VALUATION AS A CHALLENGE FOR TAX ADMINISTRATION

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Valuation issues have long posed challenges for the U.S. federal tax system. This is not just because of questions about what technique will most accurately value particular types of property. A key problem for tax administration is that taxpayers have a financial incentive to claim erroneous, self-serving valuations. This Essay analyzes tax valuation through this tax compliance lens. In so doing, it highlights the importance that third parties to the taxpayer-government relationship act at arm's length from the taxpayer. It also explains why penalties are insufficient to deter erroneous self-reported valuations. The Essay also draws on the tax compliance perspective to make some preliminary observations about valuation methodologies.

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Introduction

A 1963 article opened with the statement that "[o]ne of the most difficult problems in federal tax administration is the determination of the value of ownership interests where there is no ascertainable market quotation, as in the case of the stock of closely-held business enterprises."[1] Valuation issues remain challenging today.[2] Traditionally, federal tax valuation cases have arisen in connection with the estate or gift tax or the federal income tax consequences of a transaction such as a charitable donation or the sale of a business.[3] Those disputes continue to arise, along with the difficult valuation issues raised by "transfer pricing" for transactions between related companies.[4] In addition, recent proposals for a federal wealth tax[5] have high-

1 Chelcie C. Bosland, *Tax Valuation by Compromise*, 19 Tax L. Rev. 77, 77 (1963).

2 *See* Guy B. Maxfield, Prologue to *Proceeding with a Valuation Case Involving Closely Held Business Interests Before the United States Tax Court (Part 1)*, 34 Prac. Tax Law. 27, 28 (2020) ("There comes a time in the life of a tax lawyer when a client will ask . . . the surprisingly difficult question, 'What is it worth?'"); John A. Townsend, *Burden of Proof in Tax Cases: Valuation and Ranges—An Update*, 73 Tax Law. 389, 391 (2020) ("In 2019, Tax Court Judge Gustafson delivered the fourth chapter in a long-running, highly episodic gift-tax valuation case involving the Cavallaros, taxpayers who are husband and wife (*Cavallaro IV*). The Service started its examination of the transaction in 1998." (footnote omitted)).

3 *See* Ralph E. Lerner, *Valuing Works of Art for Tax Purposes*, 28 Real Prop., Prob. & Tr. J. 593, 594 (1993) ("A fair market appraisal of a work of art is critical for income tax purposes if the work is transferred during life to a charitable donee, for gift tax purposes if it is transferred during life to a noncharitable donee, and for estate tax purposes if it is owned at death."). The cases cited below in note 14 reflect these contexts. *Estate of Gilford* was an estate tax case. Est. of Gilford v. Comm'r, 88 T.C. 38, 39 (1987). *Messing* was a gift tax case. Messing v. Comm'r, 48 T.C. 502, 508 (1967). *Buffalo Tool & Die* involved the sale of a business. Buffalo Tool & Die Mfg. Co. v. Comm'r, 74 T.C. 441, 445 (1980). *Symington* involved a charitable deduction for a conservation easement. Symington v. Comm'r, 87 T.C. 892, 893 (1986).

4 *See* Liu Ping, *Transfer Pricing and Customs Valuation: Exploring Convergence*, 2 Glob. Trade & Customs J. 117, 117 (2007) ("When goods, intangibles and services are transferred across borders within MNEs [multinational enterprises], transfer pricing becomes an important issue for both MNEs as well as for national tax and customs authorities."); Townsend, *supra* note 2, at 389 ("Corporate valuations for estate tax are just one context of tax litigation, but there are many other contexts. A prominent example for some time now has been transfer pricing.").

5 *See, e.g.*, Emmanuel Saez & Gabriel Zucman, The Triumph of Injustice: How the Rich Dodge Taxes and How to Make Them Pay 149 (2019) ("A progressive wealth tax is possible because in contrast to taxable income, which can be artificially reduced, wealth is well defined at the very top."); Jane G. Gravelle, *Sharing the Wealth: How to Tax the Rich*, 73 Nat'l Tax J. 951, 963 (2020) ("A bolder idea is a wealth tax, proposed by two candidates

lighted the importance of valuation issues because such a tax would require periodic valuations of high-value assets.[6]

Valuation issues are challenging for two main reasons. The first is the opposing incentive the taxpayer has from the tax agency.[7] For example, where the receipt of an asset gives rise to tax, the taxpayer generally would benefit from a lower valuation.[8] In a self-reporting system, such as the U.S. federal income and transfer tax systems, taxpayers therefore have a financial incentive to report self-serving valuations in an effort to reduce their taxes.

The government can challenge the taxpayer's valuation, of course, but that requires an audit. Audit rates are generally low,[9] due to resource constraints. The Internal Revenue Service (IRS) in particular has seen its audit rates decline since 2010,[10] as Congress has starved it of funding.[11]

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for the democratic presidential nomination in 2020, Senators Bernie Sanders and Elizabeth Warren."). Wealth taxation is not a new idea, however. *See, e.g.*, George Cooper, Taking Wealth Taxation Seriously, Mortimer Hess Memorial Lecture (May 22, 1978), *in* 34 REC. ASS'N BAR CITY N.Y. 24 (1979); Deborah H. Schenk, *Foreword*, 53 TAX L. REV. 257, 257 (2000) ("[T]he Tax Law Review held an invitational symposium to explore the desirability and feasibility of a federal wealth tax.").

6 This Essay is focused on valuation, not wealth taxation. However, it is worth noting that valuation issues would likely be contentious even for a wealth tax that has a low rate because wealth taxes recur, typically annually. *See* James R. Repetti, *It's All About Valuation*, 53 TAX L. REV. 607, 610 (2000) ("[T]axpayers would have a significant economic incentive to engage in activities to reduce appraised valuations even if the tax rate were only 1.57%. An annual 1.57% tax assessed over a 30-year period has a present value equal to approximately 23% of the asset's value in Year 1, using a 6% discount rate and assuming that the asset does not appreciate in value." (footnote omitted)).

7 Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 888 (1997) ("The conflict of interest between the fisc and the self-assessing taxpayer is particularly acute under systems requiring the valuation of unmarketed properties.").

8 For example, a taxpayer who receives a painting in return for services has income for tax purposes in the amount of the value of the painting. *See* Treas. Reg. § 1.61-2(d)(1) (2016) ("[I]f services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation.").

9 For example, IRS audit rates for U.S. individuals and corporations are currently well below 1% on average. *See* DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK, 2019, at 35 tbl.17a (2019) (reporting audit rates of 0.15% of individual tax returns and 0.06% of corporate returns for the 2018 fiscal year).

10 *See* Leandra Lederman, *The Fraud Triangle and Tax Evasion*, 106 IOWA L. REV. 1153, 1195 n.268 (2021) ("Currently, the IRS reports audit rates for U.S. individuals and corporations of less than one percent. Those rates have been declining over time. For example, in 2010, those rates were 1.01 and 1.55 percent, respectively." (citations omitted)).

11 *See* KATHLEEN BURKE & SHANNON MOK, CONG. BUDGET OFF., TRENDS IN THE INTERNAL REVENUE SERVICE'S FUNDING AND ENFORCEMENT 1 (Elizabeth Schwinn & Casey Labrack eds., 2020) ("Appropriations for the IRS have fallen by a total of about 20 percent in real (inflation-adjusted) dollars between 2010 and 2018."); *see also* Kelsey Snell, *IRS Budget Cuts, Staffing Challenges Create Coronavirus Payment Headaches*, NPR (Apr. 9, 2020), https://www.npr.org/2020/04/09/830159777/irs-budget-cuts-and-staffing-challenges-create-coronavirus-payment-headaches ("Over the past 10 years . . . the IRS budget has been reduced by roughly 20% . . . .").

Where the tax administration does audit the taxpayer, that can spark protracted litigation.[12] For example, multiple U.S. Tax Court opinions authored by the late, renowned Judge Tannenwald[13] admonished the parties for taking up significant court time with valuation litigation.[14] Litigation is costly for both parties, and valuation litigation may put the IRS at a disadvantage, at least compared to sophisticated taxpayers.[15]

The second issue valuation poses is simply measurement accuracy: finding an approach or formula that fairly values private assets, or assets of a particular type. For example, even the valuation of real estate, which has highly developed systems of comparables,[16] varies widely in quality across U.S. jurisdictions that impose property taxes.[17] This measurement issue can be ameliorated with improvements in technology and methodology. For

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12 *See* Repetti, *supra* note 6, at 612 ("The most difficult, expensive, and protracted litigation in the estate tax involves the valuation of business interests."); John G. Steinkamp, *Fair Market Value, Blockage, and the Valuation of Art*, 71 DENV. U. L. REV. 335, 336 (1994) ("David Smith, Alexander Calder, and Georgia O'Keeffe expressed their artistic creativity in distinct and novel ways. . . . Their status as successful artists led to a common result after their deaths: litigation over federal transfer taxes involving the valuation of large blocks of their art." (footnotes omitted)). Valuation may involve obtaining one or more expert appraisals, for example. *Id.* at 362 ("Determining fair market value often requires an expert's appraisal. Early Treasury Regulations required that expert appraisals support the value of certain property, and cautioned taxpayers to select carefully appraisers of recognized competence." (footnotes omitted)).

13 *See The Theodore Tannenwald Jr. Foundation for Excellence in Tax Scholarship*, AM. UNIV., https://www.wcl.american.edu/impact/initiatives-programs/tannenwald/ (last visited Jan. 11, 2021) ("Throughout his almost 35 years on the bench, Judge Tannenwald distinguished himself as one of the foremost tax jurists of our time. He authored more than 1,000 opinions and served as the Chief Judge of the Tax Court from 1981–83.").

14 *See* Symington v. Comm'r, 87 T.C. 892, 904 (1986) ("We are appalled at the time and energy both the parties and the Court have had to expend in the course of trial and decision in this case."); Buffalo Tool & Die Mfg. Co. v. Comm'r, 74 T.C. 441, 451 (1980) ("As the Court repeatedly admonished counsel at trial, the issue is more properly suited for the give and take of the settlement process than adjudication."); Messing v. Comm'r, 48 T.C. 502, 512 (1967) (stating in part, "[t]oo often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiations—a process clearly more conducive to the proper disposition of disputes such as this"); *cf.* Est. of Gilford v. Comm'r, 88 T.C. 38, 62 (1987) (Hamblen, J.) ("In these times of overcrowded Court dockets and resulting delays in case disposition, the parties would be well advised to consider resolution of valuation disputes outside the litigation arena and with a commonsense approach." (footnote omitted)).

15 *See* Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 445 (2000) ("[T]he government almost always loses valuation skirmishes.").

16 *See* George W. Gau, Tsong-Yue Lai & Ko Wang, *Optimal Comparable Selection and Weighting in Real Property Valuation: An Extension*, 20 J. AM. REAL EST. & URB. ECON. ASS'N 107, 107 (1992) (stating in 1992 that "Vandell (1991) develops a rigorous minimum variance approach for modelling the selection and weighting of comparables. His technique, together with [others] . . . represent [sic] significant progress toward transforming the traditional sales comparison approach into a more scientific method").

17 That is true both within a jurisdiction and across jurisdictions.

example, computers make the use of comparables in real estate valuation faster and more systematic than it would otherwise be.[18] Improvements in technology do not necessarily eliminate valuation disputes, however. In fact, they can make valuation litigation more expensive.[19]

A key problem for tax administration, therefore, is how to minimize erroneous, self-serving valuations. This Essay examines that issue. In so doing, it highlights, in Part I, the importance that third parties to the taxpayer-government relationship act at arm's length from the taxpayer. The Essay also draws on the tax compliance perspective to make some preliminary observations in Part II about valuation methodologies.

> While the sales comparison approach works well in markets with many transactions of similar homes, it can provide seriously misleading estimates of market value for a more idiosyncratic home with few good comparable sales. Finding comparable sales is not just a function of the size of a market. Even in large cities, many areas are characterized by rental buildings that trade infrequently, and by older, unique homes that have few counterparts.

Rachel N. Weber & Daniel P. McMillen, *Ask and Ye Shall Receive? Predicting the Successful Appeal of Property Tax Assessments*, 38 PUB. FIN. REV. 74, 78 (2010). Across jurisdictions,

> the frequent reassessment of taxable properties is the most important condition for improving financial performance at the local level. . . . However, it should be noted that in practice, although state law generally sets the frequency of reassessment, intervals between appraisals vary throughout the country from one to ten years.

Soojin Kim, Il Hwan Chung & Tae Ho Eom, *Institutional Differences and Local Government Performance: Evidence from Property Tax Assessment Quality*, 43 PUB. PERFORMANCE & MGMT. REV. 388, 391–92 (2020) (citing Steven V. Melnik & David S. Cenedella, *Real Property Taxation and Assessment Processes: A Case for a Better Model*, 12 N.Y.U. J. LEGIS. & PUB. POL'Y 259, 267 (2009)).

18 *See* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1149 (1986) (stating in 1986 that "[t]he potential use of computer technology at least raises the possibility that a national real estate valuation system administered by the IRS could be implemented."); Christine Bartsch, *How to Find Comps for Your House: A Quick Crash Course*, HOMELIGHT (Nov. 20, 2018), https://www.homelight.com/blog/comps-for-my-house/ ("Curious about the going rate for properties in your area so you can nail down a competitive list price? Well, it's a lot easier to find that information now than it was 15 years ago.").

19 *See* Zelinsky, *supra* note 7, at 881 ("In some respects, modern technologies make these problems worse by increasing the complexity and cost of appraisals and valuation litigation. . . . It is true that real property appraisers have developed extensive and sophisticated data bases and valuation formulas. However, these are available to the taxpayer as well as to the tax collector. Consequently, adjudicators in real estate appraisal cases today find themselves wading through more and more information presented by the parties' experts; the existence of sophisticated data bases (and the arguments to accompany them) facilitates taxpayers' fact-intensive challenges to the government's determinations; the government can respond in kind; this expertise and information is expensive to produce and present.").

I. Valuation as a Tax Administration Issue

A. *Structural Systems*

As a general matter, enforcement of a law may be least costly when there is a structural system that spurs compliance. An easy example is a speed bump: the physical structure of the road impedes drivers from exceeding the speed limit, even without monitoring.[20] Although it does not involve a physical object, a withholding tax is something of a structural system because it takes taxes off the top, before the taxpayer/payee receives funds.[21] Federal income tax withholding is very successful at spurring accurate reporting by payees.[22] The IRS estimates a ninety-nine percent voluntary compliance rate on amounts subject to income tax withholding.[23]

Applying this idea to valuation, a structural system that limits the possibility of self-serving valuations should be helpful to the tax administration. An approach recently proposed by Professors Saez and Zucman in connection with a proposal for a wealth tax could fall into this category if it is adjusted to reflect the taxpayer's incentives. Saez and Zucman's discussion proceeds asset category by asset category and appears to come from the perspective of how the IRS can obtain valuation information.[24] In two contexts—insured art and real estate—they suggest having the IRS use valuations done for other reasons.[25]

Where such non-tax valuations could serve as a structural constraint on tax noncompliance is where the taxpayer's incentives in the two contexts oppose each other. For example, a taxpayer who owns art has an incentive

20 Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 Stan. L. Rev. 695, 696 (2007) ("[I]f the government seeks to reduce speeding in a residential neighborhood, instead of (or in addition to) imposing fines and ticketing speeders, it can construct roads in ways that help reduce speeding, such as making them narrow or winding, or including speed bumps.").

21 *Id.* at 697–98 ("Withholding taxes, like speed bumps, constrain compliance with the law. However, unlike speed bumps, withholding taxes are effective largely because they essentially make a third party responsible for paying the taxpayer's taxes."); Kathleen DeLaney Thomas, *The Modern Case for Withholding*, 53 U.C. Davis L. Rev. 81, 99 (2019) ("One important driver of the high compliance rates among taxpayers subject to withholding appears to be that withholding puts most people in a refund position.").

22 *See* Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 Fordham L. Rev. 1733, 1736 (2010) ("Withholding is well known to be highly effective in ensuring payment . . . ."); Thomas, *supra* note 21, at 84 ("Unsurprisingly, the group subject to withholding pays taxes in a more accurate and timely manner than the group not subject to withholding.").

23 *See* Barry W. Johnson & Peter J. Rose, Dep't of the Treasury, Internal Revenue Serv., Federal Tax Compliance Research: Tax Gap Estimates For Tax Years 2011–2013, at 14 fig.3 (2019) (showing noncompliance rate of one percent).

24 *See* Emmanuel Saez & Gabriel Zucman, *Progressive Wealth Taxation*, 2019 Brookings Papers on Econ. Activity, 437, 482–85 ("In the majority of cases, market values are easy to observe by the IRS with proper information reporting. Here we discuss the cases that raise challenges.").

25 *Id.* at 485 (pointing out other contexts in which these assets are valued).

not to undervalue it for insurance purposes because that would result in undercompensation if the art were stolen. That valuation could be helpful to the tax system in contexts in which a higher valuation generally results in higher taxation, such as under the estate tax or a wealth tax. This is analogous to a bank examining past tax returns to determine a prospective borrower's income—while the borrower has an incentive to overstate income to get the loan, the borrower's incentive for tax purposes is to understate income. In effect, this approach uses the opposing context to create a friction that helps reduce misstatements.[26]

By contrast, IRS reliance on real estate valuations done in other contexts likely would not provide a similar structural constraint. With respect to real estate, Saez and Zucman point to both Zillow and local property tax assessments as sources of information for the IRS.[27] Neither reflects a taxpayer-reported valuation that inserts a friction with respect to the federal tax context.

Both information sources also pose other problems for tax administration. Although Zillow reflects the technological advance that big data permits, it varies in its accuracy,[28] due in part to errors in the underlying public

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26 This is analogous to how tying tax reporting to economic substance might deter underreporting of income. *See* Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the* Compaq *Case*, 98 TAX NOTES 221, 223 (2000) ("[T]he rationale for an economic substance approach is that it may generate frictional impediments to certain socially undesirable tax planning. One could dramatize this rationale by thinking of taxpayers as metaphorically headed downstream with a foot on each of two rafts: the economic planning raft and the tax planning raft. . . . Under an economic substance approach . . . the two rafts may drift sufficiently far apart that [each taxpayer] must jump off one raft, letting it drift away while she stands entirely on the other.").

27 Saez & Zucman, *supra* note 24, at 485 (addressing the wealth tax context).

28 Zillow's statistics by city show that its estimate is generally within twenty percent of the sales prices ninety-eight or ninety-nine percent of the time, but twenty percent on either side is a wide range. *What is a Zestimate?*, ZILLOW, https://www.zillow.com/zestimate/ (last visited March 11, 2021). It reports that it is within five percent of the sales price between 62.7 and 92.8% of the time, depending on the city. *Id.* Even Zillow says that its "Zestimate" (estimate) "should be used as a starting point. We encourage buyers, sellers and homeowners to supplement the Zestimate with other research such as visiting the home, getting a professional appraisal of the home, or requesting a comparative market analysis (CMA) from a real estate agent." *Id.*

A recent paper

> find[s] a statistically significant but economically small racial bias in Zestimate. For example, while Black buyers (Hispanic sellers) overpay (oversell) by 9.3% (1.9%) in transaction prices relative to White buyers (White sellers), the algorithm only overvalues the same transactions by 1.1% (0.6%), or 12% (32%) of the market's racial price differentials.

Guangli Lu, How Machine Learning Mitigates Racial Bias in the U.S. Housing Market 2 (Nov. 15, 2019) (unpublished manuscript) (https://ssrn.com/abstract=3489519). The paper finds that Zillow's bias is smaller than the actual bias in transactions. *Id.* The apparent reason for this is that "when regressing a home's Zestimate on both the home's current market price and its future market price, Zestimate behaves as if it put a large and positive weight on the latter." *Id.* at 3.

data Zillow relies on.[29] Local assessments have serious problems, including variance in quality[30] and systematic biases.[31] Real estate valuations can already be contentious.[32] Were the IRS to rely on subnational governments' assessments, that would increase taxpayers' stakes in those valuations, likely increasing appeals. It would also raise legal questions regarding the extent to which the IRS could, in a sense, delegate tax valuation issues to state and local tax authorities.

B. *Which Third Parties Are Helpful?*

1. Third-Party Reporting

As noted above, tax withholding is highly effective at spurring payee compliance.[33] Withholding is also accompanied by reporting by the payor to the IRS and the taxpayer of the amount paid and the amount withheld.[34] Third-party information reporting even without withholding is also quite successful at spurring tax compliance. Where a payor is required to report to the IRS and the taxpayer the amount paid to the taxpayer (but no withholding is required), the IRS estimates a voluntary compliance rate of ninety-five percent.[35] That high compliance rate contrasts with an estimated voluntary compliance rate of only forty-five percent for amounts subject to income tax

29 *See* Amy Fontinelle, *Zillow Estimates: Not As Accurate As You Think*, INVESTOPEDIA, https://www.investopedia.com/articles/personal-finance/111115/zillow-estimates-not-accurate-you-think.asp (last updated June 25, 2019).

30 That is true both within a jurisdiction and across jurisdictions. *See supra* note 17 and accompanying text.

31 *See* Carlos Avenancio-León & Troup Howard, The Assessment Gap: Racial Inequalities in Property Taxation 2–3 (Mar. 31, 2020) (unpublished manuscript) (https://ssrn.com/abstract=3465010) (finding significant disparities in assessment quality by the race of the homeowner); Andrew T. Hayashi, *Dynamic Property Taxes and Gentrification*, 96 NOTRE DAME L. REV. 1517, 1519 (2021) (describing "conditions under which dynamic property taxes result in higher ETRs [effective tax rates] for black homeowners than white homeowners").

32 *See* Zelinsky, *supra* note 7, at 881–82 ("[C]ontemporary adjudications of real property values are numerous, protracted, and costly but not necessarily reliable[,] as the judgments required for real estate appraisal—selecting comparable sales, projecting future earnings, and determining replacement costs—are, to an irreducible degree, subjective and imprecise."); *cf.* JOHN L. MIKESELL, CITY FINANCES, CITY FUTURES 32 (1993) ("[A]ssessment quality is abysmal.").

33 *See supra* text accompanying notes 22–23.

34 Thomas, *supra* note 21, at 98 ("[U]nder the current U.S. system, withholding is always accompanied by third-party information reporting. Information reporting refers to the reporting of tax information (usually income, but sometimes deductible expenses) by third parties to both taxpayers and the IRS."); *see also, e.g.*, 2021 INTERNAL REVENUE SERV., FORM W-2: WAGE AND TAX STATEMENT (2021), https://www.irs.gov/pub/irs-pdf/fw2.pdf (information reporting form for wages and salaries and amounts withheld from those payments).

35 *See* JOHNSON & ROSE, *supra* note 23, at 14 fig.3 (showing a noncompliance rate of five percent for "[i]ncome subject to substantial information reporting").

that are not subject to withholding or third-party reporting.[36] In effect, the presence of a third-party information reporter reduces the taxpayer's opportunity to evade tax because the taxpayer knows that the government has been notified of the payment.[37]

In theory, third-party reporting of valuations should also be helpful, assuming that the third party is acting at arm's length from the taxpayer.[38] And there is some evidence of a procompliance effect of third-party reporting in the wealth tax context. Professors Saez and Zucman highlight that effect with a comparison of countries:

> In Sweden and Denmark, two countries with extensive third-party reporting of wealth, Seim and Jakobsen et al. find small avoidance and evasion responses: a 1% wealth tax reduces reported wealth by less than 1%. . . . In Switzerland, where there is no third-party reporting of financial wealth (due to bank secrecy), Brülhart et al. find very large responses to wealth taxation: a 1% wealth tax lowers reported wealth by 23–34%.[39]

However, Saez and Zucman note that, for Switzerland, "[t]his extremely large estimate is extrapolated from very small variations in wealth tax rates over time and across Swiss cantons and hence is not as compellingly identified as the other estimates based on large variations in the wealth tax rate."[40] Thus, further research on the effect of third-party reporting on valuation accuracy would be helpful.

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36 *See id.*

37 *See* Leandra Lederman, *Does Enforcement Reduce Voluntary Tax Compliance?*, 2018 BYU L. REV. 623, 647 ("[T]axpayers do not have an open opportunity to evade taxes on all of their income. Many sources of income are subject to third-party reporting, and it is much easier for the government to match an information return with a taxpayer's return than to conduct an audit."); *id.* at 660–67.

38 *See* Saez & Zucman, *supra* note 24, at 480 ("The most important extension of the current information reporting system would be to require financial institutions to report year-end wealth balances to the IRS.").

39 Emmanuel Saez & Gabriel Zucman, How Would a Progressive Wealth Tax Work? Evidence From the Economics Literature 4 (Feb. 5, 2019) (unpublished manuscript) (https://eml.berkeley.edu/~saez/saez-zucman-wealthtaxobjections.pdf) (citations omitted). Sweden uses prepopulated wealth tax returns and has extensive third-party reporting. *See* David Seim, *Behavioral Responses to Wealth Taxes: Evidence from Sweden*, 9 AM. ECON. J. 395, 400 (2017) ("By December 31 of the fiscal year . . . , third parties sent detailed information about individuals' financial and real-estate assets and liabilities to the tax authority who then used market prices from stock markets and real-estate neighborhood prices to value those assets. Based on these assessments, pre-populated tax forms were sent out. . . ."). In Denmark, "[m]ost assets were third-party reported under the Danish wealth tax—thus limiting the scope for evasion . . . ." Katrine Jakobsen, Kristian Jakobsen, Henrik Kleven & Gabriel Zucman, *Wealth Taxation and Wealth Accumulation: Theory and Evidence from Denmark*, 135 Q.J. ECONOMICS 329, 332–33 (2020).

40 Saez & Zucman, *supra* note 39, at 4 n.9.

2. Other Third Parties

It is important to note that not all third parties to the taxpayer-government relationship act at arm's length. Some third parties have an interest in helping the taxpayer lower the tax bill.[41] For example, consider a low-stakes valuation issue: the value of common household items donated to charities. To help taxpayers compute their charitable deductions, charities such as Goodwill and the Salvation Army provide online value guides.[42]

To some extent, the fact that these charities sell the donated items in a thrift shop provides a structural constraint on inflated amounts in the donation value guides. For example, Goodwill sells almost all clothing items of the same type at the same initial price, so the $4 valuation in its value guide of a shirt or blouse generally reflects the approximate store price for that type of item.[43] But where a thrift store sells items at widely varying prices, that structural constraint is reduced. For example, the Salvation Army lists in its valuation guide a range of $5 to $207 for a picture/painting.[44] It is also possible that charities may compete for donations on this front by suggesting higher donation amounts to the taxpayer, thus not acting at arm's length. Goodwill and the Salvation Army often list very different amounts in their value guides. For example, Goodwill specifies a value of $75 for a dining room set, while the Salvation Army provides a range of $156–$934.[45]

Intuit, the maker of TurboTax, has also entered the donation-valuation space, with an app called "ItsDeductible" for valuing donated items.[46] It critiques the Goodwill and Salvation Army donation guides, stating, "Using valuations exclusively from thrift stores run by charitable organizations isn't an

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41 *See* Lederman, *supra* note 20, at 699 ("In fact, transaction counterparties have also been known to participate in abusive tax-reduction strategies in return for a portion of the tax savings generated.").

42 *See Valuation Guide for Goodwill Donors*, GOODWILL, https://www.goodwill.org/wp-content/uploads/2020/03/donation_valuation_guide.pdf (last visited Jan. 25, 2021); *Donation Value Guide*, THE SALVATION ARMY, https://satruck.org/Home/DonationValueGuide (last visited Jan. 25, 2021).

43 *See, e.g.*, *Price List*, GOODWILL INDUS. OF THE S. PIEDMONT, https://goodwillsp.org/shop/price-list/ (last visited Jan. 25, 2021) (listing Goodwill's standard price for certain blouses and shirts in Charlotte, North Carolina, as $4.49); *Price List*, GOODWILL, https://www.goodwillky.org/wp-content/uploads/2019/02/Price-List-English-0119.pdf (last visited Jan. 25, 2021) (listing that standard price in Kentucky as $4.29). In the recent past, the price for a shirt or blouse was $3.99, at least in some parts of the country. *See* Kathryn Cargo, *Buy Items by the Pound at the First Goodwill Clearance Store in South Texas*, CALLER TIMES (Dec. 12, 2019), https://www.caller.com/story/news/local/2019/12/11/take-look-first-goodwill-clearance-store-south-texas-corpus-christi/4351017002/ ("The average price of a Goodwill shirt is $3.99 . . . ." (quoting Marjorie Boudreaux, Vice President of Marketing and Fund Development for Goodwill Industries of South Texas)).

44 THE SALVATION ARMY, *supra* note 42. Goodwill does not provide a suggested donation value for pictures or paintings. *See* GOODWILL, *supra* note 42.

45 *See* GOODWILL, *supra* note 42; THE SALVATION ARMY, *supra* note 42.

46 *ItsDeductible*, INTUIT TURBOTAX, https://turbotax.intuit.com/personal-taxes/itsdeductible/ (last visited Jan. 25, 2021).

accurate assessment, as they typically understate the true fair market value."[47] Of course, Intuit is not disinterested, either. In fact, it uses the prospect of obtaining higher deductions as part of its marketing of TurboTax's ItsDeductible, stating, for example, "*Those old clothes are worth more than you think. Get the most of what you're giving*."[48]

These are relatively low-value items. For high-stakes valuations, taxpayers may use expert appraisals.[49] At first blush, it may seem as if an appraisal would constitute objective third-party documentation. However, while expert appraisals can provide valuable information, they are not necessarily done at arm's length from the taxpayer. For example, in the context of conservation easements, Professor Nancy McLaughlin explains the natural incentive to provide a proclient valuation:

> [A]ppraisers are hired by easement donors, who have a financial incentive to pressure appraisers to assert advantageous values, and professionals in general have a natural desire to please their clients. Moreover, where reasonably supportable values for hard-to-value assets like easements vary over a wide range, and the boundary between supportable and abusive valuations is blurry at best, the practical ability of the appraisal profession to prevent any but the most egregious valuation abuse is necessarily limited.[50]

The implicit pressure resulting from simply erring in favor of the person paying the bill is less severe than the conflict of interest that arises in some appraisal contexts, however. A prominent current example involves syndicated conservation easements, which have similarities to the abusive tax shelters of the 1980s.[51] Syndicated conservation easements are typically

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47 TurboTax, *How and Where Does Its Deductible Obtain Its Values?*, INTUIT TURBOTAX, https://ttlc.intuit.com/community/credits-and-deductions/help/how-and-where-does-itsdeductible-obtain-its-values/01/26015/highlight/true (last updated Jan. 12, 2021).

48 INTUIT TURBOTAX, https://itsdeductibleonline.intuit.com/ (last visited Jan. 25, 2021) (emphasis added).

49 Internal Revenue Serv., *Publication 561: Determining the Value of Donated Property (2020)*, https://www.irs.gov/publications/p561#en_US_201911_publink1000258023 (last updated Feb. 13, 2020) ("[Y]ou generally will need an appraisal for donated property for which you claim a deduction of more than $5,000.").

50 Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations—A Responsible Approach*, 31 ECOLOGY L.Q. 1, 81 (2004). Professor McLaughlin further explains that

> [e]asement donors who intend to assert aggressive or abusive easement values can employ a complex land appraisal method, generally referred to as the "subdivision development analysis," to significantly exaggerate the before-easement value of their land and, because of the complexity of that analysis, the IRS and the courts cannot easily recognize or refute the resulting easement valuation.

Id. at 83 (footnote omitted).

51 *See, e.g.*, Stephen J. Small, *A Modest Legislative Proposal to Shut Down Specific Tax Shelters*, 151 TAX NOTES 1085, 1087, 1092 (2016) ("Today's syndication-of-conservation-easement-deductions situation is remarkably similar to how things were pre-1986. . . . [P]romoters, advisers, appraisers, and donee organizations are still actively involved in selling these transactions."); Jay Starkman, *Conservation Easements: The 21st-Century Abusive Tax Shelter*, 159 TAX NOTES 1475, 1475 (2018) ("Although I am a sole practitioner with a very

situations in which a promoter obtains an appraisal in order to sell charitable contribution deductions.[52] The Senate Finance Committee recently released a detailed report that referred to "an inflated appraisal" as "the engine of every syndicated conservation-easement transaction."[53] Thus, appraisers do not act at arm's length in this context.

Another example of a conflict of interest with respect to appraisals involves artwork. Dr. Michael Maizels and Professor William Foster explained how this worked in the 1950s and 1960s, using the example of Leo Castelli, who was trying to "aggressively promote his stable of Pop artists"[54]:

> [A]rt dealers like Castelli were well positioned to provide aggressive (if not outright inflated) appraisals that were unlikely to be successfully challenged. Such high appraisals allowed Castelli and others to promote their artists' work as a vehicle to offset the taxable income of clients willing to donate the purchased art to a museum or other public charity.[55]

Thus, these art dealers were essentially acting as accommodation parties by providing favorable appraisals.[56]

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small practice, I've had clients bring me at least six abusive CE [(Conservation Easement)] tax shelter proposals, and for many of them, I've been able to obtain the full appraisal study, which I forward to an IRS tax abuse unit (same as I did with the 1980s tax shelters). All propose 4-to-1 tax write-offs that were popular in the 1980s.").

52 *See Listing Notice—Syndicated Conservation Easement Transactions*, 2017-4 I.R.B. 544, 545 ("The promoters obtain an appraisal that purports to be a qualified appraisal as defined in § 170(f)(11)(E)(i) but that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property."); CHARLES E. GRASSLEY & RON WYDEN, SYNDICATED CONSERVATION-EASEMENT TRANSACTIONS, S. PRT. 116–44, at 17 (2020) ("The promoters typically substantiated tax deductions by procuring an inflated appraisal to say the land has substantial development potential and is therefore worth a lot, grant a conservation easement on the land, then get another appraisal (generally in the same document as the first appraisal) to say how little the land is worth after granting the easement."); William E. Ellis, *The Anatomy of Overvalued Syndicated Conservation Easements*, 169 TAX NOTES FED. 583, 588 (2020) (providing an example of a transaction discussed by the Grassley and Wyden report cited just above where a "simple buyer's perspective 'smell test' indicates that the NPV [net present value] of costs would be $38 million in excess of the NPV of net revenues ($245 million costs vs. $207 million revenues), even assuming none of the assumptions in the appraisal were challenged").

53 GRASSLEY & WYDEN, *supra* note 52, at 6; *see also* Stephen J. Small, Mark Weston, Nancy A. McLaughlin & Philip Tabas, *Some Dirty Realities About Syndicated Conservation Easements*, 167 TAX NOTES FED. 1729, 1733 (2020) ("Abusive syndicated conservation easement transactions depend on appraisers who are willing to assign grossly inflated values to the easements that have nothing to do with the true value of the easements or the properties to which they relate.").

54 Michael W. Maizels & William E. Foster, *The Gallerist's Gambit: Financial Innovation, Tax Law, and the Making of the Contemporary Art Market*, 42 COLUM. J.L. & ARTS 479, 480, 489 (2019).

55 *Id.* at 489.

56 *See* Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. CORP. L. 219, 228 n.40 (2004) (explaining that "[a]ccommodation parties such as foreign banks or tax-exempt

Maizels and Foster further explained that the IRS has increased enforcement to try to combat appraisal abuses in this context. First, "[i]n response to rampant appraisal abuse, the IRS created the Art Advisory Panel in 1968."[57] Second, "[t]he IRS also now requires taxpayers claiming charitable contributions over $50,000 to provide a Statement of Value, backed by a qualified appraisal, an appraisal summary, and a fee of $2,500, all filed before the tax return reporting the charitable contribution."[58] Nonetheless, the IRS still struggles with valuation abuses in the artwork context:

> Despite these measures, overvaluations are still "difficult to identify, substantiate and litigate," and the same charitable institutions that benefit from the contributions lack any incentive to participate in correcting valuations. Congress has since made a number of reform efforts, though none have proven to eliminate the loopholes so readily exploited.[59]

Thus, the abuses occasioned by appraisals not done at arm's length persist today.[60] An important part of the problem is that challenging an inflated appraisal requires an audit, and audit resources are limited.[61]

C. *Why Increasing Tax Penalties Isn't Sufficient*

As the discussion above has shown, the crux of the tax-valuation problem is taxpayer-asserted valuations in contexts lacking the constraints of arm's-length transactions. In contexts in which arm's-length measures cannot readily be used, an important question is how to deter self-serving, grossly erroneous valuations. In a recent essay on wealth taxation, Professor David Gamage advocated for a "sufficiently severe penalty regime being imposed to deter taxpayers from aggressively playing the audit lottery."[62] Unfortunately, however, empirical research suggests that increased penalties do not deter noncompliance to the extent one might expect them to. That is because penalties do not substitute for increased audits in the way that economic modeling may seem to suggest.

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pension funds often receive fee payments for participating in a shelter transaction in a role that is necessary to achieve the purported tax benefits").

57 Maizels & Foster, *supra* note 54, at 494 ("Any appraisal submitted to the IRS claiming a value of $20,000 or more for a single work of art will be referred to the panel for review. The panel regularly suggests adjustments to a large percentage of the appraisals it reviews, resulting in tens of millions of dollars in recovered tax revenue annually." (footnotes omitted)).

58 *Id.*

59 *Id.* at 494–95 (footnotes omitted) (quoting Ellen P. Aprill, *Reforming the Charitable Contribution Substantiation Rules*, 14 FLA. TAX REV. 275, 281–82 (2013)).

60 This issue cannot be addressed by referring to valuations for insurance purposes, *see supra* text accompanying note 26, because the taxpayer's incentive in both the insurance and charitable donation contexts is to assert a high value.

61 *See supra* text accompanying notes 9–11.

62 David Gamage, Five Key Research Findings on Wealth Taxation for the Super Rich 16 (July 27, 2019) (unpublished manuscript) (https://ssrn.com/abstract=3427827).

Economic models of deterrence typically consider the expected value of the penalty for noncompliance by multiplying the probability of detection by the amount of the penalty. In such a formula, the expected fine can be increased either by increasing the probability of detection or increasing the penalty that would be imposed. Consider the following baseline example:

> Assume that the taxpayer's transaction results in a $1,000 tax liability if reported honestly. The taxpayer is considering evading the tax by failing to report the transaction. Assume, for simplicity, that audits detect all evasion, and that, if evasion is detected, the taxpayer must pay the $1,000 of tax plus a penalty. If the audit rate is 1% and the penalty rate is 20% ($200), the expected cost of evasion is $12 (a 1% probability of paying $1,200).

If the government wants to increase the expected cost of evasion to $100, in theory, it could do so by raising the audit rate, the penalty rate, or both. For example, at a 1% audit rate, adding to the $1,000 of tax due a penalty of 900% (nine times the tax) mathematically provides an expected cost of $100.[63] Similarly, if the penalty is fixed at 20% of the tax ($200), an audit rate of 8.34% also yields an expected cost result of $100.[64] The tax administration could similarly mathematically target any expected cost of evasion, although equaling or exceeding the cost of compliance would require extremely high audit rates, extremely high penalties,[65] or a combination of still unrealistically high audit and penalty rates.[66]

Raising penalty rates is much less expensive for the government than raising audit rates because an increase in penalties requires a one-time statutory change, while an increase in audit rates requires an ongoing increase in tax-administration resources, such as personnel.[67] Thus, it superficially *appears* wiser to raise the penalty rate and leave the audit rate very low. Unfortunately, however, such an approach is unlikely to produce as much revenue for the government. That is because deterrence does not seem to be so symmetric in practice.[68] While audits are very effective at deterring non-

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63 That is, 1% of $10,000 ($9,000 penalty + $1,000 tax) = $100.

64 That is, 8.34% of $1,200 ($200 penalty + $1,000 tax) = $100.08. The extra eight cents are due to rounding of the audit rate.

65 For example, at a 1% audit rate, a penalty of 10,900% (109 times the tax) provides an expected cost of $1,100. That is, 1% of $110,000 ($109,000 penalty + $1,000 tax) = $1,100. Similarly, if the penalty is fixed at 20% of the tax ($200), an audit rate of 91.67% also yields an expected cost of $1,100. That is, 91.67% of $1,200 ($200 penalty + $1,000 tax) = $1,100.04. The extra four cents are due to rounding of the audit rate.

66 For example, even at 50% audit rate, in order to have an $1,100 expected cost of evasion, the penalty would still have to be 120% of the tax. That is, 50% of $2,200 ($1,200 penalty + $1,000 tax) = $1,100.

67 Audits are expensive. For example, for fiscal year 2019, the IRS spent approximately $3.845 billion on examinations and collections and performed 771,095 audits. DEP'T OF THE TREASURY, *supra* note 9, at 45 tbl.17b, 73 tbl.30.

68 *See* James Alm, *What Motivates Tax Compliance?*, 33 J. ECON. SURVS. 353, 365 (2019) ("Audits also have a greater deterrent impact than ?nes, despite their theoretical equivalence, at least in an expected value sense."); Lederman, *supra* note 37, at 664–65 ("With respect to monetary sanctions, studies sometimes find a positive effect, but they generally

compliance,[69] studies generally do not find substantial deterrent effects from increases in penalties.[70]

A possible explanation for the apparently limited deterrent effect of tax penalties is that people may not believe that the penalty will actually be imposed if the likelihood that noncompliance will be detected seems low.[71] So, increasing penalties without a reasonably high audit frequency may not provide much deterrence in practice. As Gamage's essay wisely recognizes, "substantial IRS enforcement resources are needed to combat gaming based on aggressive appraisal estimates."[72] In contrast with the limited deterrent effect of penalties, audits have a significant deterrent effect.[73]

II. The Role of Third Parties in Valuation Methodologies

The discussion above highlighted the roles that third parties can play in valuation, distinguishing between the productive role of arm's-length third parties and the accommodation role that interested third parties may play. This lens can help provide insights into the question of valuation methodologies.

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do not find as strong an effect of fines as they do of audit threats, or they do not get statistically significant results." (footnotes omitted)).

69 James Alm, Ali Enami & Michael McKee, *Who Responds? Disentangling the Effects of Audits on Individual Tax Compliance Behavior*, 48 Atl. Econ. J. 147, 148 (2020) ("Most all empirical evidence suggests that an increase in the audit rate increases the compliance rate, with estimated reported income-audit rate elasticities generally finding a significant positive elasticity, often between 0.2 and 0.4 and occasionally larger."); Lederman, *supra* note 37, at 655–62 (synthesizing studies and concluding that "these results suggest that an audit regime and audit threats generally are effective deterrents").

70 *See, e.g.*, Alm, *supra* note 68, at 365 ("Laboratory experiments typically ?nd that a higher ?ne rate leads to marginally more compliance, with an estimated reported income-?ne rate elasticity less than 0.1."); James Alm, Betty R. Jackson & Michael McKee, *Estimating the Determinants of Taxpayer Compliance with Experimental Data*, 45 Nat'l Tax J. 107, 110 (1992) ("Compliance increases with an increase in the fine rate; however, the coefficient on FINERATE is so small that the fine rate elasticity is virtually zero, and the coefficient is also not highly significant."); Paul Webley, *Audit Probabilities and Tax Evasion in a Business Simulation*, 25 Econ. Letters 267, 269 (1987) (laboratory experiment finding that varying the penalty rate (either twice or six times the evaded amount) had no effect on compliance).

71 *See* Alm et al., *supra* note 70, at 110 ("A policy implication is that increasing penalties may not have a noticeable effect on compliance, unless the probability of detection is increased significantly."); *see also* Govind S. Iyer, Philip M.J. Reckers & Debra L. Sanders, *Increasing Tax Compliance in Washington State: A Field Experiment*, 63 Nat'l Tax J. 7, 29 (2010) (finding, under Analysis of Variance methodology, for the Business and Occupation tax, that "[p]enalty information is, as in the case of use tax, marginally significant in the absence of detection manipulation").

72 Gamage, *supra* note 62, app. A, at 11.

73 *See* Lederman, *supra* note 37, at 655 ("Several studies have found that increasing the audit rate increases compliance. In the United States, the IRS has found both a direct effect of audits on tax collections and an indirect effect of audits of approximately six dollars for each dollar collected directly through enforcement." (footnotes omitted)).

As a threshold matter, it is well known that the difficulties that valuation poses for the tax system are avoided when the asset in question is sold in an arm's-length transaction. Such a sale reveals the market price for the asset.[74] Moreover, the taxpayer's incentive is to maximize that price, despite the attendant tax costs, because typically that will net the taxpayer the most money net of tax.[75] Put another way, where the taxpayer's counterparty is acting at arm's length, the tax administration can free ride on the taxpayer's incentive to maximize the consideration received.[76]

A sale to an arm's-length third party is thus the gold standard for valuation. Where the asset in question is not sold, valuation is still not a problem if the asset is fungible and sold in a thick market. For that reason, publicly traded securities are relatively easy to value.[77] Unfortunately, many assets are not fungible or are not sold in an active market. For example, ownership interests in closely held businesses present a particular problem.[78] There are at least two innovative approaches to addressing this issue, which have been discussed by Professors Saez and Zucman, among others, in the wealth-tax context.[79] One is a formulaic approach to valuation that draws on arm's-length sales where possible, and the other is to force a market transaction.

A. *Formulaic Approaches to Valuing Nonpublicly Traded Assets*

Formulaic approaches to valuation have three components, corresponding to different points in time: (1) the starting value, (2) periodic formulaic updates, and (3) reconciliation at the point of a sale or other disposition. The basic idea is to start with the historic purchase price, at least if the asset

74 Zelinsky, *supra* note 7, at 880 ("[W]hen the taxpayer receives cash or easily-valued property (e.g., actively marketed stock) . . . [the taxpayer] thereby provides the fisc with a virtually costless valuation as an automatic by-product of the realization event.").

75 *See id.* at 888 ("At that time [sale], the taxpayer reveals his true assessment of the value of his property to maximize his own well-being . . . . That assessment, moreover, is confirmed for the Treasury by the presence of the purchaser and his acceptance of the agreed upon price.").

76 *See id.* ("There is . . . one moment when the taxpayer and the tax collector have perfectly aligned interests, the moment of realization, when the taxpayer sells his property to a bona fide third party.").

77 Gamage, *supra* note 62, app. A, at 12 ("[P]ublic securities markets provide reliable valuations based on market trading.").

78 Repetti, *supra* note 6, at 611–12 ("Closely held business interests also would be very difficult to value. The selection of appropriate comparable businesses, the estimate of future earnings, the selection of appropriate discount rates to calculate the present value of future earnings, and the estimate of liquidation values of a business all require subjective decisions that are as much art as science."). Saez and Zucman argue that "it is likely that the share of private businesses among top 0.1 percent wealth holders is fairly large—probably around one-third." Saez & Zucman, *supra* note 24, at 482.

79 *See, e.g.*, SAEZ & ZUCMAN, *supra* note 5, at 151–52 (discussing the forced-sale approach); Gamage, *supra* note 62, app. A, at 14 (discussing "formulaic prospective valuation methodologies"); Saez & Zucman, *supra* note 24, at 483 (discussing "formula based" valuation of small businesses).

was purchased in an arm's-length exchange,[80] update the value annually using tables provided by the IRS,[81] and then true up the valuation if and when the property is sold in an arm's-length transaction.[82] As Professor George Cooper pointed out in 1979, using formulas means that annual valuations for wealth-tax purposes could be "almost automatic[ ]," rather than revisited every year.[83]

Note that this valuation process relies whenever possible on the best information available for valuation—arm's-length transactions. For example, because the annual valuations would be formulaic rather than keyed to the specific asset, the third part of the formulaic approach involves reconciliation at the time of an arm's-length transaction.[84] However, in some cases, the arm's-length disposition might never occur. For example, it is possible that any disposition of the asset occurs in a related-party or donative context.[85]

Not surprisingly, problems arise for the formulaic approach when arm's-length transactions are unavailable. In his recent wealth-tax essay, Professor Gamage proposes relying on expert appraisals if the asset was not acquired in an arm's-length transaction.[86] Professor Gamage recognizes that, as discussed above,[87] the tax system faces a significant problem of exaggerated appraisals used to support noncompliance.[88] He argues that the use of appraisals is viable if it is minimized as much as possible and the tax system provides significant deterrence to undervaluation.[89] However, reliance on audits would leave this as a soft spot in valuation enforcement in comparison to enforcement regimes that incorporate structural constraints and third-party reporting.[90]

Other issues with formulaic approaches to valuation generally involve the accuracy of the technology, not the taxpayer's incentive for a self-serving valuation. The formulaic approach to updating the starting value would

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80 Gamage, *supra* note 62, app. A, at 14 ("For assets purchased in arm's length exchanges, the purchase price is deemed to be the value of the asset in the year of purchase.").

81 *Id.* ("[I]n each subsequent year, this initial value is adjusted based on formulas that would be published by the IRS (in a similar manner to how the IRS currently annually publishes tables for various cost-of-living adjustments).").

82 *Id.* app. A, at 15.

83 Cooper, *supra* note 5, at 35.

84 Gamage, *supra* note 62, app. A, at 15. Delays in truing up the valuation could result in some deferral or acceleration of taxation, but that could be rectified by the imposition of a market rate of interest.

85 *See* Gravelle, *supra* note 5, at 961 (referring to "gifts and bequests" in the context of mark-to-market taxation).

86 Gamage, *supra* note 62, app. A, at 16.

87 *See supra* text accompanying notes 50–59.

88 *See* Gamage, *supra* note 62, app. A, at 10 ("Historically, super-rich taxpayers have taken advantage of . . . imprecision to obtain very taxpayer-favorable appraisal estimates and then have made use of these estimates for aggressive gaming to reduce tax liabilities.").

89 *See id.*, app. A, at 16.

90 *See supra* Part I.

result in misvaluations in individual cases even if it is very accurate on average. Because the formulas generally would reflect the rate of return on assets in the economy, either economy-wide or in categories of assets,[91] they might also have systematic distortions. For example, it is possible that the wealthy, as a group, invest in assets that appreciate more rapidly than the average asset in that class.[92] That is, the wealthy might be better at spotting winners.[93]

B. Forced-Sale Approaches to Valuation

An alternative to formulaic valuation of an asset is to essentially force an offer for sale to arm's-length buyers. For example, in a 1982 article, Professor Saul Levmore proposed an approach to real-property taxation in which the property owner declared the value but had to be willing to sell at that value. Levmore's proposal was as follows:

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91 *See* Gamage, *supra* note 62, app. A, at 14–15; Mark P. Gergen, *How to Tax Capital*, 70 TAX L. REV. 1, 40–41 (2016) (explaining Edward Kleinbard's formulaic approach). For discussion of rates of return on capital in the context of a proposed Dual Business Enterprise Income Tax, see generally Edward D. Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208 (2017). Note that, "[f]or assets from which owners can withdraw cash value, these deemed values would be decreased by the amount of cash value taken out of the assets." Gamage, *supra* note 62, app. A, at 15.

92 In theory, the super rich might invest in assets that tend to appreciate less than average, but that seems less likely given that being super rich will, on average, entail some kind of historic success (even though, for some people, that success will simply entail not dissipating inherited wealth). On the fraction of wealth that is inherited, see Wojciech Kopczuk & Joseph P. Lupton, *To Leave or Not to Leave: The Distribution of Bequest Motives*, 74 REV. ECON. STUD. 207, 209 (2007) ("Most of these [cited] studies have found inherited wealth to be in the range of 15–31% of total household wealth."). Inherited wealth, if remaining in the same form, may also reflect the asset choices of the person who succeeded in creating the wealth.

93 To the extent that an individual who is subject to the tax invests in assets that yield a higher-than-average return that is not captured by the tax, that could be viewed in part as something of a subsidy to entrepreneurship, which already exists in the federal income tax. *See* Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 OHIO ST. L.J. 1401, 1407 (2004). Saez and Zucman admit that "[i]t is harder to evaluate whether high taxes on success (such as a wealth tax) would discourage young innovators to start with. . . . [M]ore empirical and well-identified research is needed to resolve this key question." Saez & Zucman, *supra* note 24, at 491.

In the valuation context, any subsidy resulting from formulaic valuation may also partly be for passive investment. The income from passive investment is already favored in the federal income tax through the realization requirement and the capital-gains preference (which also applies to individuals' qualified dividends). *See* Jay A. Soled & Kathleen DeLaney Thomas, *Automation and the Income Tax*, 10 COLUM. J. TAX L. 1, 17 (2018) ("Over the past century, the Code has afforded preferential tax treatment to long-term capital gains relative to ordinary income."); *see also* I.R.C. § 1(h) (providing a set of maximum capital gains rates for individuals). However, passive investment is generally treated less favorably on the deduction side in the federal income tax. *See* Lederman, *supra*, at 1476 ("Although commentators sometimes discuss the federal income tax as if all profit-seeking activities are treated similarly, in fact, individuals' expenses and losses face limitations on deductibility that business expenses and losses do not face.").

> Periodically . . . the self-assessed amounts are publicized and any buyer who is willing to pay that amount to the owner/self-assessor is entitled to the property. An owner may always change his self-assessed amount up to the time of publication, but then the new amount represents the tax base for the next year. The system could also provide for property inspections, in order to remove any temptation to allow the exteriors of properties to deteriorate as a means of discouraging buyers. The owner could collect a fixed fee for each inspection to compensate him for any inconvenience and to discourage hobbyists. In short, the system uses forced sales, in lieu of audits and fines, as a way of encouraging accurate self-assessment.[94]

The forced-sale approach is creative in that it both (1) creates an arm's-length market where previously there wasn't one, and (2) tests the truth of a taxpayer's asserted value, creating a friction that should reduce undervaluations.[95] From a tax-enforcement perspective, these are important innovations. However, a forced-sale approach likely would be politically very unpopular, as people would object to being required to give the general public an option to force them to relocate.[96]

More recently, Professors Saez and Zucman proposed something similar for business valuation in the context of their wealth-tax proposal: payment in kind if the taxpayer feels the valuation is too high.[97] "[T]he tax authority would then sell the shares to the highest bidders on a market open to any and all bidders."[98] An advantage of this approach is that it would eliminate any liquidity issues arising from having a tax imposed in the absence of a realization event. In a sense, however, the forced-sale approach is akin to solving a problem of rising crime by making the criminalized behavior legal. That is, the approach embraces tax-driven sales although tax-motivated sales

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94 Saul Levmore, *Self-Assessed Valuation Systems for Tort and Other Law*, 68 VA. L. REV. 771, 779 (1982).

95 *See supra* note 26 and accompanying text (discussing frictions resulting from the use in the tax context of a value set in a context where the taxpayer has an opposing valuation incentive).

96 One can imagine horror stories of wealthy people availing themselves of the provision to harass their enemies by forcing them to relinquish the family homestead (or family business location) or to move at the worst possible time. *See also infra* text accompanying notes 97–106 (critiquing Saez and Zucman's approach).

97 SAEZ & ZUCMAN, *supra* note 5, at 151. Jeremy Bearer-Friend argues with respect to in-kind taxpaying generally that "[w]hile the Service has had challenges with the valuation of noncash contributions in the context of charitable donations, in-kind remittance to government would be less vulnerable to abuse[ ]" because the counterparty would be at arm's-length rather than "a potential co-conspirator" in overvaluation. Jeremy Bearer-Friend, *Tax Without Cash*, 106 MINN. L. REV. (forthcoming 2021) (manuscript at 35–36) (on file with the author).

98 SAEZ & ZUCMAN, *supra* note 5, at 151; *see also id.* at 151–52 (noting that this approach addresses liquidity concerns and that it solves the problem of the lack of an arm's-length market).

are typically considered an inefficient and unfortunate possible result of liquidity problems resulting from value-based taxes.[99]

Saez and Zucman's approach has other issues, too. For one, a controlling stake in a company could eventually be transferred to outsiders.[100] Saez and Zucman are not overly concerned about that issue, arguing both that "external CEOs might be more competent than family heirs"[101] and that "founders who remain active managers could be hired as CEOs even if they no longer control their company."[102] However, the political viability of government-controlled piecemeal transfers of closely held businesses is questionable.[103] It is true that the government can levy on property to collect unpaid taxes in certain circumstances.[104] However, that process has a significant amount of procedural protections[105] and is relatively rarely applied.[106]

Political resistance to forced sales would likely be strong. It may seem that a tax that called for transfers of shares of businesses only of very wealthy taxpayers might not face much opposition. Yet, the image of taxpayers being forced to sell family farms or family businesses to pay estate taxes[107] famously

99 *See* Schenk, *supra* note 15, at 445 (observing "that taxpayers might enter into inefficient, suboptimal sales to provide cash for the [wealth] tax").

100 *See* SAEZ & ZUCMAN, *supra* note 5, at 151–52 ("For a wealth tax imposed at an average rate of 2%, [a company like] Cargill's shareholders would hand in 2% of their shares each year (or the cash equivalent, if they prefer to retain full control of the company).").

101 Saez & Zucman, *supra* note 24, at 500.

102 *Id.* (citing Steve Jobs as an example).

103 *See* Levmore, *supra* note 94, at 784 n.41 ("[T]he commentators most critical of self-assessment rely, in large part, on the guess that society will not accept the forced sale component of self-assessment, [and] will ostracize forcing buyers . . . ."). It is possible for negative publicity to attach to the buyers of business interests sold at auction by the tax administration as well.

104 I.R.C. § 6331(a) ("If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax . . . by levy upon all property and rights to property . . . belonging to such person or on which there is a lien provided in this chapter for the payment of such tax.").

105 *See, e.g.*, I.R.C. § 6320 ("Notice and opportunity for hearing upon filing of notice of lien"); *id.* § 6303(a) ("Where it is not otherwise provided by this title, the Secretary shall, as soon as practicable, and within 60 days, after the making of an assessment of a tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof."); *id.* § 6330 ("Notice and opportunity for hearing before levy").

106 IRS seizures of tangible property are particularly infrequent. The number of seizures in 2017, 2018, and 2019 was 323, 275, and 228, respectively; the number of notices of levy sent to third parties in 2017, 2018, and 2019 was 590,249; 639,025; and 782,735. *See* DEP'T OF THE TREASURY, *supra* note 9, at 60 tbl.25; DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK 2017, at 41 tbl.16 (2017).

107 *See* Lee Ann Fennell, *Death, Taxes, and Cognition*, 81 N.C. L. REV. 567, 614 (2003) ("[T]he specter of a family losing its business or farm as a result of the estate tax is based more on myth than on reality."); David Cay Johnston, *Talk of Lost Farms Reflects Muddle of Estate Tax Debate*, N.Y. TIMES (Apr. 8, 2001), https://www.nytimes.com/2001/04/08/us/talk-of-lost-farms-reflects-muddle-of-estate-tax-debate.html ("Even one of the leading advo-

garnered sufficient opposition to further limit its application,[108] although the estate tax only applies to very wealthy taxpayers.[109] A proposed tax perceived to involve routine transfers of shares in family businesses (sometimes not really by choice) likely similarly would muster significant opposition.[110] Thus, although the forced-sale approach has the advantage from a tax-administration perspective of generating an arm's-length transaction, it may not be a realistic solution to the enforcement challenges valuation poses.

Conclusion

Valuation of noncash assets has long been a challenge for U.S. tax administration. Where a structural system can be established that constrains valuation to figures close to fair market value, that likely is optimal. Failing that, third-party reporting of values by arm's-length parties should be helpful, although more research is warranted in this regard.

The tax-compliance lens on valuation questions also helps provide insight into valuation methodologies. Valuation approaches that rely primarily on arm's-length transactions should face less noncompliance than ones that have important components of self-reporting, even if supported by an appraisal. Ultimately, however, techniques that solve a tax-administration issue by forcing an arm's-length disposition by the taxpayer may not be politically viable. These concerns—and the distributional effects of tax evasion—should be considered by any tax-reform proposal that would increase the need for asset valuation.

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cates for repeal of estate taxes, the American Farm Bureau Federation, said it could not cite a single example of a farm lost because of estate taxes.").

108 *See* Fennell, *supra* note 107, at 594 ("Not only has [the estate tax] fared poorly in opinion polls, but the political will to abolish it has been recently exercised."). "Decedents dying in 2002 have an exemption of $1 million, and the exemption will increase in steps thereafter, to reach a high of $3.5 million in 2009, before the estate tax is repealed in 2010 (subject to sunset provisions which, in the absence of further congressional action, would bring the tax back in 2011 with an exemption of $1 million)." *Id.* at 594 n.98. The exemption amount has continued to increase over time. For 2020, "the basic exclusion amount is $11,580,000," Rev. Proc. 2019-44, 2019-47 I.R.B. 1093, 1100; for 2021, that amount is $11,700,000, Rev. Proc. 2020-45, 2020-46 I.R.B. 1016, 1024.

109 At the time of significant anti-estate-tax lobbying, "the estate tax impose[d] liability on only about two percent of estates." Fennell, *supra* note 107, at 593–94.

110 George Cooper observed in 1979 that when a wealth tax was proposed in Britain, one commentator stated, "The proposals as they stand mean the end of private enterprise." Cooper, *supra* note 5, at 26.