Complexity’s Bookends

An important question in tax law design is how complex the law should be. Tax law must be complex enough to adequately address sophisticated taxpayers and transactions. But tax law also applies to all kinds of taxpayers, including those for whom complexity is inordinately burdensome. While complexity yields benefits such as accuracy, it is also costly. Therefore, the tax law design challenge is twofold: (1) to make sure the tax law is the right level of complexity, taking into account the costs, and, relatedly, (2) to make sure that the right level of complexity is targeted to the right taxpayers. In this Article, we shine a light on an important, underexamined tax law design tool that helps target the right level of complexity to the right taxpayers, which we term “taxpayer relief rules.”

Tax scholarship has long recognized that anti-abuse rules serve as an important tool that helps target the right level of complexity to the right taxpayers. By focusing on “abuse,” anti-abuse rules target taxpayers who might use sophisticated structuring methods to attempt to plan around or avoid specific tax rules. Focusing anti-abuse rules on such taxpayers allows the generally applicable tax law to be less complex than it would have to be if it tried to address this sophisticated tax planning within the details of the generally applicable law. For example, an anti-abuse rule that backstops the partnership tax rules allows the partnership tax rules to be less complex. The result is that anti-abuse rules help target the right level of complexity to the right taxpayers.

But tax scholarship has paid less attention to another feature of the tax law that has quietly shaped—and that has the potential to further influence—the development and ultimate resting point of complexity in tax law. We’ll call these “taxpayer-relief rules.” We define “taxpayer-relief rules” as rules that relieve certain taxpayers from the burdens of complex tax laws that would otherwise impose substantively unfavorable consequences on them. Taxpayer-relief rules help target simpler and more favorable consequences toward less sophisticated taxpayers. But taxpayer-relief rules do not only

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2 Weisbach, Formalism and the Tax Law.
reduce complexity’s burdens for less sophisticated taxpayers. Importantly, by alleviating less sophisticated taxpayers of the complexity of the generally applicable law, they also allow the law to be more complex (perhaps even optimally complex) for more sophisticated taxpayers.

In short, taxpayer-relief rules serve as a logical bookend to anti-abuse rules. Anti-abuse rules help target the right amount of complexity to the right taxpayers by subjecting taxpayers engaged in sophisticated tax planning to an additional layer of anti-abuse rules, which allows the generally applicable tax law (outside of the anti-abuse rules) to be less complex. Taxpayer relief rules target the right amount of complexity to the right taxpayers by subjecting less sophisticated taxpayers to less complex law, which allows the generally applicable tax law to be more complex. Together, anti-abuse rules and taxpayer relief rules serve as “complexity’s bookends,” helping determine complexity’s resting point in the tax law and targeting the right level of complexity to the right taxpayers.

Since much has been written about anti-abuse rules, our paper focuses on the other bookend—taxpayer-relief rules. We articulate a robust typology of taxpayer-relief rules and the ways in which they might enable tax law to evolve in a more complex direction, providing examples of this phenomenon. We then examine the design features of taxpayer relief rules and provide a framework to guide policymakers’ drafting of taxpayer relief rules as a means of targeting tax system complexity.

**A rough proposed outline**

- First, we outline the types of complexity that exist in tax law and that are known in the literature, such as rule-based complexity, compliance complexity, and transactional complexity.
- We then survey the existing literature that describes how anti-abuse rules have functioned as targeting vehicles that enable tax law to take aim at certain (sophisticated) taxpayers, thereby pushing down the optimal level of complexity in the law’s design for everyone else.
- We then discuss how taxpayer-relief rules can serve as a logical bookend to anti-abuse rules in circumscribing complexity. By targeting less sophisticated taxpayers and carving them out of the general (complex) law’s reach, taxpayer-relief standards allow the tax law to be closer to the optimal level of complexity for other taxpayers.
- We articulate a descriptive taxonomy of the types of taxpayer-relief rules that currently exist and give examples—examples include (1) de minimis rules, (2) anti anti-abuse rules, and (3) penalty relief rules. (We also flag and distinguish a number of related rules and features—such as safe harbors, non-enforcement, and other tax simplification measures—which, though strictly speaking are not taxpayer relief rules under our rubric, also help shape the degree of complexity in the tax law.)
• We develop a theory of how anti-abuse rules and taxpayer-relief rules may work together to help target the right level of complexity to the right taxpayers. Importantly, we explain how each targeting tool not only targets a particular group of taxpayers, but also allows the law to be closer to the optimal level of complexity for other taxpayers who are not targeted by such rules.
• Finally, we normatively evaluate how well the different types of taxpayer-relief rules have worked, where they have fallen short, where they have failed to exist at all (leaving nonenforcement, administrative-level appeals and negotiations, or “taxpayer chicken” as inferior solutions), and how they could be designed better.

A Tentative Typology of Taxpayer-Relief Rules

Here is a tentative typology of taxpayer-relief rules. We think the first three are clear examples of the types of taxpayer-relief rules that relieve certain taxpayers from more generally burdensome laws. We think that safe harbors, decisions not to enforce the tax law, and simplification measures such as the standard deduction are related features that we need to think through more but will ultimately distinguish.

1. De minimis rules

These are rules that carve out violations or amounts that are too small to be subject to the usual (burdensome) tax regime that has been designed to prevent an abuse.

An example of a de minimis rule includes the de minimis rule for market discounts in the municipal bond context.\(^3\) The general rule is that accrued market discount on sales or maturity of municipal bonds is treated as ordinary income rather than capital gain.\(^4\) The goal of this rule is to prevent leveraged investments in market discount bonds from generating ordinary interest deductions (that reduce ordinary income) while also generating capital gains treatment on subsequent sale.\(^5\) The de minimis rule states that in cases where the market discount is less than 0.25% of the bond’s stated redemption price for each complete year remaining until the bond is retired, the market discount is deemed to be zero.\(^6\) This means that the discount will be taxed at the lower capital gains rate, rather than the ordinary income rate set forth in the market discount rules.

Another example is the tax treatment of below-market loans.\(^7\) The tax law requires that if a lender makes a below-market loan (such as a loan at 0% interest), the

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\(^3\) I.R.C. § 1278(a)(2)(C).
\(^4\) I.R.C. § 1276.
\(^5\) Bittker & Lokken, 56.4 n.2
\(^6\) I.R.C. § 1278(a)(2)(C).
\(^7\) I.R.C. § 7872.
lender will be charged an imputed interest factor, even if no interest is collected.\textsuperscript{8} The rationale for this treatment is to prevent taxpayers from disguising gifts, taxable compensation, or taxable dividends, as loans (so that the donor does not need to file a gift tax return or so that the recipient of the payment does not have to pay tax on the amount received). Thus the below-market loans tax rules may be characterized as a complexifying tax rule designed to prevent abuses and avoidance of the tax law.

At the same time, however, the Code provides de minimis exceptions to the below-market loan rules. For example, if the amount of a gift loan between individuals is less than $10,000, the rules will not apply unless the gift loan is directly attributable to the purchasing or carrying of any income-producing asset.\textsuperscript{9} There is a similar $10,000 de minimis exception for compensation-related or corporate-shareholder loans.\textsuperscript{10} The regulations also exempt loans that have “no significant effect” on the federal tax liability of the lender or the borrower, such as certain employee relocation loans and certain government subsidized loans.\textsuperscript{11}

Both these de minimis rules, and others, serve as escape valves that allow certain “ordinary” taxpayers to be exempted from a broader complex rule designed to prevent abuse by more sophisticated taxpayers. The existence of these de minimis rules allows the generally applicable law to be more complex. This helps target not only simplicity to ordinary taxpayers, but also complexity to more sophisticated taxpayers.

2. Anti-anti abuse rules

Anti-anti-abuse rules are rules that exempt taxpayers from a complex, unfavorable provision if the taxpayer gains no substantial tax benefit from engaging in the transaction. For instance, the below market loan rules require Treasury to promulgate regulations exempting taxpayers from application of the rules when the interest arrangements “have no significant effect on any Federal tax liability of the lender or the borrower,”\textsuperscript{12} and the regulations do set forth these rules. These anti-anti-abuse rules serve as backstops to the underlying, complex rule regime by exempting out taxpayers whose transactions do not pose a threat to revenue collection.

3. Penalty relief rules

Another category of taxpayer-relief rules is rules that provide for penalty relief. For example, IRC § 6662 accuracy related penalties and § 6663 fraud penalties will not be imposed for any portion of an underpayment if the taxpayer can show “reasonable

\begin{itemize}
\item \textsuperscript{8} I.R.C. § 7872.
\item \textsuperscript{9} I.R.C. § 7872(c)(2).
\item \textsuperscript{10} I.R.C. § 7872(c)(3).
\item \textsuperscript{11} Treas. Reg. § 1.7872-5T.
\item \textsuperscript{12} I.R.C. § 7872(i)(1)(C).
\end{itemize}
cause” for that portion of the underpayment.\textsuperscript{13} Reasonable cause is a case-by-case, facts and circumstances determination. For example, under certain circumstances, good faith reliance on the advice of an expert may satisfy reasonable cause and therefore allow for penalty mitigation.\textsuperscript{14}

Penalty relief rules are another type of safety valve that lets the tax law carve out certain taxpayers (e.g., ordinary taxpayers acting in good faith) from a more onerous general rule intended to deter bad behavior. For example, the accuracy related and fraud penalties in § 6662 and § 6663 are clearly meant to serve a deterrent function for bad actors; therefore those penalties are designed to be harsh. However, the worry is that those harsh penalties may ensnare unsuspecting taxpayers who happen to foot fault. Reasonable cause standards and other types of penalty relief rules allow the law to be designed at an appropriately harsh level for bad actors, making them responsible for the complex tax laws that apply to them, while also ensuring that “ordinary” taxpayers do not get ensnared by foot-faults caused by complex rules.

\textit{Related Features}

There are some other taxpayer relief features of the Code that relate to those we are discussing. We think these do not quite fall under the rubric of “taxpayer-relief rules” as we define them here because, strictly speaking, they do not serve as safety valves that save “ordinary” taxpayers from more burdensome or complex regimes that are designed to curb abuses. However, they are related because they are taxpayer-friendly features that may shape the contours of substantive law.

4. Safe harbors

Safe harbors are IRS or congressional interpretations of what the law is. Safe harbor rules tell us that if you do something in manner X, you will fall within the boundaries of a rule (and thus will not be found to have violated the rule). Our tentative sense is that safe harbors are not exactly taxpayer-relief rules because they involve a determination that the taxpayer has successfully satisfied the requirements of a law. On the other hand, it is possible that an expansive safe harbor may also allow tax law to be more complex – if it’s easy for a taxpayer to be found “safe,” then this may help justify more burdensome overall rules or penalties.

5. Non-enforcement

We also think that perhaps deliberate IRS decisions not to enforce the tax law may also effectively constitute a taxpayer-relief rule. The logic here would be that Congress is justified in crafting a complex and burdensome rule as long as Treasury does

\textsuperscript{13} I.R.C. § 6664(c).
\textsuperscript{14} RIA Fed. Tax Coordinator V-2060.
not enforce that rule against taxpayers that are not the intended target. However, non-enforcement may not function in the same way as explicit taxpayer-relief rules, possibly because it is harder to tell ex ante whether the administrative agency will not enforce.

6. **Other simplification measures**

Clearly, many other tax simplification measures exist as well. Examples include the standard deduction or proposals to simply tax filing such as the Ready Return. These are not technically taxpayer-relief rules under our definition because they are not necessarily favorable to taxpayers as a substantive matter. For example, a taxpayer who takes the standard deduction might sacrifice some accuracy (e.g., may get fewer deductions) in order to alleviate her compliance burdens. Thus, such a feature is actually a *tradeoff* tools, rather than a taxpayer relief tool as we contemplate it. The Ready Return, while a simplification tool, is a tool that simplifies filing, not a design tool within the contours of the tax law.

Bottom line: We think that taxpayer relief rules serve as an important, yet underexamined counterpart to anti-abuse rules and that the two work together as tax law design tools to target the right level of complexity to the right taxpayers.