regimes that utilize accounting parameters).

106. *See* Andrew W. Jones, *FASB—The IRS's New Best Friend: How FIN 48 Affects the Taxpayer-IRS Relationship and Potential Taxpayer Challenges*, 25 GA. ST. U.L. REV. 767 (2009) (discussing the new accounting interoperation released by the FASB—FIN 48).

107. In their extensive literature review, Hanlon & Heitzman, *supra* note 26, review twelve measures of tax avoidance used in the literature: 1. GAAP ETR; 2. Current ETR; 3. Cash ETR; 4. Long-Run Cash ETR; 5. ETR Differential; 6. DTAX; 7. Total BTD; 8. Temporary BTD; 9. Abnormal total BTD; 10. Unrecognized tax benefits; 11. Tax shelter activity; 12. Marginal tax rate. As discussed below, of these twelve parameters, only one parameter, unrecognized tax benefits, can provide information on contemptuous reporting. *See* Hanlon & Heitzman, *supra* note 26, at 160 & TBL. 1 (2010) for a full explanation of the different parameters.

108. *See supra* note 28.

109. *See supra* text preceding note 104.

110. *E.g.*, Blank, *supra* note 33, at 31 (discussing ETR and other parameters, including unrecognized tax benefits, in the context of tax privacy); *see also* Montano Cabezas, *Giving Credit Where it is Due: Rethinking the Corporate Tax Paradigm,* 35 VA. TAX REV. 60 (2015) (discussing the use of ETR in "fair share" tax rhetoric).

111. For a comprehensive literature review, see Hanlon & Heitzman, *supra* note 26.

112. *See* Hanlon & Heitzman, *supra* note 26, at 139 ("Most tax avoidance measures are obtained from financial statement data because tax returns are not publicly available and access is granted to only a few . . . [y]et, it is well known that there are

a company's reported tax expenses as a reflection of a company's tax behavior falsely assumes that disclosed tax expenses reflect current and prospective tax payments and therefore it can be concluded that the higher a company's reported tax expenses are, the more tax a company is paying overall.[113]

However, as applied to the U.S. corporate environment,[114]this assumption ignores a number of pre-set rules integrated into the rules governing financial disclosure, that is, U.S. generally accepted accounting principles (GAAP).[115] Among these rules is the unique accounting treatment of tax positions: Although the actual rate of IRS audits for corporate tax returns is low,[116] when preparing its financial statements, the company is required by GAAP to assume that all the positions reported in tax returns will be audited by the IRS, [117] and, to further assume, that the IRS will be fully aware of all of the positions' relevant information.[118] Following these hypothetical assumptions—remember the low rate of audits, and the low chances, even if audited, that positions and all their details will be discovered by the IRS—GAAP requires the company to report additional tax expenses for all the positions that are not expected to sustain such a hypothetical IRS scrutiny and thus result with possible additional tax payments (Additional (deemed) Tax Expenses).

However, because of the factual, non-hypothetical, low probability of ever being challenged, these positions are not expected to result in any additional tax payments by the company. Nevertheless, due to GAAP requirements, the company reports the Additional (deemed) Tax Expenses for those positions, thus increasing the overall tax expenses as

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many problems with computing estimates of taxable income from financial statements.").

113. *See generally* Michelle Hanlon, *What Can We Infer About a Firm's Taxable Income from Its Financial Statements?*, 56 NAT'L TAX J. 831 (2003) (discussing many of the problems with trying to estimate a firm's actual tax liabilities and taxable income from the income tax expenses and disclosures in the financial statements).

114. *See supra* note 29.

115. Regulation S-X requires that financial statements be prepared using U.S. GAAP: "Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided." 17 C.F.R. §§ 210.4–.01 (2012); s*ee* Klein, *supra* note 100, at 595.

116. IRS Data Book, *supra* note 63 (reporting audit rate of one percent for corporations).

117. Fin. Acct. Standards Bd. Interpretation No. 48, Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109, ¶ 7 (2006) [hereinafter: "FIN 48"] (FIN 48, codified at ASC 740-10, requires businesses to analyze and disclose income tax risks).

118. *Id.*

reported to investors and utilized in the calculation of many commonly used tax parameters. Altogether, and as will be demonstrated below, reported tax expenses and consequently, the financial tax parameters relying on them, e.g., ETR, BTD, become an imprecise and, occasionally, misleading indication of a company's taxes.[119]

As discussed above,[120] contemptuous tax reporting involves managers taking advantage of the self-reporting regime by knowingly filing tax returns that contain positions that managers know to be inconsistent with prevailing tax doctrines (contemptuous tax positions). Contemptuous tax positions, if hypothetically audited by a fully informed IRS are positions that will result in additional hypothetical tax. Thus, under GAAP rules, contemptuous tax positions generate additional, albeit hypothetical/fictional, tax expenses reported to investors (the Additional (deemed) Tax Expenses, mentioned above), and along the way, distort corporate tax analysis.

B. The Resulting Distortion of the Analysis and Understanding Corporate Tax Behavior

The unique GAAP treatment of tax positions results in counterintuitive disclosures. Managers that reduce a corporation's tax liability by conformant reporting, i.e., using opportunistic positions that conform to prevailing tax doctrine, disclose overall reduced tax expenses, since the company saved tax and no Additional (deemed) Tax Expenses are reported, as positions are expected to sustain an audit. In contrast, companies engaged in contemptuous reporting which also reduces a corporation's factual tax payments, will nevertheless disclose overall increased tax expenses, because all contemptuous positions used in saving the tax cause the companies to recognize and disclose Additional (deemed) Tax Expenses.

Accordingly, the reporting of conformant positions causes a company's ETR and BTD parameters to decrease and increase (respectively), and thus indicate overall avoidant tax behavior. Remember, the lower the overall tax expenses reported by a company, the lower its ETR; the lower a company's ETR, the lower the tax a company is perceived as paying. In addition, the lower the overall tax expenses reported by a company, the higher its income reported to investors; the higher a company's income reported to investors, the higher the difference between the income as reported to investors and

119. *Id.* ¶ 17 ("As a result of applying this Interpretation, the amount of beneﬁt recognized in the statement of financial position may differ from the amount taken or expected to be taken in a tax return for the current year.").

120. *See supra* note 61 and accompanying text.

as reported to the IRS (BTD). And consequently the more a company is perceived as being involved in tax sheltering, etc.

In contrast, due to the Additional (deemed) Tax Expenses disclosed for positions that will not sustain a hypothetical IRS audit, companies engaged in contemptuous reporting enjoy higher ETR and lower BTD (as compared to a similar company engaged only in conformant reporting) and as a result, are seen as less engaged in tax avoidance.[121]

An example can help clarify this counterintuitive effect. Assume T-Gaming Inc. is a publicly traded software company that develops computer games. The company files an annual tax return with the IRS and publishes financial reports to its investors under SEC regulations[122] and according to GAAP.[123] After a number of troubled years, the company abandoned its offline gaming platform and adopted a new online gaming platform based on members subscriptions. Finally, the company released a blockbuster game and is therefore expected to end 2019 with a pre-tax profit of one-hundred million. In an effort to reduce expected taxes, the company hired a new tax director to work on maximizing net income. After studying the company, the director makes two recommendations for the management: First, he recommends that the company preempt recognition for tax purposes of some pre-paid expenditures; specifically, he recommends that the company claim a current deduction of fifteen million for rent paid in-advance for next year's operations (Tax Position A). This, although pre-paid, rent is not part of the current year's operation, and therefore should be capitalized and deducted only in next year's return[124] (in a similar fashion to the disclosure the company makes in its financial statements guided by GAAP rules).[125] The tax director believes he can

121. *See, e.g.*, Cohen, *supra* note 92 ("These industry-specific subsidies [of the energy sector] mean that the goodies were not evenly distributed. Utilities logged an effective tax rate of just 3.1 percent over the eight-year period. Industrial machinery, telecommunications and oil, gas and pipeline companies paid roughly 11.5 percent. Internet services paid 15.6 percent. In just two sectors — health care and retail — companies paid more than [thirty] percent of their profits in federal income tax.").

122. Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (2012); Securities Exchange Act of 1934 § 13(b), 15 U.S.C. §§ 78m(a)–(b) (2012) (noting the Commission's authority to prescribe the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of such financial reports submitted to the Commission and published to investors).

123. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 3 SEC Docket 275 (Dec. 20, 1973) (recognizing accounting and reporting standards promulgated by the FASB as generally accepted accounting principles for the purposes of Securities Acts).

124. *See* discussion in *infra* note 163.

125. *See* JOANNE M. FLOOD, WILEY GAAP: INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 2018 (2018) 394

argue the pre-empted expenditures are R&D related (the rent is paid for the company's labs) and can accordingly be expensed on the current year's tax return under IRC § 174 (further discussed in a later part of the article).[126] Therefore, even if challenged by the IRS, the director's assessment is that Tax Position A is more likely than not to hold up and result in an absolute reduction for the company of three million in this year's taxes (following the current deduction of the fifteen million in pre-paid rent).

In addition to Tax Position A, the tax director also suggests that the company report some of 2019's expenditures for technical support of its old games as *qualified research expenses* (QREs) entitled to R&D tax credit under IRC § 41 (further discussed in a later part of the article)[127] (Tax Position B). However, while explaining Tax Position B to the rest of the company's directors, the tax director admits that unlike Tax Position A, one of the code's requirements for a QRE is that it is "undertaken for the purpose of discovering information that will be useful in the development of a new or improved product."[128] Thus, in the specific case of the company, providing technical support for existing offline games remotely contributes to the discovery of such information required for the recognition of QREs. Nevertheless, the department's expenses will be reported together with all of the company's other IT expenses and therefore even in the remote chance the company will be audited by the IRS, the chance the position will be challenged is practically zero.[129] Therefore, the tax director advocates

(discussing prepaid expenses); RENEE RAMPULLA, COMMON U.S. GAAP ISSUES FACING CPAS (2018), 13-3 (discussing prepaid expenses as current assets).

126. *See infra* section IV.C. In general, business expenses associated with the development or creation of an asset whose useful life extends beyond the current year must be capitalized and depreciated over said useful life. However, § 174 allows the taxpayer to not capitalize such expenses but rather to currently deduct all reasonable R&D expenditures paid or incurred in connection with a trade or business. 26 U.S.C. § 174 (2012). *See also* Staff of Joint Comm. on Tax'n, 112th Cong., JCX-61-12, Background and Present Law Relating to Manufacturing Activities Within the United States (Comm. Print 2012) at 62, https://www.jct.gov/publications.html?func=startdown&id=4473. (describing the array of legal, expenditure, and tax law policies intended to promote R&D and innovation activity) [hereinafter Staff of Joint Comm. on Tax'n].

127. 26 U.S.C. § 41 (2012) (discussing credit for increasing research activities; *See infra* notes 165–68 and accompanying text.

128. 26 U.S.C. § 41(d)(1). Although technical support can be claimed to be partially undertaken for the purpose of discovering information that will be useful in the development of a new or improved product, it is not always the case. *See also* Nussim & Sorek, *supra* note 20, at 73–74 ("[W]ithin any R&D production process, costs may have to be further partitioned between those that account for cash support and those that do not (e.g., quality control).").

129. *See also* Robert P. Rothman, *Tax Opinion Practice*, 64 TAX LAW. 301, 311–26 (2011) (reviewing different types of tax opinions and discussing a practitioner's ability to provide opinions with low comfort levels).

adopting Tax Position B as well,[130] and saving an additional two million in taxes for the current year.

Tax Position A, which is a conformant position, and Tax Position B, which is a contemptuous position, will each have a different effect on T-Gaming Inc.'s BTD and ETR. With respect to the company's BTD, the company's financial statements, prepared according to GAAP, will show before tax earnings of one-hundred million for 2019 (remember—under GAAP, pre-paid rent is capitalized and thus will be expensed only next year).[131] Nevertheless, due to the preemption of fifteen million in rent expenses in the company's 2019 tax return, the company will report a taxable income of only eighty-five million. As a result, Tax Position A will create a tax-book difference for the company in the amount of fifteen million—one-hundred million reported to investors minus eighty-five million of income reported to the IRS on the return. With respect to Tax Position B, the R&D credit claimed under Tax Position B does not affect the income line, only the tax actually paid;[132] thus, Tax Position B will not have any effect on the company's BTD.

With respect to the company's ETR, that is, the ratio of the company's reported pre-tax income to its reported tax expenses: Tax Position A reduces reported tax expenses by three million, thereby reducing the company's ETR (remember—the ETR is equal to the reported tax expenses divided by the reported pre-tax income and so reducing reported tax expenses reduces the ETR). In contrast, as Tax Position B will not hold up if hypothetically audited by the IRS (it is a contemptuous tax position), it generates Additional (deemed) Tax Expenses. Hence, although Tax Position B saved two million in this year's factual tax payments, GAAP requires the company to report Additional (deemed) Tax Expenses of two million. Therefore—as compared with Tax Position A—Tax Position B increases the overall reported tax expenses—the numerator of the ETR calculation—by two million; thereby, increasing the company's ETR.

All in all, Tax Position A, which conforms to prevailing tax doctrine, increases the company's BTD and reduces the company's ETR and therefore signals tax avoidance. In contrast, Tax Position B,

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130. Blank, *supra* note 33, at 59 ("One determinant of a corporation's willingness to pursue aggressive tax strategies is its tax director, the individual who oversees the corporation's tax compliance and reporting obligations.").

131. RAMPULLA, *supra* note 125, at 13.

132. A tax credit, unlike a tax deduction, doesn't affect the reported taxable income, but only reduces the bottom-line tax liability as calculated after multiplying taxable income in the tax rate. For an illustration, see Herb Kirchhoff, *Tax Credit vs. Tax Exemption*, ZACKS, https://finance.zacks.com/tax-credit-vs-tax-exemption-3265.html [https://perma.cc/HV4Q-R3F8].

which is a contemptuous position, does not affect BTD but increases the company's ETR and therefore signals non-avoidance.

The same analysis regarding the contradictory effect Tax Positions A and B have on ETR and BTD holds true for all tax parameters that utilize companies' tax expenses as reported in the company's GAAP financial statements.[133] Whenever ETR or other financial tax parameters are used as an indication of a company's tax behavior,[134] they, in fact, tell only part of the story—that of the conformant position. The use of non-conformant positions, i.e., contemptuous positions, is left obscured by such tax parameters and the analysis thereof. For example, the 2016 actual effective tax rate incurred by Google,[135] recalculated while neutralizing the distortion contemptuous tax reporting creates, is much lower than the effective tax rate (ETR) reported by the company in its 2016 financial statements. Specifically, while Google reported an ETR of nineteen percent to investors,[136] neutralizing the effect of hypothetically deemed tax expenses resulting from contemptuous reporting—by utilizing the methodology described in the next section—results in an actual much lower tax rate of only 16.5 percent.[137] In other words, contemptuous tax reporting improved Google's ETR, a prominent tax parameter used to measure corporate tax compliance, by fifteen (!) percent.[138]

III. FILLING THE GAP

Although contemptuous reporting distorts corporate tax analysis based on ETR and BTD, contemptuous reporting practices require companies subject to GAAP to separately disclose aggregated numbers for all such contemptuous positions taken. Specifically, as part of requiring a company to report Additional (deemed) Tax Expenses for positions that will not sustain a hypothetical IRS audit, GAAP requires companies to include in the notes for the company's financial statements a tabular disclosure which aggregates information regarding

133. *See* Hanlon & Heitzman, *supra* note 26.

134. *See, e.g.*, Cohen, *supra* note 92; Helman, *supra* note 92.

135. SEC, *supra* note 95, at 23.

136. *Id.*

137. According to its UTB disclosure during the 2016 financial year, Google adopted $680 million worth of contemptuous positions. That same year, Google reported a 2016 pre-tax income of $24,150 million and provision for income tax of $4,672 million. Neutralizing the effect of contemptuous positions on the 2016 provision for income tax results in an actual tax rate of only 16.5 percent [($4,672 million-$680 million) / $24,150 million]. *Id.* at 79.

138. *Id.* at 23, 79 (nineteen percent (reported ETR) minus 16.5 percent (recalculated ETR) = 2.5 percent; 2.5 percent divided by 16.5 percent equals fifteen percent).

all current and past deemed tax expenses which resulted from such contemptuous reporting.[139] The aggregated deemed expenses are disclosed as "unrecognized tax benefits" (UTBs).[140]

In GAAP technical terminology, UTBs represent the cumulative difference between all tax benefits gained, i.e., tax being saved by taking reporting positions on the company's tax returns (any type of tax position), and the equivalent benefits which meet the recognition threshold established by GAAP (and therefore are recognized by GAAP as absolute tax being saved, without requiring the company to recognize Additional (deemed) Tax Expenses).[141] That is, GAAP allows a company to recognize benefits that result from taking a reporting position on tax returns, i.e., to reduce its overall tax expenses reported to investors, insofar as:

> it is more likely than not, based on the technical merits, that the position will be sustained upon examination [by the IRS] . . . [T]he term "more likely than not" means a likelihood of more than [fifty] percent; the terms "examined and upon examination" also include resolution of the related appeals or litigation processes, if any.[142]

Accordingly, the UTBs disclosure represents the difference between all tax being saved using positions reported on corporate tax returns (conformant and contemptuous positions), and the tax being saved through those positions which are expected to sustain audits (i.e., conformant positions). The resulting difference between the two are taxes being saved using contemptuous positions that managers know will not be sustained in an audit since their reporting do not correspond to prevailing tax doctrines. Thus, disclosed UTBs numbers represent the tax being avoided through the reporting of contemptuous positions by managers.

A. Contemptuous Reporting by S&P 500 Companies

In order to understand the enormous magnitude of contemptuous reporting and the cumulative economic cost in lost tax revenue, of specific interest are UTB numbers appearing as Current Year Increases in the UTB tabular disclosure. This UTB parameter represents new positions which the company took in the reported financial year while, as mentioned, knowing their reporting do not conform to prevailing tax

139. FIN 48, *supra* note 117, ¶¶ 20–21.
140. *Id.*
141. *Id.*
142. *Id.* ¶ 6.

doctrines. In GAAP terms, these positions do not fulfill the recognition threshold of more likely than not to sustain a hypothetical IRS examination.

Data about companies included in the S&P 500 index reveals that as of the end of the 2016 financial year (reported in fiscal year 2017),[143] S&P 500 companies alone had more than $192 billion worth of contemptuous positions.[144] That is $192 billion that S&P 500 companies themselves disclose as uncollected tax dollars due to contemptuous reporting.[145]

Moreover, as Table 1 below shows, "Total Contemptuous Positions"—representing total value of all current unsettled positions (new positions minus positions that were cleared during the year)—increased for every year examined. These yearly increases point to the fact that contemptuous positions are not being fully recycled.

"Recycling" means that while new contemptuous positions are adopted by the company, some of the existing contemptuous positions taken in previous years are cleared either because the company settled with the IRS, the statute of limitations passed, or because of changes in the tax code and regulation (e.g., new ruling letter released) which altered the chances for an existing position to sustain an audit.[146]

We would expect that a company that discloses a high number of UTBs increases the chance of contemptuous positions being scrutinized and challenged[147] and therefore, once challenged, contemptuous positions would clear—either because tax due was paid or the position was settled. Nevertheless, data shows that at the macro level, such recycling does not happen in full,[148] and the absolute amount of

143. 2016 was the most recent financial year for which full data was available when the empirical study was conducted. *Wharton Research Data Service*, WHARTON SCH. UNIV. PA., https://wrds-web.wharton.up-enn.edu/ (on file with author).

144. *Id.*

145. *Id.* It can be argued that because FIN 48 requires the company to create a provision for every position that doesn't fulfill the condition of more likely than not (greater than fifty percent), including provisions which have a forty-nine percent chance of being sustained, then the real amount that would have been collected by the IRS is lower than the full amount of the provisions recognized. Nevertheless, even when considering such an assumption, the amount left uncollected is still enormous: 49 percent x $192 billion=$94 billion. *See* FIN 48, *supra* note 117, ¶ 6.

146. FIN 48, *supra* note 117, ¶¶ 10, 12.

147. *See generally* Jones, *supra* note 106 (discussing the expected effects of FIN 48 on taxpayers).

148. For example, in 2014, companies adopted $21,992 million worth of contemptuous positions (Table 1, "New Contemptuous Position Taken in the Past Reporting Year" disclosed during fiscal year 2015); at the end of the financial year, the total value of contemptuous positions had increased by $2,863 million ($165,794 - $162,931) suggesting that positions valued only at $19,129 ($21,992 – $2,863) were recycled. In 2015, companies adopted $25,304 million worth of contemptuous positions; at the end of the financial year, the total value of contemptuous positions had

contemptuous positions increases every year,[149] suggesting the IRS does not get to the bottom of contemptuous reporting,[150] and therefore the positions are not fully cleared and are left on companies' balance sheets.

TABLE 1. Contemptuous Reporting by S&P 500 Companies[151]

As of End of Financial Year	**Total Contemptuous Positions**	**New Contemptuous Positions Taken in the Past Financial Year**
	(In millions USD)	
2016	$192,381	$21,576
2015	$185,557	$25,304
2014	$165,794	$21,992
2013	$162,931	$20,134

As Table 1 further shows, tax avoided by contemptuous reporting totaled more than twenty billion annually—represented by new contemptuous positions taken in the past reporting year—for the companies included in the S&P 500 index alone.[152] As mentioned,

increased by $19,763 million ($185,557 – $165,794), suggesting the vast majority of the yearly addition to contemptuous positions was not offset by an equivalent recycling of positions. *See infra* Table 1.

149. *Id.*

150. This fact supports those who, unlike Jones, *supra* note 106, expected FIN 48 disclosures not to provide much assistance to the IRS. *See* Zahn Bozanic et al., *IRS Attention*, 55 J. ACCT. RES. 79, 86–87 (2017) ("[U]pon introduction of the new financial accounting standard by the FASB, Jones suggests that the FASB became the IRS's 'new best friend.' In contrast, others have suggested FIN 48 would be of little use to the IRS, both because the FIN 48 numbers are highly aggregated (both in terms of specific transactions, and jurisdictionally), and because the IRS may have superior information in the tax return.").

151. Just as the market value of traded companies changes and consequently, their relevant size, so too has the S&P 500 index changed during the four years examined. In order to create a continuous and comparable measurement over the years, data on contemptuous positions, as reported for financial years 2017/2016/2015/2014, was calculated based on the financial statements for financial years 2016/2015/2014/2013 of companies included in the S&P 500 index (Compustat SPMI code 10) for January 31 of years 2017/2016/2015/2014 (respectively).

152. To be more accurate, the value of all contemptuous positions taken does not equal a simple addition of all the positions, but rather the expected return thereof, i.e., the monetary value of every position multiplied by the probability the position will be upheld. Because the expectation of these positions is by definition less than fifty percent, otherwise the tax benefits from the positions would not recognized as UTB under FIN 48. *See* FIN 48, *supra* note 117, ¶ 6. The yearly value of contemptuous positions is somewhere between $10 to $20 billion. *See also supra* note 145.

theoretically, managers can be deterred from reporting contemptuously by a possible sanction with a high-enough expected punishment.[153] This magnitude of contemptuous reporting engaged in by S&P 500 companies shows that, at least with respect to S&P 500 companies, such deterrence does not exist.

B. The Case of Reported R&D Expenses

Is reporting inflated research expenditures, as presented in the *Shami* case,[154] an instance of coincidentally contemptuous reporting involving R&D, or does the R&D tax incentives regime more easily accommodate contemptuous reporting? Deciphering contemptuous reporting through the analysis of UTBs disclosures enables different instances associated with contemptuous tax reporting to be tracked. Thus, it can assist in answering the question of whether the *Shami* case represents an anecdotal or a systemic instance of contemptuous reporting in which managers use the R&D tax incentives regime in contemptuous reporting.

Extending the analysis of UTBs to cover detailed disclosures of all S&P 500 companies included in the index between the years 2007, the first financial year for which UTBs are disclosed,[155] and 2017 (743 companies in total, resulting in 4,677 observations of contemptuous reporting during a period of eleven years) reveals a positive and significant correlation between reporting R&D expenses and contemptuous tax reporting.[156] This finding is based on a multivariate logistic regression that tests for a correlation between contemptuous

153. *See supra* notes 65–66 and accompanying text.

154. *Shami v. Comm'r*, 741 F.3d 560 (5th Cir. 2014).

155. *See* Jones, *supra* note 106, at 773.

156. The data used in the study is derived from the 2007-2017 financial statements of S&P 500 companies as included in Standard & Poor's Compustat North America (Fundamental Annual) database ("S&P's Compustat") for this period. S&P's Compustat was accessed through Wharton Data Research Services, *Wharton Research Data Service*, WHARTON SCH. UNIV. PA., https://wrds-web.wharton.up-enn.edu/wrds.; *see also* Rui Dai, *International Accounting Databases on WRDS: Comparative Analysis* (March 12, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2938675 [https://perma.cc/V77Y-DDU3] (noting S&P's Compustat database is the primary source for accounting data for empirical studies of US public companies, however, no such consensus exists among researchers of international finance). Intragroup correlation between multiple observations contributed by a single company as well as possible timing effects (observations are composed from a time span of eleven years during which tax regimes can change and affect contemptuous reporting) have been taken into consideration by the model implemented in the study. In order to overcome outliers included in the population, the study used bootstrapping with 500 repeats creating a "sample of samples" which was used in a linear multivariable regression with repeating measures.

reporting, i.e., newly generated UTBs reported by S&P 500 companies (UTB $>$ 0) and reported R&D expenses.

In order to provide a level of resilience (robustness) of the test's finding, Model 1, described below, was used to control for a number of alternative parameters which could affect contemptuous reporting.

(text continues on next page)

MODEL 1

For all UTB > 0: UTBi [i1 to 4,677] = B0 + β1 R&D Expenses i
+ β2 Market Value i + β3 Gross Profit i + β4 Total Assets i
+ β5 Intangible Assets i + β6 Goodwill i + β7 Total Liabilities i
+ β8 Retained Earnings i + β9 Income Taxes Total i + β10 Interest Expenses i + ε

The model's statistical results are summarized in the following table:

TABLE 2. Summarized Statistical Results

Variable	**Observed Coefficient**	Significance Level (P. Value)	**95% Conf. Interval** (Std. Err clustered by comp.)
R&D Expenses	0.029465	0.001	.0125711 .0463582
Market Value	0.000581	0.067	-.0000411 .0012039
Gross Profit	-0.00109	0.476	-.0040863 .0019085
Total Assets (excluding Intangible Assets)	0.001304	0.093	-.0002198 .002828
Intangible Assets	0.001201	0.414	-.0016801 .0040828
Goodwill	0.002295	0.333	-.0023497 .0069399
Total Liabilities	-0.00142	0.092	-.0030707 .0002318
Retained Earnings	0.000639	0.353	-.0007081 .001985
Total Income Taxes	0.006126	0.2	-.0032457 .0154984
Interest Expenses	0.010571	0.089	-.0016101 .0227521

As can be seen from Table 2, even after controlling for all parameters included above, reporting R&D expenses has a positive and significant effect on contemptuous reporting.[157] Statistically speaking,

157. Findings also show that the effect of a company's total tax liability (Total Income Taxes) on contemptuous reporting is not statistically significant (P. Value is

this means that every increase of one dollar in reported R&D expenses is correlated with an increase of about three cents in contemptuous reporting (Observed Coefficient = 0.029465); this finding's significance level is below one percent (P. Value = 0.001).[158] It can therefore be reliably said that reporting R&D expenses, i.e., incurring R&D expenditures, is a prominent factor associated with increased contemptuous reporting.

C. Contemptuous Reporting under the R&D Tax Regime

Self-reported R&D expenses can be used in contemptuous reporting under a number of sections of the tax code, all intended to incentivize R&D actives.[159] In general, the R&D tax incentives regime has been recently subjected to heavy criticism by legal scholars[160] though, not yet for its part in generating contemptuous reporting (as discussed here).[161] With respect to reporting contemptuousness, two main components of the regime deserve special attention; these are the favorable rules regarding the deductibility of R&D expenses and the tax credits they endow.[162]

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higher than accepted in this type of studies, 2%/5%/10%). *See supra* Table 2. Hence, a possible hypothesis explaining contemptuous reporting as a ratio of overall taxes due, i.e., companies with higher tax liability will be engaged in more contemptuous reporting in order to reduce tax payments than companies with lower tax liability, is not supported by the findings. This is also the case regarding possible hypotheses that associate contemptuous reporting with profitability (Gross Profit), i.e., more affluent companies are more engaged in contemptuous reporting.

158. This means that the chance that there is no connection between R&D Expenses and New Contemptuous Positions ('no connection' is the null hypothesis) given that these empirical findings are less than 0.1 percent (0.001), i.e., that the null hypothesis is mistakenly rejected is 0.1 percent. In general, the significance level for studies is set to five percent, hence the significance level between R&D Expenses and new contemptuous positions is much better than the typical requirement in statistical studies.

159. *See generally* Shay et al., *supra* note 20 (examining prominent tax incentive provisions that relate to businesses' R&D activity); Staff of Joint Comm. on Tax'n, *supra* note 126, at 62.

160. *See* Shay et al., *supra* note 20.

161. *Id.*(criticizing the prominent theoretical policy premises underlying the current R&D tax incentives regime. They argue *inter alia* that a private market failure of under-investment in innovative knowledge has not been sufficiently established to warrant application of the existing R&D tax incentives and that economic theory fails to explain sufficiently how knowledge leads to innovation that drives economic growth. They question whether the objectives of the existing R&D tax incentive regime would not be achieved more effectively through a regulatory response or a direct expenditure grant program administered by agencies such as the NSF and NIH.); Nussim & Sorek, *supra* note 20 (explaining why non-tax cash-transfers are most likely socially superior).

162. *See also* Nussim & Sorek, *supra* note 20, at 49 ("In the US, the two largest tax breaks for R&D are the expensing of research and experimental expenditures (Section 174) and the credit for increasing research activities (Section 41).").

As a general rule, business expenses associated with the development or creation of an asset whose useful life extends beyond the current year must be capitalized and depreciated over said useful life.[163] However, IRC § 174 allows the taxpayer to not capitalize such expenses but rather to currently deduct all reasonable R&D expenditures paid or incurred in connection with a trade or business.[164] In addition to the favorable deduction regime, IRC § 41 allows the taxpayer to claim a research credit equal to fourteen or twenty percent of the amount by which the taxpayer's QREs[165] for a taxable year exceeds its base amount for that year[166] (generally computed based on the average amount of the taxpayer's gross receipts for the four preceding years).[167] Thus, the research credit is generally available with respect to incremental increases in research expenses.[168]

Amounts defined as research and experimental expenditures and entitled to a favorable deduction regime and tax credits generally include costs incurred in the experimental or laboratory sense related to the development or improvement of a product, e.g., salaries for those engaged in research or experimentation efforts.[169] However, they do not include salaries paid to managers (acting as operational managers).[170] As mentioned, over-allocating managers'

163. 26 U.S.C § 162 (2012) allows taxpayers to deduct all ordinary and necessary expenses incurred during the taxable year in carrying trade or business. However, 26 U.S.C. § 263(a) (2012) requires the capitalization of costs of acquiring, producing, and improving tangible and intangible properties, while requiring the taxpayer to determine—according to regulation released by the Treasury, *e.g.*, Treas. Reg. § 1.263(a)-4 and -5 (1963)—whether expenditures related to a property are currently deductible business expenses or non-deductible capital expenditures.

164. 26 U.S.C. § 174 (2012); *see also* Staff of Joint Comm. on Tax'n, *supra* note 126, at 62.

165. Defined by 26 U.S.C. § 41(b)(1) (2012) generally as the sum of in-house research expenses and contract research expenses which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business; *see also United States v. McFerrin*, 570 F.3d 672, 676 (5th Cir. 2009).

166. An alternative simplified research credit with a fourteen percent rate and a different base amount may be claimed in lieu of the twenty percent credit. *See* Staff of Joint Comm. on Tax'n, *supra* note 126, at 63.

167. 26 U.S.C. § 41; *see also* Staff of Joint Comm. on Tax'n, *supra* note 126, at 63–64.

168. Staff of Joint Comm. on Tax'n *supra* note 126, at 63.

169. Treas. Reg. § 1.174-2(a)(1) (1963).

170. Treas. Reg. § 1.41-2(d)(1) (1963); *see also Shami v. Comm'r*, 103 T.C.M. (CCH) (2012) ("If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes [qualified research expenses]."); *Suder v. Comm'r*, 108 T.C.M. (CCH) 354 (2014) (stating managers' salaries were recognized as qualified R&D expenses to the extent that they were factually engaged in developing and working on new products).

salaries as research expenses, resulting in additional R&D credits, was denied in the *Shami* case.[171]

In addition, QUREs do not include expenses incurred once the uncertainty concerning the development or improvement of a product is eliminated.[172] For example, research activities substantially related to style, taste, cosmetic, or seasonal design factors do not qualify for R&D credits.[173] Therefore, in the development of every (successful) product, e.g., Microsoft Windows 10, there is a stage, once the product is established enough, that the company must start capitalizing expenses and stop reporting them as tax deductible or as generating tax credits.[174] Once the "establishment phase" approaches, if a company wishes to keep enjoying the R&D tax incentives, it must become contemptuous in its reporting.

As presented above, empirical findings show a positive and significant correlation between R&D expenses and contemptuous reporting. Moreover, the statistical model indicates contemptuous reporting by way of R&D expenditures in a ratio of about three cents per one dollar of reported R&D expenses. These quantitative findings receive further support from past qualitative findings published by the IRS with regard to Schedule UTP (Uncertain Tax Positions Statement).[175] Schedule UTP is a tax form that "asks for information about tax positions that affect the U.S. federal income tax liabilities of certain corporations that issue or are included in audited financial statements and have assets that equal or exceed ten million."[176] In its last publication summarizing data from taxpayers submitting Schedule UTPs, released in 2016 and covering returns for tax year 2014,[177] the IRS stated the R&D credit as the number one issue disclosed by taxpayers submitting Schedule UTP. Hence, when asked to "flag"

171. *See Shami*, 108 T.C.M. (CCH) 1415.

172. Treas. Reg. § 1.174-2(a)(1) ("Costs may be eligible under [26 U.S. Code § 174] if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.") (section added).

173. *See* 26 U.S.C. § 41(d)(3) (2012); Staff of Joint Comm. on Tax'n, *supra* note 126, at 65.

174. To be more accurate, in order to prevent a double benefit, overall deductible R&D expenses claimed are reduced by the amount of R&D credits claimed. 26 U.S.C. § 280C(c) (2012); Staff of Joint Comm. on Tax'n, *supra* note 126, at 66.

175. Schedule UTP, Uncertain Tax Position Statement, for 2010, 2011, 2012 and 2013. *UTP Filing Statistics*, TAX CONTROVERSY 360 (Aug. 15, 2016), https://www.taxcontroversy360.com/wp-content/uploads/sites/30/2016/10/UTP-Stats.pdf [https://perma.cc/WM5L-ZFUQ].

176. INTERNAL REVENUE SERV., INSTRUCTIONS FOR SCHEDULE UTP (FORM 1120) (2018) https://www.irs.gov/instructions/i1120utp [https://perma.cc/9YX8-CJSD] [hereinafter IRS Instructions].

177. *See* TAX CONTROVERSY 360, *supra* note 175.

positions that affect reported tax liabilities, the most frequently mentioned issue by taxpayers is R&D credits.

The IRS is not provided with monetary information about the uncertain tax positions included in submitted schedules,[178] and accordingly, the publication did not provide such information. In addition, since the IRS has currently been contemplating changes to Schedule UTP, no further Schedule UTP filing statistics were released by the Service beyond those released in 2016 for tax year 2014. Nevertheless, these released qualitative findings support the connection between R&D activities and contemptuous reporting as indicated by Model 1 for the entire period of 2007 to 2017, as discussed above.[179]

IV. MINIMIZING CONTEMPTUOUS REPORTING

Managers contemptuously self-report their companies' tax liabilities. They take advantage of the requirement to self-assess, and knowingly report positions that cannot be applied, according to prevailing tax doctrines, in the company's circumstances, and which will, in all probability, never be scrutinized by the IRS. Empirical analysis of S&P 500 companies shows current deterrence is not effective, and more than twenty billion worth of contemptuous positions have been taken by S&P 500 companies in every year for the last four years.[180] Assuming that across the board change from collecting corporate tax through self-reporting to inquisitorial assessment is not a feasible or welcome option,[181] other options should be considered in order to minimize contemptuous reporting.[182]

Maintaining self-reporting at its current scope while increasing the audit rate and fines, even if specifically targeting regulatory efforts in problematic regimes such as the R&D incentives, or, even moving from self-assessment to inquisitorial assessment for only certain tax regimes would all require additional resources from the IRS which is already under heavy budgetary pressure.[183] A different alternative that would

179. *See supra* p. 133.

180. *See supra* Table 1.

181. Some scholars have argued the American self-reporting system is a cultural element of American society, *e.g.*, Berger, *supra* note 46, at 759, and a result of the objection to the British. *E.g.*, Mumford, *supra* note 77. Therefore, self-reporting can be claimed as representing more than just a collection system, but an essential and very basic perception which should be kept despite its high costs in lost revenues.

182. *See* David M. Schizer, *Frictions as a Constraint on Tax Planning,* 101 COLUM. L. REV. 1312 (2001) (discussing "frictions"—"constraints on tax planning external to the tax law").

183. *See, e.g.*, Kelly Phillips Erb*, Tax Advocate Calls for More Funding, Better Customer Service at IRS,* FORBES (Jun. 29, 2018) https://www.forbes.com/sites/kellyphillipserb/2018/06/29/tax-advocate-reports-calls-

not require the IRS to invest more resources and that can nonetheless reduce contemptuous reporting is to narrow the interpretative scope of managers by making it harder to report contemptuously. This can be achieved by creating "exogenous" connections for the interpretative choices managers make when filing corporate tax returns and use these connections to have managers' choices subject to additional ex-ante scrutiny by non- IRS parties.

One way of raising such additional ex-ante scrutiny is by using the company's existing investors reporting. As long as public companies are discussed, these reports are scrutinized by a number of external parties, among them, the company's external auditor, investors and the SEC; therefore, as explained below, these entities can be utilized to screen and neutralize contemptuous reporting by managers.[184]

A. Using Investor Reporting for Improved Tax Collection – the Comprehensive Madisonian Tension Tax Policy[185]

As mentioned above with respect to BTD,[186] the potential of using ("harnessing") a company's financial statements, prepared for investors for the benefit of better tax collection has not eluded legal scholars. In order to fight "tax shelters," i.e., transactions that provide corporate managers with the opportunity to lower the company's taxable income without reducing the income reported to investors,[187] legal scholars have suggested aligning investor-reporting with tax-reporting in order to curtail aggressive tax behavior intended to lower taxable income by the effect it would have on book income.[188] Under the proposed alignment of book/tax reporting, reducing taxable income would mean reducing the income reported to investors, making it generally unappealing to the managers of public companies who are evaluated

for-more-funding-better-customer-service-at-irs/#3e9b4458d51a [https://perma.cc/6X6Q-EXRZ]; Michael Cohn, *IRS Union Fights Proposed Budget Cuts*, ACCT. TODAY (July 26, 2017), https://www.accountingtoday.com/news/irs-union-fights-proposed-budget-cuts [https://perma.cc/Z5KE-YJD6].

184. *See infra* Section IV.B.

185. In the tax context, Madisonian tension (originally used in constitutional contexts) was used as a reference to the competing incentives that business have with respect to financial and tax accounting, that is, between wanting to overstate income for financial purposes and understate it for tax purposes. *See* Shaviro, *supra* note 99, at 428–29; Lily Kahng, *Perspectives on the Relationship Between Financial and Tax Accounting*, *in* CONTROVERSIES IN TAX LAW: A MATTER OF PERSPECTIVE 93, 97 (Anthony C. Infanti ed., 2015) (mentioning "Madisonian tension" as a term coined by Shaviro).

186. *See* discussion *supra* Section II.

187. *See, e.g.*, Engler, *supra* note 99, at 540.

188. *See* sources cited *supra* note 99.

and compensated mainly according to the company's earnings as reported to the investors.

Furthermore, legal scholars have also pointed to the additional benefit book/tax alignment will bring to the reduction of managers' earning management, that is, managers' accounting manipulations that inflate earnings reported to investors (according to GAAP rules).[189] Altogether, legal scholars have suggested alignment as a means to reduce "corporate managers' incentives to engage in two socially undesirable activities: tax sheltering on behalf of shareholders and earnings management on their own behalf . . . requiring book-tax conformity would have the desirable feature of creating Madisonian tension between the managers' twin aims . . . ."[190]

Nevertheless, exposing managers to such Madisonian tension through comprehensive book-tax alignment suffers from a major drawback:[191] The company's tax income that should be fully reported is fundamentally different than the income investors care about (and accordingly, different than the income presented in the company's financial statements).[192] Consider one example: For liquidation and assurance reasons, and as a means to minimize some prominent tax frauds, the Code generally taxes only realized profits as achieved in factual transactions. However, investors care about the potential profit and the fair value, even if not yet realized. Such differences, and others, mean that measuring income for tax purposes is fundamentally different than measuring for investors.[193] Hence, aligned reporting cannot fulfil the information needs of both the IRS and investors.

In order to overcome this (arguably) pragmatic challenge,[194] some scholars advocated a single report made according to GAAP rules, thus

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189. *See, e.g.*, Shaviro, *supra* note 99, at 484.

190. *Id.*

191. *See* Engler, *supra* note 99, at 548–58 (discussing overbreadth as the principal shortcoming of the comprehensive approach).

192. *See* Yoram Keinan, *Book Tax Conformity for Financial Instruments*, 6 FLA. TAX REV. 676, 676–80 (2004) ("Since the introduction of the corporate income tax in the United States in 1909, both lawyers and accountants have discussed whether to allow corporate taxpayers to use income reported by corporations to their shareholders on their financial reports under Generally Accepted Accounting Principles ('GAAP') as the basis for imposing corporate income tax. . . . Commentators agree, however, that currently, a general book-tax conformity regime for corporate tax is not feasible."); *Cf.* Klein, *supra* note 100, at 612 (arguing that "through the process of gathering a firm's information and expressing it in accounting terms[,]" financial reporting serves some interests and not others).

193. *See* Mihir Desai, *Corporate Governance and Taxation: The Implication for Financial Reporting*, *in* BEYOND BOUNDARIES: DEVELOPING APPROACHES TO TAX AVOIDANCE AND TAX RISK MANAGEMENT 117, 119–20 (Freedman ed., 2008) (discussing financial reporting for tax authorities and capital markets).

194. *But see* Klein, *supra* note 100 (arguing GAAP norms are not neutral but political and promote an exclusive agenda—that of investors).

serving the information needs of investors, then adding to it crucial ex-post adjustments as required under the tax code.[195] Nevertheless, such proposals undermine the initial purpose of aligning the reports: Reducing taxable income, now reported following ex-post tax adjustment, would no longer affect the income reported to investors by the ex-ante GAAP report. Furthermore, this type of suggestion becomes especially impractical in the face of managers reporting contemptuously. Once ex-post adjustments due to tax considerations are permitted, managers will contemptuously report the adjustments the same way they act contemptuously today with respect to the two separate reports.[196]

Overall, comprehensive alignment of tax reporting with investor reporting as a means to reduce aggressive tax behavior (e.g., tax sheltering) was not endorsed as a policy to improve tax collection. Although the current code does contain sporadic instance of book/tax alignment,[197] the fundamental difference between the two systems results in too many differences between tax reporting and investor reporting than can be comprehensively aligned effectively.[198]

B. Replacing Madisonian Tension with Enhanced Scrutiny by External, Non-IRS Parties

While creating Madisonian tension through comprehensive book/tax alignment does not seem like a feasible or recommended tax policy,[199] investor reporting can still be harnessed to fight contemptuous reporting via a non-comprehensive policy that would impose non-IRS scrutiny over selected tax-reported items. Specifically, instead of *comprehensive alignment* of tax-reporting with investor-reporting, it is

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195. *See, e.g.*, Desai, *supra* note 99; Whitaker, *supra* note 99, at 696–98.

196. *See supra* section IV.

197. For example, under 26 U.S.C. § 472, a company reporting inventory using the last in first out (LIFO) method must use the same method in reports prepared for investors and other stakeholders. Otherwise, LIFO is prohibited from use for tax reporting. I.R.C. § 472(c) (2018).

198. *See* David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399 (2009) ("[B]ook/tax conformity carries unexplored costs that reduce its attractiveness as a policy prescription, at least in the context of equity compensation."); Shaviro, *supra* note 99, at 429 (arguing that if tax rules became more closely aligned with book income rules, book income rules would be adjusted over time to become more like the current tax rules, and the valuable role played by current financial accounting in investment decisions would be substantially diminished); Engler, *supra* note 99, at 598 ("Taxing public corporations on their book income may have some initial appeal, especially in light of the recent trends showing increasing amounts of corporate tax sheltering and tax avoidance. Nonetheless, the combination of tax and book preferences demonstrates that a comprehensive book/tax linkage approach should be rejected.").

199. *See* sources cited *supra* note 198.

proposed to create a *non-comprehensive*[200] *linkage* between managers' interpretation as adopted in selected items included in the two reports, thereby have managers' interpretations subjected to enhanced scrutiny. "Linkage between managers' interpretations" does not refer to aligning of final reported numbers, but rather to linking managers' interpretational choices as implemented when preparing reported numbers used in each of the two separate reports. For example, when contemplating how to report the financial nature (equity/debt mix) of a one million hybrid financial instrument for tax purposes and for investors,[201] it is suggested that managers be required to implement the same economic interpretations regarding the instrument on both reports.[202] (This depends on the fulfillment of a second condition of *appropriateness*, discussed below.) If interpretation results in describing the instrument as containing twenty percent debt ($200 thousand) and eighty percent equity ($800 thousand) for the purpose of reporting to investors, it would be treated the same way for tax reporting purposes (reported as a debt of $200 thousand and equity of $800 thousand).

Imposing non-comprehensive linkage will require managers to adhere to a single interpretation when reporting both to investors and the IRS. Such a requirement will make it harder for managers to report contemptuously. Managers could not report equity as debt for tax purposes (nor operational managers' salaries as R&D expenditures entitled to R&D tax credit).[203] The interpretation, which would now be included in the reports to investors as well, would be subject to the scrutiny of the company's external auditor. This would be part of the audit conducted by an independent auditor who would need to approve of the company's accounting treatment in its financial statements. In addition, as managers' interpretational choices now become part of the company's publicly disclosed reports, their interpretations will also be subject to the eye of the general public, company's investors, analysts covering its stock, and the popular media. The fact that investor

200. *See* Engler, *supra* note 99, at 559–70 (proposing a non-comprehensive alignment of investors and tax reporting in respect to certain tax deductions: loss deductions, depreciation allowances and interest expense). Engler's proposal is focused on overcoming the problem the comprehensive approach faces by creating a limited Madisonian tension only in respect to those chosen deductions. In contrast, the proposal presented by this section does not focus on creating Madisonian tension, but rather harnessing the additional scrutiny in the reporting to investors.

201. *See* Todd E. Petzel, *Derivatives: Market and Regulatory Dynamics*, 21 J. CORP. L. 108, 108 (1995) ("In most cases . . . derivatives are neither assets nor liabilities, and fitting them into the traditional framework has been a daunting task."); Patrony, *supra* note 52, at 231–32 (discussing accounting arbitrage).

202. *See* Keinan, *supra* note 192, at 681 ("I do not suggest that GAAP will substitute tax law but only provide guidance pertaining to financial instruments.").

203. *Shami v. Comm'r*, 741 F.3d 560 (5th Cir. 2014).

reporting and in correspondence, managers' interpretations, also become subject to potential SEC enforcement, adds another chilling effect for managers considering contemptuous reporting. Thus, any contemptuous reporting will become subject to the scrutiny of all these parties. For example, if the IRS were to audit a company it could ask the manager to match the tax return's reported R&D expenditures with the report to investors. In the same way, when the company's financial statements are audited, the external auditor (or the SEC) can use the tax returns to audit the R&D expenses reported to investors when examining whether reported R&D expenses truly represent R&D activity. Whenever reporting contemptuously, managers would no longer be reporting to only one party, and would be exposed to the scrutiny of additional parties.

Thus, described in general terms, the proposal maintains self-reporting for tax purposes but at the same time, subjects managers' interpretational choices to additional ex-ante scrutiny.

Nevertheless, as mentioned, tax rules used for computing taxable income and financial accounting standards (GAAP) used for investor reporting have distinct goals and may imply contradictory measurement rules that override any *ex-ante* linkage between managers' interpretational choices. For example, the tax code might include a special condition for recognizing debt,[204] thus affecting the tax interpretation of the hybrid instrument. In addition, where contradictive measurement rules apply, forcing linkage in reporting might cause some managers to prefer the tax code's interpretation over that recommended or required by the GAAP and hence, distort the information provided to investors. Collecting true tax is important; nevertheless, unbiased financial information is crucial for a functioning financial market.

Therefore, it is not suggested to enact a general tax norm that imposes across-the-board linkage between tax reporting and investor reporting, but rather to add particular norms only for those sections of the code (tax items) where it is *appropriate*, i.e., where no contradictory measurement exists between tax rules and financial accounting (GAAP) and no distortion is foreseen with respect to the information reported to investors.[205] Therefore, as explained below, a common ground for the two measurements can be used to curb

204. For example, in 2016, the IRS and the Treasury Department issued regulations under IRC section 385 that classify debt instruments based on the identities of the issuer and holders and circumstances of issuance rather than on the attributes of the particular instrument. *See* Treatment of Certain Interests in Corporations as Stock of Indebtedness, 81 Fed. Reg. 72858 (Oct. 21, 2016) (to be codified at 26 C.F.R. pt. 1) (limiting, among others things, the ability of corporations to generate additional interest deductions without new investment in the United States).

205. *See supra* text following note 202.

contemptuous reporting. As the next section shows, reporting R&D expenses is one example where the suggested linkage is appropriate.

C. Implementation in the R&D Regime

As discussed, empirical findings support an argument that the *Shami* case is not an isolated case and that the regime for reporting R&D activities lays the ground for contemptuous tax reporting.[206] However, the exact contemptuous reporting practices taken by managers can vary. Managers might be inflating R&D expenditures currently reported in the return—in absolute terms—in order to contemptuously gain additional tax credits for their companies, e.g., currently recognizing expenditures which will only be due in a future contracts. It is also possible that managers might be attaining such credits and greater deductibility of expenditures not by inflating the absolute amount of currently reported numbers but rather, by re-categorizing regular (non-R&D) expenditures as R&D expenditures on the tax return. While in the former case, overall expenses increase contemptuously, in the latter, overall reported expenses are not changed by the contemptuous behavior of managers, only the categorization of the expenses reported.

Meanwhile, the tax code currently allows managers to treat expenditures as R&D expenses for tax purposes irrespective of how expenditures are reported in the company's financial statements (e.g., IRC § 174(a)(1)).[207] No dependency exists between the reports. For example, a company can purchase a building containing a scientific laboratory as a pure real-estate investment, and accordingly have it reported to investors as a real-estate investment (i.e., as an expense capitalized as an asset) but, at the same time, contemptuously report it as a deduction, expensed in full on its tax return, as a purchase of scientific equipment entitled to R&D benefits.[208]

In order to prevent contemptuous reporting of inflated R&D expenditures or intentionally re-categorization thereof, it is proposed that managers be required to adhere to a single interpretation when reporting R&D both for tax purposes and to investors. Such a requirement will expose managers' interpretations to enhanced scrutiny of additional non-IRS parties, as mentioned above. Putting the recommendation in pure legislative language, it is proposed that Code

206. *See supra* Section III.B.

207. I.R.C. § 174(a)(1) (2018) ("A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.").

208. *Id.*

sections, such as IRC § 174(a)(1) be amended. Enacted more than half a century ago (by the tax reform of 1954),[209] IRC § 174(a)(1) currently prescribes two methods for treating research or experimental expenditures,[210] which managers can choose from (irrespective of GAAP rules).[211] Thus, the section allows todays' managers to contemptuously imply different interpretations when reporting R&D expenditures. Following the example above: Under this proposal, if the company purchased the labs as a real estate investment, it would be reported as an investment in both tax returns and GAAP statements; if the company purchased it in order to improve its R&D capacity, it would be reported as an R&D expenditure; and, if it the building was purchased both to meet current company R&D needs and as a good real estate investment, then, in a similar fashion to the treatment of the hybrid financial instrument mentioned above, managers would interpret the financial nature of the transaction as having two financial components, investment and R&D expenditure, which would be reported as such on both reports.

D. The Effect on R&D Reported to Investors

It should be emphasized that the proposed linkage between the R&D expenditures reported in the tax return and the R&D expenses reported in the financial statements for the investors does not necessarily result in the same number being reported in the two reports. This particular proposal to minimize contemptuous reporting is based on the notion, discussed below, that expensing requirements of financial accounting rules, i.e., GAAP, are broader than the parallel R&D tax expensing rules under the Code. Thus, R&D expenses reported as such in the financial statements include all legitimate tax reportable R&D expenditures. Accordingly, GAAP reported R&D expenses can be used to regulate contemptuous tax reporting, without affecting the content of financial statements as reported to investors.

With respect to reporting R&D expenses on the company's financial statements, GAAP requires companies to expense almost all

209. Act of Jan. 6, 1954, Pub. L. No. 85-591, 68A Stat. 66 (to be codified at I.R.C. § 174(a)(1)), https://www.govinfo.gov/content/pkg/STATUTE-68/pdf/STATUTE-68A-PgI.pdf [https://perma.cc/59TB-9FMF].

210. Treas. Reg. § 1.174-1 ("Section 174 provides two methods for treating research or experimental expenditures paid or incurred by the taxpayer in connection with his trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred . . . or they may be deferred and amortized . . . .").

211. *See Thor Power Tool Co. v. Comm'r*, 439 U.S. 522 (1979) (subordinating GAAP usage by the tax system to superior tax rules and principles prescribed by the Treasury).

expenditures involved in R&D activity.[212] The threshold for capitalizing—instead of reporting an expense, reporting a new asset—under GAAP rules is much higher than the threshold included in the R&D tax regime.[213] Remember, the two reports serve distinct purposes; accordingly, the preferences for expensing (deduction) and capitalizing (an asset expensed over time) are different.[214] While the tax code is conservative with respect to over-expensing and inclined toward capitalization of R&D expenses as a way to prevent over-deducting and reduced taxable income, GAAP is more conservative with respect to capitalizing, and requires immediate expensing of R&D expenses.[215] Considering one specific example of this difference: once uncertainty concerning the development or improvement of a product is eliminated IRC § 174 does not allow deductions (expensing) and IRC § 41 R&D disallows tax credit eligibility.[216] GAAP rules, to the contrary, still require that all expenditures connected to R&D be currently expensed and not capitalized even though uncertainty is eliminated and the company has a product that is expected to generate profits for the company.[217]

Allowing expenditures to be treated as R&D expenditures for tax purposes insofar as they are treated as R&D expenses for financial reporting, is expected to result in an equal or lower amount of R&D expenditures reported on the tax return than in the financial statements. That is, in the proposed linkage, reporting R&D expenses to investors will not be limited. R&D reported to investors remains intact, while tax reporting will be limited.

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212. In comparison, under IFRS, as a general principle, a company is required to capitalize expenditures once it reaches the point of developing the product (in general: demonstrating technical feasibility, intent to complete the asset, and ability to sell the asset in the future). *See* Ernst &Young, *US GAAP versus IFRS: The Basics*, 1, 16 (Jan. 2019) [hereinafter Ernst & Young] https://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.pdf [https://perma.cc/L3NZ-XEW6] (comparing R&D disclosures rules under US-GAAP and IFRS).

213. *Compare* Ernst & Young, *supra* note 212, at 17 ("[I]nternal costs related to the research phase of research and development are expensed as incurred under [the GAAP]."), *with* Treas. Reg. § 1.174-2(a)(1) ("Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or the product is eliminated.").

214. *See* Desai, *supra* note 193.

215. Any other GAAP practice would result in companies being able to divert expenses into assets—instead of reporting R&D expense, companies would have reported new assets.

216. Treas. Reg. § 1.174-2(a)(1) (2019) ("Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or the product is eliminated.").

217. Ernst & Young, *supra* note 212, at 17 (noting that some sporadic exceptions exist, such as in respect to software development).

All-in-all, the proposal contributes to the reduction of contemptuous tax reporting of R&D expenditures. The general proposal, described above with respect to the R&D tax regimes, differs from other proposals involving tax-book conformity as a means to fight tax aggressiveness,[218] in the sense that financial reporting is not being harnessed in a comprehensive way, covering across-the-board reporting, and does not involve aligning final reported numbers in order to create Madisonian tension[219] but rather, links interpretations used in the preparation of the two reports in order to apply enhanced scrutiny of the interpretations. Among other things, the proposal made in this Section confronts managers' need to report special tax adjustments, as is generally required under any pragmatic single-report approach and hence, avoids the pitfall of allowing managers to contemptuously report tax adjustments. In addition, it preserves two distinct reports which fulfill distinct needs, and reduces the effect and possible distortion on reporting information to investors.[220] However, its applicability is limited and cannot be adopted for all cases of contemptuous reporting. But, as explained here, it can be adopted in the case of reporting inflated or intentionally misclassified R&D expenses. As discussed in previous sections of the article, court cases[221] and empirical findings show R&D expenses are positively correlated with the appearance of contemptuous reporting.

CONCLUSION

Contemptuous tax reporting involves managers reporting tax positions while knowing their application in the company's circumstances contradicts prevailing tax doctrines. These positions are nevertheless reported by managers owing to the immediate tax savings they lead to for the company and in the likelihood that these positions will never be challenged by the IRS.[222] Following the conceptualization of contemptuous reporting, this article discusses empirical findings[223] that show managers are not deterred from engaging in contemptuous reporting of their company's taxes, and that S&P 500 companies alone have been reporting more than twenty billion worth of contemptuous tax positions annually in the years examined.[224] Overall, contemptuous

218. *See* sources cited *supra* note 99.

219. *See also* Shaviro, *supra* note 99.

220. *See* sources cited *supra* note 198.

221. *See supra* notes 15–19 and accompanying text.

222. *Supra* text preceding note 63 (reporting that the IRS audited only one percent of corporate income tax returns (excluding S corporation returns)).

223. *See supra* section III.

224. *See supra* Table 1.

reporting has resulted with more than $190 billion of tax funds[225] held unpaid by S&P 500 companies—only because of managers' ability to contemptuously self-report for their companies.

Despite its magnitude, contemptuous tax reporting has not yet received its due attention. While legal scholars have distinguished between different degrees of legitimacy in taxpayers' actions, overall treating tax evasion/avoidance as a spectrum of behaviors with different levels of normativity,[226] empirical corporate tax literature generally applied a uniform measurement which represents all actions taken by managers that result in de-facto reduced corporate taxes, referring to them all—evasion, avoidance and all the points in-between— as "tax avoidance."[227] In consequence, it provides fruitless empirical analyses for legal researchers and policymakers interested in distinguishing between corporate tax reductions that result from non-legitimate tax behaviors (which should be deterred) and legitimate tax selections made by taxpayers (which should be allowed). Moreover, financial tax parameters routinely used by tax scholars and policy makers do not reveal information about contemptuous practices and occasionally provide distorted information regarding corporate tax behavior resulting from contemptuous reporting.[228]

In order to fill the gap in information about corporations' tax behavior and to distinguish contemptuous reporting from other avoidance actions taken by managers, an alternative analysis, capable of deciphering contemptuous reporting, is introduced by the article.[229] The article then uses further empirical findings, supported by past qualitative publications by the IRS, and confirms the impression some recent tax cases created: Managers use self-reporting of R&D expenditures in order to contemptuously inflate entitlement to R&D tax incentives.[230]

Following its argument about a connection between R&D tax incentives and contemptuous reporting, the article focuses on minimizing contemptuous tax reporting of inflated/miscategorized R&D expenditures as an example of a more general proposal to link managers' interpretations used in tax reporting to reports for investors, thereby enhancing scrutiny over managers' contemptuous interpretations.[231]

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225. *See supra* Table 1.
226. *See supra* text accompanying notes 30–37.
227. *See supra* text accompanying notes 38–40.
228. *See supra* Section II.
229. *See supra* Section IV.
230. *See supra* Section III.
231. *See supra* Section IV.

Unlike existing proposals, suggesting comprehensively harmonizing tax reporting with investor reports,[232] this article proposes reducing contemptuous tax reporting by an approach of targeted linking of managers' interpretations used in the reporting of specific parameters;[233] as a result, have them subject to enhanced scrutiny by non-IRS entities.[234] Specifically, in light of the empirical findings discussed, and with respect to R&D expenditures, it is suggested that managers' interpretations concerning R&D expenditures, as they appear in positions taken in tax reports, would be permitted only if the same interpretations were followed in reports to investors.

All-in-all, requiring managers to adhere to a single interpretation when reporting both to investors and the IRS will make it harder for managers to report contemptuously. The interpretation, now also included in the reports to investors, would be subject to examination and authorization by the company's external auditor in an audit process conducted for the purpose of providing an independent Auditor Opinion as to the accuracy of the company's financial statements. In addition, the interpretation would also be subject to the review of the general public, stock analysts and the media since it would now be part of the company's publicly disclosed reports. Having the interpretation followed in the financial statements reported to investors adds another chilling effect on managers considering contemptuous reporting as the reporting would also be subject to potential SEC scrutiny and enforcement. Thus, the proposal this article makes preserves self-reporting for tax purposes but, at the same time, subjects managers' interpretational choices to additional ex-ante scrutiny expected to reduce contemptuous tax reporting by managers.

232. *See* sources cited *supra* note 99.
233. *See supra* Section IV.B.
234. *See supra* Section IV.B.