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The Rising Cost of Complying with the Federal Income Tax

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Executive Summary

In 2005, taxpayers will pay roughly \$1.2 trillion in federal income taxes. But America's tax burden is more than just the amount of tax paid. It also includes the cost of complying with federal taxes, including tax planning, paperwork and other hassles caused by tax complexity.

In the last century the cost of tax compliance has grown tremendously. This is due partly to the inherent difficulty of taxing income, but also because of growing non-economic demands lawmakers place on the tax code. As Congress debates the tax reform recommendations of the President's Advisory Panel on Federal Tax Reform, Members should address this growing compliance burden, and work to reduce it through tax simplification and reform.

In 2005 individuals, businesses and non-profits will spend an estimated 6 billion hours complying with the federal income tax code, with an estimated compliance cost of over \$265.1 billion. This amounts to imposing a 22-cent tax compliance surcharge for every dollar the income tax system collects. Projections show that by 2015 the compliance cost will grow to \$482.7 billion. (See Table 1 and Figures 1 and 2).

The burden of tax compliance does not fall evenly on taxpayers. It varies by type of

taxpayer, income level and state. In 2005, businesses will bear the majority of tax compliance costs, totaling nearly \$148 billion or 56 percent of total compliance costs. Compliance costs for individuals will be \$111 billion or 42 percent, and non-profits will bear nearly \$7 billion or 2.5 percent of the total.

When examined by income level, compliance cost is found to be highly regressive, taking a larger toll on low-income taxpayers as a percentage of income than high-income taxpayers. On the low end, taxpayers with adjusted gross income (AGI) under \$20,000 incur a compliance cost equal to 5.9 percent of income while the compliance cost incurred by taxpayers with AGI over \$200,000 amounts to just 0.5 percent of income.

State-by-state estimates of the 2005 federal compliance cost also vary widely because state populations and economies differ so significantly. On a per capita basis, Wyoming (\$1,242), Delaware (\$1,181) and Colorado (\$1,167) face the highest compliance cost while Mississippi (\$658), West Virginia (\$689), and Tennessee (\$705) face the lowest. Measured per \$1,000 of income, Montana (\$38), Utah (\$37), and Wyoming (\$33) face the highest compliance cost while California (\$19), Connecticut (\$20) and Massachusetts (\$21) face the lowest.

Why Compliance Costs Matter

It is important for taxpayers to have an estimate of their compliance cost because the performance of the economy is dramatically affected by the level of complexity in tax law. If lawmakers create an Internal Revenue Code that is unnecessarily complex or that changes rapidly, taxpayers will face uncertainty about how taxes will affect a business plan or investment. When the tax consequences of economic activities are unpredictable, tax policy handicaps the growth and dynamism of the U.S. economy.

Studies of the federal income tax code consistently find that the current system is excessively complex. This study concurs, quantifying the code's complexity in a way that makes clear how unnecessary much of it is. If the high cost of complying with the federal income tax were a necessary price to pay for a fair and effective tax system, there would be little room for complaint. But in fact, most complaints are justified.

Measuring the Cost of Compliance

The complexity generated by the growth and constant change of the tax code creates

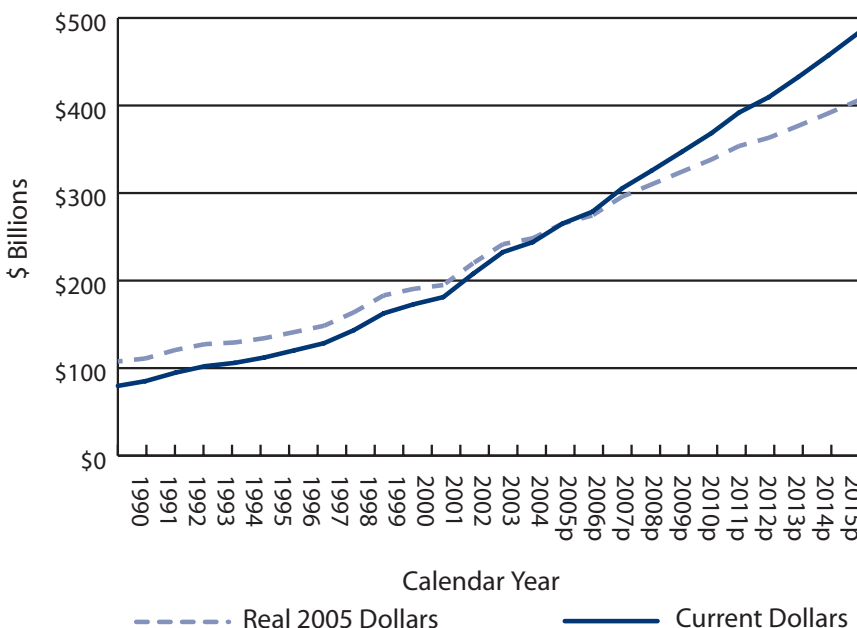
two general types of economic costs: overhead costs and opportunity costs.

The Cost of Overhead

Overhead costs of a tax system can be divided into three activities: tax planning, litigation, and compliance all of which are economically sterile activities that act like tax surcharges on taxpayers.

- *Tax planning* refers to all the economic decisions that individuals and firms make to minimize their tax liabilities under current law.
- *Tax audits and litigation* refer to the economic cost of the IRS and the Tax Court, including the legal costs that taxpayers incur while dealing with these two government institutions.
- *Tax compliance* refers to the basic actions required to file federal income tax re-

Figure 1
Total Federal Income Tax Compliance Costs
1990–2015



Source: Internal Revenue Service, Tax Foundation calculations.

Table 1
Total Federal Income Tax Compliance Costs
Calendar Years 1990–2015

	Current Dollars	Real 2005 Dollars	Percent of Federal Revenue
1990	\$79.7	\$107.6	14.1%
1991	\$85.1	\$111.0	15.5%
1992	\$94.7	\$120.7	16.4%
1993	\$102.2	\$127.4	16.3%
1994	\$106.0	\$129.3	15.6%
1995	\$112.2	\$134.2	15.1%
1996	\$120.3	\$141.2	14.4%
1997	\$128.5	\$148.4	13.9%
1998	\$143.4	\$163.8	14.3%
1999	\$162.6	\$183.1	15.0%
2000	\$172.9	\$190.5	14.5%
2001	\$181.1	\$194.9	16.0%
2002	\$207.7	\$219.8	21.7%
2003	\$232.5	\$241.6	24.8%
2004	\$243.9	\$248.3	24.4%
2005p	\$265.1	\$265.1	22.2%
2006p	\$278.6	\$274.4	21.9%
2007p	\$305.3	\$295.8	22.8%
2008p	\$325.7	\$310.0	23.0%
2009p	\$346.9	\$324.3	22.9%
2010p	\$368.4	\$338.3	22.8%
2011p	\$391.9	\$353.7	21.5%
2012p	\$409.5	\$363.1	20.7%
2013p	\$432.7	\$376.9	20.7%
2014p	\$457.2	\$391.1	20.7%
2015p	\$482.7	\$405.8	20.7%

turns, including record keeping, education, form preparation and packaging/sending.

Of these three costs, tax compliance is the only one estimated in this report. It is for this reason that the data presented here should be viewed as extremely cautious estimates of taxpayers' federal income tax compliance cost.

Opportunity Costs

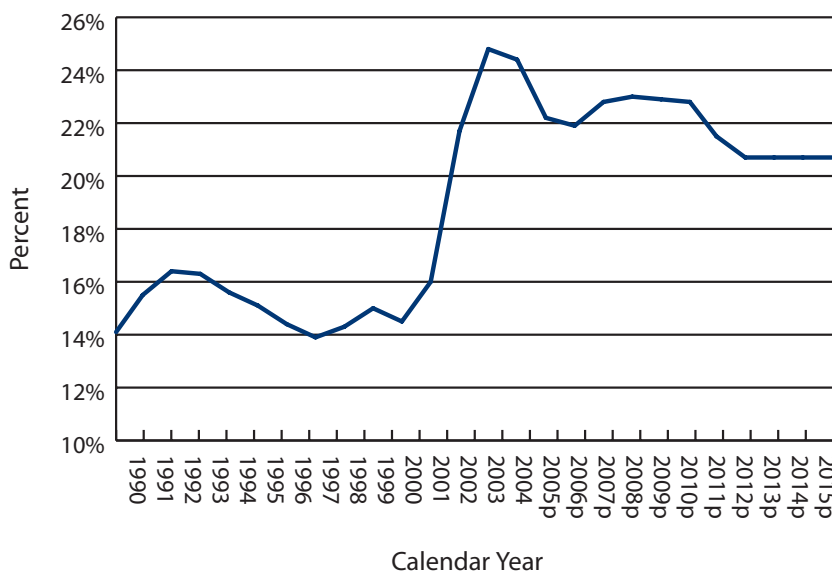
The second general type of economic cost caused by the tax system is opportunity cost. Opportunity costs are the lost value activities that are displaced by the tax system. For example, wage-earners are currently required to have federal income taxes withheld from their paychecks, in essence, forcing taxpayers to prepay their income taxes. As a result, they forgo the economic returns (interest, profit, dividends, etc.) they might have generated with this income between the time of withholding and the time when taxes are actually due. This lost value is the opportunity cost of federal withholding, and represents a real economic cost of the tax system.

In 2005, the federal government is estimated to collect \$1.2 trillion in individual

income taxes. In the absence of withholding, taxpayers could have conservatively invested this money in U.S. Treasury Bonds. In 2004, the average rate of return on a 10-year U.S. security was 4.3 percent.¹ Assuming the same rate for 2005, taxpayers could pocket \$24.8 billion in interest payments over the course of the year. In reality, the federal government collects the withheld income tax payments and uses it to fund current operations. Therefore, the forgone interest represents a significant opportunity cost of federal taxes.

However, many opportunity costs of the tax code are more difficult to quantify. For example, consider a software developer who spends considerable time complying with the tax code. That time may have instead been spent working on new ideas that could potentially blossom into profitable new products and services, creating billions of dollars of wealth. Every hour or dollar spent complying with the tax code represents resources that could have been spent tending to business problems, adding value to the U.S. economy. Unfortunately, because of the difficulty of quantifying these forgone economic activities, this study underestimates the true opportunity costs of the tax system, potentially by a large amount.

Figure 2
Federal Income Tax Compliance Costs as a Percentage of Revenue 1990–2015



Source: Congressional Budget Office, Tax Foundation.

What Causes Tax Complexity and Compliance Costs?

In 1927 the Joint Committee on Internal Revenue Taxation reported, “It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not.” This is certainly true of business income, but almost equally true of individual income as currently defined.

The inherent complexity of any income tax results from the difficulty of defining income and determining when and to whom to recognize income and expense for tax purposes. Over time, the political process of give-and-take has made these questions of how to define the tax base inordinately complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

Adding to the inherent complexities of taxing income is the complexity caused by

¹ 2004 Economic Report of the President, Table B-73.

lawmakers attempting to achieve political goals using tax policy, such as assigning tax burdens based on income level, and encouraging various socially beneficial activities.

Complexity of Taxing by Income Level

From an economic perspective, the most efficient way to levy taxes is with a head tax. In such a system, every person would pay an equal lump-sum tax. For example, if such a head tax were instituted today, every man, woman and child in America would pay \$10,834 to fund local, state and federal governments at current levels. The federal government alone accounts for almost 70 percent (\$7,071) of the tax bill, with state and local governments accounting for the remainder (\$3,763).

Economists would call such a head tax efficient because it is economically neutral, avoiding all distortion of the free-market process. The burden of a head tax does not fall on

any particular economic activity, so taxpayers' economic decisions would be unaffected by the tax system. In contrast, even the simplest income tax could never be 100 percent economically neutral precisely because the burden of the tax falls on income producing activity, inevitably persuading some taxpayers to earn less income than they otherwise would.

However, the head tax is politically unpopular for obvious reasons. Taxation anywhere near the current level in the U.S. would constitute an insuperable burden for low-income citizens. If television stars and day laborers must pool their resources to fund governments that consume roughly one-third of the nation's income as they do today, then devising a tax system that takes ability to pay into account becomes politically inevitable, even if it leads to a more complex tax code.

Today the tax code includes a multitude of provisions to adjust the tax burden according to income level. The most obvious is the graduated rate structure that increases tax liability as a percentage of income as income rises. Other provisions adjust for a taxpayer's children, family status (single, married, head of household), etc.

Table 2
Growth of the Number of Words in the Internal Revenue Code Selected Calendar Years 1955–2005

	1955	1965	1975	1985	1995	2005
Internal Revenue Code						
(Thousands of words)						
Income Taxes Only	172	243	395	776	1,060	1,286
Entire Tax Code	409	548	758	1,332	1,791	2,139
Period-to-Period Percent Growth						
Income Taxes Only	*	41.4%	62.8%	96.4%	36.6%	21.4%
Entire Tax Code	*	33.8%	38.3%	75.7%	34.5%	19.4%
IRS Regulations						
(Thousands of words)						
Income Taxes Only	547	1,638	2,456	3,594	4,663	5,778
Entire Tax Code	987	2,960	3,148	4,407	5,861	6,958
Period-to-Period Percent Growth						
Income Taxes Only	*	199.6%	49.9%	46.3%	29.7%	23.9%
Entire Tax Code	*	199.9%	6.4%	40.0%	33.0%	18.7%
Internal Revenue Code and IRS Regulations						
(Thousands of words)						
Income Taxes Only	718	1,881	2,851	4,369	5,722	7,064
Entire Tax Code	1,396	3,507	3,906	5,739	7,652	9,097
Period-to-Period Percent Growth						
Income Taxes Only	*	161.8%	51.6%	53.3%	31.0%	23.4%
Entire Tax Code	*	151.2%	11.4%	46.9%	33.3%	18.9%

Source: Tax Foundation calculations based on the annual publications of "Internal Revenue Code" and "Federal Tax Regulations" from West Publishing Company.

Complexity of Promoting Socially Useful Activities

In addition to making allowances for the poor, today's income tax code includes numerous provisions to encourage activities that are deemed socially beneficial.

On the individual side of the code, taxpayers are allowed various credits and deductions for home mortgage interest, health care expenditures and child care, to name just a few. On the business side of the code there are comparable provisions, such as the investment tax credit and preferential depreciation rules.

As a result, the income tax code today is littered with deductions and credits that are unrelated to the task of raising revenue to fund government operations. In fact, these provisions not only reduce revenues but also dramatically increase the complexity of the tax code.

The Growth of the Income Tax Code

Another factor contributing to rising tax complexity in recent years is the sheer growth in tax law. Table 2 and Figure 3 chart the dramatic growth over the past 50 years in the combined number of words in the body of both the federal income tax laws and the attendant regulations.

Since 1954, the estimated number of words in the tax code devoted to the income tax has grown from 42 percent to 60 percent, a 43 percent increase over four decades. The volume of income tax regulations has grown even more. In 1954, income tax regulations represented 55 percent of the body of tax code regulations. Today, that figure has grown to 83 percent, an increase of 51 percent.

The Tax Foundation has determined that during the past 45 years the number of words detailing income tax law has grown from 172,000 in 1955 to 1,286,000 in 2005, a staggering 648 percent increase. Income tax regulations, which provide taxpayers with the guidance in calculating taxable income, have

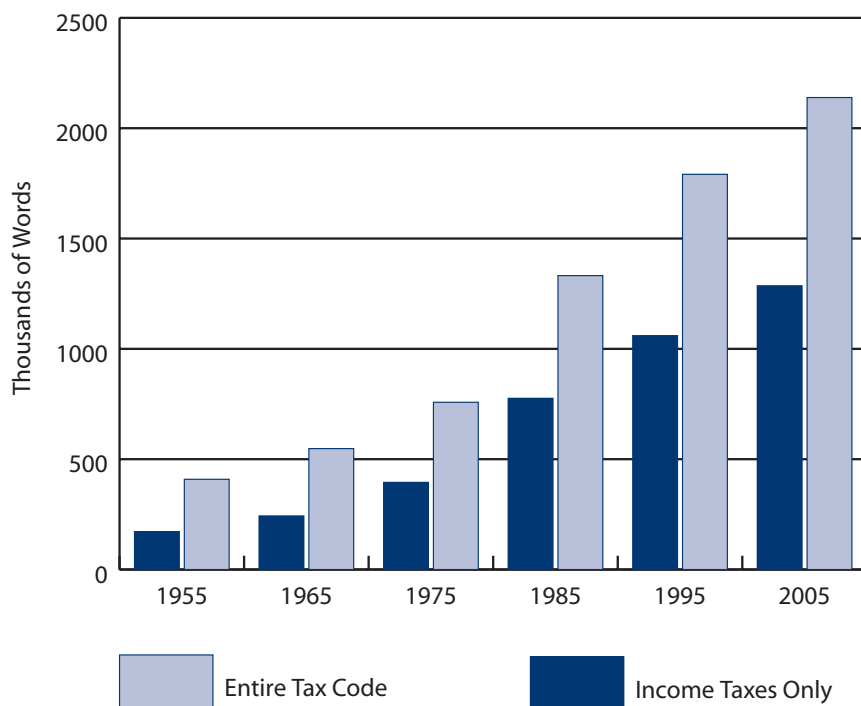
grown at an even faster pace. Federal income tax regulations have grown from 547,000 words in 1955 to 5,778,000 words by 2005, an increase of 956 percent. Taken together, the combined federal income tax code and regulations grew from 718,000 words in 1955 to 7,064,000 by 2005—an increase of 884 percent.

Perhaps a more revealing measure of tax code complexity is the increase in the number of subchapters and subsections that comprise the Internal Revenue Code. In 1955, federal income tax law was comprised of 103 code sections. By 2005, there were 736 income tax code sections, a 615 percent increase (see Table 3).

Almost all of the growth in the volume of tax law relates to tax base questions. For example, since 1955, the number of sections dealing with the “Determination of Tax Liability” has grown 1,350 percent; “Capital Gains and Losses” has grown 1,275 percent; “Deferred Compensation” (e.g., pension plans) has grown 1,550 percent; and “Computation of Taxable Income” has grown by more than 1,644 percent.

The growth in the volume of the income tax laws and regulations is a direct result of the 35 significant federal tax enactments that have taken place since 1954, which amounts to approximately one every 1.5 years. Previous Tax Foundation research (based on a sample of one-fifth of the core sections of the income tax code) found that these enactments have not only increased the volume of the tax code, but resulted, on average, in the amendment of each section once every four years (as of 1994). This instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

Figure 3
Growth of the Number of Words in the Internal Revenue Code Selected Years 1955–2005



The Consequences of Tax Complications

While some of these legislative adjustments to the tax code may be well-intentioned, they nonetheless lead to serious problems in the tax system.

The Problem of Rent-Seeking

Once inserted into the code, preferential tax provisions become entrenched over time as various groups lobby for their protection and

expansion. To economists this is known as “rent-seeking.” Such lobbies have a strong interest in maintaining tax preferences, and the general public typically mounts little opposition since the benefits are concentrated on a relatively small group of taxpayers while the costs are spread amongst everyone else. The economic resources wasted in this rent-seeking process represent a real cost of the tax system to society.

The Problem of Tax Evasion

A related problem is that a complex tax code is fertile ground for tax evasion. For example, consider the tax complexity caused by the popular deduction for charitable contributions. As for any itemized deduction, taxpayers must keep an accurate accounting of their charitable contributions. If the value is over \$250, the taxpayer is required to submit a statement from the charitable organization. While such record-keeping does not appear overly onerous, it generates substantial tax complexity in the background.

For one, charitable contributions are a significant source of “tax leakage,” a term used by the Internal Revenue Service for the loss of tax revenue caused by under-reported income or over-reported deductions. For instance, a phantom donation of \$25 a week would lead to a deduction of \$1,300 a year. Obviously, if a significant number of taxpayers did this, the revenue loss would be significant. Not all tax evaders are as blatant as the tax lawyer who was famously caught claiming to have given his church \$500 each Sunday. However, such over-reporting of deductions leads to higher compliance costs for all taxpayers as the IRS resorts to increased auditing and the addition of more tax rules and regulations.

The Problem of Administrative Complexity

Rising complexity in the tax code also leads to burdensome administrative costs. For example, charitable organizations are required to go through an approval process administered by the IRS before a contribution by an individual can be legally declared as a charitable deduction. The burden of this process is not a one-time cost because every approved charity must be aware at all times that a change in its mission could nullify its charitable status. This process is costly in terms of time and money, both for charities and the IRS.

The rules and regulations governing tax preferences like the charitable deduction not only add to the complexity in the tax code, but also lower government revenue, forcing up tax rates for all taxpayers. However, the complexity caused by this one popular deduction is the proverbial tip of the iceberg. There are thousands of similar preferences written into tax law that promote various activities or benefit certain groups of taxpayers.

These groups stand ready to defend their tax preferences with economic and emotional arguments regarding taxpayers’ ability to pay or the social benefits of the activity in question. This organized resistance to simplification has been phenomenally successful in previous decades, causing many legislators to despair of piecemeal efforts at tax simplification.

*Table 3
Comparison of 1954 Code and 2005 Code*

Subchapter of Income Tax Code	Number of Sections in Subchapter		Percent Growth
	1954	2005	
Determination of Tax Liability	4	58	1350%
Computation of Taxable Income	9	157	1644%
Corporate Distributions and Adjustments	14	34	143%
Deferred Compensation	2	33	1550%
Accounting Periods and Methods	6	34	467%
Tax-Exempt Organizations	4	19	375%
Corporations Used to Avoid Income Tax on Shareholders	4	19	375%
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	29	480%
Regulated Investment Companies, Etc.	1	17	1600%
Tax Based on Income from Within or Without the United States	9	82	811%
Gain/Loss on Disposition of Property	7	40	471%
Capital Gains and Losses	4	55	1275%
Readjustment of Tax Between Years and Special Limitations	6	7	17%
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	52	550%
TOTAL	103	736	615%

(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.

Table 4
Estimated Cost to Individuals of the Federal Income Tax System by Type of Form
Calendar Year 2005

Individuals	Number of Forms	Record-keeping (Hrs. Per Form)	Education Stage (Hrs. Per Form)	Form Prep. (Hrs. Per Form)	Packaging/Sending (Hrs. Per Form)	TOTAL (Hrs. Per Form)	Total Hours	Estimated Tax Compliance Cost (\$millions)
Forms								
1040 (a)	86,683,900	2.8	4.0	6.3	0.6	13.6	1,177,456,308	\$46,127.1
1040A (b)	10,664,000	2.3	4.0	7.0	2.3	15.5	164,936,533	\$6,461.4
1040EZ (c)	11,888,300	0.1	1.7	1.7	0.3	3.8	44,779,263	\$1,754.2
1040ES (Estimated Tax)	29,012,100	0.9	0.5	0.8	0.2	2.3	66,727,830	\$2,614.1
1040X (Amended 1040)	3,563,200	1.3	0.5	1.2	0.6	3.5	12,530,587	\$490.9
1041 (Estates and Trusts)	3,853,600	52.8	20.7	38.2	4.6	116.3	448,045,227	\$17,552.3
1041ES (Estimated Tax)	732,000	0.3	0.3	1.7	1.0	3.3	2,403,400	\$94.2
4868 (Extension of Time) (d)	8,943,600	0.4	0.2	0.2	0.2	1.0	8,943,600	\$350.4
2688 (Extension of Time) (e)	3,582,300	0.0	0.2	0.3	0.3	0.7	2,567,315	\$100.6
6251 (AMT)	3,036,930	0.3	1.3	1.7	0.6	3.9	11,793,410	\$462.0
Tax Credits								
2441 (Child Care Expenses Credit)	6,387,334	0.6	0.4	0.9	0.5	2.3	14,690,867	\$575.5
1116 (Foreign Tax)	3,871,081	2.7	1.1	2.7	0.6	7.0	27,162,087	\$1,064.1
8863 (Education Credit)	6,686,035	0.2	0.1	0.5	0.6	1.4	9,471,882	\$371.1
8839 (Adoption Credit)	57,726	0.7	0.3	2.4	0.6	3.9	226,093	\$8.9
3800 (General Business Credit)	293,994	16.3	1.4	1.7	0.0	19.3	5,683,876	\$222.7
8801 (Prior Year Minimum Tax Credit)	200,087	2.1	2.1	1.9	0.6	6.6	1,327,247	\$52.0
4136 (Fuels Tax Credit)	377,785	19.8	0.1	0.0	0.3	20.2	7,631,250	\$299.0
8880 (Retirement Savings Contribution Credit)	5,480,035	0.3	0.2	0.5	0.3	1.3	7,032,712	\$275.5
8812 (Additional Child Tax Credit)	11,293,658	0.1	0.2	0.5	0.3	1.1	12,046,568	\$471.9
1040 Schedules								
Sch A (Itemized Deductions)	56,904,989	3.1	0.7	1.6	0.3	5.6	319,616,355	\$12,521.0
Sch B (Interest & Dividends)	43,259,530	0.6	0.1	0.4	0.3	1.4	62,005,326	\$2,429.1
Sch D (Capital Gain/Loss)	40,326,389	0.9	2.5	2.3	0.5	6.2	248,679,398	\$9,742.1
Sch E (Supplemental Income)	23,849,151	3.0	1.2	1.5	0.6	6.2	148,659,710	\$5,823.8
Sch EIC (Earned Income Credit)	25,148,301	0.0	0.0	0.2	0.3	0.6	14,250,704	\$558.3
Sch H (Household Taxes)	430,423	1.6	0.5	0.9	0.6	3.6	1,542,350	\$60.4
Sch R (Elderly or Disabled Credit)	469,305	0.3	0.3	0.6	0.6	1.7	813,462	\$31.9
Estate and Gift								
706 (Estate)	63,800	9.3	6.3	11.2	8.5	35.3	2,252,140	\$88.2
709 (Gift)	292,100	0.9	1.9	2.0	1.1	5.8	1,684,443	\$66.0
Individual Total	387,351,652	123.4	52.3	90.6	27.0	293.4	2,824,959,943	\$110,668.3

(a) Includes 1040PC and electronically filed 1040 forms.

(b) Schedules 1-3 and EIC are included in the average time.

(c) Includes Telefiled 1040EZ forms.

(d) Application for automatic extension of time in which to file the individual income tax return.

(e) Application for additional extension of time in which to file the individual income tax return.

Source: Tax Foundation; Internal Revenue Service.

Table 5
Estimated Cost to Businesses of the Federal Income Tax System by Type of Form
Calendar Year 2005

Businesses	Number of Forms	Record-keeping (Hrs. Per Form)	Education Stage (Hrs. Per Form)	Form Prep. (Hrs. Per Form)	Packaging/Sending (Hrs. Per Form)	TOTAL (Hrs. Per Form)	Total Hours	Estimated Tax Compliance Cost (\$millions)
Sole Proprietorships								
Form 1040	22,650,900	2.8	4.0	6.3	0.6	13.6	307,674,725	\$14,757.1
Sch C (Sole-Proprietorship)	18,089,194	6.1	1.9	2.3	0.7	10.9	197,473,699	\$9,471.5
Sch C-EZ	2,916,206	0.8	0.1	0.6	0.3	1.7	5,006,154	\$240.1
Sch F (Farming)	1,645,500	3.5	0.5	1.4	0.3	5.8	9,585,038	\$459.7
Sch SE (Self-Employment)	22,256,209	0.3	0.3	0.4	0.3	1.3	28,562,135	\$1,369.9
4835 (Farm Rental)	795,505	3.0	0.1	1.0	0.3	4.4	3,473,704	\$166.6
8829 (Business Use of Home)	2,090,491	0.9	0.1	1.3	0.3	2.6	5,365,593	\$257.4
Partnerships								
Form 1065	2,684,100	44.3	28.2	48.9	5.4	126.8	340,209,675	\$16,317.6
Partnership Schedules								
Sch D	2,684,100	6.9	2.6	2.8	0.0	12.3	33,014,430	\$1,583.5
Sch K-1 (Partners' Share of Income)	2,684,100	20.0	12.5	13.4	0.0	45.9	123,110,720	\$5,904.8
Sch L (Balance Sheets)	2,684,100	15.5	0.1	0.4	0.0	16.0	42,900,865	\$2,057.7
Sch M-1 (Reconciliation of Income)	2,684,100	3.4	0.2	0.3	0.0	3.8	10,199,580	\$489.2
Sch M-2 (Analysis of Capital Accounts)	2,684,100	3.1	0.1	0.2	0.0	3.4	8,991,735	\$431.3
C-Corporations								
Forms								
Form 1120 (C-Corporation)	2,100,200	70.8	42.0	72.9	8.0	193.8	406,948,753	\$19,518.7
1120A (C-Corporation Short Form)	217,900	43.5	24.2	42.6	4.8	115.1	25,076,658	\$1,202.8
1120S (S-Corporation)	3,718,300	65.8	25.9	48.5	5.9	146.0	542,747,857	\$26,032.0
1120X (Amended)	15,800	13.2	1.2	3.4	0.5	18.3	288,877	\$13.9
1120F (Foreign Corporation)	28,300	105.5	41.2	68.9	7.0	222.5	6,295,335	\$301.9
1120FSC (Foreign Sales Corporation)	0	94.2	19.8	38.9	0.0	152.9	0	\$0.0
1120H (Homeowners Associations)	166,800	11.7	5.3	13.2	2.2	32.4	5,401,540	\$259.1
1120RIC (Regulated Investment Corporations)	11,900	57.2	20.7	36.3	4.0	118.2	1,405,985	\$67.4
7004 (Extension of Time) (a)	3,109,700	5.7	1.1	2.1	0.3	9.2	28,557,412	\$1,369.7
4626 (AMT)	336,032	17.2	12.6	13.5	0.0	43.3	14,538,985	\$697.3
1120 Schedules								
Sch D (Capital Gains/Losses)	2100200	6.9	3.9	6.1	0.5	17.4	36,613,487	\$1,756.1
1120S Schedules								
Sch D (Capital Gains/Losses)	3,718,300	7.2	4.6	9.6	1.3	22.7	84,467,382	\$4,051.3
Sch K-1 (Shareholders' Share of Income)	3,718,300	13.5	11.4	16.1	1.1	42.0	156,292,543	\$7,496.3
Other								
4562 (Depreciation)	13,675,608	38.5	4.3	5.1	0.0	47.8	654,149,903	\$31,375.3
2553 (Small Corporation Election)	644700	19.2	3.2	4.6	0.0	26.9	17,363,920	\$832.8
Business Total	120,110,645	661.3	268.6	456.1	43.8	1,429.8	3,078,352,769	\$147,648.3

(a) Application for automatic extension of time in which to file the corporate income tax return.

Source: Tax Foundation; Internal Revenue Service.

2005 Compliance Costs of the Federal Income Tax

As shown in Tables 4, 5, 6 and 7, the Tax Foundation estimates that in 2005 individuals, businesses and non-profits will spend over 6 billion hours complying with the federal income tax. Using an hourly cost of \$39.18 for individuals and \$47.96 for businesses and non-profits, the estimated cost of compliance in 2005 is \$265.1 billion. (See Methodology for details about how the hours and wages were determined.) Individuals bear a cost of \$110.7 billion, businesses bear a cost of \$147.7 billion

and non-profits bear a cost of \$6.8 billion. The overall compliance cost surcharge amounts to nearly 22.2 cents for every \$1 collected by the federal income tax.

This staggering economic cost can be illustrated by comparison. The \$265.1 billion tax compliance cost is greater than the revenue of Wal-Mart (\$259 billion), the largest company in America. Similarly, 6 billion hours per year represents a work force of over 2,884,000 people: larger than the populations of Dallas (1,210,393), Detroit (900,198) and Washington, D.C. (553,523) combined; more people

Table 6
Estimated Cost to Nonprofits of the Federal Income Tax System by Type of Form Calendar Year 2005

Non-Profits	Number of Forms	Record-keeping (Hrs. Per Form)	Education Stage (Hrs. Per Form)	Form Prep. (Hrs. Per Form)	Packaging/Sending (Hrs. Per Form)	TOTAL (Hrs. Per Form)	Total Hours	Estimated Tax Compliance Cost (\$millions)
Forms								
Form 990 (Tax-Exempt Organizations)	429,000	98.5	15.1	21.1	1.1	135.7	58,222,450	\$2,792.5
990-EZ	152,200	29.2	11.6	14.4	0.5	55.7	8,469,930	\$406.2
990-C (Farmers' Cooperative)	3,500	75.6	27.3	45.6	4.6	153.0	535,500	\$25.7
990-PF (Private Foundation)	94,300	140.6	28.3	33.7	0.5	203.1	19,147,615	\$918.4
990-T (Exempt Organization Business Income)	47,800	67.4	27.2	43.4	4.0	142.0	6,789,193	\$325.6
Form 4720 (Return of Excise Taxes)	2,200	39.9	16.5	23.4	1.6	81.4	179,043	\$8.6
Form 5227 (Split-Interest Trust)	12,830	65.3	11.4	19.4	1.9	98.0	1,256,699	\$60.3
990 Schedules								
Sch A	581,200	50.7	9.4	10.7	0.0	70.8	41,148,960	\$1,973.6
Sch B	675,500	4.8	1.4	1.5	0.0	7.7	5,178,833	\$248.4
Other								
8868 (Extension of Time) (a)	404,000	5.5	0.1	0.2	0.0	5.8	2,336,467	\$112.1
Non-Profit Total	2,402,530	572.0	148.1	213.1	14.2	947.3	140,928,224	\$6,759.4

(a) Application for automatic extension of time in which to file an exempt organization return.

Source: Tax Foundation; Internal Revenue Service.

Table 7
Estimated Time That Individuals, Businesses, and Non-Profit Organizations Devote to the Federal Income Tax System Calendar Year 2005

	Number of Forms	Record-keeping (Hrs. Per Form)	Education Stage (Hrs. Per Form)	Form Prep. (Hrs. Per Form)	Packaging/Sending (Hrs. Per Form)	TOTAL (Hrs. Per Form)	Total Hours	Estimated Tax Compliance Cost (\$millions)
Total for Individuals (Table 4)	387,351,652	123.4	52.3	90.6	27.0	293.4	2,824,959,943	\$110,668.3
Total for Businesses (Table 5)	120,110,645	661.3	268.6	456.1	43.8	1,429.8	3,078,352,769	\$147,648.3
Total for Non-profits (Table 6)	2,402,530	572.0	148.1	213.1	14.2	947.3	140,928,224	\$6,759.4
GRAND TOTAL	509,864,827	1,356.7	469.0	759.7	85.0	2,670.4	6,044,240,936	\$265,076.1

Source: Tax Foundation; Internal Revenue Service.

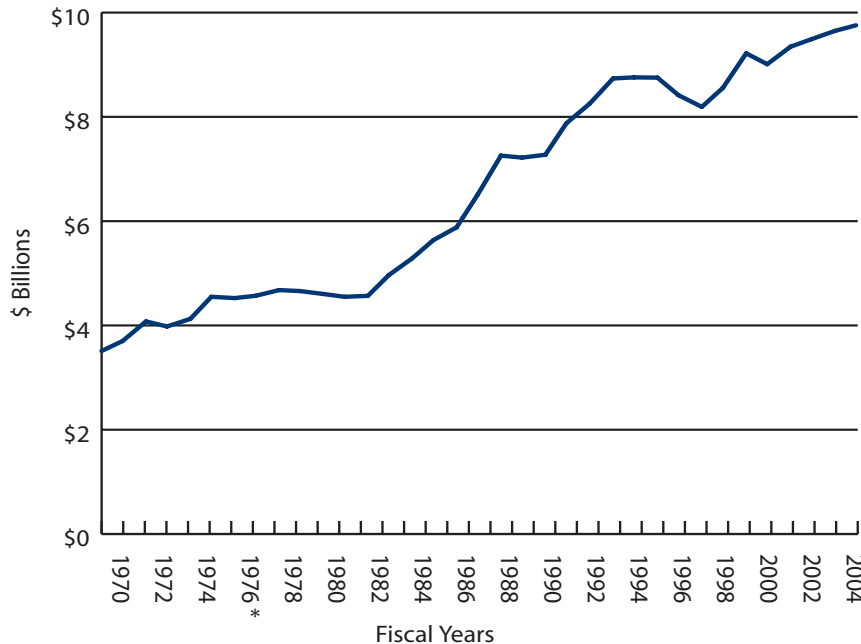
Table 8
Internal Revenue Costs, Collections and Employees
Fiscal Years 1970–2004

	Operating Costs (a) (\$ Millions)	Operating Costs (Real 2004 \$)	Gross Collections (b) (\$ Millions)	Cost of Collecting \$100	Employees (c)		
					Total	National Office	Field
1970	\$ 886.2	\$3,510.8	\$195,722.1	\$0.45	68,683	4,103	64,580
1971	981.1	3,701.6	191,647.2	0.51	68,972	4,358	64,614
1972	1,127.4	4,076.8	209,855.7	0.54	68,549	4,134	64,415
1973	1,162.0	3,980.0	237,787.2	0.49	74,170	4,505	69,665
1974	1,312.9	4,125.4	268,952.3	0.49	78,921	4,310	74,611
1975	\$1,584.7	\$4,549.0	\$293,822.7	\$0.54	82,339	4,531	77,808
1976 (d)	1,667.3	4,524.8	302,519.8	0.55	84,264	4,732	79,532
1977	1,790.6	4,568.9	358,139.4	0.50	83,743	4,994	78,749
1978	1,962.1	4,677.9	399,776.4	0.49	85,329	4,919	80,410
1979	2,116.2	4,659.2	460,412.2	0.46	86,168	4,978	81,190
1980	\$2,280.8	\$4,602.9	\$519,375.3	\$0.44	87,464	5,114	82,350
1981	2,465.5	4,549.2	606,799.1	0.41	86,156	5,110	81,046
1982	2,626.3	4,567.2	632,240.5	0.42	82,857	5,098	77,759
1983	2,968.5	4,966.3	627,246.8	0.47	83,603	4,357	79,246
1984	3,279.1	5,287.2	680,475.2	0.48	87,635	5,327	82,308
1985	\$3,601.0	\$5,634.7	\$742,871.5	\$0.48	92,259	5,454	86,805
1986	3,842.0	5,881.5	782,251.8	0.49	95,880	5,361	90,519
1987	4,365.8	6,506.7	886,290.6	0.49	102,189	6,253	95,936
1988	5,035.5	7,256.9	935,106.6	0.54	114,875	6,934	107,941
1989	5,198.5	7,218.8	1,013,322.1	0.51	114,758	7,895	106,863
1990	\$5,440.4	\$7,272.8	\$1,056,365.7	\$0.52	111,962	7,459	104,503
1991	6,097.6	7,876.9	1,086,851.4	0.56	115,628	8,286	107,342
1992	6,536.3	8,253.6	1,120,799.6	0.58	116,673	9,333	107,340
1993	7,078.0	8,736.5	1,176,685.6	0.60	113,460	9,320	104,140
1994	7,245.3	8,757.3	1,276,466.8	0.57	110,665	9,467	101,198
1995	\$7,389.7	\$8,752.4	\$1,375,731.8	\$0.54	112,024	9,738	102,286
1996	7,240.2	8,416.1	1,486,546.7	0.49	106,642	8,766	97,876
1997	7,163.5	8,191.1	1,623,272.1	0.44	101,703	7,837	93,866
1998	7,564.7	8,554.8	1,769,408.7	0.43	98,037	7,468	90,569
1999	8,269.4	9,218.6	1,904,151.9	0.43	98,730	8,078	90,652
2000	\$8,258.4	\$9,010.1	\$2,096,916.9	\$0.39	97,074	(e)	(e)
2001	8,771.5	9,345.4	2,128,831.2	0.41	97,707	(e)	(e)
2002	9,063.5	9,490.5	2,016,627.3	0.45	100,229	(e)	(e)
2003	9,401.4	9,648.3	1,952,929.0	0.48	98,824	(e)	(e)
2004	9,756.3	9,756.3	2,018,502.1	0.48	98,735	(e)	(e)

- (a) Starting with Fiscal Year 1975, represents actual IRS operating costs, exclusive of reimbursements received from other Federal agencies for services performed. While operating costs for earlier years may, in some cases, include reimbursement, the amounts involved were small and, therefore, do not affect comparability of the data on the historical costs of collecting \$100.
- (b) Starting with Fiscal Year 1988, gross collections exclude alcohol and tobacco taxes and, starting with the second quarter of Fiscal Year 1991, exclude taxes on firearms, when responsibility for all these taxes was transferred to the Bureau of Alcohol, Tobacco and Firearms. Also, starting with Fiscal Year 1993, gross collections exclude foreign treaty money and arbitrage rebates.
- (c) For Fiscal Years 1972 through 1974, includes average positions for the Economic Stabilization Program; for Fiscal Year 1974, includes average positions for the Federal Energy Program. Starting with Fiscal Year 1972, excludes 3,990 average positions transferred to the Office of the Secretary of the Treasury. In addition, for the years starting with Fiscal Year 1983 data are revised to reflect methodology in 1984 for computing average positions realized in conformance with Office of Personnel Management requirements. For these reasons, data for all years are not completely comparable.
- (d) Represents fiscal year transitional period, July through September 1976, resulting from fiscal year redefinition. Fiscal Year 1976 covered July 1975 through June 1976 (earlier years were similarly defined). Fiscal Year 1977 covered October 1976 through September 1977 (subsequent years are similarly defined).
- (e) The Internal Revenue Service discontinued the distinction between National Office and Field offices as a result of reorganization.

Source: Internal Revenue Service, Data Book (various years), Publication 55B.

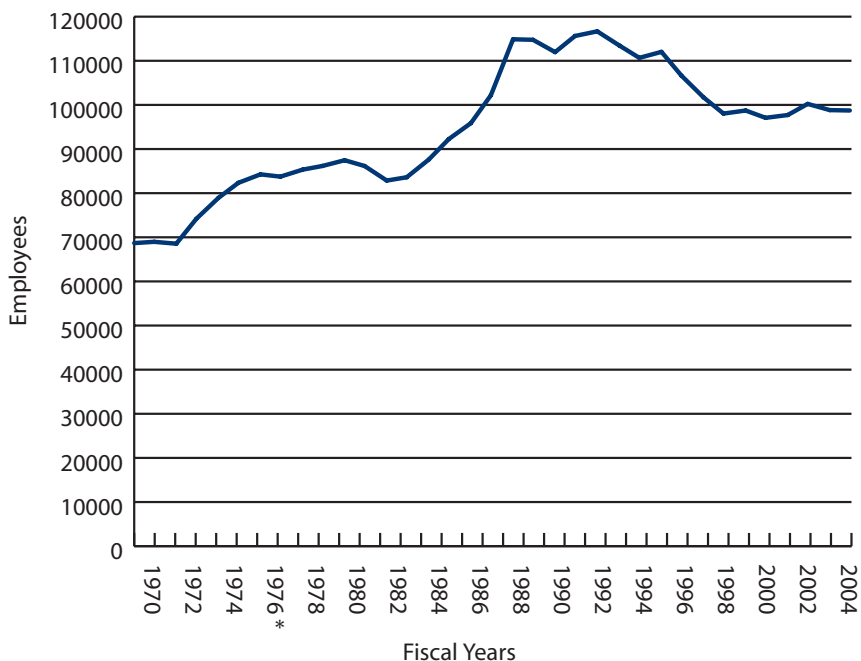
Figure 4
Total Operating Costs of the Internal Revenue Service
Fiscal Years 1970–2004 (Real 2004 \$)



* Represents fiscal year transitional period (July – September 1976) resulting from fiscal year redefinition.

Source: IRS Data Book (various years) Publication 55B

Figure 5
Total Employment of the Internal Revenue Service
Fiscal Years 1970–2004



* Represents fiscal year transitional period (July – September 1976) resulting from fiscal year redefinition.

Source: IRS Data Book (various years) Publication 55B

than would reside in four Congressional districts; and more people than work in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined.

In addition, there is a direct expense to the IRS of administering and enforcing the federal tax code—of which the federal income tax is but one of many types of taxes. Table 8 and Figures 4 and 5 detail the growth of the IRS in operating costs and in employment. Operating costs in real 2005 dollars have almost tripled between 1970 and 2004 growing from \$3.5 billion in 1970 to \$9.8 billion in 2004. Employment has risen from 68,683 employees in 1970 to 98,735 in 2004, though it is down from the peak of 116,673 reached in 1992.

Who Bears the Highest Cost of Compliance?

Because complying with tax laws represents a fixed cost for many individuals, it seems likely that lower-income individuals would bear a greater relative tax compliance burden than higher income individuals. In previous research, the Tax Foundation has found this to be true for corporations. In 1996 small corporations—those with less than \$1 million in assets—spent at least 27 times more as a percentage of assets complying with the tax code than the largest U.S. corporations. We find that the same is true for individuals.

As shown in Table 9 and Figure 6, compliance costs for individuals are quite regressive (see Methodology), hitting lower-income individuals harder than higher-income individuals. As a percentage of AGI, taxpayers earning less than \$20,000 are hit hardest. They pay a compliance cost of 5.87 percent of income. For those earning \$50,000–\$75,000, compliance cost consumes a much lower 1.56 percent of AGI. The compliance cost drops to 0.45 percent for taxpayers earning over \$200,000.

Taxpayers with less than \$50,000 of AGI pay over 54 percent of the total compliance cost to individuals—\$60.3 billion out of \$110.7 billion. This pattern occurs for two reasons. First, 60 percent of all returns are filed by taxpayers with less than \$50,000 in AGI. Secondly, taxpayers with less than \$50,000 in AGI only account for 27 percent of total AGI. Therefore, the fixed-cost nature of tax compli-

ance has a larger negative impact on lower-income individuals.

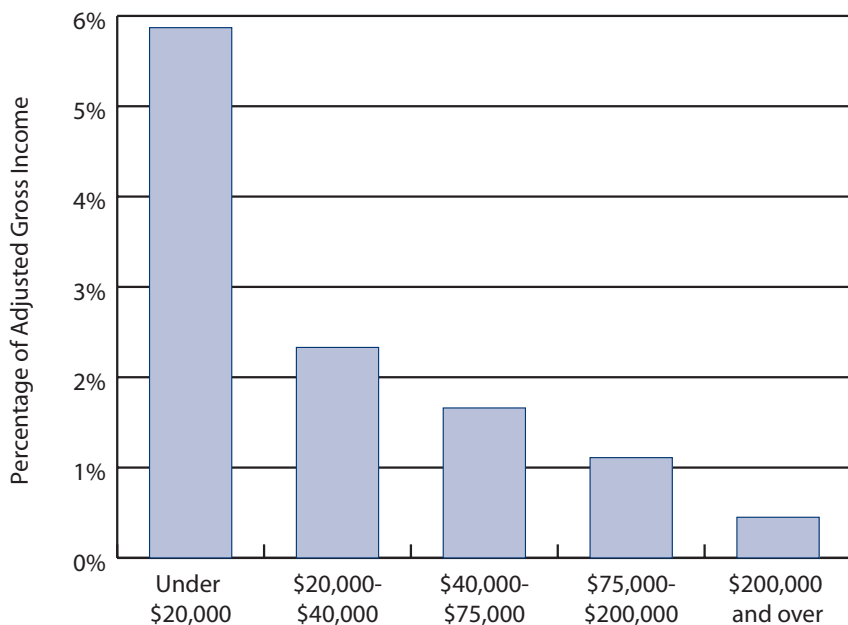
It follows, therefore, that an effective way to provide tax relief to lower-income taxpayers is via tax simplification. In fact, over 54 percent of all the tax surcharge savings resulting from tax simplification would go to taxpayers with less than \$50,000 in AGI. For example, Form 1040—which accounts for almost half of the compliance cost borne by individuals—takes 13.6 hours to complete. Every hour shaved off the 1040 would save taxpayers \$3.3 billion, or some 85.2 million hours a year—time better spent with family or tending to business.

Table 9
The Income Distribution of Federal Individual Income Tax Compliance Costs Calendar Year 2005

Taxpayer's AGI	Compliance Burden as a Percentage of AGI
Under \$20,000	5.87%
\$20,000-\$50,000	2.18%
\$50,000-\$75,000	1.56%
\$75,000-\$200,000	1.11%
\$200,000 and over	0.45%

Source: Tax Foundation, Internal Revenue Service.

Figure 6
Income Distribution of Federal Individual Income Tax Compliance Costs



Source: Tax Foundation, Internal Revenue Service

Which States Bear the Highest Cost of Compliance?

State-by-state estimates of the 2005 compliance cost vary for a variety of economic and demographic reasons (see Table 10). Table 11 breaks down the compliance cost by state and by type of taxpayer—individual, business or non-profit. On a per capita basis, Wyoming (\$1,242), Delaware (\$1,181) and Colorado (\$1,167) face the highest compliance cost while Mississippi (\$658), West Virginia (\$689), and Tennessee (\$705) face the lowest. Measured per \$1,000 of income, Montana (\$38), Utah (\$37), and Wyoming (\$33) face the highest compliance cost while California (\$19), Connecticut (\$20) and Massachusetts (\$21) face the lowest.

Measures to Reduce the Cost of Compliance

What can be done to reverse the current situation? To reduce tax compliance cost, lawmakers and regulators must focus on the causes of tax complexity. One set of causes is economic and the other set is political.

As explained above, the economic causes of complexity are inherent in any attempt to define and tax income. Tax base questions such as, “What is income?” and “When is it income?” are inherently difficult to answer, especially in the context of corporate entities. The inherent difficulty of these questions explains why, for example, the rules of depreciation and transfer pricing rules associated with foreign-source income create such mindboggling tax code complexity.

However, the political process has made an inherently complex tax system worse. To a large degree, the complexity of the current tax code is a by-product of the era of chronic federal budget deficits. The drive to balance the budget placed a policy emphasis on increasing government revenue rather than on refining and promulgating consistent definitional answers about income. In this sense, tax policy has become tactical rather than strategic. Modern tax policy has no unifying theme. Instead, the budgetary aspects of dealing with the tax system generally control the policy process. This past budgetary dynamic has combined with the issue of tax fairness and the normal

Table 10
Federal Income Tax Compliance Costs by State Per Capita and Per \$1,000 of Personal Income and Corresponding Ranks
Calendar Year 2005

	Total (\$Thousands)	Percentage of Tax Liability	Per Capita	Per \$1,000 of Net National Product	Rank		Per \$1,000 of Net National Product
					Percentage of Tax Liability	Per Capita	
All States (a)	\$265,076,056	22.2%	\$897	\$24.29	—	—	—
Alabama	\$3,219,941	26.7%	\$711	\$23.28	24	47	38
Alaska	553,629	20.5	837	21.98	39	35	43
Arizona	4,507,259	24.1	768	25.19	31	44	25
Arkansas	2,197,035	32.5	791	28.11	7	40	15
California	27,475,735	16.2	762	19.26	48	45	50
Colorado	\$5,388,835	25.0%	\$1,167	\$29.48	27	3	10
Connecticut	3,549,749	12.6	1,013	19.73	50	12	49
Delaware	988,048	28.1	1,181	30.68	18	2	5
Florida	18,755,867	23.9	1,071	30.65	33	9	6
Georgia	7,319,114	24.0	820	24.04	32	36	33
Hawaii	\$1,106,040	24.2%	\$866	\$24.11	30	31	32
Idaho	1,253,011	32.6	891	29.85	6	25	8
Illinois	11,889,942	20.1	936	23.38	41	19	36
Indiana	5,099,098	26.1	816	23.99	26	37	34
Iowa	2,674,188	32.0	899	26.05	8	23	18
Kansas	\$2,411,895	27.1%	\$877	\$25.17	23	28	26
Kentucky	3,208,358	30.2	771	24.86	12	43	28
Louisiana	3,522,208	31.9	777	25.28	9	42	22
Maine	1,259,019	29.7	955	28.35	15	17	14
Maryland	5,290,059	19.5	945	21.82	43	18	45
Massachusetts	\$6,413,657	15.7%	\$984	\$21.07	49	14	48
Michigan	8,580,129	24.6	841	23.33	28	34	37
Minnesota	4,662,462	21.2	901	22.18	38	22	41
Mississippi	1,918,420	31.8	658	24.14	10	50	31
Missouri	5,051,342	27.9	876	25.26	20	29	23
Montana	\$1,077,950	38.7%	\$1,155	\$38.40	1	4	1
Nebraska	1,731,409	31.1	993	27.06	11	13	16
Nevada	2,564,021	20.2	1,090	30.82	40	7	4
New Hampshire	1,212,655	18.5	922	22.56	47	21	40
New Jersey	9,596,512	18.6	1,097	23.06	46	6	39
New Mexico	\$1,418,602	30.2%	\$746	\$25.73	13	46	20
New York	20,945,020	19.7	1,088	25.21	42	8	24
North Carolina	7,079,188	27.2	813	25.30	22	38	21
North Dakota	619,054	33.3	974	28.91	5	16	12
Ohio	10,131,002	28.0	883	24.97	19	27	27
Oklahoma	\$3,262,950	35.6%	\$927	\$30.33	3	20	7
Oregon	3,216,470	26.4	894	26.17	25	24	17
Pennsylvania	10,483,154	22.2	844	21.94	36	32	44
Rhode Island	1,222,267	27.5	1,125	29.80	21	5	9
South Carolina	3,295,212	29.6	777	25.74	16	41	19
South Dakota	\$753,053	29.9%	\$976	\$28.86	14	15	13
Tennessee	4,206,418	21.7	705	21.57	37	48	47
Texas	18,151,157	22.3	797	23.81	35	39	35
Utah	2,529,996	38.5	1,046	36.79	2	10	2
Vermont	649,762	29.0	1,030	28.94	17	11	11
Virginia	\$6,354,535	18.7%	\$841	\$21.65	45	33	46
Washington	5,432,102	18.8	875	22.00	44	30	42
West Virginia	1,254,098	33.3	689	24.30	4	49	30
Wisconsin	4,924,727	24.4	887	24.59	29	26	29
Wyoming	629,920	22.8	1,242	33.27	34	1	3
District of Columbia	\$3,017,969	76.1%	\$5,476	\$100.85	—	—	—

(a) Forms filed internationally not included.

Source: Tax Foundation, Internal Revenue Service

Table 11
Federal Income Tax Compliance Costs by Type of Filer by State
Calendar Year 2005
\$Thousands

	Total	Individual	Business	Non-Profit
All States (a)	\$265,076,056	\$110,668,347	\$147,648,311	\$6,759,399
Alabama	\$3,219,941	\$1,432,185	\$1,712,680	\$75,076
Alaska	553,629	247,410	277,609	28,610
Arizona	4,507,259	1,640,739	2,777,771	88,749
Arkansas	2,197,035	868,421	1,278,145	50,470
California	27,475,735	11,826,059	14,931,660	718,016
Colorado	\$5,388,835	\$1,820,842	\$3,440,136	\$127,857
Connecticut	3,549,749	1,410,219	2,021,643	117,887
Delaware	988,048	377,344	586,206	24,498
Florida	18,755,867	6,472,362	11,990,886	292,618
Georgia	7,319,114	2,811,077	4,361,151	146,886
Hawaii	\$1,106,040	\$500,796	\$572,120	\$33,124
Idaho	1,253,011	426,756	798,792	27,463
Illinois	11,889,942	5,208,953	6,376,240	304,749
Indiana	5,099,098	2,240,684	2,700,037	158,377
Iowa	2,674,188	1,172,893	1,406,308	94,987
Kansas	\$2,411,895	\$1,018,715	\$1,322,168	\$71,012
Kentucky	3,208,358	1,374,291	1,757,070	76,997
Louisiana	3,522,208	1,230,745	2,215,189	76,275
Maine	1,259,019	557,666	654,479	46,874
Maryland	5,290,059	2,265,594	2,879,702	144,763
Massachusetts	\$6,413,657	\$2,948,390	\$3,237,789	\$227,478
Michigan	8,580,129	3,464,278	4,907,878	207,973
Minnesota	4,662,462	1,738,501	2,747,499	176,462
Mississippi	1,918,420	854,252	1,017,166	47,002
Missouri	5,051,342	2,352,563	2,556,643	142,136
Montana	\$1,077,950	\$338,595	\$703,498	\$35,858
Nebraska	1,731,409	677,272	1,001,109	53,028
Nevada	2,564,021	819,620	1,711,443	32,958
New Hampshire	1,212,655	509,403	659,293	43,959
New Jersey	9,596,512	3,424,417	5,953,136	218,959
New Mexico	\$1,418,602	\$629,639	\$746,198	\$42,765
New York	20,945,020	7,829,188	12,539,246	576,586
North Carolina	7,079,188	2,962,209	3,916,769	200,211
North Dakota	619,054	236,688	358,684	23,682
Ohio	10,131,002	4,863,542	4,955,894	311,566
Oklahoma	\$3,262,950	\$1,520,866	\$1,668,853	\$73,231
Oregon	3,216,470	1,275,268	1,838,640	102,562
Pennsylvania	10,483,154	5,014,860	5,094,842	373,452
Rhode Island	1,222,267	565,547	597,316	59,405
South Carolina	3,295,212	1,371,097	1,858,168	65,947
South Dakota	\$753,053	\$294,134	\$432,989	\$25,929
Tennessee	4,206,418	1,989,919	2,112,177	104,322
Texas	18,151,157	7,514,136	10,250,072	386,949
Utah	2,529,996	758,595	1,732,893	38,508
Vermont	649,762	256,507	358,651	34,604
Virginia	\$6,354,535	\$2,630,501	\$3,541,535	\$182,499
Washington	5,432,102	2,264,688	3,010,551	156,863
West Virginia	1,254,098	652,160	558,040	43,898
Wisconsin	4,924,727	2,272,859	2,492,299	159,569
Wyoming	629,920	194,035	416,399	19,486
District of Columbia	\$3,017,969	\$2,622,579	\$314,167	\$81,222

(a) Forms filed internationally not included.

Source: Tax Foundation, Internal Revenue Service

course of lobbying to accelerate the trend toward tax complexity.

Short of overhauling the entire federal tax system, Congress can work to reduce the complexity of the current tax system (and, therefore, its high compliance costs) through two courses of action. First, Congress should strive to achieve a much larger measure of tax stability. Although not measured in this study, the taxpayer uncertainty that results from frequent tax law changes is a key source of complexity. Second, legislators and regulators should place a larger emphasis on tax simplicity. There exists an inherent trade-off between completeness and simplicity. In their steady pursuit of tax revenue and tax “fairness,” legislators and regulators have emphasized completeness by trying to shut off all avenues of tax avoidance without regard to the incremental costs or unintended consequences of such an approach to governance.

Methodology

The federal income tax compliance cost estimate for calendar year (CY) 2005 is based on data from the Internal Revenue Service. Note, however, that the compliance burden for CY 2005 is associated with the tax burden for CY 2004. This difference is due to the fact that while the income tax burden is accrued in CY 2004, taxpayers do not actually file their taxes until CY 2005—with the infamous April 15th deadline.

Table 4 compiles a list of the core individual income tax forms along with both the estimated paper work burden calculation (in hours of compliance time) generated by the Internal Revenue Service. Tables 5 and 6 compile a similar list for the business and non-profit sector, respectively. These lists are far from exhaustive. Not only are many obscure forms and schedules left out, but the lists are also incomplete to the degree that adequate tax return information could not be obtained or estimated for the many schedules and forms that are common auxiliary components of the core forms.

One trend in tax filing has been the growth in alternative methods of filing, the tele-file and the e-file. These filing methods primarily affect the delivery of the tax filings rather than the filings themselves. In the case

of the tele-file, the 1040EZ must be used in order to file over the phone. As such, all tele-filed forms were counted under the 1040EZ form. In the case of the e-file, both the 1040 and 1040A forms can be filed electronically. Unfortunately, no data is available to break down the types of e-filings. In order to keep the time estimates on the conservative side, all e-files were counted as 1040 filings (as the 1040 requires less time to file than the 1040A).

Once the total number of hours spent on compliance has been determined, an hourly rate is then applied in order to determine the compliance cost. This hourly rate was determined in one of two ways.

First, for individuals who filed themselves, the report uses their hourly compensation rate (wages and salary plus benefits) as a proxy for their “tax surcharge.” Some may argue that individuals would value their time more or less highly than their hourly salary rate since it is their leisure time (time not spent in formal work) that is given up to file taxes. However, to avoid speculation, the Tax Foundation believes that the hourly compensation rate represents the best estimate of a compliance cost level for individuals.

Utilizing data from the 2004 National Compensation Survey and Employment Cost Index published by the Bureau of Labor Statistics, the Tax Foundation estimates a national hourly wage and salary rate of \$19.14. In addition, utilizing data from the National Income and Product Accounts published by the Bureau of Economic Analysis, the Tax Foundation estimates that benefits increase total compensation by 24.1 percent, for a total hourly compensation rate of \$23.75.

Second, for filings made by tax professionals, the report uses the average compensation rate for tax accountants. Unfortunately, the National Compensation Survey does not list “tax accountants” as a separate occupation. Therefore, the Tax Foundation estimates their rate by averaging “accountants and auditors” and “lawyers” together, since tax accountants must be adept not only in accounting procedures, but also in interpreting tax law and court rulings. This yields an hourly wage and salary rate of \$36.56. After adjusting this wage to include benefits, a final hourly compensation rate of \$45.37 is reached.

To derive the final average compensation cost for individual filings, the report also takes into account the number of forms prepared by individuals and those prepared by tax professionals. The latest IRS data shows that 61.6 percent of all forms are prepared by tax professionals. Using a weighted average, the final compensation cost is \$37.05. For businesses, the average compensation cost is the rate derived for the average tax accountant: \$45.37.

The compensation cost is derived for 2004—the latest year available. In order to project the compensation cost out to 2015, the cost was conservatively scaled up by the estimated growth in per capita wages and salary as published by the Congressional Budget Office. The projections for the number of forms filed by type were taken from the Internal Revenue Service’s own estimates. The hourly estimates for the projections were taken from the 2004 forms and held static throughout the projected time span; therefore, recent policy changes are not incorporated into the hourly form estimate.

The distribution of tax compliance cost, by income and by state, is the result of an allocation model developed by the Tax Foundation utilizing data published by the Internal Revenue Service – Individual Income Tax Returns, 2002 and IRS Document 6149. Utilizing this data, the model allocates every IRS form examined in the compliance study by income cohort and by state.

Why the Old Model Remains Relevant

Though the IRS will soon retire its form-by-form time estimates, there is real value in continuing to produce the Tax Foundation’s compliance cost study based on them.

First, while compliance costs in any given year are subject to dispute, the overall trend is not. By making use of original IRS form-by-form estimates, our study produces a time series of compliance costs in addition to a static estimate for the current year. This allows us to analyze how changes in tax law affect compliance costs over time—something that has not been analyzed and made public using the new Individual Taxpayer Burden Model (ITBM).

Secondly, by using form-by-form time estimates our study provides a state-by-state breakdown of tax compliance costs—something the new aggregate ITBM compliance cost figure released by the IRS does not provide. Because some states bear higher tax compliance costs than others, it is valuable for Members of Congress and state lawmakers to

know how much is at stake for their constituents in the debate over tax simplification.

For these reasons, we believe this study of compliance costs based on form-by-form time estimates provides an important contribution to the debate over the costs of complexity in the federal individual income tax.

Changes in IRS Estimates of Paperwork Burdens

Since the 1980s, the Internal Revenue Service has produced official form-by-form estimates of the time it takes to complete federal tax forms. These estimates of paperwork burdens can be found in the instructions of IRS forms under the heading “Paperwork Reduction Act Notice.” They list the time required for recordkeeping, learning tax law, preparing forms and sending returns to the IRS. These time estimates form the basis of the Tax Foundation’s study of the costs of complying with the federal income tax.

Beginning in 2006, the IRS will no longer produce form-by-form time estimates. The IRS model used to estimate paperwork burdens since the 1980s is being officially retired, and will be replaced by a new model—the Individual Taxpayer Burden Model (ITBM)—developed by IBM. Instead of producing form-by-form time estimates, the ITBM will produce one collective estimate of the compliance burden for all individual taxpayers. The IRS explained its decision to change its methodology in a recent release¹:

“When the prior model was developed in the mid-1980s, almost all tax returns were prepared manually, either by the taxpayer or a paid provider. In this context, it was determined that estimating burden on a form-by-form basis was an appropriate methodology. Today, about 85 percent of all individual tax returns are prepared utilizing computer software (either by the taxpayer or a paid provider), and about 15 percent are prepared manually. In this environment, in which many taxpayers’ activities are no longer as directly associated with particular forms, estimating burden on a form-by-form basis is not an appropriate measurement of taxpayer burden.

“Since the ITBM does not estimate burden on a form-by-form basis, IRS is no longer able to provide burden estimates for each tax form used by individuals. The ITBM estimates the aggregate burden imposed on individual taxpayers, based upon their tax-related characteristics and activities.”

¹Federal Register Notice (FR Doc 05-13593) July 8, 2005 (Volume 70, Number 130) pp. 39550–39555.



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