

SPECIAL REPORT

November 1993, No. 25

The High Cost of Tax Compliance for U.S. Business

By Arthur Hall
Senior Economist
Tax Foundation

The tax compliance costs—the “paperwork burdens”—of the U.S. business community consistently account for about two-thirds or more of the total compliance costs for all taxpayers. The Tax Reform Act of 1986, in part, sought to reduce this cost. The Act’s proponents billed it as, among other things, tax simplification.

The evidence shows, however, that the simplification effort failed to reduce compliance costs. An Arthur D. Little study—commissioned by the Internal Revenue Service and using IRS data—showed that simplification failed to reduce costs for small businesses; and for big business, a

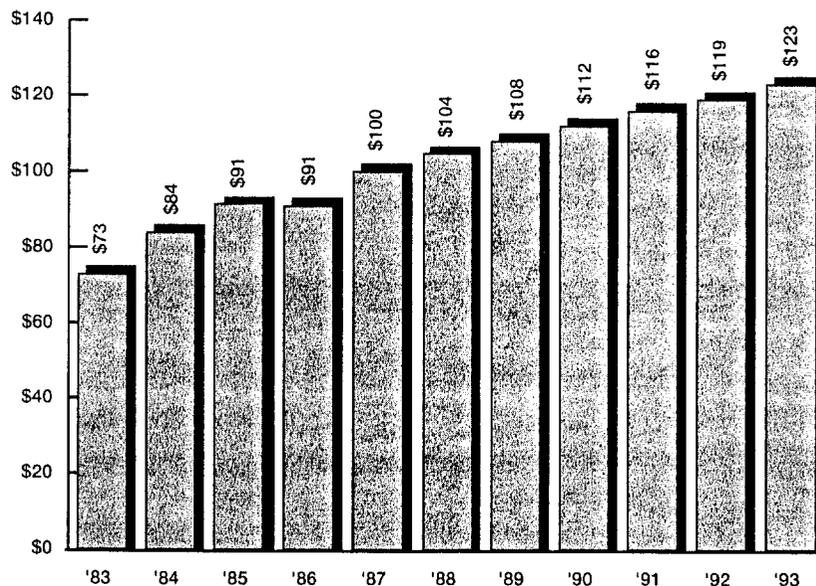
new Tax Foundation study conducted by Professors Joel Slemrod and Marsha Blumenthal reports that “there is near unanimity among senior corporate tax officers that the Tax Reform Act of 1986 added complexity to the tax system, resulting in a combination of higher compliance costs and less accurate information transmission [to the IRS].”¹ *Figure 2* shows the aspects of the Act that tax executives believe created the most complexity.

Despite efforts by the IRS to reduce the cost of tax compliance, the Tax Reform Act of 1986 and subsequent legislation has generally thwarted these efforts. For example, the tax provisions of the Omnibus Reconciliation Act of 1993 created six new tax forms and caused a revision of more than 50 existing forms.² The progress the IRS is making to reduce the cost of compliance is revealed in *Table 1*. The hours of business paperwork remains relatively flat despite the upward trend in the number of business returns filed. The continuous flow of new tax legislation accounts for the lack of progress in reducing compliance costs.

Figure 1 shows estimates of the total dollar cost of federal tax compliance for American business. For 1993, the estimated total business cost of tax compliance is \$123.4 billion. That sum corresponds to a per company average of \$6,080.30. *Figure 1* also shows that compliance costs rose about 10 percent following the 1986 Act, corroborating the results of the Tax Foundation and Arthur D. Little studies.

However, simple averages are misleading. Small corporations have a significantly higher relative cost of compliance than do the nation’s largest corporations. As *Figure 4* and *Table 5* show, corporations with annual sales of less than \$1 million face a compliance cost burden relative to sales about 10 times greater than corporations with annual sales of more than \$10 billion. This ratio probably gets even larger as firms get increasingly smaller.

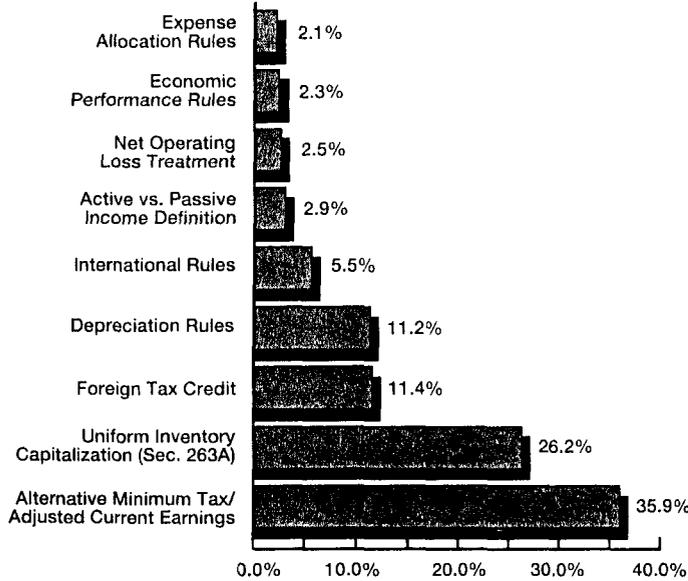
Figure 1
Estimated Total Cost of Compliance for American Businesses, 1983-1991
(\$Billions)



Note: Includes all corporations, partnerships, and nonfarm sole proprietorships.

Source: Tax Foundation; Internal Revenue Service.

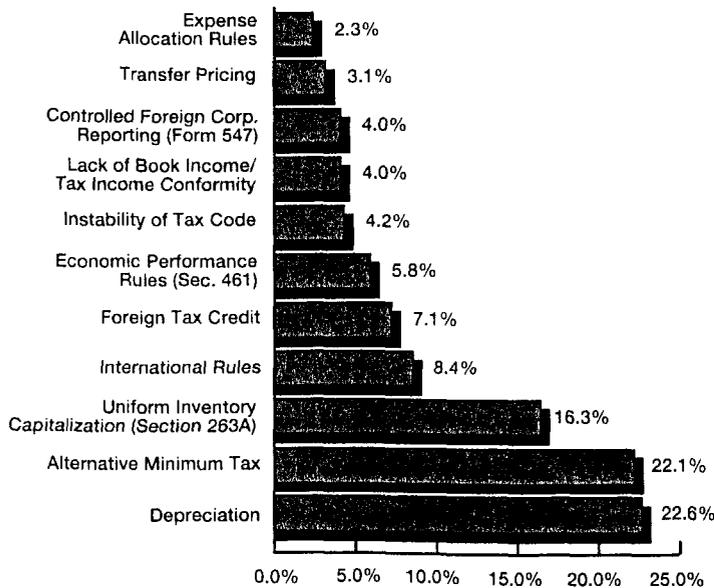
Figure 2
Where the Tax Reform Act of 1986 Has Made the Tax Code More Complex
(Percent of total survey mentions)



Note: 311 of 365 survey respondents answered this question. Many respondents listed more than one aspect. Only the responses receiving at least 10 mentions were included.

Source: Tax Foundation.

Figure 3
Where the Tax Code is Most Complex
(Percent of total survey mentions)



Note: 315 of 365 survey respondents answered this question. Many respondents listed more than one aspect. Only the responses receiving at least 10 mentions were included.

Source: Tax Foundation.

This major difference in relative compliance costs implies that the corporate income tax is an inefficient revenue source except when imposed on the very largest corporations. However, approximately 82 percent of U.S. corporations have annual sales of less than \$1 million. These firms face extremely high compliance costs relative to the tax revenue they provide.

The IRS and Tax Foundation Surveys

Both the Arthur D. Little and the Tax Foundation studies arrived at their results by conducting taxpayer surveys. But the two studies differ in two important respects: They each have a different scope and they have a different set of survey respondents.

The Arthur D. Little survey studies the overall paperwork burden (calculated in hours) imposed on the business community as a result of complying with the federal tax reporting system administered by the IRS³ (the underlying notion being that hours of paperwork is a reasonable gauge of overall compliance effort). The total hours are meant to reflect costs associated with compliance with federal income taxes, employment taxes, and their associated regulations. The business paperwork burden estimates derive from a representative survey sample of 1,106 corporations (including Subchapter S corporations) and 368 partnerships. Sole proprietorships were not included in the business survey.

Despite the exclusion of sole proprietorships from the Arthur D. Little survey, the respondents represent small business in the United States fairly well. At least 98.6 percent of the Arthur D. Little respondents had less than 500 employees, the Small Business Administration's line of demarcation for defining a small business. By Arthur D. Little's own reckoning, about 50 percent of their respondents represent "small" businesses with less than \$100,000 in annual sales; and 89.1 percent had less than \$1 million in annual sales. Finally, of the 1,090 corporate respondents that listed their asset size, only one company had assets in excess of \$250 million and only nine corporations had assets greater than \$10 million.

The Tax Foundation study, by contrast, sought to quantify the "annual incremental cost" of the income tax at both the federal and state/local levels and explicitly surveyed big business in the United States. "Incremental cost" was defined to mean what respondent companies "could save over the long run if these taxes were eliminated," excluding the tax liability itself. Of the 365 companies that responded to the Slemrod and Blumenthal survey, at least 80

Table 1
Hours of Paperwork and Estimated Labor Cost

	Paperwork Hours (Billions) ¹	Labor Cost per Hour	Compliance Cost (\$Billions)	No. of Business Returns (Millions) ²	Average Business Cost of Compliance
1983	2.8	\$26.1	\$73.1	15.2	\$4,807.50
1984	3.1	27.2	84.3	16.1	5,234.90
1985	3.2	28.3	90.6	17.0	5,328.90
1986	3.1	29.5	91.3	17.5	5,219.40
1987	3.3	30.2	99.6	18.3	5,440.40
1988	3.3	31.4	103.7	18.9	5,486.00
1989	3.3	32.7	107.9	19.5	5,534.20
1990	3.3	34.0	112.3	20.3	5,529.80
1991	3.3	35.3	116.4	20.3	5,733.10
1992	3.3	36.2	119.3	20.3	5,877.00
1993	3.3	37.4	123.4	20.3	6,080.30

Note: The business paperwork hours originally estimated by Arthur D. Little for the years 1983-1985 were, respectively, 2.7, 3.3, and 3.6 billion.

1. 1983 through 1987 and 1993 are estimated by the IRS as of October 26, 1993. 1988-1992 are Tax Foundation estimates, since neither the IRS nor OMB keep consistent records of the year-by-year total paperwork burden, or the elements that comprise that burden.

2. Includes all corporations, partnerships, and nonfarm sole proprietorships. The number of returns for 1991-1993 are estimates. All of the growth from 1987-1990 comes from the increasing number of sole proprietorships.

Source: Tax Foundation; Internal Revenue Service.

percent had more than 2,500 employees and 60 percent had more than 5,000 employees. About 89 percent of the respondents had assets in excess of \$250 million and more than 10 percent of the respondents had assets greater than \$10 billion. In addition, 91 percent of the respondents had annual sales in excess of \$268 million. Finally, almost 27 percent of the respondents belonged to the 1992 Fortune 500.⁴

IRS Cost Estimates

Table 1 shows estimates of the total and average dollar cost of the business tax compliance burden, calculated using the hours-of-paperwork-time methods developed by Arthur D. Little. As *Table 1* shows, the hours of compliance time calculated by the IRS has remained relatively constant.

Following the procedure used by James Payne in his comprehensive study of the cost of tax compliance, the hours of paperwork required are multiplied by an estimated labor cost.⁵ The labor cost estimate derives from averaging the 1985 per employee cost of Arthur Andersen, Inc. (\$35.47), one of the largest accounting firms in

the United States, and the IRS (\$21.14). *Table 1* takes the resulting average labor cost figure of \$28.31 and adjusts it for the different years by the growth of nominal wages and salaries in the private sector. This adjustment makes it possible to estimate the total cost of federal tax compliance and the per company average cost of compliance, using the hours estimated by the Arthur D. Little methodology. *Table 1* shows the calculations for each item.

Tax Foundation Cost Estimates

It is important to distinguish the results of the Arthur D. Little study from the Tax Foundation study, not only because of the latter's narrower scope, but also because of the existence of economies of scale in tax compliance. That is, as companies get larger, their total cost of tax compliance increases, but it increases at a rate less than proportional to the increase in company size. *Table 4* and *Figure 4* demonstrate this general phenomenon for U.S. companies ranked by U.S. sales. The same general result also holds true when one ranks companies by assets and number of U.S.

employees. Drs. Slemrod and Blumenthal report that the "findings of economies of scale in tax compliance costs is common in studies across countries and across types of tax."⁶

Based on the survey results, the estimated total income tax compliance cost for the Fortune 500 amounted to \$1.055 billion. This total corresponds to a per company average of \$2.11 million.⁷ *Table 2* breaks this average cost into its component parts.

One can see from the items as a percentage of the total average cost that a distinct division of labor exists among the functions. For example, Fortune 500 companies tend to contract out for a high percentage of their research (36.2%), planning (37.2%), and litigation (75.6%) work. Similarly, much (56.1%) of the record keeping and financial statement preparation occurs outside a company's tax department.

Figure 3 shows the areas in which tax executives believe the tax code adds the most to complexity and, therefore, the greatest compliance cost. Most of the elements of *Figure 3* deal with two areas of the income tax code—

either foreign-source income or capital cost recovery (i.e., rules for depreciation). Indeed, for the Fortune 500, at least half of the compliance cost generated by the federal tax code (69.5% of the total cost) is due to these two areas. The rules associated with foreign-source income alone account for an estimated 45.5 percent of federal compliance costs.

In addition, Drs. Slemrod and Blumenthal estimate that, all else being equal, being subject to the alternative minimum tax (mostly the complex depreciation rules) increases a company's compliance cost by 16.9 percent. The high cost of complying with depreciation rules may also explain why Drs. Slemrod and Blumenthal discovered that companies involved in mining or the oil and gas business experience compliance costs significantly above the Fortune 500 average.

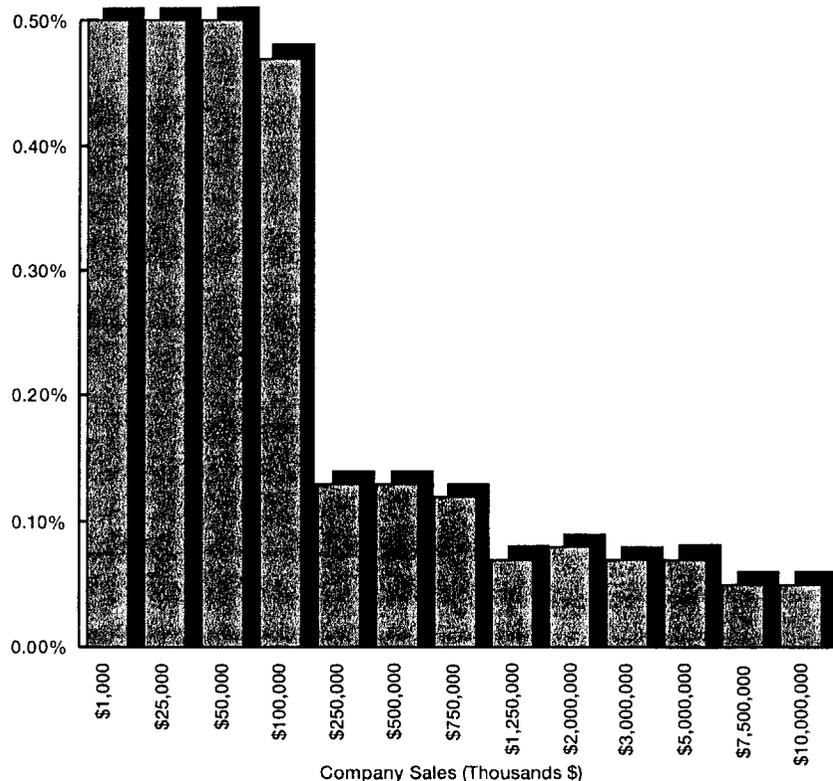
Are the Arthur D. Little and Tax Foundation Results Consistent?

Because the Arthur D. Little study calculated paperwork burdens for particular tax return forms, one can make an estimate of the lower bound of business compliance cost for just the federal income tax. In particular, the Arthur D. Little study evaluates the income tax forms for corporations (Form 1120), Subchapter S corporations (Form 1120S), and partnerships (Form 1065). Isolating these forms, however, ignores a significant segment of the business tax compliance process—such as calculating depreciation schedules—for which specific data is scarce.

For each form, the Arthur D. Little survey collected the number of hours it took to accomplish each of the following six compliance tasks: recordkeeping, obtaining tax advice, obtaining materials, finding a tax preparer, preparing the tax return, and filing the return. Since *Table 1* shows that the total burden is relatively constant over time, the 1983 hours calculation form a reasonable measure for 1992.

Table 3 shows cost estimates constructed to compare IRS average compliance cost figures with the figures resulting from the Slemrod and Blumenthal survey. The figures in *Table 3* reflect the average (weighted by company size) hours it took Arthur D. Little survey respondents to comply with each form for each task. (These hours represent companies that filed using a paid preparer, which represented about 84 percent of the respondent companies.) The total hours are multiplied by an estimate of the 1992 labor cost and an estimate of the total number of partnership returns, Subchapter S corporation returns, and the number of companies with less than \$1 million in assets that filed corporate

Figure 4
Compliance Cost-to-Sales Ratio by Amount of Firm's Annual Sales (Percent)



Source: Tax Foundation. (See Table 4.)

Table 2
Fortune 500 Average Functional Expenditure by Location of Activity
(\$Thousands)

Personnel Functions	Within Firm		Outside	Total
	Tax Dept.	Other Depts.	Assistance	
Record Keeping	\$74.6	\$128.8	\$1.3	\$204.7
Research	96.3	11.2	61.1	168.6
Planning	117.6	16.4	79.5	213.5
Dealing with other				
Personnel	61.4	23.8	10.1	95.3
Filing Returns	268.6	35.2	16.2	319.9
Audits	114.5	27.5	29.7	171.8
Appeals	30.3	4.3	33.8	68.3
Litigation	18.5	2.6	65.7	86.9
Preparing Information				
for Financial Statements	46.2	36.5	7.1	89.8
Monitoring Tax Process	48.5	10.6	11.5	70.6
Other	0.0	0.0	2.8	2.8
Personnel Total	\$876.6	\$296.9	\$318.8	\$1,492.2
Non-personnel* Total	\$339.8	\$278.4	n/a	\$618.2
Total	\$1,216.4	\$575.3	\$318.8	\$2,110.4

Federal/State Breakdown	Within Firm		Outside	Total
	Tax Dept.	Other Depts.	Assistance	
Federal	\$830.8	\$380.4	\$350.9	\$1,462.1
State	385.6	194.9	67.9	648.4
Total	\$1,216.4	\$575.3	\$318.8	\$2,110.4

* Includes equipment, supplies, etc.

Source: Tax Foundation. (Figure totals may not add up due to rounding.)

returns in 1992 (1990 is the latest data published).

A comparison of *Table 2* (generated from the Tax Foundation study) and *Table 3* reveals another way in which the estimates based on IRS data represent only a conservative estimate of the tax compliance burden. For example, the Arthur D. Little survey excluded research and planning from its list of compliance-related activities. But the increasing complexity and instability of the tax code make tax-related research and planning an important part of business activity. *Table 2* shows that these activities comprise, on average, 25.6 percent of the labor-related compliance costs for Fortune 500 companies.

Nevertheless, combining the results of the Tax Foundation study with Arthur D. Little compliance burden estimates reveals a consistent story. The compliance cost-to-annual-

sales ratios reported in *Table 4* and *Figure 4* clearly show the existence of economies of scale in tax compliance. (A similar result occurs when one uses asset size rather than sales to construct the ratio.)

The level of \$1 million in annual sales seems to be the point when corporations can begin to achieve clear economies in their income tax compliance burden. The approximately 82 percent of corporations with sales less than \$1 million face much larger relative costs.

Notes

¹ Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," Report to the Tax Foundation, July, 1993, p. 20.

² Bureau of National Affairs, Inc., "Daily Report for Executives," October 5, 1993, p. G-8.

³ For the IRS study, see Arthur D. Little, Inc.,

Table 3
1992 Estimated Cost of Federal Income Tax Compliance for Business
By Type of Activity
(\$Millions, except averages)

	Corporations ¹	Sub S Corporation	Partnerships
Recordkeeping	\$4,433	\$3,159	\$2,184
Obtaining Tax Advice	1,026	649	479
Obtaining Materials	612	358	210
Finding a Preparer	867	780	483
Preparing the Return	2,500	2,037	1,306
Filing the Return	310	189	220
Total	\$9,750	\$7,172	\$4,883
Company Average	\$5,025	\$4,553	\$3,143

1. Corporations with \$1 million or less in assets.

Source: Tax Foundation computations based on Arthur D. Little 1983 survey results.

Development of Methodology for Estimating the Taxpayer Paperwork Burden, Final Report to the Department of Treasury, Internal Revenue Service, Washington, D.C., June 1988. For an updated analysis and a source for the numbers in Table 1, see James T. Iocozzia and Garrick R. Shear, "Trends in Taxpayer Paperwork Burden," *Trend Analyses and Related Statistics*, 1989 Update, pp. 51-57.

⁴The 365 respondents to the Tax Foundation survey came from the 1,329 firms active in the IRS's Coordinated Examination Program (CEP), a project that includes mostly large firms, often with unusually complex tax situations. The responding firms, while they represent big business in the United States, do not represent any specific segment of the business community. Professors Slemrod and Blumenthal therefore used statistical techniques to make a subset of the respondents representative of the Fortune 500.

⁵James L. Payne, *Costly Returns: The Burdens of the U.S. Tax System* (San Francisco: Institute for Contemporary Studies, 1993), pp. 23-25.

⁶Slemrod and Blumenthal, p. 9.

⁷The total income tax compliance cost for all responding firms in the CEP (see note four), based on the sample responding to the Tax Foundation study, amounted to \$2.080 billion. That total corresponds to a per firm average of \$1.57 million.

Table 4
Estimated Cost of Corporate Income Tax Compliance by amount of Company's Annual Sales

Annual Sales (\$Thousands)	Compliance Cost-to-Sales Ratio (Percent)	Estimated Compliance Cost
\$1,000	0.50%	\$5,025
25,000	0.50	126,000
50,000	0.50	251,000
100,000	0.47	470,000
250,000	0.13	325,000
500,000	0.13	650,000
750,000	0.12	900,000
1,250,000	0.07	875,000
2,000,000	0.08	1,600,000
3,000,000	0.07	2,100,000
5,000,000	0.07	3,500,000
7,500,000	0.05	3,750,000
10,000,000	0.05	5,000,000

Source: Tax Foundation

SPECIAL REPORT
(ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4-12 pp.
Annual subscription: \$50.00
Individual issues \$8 + \$2 p/b.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

©1993 Tax Foundation

Librarians:
Back issues (January 1990 - November 1992) have been numbered retroactively.

Editor and
Communications Director
Stephen Gold

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005
(202) 783-2760