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Why Examples? Towards More Behaviorally-Intelligent Regulation

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WHY EXAMPLES? TOWARDS MORE BEHAVIORALLY-INTELLIGENT REGULATION

Yariv Brauner*

Tax regulation authors habitually infuse regulations with explanatory examples. These examples are viewed favorably by both the government that encourages their drafting and the taxpayers who regularly rely on such examples to assist them in dealing with the notoriously complex tax rules. Despite the ubiquity of these examples, there is no published guidance for their drafting, their use, or their interpretation. The first original contribution of this article is the exposition and classification of the advantages and deficiencies in the current use of examples in tax regulations. This article is the first to question the rationale behind the ubiquitous use of examples in tax regulations. The article uses data collected by original surveys of expert tax professionals and government employees involved in drafting tax regulations. The second original contribution of this article is the explanation of the appeal of these examples among tax experts, and the potential hazards of the examples despite this apparent appeal. This analysis uses insights from behavioral science, and particularly from the study of cognitive biases, to explain, for example, how anchoring via an example could shift the focus of a regulatory rule and alter the boundaries of the law in inappropriate or unfair ways. Finally, relying on this analysis, the article proposes — the third original contribution — a better-informed approach to the writing of examples in tax regulations.

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"No rules exist, and examples are simply life-savers answering the appeals of rules making vain attempts to exist."

Breton’s statement, written by this founder of the Surrealist movement almost a century ago, serves as an apt counterpoint to the ubiquitous use and prominence of examples, formalized in regulations, in the practice of tax law in the United States. This article is about the interplay between rules and examples and the surprising legal void in which they operate.

Tax law is often viewed as surreal — being extensive, complex, and very political. Few endeavor to master its intricacies, yet even these few enthusiasts are often stumped by the rules. It is fitting therefore that statutory tax rules are accompanied by voluminous regulations that purport

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1 André Breton, Surrealism and Painting 35 (Simon Watson trans., Icon eds., 1972) (emphasis added). The quoted text, complementary to Breton’s Surrealist manifesto, was written in 1928 in his introduction to his essay illustrating how painting could be based in Surrealism.


to make the law more accessible. These Treasury (tax) Regulations are, however, not so simple to follow themselves, being only slightly less formal articulations of the law than their statutory bases. The formality of the regulations goes beyond matters of design and language, since they are generally given strong deference by the courts, and are widely accepted in practice as governing norms, although they merely reflect the government’s interpretation of what the law is. Tax regulations are still highly complex, so their authors have long adopted a habit of infusing them with examples. This practice seems desirable, almost obvious, at first glance, purporting to make the law clearer and more universally standard; yet a second glance exposes the difficulties that this practice presents, difficulties largely obscured by the intuitive appeal of examples, and hence easy for both the nonexpert to miss and for the more sophisticated user to exploit. This article is the first to shed light on the less desirable consequences of the extensive use of examples in tax regulations, exposing the ambiguity they introduce.

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5 Treasury Regulations are general pronouncements of the government’s (administrative) interpretation of federal tax laws. They are the highest order of such pronouncements in the United States. They are promulgated by the Treasury Department (and its agency, the Service, pursuant to the statutory authority (and command) of Internal Revenue Code (Code) section 7805(a) to “prescribe all needful rules and regulations for the enforcement of this title” As a matter of norm, regulations typically appear first in the form of proposed regulations, sometimes accompanied by Temporary Regulations (which have the effect of final regulations, albeit for a limited, prescribed, period of three years), so that the public can comment on them prior to finalization. I.R.C. § 7805(e).

7 This practice is amplified by the increasing use of regulations in cases where other government proclamations had been issued in the past. See, e.g., Jasper L. Cummings, Jr., Why Not Revenue Rulings? 105 TAX NOTES 1305 (Mar. 14, 2016) (arguing that the supposed focus on regulations has not increased regulation production and has either caused or accompanied a reduction in general guidance because of the decline in revenue rulings). See also Martin J. McMahon, Jr., Reflections on the Regulations Process: “Do the Regulations Have to Be Complex” or “Is Hyperlexis the Manna of the Tax Bar?” 51 TAX NOTES 1441 (June 17, 1991) (arguing that many forces have converged to lead to voluminous, complex regulations, including the active participation of the bar in overly aggressive tax planning, to which Congress and the Service have responded with increasingly detailed anti-tax-avoidance rules).
to tax law in the United States; explaining their policy-defying potential when used, as they are at present, in an uneducated manner; and promoting a more informed, nuanced use and interpretation of such examples.8

An example (no pun intended, here or elsewhere in this article) may illustrate the legal challenge presented by regulatory examples: employees are generally permitted to enjoy untaxed employer provided coffee, doughnuts, and soft drinks.9 This rule is found in an example in the fringe benefits regulation that generally permits employees to enjoy certain employer provided perks without inclusion of the value of such perks in their gross income, namely without paying tax.10 Only de minimis fringe benefits enjoy such treatment, defined as “any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer’s employees) so small as to make accounting for it unreasonable or administratively impracticable.”11 Treasury Regulation section 1.132-6 (1992) interprets this rule, discussing first the frequency element, then clarifying that if the benefit is reducible to cash it should always be taxed.12 Treasury Regulation section 1.132-6(e)(1) concludes by formally providing examples illustrating the rule, which — as indicated by its title — states that: “Examples of de minimis fringe benefits are... coffee, doughnuts and soft drinks,” among others (hereafter, the coffee example).13 At first, this illustrative example seems straightforward, as we are all too familiar with the ubiquitous workplace kitchenette. However, one could think about alternative snacks, and begin to question the intelligibility of the rule, unless, of course, one is completely satisfied with that most traditional grub. For instance, what

8 The extensive use of regulatory examples also happens to be unique among peer countries to the United States. An informal survey of experienced tax experts from Organisation for Economic Co-operation and Development (OECD) and G20 countries revealed that no other jurisdiction uses regulatory examples (or their equivalents) extensively. Few countries’ regulations include a small number of examples in the format of open or closed lists of items to which the norm refers, yet in most countries examples are used almost exclusively in rulings and similar government proclamations of a lesser legal status than that of regulations. Note that the United States’s practice was previously similar to that of the rest of the world. See Cummings, supra note 7.


10 See I.R.C. § 132(a)(4) (exempting de minimis fringe benefits from gross income).

11 See I.R.C. § 132(e)(1).

12 The regulation also provides rules applicable to particular types of benefits, such as transit passes. Id.

13 Id. Other fringe benefits include: occasional typing of personal letters by a company secretary; occasional personal use of an employer’s copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes; occasional cocktail parties, group meals, or picnics for employees and their guests, etc. Id.
about tea, hot chocolate, and muffins? They must also qualify, for they are indistinguishable from the mentioned snacks. Yet, even this basic analogy requires interpretation that in practice is not required when coffee, doughnuts, and soft drinks are provided. Herbal infusions, health bars and fresh fruit smoothies make the analogy even less obvious. This is perhaps due to the different message these snacks project — a message of health centered nutrition rather than “free food” happiness. It may also be due to the implicit assumption that these snacks target a different, more exclusive type of employee. There is also the implicit assumption that this type of snack is costlier. The cost is not only a distinguishing factor but also a relevant factor under the regulations — taking the healthy snack outside the scope of de minimis. Yet, in this case one must ask whether espresso coffee, gluten free, oil free doughnuts, and canned energy drinks are distinguishable from the healthy snacks mentioned above, and, more importantly, would they be treated differently by taxpayers under the regulations. This illustrates how the examples present a challenging interpretation of the law — often providing little understanding and even less transparency.

Thus, not unlike Breton’s vision of good art, tax advice often relies on seemingly more down-to-earth examples, sometimes with little attention to the rules themselves. These are clearly problematic circumstances, yet tax scholarship has completely ignored the use of regulatory examples and the potential conflict between the regulatory language and the examples that accompany it.14 Moreover, examples are written into regulations (and increasingly so) with no learned basis, explicit policy, or guidance beyond the mere encouragement of their use.15 This article initiates a long-overdue analysis of the use of regulatory examples, and challenges the policy of adding examples to regulations, and “the more the better.”16 This challenge will likely be viewed as controversial and at first even summarily dismissed, including by some tax practitioners, who would find it difficult to imagine their practice without these examples. Even for the less well-

14 This article generally refers to examples in tax regulations as “regulatory examples,” and to the nonexample language of the regulations as “regulatory language.” The only other article focusing on regulatory examples focuses on the proper interpretation of these examples. See Susan Morse & Leigh Osofsky, Regulating by Examples, 35 YALE J. REG. ___ (forthcoming 2018).

15 The Service has issued no guidance regarding regulatory examples, yet private discussions with government officials confirmed a general support for their use, and an understanding that such use does not require further thought or guidance, i.e., it is left for the discretion of the regulation authors.

16 This is a quote of a high-level government official who was interviewed in an informal setting about the current attitude within the Service regarding the addition of examples to regulations.
informed reader, an assault on examples may be suspect, as she reflexively
understands that examples are fundamental to good speech and writing, as
well as to effective thinking and understanding. We humans benefit from
examples when we learn new things. Examples and counter-examples are
also fundamental to lawyering and legal education. How could one
challenge their intuitive usefulness, especially when they are written to help
taxpayers understand the notoriously incomprehensible tax laws?! The
argument of this article is not that examples are bad per se, but rather that
their current use is faulty, arbitrary, and uninformed, lacking even basic
administrative guidance as to the why, where, and how to use such
examples. It further argues that we can do better and proposes a few
simple first steps in that direction, based on insights from behavioral

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17 See Edwina Rissland, Example-Based Reasoning, in INFORMAL REASONING AND
EDUCATION 187, 187–207 (James F. Voss et al. eds., 1991) (focusing on the importance
of examples for learning in mathematics, computer science, and law). Research of example-
based learning is extensive in both education and psychology scholarship, and the utility of
examples is intuitively understood by all. Yet, it is interesting to note how powerful
examples are in comparison to other means of learning, such as direct instructions. See, e.g.,
Jo-Anne LeFevre & Peter Dixon, Do Written Instructions Need Examples? 3 COGNITION &
INSTRUCTION 1 (1986) (demonstrating experimentally the power of examples over direct
instructions in learning and problem-solving situations).

18 See, e.g., Micheline T. H. Chi, Miriam Basok, Matthew W. Lewis, Peter Reimann &
Robert Glaser, Self-Explanations: How Students Study and Use Examples in Learning to
Solve Problems, 13 COGNITIVE SCI. 145 (1989) (exploring the process of learning from
elements to self-explain concepts and to develop understanding, example-independent
knowledge of the concept); Jakke Tamminen, Matthew H. Davis & Kathleen Rastle, From
Specific Examples to General Knowledge in Language Learning, 79 COGNITIVE PSYCHOL. 1
(2015) (uncovering some key cognitive mechanisms that characterize the process of learning
from examples in the domain of language learning).

19 See, e.g., Rissland, supra note 17.

20 Even the single instance where the government explicitly provides support for the
use of examples, such support is general and self-supporting rather than real guidance. See
PLAIN LANGUAGE ACTION AND INFO. NETWORK, FEDERAL PLAIN LANGUAGE GUIDELINES 70
/FederalPLGuidelines.pdf [hereinafter FEDERAL PLAIN LANGUAGE GUIDELINES] ("Examples
help you clarify complex concepts, even in regulations. They are an ideal way to help your
readers. In spoken English, when you ask for clarification of something, people often
respond by giving you an example. Good examples can substitute for long explanations. The
more complex the concept you are writing about, the more you should consider using an
example. By giving your audience an example that's relevant to their situation, you help
them relate to your document."). As further explained in this article, this statement may be
ture, yet it does not provide any guidance as to how to achieve the goals of clarity and
certainty articulated. Note that the actual orders, including the President's Executive Order
that accompanied the Plain Writing Act of 2010, do not include any reference to the use of
§ 601 app. at 102–03 (2017).
The first original contribution of this article is the exposition of the deficiencies in the current use of examples in tax regulations. A dedicated survey of tax professionals conducted for this article demonstrates practitioner uncertainty regarding regulatory examples and also highlights other deficiencies of the current practice. The survey also strongly supports a call for reform, towards which this article makes the first steps. The second original contribution of this article is an analysis of the appeal of regulatory examples and its potential downside, based on insights from behavioral science, particularly from the study of cognitive biases. The article finally proposes, as its third original contribution, a more learned approach to the writing of regulatory examples that would rely on these behavioral insights to improve the effectiveness and perceived fairness of tax regulation in the United States.

Part I discusses the current, ubiquitous use of regulatory examples in the practice of tax law in the United States, and the deficiencies of this use. Part II follows with the related question about the appropriate clientele catered to by regulatory examples, explaining that writing for experts or for the less informed may have significant consequences that are not taken into account when examples are written, and proposing a standard for writing more effective examples. Part III analyzes the "why" question, mapping the policy challenges presented by the confusion over the purpose of regulatory examples. Part IV explores where the use of regulatory examples may be appropriate. Part V provides a few modest reform proposals based on that analysis, and Part VI concludes.

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21 See, e.g., Tom Tyler, *Psychology and Institutional Design*, 4 REV. L. & ECON. 801, 802 (2008) (discussing the general benefits for the law if its design would be based on knowledge acquired by research in Psychology). See also *Behavioral Public Finance* (Edward J. McCaffery & Joel Slemrod eds., 2006) (arguing for, and applying insights from, psychology research to tax).

22 The survey included more than 300 participants, all experienced tax practitioners, anonymously answering questions about the use of examples in their practice, as explained throughout this article. About half of the participants responded online and the other half completed an identical paper questionnaire. The online responses were practically identical to the paper responses. Participants resided in all areas of the country, although there was likely a larger representation of participants from Florida, being the author’s home state, and New York City, where much of the country’s sophisticated tax practice concentrates. Participants had various specific expertise within tax law with a strong representation from mainstream corporate tax practitioners. The purpose of the survey was to confirm the experience of the author with the use of examples in tax practice — which it did — not to draw any statistical conclusions.
II. EXAMPLES IN PRACTICE

A. The Survey

To establish the important role of regulatory examples in the practice of tax law in the United States, and to expose their deficiencies, this article considers a survey conducted among experienced tax law practitioners. More than 65 percent of participants said the use of examples in the practice of tax law is either frequent or very frequent, and an additional 20 percent said they regularly use examples in their practice. Regulator examples are proverbial "life-savers" for practitioners of tax law, providing factual narratives with which a taxpayer could compare her own relevant facts, and effectively constructing norms that could be applied to those facts with reasonable simplicity.

None of the participants dismissed the practical importance of regulatory examples. Yet, despite the lack of controversy regarding the usefulness of the examples, the participants — all sophisticated practitioners — were divided when asked about the primary purpose of regulatory examples. Approximately 40 percent of participants said the examples simply illustrate the relevant rules they accompany; 13 percent said they primarily add explanations to the rules; 5 percent said the regulatory examples primarily aim at expanding norms beyond the simple language of the regulations; and another 5 percent said their primary purpose is to prevent or permit particular taxpayer actions (or transactions). More than one-third of the participants said one cannot say that regulatory examples serve a single primary purpose, but rather that they do all or some of the above, interchangeably. Finally, a small number of participants argued the examples are written merely as a matter of tradition, with no particular purpose in mind.

These results demonstrate the confusion as to the intended role of regulatory examples and the lack of a measuring stick to evaluate their necessity and efficacy. Such disarray is consistent with the absence of official guidance on the matter, and with the want of clarity over the relationship between the examples and the regulatory language. This article argues in response that clarity of purpose is essential for proper use and

23 See supra note 22.
24 See supra note 22.
25 See supra note 22.
26 See supra note 22.
27 See supra note 22. Note, however, that this unfavorable view of regulation writing was not given as one of the options available to survey participants, but rather provided independently and spontaneously by participants under the "other" option in response to the question about the primary purpose of regulatory examples.
interpretation of rules. It also argues that some uses of examples may be inappropriate or counterproductive and therefore should be controlled — a difficult task considering their current unguided use. Finally, the article demonstrates that a clear purpose may be useful even when transparency is not intended, such as a regulatory “nudge” in a desirable direction.\(^{28}\)

The survey participants were even less complimentary about current regulation writing when they came to assess the impact of regulatory examples. Almost half of the participants (47 percent) said the examples often describe simplistic or unrealistic circumstances and therefore add little or nothing to the regulations.\(^{29}\) Forty-three percent of participants said the examples often rehash the language of regulations without adding clarity.\(^{30}\) Twenty percent of participants found the examples often introduce conflicts with the regulatory language itself or with other examples.\(^{31}\) These answers provide an unflattering picture that conflicts with the intuitive satisfaction the regulatory examples provide.

A more specific policy concern that arose from the survey is that regulatory examples often target certain taxpayer’s actions or transactions, regardless of the generality of the regulatory language — a practice negatively mentioned by 68 percent of participants.\(^{32}\) Note that such “targeting” perception is not negligible, with about 5 percent of participants even viewing it as the primary purpose of the use of regulatory examples, mentioned above.\(^{33}\) Nonetheless, the survey showed a contradiction in this context — despite the widespread concern over this practice, less than 20 percent of participants believed such use (narrow examples targeting specific actions or transactions) should be discontinued.\(^{34}\) This inconsistency only highlights the legal confusion over regulatory examples and the desirability for more informed regulation writing. One may view the targeting of specific, presumably bad, transactions as normatively justifiable, regardless of the device used, since such practice permits the Internal Revenue Service (Service) to use examples to shut down gaps in general norms. Yet, this view does not consider alternative,\(^{35}\) superior means towards the same end, such as those suggested by this article.

Finally, the survey asked participants about possible reform, and they

\(^{28}\) The term “nudge” was coined in Richard Thaler & Cass Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness 6 (2008).

\(^{29}\) See supra note 22.

\(^{30}\) See supra note 22.

\(^{31}\) See supra note 22.

\(^{32}\) See supra note 22.

\(^{33}\) See supra note 22.

\(^{34}\) See supra note 22.

\(^{35}\) See, e.g., Cummings, supra note 7.
voiced a loud and clear message about the need to rethink the current practice of regulatory examples use. Less than 10 percent of participants found the frequency of use of regulatory examples and their drafting appropriate.\textsuperscript{36} The majority of participants (about 65 percent) supported the provision of guidance and increased uniformity in the drafting of regulatory examples.\textsuperscript{37} A similar majority supported, more specifically, the elimination of general examples as well as those describing "easy" cases or unlikely circumstances.\textsuperscript{38} More than one-third of participants also supported clarification of the status of examples vis-à-vis the rest of the regulatory language (specifically arguing for an inferior status for the examples, i.e., that they be subject to the regulatory language).\textsuperscript{39} This article analytically supports all of these ideas for reform.\textsuperscript{40} It proceeds next to expose the current use of regulatory tax examples, examining first the basic question of their legal status vis-à-vis the regulatory language.

\textbf{B. The Legal Status of Examples in Treasury Regulations}

Regulatory examples cohabit with the rest of the regulatory language with no explicit norm to organize their relationships and legal status. In an effort to resolve this uncertainty, one may argue the examples are simply part of the regulatory language and should therefore carry exactly the same weight as the rest of it. According to this formal approach, an example may serve any purpose or function (so long as it is not \textit{ultra vires}). It may, for instance, extend the scope of the relevant norm beyond the regulatory language, setting the boundaries of the norm regardless of the regulatory language. This approach also requires that when an example restricts the scope of the norm provided by the regulatory language, it should not be viewed as setting the norm's outer boundaries.

A particular regulatory example, concerning the so-called continuity-of-interest requirement of tax free reorganizations, demonstrates this approach to interpretation (hereafter the continuity-of-interest example).\textsuperscript{41} The Internal Revenue Code (Code) grants a tax benefit to certain merger and acquisition transactions, termed reorganizations, pursuant to which actions that would otherwise require current taxation are ignored, deferring taxation to a later date.\textsuperscript{42} This is the case, for example, for shareholders of a

\textsuperscript{36} See supra note 22.
\textsuperscript{37} See supra note 22.
\textsuperscript{38} See supra note 22.
\textsuperscript{39} See supra note 22.
\textsuperscript{40} See infra Part VII.
\textsuperscript{41} Treas. Reg. \textsection\textsection 1.368-1(e) (2011).
\textsuperscript{42} I.R.C. \textsection\textsection 354, 361, 368. If the merger qualifies as a tax reorganization, our tax law effectively ignores this taxable event and defers it until the taxpayer otherwise disposes of
corporation T (for Target) that merges into a corporation S (for Surviving), who exchange their T shares for shares in S post-merger. This would typically trigger taxation for these shareholders in the same way they would be taxed if they simply sold (with gain) the T shares on the market. The deferral of tax is granted pursuant to the belief that it facilitates market efficiency and ignores events that are essentially just changes in form. Consistent with this “purely paper transactions” view, the regulations require substantial continuity of shareholder interest in the transaction, namely that enough of the old T shareholders must “continue” with their investment even if now it is in the format of another legal entity: S, the surviving corporation. The obvious question becomes how much continuity is sufficient for this purpose. The regulations require the application of an all facts and circumstances test to satisfy the continuity requirement. This test is naturally difficult to apply, and the solution is a regulatory example that provides that 40 percent continuity suffices to qualify a merger as a “tax free” reorganization. In practice, this percentage has become the golden standard, leaving the regulatory norm (the all fact and circumstances test) largely empty of content. Applying the approach that views regulatory examples as simply part of the regulatory language, one should then conclude that if the facts and circumstances test could tolerate less continuity, say 25 percent, it, and not the 40 percent example, would mark the outer boundaries of the

43 I.R.C. § 1001.

44 See, e.g., Yariv Brauner, A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations, 1 BYU L. REV. 1, 52–68 (2004) (reviewing the history and evolution of the reorganization rules in an appendix to the article that calls for a repeal of the reorganization rules, and demonstrates that they cannot be supported on fairness, efficiency or administrability grounds).

45 Id. at 54.


47 Measured by comparing the value of the target pre-merger in comparison to the value of surviving’s shares held by old target shareholders post-merger. Id. § 1.368-1(e)(2).

48 Id. § 1.368-1(e)(2)(v), ex. 1. The example was clearly drafted after a hallmark case found less than 39% continuity to be sufficient. See John A. Nelson Co. v. Helvering, 296 U.S. 374 (1934). Prior to the drafting of the regulations, this case had generally been considered the standard authority on the matter. Note that 40% has become the standard despite the fact that another case accepted only 25% continuity, and that the Service expressed its willingness to write a letter ruling only when 50% continuity is present. See Miller v. Commissioner, 84 F.2d 415 (1936); Rev. Proc. 77-37, 1977-2 C.B. 568. Prior to the inclusion of this example, the “safe” path for taxpayers passed through the 50% ruling threshold, so, in that sense, the example made new law.

49 See also BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.21 (2017), Westlaw.

50 See supra note 48.
continuity norm.

This is not, however, the common interpretation of the continuity-of-interest regulations. The 40 percent continuity-of-interest example sets the pragmatic boundary of the norm, supporting in this case an interpretation that distinguishes examples from the regulatory language, and possibly treating their content as *lex specialis* to the regulatory language they accompany. This approach fits the common practice regarding the continuity-of-interest example that draws the legal line to specify an otherwise inherently vague rule. The coffee example may also be interpreted in this manner, yet obviously that would be overly formalistic, as cheap tea, cookies, and water should also qualify for de minimis fringe benefit purposes. Consequently, one must consider another approach to the interpretation of regulatory examples that would view the examples as mere illustrations of the regulatory language — illustrations that clarify the content of the norm yet do not set its outer boundaries. In conclusion, different regulatory examples warrant different approaches of interpretation, leaving the status of regulatory examples generally obscure and sometimes difficult to determine.

**C. Examples in the Practice of Tax Law**

The importance of regulatory examples in the practice of law becomes self-evident in light of the above described response to our survey. The continuity-of-interest example provides a good illustration of the utility of regulatory examples. When “tax-free” treatment is sought in a merger transaction, the assertion that 40 percent continuity is sufficient is clearly superior to the application of the vague facts and circumstances test prescribed by the regulatory language. This example represents

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52 See supra Part I.

53 One may argue that the language preceding certain examples supports this interpretation. Take for instance: “the following examples illustrate this paragraph (d),” found in the context of the continuity of business enterprise (COBE) requirement. Treas. Reg. § 1.368-1(d)(5) (2011). This requirement is corollary to the continuity-of-interest requirement, and equally necessary for reorganization treatment, both discussed earlier in this Part. Yet, other examples simply follow the heading: “examples.” See, e.g., Treas. Reg. § 1.382-8(g) (2007). One cannot reasonably detect consistency or any meaningful intention here. The inclusion or exclusion of such language seems simply too arbitrary to rely on in this context.

54 See supra Part II.B.

55 Taxpayers may acquire even more certainty with 50% continuity, since the Service is willing to provide favorable private letter rulings in these cases. See Rev. Proc. 77-37,
prototypical line-drawing that is naturally very helpful for taxpayers with the right set of facts, say, 42 percent continuity, yet, they put an extra burden on a taxpayer with, say, only 35 percent continuity. The latter taxpayer may argue that her case is indistinguishable from the former case. This presents a difficulty that is inherent in all line-drawing situations— and may be viewed as simply necessary, especially when the rules are transparent and the taxpayer is given the opportunity to arrange her affairs accordingly. The question remains, however, whether a regulatory example is the appropriate device in each case, especially when the writing of examples is unregulated and likely subject to fewer controls in comparison to the regulatory language, and when the interpretation of regulatory examples is inconsistent and incoherent.

Another common type of regulatory examples is the primarily illustrative example. These examples appear to simply illustrate the regulatory or statutory language. The coffee example mentioned above\textsuperscript{56} is one seemingly straightforward illustrative example. Yet, even it requires interpretation. Simple questions arise: to what extent is the list of snacks mentioned subject to the rest of the regulatory language? Should unmentioned snacks be subject to the same test as mentioned snacks? What are the boundaries between high and low value snacks, such as between made-to-order espresso drinks and a communal coffee pot? This article returns to these questions in the next section.

Another type of illustrative example focuses on methodology rather than the mention of qualified items. To illustrate, take Treasury Regulation section 1.482-4(c)(4), Example 1 (2011):

(i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals

\textsuperscript{1977-2 C.B. 568. Yet, such certainty comes at a price that one does not need to pay if she relied solely on the language of the example: a ruling would require full disclosure and costly interaction with the government, leading most taxpayers in reality to rely on the example.}

\textsuperscript{56} See supra Part II.
in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm’s length royalty rate for the Xpharm license agreement.

This example illustrates what is likely the “king’s road” in application of the transfer pricing rules. The transfer pricing rules\(^57\) regulate multinational enterprises (MNEs) by making sure that their cross-border transactions “clearly reflect income,” which is the U. S. term for nonabusive transactions.\(^58\) Their goal is to prevent abuse of the income tax rules by such corporate groups through their ubiquitous nonmarket, intra-group transactions.\(^59\) These MNEs can otherwise easily use arbitrage techniques based on different tax rates and tax base rules to minimize their overall effective tax rates, typically at the expense of high-tax jurisdictions such as the United States.\(^60\) Transfer pricing rules universally use arm’s length

\(^{57}\) See I.R.C. § 482.

\(^{58}\) See Edward A. Morse, Reflections on the Rule of Law and Clear Reflection of Income: What Constrains Discretion, 8 CORNELL J.L. & PUB. POL’Y 445, 492 (1999) (examining the constraints on the Service’s discretion in the application of this rule). The immediate statutory source provides that the Service can intervene if a taxpayer’s method of accounting does not clearly reflect income. I.R.C. § 446(b).


methodology to prevent such abuse. The arm’s length methodology uses (market) prices used by market transactions (of unrelated parties) that are comparable to the potentially abusive transaction as a benchmark for proper pricing of intra-firm, cross-border transactions. Transfer pricing is most critically important for transactions involving intangibles since cross-border trade in intangibles is the justification for firms operating in the MNE format, which is the sole concern of the transfer pricing rules.

Example 1 illustrates the use of the comparable uncontrolled transaction (CUT) method, which is the primary and the most straightforward application of the arm’s length standard to transactions involving intangibles. The example illustrates this method well: a single product (drug Z) is transacted across borders based on essentially the same contracts with two different distributors, one an unrelated party (YDrug) in a market transaction, and one a related party (the Xpharm subsidiary) in the transaction under the scrutiny of the transfer pricing rules. The solution is quite straightforward and appealing at first glance: mandate the taxpayer to declare income from the challenged transaction with its Xpharm subsidiary using the market price used in the comparable market transaction with the unrelated YDrug company.

Finding comparable transactions is the key to success for this methodology, and indeed this difficult exercise has become a major practical challenge for taxpayers. Yet, for purposes of this article, let us focus on the level of comparability required by the example: the same product, distributed by the same producer, under the same contractual terms, to neighboring countries, with similar protection for intellectual property rights, with roughly the same size of population, similar per capita income, and a similar incidence of the disease zeezee. This is manifestly a very tall order. I often challenge my students, promising grade points as an

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61 See, e.g., Avi-Yonah, supra note 59.
63 Id. at 86-87.
65 Id. § 1.482-4(c).
66 Id. § 1.482-4(c)(4), ex. 1.
67 The use of such internal comparables is condoned and even promoted in practice by governments. See, e.g., Lorraine Eden, The Arm’s Length Standard, in Global Tax Fairness, 153, 155 (Thomas Pogge & Krishen Mehta eds., 2016).
incentive, to come up with examples for such two countries. Regardless of the (significant) degree of flexibility permitted, only one plausible example arose over the years: The Netherlands and Belgium. Indeed, these are neighboring countries, somewhat similar in population size (about 17 million v. 11+ million), gross domestic product per capita ($51,000 v. $45,00), perhaps similar propensities to get sick by one disease or another, somewhat similar economies, cultures, and values. It is not difficult to observe that one could make good arguments as to why these countries should not be viewed as similar enough to qualify under the example, yet a better example has not arisen.

Admittedly, transfer pricing requires making many pragmatic adjustments, including for dissimilarities among countries, yet it is obvious that the composition and number of the dissimilarities will make the comparison useless at a certain point if the benchmark is as demanding as that presented by the regulatory example.

The example is followed by a variation, in Treasury Regulation section 1.482-4(c)(4), Example 2 (2011):

The facts are the same as in Example 1, except that the incidence of the disease zeezee in Country Y is much higher than in Country X. In this case, the profit potential from exploitation of the right to make and sell drug Z is likely to be much higher in country Y than it is in Country X. Consequently, the Ydrug license agreement is unlikely to provide a reliable measure of the arm’s length royalty rate for the Xpharm license.

The inclusion of Example 2 demonstrates, first, that the author of the regulation was aware of the limited scope for adjustments when comparability is insufficient; second, that the focus of the author of the regulation was on the product similarity — the drug and the disease it was designed to fight in the context of market definition (since arm’s length is a market based methodology); and, third, that the author of the regulation did not find it necessary to address other country comparability factors and their impact on the possibility of the use of the CUT method. What if countries are not neighboring yet otherwise comparable? What if they are otherwise quite similar but one is much larger than the other? What if they are part of an economic arrangement such as the European Union that in effect creates a single market for many purposes? These issues are open for debate with respect to comparability, and the example does not provide guidance. The example adds only confusion to the regulatory language. The parties to a

transfer pricing dispute (taxpayers and the government) may both find support for their arguments in the example, yet it does not promote the resolution of the dispute, and it is clearly not helpful for the development of the law.

What can one learn from these transfer pricing examples? Example 1\textsuperscript{70} is obviously unrealistic. Example 2\textsuperscript{71} is negative in nature, adding little to an already unrealistic primary Example 1. One could argue that Example 2 demonstrates that market conditions (such as the propensity to catch the disease) matter more than other properties of the market population (such as its size). Yet that is senseless, because all of these properties equally affect potential profits, which are the apparent focus of the regulation as a whole. Furthermore, the example is obfuscating, since emphasis on certain comparability factors rather than others may be more easily and directly clarified by the regulatory language (as indeed it largely is in this case)\textsuperscript{72} and should not be left to implicit suggestion in examples that may be interpreted differently by different readers. Moreover, one could have clarified the primary importance of market conditions over other properties directly, in the regulatory language, with much less confusion. In conclusion, these examples add nothing to the norm prescribed by the regulation and instead likely add confusion and distraction that can be used to frustrate rather than advance the norm setting exercise.

A third type of illustrative examples merely demonstrates the mechanics of a prescribed methodology, such as plugging numbers into provided formulae. For instance, Treasury Regulation section 1.1060-1(d) (2008) illustrates the ordering rule included in Code section 1060 for allocating an acquisition price (a lump sum) among various assets in certain asset acquisitions (hereafter the section 1060 example). The issue is that the negotiated price often is paid for the “business” as a whole, naturally taking into account the values of the particular assets, yet, more importantly focusing on the future profit potential of the acquired enterprise. For tax purposes, however, the acquisition, being an assets acquisition, is viewed as a combined facilitation of acquisitions of each of the assets separately, since each of the assets must be assigned a cost basis, based on which future transactions involving such assets will be calculated and assessed for tax purposes. The allocation of the price over assets may be very meaningful for tax purposes as different types of assets are taxed differently, and therefore taxpayers may wish to optimize their tax positions at the expense

\textsuperscript{70} Id. § 1.482-4(c)(4), ex. 1.
\textsuperscript{71} Id. § 1.482-4(c)(4), ex. 2.
of the Treasury. Thus, the regulatory language provides a nonrandom ordering rule, and the purpose of the example is to demonstrate the mathematical process of assigning values according to the ordering rule, and little beyond that. This type of example is important for understanding the exact rule prescribed and how exactly the formula works.\textsuperscript{73}

In conclusion, examples are important for effective tax regulations. The regulatory language often lacks the specificity required for the application of tax law that must eventually be reduced to precise dollar numbers. Similarly, illustrations of general regulatory language may help it be more approachable and understood more quickly, precisely, and economically. Nevertheless, the noted examples also demonstrate the problems that regulatory examples introduce.

\textbf{D. Examples in Court}

The lack of guidance on the use of regulatory examples — their legal status and appropriate interpretation — has not been remedied by the courts. This is more surprising than the lack of interest among the other players in the tax world. Courts generally do not have the luxury of choosing among the legal issues presented to them in cases they must decide. Therefore, one would expect the courts to regularly consider regulatory examples as they are frequently used in tax planning. Moreover, one would expect taxpayers (and the government) to broaden their use of arguments based on regulatory examples in court. Yet, this has not been the case. Courts have generally devoted little attention to examples in their decisions. They rarely pay attention to the legal status of examples and the other fundamental aspects raised by this article. Now, the courts are not responsible for answering why, where, and how examples should be used in the regulations, yet they are responsible for interpreting the regulations — leaving their infrequent discussion of these examples puzzling.\textsuperscript{74}

This article presumes that the courts’ lack of interest in examples simply follows that of the rest of the tax community. That is, judges accept the conventional wisdom about the desirability of the use of regulatory examples.\textsuperscript{75} Indeed, as already mentioned, no decision has extensively

\textsuperscript{73} See Treas. Reg. \textsection 1.1060-1(d) (2008).

\textsuperscript{74} In addition, the courts’ neglect of explicit analysis of regulatory examples contributes to the lack of accountability by the government in the regulation of regulatory examples, as discussed throughout this article. For the importance of accountability in rulemaking, see, e.g., Mark Seidenfeld, \textit{Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking}, 87 CORNELL L. REV. 486, 514–515 (2002).

\textsuperscript{75} The survey conducted for the purposes of this article was not extended to the courts, judges, and their views about regulatory examples. See \textit{supra} note 22 and accompanying text. Therefore, this article uses the working presumption that judges simply operate in the
analyzed the role and legal status of regulatory examples. Only a few decisions even identify the issue — yet these decisions do not develop a singular approach to dealing with it. Some cases interpret the examples as being part of the regulatory scheme, not different from the other regulatory language. Other cases viewed the examples as mere illustrations of the regulatory language, and therefore subject to the norms the regulatory language sets. Still other decisions applied the examples to the facts of the cases, usually echoing arguments made by parties to the litigation. Without explicit legal analysis, these decisions implicitly take one of the above-mentioned approaches. Finally, some decisions simply ignored regulatory examples despite their direct relevance to the facts of the cases in front of them. In a nutshell, the courts share with the tax bar the same confusion over, and inconsistency in, the treatment of regulatory examples.

1. *Parks v. Commissioner*  

A recent case, *Parks*, provides a good illustration of the difficulties that courts have with regulatory examples and their struggle to avoid a comprehensive analysis of their role. In *Parks*, the Tax Court analyzed a series of radio messages funded by Mr. Parks’s private foundation to determine whether such funding constituted taxable expenditures under the same way other tax professionals operate in this regard. A separate study of this matter can be made, but for now it is beyond the scope of this article. This working presumption is sufficient for its purposes, since the primary goal of this article is not to criticize the courts’ interpretation of regulatory examples but rather to provide a better understanding of their current and potential role in the regulations.

Even in Walton v. Commissioner, 115 T.C. 589 (2000), perhaps the classical case where a court found a regulatory example invalid, it did so based on its contradiction to valid interpretation of the statute with no analysis of the role and status of regulatory examples generally. In the case, Treas. Reg. § 25.2702-3(e), ex. 5 (2005) was found in conflict with I.R.C. § 2702. See, e.g., *Parks*, infra note 81.


Id.

*Id.* at 281 (finding that, pursuant to I.R.C. § 509(a), the private foundation was exempt from income tax under I.R.C. § 501(c)(3)).
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Code section 4945. Generally, a private foundation is liable for excise taxes on expenditures for anything other than a list of specified activities, including: activities with religious, charitable, scientific, literary, or educational purposes. Regardless, a private foundation may be subject to excise taxes if it expends any amount attempting to influence legislation.

The radio messages at stake contained information and commentary relevant to pending Oregon state ballot measures at the time of their production and broadcast. The Service audited the foundation’s tax returns and concluded that the expenditures on the messages were taxable expenditures and thus subject to excise taxes. Mr. Parks argued the messages were not lobbying communications subject to excise tax because they did not directly refer to any ballot initiatives. The court disagreed and upheld the excise taxes charged. In doing so, the court concluded that because the radio messages used language that closely mirrored the explanatory statements on the initiatives mailed to the public by the Oregon Secretary of State, the messages did in fact directly refer to the ballot initiatives. Additionally, the court found that the radio messages (except one, which provided facts and statistics to support the statements made) failed to qualify as educational nonpartisan analysis, study, or research under the regulations.

For the purposes of this article, the interesting part of the decision is the analysis of the relationship between the radio messages and the ballot initiatives, or whether the messages “referred to” the initiatives as required by the regulatory language in order to charge it with the excise taxes. There appears to be little doubt that direct reference such as naming an

84 Id. at 298.
85 I.R.C. §§ 170(c)(2)(B); 4945(d)(5).
86 The Court also examined whether the manager of the foundation, Loren E. Parks, was liable for excise taxes related to such expenditures imposed by I.R.C. § 4945(a)(2) and 4945(b)(2). Parks, 145 T.C. at 326–33.
87 Id. at 281.
88 The Service also charged Mr. Parks with additional excise taxes pursuant to I.R.C. § 4945(a)(2) and 4945(b)(2) for authorizing the expenditures and for failing to take corrective action. Id.
89 Id. at 335.
90 Id.
91 Id. at 307.
92 The Court also upheld most of the excise taxes charged to Mr. Parks, noting that although Mr. Parks had received written advice from the foundation’s tax attorney on the taxability of some of the expenditures, the advice did nothing more than recite facts and express a conclusion. As such, most of the attorney’s advice was not reasoned and could not be relied upon. Id. at 329–33.
93 The complete analysis of the path taken by the Court to reach this point is beyond the scope of this article.
initiative (e.g., “Measure 61” in our case\(^{94}\)) is forbidden based on the transparent objective of the relevant law to prevent tax-favored private foundations from engaging in lobbying. Yet, the regulatory language does not explain the term “refer to,” leaving unclear the boundaries between forbidden indirect reference to an initiative and a permitted statement — presumably one that incidentally engages in similar matters as a legislative initiative, for educational purposes, for instance. The Tax Court did not engage in the general interpretation of the term “refer to” in the regulations nor did the court refer to the purpose of the regulations but rather, it immediately and directly resorted to the examples provided by the regulation. The examples mention messages using language “widely used” or “identified with” specific legislation (such as “excisable”) and in doing so, effectively expand the prohibition against lobbying by private foundations. The court ruled:

On the basis of the principles illustrated in the regulatory examples, we hold that a communication ‘refers to’ a ballot measure within the meaning of the regulations if it either refers to the measure by name or, without naming it, employs terms widely used in connection with the measure or describes the content or effect of the measure.\(^{95}\)

Yet, the court does not explicitly explain its sweeping decision on the matter. It simply adopts the language of the examples as if it were part of the regulatory language itself.\(^{96}\)

The Tax Court clearly views the examples as equal in status to the rest of the regulations when it makes its ruling based on the meaning of the relevant term (“refers to”) provided in the examples yet not in the regulatory language.\(^{97}\) The decision reads as if the court feels bound by the examples, as if they prevent it from engaging in independent interpretation of the regulatory language (the term “refer to” in this case). However, at the same time, the Court also distinguishes between the language of the regulation itself and that of the examples. It states that the examples serve an illustrative role, in the service of the core norm provided by the regulation.\(^{98}\) The \emph{Parks} court thus falls hostage to the confusion over the role of examples in tax regulations even though it exclusively bases its decision on the language of such examples.

\(^{94}\) Parks, 145 T.C. at 305.
\(^{95}\) Id. at 309.
\(^{96}\) Id.
\(^{97}\) Id. at 308–10.
\(^{98}\) Id. at 308–09.
2. *Schott v. Commissioner*  

An earlier case dealt with an example that limited the scope of a rule included in regulatory language itself, which limited a statutory rule. In *Schott*, a married couple had each contributed money to an irrevocable trust (eventually for the benefit of their descendants), known as a Grantor Retained Annuity Trust (GRAT). The terms of the trusts were similar: the trust would pay an annuity (percentage of the trust’s corpus) for a period of the shorter of fifteen years or life of the grantor. Further, if the grantor died prior to the end of the fifteen-year term, the annuity was to be paid to the spouse for the balance of the term, unless the grantor had previously revoked the right. The Code requires grantors in these circumstances to pay gift tax on the amount granted reduced by the interest retained (what they expect to get back from the trust) in the grant. Since this creates an incentive to inflate the value of the retained interest (in order to save on gift taxes), Code section 2702 limits such interest to “qualified interest” or, generally, fixed payments made at least annually. Treasury Regulation section 25.2702-2 (2005) further limits such “qualified interest,” yet specifies that retention of the right to revoke a spouse’s interest does not disqualify the grantor’s (retained) interest. An accompanying example provides facts very similar to those in *Schott* (using a ten-year period rather than fifteen) and clarifies that both the annuity to the grantor and the possible remainder to the spouse are qualified interest that should be valued under special rules provided in the regulation. These rules take into account surviving spouse situations (so-called two-life valuations) for the purposes of valuing the qualified interest and calculating the gift tax due.

The Ninth Circuit simply applied the example to the facts of the case and determined that the retained interest was sufficiently fixed and ascertainable, using valuation tables prescribed by the Service. Thus, the retained interest was “qualified” and should reduce the value of the gift made by the Schotts. Yet, in accepting the taxpayer’s position, the Court of Appeals reversed the Tax Court decision in favor of the government, which argued that the element of contingency in the Schotts’ trust with respect to the spouse’s respective remainder interests was meaningful.

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99 81 T.C.M. (CCH) 1600 (2001), rev’d, 319 F.3d 1203 (9th Cir. 2003).
100 *Schott*, 319 F.3d at 1204–05.
101 Id.
102 Id.
103 I.R.C. § 2702.
105 Id.
106 *Schott*, 319 F.3d at 1205–07.
107 Id. at 1207.
enough to disqualify (not count) such interest for the purposes of gift tax calculations. The government saw such contingency in the impossibility of predicting the actual term of the annuities (life of the couple) and consequently the start date of the spouse's remainder payments. The Court of Appeals disposed of these arguments based on the general acceptance of life annuities and the availability of valuation tables to deal with that. At the end of the day, the difference between the Tax Court and the Ninth Circuit was in their reading of an example on point. The Tax Court viewed the example as an unreasonable extension of the regulation. Based on purposive interpretation (purpose being the prevention of undervaluation of gifts), the Tax Court rejected contingencies in the structuring of these trusts. The Ninth Circuit, however, ruled that such rejection was not a reasonable reading of the statute and regulation, thereby accepting the example as authority and explicitly avoiding an analysis of its status.

In conclusion, in Schott one again sees conflicting views regarding the proper treatment of regulatory examples. Here, the two courts took different views with different outcomes in the actual case, based on their interpretation of an example. Not only have the courts not engaged in a comprehensive analysis of the role of examples in tax regulations to fill the gap left by the legislator and regulators, they have added to the confusion even when required to rule exclusively based on language included in such examples. Next, the article begins the analysis with a discussion of the clientele of regulatory examples. Identifying the proper audience of examples provides better focus for the later discussion of their proper purpose, since experts and the less informed may use examples differently.

III. FOR WHOM ARE EXAMPLES WRITTEN?

Clientele questions are difficult in the realm of law, yet the focus of this article is on the use of regulatory examples by experts and their interpretation of these examples. The survey targeted only experienced tax practitioners, since it sought to establish the real impact, and flaws, of the use of examples in tax regulations. One cannot seriously expect less informed taxpayers to peruse extensively the regulations and examples,
master them, and take a tax position based on such research. The law applies to all and is presumed to be known by all, yet, in the current legal system only experts are practically expected to delve below its surface in the tax context. There should also be no doubt that regulations are always written for experts and by experts. It is important to note the clientele of a legal instrument, such as examples, since experts and the less informed apply them differently. Experts have acquired expertise and therefore have more prior knowledge on which to base new learning. Research demonstrates that experts are quicker to notice details, put them in context, organize, and interpret them, and they do all this far better than novices. Therefore, experts have an advantage in thinking about, understanding, learning, and memorizing new details within their field when compared to the less informed. They are better at identifying relevant patterns, and therefore they are better at solving professional problems. Consequently, when an author of a regulation drafts an example for an expert, she does not have to explain everything or provide every possible factual element, relevant or not, but only what an expert would need to interpret the regulatory language correctly. She could also use some professional terms without further explanation and without the concern that a nonexpert would confuse it with — for instance, the colloquial meaning of the term. Most importantly, an expert would not need many reminders or explicit cross references to other relevant rules and definitions that would be imperative for a novice if she wished to draw conclusions about the accurate legal consequence relevant to the example. Note, however, that expertise is not always beneficial; certain biases are exacerbated by expertise, since experts may be less open than laymen to consider atypical yet possibly relevant

114 *Ignorantia juris non excusat* is of course a universal maxim. It includes exceptions and derogations, yet in the context of this article, it basically applies in its pure form. For an interesting modern American reevaluation of this principle, albeit through the ubiquitous criminal law prism, see, e.g., Ronald A. Cass, *Ignorance of the Law: A Maxim Reexamined*, 17 WM. & MARY L. REV. 671 (1976).

115 A challenge of this basic understanding would require a very different argument that would be beyond the scope of this article.


117 See supra note 116.

118 Note the differences between these related processes. See, e.g., Jonathan Baron, *Thinking and Deciding* 22, 26–29 (4th ed. 2008) (explaining especially that understanding requires more than memorization and that it is purpose based, elaborating on various theories about these processes).

119 See, e.g., supra note 116.

120 See, e.g., supra note 116.
This article demonstrates below that in these circumstances examples written by experts predominantly for experts may be counterproductive.

The distinction between experts and the less informed taxpayers is not sufficient, however, to fully comprehend the impact of examples on the practice of tax law in general and on regulatory interpretation in particular. This impact varies even among tax professionals. In a 1991 article, Marty McMahon wrote: “tax professionals obviously are the only people who need to understand the regulations, as long as they are able to communicate to their clients the impact of the rules.” McMahon, consistent with the view expressed above, clearly believes that the primary goal of regulation drafting should be to maximize their precision and effectiveness. He is (justifiably) less worried about the uninformed public’s reading of such regulations. McMahon continues, however, noting:

It does not suffice that the regulations are understandable to the members of the New York State Bar Association Tax Section or the ABA Tax Section, who comment on them or are consulted informally during the drafting process. All of these people have the time and resources to master the few provisions of the code and regulations that have been assigned to them or in which they are interested at the time. Rather, in general, our concern must be with the CPA in Wilkes-Barre, Pennsylvania, the small firm lawyer in Dayton, Ohio, the revenue agent in Bakersfield, California, and the Chief Counsel docket attorney in Boise, Idaho. These people are the typical front-line tax professional.

These comments were made in the context of the complexity of regulations in general, yet they are equally relevant to the analysis of regulatory examples. Of course, neither McMahon nor this article argues that certain lawyers are inherently more capable than others. Rather, the reality is that most taxpayers do not have access to the absolute best-informed tax advice and, more importantly, that the resources available to the average capable tax adviser may be limited, in terms of time, knowledge, legal sources, and current inside information about the Service’s precise position on all matters. The point is that it is not sufficient simply to distinguish between experts and the less informed taxpayers; the author of the regulations and the examples should have a more nuanced vision of her (expert) clientele in mind when drafting. McMahon

121 See, e.g., BARON, supra note 118. The availability bias, for example, has such opposite effects. See, e.g., Seidenfeld, supra note 74, at 501–02.
122 See McMahon, supra note 7, at 1442.
123 See McMahon, supra note 7, at 1443.
convincingly argues that regulations should be generally written with the average capable tax expert in mind.\textsuperscript{124}

An even more nuanced view is possible, which McMahon seems to accept:

To be sure, there are some cases in which the audience consists mainly of more sophisticated and specialized tax practitioners. They are in larger firms, have more time, and their clients are able and willing to pay higher fees to reflect the time necessary to comprehend the regulations. Thus, regulations dealing with complex underlying transactions may be drafted differently from those which must be applied and understood universally.\textsuperscript{125}

This view would require the author of the regulations (and the examples) to make judgment calls about the potential clientele. This view is pragmatically appealing. The assumption is that the author of the regulation is one of the best-informed experts, and hence she is positioned to best make these judgment calls. In the examples context, however, it is less appealing. First, this article's point of departure is the critique of the unlimited discretion effectively granted to regulation authors to add examples. Keeping such unlimited discretion in the context of clientele may circumvent the educated approach to example drafting advocated by the article. Second, regulation authors and the examples they draft are not neutral — they are part of the government, and an unlimited discretion about the level of sophistication of the clientele may help to mask the inappropriate use of examples, such as the targeting of specific taxpayers, as elaborated below. Note that intentional "nudging" is not problematic in this context, since appropriate nudges must be explicit and choice permitting.\textsuperscript{126}

Third, not all regulation authors are necessarily the very best-informed tax experts, and the distinction between levels of expertise expected from the clientele of different rules is complex. Relatedly, the most sophisticated experts may have more influence with the government and more resources to assert their influence. Consequently, a single standard for clientele is likely the most desirable when authors come to draft regulatory examples. A single standard of writing for the average capable tax expert does not mean that the most complex matters cannot be addressed with appropriate expertise and sophistication; it only means that if examples are added, they should be accessible for the average capable tax expert and not only for the

\textsuperscript{124} See McMahon, supra note 7, at 1443.
\textsuperscript{125} See McMahon, supra note 7, at 1443.
\textsuperscript{126} See Thaler & Sunstein, supra note 28.
most sophisticated. Such practices would prevent the excessive use of specialized terminology, nontransparent references, and particular targeting of taxpayer actions or transactions. Focusing on average, capable tax experts rather than the most sophisticated tax experts may also be useful to reduce the impact of the increased exposure of experts to cognitive biases mentioned above.\textsuperscript{127} Finally, such a standard would make the regulations more accessible to nontax experts who, as conceded, are not the primary clientele of the regulations. Yet, at the end of the day, the clients are the ones to whom the experts must explain the basic norms. Approachable regulations (as explained by experts), especially in the expectedly approachable form of regulatory examples, should go a long way to increase legitimacy of the entire norm system, further supporting the average capable tax expert standard advocated by this article.\textsuperscript{128}

The undesirability of the drafting practices mentioned above is further elaborated below,\textsuperscript{129} yet the problem with targeting examples is worth mentioning here, even though it typically deals with sophisticated, complex transactions that are usually handled by tax experts from the largest firms. Nonetheless, targeting examples may easily have grave implications for less sophisticated taxpayers and their tax advisers who may not be aware of the exact context of an example or, more importantly, the detailed circumstances of the targeted transaction. A good example of this issue is the recent so-called inversion regulations\textsuperscript{130} that responded to the concern of the government with inversion transactions generally,\textsuperscript{131} yet were written

\textsuperscript{127} See supra note 121.

\textsuperscript{128} For the importance of legitimacy for compliance, see Tyler, supra note 21, at 804, 818, 822 (explaining that people comply better with norms that agree with their perception of what’s right, arguing for procedural justice as generally more effective than deterrence to achieve compliance, especially long-term compliance that is important for taxation, and mentioning specifically that people pay taxes even when they do not support the policies supported by such taxes so long as they accept the legitimacy of the tax system and its general fairness). Tyler mentions the similarity of his conclusions to these of Margaret Levi, who focused on the deterrence model in tax compliance, since even Levi acknowledged that coercion is insufficient, requiring government to achieve quasi-voluntary compliance to make the tax system efficient. Tyler, supra note 21, at 872 (citing MARGARET LEVI, OF RULE AND REVENUE (1988)).

\textsuperscript{129} See infra Parts IV–V.

\textsuperscript{130} See Inversions and Related Transactions, 81 Fed. Reg. 20,858 (Apr. 8, 2016) (explaining that these regulations should be viewed in combination with the proposed § 385 regulations that, among other things, decrease some of the most important benefits of inversions); Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20,912 (Apr. 8, 2016).

\textsuperscript{131} See, e.g., Mike Patton, Will Inversions Sink the U.S. Economy?, Forbes (Aug. 12, 2014, 5:53 PM), http://www.forbes.com/sites/mikepatton/2014/08/12/will-tax-inversions-sink-the-u-s-economy/#271707465d30 (explaining this not-so-recent concern has been infused with political agenda, such as advocacy of tax cuts, blaming the high nominal United
with a fairly transparent aim at the proposed Pfizer-Allergan merger that eventually fell through. Next, the article begins to examine the desirable uses of regulatory examples while keeping in mind the appropriate clientele of the examples: the average capable tax expert.

IV. WHY EXAMPLES?

This part of the article examines the reasons for the prevalent use of regulatory examples, explaining their intuitive appeal to both regulation authors and users, and beginning to expose the potential downside of this practice. It begins with the various reasons for inclusion of examples in tax regulations.

A. Why Would One Wish to Include Examples in Tax Regulations?

The limitations of language in the writing of laws and regulations are well known and have long been studied. The writing of rules must strike a balance between accuracy and clarity for such rules to be effective. This balance is at the heart of the discussion of regulatory examples, because the

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132 On November 2015, Pfizer, a United States corporation and Allergan, an Irish corporation announced a merger that would have combined them into the world’s largest pharmaceutical company. The surviving corporation would have been Irish. The deal would have resulted in the biggest “inversion” transaction to date. See, e.g., Ed Pilkington, Pfizer and Allergan Poised to Announce History’s Biggest Healthcare Merger, THE GUARDIAN (Nov. 22, 2015, 3:27 PM), https://www.theguardian.com/us-news/2015/nov/22/pfizer-allergan-healthcare-merger-corporate-tax.


134 Yet, as already mentioned, this is beyond the scope of this article. For more on that tension, See generally, LANGUAGE AND THE LAW (John Gibbons ed., 2013) (exploring the complex relationship and limitations between law and language, emphasizing the importance of effective communications); Gregory Matoesian, Language and Law, in THE OXFORD HANDBOOK OF SOCIOLINGUISTICS 701, 701–19 (Robert Bayley, et al. eds., 2013) (focusing on the complex yet elusive relationship between language, law, and sociocultural context, paying particular attention to the role of power in legal discourse); Rabeea Assy, Can the Law Speak Directly to its Subjects? The Limitation of Plain Language, 38 J.L. & SOC’Y 376 (2011) (arguing that the plain English movement has exaggerated the capacity of plain language to render the law intelligible to the nonlawyer, obscuring the deeper question of legal complexity by focusing solely on language and style); David Olson, From Utterance to Text: The Bias of Language in Speech and Writing, 47 HARV. EDUC. REV. 257 (1977) (discussing generally the various meanings of language in different contexts).
immediate reason for writing examples is to improve the clarity of complex
tax rules.135 Relatedly, the so-called “plain language movement”136 was
successful in advocating more clarity in legal norm writing with the passage
of the Plain Writing Act of 2010, marshaled by Cass Sunstein and then-
President Barack Obama.137 Regardless of one’s view of this specific act,
the logic behind it138 follows the same logic of the writing of examples into
tax regulations, both having clarity and certainty in mind.139

This logic is also highly intuitive: a regulation’s author understands the
limitations of language, especially since she herself is bound by the
statutory language drafted by others. She understands the need to conform
to the standard style and format of other regulations, and she is aware of her
own literary limitations. In addition, the author is human, no sarcasm
intended, and hence she understands the power of examples in thinking,
understanding, and learning. The use of examples in learning is ubiquitous,
well studied, and universally appreciated.140 The process of learning new
things involves what cognitive scientists call “encoding,”141 as part of
mediation processes between the stimulus (what one reads, for instance)
and the response of the brain (thinking about it or memorizing it).142

135 As it appears from informal discussions with Treasury officials. See supra note 15.
136 See generally, PLAIN LANGUAGE: IMPROVING COMM. FROM FED. GOV’T TO PUB.,
137 Pub. L. No. 111-274, 124 Stat. 2861 (2010); see also Plain Language: It’s the Law,
PLAIN LANGUAGE: IMPROVING COMM. FROM FED. GOV’T TO PUB.,
138 See FEDERAL PLAIN LANGUAGE GUIDELINES, supra note 20.
139 Indeed, the federal guidelines include a specific recommendation to include
regulatory examples, with a special mention of the extensive use of examples in tax
regulation. See FEDERAL PLAIN LANGUAGE GUIDELINES, supra note 20, at 70. They assert:
“(E)xamples help you clarify complex concepts, even in regulations. They are an ideal way
to help your readers. In spoken English, when you ask for clarification of something, people
often respond by giving you an example. Good examples can substitute for long
explanations. The more complex the concept you are writing about, the more you should
consider using an example. By giving your audience an example that’s relevant to their
situation, you help them relate to your document.” FEDERAL PLAIN LANGUAGE GUIDELINES,
supra note 20, at 70. This article supports some of these notions, yet cautions against others.
See infra Parts IV.A.1–V. Such caution is supported by research conducted in related fields.
See, e.g., Samuel B. Bonsall IV, Andrew J. Leone, Brian P. Miller & Kristina Rennekamp, A
(attempting to establish measures for readability of financial disclosures and
conducting validation experiments, noting the difficulty of measuring readability even in a
field where explicit SEC guidance is available).
140 See, e.g., supra notes 17–19 and accompanying text.
141 Nugent, Pam M.S., “Encoding,” in PsychologyDictionary.org, Apr. 7, 2013,
142 This paragraph is based on ample research in cognitive psychology about learning,
Moreover, such encoding reoccurs when one retrieves whatever she originally stored when she later wishes to reuse it. The use of examples therefore facilitates thinking and learning by making connections between the new information and known information. At the same time, however, what one learns and understands is affected by previous knowledge, including examples; this prior knowledge accompanies the new information and influences its encoding. The author of regulations intuitively knows that the use of examples can make the regulations easier to understand, and to understand them in the manner she (the regulations author) wishes them to be understood. Thus, the author believes examples make her regulations more effective. She is naturally less aware of the prior knowledge (baggage) users bring with them, and the inherent lack of neutrality of her own examples and the bias they may introduce, changing the way the user of the regulations learns, understands, and eventually applies them.

The bias introduced by examples, like any other stimuli, is inherent in human cognition. Cognitive biases occur due to mental shortcuts (also known as heuristics) that we humans regularly use for effective thinking. We cannot — and do not — stop and think through every step we take and every problem presented to us in our daily affairs. Daniel Kahneman thinking and understanding. See, e.g., *Alan Baddeley, Human Memory: Theory and Practice* (Psychology Press rev. ed. 1997).

See, e.g., *How People Learn, supra* note 112, at 10–12.

See, e.g., *Daniel Kahneman, Thinking Fast and Slow* (1st ed. 2013) (containing a popular review of a lifetime of notable work on cognitive biases, mostly while working with Amos Tversky, for which Kahneman won the Nobel Prize for Economic Sciences). Legal scholarship has extensively discussed this understanding about human cognition, primarily in the context of analysis of the limitations of classic law and economics literature. These limitations, a consequence of what is often called “bounded rationality,” were explored in both theory and application, based on the insight that humans are not rational, or that their rationality is commonly bounded. See *e.g.*, Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stan. L. Rev. 1471 (1998) (explaining bounded rationality and its impact on law and economics scholarship); Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. Legal Stud. 199 (2006) (explaining how the law can be used to negate bounded rationality actively, through what they call debiasing, and not only in attempts to isolate the bias from the decision-making process).
describes this in terms of thinking “fast” and “slow.” Fast thinking and behavior are highly important for us to timely, i.e., quickly, respond to stimuli in circumstances that cannot tolerate “slow,” rigorous, and comprehensive thought processes that fully gather and analyze all available data prior to decision. Fast thinking also permits us to make more decisions, and be more effective in the majority of situations we face in life, situations that do not require deep analysis prior to decision, or situations in which the consequences of sub-optimal decisions would not be critical. Survival instincts are good examples of the necessity of fast thinking. But, even less extreme examples, such as driving and other daily chores demonstrate the importance of these fast mechanisms in our lives. To think fast, human minds create heuristics that help them operate in this efficient manner. One of the most well-known heuristics is the availability heuristic. Humans engage in decision making and other evaluations based first on what immediately comes to their minds (what is “available”), building the rest of their thought on that existing knowledge. Examples work well because they are available in the sense that they require less “processing,” and therefore they naturally trigger the availability heuristic when they describe narratives or circumstances that are easier to recall and relate to than the more general and abstract regulatory language. Consequently, examples are helpful for the human understanding of otherwise complex rules as they relate the rules to simpler-to-access-and-recall existing knowledge. Yet, at the same time, examples may steer one away from the intended focus or scope of the rules. Such diversion may be unintentional, yet it may also be intentionally used to manipulate one’s focus or scope in directions not explicitly transparent in the regulatory language itself. Intentional or unintentional, these

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146 See Kahneman, supra note 145, at 13, 20–22.
147 See Kahneman, supra note 145, at 13, 20–22.
148 Slow thinking, conversely, is characterized by comprehensive gathering of data and analysis, fit for more consequential situations in life where prompt decision-making is not necessary and the likelihood of good decision-making without rigorous study and thought processes is low. See Kahneman, supra note 145, at 13, 20–22.
149 See Kahneman, supra note 145, at 20–22.
150 See Kahneman, supra note 145, at 20–22.
153 Id.
154 See Jolls & Sunstein, supra note 145, for an example of an attempt to use the bias to direct behavior.
diversions may be undesirable, as demonstrated by past studies, including in the realm of tax law.\textsuperscript{155} The core argument of this article is that in the context of regulatory examples, we have ignored the impact of human cognition and therefore have been incapable of assessing the desirability of these regulatory examples, an exercise that the article wishes to initiate.

To better understand the impact of examples, this part of the article explores, first, their potential aims and, second, the efficacy of such aims-driven examples against the background of human cognition and its limitations. This is by no means a comprehensive analysis of the tensions between human cognition as science currently understands it and society’s perception of human understanding of the law. The article merely notes some flaws in such perception, based on insights from cognition science that could help a more educated writing of regulatory rules.\textsuperscript{156} Next, the article begins the discussion with a structured exposition of possible goals for regulatory examples.

1. Examples that Provide Mere Illustrations of the Norms

This most straightforward goal of regulatory examples is to illustrate norms.\textsuperscript{157} An instance of this type of examples is the coffee example mentioned above,\textsuperscript{158} giving coffee, doughnuts, and soft drinks as illustrations of occasional snacks that an employer is permitted to provide to her employees free of tax (to the employees).\textsuperscript{159} Another example with a similar purpose is Treasury Regulation section 1.1060-1(d) (2008) (the section 1060 example\textsuperscript{160}), which illustrates the ordering rule of Code section 1060 (allocation of tax basis to assets of a target corporation in a taxable acquisition) with plugged numbers.\textsuperscript{161} This latter example both pours content into the words of the norm and demonstrates the use of a formula provided by such norm.\textsuperscript{162}

\textsuperscript{155} See, e.g., Joshua D. Blank & Leigh Osofsky, \textit{Simplexity: Plain Language and the Tax Law}, 66 EMORY L.J. 395 (2017) (exploring the way that the Service presents tax law in its nonbinding publications, the differences between such presentation and actual applicable law, and the general unfavorable taxpayer consequences of such diversion).

\textsuperscript{156} This article uses learning and understanding as a proxy for what “we” (society) want the constituency, taxpayers in this case, to do with the rules. A more precise discussion of the relationship of taxpayers and tax law, while desirable, is beyond the scope of this article.

\textsuperscript{157} 40\% of the survey participants viewed this as the primary purpose of regulatory examples. See supra note 22.

\textsuperscript{158} See supra Part I.

\textsuperscript{159} See supra Part II.B.

\textsuperscript{160} See supra Part II.C.

\textsuperscript{161} Treas. Reg. § 1.1060-1(d) (2008). See supra Part I.C.

\textsuperscript{162} That is that generally in an asset acquisition the purchase price shall be allocated first to the basis of the more liquid assets and later to the less liquid assets. The exact
Yet, even these examples are not neutral. The coffee example necessarily distinguishes between the mentioned snacks and snacks not mentioned, such as tea, cookies, and hot chocolate.\textsuperscript{163} It does not clearly state that the list mentioned is for illustration purposes only. Most lawyers may interpret the example as merely illustrative, yet again, the mere mention of certain list items without further clarification introduces a bias. Moreover, the example does not set clear boundaries between “fancy” coffee, which is likely, yet not clearly, unqualified as a de minimis fringe benefit and regular, ubiquitous brands.\textsuperscript{164} Again, proper interpretation may reach the right conclusion in many cases, but a clearer articulation would be superior; it would moreover be less distortive, likely causing less change of behavior among taxpayers. Think about a “fancy” tea example, which, this article argues, would more likely be disqualified than “fancy” coffee as a de minimis fringe benefit.

The authors of the regulations may use availability to their advantage, and they may have already done so in this context. If they concluded that many employers provide coffee, doughnuts, and soft drinks as a matter of course, and that requiring employees to include the value of these items in income would face strong resistance or just be ignored, then they probably did the right thing by mentioning those items in the example and leaving other, less ubiquitous snacks to the application of the general rule of the regulatory language. Note, however, that they could have nudged employers otherwise, mentioning health bars, apples, and freshly squeezed juice. The point is not that one or another articulation is necessarily better or worse, but that even seemingly innocent examples are not and cannot be neutral.\textsuperscript{165}

Even the Code section 1060 example is not neutral, since the numbers used could either be simple — raising no questions about the application of the formula or the justifiability of the norm — or more realistic and reflect difficult cases, such as bargain acquisitions or ones with significant

\textsuperscript{163} See supra Part I.

\textsuperscript{164} See also Morse & Osofsky, supra note 14.

\textsuperscript{165} Note that this article does not support or oppose the use of nudges; it simply clarifies that the basic premises are valid for regulation of all forms, including nudging. Further, the typical arguments against paternalism levied against the use of nudges are of lesser importance here, since, as demonstrated throughout this article, behavioral “imperfections,” such as heuristics, impact both the authors of the regulatory examples and their users. See, e.g., Jonathan Klick & Gregory Mitchell, Government Regulation of Irrationality: Moral and Cognitive Hazards, 90 MINN. L. REV. 1620, 1625 (2006) (cautioning against paternalistic regulation mainly based on the argument that the “long-run costs of paternalistic regulations may often offset short-run gains because of the negative learning and motivational effects”).
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premiums.\textsuperscript{166} Yet, the purpose of the examples is merely to illustrate an ordering rule that many people would perhaps take a longer time to figure out if it were not supported by the numeric examples. Numeric illustrations work well with ordering rules, formulae, and such, yet even they may be manipulated to give illustrations meanings beyond their functionality. The claim of this article is that one must at least be aware of this possibility when writing or interpreting these examples. Nonnumeric specificity examples, such as the coffee example,\textsuperscript{167} are less obviously justified as their potential for bias is larger. Clear interpretation rules could be useful in this regard.

2. Examples that Explain the Norms

Some examples go beyond mere illustration of the norms provided by the regulatory language, as demonstrated above by the continuity-of-interest example.\textsuperscript{168} There, the example effectively redefines the norms. The most obvious need for these examples is in cases where the author of the regulations believes that the regulatory language cannot be sufficiently clear and therefore would benefit from the supplement of examples. Note that the problem is not one of bad or inappropriate drafting, but of the very limitations of the necessary use of language to articulate norms. One must assume that the author of the regulations believed that proper interpretation of the language should lead to the same conclusion with or without the example, but that the addition of the example would allow readers to reach the correct conclusion more simply, more quickly, and with greater certainty. A less favorable perspective of this practice would raise the possibility that regulation authors may over-rely on examples, permitting themselves to less carefully draft the regulatory language itself when the same ideas may be much more easily explained via examples.

In a way, this type of example is similar to the illustrative examples mentioned above, yet it goes beyond mere illustration. Thirteen percent of survey participants said this is the principal purpose of regulatory examples: to add explanations to the rules when the regulatory language cannot do

\textsuperscript{166} In these not uncommon circumstances, taxpayers cannot simply assign value to all numerated assets according to acceptable valuation methodologies. The assets either have no assigned value or their value does not correspond to numerated assets. Both of these situations create incentives for taxpayers to challenge, and perhaps be more creative with, the valuation methods they use, in order to minimize their tax exposure. Such behavior often results in conflicts between valuations used by sellers and buyers, and these conflicts may be used by aggressive tax planners.

\textsuperscript{167} See supra Part I.

\textsuperscript{168} See supra Part II.B.
so. The transfer pricing example mentioned above provides another good illustration of this type of examples, even if it is not a very good example of desirable drafting of regulatory examples. As a reminder: the example dictates that under comparable circumstances, a taxpayer may select the same price that it uses to license a product to an unrelated party in a licensing transaction to a related party. This is called an “internal comparable” in the practice of tax law. In this context the regulations apply the arm’s length standard to establish necessary transfer prices, yet this standard cannot be easily applied based on regulatory language alone. If comparability of the nonmarket transaction to a market transaction is the standard, then what is “sufficiently comparable”? The regulations specify factors to aid the taxpayer in the determination of comparability, yet the value given to each factor is left for the judgment of whoever applies the rules. It seems that the regulation author thought these difficult-to-interpret norms can be best explained by examples, yet, naturally, these examples are very powerful (obviously more powerful than the mere illustration of rules that could be understood without them), and hence more vulnerable to bias.

This example is particularly interesting because it only pretends to explain arm’s length application. In reality, it tells an unrealistic story, and hence it is quite useless for guidance purposes. The example could therefore be abused. For instance, if the government wished to argue that only strict comparability would permit the use of internal comparables, it would put a very heavy burden on the taxpayer to establish such strict comparability. Yet such interpretation would be ludicrous, and in fact it would be opposite to the current government’s support of internal comparables. Taxpayers could also take advantage of this example if they wished to use methodology other than the straightforward arm’s length methodology. For instance, taxpayers could argue that CUP requires strict comparability that does not exist in their cases (or in any other cases), and therefore they should be permitted to use other methods that may be more beneficial for them (and result in less tax paid to the government).

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169 See supra note 22.
171 See supra Part II.C.
172 See, e.g., STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., JCX-37-10, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 120 (2010).
173 See supra note 72.
174 See supra note 67.
175 These problems are not theoretical. They initiated the policy discussion that resulted in the 1986 amendment of Code section 482 and the Service’s 1988 White Paper titled A Study of Intercompany Pricing under Section 482 of the Code. I.R.C. § 482 (1986); I.R.S. Notice 88-123, 1988-2 C.B. 458. See also Brauner, supra note 62 (reviewing case law
In conclusion, explanatory examples are appropriate when they accompany regulatory norms that are incomplete and language dependent. Yet, some explanatory examples serve these norms poorly, and may (intentionally or unintentionally) even subvert the norms’ true purpose. The transfer pricing example abovementioned is an example of such a disservice. The reason for this example was likely that the authors of the regulations wished to avoid the complexity of real transfer pricing circumstances that depend heavily on facts and circumstances, and simply cannot be helped by the relatively concise examples written in the structure and length of those found in tax regulations.

Tax norms more often than not deal, however, with complex, highly factual, and circumstance-sensitive norms, and crude simplification of examples cannot reduce the difficulty of interpretation in such cases. Another example of this difficulty is in the so-called software regulations (hereafter the software regulation example). Treasury Regulation section 1.861-18 (1998) provides a general algorithm to aid taxpayers in the classification of transactions in software (“computer programs” in the language of the regulations). The regulation distinguishes between transactions properly classified as services, the provision of know-how, licenses of copyright rights, lease of copyrighted articles, and the sales of either copyrighted articles or copyright rights. The distinction among these types of transactions is important because, despite their habitual economic similarity, their tax treatment is often different. The algorithm provided by the regulatory language has been generally considered very useful in practice, even though its application is not simple or free from doubts. In fact, many countries have struggled with the same problems of classifying complex software transactions, and essentially all have adopted versions of the United States’s regulations. The algorithm is struggling with comparability assessments for transactions involving intangibles).


177 Many have commented on the logic of such different treatment yet this is beyond the scope of this article. See also the IBA, Bar Association Comments on OECD Digital Economy Tax Challenge Consultation, TAX NOTES (Dec. 18, 2013) (arguing that “the US “software regulations” were generally considered to be obsolete by the time they were finally published”).


supported by a set of examples that demonstrate its implementation; this article focuses on Examples 8 and 9 of the regulations.

Example 8 provides the following factual pattern:

Corp A, a U.S. corporation, transfers a disk containing Program X to Corp D, a foreign corporation engaged in the manufacture and sale of personal computers in Country Z. Corp A grants Corp D the nonexclusive right to copy Program X onto the hard drive of an unlimited number of computers, which Corp D manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in Program X. Corp D pays Corp A an amount based on the number of copies of Program X it loads on to computers.\footnote{181}

This is the classic original equipment manufacturer (OEM) agreement between PC manufacturers and software corporations. Under the regulatory language, the right to copy and sell to the public makes the transfer one of a copyright right, and since it is limited in time it would be classified as a license generating royalty income.\footnote{182}

The next example, Example 9, reads:

The facts are the same as in Example 8, except that Corp D, the Country Z corporation, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licenses (identical to the licenses described in Example 1). The terms of these licenses do not permit Corp D to make additional copies of Program X. Corp D uses each individual disk only once to load a single copy of Program X onto each separate computer. Corp D transfers the disk with the computer when it is sold.\footnote{183}

The analysis here says that no copyright right was transferred, since Corp D has no copying rights, and therefore the transaction should be treated as a sale of a copyrighted article.\footnote{184} In this way, the transaction is akin to the same of a music CD for personal consumption. This classification has dramatic consequences; under the license classification illustrated in Example 8, Corp D would typically be required to withhold consumption/1923396.pdf, (referencing the Treas. Reg. § 1.861-18 (1998) software regulation in the context of know-how and services).

\footnote{181} Treas. Reg. § 1.861-18, ex. 8(i) (1998).
\footnote{182} Id. § 1.861-18, ex. 8(ii).
\footnote{183} Id. § 1.861-18, ex. 9(i).
\footnote{184} Id. § 1.861-18, ex. 9(ii).
tax — up to 30 percent of the gross amount in the United States — while no withholding tax, or other United State tax, would typically be due under the sale classification.185

The reading of these examples together is coherent with the seemingly logical algorithm for classification of software transactions, yet the examples expose the weakness of the algorithm itself. The difference between Examples 8 and 9 is who makes the copies of the program — a clearly worthless action — and the delivery cost of the physical disks. The goal of the regulations could not have been to impose the cost of producing endless physical disks and delivering them to the client on software companies, when they could easily engage in the exact same economic transactions, via the internet for example, and avoid those costs. Yet, the advantageous tax consequences of producing the physical product may push taxpayers either to engage in wasteful activities or cheat and pretend to do so.

Note, however, that Example 10186 clarifies that the author of the regulations did not think that the mere control over copying is determinative of the classification, rather, it is the copying “for the public” that worried the author of the regulations.187 Under Example 10, Corp A enjoys the same advantageous tax treatment as Example 9.188 It seems that the concern is one of abuse and fraud, yet neither are directly addressed by the regulatory language or the regulatory examples. The examples of the software regulations therefore provide more than just illustration or even explanations of the regulatory language; they infuse the rules with nontransparent concerns, yet only in an implicit and incomprehensive manner. This is problematic since it is impossible to infer a general anti-abuse rule from these examples beyond the exact circumstance of Example 8.189

Second, the examples incentivize taxpayers either to engage in wasteful

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185 Except for inventory sales in certain circumstances. See I.R.C. §§ 861(a)(6), 865(b).
186 Treas. Reg. § 1.861-18, ex. 10(i) (1998) (“Corp A, a U.S. corporation, transfers a disk containing Program X to Corp E, a Country Z corporation, and grants Corp E the right to load Program X onto 50 individual workstations for use only by Corp E employees at one location in return for a one-time per-user fee (generally referred to as a site license or enterprise license). If additional workstations are subsequently introduced, Program X may be loaded onto those machines for additional one-time per-user fees. The license which grants the rights to operate Program X on 50 workstations also prohibits Corp E from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the license is stated to be perpetual.”).
187 Id. § 1.861-18, ex. 10(ii).
188 Id. § 1.861-18, ex. 9.
activities or cheat. Third, the examples de facto prevent the government from interpreting the regulatory language as a more general anti-abuse norm, in a manner that would be consistent and workable in all circumstances rather than only those mentioned in the examples. Examples 8-10 illustrate well the potential benefits of a general interpretation rule that would always subject the regulatory examples to the regulatory language. Finally, the revenue impact of these regulatory examples is likely negative since software transactions are easily interchangeable, usually with little cost. Therefore, the primary impact of the regulatory examples is to incentivize taxpayers to use less-taxed transactional forms, which not only cost in revenue, but are also often wasteful.

3. Examples that Shape the Contours of the Norm

Other examples go beyond explanations, clearly shaping the contours of norms, shrinking or expanding their scope beyond the regulatory language. Such regulatory examples are not rare; full 5% of our survey participants viewed such contour shaping as the primary purpose of regulatory examples as a whole. A sample follow-up inquiry with participants clarified that they thought these examples usually appear where the scope of the regulatory language is unclear, yet, the examples provide more than specificity. They go beyond what could usually be perceived as normal interpretation of the regulatory language. The continuity-of-interest regulations’ example, for instance, departs from the facts and circumstances test and provides that 40 percent continuity is sufficient, anchoring taxpayers to that percentage more powerfully than any other legal analysis.

The Parks case provides an even more conspicuous instance of this type of examples, since it does not deal with line drawing. As a reminder,
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this case revolved around radio advertisements that had been determined by the Service to influence legislation and hence to be subject to excise taxation under Code section 4945.\textsuperscript{198} The regulatory language makes advertisements that "refer to" ballot measures subject to the excise tax, yet it does not explain the level of reference required.\textsuperscript{199} The \textit{Parks} court did not engage in the general interpretation of the term "refer to" in the context of the regulations and their purpose but rather immediately and directly resorted to the examples provided in the regulation.\textsuperscript{200} These refer to messages using language "widely used" or "identified with" specific legislation to expand the prohibition.\textsuperscript{201} The Court simply relied on the examples to make the advertisements in question subject to the excise tax with no further explanation.\textsuperscript{202} For the purposes of this Part, one can observe that the examples expand the scope of the prohibition against intervention in legislation provided for by the regulatory language. Such expansion is not the only, and perhaps not even the most appropriate, interpretation of the regulatory language.

Another interesting illustration of the problem with contour-shaping examples is Treasury Regulation section 1.1275-5(d), Example 5 (1996) (hereafter the VDRI example).\textsuperscript{203} This example requires a little background: the regulation provides the conditions and rules for variable rate debt instruments (VRDIs).\textsuperscript{204} It determines whether certain complex debt instruments could be treated as debt for tax purposes (a usually favorable treatment).\textsuperscript{205} Example 5 concerns an instrument that is based on a fixed regulatory language than compared to instances in nonline drawing circumstances. \textit{But see} David A. Weisbach, \textit{Line Drawing Doctrine, and Efficiency in the Tax Law}, 84 CORNELL L. REV. 1627 (1999), and its corollary David A. Weisbach, \textit{An Efficiency Analysis of Line Drawing in the Tax Law}, 29 J. LEGAL STUD. 71 (2000) (arguing that line drawing decisions should follow efficiency analysis and not traditional tax law doctrine). The obvious conclusion is that not every line in tax law is necessarily drawn in the most desirable place and better thinking may improve the law with little cost, both generally and particularly in the case of regulatory examples.

\textsuperscript{198} \textit{Parks}, 145 T.C. at 298.
\textsuperscript{199} \textit{Id.} at 308.
\textsuperscript{200} \textit{Id.} at 308–09.
\textsuperscript{201} \textit{Id.}
\textsuperscript{202} \textit{Id.}
\textsuperscript{203} I thank Omri Marian for this example. \textit{See} Omri Marian & Andrew D. Moin, \textit{Taxation of Structured Debt in a Low-Rate Environment}, 135 TAX NOTES 323 (Apr. 16, 2012) for a more detailed explanation of the rules briefly explained here.
\textsuperscript{204} A variable rate debt instrument that does not qualify as VRDI is treated, less favorably, as contingent payment debt instrument. Treas. Reg. § 1.1275-5(a)(1) (1996).
\textsuperscript{205} Basically, VRDIs are debt instruments that provide for stated interest, compounded or paid at least annually, at: one or more qualified floating rates; a single fixed rate and one or more qualified floating rates; a single objective rate; or a single fixed rate and a single
percentage of the S&P 500 index, and asks whether this should be considered a reference to an "objective rate," therefore making the instrument eligible to be a more beneficially taxed VRDI. The example claims that it should not, despite the fact that this often-used index seems to clearly fall within the scope of the general definition of an "objective rate." This general definition is limited to rates that do not provide for significant front-loading or back-loading of interest because such disproportional loading presumably provides excessive control to the taxpayer over the risk embedded in the instrument. The example assumes that the S&P 500 index is liable, based on historical data, to always increase in value and hence result in significant "back-loading," which disqualifies the instrument at stake as a VRDI.

The point for purposes of this article is that the example seriously limits the scope of the VRDI rules with its expansion of what significant front- or back-loading means, including every index that has had consistently positive historical performance. This effectively analogizes the S&P 500 to an index where performance is within the control of the taxpayer — an obviously problematic analogy. Moreover, the example's conclusion about the historical performance of the S&P 500 index is also false because the index has not always trended upwards. It lost value in several years, including two losing periods in 2000-2002 and 2008-2009. Finally, the example uses historical data trends, with no specificity, whereas the regulatory language refers to actual risk — front- and back-loading. It is not clear why the authors of the regulation treated the S&P 500 this way. Perhaps they thought that VRDI treatment should be more restrictive than the treatment provided for by the regulatory language, yet forcing this opinion through the examples rather than the approved regulatory language is problematic at best. Another possibility is that the authors of the regulations wanted to target a specific instrument, tied to the S&P 500, that they had encountered, an equally common and problematic practice, as

objective rate that is a qualified inverse floating rate. Id. § 1.1275-5(a)(2).

206 Id. § 1.1275-5(a)(1), ex. 5.

207 See id. § 1.1275-5(c)(1) (providing that "an objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. For example, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of I.R.C. §1092(d)(1))").

208 Id. § 1.1275-5(c)(4) (providing that "notwithstanding paragraph (c)(1) of this section, a variable rate of interest on a debt instrument is not an objective rate if it is reasonably expected that the average value of the rate during the first half of the instrument's term will be either significantly less than or significantly greater than the average value of the rate during the final half of the instrument's term").

explained next.

4. Examples that Target Specific Taxpayer Actions or Transactions

While the abovementioned three types of examples demonstrate a progressively meaningful role for regulatory examples, this subsection is qualitatively different. Targeting examples do not attempt to alter the scope of the regulatory norm, but rather attempt to guarantee that specific taxpayer actions or transactions are disqualified from certain tax benefits. Put simply, a supposedly general and abstract norm is devised with intentional over-coverage and disregard for its unintentional victims to ensure that a single intended victim would not escape it. Regulatory examples are “natural” for this practice since they provide an additional guarantee that the intended target of the regulation would not escape it, as examples facilitate the mention of a more specific set of facts than typical regulatory language.

Again, this practice is not rare: approximately 5 percent of the survey participants view targeting as the primary goal of regulatory examples as a whole. The recent regulations targeting inversions provide a good example for this practice. They were clearly crafted to prevent the announced Pfizer-Allergan merger. In this case, not only the examples, but also some of the details provided for in the regulatory language, serve this purpose.

In the last two decades, Congress, and even more so the federal government, made the fight against inversion transactions a focal point of their tax policies. Various laws and regulations construct the defense against these transactions based on a scheme to eliminate or reduce their tax benefits. This would be generally possible if after the transaction less than 25 percent of the inverted MNE’s business activity is in the parent’s residence, and the shareholders of the old United States parent end up owning at least 60 percent of the shares of the new foreign parent. If a stake of 80 percent or more is kept with these shareholders, the result would

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210 See supra note 22.
211 See Inversions and Related Transactions, 81 Fed. Reg. 20,858 (Apr. 8, 2016) (explaining that these regulations should be viewed in combination with the proposed § 385 regulations that, among other things, decrease some of the most important benefits of inversions); Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20,912 (Apr. 8, 2016).
212 See supra Part II.
214 See, e.g., I.R.C. § 7874.
215 Id.
be treatment as a United States corporation. But, not unexpectedly, new inversions were designed to circumvent these rules, and new guidance was issued in 2014-2016 to plug new holes discovered in the defense against inversions.

The Pfizer-Allergan deal was not designed to meet the 60 percent threshold and would not have suffered adverse consequences if it were not for the Treasury Regulation section 1.7874-8T. The regulation addresses corporations known as multiple inverters, i.e., MNEs, that engage in a series of inversions — or acquisitions of United States corporations by foreign companies — each inversion escapes the 60 percent threshold, but, if viewed cumulatively, cover a much larger majority of assets with United States origins. The trick is that once an inversion passes the 60 percent test, the entirety of the new MNE becomes “foreign” for the purposes of the next inversion. This is possible even when all of the relevant transactions include a majority of United States assets. The government’s response in the temporary regulations was to take a cumulative (three years) approach for the calculation of the 60 percent test. This approach would eliminate the tax benefits of the Pfizer merger, and indeed Pfizer announced that it would not proceed with the transaction. People “in the know” testify that the examples, demonstrating the calculation of the continued stake of the old shareholders of the inverted companies, track the facts relevant to Pfizer and Allergan. The regulations both over-reach by effectively burdening legitimate transactions — for example in the case of a struggling American corporation where a foreign takeover is the sole hope of survival and continued employment of workers within the United States — and under-reach, since other inversions may be designed to escape their grasp in the same way that Pfizer/Allergan was allegedly designed to escape current law.

There are many difficulties with these regulations, and indeed a lawsuit is pending, challenging primarily the authority of the government to issue these regulations. However, for purposes of this article, other questions are more relevant: Are regulatory examples the appropriate format for specific targeting, especially when the regulatory language may otherwise be interpreted in a more or less expansive manner? Are targeting examples

still “examples”? There is also a question of proportionality and alternative means, including the use of explicit regulatory language or revenue rulings. Finally, specific targeting raises questions about the wisdom of such regulations that are unlikely to be considered with a wide perspective and rigid analysis and consideration of all the consequences. The regulation author clearly focused on the specific target, rather than the exact boundaries set by the regulation, including the boundary between appropriate and inappropriate transactions. The user of the regulation, however, has the legitimate choice between reliance on the original target of the regulation, based on the regulatory example, or a normal reading of the regulatory language. A difficult interpretation conflict is inescapable. In conclusion, these examples are simply unlikely to provide good general normative guidance.

5. Examples Written Without Specific Goals

Even worse are regulatory examples written as a matter of habit with no specific goal in mind. Although a small minority, about 2 percent of survey participants, stated that examples are primarily written because of tradition and with no explicit goals, essentially all the follow-up participants acknowledged the ubiquity of this phenomenon. Private conversations with government officials made it clear that authors of regulations are now expected to add examples and follow standard drafting, and they are expected to do so with no guidance or much thought of the value they add to the regulations. This view portrays quite a poor picture of the practice of regulation writing, yet it should not be dismissed outright. It corresponds to the findings about the impact of regulatory examples. As mentioned above, 47 percent of participants said the examples often describe simplistic or unrealistic circumstances and therefore add little or nothing to the regulations. In addition, 43 percent of participants said the examples often rehash the language of the regulations without adding clarity. The transfer pricing example on comparability in the context of pharmaceutical distribution serves as a good illustration of this type of example. The point is not to condemn regulation authors, who are undoubtedly under much pressure and often tight schedules, but rather highlight the deficiency in the process. The intuitive appeal of examples mentioned above and

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223 See, e.g., Cummings, supra note 7.
224 See supra note 22.
225 See supra note 22.
226 See supra note 22.
227 See supra Part II.C.
228 See supra Parts IV.A.1–IV.A.5.
further explained in cognitive bias terms in the following sections \(^{229}\) likely prevent the regulation authors from challenging this practice.

6. Examples Are Often Used for Various, Divergent Purposes, Appropriate and Inappropriate

More than one-third of survey participants stated that one cannot say the examples primarily serve a single purpose, but rather they serve all the above-mentioned purposes interchangeably. \(^{230}\) This is a reasonable account of the current state of affairs, yet it raises a question about the desirability of simply giving regulation authors unmitigated discretion over when, and to what end, to add regulatory examples. It also makes regulatory interpretation more difficult and uncertain. For instance, the lack of guidance on examples led to the inclusion of controversial targeting examples, such as those in the temporary inversion regulations mentioned above. \(^{231}\) The difficulty presented by the lack of guidance is exacerbated by the typical complexity of identifying a purpose when none is declared. Targeting examples may, for instance, be portrayed as merely illustrative, leaving harmed taxpayers with little remedy, \(^{232}\) and the regulation author is effectively free to not explain her actions. Similarly, the regulation author may continue to add aimless or useless examples, such as the transfer pricing example discussed above \(^{233}\) with little chance of control over her actions. The natural outcome of these shortcomings in forming clear purposes for the use of regulatory examples is confusion, bias, and harm to the legitimacy of the tax system. \(^{234}\) The next section explains the reasons for this state of affairs. This article does not argue that it is a result only of laziness and complicity among regulation authors but, conversely, that it is a natural outcome of the way humans think and operate, adding that the failures identified may be corrected by a better understanding of their source at human cognition.

\(^{229}\) See infra Part IV.B.

\(^{230}\) See supra note 22.

\(^{231}\) See supra Part III; supra Part IV.A.4.

\(^{232}\) Assuming, arguendo, that targeting examples are or may be considered inappropriate.

\(^{233}\) See supra Part II.C.

\(^{234}\) A good example for this is the state of the regulations promulgated pursuant to I.R.C. § 704(b). See, e.g., Tax Attorney Says Partnership Regs Require Major Changes, 2012 TNT 246-15 (Dec. 19, 2012).
B. Behavioral Insights that May Be Relevant for the Writing of Regulatory Examples

As noted, the attraction to examples in many circumstances, and their intuitive appeal in interpretation of complex tax law are deeply rooted in the human psyche. The lack of self-examination by regulation authors regarding the use of regulatory examples is therefore understandable. Similarly, the large majority of tax professionals who were interviewed while researching this article were puzzled by the questioning of this practice while contemporaneously strongly criticizing the practice itself. The interviewees came from both the government and private practice, and there was no significant difference in attitude toward the examples among them. An informal survey of tax professionals involved in the writing and authorization of regulations revealed almost a consensus that examples are necessary and are to be encouraged in any regulatory project. These regulation authors felt no need for specific guidance and limits put on the use of such examples, essentially viewing this article as a pointless challenge of the obvious.

This section examines this approach, its sources, and its justifiability, using insights from behavioral science. It may seem trivial that these insights should guide the law and regulation writing, and routinely be consulted in legal scholarship. In reality, these insights are rarely acknowledged. They are mostly ignored in acceptance of the fictions like general, complete familiarity with the law and perfect rationality of law-subjects. This is slowly changing with the ascent of the so-called behavioral law and economics school, yet tax scholarship has been slow to join this trend. In addition, the application of behavioral science, and particularly of insights from cognitive psychology, despite their relevance, is not always simple or straightforward since it requires application of what is essentially laboratory findings to complex, imperfect real life

235 See supra note 22
236 The interviewees were randomly chosen among the tax experts to whom the survey had been sent. They included Service employees, yet not actual regulation authors. See supra note 22.
237 In conformity with the implicit position of the Service, which was confirmed by high-level officials. See supra note 22.
238 Similarly, the law has been slow to take into account the behavioral aspects of government agencies' conduct. See, e.g., Seidenfeld, supra note 74, at 487–89 (arguing that administrative law generally treats the agency as a black box and explaining that such an assumption is incomplete, as it ignores behavioral impact on decision making by agency officers); Deborah Schenk, Exploiting the Salience Bias in Designing Taxes, 28 YALE J. REG. 253 (2011) (arguing for the exploitation of the salience bias in designing or modifying taxes).
239 See, e.g., Jolls, Sunstein & Thaler, supra note 145.
circumstances, which makes conclusions useful, yet tentative, requiring caution and care in application.\textsuperscript{240} Cognition study has been interested in behavior in a variety of contexts, such as learning, memorization, and cognitive development. These circumstances are informative for a study of the way taxpayers and their advisors read and use the law generally and regulations and regulatory examples particularly, yet they are sufficiently different that caution is warranted in an application of insights from cognitive studies to the reading and use of regulatory examples,\textsuperscript{241} examples must be understood, learned, and perhaps retained to memory, yet they are not, and perhaps should not necessarily be designed in a manner that would optimize all these functions. They are clearly not required to maximize memorability, for instance, or learning in the same sense as learning a language or a preferred behavior, which are classical subjects of cognitive studies.\textsuperscript{242} Rather, they should be easily understood, and understood in a universal and unified manner. It may not be complicated to write examples that are universally easier to understand than the substantive language of the regulations, yet, it is much more difficult to present examples that would be identically understood by all. This is particularly true because the mere presentation of an example changes one’s perspective about the norm in the regulation since it provides ample detailed facts to which the user relates, through availability, for instance. These insights naturally have an impact on the proper interpretation of examples, and of regulations more generally, and therefore the first step in the analysis is to understand them, understand how humans read examples.

1. How Do Humans Read Examples?\textsuperscript{243}

Human minds operate in efficiency maximizing manners. We cannot and do not stop to think through every step we take and every problem presented to us in our daily affairs. We therefore often think “fast.”\textsuperscript{244} Such

\begin{itemize}
  \item \textsuperscript{240} See, e.g., Seidenfeld, supra note 74, at 490 (arguing for a similar approach in a more general administrative law context, noting both the utility of incorporating insights from psychology and the need for caution in the implementation of conclusions drawn from such studies).
  \item \textsuperscript{241} Future study of the way we read and use law and regulations may shed further light on the issues exposed by this article. In the absence of direct study of these particular circumstances (a study which parameters may be very difficult to establish), this article proceeds based on currently available knowledge.
  \item \textsuperscript{242} See, e.g., Eysenck & Keane, supra note 116.
  \item \textsuperscript{243} This section, as well as the entire application of insights from cognition studies, is highly simplified and limited for the purposes of this article: to note the desirability of a more informed writing of regulatory examples. A comprehensive study of how humans read law is beyond the scope of this article.
  \item \textsuperscript{244} See, e.g., Kahneman, supra note 145, at 20–22.
\end{itemize}
fast thinking also triggers inherent heuristics and biases that affect our thinking in various relevant manners.245

The availability heuristic noted above246 directs us (humans) in making judgments and decisions based on the ease with which certain instances come to mind. Therefore, we might think, for example, that certain events are more probable the more we have been exposed to them, in terms of either frequency or impact.247 A realistic example, therefore, at least shifts the focus of a reader of regulations from a comprehensive analysis of the prescribed norm and all the possibilities it presents to the application of the norm to a particular set of facts articulated in the example. The example is attractive because it is easier to read than the regulatory language, it gives the reader the comforting feeling (whether true or false) that she understands the norm, and it is likely to make any analogy to the facts of the relevant legal case much simpler. The appeal of an easier to read example is intuitive, similar to the simple writing of norms in general.248

Yet, it is the availability heuristic that is especially powerful and important for the purposes of this article. It may be argued that an expert tax lawyer, who is the probable user of examples, is likely to be less affected by the mere ease of reading examples in preference to the regulatory language. An expert, however, consciously focuses on examples for specific reasons: the professional reflex (and responsibility) to analogize the example with the particular set of facts of the case at hand. What is not usually acknowledged is the additional effect of the availability heuristic in this context: the shift of attention from the general and abstract norm in the regulatory language to the example and its features that most easily come to mind. Take for instance the coffee example.249 A tax lawyer who faces a client who wishes to provide healthy snacks to her employees could engage in a comprehensive interpretation of the regulatory language; yet, she is much more likely to summarily advise the client that such provision may trigger income to the client’s employees, or to ask the client why would she not just provide healthier coffee and similar snacks rather than take unnecessary risks. An insistent client may of course obtain a memorandum guiding her on how to reduce the risk of income inclusion if she were to provide healthy snacks to her employees, yet that would cost her much more than the supply of even the most expensive coffee and doughnuts.

245 Id.
246 See supra notes 152–153 and accompanying text.
247 The research of the availability heuristic has focused on its effect on probabilistic decision-making, which the heuristic negatively impacts. See, e.g., KAHNEMAN, supra note 145, at 12–13.
248 See supra notes 134–139 and accompanying text (discussing the plain writing movement and its achievements).
249 See supra Introduction.
This cannot be the outcome that the government was trying to promote.

A similar process occurs pursuant to the so-called representativeness heuristic that affects human decisions about events based on their similarity to a representative population of events.\textsuperscript{250} We are therefore predisposed to pay attention to and make decisions based on the most salient properties of a population of events. Returning to the coffee example,\textsuperscript{251} it was clearly written in the way it was because a great majority of employers actually provided employees with various combinations of coffee, doughnuts, and soft drinks. The author of the example had not likely considered the contribution that the example itself would have to the salience of these particular snacks and to their ubiquity.

These heuristics are used to explain behavior that deviates from what some would call rational behavior.\textsuperscript{252} Notably such deviation is expected from time to time as a natural consequence of a normal, imperfect human decision-making pattern.\textsuperscript{253} Our unreserved acceptance of examples, however, ignores the potentially negative impact of such thinking on our interpretation of the unlearned and unguided writing of regulatory examples. The negative impact may be due to over-restrictiveness of regulations or to the ambiguity of the purpose or scope of the prescribed norm. Fast thinking further exacerbates this lack of clarity.

Another often-studied heuristic, known as anchoring, is also relevant in this context because it is often present when line drawing is required.\textsuperscript{254} Since line drawing is often required in tax regulations, anchoring plays a major role in the introduction of biases to tax law.\textsuperscript{255} For example, the continuity-of-interest example provides the 40 percent anchor.\textsuperscript{256} For good or for ill, this anchor affects the extent of risk taxpayers are willing to take in their tax planning. They are trying to get their continuity as close as possible to that number, even though there may be good law to support

\textsuperscript{251} See supra Introduction.
\textsuperscript{252} Rational behavior maximizes the utility of one’s actions. See, e.g., Robert Nozick, \textit{The Nature of Rationality} (1993). It naturally is not impacted by the heuristics and biases described above. Recent academic discourse prefers to use bounded rationality, i.e., rationality bounded by limitations such as heuristics, to describe actual human thinking and behavior. The term “bounded rationality” is attributed to Henry A. Simon, \textit{Models of Man} (1957).
\textsuperscript{253} See, e.g., Kahneman, supra note 145.
\textsuperscript{254} See, e.g., Kahneman, supra note 145, at 119–28. For more on line drawing in tax law, see, e.g., supra note 171.
\textsuperscript{255} See, e.g., Kahneman, supra note 145, at 119–28 (providing examples of bias introduced by anchoring); supra notes 195–197 and the accompanying text.
\textsuperscript{256} See supra Part II.B.
more or less aggressive positions. It is clearly the mentioned percentage — the anchor — that gets most, if not all, of the focus rather than the norm prescribed by the regulatory language. It is also clear that the choice of this anchor had not been made intentionally, after careful assessment of its impact and alternative measures. We know this for a fact because the 40 percent anchor reflected a particular set of facts in a single case that eventually became precedential.257

Other, nonline drawing specificity examples also introduce anchoring. The coffee example anchors what is to be considered de minimis for purposes of the fringe benefits rules with regard to the price of the mentioned snacks.258 The effect of anchoring is different from that of the availability or the representativeness heuristics.259 The example anchors de minimis snacks to the price of typical workplace coffees, doughnuts, and soft drinks. Consequently, a health-conscious employer that provides her employees with herbal tea, health bars, and fresh-squeezed juice (all organic, of course), is likely to face an issue if these snacks typically cost over three times more than the ubiquitous coffee, doughnuts, and soft drinks. This is the case because healthy snacks are not mentioned specifically in the example, are not as ubiquitous as those mentioned, and there is a price difference between healthy snacks and those snacks that have been chosen as the standard by the regulation author. Note that the cost of healthy snacks would not necessarily fail the low-cost-to-the-employer test of the regulatory language if it were not for the example that anchors what is to be considered de minimis to the cheapest, most ubiquitous workplace snacks. Finally, note that the examples themselves, when added to the regulatory language, may serve as anchors. The examples shift the focus from the independent interpretation of the regulatory language and instead anchor the process to whatever is described: a line drawn, a representative circumstance, etc. This effect is particularly powerful in the transfer pricing context, since, as mentioned, the arm’s length standard requires comparability of market transactions to nonmarket transactions.260 Under this standard every comparable transaction serves as an anchor, and a transaction that comes through an example that hints to where one should look for comparable transactions and what the standard for comparability would be, is naturally even more powerful.

257 See supra note 48.

258 See supra Introduction.

259 See, e.g., Yuval Feldman, Amos Schurr & Doron Teichman, Anchoring Legal Standards, 13 J. EMPIRICAL LEGAL STUD. 298 (2016) (explaining the effect of anchoring by the law itself, including examples of anchoring by examples provided by the law in a tort context similar to the regulatory examples discussed in this article).

260 See supra Part II.C.
A comprehensive review of the effects of heuristics and biases on the reading of regulatory examples is obviously beyond the scope of this article, yet two additional insights are essential to fully comprehend the importance of being mindful of these biases when thinking about examples in tax regulations. First, the effect of framing may be very dramatic in the writing of tax regulations. Framing was originally studied in the context of loss aversion, demonstrating that humans react differently to circumstances that involve winning and losing, despite an identity of the real economic consequences of these circumstances. It is easy to understand that taxpayers would react differently to examples that describe permissible circumstances (safe harbors) in comparison to those describing bad tax consequences (sure shipwrecks). The software regulation examples mentioned above serve as a good illustration of this issue, notably providing a roadmap for taxpayers that does not necessarily fit the purpose of the regulatory language. Similarly, the transfer pricing example, being permissive — even if with respect to unrealistic circumstances — is understandably interpreted very broadly, and taxpayers enjoy its permissive nature. A differently framed example, one that would compare two countries with 50 percent differences in GDP per capita, for instance, and that would declare such countries noncomparable for transfer pricing purposes, would likely eliminate essentially all of the potential use of arm's length for transfer pricing comparability. The difference in framing may therefore be dramatic. Note also that the choice to frame examples in one way or the other is left completely at the discretion of the regulation author. There is also no particular balancing of positive and negative examples. This article contends that it is unthinkable to expect single regulation authors to systematically make decisions about inclusion of regulatory examples based on framing (and other) effects.

Finally, Tversky and Kahneman developed what they called the "prospect theory" of human behavior, arguing — in conflict with rational choice theory that dominated classic law and economics literature — that people evaluate outcomes against an initial reference point and not based on the outcome itself. Therefore, what matters most is often the change from

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263 See supra Part IV.A.2.
264 See supra Part II.C.
265 See Daniel Kahneman & Amos Tversky, Prospect Theory: An Analysis of Decision under Risk, 47 Econometrica 263 (1979); Amos Tversky & Daniel Kahneman, Rational Choice and the Framing of Decisions, 59 J. Bus. S251 (1986); Amos Tversky & Daniel
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a current or perceived state of things. This theory also explains loss aversion, the known endowment effect, etc.\textsuperscript{266} For the purposes of this article it is important to understand, again, that people do not read examples in a void, but rather against their own experiences, and usually they have to implement a rule and use the example to interpret it from a given tax position. They will therefore identify the positive similarities or focus on the negative distinctive features of an example rather than on what it says in isolation about the regulatory language. This, of course, is not unique to tax law or to regulatory examples, yet, the research conducted for this article exposes a complete lack of attention to prospect theory, as regulation authors apparently seek to produce clear, general norms based on the assumption that users of regulations are rational, all-knowing and they do not tax plan around the rules in the regulations. Proper training or even basic guidance could improve the perspective of such authors and help them draft more effectively. Next, the article elaborates on what is needed to achieve this goal.

2. Better Informed Drafting of Examples

Can we improve the writing of regulations to rationalize the use of regulatory examples and make them more effective? The starting point must be understanding that some norms are too difficult to write generally and abstractly and hence require fine-tuning with regulatory examples. It should also be clear that the discretion granted to regulation authors cannot be unlimited, especially when they likely receive little to no training or guidance on how to apply such discretion. This article argues that regulatory examples, even when routinely added,\textsuperscript{267} are not objectionable per se, yet their use should be informed and subject to guidance and restraint.\textsuperscript{268} A better-informed approach to the drafting of examples would take into account biases that are inherent to human thinking, using methodologies to ameliorate their undesirable impact.\textsuperscript{269}

The first conclusion must be that the purpose of an added example

\textsuperscript{266} Kahneman, Advances in Prospect Theory: Cumulative Representation of Uncertainty, 5 J. Risk & Uncertainty 297 (1992).

\textsuperscript{267} Id.

\textsuperscript{268} See, e.g., Cummings, supra note 7, for previous calls for regulatory restraint.

\textsuperscript{269} As one would do in her private life in order to overcome her biases. See, e.g., Kahneman, supra note 145.
should be present and clear. Clear guidance and rules on how to interpret the examples could satisfy this conclusion with relative ease. Authors of regulations may be required to add an explanatory note to the preamble of the regulations about the purpose of the examples added.\footnote{For a more general analysis of the importance and utility of preambles for regulatory interpretation, see Kevin M. Stack, \textit{Preambles as Guidance}, 84 GEO. WASH. L. REV. 1252 (2016) (explaining that preambles are a ubiquitous, authoritative, and important source of guidance, yet one that has been largely unmentioned in the debates over agency reliance on guidance and arguing that the preamble has a dual role of justification of the regulations and guidance as to their interpretation). This article agrees and argues that preambles similarly could be used to support better understanding of examples in tax regulations.} Alternatively, they may add language that would clarify the examples’ purpose. For instance, the words “merely for illustration of the rule in . . .” or “to illustrate the formula prescribed . . .” may be added to examples that illustrate an element in the regulatory language. These additions may be required as part of simple guidance to regulation authors. Such clarifications would be easier to implement if the government clarified that examples are generally subject to the regulatory language to settle the confusion in practice and in the courts. The requirement of a clear, explicit purpose would likely eliminate those examples that do not have a purpose and would also likely eliminate examples that are unrealistic or do not add anything to the regulatory language. At the minimum, this requirement will force authors to pause and think more deeply about the consequences of adding regulatory examples.

The legal status clarification would help the examples that seem to reshape the contours of the rules, such as in the \textit{Parks} case.\footnote{See Parks v. Commissioner, 145 T.C. 278 (2015).} Accompanying guidance should alert authors of regulations to the difficulty presented by examples that go beyond reasonable interpretations of the regulatory language present. Such guidance may also advise rewriting the regulatory language in cases of doubt.

Explicit guidance should also deal with the problematic targeting practice. The government will likely be reluctant to limit itself in this regard, yet it is difficult to find a valid reason for targeting through regulatory examples rather than through rulings. Written guidance would have to settle the issue one way or the other. Note that even nudging requires transparency and a choice element.\footnote{See Thaler & Sunstein, supra note 28, at 81–100.}

Finally, heuristics and biases, such as anchoring, framing, availability, and representativeness explained above require training and some sophistication to spot and effectively tackle. In the context of regulatory examples, authors of regulations would be best served if they were properly trained in heuristics and biases so they could better identify the actual
impact of their choices. A first important step is to provide them with clear explanations of heuristics and biases and their potential impact on the use of regulations. This should be done with illustrations, such as those provided by this article, so that the authors are at least aware of potential downfalls. Awareness of heuristics and biases is key to every remedial step, and should not be difficult once the government agrees to provide guidance on the writing of regulatory examples.

Next, the article demonstrates how regulation authors could implement awareness to the various challenges, including the cognitive biases, mentioned above, and when the authors should use regulatory examples.

V. A FEW CHALLENGING CATEGORIES OF EXAMPLES AND THEIR APPROPRIATE USE IN REGULATIONS

Regulatory examples are flawed even when their purpose is clear. About 90 percent of the survey's expert participants found deficiencies in the actual drafting of examples. 273 This part elaborates on these deficiencies and their sources. It does not attempt to present a comprehensive report or a complete and optimally detailed categorization of regulatory examples, it merely discusses the most common and most conspicuous categories arising from the survey and the research performed for this article to illustrate the difficulties presented by the unguided use of regulatory examples.

A. Examples That Add Little to the Regulation

A large number of examples add little or nothing in terms of guidance to the regulatory language. These examples simply restate the words of the regulation in an example format, or describe unrealistic or rarely realistic cases, or describe cases that are too simple — so simple that their presentation effectively adds nothing to the language of the regulation. Take Treasury Regulation section 1.132-2(c) for instance, which includes the sole example provided in a fringe benefits regulation (and is different from the coffee example mentioned above) (hereafter the no-additional-cost example). 274 This example explains that the value of services provided to an employee by an employer at no (significant) additional cost does not have to be included in income by the employee. 275 The regulatory language clarifies that whatever is regularly sold to customers may be provided to an employee if such provision does not burden the employer with significant extra costs. 276 A key element for noninclusion is that the employer does not

273 See supra note 22.
275 Id.
276 Id. § 1.132-2(a)(1).
forgo revenue by providing the service to the employee.\textsuperscript{277} Moreover, the regulation specifically provides "(s)ervices that are eligible for treatment as no-additional-cost services include excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services."\textsuperscript{278} The sole example included in this regulation follows, reading: "Assume that a commercial airline permits its employees to take personal flights on the airline at no charge and receive reserved seating. Because the employer forgoes potential revenue by permitting the employees to reserve seats, employees receiving such free flights are not eligible for the no-additional-cost exclusion."\textsuperscript{279}

The example merely illustrates the most expected scenario under this regulation, and one that is fully covered by explicit regulatory language, including specificity (the mention of air tickets). The example simply repeats the regulatory language in a different format, a narrative, and adds nothing to the norm. It also demonstrates the problem that expectations of examples create. The author clearly met these expectations with little analysis of its implications. She was also probably affected by availability, since complimentary air tickets are likely the most salient among the transactions that the regulatory rule tries to prevent (the representative bias and anchoring are at work here too). One may argue the example is merely redundant, but not harmful. However, as already argued, no example is completely unbiased. Although reasonable interpretation must lead one to the conclusion that the example adds nothing to the regulatory language, it could also be read in a manner that would circumvent its purpose — as prohibitive only of relatively high-ticket items such as air tickets, for instance.

The transfer pricing example is another good example for the application of a concept — the arm’s length standard — to a structured fact pattern.\textsuperscript{280} The simple goal of the example, as mentioned, was to demonstrate the application of the rule (the CUT method using internal comparables) as derived from the arm’s length standard.\textsuperscript{281} Yet, in an attempt to create a perfect basic regulatory example, the author of the regulations drafted a completely unrealistic fact pattern, adding nothing in terms of guidance to the regulatory language.\textsuperscript{282} Yet again, the consequence of an unrealistic example is not mere nonimpact. One could infer from the example, for instance, that only perfect comparability permits the

\textsuperscript{277} Id.
\textsuperscript{278} Id. § 1.132-2(a)(2).
\textsuperscript{279} Id. § 1.132-2(c).
\textsuperscript{280} See supra Part II.C.
\textsuperscript{281} See supra Part II.C.
\textsuperscript{282} See supra Part II.C.
application of CUT, which could not have been the intent of the author of the regulations. There are multiple ways to interpret this example, basically making it useful for essentially every reasonable argument a taxpayer (or a government) wishes to make, and hence the example is worse than useless — it is harmful. This example, which is like many or most of the examples in the regulations under Code section 482, fail because they avoid the difficult cases with which the general arm’s length rules struggle — the cases where examples could be useful. Instead, these examples focus on sanitized, “laboratory” fact patterns that a prudent lawyer should easily analyze correctly based on the regulatory language alone, yet another lawyer devoted to her clients (or to the government) could interpret differently. The examples only complicate matters, as they distract from the prescribed norms, as evidenced by the survey discussed in this article. The survey asked the participants to mention a single example they “love” or “hate,” and the transfer pricing regulations were mentioned more frequently than any others in the “hate” category, by almost a quarter of the participants.\footnote{See supra note 22.} Since most of the participants are unlikely to be international tax law experts (the survey covered experts from multiple sub-fields of tax law), this data must mean that most international tax experts view these regulations as the most poorly drafted in terms of example writing in this field.

\section*{B. Examples That Limit or Expand the Scope of the Regulation}

Another issue resides with regulatory examples that define the scope of the norm they support, a controversial practice in terms of purpose as already explained. Such examples present significant design challenges. This article analyzed two good instances of regulatory examples that shape the contours of regulations beyond the regulatory language.\footnote{See supra Part IV.A.3.} First, the Parks case provides an example of regulatory language pursuant to Code section 4945 in which an advertisement that “refers to” ballot measures leads to an excise tax, but it does not explain the level of reference required.\footnote{See supra Part IV.A.3.} An example follows that states this term encompasses reference to messages using language “widely used” or “identified with” specific legislation to expand the prohibition.\footnote{See supra Part IV.A.3.} This means that direct reference to ballot measures is not needed for an effective prohibition of advertisements of the kind analyzed by the Parks Court. The Court indeed followed the example and did not engage in general interpretation of the regulatory

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\begin{enumerate}
\item See supra note 22.
\item See supra Part IV.A.3.
\item See supra Part IV.A.3.
\item See supra Part IV.A.3.
\end{enumerate}
language beyond it. This case raises many interesting questions, yet the first contribution it makes to the analysis in this article is that it confirms the importance of examples in the practice of tax law, and demonstrates that it would be unrealistic to expect tax experts always to approach the examples against a complete and balanced interpretation of the regulatory language that they accompany. A second question that this case raises is why the author of the regulations did not simply include the precise, expansive, language that she viewed as correct in the regulatory language. To have included precise language seems simple enough in this case. Any interpretation of this decision beyond a lack of thinking about the consequences of the drafting routine would be very unflattering.

The second example of the same category is found in Treasury Regulation section 1.1275-5(d), Example 5, also mentioned above. The example denies favorable treatment to debt instruments linked to the S&P 500 index, even though such treatment is generally granted to debt instruments linked to “objective rates” that are beyond the control of the relevant taxpayer (and hence, presumably do not present a risk of abuse). The example simply assumes based on historical data that the index always increases in value, resulting in a significantly “back-loaded” instrument — an assumption that is false and diverts from the seemingly obvious focus of the norm, which is to deny certain debt instruments such beneficial tax treatment because they are deemed abusive as they could easily be tailored by taxpayers to meet the basic VRDI requirements. The example therefore limits the scope of the VRDI rule, yet with no explanation, and does so in contradiction to the regulatory language. In this case the example was clearly not routinely added; the author of the regulations simply wanted to disadvantage index linked debt, or, maybe, limit the scope of VRDI based on objective rates. Yet, again, it is difficult to see why the author has not utilized different, more restrictive regulatory language in that case.

Finally, many examples provide numerical thresholds, such as the one mentioned above in the continuity-of-interest example. Some of these are very helpful as illustrations of otherwise difficult to apply norms, yet others expand or limit the scope of norms in manners that may be inappropriate or undesirable, as explained above in the discussion of anchoring and the continuity-of-interest example.

287 See supra Part IV.A.3.
288 See supra Part IV.A.3.
289 See supra Part IV.A.3.
290 See supra Part II.B.
291 See supra Part IV.B.1.
292 See supra Part II.B.
C. Examples That Blur the Scope or Aim of the Regulation or the Law (or Contradict Them)

According to the survey discussed in this article, other unfavorable examples include those that contradict the regulatory language or contradict other examples. Such examples come up in a variety of scenarios. Some simply refer to old law and were overlooked in the revision process; some are honest drafting mistakes; and some are likely the result of unclear statutory or regulatory norms that could not be remedied, despite the common effort by regulation authors to do so.

Unrealistic examples, such as the transfer pricing example mentioned above, generally obscure the scope and aim of regulations. Yet, when the examples contradict the regulatory language, they are always counterproductive. A good example of this is an illustration of the treatment of mixed business and personal travel expenses. Treasury Regulations section 1.162-2(b)(2) provides: “Whether a trip is related primarily to the taxpayer’s trade or business or is primarily personal in nature depends on the facts and circumstances in each case.” Yet, it is illustrated with an example of a taxpayer who travels for six weeks, spending the first week on activities related to her trade or business and the following five weeks on vacation. An identical example appears in Treasury Regulations section 1.162-5(e) in the context of educational expenses, where the taxpayer spends the first week attending a tax course and the rest of the six weeks on vacation. It is obvious that the author of the regulations wished to clearly illustrate that the taxpayer in these examples had vacation as her primary purpose of the tested trip. However, at the same time, the examples use durations that are rare in the United States where few employees are able to spend six weeks away from work, including five of them on vacation. Further, this very situation is discussed in Treasury Regulations section 1.274-4, which disallows certain expenses for mixed personal and business foreign travel expenses. Although this regulation focuses on foreign travel, there is no material difference in the applicable norm. The examples in Treasury Regulations section 1.274-4(g) are much more realistic than those mentioned above, using a maximum vacation period of two weeks, and, applying a different norm: the vacation portion cannot exceed 25 percent of the total time of the foreign travel when travel is beyond one week — a test that is very different from the facts and circumstances test

293 See supra Part II.C.
295 Id.
296 Treas. Reg. § 1.162-5(e), ex. 2 (1967).
mentioned in the other regulations. It is not difficult to observe the inconsistencies within these regulations and the contribution of the examples to the lack of clarity in what should be a straightforward matter. Moreover, although the Service learns from its drafting mistakes, as demonstrated next, one cannot argue that flawed drafting typifies only older regulations; this case, for instance, the better drafting predates the less realistic examples.

As mentioned, the Service has attempted from time to time to revise regulations to fix inconsistencies, yet usually these revisions become long overdue before they are made. For instance, the 2015 final Code section 851 regulations revised the examples that illustrate how the controlled group rules applicable to regulated investment companies (RICs) affect the RIC asset diversification requirements. Code section 851 provides these requirements, including a 25 percent test. When ascertaining the value of a taxpayer’s investment in the securities of an issuer, in order to determine whether the 25 percent tests have been met, a taxpayer’s proportionate part of any investment in the securities of the issuer that are held by a member of the taxpayer’s controlled group, must be aggregated with the taxpayer’s investment in the issuer. The old examples, as well as the 1942 legislative history, led taxpayers to interpret Code section 851(c)(3) as requiring two levels of controlled entities in order for a controlled group to exist. The final regulation’s new examples now clarify that two corporations are sufficient to constitute a controlled group so long as the ownership requirements of section 851(c)(3) are met.

Another example of contradictory examples can be found in the software regulations of Treasury Regulations section 1.861-18. As
explained above, these important regulations attempt to regulate the characterization of software transactions that have presented very difficult cases for taxpayers and tax authorities worldwide. The regulations are impactful, but the content is not always intellectually defensible. Some examples are difficult to understand, and, even more importantly, some examples defy the purpose of the regulations — usually by presenting a roadmap for taxpayers to achieve their desired tax consequences. This could not have been the intent of the regulations' authors. Note that this article has no quarrel with the decision to include regulatory examples in the software regulations. The regulatory norm prescribed an algorithm for characterizing software transactions, and it was appropriate to use examples to illustrate the application of such an algorithm. Moreover, the scenarios described by the software regulations were quite relevant to the industry regulated. The problem was in the choice of the detailed examples and their analysis, and especially the combination of Examples 8, 9, and 10, which cannot be fully reconciled with each other but effectively incentivize taxpayers to restructure transactions wastefully to avoid United States taxation based on a roadmap that would not have been easily inferred from the regulatory language but is recklessly articulated by the examples.

There are several hundred examples in the regulations, and therefore the comprehensive analysis of each of them is beyond the scope of this article. The article merely points to a few salient examples of flaws in the use of examples in order to advocate a better-informed process for their drafting. Next, the article provides a preliminary modest proposal on how to begin this process.

VI. A MODEST PROPOSAL

The most basic prescription for better-informed regulatory example writing includes explicit guidance to drafters on why, when, and how to include regulatory examples. It should further encourage mindfulness of

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306 See supra Part IV.A.2.
307 See supra note 178.
308 The VRDI example analyzed in the Part III.A.3 suffers from the same issues.
309 Note that in the more general context of administrative guidance there is a discourse over the desirable review process. Elizabeth Magill advocated that courts demand that agencies explain their choices of procedural modes, not just in the context of guidance documents. Elizabeth Magill, Agency Choice of Policy Making Form, 71 U. CHI. L. REV. 1383, 1412–15 (2004). Mark Seidenfeld preferred ex-post judicial review to explanations and other suggestions because he thought it would be difficult for stakeholders to obtain review if even perfunctory explanation were provided. Mark Seidenfeld, Substituting Substantive for Procedural Review of Guidance Documents, 90 TEx. L. REV. 331, 334, 373–94(2011). He also argued that the need to explain would likely mire down the agency and thereby significantly discourage appropriate use of guidance documents. Id. at 374–75.
the impact of cognitive processes, including biases, on the effectiveness of such examples, resulting in improved accountability. This section provides a modest proposal on how to initiate this process conservatively.

A. Explicit Drafting Guidance

The first, and most important, proposal of this article is that the Treasury Department provide regulation authors with explicit guidance on the drafting of regulatory examples. The drafting proposed below is derived from the insights of this article.

1. Clientele

First, the guidance should establish a standard for drafters to follow with respect to the target audience of examples. The article proposes to clarify that examples are written primarily for the benefit of tax experts, yet they should be balanced in terms of generality to accommodate the average, capable tax expert.

2. Purpose

The article further recommends that the purpose of regulatory examples should be stated explicitly and clearly. The guidelines could satisfy this requirement with relative ease, by requiring such language to be added to the preamble of the regulations. Alternatively, the guidelines should require additional regulatory language that would clarify the examples’ purpose. For instance, the words “merely for illustration of the rule in . . .” or “to illustrate the formula prescribed . . .” may precede examples that merely illustrate an element in the regulatory language. It would be desirable to advise authors to avoid including examples that add nothing to the regulatory language, or describe trivial or unrealistic fact patterns.

Such clarifications would be easier to implement if interpretation rules were also adopted. Most importantly, the government could clarify that examples are generally subject to the regulatory language to settle the
confusion in tax practice and in the courts over this matter. The interpretation rules may also settle potential controversies created by examples described in this article as reshaping the contours of the rules, such as the example featured in the Parks case.\textsuperscript{310} The guidance should alert the authors of regulations to the difficulty presented by examples that go beyond reasonable interpretations of regulatory language. Such guidance may also advise rewriting the regulatory language in cases of doubt.

Finally, the issue of targeting should be addressed. The government would likely be reluctant to limit itself in this regard, yet it is difficult to find a valid reason for targeting not to be shifted back from regulations to rulings.

3. Drafting

Even when a clear and permissible purpose for including an example in a regulation is acknowledged, the regulation’s author should ask herself whether the addition of the example is necessary. Perhaps rewriting the regulatory language or the relegation of the narrative to another type of Service proclamation, such as a ruling, would be more appropriate.

Examples are currently embedded in the regulatory language, or separated, often under a separate heading: “examples.” The drafting guidance should alert the author of regulations to the benefits of each method. If the recommendation to embed examples in the regulatory language is adopted, it should be used in cases where elaboration is required, such as a closed list of items, or, more specifically, in the case of the no-additional-cost services example noted above.\textsuperscript{311} Otherwise, examples should be separated from the regulatory language, preferably with additional language that clarifies their purpose as recommended above.

The use of examples to illustrate methodologies, formulae, and the like, such as in the case of the section 1060 example, noted above,\textsuperscript{312} should be encouraged, since these are difficult to understand using the abstract regulatory language alone. The guidance should, however, alert regulation authors to use additional caution when they contemplate the addition of other types of specificity examples. General regulatory examples, such as those where the author of a regulation believes an illustration of a prescribed norm is useful, are inherently vulnerable to the impact of cognitive biases. The coffee example is used throughout this article to demonstrate this vulnerability.\textsuperscript{313} The interpretation rules mentioned above


\textsuperscript{311} See supra Part V.A.

\textsuperscript{312} See supra Part II.C.; supra Part IV.A.1.

\textsuperscript{313} See supra Introduction.
go a long way toward fixing it, yet they are not sufficient. The guidance should alert regulation authors to the impact of heuristics, such as anchoring, framing, availability, and representativeness.

Beyond alert, better understanding of cognitive biases could assist the government to nudge taxpayers (in the Thaler & Sunstein sense\(^{314}\)) to respond in certain, desirable ways. One may argue whether such practice would be appropriate, yet this article prefers to remain agnostic on this question. Nevertheless, the article proposes that the guidance include specific terms for such use, such as the requirement for provisions to be clear and unambiguous, reflecting the purpose of the prescribed rule. For example, if targeting were considered appropriate and regulation authors chose to use an example for this purpose, they should clarify in the example the decisive offensive act, and why such a transaction has been targeted. The regulation’s authors should be cautioned to consider conflicts between the regulatory language and the targeting example, such as in the case of the VRDI example.\(^{315}\) They should also be cautioned to consider the breadth of such targeting when administered through regulations, albeit in examples.

Finally, the guidance should prescribe a procedure for avoiding conflicts among examples in the same and in different regulations — a procedure that could resolve the inconsistencies found in the mixed work and vacation examples discussed above.\(^{316}\)

4. Revisions

Examples, like other rules, may become obsolete. In general, the public comments assist the government in spotting obsolete examples or examples that become conflicting due to new rules or examples.\(^{317}\) The drafting guidance should include a statement to this effect.

**B. Education: Mindfulness About Cognitive Biases**

Cognitive bias, as explained, is difficult to overcome since it is part of normal human cognition. Yet, because bias is systematic, it is possible to predict and sometimes counter it; mindfulness about bias is helpful in ameliorating its potentially undesirable impact.\(^{318}\) Therefore, this article proposes that the drafting guidance include relevant, basic information about heuristics and biases in order to alert regulations’ authors to their

\(^{314}\) See supra note 28.

\(^{315}\) See supra Part IV.A.3.

\(^{316}\) See supra Part V.C.

\(^{317}\) See, e.g., supra notes 299–304 and accompanying text. Note the long time it took for the government to revise the regulatory examples under I.R.C. § 851. Id.

\(^{318}\) See, e.g., KAHNEMAN, supra note 145.
potential harm. Cognitive biases could be used intentionally to strengthen a point or to nudge taxpayers. Educating authors in this field would result in better-informed regulation drafting.

C. Implications for Regulatory Interpretation

Legal scholarship about regulatory interpretation is in its infancy. The rise of the regulatory state requires a theory of interpretation of regulations, yet, despite the acknowledged differences between statutes and regulations, most of the relevant scholarship has drawn upon the extensive and time-honored work on statutory interpretation. The scholarship promoted ideas such as literary, purposive, and intent-based interpretation of regulations, none of which achieved much prominence. It is not surprising then that a general interpretation theory for regulatory examples has yet to emerge. The complete lack of reference to the difficulties inherent in interpreting the regulatory examples present is, however, more surprising. As already mentioned, one would expect the courts at the very least to have taken an explicit position on the matter. Yet, as demonstrated in Part I, the courts, in similar form to the rest of the tax bar, have crudely avoided it. In response, a recent article by Morse and Osofsky introduced a new theory for interpretation of examples that generally calls for a common law, analogy-based reasoning to uncover the law inherent in the regulatory scheme. They view regulatory examples as mini-cases in support of the regulatory language. The purpose of this article is not to present a competing interpretation theory to that of Morse and Osofsky.

319 See, e.g., Frank C. Newman, How Courts Interpret Regulations, 35 CALIF. L. REV. 509 (1947) (noting the similarity of regulations and statutes, yet arguing that their differences should give rise to a separate study of appropriate regulatory interpretation); Lars Noah, Divining Regulatory Intent: The Place for a "Legislative History" of Agency Rules, 51 HASTINGS L.J. 255 (2000) (pointing to the practice of similar interpretation of statutes and regulations and arguing that courts should give more weight to the original drafting intent of the relevant agencies); Kevin M. Stack, Interpreting Regulations, 111 MICH. L. REV. 355 (2012) (stating additional differences between statutes and regulations, leading to the conclusion that different interpretation theories are required); Russell L. Weaver, Judicial Interpretation of Administrative Regulations: An Overview, 53 U. CIN. L. REV. 681 (1984) (reviewing regulatory interpretation approaches by different courts).

320 See, e.g., Jennifer Nou, Regulatory Textualism, 65 DUKE L.J. 81 (2015) (emphasizes the careful negotiation and drafting of regulations, further suggesting a variety of sources, with a determination of hierarchy, to assist in the proposed textual interpretation of regulations).

321 See, e.g., Stack, supra note 319.

322 See Noah, supra note 319.

323 See supra Part II.B.

324 Morse & Osofsky, supra note 14.

325 Morse & Osofsky, supra note 14.
since they develop their theory on the basis of the existing legal scheme. The article instead focuses on the existing legal scheme, its flaws, the reasons for such flaws, and recommendations for reform. The analysis presented by this article does, however, give rise to a few comments regarding the interpretation that should not be ignored.

The first, and most obvious point, relates to the status of examples vis-à-vis the regulatory language. Morse and Osofsky view the examples as part of, and equal ("co-equal" in their terms) to the regulatory language.\footnote{Morse & Osofsky, supra note 14.} This approach is technically reasonable and legally quite standard. As mentioned, the "co-equal" approach was used with no further discussion by some courts.\footnote{Morse & Osofsky, supra note 14; supra Part II.B.} Yet, it contrasts with the other approaches adopted by some courts and many practitioners that subject examples to the regulatory language. Morse and Osofsky's approach also ignores the language that often accompanies examples: the word "example" itself, the word "illustrates," and the term "could be illustrated" etc. This article prefers the latter approach, contrary to Morse and Osofsky, and, further, advocates the adoption of an explicit regulatory rule that subjects examples to the regulatory language. Such a rule would resolve many of the interpretation ambiguities that examples present and would therefore eliminate the need for complex interpretation endeavors. Moreover, the adoption of this rule would not limit the government's regulatory power, which seems to be the concern of Morse and Osofsky, but would instill discipline in the regulatory drafting process by requiring more precise drafting. Consequently, the interpretation rule proposed by this article is necessarily superior to the current state of the law, even if it were well theorized in accordance with Morse and Osofsky.

Secondly, this article's analysis of regulatory examples, their purposes and the motivations surrounding their use lend to a few conclusions that are relevant to the development of any regulatory interpretation theory.\footnote{Yet, any conclusions beyond tax law are outside the scope of this article.} Dominant textual interpretation of the examples in tax regulations raise serious effectiveness concerns. Suffice it to mention the impact of the cognitive biases mentioned by this article in contexts such as continuity-of-interest,\footnote{The continuity-of-interest example. See supra Part II.B.} de minimis fringe benefits,\footnote{The coffee example. See supra Introduction.} and VRDI\footnote{The VRDI example. See supra Part IV.A.3.} to demonstrate that even the most capable textual interpreter would face challenges in some nonobvious cases, such as the status of expensive healthy snacks. Moreover, if the text is not supported with clear articulations of the purpose

\begin{thebibliography}{9}
\bibitem[326]{326} Morse & Osofsky, supra note 14.
\bibitem[327]{327} Morse & Osofsky, supra note 14; supra Part II.B.
\bibitem[328]{328} Yet, any conclusions beyond tax law are outside the scope of this article.
\bibitem[329]{329} The continuity-of-interest example. See supra Part II.B.
\bibitem[330]{330} The coffee example. See supra Introduction.
\bibitem[331]{331} The VRDI example. See supra Part IV.A.3.
\end{thebibliography}
of the examples as proposed by this article, there will continue to be very few sources to assist in the accurate "purposive" interpretation of regulatory examples. Intent based regulatory interpretation also raises serious substantive and evidentiary concerns. Again, if the intent is manifested in the explicit, stated purpose then it cannot be superior to purposive interpretation, and if not, then intent based interpretation would likely lead to the same confusion that examples are met with at present, as clearly reflected by the survey and the analysis presented by this article. Finally, purposive interpretation seems superior to the other regulatory interpretation proposals, yet unless regulatory examples are accompanied by an explicit, stated purpose, purposive interpretation would likely be employed as it is at present: with confusion. The most immediate concern about regulatory examples is not how to interpret them in the context of the regulatory language, but to determine their role in the regulatory scheme. Once such role is clear: interpretation would be significantly simplified.

D. Next Steps

This article is just the first step in the study of examples in tax regulations. There are many more problematic examples that were noted by survey participants yet were not analyzed by this article due to space constraints. The analysis in this article consciously chose to draw on examples from various areas of tax law. One cannot escape the conclusion that the situation is quite similar regardless of the particular area discussed. The analysis will surely benefit from further study of the different areas of tax law to establish whether they deserve special guidance in this regard. The behavioral analysis similarly could benefit from further study and specific experimentation.

VII. CONCLUSION

Examples in tax regulations are generally favored by all stakeholders. The government encourages their ubiquitous use in the drafting of tax regulations, and taxpayers, primarily through their expert tax advisers, heavily rely on examples to navigate through the notoriously complex tax rules. Despite the ubiquity of these examples, there is no published guidance for their drafting, their use, or their interpretation. This article is the first to question the rationale behind this common, unchallenged practice and to argue for its regulation.

The article exposes the practice, first by classifying the types of examples added to tax regulations. It does so to enable a better understanding of the advantages and deficiencies in the current use of regulatory examples. To this end, the article utilizes data collected from original surveys of expert tax professionals and of government employees,
who are (or were) involved in the drafting of tax regulations. The article exposes the lack of clarity with regard to the intended clientele of regulatory examples, and it concludes that the only likely users are expert tax professionals. The article adds that even among experts there are significant differences in the perceived target audience of regulatory examples, leading it to recommend a drafting standard that would ensure that complexity levels are set with the average capable tax expert in mind.

Beyond the clientele question, the article demonstrates the lack of clarity regarding the appropriate purpose of regulatory examples. It demonstrates that some examples are simply redundant and purposeless, while others serve multiple purposes that may be difficult to identify. Finally, the article raises the possibility that certain purposes are not appropriate for regulatory examples, primarily discussing the targeting of certain taxpayer actions or transactions through general regulations rather than taxpayer specific rulings.

Despite these deficiencies, examples have a strong appeal for all stakeholders. The article explains this appeal, its benefits and its potential hazards, using insights from behavioral science and particularly from the study of cognitive biases. It explains, for example, how anchoring via an example, rather than regulatory language, could shift the focus of a regulatory rule and alter the boundaries of the law in inappropriate or unfair ways. The article further argues that cognitive biases affect both regulation authors and users in less transparent and much less controllable manners than realized. This analysis makes the point that a more careful and better-informed process could improve the clarity and the precision of the rules — goals that match the very reason for adding examples to regulations in the first place.

Relying on this analysis, this article proposes a better-informed approach to the drafting of regulatory examples. It focuses on the need for a better-informed approach together with regulatory restraint. This approach to the drafting of examples would take into account the biases that are inherent to human thinking, and hence to the reading and use of examples, and would design a methodology to ameliorate the undesirable impact of such biases. The proposed approach also emphasizes

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332 Even when fully performed, monitoring of regulation projects is sub-optimal due to the group work practice within the Treasury. Group work is both desirable, as it increases the depth of expertise involved, and undesirable, as it may amplify biases of the kind discussed in this article. See e.g., Seidenfeld, supra note 74, at 535–47. Consistently, scholars have supported controversial judicial review of rulemaking to counter some of these undesirable effects. See, e.g., Seidenfeld, supra note 74, at 514–15.

333 See, e.g., Cummings, supra note 7, for previous calls for regulatory restraint.

334 As one would do in her private life in order to overcome her biases. See, e.g., KAHNEMAN, supra note 145.
transparency of goal and impact; a proposal that should guide both the drafters and the users of examples. The article finally adds a few modest, concrete proposals that would clearly and cheaply improve the process, and support future study towards more nuanced guidance.

One cannot expect regulation drafting to be flawless, yet reasonable drafting must meet certain expectations to serve its purpose. This article argues the guidance it proposes would make the use of regulatory examples more effective, contribute to the clarity of tax law in the United States, and hopefully make it a bit less surreal.