Article

Playing with "Monopoly Money": Phony Profits, Fraud Penalties and Equity

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Most U.S. corporations do not pay federal income taxes.[1] In fact, domestic corporations have become so adept at reducing their tax bills that they accounted for less than 10 percent of all income taxes collected by the federal government from 2000 through 2003.[2] One might be surprised to discover, then, that during the last several years some corporations have been willing to report, and pay over to the Treasury, hundreds of millions of dollars in taxes that they did not owe. Why? Because paying the tax helped conceal the fact that those companies were playing with Monopoly money—fabricating profits as phony as the bright pastel-colored money used in the classic Parker Brothers board game.[3] This corporate malfeasance apparently continues to occur with some frequency. Of course, when the game was over, those same companies wanted to raid the "community chest" to get their money back by filing tax-refund claims. The problem with permitting such claims is that reporting phony income is as much a tax fraud as is failing to report real income.[4] The only difference is that the latter is subject to significant penalties, while the former is only nominally

1. From 1996 through 2000, 61 percent of U.S.-controlled corporations reported no U.S. tax liability. U.S. GEN. ACCOUNTING OFFICE, REPORT NO. GAO-04-358, COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1996–2000 2 (2004), *available at* http://www.gao.gov/new.items/d04358.pdf. Seventy-one percent of U.S.-controlled foreign corporations also reported no U.S. tax liability. *Id.*

2. INTERNAL REVENUE SERV., TREASURY DEP'T, TREASURY DEPARTMENT GROSS TAX COLLECTIONS: AMOUNT COLLECTED BY QUARTER AND FISCAL YEAR, 1987–2004 (2004), *available at* http://www.irs.gov/pub/irs-soi/04tc18fy.xls; *see also* ROBERT S. MCINTYRE & T.D. COO NGUYEN, CORPORATE INCOME TAXES IN THE BUSH YEARS 13 (2004), *available at* http://www.ctj.org/corpfed04an.pdf; David Cay Johnston, *Tax Inquiries Fall as Cheating Increases*, N.Y. TIMES, Apr. 14, 2003, at A16.

3. *See* Merle Erickson, *How Much Are Nonexistent Earnings Worth?*, CAPITAL IDEAS, Spring 2003, http://gsbwww.uchicago.edu/news/capideas/spring03/nonexistentearnings.html (discussing willingness of corporate managers to pay additional taxes in furtherance of fraudulent earnings inflation).

4. *See infra* note 23.

penalized under current rules.[5] This Article argues that because of the potentially corrosive effect that false reporting has on the tax system, the Internal Revenue Service (IRS) should remedy the deficiency of current rules by revisiting principles of equity to deny refunds of taxes paid on fraudulently inflated income.

Since the implosion of Enron in November of 2001, Wall Street has been severely shaken by an unprecedented string of accounting fraud scandals involving publicly traded corporations.[6] Most of the corporations involved have been guilty of earnings inflation—adding fictitious income to their financial statements. The appeal of earnings inflation is obvious. By means of various accounting gimmicks, or by simply manufacturing transactions that never took place, a company can create a steadily rising earnings curve that will boost its share price.[7] Not surprisingly, this produces lucrative rewards for management. Stock option grants to management frequently are tied to specified earnings targets that may be achieved more quickly by manipulating the company's books.[8] Moreover, as share prices rise based on increases in revenue and profit, management may realize ever-greater gains from sales of previously acquired shares of the company.[9]

5. *See infra* Part II.C.

6. More than fifty major publicly traded corporations were under investigation for accounting fraud and other financial misdeeds in 2002 alone. *See* Gary Stoller, *Funny Numbers*, USA TODAY, Oct. 21, 2002, at B3.

7. *See* David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 892–99 (2002) (discussing investor willingness to pay a "predictability premium" for the shares of companies reporting continuous earnings increases and the resulting "single-minded focus on boosting stock prices through short-term earnings performance [that] has become standard operating procedure at most . . . publicly traded corporations").

8. *See id.* at 906 ("A . . . likely explanation for [share price maximization] looks . . . to management's own self-interest . . . . It is now widely assumed that executives' current obsession with quarterly earnings and their effect on stock prices is connected to the dramatic increase in compensation by means of stock options.").

9. For example, from 1999 to 2001, Qwest Communications executives reaped more than $500 million from stock sales while shares were trading in the $40 range. David Leonhardt, *Qwest Leaders Made Millions in Stock Sales*, N.Y. TIMES, July 30, 2002, at C1. Of that amount, $227 million was made by one former CEO alone. *Id.* By mid-2002, however, Qwest had confessed to inflating earnings and its stock was trading at less than $1.50 per share. *Id.* Similarly, HealthSouth CEO Richard Scrushy exercised more than $201 million in stock options in the six years that the company inflated its earnings. *Closing Arguments Wind Up at Scrushy Trial*, N.Y. TIMES, May 19, 2005, at

But as the accounting scandals have unraveled, dozens of public companies have been forced to restate their earnings, and in some cases file for bankruptcy protection.[10] Congress responded to these financial accounting abuses by passing the sweeping Sarbanes-Oxley Act of 2002,[11] which was intended to strengthen the oversight of accountants, increase corporate responsibility, and enhance the ability of the Securities and Exchange Commission (SEC) to detect and investigate accounting fraud.[12] However, a company deceiving shareholders about its earnings generally must deceive the tax collector as well as the securities regulator.

Although they are not compelled to do so, corporations that inflate their earnings often pay tax on the fictitious income they create because doing so helps to hide the accounting fraud from investors, analysts and the SEC.[13] If the fraud goes undetected, an offending corporation almost certainly will be content to allow the government to keep the tax overpayments.[14] When the fraud is exposed, however, the corporation is likely to respond by seeking a refund of the overpaid taxes, which may amount to tens or even hundreds of millions of dollars.[15] World-

C3.

10. *See* James Toedtman, *Scandal Scorecard*, NEWSDAY, July 13, 2004, http://www.newsday.com/business/ny-scandal-scorecard%2C0%2C4119732 .story?coll=ny-business-utility.

11. Pub. L. No. 107-204, 116 Stat. 745.

12. *See* H.R. Rep. No. 107-610 *passim* (2002) (Conf. Rep.). In addition to the congressional response, the SEC—charged with protecting investors and maintaining the integrity of the securities markets—stepped up enforcement activity, seeking criminal penalties against dozens of officers and employees of offending companies, imposing penalties totaling roughly $1.48 billion, and ordering disgorgement of approximately $3.77 billion in ill-gotten gains in fiscal years 1999 through 2003. SEC ANN. REP. 15 (2003), *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf; SEC ANN. REP. 1 (2002), *available at* http://www.sec.gov/pdf/annrep02/ar02full.pdf; SEC ANN. REP. 1 (2001), *available at* http://www.sec.gov/pdf/annrep01/ar01full.pdf; SEC ANN. REP. 1 (2000), *available at* http://www.sec.gov/pdf/annrep00/ar00full.pdf; SEC ANN. REP. 1 (1999), *available at* http://www.sec.gov/pdf/annrep99/ar99full.pdf. Of the penalties imposed during those five years, over $1 billion was levied in fiscal year 2003 alone. SEC ANN. REP. 15 (2003).

13. *See* Press Release, Sen. Chuck Grassley, Grassley Wins Senate Approval of Corporate Crackdown Measure (May 15, 2003), http://grassley .senate.gov/index.cfm (search for "Corporate Crackdown"; then follow the resulting hyperlink) ("The con men pay a little tax to help hide their fraud, bump up the price and cash in their stock options.").

14. *See* Erickson, *supra* note 3.

15. *See* Rebecca Blumenstein et al., *After Inflating Their Income, Companies Want IRS Refunds*, WALL ST. J., May 2, 2003, at A1; Anitha Reddy &

Com,[16] for example, which created $11 billion in phony income through various accounting schemes,[17] reportedly already has collected nearly $300 million in tax refunds.[18] Qwest Communications International Inc., HealthSouth and Enron also reportedly considered or are considering filing refund claims for overpayments of income tax in similar circumstances.[19] Information on refund claims is difficult to obtain owing to the confidentiality of federal income tax returns,[20] but given the breadth of the earnings-inflation problem there are likely dozens of other corporations seeking refunds as a result of fraudulently overstated income.

Perhaps such claims are appropriate. After all, a corporation that inflates its taxable income clearly pays more federal income tax than it owes.[21] Importantly for the company, a refund of the tax paid also provides an infusion of cash that may be used to mitigate the damage to creditors or shareholders caused by the underlying accounting fraud.[22] Of course, if a tax refund *were* permitted in these circumstances, the tax rules should at least exact a hefty penalty in order to deter future

Christopher Stern, *Firms Want Refunds of Tax on Fake Profit*, WASH. POST, May 3, 2003, at E1.

16. In connection with its emergence from bankruptcy, WorldCom changed its brand name to MCI. Press Release, WorldCom, Inc., WorldCom Files Plan of Reorganization and Changes Brand Name to MCI (Apr. 14, 2003), http://global.mci.com/about/news/releases/2003/ (follow the corresponding hyperlink under "14 April, 2003").

17. Shawn Young, *MCI to State Fraud Was $11 Billion*, WALL ST. J., Mar. 12, 2004, at A3.

18. *See* Blumenstein et al., *supra* note 15. The $300 million reportedly collected by WorldCom is nearly as much as the total amount paid in federal tax refunds to all corporations in the State of Oregon in 2003. *See* INTERNAL REVENUE SERV., TREASURY DEP'T, PUBL'N NO. 55B, INTERNAL REVENUE SERVICE 2003 DATA BOOK 15 tbl.8, *available at* http://www.irs.ustreas.gov/pub/irs-soi/03db08rf.xls.

19. *See* Blumenstein et al., *supra* note 15. Enron reportedly paid no income tax in four of the five years from 1996 through 2000. *See* David Cay Johnston, *Enron Avoided Income Taxes in 4 of 5 Years*, N.Y. TIMES, Jan. 17, 2002, at A1; CITIZENS FOR TAX JUSTICE, LESS THAN ZERO: ENRON'S CORPORATE TAX PAYMENTS 1996–2000 1 (2002), http://www.ctj.org/pdf/enron.pdf.

20. The Internal Revenue Code prohibits officers and employees of the United States from disclosing any return or "return information." I.R.C. § 6103(a) (2000). Return information is defined as "any tax or information return . . . or *claim for refund*" (emphasis added). *Id.* § 6103(b).

21. HealthSouth spokesman Andy Brimmer noted, "Logically, if we overpaid taxes on income we didn't have, we may seek a refund." Blumenstein et al., *supra* note 15.

22. But see *infra* Part III.D.2 for a discussion of the "innocent investor."

use of the tax system to conceal accounting fraud. Unfortunately, the rules do no such thing. Because the relevant penalty provisions of the Internal Revenue Code apply to underpayments rather than overpayments of income tax, a corporation guilty of this kind of fraud might pay no more than a few thousand dollars in fines. One way to more adequately penalize the tax fraud committed in earnings-inflation cases would be to withhold the related tax refund.[23]

23. At this point it may be helpful to clarify a critical point regarding terminology. Can a taxpayer commit "tax fraud" by paying *too much* tax to the Treasury? As it turns out, the answer is that it is indeed possible, for several reasons. First, in simplest terms, fraud means deception. *See* Frowen v. Blank, 425 A.2d 412, 415 (Pa. 1981) ("A fraud consists in anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or silence, word of mouth, or look or gesture."); BLACK'S LAW DICTIONARY 660 (6th ed. 1990) (stating that fraud is synonymous with bad faith, dishonesty, infidelity, faithlessness, perfidy, and unfairness). Tax fraud is therefore deception with respect to one's tax liability. This is the sense in which the term is used in I.R.C. § 7206(1), which is under the title "Fraud and False Statements" and simply prohibits the willful filing of a false tax return. I.R.C. § 7206(1) (2000). No monetary loss to the government or underpayment of tax is necessary for a conviction under this statute. *See infra* note 94 and accompanying text.

Second, fraud commonly is understood to mean deception resulting in loss to another. *See* Gibbons v. Brandt, 170 F.2d 385, 391 (7th Cir. 1947) ("Fraud in its generic sense, especially as the word is used in courts of equity, comprises all acts, omissions, and concealments involving a breach of legal or equitable duty and *resulting in damage to another*.") (emphasis added); BLACK'S LAW DICTIONARY, *supra*, at 660 (defining fraud to also include perversion of truth causing one to "part with some valuable thing"). However, the loss involved need not be monetary. It may consist of the surrender of a legal right, the infliction of a legal injury or some form of detrimental reliance resulting in damage. *See* BLACK'S LAW DICTIONARY, *supra*, at 660. Thus, as will be shown, a violation of § 7206(1) is also fraud under this more limited definition of the term. See *infra* notes 106–21 and accompanying text for a discussion of the detriment to the U.S. government caused by a violation of § 7206(1).

Third, § 7206(1) and the crime most frequently associated with the notion of tax fraud—tax *evasion* under I.R.C. § 7201—were originally part of the same statute. I.R.C. § 7201 (2000). The Income Tax Law of 1913 stated that one "*who makes any false or fraudulent return* . . . with *intent to defeat or evade the assessment* required by this section . . . shall be guilty of a misdemeanor." Pub. L. No. 63-16, § II(F), 38 Stat. 114, 171 (1913) (emphasis added). This unitary provision was bifurcated in the War Revenue Act of 1917 (without any explanation in the legislative history), resulting in one provision proscribing the making of a false or fraudulent return (the predecessor to § 7206(1)) and the other proscribing the evasion or attempted evasion of tax (the predecessor to § 7201). *See* War Revenue Act, Pub. L. No. 65-50, § 1209, 40 Stat. 300, 336 (1917). Thus, it is reasonable to refer to the activity currently prohibited under § 7206(1) in its present form as "tax fraud" and to the activity prohibited under § 7201 as "tax evasion." For additional detail on the evo-

Recognizing that companies that inflate their taxable income make the IRS "an unwitting accomplice to . . . fraud,"[24] the Senate, in May 2003, approved a measure that would have increased the penalty for tax fraud to an amount equal to the overpayment of tax attributable to the fraud.[25] The effect of this provision would have been to disallow any refunds of taxes paid on fraudulently inflated income.[26] Unfortunately, the measure was dropped in the conference committee[27] and did not become part of the American Jobs Creation Act of 2004 ultimately signed by President George W. Bush in October 2004.[28] However, this Article suggests that the IRS may be able to achieve the results intended by the omitted Senate provision through

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lution of §§ 7201 and 7206(1), see Ronald H. Jensen, *Reflections on* United States v. Leona Helmsely*: Should "Impossibility" Be a Defense to Attempted Income Tax Evasion?*, 12 VA. TAX REV. 335, 346–48 (1993).

Finally, violations of § 7206(1) are described by the IRS as "Fraudulent Activities" and are investigated and prosecuted by the IRS Criminal Investigation Division's "General Tax Fraud Program." *See* Internal Revenue Service Criminal Investigation, General Tax Fraud Program, http://www.ustreas.gov/irs/ci/tax_fraud/docgeneraltaxfraud.htm (last visited Sept. 6, 2005).

24. Press Release, *supra* note 13.

25. S. 1637, 108th Cong. § 425 (2004); *see* Rob Wells, *Tax Plan Takes Shape: Lawmakers Move to Halt Refunds on False Earnings*, WALL ST. J., May 16, 2003, at A2.

26. The bill would have amended § 7206 to provide:

> If any portion of any underpayment (as defined in section 6664(a)) *or overpayment* (as defined in section 6401(a)) of tax required to be shown on a return is attributable to fraudulent action described in subsection (a), the applicable [penalty] under subsection (a) shall in no event be less than an amount equal to such portion.

S. 1637, 108th Cong. § 425 (as passed by Senate, May 11, 2004) (emphasis added). The provision subsequently was made an amendment to the Jumpstart Our Business Strength (JOBS) Act, H.R. 4520, 108th Cong. § 425 (engrossed amendment as agreed to by Senate, July 15, 2004). Had it been adopted, the efficacy of the provision as worded is somewhat doubtful because § 6401 does not define the term "overpayment." I.R.C. § 6401 (2000). It merely states that an overpayment includes amounts assessed or collected from the taxpayer after the expiration of the statute of limitations for such assessment or collection. *Id.*

27. Although the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, includes some provisions aimed at curbing corporate tax shelters and corporate tax avoidance in general, many more such provisions were dropped. *Compare* S. 1637, 108th Cong. § 425 (as reported in Senate, Nov. 7, 2003) *with* H.R. 4520, 108th Cong., §§ 811–822 (as passed by House, Oct. 7, 2004, and Senate, Oct. 11, 2004).

28. Pub. L. No. 108-357, 118 Stat. 1418. The measure resurfaced in a highway funding bill passed by the Senate on May 17, 2005, but was again dropped in final legislation. *Compare* H.R. 3, 109th Cong. § 5503 (as passed by Senate, May 17, 2005) *with* Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, Pub. L. No. 109-059 (2005).

the rules of equity.[29] Moreover, equity may well furnish a more sound approach to penalizing offenders in such cases than would a legislative enactment.[30]

Central to the thesis of this Article is the fact that tax-refund suits are in essence claims in equity, a proposition that has two important implications. First, the taxpayer filing a tax-refund suit is asking the court to impose a fair, just, and equitable "remedy"—namely, the refund of taxes paid in excess of what was due. As an equity claimant, the taxpayer is not in a position to demand that the refund be granted.[31] Second, the fact that refund suits are actions in equity means that claimants are subject to well-established equitable defenses like the doctrine of unclean hands.[32] Based on these twin propositions, this Article asserts that the IRS not only may, but should, assert equitable defenses to deny refunds of taxes paid on fraudulently inflated earnings.

Part I of the Article begins with an examination of how a company actually inflates its earnings based on the example of prominent offender WorldCom, and then addresses the relationship between accounting, or "book," income and tax income. This part of the Article also assesses the breadth of the earnings-inflation problem and analyzes the potential harm that inflation of taxable income may inflict on the federal tax system. Part II examines the current criminal and civil provisions of the Internal Revenue Code that govern tax fraud related to earnings inflation and discusses the elements of those offenses. The element of materiality is particularly critical because it

29. *See generally* Craig M. Boise, *Tax Fraud and Inflated Corporate Earnings: Is There an Alternative to the Legislative Fix?*, 106 TAX NOTES 191 (2005). Although the Senate legislation failed to receive the support of the full Congress, this does not suggest that the courts may not, or should not, attempt to achieve the results contemplated by that legislation within the sphere of their jurisdiction, particularly when doing so is consistent with what one scholar has termed the "theoretical construct that overarches the sum total of the entire Internal Revenue Code and is intended to be captured by it." Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 497 (1995).

30. *See infra* Part III.D.

31. *See* Kevin C. Kennedy, *Equitable Remedies and Principled Discretion: The Michigan Experience*, 74 U. DET. MERCY L. REV. 609, 614 (1997) ("[P]arties who have placed their case within the category of cases traditionally qualifying for equitable relief were not automatically entitled to it. Parties could not *demand* equitable relief; to the contrary, they always *requested* it.").

32. The doctrine of unclean hands derives from the general equitable admonition that "those who seek equity must themselves do equity." *See* G.W. KEETON, AN INTRODUCTION TO EQUITY 87–117 (6th ed. 1965).

addresses the question of whether *overstating* income for tax purposes (as opposed to *understating* it) causes any cognizable harm to the government that ought to be penalized. This portion of the Article concludes that the government *is* harmed by tax fraud, that the penalty provisions for the offense generally are not sufficiently robust, and that they are particularly inadequate in dealing with earnings inflation. It also describes the tax-refund process and the relative ease with which companies may obtain refunds, even where the excess taxes were paid to mask fraudulent earnings. Part II closes with the observation that a company is entitled to receive interest on overpayments of tax, which further rewards use of the tax system to disguise accounting fraud.

Part III of the Article explores the relationship between fraud-related refund claims and equity. To provide support for the application of equity as proposed in Part IV of the Article, Part III first reviews the history of equity and its relationship to tax-refund suits to establish that equity is an appropriate vehicle for evaluating tax-refund claims. It then discusses the various equitable defenses that apply in equity cases, how those defenses might be asserted by the IRS against a tax-refund claim like WorldCom's, and the related public policy implications of asserting such defenses. Finally, Part IV of the Article discusses how, as a matter of process, the IRS may use a recent change to a corporate income tax return schedule to identify fraud-related refund claims and how the congressional Joint Committee on Taxation might utilize its powers to review large refund claims.

I. THE PROBLEM OF EARNINGS INFLATION

A. FINANCIAL REPORTING

WorldCom is a stunning example of an apparently healthy company secretly manipulating its books to create nonexistent earnings and thus increase its stock price.[33] In August of 1998,

33. A trade group of CEOs convened a commission to analyze the corporate scandals of the past several years and the subsequent decline of public and investor trust in the capital markets. THE CONFERENCE BD. COMM'N ON PUB. TRUST AND PRIVATE ENTER., FINDINGS AND RECOMMENDATIONS 3 (2002), *available at* http://www.conference-board.org/pdf_free/SR-03-04.pdf. The commission concluded that attempts by corporate managers to manipulate company stock price were largely attributable to excessive use of stock options and other forms of equity-based incentive compensation. *Id.* at 5–6.

WorldCom appeared phenomenally successful. In that month, the company completed a $6.1 billion bond offering, the largest corporate bond issue in history.[34] The funds it raised helped to pay for its acquisition of MCI earlier that year.[35] Through a string of more than seventy acquisitions, capped by the MCI merger, a company that had begun as a humble reseller of long-distance telephone services for hotels in Mississippi[36] had grown to become the nation's second-largest long-distance provider with some twenty million residential customers and thousands of corporate accounts.[37] WorldCom's extensive global network facilities covered six continents and reached every major city in the world through more than 90,000 miles of land-based and undersea fiber-optic cable.[38] Virtually every major investor felt the need to have WorldCom in its portfolio and there was an expectation in some quarters that the company's mega-bond deal would lift the entire corporate bond market.[39]

But WorldCom's apparent success masked grave financial troubles that mounted in the next few years. The explosive growth that had driven the company's extraordinary earnings trajectory had come with a high price tag. By 2002, the company had accumulated over $40 billion in debt,[40] which it struggled to service as a general downturn in the telecommunications industry reduced revenue and produced a $2 trillion loss in the value of telecommunications stocks.[41] Moreover, poor management of companies that WorldCom acquired meant that

34. Gregory Zuckerman, *WorldCom Makes History with $6.1 Billion Sale of Eagerly Awaited, Strongly Demanded Bonds*, WALL ST. J., Aug. 7, 1998, at C15.

35. *Id.*

36. *See* First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner at 11–13, *In re* Worldcom, Inc., No. 02-15533 (Bankr. S.D.N.Y. Nov. 4, 2002), *available at* http://news.findlaw.com/hdocs/docs/worldcom/thornburgh1strpt.pdf [hereinafter WorldCom First Report].

37. *See* Shawn Young et al., *WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3.

38. Indictment at 2–3, United States v. Ebbers, Case No. S3 02 Cr. 1144 (BSJ) (S.D.N.Y. Mar. 2, 2004).

39. Zuckerman, *supra* note 34.

40. RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF 20 (2003), *available at* http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf.

41. *See* Simon Romero & Jonathan D. Glater, *Bankruptcy's Taut Wiring*, N.Y. TIMES, July 22, 2002, at A1.

anticipated efficiencies were not realized, and, as a result, the company's overhead costs soared.[42]

A large part of WorldCom's overhead consisted of costs associated with transmitting voice or data over communication lines. These costs are known in the telecommunications industry as "line costs." WorldCom accounted for its line costs by creating reserves on its books reflecting anticipated payments, and then releasing those reserves as bills were paid.[43] An individual might do much the same thing by making an entry in her check register for an electric bill that has not yet been paid, thus reducing her checkbook balance by the amount of the bill. Ultimately, the entry is reconciled when the check is written to the utility company.

As its financial difficulties increased, WorldCom began to boost its reported earnings by releasing its accrued line cost reserves before the line costs were paid, a move that violated generally accepted accounting principles (GAAP).[44] This practice would be similar to the individual deleting the checkbook entry for her electric bill. Although the account balance reflected in the check register increases, the expense is still owed and the register thus does not accurately reflect the individual's financial position. By April 2001, WorldCom had released all of its line cost reserves to shore up its earnings and a new strategy was needed to boost revenue.[45] It found such a strategy in altering the way it accounted for those same line costs.

Beginning in 2001, rather than continuing to treat line costs as an expense that reduced its ever-dwindling income, WorldCom began to capitalize those costs because the cost of

42. BREEDEN, *supra* note 40, at 20.

43. *See* WorldCom First Report, *supra* note 36, at 106–07.

44. DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION 2, 61–62 (2003), *available at* http://www.sec.gov/Archives/edgar/data/723527/000093176303001862/dex991.htm. Manipulation of reserves represents the most common approach to earnings management. *See* Mark W. Nelson et al., *How Are Earnings Managed? Examples from Auditors*, 17 ACCT. HORIZONS (SUPPLEMENT) 17, 22–23 (2003), (discussing an empirical study, which found that 38 percent of attempts by companies to manage earnings involved reserve transactions).

45. On a quarterly basis, WorldCom assessed the gap between actual and target revenue, and then closed the gap through the use of various accounting "opportunities" identified by the accounting groups. Third and Final Interim Report of Dick Thornburgh, Bankruptcy Court Examiner at 276, *In re* Worldcom, Inc., No. 02-15533 (AJG) (Bankr. S.D.N.Y. June 9, 2003), *available at* http://www.kl.com/files/tbl_s48News/PDFUpload307/10129/WorldCom_Report_final.pdf [hereinafter WorldCom Third Report].

capitalized items can be spread out over many years, thus reducing the immediate impact of the expense on income.[46] One commentator has likened this direct violation of GAAP to the manager of an ice cream parlor pretending that operating expenses for things such as cream, sugar and chocolate syrup really "are part of the purchase price of a new refrigerator."[47] Because capitalization made its line costs much lower, WorldCom's income increased by almost $4 billion in the next two years, insuring that the company would meet analysts' profit expectations and continue to experience surging share prices.[48] This artificial income, along with another $2 billion or so in false revenue entries and various improper accounting adjustments,[49] helped prop up WorldCom through July 2002, when the teetering edifice finally and spectacularly collapsed in bankruptcy.[50]

B. TAX REPORTING

When WorldCom inflated the book income it reported to shareholders in 1999 through the tactics just described, it created another problem—one that was tax-related. To illustrate, assume for a moment that WorldCom was guilty only of improperly capitalizing line costs in 2001 (i.e., treating the ice cream expenses as the cost of a refrigerator). By capitalizing line costs rather than deducting them from income, WorldCom reduced its expenses for 2001 by roughly $2.1 billion and thus increased its income for that year by the same amount.[51] Assuming for purposes of illustration that WorldCom had no other earnings, the company could then have reported $2.1 billion of book income for 2001. If the company's reported income

46. *Id.* at 278.

47. PAUL KRUGMAN, THE GREAT UNRAVELING 114 (2003).

48. *See* WorldCom First Report, *supra* note 36, at 109 (describing the manner in which WorldCom overstated its pre-tax income).

49. WorldCom was perpetrating accounting fraud in a number of ways other than the methods described in this Article. *See id.* at 110–17.

50. When its fraud became public, WorldCom's creditors declared the company in default on various loan commitments. *See* Jared Sandberg et al., *WorldCom to File Chapter 11, as Cash Reserves Dwindle Fast*, WALL ST. J., July 19, 2002, at A1. As its sources of funding dried up, WorldCom ran out of cash and was forced to file for bankruptcy protection. *Id.* As a result of WorldCom's bankruptcy, over $200 billion in shareholder value was destroyed and tens of thousands of WorldCom employees lost their jobs. See BREEDEN, *supra* note 40, at 12 & n.1.

51. WorldCom Third Report, *supra* note 45, at 352–53.

met or exceeded analysts' expectations, the company likely would see a boost in its stock price, thus accomplishing one of management's principal goals. The difficult question, however, was how the company should treat that $2.1 billion of phony book income for federal income tax purposes.

WorldCom had at least two choices. First, the company simply could have omitted the phantom income from its 2001 tax return. Had it done so, WorldCom's taxable income would have been $0 and the company would have paid no federal income tax.[52] However, this would have created a $2.1 billion gap between WorldCom's reported book income ($2.1 billion) on the one hand, and its taxable income ($0), on the other.[53] WorldCom would have had to reconcile this book-tax difference on Schedule M-1 of its federal income tax return.[54] Given the size of the gap, the IRS might well have been alerted to WorldCom's accounting fraud.[55] Further, to analysts who closely followed the company, such a sizeable book-tax difference might have suggested that WorldCom either was "managing" its earnings[56]

52. Under GAAP, WorldCom would have been required to record an additional deferred tax expense equal to the tax on $2.1 billion to account for the expectation that income taxes ultimately would be paid on the reported book income. Assuming a hypothetical effective tax rate of 20 percent, this would have produced a deferred tax expense of $420 million. Some studies have indicated that there is a negative association between deferred taxes (represented by the book-tax gap) and a company's share returns. *See, e.g.*, Paul K. Chaney & Debra Jeter, *The Effect of Deferred Taxes on Security Prices*, 9 J. ACCT. AUDITING & FIN. 91, 114 (1994); Lillian F. Mills & Kaye J. Newberry, *The Influence of Tax and Non-Tax Costs on Book-Tax Reporting Differences: Public and Private Firms*, 23 J. AM. TAX'N ASS'N 1, 1 (2001).

53. In reality, failing to report the artificial income would have increased, rather than created, a book-tax difference since WorldCom, like most companies, already would have had a book-tax difference. This difference occurs because income is calculated differently for financial accounting purposes than for federal income tax purposes. *See generally* George A. Plesko, *Corporate Tax Avoidance and the Properties of Corporate Earnings*, 57 NAT'L TAX J. 729 (2004) (describing the differences between the rules used to compute income for financial and tax-reporting purposes).

54. In a variation on this approach, WorldCom could have shifted the artificial income to an offshore subsidiary in a low-tax jurisdiction, thus making the book-tax difference permanent and avoiding the recognition of the deferred tax liability described *supra*, note 52. *See* ACCOUNTING FOR INCOME TAXES—SPECIAL AREAS, Opinion No. 23 (Accounting Principles Bd. 1972).

55. There is evidence that sizeable book-tax differences may attract IRS scrutiny. *See* Lillian F. Mills, *Book-Tax Differences and Internal Revenue Service Adjustments*, 36 J. ACCT. RES. 343, 345 (1998).

56. Management of earnings occurs "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance

or had low earnings quality.[57] Intensified IRS scrutiny or a market perception of earnings irregularities would have been equally disastrous to a company that was concealing billions of dollars of artificial income in the midst of an industry downturn, and these considerations may have resulted in WorldCom's decision to report the phantom income.

Alternatively, WorldCom could have elected to report the $2.1 billion of phantom book earnings as taxable income on its income tax return. Because the fictitious book income ($2.1 billion) would match taxable income ($2.1 billion), this approach would produce no book-tax difference to be reconciled on Schedule M-1, thus greatly reducing the likelihood that WorldCom's earnings inflation would be discovered.[58] Of course, the drawback would be the cash outlay necessary to pay taxes on the income.[59] Again, assuming WorldCom had no other earnings and was subject to a hypothetical effective tax rate of five percent, the company would incur a tax liability of $105 million on the phantom income.[60]

of the company or to influence contractual outcomes that depend on reported accounting numbers." Paul M. Healy & James M. Wahlen, *A Review of the Earnings Management Literature and Its Implications for Standard Setting*, 13 ACCT. HORIZONS 365, 368 (1999).

57. "Earnings quality" refers to the level of sustainability of a company's earnings. *See* Scott A. Richardson, *Earnings Quality and Short Sellers*, 17 ACCT. HORIZONS (SUPPLEMENT) 49, 49 (2003). Low-quality earnings could result from overvaluation of receivables, aggressive manipulation of reserves, or inappropriate valuation of inventory, and are characterized by an increase in current earnings without any corresponding increase in cash flows. *Id*.

58. WorldCom actually had a third alternative. It could have reported its inflated earnings as additional gross income and then fabricated corresponding deductions to reduce or eliminate its taxable income. The result would have been earnings inflation with no tax cost. However, creating $300 million worth of phony deductions would have exposed the company to significant audit risk.

59. Responding to reports that Enron paid no federal income tax from 1996 through 2000, one scholar has noted that despite the inflated earnings on its income statement, the company did not have any *real* income on which to pay tax. *See* Victor Fleischer, *Enron's Dirty Little Secret: Waiting for the Other Shoe to Drop*, 94 TAX NOTES 1045, 1045 (2002). The lack of real income, however, was no impediment to paying income tax in other cases, such as that of WorldCom.

60. Although the largest corporations pay tax at a maximum marginal rate of 35 percent, in 2000, an estimated 94 percent of U.S. corporations filing tax returns reported paying taxes of less than 5 percent of their income. *See* U.S. GEN. ACCOUNTING OFFICE, *supra* note 1, at 2. WorldCom probably could have utilized net operating loss ("NOL") carryforwards or carrybacks to offset at least some of the phantom taxable income and thus further reduce its tax liability. In such circumstances, WorldCom would not be entitled to a refund,

Of these two alternatives, WorldCom evidently chose the latter, electing to report some or all of the fraudulent book income it created on its federal income tax returns and pay the resulting income tax.[61] WorldCom's situation illustrates the impact that earnings inflation in a company's financial accounts has on its tax accounting. A company that inflates earnings must either falsify its federal income tax return and pay tax on phantom income or face a significant risk that its earnings fraud will be detected. Thus, for many companies that inflate book income, tax fraud becomes a necessary component of the accounting fraud.

C. THE SCOPE OF THE PROBLEM

Unfortunately, WorldCom is not alone in engaging in fraudulent earnings inflation.[62] The problem is significant and has grown in recent years, creating a corresponding threat to the integrity of corporate income tax reporting in the eyes of the public and other corporations alike. A 1999 study released by the Committee of Sponsoring Organizations of the Treadway

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but might seek to reinstate the NOLs. Any attempt to reinstate NOLs should, like refund claims, be subject to the equitable defenses discussed in this Article.

61. According to a recent study of firms that overstated accounting income and paid additional taxes as a result, the median firm was willing to pay an additional eight cents in income tax for each dollar of inflated pre-tax earnings. *See* Merle Erickson et al., *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 387 (2004).

62. Other companies that have restated previously inflated earnings include: Bristol-Myers Squibb ($2.5 billion from 1999 to 2002), Computer Associates ($1 billion), Enron ($1.2 billion in 2000), HealthSouth ($2.5 billion since 1986), Qwest Communications International ($144 million in 2000 and 2001), Rite Aid Corporation ($1.6 billion), and Xerox ($6.4 billion from 1997 to 2001). *See* Toedtman, *supra* note 10. AOL Time Warner also overstated its earnings by $500 million from 2000 through 2002. *See* Julia Angwin, *SEC Fines Time Warner $300 Million*, WALL ST. J., Mar. 22, 2005, at A3. Earnings manipulation has not been limited to U.S. corporations. Dutch food retailer, Ahold NV, has acknowledged that it exaggerated earnings by $1.08 billion from 2000 to 2002 (although Ahold's U.S. subsidiary, U.S. Foodservice, accounted for $856 million of the overstatement). *Ahold's Estimate of Restatement Is Raised Again*, WALL ST. J., July 2, 2003, at B7; Deborah Ball, *Ahold Chairman Plans to Resign Amid Overhaul*, WALL ST. J., Sept. 18, 2003, at B4. Likewise, in Italy, international dairy giant Parmalat SpA, reportedly inflated its earnings by more than $1 billion and attempted to hide more than $8 billion in debt. Alessandra Galloni et al., *Scope of Scandal at Parmalat Widens to More Than $8 Billion*, WALL ST. J., Dec. 24, 2003, at A1.

Commission (COSO)[63] assessed the extent of corporate financial statement fraud for the eleven-year period from 1987 through 1997.[64] The commissioned study examined hundreds of Accounting and Auditing Enforcement Releases (AAERs) issued by the Securities and Exchange Commission (SEC), in order to identify specific instances of financial statement fraud.[65] Only those AAERs that reflected a violation of the SEC rules most directly related to financial fraud were included in the study's sample.[66] The study found that from 1987 through 1997, nearly 300 companies were involved in financial statement fraud.[67] Of the 200 companies randomly selected from this group for closer examination, all were publicly traded, but they tended to be relatively small (less than $100 million in total assets).[68] Only 22 percent of the companies were listed on the New York or American Stock Exchanges.[69]

The number of companies inflating earnings rose dramatically after 1997, according to a 2002 General Accounting Office (GAO) study.[70] To identify earnings inflation, the GAO Study examined financial statement restatements announced by publicly traded companies during the period from 1997 through June, 2002. The study was limited to restatements arising from "accounting irregularities," or situations in which a company initially had not fairly presented its financial statements in ac-

63. COSO is a private sector initiative, jointly sponsored and funded by the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, the Institute of Management Accountants, and the Institute of Internal Auditors. COSO Home Page, http://www.coso.org (last visited Sept. 6, 2005).

64. MARK S. BEASLEY ET AL., COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, FRAUDULENT FINANCIAL REPORTING 1987–1997: AN ANALYSIS OF U.S. PUBLIC COMPANIES 4 (1999), *available at* http://www.coso.org/publications/FFR_1987_1997.pdf.

65. BEASLEY ET AL., *supra* note 64, at 4. An AAER contains a summary of enforcement action taken against a public company by the SEC. *Id.*

66. Specifically, the study focused on violations of Rule 10(b)-5, 17 C.F.R. § 240.10b-5 (2005) (promulgated by the SEC under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (2000)), and section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q (2000). BEASLEY ET AL., *supra* note 64, at 4.

67. BEASLEY ET AL., *supra* note 64, at 4.

68. *Id.* at 5.

69. *Id.*

70. U.S. GEN. ACCOUNTING OFFICE, REPORT NO. GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS 4 (2002), *available at* http://www.gao.gov/new.items/d03138.pdf.

cordance with GAAP.[71] The growth in the number of earnings restatements during the period studied was remarkable. Whereas the COSO Study found 300 incidents of financial statement fraud in the eleven-year period it covered, the GAO Study found that 225 companies restated earnings because of accounting irregularities in 2001 alone, with 250 more company restatements projected for 2002.[72] Between 1997 and June, 2002, the number of companies restating earnings grew by 145 percent, with that growth expected to increase to 170 percent by the end of 2002.[73] In other words, during the five-year period studied, roughly 10 percent of all listed companies announced a restatement of earnings arising from accounting irregularities, most of which involved the sort of fraud committed by WorldCom.[74]

As the incidence of earnings restatements increased, the profile of companies restating earnings also shifted. According to the GAO Study, large company restatements rose significantly after 1997.[75] The median market capitalization of a restating company rose from $500 million in 1997 to over $2 billion in 2002. Moreover, of the 125 public companies that restated earnings because of accounting irregularities in 2002, 107 (over 85 percent) were listed on either the New York Stock Exchange or NASDAQ—markets that are home to the largest corporations.[76]

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71. *Id.* at 2. Over half of the accounting irregularities resulted from improper "revenue recognition" or "cost or expense related issues." *Id.* at 20–21. Creating fictitious income would fall within the former category, while WorldCom's improper capitalization of line costs would fall within the latter category. *Id.* at 19–20.

72. As of this writing, the GAO has not updated its study for periods after June, 2002. A more recent study by the Huron Consulting Group indicates that between the years 2000 and 2004 overall financial statement restatements nearly doubled, increasing from 233 to 414. HURON CONSULTING GROUP, 2004 ANNUAL REVIEW OF FINANCIAL REPORTING MATTERS 4 (2005), *available at* http://www.huronconsultinggroup.com/uploadedFiles/Huron_2004_Review%20of%20Financial%20Reporting%20Matters.pdf.

73. *See* U.S. GEN. ACCOUNTING OFFICE, *supra* note 70, at 4.

74. *Id.*

75. For purposes of the study, a "large" company was one with a market capitalization of over $10 billion. *Id.* at 4 n.6. The study obtained similar results where a large company was defined as one having over $1 billion in assets. *Id.*

76. *See* National Association of Securities Dealers Automated Quotations (NASDAQ), NASDAQ National Market Securities, http://www.nasdaq.com/asp/symbols.asp?exchange=NNM (last visited Sept. 12, 2005); New York Stock Exchange, Listed Company Directory, http://www.nyse.com/about/listed/

In short, the COSO study and the GAO Study compellingly suggest that for at least the last eighteen years we have been in a period of significant corporate earnings restatements that have accelerated dramatically since 1997. In a large number of cases, those restatements correct for earnings inflated through fraudulent accounting activity by a group of companies that includes a rapidly growing percentage of large, publicly traded corporations. Although it is possible that corrective steps taken by the SEC and Congress to reduce fraudulent financial reporting[77] may begin to reduce the incidence of earnings inflation, none of the available data suggest that this has occurred, and anecdotal evidence indicates that earnings inflation remains a problem.[78] Moreover, the COSO study makes it clear that although the number of cases has ballooned in the last few years, earnings inflation has been a persistent part of the corporate

listed.html (last visited Sept. 12, 2005).

77. *See supra* note 12.

78. Corporate earnings restatements reached a record high in 2004. *See* Diya Gullapalli, *To Err Is Human, To Restate Financials, Divine*, WALL ST. J., Jan. 20, 2005, at C3 (noting the Huron Study reported a 28 percent increase in error-driven restatements to set the record in 2004). Unlike the COSO and GAO Studies, the Huron Study did not differentiate between restatements that were attributable to fraud and those that were not. *See* HURON CONSULTING GROUP, *supra* note 72, at 3. However, it is not unreasonable to expect that, at the very least, a relatively constant percentage of all restatements will involve the type of illegal activity identified in the COSO and GAO Studies. Thus, one could reasonably conclude that, given the large number of overall restatements, those involving irregularities of the sort identified in the COSO Study and the GAO Study also increased. Companies that recently admitted inflating their earnings under circumstances that indicate fraudulent activity include Fannie Mae, the giant mortgage-finance company, which was found to have overstated its earnings by some $9 billion during a period beginning in 2001 and continuing through mid-2004, *see* James R. Hagerty et al., *Fannie Is Directed to Restate Results After SEC Review*, WALL ST. J., Dec. 16, 2004, at A1; Krispy Kreme Doughnuts, Inc., which overstated its net income by as much as 8 percent for fiscal year 2004, *see* Mark Maremont & Rick Brooks, *Fresh Woes Batter Krispy Kreme*, WALL ST. J., Jan. 5, 2005, at A3; and Nortel Networks Corporation, which overstated its 2003 net income by almost $300 million, *see* Mark Heinzl & Ken Brown, *Nortel Unveils New Accounting Flubs*, WALL ST. J., Jan. 12, 2005, at A3. Additionally, several restaurant operators, including Applebee's International Inc., CKE Restaurants, Inc. (owner of the Hardee's and Carl's Jr. chains), Brinker International (operator of Chili's), and Darden Restaurants (operator of Red Lobster, Olive Garden and other chains), improperly understated lease expenses and thus inflated reported earnings. *See* Steven D. Jones & Richard Gibson, *Restaurants Serve Up Restatements: More Scrutiny of Leases Is Leading Some Chains to Trim Their Past Profits*, WALL ST. J., Jan. 26, 2005, at C3.

financial reporting picture for over a decade and a half. Thus, it is likely that the concomitant tax fraud will persist for some time as well.

II. TAX FRAUD: PENALTIES AND REFUNDS

For companies that engage in earnings inflation, falsify their tax returns to conceal the earnings inflation, and then get caught, there are consequences. The SEC imposes some measure of punishment for companies' violation of securities law.[79] The IRS may also impose penalties for a company's violation of the tax law. This part of the Article discusses the severity of the penalties attached to tax fraud and then describes how readily a corporation may retrieve the taxes it paid based on a fraudulent tax return, receiving interest on the refund to boot.

A. TAX FRAUD DEFINED

The Internal Revenue Code contains a host of penalty provisions designed to reinforce government claims to revenues owed by U.S. taxpayers. These provisions fall into two general categories: civil penalties and criminal penalties.[80] Both a civil penalty and a criminal penalty potentially are applicable to the filing of a fraudulent tax return by a taxpayer in a situation like WorldCom's. However, as discussed below, in the circumstance of an overpayment of tax, the civil tax fraud offense carries no penalty.[81] The criminal offense of signing a fraudulent or false income tax return, on the other hand, *is* subject to a positive penalty where a tax overpayment is involved.[82] Unfortunately, that penalty is extremely small in both real and relative terms and thus will not likely deter nor adequately punish the corporate malfeasance involved.[83] Moreover, congressional attention to tax penalties, in general, has inexplicably failed to

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79. *See supra* note 12.

80. A critical difference between civil and criminal penalties in this context is that civil penalties may be collected through assessment procedures, whereas criminal penalties are imposed only after a criminal conviction. *See* Jasper v. Hellmich, 4 F.2d 852, 855–56 (E.D. Mo. 1925) (holding that where "penalties" as opposed to "taxes" are involved, the Constitution's due process guarantees may not be disregarded by permitting assessment without a jury trial). Tax assessment procedures are described generally in §§ 6203, 6204. I.R.C. §§ 6203–6204 (2000).

81. I.R.C. § 6663 (2000).

82. *Id.* § 7206(1).

83. *See infra* Part III.D.3 (discussing penalty optimality).

focus on the criminal sanction.[84] This section discusses the civil and criminal fraud penalty provisions, as well as the interest-on-overpayment provision.

1. Civil Tax Fraud

The civil tax fraud statue imposes a substantial penalty that is added to the tax owed by the taxpayer where fraud is involved.[85] However, the penalty is calculated under the statute as 75 percent of the amount by which the taxpayer fraudulently *underpaid* its tax.[86] Thus, in a case like WorldCom's, where an overpayment rather than an underpayment of tax is involved, application of the civil fraud penalty produces no fine. Accordingly, although the Code purports to impose a civil penalty for fraud, that penalty, in effect, merely serves as a reinforcement of the statutory prohibition on tax evasion.[87] Thus, only the

84. In 1998, Congress directed the Secretary of the Treasury and the congressional Joint Committee on Taxation to review the administration and implementation by the IRS of the penalty provisions of the Internal Revenue Code and make recommendations to simplify penalty administration. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3801, 112 Stat. 685, 782. In sweeping studies released in July 1999 (the Joint Committee study ran to more than 600 pages in two volumes; the Treasury study was a terse 188 pages), neither the Treasury nor the Joint Committee made reference to either of I.R.C. §§ 7206 or 7207. *See* STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) (Comm. Print 1999), *available at* http://www.access.gpo.gov/congress/joint/hjoint01cp106.html (follow hyperlinks corresponding to JCS-3-99); TREASURY DEP'T, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND PROPOSALS (1999), *available at* http://www.ustreas.gov/offices/tax-policy/library/ctswhite.pdf. Although the Joint Committee noted that its study was confined to "civil penalties," it is not clear why, since the congressional mandate was not limited to civil penalties. Internal Revenue Service Restructuring and Reform Act of 1998 § 3801; STAFF OF JOINT COMM. ON TAXATION, *supra*, at 13. Moreover, the Joint Committee *did* discuss the I.R.C. § 7203 criminal penalty for willful failure to pay estimated tax and otherwise took a broad approach to its task. I.R.C. § 7203; STAFF OF JOINT COMM. ON TAXATION, *supra*, at 13–14, 112. For example, the Committee discussed whether or not to include the "marriage penalty" and provisions that deny deductions for failure to properly substantiate expenses. STAFF OF JOINT COMM. ON TAXATION, *supra*, at 13–14, 112.

85. I.R.C. § 6663.

86. *Id.* ("If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.").

87. *Id.* § 7201.

criminal fraud penalty discussed in the following section applies to a corporation that inflates its taxable income in order to disguise the inflation of its accounting income.

2. Criminal Tax Fraud

When a corporation like WorldCom files a federal income tax return reflecting fraudulently inflated income, the corporation becomes subject to the felony "fraud and false statement" provisions of § 7206(1).[88] That section applies to any person who "[w]illfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter."[89] Thus, for a corporation to be convicted under the "fraud and false statement" provision there must be (1) an officer who willfully signs the corporation's tax return; (2) the execution of that signature under penalty of perjury; and (3) the officer's knowledge that the return is false and inaccurate.[90]

88. *Id.* § 7206(1). Technically, two additional criminal provisions might apply. First, the general federal fraud statute, which is similar to § 7206(1), would apply to a taxpayer that knowingly and willfully "(1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact; (2) makes any materially false, fictitious, or fraudulent statement or representation; or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry." 18 U.S.C.A. § 1001 (West 2005). The IRS Criminal Investigation Division has jurisdiction to investigate violations of the fraud statue. 26 C.F.R. § 601.107(a) (2005); Internal Revenue Service, United States Code Statutes for Which Criminal Investigation Has Jurisdiction, http://www.irs.gov/compliance/enforcement/article/0,,id=108861,00.html (last visited Sept. 12, 2005) (listing sections of the United States Code over which the Criminal Investigation Division has jurisdiction). Because 18 U.S.C.A. § 1001 generally is co-extensive with I.R.C. § 7206(1), it is not discussed separately here.

Second, a corporation might also be subject to the misdemeanor "willful delivery or disclosure of false documents" provisions of § 7207. I.R.C. § 7207 (Supp. 2002). That section applies to "[a]ny person who willfully delivers or discloses to the Secretary any list, return, account, statement, or other document, known by him to be fraudulent or to be false as to any material matter." *Id.* To be convicted under this provision there must be, with respect to the corporation, (1) a willful act of delivery or disclosure; and (2) knowledge that the document delivered is false and inaccurate. For purposes of § 7207, "willfulness" and "knowledge" are defined in the same manner, described below, as they are for purposes of § 7206(1). *See infra* notes 91–93 and accompanying text.

89. I.R.C. § 7206(1).

90. Each of these acts, if committed by agents or employees of a corporation acting within the scope of their employment, is considered to have been committed by the corporation under general agency principles. *See* N.Y. Cent.

The "willfulness" required in the first element refers to a voluntary, intentional violation of a known legal duty.[91] As to the execution of the signature under perjury, a corporate officer always signs the corporation's tax return under penalty of perjury.[92] Finally, a corporate defendant satisfies the "knowledge"

& Hudson R.R. Co. v. United States, 212 U.S. 481, 495 (1909) ("We see no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has intrusted authority to act . . . ."). This includes acts related to the filing of corporate tax returns. United States v. Shortt Accountancy Corp., 785 F.2d 1448, 1454 (9th Cir. 1986) ("A corporation will be held liable under 26 U.S.C.S. § 7206(1) when its agent deliberately causes it to make and subscribe to a false income tax return."); Inner-City Temps., Inc. v. Comm'r, 60 T.C.M. (CCH) 726, 733 (1990) (noting that for a corporation, requisite fraudulent intent must be found in the acts of its officers and shareholders). For the corporation to be liable, the employee first must have intended that his act would have produced some benefit to the corporation, or some benefit both to himself and the corporation. United States v. Gold, 743 F.2d 800, 823 (11th Cir. 1984). The reason for requiring that an agent acted with intent to benefit the corporation is to prevent the corporation from being criminally liable for actions of its agents that are contrary to the company's interests or solely for the agent's benefit. United States v. Automated Med. Labs., Inc., 770 F.2d 399, 407 (4th Cir. 1985). A corporation is not relieved of criminal liability, however, merely because the employee may have derived some personal benefit from his actions. United States v. Ruidoso Racing Ass'n, Inc. v. Comm'r, 476 F.2d 502, 505–06 (10th Cir. 1973); Crescent Mfg. Co. v. Comm'r, 7 T.C.M. (CCH) 630, 631–32 (1948). Moreover, a corporation generally may not avoid criminal liability by simply asserting that an agent violated a corporate policy of adhering to the law. United States v. Hilton Hotel Corp., 467 F.2d 1000, 1004 (9th Cir. 1972) ("[Corporate] liability may attach without proof that the conduct was within the agent's actual authority, and even though it may have been contrary to express instructions."); Cont'l Baking Co. v. United States, 281 F.2d 137, 150 (6th Cir. 1960) ("A corporation which employs an agent in a responsible position cannot say that the man was only 'authorized' to act legally and the corporation will not answer for his violations of law which inure to the corporation's benefit.").

91. United States v. Bishop, 412 U.S. 346, 360 (1973).

92. I.R.C. § 6065 (2000). A corporation's tax return must be signed by its president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer authorized to sign. *Id.* § 6062; INTERNAL REVENUE SERV., TREASURY DEP'T, CAT. NO. 1145ST, INSTRUCTIONS FOR FORMS 1120 AND 1120-A 3 (2004), *available at* http://www.irs.gov/pub/irs-pdf/i1120_a.pdf. The corporate tax return includes the following statement immediately above the officer's signature line: "Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete." INTERNAL REVENUE SERV., TREASURY DEP'T, FORM 1120, U.S. CORPORATION INCOME TAX RETURN (OMB NO. 1545-0123) 1 (2004), *available at* http://www.irs.gov/pub/irs-pdf/f1120.pdf.

element of the offense if corporation's employees collectively possess the requisite knowledge.[93]

B. MATERIALITY AND HARM

It is important to note that a tax deficiency is *not* a requisite element of § 7206(1).[94] That is, the filing of a fraudulent return subjects the taxpayer to the tax fraud penalty regardless of whether the fraud results in an underpayment of tax. Taxpayers have attempted to read a tax deficiency element into the statute by focusing on the requirement that a return be true and correct "as to every material matter."[95] A false statement on a return cannot be "material," so the argument goes, if it does not result in a loss of tax revenue to the government. The courts' responses to this issue inform one normative question raised by this Article's proposal to use equity to significantly increase the penalty for tax fraud—namely, whether a substantial penalty, or any penalty at all, should be attached to an offense that results in an *overpayment* of tax.

Courts have long held that, for purposes of § 7206(1), a false statement is material if it is necessary to compute the tax involved,[96] or "has 'the potential for hindering the IRS's efforts to monitor and verify the tax liability' of the corporation and

93. The First Circuit has described it this way: "Corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. The aggregate of those components constitutes the corporation's knowledge of a particular operation." United States v. Bank of New England, N.A., 821 F.2d 844, 856 (1st Cir. 1987); *see also Shortt Accountancy Corp.*, 785 F.2d at 1454. Were it otherwise, a corporation could avoid liability by simply asserting that no single employee comprehended the full import of information that was obtained by several employees. *Bank of New England*, 821 F.2d at 856.

94. I.R.C. § 7206(1) (2000); *e.g.*, United States v. Marashi, 913 F.2d 724, 736 (9th Cir. 1990); United States v. Marabelles, 724 F.2d 1374, 1380 (9th Cir. 1984); United States v. Brooksby, 668 F.2d 1102, 1104 (9th Cir. 1982); United States v. Jacobson, 547 F.2d 21, 24 (2d Cir. 1976); United States v. Miller, 491 F.2d 638, 646 (5th Cir. 1974). A tax deficiency is also not an element of the misdemeanor "willful delivery or disclosure of false documents" provisions of I.R.C. § 7207. I.R.C. § 7207 (Supp. 2002); Sansone v. United States, 380 U.S. 343, 352 (1965).

95. § 7206(1); *see also Sansone*, 380 U.S. at 352 (construing § 7207); *Marabelles*, 724 F.2d at 1380 (construing § 7206(1)); United States v. Coppola, 425 F.2d 660, 661 (2d Cir. 1969) (construing § 7207).

96. United States v. Warden, 545 F.2d 32, 37 (7th Cir. 1976) (holding that omitted items may be material where reporting is necessary "for the taxpayer to estimate and compute his tax correctly"); United States v. Rayor, 204 F. Supp. 486, 490 (S.D. Cal. 1962) (to same effect).

the taxpayer."[97] The cases establishing this materiality standard present three distinct factual situations: those in which the taxpayer's fraudulent return results in an *underpayment* of taxes, those in which the return results in *no change* in the taxes paid, and those resulting in an *overpayment* of taxes. As one intuitively would expect, courts uniformly have found materiality in the first situation. That is, if a taxpayer has underreported taxable income and, as a result, underpaid her income tax, courts virtually always find the tax return to be false with respect to a "material" matter.[98] However, the courts have reached exactly the same conclusion in the second situation, as well. For example, in *United States v. Marashi*, the Ninth Circuit rejected the taxpayer's claim that his return was not fraudulent because available deductions would have left him with no tax deficiency.[99] The court held that falsifying gross re-

97. United States v. Peters, 153 F.3d 445, 461 (7th Cir. 1998) (quoting United States v. Greenberg, 735 F.2d 29, 32 (2d Cir. 1984)); *accord Greenberg,* 735 F.2d at 31 ("The purpose of § 7206(1) is not simply to ensure that the taxpayer pay the proper amount of taxes—though that is surely one of its goals. Rather, that section is intended to ensure also that the taxpayer not make misstatements that could hinder the Internal Revenue Service . . . in carrying out such functions as the verification of the accuracy of that return or a related tax return."); United States v. Taylor, 574 F.2d 232, 235 (5th Cir. 1978); United States v. Goldman*,* 439 F. Supp. 337, 344 (S.D.N.Y. 1977) ("[A] statement is material if it is capable of influencing actions of the IRS in any matter within its jurisdiction."); United States v. DiVarco, 343 F. Supp. 101, 103 (N.D. Ill. 1972) ("[W]ithout truthful representation as to all matters it becomes administratively more difficult, if not impossible, for the Internal Revenue Service (IRS) to compute the amount of tax due or to check on the accuracy of returns."), *aff'd*, 484 F.2d 670 (7th Cir. 1973). Under this standard, even a failure to properly characterize the *source* of income may be material for these purposes. *DiVarco*, 484 F.2d at 673 ("The plain language of the statute does not exclude the matter of the source of income from the definition of 'material matter.' In light of the need for accurate information concerning the source of income so that the Internal Revenue Service can police and verify the reporting of individuals and corporations, a misstatement as to the source of income is a material matter."); United States v. Sun Myung Moon, 532 F. Supp. 1360, 1366 (S.D.N.Y. 1982) (to same effect).

98. *See, e.g.*, United States v. Bishop, 412 U.S. 346, 350 (1973); *Sansone*, 380 U.S. at 352; United States v. Bove, 155 F.3d 44, 49 (2d Cir. 1998); United States v. Holland, 880 F.2d 1091, 1096 (9th Cir. 1989); *Marabelles*, 724 F.2d at 1380; United States v. Fern, 696 F.2d 1269, 1274–75 (11th Cir. 1983); *Brooksby*, 668 F.2d at 1103; United States v. Paepke, 550 F.2d 385, 391–92 (7th Cir. 1977); *Warden*, 545 F.2d at 37; *Coppola*, 425 F.2d at 662 (construing § 7207).

99. 913 F.2d 724, 736 (9th Cir. 1990).

ceipts was a material violation of the statute irrespective of the fact that the deception did not increase the taxpayer's tax liability.[100]

The most compelling case for finding a lack of materiality is in the third situation, where the taxpayer's false return results in too much tax being paid. As government tax revenues actually are augmented (at least temporarily), one might expect courts to find that any false statement on the return would be immaterial. Nonetheless, even in this circumstance, the imposition of tax fraud liability has been sustained. In *United States v. Goldman*, for example, the taxpayer sought to dismiss a charge of fraud under § 7206(1) on the ground that any misstatements contained in his tax returns were immaterial because they resulted in an overpayment of taxes.[101] The court declined to dismiss the charge and held that a false statement could be material even if the result was that the taxpayer paid too much tax.[102] In short, a false statement regarding a matter necessary to correctly compute one's tax liability or that hinders the IRS's determination of tax liability is material, regardless of its ultimate effect on tax liability.[103]

100. *Id.*; *see also* United States v. Minneman, 143 F.3d 274, 279 (7th Cir. 1998); *Greenberg*, 735 F.2d at 31–32; *Taylor*, 574 F.2d at 235; United States v. Tsanas, 572 F.2d 340, 343 (2d Cir. 1978); *Rayor*, 204 F. Supp. at 490.

101. I.R.C. § 7206(1) (2000); 439 F. Supp. 337, 344 (S.D.N.Y. 1977).

102. *Goldman*, 439 F. Supp. at 344; *accord* United States v. Fawaz, 881 F.2d 259, 263 (6th Cir. 1989) (holding that an understatement of expenses on income tax return was a material matter); United States v. Lamberti, 847 F.2d 1531, 1536 (11th Cir. 1988) (upholding taxpayer's conviction under § 7206(1) for filing returns that overstated income); United States v. Bouzanis, No. 00 CR 1065, 2003 U.S. Dist. LEXIS 3289, at *4 (N.D. Ill. Mar. 6, 2003) (rejecting argument that taxpayer's overstatement of income, although false, was not fraudulent because it was not material); United States v. Lee, 667 F. Supp. 1404, 1419 (D. Colo. 1987) (noting that overstatement of income to conceal payments made to others is a violation of § 7206(1)), *rev'd sub nom.* United States v. Gaudreau, 860 F.2d 357 (10th Cir. 1988); United States v. Potstada, 206 F. Supp. 792, 793–94 (N.D. Cal. 1962) (rejecting taxpayer's motion to dismiss tax fraud charge on the ground that false statement in gift tax return procured for the government a tax that was not owing, and was thus not material).

103. The holdings in these cases are reinforced by the fact that Congress made tax fraud under § 7206(1) a crime separate and apart from tax evasion under § 7201. I.R.C. §§ 7201, 7206(1) (2000); *see also Goldman*, 439 F. Supp. at 344 ("The conclusion that an overstatement of income may result in a [fraud] prosecution is buttressed by the congressional determination to make § 7206(1) a crime separate and apart from income tax evasion, 26 U.S.C. § 7201."); *supra* note 23 (discussing the relationship between §§ 7201 and 7206(1)).

This construction of materiality follows from the fact that § 7206(1) is, in essence, a perjury statute—it punishes the act of executing and submitting a false return.[104] Thus, when the false return is filed, the offense is complete, regardless of the tax consequences that may flow from that return.[105] Filing a false tax return is punishable because it causes harm to the government. As suggested by the standard for materiality, filing a false return makes it more difficult for the IRS to monitor and verify the taxpayer's income.[106] A number of cases have addressed this harm in more specific terms.

For example, in *Badaracco v. Commissioner*, two business partners filed fraudulent tax returns and then voluntarily disclosed the fraud in amended returns and paid the tax owed.[107] When they were assessed a penalty for filing the original fraudulent returns, the taxpayers asserted that as a matter of equity and public policy the standard statute of limitations should apply (as opposed to the unlimited time available to the government to make assessments on fraudulent returns), thereby barring imposition of the fraud penalty.[108] They argued that the amended return provided the government all of the information necessary to make a knowledgeable assessment of the tax owed, and, thus, the statutory provision eliminating the limitations period in cases of fraud was not justified.[109] The Su-

104. *See* United States v. Scholl, 166 F.3d 964, 980 (9th Cir. 1999) ("Whether there was an actual tax deficiency is irrelevant because the statute is a perjury statute."); United States v. Marashi, 913 F.2d 724, 736 (9th Cir. 1990) ("Section 7206(1) is a perjury statute; it is irrelevant whether there was an actual tax deficiency."); United States v. Paepke, 550 F.2d 385, 392 (7th Cir. 1977); United States v. Romanow, 509 F.2d 26, 28 (1st Cir. 1975) (stating that the primary purpose of § 7206(1) is to impose penalties of perjury on those who willfully falsify their returns); United States v. DiVarco, 484 F.2d 670, 673 (7th Cir. 1973) (holding that willful and knowing false statements about a source of income are material under § 7206(1), regardless of the effect of the statements). One scholar has characterized certain "false statement" crimes as hybrids that reflect attributes of both "lying crimes" (such as perjury) and "misleading crimes" (such as fraud). *See* Stuart P. Green, *Lying, Misleading, and Falsely Denying: How Moral Concepts Inform the Law of Perjury, Fraud, and False Statements*, 53 HASTINGS L.J. 157, 173–74, 191–98 (2001).

105. *Marashi*, 913 F.2d at 736 (quoting United States v. Miller, 545 F.2d 1204, 1212 n.10 (9th Cir. 1976)).

106. *See supra* notes 96–97. Indeed, this is typical of virtually all perjury statutes, which one scholar has characterized as involving "deception intended to obstruct the administration of justice or government investigation or operations." Green, *supra* note 104, at 173–74.

107. 464 U.S. 386, 389 (1984).

108. *Id.* at 389.

109. *Id.* at 397–98.

preme Court rejected this argument, noting that the provision eliminating the limitations period for fraudulent returns was justified by the government's need for additional time to overcome specific detriments resulting from the original fraudulent return.[110] First, the Court found that where a fraudulent return is filed, the government's ability to ascertain the taxpayer's true tax liability may be compromised; during the period of time that the government relies on the false return, the taxpayer's underlying records may be falsified or even destroyed.[111] Second, the Court found that the fraudulent return means the government must be particularly diligent and thorough in its determination of the taxpayer's correct tax liability because filing the original fraudulent return makes the taxpayer inherently less trustworthy.[112] Third, "the difficulties that attend a civil fraud investigation are compounded" because of the potential need to refer the case for criminal prosecution.[113]

In *United States v. Goldman*,[114] the court discussed two additional burdens related to those identified by the Supreme Court in *Badaracco*. First, the court noted that "[t]he accuracy of items of taxable income reported on the return of one individual or entity may affect the ability of the IRS to assess the tax liability of another taxpayer."[115] That is, the tax returns of different taxpayers may contain information about the same transactions. If that information is falsified in one return, the IRS must devote additional resources to the determination of which return is correct. The court also observed that "overstated income may shield from scrutiny falsely inflated deduc-

110. *Id.* at 398.

111. *Id.*

112. *Id.* at 399 (noting that this difficulty is not mitigated by the filing of an amended return as the amended return "comes carrying no special or significant imprimatur; instead, it comes from a taxpayer who already has made false statements under penalty of perjury").

113. *Id.*

114. 439 F. Supp. 337 (S.D.N.Y. 1977).

115. *Id.* at 344; *see also* United States v. Fawaz, 881 F.2d 259, 264 (6th Cir. 1989) ("A false statement is material when it hampers the IRS in verifying . . . related returns submitted by the defendant taxpayer or by a business entity in which he or she has a direct interest."); United States v. Greenberg, 735 F.2d 29, 31 (2d Cir. 1984) (noting that the prohibition on false statements is designed in part to ensure that the IRS is able to verify the accuracy of related tax returns).

tions," thus making it more difficult for the IRS to check the accuracy of a return.[116]

Finally, a more broadly applicable harm associated with the filing of a fraudulent return is the significant potential for undermining voluntary compliance with the tax rules. The U.S. tax system relies heavily on truthful self-reporting by taxpayers.[117] As the Ninth Circuit observed in affirming a conviction under I.R.C. § 7206, "[B]ecause the tax system is based on self-reporting, the government depends upon the good faith and integrity of each potential taxpayer to disclose honestly all information relevant to tax liability."[118] If each potential taxpayer does not disclose honestly all information relevant to his or her tax liability, the integrity of the nation's tax system is damaged.[119] If the number of false tax returns grows, so, too, will public doubt about the accuracy and truthfulness of all tax returns within the system. If the public perceives that there is

116. *Goldman*, 439 F. Supp. at 344; *see also* Spies v. United States, 317 U.S. 492, 495 (1943) ("[T]axpayers' neglect or deceit may prejudice the orderly and punctual administration of the system as well as the revenues themselves."). As discussed in *supra* text accompanying notes 95–96, an element of the offense of filing a false tax return under I.R.C. § 7206(1) is that the false statement on the return be "material," a term that in this context the courts have interpreted to mean a false statement that "could have influenced or affected the IRS in carrying out the functions committed to it by law." United States v. DiRico, 78 F.3d 732, 736 (1st Cir. 1996) (citing to United States v. Romanow, 509 F.2d 26, 28 (1st Cir. 1975)); *see also* I.R.C. § 7206(1) (2000); *Fawaz*, 881 F.2d at 263–64; United States v. Taylor, 574 F.2d 232, 235 (5th Cir. 1978); United States v. DiVarco, 484 F.2d 670, 673 (7th Cir. 1973). Thus, the language of the tax fraud statute itself, as interpreted by the courts, suggests that false statements risk impeding IRS attempts to determine a particular individual's tax liability.

117. *See Spies*, 317 U.S. at 495 ("The United States has relied for the collection of its income tax largely upon the taxpayer's own disclosures rather than upon a system of withholding the tax from him by those from whom income may be received. This system can function successfully only if those within and near taxable income keep and render true accounts."); United States v. Lowe, No. 95-10111, 1996 U.S. App. LEXIS 1628, at *9 (9th Cir. Jan. 18, 1996). Although the U.S. tax system today relies much more heavily on withholding than it did in 1943, when *Spies* was decided, there remain enough exceptions to withholding to warrant concern about any trends in taxpayer behavior that would tend to undermine voluntary compliance.

118. *Lowe*, 1996 U.S. App. LEXIS 1628, at *9–10 (quoting United States v. Bisceglia, 420 U.S. 141, 145 (1975) (internal quotations omitted).

119. *See* United States v. Bove, 155 F.3d 44, 49 (2d Cir. 1998) (observing that filing a false tax return in violation of § 7206 is an offense that undermines "the integrity of the nation's tax system"); *see also* U.S. SENTENCING GUIDELINES MANUAL § 2T1.1 introductory cmt. (2004) ("The criminal tax laws are designed to protect the public interest in preserving the integrity of the nation's tax system.").

widespread gaming of the system for personal advantage (whether by understatement or overstatement of income), voluntary compliance is likely to be sharply reduced.[120] Thus, as the Seventh Circuit has observed, "For the . . . system to function properly, there must be not just truthful reporting, but also *the ability to assure truthful reporting*."[121]

In summary, a tax return may be fraudulent with respect to a material matter regardless of whether there is a corresponding loss of tax revenue to the government. This conclusion is derived from the fact that the act of filing a false return harms the government. The extent to which the harm caused by the filing of a fraudulent return should influence the *amount* of the fraud penalty is part of the discussion of public policy in Part III.D.3. The following section begins to frame that issue by examining the magnitude of the current penalty.

C. MAGNITUDE OF CURRENT PENALTY

Vigorous IRS prosecution of corporations filing income tax returns in violation of the criminal tax fraud provisions likely would have no discernible deterrent effect because only nominal penalties are available. For example, the maximum fine imposed on a corporation that violates § 7206(1) is $500,000.[122]

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120. Although now a number of years out of date, the IRS commissioned a study in 1984 to better understand what factors encouraged noncompliance with the tax system. YANKELOVITCH, SKELLY, & WHITE, INC., TAXPAYER ATTITUDES STUDY: FINAL REPORT 2 (1984). As one measure of compliance, the study evaluated attitudes condoning tax cheating. *Id.* at 56. A key variable that was closely linked to attitudes condoning tax noncompliance was "skepticism about human integrity." *Id.* As defined by the study, this variable reflects the belief that most people cheat; indeed, that the only people who do not cheat are those who cannot find opportunity to do so. *Id.* When taxpayers were asked to assign weights to several reasons why "other people" cheat on taxes, one of the factors most responsible for cheating was the perception that the tax system is unfair. *Id.* at 62. There is substantial economic literature on the effect of taxpayer attitudes on tax compliance, with most researchers concluding that taxpayer perceptions of fairness in the tax system and perceptions of compliance by other taxpayers significantly affect the overall rate of tax compliance. *See, e.g.*, Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, *in* WHY PEOPLE PAY TAXES 193, 214 (Joel Slemrod ed., 1992).

121. United States v. Paepke, 550 F.2d 385, 391 (7th Cir. 1977) (emphasis added).

122. Although I.R.C. § 7206(5)(B) provides a penalty of $500,000, the Criminal Fine Enforcement Act of 1984 imposed alternative maximum fines for federal crimes occurring after December 31, 1984. I.R.C. § 7206(5)(B) (2000); Pub. L. No. 98-596, § 6, 98 Stat. 3134, 3136–38. The maximum fine applicable to an organization convicted of a felony is equal to the greater of (1)

However, the actual fine imposed would be considerably less because of the overlay of the Federal Sentencing Guidelines promulgated by the U.S. Sentencing Commission.[123] According to the Guidelines, sentencing for the filing of fraudulent or false returns under § 7206 begins with a base offense level that is determined by the amount of the tax loss.[124] Because overstatements of income do not produce a tax loss, the default base offense level results in a fine of a mere $5,000,[125] which may be increased to $40,000 if the crime involves "sophisticated means."[126] Assuming that sophisticated means are used, and that the corporation is subject to the maximum culpability factor enhancement provided by the Guidelines, the fine would still not exceed $160,000.[127] Whether or not the lower fine de-

$500,000 and (2) an alternative fine equal to twice the amount of any pecuniary gain derived from the offense. Criminal Fine Enforcement Act of 1984 § 6. A corporation violating the misdemeanor "willful delivery or disclosure of false documents" provisions of I.R.C. § 7207 would be subject to a maximum fine of $200,000. I.R.C. § 7207 (Supp. 2002). Although § 7207 provides a maximum fine of $50,000, under the Criminal Fine Improvement Act of 1987, the maximum fine for an organization convicted of a misdemeanor not resulting in death is equal to the greater of (1) $200,000 and (2) an alternative fine equal to twice the amount of any pecuniary gain derived from the offense. Pub. L. No. 100-185, § 6, 101 Stat. 1279, 1280 (codified in part at 18 U.S.C. § 3571 (2000)). The alternative fines do not apply, however, if their application would "unduly complicate or prolong the sentencing process." 18 U.S.C. §§ 3571(c)–(d). It is likely that the alternative fines would not apply in a case like WorldCom's; although the company clearly benefited from exaggerating its taxable income to disguise inflation of its book income, quantifying that benefit would be extremely difficult.

123. *See generally* U.S. SENTENCING GUIDELINES MANUAL (2004). In the recent case of *United States v. Booker*, the Supreme Court struck down as unconstitutional the provisions of the Sentencing Guidelines that made them mandatory. 125 S. Ct. 738, 764 (2005) (Breyer, J., majority opinion in part). Thus, after *Booker*, district courts "are not bound to apply the Guidelines, [but] must consult those Guidelines and take them into account when sentencing." *Id.* at 767; *see also* 18 U.S.C. § 3553 (2000). Therefore, although courts will not be required to impose the lower sentence provided in the Guidelines for filing fraudulent and false returns, they nevertheless may do so absent other compelling considerations. As a result, the penalty under § 7206 likely will remain inconsequential.

124. U.S. SENTENCING GUIDELINES MANUAL, *supra* note 119, § 2T1.1(a).

125. *Id.* §§ 2T1.1(a)(2), 2T1.1(b)(2), 8C2.4(d).

126. *Id.* §§ 2T1.1(b)(2), 8C2.4(d).

127. This figure is based on a maximum culpability multiplier of four, which is arrived at by assuming that the corporate taxpayer (1) tolerated criminal activity, (2) had a prior history of criminal activity, and (3) obstructed the investigation of the offense. *Id.* §§ 8C2.5(a)–(c), (e), 8C2.6. This penalty would be imposed in lieu of the $500,000 maximum provided by the statute. *See id.* § 8C3.1(a).

termined under the Guidelines actually would be imposed, it is a pittance compared, for example, to the nearly $300 million that WorldCom is reported to have collected in tax refunds.[128]

One might suspect that Congress *intended* to impose only nominal punishment on those who file false tax returns. While this is possible, the fine imposed for criminal tax evasion under § 7201 is equally small,[129] despite the fact that the government clearly considers tax evasion a serious offense.[130] The better explanation is that this is simply an example of the tendency for civil penalties in this area to be significantly greater than the corresponding criminal sanction.[131] Perhaps as a result of this tendency, criminal prosecution has not played a significant role in the government's response to tax fraud and tax evasion.[132] The higher burden of proof and the need to establish

128. *See* Blumenstein et al., *supra* note 15.

129. I.R.C. § 7201 (2000) ("Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.").

130. *See, e.g.*, *Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies: Hearing Before the S. Comm. on Finance* (GAO-05-527T), 109th Cong. 12 (2005) (statement of David M. Walker, Comptroller General of the United States) (noting the government's longstanding concern about the $312 to $353 billion "tax gap" created by taxpayer noncompliance).

131. This tendency is puzzling because criminal penalties typically are considered to be punitive in nature, while civil penalties are remedial in nature and designed to compensate the government for its loss from the fraud. *See* Helvering v. Mitchell, 303 U.S. 391, 398–401 (1938). Given this understanding of the respective purposes of criminal and civil penalties, one would expect that the former would be significantly greater than the latter. In fact, the opposite is true, and the courts have reinforced this fact by concluding that penalties of 50 percent of an understatement of income attributable to fraud are remedial rather than punitive in nature. *E.g.*, *id.* at 401–03; Barnette v. Comm'r, 95 T.C. 341, 347–48 (1990).

132. Between 1998 and 2003, the IRS imposed a total of approximately 14,500 civil penalties for tax fraud. This figure includes civil fraud penalties assessed, after abatements, in five categories: individual income tax, corporate income tax, employment tax, excise tax, and estate and gift tax. *See* Internal Revenue Service, SOI Tax Stats - Enforcing Laws, Civil Penalties Assessed and Abated, http://www.irs.gov/taxstats/compliancestats/article/0,,id=97177,00.html (last visited Sept. 12, 2005). During the same six-year period, however, a total of only approximately 3,600 indictments were brought under the Internal Revenue Code's criminal fraud provisions. *See* Internal Revenue Service, Enforcement Strategy - Criminal Investigation (CI), Criminal Investigation (CI) Annual Business Reports, http://www.irs.gov/compliance/enforcement/article/0,,id=107522,00.html (last visited Sept. 12, 2005). This figure includes indict-

the requisite intent make it difficult for the government to successfully prosecute taxpayers under criminal provisions such as §§ 7201 and 7206(1).[133] Thus, the civil tax fraud provision has become the staple of federal tax evasion and tax fraud prosecutions, and the penalty associated with that offense is significant in the case of underpayments of tax.[134] Unfortunately, as noted above, the civil tax fraud offense is not subject to any penalty where the fraudulent tax return gives rise to an overpayment of tax. What is needed is a more robust penalty to deter corporations from making fraudulent statements to the IRS in order to bolster false earnings reports to shareholders.

D. GETTING A REFUND

Before discussing how refund claims might be denied in circumstances that involve false tax returns, it may be helpful to review the refund process itself. As will be seen, the process is somewhat mechanical, and the IRS's role in the process, to date, generally has been ministerial in nature.

1. The Process

A corporate tax-refund claim that does not simply involve an erroneous payment generally arises from a dispute between the corporation and the government about the correct tax treatment of some item of income, credit, or deduction. In such circumstances, the Secretary of the Treasury is authorized to make a refund only if it is determined that there was an "over-

ments brought under §§ 7206(1)–(2), 7207. *Id.*; *see also* I.R.C. §§ 7206(1)–(2), 7207 (2000 & Supp. 2002, respectively). A direct comparison of civil and criminal fraud penalties leveled against corporate offenders is not possible, as the IRS has only recently begun to compile separate statistics relating to criminal penalties for corporate tax fraud. However, in general, the IRS apparently has heavily favored civil sanctions in tax fraud cases, as evidenced by the fact that civil penalties outnumbered criminal penalties by more than five to one during this period.

133. *See* 1 STAFF OF JOINT COMM. ON TAXATION, *supra* note 84, at 143 ("It is a felony to sign a return unless the signer believes it to be 'true and correct as to every material matter.' However, criminal prosecution and conviction is [sic] rare because the government must prove the offending taxpayer's guilty state of mind beyond a reasonable doubt. Two of the Code's *civil penalties* . . . provide the principal means by which the Federal government assures accuracy of tax return information.") (emphasis added).

134. *See supra* note 86 and accompanying text.

payment" of tax.[135] Although the term is not explicitly defined in the Internal Revenue Code, the Supreme Court has held that an overpayment arises from "the payment of more than is rightfully due."[136] Thus, a company that has paid federal income tax on earnings that were fraudulently inflated quite clearly has made an overpayment for these purposes and may seek a refund of the excess tax paid.

The Treasury Secretary is not merely "authorized" to issue refunds. The Code provides that where a person makes an overpayment, the Secretary "*shall*, subject to [certain exceptions] refund any balance to such person."[137] The refund requirement, as applicable to corporations, is subject to only three exceptions.[138] First, the Secretary *may* credit the amount of the overpayment against any outstanding internal revenue tax liability of the corporation that made the overpayment.[139] Next, the amount of any overpayment to be refunded must be reduced by the amount of any past-due, legally enforceable debts owed to federal agencies.[140] Finally, if the corporation owes past-due, legally enforceable, state income tax obligations, the refund is further reduced by those amounts.[141] Apart from these exceptions, nothing in the statute authorizes the Secretary to depart from the command of § 6402 that an overpayment of tax be refunded to the taxpayer.

135. *See* I.R.C. § 6402(a) (2000).

136. Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947). The only statutory content given to the term is found in I.R.C. § 6401(a), which states that an overpayment includes amounts assessed or collected from the taxpayer after the expiration of the statute of limitations for such assessment or collection. I.R.C. § 6401(a) (2000).

137. I.R.C. § 6402(a) (emphasis added); *see also* Treas. Reg. § 301.6402-1 (1985). In lieu of receiving a refund check, a taxpayer may elect to credit the amount of any refund against the amount of estimated income tax for any taxable year. *See* § 6402(b).

138. This statement assumes that the corporation has timely filed a refund claim in accordance with the provisions of I.R.C. § 6511. I.R.C. § 6511 (Supp. 2002). A number of issues have arisen in the interpretation of these provisions, the treatment of which is beyond the scope of this Article. *See* MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 11.05 (rev. 2d ed. 2002).

139. *See* I.R.C. §§ 6402(a), (e)(3).

140. *See Id.* §§ 6402(d), (e)(3). In the case of individuals, refunds must be reduced by amounts of past-due child support before being reduced for debts owed to federal agencies. *See Id.* §§ 6402(c), (e)(3).

141. *Id.* § 6402(e)(3).

No refund will be forthcoming, however, unless and until the taxpayer files a timely claim for refund.[142] A refund claim must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires later.[143] The amount of the refund to which the taxpayer is entitled may be limited by the timeliness of the refund claim. If the refund claim is filed within three years from the time the return was filed, the refund may not exceed the portion of the tax paid during the three-year period immediately preceding the filing of the claim, plus the period of any extension granted for the filing of the return.[144] If the refund claim is not filed within three years from the time the return was filed, the refund is limited to the portion of the tax paid during the two years immediately preceding the filing of the claim.[145] The three-year statutory refund period may not be extended except in conjunction with an extension of the limitations period for the assessment of tax.[146]

A refund claim may be filed in one of two ways. First, if a corporation files a properly executed original income tax return reflecting an overpayment of tax for the taxable year (for example because of excess quarterly estimated tax payments), the tax return itself serves as the claim for credit or refund of such overpayment.[147] Alternatively, where the overpayment is not discovered until after a tax return has been filed, the corporation must file an amended return on Form 1120X.[148] In the

142. *Id.* § 6511(b)(1); Treas. Reg. § 301.6402-1 (1985) (noting that the Secretary may not make a refund unless a claim for credit or refund is timely filed by the taxpayer). The refund claim also is a jurisdictional prerequisite for the filing of a refund suit. *See* I.R.C. § 7422(a) (2000) (noting that no refund suit may be filed until a refund claim has been filed with the Secretary).

143. I.R.C. § 6511(a). If no return was filed by the taxpayer, the refund claim must be filed within two years from the time the tax was paid. *Id.*

144. *See id.* § 6511(b). The three-year statutory refund period is relatively short. If a corporation's earnings inflation is not discovered within the three-year period, then no refund will be available unless the limitations period has been extended in conjunction with an extension of the limitations period for the assessment of tax. *See id.* §§ 6511(c), 6501(c)(4) (Supp. 2002 & West 2005, respectively).

145. *See id.* § 6511(b)(2)(B).

146. *See id.* §§ 6501(c)(4), 6511(c).

147. Treas. Reg. § 301.6402-3(a)(5) (as amended in 1997). A corporation files its income tax return on Form 1120. *Id.*

148. *Id.* § 301.6402-3(a)(3) (as amended in 1997).

situation involving inflated earnings, a corporation like WorldCom knowingly files a false tax return reflecting excessive income and thus an income tax liability that is greater than what is rightfully due. The overpayment of tax is "discovered" when the SEC uncovers the fraudulent inflation of earnings. Thus, claims for refunds of tax paid on inflated earnings are filed by means of amended returns.

Once the amended return has been duly filed by the corporation, the IRS has six months to review the refund claim and determine whether to allow it.[149] If the IRS disallows the refund claim or fails to respond within six months from the date the refund claim is filed, the corporation may file a refund suit.[150] The suit may only be brought in an appropriate federal district court or in the U.S. Court of Federal Claims.[151]

2. The Overpayment Interest Bonus

Not only is a company that has fraudulently overstated its income entitled to a ready refund of the tax paid, the offending corporation also is entitled to receive interest from the U.S. Treasury on the amount of any overpayment of tax. Section 6611[152] directs that interest "shall be allowed and paid upon any overpayment . . . of any internal revenue tax" at a rate that currently is set at 2.5 percent for refund amounts in excess of $10,000.[153] Generally, the interest is payable from the date of the overpayment of tax, except that if the IRS refunds an overpayment within forty-five days of the filing of the refund claim, interest is not payable during that forty-five-day period.[154] The

149. I.R.C. § 6532(a)(1) (2000). As discussed in Part IV.B, *infra*, a tax refund in excess of $2 million may not be paid out until the Joint Committee has received a report of the refund and has had thirty days to review it.

150. Treas. Reg. § 301.6532-1(a) (1967).

151. 28 U.S.C. § 1346(a)(1) (2000).

152. I.R.C. § 6611 (2000).

153. *See* Rev. Rul. 2004-111, 2004-51 I.R.B. 989. A rate of 4 percent applies to corporate tax refunds of $10,000 or less. *Id.*

154. I.R.C. §§ 6611(b)(2), (e)(2). See *supra* Part II.B for a discussion of "overpayment" in this context. For an argument that interest should be payable on tax overpayments even during this forty-five-day period, see Jeremy R. Polk, Comment, *Compensation for the Fruit of the Fund's Use: The Takings Clause and Tax Refunds*, 98 NW. U. L. REV. 657, 657–61 (2004).

effect of this provision is to permit a corporation to use the federal income tax system to disguise its accounting fraud, while insuring that should the fraud be discovered, the corporation at least will be compensated in part for the time value of the money that it deposited with the U.S. Treasury to accomplish the fraud. The Internal Revenue Code thus unwittingly provides something akin to the "unwind" provisions associated with abusive corporate tax shelters.[155]

The federal income tax-refund process as just outlined is fairly straightforward. Refunds of overpayments of tax are statutorily required, and once the procedural requisites have been satisfied and a refund claim filed, the only task for the IRS is to determine whether the tax paid is more than the amount rightfully due. If so, the refund must be allowed with accrued interest on the overpayment. The set of provisions leading to this result seems impervious to considerations of fairness or justice. However, it is precisely at the intersection of strict legal rules and apparent injustice that courts historically have exercised their equitable powers.[156] That is, the role of equity within the legal system is to dispense justice at the interstices of inflexible legal rules.[157] The following section addresses the application of equity in the context of tax-refund suits.[158]

155. A feature of most abusive corporate tax shelters is a contractual provision entitling the participant in the shelter to effectively "unwind" the transaction if the intended tax consequences are denied by the IRS. This type of provision (also referred to as "contractual protection") now figures in the definition of a tax shelter under corporate tax shelter regulations issued in 2003. *See* Treas. Reg. § 1.6011-4 (as amended in 2003). To the extent that a corporation inflating earnings at the cost of an increase in income taxes can recoup that cost through a tax refund when the earnings inflation is discovered, it has effectively secured "contractual protection" for its fraudulent activity.

156. *See* Thomas O. Main, *Traditional Equity and Contemporary Procedure*, 78 WASH. L. REV. 429, 430 (2003) ("Equity moderates the rigid and uniform application of law by incorporating standards of fairness and morality into the judicial process.").

157. *See* Kennedy, *supra* note 31, at 609 ("In a broad jurisprudential sense, equity means the power to do justice in a particular case by exercising discretion to mitigate the rigidity of strict legal rules.").

158. *See* Alamo Nat'l Bank v. Comm'r, 95 F.2d 622, 623 (5th Cir. 1938) ("The right and wrong of things and equitable principles have a place in tax matters.").

III. REFUND SUITS AND EQUITY

Equity has been defined as "[j]ustice administered according to fairness as contrasted with the strictly formulated rules of common law."[159] Because WorldCom falsified its tax returns to lend credibility to, and avoid detection of, its fraudulent financial activity, denying the company's claim for a refund of tax on the falsely reported income arguably would be "equitable" in the sense of responding to normative conceptions of fairness. But equity involves more than abstract notions of morality and fair play. It also has a well-defined formal dimension, which governs the circumstances under which a court may dispense an equitable remedy.[160] Unless a tax-refund claim is

159. BLACK'S LAW DICTIONARY 540 (6th ed. 1990); *see also* Main, *supra* note 156, at 430. As a jurisprudential system, equity originated with the Chancellors of the English High Court of Chancery as an alternative to the common law dispensed at the same time (and often with contradictory results) by the judges of the English law courts. *See generally* KEETON, *supra* note 32, at 11–36 (discussing the development of equitable jurisdiction of English courts); John J. Farley, III, *Robin Hood Jurisprudence: The Triumph of Equity in American Tort Law*, 65 ST. JOHN'S L. REV. 997, 1001 (1991). Over the centuries, the common law courts became increasingly inflexible as a result of a system of writs that required a plaintiff to fit his claim to a particular form of action or be thrown out of court. *See* Farley, *supra*, at 1000–01. By contrast, the Court of Chancery administered a jurisprudence that grew progressively more popular because it blunted the harsher effects of the law courts' system of writs. Farley, *supra*, at 1001; Stephen N. Subrin, *How Equity Conquered Common Law: The Federal Rules of Civil Procedure in Historical Perspective*, 135 U. PA. L. REV. 909, 918–19 (1987). Among other reasons, Chancery was preferred because of the equitable nature of the remedies it dispensed. The court could make restitutionary awards of money or property, issue declaratory relief, impose so-called "coercive" remedies, and enforce its coercive remedies through the power of contempt, a power not available to a law court. *See* DAN B. DOBBS, LAW OF REMEDIES § 2.1, at 49 (abr. 2d ed. 1993) (explaining that a coercive remedy "did not merely declare the defendant's debt or obligation, but instead commanded the defendant to do or refrain from a specified act"). A law court, however, could only issue judgments declaring a defendant's debt or obligation and order seizure of the defendant's property to satisfy the judgment. DOBBS, *supra*, § 2.1, at 49. The rivalry between Chancery and the law courts in England was not finally resolved until passage of the Judicature Acts of 1873, which created a unified court structure charged with applying both equity and the common law. *See* Farley, *supra*, at 1001. However, over a period of several hundred years, that rivalry helped to shape the significant evolution of English common law. *See* Main, *supra* note 156, at 429 ("Much of the grand history of Anglo-American law could be characterized as an epic struggle between the regimes of law and equity.").

160. Dan Dobbs distinguishes between two meanings of equity and equitable. Thus, "[o]ne group of ideas associated with the term equity suggests fairness and moral quality." DOBBS, *supra* note 159, § 2.1(3), at 55. A second meaning "refers simply to the body of precedent or practice or attitude of equity courts." *Id.* at 56. The latter governs the circumstances under which a

"equitable" in this more formal sense, a court would be powerless to uphold the IRS's denial of a tax refund. This raises the central question of whether a tax-refund claim is a legal action or an equitable action.[161] In the pivotal case of *Stone v. White*, the Supreme Court concluded that it partakes of elements of both.[162]

A. *STONE V. WHITE*

Stone v. White involved a testator, Mr. Stone, who left property in trust for his wife.[163] As was her right, Mrs. Stone elected to receive the income from the trust instead of any dower or statutory interest to which she might have been entitled.[164] At the time, several circuit courts of appeals had held that dower rights given up in exchange for trust income were to be treated as payment for a deemed annuity.[165] Thus, like income from an annuity, trust income was not taxable to the beneficiary of the trust until the aggregate income payments received exceeded the amount deemed paid for the annuity.[166]

Adhering to the decisions in the circuit court cases, Mrs. Stone did not report the income she received from the trust because it did not exceed the amount she was deemed to have

plaintiff may pursue an equitable remedy. *See id.*

161. The American Colonies adopted the distinction between law and equity along with the English legal system. *See* John R. Kroger, *Supreme Court Equity, 1789–1835, and the History of American Judging*, 34 HOUS. L. REV. 1425, 1438 (1998). The language of the U.S. Constitution is a historical testament to the distinction, which persisted formally until 1938. *See* U.S. CONST. art. III, § 2, cl. 1 ("The judicial Power shall extend to all Cases, *in Law and Equity*, arising under this Constitution [and] the Laws of the United States . . . ." (emphasis added)). On Sept. 16, 1938, the Federal Rules of Civil Procedure became effective, thus merging law and equity in the federal courts. *See* FED. R. CIV. P. 1 ("These rules govern the procedure in the United States district courts in all suits of a civil nature *whether cognizable as cases at law or in equity* . . . ." (emphasis added)); FED. R. CIV. P. 2 ("There shall be one form of action to be known as 'civil action.'"); Ross v. Bernhard, 396 U.S. 531, 539 (1970) ("Under the Rules there is only one action—a 'civil action'—in which all claims may be joined and all remedies are available."). Today, federal courts exercise both equitable and legal powers in adjudicating claims.

162. 301 U.S. 532, 534 (1937).

163. *Id.* at 533.

164. *Id.*

165. *See, e.g.*, Allen v. Brandeis, 29 F.2d 363, 364 (8th Cir. 1928); United States v. Bolster, 26 F.2d 760, 763 (1st Cir. 1928); Warner v. Walsh, 15 F.2d 367, 367 (2d Cir. 1926).

166. This treatment of annuity income ultimately was replaced in 1954 by § 72. I.R.C. § 72 (West 2005).

paid for the annuity. Instead, the tax on the income was assessed against, and paid by, the trust.[167] After the statute of limitations had run for collecting the tax from Mrs. Stone, the Supreme Court in *Helvering v. Butterworth*, overruled the earlier circuit court decisions and held that beneficiaries were indeed taxable on trust income.[168] Relying on *Butterworth*, the trustees of the Stone trust sued to recover the tax that the trust had improperly paid.[169]

The case appeared simple; the trust had paid income tax it did not owe and was therefore due a refund. Surprisingly, however, the Supreme Court denied the trust's refund claim.[170] The Court recognized that if it granted the refund to the trust, no tax would be paid on the trust's income, since the statute of limitations barred collection of the tax from Mrs. Stone, the beneficiary who actually owed the tax under the *Butterworth* holding.[171] Thus, the Court disregarded the separate entity status of Mrs. Stone and the trust, and treated Mrs. Stone's obligation to pay the tax as though it were the obligation of the trust.[172]

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167. *Stone*, 301 U.S. at 533.

168. 290 U.S. 365, 370 (1933) ("When she makes her election the widow decides to accept the benefits of the will with the accompanying rights and liabilities. In no proper sense does she purchase an annuity. For reasons satisfactory to herself, she expresses a desire to occupy the position of a beneficiary and we think she should be so treated.").

169. *Stone*, 301 U.S. at 533–34.

170. *Id.* at 535.

171. *Id.* at 536.

172. *Id.* at 537 ("[A] court of equity takes cognizance of the identity in interest of trustee and *cestui que trust*."). In this regard, the Court's decision reflected a judicial trend in the United States, beginning in the mid-1920s and continuing through the 1930s, of adopting a less formalistic approach to the interpretation of statutory provisions, particularly tax provisions. The most notable example of this trend is Judge Learned Hand's decision in *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), decided just three years before *Stone* and subsequently affirmed by the Supreme Court in *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Gregory*, the Court rejected the taxpayer's attempt to reduce her tax burden with a tax scheme that was technically permissible but that lacked a valid business purpose. *Id.* at 470. Like the decision in *Stone*, *Gregory* reflected an assertion of purposive judgment over formalistic interpretation. The decisions in *Stone* and *Gregory*, however, were influenced by political, ideological, and economic factors unique to the United States. A different set of factors was at work in Britain. In the 1930s, British courts took a path in adjudicating tax matters that was decidedly more formalistic than the approach adopted by U.S. courts. *See* Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 963 (2004).

Ignoring legal forms in this manner and collapsing the tax obligations of Mrs. Stone and the trust in order to reach a just outcome clearly was an exercise of equitable powers.[173] However, the tax-refund suit brought by the trust, like the tax-refund claims asserted by WorldCom and others, historically was a *legal* action rather than an *equitable* action, as the Court itself acknowledged.[174] A principal tenet of equity was that an equitable remedy was not available to enforce a legal right.[175] How could the Court employ equity in what seemed clearly to be an action at law?

B. EVOLUTION OF THE REFUND SUIT

In answering that question, the *Stone* Court acknowledged that by virtue of its historical pedigree the tax-refund suit was a legal action; it was the lineal successor of the common law count *indebitatus assumpsit*.[176] However, the Court noted that

173. The Court had no doubt about its authority to exercise equitable powers. *See Stone*, 301 U.S. at 536–37 (noting that the Court was "free to consider equitable rights and duties," and referring to the Court as "a court of equity" and as having "equity powers"). This Article is concerned with tax-refund suits, which may be brought only in one of the federal district courts or in the U.S. Court of Federal Claims. 28 U.S.C. § 1346(a) (2000). The federal district courts were established under the powers granted to Congress by Article III of the U.S. Constitution. Thus, federal district courts may exercise equitable powers with respect to the resolution of tax-refund suits as a constitutional matter. *Stone* would appear to require the Court of Federal Claims, which is an Article I court, *see* 28 U.S.C. § 171(a) (2000), also to exercise equitable powers, at least to the extent of considering equitable defenses to tax refund suits. *See Stone*, 301 U.S. at 535; *cf.* Henry v. United States, 14 Cl. Ct. 795, 799–800 (1988) (considering and ultimately rejecting a taxpayer's equitable estoppel claim on its merits). For an excellent treatment of the extent to which courts established under Article I (such as the Tax Court) may exercise equitable powers, see Leandra Lederman, *Equity and the Article I Court: Is the Tax Court's Exercise of Equitable Powers Constitutional?*, 5 FLA. TAX REV. 357, 375 (2001).

174. *See Stone*, 301 U.S. at 536.

175. This is known as the "adequacy of legal remedy" or "irreparable harm" test, which traditionally permitted equitable relief only in cases where the available legal remedy was inadequate. There has been substantial debate in the last two decades about whether the rule actually is observed in practice by the courts, with many scholars having written its epitaph. *See* DOBBS, *supra* note 159, § 2.5(3), at 97 ("The adequacy rule, as a rule that simply bars the gate, is virtually dead and probably should be."); Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 687, 692 (1990) ("I conclude that the irreparable injury rule is dead.").

176. *Stone*, 301 U.S. at 534 ("The action, brought to recover a tax erroneously paid, *although an action at law*, is equitable in its function.") (emphasis added); *cf.* Yung F. Chiang, *Payment by Mistake in English Law*, 11 FLA. J.

the action had an equitable function.[177] Indeed, a brief overview of the history of the *indebitatus assumpsit* action supports the court's assertion.

First, equity had a significant effect on the origin of the *assumpsit* action.[178] The early English common law system recognized two actions that covered many of the contract-like obligations that arose in the course of business and personal interactions—namely, covenant and debt.[179] Both covenant and debt actions suffered from infirmities that left them, like much of the common law system of writs, unavailable for the resolution of many disputes. For example, an action for covenant was the appropriate remedy for most breaches of promise, but covenant could not be used for promises to pay money or to deliver goods. It also required a written document under seal, an element that was frequently missing in many routine commercial transactions.[180] An action for debt, on the other hand, which was available to recover amounts due creditors, did not require an obligation under seal.[181] However, an action for debt applied only to amounts fixed at the time of the contract, and it could be defeated by wager of law.[182] These considerations made debt a less than satisfactory remedy for breaches of promises to pay money.

INT'L L. 91, 97–98 (1996) ("In England, an action to recover payment for money had and received on the ground of mistake is within the jurisdiction of the court of law. Chancery, the equity court, never dealt with such action unless the plaintiff based the action on the fraud on the part of the defendant or unless the plaintiff, in an insolvency case, requested the court to distribute assets among claimants.").

177. *Stone*, 301 U.S. at 534.

178. *Assumpsit* means "he undertook" or "he promised." Arthur A. Leff, *The Leff Dictionary of Law: A Fragment*, 94 YALE L.J. 1855, 2082 (1985).

179. *See* James Oldham, *Reinterpretations of 18th-Century English Contract Theory: The View from Lord Mansfield's Trial Notes*, 76 GEO. L.J. 1949, 1950–53 (1988).

180. *See id.* at 1951; Leff, *supra* note 178, at 2083. Thus, an action for covenant was unavailable for a significant number of disputes involving breach of promise.

181. *See* Oldham, *supra* note 179, at 1952.

182. *See* Leff, *supra* note 178, at 2083. James Oldham describes wager of law as "the ability of the defendant to 'wage his law' by bringing to court a specified number of 'oath helpers,' or compurgators, who, under oath, affirmed defendant's position that no debt was owed. This 'wager of law' automatically entitled the defendant to prevail." Oldham, *supra* note 179, at 1953 n.24 (citing A.W.B. SIMPSON, A HISTORY OF THE COMMON LAW OF CONTRACT 137–44 (1975)). *Assumpsit* actions originally were encouraged as a means of eliminating the defense of wager of law. *See* Moses v. Macferlan, (1760) 97 Eng. Rep. 676, 678 (K.B.).

The Court of Chancery stepped into the breach (so to speak) by providing equitable relief for certain broken promises and trade disputes.[183] The law courts responded to the competition from the Court of Chancery by gradually expanding the writ system to include the writ in trespass, an action borrowed from tort law.[184] The writ in trespass permitted a plaintiff to seek compensatory damages for some wrong done to him.[185] From the writ in trespass, the English common law eventually produced the *assumpsit* action, which by about 1400 had become the basis for recovery for breach of contract.[186] As discussed below, breach of contract is the action underlying tax-refund suits. Thus, the very genesis of the action by which a tax refund may be claimed owes much to equity.

Second, in the *assumpsit* action, which preceded the development of the action for breach of contract, the plaintiff alleged that the defendant had made a promise that he failed to perform.[187] Originally, *assumpsit* required an express promise, but the forces of equity influenced its development. *Assumpsit* ultimately came to be applied even where there was no explicit promise or contract.[188] Where justice required that the plaintiff be granted relief, common law judges simply implied a promise and held the defendant liable on that promise.[189] Thus, equity

183. *See, e.g.*, S.F.C. MILSOM, HISTORICAL FOUNDATIONS OF THE COMMON LAW 324 (2d ed. 1981).

184. *See* Oldham, *supra* note 179, at 1953 (discussing the shortcomings of debt and covenant, and observing that during the fifteenth century, "Chancery began to intervene to fill the gaps, and, in jealous response, the law courts sought a means of expanding the writ system").

185. *See* David J. Seipp, *The Distinction Between Crime and Tort in the Early Common Law*, 76 B.U. L. REV. 59, 69 (1996).

186. *See* DOBBS, *supra* note 159, § 4.2(1), at 383–84; Oldham, *supra* note 179, at 1955. As Oldham observes, "It is one of the ironies of English legal history that the classical law of contracts emerged not from the medieval writs governing 'expectations of good faith . . . between individual persons' but from trespass, a species of tort law." Oldham, *supra* note 179, at 1950 (citing J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 263 (2d ed. 1979)).

187. *Assumpsit* was a legal action, but like its predecessor the writ in trespass, it evolved because the law courts desired to compete with the Court of Chancery by becoming more "equitable." *See* BLACK'S LAW DICTIONARY 122 (6th ed. 1990); Keeton, *supra* note 32, at 39–40 (describing how the law courts expanded their powers based on a rivalry with the Court of Chancery).

188. *See* J.B. Ames, *The History of Assumpsit*, 2 HARV. L. REV. 53, 54, 58 (1888) (discussing the decline of the "explicit promise" requirement of *assumpsit* actions).

189. *See* DOBBS, *supra* note 159, § 4.2(1), at 383 ("Sometimes the contract would be express, sometimes implied by the parties' actions, but in either event a genuine contract."). *Assumpsit* actions not only were sustained on the

affected the development of *assumpsit* again, permitting an action for breach of contract where a formal contract or promise was not present.

Third, in some circumstances, an *assumpsit* action involved the breach of a promise to pay an antecedent debt.[190] Here again, equity was influential, as the antecedent debt itself came to be implied based on notions of fairness.[191] Thus evolved the *indebitatus assumpsit* action,[192] which became the form of *assumpsit* used for breach of an implied promise to repay an antecedent debt where that debt was itself implied based on notions of fairness and equity.[193]

basis of implied promises or contracts; they often were maintained in the absence of *any* contract, implied or otherwise. *Id.* Again, the critical element in such cases was the necessity to render justice in the face of an inflexible legal form. As Dobbs has observed, "the assumpsit action also came to be used when the parties had no contract at all, *so long as the plaintiff could convince the court that he ought to recover something from the defendant as a matter of justice or good conscience*." *Id.* (emphasis added).

190. In *Slade's Case*, (1602) 76 Eng. Rep. 1074 (K.B.), failure to perform was expanded to include the failure to pay over money owed, a type of nonfeasance that previously could be remedied only by an action in debt. *See* Oldham, *supra* note 179, at 1957.

191. *See* Clinton W. Francis, *The Structure of Judicial Administration and the Development of Contract Law in Seventeenth-Century England*, 83 COLUM. L. REV. 35, 110 (1983) ("The defendant's undertaking in indebitatus counts was expressed as a subsequent promise to pay for an antecedent debt, an expression that in most instances was probably entirely fictional. The common law courts, recognizing the value of the indebitatus count as an 'expeditious remedy,' promoted its use, while turning a blind eye to the fictional averment of a subsequent promise."). The seminal case on this point is *Moses v. Macferlan*, (1760) 97 Eng. Rep. 676 (K.B.), in which the plaintiff, Moses, had endorsed certain notes to Macferlan, who agreed to indemnify Moses on the endorsements. *Id.* at 676. Notwithstanding his agreement, Macferlan later sued Moses on his endorsements. *Id.* The court refused to hear evidence of Macferlan's agreement to indemnify Moses, and Macferlan prevailed. *Id.* Moses then sought to recover the judgment awarded to Macferlan in an *indebitatus assumpsit* action. *Id.* at 677. In granting relief to Moses, Lord Mansfield, the Chief Justice of the Court of King's Bench, described the implied debt and promise as follows: "If the defendant be under an obligation, from the ties of natural justice, to refund; *the law implies a debt, and gives this action, founded in the equity of the plaintiff's case, as it were upon a contract*." *Id.* at 678 (emphasis added). In other words, because under principles of natural justice Macferlan had an obligation to indemnify Moses in accordance with his agreement, the court implied a debt from Macferlan to Moses. This implied debt carried with it an *assumpsit* or promise by Macferlan to pay the indemnity amount, a promise that Macferlan broke when he recovered the indemnity amount from Moses in the earlier action.

192. *Indebitatus assumpsit* means "being indebted he undertook or promised." Leff, *supra* note 178, at 2083.

193. *Indebitatus assumpsit* would only lie for breach of a duty to pay

Finally, equity also affected the later extension of the *indebitatus assumpsit* action to apply not only to contracts or promises implied in fact, but also to contracts implied in law, or "quasi-contracts."[194] This led to the use of *indebitatus assumpsit* to obtain refunds of taxes that had been illegally or erroneously collected.[195] As pleading became standardized in the seventeenth century, certain common counts arose under *indebitatus assumpsit*, one of which, the count for "money had and received to the plaintiff's use," became the basis of the modern tax-refund suit.[196]

The Court in *Stone* concluded that, based on its close historical relationship to equity, a tax-refund suit "brought to recover a tax erroneously paid, *although an action at law, is equitable in its function*."[197] The court noted that the *indebitatus assumpsit* action had long been used to recover on rights of an equitable nature and that such suits were invariably controlled by equitable principles.[198] Based on this pedigree, the *Stone* court was free to "do equity" and deny the trustees' claim for refund.[199]

C. Equitable Defenses to Refund Suits

The most critical implication of the equitable status of a tax-refund suit is that the action may be defended in equity.[200] In *Stone*, the Supreme Court held, "since, in [a tax-refund] action, the plaintiff must recover by virtue of a right measured by

money. Ames, *supra* note 188, at 64.

194. *Id.* at 65–66.

195. *See id.* (citing City of London v. Goree, (1677) 86 Eng. Rep. 192 (K.B.) (involving an *assumpsit* action to recover money due by custom)); *cf.* Leff, *supra* note 178, at 2083 (discussing the evolution of *indebitatus assumpsit*).

196. *See* Estate of Mueller v. Comm'r, 153 F.3d 302, 304 (6th Cir. 1998) (quoting Stone v. White, 301 U.S. 532, 534 (1937)).

197. *Stone*, 301 U.S. at 534 (emphasis added).

198. *Id.*; *see also* United States v. Jefferson Elec. Co., 291 U.S. 386, 402–03 (1933) ("[The *assumpsit* action] is often called an equitable action and is less restricted and fettered by technical rules and formalities than any other form of action . . . . It approaches nearer to a bill in equity than any other common law action."); Champ Spring Co. v. United States, 47 F.2d 1, 3 (8th Cir. 1931) ("While [the tax-refund suit] is an action at law, it is nevertheless governed by equitable principles.").

199. *Stone*, 301 U.S. at 537 ("[T]he fact that the petitioners and their beneficiary must be regarded as distinct legal entities for purposes of the assessment and collection of taxes does not deprive the court of its equity powers or alter the equitable principles which govern the type of action which petitioners have chosen for the assertion of their claim.").

200. *See* DOBBS, *supra* note 159, § 2.1(3), at 57.

equitable standards, it follows that it is open to the defendant to show any state of facts which, *according to those standards*, would deny the right."[201] Similarly, in a case decided the same day as *Stone*, the Supreme Court held that a tax-refund suit permits the Commissioner to secure "a final adjudication of his right to withhold the overpayment . . . on the ground that other taxes are due from the taxpayer, *or that upon other grounds he is not equitably entitled to the refund*."[202] Thus, in a refund suit, the IRS has the entire range of equitable defenses at its disposal.

Equity is grounded in a rich tradition of equitable maxims.[203] The various equitable defenses that populate federal case law are derived from those maxims.[204] Given the procedural posture of refund claims for taxes paid on fraudulently inflated earnings, not all equitable defenses would be applicable.[205] Three equitable defenses, however, seem particularly

201. *Stone*, 301 U.S. at 535 (emphasis added); *see also* Davis v. United States, 77-1 U.S. Tax Cas. (CCH) ¶ 13,195, at 87,274 (D. Tex. 1977) ("The Supreme Court [in *Lewis v. Reynolds*, 284 U.S. 281, 283 (1932)] . . . felt that an action for refund was an equitable action . . . and therefore equitable defenses should also apply.").

202. United States *ex rel.* Girard Trust Co. v. Helvering, 301 U.S. 540, 543 (1937) (emphasis added); *see also* Lewis v. Reynolds, 284 U.S. 281, 283 (1932) (holding that even where a statute of limitations bars assessment and collection of additional tax, the government may retain payments already received if such amounts might have been properly assessed and collected).

203. In his seminal book on equity, Keeton lists thirteen such maxims. *See* KEETON, *supra* note 32, at 89.

204. For example, the equitable maxim, "He who comes into Equity must come with clean hands," is the basis for the doctrine of unclean hands. *See* KEETON, *supra* note 32, at 87–117 (discussing equitable defenses). Similarly, the equitable maxim "Delay defeats equities" gave rise to the doctrine of laches. *See id.*

205. The more important equitable defenses include the following: (1) Equitable Tolling permits a plaintiff to file suit after the running of the statute of limitations if, despite diligent effort, she cannot determine whether she has a viable claim. *See* Perez v. United States, 167 F.3d 913, 917 (5th Cir. 1999); Flight Attendants Against UAL Offset v. Comm'r, 165 F.3d 572, 575 (7th Cir. 1999). (2) Equitable Estoppel precludes one party from asserting a claim against another party who has detrimentally altered her position in reliance on the first party's misrepresentation or concealment of a material fact. *See* Kennedy v. United States, 965 F.2d 413, 418 (7th Cir. 1992). (3) Equitable Recoupment allows a taxpayer to recoup or offset previously overpaid taxes against current taxes where the statute of limitations on a refund claim has run, if the two taxes arose out of the same transaction and were assessed on inconsistent legal theories. *See* Estate of Branson v. Comm'r, 264 F.3d 904, 909 (9th Cir. 2001). (4) Doctrine of Laches denies relief where the defendant has been prejudiced by the plaintiff's failure to diligently prosecute his claim. *See* Zelazny v. Lyng, 853 F.2d 540, 541 (7th Cir. 1988). (5) Quasi-Estoppel, like

apposite to claims for refunds of tax paid on fraudulently inflated earnings: the doctrine of unclean hands, equitable estoppel, and quasi-estoppel.

1. The Doctrine of Unclean Hands

One of the most familiar equitable maxims is that one who comes into equity must come with clean hands. The maxim is more than a "mere banality"; it is the underpinning of the doctrine of unclean hands, which may be an absolute bar to recovery in a tax-refund suit.[206] The Supreme Court has described the doctrine as an "ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief."[207] The doctrine is rooted in the historical notion of the court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith.[208] Under the unclean hands doctrine, a court sitting in equity has wide-ranging discretion in refusing to aid the unclean litigant, and it is not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion.[209]

The essence of the doctrine is the denial of equitable relief to a plaintiff who commits a wrong in the same transaction in which he claims to have been injured.[210] For example, in *Precision Instrument Manufacturing Co. v. Automotive Maintenance*

equitable estoppel, precludes a plaintiff from asserting a claim against a defendant, where the plaintiff has taken inconsistent positions, but does not require misrepresentation or concealment by the plaintiff or detrimental reliance by the defendant. *See* Neiman-Marcus Group, Inc. v. Dworkin, 919 F.2d 368, 371 (5th Cir. 1990). (6) Doctrine of Unclean Hands prevents relief to a plaintiff who is a wrongdoer in the same transaction in which he claims to have been injured. *See* Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co., 324 U.S. 806, 815 (1945). (7) Unjust Enrichment prevents a defendant from retaining a benefit which has come to her at the expense of the plaintiff. *See* Vanacore v. Kennedy, 86 F. Supp. 2d 42, 52 (D. Conn. 1998). (8) Promissory Estoppel enforces a promise made without consideration if the promisee detrimentally relied on the promise and such reliance could reasonably have been expected by the promisor. *See* Schonholz v. Long Island Jewish Med. Ctr., 87 F.3d 72, 85 (2d Cir. 1996).

206. Lampenfield v. Internal Revenue Serv., 91-1 U.S. Tax Cas. (CCH) ¶ 50,038, at 87,161, 87,166 (W.D. Pa. 1991).

207. *Precision Instrument*, 324 U.S. at 814.

208. N.Y. Football Giants, Inc. v. Los Angeles Chargers Football Club, Inc., 291 F.2d 471, 474 (5th Cir. 1961).

209. *Lampenfield*, 91-1 U.S. Tax Cas. (CCH), at 87,161, 87,166 (discussing Keystone Driller Co. v. General Excavator Co., 290 U.S. 240, 245–46 (1933)).

210. Smith v. World Ins. Co., 38 F.3d 1456, 1462 (8th Cir. 1994).

Machinery Co., the plaintiff sought to enforce a contract involving certain patents that it knew were fraudulent at the time the contract was executed.[211] The Supreme Court declined to enforce the contract, holding that the plaintiff's conduct in failing to disclose the patent fraud to the U.S. Patent Office did not "conform to *minimum ethical standards* and [did] not justify [plaintiff]'s . . . attempt to assert and enforce . . . perjury-tainted patents and contracts."[212]

It is not necessary that the misconduct giving rise to application of the doctrine be punishable as a crime or otherwise be legally actionable.[213] Any willful act transgressing equitable standards of conduct is sufficient cause for invocation of the doctrine, as the language of the Court in *Precision Instrument* suggests.[214] By the same token, the doctrine of unclean hands clearly applies where the plaintiff's act consists of a direct violation of a statute.[215] In addition, the equitable or statutory violation must be closely related to the matter being litigated. Courts will apply the doctrine only where the plaintiff's act in some measure affects the equitable relations between the parties regarding the issue brought before the court for adjudication.[216] Although the "broad" form of the conduct standard[217] is sufficient to constitute unclean hands, it could raise thorny questions as to the scope of "minimum ethical standards." Therefore, this Article proposes adopting a "narrow" form of the conduct standard. In other words, a refund claim would be summarily denied only if the taxpayer had directly violated a statute connected with the matter in litigation.

211. 324 U.S. 806, 818–20 (1945).

212. *Id.* at 816 (emphasis added).

213. *See N.Y. Football Giants, Inc.*, 291 F.2d at 474.

214. 324 U.S. at 815; *see also N.Y. Football Giants, Inc.*, 291 F.2d at 474.

215. *See* Metro Motors v. Nissan Motor Corp. in U.S.A., 339 F.3d 746, 750–51 (8th Cir. 2003) ("Well-accepted general principles of equity support [plaintiff's] contention that a statutory violation gives a party unclean hands."); *In re* Estate of Bruner, 338 F.3d 1172, 1177 (10th Cir. 2003) (unlawful or inequitable conduct, defrauding the government); Promac, Inc. v. West, 203 F.3d 786, 789 (Fed. Cir. 2000) (violation of federal regulations); Smith v. World Ins. Co., 38 F.3d 1456, 1463 (8th Cir. 1994) ("[E]quity, under the general maxim that one who seeks equity must come with clean hands, will refuse its aid to a litigant who violates a statute directly connected with the matter in litigation."); Intercorp, Inc. v. Pennzoil Co., No. 86-G-0911-S, 1987 U.S. Dist. LEXIS 12041, at *2 (N.D. Ala. Dec. 30, 1987) (illegal conduct).

216. Keystone Driller Co. v. General Excavator Co., 290 U.S. 240, 245 (1933).

217. S*ee supra* note 213 and accompanying text.

Finally, an important consideration in the application of the doctrine of unclean hands, and indeed, in the application of all of the equitable defenses, is the resulting effect on public policy.[218] When a suit in equity relates to the public interest, the doctrine of unclean hands assumes wider and more significant proportions because application of the doctrine to deny relief not only resolves a private injustice, it also has the potential to avert an injury to the public.[219] For example, in *Precision Instrument*, the Supreme Court observed that the possession and assertion of patent rights were "issues of great moment to the public" and assessed the claims at issue against public, as well as private, standards of equity.[220] Therefore, the Court's ultimate refusal to enforce the plaintiff's patent claims supported the public interest in seeing that patents, and the monopolies inherent in them, be limited to their proper scope and be granted in an environment free of fraudulent conduct.[221]

In a situation like WorldCom's, each of the requisite elements of the doctrine of unclean hands is present. WorldCom sought equitable relief in the form of a refund of excess taxes paid.[222] However, the company committed a wrong in the very transaction in which it claims to have been injured, the paradigm case for application of the doctrine of unclean hands. WorldCom directly violated § 7206,[223] and thus satisfies the narrow form of the conduct standard. There is no need to inquire into whether WorldCom also breached standards of ethical conduct, although it clearly did.

The WorldCom situation also meets the requirement that the doctrine of unclean hands be applied only where the plaintiff's act (here, the violation of § 7206) is closely related to the matter being litigated. Had WorldCom not filed fraudulent tax returns for the years in question in violation of § 7206, no excess tax would have been paid, and there would be no need for the company to commence litigation to obtain a tax refund.

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218. Public policy is discussed here as a consideration in the traditional equitable defenses. See *infra* Part III.D for a discussion of public policy as a free-standing, equity-flavored doctrine.

219. *See Precision Instrument*, 324 U.S. at 816; Morton Salt Co. v. Suppiger Co., 314 U.S. 488, 492–94 (1942); *N.Y. Football Giants, Inc.*, 291 F.2d at 474.

220. 324 U.S. at 816 (quoting Hazel-Atlas Glass Co. v. Hartford-Empire Co., 322 U.S. 238, 246 (1944) (internal quotations omitted)).

221. *Precision Instrument*, 324 U.S. at 816.

222. *See* Blumenstein et al., *supra* note 15.

223. I.R.C. § 7206 (2000).

Thus, WorldCom's fraud measurably "affect[s] the equitable relations between the parties" regarding the tax-refund claim.[224]

Denying WorldCom's equitable claim for a tax refund in such circumstances also comports with the public policy aspect of the unclean hands doctrine. The integrity and accuracy of all federal income tax returns is no less important to the public than the possession and assertion of patent rights, which the Court in *Precision Instrument* held to be of "great moment to the public."[225] Courts have frequently noted the strong public policy interest in the accurate reporting of income.[226]

2. Equitable Estoppel

Estoppel is a term used widely in the law, which, in its most general sense, refers to the situation in which a party is precluded or "stopped" from taking some action or making some argument or claim.[227] The preclusion may result from a prior, overriding rule or claim, or, as in the case of "equitable" estoppel, it may result from considerations of fairness and justice.[228] Thus, the doctrine of unclean hands discussed in the previous section is a species of equitable estoppel, precluding equitable relief where the party seeking it has done wrong in the particular transaction. The doctrine is rooted in concerns of public policy, fair dealing, common honesty, good faith, and justice.[229]

Equitable estoppel differs from the unclean hands doctrine in that it prevents a party from asserting a claim against another party who has detrimentally altered her position in reli-

224. Keystone Driller Co. v. Gen. Excavator Co., 290 U.S. 240, 245 (1933).

225. 324 U.S. at 815–16 (quoting *Hazel-Atlas Glass Co.*, 322 U.S. at 246 (internal quotations omitted)); *see also* Morton Salt Co. v. Suppiger Co., 314 U.S. 488, 492–94 (1942).

226. *See supra* notes 117–21 and accompanying text.

227. *See* DOBBS, *supra* note 159, § 2.3(5), at 64–65.

228. *See* Heckler v. Cmty. Health Servs., 467 U.S. 51, 59 (1984) ("Estoppel is an equitable doctrine invoked to avoid injustice in particular cases."); Readco, Inc. v. Marine Midland Bank, 81 F.3d 295, 301 (2d Cir. 1996) ("Equitable estoppel is imposed by law in the interest of fairness to prevent the enforcement of rights which would work fraud or injustice upon the person against whom enforcement is sought and who, in justifiable reliance upon the opposing party's words or conduct, has been misled into acting upon the belief that such enforcement would not be sought."); Melrose Assocs., L.P. v. United States, 43 Fed. Cl. 124, 147 (Ct. Cl. 1999) ("The doctrine of equitable estoppel is a judicial remedy by which a party may be precluded by its own act or omission, from asserting a right to which it otherwise would have been entitled.").

229. *E.g.*, Hilco Prop. Servs. v. United States, 929 F. Supp. 526, 539 (D. N.H. 1996).

ance on the first party's misrepresentation.[230] Where the elements of equitable estoppel apply, a party is absolutely barred from asserting a right that under other circumstances would be indisputable.[231] In this way, a party is prevented from taking unconscionable advantage of her own wrong by asserting her strict legal rights.[232]

The elements of equitable estoppel vary somewhat from court to court, but the oft-cited list in the Sixth Circuit's opinion in *Armistead v. Vernitron Corp.* is representative, and includes the following:

> (1) conduct or language amounting to a representation of material fact; (2) awareness of the true facts by the party to be estopped; (3) an intention on the part of the party to be estopped that the representation be acted on, or conduct toward the party asserting the estoppel such that the latter has a right to believe that the former's conduct is so intended; (4) unawareness of the true facts by the party asserting the estoppel; and (5) detrimental and justifiable reliance on the representation by the party asserting estoppel.[233]

In addition to these elements, there are some additional considerations in the application of the doctrine of equitable estoppel. Most importantly for its application to tax-refund claims, the doctrine is available for both legal and equitable claims.[234] Whereas the doctrine of unclean hands applies to equitable or equity-like actions, equitable estoppel is subject to no

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230. Kennedy v. United States, 965 F.2d 413, 417 (7th Cir. 1992); *see also* Kosakow v. New Rochelle Radiology Assocs., P.C., 274 F.3d 706, 725 (2d Cir. 2001); Portmann v. United States, 674 F.2d 1155, 1158 (7th Cir. 1982).

231. *Hilco Prop. Servs.*, 929 F. Supp. at 540 (stating that equitable estoppel "prevents the assertion of what would otherwise be an unequivocal right") (quoting 28 AM. JUR. 2D *Estoppel and Waiver* § 33 (1966)).

232. Plymouth Foam Prods. v. City of Becker, 120 F.3d 153, 157 (8th Cir. 1997).

233. Armistead v. Vernitron Corp., 944 F.2d 1287, 1298 (6th Cir. 1991); *see also* Lehman v. United States, 154 F.3d 1010, 1016–17 (9th Cir. 1998); Burdine v. Dow Chemical Co., 923 F.2d 633, 635 (8th Cir. 1991) (applying Arkansas law); Portmann v. United States, 674 F.2d 1155, 1167 (7th Cir. 1982) (adopting elements listed in the Ninth Circuit's decision in TRW, Inc. v. Federal Trade Comm., 647 F.2d 942, 950–51 (9th Cir. 1981)).

234. *See* Cange v. Stotler & Co., 826 F.2d 581, 585 (7th Cir. 1987) ("The federal doctrine of equitable estoppel applies to actions brought in federal courts at law and equity." (citing Glus v. Brooklyn E. Dist. Terminal, 359 U.S. 231, 232–33 (1959))); DOBBS, *supra* note 159, § 2.3(5), at 66 ("Equitable estoppel originated in decisions of equity courts, as its name implies; but it has long since 'worked over' into law. This means that estoppel, when established, affects not only equitable remedies, but also legal remedies.").

such limitations.[235] Thus, it may be raised as a defense to tax-refund claims without relying on the historically equitable nature of such claims.

Another consideration in the application of equitable estoppel is that it should operate always as a shield and never as a sword.[236] In other words, equitable estoppel does not work as a positive gain to a party,[237] but rather serves to prevent a loss that otherwise would occur by strict application of the law.[238] It should not be applied beyond what is necessary to "promote the ends of justice" and "accomplish that which ought to be done between [the parties]."[239]

The first four elements of equitable estoppel as enumerated by the Sixth Circuit in *Armistead v. Vernitron Corp.* are clearly satisfied in a tax-refund situation like that of WorldCom's. WorldCom made a representation on its federal income tax return of a material fact—its taxable income—while being aware that its true income was in fact much less.[240] WorldCom's false representation of its income on a document executed under penalty of perjury was conduct calculated to induce the IRS to "act" by accepting the income tax return as a true and accurate statement of its income and tax liability, and foregoing enforcement action for failure to file a correct tax return.[241] Of course, the IRS was unaware of WorldCom's true income, since the federal income tax system relies on taxpayers to apprise the government of their tax obligations through self-reporting.

The fifth element of equitable estoppel is detrimental reliance by the party asserting the estoppel. The case law in this area requires detriment, injury, or prejudice to the party claiming the estoppel.[242] Moreover, the prejudice or injury involved

235. DOBBS, *supra* note 159, § 2.3(5), at 66.

236. *E.g.*, Lacy v. United States, 216 F.2d 223, 225 (5th Cir. 1954); Arnold & Assocs., Inc. v. Misys Healthcare Sys., 275 F. Supp. 2d 1013, 1023 (D. Ariz. 2003).

237. G.S. Johnson Co. v. Nev. Packard Mines Co., 272 F. 291, 309 (D. Nev. 1920).

238. The Tampico v. Crossett W. Lumber Co., 270 F. 537, 542 (9th Cir. 1921).

239. Cook v. Ball, 144 F.2d 423, 438 (7th Cir. 1944).

240. *See supra* notes 16–18 and accompanying text.

241. *See* United States v. Rayor, 204 F. Supp. 486, 492 (S.D. Cal. 1962) (observing that the government has a right to believe, before acting on a return, that the return truthfully reflects the taxpayer's income and expenditures).

242. Portmann v. United States, 674 F.2d 1155, 1167 (7th Cir. 1982) (quot-

must be "actual and material or substantial, and not merely technical or formal."[243] In WorldCom's case, the IRS clearly relied on the false representations contained in the company's tax return. The question is whether there was a corresponding detriment to the IRS since there was an overpayment of tax rather than a tax deficiency.[244] As discussed in Part II.B, the courts have answered that question affirmatively.[245] In *Badaracco*[246] and *Goldman*,[247] the courts discussed the specific detriment to the government caused by the filing of false returns, including increasing its administrative burdens, hindering the verification of the taxpayer's correct tax liability, and undermining voluntary compliance. These are "actual" rather than merely "technical" harms, and they should be sufficient to satisfy the requirements of the doctrine of equitable estoppel. Moreover, because estoppel in this situation would redress actual harms to the government, its function would be that of a shield rather than a sword.

In sum, equitable estoppel presents a viable defense that the government may assert to deny a refund claim where tax fraud is involved. Unlike the defense of unclean hands, it may be raised as a defense against legal as well as equitable claims. However, the need to establish detrimental reliance makes it somewhat weaker than the unclean hands defense.

3. Quasi-Estoppel

Closely related to equitable estoppel is the doctrine of quasi-estoppel, sometimes referred to as the "duty of consistency."[248] This doctrine precludes a party from asserting, to another's disadvantage, a right that is inconsistent with a position he has previously taken. "The doctrine applies when it would be unconscionable to allow a person to maintain a position inconsistent with one to which he acquiesced, or from which he accepted a benefit."[249] In general, the elements of

ing United States v. Fox Lake State Bank, 366 F.2d 962, 965 (7th Cir. 1966)) (requiring substantial injury from reliance).

243. *See* 28 AM. JUR. 2D *Estoppel and Waiver* § 78 (1966).

244. Of course, in the circumstances addressed by this Article there *never* would be a tax deficiency, since a tax deficiency would not give rise to either a refund claim or a need to deny that claim on grounds of equity.

245. *See supra* notes 100–13 and accompanying text.

246. Badaracco v. Comm'r, 464 U.S. 386, 398–400 (1984).

247. United States v. Goldman, 439 F. Supp. 337, 344 (S.D.N.Y. 1977).

248. Estate of Letts v. Comm'r, 109 T.C. 290, 296 (1997).

249. Stinnett v. Colo. Interstate Gas Co., 227 F.3d 247, 258 (5th Cir. 2000);

quasi-estoppel are (1) a party's taking of a position and the acceptance of the benefits of that position, and (2) the party's subsequent taking of an inconsistent position to avoid corresponding obligations or effects of the initial position.[250] In tax cases, courts sometimes have included the additional element of an expired statute of limitations. Thus, in *Beltzer v. United States*, the elements were:

> (1) the taxpayer has made a representation or reported an item for tax purposes in one year, (2) the Commissioner has acquiesced in or relied on that fact for that year, and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year.[251]

The third element in the latter formulation highlights the situation where inconsistent positions would permit a taxpayer to "whipsaw" the IRS.[252]

Beltzer v. United States provides an example of the application of quasi-estoppel in the tax context. In that case, the taxpayer inherited shares of stock that had been undervalued on

see also Long v. Turner, 134 F.3d 312, 318 (5th Cir. 1998). A critical difference between equitable estoppel and quasi-estoppel is that the latter does not require a showing of either a misrepresentation by one party or reliance on that misrepresentation by the other party. *Long*, 134 F.3d at 318.

250. *E.g.*, VT, Inc. v. Geico Ins. Co., No. 3:03-CV-0522-P, 2004 U.S. Dist. LEXIS 11849, at *24 (N.D. Tex. June 16, 2004); *see also* Alamo Nat'l Bank v. Comm'r, 95 F.2d 622, 623 (5th Cir. 1938).

251. 495 F.2d 211, 212 (8th Cir. 1974); *see also* Griffith v. United States, 71-1 U.S. Tax Cas. (CCH) ¶ 9280, at 86,084 (N.D. Tex. 1971); Harvey & McMillan v. United States, 64-2 U.S. Tax Cas. (CCH) ¶ 9720, at 93,838 (S.D. W. Va. 1964); *Estate of Letts*, 109 T.C. at 296 (1997).

252. The Fifth Circuit discussed the "whipsaw" dilemma as follows:

> In income taxation what is done in one tax year is sometimes projected into another where the same fact must govern. There being continuity, there ought to be consistency in treatment. If, for instance, a sale is made on deferred payments, and the taxpayer returns it as an installment sale, charging himself only with the cash collection, and the Commissioner acquiesces, the taxpayer could not in later years refuse to pay on the deferred collections by asserting that he stated the facts wrongly in the first instance and ought to have paid on all then, unless he should offer to correct also the first tax settlement. So if a taxpayer who acquired gain in an exchange of property sets up as its measure a value of what he received in which the Commissioner acquiesces, that value is the basis to be taken in measuring a further gain on a sale of the property in a later year. The taxpayer cannot say: "I was mistaken. The value was many times what I said it was. I therefore realized less gain on the last sale," without doing justice all around in correcting his mistake.

Alamo Nat'l Bank, 95 F.2d at 623.

the decedent's estate tax return.[253] When the taxpayer sold the shares several years later for an amount considerably greater than the value reflected in the estate tax return, he argued that his adjusted basis in the shares, for purposes of calculating the capital gain on the sale, should have been greater than the value reflected in the estate tax return.[254] The higher basis would have reduced the tax paid on the sale, for which the taxpayer sought a refund.[255] The IRS invoked the doctrine of quasi-estoppel to deny the taxpayer's refund claim and the Eighth Circuit affirmed the government's position, holding that the taxpayer could not assign stock a low value for purposes of determining the estate tax due, and later, when the statute of limitations had run on the collection of the estate tax, change that value so as to reduce the amount of capital gains tax due on the sale of the stock.[256]

Quasi-estoppel, although presenting fewer requirements for its application, is a bit more awkward to employ in the case of refund claims for fraudulently inflated income tax than the doctrines of unclean hands or equitable estoppel, at least as the doctrine has developed in the area of tax law. The fraudulent inflation of one's tax liability is counterintuitive and as a result, the relevant statutes and legal doctrines are ill-suited to deal with such cases.[257] Nevertheless, quasi-estoppel offers the IRS yet another possible equitable defense to payment of refund claims in cases such as WorldCom's.

First, the Commissioner relied on WorldCom's assertion that its income was some $11 billion more than it really was.[258] Although this position cost the company additional taxes, it permitted WorldCom to represent to its investors that it was thriving when, in fact, it was teetering on the edge of financial ruin. This benefit clearly had monetary value to the company measured by the amount of the taxes that it paid.[259] WorldCom subsequently sought to change the representation that it had previously made (namely, that its income was $11 billion more

253. *Beltzer*, 495 F.2d at 212.

254. *Id.*

255. *Id.*

256. *Id.* at 212–13. For a similar case, see *Alamo Nat'l Bank*, 95 F.2d at 623.

257. *See, e.g.*, *supra* note 81 and accompanying text (regarding I.R.C. § 6663 (2000)).

258. *See* Young, *supra* note 17.

259. *See* Erickson et al., *supra* note 61, at 388, 391.

than it actually was) so as to avoid the consequences of that earlier position (namely, the permanent loss of the taxes paid on the inflated income). All that is missing is an expired statute of limitations. This should not be fatal, however. As noted above, the expired statute of limitations element simply describes one situation in the tax law in which the IRS potentially may be whipsawed and where the application of quasi-estoppel is particularly apposite.[260] The benefit WorldCom enjoyed, unlike a reduction in taxes, does not become fixed upon the expiration of a statute of limitations. Moreover, the two elements of the traditional version of quasi-estoppel would be satisfied, and there does not appear to be any authority that suggests the tax version must be used exclusively in tax-related cases.

In short, to successfully assert the equitable defense of quasi-estoppel to WorldCom's tax-refund claim, the IRS would need only show that WorldCom benefited from the position it took on its federal income tax returns, and that it now seeks to change that position in order to avoid the consequences it entails.[261] Given the facts of the case, such a showing is easily made.

D. Public Policy Issues

As noted in the preceding discussion of the various equitable defenses, a primary concern of equity is public policy.[262] That is, does public policy demand the application of the particular equitable defense, and if that defense is applied, what will be the effect on public policy? But apart from its relationship to specific equitable defenses, public policy presents broader issues that may affect the use of equity as proposed in this Article. Some of these issues are addressed under the three broad headings in the remainder of this Part III.

1. Rules v. Standards

The history of the development of equity, as described in Part III.B, reflects the ongoing tension between judge-made law (equity) on the one hand, and statutory rules (common law) on the other. While the tax law does not want for statutory rules,

260. *See supra* note 252 and accompanying text.

261. Neiman-Marcus Group, Inc. v. Dworkin, 919 F.2d 368, 371 (5th Cir. 1990) (explaining that to establish quasi-estoppel, one must show that the party to be estopped "can be equitably charged with choosing to accept benefits in a manner genuinely inconsistent with his subsequent claim").

262. *See supra* notes 218–21 and accompanying text.

it has been significantly shaped by judge-made law.[263] For example, in the 1930s it was a judicial move away from formalism in the tax law that culminated in the Supreme Court's decision in *Gregory v. Helvering*.[264] In that case, the court first articulated the business purpose doctrine, a "standard" that permits the denial of favored tax treatment for transactions that lack sufficient business purpose.[265] An equally influential judge-made standard was articulated four decades later by the Supreme Court in *Knetsch v. United States*.[266] That standard, the well-known "economic substance doctrine," permits a transaction to be disregarded if there is no economic substance to the transaction beyond the tax benefit sought.[267]

Although the debate is not over, where tax law is concerned, standards such as these are seen by some scholars as superior to rules in many respects.[268] The principal reason is that standards do not require frequent amendment to adapt to incremental change.[269] This view has been reinforced recently

263. *See* Likhovski, *supra* note 172, at 980.

264. 293 U.S. 465 (1935).

265. *Gregory*, 293 U.S. at 469 (describing the purported corporate reorganization in the case as "[s]imply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner").

266. 364 U.S. 361 (1960).

267. *Id.* at 366.

268. *See, e.g.*, RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 57 (1990) ("A society in as much [legal] ferment as ours needs a mechanism for legal change, and it is not obvious that the combination that predominates in federal income taxation—extremely detailed statutory specifications with frequent amendments and continuous executive rule making—is always to be preferred to judicial administration of flexible standards."); David A. Weisbach, *Costs of Departures from Formalism: Formalism in Tax Law*, 66 U. CHI. L. REV. 860, 860 (1999) ("[O]ver the last several years, the purely rule-oriented approach to the tax law has begun to be perceived as a failure."). *But see* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (arguing that if cases are anticipated to arise frequently and have important recurring characteristics, as is the case with tax law, rules will not only be preferable, but might be expected to be more precise).

269. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 590 (5th ed. 1998) ("To control behavior through a set of detailed rules rather than through a general standard involves costs . . . in revising the rules to keep them abreast of changing conditions; as we have noted, a specific rule will obsolesce more rapidly than a general standard."); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L. & CONTEMP. PROBS. 673 (1969) (recognizing, over three decades ago, the

in assessing the problem of abusive corporate tax shelters.[270] Attempts to shut down tax shelters with rules simply result in new avoidance maneuvers, which in turn require additional rules that are again exploited, and so on.[271] An anti-avoidance standard, by contrast, is adaptable to transactions as they mutate.[272] To illustrate with an example, following the *Knetsch* decision,[273] Congress enacted a rule to prevent the transaction employed by Knetsch—namely, the deduction of interest paid in connection with tax-deferred annuities.[274] The rule was effective for that transaction but, unlike the economic substance standard articulated by the Court, was useless in addressing subsequent variations of the transaction, such as corporate-owned life insurance, which surfaced in the early 1990s.

The point here is that the use of equitable defenses as a means of denying tax-refund claims in earnings-inflation cases, like the use of standards in other contexts, may well be preferable to a legislative enactment that would increase the penalty applicable to fraudulent returns.[275] In the particular context of § 7206,[276] equitable defenses would share with the legislative approach the advantages of addressing the overpayment issue not contemplated by the original penalty and of imposing a penalty that would not likely become obsolete by virtue of inflation or similar factors.[277] Unlike the legislative solution, however, equitable defenses would not be susceptible to obsolescence as tax fraud evolves.

value of standards in managing the complexity of tax law).

270. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 247–48 (2002).

271. *See* Surrey, *supra* note 269, at 686 ("[R]ules in turn bring about new frontiers of interpretation and maneuver, which are settled by new statutory rules, again creating new frontiers. The tax universe is indeed limitless, with no frontier ever providing a finite boundary.").

272. There have been several attempts to codify the economic substance doctrine, most recently in the Senate's version of the legislation that became the American Jobs Creation Act of 2004. The economic substance provision, along with the increased penalty that would cover tax fraud involving overstatements of income, was dropped in conference. *Compare* S. 1637, 108th Cong. § 425 (2004) *with* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

273. Knetsch v. United States, 364 U.S. 361 (1960).

274. I.R.C. § 264(a)(4) (2000).

275. *See supra* notes 24–28 and accompanying text (discussing efforts by the Senate to increase fraudulent overpayment penalties).

276. I.R.C. § 7206 (2000).

277. *See supra* notes 122–28 and accompanying text (discussing penalty amounts).

One trade-off in adopting standards over rules is the diminished certainty that accompanies vaguer, judge-made law.[278] The use of equitable defenses in denying a fraud-related refund claim in a case like WorldCom's, for example, would establish a new precedent. It would initially create some uncertainty as taxpayers evaluate whether the denial would likely be repeated in other cases, and if so, under what specific sets of circumstances. Viewed *ex ante*, WorldCom could not have known that its refund claim would be denied based on then-established precedent. This, of course, is the ultimate in uncertainty. On the other hand, equitable principles are generally well established and well known, and their application in this context should not be wholly unexpected.[279] Moreover, as precedent is developed for the use of equity in this context, certainty and predictability will likely increase.[280]

2. The "Innocent Investor"

One could construct a public policy argument that suggests it would be unfair for the IRS to retain tax overpayments that otherwise might be used to mitigate damages suffered by innocent creditors and shareholders of a corporation that had inflated earnings. After all, the direct cost of any penalty generally will be borne by shareholders in addition to the potential indirect costs associated with the penalty.[281] There are three responses to this argument. First, both creditors and shareholders assume the risks of their investments in a corporation, including risks related to the behavior of management.[282]

278. *But see* Weisbach, *supra* note 270, at 247–48 (arguing that the effects of uncertainty are difficult to predict and may, in fact, be positive).

279. In fact, the permanent loss of the $300 million it paid in taxes should not have been a surprise to WorldCom at all. Because a refund claim generally must be filed within three years from the time the return was filed, WorldCom must have expected either to forfeit the taxes paid or admit within two years that it had inflated its taxable income. *See supra* notes 142–46 and accompanying text.

280. *See* Kaplow, *supra* note 268, at 611 ("To the extent laws are promulgated as standards, predictability will be enhanced by precedent to the extent precedent transforms standards into rules.").

281. Christopher Kennedy, *Criminal Sentences for Corporations: Alternative Fining Mechanisms*, 73 CAL. L. REV. 443, 448–49 (1985).

282. *Id.* at 452–53 ("[W]hile the possibility of large fines introduces an added element of risk into the shareholder's investment, shareholders are uniquely situated to neutralize risk through diversification. What is more, this risk will have been reflected in lower share prices when the investor bought his shares. Hence the view that shareholders are 'innocent' should be no bar to

Sometimes the assumption of these risks is rewarded; sometimes investors are penalized.[283] Both creditors and shareholders can reduce the risk associated with unlawful conduct of managers in one firm by investing in many others.[284] Moreover, under general corporate law, the shareholder enjoys immunity from personal liability for the actions of corporate management even when those actions injure third parties, including creditors.[285]

A second response is that a refund retained by the Treasury, as proposed in this Article, is in the nature of a penalty because it is retained as a result of the taxpayer's fraudulent conduct. The denial of a tax refund by the IRS differs from an outright penalty only in that it is imposed by a court out of considerations of equity in the particular case, rather than as a matter of positive statutory law. Penalties routinely are imposed on corporations without consideration of their impact on innocent shareholders.[286] As a matter of policy, penalties for corporate wrongdoing ought not to be waived simply because shareholders were not directly involved in the wrongdoing. Taken to its logical conclusion, this argument would preclude imposition of virtually all monetary penalties on publicly traded corporations since shareholders bear the costs of such penalties but rarely are involved in management activities, fraudulent or not.

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fines that eliminate the prospective profit in criminal conduct."). Creditors face more risk than shareholders because they generally lack the opportunity to profit from corporate malfeasance. *See id.* at 452. However, creditors may attempt to manage these risks through covenants and other restrictions.

283. Shareholders often benefit from the crime of managers, as did WorldCom shareholders who sold stock during the run-up in the company's stock price. Since they bear no personal responsibility for management's criminal activity, shareholders have little incentive to hire managers willing to adhere to the law. *See* POSNER, *supra* note 269, at 464.

284. *See* Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 315, 320 (1991) (observing that shareholders "can reduce the risk associated with individual stock holdings in particular firms by owning a fully diversified portfolio of securities").

285. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(6) (2005) (stating that unless a corporation's certificate of incorporation contains a statement providing to the contrary, "stockholders . . . of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts").

286. *See, e.g.*, Cynthia A. Glassman, Comm'r, SEC, Remarks at the 13th Annual Public Fund Boards Forum: The Challenges of Striking a Regulatory Balance (Dec. 6, 2004), http://www.sec.gov/news/speech/spch120604cag.htm (expressing concern over the trend of increasing corporate penalties that too often hurt the investors that the SEC is supposed to protect).

Finally, a no-refund policy would be beneficial to shareholders to the extent that it creates incentives for corporations to accurately report earnings. A corporation facing the potential forfeiture of all federal income taxes paid on inflated earnings is more likely to impose stricter internal controls to prevent earnings inflation and the concomitant tax fraud, than is a corporation facing a maximum penalty of a few hundred thousand dollars.

3. Penalty Optimality

A third matter of public policy concern is the extent to which the use of equitable defenses to deny refund claims results in the effective imposition of an optimal penalty. Although the rationality and, thus, the efficacy of the current tax penalty system have been criticized, few would dispute that tax penalties are necessary to insure substantial compliance with the tax laws.[287] To achieve such compliance, the congressional Joint Committee on Taxation has recommended that tax penalties "(1) encourage voluntary compliance, (2) operate fairly, (3) deter undesired behavior, and (4) be designed in a manner that promotes efficient and effective administration of the provisions by the IRS."[288] These elements suggest affecting taxpayer behavior in ways consistent with the collection of tax revenues and the smooth functioning of the tax system. In other words, the elements focus on optimality.

The economic model of optimality is familiar. A person presumably will commit a crime if the benefits of doing so exceed the expected costs to him.[289] Thus, if apprehension is certain, increasing the potential costs associated with the crime by imposing a penalty will deter its commission.[290] Of course, appre-

287. *See, e.g.*, Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 344 (1989) (observing that tax penalties are "remarkably crude policy instruments," but noting that such penalties discourage illegal or undesirable activity).

288. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 84, at 31. The first and third of these elements seem to be after the same thing (i.e., a penalty can *encourage* voluntary compliance only to the extent that it *deters* noncompliance).

289. This analysis is based on Bentham's theory that an individual will seek to maximize satisfaction and thus will be deterred from committing a crime if its costs exceed its benefits. *See* JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION 166 (J.H. Burns & H.L.A. Hart eds., 1970). There are other theories as well. *See* Zolt, *supra* note 287, at 361–62.

290. Deterrence has a particular meaning in the context of corporate crime

hension is never certain absent a 100 percent audit rate, which is not possible in an environment of limited government resources. Therefore, the expected cost of a crime is the product of the penalty imposed and the probability of apprehension and conviction. Where the probability of apprehension is relatively low, the expected cost of the crime can be raised by increasing the amount of the penalty imposed.[291] Given that audits are limited by available government resources, a high-penalty, low-audit regime is likely to be most administratively efficient, thus satisfying the fourth characteristic identified by the Joint Committee.[292] The only upper limit on the penalty amount under the economic model is fairness, which is also the second characteristic recommended by the Joint Committee. Fairness entails making the penalty proportional to the crime.[293] A high-penalty regime may be considered unfair, and compliance will not be encouraged if the penalty does not appear to fit the crime.[294]

By the Joint Committee's standards, the current tax fraud penalty is a dismal failure in addressing the filing of fraudulent returns.[295] Given the trivial dollar amount of the fine imposed,[296] the current penalty will not deter the filing of fraudulent returns by corporations, to which it clearly is intended to apply.[297] Moreover, the current penalty lacks proportionality

that relates to Bentham's notion of maximizing satisfaction. Kennedy, *supra* note 281, at 450 ("In evaluating the obstacles to a satisfactory rationale for corporate fines, it is first important to define the sort of deterrence that is their goal. The word 'deterrence' is perhaps misleading in the corporate context, since it connotes crime prevention through fear. But corporate fines deter not so much through fear as through cancellation of motive. The essence of fines that eliminate expected gain is simply the neutralization of one of the stimuli for corporate crime: the profit motive.").

291. *See* POSNER, *supra* note 269, at 242–43 (applying economic analysis to crime and criminal sanctions); Kennedy, *supra*, note 281, at 447 ("The fine must reduce the expected gain of a violation to zero or below, incorporating a multiplier to counterbalance the possibility that a violation would escape detection.").

292. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 84, at 37.

293. Leo P. Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 VA. TAX REV. 535, 570 (1991) ("Penalties for tax offenses should be equitable, and to be equitable, they must be proportional.").

294. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 84, at 37. By the same token, a penalty that is too low also reflects a lack of proportionality and will tend to discourage compliance.

295. The criticisms leveled here apply to fraudulent understatements and overstatements of income and tax.

296. *See supra* notes 122–28 and accompanying text.

297. *See* I.R.C. § 7206(5) (2000) (specifying the fine amount in the case of

because it is a fixed dollar amount that applies irrespective of either the financial circumstances or the culpability of the offender. Thus, the penalty falls more heavily on individual taxpayers filing fraudulent returns than it does on corporations.[298] The penalty is not likely to encourage compliance either, since it lacks proportionality and may therefore be viewed as unfair. Finally, the penalty is neither administratively efficient nor effective. Minimal revenue is likely to be collected either from the penalty itself or as a result of the penalty's effect in deterring the fraud that the statute proscribes.[299]

By contrast, consider the denial of a refund claim on the grounds of equity. The lost refund in some cases will be quite high. For example, in WorldCom's case, the penalty likely would have been around $300 million. Whether *any* penalty would have been sufficient to deter the company's earnings inflation is not clear.[300] However, to the extent that earnings inflation *can* be deterred, a penalty of $300 million is much more likely to be effective than a likely maximum penalty of $160,000.[301] Where audit probability is low, an increased penalty is necessary to insure that the cost of the crime is sufficiently high to at least potentially have a deterrent effect.[302] Thus, the denial of a refund is likely to achieve a greater measure of deterrence than the current penalty.

corporations).

298. Much of the current system of penalties suffers from a lack of proportionality. Zolt, *supra* note 287, at 345–46.

299. *See supra* note 125 and accompanying text.

300. Arguably, WorldCom executives would not have been deterred by the possibility that overpaid taxes would not be refundable, if they even considered the question in the first place. In fact, if the corporation expected to conceal its fraud for at least as long as the three-year statute of limitations on refund claims, then the decision to inflate the corporation's earnings was made in the face of a *prepaid* penalty of $300 million. On the other hand, it seems likely that, in many cases, corporations inflating their earnings do so as a temporary measure, with the intention of reversing the overstatement in the future.

301. *See supra* notes 122–27 and accompanying text. Of course, the argument that denying a refund would not deter earnings inflation in some cases applies with equal force to a penalty of *any* size that one might impose.

302. *See* POSNER, *supra* note 269, at 244 ("If the costs of collecting fines are assumed to be zero regardless of the size of the fine, the most efficient combination is a probability arbitrarily close to zero and a fine arbitrarily close to infinity."). However, the potential penalty imposed on a given corporation in the form of denying a tax refund is necessarily capped at an amount equal to the product of the overstated earnings and the corporation's effective tax rate.

As discussed above, the upper limit on a penalty should be measured by its potential to be perceived as excessive. At first blush, denying WorldCom a refund of $300 million in taxes paid on phony income might be viewed as not proportional to the offense. Of course, in real terms, the denial of the refund would be exactly proportional to the offense because it would be measured directly by the amount of WorldCom's fraudulent overstatement of its tax liability. Even weighed against the potential harm caused by WorldCom's tax fraud, though, it is not clear that the denial of a refund would be excessive. A fine of $300 million certainly is large, but it failed to shock the conscience of the U.S. Senate, which voted unanimously for legislation that would have imposed just such a fine.[303] Perjury in its various forms has always been considered one of the most odious of criminal offenses.[304] It was punishable by death under the Code of Hammurabi, Roman law, and French law.[305] In more enlightened times, the Supreme Court has called perjury "an obvious and flagrant affront to the basic concepts of judicial proceedings," and described "effective restraints against this type of egregious offense" as "imperative."[306] Moreover, a penalty of 100 percent of an overpayment of tax is not far from the currently applicable civil penalty of 75 percent of any understatement of tax attributable to fraud.[307] Considering that no

303. *See supra* notes 24–26 and accompanying text. Historically, many corporate fines have been absurdly low, and a number of legislatures are moving toward fines that reflect some multiple of the gain from prohibited conduct. *See* Kennedy, *supra* note 281, at 453 n.41.

304. *See* Stuart P. Green, *Lying, Misleading, and Falsely Denying: How Moral Concepts Inform the Law of Perjury, Fraud, and False Statements*, 53 HASTINGS L.J. 157, 174–75 (2001).

305. *See* Bennett L. Gershman, *The "Perjury Trap"*, 129 U. PA. L. REV. 624, 636 (1981). Putting aside the death penalty for the moment, the seriousness with which perjury is viewed is not unwarranted given the necessity for truth in human dealings. As one moral philosopher has said, "trust in some degree of veracity functions as a *foundation* of relations among human beings; when this trust shatters or wears away, institutions collapse." SISSELA BOK, LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE 31 (Vintage Books 1989) (1978).

306. Gershman, *supra* note 305, at 636 n.44 (citing United States v. Mandujano, 425 U.S. 564, 576 (1976)).

307. I.R.C. § 6663 (2000). The Supreme Court has determined that the civil fraud penalty is not even punitive, but rather is a "remedial sanction" provided primarily for revenue protection and to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud. *See* Helvering v. Mitchell, 303 U.S. 391, 401 (1938) (construing a 50 percent fraud penalty).

interest would attach to the amount owed, as would be the case in a typical underpayment situation, denial of a refund does not appear unduly punitive.

The denial of a refund also achieves administrative efficiency and effectiveness. It is administratively simple, requiring only determination of the amount of the refund that is sought and verification as to whether the refund arose in connection with earnings inflation.[308] Further, the denial of refunds would yield significant returns on audit resources expended. In sum, the denial of refund claims in tax fraud cases involving inflated earnings is likely to have a greater deterrent effect, encourage compliance to a greater degree, be perceived as more fair, and be more administratively efficient and effective than the current penalty regime.

IV. APPLYING EQUITY TO REFUND CLAIMS

So far, this Article has assessed the scope of the earnings-inflation problem and its impact on tax reporting, examined the inadequacy of existing penalties to effectively discourage tax fraud related to earnings inflation, reviewed both the equitable pedigree of tax-refund claims and the equitable defenses that might be asserted in response to such claims, and discussed various relevant public policy issues. The remainder of the Article discusses how the IRS can establish the connection between earnings inflation on the one hand, and a claim for refund of taxes paid on the inflated earnings on the other. This part of the Article concludes with an assessment of the roles of both the IRS and the Joint Committee in asserting equitable defenses to refund claims.

A. ESTABLISHING THE TAX-FRAUD CONNECTION

Until recently, no simple mechanism existed for determining whether a particular refund claim was linked to earnings inflation and therefore should be denied. That is, there was no easy way of linking a given tax-refund claim to fraudulent activity on the part of the corporate taxpayer that might give rise to an equitable defense to the claim. In a case such as WorldCom's, where the accounting fraud was widely reported by the

308. The administration of refunds under this approach is discussed in greater detail in *infra* Part IV.

media, the IRS could, of course, ferret out the tax fraud that masked the earnings inflation. However, not all cases would necessarily be as publicly visible.

Fortunately, this knowledge gap will be eliminated for tax years ending on or after December 31, 2004. In an effort to increase the transparency of corporate tax return filings in general, Treasury and the IRS have issued Schedule M-3, which would replace the current Schedule M-1 on which a corporation reconciles the difference between its book income and taxable income.[309] Importantly, the new Schedule M-3 asks the reporting corporation whether it has restated its financials for periods covered by the schedule and, if so, requests an explanation of each item restated.[310] This new form will permit the IRS to establish the necessary nexus between accounting fraud, on the one hand, and tax fraud, on the other. During IRS processing, a Schedule M-3 that indicates that earnings were restated in the year for which the refund is claimed should immediately trigger closer scrutiny.

For example, assume that a company like WorldCom files an amended return requesting a refund of taxes paid on fraudulently inflated income. Because the company has to show on Schedule M-3 that it has restated its earnings, the IRS will be able to investigate the relationship between the earnings inflation and the refund claim. If the investigation indicates that the company was engaged in accounting fraud and falsified its original tax return to conceal the fraud, the IRS should then impose liability under I.R.C. § 7206(1)[311] and deny the refund claim based on the doctrine of unclean hands or another applicable equitable defense.[312]

309. *See* Press Release, Internal Revenue Service, Treasury and IRS Issue Revised Tax Form for Corporate Tax Returns (July 7, 2004), http://www.irs.gov/newsroom/article/0,,id=124997,00.html; Press Release, Office of Public Affairs, Treasury Department, Treasury and IRS Issue Final Version of Tax Form for Corporate Tax Returns (Oct. 25, 2004), http://www.treas.gov/press/releases/js2058.htm.

310. INTERNAL REVENUE SERV., SCHEDULE M-3 (FORM 1120), NET INCOME (LOSS) RECONCILIATION FOR CORPORATIONS WITH TOTAL ASSETS OF $10 MILLION OR MORE (OMB NO. 1545-0123) 1 (2004), *available at* http://www.irs.gov/pub/irs-utl/final_m-3_form_102504.pdf.

311. I.R.C. § 7206(1) (2000).

312. Violation of § 7206(1) would constitute the bad conduct needed to support the IRS's denial of the company's refund claim based on the defense of unclean hands. As discussed in *supra* Part III.C, the doctrine of unclean hands requires bad conduct on the part of the taxpayer. Although such conduct need not rise to the level of a statutory violation, such a violation clearly establishes

B. EXPANDING JOINT COMMITTEE REVIEW

A policy of denying certain tax-refund claims on grounds of equity should reflect the limits of IRS resources by targeting only sizable tax-refund claims. One approach would be to link equitable review of tax-refund claims to the existing review of large refunds that the congressional Joint Committee on Taxation is statutorily required to undertake.[313] Under current law, a refund in excess of $2 million may not be paid until after the expiration of thirty days from the date on which a report summarizing the proposed refund is submitted for review to the Joint Committee.[314] The report must specify the name of the person (or entity) to whom the refund or credit is to be made, the amount of the refund or credit, and a summary of the relevant facts.[315] The report mandated by § 6405 is prepared by

that the taxpayer has unclean hands. *See supra* notes 210–15 and accompanying text.

313. The Joint Committee is comprised of five members of the Senate Finance Committee and five members of the House Ways and Means Committee (in each case, three of the five are members of the majority party, while two are members of the minority party). I.R.C. § 8002 (2000). The Joint Committee was created by Congress in 1926 to exercise oversight of the Bureau of Internal Revenue (the precursor to the IRS). *See* Revenue Act of 1926, Pub. L. No. 69-20, § 1203, 44 Stat. 9, 127–28. The Bureau of Internal Revenue was widely viewed at the time as serving the interests of the very wealthy at the expense of ordinary taxpayers. *See, e.g.*, 68 CONG. REC. S2364 (1927) (statement of Sen. Heflin) (arguing that through the Bureau of Internal Revenue, Republicans controlled the taxing power of the nation and were using that power to "impoverish the masses and to enrich a favored few"). Senator James Couzens was rewarded with a notice for more than $10 million in back taxes in response to his public criticism of the Bureau of Internal Revenue for its valuation of oil properties. *Recommendations of the National Commission on Restructuring the IRS on Executive Branch Governance and Congressional Oversight of the IRS: Hearing Before the Comm. on Ways and Means H.R.*, 105th Cong. 177–78 (statement of Kenneth J. Kies, Chief of Staff, Joint Comm. on Taxation). Then-Treasury Secretary Andrew Mellon, who had benefited from the Bureau's valuation as the principal owner of Gulf Oil, was believed to be responsible for the retaliation. *Id.* Senator Couzens's investigation led to the creation of the Joint Committee. *Id.*

314. I.R.C. § 6405(a) (2000). Concerned about the integrity of the refund process, Congress expanded the Joint Committee's mandate two years after its creation by requiring that all tax refunds in excess of $75,000 be reported to, and reviewed by, the Joint Committee before they were paid. *See* Revenue Act of 1928, Pub. L. No. 70-562, § 710, 45 Stat. 791, 882. The current review threshold of $2,000,000 was set by section 305 of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 305, 114 Stat 2763, 2763A-634.

315. I.R.C. § 6045(a). The statute also requires that the report include the "decision of the Secretary," but this provision seems superfluous because there would be no refund to trigger the reporting requirement unless the Secretary had determined to pay the refund claim.

personnel within the IRS and submitted to the Joint Committee. The report is then reviewed by staff attorneys working under the supervision of the Joint Committee's Chief of Staff.[316] If no problems appear on the face of the report, the Joint Committee notifies the IRS that it has no objection to payment of the refund.[317]

Whether the Joint Committee plays a sufficiently active role in reviewing tax refunds and whether it even has any actual authority has been debated periodically in Congress since shortly after the Committee's inception.[318] It is safe to say, however, that for decades Joint Committee review has served no meaningful limiting function with respect to the payment of refunds.[319] This Article proposes that the Joint Committee be involved in assessing the viability of equity cases. When presented with a report from the IRS regarding a refund claim in excess of $2 million that arises in connection with earnings-inflation activity by the taxpayer, the Joint Committee would evaluate the applicability of the various equitable defenses

316. The Joint Committee staff is responsible for a number of other activities, including assisting members of Congress in preparing bills for introduction, facilitating Ways and Means Committee and Finance Committee markups of tax legislation, and drafting the explanation of legislation contained in the reports of the Ways and Means, Finance and Conference Committees. *See* Donald L. Korb et al., *Rethinking Refund Review: Understanding the Joint Committee on Taxation*, CORP. BUS. TAX'N MONTHLY, Nov. 2002, at 3, 4.

317. Note that § 6405(a) does not specifically grant the Joint Committee veto power over the payment of large refunds; it merely requires a thirty-day delay period. As a practical matter, however, the IRS will not generally issue such refunds without Joint Committee approval. *See* Diana Lisa Erbsen, *The Joint Tax Committee Refund Review Function: Is It 'Worth a Damn'?*, 72 TAX NOTES 227, 230–31 (1996). The grant of veto authority to the Committee has been proposed. *Id.* at 228 n.15. However, a Joint Committee power to approve or disapprove the issuance of refunds would create a legislative veto over executive branch action in violation of the Constitution. *See* INS v. Chadha, 462 U.S. 919, 952 (1983) (holding that congressional veto of an executive branch decision to suspend the deportation of an alien constituted legislative action that required approval of both houses of Congress and presentation to the president).

318. The initial efforts of the Joint Committee to review large refunds were unimpressive and were the subject of a heated floor debate in the House on January 5, 1929. *See* Erbsen, *supra* note 317, at 229–30. Clearly, the Joint Committee *could* play a meaningful role in limiting refunds. However, as a practical matter, the IRS will not issue large refunds without Joint Committee approval, notwithstanding the absence of an absolute Joint Committee veto. *Id.*

319. *Id.* (noting that procedures followed by the contemporary Joint Committee do not vary significantly from the procedures that were criticized in the 1920s).

based on the conduct of the taxpayer and advise the IRS in appropriate cases to deny the refund claim on such grounds. Importing the consideration of equitable defenses into the rather perfunctory Joint Committee review would perhaps provide the impetus for an expanded role for the Joint Committee staff in this area.

CONCLUSION

It is not yet clear whether congressional and SEC responses will stem the tide of earnings inflation by U.S. corporations, but it is quite possible that earnings inflation may be a persistent phenomenon that has simply been highlighted by the recent weakness in the economy.[320] To the extent that earnings inflation persists, it will continue to pose problems for the tax system because of the utility of fraudulent tax reporting in concealing accounting fraud.

Like all tax fraud, overstatement of taxable income creates additional administrative burdens for the IRS and Treasury. Once fraud on a tax return is discovered, the IRS must be especially diligent in its investigation because the taxpayer has demonstrated a propensity toward dishonesty and falsehood. In particular, fraud cases involve a greater likelihood that, in addition to the tax return, the taxpayer's underlying records have also been falsified. Where income has been *overstated* by the taxpayer, there is a concern that the overstatement may conceal falsely inflated deductions. Tax fraud also makes it more difficult for the IRS to determine the tax liability of other persons whose income, deductions or credits are in some way related to the taxpayer. Perhaps most importantly, tax fraud tends to undermine the integrity of the tax system. Where fraud is common, the government cannot be confident that the records and returns upon which tax liabilities, and therefore government revenues, are based are truthful and accurate. Unpunished tax fraud, in turn, tends to discourage the voluntary compliance upon which the tax system relies. Thus, penalizing tax fraud where there is an overstatement of income or an overpayment of tax is supported by substantial policy considerations.

320. *See* Eduardo Porter, *More Corporate Crime, or Just Prosecutions?*, N.Y. TIMES, Oct. 31, 2004, at WK12.

Given these policy considerations, it is unconscionable that a taxpayer should not only avoid significant penalties, but also readily receive a refund of taxes in excess of what was really owed along with interest on the overpayment. Unfortunately, that is exactly the way the current system works. The use of equity to deny refunds in such cases, as proposed in this Article, would serve as a meaningful penalty where no penalty of substance presently exists. A penalty imposed by equity is consistent with the growing consensus that standards, as opposed to rules, may be more effective in dealing with tax fraud. Recent attempts to codify the economic substance doctrine first articulated in *Knetsch* in 1969, attest to the perceived, continued usefulness of overarching standards to fill the inevitable gaps created by legal rules.[321] Nor would equity in this context do undue injury to innocent shareholders, given general agency principles, notions of shareholder risk, and risk management. Compared to the present system, the penalty imposed by equity would much more closely approach optimality in terms of the government's stated criteria of deterrent effect, encouragement of voluntary compliance, perceived fairness and proportionality, and efficiency and effectiveness of administration.[322]

Based on these considerations, the IRS should begin to move in the direction suggested by this Article by identifying earnings-inflation-related tax-refund claims. This step in the process will be fortuitously aided by the newly revised Schedule M-3 to the corporate tax return, which will provide the IRS with previously unavailable information to link tax fraud to earnings inflation. The IRS should include in its tax-refund reports to the Joint Committee a summary of any fraudulent activity engaged in by the taxpayer, and its relationship to the tax fraud. For its part, the Joint Committee should evaluate large refund claims in light of equitable principles and recommend that the IRS deny refund claims in appropriate circumstances.

321. *See supra* notes 266–77 and accompanying text.

322. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 84, at 31.