

TAX POLICY IN A WORLD WITH COMPLEX FIRMS: A PIGOUVIAN APPROACH

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*Forthcoming, Virginia Tax Review
Draft: September 2026*

Complex business structures have overwhelmed U.S. tax enforcement. As a result, trillions of dollars of business activity now lie beyond the reach of meaningful oversight. It is likely the costliest challenge in U.S. tax enforcement today.

Yet surprisingly, the U.S. tax system currently subsidizes this complexity — not through credits or deductions, but unintentionally through how it enforces the tax law. As a result, even though some complexity is desirable for businesses and society, the tax enforcement system currently encourages too much. This subsidy not only distorts incentives and harms overall growth, but also actively redistributes economic value from simple taxpayers and the general public to large complex firms.

The subsidy arises because complex firms are costly to audit and enforcement is funded by general revenues. If the IRS attempts to thoroughly enforce the law against complex firms, the resource costs can be enormous, and these costs are borne by simpler taxpayers who pay into the general treasury. On the other hand, if the government retreats because complex firms are too difficult to audit, then this retreat allows the complex firms to avoid deficiency assessments, take more aggressive tax positions, and achieve lower tax rates — thus displacing tax burdens onto simpler taxpayers. Either way, the firm does not internalize the true social cost of its complexity: the costs are displaced onto simpler taxpayers and the general public, resulting in regressive policy, perverse incentives, and deadweight loss to society.

These distortions are externalities, and they can be cured with Pigouvian policy. This article offers a theoretical framework to understand and address these social costs of complexity, and shows how a combination of Pigouvian fees, penalty adjustments, and improved reporting can align incentives, eliminate the inherent subsidy, and restore efficiency. The article also offers a case study applying these findings to the most intractably complex firms: large partnerships.

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Introduction

A fair and efficient tax system is not a costless public good: effective tax enforcement requires funding, trained agents, and substantial investments in administrative capacity. But when the subjects of investigation are complex firms — *i.e.*, firms whose structures, activities, or characteristics interact with tax rules in ways that require large amounts of information and resources to determine their tax liabilities — enforcement becomes especially costly. These complex firms are typically large and well-resourced, involve elaborate entity structures, engage in complicated transactions, are governed by dense and intricate tax rules, and are advised by teams of sophisticated lawyers and accountants who can outmatch the capacity of the Internal Revenue Service (Service). As a salient example of the enforcement challenge posed by this complexity, a number of these firms file tax returns over 10,000 pages long.¹

Recent evidence reveals how the Service has become overwhelmed by complex firms. Over the previous decade, audit rates for C corporations with over \$100 million in assets fell by roughly three-quarters, from 31 percent to 7 percent, while recommended tax adjustments per firm fell by two-thirds.² Audits of large partnerships — the most challenging entities for the Service to audit — are now vanishingly rare, with fewer than 0.3 percent examined in 2019, and even so, almost all ran out of time before the statute of limitations hit.³

¹ See William McBride, *Results of a Survey Measuring Business Tax Compliance Costs*, TAX POLY CTR. (2024). It is not uncommon for large multinational corporations to file U.S. federal income tax returns in excess of 10,000 pages. For large partnerships with hundreds or thousands of partners, where Schedule K-1s are attached for every partner, often with additional attached schedules on each, the page number can quickly grow enormous.

² The calculation compares data from 2019 and 2010. Audit data for 2019 are from Internal Revenue Service, *Data Book, 2024*, Publication 55-B, 36-45, Table 17 (May 2025), <https://www.irs.gov/pub/irs-pdf/p55b.pdf>, [hereinafter IRS Data Book 2024]. Audit data for 2010 are from Internal Revenue Service Table 3-1. Examination Coverage and Recommended Additional Tax After Examination, by Type and Size of Return, Tax Years (2010)–2023, <https://www.irs.gov/pub/irs-soi/25db-3-01-ex-allyears.xlsx>. Data for C corporations over \$100 million in assets are aggregated, including both closed and in-process audits.

³ U.S. Gov't Accountability Off., GAO-14-746T, *Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships*, at 18-19, Figure 8 (2023), <https://www.gao.gov/assets/gao-23-106020.pdf>.

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The Service’s own data confirm that it is outmatched: audits of these firms consume hundreds of hours per agent, and even top examiners struggle to verify the accuracy of returns.⁴ In fact, these audits have been so unsuccessful that the Service cannot produce reliable tax gap estimates for these entities.⁵

Perhaps most surprising, however, is that the current U.S. tax enforcement system actually subsidizes this complexity, rather than discouraging it. In short, as shown throughout the article, while large complex firms enjoy the benefits of weakened enforcement, smaller and simpler taxpayers — namely workers and small businesses — are the ones disproportionately covering their costs through several distinct pathways. This subsidy creates distortions that generate perverse incentives, regressive effects, and broad social costs.⁶

This article offers a theoretical framework to understand and address these distortions and costs, identifying two distinct channels of harm from complexity: *shielding* and *expenditure*. The first, *shielding*, is the most intuitive. As a firm becomes increasingly complex, it becomes more difficult and costly for the government to detect evasion by the firm or to challenge its aggressive tax positions. As a result, the firm is less likely to face consequences for aggressive positions it takes, either because audits are less likely to be successful or because the Service is more likely to bypass the firm entirely. Thus, even though complexity itself is completely legal, complexity “shields” the firm from the Service.⁷

[hereinafter GAO Complex Partnerships] (audit rate); *id.* at 19 (time constraints). Large partnerships are those with at least \$100 million of assets and 100 partners.

⁴ *Id.*

⁵ See U.S. Gov’t Accountability Off., GAO-24-106449, *Tax Gap: IRS Should Take Steps to Ensure Continued Improvement in Estimates*, *infra* note 78.

⁶ The paper adopts standard terminology from public economics. A “cost” refers to any loss in value to society—such as wasted resources, distorted behavior, or reduced economic output.

⁷ To see the shielding channel in a simple numerical example, consider a scenario where the government is deciding whether to undertake an audit of a firm, and if it does so, to what level of thoroughness. If an audit of typical thoroughness would cost the government \$100 worth of resources, but allows the government to collect an expected \$250 in additional revenue from discovered deficiencies, it makes sense from a resource perspective for the government to undertake the audit. But now, what happens if the firm is complex and the typical audit costs \$1,000 instead of \$100? From a resource perspective, the government should either bypass the firm or consider undertaking a less intensive audit. Thus, because of the firm’s complexity, the firm has

And because the government now collects less from complex firms, for any desired level of government revenue the relative tax burden is now displaced onto simpler taxpayers.

But complexity also causes harm through an *expenditure* channel, a novel pathway identified in this article. As a firm becomes more complex, investigations of that firm are costlier, requiring the expenditure of additional government resources that could have been used elsewhere. The result is that the government now faces a tighter budget constraint and is forced to make a welfare-reducing choice: reduce expenditures, raise taxes, or some combination of the two.⁸ Most importantly, and unlike shielding, the expenditure channel causes harm even if the complex firm itself is *perfectly compliant* — because the government cannot know compliance *ex ante*, so it must engage in a costly investigation to verify.

To better appreciate these two channels of harm, it's helpful to recognize that they arise because of the combination of two facts that create a no-win situation for the Service: first, that enforcement against complex firms is very costly, and second, that enforcement is funded by general revenues.⁹ On the one hand, if the Service chooses to save money by reducing its enforcement against complex firms, or skips auditing them entirely, the complex firms then enjoy weaker enforcement and can take more aggressive tax positions. This is the shielding channel. On the other hand, if the Service does undertake costly audits of complex firms, it must burn through scarce government resources funded by general taxpayers that could be put toward other uses. This is the

been shielded from the typical enforcement it would have otherwise faced. For a more thorough discussion of these mechanisms, see Part I.D.1.

⁸ To see the expenditure channel, consider the same scenario as above in note 7: the government is considering whether to undertake an audit of a firm, and to what level of thoroughness. Again, assume an audit of typical thoroughness would cost \$100, and is expected to collect \$250 in revenue. Now, what happens if the firm is complex, and so the typical audit would cost \$240 rather than \$100? From a resource perspective, in this case the government should still undertake the audit, but it now only collects a net of \$10 rather than \$150. Because of the firm's complexity, the government now has fewer net resources than it would have had otherwise, meaning the government's budget is now tighter: it must either cut expenditures or raise taxes relative to the world where the firm was simpler. For a more thorough discussion of the mechanisms, see Part I.D.2.

⁹ For a discussion of the costs of enforcement against complex firms, see *infra* Part II.

expenditure channel. Thus, these two channels are fundamentally linked as two sides of the same coin, driven by complexity. But under the current U.S. tax system, the Service can only do its best to minimize the total costs by balancing the two. Either way, these fiscal costs are displaced onto simpler taxpayers, subsidizing complex firms and distorting incentives.

What policies can address this problem? The key insight of this article is to point out that these costs arise from complexity itself, rather than from wrongdoing, and thus must ultimately be addressed by policies that target complexity. Traditional enforcement policies that target wrongdoing, such as increasing enforcement budgets or raising penalties, backfire in this setting in that they actually encourage *more* complexity.¹⁰ They treat a symptom and not the cause. A different toolkit is needed here.

First, to address shielding — where complexity protects a firm’s own aggressive positions — a promising instrument is one that draws on classical deterrence theory: a “complexity adjustment” to deficiency assessments and penalties that scales up sanctions as complexity makes enforcement more difficult. The policy not only helps restore deterrence incentives but also improves the return on auditing complex firms, allowing a welfare-improving reallocation of audit resources.

But while the shielding problem follows canonical deterrence logic, the expenditure channel requires a novel approach. Drawing on economic theory, a core contribution of this article is to show that the natural policy solution for the expenditure channel is to impose a fee or tax on complexity itself, or a “complexity fee.” This fee, which could take the form of a user fee or an excise tax, prices in the marginal fiscal cost of enforcement against more complex firms. The fee thus forces firms to internalize the social costs of their organizational and transactional choices on the government budget — just as a pollution tax prompts firms to account for environmental harm from their production choices.

There are numerous examples where federal law already requires actors to internalize their public resource costs through excise taxes or

¹⁰ Simply increasing enforcement or raising penalties actually incentivizes firms to adopt additional complexity rather than reduce complexity, because additional discourages enforcement against them and thus makes penalties less likely. *See infra* Part III.F.

regulatory fees. Excise taxes on gasoline, diesel, and heavy trucks cause drivers to internalize how their harm to roads, bridges, and transportation infrastructure creates burdens for others.¹¹ Similarly, fees on nuclear power plants, securities issuers, and banks, among others, are designed to cause the actors to internalize the costs of the regulatory burden they impose on the government budget, which would otherwise be funded by all taxpayers.¹² An apt example familiar to most Americans is the security fee charged by the TSA: airline passengers pay a fee *ex ante* to cover the public resource costs of their screening, regardless of whether passengers are compliant. This is because the government cannot know beforehand who is or is not a threat, and the screening of every passenger requires trained personnel and expensive equipment.¹³

In all of these cases, the fees or taxes function as “Pigouvian taxes” — taxes that cause actors to internalize social costs rather than displacing them onto others and thus encourage socially optimal activity. Because of this design, a complexity fee offers several valuable policy benefits. Unlike an outright ban on complex structures, a complexity fee preserves the ability of firms to use complex structures when the benefits outweigh the social costs. In this sense, the fee is like a “toll charge” for choosing a complex form: it charges the firm the amount appropriate to cover the social costs (rather than displacing them), and thus allows firms to optimally self-select rather than requiring the government to guess *ex ante* which structures are cost-effective. The fee can also be implemented at relatively low administrative cost: a simple version can be based on observable features already reported to the Service, where liabilities can be easily cross-checked. And because Pigouvian taxes improve outcomes even when imprecise, this approach is well-tailored to imperfections in the real world.

The paper also explores a policy tool that can complement the efficacy of a penalty adjustment or complexity fee, while also being more

¹¹ See I.R.C. § 4081(a)(2)(A)(iii) (imposing a tax on highway motor fuel); *see also* I.R.C. § 9503(b)(1) (crediting revenues to the Highway Trust Fund).

¹² See 42 U.S.C. §§ 2215 (nuclear fees); 15 U.S.C. § 78ee (securities issuer fees); 12 U.S.C. § 1817(b) and 12 U.S.C. § 16 (fees on banks).

¹³ See 49 U.S.C. § 44940(a) (imposing a per-passenger security fee to fund aviation security screening services).

feasible to implement: improved reporting by complex firms on their tax returns. Although unable to achieve a first-best solution alone, a more comprehensive reporting regime can actually make headway against both the shielding and expenditure distortions simultaneously. The extra information not only makes detection easier (reducing shielding), but also makes audits less costly (reducing expenditure). It can also boost the effectiveness of a complexity fee and penalty adjustment if implemented together, making it a powerful tool that should be pursued regardless of the feasibility of the other policies.

Note that the typical downside of additional reporting is the extra compliance burden on taxpayers. But an important insight of the theory is that compliance burdens are less concerning in the context of complex firms. At worst, they function as an “in-kind” Pigouvian tax on complex firms, which can actually be socially valuable, and thus flips the traditional cost-benefit analysis of compliance burdens, making them even more appealing in this setting.

All that said, no single policy instrument can fully address the two channels of distortion on its own. The optimal response is therefore a package of complementary tools. Penalty adjustments, a complexity fee, and targeted reporting each address different margins of the same underlying problems and reinforce one another when used together. A coordinated policy mix can therefore achieve higher welfare than either one applied in isolation.

As a case study of these principles and policy suggestions, this article focuses on complex partnerships, which are the most extreme and intractable case of complexity.¹⁴ Although the theory applies to all taxpayers, partnerships have proven to be the most severe manifestation of these problems. The discussion throughout the paper is therefore framed using examples from partnerships, and the policy suggestions focus on partnerships. But it is important to recognize that the principles and takeaways extend much more broadly.

The remainder of the paper is organized as follows. Section I lays out the theory, providing a framework to understand complexity and the two channels of distortions. Section II describes the setting: it discusses recent trends in the Service’s enforcement of complex firms and how

¹⁴ See *infra* Part II.

weak enforcement has become. Section III lays out policy solutions and the theory behind them. Section IV offers a practical proposal in the context of complex partnerships. Section V addresses potential concerns and limitations.

I. A Framework for Understanding the Costs of Complexity

When a firm decides to arrange its activities, what makes one choice “more complex” or “less complex” than another? And how does complexity create social costs that are not internalized by the firm? This section addresses these core questions, laying out a theoretical framework for the social costs of complexity.

A. What it Means to be “Complex”

For purposes of this paper, *complexity* is defined functionally, from the perspective of the Service. More precisely, a firm, entity, or taxpayer is defined as being more complex if, under the tax law, by virtue of either its organization or the type of transactions in which it engages, there is a greater expected resource cost to the administrator to gather and evaluate the information required to determine the correct tax liability of the firm, entity, or taxpayer, or its owners if applicable. In simpler language, complexity can be thought of as a measure of the expected information evaluation burden on the Service to verify that the tax liabilities are in fact accurate, given the structure and transactions undertaken.¹⁵

This definition of complexity is itself quite dense, with implications worth expanding. There are four worth highlighting.

First, complexity is not illegal. Being complex is entirely distinct from illegality, and is not a prerequisite, consequence, nor automatic indicator of illegality. A firm engaged in evasion could be extremely simple, and a perfectly compliant firm could be extremely complex. This is the reason why the costs of complexity cannot be fully addressed by

¹⁵ “Expected” cost is used rather than “actual” cost to ensure that complexity reflects features of the taxpayer’s structure and activities under tax law, not idiosyncratic variation in the competence or efficiency of enforcement; an inefficient audit of a simple firm does not make that firm complex.

only increasing penalties.

Second, all persons — entities or individuals — subject to tax administration have some degree of complexity. The logic applies broadly, but this paper focuses on what has proven to be the most intractable setting: complex firms, especially partnerships. All individuals and entities that report tax information require at least some resource cost to verify tax liabilities and thus have some “complexity.” Some taxpayers and settings can be extremely complex, including: trusts used for estate planning,¹⁶ multinational corporations spread across numerous jurisdictions with intracompany transactions,¹⁷ large mergers and acquisitions,¹⁸ cryptocurrency transactions,¹⁹ and derivatives transactions,²⁰ among others. While this is true, the focus of this paper is on complex firms, especially partnerships, because these have become uniquely intractable. For this reason, the term “firms” is used throughout as the relevant actors for the theoretical discussion, although the principles apply broadly.

Third, organizational, ownership, and transactional choices affect the firm’s complexity. This is a straightforward implication from the definition. The tax administrator will require different information to enforce the tax law if the firm organizes as a sole proprietorship, a C-corporation, an S-corporation, or a partnership, because each class of

¹⁶ Estate planning with trusts implicates complex grantor trust rules, valuation regimes, overlapping entities, and complex interactions between income, estate, and gift tax rules. *See, e.g.*, I.R.C. §§ 671–679, 2036–2038, 2702.

¹⁷ Large multinational corporations implicate complex rules governing transfer pricing, controlled foreign corporations, base erosion, consolidated returns, while also creating opportunities for jurisdictional arbitrage. *See, e.g.*, I.R.C. §§ 482, 1501–1504, 951–965, 250, 59A, 367, 6038, 6038A–6038C.

¹⁸ Large mergers and acquisitions implicate complex nonrecognition, basis, and continuity rules, categorizations of the transaction, limitations, and detailed reporting and valuation requirements. *See, e.g.*, I.R.C. §§ 338, 351, 354–368, 381, 382, 1060; Treas. Reg. §§ 1.368-1, 1.382-2.

¹⁹ Cryptocurrency transactions implicate complex classification, tracking, valuation, and reporting issues, including the taxation of exchanges and forks, basis tracking across wallets and platforms, and reporting gaps. *See* I.R.C. §§ 61, 1001, 1012; I.R.S. Notice 2014-21; I.R.S. Rev. Rul. 2019-24; I.R.C. §§ 6045, 6045A, 6050I.

²⁰ Derivatives transactions implicate complex timing, character, and valuation rules, including mark-to-market rules, straddle rules, notional principal contract rules, hedging provisions, and anti-conversion rules, often requiring detailed identification and reporting to prevent arbitrage. *See* I.R.C. §§ 446, 475, 988, 1092, 1221(a)(7), 1256; Treas. Reg. §§ 1.446-4, 1.1221-2.

entity is subject to distinct rules. Likewise, a firm that organizes as multiple related entities will generally be more complex, all else equal, than a single-entity or zero-entity firm, because now additional information will be required to ensure the tax liabilities are correct.

The interaction between a business entity and owners can create additional complexity. For example, because partnerships and S-corporations are pass-through entities, income is not taxed at the entity level but passes through to owners and is subject to tax based upon the owners' distinct tax situations.²¹ This feature adds complexity because additional information is needed to compute the tax liabilities arising from the firm's income. Likewise, C-corporations may become more complex if they have different classes of stock with different economic and management rights.

Transactions undertaken by the firm also range in complexity. For example, an acquisition of a tract of real property for cash by one C-corporation from another is much less complex than a tax-free merger between the two. The latter is a nonrecognition transaction that delays recognition of gain or loss, so there is more information required to keep track of basis in the exchanged assets, to ensure qualification for the nonrecognition provisions, and to ensure that taxpayers recognize the proper amount of gain or loss, if any.

Fourth, even small changes in the economics of firms and transactions can have very large effects on complexity, because it is the tax law itself, and not economics, that ultimately determines the amount of information needed to resolve tax liabilities. The tax law sometimes treats transactions that are economically similar for the participants very differently in terms of tax consequences. This also means that the tax law itself can dramatically increase the complexity of a firm, even if the economics of a firm's actions change only marginally.

To see this phenomenon, consider an entity organized as a partnership that undertakes one of two similar transactions. In the first, the firm makes a nonliquidating distribution of \$100 cash to a partner, which the partner uses to buy an asset. In the second, the partnership makes a nonliquidating distribution of an asset worth \$100 to the same

²¹ See I.R.C. §§ 701, 702 (partnerships as passthrough entities); id. §§ 1363(a), 1366 (S corporations as passthrough entities).

partner. Even though the two transactions are economically similar, the latter requires the tax administrator to obtain and process a vast amount of additional information to determine correct tax liabilities. Specifically, the second transaction likely requires additional information about: the basis, fair market value, nature and character, and holding period of the asset itself;²² whether the partnership has a §754 election in effect;²³ the basis, fair market values, and character of all of the remaining partnership assets;²⁴ how and when the partnership acquired the asset, the facts and circumstances surrounding that acquisition, as well as its initial basis and fair market value;²⁵ any depreciation methods and histories of the partnership for this asset and other assets;²⁶ whether the property is encumbered by any liabilities, and by how much;²⁷ details of the partnership agreement that affect the allocation of liabilities among partners;²⁸ information about all partners' capital accounts before and after the distribution, including all other transactions that affect all partners' capital accounts that year;²⁹

²² This information is necessary to (1) adjust the partner's outside basis and capital account correctly under I.R.C. § 705 and Treas. Reg. §1.704-1(b)(2)(iv); (2) determine the partner's basis, holding period, and character of the distributed asset under §§ 732, 1221, 1223; (3) evaluate whether the distribution is treated as a cash equivalent under § 731(c); and (4) assess whether the distribution triggers disproportionate distribution rules under § 751(b).

²³ An election can change the basis of remaining partnership property under I.R.C. § 734.

²⁴ This information is necessary with a I.R.C. § 754 election in effect, which may require a basis adjustments to partnership property under § 734(b). The adjustments are affected by character rules under § 755 and Treas. Reg. §§ 1.734-1(b), 1.755-1.

²⁵ These facts affect allocation of tax and book items under I.R.C. § 704(c) and Treas. Reg. § 1.704-3. They also affects anti-abuse analysis under §§ 704(c), 707, and § 737.

²⁶ Depreciation paths not only prevent shifting of tax and book items under I.R.C. § 704(c) and Treas. Reg. § 1.704-3, they also affect the property's adjusted basis, which determines tax consequences of the distribution under §§ 731, 732, and 734. Depreciation paths also affect character of the asset under §§ 1245 or 1250, and affect the allocation of basis adjustments under § 734(b) if a § 754 election is in effect.

²⁷ Liabilities on the distributed asset can trigger deemed cash contributions or distributions under I.R.C. §§ 752 and 731(a).

²⁸ A partner's share of partnership liabilities affects their outside basis and thus their ability to receive distributions without recognizing gain under I.R.C. § 731(a). The allocation of liabilities depends on whether the liabilities are recourse or nonrecourse and how risk of loss or economic benefit is allocated under the partnership agreement. *See* Treas. Reg. §§ 1.752-1 through 1.752-3, and § 1.704-1(b)(4)(iv).

²⁹ To ensure the distribution complies with the partnership's economic

facts and circumstances about the economic context of the distribution;³⁰ and the domestic or foreign status of the partner,³¹ among other potential critical pieces of information.³²

B. Illustration of Complexity in Practice

The definition of complexity above provides a theoretical basis to examine externalities, but how does complexity actually look in practice? How does the information burden on the Service change when choices about the structure and operation of the firm change? It is useful to contrast hypothetical low-complexity scenarios with a high-complexity scenario to appreciate the potentially enormous difference in the amount of information required to verify tax liabilities.

Recall that complexity in this article is defined functionally, in that what matters is the informational burden required to resolve the tax liabilities of taxpayers. Under this definition, the following three examples have low complexity:

Firm A: Sole proprietor where the owner earns income for services (e.g., a consultant) with minimal expenses (e.g.,

arrangement and does not effect an impermissible capital shift, it must be reflected in properly maintained capital accounts under Treas. Reg. § 1.704-1(b)(2)(iv), including accurate partner balances before and after the distribution and all transactions affecting capital during the year, and must be consistent with the qualified income offset requirements. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(d).

³⁰ The facts and timing of a distribution may trigger recharacterization under anti-abuse rules, including treatment as a disguised sale under I.R.C. § 707(a)(2)(B). *See* Treas. Reg. §§ 1.707-3(b)(2), (c), (e). Transactions lacking economic substance or inconsistent with subchapter K's intent may also be recharacterized. *See* I.R.C. § 7701(o); Treas. Reg. § 1.701-2(b), (e).

³¹ The foreign or domestic status of the partner may affect withholding obligations under I.R.C. §§ 1445, 1446, and 1441, reporting requirements under §§ 6038C and 6031, and the potential application of effectively connected income (ECI) rules under § 875. *See also* Treas. Reg. §§ 1.1446-1 through 1.1446-6 (detailing withholding tax obligations on distributions to foreign partners) and IRS Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax).

³² For example, additional information may be required to evaluate potential adjustments or recharacterizations under the centralized partnership audit regime (I.R.C. §§ 6221-6241), under common law doctrines such as step transaction or substance over form, or under the partnership anti-abuse regulation, which requires scrutiny of whether a partnership arrangement has a substantial purpose consistent with Subchapter K. *See* Treas. Reg. § 1.701-2(b), (c); *see also* I.R.C. § 7701(o).

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travel expenses).

Firm B: S-corporation with a single shareholder and no assets other than cash. The shareholder performs services, and has minimal expenses. The only contributions or distributions are cash.

Firm C: A C-corporation with a single shareholder. The corporation is a small retail firm with income only from sales, and minimal expenses outside of rent, utilities, and inventory. There are no distributions or contributions in the tax year.

In each of these three cases, the firms require only a relatively small amount of information for the Service to verify the accuracy of reported liabilities attributable to the operations of the firm. The Service would need to verify the accuracy of the reported income and expenses with receipts and invoices, and that the activity reported is bona fide and not simply disguised personal consumption. Also, for Firms A and B, the Service would also need to verify that the firm's income is incorporated into the calculation of the individual's own tax liability correctly, whether as self-employment income or as salary and pass-through income, as applicable.³³ For Firm C, the Service will need to verify that inventory and cost of goods sold are reported using a consistent method that clearly reflects income, but this is typically straightforward for a small, simple retail operation.³⁴ In each case, the calculation is relatively straightforward.

Contrast these examples with the administrative burden that arises from a more complex firm:

³³ For sole proprietors (Firm A), income is reported directly on the individual's return via Schedule C and is subject to self-employment tax under I.R.C. § 1401. For S-corporations (Firm B), corporate income passes through to the shareholder under § 1366, and is reported on the shareholder's individual return. In addition, any shareholder who performs services for the S-corporation must be paid "reasonable compensation" as wages, which is subject to employment tax under §§ 3101 and 3111 and reasonable compensation rules. *See* Rev. Rul. 74-44, 1974-1 C.B. 287; *David E. Watson, P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012) (upholding IRS recharacterization of distributions as wages due to unreasonably low salary).

³⁴ *See* I.R.C. §§ 471(c) and § 446(b); Treas. Reg. § 1.471-1; IRS Pub. 538, Accounting Periods and Methods (2024).

Firm D: Partnership with 25 partners, ten of which are partnerships themselves, so that the items of income, gain, loss and deduction pass through multiple tiers before reaching ultimate taxpayers and affecting tax liabilities.³⁵ Partners include foreign individuals and entities from multiple jurisdictions, multiple types of entities, trusts, partners with different taxable years and accounting methods, and multiple related parties.³⁶ There is a general partner and limited partners, with a mix of active and passive involvement in management and operations.³⁷ The partnership assets consist of a mix of types, have different fair market values and tax bases, were contributed by different partners at different times, some encumbered, each with various amounts of built-in gain or loss.³⁸ The partnership makes multiple

³⁵ Tiered partnerships require the IRS to trace tax items to the top of the ownership chain. Moreover, compliance with anti-abuse rules cannot be evaluated by examining the entity alone, but must consider the effects on the tax outcomes of the ultimate partners.

³⁶ The presence of foreign partners triggers a host of sourcing, withholding, and treaty compliance obligations for the partnership, including the application of I.R.C. §§ 1441-1446, the § 871 and § 881 withholding regimes, and § 894 treaty overrides. *See also* Treas. Reg. § 1.1446-1 (withholding on effectively connected income allocable to foreign partners). Because different types of entities, especially foreign, are subject to different tax regimes, arbitrage opportunities exist, triggering substantial economic effect analysis under Treas. Reg. § 1.704-1(b). Partners with different taxable years or accounting methods trigger analysis under § 706, which involves complex calculations. Related-party partners may invoke special rules under §§ 267 and 707, including disallowance of losses, recharacterization of transactions, or denial of nonrecognition treatment. All of these opportunities for arbitrage implicate the general partnership anti-abuse rule under Treas. Reg. § 1.701-2.

³⁷ The distinction between active and passive partners affects the tax treatment of income, loss, and deductions under several provisions, requiring partner-specific factual determinations by the IRS. For example, applying the passive activity loss rules of § 469 and the self-employment tax rules of I.R.C. § 1402(a)(13). *See Soroban Capital Partners LP v. Commissioner*, T.C. Memo. 2025-52, at *2–20 (May 28, 2025) (applying a functional analysis under § 1402(a)(13)); cf. *Sirius Solutions, L.L.P. v. Commissioner*, No. 24-60240, slip op. at 5–12 (5th Cir. Jan. 16, 2026) (interpreting “limited partner” in § 1402(a)(13) by reference to limited liability).

³⁸ In addition to the general basis rules under I.R.C. §§ 721–723, contributions of property with built-in gain or loss require the partnership to allocate tax items going forward in a manner that accounts for the pre-contribution discrepancy, using one of several permissible accounting methods applied on a property-by-property basis. *See*

distributions throughout the year of different types of assets to partners.³⁹ Income arises from numerous sources and multiple lines of trade or business, as well as from numerous distinct investments, and there are numerous sources of expense, deduction, and loss. These items of income, gain, deduction, and loss are allocated to the different partners using an extremely intricate arrangement in the partnership agreement that depends on hurdle rates and various other contingencies.⁴⁰

The burden on the Service to collect, organize, and evaluate information to verify the accuracy of the tax liability for the partners above is mindbogglingly larger than the amount of information needed to resolve the first three firms, likely by many orders of magnitude.

C. Why Do Firms Choose Complex Structures and Transactions?

Although complexity can give rise to social costs by facilitating evasion or more aggressive tax positions, there are many perfectly benign reasons that firms choose structures and transactions that are complex. At a high level, complexity reflects the need to coordinate diverse sets of economic interests between entrepreneurs, capital providers, service providers, suppliers, customers, and other transactional counterparties under complex legal regimes across

I.R.C. § 704(c); Treas. Reg. § 1.704-3. Contributions may also implicate character-preservation and gain-recognition rules under §§ 724 and 721(b). Contributions encumbered by liabilities can trigger disguised sale analysis under § 707(a)(2)(B) and require partner-specific basis and liability adjustments under § 752 and Treas. Reg. §§ 1.704-2, 1.752-1 through -5.

³⁹ Property distributions require the partnership to apply a host of rules that interact and turn on the character, timing, basis, and value of the distributed assets, the recipient partner's outside basis, inside basis, and capital accounts, as well as the nature and substance of the distribution. *See* I.R.C. §§ 731–735. The distribution can trigger anti-shifting rules under §§ 704(c), 751, and 755, disguised sale rules under § 707, as well as anti-mixing bowl rules and other anti-abuse rules under § 737. A § 754 election can trigger further basis adjustments under §§ 734(b) and 755.

⁴⁰ Partnership allocations must have substantial economic effect, meaning they reflect the partners' economic risk and reward rather than merely shifting tax consequences. *See* Treas. Reg. § 1.704-1(b). The test is a fact-intensive inquiry that often requires evaluating complex allocation agreements while assessing what was known among the partners in light of their unique tax positions. If the allocations fail, the IRS must reallocate income following the partners' interest in the partnership. *See* Treas. Reg. § 1.704-1(b)(3).

multiple jurisdictions over an extended period of time. Complexity also often arises as a reflection of choices by tax policymakers that have traded off administrability of the tax law to achieve desirable incentives for taxpayers or more accurate tax results. Complexity may also arise from perfectly legal tax planning conducted by the firm. All of these reasons for complexity are benign, but can nevertheless render the firm significantly less legible to a tax administrator.

As an illustration, consider the example of Firm D above. The features that make the firm complex are not only legal, but can be economically rational. The large and varied partner base reflects a range of economic contributions from a diverse set of actors, whether they are passive capital providers or contribute labor and expertise. The use of multiple and tiered partnerships helps accommodate the tax, compliance, and liability protection needs of these diverse partners. The income of different characters arises naturally from different operations and investments. Also, the complex allocations reflect the intricate sharing of profit and risk between partners, while distribution provisions accommodate needs for liquidity. In short, complexity should not be interpreted as an indicator of malintent or even of aggressive tax positions.

D. Two Distortions and Subsidies: The Social Costs of Complexity

Business complexity creates economic distortions through the tax enforcement system. These distortions arise because, under the current tax system, complexity shifts fiscal burdens onto simpler taxpayers. This shift not only subsidizes complex firms at the expense of simpler taxpayers, but also generates deadweight loss for all of society.

The distortions arise because of the combination of two facts: first, that audits of complex firms are very expensive, and second, that these audits are funded by general revenues. As a result, the Service faces a lose-lose situation when choosing whether to audit a complex firm. On the one hand, if the Service aims to preserve its scarce resources by reducing its enforcement against complex firms, that choice effectively subsidizes complex firms over simpler taxpayers: complex firms now face weaker enforcement, and so can take more aggressive tax positions. This is the shielding channel of harm. But on the other hand, if the Service chooses to knuckle down and audit the complex firm, it must expend more resources to do so than it would have had the firm been simpler. This is the expenditure channel. The distinct costs of each are

discussed here.

1. *Shielding Channel*

The first set of distortions occurs because complexity can “shield” a firm by making tax enforcement more difficult. As a firm becomes more complex, the government faces additional challenges in a myriad of ways. Gathering the relevant information, finding agents with the right expertise, distinguishing legal from illegal conduct, completing audits before the statute of limitations expires, or successfully defending adjustments on appeal generally all become more challenging when firms are more complex.

This extra difficulty thus subsidizes complex firms by lowering their tax burdens relative to simpler taxpayers, which occurs in two ways. First, weaker enforcement means lower penalties and deficiency assessments, all else equal. The government will face additional difficulty securing deficiencies and penalties against the firm; it may also give up the audit early, or bypass the firm entirely, deciding that the audit is simply not worth the expense. Second, from the firm’s perspective, because the government chooses to rationally weaken its enforcement against the more complex firm, the firm can be more comfortable with taking more aggressive positions and reporting lower tax liabilities in the first place, further lowering its tax bill relative to simpler taxpayers.

This lower tax burden on complex firms creates real social costs, in two ways. First, the government collects less revenue both because of lower audit collections and because firms now take more aggressive positions, tightening its budget constraint. The government must respond by reducing spending, raising taxes, or both. Reduced spending lowers the provision of public goods and services, while higher taxes create additional deadweight loss and strengthen incentives for noncompliance by increasing the returns to underreporting.⁴¹

⁴¹ Under standard economic theory, income taxes distort behavior by reducing the after-tax return to work, saving, or investment, thereby discouraging productive activity. This distortion creates deadweight loss: a loss of total economic value that is not offset by gains elsewhere. The magnitude of this loss increases with the square of the tax rate, making additional revenue from higher income taxes increasingly costly at the margin. *See, e.g.,* Jonathan Gruber, PUBLIC FINANCE AND PUBLIC POLICY 589-622 (6th ed. 2019).

Second, shielding also distorts private allocations of capital and labor. Because shielding lowers the effective tax burden on complex firms, capital and labor flow toward those firms even when they are less productive than simpler uses on a pre-tax basis. In equilibrium, after-tax returns equalize, but society is worse off because private sector resources have now been drawn away from their most productive uses in less complex firms toward less productive (but now tax subsidized) uses in complex firms.⁴² Importantly, this cost arises completely separately from any loss of public revenue discussed above—it is driven instead by suboptimal allocations in the private sector due to the tax incentives created by the skewed enforcement.

In sum, by making tax enforcement more challenging, additional complexity shields firms, who as a result enjoy lower tax burdens. The lower tax burdens not only lower revenue collections and thus tighten the government budget, but also distort allocations of capital and labor toward complex firms and away from more productive uses.

2. *Expenditure Channel*

The second set of distortions occurs through the government's enforcement expenditures. Under the current tax system, as explained below, the extra costs of enforcement against complex firms are spread out across taxpayers and the general public, rather than internalized by the complex firm. This arrangement subsidizes complex firms at the expense of simpler taxpayers.

To conduct enforcement against any taxpayer, simple or complex, the government must expend resources. When a firm adopts more complex arrangements, the cost of that enforcement rises: the government must expend more resources to achieve the same level of thoroughness compared to the case where the firm had been simpler.⁴³ The question is: who pays for that expense?

Under the current U.S. tax system, the costs of tax enforcement

⁴² Note that this conclusion assumes that markets are otherwise competitive. This assumption allows us to isolate the directional effect of this particular distortion.

⁴³ Note that this point is true by how complexity is defined in the paper. See *supra* Part I.A. It is also observed in practice: large partnerships, which place a large burden on the Service for investigations, are well documented as requiring vastly more resources per dollar collected than simpler filers. See *infra* Part II.

are funded through the federal budget and thus borne by taxpayers generally.⁴⁴ More specifically, most IRS funding has historically consisted of discretionary funding provided through annual appropriations acts.⁴⁵ Congress has also occasionally provided supplemental funding outside the ordinary annual appropriations process.⁴⁶ In either case, the costs of enforcing the tax laws are borne through the federal budget rather than charged to the particular taxpayers who generate those costs or financed through enforcement collections.

As a result of this funding structure, firms do not internalize the fiscal costs of their increased complexity, which deplete resources that could be used for other public goods and services and that are funded broadly by all taxpayers. For example, if a firm chooses to operate under a more complex arrangement such that it costs the government an additional \$1 million to audit the firm, that \$1 million cost is socialized across all taxpayers rather than borne by the firm, and that \$1 million draws down resources available for other uses. As a result, even though the firm's extra complexity cost society \$1 million of public funding, it does not take this real social cost into account when making its own profit-maximizing decisions. Put another way, the choice to be more complex in the firm's own calculus is artificially cheap compared to the real cost to society — because the rest of society is actually bearing that cost and subsidizing the firm's choice to be more complex.

The social costs are straightforward: because enforcement now costs more to achieve the same standard as under a simpler arrangement, the government now has fewer resources available for other activities. As with shielding above, the government's budget is tightened. As a result, the government must respond by reducing

⁴⁴ See Congressional Research Service, *Internal Revenue Service Appropriations*, FY2025, CRS In Focus No. IF12647 (Apr. 29, 2024); Congressional Budget Office, *How Changes in Funding for the IRS Affect Revenues*, CBO Publication No. 60037 (Feb. 29, 2024).

⁴⁵ See Congressional Research Service, *Internal Revenue Service Appropriations*, *supra* note 43.

⁴⁶ As a notable recent example, the Inflation Reduction Act of 2022 provided the IRS with \$78.9 billion in mandatory, multiyear funding available through fiscal year 2031, including \$45.6 billion specifically designated for enforcement and \$25.3 billion for operations support. See *id.*

spending elsewhere, raising taxes, or both.

3. *The Expenditure Channel with a Fixed Enforcement Budget*

The social harm from the expenditure channel, as discussed above, comes from extra expenditure on the firm's audit, thus tightening the government budget. But what happens if the audit budget is fixed in the short run?

In practice, Congress makes annual appropriations not only for the Service generally, but also for specific accounts, where enforcement is one.⁴⁷ In other words, in any given tax year, the Service is operating on a fixed enforcement budget.

To see the effects of a fixed budget, it's helpful to distinguish between the short and long run. In the short run, every dollar spent on one audit is a dollar drawn away from another audit. As a result, enforcement will be weaker for *other* taxpayers, who are now audited less because there are fewer audit resources left to go around.

But it turns out that not all taxpayers benefit evenly, because enforcement resources are largely siloed between different types of taxpayers, as explained below. As a result, the additional expenditure to investigate a complex firm will thus primarily benefit the group of taxpayers in the same enforcement silo, rather than all taxpayers generally. And it turns out that the group who benefits most is comprised of other complex firms.

Explained in more detail, the Service's enforcement resources are not flexibly allocated between different ongoing examinations as needed throughout the year.⁴⁸ Instead, resources are subdivided and allocated *ex ante* between different business operating divisions (BODs) that each handle investigations of specific types of taxpayers.⁴⁹ It is administratively difficult to reallocate resources across the BODs, even across several years, because most of these allocations are made based

⁴⁷ See Congressional Research Service, *Internal Revenue Service Appropriations*; Congressional Budget Office, *How Changes in Funding for the IRS Affect Revenues*, *supra* note 43.

⁴⁸ See Treasury Inspector Gen. for Tax Admin., *Opportunities Exist for the IRS to Develop a More Coordinated Approach to Examination Workplan Development and Resource Allocation* 2-5 (2023).

⁴⁹ *Id.*

upon the payroll of each BOD, which changes at a slow pace.⁵⁰

Enforcement of the most complex firms is handled by the “Large Business & International Division.”⁵¹ As a result of this resource siloing, the incidence of the benefits from one additional complex firm will thus likely fall in the short run on *other complex firms*. In other words, while an additional complex firm benefits other complex firms by drawing down enforcement resources within that silo, simpler taxpayers suffer: less revenue is raised from complex firms, which displaces the relative tax burdens of financing the government onto simpler taxpayers.

In the long run, however, appropriations can change and resources can more easily be reallocated. As a result, the problem generalizes to the one described above in Part I.D.3: the government faces a tighter budget constraint. As a result, the government can respond by raising taxes or choosing where to cut spending to cover the shortfall.

4. *Distributional Effects*

Beyond the effects discussed above, there are also indirect distributional effects. First, there are effects through the markets for firm inputs, like equipment and labor. Because the distortions subsidize complexity, it increases demand for specialized legal and tax services, raising returns to professionals who design and maintain complex structures. At the same time, the flow of additional capital into complex firms increases demand for the types of labor and capital used in

⁵⁰ There is some flexibility to request appropriations to fund additional initiatives or investments by particular BODs. *See id.* at 4. And there is room for leadership discretion to allocate appropriation surpluses and deficits. *See id.* at 5. But for the most part, appropriations are simply allocated across BODs based on payroll, which changes slowly. *See id.* at 5 (“If there are no appropriations for additional investments, ... the funding to the BODs is allocated based on the employees on roll who have already been hired. In [such an environment], if the IRS wanted to shift resources from one division to another to prioritize different types of work, IRS management would have to wait for employees to leave the organization through attrition and then reassign any available funding to a different division.”) (citation omitted).

⁵¹ The division handles “generally examines C corporations, S corporations, and partnerships with assets greater than \$10 million and individual taxpayers with international-related issues on their tax returns. These businesses typically employ large numbers of employees, involve complicated issues involving tax law and accounting principles, and conduct business in an expanding global environment.” *Id.* at 3.

complex firms.

Distributional effects can also arise through the Service’s own enforcement choices. Faced with limited resources, to the extent the Service allocates more enforcement resources toward cases where audits yield the greatest return per dollar spent, this will shift burdens onto taxpayers where the yield per dollar spent is higher. Because audits of complex firms are more costly and less fruitful, simpler taxpayers become more attractive enforcement targets. As a result, enforcement pressure shifts toward simpler firms and wage-earners, increasing their effective tax burdens relative to more complex firms. Indeed, these are the exact trends we observe in practice, as discussed in Part II.A.

II. Weak Enforcement of Complex Entities in Practice

The enforcement challenges posed by complex entities are visible in the Service’s enforcement statistics during the 2010s. As the Service’s resources waned, enforcement against complex firms plummeted.⁵² For example, while nearly all corporations with over \$20 billion in assets were audited in 2010 (87 percent), by 2021 the share had fallen to only 15 percent.⁵³ At the same time, the share of these audits with a “no change” result increased from 11 percent to 90 percent.⁵⁴ Patterns were similar for all large corporations and large partnerships, with audit rates for those falling by 82 percent and 79 percent through 2019, respectively, as seen in Figure 1.⁵⁵

⁵² See *infra* notes 56–59 and accompanying text (discussing the decline in IRS enforcement resources).

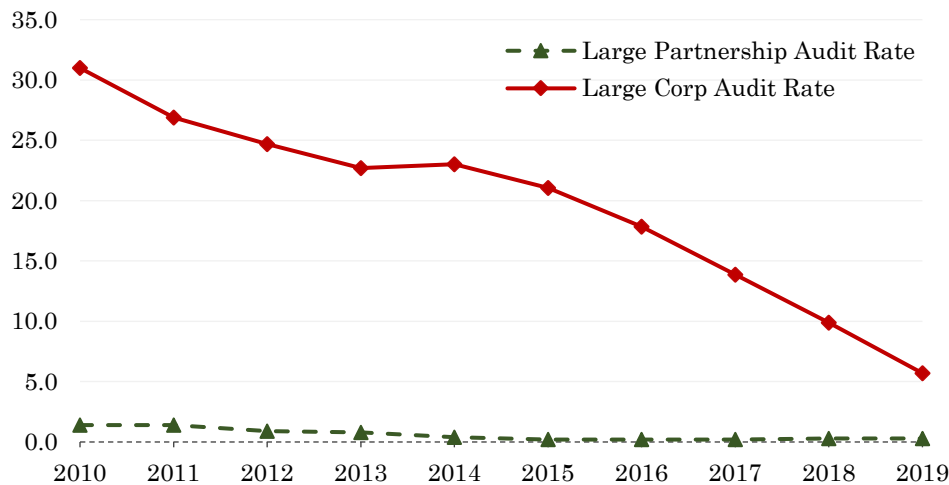
⁵³ IRS Data Book 2024, at 36-45, Table 17.

⁵⁴ *Id.*

⁵⁵ Calculated from data used in Figure 1.

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Figure 1. Audit Rates of Large Firms⁵⁶



These sharp declines in enforcement were driven partly by resource shortages. During the 2010s, the Service’s budget fell by 20 percent,⁵⁷ but enforcement was hit especially hard: the budget for enforcement fell by 26 percent,⁵⁸ while the number of revenue agents fell 35 percent through 2018.⁵⁹ The number of agents handling the most complex cases of large business entities fell by 48 percent.⁶⁰ This course cannot be reversed easily, as data suggest that new agents require

⁵⁶ Data for corporations are from IRS Data Book 2024, at 36-45, Table 17. “Large corporations” are all corporations except 1120-S with at least \$100 million in assets. Data for large partnerships (at least \$100 million in assets and 100 partners) are from GAO Complex Partnerships.

⁵⁷ Treasury Inspector Gen. for Tax Admin., Ref. No. 2021-30-011, *Interim Results of the 2021 Filing Season: Effectiveness of the IRS’s Efforts to Provide Customer Service and Protect Taxpayer Information Remains Mixed*, at 4 (2021), <https://www.tigta.gov/sites/default/files/reports/2024-11/202130011fr.pdf>, [hereinafter TIGTA 2021 Filing Season Report].

⁵⁸ The operating budget for enforcement in 2010 was \$5.5 billion, compared to \$4.7 billion in 2019. Inflation between the periods was roughly 16.0 percent, using BEA GDP Price Deflator. See Dep’t of the Treasury, *FY 2011 Budget in Brief*, at 1 (2010); Dep’t of the Treasury, *FY 2020 Budget in Brief*, at 1 (2019), <https://home.treasury.gov/system/files/266/FY%202011%20BIB%20%282%29.pdf>.

⁵⁹ Cong. Budget Off., *Trends in the Internal Revenue Service’s Funding and Enforcement*, at 1 (2020), <https://www.cbo.gov/system/files/2020-07/56422-CBO-IRS-enforcement.pdf>.

⁶⁰ *Id.* In 2019 alone, however, the Large Business & International enforcement office lost 231 staff-years due to net loss of staff. TIGTA 2021 Filing Season Report, at 3.

substantial resources and time to become proficient.⁶¹

Such shortages are especially consequential for enforcement against large firms, because that task is very costly.⁶² Large businesses today file enormously complex tax returns, many over 10,000 pages long, encompassing hundreds of related entities.⁶³ One company, General Electric, filed a 57,000-page return in 2010 (and managed to declare no tax liability on \$14 billion of profits).⁶⁴ These filings, of course, cannot be reviewed quickly: data from 2006 reveal that audits of large corporations required over 1,500 staff hours on average, and filing complexity has only increased since then.⁶⁵

But of all firms, large partnerships are likely the hardest to audit, because they are pass-through entities that can stack into complex chains and are subject to highly complex tax rules.⁶⁶ As seen in Figure 1, large partnerships — defined by the GAO as partnerships with over \$100 million of assets and 100 partners — are audited at only a tiny fraction of the rate of large corporations: only 54 out of over 20,000 were audited in 2019. Over 80 percent of these audits resulted in no tax change, and almost all ran out of time: the average audit concluded 2.99

⁶¹ On average, new hires require 2-3 years of training, and for every 100 it requires 18 experienced full time agents to train them during this time. See Treasury Inspector Gen. for Tax Admin., Ref. No. 2023-30-054, *Fiscal Year 2023 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results*, at 16-17 (2023), <https://www.tigta.gov/reports/audit/fiscal-year-2023-statutory-audit-compliance-legal-guidelines-restricting-use-records>.

⁶² See Janet Holtzblatt, *Too Many IRS Audits of Big Businesses Result in No Change in Tax Liability*, TAX POL'Y CTR. (2021), <https://taxpolicycenter.org/taxvox/too-many-irs-audits-big-businesses-result-no-change-tax-liability>.

⁶³ See McBride, *supra* note 1. The average size of survey respondents was 212 entities. Talk about partnerships. Although the survey is for corporations, partnerships can also generate exceptionally long returns due to the volume of attached schedules and the Schedule K-1s required for each partner.

⁶⁴ John McCormack, GE Filed 57,000-Page Tax Return, Paid No Taxes on \$14 Billion in Profits, WASH. EXAM'R (Nov. 17, 2011), <https://www.washingtonexaminer.com/news/224855/ge-filed-57000-page-tax-return-paid-no-taxes-on-14-billion-in-profits/>.

⁶⁵ Transactional Records Access Clearinghouse (TRAC), *Easier Times for Biggest Corporations*, TRAC IRS (Apr. 4, 2006), <https://tracreports.org/tracirs/latest/current/>.

⁶⁶ For a discussion of the features that make partnerships especially complex, see the discussion in Part IV.B. See also Edward Fox et al., *How to Tax Business? Economic Rents, Legibility, and the Corporate-Pass-Through Divide*, Working Paper (2026).

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years after filing, with a statute of limitations of 3 years.⁶⁷ The audits are demanding, with the average auditor recording 345 hours per case.⁶⁸ And of the audits that did result in a net change in 2019, the result was an average tax *reduction* of \$264,000 — a massive retreat from the \$2.6 million *positive* adjustment recorded on average for years 2009-2012.⁶⁹

The core challenge, particularly with partnerships, is complexity. Beyond the trends discussed above, in a recent GAO investigation that interviewed the Service’s employees, revenue agents consistently cited the complexity of business structures as a major obstacle to enforcement, emphasizing the difficulty posed by multi-tiered partnership arrangements.⁷⁰ Agents also pointed to the complexity of partnership tax law itself, noting that they often require assistance from outside specialists.⁷¹ Recent research likewise shows that audits of complex partnerships are often closed very quickly with no change, suggesting that the entities are simply too difficult to be worth the time.⁷²

⁶⁷ GAO Complex Partnerships, at 19.

⁶⁸ *Id.*

⁶⁹ For the 2019 data, see *id.* For the earlier years, see U.S. Gov’t Accountability Off., GAO-14-746T, *Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits*, at 11, Table 1 (2014) (statement of James R. White, Director, Strategic Issues), <https://www.gao.gov/assets/gao-14-746t.pdf>. Over the period 2009-2012, \$828 million of net adjustments were recommended across 317 partnerships.

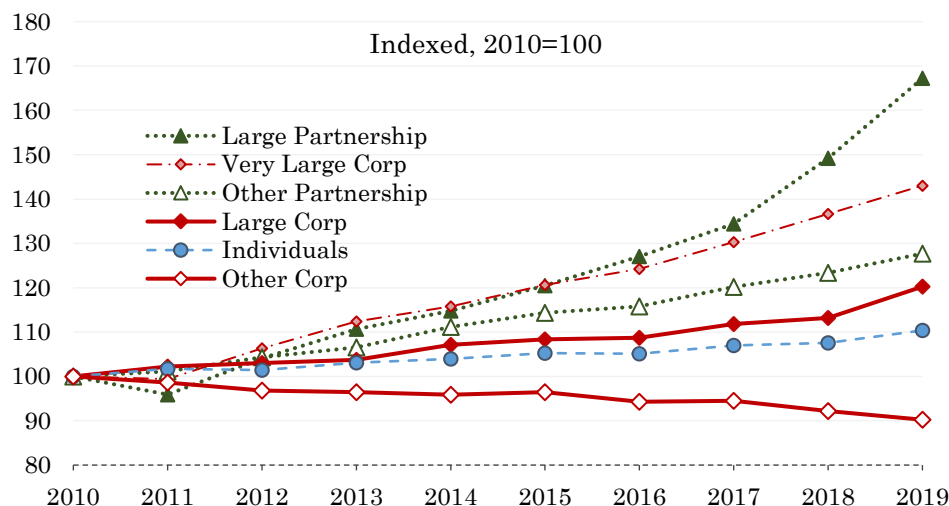
⁷⁰ GAO Complex Partnerships, at 25.

⁷¹ *Id.*, at 25-26. See also U.S. Gov’t Accountability Off., GAO-22-104960, *Tax Compliance: Trends of IRS Audit Rates and Results for Individual Taxpayers by Income* (2022), <https://www.gao.gov/assets/730/720549.pdf> (discussing how IRS officials require training and extra time to get up to speed on law changes).

⁷² See Ryan Hess *et al.*, *The Spiderweb of Partnership Tax Structures*, Working Paper (November 2024), at 28.

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Figure 2. Growth of Large Firms⁷³



A major challenge for tax administration is that complexity in business structures is growing, especially among partnerships. As Figure 2 reveals, large partnerships and corporations have been growing far faster than small corporations and individual taxpayers. Large partnerships are growing the fastest of all, up nearly 70 percent over their 2010 numbers by 2019, outpacing even the largest corporations. The structures within entities are getting even more complex over time as well: while only 36 large partnerships had at least 20 tiers in their entity structures in 2002, by 2019 over 6,000 had that many tiers.⁷⁴ Coupled with the resource constraints, this rising complexity has left the IRS simply outmatched. In its 2023 strategic plan, the IRS conceded that “[t]he rising breadth and complexity of tax administration, coupled with the sophisticated ways that some taxpayers attempt to evade tax, have outpaced our resources and ability to monitor compliance and close the gap between taxes owed and collected.”⁷⁵

Complexity has made these firms sufficiently opaque that even the official “tax gap” estimates by the Service punt on the magnitude of

⁷³ Data for large partnerships are from GAO Complex Partnerships, at 10, Fig. 2. Data for other entities and individuals are from IRS Data Book 2024, at 36-45, Table 17.

⁷⁴ GAO Complex Partnerships, at 17.

⁷⁵ Internal Revenue Serv., *Inflation Reduction Act Strategic Operating Plan: FY2023-2031*, at (Pub. 3744, Rev. 4-2023), <https://www.irs.gov/pub/irs-pdf/p3744.pdf>.

the underreporting. The tax gap — i.e., the difference between taxes legally owed and the amount taxpayers actually pay — is generally estimated by extrapolating from the results of random audits.⁷⁶ But the audits of complex entities, especially partnerships, are sufficiently challenging that the Service makes clear that there do not exist accurate estimates of the gap. As reported by the GAO, the “IRS lacks data to estimate noncompliance fully and reliably” in the case of partnerships, “because of the difficulty in detecting sophisticated forms of noncompliance in audits.”⁷⁷ The report continues: “the complex nature of these returns and the resources required to audit them suggests that even the top examiners might not be able to consistently detect all noncompliance.”⁷⁸

Complexity has also displaced relative tax burdens onto average American taxpayers, especially lower-income filers. As the Service’s resources declined, the agency has increasingly relied on automated tools and correspondence audits, which are better suited to simple returns.⁷⁹ As a result, audit rates for lower-income taxpayers have declined less than those for complex entities and higher-income individuals — a disparity GAO attributed to the greater automation of lower-income audits, which made them easier to sustain despite staffing cuts.⁸⁰ Internal Service analysis confirmed that audits of the lowest-income EITC claimants generated as much recommended tax per staff hour as some millionaire audits — not necessarily due to comparable

⁷⁶ See Internal Revenue Serv., *Tax Gap Projections Methodology*, Pub. No. 6031, at 5 (Rev. 10-2024), <https://www.irs.gov/pub/irs-pdf/p6031.pdf> (noting that similar methods are used from the 2014-2016 estimate), and Internal Revenue Serv., *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016*, Pub. No. 1415, at 17 and 21 (Rev. 10-2022), <https://www.irs.gov/pub/irs-pdf/p1415.pdf> (noting that random audits generally form the basis for individual and corporate estimates).

⁷⁷ U.S. Gov’t Accountability Off., GAO-24-106449, *Tax Gap: IRS Should Take Steps to Ensure Continued Improvement in Estimates*, at 7-8 (2024), <https://www.gao.gov/assets/gao-24-106449.pdf>. While describing the methodology to calculate the tax gap, the IRS concedes that “However, the projections cannot fully represent noncompliance in some components of the tax system, particularly as relates to corporation income tax, income from flow-through entities, foreign or illegal activities, and digital assets. For example, the IRS does not have a reliable method for estimating the corporation income tax nonfiling tax gap[.]” Internal Revenue Serv., *Tax Gap Projections Methodology*, Pub. No. 6031 (Rev. 10-2024), at 8.

⁷⁸ *Id.*

⁷⁹ See GAO, *Tax Compliance*, supra note 58, at 1.

⁸⁰ *Id.*

amounts of noncompliance, but because simple audits can be completed in bulk, while complex audits take longer.⁸¹ The Service thus defaulted to enforcement where it was administratively cheapest, not necessarily where noncompliance was highest.

The distributional consequences are even more stark once ownership is taken into account. Roughly 70 percent of partnership income flows to the top 1 percent of households, and recent research shows that the tax benefits of complex allocation and structuring accrue overwhelmingly to the very top of the distribution, with nearly 30 percent of such benefits flowing to the top 0.01 percent alone.⁸² This finding is consistent with the tax incidence literature more broadly, which has found that business tax subsidies accrue primarily to capital owners at the top of the distribution.⁸³ The enforcement subsidy created by complexity operates much like other business tax subsidies: although it is formally neutral with respect to ownership, its economic benefits flow disproportionately to those at the top.

Taken together, these trends reflect the operation of both shielding and expenditure distortions in practice. Shielding is evident in the growing difficulty of detecting and sustaining adjustments against complex firms: the Service skips most complex firms, audits run up against statutory deadlines, proposed adjustments have collapsed, and a large and rising share of audits now close with no change or even net refunds. Commissioner Werfel even lamented how taxpayers have been able to “hide behind complexity.”⁸⁴ At the same time, the expenditure distortion is apparent in the extraordinary amount of time and resources required to examine complex firms, which have sharply constrained the number of audits that can be done on a shrinking budget. Faced with

⁸¹ *Id.* at 20.

⁸² See Michael Cooper et al., *Business in the United States: Who Owns It, and How Much Tax Do They Pay?*, 30 TAX POL'Y & ECON. 91, 106 (2016) (top 1 percent); Michael Love, *Who Benefits from Partnership Flexibility?*, 251 J. PUB. ECON. 105493 (2025), at 2 (top 0.01 percent).

⁸³ See generally Max Risch, *Trickle-Down Revisited*, 39 OXFORD REV. ECON. POL'Y 498 (2023).

⁸⁴ Internal Revenue Service, *IRS Announces New Steps to Combat Abusive Use of Partnerships; Agency's Focus Intensifies as New Guidance Closes Loopholes Worth Tens of Billions*, IR-2024-166 (June 17, 2024), <https://www.irs.gov/newsroom/irs-announces-new-steps-to-combat-abusive-use-of-partnerships-agencys-focus-intensifies-as-new-guidance-closes-loopholes-worth-tens-of-billions>.

these constraints, the Service has increasingly reallocated enforcement toward simpler cases that can be audited more quickly and at lower cost.

III. Policy Solutions

Given the costs of complexity discussed above, what policy solutions are available? This part offers responses that apply the theoretical framework in Part I to address both channels.

A. *Shielding*

As discussed in Part I, shielding arises because complexity makes enforcement more difficult, lowering collections and thus the expected cost of noncompliance, encouraging more aggressive behavior.

This problem, though it may appear new, is a familiar and well-theorized issue: how to deter illegal or overly aggressive behavior when it is difficult or costly to detect.⁸⁵ But even though the core challenge is not new, its manifestation in the context of complexity raises novel design questions. The aim in this part is therefore not to reinvent foundational theory about how to address the underlying problem, but instead to discuss how existing understanding of deterrence can guide policy design in this particular setting.

1. *Basic Policy Framework: A Penalty Adjustment*

The basic framework for understanding deterrence with detection challenges traces back to the work of Jeremy Bentham,⁸⁶ which was formalized in modern economic terms by Gary Becker.⁸⁷ Their insight is that rational actors respond not to the nominal penalties imposed by law, but to expected penalties — the product of the nominal sanction and the probability that it will actually be enforced. In other words,

⁸⁵ For a review of literature on this topic relevant to the tax context, see Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569 (April 2006). See also Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 366-371 (Fall 2005).

⁸⁶ Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation*, in 1 WORKS OF JEREMY BENTHAM 1, 86-91 (John Bowring ed., 1843).

⁸⁷ Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

individuals and firms contemplating a potentially unlawful act weigh the expected gain against the expected cost, where the latter depends critically on how likely the activity is to be detected and punished.⁸⁸ If enforcement is rare or uncertain, even large nominal penalties may exert little deterrent force. Conversely, even modest fines can have powerful deterrent effects when detection is virtually certain.

A central implication of this framework is that deterrence can, in principle, be maintained even when enforcement is imperfect — so long as penalties are scaled appropriately. If the probability of detection is low, the penalty can be raised to preserve the same expected cost of noncompliance. This logic yields a straightforward policy prescription: to deter unlawful behavior that is difficult to detect, increase the penalty to match the inverse of the detection probability.⁸⁹ In theory, this ensures that actors face the full expected cost of their decisions and are discouraged from engaging in behavior that imposes social harm.

Applied to the problem of shielding, the Becker-Bentham logic suggests a straightforward prescription: as complexity lowers the probability of detection, the penalty for underreporting should increase correspondingly. That is, there should be a complexity “penalty adjustment.” Under this logic, complexity is not penalized itself, but simply factors into an adjustment for any underreporting, including both deficiency assessments and penalties layered on top.⁹⁰

However, as every lawyer knows, the real world is never as simple as a law and economics model.⁹¹ While the theory provides a clean solution, in practice the strategy faces limitations that prevent its application in most settings.

⁸⁸ For example, suppose a firm stands to gain \$100 by engaging in a tax avoidance strategy that would be disallowed if audited, and the nominal penalty for noncompliance is \$1,000. If the probability of detection is only 5%, the expected penalty is just \$50—less than the expected gain—so the strategy may still be attractive to a rational actor.

⁸⁹ To continue the example in note 87, to deter the behavior, the penalty would need to be raised to at least \$2,000, so that the expected cost ($\$2,000 \times 5\% = \$100$) offsets the expected gain.

⁹⁰ For simplicity, the term “penalty adjustment” is used throughout the paper, but it is important it scales not only penalties but also regular deficiencies.

⁹¹ See, e.g., Alex Raskolnikov, *Accepting the Limits of Tax Law and Economics*, 98 CORNELL L. REV. 523 (March 2013). See also Logue, *supra* note 71, at 366-371.

Perhaps most importantly, the optimal penalty rule assumes that the government can accurately estimate a scaling factor that accounts for the additional challenges of enforcement. But in practice, this is rarely possible. Enforcement challenges vary widely across actors, actions, and contexts, often in ways that are difficult to observe, model, or estimate.⁹²

A second limitation arises from behavioral evidence suggesting that individuals do not respond to low-probability, high-penalty threats in the way the model assumes. Empirical studies suggest that the deterrent effect of large but unlikely penalties is often weak, particularly when the sanction is delayed, uncertain, or perceived as arbitrary.⁹³ Likewise, there may be complex sociological effects at play, including difficult-to-measure peer effects and cultural effects.⁹⁴

A third issue is that the canonical model assumes that actors are financially capable of paying large penalties, but in practice the multipliers to adjust for low detection can generate tax penalties beyond what the actors can pay, effectively capping the penalty.⁹⁵ This problem arises not only in the case of low-wealth individuals, but also in the case of thinly capitalized firms.

Finally, even when penalties are both administrable and enforceable, legal and political constraints may limit their use. Extremely high sanctions can raise concerns about proportionality, fairness, and due process. Optimal deterrence may thus become politically or legally infeasible. For example, statutory penalties in the tax code currently are very small relative to what might be prescribed

⁹² See, e.g., Giuseppe Dari-Mattiacci & Alex Raskolnikov, *Optimal Regulatory Enforcement*, AM. L. & ECON. REV. (2024), ahad013, <https://doi.org/10.1093/aler/ahad013> (discussing how optimal penalties shift under different assumptions)

⁹³ See Daniel S. Nagin, *Deterrence: A Review of the Evidence by a Criminologist for Economists*, 5 ANN. REV. ECON. 83 (2013); Robert Apel, *Sanctions, Perceptions, and Crime: Implications for Criminal Deterrence*, 29 J. QUANTITATIVE CRIMINOLOGY 67 (March 2013).

⁹⁴ See, e.g., Dan M. Kahan, *Between Economics and Sociology: The New Path of Deterrence*, 95 Mich. L. Rev. 2477 (August 1997).

⁹⁵ See A. Mitchell Polinsky & Steven Shavell, *A Note on Optimal Fines when Wealth Varies Among Individuals*, 81 AM. ECON. REV. 618 (1991).

by a Becker-Bentham optimum accounting for low audit risks.⁹⁶

2. *Application to Complex Firms*

Although these critiques of a Becker-Bentham approach are important, there are grounds to think a penalty adjustment could still be an effective deterrent for shielding. First, the effects of complexity on enforcement are measurable. Complexity is a visible feature of firms' organizational and transactional choices.⁹⁷ The relevant metric is therefore the incremental enforcement effort required to audit a complex firm relative to a simple one. These marginal enforcement costs can be estimated using internal audit data, such as staff hours, duration, and examiner specialization.

Second, the behavioral critiques of the Becker-Bentham model may also carry less force in a complex firm setting. The actors enjoying the benefit of shielding from complexity are sophisticated firms advised by experts, who are more likely to assign appropriate weight to credible legal, financial, and reputational risks.

Third, the challenge of thinly capitalized firms or judgment-proof individuals is mitigated in the setting of complex firms. These firms tend to be very large in terms of both asset values and cash flow. Also, in the case of partnerships, the entities are pass-throughs, and the owners tend to be very high-income and high net wealth individuals.

For these reasons, a “complexity adjustment” may be a sensible instrument to address the shielding problem. A practical design in the partnership context is offered in Part IV.C, but the simple gist is that as complexity of the firm increases according to salient reported metrics, a larger scaling factor can be applied to deficiencies and penalties.

In practice, such an adjustment would apply at the point of the Service's assessment of liabilities and penalties. That is, once the final

⁹⁶ See Raskolnikov, *Crime and Punishment*, supra note 71. See also Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111 (2009) (pointing out how standards for penalties are too low); cf. Mark P. Gergen, *Uncertainty and Tax Enforcement: A Case for Moderate Fault-Based Penalties*, 64 TAX L. REV. 453, 470–72 (2010) (optimal penalties must balance low detection with risk aversion).

⁹⁷ Consider the examples discussed above in Parts I.A and I.B. In each case, the observable choices of structure and forms of transaction generate predictable increases in the amount of information needed to resolve the tax liability.

liability is determined, including any deficiency or penalty.⁹⁸ The complexity adjustment would layer on top. Importantly, the adjustment would not only apply to the firm itself, but also to any relevant penalties on advisors and preparers.⁹⁹ Not only can advisors and preparers facilitate underreporting with the cloak of complexity, but also reap rewards when clients successfully underreport their tax liabilities.

Another nice feature of the complexity adjustment is that it mechanically incentivizes better detection through whistleblowers. The Service's Whistleblower Program offers awards based on the total amount collected, including taxes, penalties, and interest.¹⁰⁰ As the adjustment raises total assessments, it correspondingly raises the payout to whistleblowers.

The adjustment also indirectly improves the efficiency of audit selection by the Service. Recall that shielding reduces the expected returns from auditing complex firms, which discourages the Service from undertaking these audits. However, the adjustment corrects this distortion, causing the Service to audit complex firms closer to the socially optimal rate.

Despite these benefits, the optimal approach to address shielding is likely multifaceted to account for the basic shortcomings of a purely penalty-based solution. Complementary policies include efforts to make enforcement more salient for actors, which would improve the credibility of the risk. For example, publicizing enforcement efforts and success rates, achieving high-profile victories in court, or issuing letters to prompt voluntary compliance can all help achieve this goal. Even the

⁹⁸ The IRS formally assesses tax liabilities and penalties through a process governed by Subchapter B of Chapter 63 of the Internal Revenue Code. Once a tax deficiency is identified—typically through audit or examination—the IRS computes the additional tax owed and applies any relevant penalties under Subchapter A of Chapter 68. Penalties may include negligence or disregard (I.R.C. § 6662(b)(1)), substantial understatement (§ 6662(b)(2)), or fraud (§ 6663). The total amount, including both tax and penalties, is then “assessed” by recording the liability on the IRS’s books, which gives rise to a legally enforceable debt. *See* I.R.C. §§ 6201-6203; IRM 4.10.8.2.1 (05-14-1999); IRM 20.1.1.2 (11-25-2011). The complexity adjustment proposed here would apply after this determination, modifying the total assessment.

⁹⁹ *See* I.R.C. §§ 6694 and 6701.

¹⁰⁰ *See* § 7623(b); Treas. Reg. § 301.7623-2(a)-(d). *See also* Internal Revenue Service, Whistleblower Office, *Annual Report to Congress: Fiscal Year 2024* (May 2025), <https://www.irs.gov/pub/irs-pdf/p5241.pdf>.

perception of heightened attention — if credibly conveyed — can shift taxpayer expectations and increase compliance.

B. Expenditure

The expenditure channel, unlike shielding, poses a novel problem that has not yet been directly addressed in the enforcement literature — even in the tax enforcement literature. As described in Part I.D, the expenditure distortion arises because audits of complex firms are especially resource-intensive, but the complex firm itself does not internalize this cost when deciding the complexity of its own activities. Instead, the cost is displaced to the public, drawing down public resources that could have been devoted to other productive uses. Crucially, this social cost is generated by complexity itself, not by evasion, and therefore occurs even when the complex firm is fully compliant. As a result, the social costs cannot be remedied by adjusting penalties, or by other deterrence tools aimed at noncompliance.

1. A Pigouvian Solution: the “Complexity Fee”

The standard economic solution to this kind of problem is a Pigouvian instrument, named after the economist Arthur Pigou, which forces that actor to internalize the social cost, rather than displacing it onto the public.¹⁰¹ The instrument, which could take the form of a fee or tax, works by charging the actor an amount equal to the extra cost their behavior imposes on others.

The canonical example is the case of pollution or carbon emissions. A factory will optimize its profits while emitting pollutants or carbon into the air as part of its production process, but the firm does not take into account the costs to others from these emissions. As a result, the firm will engage in more polluting activity than is socially optimal, since those harms are external to its private decision-making. A Pigouvian tax corrects this distortion by imposing a charge equal to the marginal social damage caused by each unit of pollution. Once this cost is reflected in the firm’s bottom line, its private incentives change: emitting becomes more expensive, and the firm will reduce emissions until the private benefit of doing so equals the now-internalized social

¹⁰¹ See Thomas Helbling, *Externalities: Prices Do Not Capture All Costs*, 47 FIN. & DEV. 48, 49 (2010); ARTHUR C. PIGOU, *THE ECONOMICS OF WELFARE* 172–203 (4th ed. 1932).

cost. This mechanism drives behavior toward the social optimum, not by mandating specific conduct or limiting output, but by using prices to align private choices with public welfare.

In the case of complex firms, the Pigouvian tax can take the form of a “complexity fee” on the firms themselves, effectively a toll charge on complexity that accounts for the expected cost on the fisc.

2. *Appealing Features*

A complexity fee is well suited to address the externalities generated by complexity because it targets the source of harm directly. In optimal tax theory, negative externalities should be taxed at their source when administrable, rather than addressed indirectly through broader instruments.¹⁰² Because a complexity fee does exactly this, it offers several advantages.

First, by pricing complexity directly, a Pigouvian tax preserves productive activity while discouraging socially excessive complexity. Unlike an outright ban on complex structures, the fee allows firms to self-sort. Firms may use complex structures as long as they pay the social cost. Firms that can simplify at low cost will do so, while firms for which complexity is more valuable will choose to pay the fee. This self-sorting achieves efficiency gains without requiring the government to micromanage firm structure; the administrator need only estimate and price the expected social cost, leaving firms to optimize privately.

Second, the Pigouvian tax encourages productive innovation while minimizing cost. By targeting the source of the social harm (complexity), firms are still encouraged to be productive, but to innovate ways to reduce their reliance on a costly input while achieving that outcome.

Third, a complexity fee is welfare-improving even under imperfect information, making it a particularly robust policy tool. Even if the government cannot calculate the exact marginal harm of an externality, a fee will still move the system in the right direction unless the social harm is wildly overestimated or administrative costs of the tax are large

¹⁰² See Wojciech Kopczuk, *A Note on Optimal Taxation in the Presence of Externalities*, 80 ECON. LETTERS 81 (2003); see also Agnar Sandmo, *Optimal Taxation in the Presence of Externalities*, 77 SWED J. ECON. 86 (1975).

relative to the benefits. This is often described as a “second-best” justification: when perfect regulation is infeasible, even an imperfect Pigouvian tax can outperform noncorrective regimes.

Fourth, Pigouvian taxes themselves generate revenue, which can be used to reduce distortions caused elsewhere in the tax system. This creates the potential for a so-called “double dividend”: the fee not only reduces externalities but it also raises revenue, which allows a reduction of distortive taxes elsewhere. Put another way, Pigouvian taxes both reduce a social harm while also *easing* the government’s budget constraint.

Fifth, in this particular setting, a fee can likely be implemented at relatively low administrative cost. Although the full downstream consequences of the distortion may appear difficult to measure, the administrator does not need to estimate them directly. Those consequences would be avoided if enforcement capacity were restored to the level that would have prevailed absent the firm’s complexity. And because the expenditure distortion is simply the extra use of government resources, the Service can estimate this extra cost with internal data about the resources used to audit firms with various structures and transactions. The tax can also be applied to a base that is calculated using information already reported on existing returns, mitigating administrative and compliance burdens.

Also, as a more forward-looking benefit, a complexity fee can help simplify the tax code. Because the tax induces self-sorting by firms, it reveals information to policymakers about the value of different complex features in practice. If firms abandon certain features, it reveals the value is not worth the social cost once appropriately priced. These observations can help guide future substantive reforms to simplify the tax code.

3. Design Options for Implementation

The guiding principle for designing a complexity fee is simple: internalize the marginal enforcement costs that a firm’s complexity imposes on the tax system. This article uses the term “complexity fee” to capture this idea. In practice, Congress has options for the legal mechanism to implement it. On the one hand, and most straightforward, Congress could delegate authority to the Treasury to set a fee to defray its costs. Alternatively, the complexity fee could also be implemented as

an excise tax where Congress sets the base and rates.

Delegating to the Treasury to set a fee. Congress frequently delegates authority to agencies to set and collect fees or other exactions. It could do so here as well, delegating authority to the Treasury to set the details of the exactions to defray its costs.

The key advantage of delegating the complexity fee in this way is that the Treasury can calibrate the exactions to minimize superfluous burdens on taxpayers while also causing complex firms to internalize their fiscal externalities more precisely. This flexibility allows the Treasury to adapt as additional enforcement data is collected, as business structures and transactions evolve over time, as Treasury audit technology improves, as tax reporting changes, and as the tax law continues to change. Also, ideas along the lines of user fees have already begun to receive some attention in policy circles as a way to address the enforcement costs associated with partnership complexity, suggesting that this alternative may have political appeal.¹⁰³

Delegations of exaction authority are common. The Office of Management and Budget counted at least \$473 billion in federal fees collected in fiscal year 2024.¹⁰⁴ Some of the most common examples that affect most Americans include highway and bridge tolls,¹⁰⁵ aviation user fees,¹⁰⁶ court filing fees,¹⁰⁷ immigration application and processing fees,¹⁰⁸ and patent and trademark fees.¹⁰⁹ Beyond simple user fees, and more directly relevant to the discussion of a complexity fee, many regulatory fees impose exactions on regulated actors to defray the cost of their regulation. For example, the Nuclear Regulatory Commission assesses and collects fees on nuclear power facilities to defray the costs of licensing, oversight, and regulatory services in proportion to the

¹⁰³ See David S. Mitchell, , *Tax Avoidance Among Large, Complex Partnerships in the United States* (Feb. 12, 2025), <https://equitablegrowth.org/research-paper/tax-avoidance-among-large-complex-partnerships-in-the-united-states/> (discussing a nominal user fee on individual partners of the most highly tiered partnerships).

¹⁰⁴ See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2025, at 213 tbl. 19-3 (2024) (using the term “user charges”).

¹⁰⁵ See 23 U.S.C. § 129(a).

¹⁰⁶ See 49 U.S.C. § 45303, 45301.

¹⁰⁷ See 28 U.S.C. § 1914(a), 1913.

¹⁰⁸ See 8 U.S.C. § 1356.

¹⁰⁹ See 35 U.S.C. § 41; 15 U.S.C. § 1113.

regulatory burden on the agency.¹¹⁰ Similarly, the Securities and Exchange Commission collects fees from securities issuers that scale with the size of the offering.¹¹¹ Also, banks are assessed fees by federal regulators that scale with the size of the bank.¹¹² The EPA collects fees from regulated facilities that defray monitoring and enforcement costs and are calibrated to the regulatory burden.¹¹³ In each case, the fee causes the actor to internalize the fiscal burden on the administrator of regulating and overseeing them.

One apt example that most Americans have experienced firsthand is the TSA security fee.¹¹⁴ The TSA collects a \$5.60 fee from each passenger per airline trip, which is assessed *ex ante* regardless of whether the passenger is compliant with TSA rules. The fee is not a penalty, but a mechanism to ensure that travelers internalize the costs of the personnel, technology, equipment, and other resources required to screen them, much like the complexity fee. It is collected *ex ante* because the government does not know who is compliant or not, and thus must screen each passenger.

The Service in fact already administers a fee regime that scales with administrative burden: fees for rulings, opinions, and determinations requested by taxpayers.¹¹⁵ When taxpayers request these services from the Service, they pay a fee to cover the administrative costs. The statute grants a great deal of discretion to the Service to design and administer the fee schedules, guiding the Service to impose fees that “vary according to categories (or subcategories) established by the Secretary,” and that are “determined after taking into account the average time for (and difficulty of) complying with requests in each category (and subcategory),” and that “are payable in advance.”¹¹⁶ The fees are set by the Service annually in a Revenue Procedure issued at the outset of the year.¹¹⁷

¹¹⁰ See 42 U.S.C. §§ 2215.

¹¹¹ See 15 U.S.C. § 78ee.

¹¹² See 12 U.S.C. § 1817(b) (Federal Deposit Insurance Corporation); 12 U.S.C. § 16 (Office of the Comptroller of the Currency).

¹¹³ See 42 U.S.C. § 7661(b)(1).

¹¹⁴ See 49 U.S.C. § 44940(a).

¹¹⁵ See I.R.C. § 7528.

¹¹⁶ See I.R.C. § 7528(b)(1)(B).

¹¹⁷ See, e.g., Rev. Proc. 2026-1, pt. IV & app. A.

If this path is chosen, the design of the delegation must satisfy the constitutional test for delegations of exactions. It is worth highlighting the key contours of this test here.

To pass constitutional muster, the grant of authority to the Treasury must provide an “intelligible principle” for the exercising that authority.¹¹⁸ The Supreme Court has held that Congress need not “prescribe detailed rules,” but that it is sufficient to “delineate the general policy, the public agency which is to apply it, and the boundaries of this delegated authority,”¹¹⁹ so long as the guidance is “such that Congress, the courts and the public can ascertain whether the agency has conformed to the standards which Congress has prescribed.”¹²⁰

In practice, the intelligible principle test has permitted a wide range of Congressional delegations to the executive branch. The Court itself in *FCC v. Consumers’ Research* in 2025 even observed that “we have almost always found” that this test has been satisfied by the statute in question. For example, in *Consumers’ Research*, the Court upheld a statutory scheme delegating power to the Federal Communications Commission (FCC) to collect fees from telecommunications carriers to subsidize low-income customers and to subsidize the provision of services in high-cost, rural areas. The statute authorized the FCC to develop a mechanism to impose exactions on carriers that are “equitable and nondiscriminatory” and “sufficient” to fund the service goals laid out in the statute.¹²¹ Despite the fact that the “[t]here is not a number or rate in sight” in the statute,¹²² the Court nevertheless found this scheme provided both the “general policy” and “boundaries” necessary to satisfy the intelligible principle standard, because the exactions were bounded in practice by targeting them to an amount “sufficient” to fund the subsidy program, which the Court determined was well-defined in its scope.¹²³

¹¹⁸ See *J. W. Hampton, Jr., & Co. v. United States*, 276 U.S. 394, 409 (1928).

¹¹⁹ *Am. Power & Light Co. v. SEC*, 329 U.S. 90 (1946); see also *FCC v. Consumers’ Rsch.*, 606 U.S. 656, 673 (2025) (reaffirming).

¹²⁰ *Opp Cotton Mills, Inc. v. Adm’r of Wage & Hour Div.*, 312 U.S. 126, 144 (1941); see also *Consumers’ Rsch.*, 606 U.S. at 673 (reaffirming).

¹²¹ See 47 U.S.C. 254; see *id.* §254(d) (funding mechanism).

¹²² *Consumers’ Rsch.*, 606 U.S. at 681.

¹²³ *Id.* at 680-682. Importantly, the subsidy program did not require explicit amounts of funding, but rather was guided by six principles that effectively bounded

TAX POLICY IN A WORLD WITH COMPLEX FIRMS

In the case of a complexity fee, the purpose is to defray the expected enforcement cost against complex firms. A delegation can thus easily provide both a clear “general policy” and “boundaries” to achieve that specific, targeted goal. More precisely, the statutory authorization can give Treasury clear guidance to target exactions to reflect the expected costs of enforcement, along with a standard that targets or bounds the level of enforcement.¹²⁴ A well-drafted statute effecting this design should easily pass constitutional muster under the framework discussed above.¹²⁵

its size and scope. This set of principles was sufficient, in combination with the targeting of the exactions to meet the needs of the program, to satisfy the intelligible principle standard. *Id.* at 682-691. Other statutory schemes approved by the Court have left even more room for executive discretion, including a delegation to set air quality standards “requisite to protect the public health” with “an adequate margin of safety” (*Whitman v. Am. Trucking Ass’ns*, 531 U.S. 457, 472 (2001)), and a delegation to ensure that holding companies do “not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders.” (*Am. Power & Light Co.*, 329 U.S. at 104).

¹²⁴ The statute may, for example, guide the Treasury to target a level of enforcement that corresponds to optimal enforcement models. See Michael Keen & Joel Slemrod, *Optimal Tax Administration*, 152 J. PUB. ECON. 133 (2017).

¹²⁵ A few additional points about the constitutionality of delegations are worth noting. First, the Supreme Court has consistently held that the taxing power is not subject to any heightened nondelegation scrutiny, so for nondelegation purposes it does not matter if the delegated power is a tax or a regulatory power (see *Consumers’ Rsch.*, 493 U.S. at 681; see also *J. W. Hampton*, 276 U.S. at 409; *Skinner v. Mid-America Pipeline Co.*, 490 U.S. 212, 220 (1989)). But delegation of authority to “tax,” in that the power raises general revenue, or raises revenue for broad public purposes, is subject to the Origination Clause constraint requiring that revenue-raising legislation arise in the House of Representatives. See *United States v. Munoz-Flores*, 495 U.S. 385, 387 (1990) (application of the Origination clause); see also *National Cable Television Assn., Inc. v. United States*, 415 U.S. 336, 341-343 (1974) (*NCTA*) (distinguishing a tax from a fee); *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 567 U.S. 519, 561-575 (2012) (*NFIB*) (distinguishing a tax from a penalty); *Consumers’ Rsch.*, 606 U.S. at 676-678 (lamenting the murky boundaries of what constitutes a tax). There has also been extra scrutiny on the statutory interpretation of delegations when the powers function like a tax but Congress has not been explicit, interpreting the statute narrowly. See *NCTA*, 415 U.S. at 341-343. This line of scrutiny can be avoided by making the statute more explicit or by ensuring the exactions and uses are within the scope of a clear policy goal set out for the agency. See, e.g., *Consumers’ Rsch.*, 606 U.S. at 734-735 (Gorsuch, J., dissenting). Earmarking the funds to enforcement makes it clear that the exaction is defraying agency costs rather than a disguised general revenue-raising tax lacking intelligible principles. The Court has also indicated that delegations with larger potential impacts on the economy require more guidance from Congress. See *Whitman*,

An excise tax set by Congress. A complexity fee could also be implemented as an excise tax set by Congress. This comes with a distinct tradeoff. On the one hand, an excise tax with a base and rate set in statute is more certain to apply going forward, less subject to administrative and judicial discretion. On the other hand, it is extremely rigid and would be difficult to adapt to the changing costs of the enforcement landscape. For these reasons, it is likely the less favorable approach in most policy settings, but is still worth laying out as an alternative for settings where policymakers feel there are sufficient political economy constraints that make a delegation unworkable.

First of all, what is an excise tax? Unlike income taxes, which are levied on the taxable income of firms, excise taxes are levied on specific goods, services, or activities, and are commonly used to induce actors to internalize social costs.¹²⁶ A complexity fee thus fits naturally within this framework because the base of the tax would be a firm’s use of structures and transactions that give rise to complexity, rather than the firm’s income or receipts.

Excise taxes are well-established and widely used policy instruments across a range of settings, with a long history. There are over sixty distinct federal excise taxes currently in effect, spanning the domains of transportation, energy use, alcohol and tobacco, the environment, and others.¹²⁷ Although excise taxes account for only a relatively small share of federal revenue today — collectively raising roughly \$98 billion in 2023, or about 2–3 percent of total receipts — they historically played a central role in federal finance.¹²⁸ In the early

531 U. S., at 475; *see also* *Consumers' Rsch.*, 606 U.S. at 673 (reaffirming). Therefore, Congress should aim to provide more guidance, as more taxpayers are implicated by the delegation of complexity fees than most delegated exactions. Furthermore, in the wake of *Loper Bright Enterprises v. Raimondo*, which discarded *Chevron* deference in favor of independent judicial interpretation, the importance of clear statutory guidance is even greater. *See Loper Bright Enters. v. Raimondo*, 603 U.S. 58 (2024); *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

¹²⁶ *See* Cong. Rsch. Serv., R43189, *Federal Excise Taxes: An Introduction and General Analysis* 1, 5 (2013).

¹²⁷ *See* Internal Revenue Serv., Statistics of Income Div., *Federal Excise Taxes or Fees Reported to or Collected by the Internal Revenue Service, Alcohol and Tobacco Tax and Trade Bureau, and U.S. Customs and Border Protection, by Type of Excise Tax, Fiscal Years 1999-2023*, <https://www.irs.gov/statistics/soi-tax-stats-excise-tax-statistics>.

¹²⁸ *Id.*

United States, excise taxes constituted a substantial portion of federal revenue, in part because the bases were easy to observe and inexpensive to administer.¹²⁹

The shift in revenue composition away from excise taxes toward income and payroll taxes does not imply that excise taxes are less effective than before. Excise taxes remain an important tool for addressing externalities. Most of the \$98 billion mentioned above arises from taxes that are Pigouvian in nature. Classic examples include taxes on gasoline and diesel fuel, which not only counter harmful emissions but also price in depreciation of roads and bridges as they are used by drivers.¹³⁰ There are also taxes on distilled spirits, wine, beer, and tobacco.¹³¹ A few smaller excise taxes are particularly apt, including the “gas guzzler” tax on fuel-inefficient vehicles,¹³² the heavy vehicle tax for highways,¹³³ and environmental taxes such as those on ozone-depleting chemicals.¹³⁴

An excise tax is also appealing because, unlike an income tax, it is not offset by deductions of the firm. A firm pays the tax regardless of whether it reports income or loss in a given year, which is appropriate because the measure of the harm does not depend on income.

Excise taxes also rest on a constitutional footing distinct from income taxes that affords Congress greater flexibility to design the tax base. While income taxes are authorized by the Sixteenth Amendment, excise taxes are authorized by Article I, Section 8, Clause 1 of the Constitution, which empowers Congress to lay and collect “Taxes,

¹²⁹ Brenda Yelvington & William F. Shughart II, *Excise Taxes in Historical Perspective*, in *TAXING CHOICE: THE PREDATORY POLITICS OF FISCAL DISCRIMINATION* 31, 31-56 (William F. Shughart II ed., 1997).

¹³⁰ See I.R.C. § 4081(a)(2)(A)(iii) (imposing a tax on highway motor fuel); *see also* I.R.C. § 9503(b)(1) (crediting revenues to the Highway Trust Fund).

¹³¹ See I.R.C. § 5001(a)(1) (imposing an excise tax on distilled spirits); *id.* § 5041(a) (imposing an excise tax on wine); *id.* § 5051(a) (imposing an excise tax on beer); *id.* § 5701(a)–(b) (imposing excise taxes on tobacco products, including cigarettes); *see also id.* § 9511(a)–(b) (providing for the transfer of tobacco excise tax revenues to the Children’s Health Insurance Program trust fund).

¹³² See I.R.C. § 4064.

¹³³ See I.R.C. §§ 4481-4482 (imposing an annual tax on heavy highway vehicles with a taxable gross weight of 55,000 pounds or more).

¹³⁴ See I.R.C. §§ 4681-4682 (imposing a tax on ozone-depleting chemicals manufactured or imported for sale or use in the United States).

Duties, Imposts and Excises.” As a result, whereas income taxes must be levied on income, and risk being deemed unapportioned “direct taxes” if they stray beyond that boundary, excise taxes are subject to more permissive constitutional constraints, generally requiring only geographic uniformity.¹³⁵ Consistent with this understanding, the Supreme Court has broadly upheld excise taxes on a wide range of activities and transactions, including taxes on transfers of property at death, gifts, and even the ownership of carriages.¹³⁶

There is also direct precedent for taxing the taxpayer’s choice of form to conduct business. In *Flint v. Stone Tracy Co.*, the Supreme Court upheld a federal corporate tax enacted prior to the Sixteenth Amendment as a constitutional excise on the privilege of doing business through the corporate form.¹³⁷ As the Court explained, “[t]here are distinct advantages in carrying on business in the manner specified in the Corporation over carrying it on by partnerships or individuals, and it is this privilege which is the subject of the tax.”¹³⁸ The logic of a complexity fee is precisely analogous: the tax targets the privilege of using particularly complex legal forms or transactions that generate measurable social costs.

If Congress opts for this excise tax approach, it sets the base and rates in statute. The downside of this option of course is that it lacks the

¹³⁵ The Constitution grants Congress the power to lay and collect taxes, including “Duties, Imposts and Excises,” provided that such taxes are “uniform throughout the United States.” U.S. Const. art. I, § 8, cl. 1. *United States v. Ptasynski*, 462 U.S. 74, 82-85 (1983) (holding that the Uniformity Clause requires only “geographic uniformity,” meaning the tax must operate the same across all states where the taxed subject is found, and allowing exemptions based on functional, non-geographic criteria). See also Robert G. Natelson, *What the Constitution Means by ‘Duties, Imposts, and Excises’ — and ‘Taxes’ (Direct or Otherwise)*, 66 CASE W. L. REV. 297 (2015). However, direct taxes must be apportioned across the States. See U.S. Const. art. I, § 9, cl. 4 (“No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.”). The boundary of what constitutes “income” for purposes of the Sixteenth Amendment has long been the subject of judicial scrutiny, imperiling some taxes designed as income taxed but that are ultimately deemed unapportioned direct taxes. See John R. Brooks & David Gamage, *The Original Meaning of the Sixteenth Amendment*, 102 WASH. U. L. REV. 1 (2024).

¹³⁶ See *Knowlton v. Moore*, 178 U.S. 41 (1900) (succession); *Bromley v. McCaughn*, 280 U.S. 124 (1929) (gifts); *Hylton v. United States*, 3 U.S. (3 Dall.) 171 (1796) (carriages).

¹³⁷ 220 U.S. 107, 142 (1911).

¹³⁸ *Id.*

flexibility or adaptability that comes with delegation. Updating bases or rates would require subsequent legislation, and even though reconciliation allows tax statutes to generally bypass the Senate filibuster, updates may yet be infrequent or politically impossible. Although Pigouvian taxes are robust to imperfections, locking in bases and rates by statute — especially when the first implementation will operate on limited information — is especially risky. Although it could be argued that statutory bases and rates offer an advantage of stability — avoiding, for instance, the dramatic flips seen in internet neutrality regulations — stability can become a liability in a landscape that regularly evolves and adapts.¹³⁹ Complexity is inherently dynamic: as tax laws, audit and compliance technologies, and planning strategies shift, a static excise tax risks becoming increasingly imprecise and clunky. For these reasons, the excise tax approach is likely less favorable than a delegated exaction authority as a policy instrument for addressing the concerns of complexity.

C. Policy Complementarity

While a complexity fee addresses the expenditure distortion, and thus reduces the incentive for any firm to use complex structures, it does not fully eliminate the harms of shielding. Firms may still adopt extra complexity, even with the complexity fee, if doing so sufficiently reduces government's ability to detect underreporting or challenge tax positions. For this reason, a complexity fee is not a substitute for targeted enforcement penalties, but rather a complement.

The inverse is also true: a penalty adjustment cannot address the full social costs of complexity. The simplest way to see this is to consider a complex firm that is perfectly compliant. Such a firm will not take on extra complexity to facilitate underreporting, but the firm still adopts too much complexity because it does not internalize the fiscal costs it creates.

Importantly, the two instruments reinforce one another. On the one hand, the fee reduces overall complexity and in doing so, discourages shielding, because now firms face a higher cost of adopting more complex structures. This means that penalty adjustments need not be as large

¹³⁹ See Kristina M. Lagasse, *Shaping the Future of the Internet: Regulating the World's Most Powerful Information Resource* in U.S. Telecom Ass'n v. FCC, 63 LOY. L. REV. 321 (2017).

as they would be without a tax. On the other hand, the penalty adjustments discourage the use of complexity for the sake of shielding, which reduces overall complexity in the system, and thus reduces the expenditure distortion overall because now there are fewer complex firms to investigate. As a result, the optimal complexity fee will be lower in a world with penalty adjustments. Both instruments combined lower both complexity and noncompliance more than either would alone.

D. Improved Tax Reporting

In addition to penalty adjustments and Pigouvian taxation, there is a third policy instrument for addressing the costs of complexity: targeted tax reporting improvements. Unlike the penalty adjustment and the complexity fee, which operate by changing firms' incentives through penalties and direct taxes, reporting operates through informational channels. When reporting requirements are well targeted and effective, the additional information makes complex firms more legible to the Service, reducing both the cost of enforcement (expenditure) and the ability of complexity to obscure aggressive tax positions (shielding). At the same time, reporting imposes compliance costs on firms, which function as an in-kind Pigouvian tax on complexity. For these reasons, targeted reporting can serve as a powerful complement to both the penalty adjustment and the complexity fee.

With respect to shielding, reporting raises the probability that noncompliance will be detected or successfully challenged. It thus functions as a complement to the penalty adjustment: the extra reporting makes the penalties more likely to bite. The two instruments operate on different margins — one on detection, the other on sanctions — so one cannot fully replace the other. But when extra reporting is used, optimal deterrence can be achieved with lower penalty adjustments.

With respect to the expenditure distortion, reporting reduces the administrative resources required to audit complex firms. It discloses organized and standardized information that the administrator would otherwise need to reconstruct during an audit. As with shielding, reporting thus complements the effect of the complexity fee, so that optimal complexity can be achieved with a lower complexity fee.

But reporting also creates compliance costs for taxpayers. These

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burdens are potentially substantial, and must be weighed carefully by administrators when promulgating reporting rules.¹⁴⁰ Ideally, any additional reporting would be costless, but this is of course an impossibility. These costs may cause a firm to reduce production so that it can devote more resources to compliance. And such burdens likely fall especially hard on smaller and younger firms, especially if the task falls on a sole owner-operator.

But these concerns, while legitimate and important, are mitigated when the burden falls on complex firms, because these firms would optimally be subject to a complexity fee anyway. Put another way, in a world with complexity, the reporting burden is not as wasteful as one might think, because the burden functions as an “in kind” complexity fee. The difference is that the administrator receives additional information rather than cash.

A familiar example of this phenomenon already exists in the context of tax-free corporate spin-offs. Transactions aiming to qualify are subject to exceptionally detailed reporting requirements; while obtaining advance assurance from the Service is optional, taxpayers who choose to do so must follow rigorous procedural requirements set forth in the Service’s Revenue Procedures.¹⁴¹ These requirements are costly for taxpayers to satisfy, but they also substantially reduce the burden on the Service to evaluate highly complex transactions. The extra reporting thus causes taxpayers engaging in spin-offs to internalize some of the fiscal burden of the regulation of these complex transactions.

In practice, such additional reporting by complex firms could take a number of different forms. It could simply include additional fields on existing tax forms, or additional schedules attached to an existing tax form. It could also include more detailed disclosure requirements describing the substance of transactions, similar to “reportable

¹⁴⁰ See *Small Businesses: IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts*, GAO-15-513, at 1 (Gov’t Accountability Off. June 30, 2015) (discussing the challenge of balancing compliance costs for small businesses with efforts to improve tax compliance).

¹⁴¹ See I.R.C. § 355; Rev. Proc. 2017-52, 2017-41 I.R.B. 283; Rev. Proc. 2018-53, 2018-43 I.R.B. 667. See generally Rev. Proc. 2025-30, 2025-40 I.R.B. 1 (modifying procedures for letter ruling requests); Rev. Proc. 2024-24, 2024-22 I.R.B. 1093.

transactions” currently.¹⁴² It could also require certain types of easy-to-process structured data, for example, a requirement that detailed information about transactions be submitted in digital formats that can be efficiently analyzed by the administrator with the aid of the latest technology. The key is that the form and substance of the reporting accomplish its goals: reducing the cost of enforcement (less expenditure) while also making complex firms less opaque (less shielding).

E. “Win-Win” Policies

Separate from the above policies, the administrator should always adopt “win-win” solutions that increase enforcement efficiency within existing budget constraints without requiring additional compliance burdens. These include improvements such as: more effective staff training, better detection algorithms with available information, and improving the efficiency of internal processes. Not taking these actions is simply leaving money on the table.

However, these “win-wins” do not eliminate the need for the corrective tools discussed earlier. So long as complexity makes audits more challenging and costlier, shielding and expenditure distortions will persist, and thus there will be room for the policies mentioned earlier.¹⁴³

F. Inferior Solutions

Note that the problems of shielding and expenditure cannot be fixed by simply increasing enforcement, raising penalties, or adjusting tax rates. In fact, using these tools alone will create perverse incentives that exacerbate the problem, rather than address it.

First, consider increasing enforcement expenditure. Because of shielding, firms have a greater incentive to adopt complexity to discourage the enforcement. Extra enforcement expenditure also

¹⁴² The federal “reportable transaction” regime is governed by Treas. Reg. § 1.6011-4 and requires taxpayers participating in specified transactions—including listed, confidential, or contractually protected transactions—to disclose detailed information on Form 8886 regarding structure, participants, and expected tax treatment. Failure to disclose can trigger penalties under §§ 6707 and 6662A and may eliminate reasonable-cause defenses. *See also* I.R.C. §§ 6111 and 6112 (applying to promoters and advisers).

¹⁴³ That is, so long as administrative costs do not outstrip the benefits. But given the scale of complexity discussed in Part II, that is highly unlikely.

mechanically makes the expenditure channel larger.

Second, consider heightened penalties. Firms will once again face a stronger incentive to adopt complexity to shield themselves. Again, even if evasion is reduced overall, there will be greater complexity and even greater distortions favoring complex firms.

Third, consider raising the income tax solely on complex firms. These firms would then face a greater incentive to underreport than before, because it is more valuable to do so. Also, if a firm has low taxable income or net losses, the higher tax rate will have no effect.

In sum, even though the initial intuition may simply be to increase enforcement, raise penalties, or even raise income taxes on complex firms, these measures are imprecise and create perverse incentives that backfire.

IV. A Complexity Fee on Complex Partnerships

This Part translates the theory and evidence developed above into a proposal for a Pigouvian complexity fee. Although the principles of complexity apply broadly, it is beyond the scope of this paper to offer an example complexity fee on all complex entities and transactions. Instead, the paper focuses on the most pressing case: complex partnerships. Therefore, this part offers a simple framework for applying the above concepts to what have become the most intractable entities for the Service's enforcement action.

A. Inherent Challenges in Design

There are inherent challenges to designing a complexity fee, because the harm does not lend itself easily to a “base $\times$ rate” framework. Normally, a simple optimal Pigouvian tax applies a price per unit, where the unit represents a measurable quantity of the source of social harm, and the price represents the marginal social harm that unit causes. A clear example of this concept is the federal excise tax on cigarettes, which is imposed on counts.¹⁴⁴ The exaction thus scales appropriately with the harm.

¹⁴⁴ See I.R.C. § 5701(b).

Complexity, however, is not quantifiable in discrete units. Also, interactions between different activities or taxpayer choices can compound complexity. Moreover, the actual cost to the administrator is, at least to some degree, endogenous with technology. If the administrator can use better technology to organize and evaluate vast quantities of information, the burdens on the administrator decrease.

For all of these reasons, no practical implementation of a complexity fee will be perfect. But the reader should keep two things in mind. First, as discussed above in Part III.B, a Pigouvian tax has “second-best” robustness, where being in the ballpark (but incorrect) is better than no correction at all. Second, while more precision is desirable, it comes at the cost of administrative and compliance burdens. The proposal below aims to balance these concerns.

B. An Example Complexity Fee Regime

1. Basic Structure

A complexity fee could take many forms, as long as it targets the source of the complexity. The example here draws from the existing structure of many federal excise taxes as well as the Service’s current user fees: there is a schedule of distinct, measurable bases, to which rates are applied.

For example, consider the excise tax on tobacco. Section 5701 defines a schedule of products as distinct tax bases (small cigars, large cigars, small cigarettes, large cigarettes, cigarette papers, cigarette tubes, snuff, chewing tobacco, pipe tobacco, and roll-your-own tobacco). It then applies a rate to each (e.g., \$50.33 per thousand small cigarettes, \$105.69 per thousand large cigarettes, \$0.0315 per 50 cigarette papers, \$0.063 per 50 cigarette tubes, etc.).¹⁴⁵ Similarly, Appendix A of Revenue Procedure 2026-1 defines a schedule of the Service’s services and activities to which user fees apply.¹⁴⁶

A similar framework can be used to implement a complexity fee. A schedule of bases can identify observable features of partnerships, and then rates can be applied to those features, either on a fixed fee basis or in a way that scales with economic flows through those features. The

¹⁴⁵ I.R.C. § 5701.

¹⁴⁶ See Rev. Proc. 2026-1, app. A.

total fee is then assessed on each partnership annually by summing the components.

There are a few important reasons a design like this makes sense. First, and most importantly, the schedule allows the fee to target sources of complexity relatively precisely, and very importantly, to exclude the simple partnerships that do not have those features. A partnership with no complex features thus pays no fee.

Second, the fee is assessed at the partnership level rather than the partner level because the sources of complexity arise from decisions made within the partnership itself. For example, a single individual owning depreciable property is not especially complex, but tax analysis becomes complex when the property is owned within a partnership, because now complex anti-shifting rules are triggered.¹⁴⁷ Assessing the fee at the partnership level therefore causes the owners to internalize the administrative costs created by choosing to structure activities through a partnership in ways that generate complexity.

Assessing the fee at the partnership level also avoids misallocating responsibility to parties who may lack control over the relevant choices, and thus cannot internalize the cost. If the fee were instead imposed on partners — for example, for holding an interest in a multi-tier structure — it could fall on partners who have no ability to influence the partnership’s investment or structural decisions.

Also, even though partnerships are pass-through entities, it is not unusual for the partnership itself to face taxes or fees.¹⁴⁸ Any of the fees or excise taxes listed as examples above in Part III.B.3 that are incurred by a partnership in the course of business are assessed on the partnership itself. A complexity fee would be no different.

Finally, the combination of a schedule of bases and rates ideally would simplify compliance and administration. Like the current Service’s user fees, taxpayers can see clearly what activities trigger fees. To minimize burdens, it would be ideal for the fee to be calculated directly with numbers already reported elsewhere on the return.

¹⁴⁷ See I.R.C. § 704(c) (anti-shifting rules for contributed property); Treas. Reg. §§ 1.704-3 (requiring special allocations to prevent shifting of tax consequences).

¹⁴⁸ See I.R.C. §§ 701, 702, 703 (passthrough treatment).

2. *What is Included?*

What bases should be included in the structure, and at what rate should they be assessed? This is a challenging question that ought to receive thorough consideration by a mix of economists, accountants, and lawyers. As a baseline to start the conversation, however, I offer a few categories here that could be included in such a schedule, and the reason for their inclusion.

a. Higher-tier partnerships. The stacking of partnerships atop other partnerships is unambiguously the most significant contributor to complexity from an enforcement perspective. When a partnership is a partner in a lower-tier partnership, the Service can no longer resolve tax consequences at just one level. Instead, all the pass-through, allocation, deferral, and liability rules described above must be applied across each tier simultaneously.¹⁴⁹

This complexity might be manageable if there are perhaps only two tiers and only a small number of partners. But recent evidence reveals that partnerships form complex chains of ownership that overlap significantly, forming impenetrably complex entity arrangements. According to the GAO, by 2012 the average large partnership had over 530,000 partners after tracing through all of the tiers.¹⁵⁰ And as documented in recent research, in 2020 more than \$1.2 trillion of income and losses flowed through an interconnected entity structure involving more than 670,000 interconnected partnerships.¹⁵¹ In fact, more than 1,000 partnerships combine to form a giant “loop,” where each partnership owns itself indirectly through its ownership of other partnerships.¹⁵² In short, competent enforcement in such a setting is essentially impossible.¹⁵³

¹⁴⁹ For a thorough discussion of the enforcement challenges associated with stacked partnerships, see Edward Fox et al., *How to Tax Business? Economic Rents, Legibility, and the Corporate–Pass-Through Divide*, Working Paper (2026).

¹⁵⁰ GAO Complex Partnerships, at 16.

¹⁵¹ Love, *Who Benefits from Partnership Flexibility?*, *supra* note 68, at 16.

¹⁵² *Id.* at 37.

¹⁵³ Note that imposing an exaction on economic flows from lower-tier to higher-tier entities is not without historical precedent. In 1935, the dividends-received deduction for corporations was set to 85 percent rather than 100 percent, to discourage stacking that could make it easier to avoid taxes. See Boris I. Bittker & James S. Eustice, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 5.05 n.168 (7th

b. Unidentified partners. Recent empirical research has revealed that a significant portion of partners are unidentifiable from filings.¹⁵⁴ This poses a significant challenge for the Service because many anti-abuse rules require understanding the tax consequences of partnership activities to different partners, which is impossible if the partnership cannot report sufficient information to identify the partner on the Schedule K-1.

c. Foreign partners, especially foreign entities. Because these partners reside outside U.S. jurisdiction, the Service faces significant information hurdles, where access to foreign books and records for verification is severely limited. They also necessitate complex determinations regarding income sourcing, characterization, and treaty-based withholding compliance.¹⁵⁵ Furthermore, the disparate tax treatment between domestic and foreign partners creates fertile ground for unlawful arbitrage, while the lack of extraterritorial reach results in a diminished enforcement capacity.

d. Partners who are not individuals, particularly entities with passthrough qualities like trusts or S-corporations. Individual partners are generally the least complex endpoint of pass-through taxation because tax liability ultimately terminates with a single return. By contrast, when a partnership allocates income or distributes property to an entity partner, the inquiry can extend to the owners and beneficiaries of that entity, and certainly will in the case of trusts and S-corporations. This substantially expands the scope of information the Service must gather and evaluate. Entity partners may themselves be owned by other entities, increasing complexity further. They are also subject to distinct tax regimes, providing opportunity for unlawful arbitrage. They can also be under common control, giving rise to manipulation opportunities.

e. Distributions of property generally. Distributions of property require the Service to reconstruct and verify a wide set of interdependent tax attributes that are unnecessary in the case of cash distributions. Determining the correct tax consequences of a property

ed. 2000 & Supp. 2024).

¹⁵⁴ See Cooper *et al.*, *supra* note 68; Michael Love, *Where in the World Does Partnership Income Go? Evidence of a Growing Use of Tax Havens*, 79 NAT'L TAX. J. 7 (2026).

¹⁵⁵ See I.R.C. §§ 861-865 (sourcing rules); *id.* §§ 1441-1446 (U.S. source withholding rules); *id.* §§ 871, 881 (foreign taxpayer regimes).

distribution requires an enormous set of information to evaluate tax consequences under numerous anti-shifting and anti-abuse regimes. A thorough discussion with an example is available in Part I.A.

f. Depreciation, amortization, or sale of § 704(c) property. Property subject to § 704(c) (i.e., property with value-basis discrepancies at the time of contribution or as partners join) requires the Service to track and verify book-tax differences over time and across partners.¹⁵⁶ When such property is depreciated, amortized, or disposed of, the administrator must determine the built-in gain or loss at contribution or as partners join along the way, the method used to allocate that disparity, and the history of those allocations across tax years and partner-level returns.

g. Contribution, distribution, or depreciation of encumbered property. Encumbered property requires the Service to determine how liabilities are allocated among partners and how those allocations interact with basis, depreciation, and gain recognition rules.¹⁵⁷ When property subject to debt is contributed, distributed, or depreciated, the administrator must verify the amount and nature of the liability, the method used to allocate it among partners, and the consistency of those allocations across partnership and partner-level returns. The transactions also give rise to complex anti-abuse analysis.¹⁵⁸

h. Allocations that deviate from fixed percentage splits. Allocations that depart from fixed percentage shares require the Service to interpret partnership agreement provisions and engage in fact-intensive analysis of compliance with the substantial economic effect rules.¹⁵⁹ Such allocations often depend on contingent formulas, targeted capital

¹⁵⁶ See I.R.C. § 704(c) (contributed property with built-in gain or loss); Treas. Reg. §§ 1.704-3(a)–(c) (allocations methods); *id.* § 1.704-3(a)(6) (rules for changes in partnership interests); *see also* I.R.C. §§ 722, 723 (basis of contributed property); Treas. Reg. §§ 1.704-1(b)(2), 1.704-3(d) (consistency and anti-abuse requirements).

¹⁵⁷ See I.R.C. §§ 752(a)–(b) (allocations of liabilities); *id.* §§ 722, 731, 732, 733 (interaction between liabilities, outside basis, and distributions); Treas. Reg. §§ 1.752-1 to -7 (detailed rules governing recourse and nonrecourse liabilities); *see also* I.R.C. §§ 465, 469 (at-risk and passive activity limitations triggered by liability characterization); *see also* Treas. Reg. § 1.704-1(b)(ii)(2) (economic effect rules); Treas. Reg. § 1.704-2 (nonrecourse deduction rules).

¹⁵⁸ See I.R.C. § 707(a)(2)(B) (disguised sales).

¹⁵⁹ See I.R.C. § 704(b) (requiring allocations to have substantial economic effect); Treas. Reg. § 1.704-1(b)(2) (substantial economic effect requirements); *id.* § 1.704-1(b)(2)(iv) (capital account maintenance rules).

accounts, or preferred returns, making application of the rules especially challenging.

i. Allocations of liabilities that deviate from fixed profits shares. Liability allocations that do not track a fixed profit interest require the Service to evaluate partner-specific risk exposure or details of the partnership agreement on the sharing of nonrecourse liabilities.¹⁶⁰ The stakes are high, as this area has been fertile ground for past evasion schemes.¹⁶¹

j. Many partners. An increase in the number of partners materially raises administrative complexity because it multiplies the number of partner-level determinations the Service must verify for a single partnership. Since partners must be considered in combination for many anti-abuse rules, more partners makes enforcement harder for all partners and the partnership as a whole.

A note on the choice of bases. A complexity fee based on some combination of the above bases would likely leave many, if not most, partnerships untouched. Recent empirical research suggests that most partnerships are very simple structures with mostly operating income and a small number of partners, or what one might think of as “small businesses.”¹⁶² A fee structure based on categories above would concentrate predominantly on a small number of especially large and complex partnerships — the ones that have exactly given the Service the most trouble in audits.

3. Design Details and Implications

While the above suggestion offers a basic structure with possible base categories, there are important details that remain to be decided, with substantial implications for incentives and administrability. Once again, these decisions should be informed with thorough consideration

¹⁶⁰ See I.R.C. § 752(a)–(b) (allocations of partnership liabilities); Treas. Reg. §§ 1.752-1 and -2 (recourse liability allocations); *id.* § 1.752-3(a)–(d) (allocation of nonrecourse liabilities); see also Treas. Reg. § 1.704-1(b)(2)(ii) (economic effect).

¹⁶¹ See, e.g., IRS Notice 1999-59, 1999-44 I.R.B. 590 (1999), <https://www.irs.gov/pub/irs-drop/n-99-59.pdf>; IRS Notice 2000-44, 2000-26 I.R.B. 1257 (2000), <https://www.irs.gov/pub/irs-drop/n-00-44.pdf> (describing abusive tax shelters involving partnership liability allocation rules).

¹⁶² See Love, *Who Benefits from Partnership Flexibility?*, *supra* note 68, at 15.

by economists, accountants, and lawyers.

One decision is whether to key the base off of economic flows (such as total allocations or distributions) or simply as a binary trigger for a fixed fee, or a mix of both. Current Service user fees are a mix of both: fixed fees, where some are larger if the taxpayer requesting the service is larger.¹⁶³ Each option has its advantages and disadvantages.

A fixed fee triggered by a binary condition is the simplest to administer, but it risks poorly capturing the true social cost. Consider, for example, a fixed \$1,000 fee triggered by the presence of a higher-tier partnership. Should the same fee apply to a partnership that earns \$10,000 and allocates \$100 to a higher-tier partnership as to one that earns \$10 billion and allocates \$100 million to a higher-tier partnership, all else equal? In the latter case, far more is at stake. Not only does the latter case represent greater risk to public revenue, in that there is likely more room for substantial underreporting, but the Service will rationally devote more enforcement resources to larger firms because success generates a greater return. Because the social cost reflects resource expenditure, it scales with the size of the firm and the amounts at stake. For these reasons, a fee that scales with the magnitude at stake — either as a continuous scaling or as a step-wise function — will better reflect the expenditure costs of the complex firm.¹⁶⁴

A fee that scales with economic magnitude, while perhaps more precise, raises the question of how to compute the tax base. For administrative simplicity, the fee could ideally be calculated using information already reported elsewhere by the taxpayer. For example, a simple version of a base that measures flows to higher-tier partnerships could simply sum the absolute value of items reported on Schedule K-1s issued by the partnership to higher-tier partnerships. This is mechanical and administrable. But the downside is that it does not capture the full economic magnitude of flows to higher-tier partnerships, and thus causes distorted incentives and fails to capture the value at stake. To see this, note that Schedule K-1s only record *net* amounts, rather than gross amounts. A partnership could therefore allocate \$1

¹⁶³ See Rev. Proc. 2026-1, app. A.

¹⁶⁴ Note that the fee need not be linear, or could mix the binary and scaling concepts. For example, the fee could start at a binary \$100 fee, which then scales up gradually with size in nonlinear or step-wise way.

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million of operating income and \$1 million of depreciation to a higher-tier partnership and report \$0 on the Schedule K-1, avoiding the fee. A more precise approach could require the firm to sum the absolute value of individual items, which would yield a base of \$2 million. However, this approach requires a greater compliance burden and would be harder for the Service to verify.

Perhaps the biggest takeaway from the example here is the helpfulness of improved information reporting in this context. If a complexity fee is on the table, administrators should simultaneously consider updating information reporting to ensure that a well-targeted complexity fee is both feasible and low-burden, while also bringing the benefits discussed in Part III.D.

That said, it is important that any base that scales with size is not keyed off of the firm's income. That would simply be an income tax, with all the failings discussed in Part III.F. A base that is keyed on the true amount at stake — including income, losses, deductions, distributions, or contributions — is much more apt to reflect true costs.

A third question is to what extent there should be interaction and overlap between bases. For example, while a distribution may be complex, it is even more complex when it is made to a foreign partner or higher-tier partnership. Whether the fee should be additive or interact in some more nuanced way is an important design question.

A fourth question involves how to design the boundaries of the bases. It is important to avoid “notches” or “cliffs” that do not correspond to actual boundaries of complexity. For example, if there is a fee that applies when there are more than 10 partners, many partnerships will “bunch” at 10 partners to avoid the tax cliff at 11 partners. This is an inefficient distortion. But that said, if the edge of the base actually corresponds to a true boundary of complexity, then such a cliff is appropriate. For example, a fee that is triggered by the existence of a higher-tier partnership makes more sense, because the mere presence of that entity adds significantly to the complexity of the partnership.

Finally, it is worth noting that a regime designed following the basic structure above can potentially generate very large amounts of revenue with very low rates, because the potential bases can be very big. For example, highly simplified and conservative calculations suggest that in 2022 there was likely at least \$2.1 trillion of income or loss

allocated to or property distributed to higher-tier partnerships, \$740 billion to foreign partners, and another \$1.6 trillion to partners who are other U.S. entities.¹⁶⁵ Applying even a 0.1 percent fee rate to this sum (a tenth of one percent!) generates a static estimate of \$4.4 billion collect, nearly the size of the *entire* Service enforcement budget request for 2023 (\$5.9 billion).¹⁶⁶

C. *Extension to Shielding*

The framework described above illustrates how a complexity fee could be designed to address the expenditure distortion, but it can also be extended to address shielding. For example, the complexity fee can serve as an input into the penalty adjustment itself. This is conceptually natural: the penalty adjustment is intended to scale sanctions to account for enforcement difficulty, and the complexity fee already provides a rough, administrable measure of that difficulty.

One straightforward approach would calibrate the penalty adjustment by comparing (a) the firm's complexity fee liability to (b) some measure of total economic value flowing through the firm, perhaps

¹⁶⁵ These are back-of-the-envelope calculations using the following sources. Lower-bound allocations of income and loss can be approximated using Table 1 from the IRS Statistics of Income Partnership Tables, broken down by industry. See Internal Revenue Serv., Table 1. All Partnerships: Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income, and Total Net Income (Loss) minus Deductions, by Industrial Group, Tax Year 2023, at <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry>. As a conservative measure, I narrow to only three industries, where complexity is most likely to occur: Finance and Insurance, Real Estate and Rental and Leasing, and Management of Companies. Table 1 reports \$6.016 trillion of total allocations for these industries in 2023. This is calculated by summing the absolute values of total income, total deductions, and all portfolio income items. Note that this is a lower bound because the portfolio income items are netted in Table 1. Total fair market value of property distributions in 2023 were \$456 billion. See Internal Revenue Serv., Statistics of Income—2023 Partnership Returns Line Item Estimates, Pub. 5035 (Rev. Dec. 2025), at 11 (line K19b) <https://www.irs.gov/pub/irs-pdf/p5035.pdf>, at 12 (Line K19b). To arrive at total allocations to higher tier partnerships, foreign partners, and other U.S. entity partners, I use the shares of income allocations in Love, *Where in the World*, supra note 137, Figure 12, or roughly 32.4 percent, 11.4 percent, and 24.5 percent, respectively. These result in (rounded) totals of allocations plus distributions of \$2.1 trillion, \$740 billion, and \$1.6 trillion, respectively.

¹⁶⁶ Internal Revenue Serv., *U.S. Dep't of the Treasury, Fiscal Year 2023 Budget in Brief*, Pub. 5530 (Rev. 3-2022), at 2, <https://home.treasury.gov/system/files/266/19-IRS-FY-2023-BIB.pdf>.

the sum of allocations, distributions, and contributions, or some similar measure based on already reported statistics. The penalty adjustment could then be calculated as the ratio of (a) to (b), multiplied by some scaling factor. The resultant penalty adjustment thus serves as a rough proxy for the firm's complexity relative to its size, and can be applied to penalties and deficiency assessments. To address fairness and proportionality concerns, the resulting adjustment could be subject to a cap.

Other methods of constructing a penalty multiplier are of course possible. For example, the multiplier could be based directly on selected indicators used in the complexity fee schedule. But once a complexity fee has already been computed, reusing it as the basis for the penalty adjustment helps minimize administrative costs.

V. Concerns and Limitations

Part III makes the case for a combination of policies to address the social costs of complexity, most notably a complexity fee. But there are counterarguments why in practice these policy suggestions might not be as effective as hoped, might not be practicable, or might not be desirable. This part considers these concerns.

Why should a firm face a fee even when it is perfectly compliant? The fee might at first seem counterintuitive: why must a private actor pay a fee for engaging in complexity, even where it has done nothing wrong?

The answer is that we live in an imperfect world, where society has chosen to organize a government to address collective action problems and market failures, and where doing so requires expenditure of scarce resources, collected through taxation. Enforcing the tax law is necessary to ensure those resources are collected, and enforcement itself is costly. In such a setting, private choices that raise the cost of enforcement generate real fiscal externalities that lower societal welfare, even where those choices serve entirely legitimate business purposes.

It's actually the same logic that justifies a carbon or pollution tax. A manufacturing firm may operate with completely *bona fide* business motives, yet the unintended emissions still impose a real cost on society

because we live in an imperfect world where emissions cause environmental and health harms.¹⁶⁷ The tax causes the firm to internalize this cost on the public, even though there was no intent to cause harm. The complexity fee in this article operates on the same principle: it causes firms to internalize real costs on the public, irrespective of whether the firm's complexity reflects any noncompliance or intent to cause harm.

What if there is actually little noncompliance in practice among complex firms? Do the policies still make sense if there is only a small amount of noncompliance by complex firms? After all, audits of partnerships in 2019 resulted in net *refunds* rather than additional assessments.¹⁶⁸

This concern falls short for several reasons. Most importantly, even if it is true, the proposed policies are still welfare-improving. As long as there is complexity and there are audits, there is both shielding and expenditure distortions. These policies therefore improve welfare unless the cost of administration and compliance outweighs the benefits — and that is highly unlikely given the scale of complexity discussed in Part II.

Second, even if current audits suggest low rates of noncompliance, the true level of noncompliance is unknowable given how challenging these audits are.¹⁶⁹ As discussed in Part II, there are no reliable estimates of the tax gap for complex firms. The facts appear more consistent with a story of resource constraints and complexity than a story of near-perfect compliance.

What if complexity arises from activities that appear to be socially beneficial? A firm that opens a new location purchases an extra machine becomes marginally more complex. A firm that expands to a new jurisdiction becomes even more complex. The theory suggests that as complexity rises so should the tax. Is that correct too even in

¹⁶⁷ Imagine a world where emissions caused no harm, and immediately dissipated. There would be no need for a tax. The same is true if enforcement were costless: there would be no need for a fee to achieve the social optimum. In each case, the policy need arises because we live in an imperfect world.

¹⁶⁸ See GAO Complex Partnerships at 1.

¹⁶⁹ There is no current estimate of the tax gap for partnerships because audits have not been sufficiently successful to support a reliable estimate. See *supra* note 78.

these cases?

Yes. As firms become more complex, they impose negative externalities on the government budget by making enforcement more challenging and costly. A Pigouvian tax corrects this distortion. Even on activities that appear to be beneficial.

To provide a more nuanced answer, the optimal policy hinges on whether the benefits of the activity are captured privately or if there are positive spillovers. If there are positive spillovers to the underlying activity, that should be subsidized. So, the optimal policy is a tax on complexity plus a subsidy on positive activities. For example, if many complex partnerships are organized to fund scientific research, the answer is not to abandon a complexity fee, but to impose the complexity fee while subsidizing the scientific research. This encourages the productive activity to be organized in a way that avoids unnecessary complexity.

Why not just impose a fee for audits? For example, the fees assessed by the Nuclear Regulatory Commission are in part calculated by the hours the regulators spend assessing a facility.¹⁷⁰ Why not do the same for tax, just charging an hourly fee when a firm is audited?

The central concern with this approach is that audits are unpredictable and lumpy. Unlike the steady regulatory costs in a heavily regulated industry, audits are an unexpected cost that can be quite burdensome even without the hourly fee. An hourly fee adds insult to injury and can even be perceived as a penalty for bad luck.

Also, an hourly rate punishes taxpayers for idiosyncratic inefficiencies of an audit — a slow auditor will cost a taxpayer more through no fault of their own. In contrast, an *ex ante* fee allows taxpayers to factor in the social costs as they are choosing their business structure and transactions, allowing taxpayers to more accurately and smoothly price in their costs. It also encourages the government to economize and not waste resources.

If complexity is such a problem, why not just simplify the tax code? Partnerships can become especially complex because

¹⁷⁰ See Fee Schedules; Fee Recovery for Fiscal Year 2025, 90 Fed. Reg. 26730, 26732 (June 24, 2025).

Subchapter K creates an environment where this occurs. Why not then reform Subchapter K (or other complex areas of the Code) to reduce this complexity, rather than the fixes suggested here?

Although there may indeed be a compelling case for reform, what this paper addresses is a much more fundamental problem inherent in the design of tax systems generally: except in the most trivially simple tax systems, there will *always* be complexity, and it will *always* give rise to the shielding and expenditure distortions.¹⁷¹ Therefore the proposals here will still be relevant even if the Code is substantially reformed. They are thus not substitutes for larger reforms, but complements.

What if these policies lack popular support? Even if these proposals are optimal in theory, their political viability depends partly on public opinion. The policies may face challenges because they may be difficult to communicate, or they target harms that are diffuse while their benefits are less salient. They also impose exactions on behaviors that appear benign, which may seem unfair to the public.

Similar dynamics have undermined past policies. For example, the ACA's individual mandate exaction, which sought to address an intangible externality, polled net unfavorable by 29 points.¹⁷² Compounding the challenge, the Service has the lowest favorability of any federal agency, and the primary benefits of these policies would be realized through improved tax enforcement.¹⁷³

Despite these headwinds, public support is not necessarily out of reach. First of all, the exactions here are not imposed on average American households, but instead on a narrow class of relatively large

¹⁷¹ One example of a trivially simple tax system is a head tax: a certain fixed fee imposed on all individuals.

¹⁷² See Pew Research Center, *Section 6: Opinion About Health Care*, Pew Research Center (Mar. 14, 2012), <https://www.pewresearch.org/politics/2012/03/14/section-6-opinion-about-health-care/>. The article also notes that opinion shifted as the framing focused more or less on the penalty aspect of the mandate.

¹⁷³ See Andy Cerda, *Americans See Many Federal Agencies Favorably, But Republicans Grow More Critical of Justice Department*, Pew Research Center: Short Reads (Aug. 12, 2024). Only 38 percent of Americans had a favorable view of the IRS in 2024, compared to 50 percent with an unfavorable view. This is despite the fact that 71 percent of Americans trusted the IRS to fairly enforce the tax laws. See Department of the Treasury, Internal Revenue Service, *Comprehensive Taxpayer Attitude Survey (CTAS) Executive Report*, IRS Publ. 5296 (Rev. 3-2020) (Mar. 11, 2020), at 14.

and complex firms — at a time when 83 percent of Americans are bothered that some businesses aren’t paying their fair share of taxes.¹⁷⁴ A useful parallel is the passage of the excise tax on share buybacks in the Inflation Reduction Act, which similarly targeted a limited set of corporate practices.¹⁷⁵ Unlike the ACA’s individual mandate penalty, the buyback tax has attracted little mainstream attention at all. This suggests that the main political challenge to complexity-related policies may not be broad public resistance, but concentrated lobbying by affected industries, discussed more below.

Even if these policies reached mainstream public awareness, there is still evidence that excise taxes can garner broad support when they are seen as appropriate and when the revenue is used in ways that align with the taxed activity. For example, despite complaints about tolls, Americans prefer them over general taxes for funding transportation, reflecting support for the “user pays” principle.¹⁷⁶ Gasoline taxes — typically unpopular — gain support when earmarked for road maintenance, safety, or environmental goals.¹⁷⁷ Similarly, taxes on alcohol and cigarettes are more accepted when tied to health- or safety-related spending.¹⁷⁸ One striking example: while only 44 percent

¹⁷⁴ J. Baxter Oliphant, *Top Tax Frustrations for Americans: The Feeling That Some Corporations, Wealthy People Don’t Pay Fair Share*, Pew Research Center: Short Reads (Apr. 7, 2023), <https://www.pewresearch.org/short-reads/2023/04/07/top-tax-frustrations-for-americans-the-feeling-that-some-corporations-wealthy-people-dont-pay-fair-share/>.

¹⁷⁵ See I.R.C. § 4501 (imposing a 1% excise tax on the repurchase of corporate stock), added by Inflation Reduction Act of 2022, Pub. L. No. 117-169, § 10201, 136 Stat. 1818, 1839.

¹⁷⁶ A national survey in 2011 reported 58 percent of Americans said new highways should be funded by tolls paid by drivers using them, compared to only 28 percent who favored raising taxes on everyone for new road construction. See Reason Foundation, *Poll Finds Support for Toll Roads, Public-Private Partnerships*, Reason Commentary (Dec. 20, 2011), available at <https://reason.org/commentary/poll-finds-support-for-toll-roads-p/>.

¹⁷⁷ See Asha Weinstein Agrawal *et al.*, *What Do Americans Think About Federal Tax Options to Support Transportation? Results from Year Fourteen of a National Survey*, Mineta Transp. Institute (Nov. 2023); Mineta Transportation Institute, *Will Americans Support Fuel Tax Increases? The Answer Could Be Surprising*, UTC Spotlight (Mar. 2014); Reason Foundation, *supra* note 158.

¹⁷⁸ A 2007 poll found 67% of U.S. voters supported a 75-cent cigarette tax increase to fund children’s health insurance, with support remaining high even for larger increases. Voters often view such taxes not as general revenue tools, but as public health measures to discourage harmful behavior and fund its consequences—

of Americans support sugary beverage taxes in general, support rises to 66 percent when the revenue funds health initiatives.¹⁷⁹

Drawing on these lessons from other excise taxes, one option available is to earmark the revenue from a complexity fee to fund the Service's enforcement, including customer service during the review and filing process. This would create a fitting link: complex firms that strain the Service's capacity would help finance efforts to make the tax system easier and more accessible for ordinary Americans, with less burden on average taxpayers. While public finance economists rightly note that money is fungible and earmarking may constrain efficient allocation, such critiques often overlook nonpecuniary factors that matter to many Americans. In a democratic society, perceptions of fairness and trust in how tax dollars are used are important policy goals in their own right.

What about lobbying and special interests? Perhaps the most formidable political obstacle to a complexity fee is opposition from the industries it would affect most directly — particularly private investment firms that rely on complex structures for tax advantages. The tax-favored treatment of carried interest illustrates the power of this sector: despite bipartisan calls for reform and fairly widespread public recognition of its inequity, the provision has survived repeated efforts at repeal due to aggressive lobbying and campaign donations by the private equity industry.¹⁸⁰ This is not an isolated case. Complex tax

essentially, “fees on smokers” rather than general taxes. See *Poll: Americans Favor Raising Cigarette Tax for Kids' Health Care*, Commonwealth Fund (Jan. 25, 2007), <https://www.commonwealthfund.org/publications/newsletter-article/poll-americans-favor-raising-cigarette-tax-kids-health-care>; Press Release, Campaign for Tobacco-Free Kids, *Poll Shows Strong Voter Support for Cigarette Tax Increase to Fund Children's Health Coverage* (Jan. 25, 2007), https://www.tobaccofreekids.org/press-releases/id_0002. Similar trends apply to alcohol: surveys repeatedly show substantial support for alcohol tax increases when proceeds are directed toward prevention and treatment. See K. A. Wagenaar et al., *Public Opinion on Alcohol Policies in the United States: Results from a National Survey*, 103 AM. J. PUB. HEALTH 11, 1957 (2013), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3735171/>; Kelly Hughes, *Alcohol Taxes Are a Public Health Win-Win*, Global Health Now (Sept. 6, 2023), <https://globalhealthnow.org/2023-09/alcohol-taxes-are-public-health-win-win>.

¹⁷⁹ Alexandra Wright et al., *Policy Lessons from Health Taxes: A Systematic Review of Empirical Studies*, 17 BMC PUBLIC HEALTH 583 (June 19, 2017).

¹⁸⁰ Despite repeated efforts from both parties to reform the tax treatment of carried interests, the provision has largely survived. A limited reform was enacted in the Tax Cuts and Jobs Act of 2017, adding I.R.C. § 1061 to restrict long-term capital gain

preferences across real estate, oil and gas, and multinational corporations have persisted in part because their technical opacity makes them harder for the public to scrutinize and easier for lobbyists to protect.

That said, history offers some reason for cautious optimism. In recent years, both parties have passed major reforms against the interests of powerful lobbies — including a new excise tax on stock buybacks,¹⁸¹ the corporate alternative minimum tax,¹⁸² and several anti-abuse rules targeting international tax avoidance and profit shifting by large corporations.¹⁸³ The enactment of these policies suggests that even entrenched special interests do not pose insurmountable obstacles when the setting is opportune.

Perhaps most relevant is the enactment of the reformed partnership audit regime in 2015, which replaced the unwieldy TEFRA procedures with a centralized audit and collection system.¹⁸⁴ The reform passed on a bipartisan basis as part of the Bipartisan Budget Act of 2015 — demonstrating that even highly technical changes to complex pass-through regimes have been passed to improve enforcement and administrative efficiency.

What if the operational costs are high? One possible concern is that even if a complexity fee is theoretically well-motivated, the cost of administering it—along with any compliance burden or economic

treatment unless assets are held for more than three years. Additional proposals have followed in subsequent Congresses. For discussion of legislative history and reform proposals, see Jane G. Gravelle & Donald J. Marples, *Taxation of Carried Interest*, Cong. Rsch. Serv. R46447 (2020); Edward McCaffery & Rebecca Kysar Jones, *The Carried Interest Loophole*, 78 TAX L. REV. 401 (2024).

¹⁸¹ See I.R.C. § 4501, added by Inflation Reduction Act of 2022, Pub. L. No. 117-169, § 10201, 136 Stat. 1818, 1839.

¹⁸² See I.R.C. § 55, added by Inflation Reduction Act of 2022, Pub. L. No. 117-169, § 10101, 136 Stat. 1818, 1833.

¹⁸³ See I.R.C. §§ 951A (Global Intangible Low-Taxed Income or GILTI) (imposes current U.S. tax on certain low-taxed foreign earnings of controlled foreign corporations) and 59A (Base Erosion and Anti-Abuse Tax or BEAT) (imposes a minimum tax on large U.S. corporations that make deductible payments to related foreign parties). Both provisions were enacted by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, §§ 14201, 14401, 131 Stat. 2054, 2208, 2253 (2017).

¹⁸⁴ See Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101, 129 Stat. 584, 625 (codified at I.R.C. §§ 6221-6241).

distortion it creates if it is imprecisely targeted — might outweigh the value it generates. But this objection proves less worrisome on closer inspection.

First, as discussed in Part III, the fee can be designed using internal administrative data to understand what features are actually complex. As well, the fee can be reported using data that is already reported (or at least already maintained) by taxpayers, minimizing compliance costs. And to the extent the tax base can incorporate features that the taxpayer has an incentive to report accurately (like deductions), the boundaries become even more resistant to underreporting.

Second, any deadweight loss caused by imprecision in the fee is likely to be modest. Unlike taxes that target externalities with difficult-to-measure real-economy harms, such as cigarette or alcohol consumption, this fee targets complexity that is observable and burdens the administrator directly. This makes it feasible to tailor the fee with relatively high precision.

Also, as with most Pigouvian taxes, imperfect implementation is still better than inaction. As discussed in Part III, the second-best robustness of the approach means that even an imprecisely calibrated complexity fee is likely to improve social welfare. In this context, the perfect should not be the enemy of the good.

Fallback: targeted reporting and “win-win” policies. Even if a complexity fee or penalty enhancements prove politically or administratively infeasible, policymakers need not abandon efforts to address the costs of complexity. At a minimum, the administrator should pursue additional targeted reporting requirements for complex firms. As discussed in Part III.D, these requirements can reduce both shielding and expenditure distortions by making complex structures more legible to the government. While such reporting may impose additional compliance burdens, a key takeaway is that these burdens are less troubling in a complexity context: at worst, they function as an “in-kind” complexity fee, scaling with the administrative burden the firm imposes and aligning private and public costs. Also, because reporting rules can be adopted through administrative action, they offer a practical alternative when legislative options are out of reach. And because the burden is framed as providing information — not cash — they may be more politically palatable.

Beyond additional reporting, the administrator should also prioritize the suite of low-cost “win-win” policies mentioned in Part III.E: improved audit targeting, better use of technology, and other general enhancements to enforcement efficiency. These reforms do not cause compliance burdens or require congressional approval. While they cannot fully eliminate the problems of shielding or expenditure, they complement any other reform and help tighten the enforcement system even in the absence of new tools.

Conclusion

Business complexity has become one of the defining challenges of modern tax administration. Yet the problem is not simply that complexity makes audits more difficult. As this article has argued, the current tax enforcement system unintentionally subsidizes this complexity, shifting the costs of complex firms onto others. As a result, firms do not face the true cost of complexity when making private decisions, leading to too much complexity and broad, inefficient, social costs.

This article develops a theoretical framework to understand these distortions and social costs. It identifies two distinct channels through which distortions arise. First, complexity shields the firm from enforcement by stymieing investigations and discouraging auditors from targeting the firm, which reduces collections and encourages the firm to adopt more aggressive tax positions. Second, by making audits more challenging, complexity requires the administrator to expend more resources to complete a thorough investigation than it otherwise would have, where these costs are spread out across the public. In each case, the complex firm is subsidized by displacing burdens onto simpler taxpayers. Put another way, complexity creates costly externalities that are not internalized by the firm.

Viewing complexity through this lens reframes the policy problem. If complexity generates externalities, the goal is not to eliminate complexity altogether — as much of it reflects legitimate business needs — but to ensure firms face the full social cost of the complexity they create, so that markets can sort complexity whose benefits exceed its costs from complexity that persists only because its costs are borne by others.

This reframing is the article's central theoretical contribution, and it in turn shapes the optimal policy response. Because complexity creates two distinct distortions, no single instrument can address both completely, and instead a package is optimal. The shielding channel calls for deterrence that scales with complexity, suggesting a complexity adjustment to deficiencies and penalties. The expenditure channel calls for a Pigouvian complexity fee that causes firms to internalize the added administrative burden they impose, which would otherwise be displaced to the broader public.

Of the tools this article proposes, however, improved targeted reporting deserves particular emphasis. It occupies a unique position because it works on both distortions at once: better reporting makes aggressive positions easier to detect, while also reducing the resources needed to evaluate complex returns. And where reporting imposes compliance costs, those costs can be welfare-improving as an in-kind Pigouvian complexity fee. Reporting has one further advantage that the other instruments lack: because it can be implemented through administrative action rather than statute, it does not depend on Congress. For that reason, it may be the single most practical lever available to policymakers today, capable of doing real work on both channels while legislative solutions remain out of reach.