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Tax Compliance Through Governmental Capture: An Ethical Assessment

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Tax Compliance Through Governmental Capture: An Ethical Assessment

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Introduction

A recent report by the U.S. Department of the Treasury places the tax gap, defined as the difference between income tax due and income tax collected, at $600 billion annually (Sarin, 2021). That amounts to fifteen percent of all income taxes owed and three percent of the U.S. GDP. Over a ten-year period, the shortfall comes to a staggering $7 trillion, equaling all the taxes paid by the lowest-earning ninety percent of taxpayers. By leaving excess money in the economy, the tax gap curbs the power of monetary policies aimed at price stability (Murphy, 2015, p. 61). The shortfall also affects the fiscal policy as spending is trimmed or other taxes are raised to help temper the budget deficit. The gap also exacerbates income polarization. Too often one finds two tax systems at play, one for the well-heeled and corporate actors who find ways to shield their tax obligations, and another for the common person subject to payroll and social security deductions secured with every paycheck. Some of the largest corporations and wealthiest individuals notoriously pay little or no income tax (Eisenger et al., 2021), and wealth and income disparities continue to spiral upward contributing to a rising cynicism among the taxpaying public.

Tax gap issues similar to those in the United States plague the European Union (EU, 2021), the United Kingdom (HMRC, 2021), and nations elsewhere (Ostas & Hilling, 2016, p. 749). One study identifies and compares tax gap data for sixty-one countries around the world (Khwaja & Iyer, 2014). While this Report offers a U.S.-centric perspective, its ethical insights apply wherever one finds a symbiotic relationship between tax evasion and government corruption. In particular, the ethical analysis in this Report applies to E.U. and U.K. tax contexts that rely on "big four" accounting expertise, experience tax erosion through profit shifting, and suffer from undetected tax evasions of various forms. In short, the tax gap, including its ethical dimensions, is of global concern.

This Report focuses on the symbiosis between government officials and taxpayers that allows this staggering tax gap to persist. The Report finds moral blame among both government officials and taxpayers. Turning first to the government, studies show that an increase in government spending on U.S. tax enforcement could yield an eight-fold return (Sarin, 2021). Yet over the past decade, the budget for the Internal Revenue Service has been cut by one-fifth (Dore, 2021). Moreover, the audit rate has decreased more sharply for upper-income earners and corporations than for Earned Income Tax Credit recipients (Sarin, 2021). High-income earners and corporate actors often find ways to conceal income through tax shelters and the offshoring of profits. During a 2007 campaign speech, presidential candidate Barak Obama criticized tax havens. Flashing a smile, he quipped: "You've got a building in the Cayman Islands where 12,000 companies supposedly are located. Now, that's either the biggest building in the world or the biggest tax rip-off in the world!" (Hashemi & Velarde, 2021). Notwithstanding his bully pulpit and quick smile, during his two terms as President, the notorious Cayman building remained open for business. Today, there is an estimated $32 trillion of untaxed money reported in places where no money was earned and then reinvested around the globe (Sarin, 2021).

The judiciary also plays a role in supporting the tax gap. Tax avoidance strategies, by definition, rely on literal interpretations of tax provisions while violating the spirit of the tax code. Tax courts in most, if not all, nations have access to general anti-avoidance rules (GAARs) that enable judges to discount strained literal interpretations of tax law that lead to absurd results (Ostas & Hilling, 2016, pp. 767-768). U.S. judicial precedents created at least five interrelated GARRs, including the "substance-over-form," "step transaction," "sham transaction," "business purpose," and "economic substance" rules (Libin, 2010, p. 340). In 2010, Congress formally codified the latter two. The use of these five GAARs continues to be somewhat sporadic and difficult to predict (Ostas & Hilling, 2016, pp. 765-66). Judges have significant discretion. Sometimes a court sides with the literal interpretation, implicitly blaming the legislature for any imprecisions in the Code. At other times, a court looks beyond form to substance and condemns the taxpayer for overreaching. Summarizing the ambivalent status of contemporary precedents, one tax scholar quipped: "Substance controls over form, except, of course, in those cases in which form controls" (McMahon, 2001, p. 195).

Legislators also share part of the blame for failing to close tax loopholes. Consider a profit-shifting scheme initiated with a transfer of intellectual property by a U.S. parent to one of the 12,000 wholly-owned subsidiaries domiciled in the Grand Cayman building referenced by President Obama. The subsidiary licenses the property back to its parent in exchange for royalty payments with group profits being assigned to the Caymans and deductions taken in the United States. No one involved in the transaction ever visits the Caymans, nothing is produced there, and the profits are reinvested around the world without ever being taxed beyond the zero percent corporate income tax rates in the Cayman Islands. The only connection to the Caymans is a postal address and incorporation papers stamped by a Cayman official. The scheme lacks economic substance, yet when obfuscated and concealed, it may be difficult to detect, and if detected, the courts may lack the political will to invalidate the plan. A shift in tax regulations coupled with an enhanced enforcement budget enabling the hire of well-trained revenue agents could help address the matter. When coupled with heightened executive branch scrutiny on profit-shifting, a pragmatic shift in judicial interpretive philosophy embracing GAARs, and coordination within the international community, Congress could finally close that loophole. For now, money continues to flow offshore.

Turning to the taxpaying public, taxpayers are unlikely to pay a tax unless they feel legally or morally compelled to do so. The immense scope of the tax gap suggests that calculations are done, and taxpayers often risk that an aggressive tax position will not be challenged; if challenged, it will prevail, and if the position proves invalid, the consequences will be limited to back taxes with interest and a modest fine. With such a mindset, tax compliance becomes a subset of financial risk management (FRM) where political obligations are monetized with reference to projected pecuniary consequences of alternative actions. Sometimes these actions include self-interested lobbying of governmental actors to secure special tax breaks or to resist changes proposed by others. Of course, actions involving large tax consequences are seldom taken without professional advice (Middleton, 2021, video recording at 10:16). Aggressive tax-sheltering can be deliberately complicated involving multiple steps and esoteric legal instruments and exotic financial arrangements designed to exploit hyper-literal interpretations of tax law in ways never contemplated by Congress. As one scholar observes: “Tax shelters today seem bolder and more complicated. At the same time, they are lacking in substance to such a degree that the creators of these newer strategies must surely know they have little to litigate if their clients are caught” (Kovach, 2008, p. 277).

The problem with the FRM approach to tax compliance is that it overemphasizes the positive elements of law, decoupling the taxpayer's legal obligation from its moral underpinnings. Pursuant to FRM logic, law and legal interpretations are manipulated for private gain with no regard for the moral duty to obey the law or the moral duty to support reasonably just social institutions such as the administration of justice. Socrates voluntarily drank the fatal hemlock out of respect for his political obligations to the Athenian state (Plato, 2008, pp. 63-83). Yet somehow taxpayers and tax advisors ignore the ethical duty to obey the law. Within the legal literature, one finds the Hart-Fuller debate wherein H. L. A. Hart joined Oliver Wendell Holmes, Jr. (Holmes, 1897, p. 459) in declaring a strict separation of legal and moral issues and locating the role of judging solely within the positive realm (Hart, 1958, pp. 594-95). Lon Fuller argued that moral principles cannot help but influence both judges and legislatures and that it was disingenuous to exclude notions of individual and societal morality in any assessment of law (Fuller, 1958, p. 630). If one embraces the moral obligation to obey the law, akin to Socrates, then that obligation must involve more than a licentious FRM admonishment to do whatever one can get away with. The tax law has an ethical moment and professionally honest interpretations of law must account for both the moral consequences of alternative readings and the value-laden genesis of the particular law in issue.

Socrates's stoic notion of political obligation and Fuller's natural law jurisprudence provide swords with which to cut the gordian knot that entangles taxpayer self-interest with the self-interest of government officials. Well-healed taxpayers, whether members of the top one percent or large corporate entities, have a special influence on government officials intent on reelection. Stoic philosophy, initiated by Socrates and then propelled by Aristotle, calls for temperance and self-restraint when interacting with the law (Aristotle, 2019, pp. 98-99). Adam Smith similarly embraced stoic philosophy in his call for prudence, defined as self-interest tempered with justice and beneficence (Smith, 1982, pp. 78-79). Milton Friedman reminds us that the profit must be achieved ethically (Friedman, 1970, p. 33). Archie Carroll's pyramid of social responsibility has an ethical obligation at its core (Carroll, 2016, p. 5).

Fuller's jurisprudence reminds us that law projects from ethical values, giving them voice and effect. In this light, respect for one's legal obligations includes cooperating with the formation, implementation, and reform of tax regulations at the local, national, and international levels.

Solving the tax gap requires a proper framing of ethical obligations by both taxpayers and government authorities (VIRTEU, 2021). Both tax fraud and government corruption emerge from the familiar triangle of temptation, opportunity, and rationalization (Lederman, 2021, pp. 1153-56). For the taxpayer, tax shelters and profit shifting provide temptation and opportunity, and the jurisprudential positivity of FRM offers a rationalization. For government officials, campaign finance funds and the revolving door of regulation can be seductive. Stoic philosophy offers a solution. Socrates reminds us that the unexamined life is not worth living. Ethics must run throughout the business model to give it legitimacy. Similarly, government officials are privileged to serve the common good. Armed with such values, solving the tax gap becomes easy. Without them, no amount of legislation is likely to make a difference.

1. Taxpayer Ethical Obligations with Regard to Law

The ethical duty to pay taxes is rooted in the broader political obligation to obey reasonably just laws promulgated in reasonably just societies (Edmundson, 1999, pp.1-15). Philosophical discussions of political obligation trace to Plato's recounting of Socrates's trial and death (Plato, 2008 pp.63-82). Condemned to die for the crime of corrupting the minds of Athenian youth, Socrates's friend, Crito, offers a means of escape. A dialogue ensues where Socrates offers four reasons why stoic virtue demands legal obedience. First, Socrates argues that his lifelong residence in Athens implies his consent to follow Athenian law. Second, he reasons that because he has benefited from the law, the ethics of reciprocity requires his return obedience. Third, Socrates argues from a principle of fairness and finds a duty to obey law rooted in the obedience of others. Finally, employing a pragmatic perspective, Socrates notes that if legal obedience became a widespread matter of personal choice, then Athens would surely fail. Socrates chooses virtue over life and refuses Crito's offer to escape.

Of course, not everyone embraces a robust political obligation to obey tax law. Libertarian political philosopher Robert Nozick (1974, pp. 169-70), for example, famously argued that redistribution in the form of compulsory taxation is morally "on par with forced labor." Nozick's view threatens to provide a rationalization for both tax evasion and the corrupt underenforcement of tax law by government officials. This rhetorical support for evasion and corruption supports the tax gap and frustrates the democratically determined policy justifications underlying tax law. These justifications typically involve pragmatic compromises and the balancing of social norms. Ultimately, tax is used for both monetary and fiscal policy reasons and to alleviate income polarization (Avi-Yonah, 2006). The tax gap frustrates these democratically determined legislative goals.

Comparing Socrates with Nozick, it is important to note that even among political philosophers who find a robust duty to obey the law, there is room for permissible civil disobedience (e.g., Rawls, 1969). Sophocles examined civil disobedience in the play Antigone, where his protagonist justifiably defies Creon's decree she deems unjust (Sophocles, 442 BCE). Similarly, Harriet Tubman defied slavery laws; Mahatma Gandhi incited a boycott of the British salt tax; and Martin Luther King, Jr. led sit-ins. If the state is unjust, then there is no ethical duty to obey its law. Yet, the logic of civil disobedience does not extend to the income tax codes promulgated in accord with due process in democratic societies. Within such societies, some combination of the Socratic appeals to consent, reciprocity, fairness, and pragmatism must carry the day. In short, libertarian philosophers are ethically free to advocate their political positions, but they are not ethically free to disobey tax law.

1.1. Complying with Tax Law – Competing Frameworks

The tax gap, by definition, derives from tax evasion, tax insolvency, and tax avoidance (Murphy, 2014, pp. 5-6). Evasion involves criminal activity without recourse to legal excuses, such as failing to report self-employment income or deliberately falsifying a return. Evasion potentially involves jail time. Insolvency arises when a taxpayer files bankruptcy or otherwise becomes incapable of paying a tax. Tax avoidance refers to not paying a tax or paying a reduced tax based on the assertion of a literal interpretation of tax law that one knows was not intended by the legislature, and if challenged, may not prevail in court. Of course, if the taxpayer's interpretation were to prevail, then no additional tax would be due, and the failure to pay would not be within the tax gap. If the interpretation proves invalid, however, then the taxpayer must pay back taxes with interest and potentially a civil penalty. Studies estimate that about one-half to two-thirds of the tax gap in the United Kingdom derives from evasion, about one-sixth from insolvency, and one-sixth to one-third from avoidance (e.g. Murphy 2014, pp. 2-4; HMRC 2021, p.11).

Like all areas of law, tax law has to be interpreted. Disputes over tax interpretation typically involve a tension between the letter and the spirit of the law (Symposium, 2001). The letter, of course, refers to a literal interpretation of the statute or regulation. But words can have more than one meaning, and ambiguity makes the law difficult to interpret (Dickerson, 1975, pp. 42-49). Words can be vague, requiring the drawing of lines between taxable and non-taxable activities without clear guidance (Dickerson, 1975, pp. 49-51). Tax laws also can have gaps, conflicts, and inconsistencies. This is particularly true when more than one taxing authority claims jurisdiction, as one often finds in interstate transactions and in the global arena (Murphy, 2014).

In taking a tax position, two frameworks to legal compliance present themselves. The first defines a taxpayer's legal obligation with sole reference to the likely consequences of taking the tax position. This orientation follows the economic logic of financial risk management (FRM). It also ignores the complex sets of normative comprises incumbent in tax regulations and the ethical aspirations that the law seeks to advance. The alternative orientation to a tax filing employs the full panoply interpretive tools, including reference to legislative intent and public purpose incumbent in tax law. Here, the compliance norm requires the construction of a professionally honest interpretation of the law and self-restraint in adopting such a position when a more disingenuous interpretation seems cost-effective. The following sections contrast these competing frameworks, beginning with FRM.

1.2. Financial Risk Management – Exacerbating the Tax Gap

Pursuant to FRM, political obligations are framed with sole reference to projected liabilities. From an ethical perspective, this framework poses several difficulties. First, FRM frames law in strictly positive terms, ignoring the moral dimensions of legal obedience. Second, tax law is highly influenced by the lobbying process; yet FRM tends to ignore the influence that corporate expertise and resources have on law and legal outcomes, or perhaps more accurately, incorporates the role of corporate prerogatives when conducting a marginal benefit equals marginal cost calculation upon which the FRM definition of compliance turns. Third, sometimes tax evasion goes undetected; or alternatively, it can be characterized as tax avoidance so as to move taxpayer exposure from the criminal to the civil docket. When tax laws are underenforced, FRM calculations counsel evasion. In short, the FRM approach to compliance exacerbates the tax gap.

Consider first the positivity of law incumbent in the logic of FRM. The positivity of law refers to the way law confronts taxpayers solely as the threat of consequences for non-compliance. In the well-known articulation given by Oliver Wendell Holmes, Jr.:

> "If you want to know the law and nothing else, you must look at it as a *bad man*, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience (Holmes, 1897, p. 459, emphasis added)."

This heuristic, Holmes thought, was necessary to "dispel a confusion between morality and law" (1897, p. 459). Holmes wrote: "A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money" (1897, p. 459). FRM's economic logic dictates that tax compliance at its finest, and by design, corresponds to the way Holmes's bad man views and responds to legal norms.

The positivity expressed by Holmes reaches its most celebrated articulation in the works of H. L. A. Hart. Hart backs Holmes and other positivists to defend "the separation of law as it is and the law as it ought to be," implying that a judge's (or taxpayer's) fidelity to the law does not require any judgment about whether the legal rule in question was "morally desirable" (1958, p. 599). Lon Fuller famously argued against Hart's positivism with the contention that what makes the law "law" is not merely its form and genesis by the state, but what he calls its inner morality (1958, p. 630). According to Fuller, discerning one's legal obligations requires more than a prediction of the positive threat of enforcement dictated by a regulatory text, because it takes more than state power to make law. Ultimately, tax law expresses democratically determined social values and seeks to promote those values. Ignoring those values violates the Socratic virtue of legal obedience and contributes to the tax gap.

The rubric of FRM portrays law as an exogenously imposed given. Yet, taxpayers have a host of legal strategies with which to influence the creation, reform, and enforcement of tax law (LoPucki & Weyrauch, pp. 1443-71). Telling taxpayers to simply follow the law, when they help write the law, can be somewhat circular. Moreover, sometimes tax law is underenforced. Regulators may lack the resources or the political will to adequately monitor taxpayer activities, and taxpayers can often conceal or obfuscate their actions. In such cases, both Holmes's bad man understanding of political obligation and an FRM approach to tax compliance would counsel aggressive tax positions even if the positions were unlikely to prevail in court. If a position were challenged, lawyers may advocate strained interpretations of both the law and the facts while characterizing those interpretations as valid. If a literal interpretation is found, then the matter no longer carries criminal sanctions; hence, everything reduces to pecuniary calculations that often counsel tax evasion and illegitimate avoidance strategies.

1.3. Professionally Honest Interpretations – Reducing the Tax Gap

Of course, there is an alternative to FRM. Taxpayers could comply with a professionally honest reading of legal materials even in situations where evasion seems to pay. Tax courts tend to follow the traditional techniques of statutory interpretation (Black, 1911). Statutory interpretation begins with due deference to the plain meaning of the language expressed in the legal rule (Scalia, 1997). If that language is clear on its face, then that ends the inquiry, and the fact pattern is simply examined under the literal language of the rule and a judgment is rendered. In most tax cases, plain meaning analysis suffices, and no further inquiry into meaning is appropriate. In some settings, however, the language of the law seems ambiguous, vague, gap-riddled, or conflicted (Dickerson, 1975). In those situations, interpretation requires inquiry into maxims of construction, legislative purpose, and relevant judicial precedents (Kim, 2008).

Tax law can be quite complicated, and taxpayers typically seek professional tax advice before taking a tax position. Although not all tax planners are lawyers, many are. U.S. lawyers are subject to a code of ethics articulated in the American Bar Association's Model Rules of Professional Conduct (ABA, 2010). The Preamble distinguishes between the roles lawyers play as advisors and as advocates. It states:

> "As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system (ABA, 2010, Preamble)."

Absent the zealous advocacy norms of an adversarial setting, tax advisors have a professional obligation to reflect upon the broader duties of the client, including the ethical obligation to abide by a professionally honest interpretation of tax law. ABA Rules state: "In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors that may be relevant to the client's situation" (ABA, Rule 2.1, 2010). The Comment to Rule 2.1 explains: "It is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied" (ABA, 2010).

2. Governmental Ethics – Formation and Implementation of Tax Policy

A Theory of Justice by John Rawls remains one of the most influential works of political philosophy penned in the twentieth century (1971). Employing contractarian logic and the imagery of a veil of ignorance, Rawls articulates and defends his vision of a just society. Under a veil of ignorance, a person is unaware of their initial endowment of wealth and talent. Rawls argues that under such conditions people would agree to form political institutions that (1) guaranteed the greatest possible liberty compatible with similar liberty to others and (2) only permitted social and economic inequalities that would inure to the benefit of all (Rawls, 1971, pp. 136-41). Armed solely with these two principles, known respectively as the "equal liberty principle" and the "difference principle," Rawls defends government-enforced tax and transfer policies that lie at the heart of the democratic welfare state.

Recognizing that redistribution erodes work incentives, justice permits income inequalities that inure to the benefit of the least well off. Hence, Rawls is not articulating an egalitarian state. Nor is he describing utilitarianism. His principles proceed in serial order with the liberty principle coming before the difference principle (Rawls, 1971, p. 61). Rejecting utilitarianism, he writes, "This ordering means that a departure from the institutions of equal liberty required by the first principle cannot be justified by, or compensated for, by greater social and economic advantages" (1971, p.61).

Although his treatise focuses on principles of good governing, Rawls also addresses personal ethics (1971, p. 54). With regard to the political obligation in a just society, Rawls articulates a virtue of personal civility and defends that virtue on first-order grounds. For Rawls, civility requires the support of reasonably just social institutions, including the administration of law (1971, p. 355). As a corollary, Rawls addresses aggressive legal strategies. He writes:

> "[We] have a natural duty of civility not to invoke the faults of social arrangements as too ready excuse for not complying with them, not to exploit the inevitable loopholes in the rules to advance our interests. The duty of civility imposes a due acceptance of the defects of institutions and certain restraint in taking advantage of them (1971, p. 355)."

Rawls recognizes and accepts the self-interested nature of humans (1971, p. 11). He notes that complete egalitarianism destroys work incentives and impoverishes all (1971, p. 270). Self-interest, by contrast, motivates industry and generates bounty (1971, p. 151). Yet, when unrestrained, self-interest becomes ethically unjustifiable. Rawls writes, "Although egoism is logically consistent and in this sense not irrational, it is incompatible with what we intuitively regard as the moral view. The significance of egoism philosophically is not as an alternative conception of right but as a challenge to any such conception" (1971, p. 136).

Rawls distinguishes between "strict compliance" and "partial compliance" ethical theories (1971, p. 8). Strict compliance, discussed in Part I of the book, applies to reasonably just societies where everyone "is presumed to act justly and to do his part in up-holding just institutions" (1971, p. 8). Partial compliance theory, discussed in Part II, informs the theory of punishment and the scope of permissible civil disobedience. Rawls notes that his primary aim is in describing virtues appropriate for perfectly just societies (1971, p.8). Part I provides a map to appropriate governmental policy goals; Part II explores the appropriate governmental means of dealing with malfeasance.

2.1. Executive Enforcement Proclivities

Tax policy changes with changing administrations. Coming out of the Second World War, the United States enjoyed a golden era complete with a growing middle class supported by labor union membership and free college education for veterans. Income polarization ebbed as the ratio between CEO pay and average worker pay hovered around twenty, as compared to 361 times today (Hembree, 2018). Holding most of the world's gold supply and with an industrial base intact, the United States helped rebuild Germany and Japan and supported international institutions, including the World Trade Organization. As of 1950, the European Coal and Steel Community, the precursor to the EU, began to unite European countries economically and politically in order to secure a lasting peace. In the early 1960s, President John F. Kennedy ushered in a stimulus package that included significant tax cuts and efforts to close tax loopholes (Rukstad, 1992, pp. 236-42). The 1960s were, by all accounts, very prosperous in the United States with high growth rates, low unemployment, and low inflation.

President Kennedy proudly drew upon expert knowledge and lobbyist expertise in advocating his public policies. In support of private lobbying, he wrote:

> "Lobbyists are, in many cases, expert technicians and capable of explaining complex and difficult subjects in a clear, understandable fashion…. They engage in personal discussions with members of Congress in which they can explain in detail the reason for positions they advocate…. Because our congressional representation is based on geographical boundaries, the lobbyists who speak for the various economic, commercial and other functional interests of this country serve a very useful purpose and have assumed an important role in the legislative process (Kennedy, 1998, p. 3)."

Hence, as President Kennedy emphasizes, lobbying has virtues and lobbyists play an important role in a representative government.

Notwithstanding President Kennedy's optimism, today, public opinion is more likely to reflect reservations with lobbying than admiration. Perhaps this simply reflects a more politically cynical time. In a 1964 poll, seventy-six percent of Americans said that they trusted the government to do the right thing "just about always" or "most of the time" (Boren, 1996, p. 1). Asking the same question in 1994, the number dropped to twenty-one percent, with about half of the respondents stating that the federal government was "controlled by lobbyists and special interests" (Boren, 1996, p. 2). The public concern is not just with unsavory tactics employed by paid lobbyists, but more fundamentally with the ability of the financially well-heeled to shape the law to serve their private interests rather than the public good.

In 1980, presidential candidate Ronald Reagan tapped into a growing cynicism about government regulations. Reagan famously denounced the government as the problem, not the solution. While in office, he slashed the top individual tax bracket from fifty to twenty-eight percent, raised social security taxes on workers, attacked organized labor, and refused to enforce antitrust law, all of which began the steady increase in wealth polarization that continues unabated (Ruckstad, 1992, pp. 267-300).

Of course, cutting the capital gains tax rate (President George H. W. Bush), eliminating the inheritance tax (President George W. Bush), or halving the corporate income tax rate (President Donald Trump) does not contribute to the tax gap. President Trump's defiant attitude toward tax compliance; however, may be another story. President Trump not only refuses to make his taxes public; he has also suggested that he is too "smart" to pay taxes (Mangan, 2016). His suggestion is that smart people find ways to hide their income. In essence, he used his bully pulpit to rationalize cost-effective evasion and avoidance practices. Not surprisingly, President Trump cut IRS funding and decreased the audit rate more sharply for upper-income earners and corporations than for Earned Income Tax Credit recipients (Sarin, 2021).

2.2. Capture Theory of Tax Regulation

The Rawlsian view of good government, buttressed by the virtue of civility, places government tax regulations in a positive light and projects a robust duty of cooperation on the taxpaying public. The view is consistent with the so-called "Public Interest" theory of regulation, popular in the early to mid-twentieth century (Croley, 1998, pp. 65-70). Pursuant to this view, paying taxes is a civic virtue, and one lives within the spirit of the tax code.

By the early 1970s, this optimistic view of government and civility began to shift. During that decade, Chicago school economists articulated and developed what is commonly called the

“Capture Theory” of regulation (Stigler, 1971). According to the Capture Theory, businesspersons use the regulatory process to secure private economic advantages, most notably by erecting barriers to entry that generate economic rents (Posner, 1975). Regulated firms achieve these advantages, in part, by controlling the flow of information to regulators (Kochan, 1998, p. 81). Control also derives from the perverse incentives created by the so-called “revolving door” of regulation whereby regulators are recruited from the industry that they regulate and return to that industry after completing their term of government service (Johnson, 1983). Such a practice was discussed during the VIRTEU International Symposium “The Professionals: Dealing with the Enablers of Economic Crime” where Paul D. Scott explained that it is particularly problematic where agencies personnel’s next carrier move is in the same industry they are supposed to monitor and control (Scott, 2021, video recording at 57:17). According to the Capture Theory, these information flows and perverse incentives result in a set of regulatory laws (e.g., entry barriers, rate controls, product standards) that mirror those created by economic cartels (Posner, 1974, p 344).

Political scientists offer an equally negative view of regulatory law under the rubric of “Public Choice” (Olson, 1965). Like the Capture theorists, Public Choice theorists assert that the substance of most business regulations has much less to do with the public interest than with the private will of the politically well-organized (Buchanan & Tullock, 1962; Downs, 1957). According to Public Choice Theory, legislators and agency officials respond to special-interest groups that use the lobbying process and campaign contributions to seek private goals. Of course, if competing special interest groups were balanced with each given full voice in the regulatory process, then some semblance of the public good might result (Dahl, 1961). But given the logic of collective action, some groups will be represented, and some will not. Interacting with the regulatory process is not cost-free, and these costs will only be worthwhile if the benefits derived from the regulatory change are direct and substantial. The result, according to Public Choice Theory, is a set of regulations that systematically favors the politically well-organized with narrow interests at the cost of the common good.

The Capture Theory and Public Choice perspectives remain highly influential today. Both provide a cynical view of the democratic process and resulting regulatory regime, including tax provisions. If correct, the taxpayer capture of government punctuates the opportunity and motivational sides of the fraud/corruption triangle. It also offers a rationalization for fraudulent and corrupt actions. In short, compliance through governmental capture exacerbates the tax gap.

2.3. Influence of Judicial Predispositions

Tax avoidance schemes can be complex, and whether the schemes succeed very much depends on the judicial predisposition towards literal interpretations of tax provisions. Consider the double Irish with a Dutch sandwich scheme adopted by Google (Kleinbard, 2011). Google set up a subsidiary in Ireland, transferring intellectual property in exchange for stock. Pursuant to Irish law, the Irish subsidiary was then combined with a subsidiary in Bermuda establishing a dual residency with regard to tax. The U.S. government perceived the company as Irish because that is where it was incorporated, and the Irish government perceived the domicile as Bermuda because that is where its “mind and management” was centered (Kleinbard, 2011, p. 709). The Irish/Bermuda subsidiary then licensed the intellectual property to a Dutch corporation pursuant to a contractual arrangement that required the Dutch corporation to relicense the property to a second Google-owned subsidiary in Ireland. That second Irish entity then marketed the intellectual property throughout Europe, the Middle East, and Africa. The marketing entity paid royalties to the Dutch company who then paid royalties to the Irish/Bermuda firm, and the income was reported in tax-free Bermuda (Kleinbard, 2011, p. 712). These complications were used because the transfers between the Irish companies and the Dutch company were not recognized as taxable events under U.S. tax law, and the transfer between two members of the European Union is not subject to a withholding tax (Kleinbard, 2011). This aggressive tax planning was quite effective, and Google paid virtually no corporate income tax in the United States, or elsewhere.

It is important to note that U.S. tax courts have tools with which to invalidate step transactions schemes of this type. In particular, the U.S. Supreme Court has developed a set of general anti-avoidance rules (GAARs) that disallow hyper-literal, self-serving interpretations of tax regulations. These include the “substance-over-form,” “sham transaction,” “step transaction,” “economic substance,” and “business purpose” rules (Libin, 2010). The doctrine of substance-over-form traces to U.S. v Phelps, where the U.S. Supreme Court directed lower courts to ignore the form of a tax transaction if that form has no substantive content (257 U.S. 156 (1921)). The sham transaction rule arose in Higgins v. Smith where the Supreme Court held that when a tax event is unreal or a sham, then that lower courts should “disregard the effect of the fiction as best serves the purposes of the tax statute” (308 U.S. 473, 477 (1940)).

A third GAAR, the business purpose rule, traces to the Supreme Court case of Gregory v. Helvering (293 U.S. 465 (1935)). Gregory sought to acquire a set of shares from her investment company without declaring a dividend. She first directed her company to sell the shares to a newly-formed company, which then transferred the shares to her, and then the newly-formed company dissolved. The three steps, taken collectively, satisfied the literal requirements for a tax-free reorganization, so no dividend was declared. Gregory later sold the shares claiming a favorable capital-gains rate. The U.S. Supreme Court held that Congress had intended that reorganizations done for a business purpose should not be a taxable event, but the taxpayer in Gregory had no purpose other than to reduce her taxes (Gregory, p. 470). The favorable treatment was disallowed.

The difficulty with the tax gap is that courts seem reluctant to use GAARs to invalidate avoidance schemes. A court that views itself as a full partner in a governmental attempt to protect the tax base will likely take an expansive view of GAARs and disallow literal arguments akin to the one advanced in Gregory. By contrast, a court intent on protecting the letter of the law, as specified in the reorganization provisions of the Code, will likely restrict itself in anti-tax avoidance (ATA) matters. The same appears true with regard to Google’s global profit shifting. Potentially, the ATA doctrines could be used to limit abuses in this area. However, the immense scale of U.S. tax avoidance through profit shifting suggests that relatively little is being done with ATA doctrines to discourage the practice. It is interesting to note that effective January 1, 2020, Google voluntarily announced that it will no longer use the "Double Irish, Dutch Sandwich" loophole (Helmore, 2020).

There is no direct evidence regarding the source of the reluctance of tax judges to aggressively use GAARs to discourage tax avoidance. Part of the answer likely lies in the process by which judges are selected. Federal nominations come from the President and require Senate confirmation. Given their desire for reelection, neither the President nor most individual senators are likely to appoint or to confirm politically active tax judges that threaten to disrupt entrenched power structures. In fact, the confirmation hearings often probe the nominee's respect for "the rule of law," likely framed in formalistic and textualist trappings. On the state level, most tax judges are selected by the state legislature, while some are appointed by the Governor. Some states use partisan or non-partisan elections. One suspects that these processes may be subject to capture through campaign finance and lobbying activities that seek politically conservative tax judges ideologically committed to libertarian ideals and to a formalistic jurisprudence. More scholarly research on the source of the judiciary's political and class predispositions toward tax seems warranted.

3. Cutting the Gordian Knot – Ethical Frameworks

The symbiotic relationship between elected officials and wealthy taxpayers creates a conundrum for those seeking to close the tax gap. There seems to be little to no lobbying efforts in favor of hiring more internal revenue agents. Nonetheless, the Biden Administration has called for significantly increasing the IRS budget, specifically $80 billion of investment over the next ten years (Sarin, 2021). Whether Congress cooperates is still to be seen. Ultimately, many taxpayers and governmental officials may need to rethink and reframe the ethical standards to which they hold themselves. The goal is to undermine, and ideally remove, any self-serving rationalizations that may encourage taxpayers to evade or unjustifiably avoid their tax obligations. In short, eliminating the tax gap requires an attack on the "rationalization" leg of the corruption/fraud triangle (Lederman, 2021).

3.1. Stoic Self-Restraint

Stoic philosophy, initiated by Socrates and then propelled by Aristotle, calls for temperance and self-restraint when interacting with the law (Aristotle, 2019, pp. 98-99). In his discussion of justice in Nicomachean Ethics, Aristotle anticipates and answers those who claim that legal compliance should be about responding to the positive command of the sovereign coupled with the likely economic consequences to the citizen (Aristotle, 2019, pp. 98-99). In Aristotle's jargon, the FRM practitioner and the Holmesian positivist both make the mistake of equating the moral virtue of "justice" with a positivistic reading of "legal justice" (Aristotle, 2019, 99). Aristotle contends that in practice this positive understanding of moral justice as legal justice requires a corrective virtue that he characterizes in terms of epieikeia, alternatively interpreted as equity or decency.

Aristotle recognizes that the law will always be an imperfect institution. He contends that the stoic virtue of decency "rectifies" legal justice. The rectification responds to legal regulation's inherent generality, or universality. Aristotle writes:

"[A]ll law is universal, but in some areas, no universal rule can be correct; and so where a universal rule has to be made, but cannot be correct, the law chooses the universal rule that is usually correct, well aware of the error being made. And the law is no less correct on this account; for the source of the error is not the law or the legislator, but the nature of the object itself, since that is what the subject matter of actions is bound to be like (Aristotle, 2019, p. 99)."

For Aristotle, the limitation of legal regulation is not ontological—a function of the facticity of law—but rather political. The mistake is in the institutional division of labor between lawgiver and legal subject (taxpayer), after the legal regulation takes positive form. Applied to taxation, Aristotle rejects the idea that taxpayers should lean on the positive edge of legal regulation to chase financial gains. His rejoinder from decency would be that the justice of law comes from the purpose of the law—its raison d'être—not merely its positivistic rendering and sting, and therefore, that if “good” law (well-founded and legitimate) is indeed to be good and serve as a fount of justice, moral virtue entails decency from legal subjects to dig beneath the verbal veneer of law to consult its ethical purpose. He writes:

> “It is also evident from this who the decent person is. For he is one who decides on and does such actions, not an exact stickler for justice in the bad way, but by taking less than he might even though he has the law on his side (Aristotle, 2019, p. 99).”

Here, Aristotle is expressing the need for stoic self-restraint that cuts an overly entitled sense of legal prerogative down to size. The virtue of decency requires the “stickler” to avoid taking undue advantage of substantive error manifest in reasonably just laws.

The virtue ethics tradition that follows Aristotle and other Stoics and all the way up through Adam Smith and contemporary theorists, including John Rawls, hinges on the idea of moderation and self-restraint. To rectify the limitations with FRM, taxpayers need a principle of self-restraint expressly tailored to moderate the incentive and opportunity to capitalize on a legal entitlement not to consider their political obligations. Aristotle develops his account of decency to answer this precise theoretical need. Similarly, Adam Smith called for prudence, defined as self-interest tempered by justice and benevolence (Ostas & de los Reyes, 2020, pp. 20-22). John Rawls called for the virtue of civility and self-restraint when presented with self-serving legal prerogatives (Rawls, 1971, p. 355). In each case, taxpayers are asked to take less than they might if they pressed every opportunity to evade or to unjustifiably avoid tax law.

3.2. Revisiting the Social Responsibility Pyramid

Corporate executives owe a fiduciary duty of loyalty to shareholders. Presumably, shareholders like wealth. Hence, executives are likely to approach the topic of corporate taxation with an economic orientation. Yet, the executive's economic goals must be tempered with due respect for the law and widely-shared ethical customs. As Milton Friedman famously stated, the appropriate role for a corporate executive is "to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom" (Friedman, 1970, p. 32).

Friedman's formulation, though sometimes criticized, continues to be cited as seminal (Stigler Center, 2020). It also proves useful in assessing the executive's competing responsibilities in setting the corporation's tax strategies. In particular, if an executive discovers that a strained interpretation of a legal text advances the economic interests of the shareholders, then perhaps the executive must adopt that interpretation. It would seem unlikely that asserting a self-serving interpretation of a law, for example, arguing for a literal construction of a statute without reference to legislative intent, would be illegal. Hence, the only meaningful restraint on the exploitation of legal loopholes, if there is one, would come from ethics.

At first blush, the notion that ethical concerns must control a tax decision, even at the expense of shareholder profit, might seem odd. It should not. The idea is incumbent in Milton Friedman's formula suggested some fifty years ago. Perhaps the sense of oddity comes from the perception that individual ethics are too idiosyncratic and personal to be of much use as a guide to business conduct (Payne, 1994, pp. 154-55). It is true that people sometimes differ on ethical questions. If a lie serves the common good, then a utilitarian will lie; a deontologist will not. Yet, most times, ethical assessments converge. A lie that advances only the narrow interests of the liar is universally condemned. When ethics converge, the executive is morally required to follow the widely-shared ethical custom.

Ethics runs throughout the four realms of Archie Carroll's "Pyramid of Social Responsibility" (Carroll, 2016, p. 5). Initially penned in 1991, the pyramid depicts economic, legal, ethical, and philanthropic responsibilities ascending from its economic base. With the exception of Friedman's CSR formulation, "Carroll's CSR pyramid is probably the most well-known model of CSR" (Carroll, 2016, p. 2). Carroll highlights the importance of business ethics. He writes: "Though the ethical responsibility is depicted in the pyramid as a separate category of CSR, it should also be seen as a factor which cuts through and saturates the entire pyramid" (Carroll, 2016, p. 5). He notes that economic goals must be attained ethically, and that "most laws grew out of ethical issues, [and] once formalized they represented 'codified ethics' for that society" (Carroll, 2016, p. 5).

An embrace of ethics could cure the tax gap. Proper framing is essential. The ethical, legal, and economic responsibilities of a corporate executive form a hierarchy. In particular, economic motives must be tertiary to ethical and legal concerns. Shareholders never have legal authority, and seldom have moral authority, to empower an executive to violate the law. Though less appreciated, a similar reasoning informs the relationship between economics and ethics. Just as shareholders have no legal authority to empower an executive to behave illegally, they similarly have no moral authority to authorize an executive to behave unethically (Goodpaster, 1991, p. 68; Spoerl, 1997, pp. 278-79). Hence, even though an executive is a fiduciary for the shareholders, an executive's economic responsibilities are subordinate to legal and moral obligations (VIRTEU, 2021).

4. Undue Influence and Institutional Challenges

The VIRTEU project seeks to identify cases and occurrences that may be symptomatic of undue influence on the process of political decision-making with regard to tax. The following table highlights the role of business ethics, political obligation, and governmental ethics that deserve further investigation.

Table 1. Potential cases of undue influence and institutional challenges.

The practice of limiting the scope of the criminalization of tax evasion practices	Taxpayers are unlikely to pay taxes unless they feel legally or morally compelled to do so. The staggering size of the tax gap suggests that calculations are done, and taxpayers often conclude that there is little chance of conviction for criminal tax evasion and that any consequences of an aggressive tax position will be limited to the paying of back taxes with interest and a civil fine. The government's reluctance to use the criminal sanction signals an acquiescence of aggressive tax practices and erodes the taxpayer's sense of political obligation to support the tax system.

The adoption of legal instruments favorable to tax evaders (e.g., tax amnesties and forms of negotiated resolutions).	Tax officials have wide latitude in settling tax disputes through deferred prosecution agreements that often lack transparency and frequently employ vague concepts that seem to favor politically powerful actors. This practice contributes to the general cynicism among the taxpaying public that the tax system is rigged and erodes the ethical commitment of the public toward compliance.
The continued reluctance to adopt effective transparency regimes	There seems to be little interest among the taxpaying public favoring reforms that would reduce the tax gap. Perhaps this is due to the diffuse nature of the tax gap issue and the logic of collective action. Absent public pressure for general reforms, government officials become tempted by special interest groups who may benefit from a lack of transparency. This appears particularly troublesome in complex inter-group transfers and the offshore secrecy issues illustrated in the Google tax scandal. Governments proved ineffective in challenging Google's tax strategy with change coming only after the practice was widely reported in the press.
Deregulation, exceptionalism, and potential harmful tax practices adopted by national states competing against each other.	Offshore tax havens compete for business by offering low or non-existent taxes and privacy laws that conceal unsavory, and potentially illegal, business practices. One postal address in the Cayman Islands is home to over 12,000 companies. Citing respect for national sovereignty and the rule of law, industrialized nations seem incapable of ending the absurd practice of reporting income in places where no business is conducted. The Cayman Islands has 55,000 citizens and one movie theater; yet companies domiciled there retain untaxed assets that exceed the wealth of all the banks in New York City by a factor of four (Shaxson, 2011, p.18).
Revolving door practices, unethical lobbying and undue influences on the political decision-making process, and other potential institutional challenges	Cynicism regarding the capture of government by special interests erodes the virtues of civility, temperance, and prudence that support market economies. This cynicism cuts across political parties. The capture of government is both a central feature of the class struggle articulated by Karl Marx and a central tenant of the neo-liberal political economy associated with Chicago-school economics. Once taxation is seen as illegitimate, there is no ethical reason to cooperate with tax authorities.
Adoption of a high level of complexity in regulation, or	Complexity favors those who can retain and exploit expert advice. That advice typically follows the logic of financial risk management which decouples the taxpayer's legal obligations

imposition of procedural burdens or other obstacles to investigations and enforcement.	from its moral underpinnings. A game emerges where each legislative attempt to close a loophole is followed by a new avoidance practice adapted to the legislative change. Experts are incentivized to play this game which well-heeled and corporate taxpayers typically find very lucrative.
Any other potential symptom of undue influence on the political decision-making process.	Disputes over tax law interpretation typically involve a tension between letter and spirit. How a taxpayer or a court resolves that tension depends in part on their jurisprudential predisposition. An advocate, of course, will choose a self-serving disposition. Outside the advocacy setting, ethical reasoning requires both tax advisors and tax courts to offer professionally honest interpretations. It seems, however, that tax courts tend to unduly favor textualism and to follow a libertarian-based view of the spirit of the tax code. If true, this jurisprudential attitude exacerbates the tax gap. Research exploring the strength and potential source of this jurisprudential bias seems warranted. One suspects that the bias derives in part from the judicial selection process influenced by wealthy and corporate taxpayers.

Conclusion

In some contexts, a person may appear ruthlessly self-interested, calculating, and conniving. In other contexts, the same person may demonstrate a capacity for totally selfless behavior, apparently sacrificing their own self-gain for the good of others. This complexity of human motivation and behavior suggests that there is more than one reason that a person may obey or disobey the law, including the laws regarding tax fraud and corruption. The fraud/corruption triangle highlights two, sometimes conflicting, human motivations: pecuniary self-interest and moral self-restraint.

This report highlights the need for moral self-restraint in the realm of tax. The tax gap, defined as uncollected taxes due, has reached staggering levels across the globe. One-sixth of the gap is due to taxpayer insolvency; the remainder constitutes malfeasance, including four-sixths due to evasion, which could include jail time, and one-sixth due to tax avoidance that if challenged would result in the paying of back taxes, interests, and a civil penalty. In other words, the vast majority of the tax gap constitutes crimes and intentional malfeasances that are currently going unpunished.

The fraud triangle frames white-collar misdeeds with reference to motive, opportunity, and rationalizations. Much of the VIRTEU Project focuses on the "opportunity" side of the triangle, suggesting changes in international and national government policies that can reduce both tax evasion and the government corruption that supports it. This report, by contrast, highlights the role of ethical reflection in removing the rationalizations that too often provide a psychological balm to the white-collar criminal conducting a cost-benefit analysis before adopting an evasive scheme.

Part 1 of the Report roots the ethical duty to pay tax to the general ethical obligation to obey reasonably just law promulgated in reasonably just societies. This grounding draws support from Socrates, Aristotle, Smith, and Rawls, finding commonality in each of the views. Part 1 also identifies two rationalizations that derail the moral self-restraint necessary to counter white-collar crimes. The first rationalization removes the moral content from the law and thereby reduces the obligation to obey the law to a financial calculation of the likely legal consequences of alternative tax positions. The second rationalization suggests that tax positions taken pursuant to a self-centered notion of financial risk management are justified when interacting with government officials. When combined, these two rationalizations turn the obligation to obey law into a licentious admonition to do whatever one can get away with. This would include concealment and obfuscation of tax practices and the corruption of the democratic process.

Part 2 examines the formation and implementation of tax policy with particular emphasis on the influence of well-heeled and corporate taxpayers. Drawing on the "Capture Theory" of regulation, developed in economics, and the "Public Choice" theory of government popular among political scientists, Part 2 traces the corrupt influences taxpayers have on all three branches of government: executive, legislative, and judicial. The influence derives from the campaign finance system, the lobbying process, and the well-documented revolving door of regulation. The influence expresses itself in underfunding IRS activities and a judicial formalism that rejects robust uses of anti-abuse doctrines established by long-standing precedent.

Part 3 offers a partial solution to the symbiotic relationship between taxpayers and government officials. It begins with moral philosophy, highlighting the role of stoic self-restraint. Aristotle offers the virtue of epieikeia as a moral guide to interacting with unintended legal prerogatives created by inevitable imperfections in law. Advocating temperance in all things, Aristotle's moral justice demands taking less than what one might when legal opportunities present themselves. Similar views are supported by Adam Smith's stoic embrace of the virtue of prudence and John Rawls's call for the virtue of civility. Part 3 closes by revisiting two commonly cited works on corporate social responsibility, Milton Friedman's embrace of the profit incentive and Archie Carroll's notion of a responsibility pyramid. Friedman argues that profit must be tempered by legal and ethical constraints. Carroll reminds us that the law expresses ethical concerns and seeks ethical goals and that responsible corporate citizenship means abiding by both the letter and spirit of the law. Although not all the tax gap derives from corporate activities, much does, and the call for corporate social responsibility comes to the fore.

In summary, this Report advocates ethical self-restraint in the realm of taxation. The tax gap is not entirely a matter of corporate power, yet corporate executives play a role. It can be tempting to misinterpret Smith's call for prudence as an embrace of greed or to read Friedman's advocacy of profit as a license to ignore the human consequences of corporate policies. Both misreadings serve as rationalizations for corporate malfeasance in many areas, including taxation and government corruption. Honest moral reflection can go a long way in removing those self-serving rationalizations and accentuating the better side of human nature. The tax gap is not just a matter of temptation and opportunity, it is a function of inappropriate and indefensible ethical rationalizations as well.

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The project explores the interconnections between tax crimes and corruption to unravel the intimate relationships that exist between fraudulent and corrupt practices in the area of taxation with a focus on VAT fraud, which poses a direct threat to the European Union's financial interests.

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