ADMINISTERING FACTS-AND-CIRCUMSTANCES-BASED TAX TESTS

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Oftentimes, the appropriate tax treatment of a transaction or event depends on a holistic analysis of relevant facts and circumstances. Facts-and-circumstances-based tests are challenging to administer because they are challenging to enforce and because they address challenging topics on which to provide useful administrative guidance. When a taxpayer claims tax treatment that depends on application of such a test, the IRS cannot determine whether the taxpayer's claimed position is correct without knowing the relevant facts and circumstances. Yet, often, taxpayers are not required to disclose the relevant facts and circumstances when filing a tax return, making enforcement difficult. Likewise, providing administrative guidance on facts-and-circumstances-based tests is daunting. If the IRS provides concrete examples of the application of such a test, there is a risk the concrete examples will mislead taxpayers. Taxpayers may come away with the impression that the concrete examples illustrate universal rules, which is not the case given the facts-and-circumstances-based nature of the test. If the IRS steers away from offering concrete examples, however, taxpayers will face uncertainty when attempting to determine their tax treatment.

This Article proposes a new, two-fold approach to administering facts-and-circumstances-based tests. First, lawmakers ought to require more detailed, standardized disclosure from taxpayers who claim tax positions

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based upon certain facts-and-circumstances-based tests. Second, when offering examples that illustrate the likely application of such tests, the IRS should steer taxpayers towards claiming the likely outcome but also supplying the relevant disclosure in case the taxpayer's facts warrant departure from the likely outcome. Making facts-and-circumstances-based tests more administrable aligns with the IRS's recent pledge to focus additional auditing resources on taxpayers with higher incomes.

INTRODUCTION

Outside observers may imagine that tax law consists of a comprehensive set of fully specified rules capable of producing precise numerical answers to every tax question.[1] In reality, despite the existence of many technical tax rules, the answers to a multitude of tax questions are cloaked in uncertainty.[2] Uncertainty in tax law stems from a variety of sources. In many contexts, uncertainty arises because tax law employs a facts-and-circumstances-based test to make a given determination.[3]

For instance, an individual taxpayer may be entitled to a deduction for medical expenses.[4] In addition to complying with other requirements, an expense must have been incurred for "medical care" to qualify for this deduction.[5] The determination of whether something constitutes "medical care" requires an examination of facts and circumstances.[6] To take another example, a taxpayer can exclude the value of property from income if the taxpayer receives the property as a gift.[7] Whether a transfer is a gift turns on the transferor's intent.[8] Ascertaining the transferor's intent requires an examination of all relevant facts and circumstances.[9] Other examples pervade the Internal Revenue Code, Treasury Regulations, and case law.[10]

Facts-and-circumstances-based tests are challenging to administer because they are challenging to enforce and because they address challenging topics on which to provide useful administrative guidance. When a taxpayer's claimed tax treatment depends upon the application of such a test,

[1] *See* Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 363 (2005) ("That there can be significant substantive legal uncertainty in the tax laws may come as a surprise to nonexperts in the field."); Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489, 494 (2011) ("As is well known to tax experts but perhaps much less well known to nontax experts, taxpayers with more complicated tax profiles regularly have to deal with tax law uncertainty.") (footnote omitted).

[2] For additional discussion of various causes of uncertainty in tax law, see, for example, Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 144 (2009); Jeffrey H. Kahn, *Hedging the IRS—A Policy Justification for Excluding Liability and Insurance Proceeds*, 26 YALE J. ON REG. 1, 2–3 (2009); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1032–34 (2009); Logue, *supra* note 1, at 363; Osofsky, *supra* note 1, at 494.

[3] *See* Andrew T. Hayashi, *A Theory of Facts and Circumstances*, 69 ALA. L. REV. 289, 293–94 (2017).

[4] *See infra* Part I.A.

[5] *See infra* Part I.A.

[6] *See infra* Part I.A.

[7] *See infra* Part I.B.

[8] *See infra* Part I.B.

[9] *See infra* Part I.B.

[10] *See infra* notes 41–45 and accompanying text.

the IRS cannot possibly determine whether the claimed tax treatment is appropriate without knowing the relevant facts and circumstances. Yet, often, the information that taxpayers must provide when filing a tax return provides the IRS with no details about the surrounding facts and circumstances, making enforcement difficult. Of course, the IRS could obtain additional information during an audit, but the vast majority of tax returns are not audited. For all individual returns filed for tax years 2012 through 2020, the overall audit rate was approximately 0.49%.[11]

Moreover, taking a tax position based upon a facts-and-circumstances-based test does not necessarily increase the likelihood of audit. This is true, in part, because the fact that a taxpayer has taken such a position will not necessarily be evident from the face of a taxpayer's return. From the return, the IRS can ascertain whether a taxpayer has claimed a deduction that turns upon the application of such a test, but the IRS cannot always determine whether a taxpayer has excluded an item from income based on the application of such a test. Furthermore, even if a tax return does reveal that a taxpayer has taken a position based on a facts-and-circumstances-based test, that information will not necessarily increase the chances of an audit. Various factors guide selection for audit, including the amount of additional tax liability that an audit is expected to uncover and the cost or difficulty of the audit.[12] It is possible that facts-and-circumstances-based determinations increase the difficulty and cost of audits.

In addition to enforcing tax law, the IRS is tasked with providing taxpayers with guidance to enable them to comply with what the law requires.[13] Even in the case of fully specified rules, developing useable guidance is a daunting endeavor.[14] Attempting to provide useful guidance on facts-and-circumstances-based tests may be even more challenging.[15] In

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[11] I.R.S., PUB. NO. 55-B, DATA BOOK, 2022, at 33 (2023).

[12] *See* Sarah B. Lawsky, *Fairly Random: On Compensating Audited Taxpayers*, 41 CONN. L. REV. 161, 164–68 (2008); Leigh Osofsky, *Concentrated Enforcement*, 16 FLA. TAX REV. 325, 334–36, 364 (2014) ("[T]he GAO reported in 2007 that the IRS's enforcement programs annually contact less than five percent of estimated noncompliant sole proprietors. A principal explanation for this statistic is that finding cash business evasion requires intensive and expensive audits, which the limited enforcement resources cannot yield in sufficient quantities.") (footnote omitted).

[13] *See* Joshua D. Blank & Leigh Osofsky, *Simplexity: Plain Language and the Tax Law*, 66 EMORY L.J. 189, 196–97 (2017).

[14] *See id.* at 201 (describing various challenges faced by the IRS when it attempts to explain tax law).

[15] *See* Joshua D. Blank & Leigh Osofsky, *Automated Legal Guidance*, 106 CORNELL L. REV. 179, 223 (2020) [hereinafter Blank & Osofsky, *Automated Legal Guidance*] (noting that the IRS's

some cases, the IRS simply refrains from providing guidance on such tests altogether. The IRS's reticence might stem from its view that guidance on such tests would be: (1) unhelpful given that any particular taxpayer's facts would likely differ—at least somewhat—from what the guidance would describe, (2) misleading to taxpayers, or (3) willfully misread by taxpayers.[16]

When the IRS withholds guidance on facts-and-circumstances-based tests, taxpayers typically face greater uncertainty. Greater uncertainty may lead to higher costs of enforcement[17] and less uniform enforcement.[18] Also, different taxpayers respond differently to uncertainty. Cautious taxpayers may respond by paying potentially more in tax than they owe, while other taxpayers may exploit additional uncertainty by taking aggressive tax positions that err on the side of underreporting tax liability.[19] Moreover, given greater uncertainty, the latter group may be less likely to face penalties even if their claimed tax treatment is successfully challenged.[20]

Interactive Tax Assistant often attempts to provide answers that reduce the "uncertainty that would be inherent in standards and the complexity that would flow from many rules").

[16] *See* Emily Cauble, *Questions the IRS Will Not Answer*, 97 IND. L.J. 523, 554–69 (2022) (describing potential explanations for the IRS's seeming reluctance to issue letter rulings with respect to some facts-and-circumstances-based topics); Stephen M. Goodman, Note, *The Availability and Reviewability of Rulings of the Internal Revenue Service*, 113 U. PA. L. REV. 81, 86–89 (1964) (providing additional discussion of the IRS's no ruling policies).

[17] *See* Edward Yorio, *Federal Income Tax Rulemaking: An Economic Approach*, 51 FORDHAM L. REV. 1, 7–8, 19-23 (1982).

[18] *See* L. Harold Levinson, *The Legitimate Expectation that Public Officials Will Act Consistently*, 46 AM. J. COMP. L. 549, 558 (1998) ("Throughout the legal system, officials administer statutes or apply judicial precedents which require determinations based on vague terms, such as 'in the public interest.' Inconsistent exercises of this discretion are inevitable, and cannot all be remedied by judicial review . . . ."); Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349, 372 (1993) ("An important source of uncertainty is the discretion of lower-level bureaucrats . . . .").

[19] *See* Sheldon I. Banoff, *The Use and Misuse of Anti-Abuse Rules*, 48 TAX LAW. 827, 837 (1995); Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173, 196–97 (1991); Richard J. Kovach, *Bright Lines, Facts and Circumstances Tests, and Complexity in Federal Taxation*, 46 SYRACUSE L. REV. 1287, 1303 (1996); Logue, *supra* note 1, at 374–75; Osofsky, *supra* note 1, at 492; David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 249 (2002). For a similar observation regarding standards in law generally, see, for example, Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 385 (1985).

[20] *See* Gergen, *supra* note 19, at 196–97 ("Penalties are imposed for positions taken without substantial authority, but whether there is substantial authority for a position depends on the weight of the authority against it, and so weak arguments may seem substantial under standards that initially leave much in doubt."); Osofsky, *supra* note 1, at 492, 507–11. See also Michael L. Cook & Corby Brooks, *Determining Whether Substantial Authority Exists in Facts and Circumstances Cases*, 111

When the IRS does attempt to clarify a facts-and-circumstances-based test by providing examples of how the test will apply to specific facts, the concrete examples may mislead taxpayers. If the examples are contained in informal guidance like IRS publications the harm to misled taxpayers is particularly great given their limited ability to rely on informal guidance.[21] Moreover, various sources of informal IRS guidance do, indeed, contain potentially misleading statements, including a number of potentially misleading statements that have been catalogued by Professors Blank and Osofsky.[22]

Not all instances of potentially misleading guidance involve the application of facts-and-circumstances-based tests. However, many examples do, and the task of offering guidance that is *not* potentially misleading is arguably particularly difficult in the case of a facts-and-circumstances-based test.[23] This is true because including in the guidance concrete examples of the application of facts-and-circumstances-based tests may convey the inaccurate impression that universal rules govern tax outcomes. Given the facts-and-circumstances-based nature of the tests, inevitably exceptions exist to any general rules, and conveying all the potential exceptions in the guidance is prohibitively difficult, if not impossible.[24]

J. TAX'N 173 (2009), for a discussion of whether certain penalty defenses are available when a taxpayer claims a position based on a facts-and-circumstances-based test. Greater uncertainty may also prompt taxpayers to use professional tax return assistance, and some studies show that taxpayers who engage professional tax return preparers are more likely to underreport when confronted with uncertainty. Osofsky, *supra* note 1, at 535.

[21] *See infra* notes 212 and 216 and accompanying text.

[22] *See* Blank & Osofsky, *supra* note 13, at 207–28; Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 210. For other examples, see *infra* notes 181–187 and accompanying text.

[23] For examples of some misleading statements that fall in the facts-and-circumstances-based category, see *infra* Part III.C.

[24] *See* Hayashi, *supra* note 3, at 294 ("There may simply be too many facts that have too different evidentiary values in too many different situations to specify them all in advance."); Osofsky, *supra* note 1, at 496 ("Reducing uncertainty to zero in all cases clearly is not feasible from a cost-benefit perspective. Take § 162 as an example. It provides that taxpayers may deduct all ordinary and necessary business expenses. While tax administrators theoretically could list every conceivable expense in every possible situation and indicate whether or not such expense would be an ordinary and necessary business expense, doing so would clearly have rapidly declining marginal returns."). This relates to the observation in the literature on rules vs. standards, generally, that utilizing a rule rather than a standard tends to be cheaper (taking into account costs of promulgation

As discussed above, uncertainty that follows from withholding guidance on facts-and-circumstances-based tests produces undesirable consequences. Providing potentially misleading guidance also produces undesirable consequences. Sometimes misleading guidance is unduly unfavorable in that, for instance, it leads taxpayers to fail to claim a deduction or credit to which they are entitled. In that case, some taxpayers will be subject to higher tax liability than what law requires. An inability to rely on the informal guidance means that, if misled taxpayers later discover that they are entitled to the deduction or credit after the time for amending their return has expired, such taxpayers likely cannot use the fact that they were misled by IRS guidance to obtain more time to amend their return.[25] These results are inequitable, particularly if taxpayers who are not well-advised are more likely to be misled by informal unduly unfavorable guidance.[26]

Sometimes, misleading guidance is unduly favorable. For instance, it may steer a taxpayer towards taking a deduction to which the taxpayer is not, in fact, entitled. Unduly favorable guidance has tax-revenue-reducing and inequitable effects. A taxpayer who follows unduly favorable guidance is not harmed but is in fact benefited by paying less tax than they owe—at the expense of the government collecting less tax revenue than intended—provided the taxpayer's return is not audited.[27] By contrast, if the taxpayer's return is audited and their incorrect position is discovered and successfully challenged, they will owe additional tax liability, interest, and potential penalties.[28] Moreover, not all taxpayers face the same likelihood of audit. Significantly, a recent study estimated that Black taxpayers face a higher probability of being audited, facing audit rates that are between 2.9 and 4.7 times the rate of non-Black taxpayers.[29] In addition, earned income tax credit

and enforcement) when the rule will be applied frequently to similar fact patterns. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 563 (1992).

[25] *See infra* note 212 and accompanying text.

[26] Blank & Osofsky, *supra* note 13, at 243–44; Joshua D. Blank & Leigh Osofsky, *Automated Agencies*, 107 MINN. L. REV. 2115, 2172 (2023); Joshua D. Blank & Leigh Osofsky, *The Inequity of Informal Guidance*, 75 VAND. L. REV. 1093, 1129–30 (2022) [hereinafter Blank & Osofsky, *Inequity*]; Emily Cauble, *Detrimental Reliance on IRS Guidance*, 2015 WIS. L. REV. 421, 463–65 (2015).

[27] *See* Blank & Osofsky, *supra* note 13, at 242.

[28] *See infra* note 216 and accompanying text.

[29] *See* Hadi Elzayn et al., Measuring and Mitigating Racial Disparities in Tax Audits 3 (Jan. 30, 2023) (unpublished working paper) (on file with Stanford Inst. for Econ. Pol'y Rsch.); *see also* Steven A. Dean, *Filing While Black: The Casual Racism of the Tax Law*, 2022 UTAH L. REV. 801,

(EITC) recipients face high rates of audit. For instance, in the 2017 tax year, the audit rate for tax returns that included a claim to the EITC was 1%, compared to a 0.3% audit rate for returns that did not include a claim to the EITC.[30]

The IRS has pledged to address audit rate disparities going forward[31] and to use additional resources to audit taxpayers with higher incomes.[32] Auditing taxpayers with higher incomes can be difficult for a variety of reasons—for instance, such taxpayers are more likely to earn income that is not subject to third party reporting,[33] they are more likely to hold interests in businesses,[34] and they are more likely to engage in certain types of tax evasion.[35] Likely, it is also the case that their tax treatment is more frequently determined under facts-and-circumstances-based tests.[36] Indeed, as described below, many of the examples of such tests discussed in this Article disproportionately affect

802 (2022) ("ProPublica has shown, for example, that because of the perils of filing income taxes while Black, the five most heavily audited counties in the United States are Black and poor.")

[30] *See* CONG. RSCH. SERV., IN11952, AUDITS OF EITC RETURNS: BY THE NUMBERS 2 (2022).

[31] Letter from Daniel I. Werfel, Comm'r, Dep't of the Treasury, to Members of the U.S. Senate (May 15, 2023) (on file with author).

[32] I.R.S. News Release IR-2023-166 (Sept. 8, 2023).

[33] *See* Joshua D. Blank & Ari Glogower, *Progressive Tax Procedure*, 96 N.Y.U. L. REV. 668, 680–81 (2021); Emily Cauble, *Time for a Tax Return Filing Fee*, 58 HARV. J. ON LEGIS. 103, 124–25 (2021); William A. Drennan, *Strict Liabilities and Tax Penalties*, 62 OKLA. L. REV. 1, 9–10 (2009).

[34] *See* Blank & Glogower, *supra* note 33, at 679.

[35] *See* Blank & Glogower, *supra* note 33, at 680; Leandra Lederman, *The IRS, Politics, and Income Inequality*, 150 TAX NOTES 1329, 1332 (2016); Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26,475, 2019) ("Because the returns of the high-income are most complex, these examinations are most costly and most time-consuming.").

[36] When discussing issues that the IRS will encounter when auditing taxpayers with high incomes, commentators have listed various topics, many of which involve facts-and-circumstances-based tests. *See* Andrew R. Roberson et al., *IRS Refocuses on Enforcement of High-Income and High-Wealth Individuals*, TAX NOTES FED. 1806–08 (2023) (listing areas of focus in an audit of a high-income high-wealth individuals); *see also* Drennan, *supra* note 33, at 5 (noting that wealthy taxpayers' transactions "are more likely to have uncertain tax consequences"); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 27 (1993) ("One explanation might be that tax law is more determinate for the common tax issues arising among the general populace than for the tax issues likely to be confronted by tax professionals."); Osofsky, *supra* note 1, at 493 ("The average taxpayer with a simple tax situation, such as receipt of only wage and interest income, does not experience significant legal uncertainty regarding tax liability.").

taxpayers with higher incomes.[37] Consequently, measures that facilitate enforcement of certain facts-and-circumstances-based tests would align with a focus on auditing taxpayers with higher incomes.

Given the challenges that facts-and-circumstances-based tests pose to tax enforcement and the development of useful but not misleading guidance, this Article proposes a new, two-fold approach to administering facts-and-circumstances-based tests. First, lawmakers ought to require more detailed disclosure from taxpayers who claim tax positions based upon certain, specified facts-and-circumstances-based tests. To ensure that the disclosure is detailed and standardized in a way that makes it useful to the IRS, the IRS should create forms with questions that prompt taxpayers to supply the relevant information. Second, when offering examples that illustrate the likely application of such tests, the IRS should steer taxpayers towards claiming the likely outcome but also supplying the relevant disclosure in case the taxpayer's facts warrant departure from the likely outcome.

This two-fold approach is intended to make facts-and-circumstances-based tests more administrable. It is intended to equip the IRS with information needed to enforce the tests and to reduce the likelihood that a taxpayer's claim of incorrect tax treatment will go undetected. It is also intended to facilitate providing useful concrete examples in guidance by mitigating the harms that would follow if a taxpayer were misled by the guidance. While several objections to the approach might be raised, potential objections are either misplaced or could be addressed by adjusting the proposal's design.[38]

Existing literature discusses: (1) when tax law employs facts-and-circumstances-based tests to inquire into taxpayer motive or purpose, (2) why tax law employs facts-and-circumstances-based tests, (3) whether and when such tests might helpfully be replaced with clear rules or supplemented by safe harbors or rebuttable presumptions, and (4) which factors courts and the

[37] *See infra* notes 55–57, 103 and accompanying text. Other examples also illustrate this observation. For instance, a facts-and-circumstances-based test determines whether gain on the sale of real estate is ordinary income or capital gain. *See infra* note 44. According to Congressional Budget Office Estimates, for 2019, the tax expenditure resulting from the preferential tax rate that applies to net capital gain and some dividend income (not all of which relates to real estate) was $140 billion, 95% of which benefited households in the top 20% by income and 75% of which benefited households in the top 1% by income. *See* CONG. BUDGET OFF., THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN 2019, at 10–11 (2021).

[38] *See infra* Part V.

IRS ought to examine when applying facts-and-circumstances-based tests.[39] Even if some facts-and-circumstances-based tests might usefully be replaced with rules or accompanied by safe harbors or rebuttable presumptions, facts-and-circumstances-based tests will inevitably play a role in determining tax outcomes.[40] Therefore, this Article takes as a given the existence of facts-and-circumstances-based tests and builds upon existing literature by, first, describing the particular challenges to tax administration posed by facts-and-circumstances-based tests and, second, proposing an approach to administering such tests to cope with these challenges.

The remainder of this Article proceeds as follows. Part I describes several examples of facts-and-circumstances-based tests used to make tax determinations. Part II describes the minimal information that taxpayers must disclose when claiming tax treatment that depends on the application of a facts-and-circumstances-based test. Part III discusses the lack of guidance on facts-and-circumstances-based tests, as well as attempts to provide guidance on such tests that have resulted in potentially misleading statements. Part IV turns to an in-depth discussion of this Article's proposal. It discusses and provides examples of detailed, standardized disclosures that lawmakers should require. It describes the consequences that would follow if a taxpayer failed to provide the required disclosure. Part IV also describes the approach

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[39] *See* Ellen P. Aprill, *Why the IRS Should Want to Develop Rules Regarding Charities and Politics*, 62 CASE W. RES. L. REV. 643 (2012); Blank & Osofsky, *Inequity*, *supra* note 26, at 1141–42; Emily Cauble, *Presumptions of Tax Motivation*, 105 IOWA L. REV. 1995 (2020) [hereinafter Cauble, *Presumptions*]; Emily Cauble, *Safe Harbors in Tax Law*, 47 CONN. L. REV. 1385 (2015) [hereinafter Cauble, *Safe Harbors*]; Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131, 131–35, 141–45 (2001); Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW. 807, 807–08, 815–16 (1995); Hayashi, *supra* note 3; Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 391–93 (2010); Susan C. Morse, *Safe Harbors, Sure Shipwrecks*, 49 U.C. DAVIS L. REV. 1385 (2016); Leigh Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, 61 BUFF. L. REV. 1057, 1059–61, 1082 (2013); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001); David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 880–81 (1999); Yorio, *supra* note 17.

[40] For various reasons, replacing facts-and-circumstances-based tests with rules is not always desirable. *See* Cauble, *Presumptions*, *supra* note 39, at 2028–37. Furthermore, if such a test is supplemented with a safe harbor, a facts-and-circumstances-based test will govern the tax treatment of taxpayers outside the safe harbor. *See* Cauble, *Safe Harbors*, *supra* note 39, at 1388; Morse, *supra* note 39, at 1391 ("The activity described by the safe harbor is subject to a rule; other activities are subject to a standard."). Similarly, if such a test is supplemented with a rebuttable presumption, a facts-and-circumstances-based test will govern the determination of whether the presumption can be rebutted. *See* Cauble, *Presumptions*, *supra* note 39, at 2021.

that the IRS could take to providing concrete examples of the application of facts-and-circumstances-based tests in a way that could steer taxpayers towards claiming the likely outcome while also supplying disclosure in case their facts warrant departure from the likely outcome. In addition, Part IV describes the benefits of this two-fold approach. Finally, Part V describes and responds to potential objections to this Article's proposed approach.

I. EXAMPLES OF FACTS-AND-CIRCUMSTANCES-BASED TESTS

Tax law is replete with facts-and-circumstances-based tests.[41] For purposes of illustration, this Part will describe several such tests; namely, the tests used to determine: (1) whether something constitutes "medical care," (2) whether a transfer is a gift, and (3) whether a taxpayer is able to exclude from income gain from a home sale. The examples described below are only a few of many. Tax law employs facts-and-circumstances-based tests to make many other determinations including, among other examples: (1) whether an activity is profit-motivated or merely a hobby,[42] (2) whether a taxpayer is entitled to a casualty loss deduction,[43] (3) whether gain from sale of property is capital gain or ordinary income,[44] and (4) whether transactions are excessively tax-motivated in various contexts.[45]

A. Whether an Expense is a Medical Expense

An individual taxpayer can deduct medical expenses to the extent that they exceed 7.5% of the taxpayer's adjusted gross income.[46] For the 2021 tax year, the aggregate tax expenditure resulting from taxpayers claiming medical expense deductions was estimated to be $8,350,000,000.[47] Taxpayers can claim a medical expense deduction only if they itemize deductions rather than claim the standard deduction.[48] If a taxpayer claims

[41] *See* Hayashi, *supra* note 3, at 293–95, 307.

[42] *See* Treas. Reg. § 1.183-2(b); *see also* Hayashi, *supra* note 3, at 307–12.

[43] *See* Jeffrey H. Kahn, *The Misconstruction of the Deductions for Business and Personal Casualty Losses*, 21 FLA. TAX REV. 622, 643–51 (2018).

[44] *See* Emily Cauble, *Taxing Composite Transactions*, 77 SMU L. Rev. (forthcoming 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4531806.

[45] *See* Hayashi *supra* note 3, at 297 n.28.

[46] I.R.C. § 213(a).

[47] OFF. OF TAX ANALYSIS, U.S. DEP'T OF TREASURY, TAX EXPENDITURES tbl.1 (2021).

[48] *See* I.R.C. § 63(b) (omitting the deduction for medical expenses from the list of deductions from adjusted gross income that are allowed if an individual does not elect to itemize), 63(d)

the standard deduction, then the taxpayer, when computing taxable income for any given year, deducts a set dollar amount, adjusted annually for inflation.[49] For 2024, for instance, the standard deduction is $14,600 for single taxpayers and $29,200 for married taxpayers filing a joint return.[50] If, instead, the taxpayer opts to itemize deductions, the taxpayer will deduct an amount equal to certain actual expenses incurred by the taxpayer, subject to various limitations.[51] Generally, taxpayers itemize deductions only when their total allowable itemized deductions are higher than the standard deduction. Because this is more often true for taxpayers with higher incomes, taxpayers with higher incomes are more likely to claim itemized deductions.[52] For example, for the 2020 tax year, the IRS estimates that, of the 35,834,267 individual income tax returns reporting adjusted gross income under $15,000, 328,479 returns (or 0.92%) itemized deductions.[53] By contrast, of the 6,174,481 individual income tax returns reporting adjusted gross income of $250,000 or more, 3,093,796 (or 50.12%) itemized deductions.[54] Likewise, the medical expense deduction (given that it is an itemized deduction) is claimed disproportionately by taxpayers with higher incomes. For example, for the 2020 tax year, the IRS estimates that, of the 35,834,267 individual income tax returns reporting adjusted gross income under $15,000, 251,623 returns (or 0.70%) claimed a deduction for medical expenses.[55] By contrast, of the 6,174,481 individual income tax returns reporting adjusted gross income of $250,000 or more, 101,574 returns (or 1.65%) claimed a deduction for medical expenses.[56] Relatedly, based on Tax Policy Center estimates, for 2019, taxpayers in the top 20% (by income) reaped 47.9% of the benefit of the medical expense deduction, compared to taxpayers in the bottom 20% who obtained only 0.2% of the benefit.[57]

(defining itemized deductions as deductions other than those allowed in arriving at adjusted gross income and other than those listed in Section 63(b)).

[49] I.R.C. § 63(c). A larger standard deduction is available in some cases. *Id.*

[50] Rev. Proc. 2023-34, 2023-48 I.R.B. 1287.

[51] I.R.C. § 63(b), (d)–(e).

[52] *See* David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 315 (2015).

[53] Michael Parisi, *Individual Income Tax Returns, Preliminary Data, Tax Year 2020*, STAT. OF INCOME BULL., Spring 2022, at 11.

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Table T18-0044 – Tax Benefit of the Itemized Deduction for Medical Expenses*, TAX POL'Y CTR. (Apr. 12, 2018), https://www.taxpolicycenter.org/model-estimates/medical-expense-deduction-april-2018/t18-0044-tax-benefit-itemized-deduction-medical.

Determining whether something is a deductible medical expense involves a facts-and-circumstances-based inquiry.[58] Deductible medical expenses are expenses "not compensated for by insurance or otherwise for 'medical care' of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent."[59] The Internal Revenue Code specifies that "medical care" does not include "cosmetic surgery or other similar procedures."[60] However, this general rule is subject to an exception. Medical care can include cosmetic surgery or procedures that are "necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease."[61]

The Internal Revenue Code defines "medical care" to include, among other items, amounts paid "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."[62] In addition to providing other guidance, the Treasury Regulations provide, "[A]n expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care."[63]

Many difficult determinations in this arena involve the assessment of whether something constitutes "medical care" or is instead "merely beneficial" to an individual's "general health."[64] In a number of cases, courts have held that trip expenses fall into the latter category and are non-deductible.[65] For example, in *Havey v. Commissioner*, a taxpayer's doctor recommended a trip to a location with a better climate because of the

[58] For discussion of the determination of whether something qualifies as a deductible medical expense, see, for example, Katherine T. Pratt, *Inconceivable? Deducting the Costs of Fertility Treatment*, 89 CORNELL L. REV. 1121, 1139–44 (2004).

[59] I.R.C. § 213(a).

[60] *Id.* § 213(d)(9).

[61] *Id.* § 213(d)(9).

[62] *Id.* § 213(d)(1)(A).

[63] Treas. Reg. § 1.213-1(e)(1)(ii).

[64] *See* Pratt, *supra* note 58, at 1141 ("Much of the case law under § 213 involves taxpayers trying to deduct as a medical expense the cost of an item, such as a pool or a vacation, which is usually purchased for nonmedical personal reasons.").

[65] Other cases in this category include Ring v. Comm'r, 23 T.C. 950 (1955) (holding that a trip to the Shrine of Our Lady of Lourdes to seek spiritual aid and take mineral baths did not constitute medical care); Ochs v. Comm'r, 195 F.2d 692 (2d Cir. 1952) (holding that expenses incurred to send the taxpayer's and his spouse's children to boarding school did not constitute medical expenses); Rodgers v. Comm'r, 241 F.2d 552 (8th Cir. 1957) (holding that costs of trips to states with milder climates did not constitute deductible medical expenses).

taxpayer's spouse's heart condition.[66] The court was not persuaded that the trip constituted medical care because a change in climate was not the generally accepted treatment for the taxpayer's spouse's condition, the taxpayer and his spouse had taken similar trips for vacation purposes in previous years before the onset of the heart condition, and the taxpayer's spouse received no medical services during the trips.[67] The court listed several factors relevant to the inquiry of whether something constitutes medical care, including (1) the taxpayer's "motive or purpose," (2) whether the expense was "incurred at the direction or suggestion of a physician," (3) whether the "treatment bear[s] directly on the physical condition in question," (4) whether it would be reasonable to believe that the treatment would be effective, and (5) whether the treatment is undertaken "proximate in . . . time to the onset or recurrence of the disease or condition."[68]

Watkins v. Commissioner offers an example of a case with a different outcome.[69] In *Watkins*, the court allowed the taxpayers' medical expense deduction for the costs of trips taken to Florida.[70] The taxpayers' physicians had each "prescribed" the trips because natural sunlight treatments would mitigate the condition from which each was suffering.[71] The court allowed the deduction, noting that the medical conditions existed immediately before the taxpayers went to Florida, the taxpayers' physicians prescribed the trips, and the trips alleviated the taxpayers' physical conditions providing benefits that were "apart from the general benefit to health which any vacationer or visitor would receive from being out of doors in the sun."[72] A wide array of other cases and rulings also address the question of whether something is an expense of medical care or merely a non-deductible personal expense.[73]

B. Whether a Transfer is a Gift

Just as determining whether an expense is incurred for medical care often requires a facts-and-circumstances-based inquiry so too does determining whether property is received by gift. Under Internal Revenue Code Section

[66] 12 T.C. 409, 410 (1949).
[67] *Id.* at 412–13.
[68] *Id.* at 412.
[69] 13 T.C.M. (CCH) 320 (1954).
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *See* Cauble, *supra* note 16, at 538, 541–42.

102(a), a taxpayer can exclude from income the value of property received as a gift.[74] The Supreme Court has held that the transferor's intention must be "detached and disinterested generosity" for a transfer to constitute a gift.[75] Determining whether the transferor possesses the required intent necessitates an examination of all the relevant facts and circumstances. In adopting this test, the Supreme Court rejected the IRS's request for clearer tests and stated, "We are of opinion that the governing principles are necessarily general . . . and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases."[76]

To determine whether a transferor possesses the required intent, courts have examined a variety of facts and circumstances, including: (1) statements made by the transferor at or near the time of the transfer,[77] (2) the relationship between the transferor and transferee,[78] (3) the transferor's tax treatment of the transfer (whether, for instance, the transferor claimed a trade or business expense deduction),[79] (4) whether the transferor has received or has an expectation of receiving an economic benefit from the transferee, [80] and (5) whether the transferee has already been adequately compensated for any economic benefit provided to the transferor.[81]

C. Ability to Exclude from Income Gain from Sale of a Home

Facts-and-circumstances-based tests also determine whether a taxpayer can exclude from income gain from sale of a home. Under Internal Revenue Code Section 121, a single taxpayer can exclude from income up to $250,000 of gain from sale of a home, provided that various requirements are met.[82] Married taxpayers filing a joint return can exclude up to $500,000 of such gain, provided that various other requirements are met.[83]

[74] I.R.C. § 102(a).

[75] Comm'r v. Duberstein, 363 U.S. 278, 285–86 (1960).

[76] *Id.* at 284–85.

[77] *See* Runyon v. Comm'r, 49 T.C.M. (CCH) 208 (1984).

[78] *See, e.g.*, Mesinger v. Comm'r, 31 T.C.M. (CCH) 1127 (1972).

[79] *See, e.g.*, *Duberstein*, 363 U.S. at 287–88.

[80] *See, e.g.*, *id.* at 285.

[81] *See, e.g.*, *Runyon*, 49 T.C.M. (CCH) 208.

[82] I.R.C. § 121(a), (b)(1), (b)(3).

[83] *Id.* § 121(a), (b)(2).

For a single taxpayer to be eligible to exclude up to $250,000, they must have owned the home for periods of time totaling at least two years during the five-year period ending on the date of sale, they must have used the home as a principal residence for periods of time totaling at least two years during that five-year period, and they must not have excluded gain from sale of another home from income during the two-year period ending on the date of sale.[84] Special rules apply if the taxpayer used the home for some purposes other than as a principal residence.[85]

The Treasury Regulations make clear that whether property is used as a taxpayer's residence "depends upon all the facts and circumstances,"[86] and, if a taxpayer uses multiple properties as residences, whether a given property is used as the taxpayer's principal residence also "depends upon all the facts and circumstances."[87] The regulations further provide that, if a taxpayer uses two residences during a year, the residence that the taxpayer uses for the majority of the year "ordinarily" will be considered the taxpayer's principal residence.[88] According to the regulations, in addition to the taxpayer's use of each residence, other factors that are relevant to determining which residence is the principal one include "but, are not limited to—(1) The taxpayer's place of employment; (2) The principal place of abode of the taxpayer's family members; (3) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card; (4) The taxpayer's mailing address for bills and correspondence; (5) The location of the taxpayer's banks; and (6) The location of religious organizations and recreational clubs with which the taxpayer is affiliated."[89]

If a taxpayer sells a home but does not meet one or more of the timing requirements described above, they may still be able to exclude from income some or all of the resulting gain (up to a cap that is lower than the $250,000 cap that applies when a taxpayer fully meets the timing requirements).[90] In such a case, the taxpayer must have sold the home because of a change of place of employment, health or "unforeseen circumstances."[91] If not, a failure to meet the timing requirements causes the taxpayer to lose eligibility for the

[84] *Id.* § 121(a), (b)(1), (b)(3).
[85] *Id.* § 121(b)(5).
[86] Treas. Reg. § 1.121-1(b)(1) (2002).
[87] *Id.* § 1.121-1(b)(2).
[88] *Id.*
[89] *Id.*
[90] I.R.C. § 121(c).
[91] *Id.*

income exclusion entirely.[92] For example, imagine a single taxpayer sells a home that they owned and used as a principal residence for only one year within the five-year period ending on date of sale (one half of the two years required), and imagine they have not excluded gain from sale of another home within the preceding two years. If they sell the home because of change of place of employment, health or "unforeseen circumstances," they can exclude from income up to $125,000 of gain (one half of the $250,000 cap that applies if the timing requirements were fully met).[93] If the sale was not motivated by one of these causes, they could not exclude any of the gain from income because of their failure to meet the timing requirements.

If a taxpayer's facts meet the requirements of one of several safe harbors contained in the Treasury Regulations, the taxpayer's home sale is deemed to be attributable to change of place of employment, health, or unforeseen circumstances.[94] If a taxpayer does not comply with a safe harbor, all the relevant facts and circumstances must be analyzed to determine whether the sale was motivated by one of these causes.[95] For example, under a safe harbor, a sale is deemed to be motivated by change of place of employment if (1) the change of place of employment occurs during the time that the taxpayer owned the home and used it as a principal residence and (2) the new place of employment is at least fifty miles farther from the home the taxpayer sold than was the former place of employment.[96] If there was no former place of employment, the second prong of this safe harbor test is met if the new place of employment is at least fifty miles away from the home the taxpayer sold.[97] If the taxpayer fails to meet this safe harbor, all the facts and circumstances must be examined to determine whether the "primary" reason for the sale was change in place of employment.[98] The regulations provide a non-exclusive list of potentially relevant factors, including: (1) whether the home sale occurs close in time to the change in employment location and, relatedly, whether the employment change occurs while the taxpayer owned and used the home as a principal residence, (2) whether "the suitability of the property as the taxpayer's principal residence materially changes," (3) whether "the taxpayer's financial ability to maintain the property is

[92] *Id.* § 121(a), (c).
[93] *Id.* § 121(c).
[94] Treas. Reg. § 1.121-3(c)(2), (d)(2), (e)(2) (2004).
[95] *Id.* § 1.121-3(b).
[96] *Id.* § 1.121-3(c)(2).
[97] *Id.* § 1.121-3(c)(2)(ii).
[98] *Id.* § 1.121-3(c)(1).

materially impaired," (4) how often the taxpayer used the home as a residence during the time the taxpayer owned the home, and (5) whether the circumstances giving rise to the sale (in this case, the job change) were reasonably foreseeable when the taxpayer began to use the property as their principal residence.[99]

The regulations also provide two illustrative examples of sales that are motivated by change in place of employment under this facts-and-circumstances-based test.[100] One example features a taxpayer who falls just short of qualifying for the safe harbor (the new place of employment is only forty-six miles farther from the home that was sold than was the taxpayer's former place of employment; not fifty miles), and also the taxpayer is an emergency room doctor who needs to live particularly close to work so that they can arrive quickly when called into work at unscheduled hours.[101]

In addition, the regulations set forth safe harbors under which home sales will be deemed to be motivated by health or unforeseen circumstances.[102] Facts-and-circumstances-based tests govern the tax treatment if a taxpayer fails to meet the requirements of any of these safe harbors.

According to Congressional Budget Office estimates, in 2019, the ability to exclude from income gain from sale of a principal residence resulted in an aggregate tax expenditure of $35 billion.[103] Households with incomes in the top 40% benefited from 70% of this tax expenditure.[104] Higher income households obtain a disproportionate amount of the benefit, in part, because a higher percentage of higher income households use the exclusion at all (6% of households in the top 20% by income compared to 2% of households in the bottom 20% by income).[105] Higher income households also obtain a disproportionate amount of the benefit because, when they do use the exclusion, they tend to exclude larger gains.[106]

The fact that higher income households are more likely to use the exclusion is consistent with home ownership rates being greater for higher income households. For example, over the 2010–2017 time period, the home

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[99] *Id.* § 1.121-3(b).

[100] *Id.* § 1.121-3(c)(4) (examples 3 and 4). For discussion of the use of examples, see generally, Susan C. Morse & Leigh Osofsky, *Regulating by Example*, 35 YALE J. ON REG. 127 (2018).

[101] Treas. Reg. § 1.121-3(c)(4) (2004) (example 4).

[102] *Id.* § 1.121-3(d)(2), (e)(2).

[103] CONG. BUDGET OFF., THE DISTRIBUTION OF MAJOR TAX EXPENDITURES 24 (2021).

[104] *Id.*

[105] *Id.* at 25.

[106] *Id.*

ownership rate for households with incomes less than $30,000 was estimated to be 36%, compared to 84% for households with incomes greater than or equal to $150,000.[107] Furthermore, one of the facts-and-circumstances-based tests that determines applicability of the exclusion applies when a taxpayer needs to determine which of multiple residences is their principal one—which is presumably a question confronted by higher income taxpayers to a particularly disproportionate degree. Home ownership rates also vary by race.[108] For example, in 2019, home ownership rates were: 45% for Black families, 47.6% for Hispanic families, and 73.7% for White families.[109]

II. EXISTING REPORTING REQUIREMENTS

When a taxpayer claims a deduction or excludes an item from income and the correctness of that claimed tax treatment depends upon the application of a facts-and-circumstances-based test, the IRS stands no chance of determining whether the claimed tax treatment is appropriate without knowing the relevant facts and circumstances. Yet, often, the information that a taxpayer must disclose when filing a return does not provide the IRS with the necessary information (and does not prompt the taxpayer to consider the necessary information).[110]

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[107] Jeffrey M. Jones, *Older Americans Buck Trend of Decreased Homeownership*, GALLUP (Jul. 26, 2017), https://news.gallup.com/poll/214514/older-americans-buck-trend-decreased-homeownership.aspx?g_source=&g_medium=&g_campaign=tiles.

[108] *See* Dorothy Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329, 348–54 (2009); Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751, 779–80 (1996).

[109] Janet Holtzblatt & Laura Kawano, *Taxation of Capital Income is Not Race Neutral*, TAX POL'Y CTR. (Sept. 28, 2023), https://www.taxpolicycenter.org/taxvox/taxation-capital-income-not-race-neutral.

[110] For somewhat related discussion about how the level of disclosure required on tax returns affects the IRS's ability to identify tax shelters or questionable reporting positions, see, for example, Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1640 (2009), Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289, 294–97 (2002) ("In spite of . . . the fact that tax returns do include questions and mandated schedules intended to amplify the line-item entries on the returns, the current level of return disclosure . . . does not enable revenue agents to identify certain tax shelters."), Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 591 (2006) ("Because auditors decide where to focus their efforts based on items rather than transactions, the level of tax return specificity is critically important to the success of the red flags strategy . . . The more detailed are the items required to be shown on a return (within limits), the better the strategy works."), and David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 227 (2002).

Consider, for example, a taxpayer who claims a deduction for medical expenses. To do so, the taxpayer must file "Schedule A" with their tax return.[111] On one line of Schedule A, the taxpayer simply lists a total dollar amount for all unreimbursed medical expenses that the taxpayer claims qualify for the deduction.[112] The taxpayer is not required to provide any further information with their return. Moreover, if the taxpayer's position were later successfully challenged, the taxpayer has a defense against certain penalties as long as they had a "reasonable basis" for the position,[113] they have kept adequate books and records so they can substantiate the position, and "the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return."[114] The IRS regularly issues a revenue procedure indicating when merely listing an item on a tax return is adequate disclosure for purposes of this penalty defense.[115] Under that revenue procedure, all a taxpayer must do to meet the adequate disclosure requirement with respect to medical expenses is complete Schedule A (which, again, only requires listing a total dollar amount of unreimbursed medical expenses).[116]

If a taxpayer takes the position that gain from sale of a home can be excluded from income under Internal Revenue Code Section 121, what the taxpayer must report on their return depends on whether the transaction was subject to "information reporting" and on whether the taxpayer takes the position that all gain is excludable. In some cases, home sales are subject to information reporting, meaning someone other than the taxpayer (typically the person responsible for closing the transaction) must file a Form 1099-S.[117] When this occurs, the taxpayer (and the IRS) will receive a Form 1099-S that contains information about the transaction (the closing date, proceeds of the sale, the seller's name, the seller's tax ID number, and the seller's

[111] I.R.S., SCHEDULE A (FORM 1040) (2023).

[112] *Id.*

[113] The reasonable basis standard is described in Treas. Reg. § 1.6662-3(b)(3).

[114] I.R.C. § 6662(d)(2)(B)(ii) (defense to substantial understatement penalty); Treas. Reg. § 1.6662-4(e)(2)(iii) (describing the requirement to maintain adequate books and records). The defense is not available for any item attributable to a tax shelter. I.R.C. § 6662(d)(2)(C). In some cases, a taxpayer may also have a defense against penalties if the taxpayer establishes "reasonable cause" and "good faith." *See I.R.C.* § 6664(c)(1); Treas. Reg. § 1.6664-4(a), (c).

[115] Rev. Proc. 2023-40, 2023-51 I.R.B. 1553.

[116] *Id.* This suffices for purposes of a defense against the penalty for substantial understatement of tax. *Id.*

[117] I.R.C. § 6045.

address).[118] Not all home sales are subject to information reporting. If the sale price is $250,000 or less and the seller has provided, to the person who would otherwise be required to file the Form 1099-S, a written assurance that the seller is eligible to exclude all gain from income under Code Section 121, then information reporting is not required (but is, still, allowed).[119] If the sellers also provide a certification that they are married, a similar exception applies up to $500,000.[120]

If a taxpayer who sells a home receives a Form 1099-S, then the taxpayer must include some details about the sale on forms and schedules filed with their tax return even if they ultimately exclude all gain from income.[121] In addition, even if information reporting is not required, the taxpayer must include some details about the home sale on forms and schedules filed with their tax return if they are required to include some of the gain in income.[122] However, in either case, the details that the taxpayer reports with their return are merely the dates the property was acquired and sold, the amount of the gain prior to taking into account what can be excluded, and the amount that can be excluded from income.[123] No other details—including information about the use of the property or the reasons for its sale—are reported.[124] If information reporting is not required so that the taxpayer does not receive a Form 1099-S and the taxpayer takes the position that all gain from sale is excluded from income, then the taxpayer is not required to include any information about the transaction on or with their tax return.

If the taxpayer does include the information described above about a home sale on the schedules that accompany their tax return, that information alone does not seem to constitute "adequate disclosure" for purposes of the penalty defense rules described above.[125] This appears to be the case because it is not contained in the revenue procedure that describes when merely listing an item on a tax return is adequate disclosure for purposes of a defense

[118] I.R.S., FORM 1099-S (Jan. 2022).

[119] I.R.C. § 6045(e)(5); I.R.S., INSTRUCTIONS FOR FORM 1099-S, at 1 (2021); *see also* Lily Kahng, *Path Dependence in Tax Subsidies for Home Sales*, 65 ALA. L. REV. 187, 224–27 (2013).

[120] I.R.C. § 6045(e)(5)(A)(iii).

[121] *See* I.R.S., INSTRUCTIONS FOR FORM 8949, at 6 (2024).

[122] *Id.*

[123] *Id.* at 5–6; *see also* I.R.S., 2022 INSTRUCTIONS FOR SCHEDULE D, at D-2 (2022).

[124] Under prior law—at a time when home sales were subject to non-recognition if the taxpayer purchased a replacement home—taxpayers were required to submit a more detailed form, but even that form included minimal questions about the use of the property. *See* I.R.S., FORM 2119 (1991).

[125] *See infra* note 126 and accompanying text.

against the substantial understatement penalty.[126] Thus, to have a defense based on having disclosed a position for which the taxpayer has a "reasonable basis", the taxpayer would be required to file an additional form with more details about the tax position the taxpayer claimed.[127] On this form, the taxpayer must "include a description of the relevant facts affecting the tax treatment of the item."[128] To supply the required information, the taxpayer must "include information that can reasonably be expected to apprise the IRS of the identity of the item, its amount, and the nature of the controversy or potential controversy."[129]

However, even without disclosure, a defense to certain penalties is available as long as a taxpayer meets the higher (than "reasonable basis") bar of taking a position based upon "substantial authority".[130] As the Treasury Regulations describe it, a taxpayer has a reasonable basis for taking a tax position if the position is "reasonably based" on one or more of certain sources of authority (including statutory provisions, regulations, court cases, revenue rulings, revenue procedures, legislative history, and letter rulings), "taking into account the relevance and persuasiveness of the authorities, and subsequent developments."[131] By contrast, the Treasury Regulations explain that there is "substantial authority" for a position when "the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment."[132] Both the "reasonable basis" standard and the "substantial authority" standard may, in fact, be less exacting than the preceding descriptions, on their own, might suggest. Consider the fact that the "substantial authority" standard is less stringent than the "more likely than not" standard, which is met when there is a greater than 50% chance that the taxpayer's position would be upheld if challenged.[133] The "reasonable basis" standard is, in turn, less rigorous than

[126] Rev. Proc. 2023-40, 2023-51 I.R.B. 1553.

[127] Assuming the taxpayer's position is not contrary to a regulation, they would file Form 8275. I.R.S., INSTRUCTIONS FOR FORM 8275, at 1 (2020).

[128] *Id*. at 3.

[129] *Id.*

[130] I.R.C. § 6662(d)(2)(B)(i) (defense to substantial understatement penalty). The defense is not available for any item attributable to a tax shelter. *Id.* § 6662(d)(2)(C). In some cases, a taxpayer may also have a defense against penalties if the taxpayer establishes "reasonable cause" and "good faith." *See id.* § 6664(c)(1); Treas. Reg. § 1.6664-4(a), (c) (2003).

[131] Treas. Reg. § 1.6662-3(b)(3) (2003).

[132] *Id.* § 1.6662-4(d)(3).

[133] *Id.* § 1.6662-4(d)(2).

the "substantial authority" standard.[134] The "reasonable basis" standard has been described as a tax position that has at least a 20% chance of prevailing on the merits (or sometimes 10%), while "substantial authority" has been described as translating into at least a 40% chance of prevailing on the merits (or sometimes 35%).[135]

If a taxpayer excludes from income a transfer because the taxpayer takes the position that it was received as a gift, the taxpayer often includes no information about the transaction at all on their income tax return. To avail themselves of a penalty defense based on having disclosed a position for which they have a "reasonable basis", the taxpayer would be required to file an additional form with more details about the tax position the taxpayer claimed.[136] However, again, generally no disclosure is necessary to preserve certain penalty defenses if the tax position is based upon "substantial authority."

III. EXAMPLES OF EXISTING GUIDANCE (OR LACK OF GUIDANCE) ON FACTS-AND-CIRCUMSTANCES-BASED TESTS

Facts-and-circumstances-based tests present challenges at the enforcement stage. The IRS needs all relevant facts to discern whether a taxpayer's claimed treatment is correct and will not have all the relevant facts without an audit, particularly given that taxpayers are required to provide little or no detail with their tax returns as discussed above in Part II. Facts-and-circumstances-based tests also create difficulties when the IRS attempts to develop useful administrative guidance. Perhaps, in part, because of the difficulties inherent in developing useful guidance on such tests,[137] sometimes the IRS has refrained from providing guidance on such tests altogether. Parts III.A and III.B below will discuss the lack of guidance on such tests. Sometimes the IRS does attempt to clarify a facts-and-circumstances-based test by providing examples of how the test will apply to

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[134] *Id.*

[135] *See* Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 116–17 (2009); Lawsky, *supra* note 2, at 1047–48.

[136] Assuming the taxpayer's position is not contrary to a regulation, they would file Form 8275. I.R.S., INSTRUCTIONS FOR FORM 8275, at 1 (2020).

[137] For discussion of other possible explanations for why the IRS has not issued letter rulings on such topics, see Cauble, *supra* note 16, at 554–68; *see also* Logue, *supra* note 1, at 409–10 ("One conceivable answer is that the Service . . . does not have . . . a large enough or sufficiently capable staff to do the factual and legal analysis necessary to issue rulings on such fact-intensive questions without running a big risk of adverse selection and moral hazard.").

specific facts, and, in the process, describes concrete examples that may mislead taxpayers. Examples of this phenomenon are discussed in Part III.C below. Not all instances of potentially misleading guidance involve the application of facts-and-circumstances-based tests. However, many examples do, and the task of offering guidance that is *not* potentially misleading is arguably particularly difficult in the case of a facts-and-circumstances-based test. If the IRS provides examples of the application of such tests, it may create the mistaken impression that universal rules govern tax outcomes. Furthermore, as a recent study by Professor Tahk shows, some facts-and-circumstances-based tests generate a large volume of tax litigation.[138] Thus, some are associated with large bodies of case law that can be difficult to coherently summarize.

A. Lack of Letter Rulings

If a taxpayer plans to carry out a transaction or has engaged in a transaction and its consequences are governed by a facts-and-circumstances-based test, the taxpayer and the taxpayer's advisors may be unable to reach a firm conclusion about the transaction's tax outcome. When a taxpayer and their advisors are unable to find an answer to the question of tax treatment even after searching for one in the Internal Revenue Code, the Treasury Regulations, existing case law, and guidance issued by the IRS taking various forms, including Revenue Rulings, in some instances, the taxpayer might request a letter ruling from the IRS.[139]

To obtain a letter ruling, the taxpayer must submit a request that describes the facts of the transaction in detail, discusses the applicable legal authority, and explains the taxpayer's view of how the transaction ought to be treated based upon that authority.[140] The taxpayer must also pay a user fee when requesting a ruling—the amount of the fee depends upon the type of request, the income of the taxpayer requesting the ruling and other factors.[141]

If the IRS agrees that the transaction's tax treatment is what the taxpayer described in the request, the IRS will issue a letter ruling to the taxpayer.[142] Provided that the taxpayer accurately and completely disclosed the relevant

[138] Susannah Camic Tahk, *The Tax Separation of Powers*, (manuscript at 7–20), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4739010.

[139] *See* Rev. Proc. 2024-1, 2024-1 I.R.B. 1 § 2.01 (describing letter rulings).

[140] *Id.* § 7 (setting forth general instructions for requesting letter rulings).

[141] *Id.* app. A (setting forth the user fee schedule).

[142] *Id.* § 5 (setting forth circumstances under which an Associate office will issue a letter ruling).

facts in the request and provided that the taxpayer carries out the transaction in the manner described in the request, the taxpayer can generally rely upon the ruling.[143] Technically, no other taxpayer can rely upon the ruling as a guarantee that the other taxpayer's treatment will be what the ruling describes.[144] That said, letter rulings are published in anonymized form and other taxpayers often look to them as a guide to the IRS's likely position on how similar transactions ought to be treated.[145] Also, even letter rulings issued to other taxpayers represent a type of authority than can be taken into account for purposes of determining whether a taxpayer meets the "reasonable basis" or "substantial authority" standards required for defenses against certain penalties.[146]

The IRS will not issue letter rulings on certain topics.[147] Each year, the IRS publishes a revenue procedure that describes topics on which it will not rule.[148] The revenue procedure describes some topics in very general terms. For instance, the revenue procedure states that the IRS will not answer "questions that the Service determines, in its discretion, should not be answered in the general interests of sound tax administration, including due to resource constraints".[149] The revenue procedure also lists numerous specific topics on which the IRS will not rule or "ordinarily" will not rule.[150]

Many facts-and-circumstances-based determinations occupy the no ruling list.[151] Among many other topics, examples include: (1) whether a transfer is a gift within the meaning of Internal Revenue Code Section 102(a), (2) whether property qualifies as a taxpayer's principal residence, (3) whether a taxpayer is engaged in a trade or business, and (4) "whether a capital expenditure for an item that is ordinarily used for personal, living, or

[143] Treas. Reg. § 601.201(l)(2), (5) (2019) (providing that, when determining a taxpayer's liability, the IRS will verify the accuracy of facts on which a letter ruling was based and verify that the transaction was carried out as described in a ruling request and describing limited circumstances in which the revocation or modification of a ruling will be applied retroactively).

[144] *See id.* § 601.201(l)(1) ("A taxpayer may not rely on an advance ruling issued to another taxpayer.").

[145] *See* Rachelle Y. Holmes, *Forcing Cooperation: A Strategy for Improving Tax Compliance*, 79 U. CIN. L. REV. 1415, 1427 (2011) (describing letter rulings as providing "helpful guidance" to other taxpayers).

[146] Treas. Reg. §§ 1.6662-4(d)(3)(iii), 1.6662-3(b)(3) (2003).

[147] For further discussion, see Cauble, *supra* note 16; Goodman, *supra* note 16.

[148] *See* Rev. Proc. 2024-3, 2024-1 I.R.B. 143.

[149] *Id.* § 3.02(10).

[150] *Id.* §§ 3.01, 4.01.

[151] For further discussion, see Cauble, *supra* note 16; Goodman, *supra* note 16.

family purposes, such as a swimming pool, has as its primary purpose the medical care of the taxpayer or the taxpayer's spouse or dependent."[152]

In addition to including various facts-and-circumstances-based tests on its official no ruling list, the IRS has sometimes declined to rule in response to a request and explained its refusal by pointing to the facts-and-circumstances-based nature of the question involved.[153] In among other instances, the IRS has offered the facts-and-circumstances-based nature of a determination as a justification for not ruling with respect to whether earnings accumulated by a business exceed the reasonable needs of the business for purposes of the accumulated earnings tax,[154] whether stock appreciation rights have a readily ascertainable fair market value on the date of the grant for purposes of Section 83,[155] whether deferred compensation is subject to a substantial risk of forfeiture for purposes of Section 83,[156] whether expenses are deductible business expenses or must be capitalized and amortized,[157] whether a note is readily tradable for purposes of Section 453,[158] whether a corporation's separate corporate existence should be respected or disregarded,[159] whether the expense of electricity to operate an air conditioner constitutes a deductible medical expense,[160] the year in which a loss is sustained for purposes of Section 165,[161] whether a loss constitutes a theft loss,[162] whether a loss constitutes a casualty loss,[163] and whether a stock redemption is not essentially equivalent to a dividend within the meaning of Internal Revenue Code Section 302(b)(1).[164] Moreover, not all instances when the IRS has refused to rule can be gleaned from publicly available letter

[152] *See* Rev. Proc. 2024-3, 2024-1 I.R.B. 143 § 3.01(20), (32), (35), (43).

[153] *See infra* notes 154–164 and accompanying text.

[154] I.R.S. Priv. Ltr. Rul. 87-07-019 (Nov. 13, 1986).

[155] I.R.S. Priv. Ltr. Rul. 80-46-089 (Aug. 21, 1980).

[156] I.R.S. Priv. Ltr. Rul. 80-49-091 (Sept. 12, 1980).

[157] I.R.S. Priv. Ltr. Rul. 77-43-052 (July 28, 1977).

[158] I.R.S. Priv. Ltr. Rul. 81-19-012 (Feb. 10, 1981).

[159] I.R.S. Priv. Ltr. Rul. 54-07-29-5620A (July 29, 1954).

[160] I.R.S. Priv. Ltr. Rul. 83-17-035 (Jan. 24, 1983).

[161] I.R.S. Priv. Ltr. Rul. 85-01-035 (Oct. 5, 1984).

[162] I.R.S. Priv. Ltr. Rul. 81-43-107 (July 31, 1981).

[163] I.R.S. Priv. Ltr. Rul. 78-28-048 (Apr. 13, 1978).

[164] I.R.S. Priv. Ltr. Rul. 78-26-014 (Mar. 28, 1978).

rulings because often taxpayers may withdraw a request (or not make a request) when the IRS indicates that it will not rule.[165]

It is not universally true that the IRS refuses to issue letter rulings on all facts-and-circumstances-based tests. One such topic on which the IRS has issued letter rulings is the question of whether a home sale was motivated by change of place of employment, health, or unforeseen circumstances.[166] On that topic, the IRS has issued nineteen letter rulings, all of which concluded that the taxpayer's home sale was motivated by change of place of employment, health, or unforeseen circumstances.[167] Eight of these letter rulings involve taxpayers who moved because of an increase in family size as a result of the birth of a child, adoption of a child, or stepchildren starting to live in the taxpayer's home.[168]

Even when the IRS is willing to issue letter rulings on a facts-and-circumstances-based topic, however, seeking a letter ruling is not always a feasible option. As of February 2024, the fee for obtaining a letter ruling on many topics affecting individual taxpayers is $3,000 (if the person's gross income is less than $250,000) or $8,500 (if the person's gross income is less than $1 million but greater than or equal to $250,000).[169] In addition, typically, a taxpayer must incur the cost of paying an advisor to prepare the detailed ruling request.[170]

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[165] For further discussion, see Joshua D. Blank, *The Timing of Tax Transparency*, 90 S. CAL. L. REV. 449, 503–07 (2017).

[166] *See infra* note 167.

[167] I.R.S. Priv. Ltr. Rul. 2016-28-002 (Apr. 11, 2016); I.R.S. Priv. Ltr. Rul. 2007-45-011 (Aug. 13, 2007); I.R.S. Priv. Ltr. Rul. 2008-20-016 (Feb. 7, 2008); I.R.S. Priv. Ltr. Rul. 2006-26-024 (Mar. 23, 2006); I.R.S. Priv. Ltr. Rul. 2006-04-013 (Oct. 18, 2005); I.R.S. Priv. Ltr. Rul. 2004-03-049 (Sept. 26, 2003); I.R.S. Priv. Ltr. Rul. 2006-13-009 (Dec. 19, 2005); I.R.S. Priv. Ltr. Rul. 2007-02-032 (Sept. 29, 2006); I.R.S. Priv. Ltr. Rul. 2007-25-018 (Mar. 15, 2007); I.R.S. Priv. Ltr. Rul. 2005-04-012 (Oct. 14, 2004); I.R.S. Priv. Ltr. Rul. 2008-26-024 (Mar. 19, 2008); I.R.S. Priv. Ltr. Rul. 2006-15-011 (Dec. 8, 2005); I.R.S. Priv. Ltr. Rul. 2006-01-009 (Sept. 30, 2005); I.R.S. Priv. Ltr. Rul. 2006-01-022 (Sept. 30, 2005); I.R.S. Priv. Ltr. Rul. 2006-01-023 (Sept. 30, 2005); I.R.S. Priv. Ltr. Rul. 2006-52-041 (Sept. 30, 2005); I.R.S. Priv. Ltr. Rul. 2006-30-004 (Apr. 28, 2006); I.R.S. Priv. Ltr. Rul. 2009-47-024 (Aug. 13, 2009); I.R.S. Priv. Ltr. Rul. 2008-41-022 (July 7, 2006).

[168] I.R.S. Priv. Ltr. Rul. 2016-28-002 (Apr. 11, 2016); I.R.S. Priv. Ltr. Rul. 2007-45-011 (Aug. 13, 2007); I.R.S. Priv. Ltr. Rul. 2006-13-009 (Dec. 19, 2005); I.R.S. Priv. Ltr. Rul. 2007-25-018 (Mar. 15, 2007); I.R.S. Priv. Ltr. Rul. 2008-26-024 (Mar. 19, 2008); I.R.S. Priv. Ltr. Rul. 2006-01-022 (Sept. 30, 2005); I.R.S. Priv. Ltr. Rul. 2006-52-041 (Sept. 30, 2005); I.R.S. Priv. Ltr. Rul. 2008-41-022 (July 7, 2006).

[169] *See* Rev. Proc. 2024-1, 2024-1 I.R.B. 1 app. A.

[170] *See, e.g.*, Givati, *supra* note 2, at 152 ("The cost of professional advice to obtain a letter ruling is usually thought to be considerable.").

B. Superficial (or Non-Existent) Informal IRS Guidance

Taxpayers who are not represented by an advisor are unlikely to seek an answer to their tax questions in formal sources of guidance like the Internal Revenue Code, Treasury Regulations, case law, or Revenue Rulings, and they are unlikely to seek their own letter rulings.[171] Moreover, even if taxpayers do look to formal sources of tax law or do wish to obtain letter rulings, in many cases, they will not obtain an answer to their questions about how they fare under facts-and-circumstances-based tests. Taxpayers might turn to informal sources of IRS guidance, like IRS publications and instructions accompanying tax forms. However, just as the IRS's approach to issuing letter rulings on facts-and-circumstances-based tests sometimes involves withholding guidance, so too, the IRS often provides limited guidance on facts-and-circumstances-based tests in informal guidance.[172]

For example, a number of IRS publications inform taxpayers that, generally, property received as a gift is not included in income.[173] However, these publications make no attempt to explain how to determine whether property was received as a gift.

In some other cases, IRS publications provide a non-exclusive list of factors that are considered when applying a facts-and-circumstances-based test.[174] However, the publications provide no further guidance on how the factors are applied or weighed. For example, a facts-and-circumstances-based test applies to determine whether an activity is profit-motivated or merely a hobby.[175] When describing this facts-and-circumstances-based test, an IRS publication states: "In determining whether you are carrying on an activity for profit, several factors are taken into account. No one factor alone

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[171] Blank & Osofsky, *supra* note 13, at 243–44; Blank & Osofsky, *Automated Agencies*, *supra* note 26, at 2172; Blank & Osofsky, *Inequity*, *supra* note 26, at 1129–30; Cauble, *supra* note 26, at 463–65; Andrea Monroe, *Hidden in Plain Sight: IRS Publications and a New Path to Tax Reform*, 21 Fla. Tax Rev. 81, 90–91 (2017).

[172] *See infra* notes 173–179 and accompanying text.

[173] *See* I.R.S., PUBLICATION 17: YOUR FEDERAL INCOME TAX 76 (2023), https://www.irs.gov/pub/irs-pdf/p17.pdf ("In most cases, property you receive as a gift, bequest, or inheritance isn't included in your income."); I.R.S., PUBLICATION 525: TAXABLE AND NONTAXABLE INCOME 34 (2023), https://www.irs.gov/pub/irs-pdf/p525.pdf (includes the same statement).

[174] *See* I.R.S., PUBLICATION 535: BUSINESS EXPENSES 7 (2022), https://www.irs.gov/pub/irs-pdf/p535.pdf.

[175] *See id.*

is decisive."[176] The publication goes on to provide a non-exclusive bullet-point list of factors.[177]

As another example, when addressing whether a taxpayer's reason for selling a home is change of place of employment, health or unforeseen circumstances, an IRS publication provides information about the potential safe harbors that might apply.[178] The publication also discusses whether sales that fall outside of the safe harbors can qualify.[179] Regarding that facts-and-circumstances-based determination, the publication states:

> Even if your situation doesn't match any of the standard requirements described above [the safe harbors], you still may qualify for an exception. You may qualify if you can demonstrate the primary reason for sale, based on facts and circumstances, is work related, health related, or unforeseeable. Important factors are:
>
> - The situation causing the sale arose during the time you owned and used your property as your residence,
> - You sold your home not long after the situation arose,
> - You couldn't have reasonably anticipated the situation when you bought the home.
> - You began to experience significant financial difficulty maintaining the home.
> - The home became significantly less suitable as a main home for you and your family for a specific reason . . .[180]

The publication provides no examples of how these factors might be applied to concrete facts. It also gives no guidance on how taxpayers should weigh the factors.

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[176] *See id.*

[177] *Id.* Professors Blank and Osofsky also note some ways in which the publication's description of the factors differs from how the factors are described in Treasury Regulations. *See* Blank & Osofsky, *supra* note 13, at 226–28.

[178] *See* I.R.S., PUBLICATION 523: SELLING YOUR HOME 6 (2023), https://www.irs.gov/pub/irs-pdf/p523.pdf.

[179] *See id.* at 7.

[180] *Id.* Professors Blank and Osofsky also note some ways in which the publication's description of the factors differs from how the factors are described in Treasury Regulations. *See* Blank & Osofsky, *supra* note 13, at 217–19.

C. Potentially Misleading Informal IRS Guidance

Sometimes the IRS attempts to provide more concrete informal guidance on facts-and-circumstances-based tests, and, in the process, offers taxpayers potentially misleading examples. To illustrate, consider the following statement from the IRS publication on medical and dental expenses:

> You can include in medical expenses amounts you pay for transportation to another city if the trip is primarily for, and essential to, receiving medical services . . . . You can't include in medical expenses a trip or vacation taken merely for a change in environment, improvement of morale, or general improvement of health, even if the trip is made on the advice of a doctor.[181]

While this generalization is useful and true when applied to many taxpayers, it is susceptible to misinterpretation when applied to other taxpayers.

Consider the example of a taxpayer who suffers from breathing difficulties after having a stroke. The taxpayer lives in a city that is temporarily affected by hazardous air quality caused by wildfire smoke. The taxpayer's doctor strongly recommends traveling and staying in another location while the taxpayer's home city is affected by hazardous air quality.

If this taxpayer seeks no medical services in the other location, they may very well interpret the IRS publication's statements to mean that they cannot include the cost of the trip in medical expenses. In fact, however, while the correct tax outcome is not entirely clear, existing case law suggests that the cost of the trip likely does qualify under the facts described.[182]

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[181] *See* I.R.S., PUBLICATION 502: MEDICAL AND DENTAL EXPENSES 14 (2023), https://www.irs.gov/pub/irs-pdf/p502.pdf.

[182] *See supra* notes 69–72 and accompanying text. *See also* THOMPSON REUTERS TAX AND ACCOUNTING, FEDERAL TAX COORDINATOR ¶ K-2209 (2d ed. 2024) ("IRS and the courts generally allow medical expense deductions for the *transportation costs* of such trips if (1) the trip is made in good faith for medical rather than pleasure or other personal considerations; (2) the person making the trip has a specific ailment or condition; and (3) the change in locality is recognized medically as an aid in curing or alleviating that ailment or condition. . . . However, the mere expectation that a change in environment and living conditions prescribed by a physician may mitigate an individual's illness through improvement of his general health isn't sufficient ground for deduction.").

In this example, the IRS publication may prompt a taxpayer to form an unduly unfavorable impression about tax law. As a result, the publication may cause the taxpayer to pay more tax than they owe.[183]

Various sources of informal IRS guidance contain other, similar examples. On the topic of casualty losses (which is another facts-and-circumstances-based tax topic),[184] tax form instructions list various losses that a taxpayer *cannot* deduct.[185] That list includes, "money or property misplaced or lost."[186] While there are certainly cases holding that taxpayers are not allowed casualty loss deductions for property that was simply misplaced,[187] some taxpayers may read "misplaced or lost" to disallow deductions in some cases in which courts have, in fact, allowed a deduction.[188]

As another example, the IRS publication regarding medical expenses states: "You can't include in medical expenses amounts paid to whiten

[183] Most taxpayers who claim a medical expense deduction earn high amounts of income. *See supra* notes 55–57 and accompanying text. As a result, many taxpayers claiming the deduction may be able to seek expert advice rather than act upon their own interpretations of IRS guidance. However, while most taxpayers who claim the deduction earn high amounts of income, this is not universally true. *See supra* notes 55–57 and accompanying text. Furthermore, even a taxpayer who is not eligible for a medical expense deduction because they claim the standard deduction might want to determine whether an expense qualifies as medical care for purposes of using a health FSA, for example. If they consult IRS Publication 969 for guidance, that publication refers them to Publication 502 for a discussion of qualified medical expenses. I.R.S., PUBLICATION 969: HEALTH SAVINGS ACCOUNTS AND OTHER TAX-FAVORED HEALTH PLANS 14 (2023), https://www.irs.gov/pub/irs-pdf/p969.pdf (referring to Publication 502).

[184] *See, e.g.*, Kahn, *supra* note 43, at 643–51.

[185] *See* I.R.S., INSTRUCTIONS FOR FORM 4684, at 2 (2023), https://www.irs.gov/pub/irs-pdf/i4684.pdf.

[186] *Id.*

[187] *See, e.g.*, Keenan v. Bowers, 91 F. Supp. 771 (E.D.S.C. 1950) (disallowing a casualty loss deduction when unbeknownst to her husband, a wife had wrapped her rings in a piece of tissue that her husband later flushed down a toilet).

[188] As just one example, consider *White v. Comm'r*, a case in which a husband accidentally slammed a car door on his wife's hand which broke her diamond ring, causing the diamond to fall out on a gravel driveway, and the couple was unable to find the missing diamond. 48 T.C. 430, 431–32 (1967). On the one hand, it is true that the tax form instructions are not inconsistent with this case given that the diamond was not simply misplaced or lost in that the loss was preceded by damage to the ring, and, indeed, the court noted that, if the wife had merely dropped her ring on the driveway, the result may have been different. *Id.* at 433. On the other hand, some taxpayers might think of the facts of the case as involving a situation where property was misplaced or lost.

teeth."[189] For many taxpayers, teeth whitening likely does not constitute medical care because it is a cosmetic procedure, and, generally, cosmetic procedures do not constitute medical care.[190] However, as Professors Blank and Osofsky observe, for some taxpayers, teeth whitening expenses might qualify.[191] A cosmetic procedure is considered "medical care" if it is "necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease."[192] As Professors Blank and Osofsky observe, a taxpayer's teeth whitening expenses may qualify for this exception if, for instance, the taxpayer receives teeth whitening services to correct discoloration caused by chemotherapy received as a cancer treatment.[193]

If such a taxpayer makes use of the IRS publication, they may be spared from being misled by the statement about teeth whitening. That statement is followed immediately by a note referring users to the publication's earlier discussion of cosmetic surgery and a hyperlink that takes the user to that discussion.[194] That earlier discussion includes the following: "You can include in medical expenses the amount you pay for cosmetic surgery if it is necessary to improve a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease."[195] If the taxpayer who obtains teeth whitening to correct discoloration caused by chemotherapy makes use of the IRS publication and follows the recommendation to see the earlier discussion of cosmetic surgery, they may come away with the impression that the teeth whitening services qualify as medical care. However, Professors Blank and

[189] *See* I.R.S., PUBLICATION 502: MEDICAL AND DENTAL EXPENSES 16, https://www.irs.gov/pub/irs-pdf/p502.pdf.

[190] *See* I.R.C. § 213(d)(9)(A).

[191] Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 214–15.

[192] I.R.C. § 213(d)(9)(A).

[193] Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 214–15. Furthermore, the IRS has issued a Revenue Ruling concluding that teeth whitening services undertaken to correct discoloration due to age do not qualify that notes that the discoloration was not caused by a "disfiguring disease or treatment". Rev. Rul. 2003-57, 2003-22 I.R.B. 959. This statement suggests that teeth whitening services that do correct discoloration caused by a "disfiguring treatment" might qualify, as Professors Blank and Osofsky note. Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15 at 214–15. However, it is not certain that the IRS would agree with this analysis given that the Revenue Ruling also notes that the discoloration is not a "deformity". Rev. Rul. 2003-57, 2003-22 I.R.B. 959.

[194] *See supra* note 189, at 15–16.

[195] *Id.* at 15.

Osofsky offer the teeth whitening example as an instance of potentially misleading informal IRS guidance delivered via a channel that is different from the IRS publication.[196] In the case of that different channel, the statement about teeth whitening is separated from and does not refer to the more complete discussion of cosmetic surgery.[197]

In particular, the IRS makes a tool available on its website called the "Interactive Tax Assistant."[198] On the landing page, users can find the following description of the Interactive Tax Assistant: "The Interactive Tax Assistant (ITA) is a tool that provides answers to several tax law questions specific to your individual circumstances. Based on your input, it can determine if you have to file a tax return, your filing status, if you can claim a dependent, if the type of income you have is taxable, if you're eligible to claim a credit, or if you can deduct expenses."[199]

From there, the user might click on: "Can I Deduct My Medical and Dental Expenses?". They will next be prompted to select the relevant tax year from a dropdown menu. Assume they select 2022. Next, they respond "yes" to the question "were the expenses incurred or paid in 2022?" They respond "no" to the question "were the expenses paid or incurred for someone who is deceased as of the last day of 2022?" They respond "unsure" to the question "are you itemizing deductions on Schedule A?" They respond "no" to the question "do you know the amount of adjusted gross income reported on this return?" From a dropdown menu asking them to supply their marital status, they select "single, unmarried, or legally separated." When asked for their filing status for 2022, they select "single" from a dropdown menu. Now, they are presented with a screen asking them to select the type of expense. They can click on a link that brings them to an alphabetical list displaying all the options and see that "Teeth Whitening Expenses" is one option. At that point, they can pick "T" from a drop-down menu asking for the starting letter of their expense. Then, from a second dropdown menu, they can select "Teeth Whitening Expenses."

The Interactive Tax Assistant will next display a screen that simply says: "The Teeth Whitening Expenses are not a deductible expense."[200] It makes

[196] Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 214–15.

[197] *See id.* at 220.

[198] I.R.S., *Interactive Tax Assistant (ITA)*, https://www.irs.gov/help.ita (last visited Mar. 19, 2024).

[199] *Id.*

[200] *See id.*

no mention of any possible exception and does not refer the user to a more complete discussion of cosmetic procedures.

The examples above all entail instances of potentially misleading IRS guidance that is unduly *unfavorable*—it may steer taxpayers towards reporting and paying more tax liability than they owe. Sometimes potentially misleading IRS guidance is, instead, unduly *favorable*. As one example, Professors Blank and Osofsky point to the Interactive Tax Assistant's answer to the question of whether the cost of artificial teeth qualifies for a medical expense deduction.[201] The Interactive Tax Assistant indicates that the cost of artificial teeth is a qualified deductible expense.[202] As Professors Blank and Osofsky note, this is not inevitably true. They provide an example of a taxpayer who obtains artificial teeth for purely cosmetic reasons and under circumstances where the procedure would not qualify as medical care.[203] In particular, they provide an example of a taxpayer who has his teeth replaced with artificial teeth merely to improve his appearance. [204]

Providing potentially misleading guidance produces undesirable consequences. Many taxpayers do, in fact, make use of informal IRS guidance delivered through various channels.[205] For example, in response to a 2017 IRS survey, slightly under 60% of taxpayers with incomes less than $20,000 reported being very likely to use the IRS helpline, compared to slightly over 40% for taxpayers with incomes above $50,000.[206] In response to that same survey, approximately 50% of taxpayers with incomes less than $20,000 indicated that they would be very likely to seek assistance from an IRS office location near their home, compared to approximately 30% for taxpayers with incomes above $50,000.[207] The percentage of taxpayers who reported being very likely to use the IRS's website generally increased with income. In particular, slightly over 60% of taxpayers with incomes over

[201] Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 210–11.

[202] *Id.*

[203] *Id.*

[204] *Id.*

[205] *See also* Blank & Osofsky, *supra* note 13, at 228–33; Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 204 ("The IRS reported that in 2015, ITA responded to 660,430 requests for answers to tax law questions . . . .").

[206] I.R.S., COMPREHENSIVE TAXPAYER ATTITUDE SURVEY (CTAS) 35 (2017), https://www.irs.gov/pub/irs-soi/17ctas_report.pdf. For discussion of an earlier survey, see Cauble, *supra* note 26, at 464–65.

[207] I.R.S., COMPREHENSIVE TAXPAYER ATTITUDE SURVEY (CTAS) 35 (2017), https://www.irs.gov/pub/irs-soi/17ctas_report.pdf.

$50,000 reported being very likely to use the IRS website, compared to slightly over 40% in the case of taxpayers with incomes under $20,000.[208]

Furthermore, as others have noted, even taxpayers who do not, directly, make use of informal tax guidance often use tax return assistance that, in turn, makes use of informal guidance.[209] For example, TurboTax allows its users to ask questions of tax professionals who often simply restate information contained in IRS publications, and TurboTax incorporates IRS publications into the information that it shares with users in other ways.[210] Furthermore, taxpayers with incomes below specified thresholds are eligible for free tax filing assistance through Volunteer Income Tax Assistance (VITA) programs, and, as Professor Monroe has noted, VITA volunteers may be trained based on IRS publications.[211]

When misleading guidance is unduly *unfavorable*, some taxpayers will be subject to higher tax liability than what law requires. An inability to rely on the informal guidance means that, if a taxpayer later discovers that they are entitled to a deduction or a credit (or to exclude an item from income) after the time for amending their return has expired, they likely cannot use the fact that they were misled by the guidance to obtain more time to amend their return.[212] Particularly because taxpayers who are not well represented may be more likely to be misled by unduly unfavorable informal guidance, the results are inequitable.[213] Moreover, in response to a 2021 Taxpayer Attitude Survey, taxpayers with lower incomes were more likely to report that they trusted the IRS to help them understand their tax obligations.[214]

Unduly *favorable* guidance has tax-revenue-reducing and inequitable effects. A taxpayer who follows unduly favorable guidance is not harmed but is, in fact, benefited by paying less tax than they owe (at the expense of the government collecting less tax revenue than intended) provided the

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[208] *Id.*

[209] *See* Blank & Osofsky, *supra* note 13, at 229–33; Monroe, *supra* note 171, at 94–98.

[210] *See* Blank & Osofsky, *supra* note 13, at 229–33; Monroe, *supra* note 171, at 94–96.

[211] Monroe, *supra* note 171, at 96–98.

[212] *See, e.g.*, Tallon v. United States, No. 83-1349, 1984 WL 1359, at *3 (C.D. Ill. Sept. 28, 1984); *see also* Cauble, *supra* note 26, at 435–37.

[213] Blank & Osofsky, *supra* note 13, at 243–44; Blank & Osofsky, *Automated Agencies*, *supra* note 26, at 2172; Blank & Osofsky, *Inequity*, *supra* note 26, at 1129–30; Cauble, *supra* note 26, at 463–65.

[214] I.R.S., COMPREHENSIVE TAXPAYER ATTITUDE SURVEY (CTAS) 35 (2021), https://www.irs.gov/pub/irs-pdf/p5296.pdf.

taxpayer's return is not audited.[215] By contrast, if the taxpayer's return is audited and the error is uncovered, they will owe additional tax liability, interest, and potential penalties.[216]

With respect to accuracy-related tax penalties, it is clear that informal sources of guidance (such as IRS publications, tax forms and instructions, advice delivered via the Interactive Tax Assistant and advice delivered via the IRS helpline) are not considered for purposes of determining whether a taxpayer's position has a "reasonable basis" or is based upon "substantial authority."[217] In some cases, a taxpayer may nevertheless have a defense against penalties if the taxpayer establishes "reasonable cause" and "good faith".[218] Reliance on informal guidance will not *automatically* establish "reasonable cause" and "good faith".[219] In *Sadberry v. Commissioner*, the taxpayer, an attorney, claimed to have relied on tax form instructions.[220] The Tax Court determined that the taxpayer had not established reasonable cause, stating, "Petitioner's knowledge, education, and experience as an attorney should have motivated him to seek professional tax advice rather than to engage in guesswork with respect to his return."[221] Nevertheless, it is possible that reliance on informal guidance may be one factor that is considered.[222] The Internal Revenue Manual, for instance, provides that the IRS "may provide penalty relief based on a taxpayer's reliance on erroneous oral advice" received from the IRS.[223] In determining whether to grant such relief, the IRS considers whether the taxpayer exercised "ordinary business care and prudence in relying on [the] advice," whether the IRS provided correct information by other means (such as through tax forms), and the type of

[215] *See also* Blank & Osofsky, *supra* note 13, at 242.

[216] *See* Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 234–35; Blank & Osofsky, *Inequity*, *supra* note 26, at 1151–54; Cauble, *supra* note 26, at 431–32. *See also* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323, 372–73 (2008) (in which a former IRS chief counsel describes the lack of ability to rely on the IRS's publications, tax forms and accompanying instructions, and oral communications).

[217] *See* Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003) (not listing these informal sources of guidance).

[218] *See* I.R.C. § 6664(c)(1); *id.* § 1.6664-4(a), (c) (as amended in 2003).

[219] Treas. Reg. § 1.6664-4(c) (as amended in 2003).

[220] 87 T.C.M. (CCH) 982, 8 (2004).

[221] *Id.*

[222] *See* Treas. Reg. § 1.6664-4(b) (as amended in 2003).

[223] *Internal Revenue Manual* (IRM) 20.1.1.3.3.4.2 (Dec. 11, 2009).

supporting documentation provided by the taxpayer.[224] Even if, in theory, reliance on informal guidance might help to establish a reasonable cause and good faith defense against penalties in some cases, taxpayers may confront various practical difficulties in raising the defense.[225] Furthermore, even if a taxpayer is not subject to penalties, discovering that their tax liability is higher than they expected based on informal guidance may leave the taxpayer in a worse position than where they would have been had they not received unduly favorable guidance. This occurs if the taxpayer has, in the interim, taken steps that cannot be easily undone.[226]

Moreover, a taxpayer who follows unduly favorable guidance will owe additional tax liability, interest, and potential penalties only if they are audited and not all taxpayers face the same likelihood of audit. Significantly, a recent study estimated that Black taxpayers face a higher probability of being audited (facing audit rates that are between 2.9 and 4.7 times the rate of non-Black taxpayers).[227] The study found that only a small amount of the disparity (14%) stems from the higher audit rate faced by EITC recipients.[228] Regarding the high audit rate for EITC recipients generally, in the 2017 tax year, the audit rate for tax returns that included a claim to the EITC was 1%, compared to a 0.3% audit rate for returns that did not include a claim to the EITC.[229]

IV. PROPOSAL IN DETAIL

To mitigate the problems described above in Parts II and III, lawmakers should require more detailed, standardized disclosure whenever a taxpayer's reported tax consequences depend upon the application of certain facts-and-circumstances-based tests. If a taxpayer claimed a deduction that was associated with such a disclosure requirement, the IRS would automatically

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[224] *Id.*

[225] For discussion of practical difficulties in the context of advice received via phone, see Cauble, *supra* note 26, at 432. For discussion of practical difficulties in the context of advice received via the Interactive Tax Assistant, see Blank & Osofsky, *Automated Legal Guidance*, *supra* note 15, at 234–35.

[226] *See also* Cauble, *supra* note 26, at 457–58; Comment, *Never Trust a Bureaucrat: Estoppel Against the Government*, 42 S. CAL. L. REV. 391, 399 (1969); Jonathan P. Schneller, *The Earned Income Tax Credit and the Administration of Tax Expenditures*, 90 N.C. L. REV. 719, 785–86 (2012).

[227] *See* Elzayn et al., *supra* note 29, at 3.

[228] *Id.* at 4.

[229] CONG. RSCH. SERV., IN11952, AUDITS OF EITC RETURNS: BY THE NUMBERS 2 (2022).

disallow the claimed deduction unless and until the taxpayer supplied the required disclosure. If a taxpayer excluded an item from income that was associated with such a disclosure requirement, at least when the item was subject to information reporting, the IRS could automatically determine that the item should be included in income unless and until the taxpayer supplied the required disclosure. If a taxpayer excluded an item from income that was associated with such a disclosure requirement and the item was not subject to information reporting, the IRS would not be equipped to automatically assess additional tax liability. However, the lack of disclosure could, in some cases, increase the likelihood of the taxpayer becoming subject to penalties.

Alongside the requirements for more detailed disclosure, in its informal guidance, the IRS could provide specific examples that illustrate the typical application of facts-and-circumstances-based tests. At the same time, the IRS could alert taxpayers to the fact that different tax outcomes are possible, remind them of any applicable disclosure requirements, and suggest steps they could take if they want to claim the typical tax treatment but guard against the possibility that their circumstances may be exceptional.

This part will proceed by describing, in more detail, what disclosure should be required, the consequences of failing to provide the required disclosure, and how the IRS could use informal guidance to steer taxpayers towards claiming likely outcomes.

A. The Required Disclosure

Lawmakers should require more detailed, standardized disclosure whenever a taxpayer's reported tax consequences depend upon the application of certain, specified facts-and-circumstances-based tests. To streamline the process for taxpayers and the IRS, the IRS should provide standard forms to use for the required disclosure, and taxpayers would file the forms as schedules along with their tax returns.

Some examples may further illustrate the general concept. Consider, for instance, a single taxpayer[230] who sells a home and takes the position that some or all of the gain can be excluded from income under Internal Revenue Code Section 121. This taxpayer should be required to file a schedule with their return on which they supply answers to questions that can be used to assess the taxpayer's claim that they owned the home and that the home was

[230] I.R.C. § 121. The schedule filed by married taxpayers filing a joint return would include slightly different questions to solicit the information needed to determine the maximum gain they can exclude.

the taxpayer's principal residence for the required periods of time. For instance, the taxpayer would list the date they purchased the home and the date of sale.[231] The taxpayer would list the dates when they lived in the home, as well as the dates when they lived anywhere else. If they lived elsewhere, they would be asked questions that could be used to determine whether and when the home was their principal residence (questions about where they worked during different time periods, what address(es) they listed for various official purposes at different times, and so forth).[232] The taxpayer would also be asked whether they had excluded from income gain on sale of another home within the two-year period ending on date of sale of this home, and, if so, when that earlier sale occurred.

If the answers to the previous questions made clear that the taxpayer met all the timing requirements under Internal Revenue Code Section 121, then the taxpayer could skip questions related to the reason for the home sale. If, however, the taxpayer failed to meet one or more of the timing requirements but still planned to exclude some gain from income because the sale was motivated by change of place of employment, health, or unforeseen circumstances, then the taxpayer would be required to answer further questions about the reasons for the sale. If the taxpayer's answers to some questions indicated that they met the requirements of a safe harbor under which their sale is deemed to be motivated by one of these causes, the taxpayer could skip some further questions. For instance, if the taxpayer's answers to initial questions indicated that they were hired for a new job during the time that they owned the home and used it as a principal residence and the new job was at least fifty miles farther from the home the taxpayer sold than was the taxpayer's former job, then the taxpayer would qualify for a safe harbor under which the sale is deemed to be motivated by change of place of employment.[233] In that case, the taxpayer could skip additional questions about the reason for the sale. If the taxpayer did not meet this safe harbor's requirements but did indicate that the sale was motivated by a change in employment location, the taxpayer would be directed to some

[231] If the taxpayer did not use the property as their principal residence for some periods of time, special rules might apply. *Id.* § 121(b)(5). Therefore, the disclosure form would also need to include questions to ferret out if and when the taxpayer did not use the property as a principal residence.

[232] *Id.* § 121(a). If they lived in the home being sold (and only in that home) for long enough that it must have been their principal residence for the requisite period of time (by virtue of the fact that it was their only residence for that period of time), then the taxpayer could skip these follow-up questions.

[233] Treas. Reg. §1.121-3(c)(2).

further questions requiring the taxpayer to supply information such as: (1) the typical time that it would take to commute from the old home to the new job (and how that compares to the commute time from the new home to the new job), (2) a description of any job-related reasons why the taxpayer needs to get to work quickly (such as the possibility of being called in for emergencies), (3) a description of any other reasons why the taxpayer needs to live particularly close to their job location like more accessibility to transportation or other factors, and (4) whether the job change was accompanied by a decrease in pay that affected the taxpayer's ability to afford their old home. Given the facts-and-circumstances-based nature of the inquiry, the disclosure form should also include a catch-all question asking the taxpayer to describe any other reasons why the job change led to the home sale as well as any other reasons for the sale.

As another example, if a taxpayer excluded property from income based on the position that it was received as a gift, the taxpayer could be required to submit a disclosure form, likely subject to a de minimis exception as explained in Part V.C. below. The form would ask the taxpayer what they received, from whom they received it, what their relationship was to the transferor, whether they provided (or might provide in the future) something of value to the transferor in exchange, whether the transferor stated their reason for making the transfer (and, if so, what that reason was), and (if known) whether the transferor had claimed or planned to claim a tax deduction with respect to the transfer. In general terms, the questions on any given form could be based upon factors that Treasury Regulations, case law or rulings have identified as relevant.

The advantages of requiring more detailed disclosure are several. First, when taxpayers supply the relevant information with their tax return, the IRS will be in a better position to assess the validity of some claims based on the face of the return itself. Requiring more detailed disclosure is not, of course, a substitute for audit. However, including more information with a return may enable the IRS to make better informed decisions about how to allocate its scarce auditing resources.

Second, supplying standardized disclosure forms would prompt taxpayers to consider and answer questions relevant to whether their claimed tax treatment is appropriate. As a result, more taxpayers may report correct tax outcomes. In recent work, Professors Alm, Soled, and Thomas propose that the IRS add questions to tax returns that "prod[] taxpayers to report honestly."[234] For instance, because some categories of income—like cash payments received by sole proprietors—are plagued by underreporting, they propose that the IRS could ask yes/no questions on tax returns that might prompt better compliance given people's lesser willingness to lie by commission in response to such a question than by omission.[235] In other words, as Professors Alm, Soled, and Thomas observe, incorporating additional questions may reduce deliberate non-compliance. Relatedly, including questions that prompt taxpayers to consider each factor relevant to their treatment under facts-and-circumstances-based tests may reduce inadvertent non-compliance.

Third, requiring more detailed disclosure by all taxpayers at the reporting stage narrows the gap between the information that all taxpayers must supply and the information that only the subset of taxpayers who are audited must supply at the enforcement stage. As discussed below, while this might be framed as a drawback to the proposal in that it entails increased administrative burden for taxpayers at the reporting stage,[236] it could also be seen as one of the proposal's virtues. When a taxpayer is audited, the incremental administrative burden to that taxpayer resulting from audit may be less if they were required to supply detailed disclosure at the reporting stage.[237] Moreover, requiring advance disclosure by the taxpayer could prompt compliance with the requirement that taxpayers maintain adequate books and records to substantiate their claims.[238]

[234] James Alm et al., *Multibillion-Dollar Tax Questions*, 84 OHIO STATE L.J. 895, 898 (2024).

[235] *Id.*

[236] *See infra* Part V.C.

[237] This may also mitigate the perception that random audits (the small percentage of audits that the IRS conducts on a purely random basis) are unfair. For discussion of this issue, *see, e.g.*, Lawsky, *supra* note 12, at 208 ("Even though it is generally fair for the government not to compensate taxpayers for randomly imposed audit costs, taxpayers may still perceive this lack of compensation as unfair. This perceived unfairness should matter to a welfarist, because people prefer to comply with laws, including tax laws, that they perceive to be fair. In particular, if randomly imposing audit costs on a few individuals for the good of the whole is seen as unfair and thus creates demoralization costs, compensating taxpayers for these randomly imposed audit costs may reduce social costs and increase compliance.").

[238] The requirement for taxpayers to maintain books and records, in turn, offers various advantages. *See* Yorio, *supra* note 17, at 33–34.

B. The Effects of Not Supplying the Required Disclosure

As discussed above in Part IV.A, in certain cases, lawmakers should require taxpayers to disclose more detailed information on schedules filed with their tax returns. To reduce the likelihood that taxpayers would inadvertently fail to file required disclosures, tax forms and tax filing software could alert taxpayers to the need to file. Furthermore, if a taxpayer failed to file the required disclosure, then, in the case of a deduction, the IRS could automatically disallow the deduction. In other words, by default, the IRS could presume that a taxpayer was not entitled to the deduction unless and until the taxpayer supplied the required disclosure.[239]

In the case of exclusions from income, lawmakers could adopt a parallel approach as long as the item that the taxpayer excluded from income was subject to information reporting. For instance, imagine a taxpayer sold a home and took the position that some or all of the gain could be excluded from income under Internal Revenue Code Section 121. Imagine too that the sale was subject to information reporting so that the taxpayer and the IRS received a Form 1099-S from the person who closed the transaction. In such a case, unless and until the taxpayer supplied the disclosure form that contained questions described in Part V.A above, the IRS could automatically assess additional tax liability that would result from the taxpayer including all gain in income.[240]

If a taxpayer excluded an item from income and did not supply the required disclosure, the IRS would have a difficult time detecting the taxpayer's failure to disclose if the item was not subject to information reporting. For example, imagine a taxpayer excluded an item from income because the taxpayer took the position that the item was received as a gift, and the taxpayer did not supply the required disclosure. Likely, the IRS might fail to detect this taxpayer's omission assuming that the item was not subject to information reporting, although it is possible the IRS could detect the

[239] This could be framed as adopting a "penalty default" rule to induce taxpayers to provide information. For discussion of "penalty default" rules in the context of contract law, see Ian Ayres & Robert Gertner, *Filing Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). For discussion of their use in the context of tax elections, see Emily Cauble, *Tax Elections: How to Live with Them If We Can't Live Without Them*, 53 SANTA CLARA L. REV. 421, 459 (2013); Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. LEGIS. 21, 67 (2010); Heather M. Field, *Tax Elections & Private Bargaining*, 31 VA. TAX REV. 1, 50–56 (2011).

[240] To facilitate this, the Form 1099-S would need to include not just the proceeds of the sale but also information about the seller's basis.

omission on audit. The difficulty of detecting such an omission makes ensuring compliance with disclosure requirements more difficult in such a case.[241]

Nevertheless, two factors mitigate, to some degree, the difficulty of ensuring compliance. First, in some cases, failing to report income of a sufficient amount extends the period of time during which the IRS is allowed to audit a taxpayer's return.[242] Indeed, the Supreme Court has reasoned that the particular difficulty of detecting unreported income is what justifies an extended statute of limitations for examining tax returns in such cases.[243]

Second, a failure to supply the required disclosure could subject the taxpayer to penalties. In some cases, existing law produces this result. For instance, if the taxpayer's position that an item could be excluded from income as a gift is detected by the IRS and successfully challenged and if the taxpayer had merely a "reasonable basis" for their position, the taxpayer may, in some cases, be subject to penalties that would not have applied if the taxpayer had disclosed their tax position.[244] Such a penalty would only apply in some cases. It would generally not apply, for instance, if the taxpayer met the somewhat higher bar of taking a position that was based on "substantial authority."[245] If the existing penalty regime creates insufficiently strong incentives to file the required disclosure, lawmakers could adopt additional

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[241] *See also* Alm et al., *supra* note 2344, at 937–38 (discussing how taxpayers may be more likely to supply false information when the information is not verifiable).

[242] *See* I.R.C. § 6501(e)(1).

[243] *See* Colony, Inc. v. Comm'r, 357 U.S. 28, 36 (1958) ("We think . . . Congress manifested no broader purpose than to give the Commissioner an additional two years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting 'gross income' or one, such as overstated deductions, affecting other parts of the return."); *see also* LEANDRA LEDERMAN & STEPHEN MAZZA, TAX CONTROVERSIES PRACTICE AND PROCEDURE, at 340 (4th ed. 2018).

[244] I.R.C. § 6662(d)(2)(B) (defense to substantial understatement penalty requires disclosure unless it is based on substantial authority). This assumes that the "reasonable cause" and "good faith" defense is not available. *See* I.R.C. § 6664(c)(1); Treas. Reg. § 1.6664-4(a), (c) (as amended in 2003).

[245] *See* I.R.C. § 6662(d)(2)(B) (understatement amount shall be reduced if "there is or was substantial authority for such treatment," acting as a defense to the substantial understatement penalty).

penalties that generally would apply when the taxpayer failed to file the required disclosure.

C. Steering Taxpayers Towards Typical Treatment

As discussed above, lawmakers ought to require more detailed disclosure from taxpayers when they take certain tax positions that depend on the application of facts-and-circumstances-based tests. In addition, in its informal guidance, the IRS ought to describe the likely application of such tests to typical fact patterns (to steer taxpayers towards claiming likely outcomes). At the same time, the IRS ought to warn taxpayers that tests are based upon all relevant facts and circumstances so that different tax outcomes are possible,[246] remind them of the disclosure requirements, and suggest steps they could take if they want to claim the typical tax treatment but guard against the possibility that their circumstances may be exceptional.

For example, almost certainly, in the vast majority of cases, a taxpayer cannot claim a casualty loss deduction for "money or property misplaced or lost."[247] An IRS publication could indicate that this is true in most cases but also note that the determination of whether an event is a casualty involves a facts-and-circumstances-based analysis. The publication could further explain that taxpayers could file a return without claiming the deduction while at the same time supplying responses to a standardized disclosure form so that, if the taxpayer is entitled to the deduction, the IRS could determine that the taxpayer is owed a refund. Finally, if the taxpayer did claim a casualty loss deduction when filing their return, the deduction would be automatically disallowed unless and until the taxpayer supplied the required disclosure.

Currently, taxpayers must complete a form that requests information about each item of property that was affected by the casualty.[248] However, the taxpayer is not asked to provide any description of the event giving rise to the loss (other than noting whether it is attributable to a Federally declared disaster).[249] A more detailed disclosure form could ask questions about the

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[246] Somewhat relatedly, Professors Blank and Osofsky have proposed that the IRS, in its publications, (1) "red-flag IRS simplifications explicitly (through footnotes, notations, interactive online links, appendices, or other means), (2) explain that they represent safe-harbor positions, and (3) briefly identify other reasonable interpretations of the tax law." Blank & Osofsky, *supra* note 13, at 252.

[247] *See supra* notes 187–188 and accompanying text.

[248] I.R.S., INSTRUCTIONS FOR FORM 4684, at 2 (2023), https://www.irs.gov/pub/irs-pdf/i4684.pdf.

[249] *Id.*

event giving rise to the loss (especially in cases in which it is not a Federally declared disaster). For tax years beginning December 31, 2017 and before January 1, 2026, a taxpayer's ability to deduct losses (except those incurred in a trade or business or in transactions entered into for profit) is generally limited to only losses attributable to a federally declared disaster.[250] However, even in those years, taxpayers who recognize casualty gains are eligible to deduct casualty losses against those gains even if the losses do not arise from a federally declared disaster.[251] Therefore, even in those years, some taxpayers grapple with the facts-and-circumstances-based question of whether an event constitutes a casualty.[252]

To take another example, in the vast majority of cases, if a taxpayer sells a home and moves to a larger home following an increase in the number of people living with the taxpayer that occurs after the taxpayer purchased the home they are selling, the sale will be considered attributable to unforeseen circumstances.[253] An IRS publication could indicate that this is true in most cases. At the same time, the publication could warn taxpayers that there may be exceptions because the determination of whether a sale is attributable to unforeseen circumstances is based upon all the relevant facts and circumstances (unless the taxpayer qualifies for one of several safe harbors, which the publication could also describe as it does currently). The publication could alert taxpayers to the fact that, if they file and exclude some gain from income, they need to also file the required disclosure. Provided the sale was subject to information reporting, the IRS could automatically assess any additional tax liability that would result from including all gain in income unless the taxpayer supplied the required disclosure.[254] Even if the sale were not subject to information reporting, a failure to supply the required disclosure could increase the likelihood that the taxpayer might become subject to penalties in certain cases. Expanding information reporting requirements to cover more home sales (and, when feasible, to cover other types of transactions) would also make it so a failure to disclose would be readily detectable in more cases.[255]

[250] I.R.C. § 165(h)(5)(A).

[251] *Id.* § 165(h)(5)(B).

[252] *See* Kahn, *supra* note 43, at 627–28.

[253] *See supra* note 168 and accompanying text.

[254] To facilitate this, the Form 1099-S would need to include not just the proceeds of the sale, but also information about the seller's basis.

[255] Expanding information reporting would also facilitate ensuring compliance more generally. *See* Kahng, *supra* note 119, at 224–27.

Providing guidance that steers taxpayers towards taking initial filing positions that are likely correct facilitates administrative efficiency by decreasing the number of instances in which the IRS needs to redetermine tax liability.[256] At the same time, requiring detailed disclosure when taxpayers take a favorable tax position (claim a deduction or exclude an item from income, for instance) and suggesting that taxpayers can provide detailed disclosure when they take an unfavorable tax position (forgoing a deduction or including an item in income, for instance) allows the IRS to more readily determine if the taxpayer's claimed tax position is correct. This will mitigate the harms that would otherwise follow when more concrete guidance on facts-and-circumstances-based tests misleads taxpayers into taking unduly favorable or unduly unfavorable filing positions. Moreover, while many facts-and-circumstances-based tests disproportionately affect taxpayers with higher incomes who may be more able to obtain expert advice rather than act upon their own interpretations of IRS guidance, even tests that disproportionately affect taxpayers with higher incomes affect some taxpayers at lower levels of income who may be less able or likely to obtain expert advice.[257] Finally, more detailed disclosure can also reduce the incremental burden of auditing taxpayers who take positions based on facts-and-circumstances-based tests.

V. ADDRESSING POTENTIAL OBJECTIONS

Readers may object to this Article's proposed approach on the grounds that: (1) it is too administratively burdensome for the IRS, (2) it undermines the existing disclosure regime's potential to incentivize detailed disclosure of only questionable tax positions, (3) it is too administratively burdensome for taxpayers, (4) it encroaches on taxpayer privacy, or (5) it facilitates efforts by taxpayers to claim unduly favorable tax treatment. Each of these potential objections is discussed, in turn, below. As the following discussion will illustrate, various features (or potential features) of this Article's proposed approach address or mitigate each of these concerns.

[256] Admittedly, this Article's proposed approach does not fully address uncertainty at the planning stage. A taxpayer who wants to determine whether gain from a home sale can be excluded from income before selling a home, for instance, may seek more certainty than what they can gather from examples that illustrate likely tax outcomes. This Article's proposed approach is not intended to be a substitute for other ways that taxpayers might obtain certainty, like letter rulings.

[257] *See also supra* note 183.

A. Too Burdensome for the IRS

Some readers might object to the proposed approach on the grounds that it is too administratively burdensome for the IRS. Given limited IRS resources, the additional disclosure may serve no purpose if the IRS has no time to review it. The IRS does, indeed, work with limited resources. For instance, in 2022, the IRS employed the equivalent of 79,070 full-time employees, 9.1% fewer than the number employed in 2013 (but more than the numbers employed in 2016–2021).[258] However, two features of this Article's proposed approach can mitigate the concern that it imposes too much of a burden on the IRS. First, requiring the disclosure on standard schedules can streamline processing so that the IRS can more readily sort strong positions from more questionable ones.[259] Technology may be of some aid in this process—on a somewhat related note, the IRS has announced plans to use artificial intelligence to assist in its increased audits of complex partnerships.[260] Second, this Article's proposed approach could be adopted incrementally. For instance, initially at least, more detailed disclosure could be required only in the case of determining whether a taxpayer was eligible to exclude from income gain from sale of a home and perhaps certain other specified facts-and-circumstances-based tests that disproportionately affect high income taxpayers, such as the classification of gain from sale of real estate as capital gain. Third, even if the IRS does not review all reported information, including the more detailed questions may, itself, guide taxpayers towards reporting the correct tax treatment.[261]

B. Undermines Existing Disclosure Regime's Incentives

Some readers might speculate that requiring detailed disclosure from all taxpayers could undermine the existing disclosure regime's ability to incentivize detailed disclosure with respect to only questionable tax positions. Under existing law, in some cases, a taxpayer is entitled to a

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[258] *See* I.R.S., *IRS Budget and Workforce*, https://www.irs.gov/statistics/irs-budget-and-workforce (last visited Mar. 17, 2024).

[259] Relatedly, in the context of the tax shelter disclosure rules, Professor Blank has described the potential for over-disclosure (or disclosure of transactions that are not abusive or other information that makes it more difficult for the IRS to identify relevant information). Blank, *supra* note 110. As Professor Blank notes, additional information does not represent problematic over-disclosure when the IRS can easily determine that it is not relevant. *Id.* at 1645, 1686–87.

[260] I.R.S. News Release IR-2023-166 (Sept. 8, 2023).

[261] *See* Alm et al., *supra* note 234, and accompanying text.

defense against penalties if they have provided disclosure of a tax position as long as they have a "reasonable basis" for the position.[262] If the taxpayer meets the higher bar of taking a position based upon "substantial authority," they are entitled to a penalty defense even absent more detailed disclosure.[263] Ideally, the existing disclosure requirements make it so that taxpayers taking tax positions that are more clearly correct are less likely to provide detailed disclosure.[264] For such taxpayers, detailed disclosure provides no benefit given that they will not be subject to penalties even absent disclosure, and, at the same time, disclosure is not entirely costless—it requires some time and effort on the taxpayer's part and the taxpayer may also be concerned that it will attract IRS scrutiny of other aspects of their return that may not be as solidly grounded in tax law. By contrast, if this Article's proposal were adopted, all taxpayers taking positions based on certain facts-and-circumstances-based tests would be required to provide detailed disclosure. Requiring universal disclosure could hinder the ability to use disclosure's penalty mitigating role to incentivize disclosure of only more questionable tax positions.

Two responses to this concern are warranted. First, the existing disclosure regime's effectiveness at screening out disclosure of strong positions is limited.[265] While it may be true that some taxpayers who report correct and solidly grounded tax outcomes will not provide detailed disclosure, some

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[262] *See* I.R.C. § 6662(d)(2)(B)(ii).

[263] *See id.* § 6662(d)(2)(B)(i).

[264] For related discussion of screening mechanisms in tax law, generally, see Emily Cauble, *Protective Tax Elections*, 13 COLUM. J. TAX L. 77, 103–06 (2022); Hayashi, *supra* note 3, at 300 (describing how courts, when they apply facts-and-circumstances-based tests, should treat as relevant facts that act as screening mechanisms because they are costlier for taxpayers to manufacture when they are attempting to camouflage their state of mind than when they genuinely possess the requisite state of mind); Osofsky, *Who's Naughty and Who's Nice? Frictions, Screening, and Tax Law Design*, *supra* note 39, at 1087–92; Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689 (2009) (proposing the adoption of two different tax regimes—with one (the "deterrence regime") designed for taxpayers who seek to game the system ("gamers") and one (the "compliance regime") designed for others, where the compliance regime would be associated with various features—like a pro-IRS presumption in litigation or imposing penalties unless claimed tax positions meet a higher standard for their likelihood of prevailing on the merits—that would be particularly costly for gamers so that these features would prompt gamers to opt for the deterrence regime); Emily Ann Satterthwaite, *Tax Elections as Screens*, 42 QUEEN'S L.J. 63 (2016).

[265] *See* Drennan, *supra* note 33, at 39 (noting that, under current law, disclosure provides taxpayers with only a "slight edge in avoiding the substantial understatement penalty").

taxpayers in this group may still disclose out of an abundance of caution.[266] Furthermore, some taxpayers claiming weak tax positions may refrain from disclosing (even if their positions are strong enough that disclosure would offer penalty protection and especially if they are not) in hopes that their positions will not be detected if they do not disclose them.[267] Relatedly, under current law, a taxpayer who takes a position that is contrary to a regulation can avoid penalties if they disclose the position, have a good faith basis for challenging the validity of the regulation, and meet certain other requirements.[268] One of the revenue measures included in President Biden's budget proposal entails requiring universal disclosure of tax positions that are contrary to regulation.[269] The explanation of the proposal notes, "Some taxpayers have eschewed penalty protection by forgoing the disclosure of positions that are contrary to a regulation in the hopes of avoiding scrutiny."[270] In other words, some taxpayers forgo disclosure in favor of taking their chances that they will not be audited.

Second, to the extent that the existing disclosure regime does create useful incentives, it is possible to build similar incentives into this Article's proposed approach. In particular, if a taxpayer intended to use disclosure as a defense against penalties when they have only a "reasonable basis" for a claimed tax position, they could be required to note that fact in response to a question on the detailed disclosure schedule and also provide a response to a question asking for a description of why the position they are claiming is somewhat questionable.[271]

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[266] In a similar vein, Professor Blank has identified reasons why cautious taxpayers may over-disclose in the context of the tax shelter reporting rules. *See* Blank, *supra* note 110, at 1656–64.

[267] *See* Raskolnikov, *supra* note 110, at 582–83 ("The variation of nominal penalties for disclosed and undisclosed transactions is relatively modest. On the other hand, the probability of detection increases dramatically with disclosure . . . . Furthermore, because the probability of having to pay tax if a transaction is revealed is higher for more aggressive transactions while the likelihood that a transaction would be eventually detected does not necessarily depend on its aggressiveness, taxpayers have stronger incentives not to disclose more dubious schemes.").

[268] I.R.C. § 6662(b)(1); Treas. Reg. § 1.6662-3(c) (as amended in 2003).

[269] I.R.S., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS, 80 (Mar. 2022), https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf.

[270] *Id.*

[271] For a proposal that taxpayers, generally, should be required to disclose instances in which their claimed tax positions are uncertain, see Doran, *supra* note 135, at 154.

C. Too Burdensome for Taxpayers

Some readers may object to this Article's proposed approach because requiring that taxpayers include and submit more detailed schedules with their tax returns will make tax compliance more time consuming and unpleasant. Several responses to this objection are worth noting.

First, it seems plausible that, at least to a point, many taxpayers view uncertainty about whether their claimed tax treatment is correct as more burdensome than the time required to complete their returns. As a result, they may be willing to spend some additional time completing tax return schedules if the schedules contain additional questions that provide more clarity and certainty about the appropriate tax treatment. Indeed, in a recent experimental survey, Professors Choi and Kleiman found that respondents were "willing to pay more to eliminate their risk of making a mistake or being audited (about $72, on average) than they were willing to pay to eliminate all the time they spend on tax compliance activities (about $53, on average)."[272]

Second, and relatedly, the additional administrative burden can be mitigated by the IRS providing well-designed schedules that direct taxpayers to skip questions that are not relevant based upon answers to earlier questions.[273] Third, the additional administrative burden could be mitigated if the proposed approach was accompanied by de minimis rules. For instance, if detailed disclosure (for income tax purposes) were generally required for transfers that a taxpayer classifies as gifts, an exception to the general disclosure requirements could apply provided that the total of such transfers from a given transferor during a period of time did not exceed a specified dollar threshold.

Fourth, as noted above in Part V.A, this Article's proposed approach could be adopted incrementally. For instance, initially at least, more detailed disclosure could be required only with respect to the determination of whether gain from a home sale is excludable from income and potentially certain other specified facts-and-circumstances-based tests that disproportionately affect high income taxpayers. In the case of home sales, in particular, the administrative burden on taxpayers would not be particularly significant because, for any given taxpayer, such a transaction occurs infrequently. Even if a taxpayer engages in such a transaction more

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[272] Jonathan H. Choi & Ariel Jurow Kleiman, *Subjective Costs of Tax Compliance*, 108 MINN. L. REV. 1255, 1261–62 (2024).

[273] Relatedly, see Alm et al., *supra* note 234, at 943, 949–50 (discussing how asking "gatekeeper" questions can streamline compliance with reporting requirements).

frequently, they can generally use the exclusion only once every two years.[274] It is also likely a significant transaction, making it easier for taxpayers to recall and gather the relevant information.

Fifth, if this Article's proposed approach is employed with respect to facts-and-circumstances-based tests that tend to affect taxpayers with higher incomes, they will be well-equipped to cope with the additional compliance burdens. Moreover, if the proposal were adopted in connection with an activity that tends to benefit taxpayers with high incomes (like home sales), taxpayers with incomes below a certain threshold could be exempted from the disclosure requirements (but still permitted to disclose to enable review that could determine they had overpaid).[275]

D. Too Much of an Invasion of Taxpayer Privacy

Requiring that taxpayers supply detailed disclosure about some topics (like medical expenses) could raise privacy concerns, even if the IRS were able to ensure that the information would remain confidential.[276] That concern (and risks of inadvertent confidentiality breaches) may counsel against lawmakers requiring detailed disclosure with respect to some topics (like the medical expense deduction).[277] However, they could use a modified approach. For instance, the schedule on which taxpayers report a medical expense deduction could include one global yes/no question that asks: "Do your reported medical and dental expenses include any of the following: trip expenses, expenses related to exercise or a recreational activity, food or food preparation expenses, expenses that involve modifying or remodeling a residence, car-related expenses, expenses for household systems such as air conditioning systems, humidification and/or filtration systems, or expenses for household appliances?" The listed expenses sometimes constitute medical care but also are often non-deductible personal expenses. From time

[274] *See* I.R.C. § 121(b)(3).

[275] For related discussion of adjusting various procedural rules to take into account taxpayers' incomes, see Blank & Glogower, *supra* note 33; Joshua D. Blank & Ari Glogower, *The Trouble with Targeting Tax Shelters*, 74 ADMIN. L. REV. 69, 89–90 (2022) (discussing imposing greater third-party information reporting requirements in the case of payments made to high-income or wealthy taxpayers and also requiring wealth reporting from such taxpayers).

[276] *See* Michelle D. Layser, *Privacy and Tax Information Collection: A Response to Blank and Glogower*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4785656; Adam B. Thimmesch, *Tax Privacy?*, 90 TEMP. L. REV. 375 (2018).

[277] This would also need to be taken into account when crafting certain questions on the disclosure form for home sales.

to time, the IRS could add to the list based on its auditing experience. To guard against the possibility that taxpayers might interpret the question as an indication that the listed expenses qualify, the schedule could warn taxpayers that often the listed expenses do not qualify and refer them to places in the relevant publication where they can read more. If the taxpayer is claiming a deduction for such an expense, their tax position would not be treated as adequately disclosed (for penalty protection purposes) unless they checked "yes" in response to this question.

E. Likely to Facilitate Efforts by Taxpayers to Claim Unduly Favorable Treatment

Some readers may be wary that, if the IRS provides clearer guidance on how taxpayers with given facts will fare under a facts-and-circumstances-based test, some taxpayers might exploit that clearer guidance. For instance, if IRS guidance indicates that taxpayers with certain facts are typically eligible for a deduction or income exclusion, taxpayers might falsely claim (or, in some cases, create) those facts and report favorable tax treatment to which they are not (or otherwise would not) be entitled.[278] In a similar vein, many scholars have expressed the concern that replacing standards in tax law with clear rules could create a roadmap for taxpayers to design their transactions or alter their behavior in order to obtain more favorable tax treatment than lawmakers intend.[279]

[278] *See* Hayashi, *supra* note 3, at 294–95 ("The second reason not to specify the facts is that doing so would provide a strategic advantage to the regulated parties. Once Congress or the Treasury Department specifies the facts from which factfinders must draw an inference favorable to the taxpayer, then all taxpayers have an incentive to produce those facts.").

[279] *See, e.g.*, Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 57 (2004); Hayashi, *supra* note 3, at 291 ("If the facts that create a favorable inference about a hidden factor are publicized in advance, they will provide a roadmap for well-advised individuals to create those very facts to induce factfinders to draw the inference those individuals want."); Calvin H. Johnson, *H.R. ___, The Anti-Skunk Works Corporate Tax Shelter Act of 1999*, TAX NOTES 443, 445 (1999) ("Loopholes can be created in any human tax system unless the system is defended and repaired."); Logue, *supra* note 1, at 366 ("[I]t simply is not possible to write tax laws that are devoid of all unintended loopholes."); Martin J. McMahon Jr., *Beyond a Gaar: Retrofitting the Code to Rein in 21st Century Tax Shelters*, TAX NOTES 1721, 1722 (2003) ("The mechanical terms of specific rules . . . provide a tremendous temptation to treat the rules as an instruction manual for creating and structuring transactions outside the ordinary course of business or normal investments in which the taxpayer would not engage except as a result of the tax avoidance potential of the inventive transaction."); Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401,

Two features of this Article's proposed approach should allay this concern. First, while this Article proposes that the IRS provide more examples in its guidance of how facts-and-circumstances-based tests *typically* apply, it is not proposing the adoption of clear rules specifying that the tax outcome will always be the typical outcome. Rather, the guidance should make clear that, while the described outcome is typical, it is not inevitable given the facts-and-circumstances-based nature of the test. Second, while this Article proposes that lawmakers should require that taxpayers supply more detailed disclosure, the required disclosure is not a substitute for verification of the disclosed facts on audit.

CONCLUSION

In many instances, the appropriate tax treatment of a transaction or event depends upon the application of a facts-and-circumstances-based test. Issuing helpful but not misleading guidance on facts-and-circumstances-based tests is a particularly challenging endeavor. To clarify how such a test operates, the IRS might offer examples of the typical tax treatment of various fact patterns. Given the facts-and-circumstances-based nature of the test, exceptions to typical tax treatment are inevitable, which leads to the risk that taxpayers might be misled if they read the examples as conveying universal rules.

Enforcing facts-and-circumstances-based tests is also difficult. Given the facts-and-circumstances-based nature of the test, the IRS cannot determine whether a taxpayer's claimed tax treatment is correct without knowing all the facts, and the information supplied on tax returns falls well short of providing all the relevant facts.

Particularly given that many facts-and-circumstances-based tests disproportionately affect the tax treatment claimed by taxpayers with higher incomes and given the IRS's plan to focus additional auditing resources on such taxpayers, lawmakers should require additional disclosure from taxpayers who claim tax positions based on the application of certain facts-

409 (2010) ("[T]hese flaws create a playground for those who engage in transactions that comply with . . . literal language, yet result in tax consequences that Congress did not contemplate."); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, TAX NOTES 511, 512–13 (2002) ("Inevitably, there will be some unforeseen interaction of the tax rules so that, if one arranges one's affairs in just the right manner, magic happens."). For similar discussion regarding rules, generally, see, for example, Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 179 (2015); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 995 (1995).

and-circumstances-based tests to streamline enforcement. Additionally, the IRS should offer examples of the typical application of such tests to guide taxpayers towards claiming likely outcomes, while, at the same time, noting that exceptions exist. Requiring taxpayers to supply more detailed disclosure would enable the IRS to determine whether a taxpayer's facts warrant departure from the likely outcome.