TAX FOUNDATION
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SPECIAL BRIEF

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The Impact of Tax Complexity on Small Businesses

Testimony Before the Subcommittee on Tax, Finance, and Exports of the House Small Business Committee

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Mr. Chairman and Members of the Committee, it is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the impact of tax complexity on small businesses.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. As such, we do not take positions on specific legislative proposals. The Tax Foundation does not receive any federal funds.

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Ironically, all of their compliance effort is essentially for naught from a public finance point of view because the largest firms in asset size, with assets of more than $250 million, pay well over three-quarters of the corporate income tax take.

Basic Principles

Our goal is to explain as precisely and as clearly as possible the current state of fiscal policy in light of established tax principles, so that you, the policy makers, have the information to make informed decisions. Among these principles, several apply to the issue at hand. A good tax system should: (1) be as simple as possible; (2) not be retroactive; (3) be neutral in regard to economic activities; and (4) be stable.

Because complying with tax laws is a fixed cost for any business, it seems likely that smaller businesses will bear a greater relative compliance burden than larger companies. In fact, this is a common research finding, and all the studies the Tax Foundation has ever conducted on tax complexity demonstrate that economies of scale exist in tax compliance.

In 1996, for example, small corporations — those with less than $1 million in assets — spent at least 27 times more on compliance as a percentage of assets than the largest U.S. corporations — those with $10 billion or more in assets. This is especially important to consider because more than 90 percent of all U.S. corporations have assets of less than $1 million.

Ironically, all of their compliance effort is essentially for naught from a public finance point of view because the largest firms in asset size, with assets of more than $250 million, pay well over three-quarters of the corporate income tax take. Clearly, this disproportionate effort by small firms yields a poor cost-benefit ratio from a public policy viewpoint.

While some tax simplification for small businesses has occurred since 1996, most notably the Taxpayer Relief Act of 1997 (TRA 97), we believe our results remain illustrative of the magnitude in the tax compliance burden faced by small businesses. For instance, two important measures of tax complexity continue to climb-the size of the tax code and the instability of the tax code.

Today, there are more than 1.6 million words in the code. Clearly, these two mammoth volumes must be daunting to a new small business that's trying to focus its talent on developing and marketing product.

The Size of the Code

Figure 1 reveals that the number of words in the tax code has been steadily increasing. In 1955, there were 409 thousand words in the Internal Revenue Code, and 40 years later in 1995 there were more than 1.4 million words. Today, there are more than 1.6 million words. The number of sections in the code has been rising even faster than the word count.

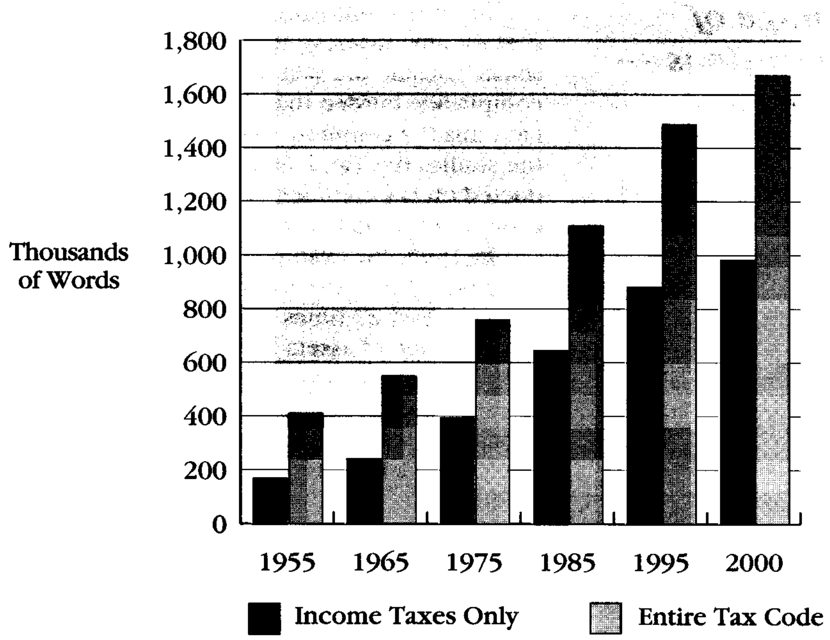
Table 1 shows that in 1954, there were 103 sections; today, there are 725. That's an increase of 604 percent. Clearly, the two mammoth volumes of the code must be daunting to a new small business that's trying to focus its talent on developing and marketing product.

The Instability of the Code

In addition to the complexity associated with the sheer size of the tax code, small businesses must also contend with the instability of the tax code. In other words, it is not just a matter of learning the tax code a single time, rather it is an ongoing process of keeping up-to-date with the latest legislative changes, regulatory changes and tax court rulings.

In terms of legislative changes, Tax Foundation research has found that, on average, every section of the Internal Revenue Code is amended once every four years. This is a direct result of the 32 significant federal tax

Figure 1
Growth of the Internal Revenue Code as Measured by the Estimated Number of Words
Selected Years, 1955 - 2000



Year	Income Tax Provisions Only	Entire Tax Code
1955	171,628	409,421
1965	242,604	547,910
1975	394,985	757,890
1985	644,600	1,106,661
1986	642,842	1,101,094
1987	682,104	1,122,190
1988	689,722	1,143,286
1989	760,628	1,238,804
1990	774,692	1,269,276
1991	758,870	1,265,760
1992	757,112	1,266,932
1993	763,558	1,283,926
1994	806,922	1,339,010
1995	880,758	1,488,440
1996 (a)	899,803	1,520,084
1997	918,848	1,551,728
1998	962,212	1,606,519
1999	973,346	1,661,310
2000	982,136	1,669,514

(a) Interpolated.

Source: Tax Foundation calculations based on the annual publication "Internal Revenue Code" from West Publishing Company.

enactments that have taken place since 1954- or approximately one every 1.4 years.

Learning the tax code ... is an ongoing process of keeping up-to-date with the latest legislative changes, regulatory changes and tax court rulings. ... On average, every section of the Internal Revenue Code is amended every four years.

This legislative instability, however, does not take into account the fact that as tax laws change, so do the regulations that accompany such laws. As a general rule, surges in proposed IRS regulations occur in the first three years after significant tax legislation has been enacted. This is perhaps the most important reason why the jury is still out on TRA 97's effect on tax simplification. These surges in IRS regulatory activity add to the cost of planning and compliance for small businesses in several ways.

First, those small businesses affected by the proposed regulations must, either directly or indirectly through advisors, ascertain how the new tax law environment will alter their economic circumstances.

Second, many small businesses (or their advisors) will expend the resources necessary

Table 1
Comparison of Subsections in the Internal Revenue Code
1954 and 2000

Subchapter of Income Tax Code	Number of Sections in Subchapter 1954	Number of Sections in Subchapter 2000	Percentage Growth
Determination of Tax Liability	4	50	1150%
Computation of Taxable Income	9	152	1589%
Corporate Distributions and Adjustments	14	35	150%
Deferred Compensation	2	31	1450%
Accounting Periods and Methods	6	33	450%
Tax-Exempt Organizations	4	19	375%
Corporations Used to Avoid Income Tax on Shareholders	4	27	575%
Banking Institutions	3	8	167%
Natural Resources	3	10	233%
Estates, Trusts, Beneficiaries, Etc.	7	32	357%
Partners and Partnerships	7	36	414%
Insurance Companies	5	30	500%
Regulated Investment Companies, Etc.	1	22	2100%
Tax Based on Income from Within or Without the United States	9	79	778%
Gain/Loss on Disposition of Property	7	40	471%
Capital Gains and Losses	4	56	1300%
Readjustment of Tax Between Years and Special Limitations	6	7	17%
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	44	450%
TOTAL	103	725	604%

(a) Includes all subchapters not explicitly listed as well as Chapters 2-6 of Subtitle A of the Internal Revenue Code.

Source: Tax Foundation computations from Internal Revenue Code.

to comment on the proposed regulations.

Finally, once the proposed regulations become finalized, small business owners must learn how the new tax laws and regulations interact with the existing body of laws and regulations so that they can most advantageously rearrange their business affairs and portfolios. These rearrangements carry transaction costs in addition to the cost of tax compliance.

The benefits of reducing the tax complexity burden would dramatically benefit small businesses since they currently bear a disproportionate amount of the burden.

Between the changes in legislation and regulation, the tax code is almost always in a state of fluctuation. Such instability also spills over into the tax courts. And since it typically takes a taxpayer's dispute three years to appear on court dockets, small businesses are at an inherent disadvantage not only in terms of the necessary financial commitments but also in the necessary time commitments that such litigation entails.

Conclusion

The tax complexity due to the size and instability of the tax code creates two general types of economic costs. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance and litigation. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty.

Even large businesses may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment, but small businesses are even more in the dark. If small business owners cannot accurately predict the tax consequences of a particular economic activity, either because of the size or instability in the tax code, then tax policy is handicapping the growth and dynamism of small businesses and of the entire U.S. economy.

In conclusion, the benefits of reducing the tax complexity burden would dramatically benefit small businesses since they currently bear a disproportionate amount of the burden. This could be done under a comprehensive revision of the tax code guided by established tax principles, such as those supported by the Tax Foundation. In addition, such tax reform would diminish the need for corrective tax legislation in the future and thereby increase the stability in the tax code and regulations.●

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The Tax Foundation, an independent, nonprofit, nonpartisan research and public education organization. It is classified by the IRS as a 501(c)(3) organization and is chartered in the District of Columbia.

The Tax Foundation has monitored tax and fiscal activities at all levels of government since 1937.

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