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The Income Tax Compliance Cost of Large and Mid-Size Businesses

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THE INCOME TAX COMPLIANCE COST OF LARGE AND MID-SIZE BUSINESSES

A Report to the IRS LMSB Division

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1. Introduction

This report presents evidence on the compliance costs of medium-sized[1] businesses based on a survey conducted by the Office of Tax Policy Research. The survey attempts to measure the size and composition of compliance costs and to identify firm characteristics that affect these costs.

This project is motivated by the fact that very little is known about the nature or magnitude of the compliance costs borne by this sector of the economy in the United States. Much previous research in other countries and on other sectors in the United States has, though, indicated that compliance costs are regressive with respect to firm size indicators, suggesting that compliance costs may be relatively more burdensome to this sector compared to the biggest companies. Given the large number of medium-sized firms, the total compliance cost could be very significant.

The report is organized as follows. Section 2 presents an overview of other business compliance cost studies in the U.S. and in other countries. Section 3 describes the sampling and survey design methodology of this study and addresses the issues of response bias and weighting. Section 4 presents the basic compliance cost results from the survey, and Section 5 elaborates on these results with a multiple regression analysis. Section 6 discusses the results of ancillary questions about the tax process. Section 7 concludes the report. Appendices include the surveys sent out to the taxpayers and the tax professionals, the cover letters, supplementary information, and data appendices.

2. Putting Compliance Costs in Perspective

2.1 Compliance Cost Studies in the U.S.

Hard quantitative evidence about the compliance costs incurred by businesses in the United States is scarce. Most estimates come from three surveys: Blumenthal and Slemrod (1992), Slemrod (1996), and a study commissioned by the Internal Revenue Service and carried out by Arthur D. Little (ADL) in 1985. Others such as Payne (1985)

[1] The companies surveyed are under the purview of the Large and Mid-Size Business (LMSB) Division of the Internal Revenue Service. Because there is a separate program within LMSB, the Coordinated Industry Case program (CIC), that covers approximately 1350 of the largest companies, and for the sake of expositional brevity, in this report we refer to the companies in this sample as being of medium size.

and Hall (1995) have reinterpreted and reevaluated data from the Arthur D. Little study. Slemrod and Sorum (1984) and Blumenthal and Slemrod (1992) presented some estimates of the compliance costs of self-employed taxpayers. Both surveys indicated that on average self-employed taxpayers spent nearly three times as much of their own time on tax compliance as other taxpayers (60 hours, as opposed to 21 hours[2]), and were twice as likely to use professional assistance to prepare their taxes.

The ADL estimates are based on a questionnaire mailed to 4,000 partnerships and corporations and to their tax preparers. As part of its contract with the IRS, ADL developed a model that would enable the IRS to estimate compliance burdens, form by form, and update the burden estimates as the tax system changed over time. The survey yielded estimates of six components of the burden – keeping records, getting advice, obtaining materials, sending and working with a preparer, preparing the return, and sending the return. ADL devised several models of how these six components of burden depended on readily observable variables. In the end ADL used simplified versions in which each component of the burden is presumed to depend upon at most two of three tax form variables: the number of lines on the form, the number of line items in the form instructions to the Internal Revenue Code and Regulations, and the number of attachments requested that are IRS forms. The resulting model generated an estimated compliance burden of 2.7 billion hours for businesses in 1983 – a number five times higher than the aggregate estimated from the survey results – 546.7 million hours. The ADL study did not attempt to translate the estimates of time spent on tax compliance into dollar values. Slemrod (1996) argues that the shortcomings of the ADL model make its compliance cost estimates (and those of other researchers who have based their estimates on the ADL model) unreliable.

Payne (1993) used the ADL model to estimate the number of hours devoted to compliance – 3.614 billion in 1985 – and used an hourly rate of $28.31 (the average of the hourly rate of IRS employees and that of employees at Arthur Andersen, Inc.) to arrive at a business compliance cost of $102.31 billion. Hall (1995) began with an official IRS estimate of the total time devoted to compliance – 5.1 billion hours in 1995 –

[2] In the 1989 survey, the average time spent on taxes by taxpayers that were homemakers, employed, or retired was about 21 hours.

that was obtained using a modified version of the ADL burden model. He made assumptions about the proportion of this burden that was accounted for by the corporate income tax, and arrived at an estimate of 2.4 billion hours. He then used a method similar to Payne's to reach an estimated hourly value of $39.60. This procedure yielded total annual business compliance costs of $141.1 billion.

Blumenthal and Slemrod (1992) and Slemrod (1996) both focus on the largest companies under the purview of what was formerly known as the Coordinated Examination Program (CEP), and what is now known as the Coordinated Industry Case program (CIC). The average compliance cost incurred by the companies in the CIC sample was $1,565,100 in 1992 and $1,899,300 in 1996. Over half of these costs were personnel costs within the firm. These studies suggest that firm size is an important determinant of compliance cost: while firms with more assets incur greater compliance costs, there are clear economies of scale, and compliance costs as a proportion of firm size decrease as a firm's asset size increases. Blumenthal and Slemrod also conclude that the existence of multiple active entities, liability for the Alternative Minimum Tax, and presence of ongoing appeals or litigation contribute significantly to higher compliance costs.

The Blumenthal-Slemrod, Slemrod, and ADL surveys are based on questionnaires mailed to the participants. The low response rate of the survey questionnaires – between 30 and 40 percent – raises concern about respondent bias. However, the direction of the bias is not clear. It is conceivable that on average the respondents are irate taxpayers that consider tax compliance to be onerous, in which case the results will overstate the true costs of compliance.[3] On the other hand, it has been suggested[4] that taxpayers who find tax forms particularly objectionable are more likely not to respond to complicated questionnaires. Such behavior will understate the true compliance cost.

Furthermore, it is difficult to measure the incremental cost of tax compliance – the cost that is incurred by the company solely because it needs to comply with the income tax. This is particularly true of smaller firms because those firms often do not have separate accounting departments.

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[3] Tait (1988, p. 352).

[4] Sandford (1995).

2.2 Business Compliance Cost Studies from Other Countries

In other countries there have been several studies of the costs businesses incur in the process of complying with various taxes. Some of these studies analyze the costs incurred by small and medium-sized companies in complying with business income taxes. Four recent studies that measured the compliance costs of public companies in Hong Kong, Malaysia, and Singapore[5] had similar findings. First, although larger firms generally incurred higher compliance costs than small and medium-sized firms, compliance costs were regressive in the sense that smaller firms faced greater compliance costs as a proportion of sales than medium-sized and large firms. Second, larger firms spent a greater proportion of their total compliance expenditures on tax planning than did smaller firms.

There have been several studies of business tax compliance costs in Australia and New Zealand.[6] Large companies in these two countries were generally found to have greater total compliance costs than small firms, but as a proportion of turnover, compliance costs were greater for smaller firms than for larger firms. The Sandford and Hasseldine study, which was a large scale mail survey of businesses in New Zealand, found that compliance costs were "strongly regressive" and that compliance costs associated with the income tax were estimated to be 19 percent of the revenues collected by the income tax. Sandford and Hasseldine surveyed 9,541 New Zealand businesses chosen by the New Zealand Internal Revenue Department, and they received 2,954 usable responses. The study focused on compliance costs associated with the goods and services tax and the business income tax. Based on five separate surveys of compliance costs of major Australian taxes, Pope found that 40.7 percent of all compliance costs were attributable to the companies' income tax, while only 21.5 percent of tax revenues came from this tax. Pope also found that the companies' income tax raised A$4.36 for every dollar of compliance costs. Furthermore, companies' compliance costs as a percentage decreased as tax liability and business size increased. Pope's study of the

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[5] Ariff, Loh and Talib (1995); Loh, Ariff, Ismail, Shamser and Ali (1997); Ariff, Ismail and Loh (1997); and Chan, Cheung and Ariff (1999).

[6] E.g., Pope (1995); Sandford and Hasseldine (1992).

compliance costs of the companies' income tax was based on a survey conducted in 1992 and sent to 2,531 companies throughout Australia.

Compliance cost studies have also been conducted in the United Kingdom and the Netherlands. The United Kingdom study (Sandford *et al* 1989) revealed that compliance costs of the corporation income tax in 1986-87 were approximately 2.22 percent of the revenue collected. Businesses' compliance costs for the corporate tax (and for other taxes studied) were found to be strongly regressive: small businesses (up to £100,000 of taxable turnover) had compliance costs equal to 0.79 percent of taxable turnover, while compliance costs for medium-sized (£100,000 to £1 million) and large (over £1 million) businesses were 0.15 and 0.04 percent, respectively, of taxable turnover. The Netherlands study (Allers 1994) yielded results similar to those of the U.K. study. The Netherlands study was a large-scale survey of 5,193 firms and asked questions about compliance with various business taxes, including the corporate income tax. Of the firms surveyed, 1,053, or 20 percent of the total, gave usable responses. The survey found that the costs of complying with the corporate income tax amounted to approximately 4 percent of the revenue generated. The study also found that compliance costs per employee and as a proportion of turnover decreased significantly as firm size increased.

The vastly different survey populations as well as the divergent tax law and processes across countries, not to mention non-uniform survey methodologies, make it impossible to draw many clear generalizations about the cost to businesses of complying with income tax laws. It is, though, universally concluded that compliance costs are regressive with respect to any of several measures of firm size.

3. Survey Design and Execution

3.1 Sampling

For our survey, the sample was drawn from the Large and Mid-Size Business population, which comprises 230,945 business tax returns of businesses with at least $5 million in assets (or in the case of partnerships, those partnerships that have more than a certain number of partners). These businesses remitted $72.7 billion in taxes in 1999, not including any individual taxes owed by owners of pass-through entities. In sampling from this population, efforts were made to ensure adequate representation of companies filing different tax forms, and companies belonging to different industry categories.

To ensure broad coverage by both sector and form type, the taxpayer population was divided into four tax return types (Form 1065, Form 1120, Form 1120S, and Other – which includes Forms 1120F, 1120FSC, 1120L, 1120ND, 1120PC, 1120REIT, 1120RIC, and 990C)[7] and five sectors (Communications, Technology, and Media; Finance, Insurance, and Healthcare; Food, Retail, and Pharmaceuticals; Heavy Manufacturing, Construction, and Transportation; and Natural Resources). From each of these twenty form-sector categories, a random sample of 125 companies was drawn, generating a total sample size of 2,500.[8]

Because we suspected that many of these businesses had no in-house tax compliance department and instead outsourced all tax activities, we felt that additional valuable information might be obtained from a separate survey of tax professionals that handle the tax affairs of this category of companies.[9] The tax professional sample was also drawn from the LMSB master file. In choosing the sample, taxpayers that were part of the taxpayer survey and those with no preparer information were removed from the population, as were records of companies that are part of the CIC, leaving a population of 172,553 records. The three types of returns that report preparer information - Form 1065, Form 1120, and Form 1120S - were then broken into the same five industry lines as those used in the taxpayer survey. This breakdown yielded 15 categories. The sample size of 2,001 was obtained by drawing random samples of either 133 or 134 records from each

[7] "Form 1120" as defined by the IRS includes companies that filed only a Form 1120. Section 4.2 describes the form categories that we defined and that are consistent with the appendix tables other than Table A-1.

[8] From the 230,945 records contained in the LMSB master file, taxpayers in the CIC sample were eliminated. The 221,377 remaining records were used to create the sample. Surveys were sent to 2,499 companies. One record was deleted because it was a duplicate.

[9] The original proposal was to send surveys to taxpayers and their respective tax professionals. This methodology was employed by Arthur D. Little in their survey of companies in 1985. However, it was felt that this would violate client confidentiality, and it was decided to send surveys to independent groups of taxpayers and tax professionals.

of these 15 categories. From these 2,001 records some were eliminated, and surveys were sent to the tax professionals listed on the taxpayer returns.[10]

The survey design reflected the objective of learning about compliance costs by industry and the type of tax form filed. From a policy standpoint, this would yield useful information about which aspects of the tax code are most burdensome to taxpayers.

The sampling methodology, coverage rates, and response rates are detailed in Table A-1. The objective of having adequate coverage for each of twenty (or fifteen, in the tax professional survey) form type/sector groups of varying size meant that the sampling rates varied widely. Table 1, which presents data on sampling and response rates by form type and industry, shows that sampling rates range from 43.4 percent for companies in the Communications, Technology and Media sector that filed a Form 1120F or 1120FSC, to 0.2 percent for companies in the Heavy Manufacturing and Transportation sector that filed a partnership return (Form 1065).[11] Table A-2 shows that, if firms are categorized by activity code, the sampling rates (the number of companies in the survey sample, as a percentage of the number of companies in the LMSB population) ranged from as low as 0.5 percent for activity code 481 (partnership Form 1065 with 10 or fewer partners and gross receipts under $100,000) to 18.5 percent for activity code 259 (Form 1120F with assets under $50,000,000). The respondent population thus differs significantly from the underlying LMSB population, and this requires that the results be weighted appropriately in order to present an accurate picture of the LMSB population. The weighting procedures are detailed in Section 3.5.

3.2 Survey Design

The survey design draws on experience with OTPR surveys of the CIC program population conducted in 1992 and 1996. Those surveys benefited from an advisory panel consisting of corporate tax officers organized by the Tax Foundation and representatives

[10] From the sample of 2,001 tax professionals, we deleted 124 records because they were from duplicate preparers. Twenty-nine had missing information. The remaining 24 were dropped due to address problems.

[11] Table A-1 and Table 1 differ in the categorization of form types. Table A-1 uses the form type categories used in the sampling procedure, while Table 1 uses the activity code-based form type categories described in Section 4.2.

of the IRS's CIC Program, and from officials at the U.S. Office of Management and Budget. It also drew on the survey instruments used by researchers in the investigation of compliance costs in the United Kingdom and Australia.[12]

For this project, a pilot taxpayer survey was prepared that incorporated some elements of the previous CIC surveys, with the questions tailored to medium-sized businesses. A second pilot for the tax professionals was also designed. These pilot surveys were then discussed with members of a focus group comprised of representatives of the National Association of Enrolled Agents and members of the LMSB division of the IRS that was convened on October 27, 2000. The suggestions of the focus group attendees were incorporated into the final versions of our surveys.

The taxpayer survey was 14 pages long (including the cover page and the table of contents) and was divided into four parts. The table of contents gave an overview of the different parts of the survey. Part One asked about the compliance costs of hiring an external firm to prepare the company's taxes. Respondents were asked to break these costs into pre-filing, filing, and post-filing expenses. To help them do this, we cited examples of the types of activities that fell under each of these categories. Part Two asked about compliance costs incurred within the company. We outlined some examples of activities that should and should not be included in these costs and asked companies to identify personnel and non-personnel costs, break down expenses into pre-filing, filing, and post-filing expenses, and attempt to break down each of these categories further. Part Three was devoted to questions about specific aspects of the tax code that increased tax complexity and the compliance burden. We also asked taxpayers if there were tax provisions that they did not make use of or business activities they did not undertake because of the tax complexity involved. The final part of the survey, left optional, asked participants about their company's characteristics.

The tax professionals' survey presented some unique methodological challenges. Asking the tax professional to estimate the compliance costs of an actual client company might have violated client confidentiality.[13] Our alternate strategy was to describe a

[12] Sandford, Godwin, and Hardwick (1989) and Pope, Fayle and Chen (1991).

[13] It might also have caused the tax professional to bill the client. As it happened, one tax professional that received the survey tried to bill the IRS for his or her time.

hypothetical company and ask the tax professional to estimate the compliance cost for a company that fit that description. Because it was important that the tax professional be familiar with dealing with the tax affairs of the kind of company about which we requested information, we distilled a small set of the key characteristics of the actual client company (which did not include any of the companies to which we sent taxpayer surveys) and presented those characteristics to the tax professional as a hypothetical company. These key characteristics were the industry code and the North American Industry Classification System (NAICS) code, total assets, gross receipts or sales, total net income, the principal tax form filed in the last tax year, the number of partners or shareholders, whether or not the company was subject to the Alternative Minimum Tax, and whether or not the company was subject to an audit or had been audited in the recent past. In addition, for partnerships, we provided the tax professional with some hypothetical Schedule K information.

The survey for the tax professional was 11 pages long (including the cover page, description of the hypothetical client company, and the table of contents). Part One described the characteristics of the hypothetical company. Part Two asked the tax professional to estimate the compliance costs for the company described in Part One. It asked the professional to attempt to break these costs down into pre-filing, filing, and post-filing costs and also into federal and state tax compliance costs. Finally, Part Three asked professionals to draw upon their years in practice to comment on the types of tax provisions that increase tax complexity and contribute to the compliance cost burden. It also asked the tax professionals if their clients had ever asked them about tax shelters and if they had ever recommended that a client refrain from a particular business activity to avoid the additional tax complexity.

Lessons from the previous surveys were incorporated to ensure better response rates and more informative answers from both the taxpayers and tax professionals. In particular, we made Part Four on the taxpayer survey optional and placed it at the end of the survey, presented clear guidelines about what should and should not be considered a compliance cost, and reduced the number of categories of compliance costs (pre-filing, filing and post-filing costs). In the previous surveys, questions that asked respondents to break up costs into fine categories were not well received. Many respondents chose to group several categories together, and this presented a coding problem. We also adapted the previous surveys to better suit the LMSB sample by eliminating multiple questions on foreign operations.

3.3 Survey Execution

The surveys were sent out soon after the April 15, 2001 tax deadline had passed. We used standard techniques to maximize the response rate. A pre-mailing correspondence was sent out two weeks before mailing the actual surveys.[14] This correspondence included a letter from IRS Commissioner Charles Rossotti urging the recipients of the survey to participate and a letter signed by OTPR co-directors Joel Slemrod and James R. Hines Jr. stating the purpose of the survey and assuring the recipients that their responses would be kept confidential.

Two weeks after the pre-mailing letter was sent out, we mailed the survey package, which contained a cover letter from Professors Slemrod and Hines, a letter from Tax Executives Inc. urging its members to respond to the survey, the survey itself, and a self-addressed, stamped envelope. Pre-printed address labels were provided by the IRS. Much care was taken to ensure that the surveys were addressed to the appropriate individual. Since each tax professional was asked to respond based on a unique hypothetical company, it was important to ensure that the hypothetical companies, surveys, and address labels all matched up.

Two sets of follow-up postcards were sent out urging non-respondents to return completed surveys.[15] In addition, in the first week of October 2001, the deputy commissioner of the LMSB division of the IRS sent a letter to the survey participants urging them to respond to the survey.

3.4 Response Rate and Respondent Bias

[14] Pre-mailing letters for the taxpayer surveys were sent out on June 20, 2001. The corresponding surveys were mailed on July 3, 2001. Pre-mailing letters for the tax professional survey were sent out on July 18, 2001. Tax professional surveys were mailed on August 1, 2001.

[15] Reminders were sent to taxpayers on August 21, 2001 and September 18, 2001. Only one reminder was sent out to the tax professionals (on September 25, 2001).

Of the 4,323 (2,499 taxpayer and 1,824 tax professional) surveys sent out, we received 454 responses. Of these, 11 surveys were returned with no questions answered, leaving us with 443 usable surveys. The effective response rate was thus 10.25 percent (443/4,323). The response rate of the tax professionals (11.95 percent, or 218/1,824)[16] was higher than that of the taxpayers (9.00 percent, or 225/2,499). In general, tax professionals' responses were also more complete: professionals tended to leave fewer questions unanswered. As we had anticipated, the response rate from the mid-size businesses was significantly lower than the response rate to our earlier survey of CIC companies (27.50 percent in 1992). This may be partly due to the inability to address the survey to the right personnel or department and to the fact that many of the companies surveyed had no in-house tax departments that could address the questions asked in the survey.

The low response rate raises the question of respondent bias — whether those taxpayers (or tax professionals) that respond are different from those that do not respond. Respondent bias can be a problem because, for example, if companies with especially large compliance costs for their size are more likely to return the survey, this will impart an upward bias to the compliance cost estimates. If the difference is systematically related to an observable characteristic of the taxpayer, such as asset size, then this can be adjusted for by assigning size-related weights to each response; we discuss such a procedure below. To the extent that the response bias is not related to any observable characteristic, it cannot be corrected in analyzing survey data. Note that this problem would not be alleviated by increasing the size of the surveyed population.

The sampling rate (surveys sent divided by taxpayer population) of just over 1 percent combined with the response rate (surveys received divided by surveys sent) of about 10 percent implies that the coverage rate (surveys received divided by total taxpayer population) was just over 0.1 percent for both taxpayers and the tax professionals.

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[16] This is the effective response rate, and differs from the rate in Table A-1. The rates in Table A-1 are based on the number of tax professionals sampled, rather than the number of tax professional surveys mailed. As described above in footnotes 8 and 10 and in the accompanying text, we were unable to mail surveys to every tax professional and taxpayer sampled.

3.5 Sample Weighting

The low coverage rate raises a number of important issues. The first is the reliability of the estimates produced from the survey responses. This applies to overall totals, but it applies with special force to sub-categories where averages are based on very small numbers of responses for each cell of the sampling table.

We are concerned about bias in estimated total compliance costs due to differential coverage across categories with different average costs. We noted above that the sampling rates varied across types of taxpayers, with some groups such as foreign-owned firms being over-sampled. Based on past surveys, we are also concerned that larger firms, which on average have higher compliance costs, are more likely to respond. In this case, a simple average of compliance costs will be an overestimate of the true population average.

To deal with the variation in coverage rates across types of taxpayers, we compute a set of weights which, when applied to the survey responses, are designed to produce a more accurate picture of the compliance costs and attitudes of the taxpayer population.[17] These weights are computed as the ratio of the taxpayer population to the number of responses and are computed for each of the sixteen different activity codes[18] that comprise the LMSB population for which we have at least one response.[19] Activity codes categorize taxpayers by both the principal tax form filed and the asset size. These weights and the underlying data used to compute them are displayed in Table A-2.[20]

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[17] We could have instead used the sampling weights based on the 20 (or 15, in the case of tax professionals) industry/form type groups used in designing the survey sample. However, 21 percent of our respondents reported no industry category, and 45 percent of respondents reported either no form type or multiple form types. Due to the inability to accurately characterize respondents by the industry-form type categories consistent with the sampling methodology, we decided to use a different weighting scheme.

[18] One of the sixteen categories, taxpayers filing Form 990C (farm cooperatives), is not technically assigned an activity code.

[19] An alternative procedure would have been to compute weights for each sector *and* activity code cell for which there was at least one survey response. This procedure would have produced 74 different cells and corresponding weights. Because under this procedure 14 of the 74 cells would have had just one respondent and another 12 would have had just two, we felt that this would have introduced too much variance in the weighted totals. For the same reason, in the analysis that follows, all of the sub-categories are based on unweighted responses, while only the overall averages are based on weighted averages.

[20] The weighting methodology is discussed in the Data Appendix II.

One striking finding that potentially affects the accuracy of our aggregate estimates is the systematic differences between the asset sizes of survey respondents as reported by the respondents themselves and the asset sizes of the firms based on IRS data.[21] Table A-3 illustrates these differences. For example, according to IRS asset size data, 7 survey respondents had more than $1 billion in domestic assets, and 10 had domestic assets from $250 million to $1 billion. According to the firms themselves, however, 27 respondents had more than $1 billion in domestic assets, and 21 had domestic assets of $250 million to $1 billion. At the other extreme, as Table A-3 also illustrates, IRS data shows that *no* survey respondents had domestic assets of less than $5 million, but based on the firms' responses, 17 respondents had less than $5 million in domestic assets. On average, the former discrepancy by far dominated: the average domestic asset size of survey respondents according to the respondents themselves was $667 million, while the corresponding average respondent size according to IRS data was only $123 million.

We were unable to ascertain the reason for the great discrepancy between firm-reported and IRS-reported asset size. One possible reason, which was cited as a problem in a study of compliance costs of major taxes in Australia,[22] is that firms might have given answers to our survey for all members of groups of companies, while the IRS data might cover only an individual taxpayer within a group of companies.[23] If that were the case, it is easy to see that the firm's reported asset size could be much larger than the IRS's asset figure. This implies that the compliance costs reported by survey respondents could be much higher than they would have been if each survey respondent had answered our survey only for a single firm and not for groups of firms. Below we report a

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[21] IRS data refer only to the size of domestic assets. Our survey companies were asked to report U.S. assets and foreign assets separately.

[22] Pope (1995).

[23] This problem might not occur for a group of companies filing a consolidated tax return. Although we were not able to confirm this speculation, where a group of companies files a consolidated return, the IRS data might treat the entire consolidated group as a single taxpayer. A review of the completed surveys, however, suggested that numerous firms were affiliated with other firms but did not file consolidated returns. According to IRS, based on SOI data, only 6,200 of the 221,377 companies in the LMSB population reported that they were part of an affiliated group. Of the 2,500 companies in our taxpayer sample, there were only 73 such companies.

procedure to adjust the estimated aggregate compliance costs for the possible error introduced by this discrepancy.

4. The Magnitude and Nature of Tax Compliance Costs

4.1 Breakdown by Asset Size

Table 2 begins the reporting of the survey results. Before discussing the figures in the table, one further methodological issue must be addressed. We asked taxpayers to give their best estimate of three distinct categories of compliance costs: internal personnel costs, internal non-personnel costs, and money paid to tax professionals such as accounting firms. In many cases, respondents would give answers to one or more of these categories (including writing a zero), but leave others blank.[24] Where a respondent left a category blank, we interpreted that blank as a non-answer, not – as in the case where a respondent answered with a zero – an answer of zero costs for that category. In what follows the cost estimates are calculated separately for each of the three components of cost and averaged over *only those respondents that provided a response to that question.* (This implies*, inter alia*, that the sub-component averages are calculated over different groups of companies.) The average total compliance cost is then the sum of the three separately calculated averages. We also calculated costs using an alternative procedure: dropping all the respondents that did not respond to all three cost component questions, and calculating the average compliance cost averaged only over these respondents. Dropping from the analysis those respondents that left some questions unanswered would result in the loss of valuable information. This method could, conceivably, exacerbate the problem of respondent bias – if larger firms are more likely to provide estimates of all three components of cost, our estimate of total compliance cost

[24] It is worth mentioning here that the cover letter that accompanied the taxpayer survey clearly stated: "The crucial piece of information we are looking for is the cost you incur to comply with the income tax. If you hired someone else to manage your tax affairs, we simply want to know how much you paid them! To be sure, the survey has many more questions, and any additional information you provide us will significantly enhance the quality of our analysis." It is conceivable that, thus prompted, many respondents chose to provide us with only their external cost of tax compliance.

will be upwardly biased.[25] In Data Appendix III we outline alternative procedures to calculate and characterize the average compliance cost.

At the outset of our discussion of the data, an important feature of the tables merits mention*: except for the average total compliance cost figure that appears in the bottom right corner of Tables 2 and 3, all of the averages in the tables are unweighted averages (that is, not adjusted to account for the variations in the survey's coverage rates among different kinds of taxpayers).* We show unweighted, rather than weighted, averages for the reason described in footnote 18 above.[26]

The final column of Table 2 shows average total compliance costs according to asset size category. For firms with $5 million or more in assets, average total compliance costs systematically increase with increasing firm size as measured by asset size. Firms in the $5 million to $10 million asset category had an average of $35,443 in compliance costs; firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent on average $149,876; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; firms with $250 million to $1 billion in assets had an average of $426,367 in compliance costs; and firms with over $1 billion in assets incurred an average of $1,331,643 in compliance costs. The average for companies with less than $5 million in reported assets is actually higher than for the next two asset size groups, suggesting that included in this category are companies in unusual situations, such as formerly large firms in liquidation or companies in the process of being acquired.

Consistent with all earlier research, compliance costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms. Thus, for instance, as described above, firms in the $5 million to $10 million asset category spent on average $35,443 on total compliance costs, while firms in the $100 million to $250 million category – firms 10 to 50 times the size of the $5 million

[25] It turns out that the overall weighted average compliance costs computed in this alternative way are about 15 percent higher than if computed in the baseline way.

[26] The qualitative conclusions we draw about the nature of compliance costs, as opposed to those relating to aggregate compliance costs, are not much affected by analyzing unweighted responses.

to $10 million firms – spent on average $243,942 on total compliance costs – only seven times the average amount spent by the smaller firms.

The relationship between compliance cost and asset size can be summarized by estimating the best-fitting log-linear statistical relationship between reported total compliance cost and reported assets.[27] If we do so, we find the relationship depicted in Figures 1A and 1B. Figure 1B shows that estimated costs as a fraction of total assets decline as a fraction of total assets. Similar relationships obtain between compliance costs and other measures of size, such as sales or employment. Compliance costs for the LMSB population are clearly regressive in terms of company size.

4.2 Breakdown by Form Type

In the bottom row of Table 2, compliance costs are also shown based on the principal tax form an entity filed. Firms were divided into four form type categories – Form 1120 and other forms,[28] Form 1120F, Form 1120S, and Form 1065. Form 1120 is the tax form used by domestic corporations. Form 1120F is the form used by non-U.S. corporations. The Form 1120F category also includes firms that filed Form 1120FSC, that is, firms that are foreign sales corporations. Form 1120S is filed by corporations that qualify for pass-through tax treatment (taxation at the shareholder level only) under subchapter S of the Internal Revenue Code. Form 1065 is the form filed by partnerships. The categorization is based on information supplied to us by the IRS, and is *not* based on the forms that survey respondents reported that they filed. More specifically, we have assigned each firm to a particular form type category based on the activity code assigned to that firm by the IRS. The IRS assigns an activity code to a taxpayer based generally on the tax form that the taxpayer files and the asset size of the taxpayer. We used activity codes as the basis for assigning survey respondents to form type categories because in

[27] These figures are based on the estimated relationship ln (total compliance cost) = 0.7409 + 11.0281 (dummy variable for assets not reported) + 0.5969 ln (total assets). The dummy variable is assigned a value of zero if firms responded to the question on asset size, and assumes a value of one if firms provided no response to the question on asset size.

[28] The other forms include the following: Form 1120L, which is filed by life insurance companies; Form 1120ND, the return for nuclear decommissioning funds; Form 1120PC, which is filed by property and casualty insurance companies; Form 1120REIT, used by real estate investment trusts; Form 1120RIC, the form filed by regulated investment companies (mutual funds); and Form 990C, the form used by farmers' cooperative associations.

many cases there were discrepancies between the form type or types that survey respondents reported filing and the form type filed by the respondents according to the IRS form type information. In particular, it often happened that a survey respondent reported filing multiple forms – both a Form 1120 and a Form 1065, for example – while according to the IRS form type information, the company filed only a single form.[29] We decided that the best way to deal with the discrepancies between what survey respondents reported and what the IRS information said was to use the IRS activity codes as the basis for classifying firms according to form type filed.[30]

Of these four form type categories, firms falling under the Form 1120F category reported by far the highest average compliance costs – $1,269,132. Firms in the Form 1120S category had on average the lowest compliance costs, at $108,129. Firms assigned to the Form 1065 category reported average compliance costs of $518,845, and firms in the Form 1120 and other forms category spent an average of $257,973 in complying with the income tax rules.[31] Because there is almost certainly a relationship between firm size and what form type class the firm falls in, these cross tabulations cannot be interpreted as evidence of a causal relationship—i.e., that form type *causes* differential compliance costs. We will investigate the causal links more carefully in the multiple regression analysis contained in Section 5.

4.3 Breakdown by Industry

Table 3 shows compliance costs based on industry category as well as asset size. As is seen in Table 3, total compliance costs varied widely across industries. Firms in the communications, technology, and media industry had the highest average total compliance costs; they spent $719,740 on average. Firms in the retail, food and healthcare group spent the lowest average amount, $249,192.

[29] Our survey asked companies to indicate the type of tax form they had filed in the most recent tax year. Eleven percent of taxpayers did not respond to that question. Of those that responded, 34 percent indicated that they had filed more than one type of tax form.

[30] Tax professionals were asked to report compliance costs for a hypothetical company that we specified, and hence, there were no such ambiguities.

[31] Recall that these estimates of total compliance costs are *unweighted* estimates.

The pattern of increasing compliance costs with increasing firm size generally holds within the different industry categories, but this pattern sometimes breaks down. Where compliance costs do not increase with firm size within a given industry category, though, the result might be explained by the small number of firms within each asset range in that industry category. Often, the survey sample for a given asset range and industry category includes only one to four firms. Table 3A gives a breakdown of the respondents by asset size and industry.[32]

4.4 Breakdown of Overall Costs

Table 4[33] shows the proportion of firms' total compliance spending devoted to each of three categories: internal personnel costs, internal non-personnel costs, and external costs.[34]

As can be seen in the table, a large proportion of average total compliance spending, 58.7 percent, was comprised of internal personnel costs. Firms devoted 24.8 percent of their total compliance spending to external assistance. Internal, non-personnel costs accounted for 16.5 percent of compliance spending.

No patterns in the breakdown of overall compliance costs emerge based on firm asset size. The form type categories, however, yield some interesting variations. As can be seen in the bottom row of Table 4, firms in the Form 1120F category (which, as described above, includes foreign sales corporations) and the Form 1120S category reported devoting significantly greater percentages of their total compliance costs to

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[32] Note that this is the number of companies that responded to the survey, and is not necessarily equal to the number of companies underlying each of the cells of Table 3.

[33] In constructing Table 4, we used the methodology described in Section 4.1. First, we computed averages for each of the three components of total cost. Next, we summed them to obtain the average total compliance cost. Table 4 expresses each component cost as a percentage of the average total compliance cost. Note that the average value, as reflected in the "All" forms column and the "All" asset sizes row, can sometimes seem inconsistent with the data in the individual cells. This can be attributed to missing data. When averages are computed in the presence of missing data (averaging only over non-missing values), the procedure, in effect, assigns to the missing data the average value of the non-missing data. This can skew the results in the "All" category.

[34] Personnel costs include salaries and fringe benefits paid for business income tax compliance work. Non-personnel costs include costs for such things as software, data processing, record storage and retrieval, office space, general supplies, copying, faxing, and travel. External costs are expenditures made for outside tax services, such as those performed by accountants and tax lawyers.

external services than did firms in the Form 1120 (and other) and Form 1065 categories. Firms in the Form 1120F and Form 1120S categories also spent, on average, significantly smaller proportions of their total compliance budgets on internal personnel costs than did firms in the other two categories.

4.5 Breakdown of Internal Compliance Costs

Table 5[35] provides information about firms' allocation of their internal tax compliance costs. The table divides overall internal compliance spending (personnel and non-personnel costs) into spending on pre-filing, filing, and post-filing activities.[36] The bottom panel of the first column shows that companies devoted an average of 50.0 percent of their internal spending to filing activities, 38.8 percent to pre-filing activities, and 11.2 percent to post-filing activities. On average, larger firms generally devoted higher percentages of their total internal compliance spending to post-filing activities and lower percentages to pre-filing activities than did smaller firms. Thus, for instance, firms in the $250 million to $1 billion asset category and in the greater than $1 billion asset category reported spending on average 12.8 and 16.6 percent, respectively, of their total internal compliance costs on post-filing activities, while firms in the $5 million to $10 million and $10 million to $50 million asset categories spent, on average, 5.1 percent and 8.4 percent respectively on post-filing activities. As is seen in Table 5, the relative percentages for spending on pre-filing activities for small and large firms is reversed.

The survey subdivided internal pre-filing, filing, and post-filing costs into smaller categories, and Table 5 shows the results of that subdivision. Spending on tax planning constituted an average of 31.8 percent of internal pre-filing costs; soliciting tax guidance and information accounted for 22.5 percent; and maintaining tax-related records was 43.8 percent. Of the amount spent within the company on filing costs, firms spent 58.9 percent on average on collecting data for a tax professional, 11.3 percent on preparing the

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[35] The average percentage indicated in the table is the average of percentage value assigned to each category by the taxpayer, averaged only over those taxpayers that responded to the relevant question.

[36] Firms were told that pre-filing activities include tax planning, obtaining tax guidance and information, and maintaining tax-related records. Filing activities include the collection of data for tax professionals, preparation of the tax return from financial data, and the calculation of the tax owed. Post-filing activities include filing amended returns, the audit process (including appeals, litigation, and collection), and responding to IRS notices.

tax return from financial data, and 1.4 percent on calculating the tax. Of the total amount expended on internal post-filing activities, 20.0 percent went to amended return preparation, 39.9 percent was spent on the audit process, and 30.3 percent was devoted to responding to IRS notices.[37]

The division of internal pre-filing, filing, and post-filing costs into narrower categories yielded certain interesting results. Larger firms on average spent a greater percentage of their pre-filing costs on tax planning than did smaller firms. Thus, firms in the $250 million to $1 billion and greater than $1 billion asset categories reported spending on average 40.4 percent and 45.4 percent, respectively, of their pre-filing costs on tax planning, while firms with $5 million to $10 million in assets devoted only 14.4 percent of pre-filing spending to such planning. Conversely, smaller firms devoted, on average, higher percentages of their pre-filing spending to the maintenance of tax-related records than did larger firms. Table 5 also shows a pattern in filing costs based on asset size: as firm asset size increased the average percentage of filing costs devoted to collecting data generally decreased, and the average percentage of filing costs spent on preparing the tax return generally increased.

4.6 Magnitude and Nature of Outside Services Used, As Reported by Taxpayers and Tax Professionals

Table 6 presents information on outside services purchased by taxpayers, as reported by taxpayers and as reported by tax professionals with regard to hypothetical client companies. A remarkable finding is that, for companies in the middle range of size, from $10 million to $250 million in reported assets, the tax professionals report a much lower cost than do the taxpayers themselves— in some cases, about one-third as much. Part of this large discrepancy may be due to the fact that the amount that taxpayers report spending may include not only the amount paid to their accounting firm, but also to law firms and other services. However, according to the taxpayers surveyed, 92.6 percent of spending on outside services went to accounting firms, so this is unlikely

[37] The percentages in each of the categories – pre-filing, filing, and post-filing – do not add to 100 because some firms listed "other" categories of costs (1.9 percent, 28.3 percent, and 9.8 percent of costs, respectively, for each of the three categories).

to be the reason for the discrepancy.[38] Part may be due to the fact that the tax professionals have an incentive to lowball what they say they charge. The fact that tax professionals were reporting the external cost incurred by a hypothetical company (for which little detail was provided) could also account for some of the difference between estimates. The huge discrepancy certainly raises questions about the accuracy of the self-reports of both the taxpayers and the tax professionals.[39]

In addition, the unweighted average total asset size of the hypothetical firms ($23.3 million) is significantly lower than the unweighted average total asset size of the taxpayers that responded to the survey ($1.1 billion). This makes it impossible to draw conclusions from a comparison of the unweighted average external costs reported by the taxpayers with those reported by the tax professionals.

We asked companies to estimate the percentages of their external spending made for pre-filing, filing, and post filing assistance. On average, 27.4 percent of expenditures on outside tax assistance were devoted to pre-filing activities, 64.9 percent consisted of filing costs, and 7.7 percent was spent on post-filing activities. As is evident in Table 6, the percentage of costs for outside tax assistance devoted to pre-filing activities persistently increased with firm size, and the proportion of total expenditures made on filing activities consistently decreased as firm size increased.

Tax professionals were also asked to break down their estimates of amounts paid to them by clients into pre-filing, filing, and post-filing costs. The last column of Table 6 shows the estimates made by tax professionals for the percentages of their total charges that would be for pre-filing, filing, and post-filing activities. For all asset size categories, the majority of costs was for filing activities. Overall, tax professionals reported that

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[38] Law firms accounted for 5.9 percent and "others" accounted for 1.5 percent of outside spending.

[39] Regression analysis is a natural way to objectively measure this discrepancy. We combined the results obtained from the surveys sent to taxpayers and tax professionals and regressed the external cost on asset size and a dummy variable which took the value 1 if the survey was sent to a company and a value of zero if the survey was sent to a tax professional. These results are presented in Exhibit 1C. The coefficient on the dummy variable indicated that the external costs, as reported by the taxpayer were about 93 percent higher than the corresponding amount reported by the tax professional. When other variables were included, this differential increased to 283 percent. [Note that since the dependent variable is in logarithmic form, the percentage impact of any one dummy variable is computed as ($e^{\text{coefficient}}$ – 1)]. This suggests that the discrepancy between taxpayer-reported and tax-professional-reported outside costs is not due only to the different methodologies, including sampling methodologies, used in the two surveys.

59.5 percent of the total amount they charged would be for filing activities, 25.8 percent would be for pre-filing activities, and 14.6 percent would be for post-filing activities. There are no patterns evident in tax professionals' responses by the size of the hypothetical firm.

Table 7 breaks down pre-filing, filing, and post-filing costs billed by the tax professionals into smaller categories. Of pre-filing costs, tax professionals estimated that 46.9 percent would be accounted for by tax planning, 27.1 percent would be devoted to providing tax guidance and information, and 21.3 percent would be billed for maintaining tax-related records. Tax professionals estimated that 36.7 percent of filing costs would be billed for collecting data, 47.0 percent for preparing the tax return, and 13.7 percent for tax calculation. Of post-filing costs, an estimated 17.2 percent would, according to tax professionals' estimates, be accounted for by work on amended returns, 29.5 percent on the audit process, and 31.9 percent in responding to IRS notices. No strong patterns of spending were evident based on the size of the firm the tax professional would serve or the form or forms the firm would file. [40]

Several questions in the taxpayer and tax professional survey elicited additional details about the magnitude and nature of outside services used. Table 8 shows that a higher percentage of survey respondents, 85.1 percent, reported paying for tax return preparation than for any of six other services.[41] 76.4 percent of firms surveyed reported spending money for outside tax planning or tax advice. At the low end, only 2.9 percent of firms spent money for outside assistance with collection matters, and only 7.7 percent paid an outside professional to assist with record-keeping. Interestingly, while larger firms in some cases use outside tax professionals at a higher rate than do smaller firms, the larger firms do not do so on a persistent basis.[42] As an example, the percentage of firms with more than $1 billion in assets that used each type of outside service other than collection assistance and record-keeping is smaller than the percentage of firms in the

[40] The percentages in each of the categories – pre-filing, filing, and post-filing – do not add to 100 because some firms listed "other" categories of costs (4.3 percent, 2.6 percent, and 5.6 percent of costs, respectively).

[41] For this question and those that follow, the averages are computed based only on those businesses that responded to each question.

[42] The breakdowns by asset size are not shown in Table 8.

$250 million to $1 billion asset category that did so. This decreased usage of outside professional services may reflect, among other possible reasons, the fact that 94.1 percent of firms with assets of more than $1 billion have separate tax departments, while only 82.4 percent of firms in the $250 million to $1 billion asset category have such departments. In addition, our survey responses indicated that larger firms spent a higher percentage of their outside compliance costs on law firms and a lower percentage on accounting firms than did smaller firms.

In the tax professional survey we asked which services tax professionals thought hypothetical firms would purchase. As is seen in Table 8, for each of the seven services given as choices, the percentage of tax professionals who thought taxpayers would use the service was higher than the percentage of taxpayers that claimed to actually pay for the service. As in the taxpayer survey, the service that the highest percentage of tax professionals thought taxpayers would use was tax return preparation; 98.6 percent of tax professionals said the hypothetical firm described in the survey would hire a professional for this purpose. Also as in the taxpayer survey, the service that garnered the lowest percentage of positive responses from tax professionals, 20.3 percent, was help with collection matters. The results of the tax professional survey were similar to the results of the taxpayer survey in the lack of a strong, systematic pattern of increasing use of professional services with increasing firm size.

4.7 Breakdown by Federal, State and Local, and Foreign Compliance Costs

Table 9 shows the division of internal compliance costs among amounts spent on federal, state and local, and foreign compliance matters and provides a breakdown of external costs into federal and state components. Overall, an average of 67.0 percent of each firm's total annual compliance spending for internal costs was devoted to federal tax compliance, 26.3 percent was spent on state and local compliance, and 6.8 percent was spent on compliance with foreign-source income rules. These results are similar to the results found in our 1996 survey of large corporations: firms in that earlier survey devoted an average of 74.3 percent of their *total* (not just internal) compliance costs to federal compliance and 25.7 percent to state and local compliance.[43] With a few

[43] In that survey firms were not asked about foreign compliance costs.

exceptions, as asset size increases, the proportion of compliance costs spent on federal compliance decreases and the proportion spent on foreign compliance increases.

We also asked firms to report the percentages of their total *external* compliance expenditures devoted to federal, state and local, and foreign compliance matters. On average, 73.2 percent of firms' total cost of outside services was devoted to federal compliance, 23.1 percent was spent on state and local tax compliance, and 3.7 percent was spent on compliance with foreign source income rules.

The last column of Table 9 reports the breakdown of external costs into federal and state and local compliance matters based on the answers of tax professionals. The survey did not ask tax professionals to assign an amount charged to foreign compliance. Tax professionals estimated that 80.0 percent of the amounts they charged would be for federal compliance and 20.0 percent would be for state and local compliance.

4.8 Assessing Aggregate Compliance Costs

Using the survey results to derive an estimate for the total compliance costs of the LMSB population is fraught with several problems. The vast difference in coverage rates by observable characteristics related to size and principal form type is dealt with by assigning the weights discussed in Section 3.5. Response bias unrelated to observable characteristics cannot be corrected for. The clear discrepancy between the estimates of outside expenses given by the taxpayer and tax professionals is a source of concern. Finally, there is the issue of the discrepancy between taxpayer-reported asset size and the IRS measure of asset size. The last two, and possibly the second, issue would all imply that the weighted estimates of total compliance cost based on taxpayer survey results are too high. But how much too high?

If taxpayer responses are weighted to reflect the underlying population, the estimated average compliance cost of businesses in the LMSB population is $254,451.[44] This figure is shown in the bottom right panel of Tables 2 and 3. These costs are, however, highly skewed. The (weighted) median compliance cost is only $114,705.

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[44] We also computed the weighted average cost using the form type and industry-based sampling weights (based on IRS data). The resulting average cost is $252,614 – less than 1% different from this estimate. Thus, the weighted average estimate is not sensitive to an alternative reasonable weighting methodology.

Table A-4 clearly highlights the discrepancies between the average cost estimates and the corresponding median cost estimates.[45]

There is an important reason to suspect that this estimate of average compliance cost needs to be adjusted to more accurately reflect the true average of the LMSB population. As described earlier in the report, there was a large discrepancy between firms' own estimates of their asset sizes and the IRS's information on firm asset size. To provide an estimate of the potential impact on the compliance cost estimate of this discrepancy, we pursued two different strategies.

In our first procedure, we recalculated the compliance cost for each survey respondent as follows. We computed the asset ratio – the ratio of IRS-reported asset size to taxpayer-reported asset size for all taxpayer respondents. To minimize the correction needed for gross discrepancies, if the asset ratio was either greater than 20 to 1 or less than 1/20th, we used those bounds.[46] We then made use of the estimate from a simple regression analysis that the elasticity of total compliance costs with respect to domestic asset size is approximately 0.5.[47] We then multiplied the components of compliance cost (cost of outside assistance, personnel costs, and non-personnel costs) by a factor equal to (asset ratio)$^{0.5011}$. In simple terms, this procedure adjusts the reported compliance costs of each taxpayer by a factor based on the discrepancy in asset sizes and an estimate of the impact on compliance costs of that discrepancy. Then we computed an adjusted weighted average compliance cost equal to the weighted sum of the adjusted individual cost components. This procedure yielded an *adjusted* weighted average cost estimate of $134,954, nearly 50% lower than the unadjusted estimate.[48]

Multiplying this estimate by the size of the LMSB population of 221,377 yields a total compliance cost of $29.9 billion. Of this, approximately 25.5[49] percent was due to

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[45] The weighted median compliance costs are based on companies that reported all three components of compliance cost. The average costs are computed as described in Section 4.1.

[46] When asset data - either self-reported or IRS data - were unavailable, no adjustment was made.

[47] This is based on the regression equation: ln (total compliance cost) = 2.6101 + 9.5832 (dummy variable for U.S. assets not reported) + 0.5011 ln (reported U.S assets)

[48] The corresponding median compliance cost is $82,417.

[49] Taxpayers attributed 23.1 percent of external and 26.3 percent of internal (personnel and non-personnel costs) compliance costs to complying with state and local taxes. As a percentage of total costs, external and internal costs constituted 24.8 and 75.2 percent, respectively.

state and local income tax, so eliminating that part generates a $22.3 billion total compliance cost of the federal income tax system.

As an alternative to the weighting and asset adjustment procedure described, we used the results from a simple regression of compliance costs on IRS-reported assets[50] to predict compliance costs for each taxpayer in the entire LMSB population of 221,377 companies. The predicted average cost using this procedure is $127,481, or about 5.5 percent lower than our adjusted weighted average compliance cost estimate of $134,954. Using this estimate and subtracting the cost due to state and local income tax systems, the total cost of complying with the federal tax system is $21.0 billion. Thus, the two procedures we have used to adjust the survey results to account for the discrepancy between self-reported and IRS-reported assets generate very similar estimates of aggregate compliance costs - $21.0 billion and $22.3 billion.

In order to determine the robustness of this range and the underlying average compliance cost, we have computed the average cost using alternate methodologies. Data Appendix III describes these alternate methodologies, and Table A-4 summarizes the results of these sensitivity analyses. Our best estimate of the aggregate compliance costs of the LMSB sector is about $22 billion.

This estimate of the aggregate compliance costs—and all of the estimates in this report—are indeed just estimates and in principle all have confidence intervals accompanying them. In this report we have chosen not to report confidence intervals because we believe that the most significant source of error is not due to the fact that we base the estimates on a relatively small sample of the LMSB population. Rather it is due to potential respondent bias and the adjustment for reported asset size discrepancy described above. There is, unfortunately, no procedure for assessing the possible error introduced by these factors.

One useful benchmark for the total compliance costs of a sector is the revenue raised from that sector. According to the 1999 Statistics of Income data, the LMSB

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[50] ln(Total Cost) = 5.7488 + 0.4206 ln(IRS assets) +8.9658 (Dummy Variable for Blank Assets) -1.2459 (Dummy Variable for the Financial & Professional Services Industry) -1.1120 (Dummy Variable for the Natural Resources & Construction Industry) -0.4640 (Dummy Variable for the Communication, Technology & Media Industry) -1.0607 (Dummy Variable for the Heavy Manufacturing & Transportation Industry) -0.0634 (Dummy Variable for Form 1065 filers) -0.8271 (Dummy Variable for Form 1120 filers) -0.8141 (Dummy Variable for Form 1120S filers)

population paid $72.7 billion in taxes in that year, excluding any individual taxes paid by owners of pass-through entities. Adjusting for inflation, this amounts to $75.1 billion in 2000 (which is the tax year for which our respondents provided information). Thus, the ratio of estimated total compliance costs to revenue is between 28.0 percent (21.0/75.1) and 29.6 percent (22.3/75.1). This is between 10 and 11 times as much as the 2.7 percent estimated in Slemrod (1996) for the CIC population in 1992.

From one perspective, this much higher ratio of compliance costs to revenue is not surprising, because it is consistent with the long-suspected (and oft-documented in other countries) regressivity of business compliance costs. In another important sense, though, this ratio is misleading on the high side. This is because 60.5 percent of the LMSB population consists of pass-through businesses such as partnerships and Subchapter S corporations, and 65.7 percent of all weighted compliance costs come from pass-through entities. These entities do not themselves remit tax, although their owners pay tax on the income they generate. As a fraction of the tax paid by the non-pass-through entities and the *owners* of the pass-through entities, the percentage of compliance costs would certainly be significantly lower.[51] Similarly, an additional 1.5 percent of the LMSB population is made up of firms that file Form 990C, 1120FSC, or 1120F, and 6.6 percent of all weighted compliance costs are incurred by firms filing these form types. Firms that file Form 990C are generally exempt from federal income tax; firms that file Form 1120FSC pay federal tax under preferential rules that significantly reduce their tax burden; and firms filing Form 1120F generally pay federal tax only on their U.S.-source income. The fact that these firms pay no federal tax or pay a lower rate of tax than do domestic taxable corporations further exaggerates the ratio of compliance costs to tax revenues generated.

5. *The Magnitude and Nature of Tax Compliance Costs: Insights from the Multiple Regression Analysis*

[51] According to IRS data, net income reported by pass-through entities (those filing Form 1065 and Form 1120S) for the 2000 tax year was $117 billion. At the 34 percent tax rate, this amounts to $39.8 billion in tax revenues. Including these tax revenues, the ratio of estimated total compliance costs to revenue declines to between 18.3 percent and 19.4 percent.

Although compliance costs are clearly related to firm size, to some extent that relationship may be standing in for other characteristics of companies that affect compliance cost. For example, bigger firms are more likely to operate in many states and abroad. If multi-state and foreign operation increase compliance costs, then it may be those characteristics, rather than size per se, that are the drivers of cost. To investigate this issue, the natural methodology is a multiple regression analysis, which can isolate the influence of separate attributes of companies, holding constant (in a statistical sense) other attributes such as size.

Slemrod and Blumenthal (1996) report on the results of such an analysis for the CIC survey respondent population. This analysis suggested that the measure of size (in that case, worldwide employment) is an independent determinant of compliance cost, even when other indicators of complexity are considered. Holding size constant, several other cost determinants were found. Being in the mining or oil and gas sector increased costs substantially, while being in the wholesale or retail trade sector implied lower costs than otherwise. A larger number of active entities meant higher compliance costs. Firms subject to the Alternative Minimum Tax had significantly higher compliance costs. Having an ongoing appeal did not appear to be significantly associated with higher costs, whereas having ongoing litigation was associated with higher costs.

We performed a multiple regression analysis on the information provided by the taxpayers and the tax professionals. We included in our econometric analysis survey responses provided by companies with reported assets greater than $5 million. For the regressions involving total compliance costs, in order to have the maximum possible sample size for the analysis, we included all companies that reported costs and at least one other potential influence on costs, provided that those firms gave responses to *all three* components of compliance cost. When there were missing data, we inserted a dummy variable that was assigned a value of zero when data for that variable were missing.

The results of this exercise are shown in Exhibits 1A, 1B, and 1C. Sheer size, as measured by total assets, has an independent effect on compliance costs, but its coefficient is significantly lower than when it is assumed to be the *only* determinant. Exhibit 1A refers to the total compliance cost. While a 1 percent increase in assets is associated with a 0.60 percent increase in costs when it is the only influence, it is associated with a 0.46 percent increase when other determinants of cost are included. In other words, the estimated influence on costs is about one-fourth less when other influences on cost are accounted for.

Unlike the results for the CIC population, the regression analysis does not find any statistically significant relationship between sector and compliance costs in the LMSB population.[52] It also finds no relationship between the type of tax form a company filed and the compliance costs.[53] It does, though, find a few characteristics of a company or a company's tax return that positively affect compliance costs, holding other factors constant. The first is being subject to the Alternative Minimum Tax (AMT), which adds 11.5 percent to total compliance costs.[54] Calculating the Alternative Minimum Tax even when the company was not subject to the AMT adds 136 percent to compliance costs. An international presence adds 143 percent, and being a publicly held company adds 26 percent to compliance costs.

Exhibit 1B shows that external costs are even more regressive than total costs.[55] These costs rise by only 0.25 percent for each percent increase in total assets. However, when external compliance costs are regressed on multiple variables, this rises to 0.28 percent. Outside costs appear to be much higher (230 percent) for companies that file a Form 1120F, but this relationship is only barely statistically significant. Calculating the AMT despite not being subject to it adds 54 percent to external costs, while being publicly held increases costs by 71 percent.

Tax professionals were asked to estimate the amount they would charge a client based upon certain characteristics of a hypothetical firm. The regression results based on these responses suggest a much larger connection between asset size and outside costs,

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[52] This result and other tests of significance in this section are determined at the 10 percent level of significance.

[53] When total costs were regressed on assets and 19 different form type-industry interaction variables, only 3 of the 19 interaction variables were statistically different from zero. All 3 variables had "Other Forms" as the form type.

[54] Since the dependent variable is in logarithmic form, the percentage impact of any one dummy variable is computed as ($e^{\text{coefficient}} - 1$). For instance, the percentage increase in compliance cost for a firm that is subject to the AMT (vis-à-vis a firm that is not subject to the AMT) is ($e^{0.1093} - 1$), or 11.5 percent.

[55] Based on companies' responses.

amounting to an elasticity of 0.44 or 0.45 depending on whether other explanatory variables are included in the regression. Of the other explanatory variables investigated, dealing with current and past audits affected the amount charged by the tax professional positively, by 75 percent and 43 percent, respectively.

Exhibit 1C shows the results for internal costs. When only asset size is included as an explanatory variable, a one percent increase in assets is associated with a 0.60 percent increase in costs; this drops to 0.35 when other explanatory variables are allowed. By far the biggest influence on internal costs was having foreign operations. Being a multinational company is associated with 211 percent higher internal costs, and each additional country with operations added another 2.5 percent. Being publicly held increased costs by 46 percent, but that relationship is not statistically significant at usual standards.

6. *Sources and Consequences of, and Suggested Policy Responses to, Complexity: Qualitative Answers from Taxpayers and Tax Professionals*

6.1 *Sources of Complexity*

The survey included several questions designed to determine which provisions of the tax code are sources of complexity. Taxpayers were asked which of six aspects of the tax code were most responsible for costs of complying with the federal corporate tax rules; they could check more than one, if applicable. Table 10 shows the responses. The aspect cited by the highest percentage (60.4 percent) of taxpayers were the depreciation rules. 50.5 percent of firms cited the Alternative Minimum Tax. The feature of the tax code cited the least were the depreciation recapture rules of section 1231; only 16.8 percent of firms cited these rules. Several firms also wrote in additional provisions as most responsible for compliance costs. The provisions written in by the most respondents were the capitalization rules of section 263A and the research and development credit rules. Eight firms mentioned each of these provisions.

Table 10 also shows tax professionals' answers to the same question regarding which tax code provisions are sources of complexity. Their answers were similar to the taxpayers' responses, with two notable exceptions. The provision cited by the largest proportion of tax professionals was the Alternative Minimum Tax, followed by the depreciation rules: 76.6 percent and 67.3 percent of tax professionals selected these provisions. The other major difference is the much greater prominence given to partner-shareholder issues by the tax professional: they cited this more than twice as often as the taxpayers, 63.1 percent versus 31.2 percent. As in the taxpayer survey, the capitalization rules of section 263A were the rules most often written in as another source of complexity.

6.2 Suggestions for Simplification

Table 11 shows how taxpayers and tax professionals ranked six tax reform options based on each option's relative ability to simplify tax compliance. By a small amount, taxpayers selected the establishment of complete uniformity among state and local corporate income tax rules and conformity to federal rules as the most likely to simplify tax compliance. Our 1996 survey of large companies produced a similar answer. In that survey companies were asked to quantify the potential compliance cost savings from various proposed simplifications. Firms identified the establishment of uniformity among the states and between the states and the federal governments as the reform that would generate the second highest level of savings.   In the current survey, two suggestions closely followed state and federal uniformity: first, the elimination of depreciation rules and their replacement with immediate expensing based on capital costs, and second, the abolition of the Alternative Minimum Tax. The choice viewed as least able to simplify the tax process was the elimination of reporting requirements of all non-tax-computation-related information such as business activity code, ownership of over 50 percent of voting stock, and Forms 5471 and 5472. Interestingly, the provision ranked second to last in its ability to simplify the tax process was the abolition of the capitalization rules of section 263A. This result may be in tension with another survey response: as mentioned above, when asked about aspects of the tax code that were most responsible for compliance costs, eight firms specifically mentioned the section 263A rules.

Tax professionals responded somewhat differently. As Table 11 shows, they rated as most able to simplify the tax process the abolition of the Alternative Minimum Tax. Next in effectiveness came the abolition of section 263A. As with taxpayers, the option seen as least effective in simplifying the tax process was the elimination of the reporting requirements of all non-tax-computation-related information.

The survey also asked firms with foreign operations for suggestions to simplify tax rules dealing with foreign-source income. Table 12 shows that six of the seven possible suggestions were chosen by between 41.4 percent and 60.3 percent of the firms answering the question: 60.3 percent of the firms selected each of two suggestions – first, that excess foreign tax credits be permitted to be carried forward indefinitely, and second, that the allocation rules for interest, research and development, and other expenses be simplified – while 41.4 percent of firms chose the suggestion that information entries in Form 5471 be required to be reported only every other year. Only 6.9 percent of firms chose the suggestion of changing the definition of earnings and profits to conform to foreign income definitions, far below any of the other six options given.

Tax professionals gave somewhat different responses from taxpayers when asked to choose among the seven possible suggestions for simplifying tax compliance rules dealing with foreign source income. As Table 12 shows, the suggestion selected by the highest proportion of tax professionals, 60.8 percent, was to change the definition of earnings and profits to conform to domestic income definitions. On the other hand, only 21.5 percent of tax professionals chose the suggestion of permitting excess foreign tax credits to be carried forward indefinitely, a significantly lower percentage than the 60.3 percent of taxpayers choosing this suggestion. As in the taxpayer survey, a small proportion of respondents – 5.7 percent of tax professionals – chose the suggestion of changing the definition of earnings and profits to conform to foreign income definitions. Several tax professionals wrote in additional suggestions for simplification. Four tax professionals suggested eliminating or simplifying the section 263A capitalization rules, and three tax professionals suggested making state and local tax rules uniform.

6.3 Consequences of Complexity

According to the surveys, the median increase in compliance costs between 1996 and 2000 was 25 percent, while the median increase in total revenues among these firms was 22 percent. This suggests that costs are rising only slightly faster than revenues over this period.

An increase in costs is one symptom of a changing environment and reflects one response of firms to the environment. But firms may have responses other than simply increasing spending on tax compliance. One set of questions in the taxpayer survey was designed to learn more about how firms have responded to a changing environment. 66.9 percent of firms reported that they used computerization to deal with increased complexity, while only 8.3 percent reported that they resorted to a lower level of tax compliance to deal with greater complexity. 24.9 percent of firms surveyed reported that they had hired more people to handle tax compliance matters, and 51.9 percent reported that they had hired outside consultants.[56]

The survey posed two questions intended to provide information about how tax code complexity affects companies' tax strategies and business planning. Neither has been asked in any previous compliance cost study. First, the survey asked whether there were tax-reducing provisions that they might have taken advantage of, but did not because of the complexity involved. Firms were given seven choices and also the option of saying that they were unaware of any such tax provisions. As Table 13 shows, about two-thirds of taxpayers said they were not aware of any tax provision the firm did not take advantage of because of its complexity. But one-third did mention at least one such provision, with the fractions ranging from as high as 14.1 percent to as low as 4.7 percent. At the top of the list, at 14.1 percent, were corporate tax shelters, followed by tax credits other than the foreign tax credit, mentioned by 12.0 percent of taxpayers.

Tax professionals were asked the same question with respect to their clients. Strikingly, as Table 13 shows, a significantly higher percentage of tax professionals than taxpayers said certain tax provisions that might have reduced taxpayers' liability were not used because of their complexity — only 37.7 percent mentioned that they were unaware of any such provisions. In particular, 32.4 percent of tax professionals said that they did not take advantage of corporate tax shelters because of their complexity, compared to only 14.1 percent of taxpayers. 30.9 percent of tax professionals said that because of the complexity involved they did not consider the foreign sales corporation rules as a way of

[56] There is no table reporting these results.

reducing a client's tax liability, while only 4.7 percent of firms said complexity caused them not to consider these rules.

The survey also asked a related but distinct question – whether a company might have otherwise undertaken a business activity, but did not because of the tax complexity involved. Firms were given eight choices and the option of saying that they were aware of no such activities. Table 14 shows the results. 72.9 percent of taxpayers were not aware of any activity not undertaken because of tax complexity. Of the remainder who were aware of activities foregone, the top three mentioned were expanding operations into other states (10.4 percent), establishing a foreign subsidiary or branch (8.9 percent), and restructuring executive compensation (8.3 percent).

As with the question about foregone tax provisions, the question about foregone business activities generated different responses from tax professionals than from taxpayers. As Table 14 illustrates, only 37.2 percent of tax professionals were not aware of any business activities that their clients might have undertaken but did not because of the tax complexity involved. The most striking difference in responses between taxpayers and tax professionals was with respect to the choice to establish a foreign subsidiary or branch: 35.3 percent of tax professionals said their clients might have established a foreign subsidiary or branch but did not do so because of tax complexity, while only 8.9 percent of taxpayers said complexity caused them not to set up such a foreign entity. Substantially more tax professionals mentioned expanding operations into other states (30.0 percent versus 8.9 percent) and restructuring executive compensation (20.8 percent versus 8.3 percent).

The differences between tax professional and taxpayer responses to these questions might be explained at least in part by possible differences between the kinds of clients served by the tax professionals surveyed and the kinds of businesses represented by the firms surveyed. It is also likely that the professional has principal responsibility for making many of these decisions on behalf of the taxpayer, and is more aware of the details of the tax choices made on behalf of the taxpayer.

The taxpayer survey asked whether firms had encountered problems in complying with the tax code that were not otherwise addressed in the survey. This question asked survey respondents to provide written responses. Many firms discussed general tax law complexity in their responses. One respondent gave the following short answer that was fairly typical of other responses: "Overall, I still feel the tax system is too complex." A few respondents complained of problems with audits or with unhelpful IRS personnel. The representative of one firm wrote of "inconsistent interpretation of Code by auditors, resulting from lack of training and not understanding our business."

6.4 Relations between Taxpayers and Tax Professionals

Tax professionals were asked two questions that taxpayers were not asked - whether their firms' interactions with clients had changed significantly over the last four years and, if interactions had changed, how they had changed. The survey provided three possible changes and allowed tax professionals to write in other changes. By far the change chosen by the highest percentage of tax professionals was increased automation with a resulting decrease in compliance costs; 91.0 percent of tax professionals marked this change. At the opposite extreme, only 8.2 percent of tax professionals chose the change of fewer filing requirements due to clients' increased use of tax software. Several tax professionals wrote in additional changes or responded that they had experienced no significant changes in their relationships with clients. Sixteen tax professionals said their relationships had not significantly changed, and nine spoke of changes resulting from increased complexity and frequent law changes.[57]

6.5 Tax Shelters

Tax professionals also were asked a set of questions intended to show whether certain tax shelter activities are common. 80.0 percent of tax professionals responded to this question. As Table 15 shows, 69.4 percent of tax professionals had been approached by clients to look into tax shelters for the clients' businesses, 55.5 percent had been approached by promoters advertising tax shelters, and 69.9 percent had looked into real estate and personal property as possible tax shelters. In contrast, only 7.5 percent of tax professionals said they had set up a tax shelter for a client.

[57] There are no tables reporting the results discussed in Section 6.4.

Conclusion

Our analysis of the responses of taxpayers and tax professionals in the LMSB sample confirms the regressivity of business compliance costs and suggests that, as a proportion of taxes paid, they are significantly higher than for the largest U.S. businesses. As a fraction of revenue raised, these costs are also apparently much higher than for the CIC population or for individual taxpayers. Comparisons to revenue must be done carefully, however, because the majority of LMSB "taxpayers" are in fact not taxpaying entities, but are rather pass-through entities.

Rather than restate the detailed conclusions of the analysis, it is worthwhile to state the methodological caveats that must be applied to the results. The response rate of approximately 10 percent is troubling, and raises the possibility of bias related to unobservable differences between the respondent and non-respondent populations. Larger-scale surveys have the potential to reduce the variance of estimated compliance costs of the LMSB population, but will not address the potential respondent bias unless some way of raising the response rate—while maintaining the integrity of the responses—is found. The apparent large discrepancies between taxpayer-reported characteristics, specifically asset size, and IRS official data raises the possibility that the reported compliance costs refer to different entities than the IRS records pertain to. We have attempted to estimate the potential effect of this, which is large indeed, but even this method may fail to account for this problem if the survey responses actually refer to the sum of multiple entities in the LMSB population. Further investigation of this issue is crucial.

Even in the face of these methodological concerns, the central conclusions seem to be quite robust: the compliance costs of small and mid-size businesses are large in an absolute sense, and larger relative to size than for the biggest businesses in America.

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Figure 1A

Estimated Relationship Between Total Compliance Cost and Total Assets, As Reported by Taxpayers

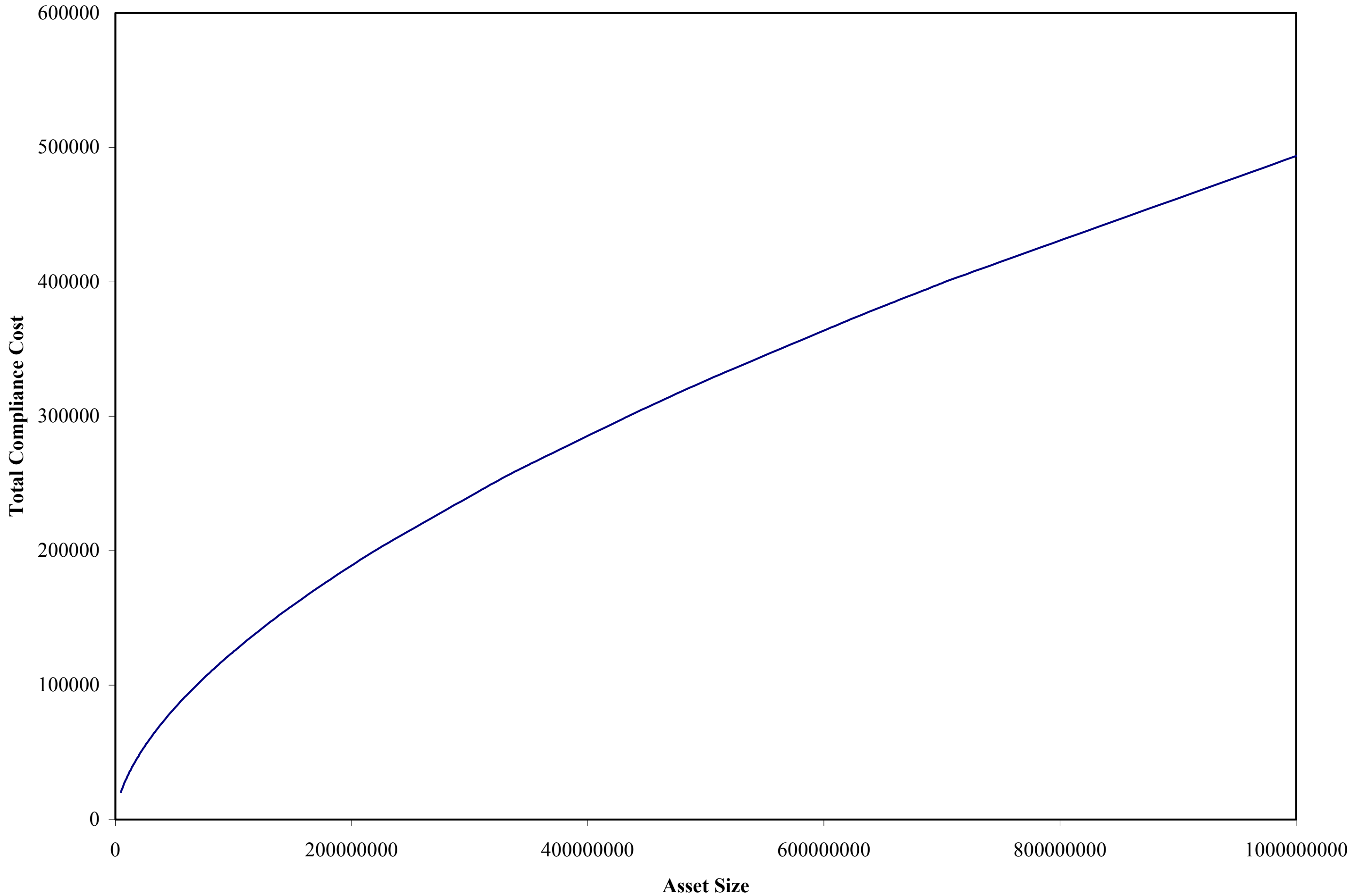

Figure 1B

Estimated Relationship Between Average Compliance Costs and Total Assets, As Reported by Taxpayers

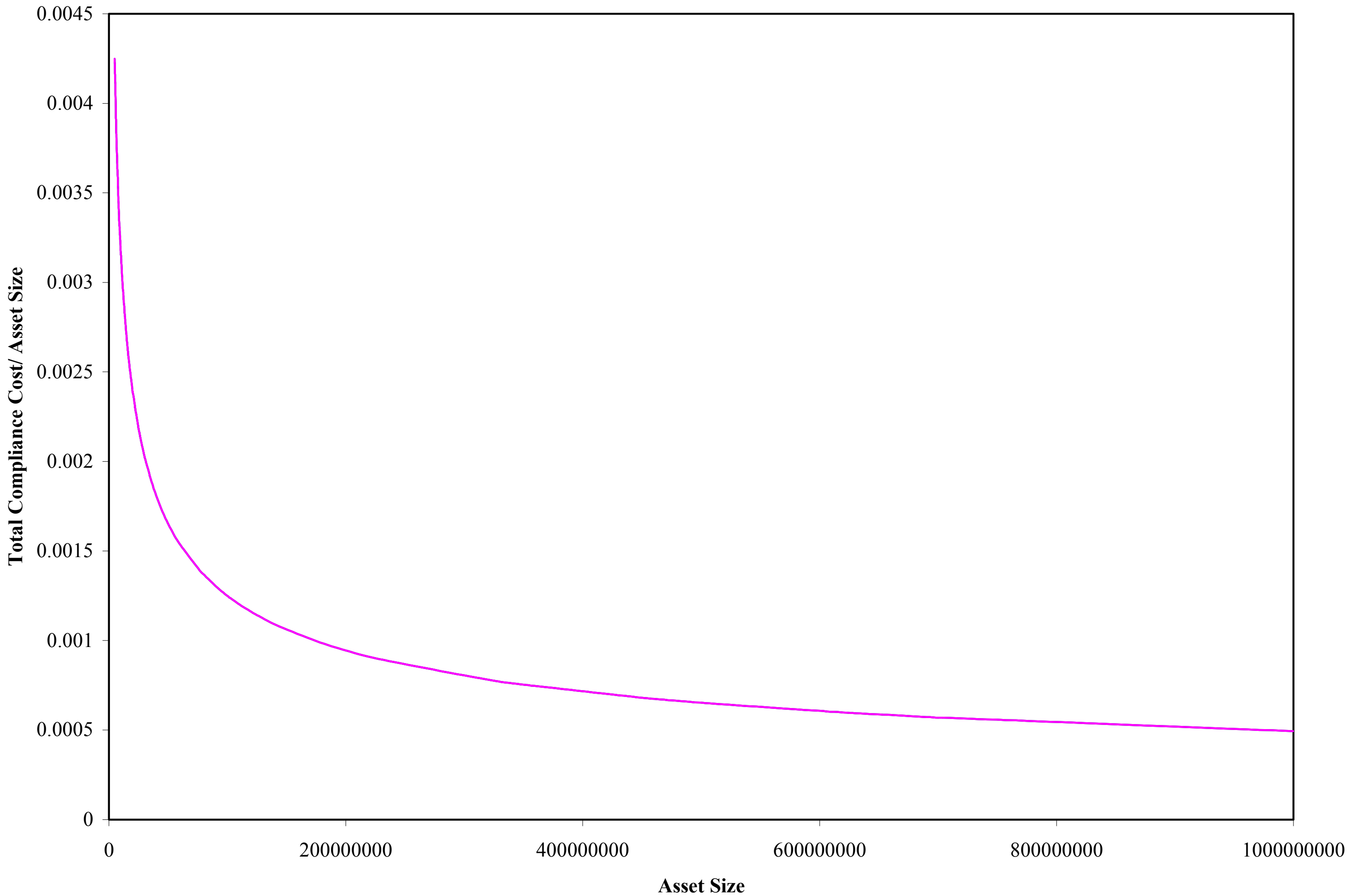

Table 1

Information on Sampling and Response Rates (Taxpayer Survey), by Form Type and Industry

Industry		Form 1120 and others	Form 1120F	Form 1120S	Form 1065	All
Communications, Technology & Media	Universe	9459	288	4375	4417	18539
	Sample	130	125	122	126	503
	Sampling Rate	1.37%	43.40%	2.79%	2.85%	2.71%
	Number of Respondents	12	18	14	10	54
	Response Rate	**9.23%**	**14.40%**	**11.48%**	**7.94%**	**10.74%**
	Coverage Rate	0.13%	6.25%	0.32%	0.23%	0.29%
Financial & Professional Services	Universe	29545	506	4196	21995	56242
	Sample	247	6	126	126	505
	Sampling Rate	0.84%	1.19%	3.00%	0.57%	0.90%
	Number of Respondents	16	1	9	6	32
	Response Rate	**6.48%**	**16.67%**	**7.14%**	**4.76%**	**6.34%**
	Coverage Rate	0.05%	0.20%	0.21%	0.03%	0.06%
Heavy Manufacturing and Transportation	Universe	22616	979	20501	52518	96614
	Sample	124	125	124	125	498
	Sampling Rate	0.55%	12.77%	0.60%	0.24%	0.52%
	Number of Respondents	12	12	8	13	45
	Response Rate	**9.68%**	**9.60%**	**6.45%**	**10.40%**	**9.04%**
	Coverage Rate	0.05%	1.23%	0.04%	0.02%	0.05%
Natural Resources & Construction	Universe	7332	238	4337	2984	14891
	Sample	235	13	124	123	495
	Sampling Rate	3.21%	5.46%	2.86%	4.12%	3.32%
	Number of Respondents	22		13	13	48
	Response Rate	**9.36%**	**n.a.**	**10.48%**	**10.57%**	**9.70%**
	Coverage Rate	0.30%	n.a.	0.30%	0.44%	0.32%
Retail, Food & Healthcare	Universe	15941	485	10831	7834	35091
	Sample	135	114	125	125	499
	Sampling Rate	0.85%	23.51%	1.15%	1.60%	1.42%
	Number of Respondents	15	11	6	13	45
	Response Rate	**11.11%**	**9.65%**	**4.80%**	**10.40%**	**9.02%**
	Coverage Rate	0.09%	2.27%	0.06%	0.17%	0.13%
All	Universe	84893	2496	44240	89748	221377
	Sample	871	383	621	625	2500
	Sampling Rate	1.03%	15.34%	1.40%	0.70%	1.13%
	Number of Respondents	77	42	50	55	225
	Response Rate	**8.84%**	**10.97%**	**8.05%**	**8.80%**	**9.00%**
	Coverage Rate	0.09%	1.68%	0.11%	0.06%	0.10%

Note: One respondent could not be categorized by form type or industry

Table 2

Average Compliance Costs, by Form Type and Asset Size, As Reported by Taxpayers

Asset Size	Form 1120 and others	Form 1120F	Form 1120S	Form 1065	All
< $5M	$52,400	$184,309		$33,933	$105,467
$5M - $10M	$24,864		$48,750	$25,467	$35,443
$10M - $50M	$62,969	$40,775	$160,177	$43,167	$93,876
$50M - $100M	$203,365		$200,000	$107,688	$149,876
$100M - $250M		$283,750	$78,100	$294,083	$243,942
$250M - $1B	$377,188	$578,021	$140,750	$226,275	$426,367
> $1B	$942,429	$1,672,870		$1,249,809	$1,331,643
No Asset Size Reported	$176,831	$4,213,517	$43,333	$267,440	$1,221,266
All	$257,973	$1,269,132	$108,129	$518,845	**$254,451**

Table 3

Average Compliance Costs, by Industry Category and Asset Size, As Reported by Taxpayers

Asset Size	Communications, Technology & Media	Financial & Professional Services	Heavy Manufacturing & Transportation	Natural Resources & Construction	Retail, Food & Healthcare	No Industry Reported	All
< $5M	$354,333		$56,633			$46,439	$105,467
$5M - $10M	$33,773	$22,683	$20,544	$15,400	$20,041	$93,839	$35,443
$10M - $50M	$67,983	$35,533	$59,121	$60,142	$164,890	$69,576	$93,876
$50M - $100M	$145,000	$13,720	$376,625		$168,000	$151,188	$149,876
$100M - $250M	$410,000	$489,600	$296,208		$205,000	$105,600	$243,942
$250M - $1B	$569,583	$382,875	$314,633	$185,000	$710,000	$149,000	$426,367
> $1B	$1,479,716	$533,000	$1,583,333	$1,265,438	$1,235,000	$1,650,000	$1,331,643
No Asset Size Reported	$71,000	$550,000		$58,500		$1,487,745	$1,221,266
All	$719,740	$272,849	$582,441	$382,163	$249,192	$640,353	**$254,451**

Table 3A

Number of Respondents, by Industry Category and Asset Size, As Reported by Taxpayers

Asset Size	Communications, Technology & Media	Financial & Professional Services	Heavy Manufacturing & Transportation	Natural Resources & Construction	Retail, Food & Healthcare	No Industry Reported	All
< $5M	3	1	3	1	3	5	16
$5M - $10M	6	3	8	2	7	4	30
$10M - $50M	6	8	11	16	18	9	68
$50M - $100M	3	2	2	2	2	4	15
$100M - $250M	1	5	4	2	4	2	18
$250M - $1B	7	2	4	1	1	2	17
> $1B	10	6	6	7	2	2	33
No Asset Size Reported	3	1	2	2	1	19	28
All	39	28	40	33	38	47	225

Table 4

Breakdown of Compliance Costs into Internal Personnel, Internal Non-Personnel, and External Costs, by Asset Size and Form Type

Asset Size		Form 1120 and others	Form 1120F	Form 1120S	Form 1065	All
< $5M	Personnel	4.6%	38.7%		73.7%	45.8%
	Non-Personnel	1.9%	28.5%		14.7%	21.4%
	External	93.5%	32.8%		11.6%	32.8%
$5M - $10M	Personnel	56.9%		44.7%	78.5%	53.3%
	Non-Personnel	6.2%		15.5%	3.9%	12.7%
	External	36.9%		39.8%	17.5%	34.1%
$10M - $50M	Personnel	50.6%	13.2%	67.8%	62.7%	61.4%
	Non-Personnel	11.8%	2.5%	6.9%	4.6%	8.4%
	External	37.6%	84.3%	25.3%	32.7%	30.2%
$50M - $100M	Personnel	67.0%		50.0%	59.4%	58.3%
	Non-Personnel	5.7%		n.a.	9.3%	6.4%
	External	27.4%		50.0%	31.3%	35.3%
$100M - $250M	Personnel		62.6%	64.0%	41.4%	53.5%
	Non-Personnel		10.1%	7.2%	18.7%	12.1%
	External		27.3%	28.8%	39.9%	34.4%
$250M - $1B	Personnel	58.6%	48.1%	2.7%	76.5%	52.5%
	Non-Personnel	9.6%	15.6%	8.5%	4.5%	12.2%
	External	31.8%	36.3%	88.8%	19.0%	35.4%
> $1B	Personnel	68.2%	53.5%		65.3%	60.7%
	Non-Personnel	13.4%	28.2%		11.4%	19.5%
	External	18.4%	18.2%		23.2%	19.8%
No Asset Size Reported	Personnel	84.6%	35.3%	34.6%	46.8%	47.1%
	Non-Personnel	5.3%	11.9%	2.3%	18.7%	11.2%
	External	10.1%	52.8%	63.1%	34.5%	41.8%
All	Personnel	70.2%	42.7%	59.6%	69.5%	58.7%
	Non-Personnel	11.5%	20.6%	7.8%	12.7%	16.5%
	External	18.4%	36.7%	32.6%	17.9%	24.8%

Table 5
Breakdown of Internal Costs, As Reported by Taxpayers, By Asset Size

Asset Size	Internal Costs		Pre-Filing Costs		Filing Costs		Post- Filing Costs	
< $5M	Pre-Filing	16.0%	Tax planning	23.0%	Collecting data for a tax professional	78.0%	Amended returns	n.a.
	Filing	72.0%	Tax guidance and information	18.0%	Preparing the tax return from financial data	6.0%	Audit process	n.a.
	Post-Filing	12.0%	Maintaining tax-related records	58.0%	Calculation of tax	n.a.	Responding to IRS notices	n.a.
			Other	1.0%	Other	16.0%	Other	100.0
$5M - $10M	Pre-Filing	47.7%	Tax planning	14.4%	Collecting data for a tax professional	80.3%	Amended returns	34.3%
	Filing	47.1%	Tax guidance and information	20.9%	Preparing the tax return from financial data	4.5%	Audit process	15.7%
	Post-Filing	5.1%	Maintaining tax-related records	64.7%	Calculation of tax	n.a.	Responding to IRS notices	35.7%
			Other	n.a.	Other	15.2%	Other	14.3%
$10M - $50M	Pre-Filing	48.3%	Tax planning	24.7%	Collecting data for a tax professional	72.9%	Amended returns	27.6%
	Filing	43.3%	Tax guidance and information	21.2%	Preparing the tax return from financial data	8.4%	Audit process	28.1%
	Post-Filing	8.4%	Maintaining tax-related records	52.8%	Calculation of tax	0.4%	Responding to IRS notices	29.9%
			Other	1.3%	Other	18.3%	Other	14.5%
$50M - $100M	Pre-Filing	38.2%	Tax planning	36.4%	Collecting data for a tax professional	59.2%	Amended returns	26.0%
	Filing	49.8%	Tax guidance and information	15.7%	Preparing the tax return from financial data	12.1%	Audit process	24.5%
	Post-Filing	12.0%	Maintaining tax-related records	45.0%	Calculation of tax	n.a.	Responding to IRS notices	36.0%
			Other	2.9%	Other	28.8%	Other	13.5%
$100 - $250M	Pre-Filing	29.5%	Tax planning	25.5%	Collecting data for a tax professional	51.5%	Amended returns	22.1%
	Filing	62.3%	Tax guidance and information	29.5%	Preparing the tax return from financial data	23.0%	Audit process	31.4%

Table 5 (continued)
Breakdown of Internal Costs, As Reported by Taxpayers, By Asset Size

Asset Size	Internal Costs		Pre-Filing Costs		Filing Costs		Post- Filing Costs	
$100 - $250M	Post-Filing	8.2%	Maintaining tax-related records	43.5%	Calculation of tax	1.5%	Responding to IRS notices	36.4%
			Other	1.5%	Other	24.0%	Other	10.0%
$250M - $1B	Pre-Filing	37.0%	Tax planning	40.4%	Collecting data for a tax professional	49.1%	Amended returns	20.0%
	Filing	50.2%	Tax guidance and information	24.9%	Preparing the tax return from financial data	11.6%	Audit process	37.7%
	Post-Filing	12.8%	Maintaining tax-related records	31.8%	Calculation of tax	1.5%	Responding to IRS notices	39.8%
			Other	2.9%	Other	37.9%	Other	2.5%
> $1B	Pre-Filing	33.5%	Tax planning	45.4%	Collecting data for a tax professional	32.7%	Amended returns	9.1%
	Filing	49.9%	Tax guidance and information	25.2%	Preparing the tax return from financial data	16.1%	Audit process	62.3%
	Post-Filing	16.6%	Maintaining tax-related records	27.0%	Calculation of tax	4.1%	Responding to IRS notices	23.9%
			Other	2.4%	Other	47.0%	Other	4.7%
No Asset Size Reported	Pre-Filing	30.0%	Tax planning	32.5%	Collecting data for a tax professional	68.1%	Amended returns	14.0%
	Filing	56.9%	Tax guidance and information	20.6%	Preparing the tax return from financial data	7.5%	Audit process	67.0%
	Post-Filing	13.1%	Maintaining tax-related records	43.8%	Calculation of tax	1.3%	Responding to IRS notices	16.5%
			Other	3.1%	Other	23.1%	Other	2.5%
All	Pre-Filing	38.8%	Tax planning	31.8%	Collecting data for a tax professional	58.9%	Amended returns	20.0%
	Filing	50.0%	Tax guidance and information	22.5%	Preparing the tax return from financial data	11.3%	Audit process	39.9%
	Post-Filing	11.2%	Maintaining tax-related records	43.8%	Calculation of tax	1.4%	Responding to IRS notices	30.3%
			Other	1.9%	Other	28.3%	Other	9.8%

Table 6

Average External Costs and Breakdown of External Costs, As Reported by Taxpayers and Tax Professionals, by Asset Size

Asset Size	As Reported By Taxpayers			As Reported By Tax Professionals		
< $5M	$34,547	Pre-Filing Filing Post-Filing	15.7% 77.9% 6.4%	n.a.	Pre-Filing Filing Post-Filing	n.a.
$5M - $10M	$12,082	Pre-Filing Filing Post-Filing	23.3% 70.9% 5.9%	$16,257	Pre-Filing Filing Post-Filing	24.8% 60.8% 14.4%
$10M - $50M	$28,363	Pre-Filing Filing Post-Filing	25.9% 66.9% 7.1%	$10,600	Pre-Filing Filing Post-Filing	27.6% 57.4% 15.0%
$50M - $100M	$52,957	Pre-Filing Filing Post-Filing	26.5% 68.5% 5.0%	$17,078	Pre-Filing Filing Post-Filing	24.4% 62.8% 12.9%
$100M - $250M	$83,861	Pre-Filing Filing Post-Filing	32.0% 58.3% 9.7%	$39,917	Pre-Filing Filing Post-Filing	23.3% 60.8% 15.8%
$250M - $1B	$150,841	Pre-Filing Filing Post-Filing	39.0% 52.2% 8.8%	$209,000	Pre-Filing Filing Post-Filing	27.5% 50.0% 22.5%
> $1B	$264,032	Pre-Filing Filing Post-Filing	40.6% 48.9% 10.5%	n.a.	Pre-Filing Filing Post-Filing	n.a.
No Asset Size Reported	$509,968	Pre-Filing Filing Post-Filing	19.2% 72.0% 8.8%	n.a.	Pre-Filing Filing Post-Filing	n.a.
All		Pre-Filing Filing Post-Filing	27.4% 64.9% 7.7%		Pre-Filing Filing Post-Filing	25.8% 59.5% 14.6%

Table 7

Breakdown of External Costs, As Reported by Tax Professionals, By Asset Size

	Pre-Filing Costs		Filing Costs		Post- Filing Costs	
$5M - $10M	Tax planning	48.3%	Collecting data	38.4%	Amended returns	21.1%
	Tax guidance and information	27.2%	Preparing the tax return from financial data	45.9%	Audit process	27.0%
	Maintaining tax-related records	21.7%	Calculation of tax	13.3%	Responding to IRS notices	27.5%
	Other	2.7%	Other	2.4%	Other	4.8%
$10M - $50M	Tax planning	46.1%	Collecting data	35.0%	Amended returns	14.1%
	Tax guidance and information	27.2%	Preparing the tax return from financial data	48.4%	Audit process	34.0%
	Maintaining tax-related records	18.9%	Calculation of tax	14.0%	Responding to IRS notices	30.7%
	Other	6.6%	Other	2.6%	Other	6.0%
$50M - $100M	Tax planning	38.7%	Collecting data	33.4%	Amended returns	12.7%
	Tax guidance and information	23.0%	Preparing the tax return from financial data	49.7%	Audit process	26.2%
	Maintaining tax-related records	35.5%	Calculation of tax	14.4%	Responding to IRS notices	54.2%
	Other	2.8%	Other	2.5%	Other	6.9%
$100 - $250M	Tax planning	53.8%	Collecting data	40.0%	Amended returns	n.a.
	Tax guidance and information	32.9%	Preparing the tax return from financial data	39.2%	Audit process	12.5%
	Maintaining tax-related records	9.6%	Calculation of tax	15.4%	Responding to IRS notices	75.0%
	Other	3.8%	Other	5.4%	Other	12.5%

Table 7 (continued)

Breakdown of External Costs, As Reported by Tax Professionals, By Asset Size

Asset Size	Pre-Filing Costs		Filing Costs		Post- Filing Costs	
$250M - $1B	Tax planning	50.0%	Collecting data	30.0%	Amended returns	20.0%
	Tax guidance and information	30.0%	Preparing the tax return from financial data	50.0%	Audit process	60.0%
	Maintaining tax-related records	15.0%	Calculation of tax	15.0%	Responding to IRS notices	20.0%
	Other	5.0%	Other	5.0%	Other	n.a.
All	Tax planning	46.9%	Collecting data	36.7%	Amended returns	17.2%
	Tax guidance and information	27.1%	Preparing the tax return from financial data	47.0%	Audit process	29.5%
	Maintaining tax-related records	21.3%	Calculation of tax	13.7%	Responding to IRS notices	31.9%
	Other	4.3%	Other	2.6%	Other	5.6%

Table 8

Services Provided By the Tax Professional

	% Checked by Taxpayers	% Checked by Tax Professionals
Audit-related services	61.1%	71.6%
Collection matters	2.9%	20.3%
Preparing the tax return	85.1%	98.6%
Preparing amended returns	55.8%	73.9%
Record keeping services	7.7%	21.6%
Responding to IRS notices	43.3%	94.5%
Tax planning/ Tax advice	76.4%	93.1%

Note: The other services mentioned by taxpayers were the review of tax returns and advance pricing agreement services. Other services mentioned by tax professionals were state & local compliance services, assistance with employee benefit plans or retirement plans, and the preparation of financial statements.

Table 9

Breakdown of Internal and External Costs, by Federal, State & Local, and Foreign

Asset Size		Breakdown of Internal Costs, As Reported by Taxpayers	Breakdown of External Costs, As Reported by Taxpayers	Breakdown of External Costs, As Reported by Tax Professionals
< $5M	Federal	71.8%	67.5%	
	State and Local	16.0%	24.3%	n.a.
	Foreign	12.2%	8.2%	
$5M - $10M	Federal	81.6%	78.3%	81.2%
	State and Local	18.4%	21.7%	18.8%
	Foreign	n.a.	n.a.	
$10M - $50M	Federal	74.5%	74.9%	79.4%
	State and Local	22.9%	23.6%	20.6%
	Foreign	2.6%	1.5%	
$50M - $100M	Federal	61.7%	67.3%	74.1%
	State and Local	30.8%	28.9%	26.0%
	Foreign	7.5%	3.8%	
$100M - $250M	Federal	58.9%	76.2%	83.0%
	State and Local	35.6%	21.2%	17.0%
	Foreign	5.6%	2.6%	
$250M - $1B	Federal	60.4%	68.5%	77.5%
	State and Local	31.0%	25.2%	22.5%
	Foreign	8.6%	6.3%	
> $1B	Federal	57.6%	69.0%	
	State and Local	29.0%	17.5%	n.a.
	Foreign	13.4%	13.5%	
No Asset Size Reported	Federal	71.5%	74.6%	
	State and Local	24.5%	25.4%	n.a.
	Foreign	4.0%	n.a.	
All	Federal	67.0%	73.2%	80.0%
	State and Local	26.3%	23.1%	20.0%
	Foreign	6.8%	3.7%	

Note: Tax Professionals were not asked to report the foreign component of costs.

Table 10

Aspects of Tax Code and Processes Most Responsible for Compliance Costs

	% Checked by Taxpayers	% Checked by Tax Professionals
Alternative Minimum Tax	50.5%	76.6%
Basis Computation	40.6%	50.0%
Depreciation	60.4%	67.3%
Depreciation Recapture (Form 1231)	16.8%	22.0%
Federal-State non-conformity	34.7%	42.1%
Partner-shareholder basis issues	31.2%	63.1%

Note: The top five others mentioned by taxpayers, in order of the number of times mentioned were, R&D Credit, capitalization rules of section 263A, Foreign Tax Credit, Foreign Sales Corporation, and Form 5471. The top five others mentioned by tax professionals, in order of the number of times mentioned were, capitalization rules of section 263A, passive activity loss rules, general complexity, difference between GAAP accounting and tax accounting, and consolidated return rules

Table 11

Suggestions for Simplification
Average Ranking of Six Simple Suggestions, by Taxpayers and Tax Professionals

	Taxpayers	Tax Professionals
Abolish Section 263A (Uniform Capitalization Rules)	4.0	3.0
Abolish the Alternative Minimum Tax	3.1	2.5
Eliminate depreciation rules, to be replaced by immediate expensing of capital asset costs	3.1	3.3
Eliminate reporting requirements of all non-tax-computation-related information	4.4	4.7
Establish complete uniformity among state and local corporate income tax rules as well as conformity to federal rules	2.9	3.3
Reduce filing requirements to audited financial statements plus Schedule M-1 detail	3.7	4.3

Note: 1 is the most simplifying tax process, 6 is the least simplifying tax process.

Table 12
Suggestions for Simplification
Tax Rules Dealing with Foreign Source Income

	% Checked by Taxpayers	% Checked by Tax Professionals
Change the definition of Earnings and Profits to conform to domestic income definitions	44.8%	60.8%
Change the definition of Earnings and Profits to conform to foreign income definitions	6.9%	5.7%
Eliminate or simplify the use of "baskets" to calculate foreign tax credit limits	55.2%	44.9%
Permit excess foreign tax credits to be carried forward indefinitely	60.3%	21.5%
Provide simplified transfer pricing guidelines	56.9%	40.5%
Require information entries in Form 5471 to be reported only every other year	41.4%	25.3%
Simplify the allocation rules for interest, R&D, and other expenses	60.3%	43.7%

Note: The other simplifications mentioned by tax professionals were, eliminating capitalization rules of Section 263A, making state and local tax rules uniform, and simplifying or eliminating the Alternative Minimum Tax.

Table 13
Tax Reducing Provisions Not Considered Because of Tax Complexity

	% Checked by Taxpayers	% Checked by Tax Professionals
Accelerated depreciation	6.3%	4.4%
Corporate tax shelters	14.1%	32.4%
Inventory account changes	9.9%	20.6%
Foreign sales corporation	4.7%	30.9%
Foreign tax credits	5.7%	9.8%
Other tax credits (business energy, R&E etc.)	12.0%	20.1%
Section 179 deductions (Property Depreciation)	5.2%	1.5%
Not aware of any	67.7%	37.7%

Note: The other provisions mentioned by taxpayers were, Low Income Housing Tax Credit, use of foreign entities (Section 482), general timing difference opportunities, and estimated tax payment planning. The other provisions mentioned by tax professionals were, the last-in-first-out method of accounting rules and the empowerment Zone rules

Table 14

Business Activities Not Undertaken Because of Tax Complexity

	% Checked by Taxpayers	% Checked by Tax Professionals
Acquire another company	5.7%	6.8%
Dissolve/ liquidate the company	5.7%	15.0%
Establish a foreign subsidiary or branch	8.9%	35.3%
Establish E-commerce operations	1.6%	9.2%
Expand operations into other states, thereby establishing taxable nexus	10.4%	30.0%
Restructure executive compensation (such as offering stock options)	8.3%	20.8%
Sell all or part of the company	5.7%	11.6%
Undertake a joint venture	6.3%	9.7%
Not aware of any	72.9%	37.2%

Note: The other business activities mentioned were, Building new buildings, providing additional employee benefit plans, and savings plans.

Table 15

Tax Professionals and Tax Shelters

	% Checked by Tax Professionals
Been approached by clients to look into tax shelters for their businesses	69.4%
Been approached by promoters advertising tax shelters	55.5%
Looked into real estate and personal property as possible tax shelters	69.9%
Set up a tax shelter for a client	7.5%

Exhibit 1A

Results from the Regression Analysis

Sample	Taxpayers		Taxpayers	
Dependent Variable	Log (Total Compliance Costs)		Log (Total Compliance Costs)	
	$R^2 = 0.6430$		$R^2 = 0.7389$	
	Adj $R^2 = 0.6360$		Adj $R^2 = 0.6688$	
Independent Variables	Coefficient	Std. Error	Coefficient	Std. Error
Constant	0.7409	0.8240	2.2912	1.5583
Log (Assets)	0.5969	0.0440	0.4639	0.0772
Blank Assets	11.0281	0.8780	8.6283	1.4961
Form 1120			-0.0761	0.3143
Form 1120F			-0.0722	0.3905
Form 1120S			0.2545	0.3514
Comm/ Tech/ Media			-0.0349	0.3723
Financial Svcs			-0.4890	0.3841
Manuf/ Transportation			-0.0727	0.3571
Natural Resources			-0.1377	0.3622
Blank Industry			0.2426	0.4198
Subject to AMT			0.1093	0.4740
Blank AMT Subj			-0.5162	0.5308
Calculate AMT			0.8593	0.4429
Blank AMT Calc			0.6747	0.4681
MNC			0.8864	0.3233
Blank MNC			0.6273	0.7429
MNC* No. of Countries			-0.0012	0.0133
Publicly Held			0.2345	0.2755
Blank PubHeld			-0.2625	0.5325
Consolidated Returns			-0.0018	0.0022
Blank Cons. Returns			0.1854	0.3073
Unconsolidated Returns			-0.0510	0.1130
Current Audits				
Past Audits				

Exhibit 1B

Results from the Regression Analysis (continued)

Sample	Taxpayers				Tax Professionals			
Dependent Variable	Log (External Compliance Costs)				Log (External Compliance Costs)			
	$R^2 = 0.0440$		$R^2 = 0.1862$		$R^2 = 0.1497$		$R^2 = 0.2553$	
	Adj $R^2 = 0.0340$		Adj $R^2 = 0.0815$		Adj $R^2 = 0.1457$		Adj $R^2 = 0.2141$	
Independent Variables	Coeff.	Std. Error	Coeff.	Std. Error	Coeff.	Std. Error	Coeff.	Std. Error
Constant	5.1822	1.5699	4.9730	2.5201	1.4616	1.2092	1.3715	1.2974
Log (Assets)	0.2471	0.0869	0.2761	0.1331	0.4467	0.0736	0.4433	0.0803
Blank Assets	4.8478	1.6348	5.4832	2.4367				
Form 1120			-0.2081	0.5281			-0.2674	0.1894
Form 1120F			1.1931	0.7158				
Form 1120S			0.4817	0.5640			-0.1806	0.1812
Comm/ Tech/ Media			0.0029	0.6327			-0.1230	0.2180
Financial Svcs			-0.9154	0.6409			-0.4499	0.2227
Manuf/ Transportation			-0.4090	0.6188			0.0779	0.1998
Natural Resources			-0.6288	0.6574			0.2344	0.1830
Blank Industry			0.4031	0.6736				
Subject to AMT			-0.6848	0.9262			0.1214	0.3466
Blank AMT Subj			-1.6865	0.9799				
Calculate AMT			0.4286	0.6697				
Blank AMT Calc			1.3657	0.9159				
Number of Partners							0.0001	0.0000
MNC			-0.8372	0.5864				
Blank MNC			-0.2200	0.9758				
MNC* # of Countries			0.0014	0.0150				
Publicly Held			0.5374	0.5929				
Blank PubHeld			0.0602	0.9087				
Consolidated Returns			-0.0140	0.0052				
Blank Cons. Returns			-0.6744	0.4787				
Unconsolidated Returns			-0.0893	0.2114				
Current Audits							0.5584	0.3000
Past Audits							0.3581	0.1750

Exhibit 1C

Results from the Regression Analysis (continued)

Sample	Taxpayers				Taxpayers + Tax Professionals			
Dependent Variable	Log (Internal Compliance Costs)				Log (External Compliance Costs)			
	$R^2 = 0.5641$		$R^2 = 0.6985$		$R^2 = 0.0787$		$R^2 = 0.1868$	
	Adj $R^2 = 0.5561$		Adj $R^2 = 0.6248$		Adj $R^2 = 0.0719$		Adj $R^2 = 0.1378$	
Independent Variables	Coeff.	Std. Error	Coeff.	Std. Error	Coeff.	Std. Error	Coeff.	Std. Error
Constant	0.1549	0.9548	3.9260	1.6848	6.9648	0.5913	6.6128	1.4409
Survey Dummy					0.6562	0.2007	1.3436	0.9903
Log (Assets)	0.6017	0.0504	0.3522	0.0826	0.1111	0.0352	0.0881	0.0418
Blank Assets	11.3064	1.0140	6.5287	1.6548	1.9152	0.6047	1.5629	0.6437
Form 1120			-0.0635	0.3480			-0.1506	0.2541
Form 1120F			-0.4286	0.4224			1.3109	0.4861
Form 1120S			-0.1146	0.4033			0.1363	0.2553
Comm/ Tech/ Media			-0.1774	0.4264			0.0115	0.3157
Financial Svcs			-0.6841	0.4405			-0.4056	0.3112
Manuf/ Transportation			-0.1360	0.4077			-0.1457	0.2972
Natural Resources			-0.1023	0.4254			0.0319	0.2861
Blank Industry			0.2948	0.4784			0.7167	0.4477
Subject to AMT			0.1572	0.5534			-0.2054	0.4781
Blank AMT Subj			-0.4325	0.6118			-1.3471	0.5886
Calculate AMT			0.7203	0.5050			0.3912	0.4850
Blank AMT Calc			0.5202	0.5345			1.0548	0.5997
MNC			1.1356	0.3600			-0.6740	0.4211
Blank MNC			0.4874	0.8594			0.2896	0.7276
MNC* # of Countries			0.0245	0.0124			0.0086	0.0110
Publicly Held			0.3799	0.3139			0.6572	0.4144
Blank PubHeld			0.1481	0.6216			0.1764	0.6743
Consolidated Returns			-0.0020	0.0025			-0.0120	0.0037
Blank Cons. Returns			0.0293	0.3544			-0.7019	0.3455
Unconsolidated Returns			-0.0784	0.1319			-0.0884	0.1569

Table A-1

Information on Sampling and Response Rates (Taxpayer & Tax Professional), by Form Type and Industry
(Note: these form type categories correspond to the form categories used by the IRS while sampling)

Industry		Tax Payer	Tax Prof.	Tax Payer	Tax Prof.	Tax Payer	Tax Prof.	Tax Payer	Tax Prof.	Tax Payer	Tax Prof.
		Form 1120		Form 1120S		Form 1065		Other Forms		All	
Communications, Technology & Media	Universe	9459	7993	4375	3885	4417	3150	288		18539	15028
	Sample	125	134	125	133	125	134	125		500	401
	Sampling Rate	1.32%	1.68%	2.86%	3.42%	2.83%	4.25%	43.4%		2.70%	2.67%
	# of Respondents	12	10	14	13	10	8	18		54	31
	Response Rate	**9.60%**	**7.46%**	**11.2%**	**9.77%**	**8.00%**	**5.97%**	**14.4%**		**10.8%**	**7.73%**
	Coverage Rate	0.13%	0.13%	0.32%	0.33%	0.23%	0.25%	6.25%		0.29%	0.21%
Financial & Professional Services	Universe	18120	15051	4196	3609	21995	17847	11931		56242	36507
	Sample	125	134	125	133	125	133	125		500	400
	Sampling Rate	0.69%	0.89%	2.98%	3.69%	0.57%	0.75%	1.05%		0.89%	1.10%
	# of Respondents	11	11	9	16	6	8	6		32	35
	Response Rate	**8.80%**	**8.21%**	**7.20%**	**12.0%**	**4.80%**	**6.02%**	**4.80%**		**6.40%**	**8.75%**
	Coverage Rate	0.06%	0.07%	0.21%	0.44%	0.03%	0.04%	0.05%		0.06%	0.10%
Heavy Manufacturing and Transportation	Universe	22616	19086	20501	18019	52518	43806	979		96614	80911
	Sample	125	133	125	133	125	134	125		500	400
	Sampling Rate	0.55%	0.70%	0.61%	0.74%	0.24%	0.31%	12.8%		0.52%	0.49%
	# of Respondents	12	17	8	15	13	10	12		45	42
	Response Rate	**9.60%**	**12.8%**	**6.40%**	**11.3%**	**10.4%**	**7.46%**	**9.60%**		**9.00%**	**10.5%**
	Coverage Rate	0.05%	0.09%	0.04%	0.08%	0.02%	0.02%	1.23%		0.05%	0.05%
Natural Resources & Construction	Universe	6453	5266	4337	3897	2984	1910	1117		14891	11073
	Sample	125	134	125	133	125	133	125		500	400
	Sampling Rate	1.94%	2.54%	2.88%	3.41%	4.19%	6.96%	11.2%		3.36%	3.61%
	# of Respondents	8	19	13	29	13	16	14		48	64
	Response Rate	**6.40%**	**14.2%**	**10.4%**	**21.8%**	**10.4%**	**12.0%**	**11.2%**		**9.60%**	**16.0%**
	Coverage Rate	0.12%	0.36%	0.30%	0.74%	0.44%	0.84%	1.25%		0.32%	0.58%

Table A-1 (continued)

Information on Sampling and Response Rates (Taxpayer & Tax Professional), by Form Type and Industry
(Note: these form type categories correspond to the form categories used by the IRS while sampling)

Industry		Tax Payer	Tax Prof.	Tax Payer	Tax Prof.	Tax Payer	Tax Prof.	Tax Payer	Tax Prof.	Tax Payer	Tax Prof.
		Form 1120		Form 1120S		Form 1065		Other Forms		All	
Retail, Food & Healthcare	Universe	15913	13210	10831	9556	7834	6268	513		35091	29034
	Sample	125	133	125	134	125	133	125		500	400
	Sampling Rate	0.79%	1.01%	1.15%	1.40%	1.60%	2.12%	24.4%		1.42%	1.38%
	# of Respondents	14	19	6	16	13	11	12		45	46
	Response Rate	**11.2%**	**14.3%**	**4.80%**	**11.9%**	**10.4%**	**8.27%**	**9.60%**		**9.00%**	**11.5%**
	Coverage Rate	0.09%	0.14%	0.06%	0.17%	0.17%	0.18%	2.34%		0.13%	0.16%
All	Universe	72561	60606	44240	38966	89748	72981	14828		221377	172553
	Sample	625	668	625	666	625	667	625		2500	2001
	Sampling Rate	0.86%	1.10%	1.41%	1.71%	0.70%	0.91%	4.21%		1.13%	1.16%
	# of Respondents	57	76	50	89	55	53	62		225	218
	Response Rate	**9.12%**	**11.4%**	**8.00%**	**13.4%**	**8.80%**	**7.95%**	**9.92%**		**9.00%**	**10.9%**
	Coverage Rate	0.08%	0.13%	0.11%	0.23%	0.06%	0.07%	0.42%		0.10%	0.13%

Note: One taxpayer that responded to the survey could not be categorized by form type or industry

Table A-2

Weighting Methodology

Form Category	Activity Code	(A) Number of companies in LMSB population	(B) Number of companies in survey sample	(C) Number of companies that responded	(B/A) Sampling Rate	(C/B) Response Rate	(C/A) Coverage Rate	Weight assigned to each respondent
990C		907	123	16	13.6%	13.0%	1.76%	0.06
Form 1120 & others	203	1737	12	1	0.7%	8.3%	0.06%	1.77
	205-215	982	9	0	0.9%	n.a.	n.a.	n.a.
	217	27976	254	17	0.9%	6.7%	0.06%	1.68
	219	29748	247	23	0.8%	9.3%	0.08%	1.32
	221	7548	64	7	0.9%	10.9%	0.09%	1.10
	223	7514	76	4	1.0%	5.3%	0.05%	1.92
	225	8481	86	10	1.0%	11.6%	0.12%	0.87
1120FSC	241	1230	183	27	14.9%	14.8%	2.20%	0.05
1120F	259	833	154	11	18.5%	7.1%	1.32%	0.08
	263	198	32	3	16.2%	9.4%	1.52%	0.07
	265	235	14	1	6.0%	7.1%	0.43%	0.24
Form 1120S	289	24431	327	30	1.3%	9.2%	0.12%	0.83
	290	19809	294	20	1.5%	6.8%	0.10%	1.01
Form 1065	481	54163	243	20	0.5%	8.2%	0.04%	2.76
	482	17311	236	26	1.4%	11.0%	0.15%	0.68
	483	18274	146	9	0.8%	6.2%	0.05%	2.07
Total		221377	2500	225	1.1%	9.0%	0.10%	

Table A-3

Differences in Firm Characteristics
Number of Respondents, by Domestic Asset Size and Form Type, Based on IRS Data on Asset Size

Asset Size	Form 1120 and others	Form 1120F	Form 1120S	Form 1065	All
< $5M					n.a.
$5M - $10M	22	12	29	19	82
$10M - $50M	32	20	17	26	95
$50M - $100M	7	3	2	2	14
$100M - $250M	5	5	1	3	14
$250M - $1B	6	1	0	3	10
> $1B	5	0	0	2	7
Asset Size Not Known	1	1	1	0	3
All	78	42	50	55	225

Number of Respondents, by Domestic Asset Size and Form Type, Based on Asset Sizes Reported by Respondents

Asset Size	Form 1120 and others	Form 1120F	Form 1120S	Form 1065	All
< $5M	2	6	4	5	17
$5M - $10M	13	0	11	6	30
$10M - $50M	28	2	24	13	67
$50M - $100M	7	1	2	4	14
$100M - $250M	6	4	2	6	18
$250M - $1B	4	12	1	4	21
> $1B	7	8	0	12	27
No Asset Size Reported	11	9	6	5	31
All	78	42	50	55	225

Table A-4

Sensitivity Analyses: Summary of Results
Average Compliance Costs

	Results Reported in Section 4.8 of the Report	Using Sampling Weights	With Imputed Internal Costs	Setting Blanks Equal to Zero
Unweighted & Unadjusted	$507,839	$507,839	$427,778	$332,773
Wtd. Avg. (common wts.)	**$254,451**	$252,614	$212,057	$150,037
Wtd. Avg. (component-specific wts.)	$226,050	$248,343	$216,920	$150,037
Adj. Wtd. Avg. (common wts.)	**$134,954**	$146,485	$134,429	$83,683
Adj. Wtd. Avg. (component-specific wts.)	$121,348	$143,526	$134,519	$83,683

The bolded numbers are the ones frequently referred to in Section 4.8 and Data Appendix III.

Median Compliance Costs

	Results Reported in Section 4.8 of the Report	Using Sampling Weights	With Imputed Internal Costs	Setting Blanks Equal to Zero
Unweighted & Unadjusted	$135,375	$135,375	$93,000	$35,000
Wtd. Avg. (common wts.)	$114,705	$94,219	$80,203	$28,164
Wtd. Avg. (component-specific wts.)	n.a.	n.a.	n.a.	n.a.
Adj. Wtd. Avg. (common wts.)	$82,417	$72,613	$48,511	$18,040
Adj. Wtd. Avg. (component-specific wts.)	n.a.	n.a.	n.a.	n.a.

Data Appendix I: Procedures for Dealing with Missing, Ambiguous, and Inconsistent Survey Responses

In gathering data from completed surveys, we had to establish numerous procedures for resolving ambiguities regarding survey answers. Below we describe the most significant procedures we adopted. It may be helpful in reading this appendix to refer to the surveys included as part of this report.

In each of several questions, numbers 3, 4, 5, 9, 11, and 12a, 12b, and 12c, taxpayers were asked to give percentages that together should add up to 100 percent. Question 3 asked firms to estimate the percentages of the total cost of outside tax services devoted to federal income tax compliance, state and local tax compliance, and foreign source income tax compliance. Question 4 asked firms to estimate the percentages of their expenditures on outside tax assistance that went to accounting firms, law firms, and other professionals. In question 5, taxpayers estimated the percentage of their expenditures on outside tax assistance accounted for by pre-filing, filing, and post-filing activities. Question 9 asked taxpayers to state the fractions of their total budget for tax compliance salaries devoted to federal, state and local, and foreign compliance. In question 11, taxpayers were asked to estimate the percentages of internal compliance costs spent on pre-filing, filing, and post-filing activities. Questions 12a, 12b, and 12c asked taxpayers to break down pre-filing, filing, and post-filing spending into smaller categories. For each of these questions, some taxpayers gave percentages that did not add to 100. Where this was the case, we assigned proportional weights to the percentages so that the weighted percentages added to 100.

Taxpayers were asked to give numerical responses to questions 2, 8, and 10. Question 2 asked taxpayers to estimate the total costs incurred in obtaining outside services to help prepare income tax returns. Question 8 asked firms to estimate their total annual budgets for salaries devoted to complying with business income taxes, both within and outside tax departments. Question 10 asked firms to estimate their total non-personnel costs of complying with the tax laws. Some taxpayers gave numerical responses with an “M” at the end – 50M for example. We generally interpreted “M” in these answers to mean thousand for two reasons: first, million generally did not correspond at all with other taxpayer responses, and second, in previous surveys respondents tended to use “M” to indicate thousands.

In question 29 of the taxpayer survey, to the contrary, we interpreted an “M” following the numerical response as million because the question itself explicitly told respondents to use M for million. That question asked firms for their total number of employees, total assets, and net receipts or sales. Similarly, we interpreted notations of “K” and “B” as “thousands” and “billions” respectively.

In question 7 of the taxpayer survey we asked firms to estimate the amount of time, in staff years, devoted to complying with business income taxes. Where a respondent gave a very large number in relation to the number of people employed in its tax department (or in relation to the firm’s total number of employees) and did not write “years” or “staff years” next to the number, we interpreted the number to mean number of staff *hours*. For example, one respondent stated that it employed six people in its tax department and wrote that the number of staff years within the tax department devoted to compliance was 12,000. We interpreted this answer to mean six staff years of 2000 hours each.

In question 8 of the taxpayer survey we asked firms to estimate the total annual budget for salaries devoted to complying with business income taxes. In some cases firms’ answers seemed to be unusually large in relation to the number of people working in the tax department and the total number of staff years devoted to complying with business income taxes. In these cases we interpreted the answers to questions 6, 7, and 8 together to determine whether the salary answers to question 8 were total annual salaries for people whose work included tax compliance activities or, as the survey asked, salaries only for tax compliance activities, not other activities as well. If we determined that the salary answers were total annual salaries for all work, not for tax compliance work alone, we calculated a salary amount for compliance work based on the number of staff years the firms said were devoted to compliance.

Question 19 of the taxpayer survey asked firms to rank six options on a one to six scale in terms of their ability to simplify the tax compliance process. Some taxpayers did not rank the six options from one to six but instead assigned the same number or numbers to more than one option. In these cases we re-ordered the firms' rankings based on two principles: first, that the rankings added to 21 (because the sum of the numbers one through six is 21) and second, that the rankings were similar to sports rankings so that, for example, if a taxpayer gave a one to two options and a two to another option, we turned each one into a 1.5 and made the two a three.

Question 28 of the taxpayer survey asked firms to indicate which one of five given industry categories best described their activities. Firms were giving the choice of marking "Other" and writing a description of their business or writing the NAICS code applicable to their business. Where a firm did so, we generally used this NAICS code or business description to place the firm in one of the five given industry categories. If we could not determine which of the five industry categories was most appropriate for the firm, we treated the firm in our data compilation as not having given us an industry category.

In some cases we could not determine with a reasonable degree of certainty the meaning of answers given by survey respondents. Where we did not feel reasonably certain about the meaning of a particular answer, we treated that answer as missing and did not include it in our analyses.

Some questions provided several possible answers and asked firms to check all answers that were appropriate. Where a firm checked at least one answer but not others, we treated the firm as having answered affirmatively to the checked answers and negatively to the answers not checked. But where a firm did not check any answers, we treated the firm as having not responded at all. We used this approach for purposes of computing averages: firms treated as not having responded at all were omitted from the calculation of averages.

Some questions had several parts, and an answer to the first part dictated the answers to later parts. Thus, for example, question 30a of the taxpayer survey asked firms whether they operated in countries other than the United States; question 30b, asked, if yes, in how many different countries; and question 30c asked firms whether they operated in any of three given countries. If a firm answered "no" to question 30a but left blank the response areas in question 30b and question 30c, we treated the firm as having answered "zero" to question 30b and "none of the above" to question 30c.

In the tax professional survey we encountered issues similar to those described above, and addressed them similarly.

Data Appendix II: Weighting Methodology

Survey respondents fell into 16 different IRS activity code categories. In making findings based on the survey data, we assigned each company a weight intended to make the survey sample representative of the entire LMSB population. Weighting was necessary because companies in certain activity code categories were over-represented in the sample of companies to which surveys were sent. Thus, for instance, companies that file Form 1120FSC constitute approximately 0.6 percent of the entire LMSB population. But because surveys were sent to 14.9 percent of all companies in the LMSB population that file Form 1120FSC (compared to an overall sampling rate of 0.1 percent), companies filing Form 1120FSC comprised 12 percent of our survey respondents. To correct for this, we used the following equation and assigned an appropriate weight to each company:

$$W_i = \frac{\text{Proportion of activity code category in the LMSB population}}{\text{Proportion of activity code category in the taxpayer respondent sample}}$$

Note, however, that none of our respondents belonged to Activity Codes 205 through 215. The weights described in Table A-2 adjust for this.

Data Appendix III: Sensitivity Analysis

This section reports on some additional sensitivity analyses of the procedures reported in the text. They address the following concerns:

1) Do the results change substantially when component-specific weights (separate weights for the personnel, non-personnel, and external cost components of compliance cost) are used to compute weighted average costs?
2) Is it true that larger firms (with higher compliance costs) generally tend to report all three individual components of compliance cost? If so, is our average compliance cost estimate upwardly biased?
3) Do the results change substantially when we use sampling weights (industry-form type weights) rather than activity code-based weights?
4) Is it possible to set an absolute lower bound on the compliance cost estimate?

The issue of larger firms being more likely to report all components of cost is particularly troubling. Of the 225 taxpayers that responded to our survey, 19 gave us *no* cost information, 206 responded to the question on external compliance cost, 129 responded to the question on internal personnel cost, and only 125 responded to the question on internal non-personnel cost. Only 108 respondents gave us *all three* components of compliance cost. Further, 37 percent of the firms that reported personnel and non personnel costs had assets greater than $250 million, while only 20 percent of firms that reported external costs had assets greater than $250 million.[58]

We could account for this discrepancy in two ways: one, assign component-specific weights, and two, impute costs for those firms that gave us external costs, but not personnel or non-personnel costs.

To test for Question 1, we assigned separate weights for each of the individual components of cost and re-computed the average compliance cost, resulting in an estimate - $121,348 - that was about 10 percent lower than the corresponding adjusted weighted average compliance cost.[59]

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[58] Note that 22 percent of our respondent sample reported assets greater than $250 million.

[59] These results are reported in rows 4 and 6 of the two panels of Table A-4.

To test for Question 2, we first regressed the ratio of personnel and non-personnel costs to external costs on total assets and a dummy variable (DV) for those respondents that reported no assets.[60] The regression equations obtained were:

$$\left(\frac{\text{Personnel}}{\text{External}}\right)\text{Cost} = -8.3256 + 0.6786\ \text{Ln(Total Assets)} + 11.6376\ \text{(No Asset DV)}$$

$$\left(\frac{\text{Non - Personnel}}{\text{External}}\right)\text{Cost} = -7.4808 + 0.5231\ \text{Ln(Total Assets)} + 7.8543\ \text{(No Asset DV)}$$

We used these regression equations to predict the ratio of personnel and non-personnel costs to external costs for all our respondents. Using these predicted ratios, we computed the corresponding personnel and non-personnel costs for all the firms that reported external costs. We merged the generated series with those from the survey responses so that we only imputed costs for firms that did *not* report personnel and non-personnel costs. Using these data, we then computed the average compliance cost as the sum of the average of the individual components. The adjusted weighted average compliance cost obtained was $134,429, only 0.4 percent lower than the corresponding non-imputed estimate.[61]

To test for Question 3, we used the industry-form type weights derived from the sample stratification.[62] The resulting adjusted weighted average estimate (adjusting for asset size discrepancies) of $146,485 was 8.5 percent higher than the estimate previously obtained.[63]

As an answer to Question 4, we computed the average compliance cost based on the assumption that any blank response to a survey question was a zero. This is

[60] To minimize the correction needed for gross discrepancies, if this ratio was either greater than 20 to 1 or less than 1/20th, we used those bounds.

[61] These results are reported in Column 4 of the panels of Table A-4. Note that the common weights estimate does not differ significantly from the component-specific weights estimate because only a handful of firms reported personnel or non-personnel costs, but *not* external costs.

[62] Note that in order to do this we used the IRS data on industry and form type, which differ significantly from the corresponding self-reported data.

[63] These results are reported in Column 3 of the two panels of Table A-4.

obviously an extreme assumption, but it helps us determine a likely lower bound to compliance cost. This exercise yields adjusted average compliance costs of $83,683, or aggregate federal compliance costs for the LMSB population of $13.8 billion.[64]

[64] Excluding the 25.5% attributed by taxpayers as the cost of complying with state and local tax laws.

SURVEY INSTRUMENTS FOR THE TAX PROFESSIONALS

Pre-mailing

1. Letter from IRS Commissioner Charles O. Rossotti.
2. Letter from the Office of Tax Policy Research.

Survey

3. Cover letter from the Office of Tax Policy Research.
4. Letter from the Tax Executives Institute, Inc.
5. Tax Professional Survey.

Follow-up

6. Follow-up postcard.
7. Letter from IRS Deputy Commissioner (Large and Mid-Size Business Division) Deborah Nolan.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

Dear Tax Professional:

I am writing to ask for your help on a very important project that could benefit you and thousands of business taxpayers across America.

We hear from many business owners and tax professionals that preparing and filing federal tax returns is time-consuming and expensive. The IRS wants to make this situation better, but we need your help.

We are mailing a questionnaire to you and a number of other tax professionals to find out how long it takes and how much money it costs for businesses to comply with our tax laws each year.

This confidential survey is being conducted for the IRS by the Office of Tax Policy Research at the University of Michigan Business School. The researchers will keep your answers private, but will give the IRS an overall analysis, which we can use to help reduce the burden of our tax system on business taxpayers and their tax preparers.

Please take part in this survey. Your participation is entirely voluntary, and we will have no way of knowing whether or not you participated. However, we do need your help and your real life experiences when it comes to filing taxes. We can use this information to make filing taxes easier for all businesses and their tax preparers.

Again, all information you provide will be used <u>only</u> for estimating taxpayer burden, and will be seen <u>only</u> by the university researchers. The IRS will not receive the information you provide, only a report on the findings and conclusions.

In the next two weeks, you will be receiving a letter from the Office of Tax Policy Research, University of Michigan, requesting your participation in this important survey. I hope you will agree to participate. Together we have a great opportunity to improve the way the IRS serves taxpayers. Thank you.

Sincerely,

Charles Rossotti

Charles O. Rossotti

University
of Michigan
Business
School

May, 2001

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Tax Policy Research
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48109-1234

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Joel Slemrod
Director

James R. Hines Jr.
Research Director

Mary Ceccanese
Coordinator

Varsha Venkatesh
Project Manager

Dear Tax Professional:

The Office of Tax Policy Research, a research office at the University of Michigan Business School, is pleased to be conducting a study of the time and money that business taxpayers spend in complying with their income tax obligations.

As stated in the letter from Commissioner Rossotti, the IRS has asked us to conduct this survey. The results of this study will help the IRS understand the burden placed on business taxpayers, and will help them identify ways to reduce that burden. We are a non-partisan, academic research center that is not affiliated with the IRS. Our office facilitates research on the tax system and serves as a liaison on tax issues among the academic, business, and policymaking communities.

Your tax firm has been randomly selected to participate in this study. While your participation in this study is entirely voluntary, your input is critical to its success. Please be assured that your responses will be kept strictly confidential. We will not be asking you about any information from your clients' business tax returns. We only want to know about the time and money spent helping companies like your clients to comply with their business tax obligations. You can expect to receive our survey in approximately two weeks. We expect that completion of the survey will take less than half an hour of your time.

If you have any questions or concerns about this study, please contact Mary Ceccanese of the Office of Tax Policy Research at (734) 763-3068, or otpr@umich.edu. We join Commissioner Rossotti in thanking you for your cooperation.

Sincerely,

Joel Slemrod

James R. Hines Jr.

University
of Michigan
Business
School

June, 2001

Dear Tax Professional:

We, the Office of Tax Policy Research, are writing to enlist your help and cooperation in understanding a crucial aspect of the federal tax system -- the magnitude and extent of the compliance costs borne by businesses like your clients. The enclosed survey is being sent to 2,000 tax professionals in the United States. As we mentioned in our earlier letter, this project is designed to enable us to suggest policy and procedural changes which could improve the tax code's efficiency, equity, and simplicity.

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Joel Slemrod
Director

James R. Hines Jr.
Research Director

Mary Ceccanese
Coordinator

Varsha Venkatesh
Project Manager

It won't take long!

The survey is composed of three parts and should take no more than one half hour to complete. The crucial piece of information we are looking for is how much you charge your clients to help them comply with the corporate and other business income tax system. To be sure, the survey has many more questions, and any additional information you provide us will significantly enhance the quality of our analysis. Your detailed responses will allow us to make recommendations about specific provisions of the tax code.

Who we are

The Office of Tax Policy Research (OTPR), a research office of the University of Michigan Business School, is non-partisan, and is not affiliated with the Internal Revenue Service. Our office conducted similar studies on the compliance costs of large corporations in 1992 and 1996, the results of which are now acknowledged to be one of the most reliable guides to corporate compliance cost. You can learn more about our organization by going to our web site, www.otpr.org.

Who is funding this project?

We are conducting this survey under contract to the Internal Revenue Service.

Won't this violate client confidentiality?

No. In this survey we ask you to estimate the cost of preparing a tax return for a *hypothetical* firm. Because we respect your confidentiality agreements with your clients, we would like you to give us your best estimate of the fee you would charge this representative firm to help them comply with the business income tax laws.

Once OPTR has analyzed the data, we will prepare a report that makes use of only summary information for the Large and Medium-Size Business (LMSB) division of the IRS, for the purposes of making internal changes and improving their interaction with taxpayers. The IRS will not have access to any completed surveys, and there will be no disclosure of individual responses to any branch of the government. Furthermore, you can be assured that the survey results will be reviewed only by us and our research assistants. In reporting our findings, no individual firm or tax professional will be identified.

Why should you participate?

Because we are asking about issues that affect you on a daily basis. This survey will give us a better understanding of the tax provisions that affect businesses, and will enable us to make recommendations to improve the system.

University
of Michigan
Business
School

We hope you will take the time to respond to this survey. If, as you complete the survey, you have any questions, please feel free to contact us through Mary Ceccanese at (734) 763-3068, or otpr@umich.edu. We would like to receive all surveys back by September 1, 2001, and have enclosed a postage-paid envelope for your convenience. Your time and effort are greatly appreciated. Thank you.

Joel Slemrod

James R. Hines Jr.

Enclosures

Tax Executives Institute, Inc.

1200 G Street, N.W., Suite 300
Washington, D.C. 20005-3814
Telephone: 202/638-5601
Fax: 202/638-5607

June 2001

Dear Colleague:

Tax Executives Institute is the preeminent association of business tax professionals in North America, with more than 5,300 members. Most TEI members work for companies who are under continual audit by the Internal Revenue Service and, thus, know first-hand the costs, complications, and consternation of complying with the tax laws. TEI has long supported efforts to improve tax administration and is proud of its record, both nationally and through our 53 local chapters, of working with the IRS to improve compliance, shorten audits, and minimize taxpayer burden.

Although TEI's interaction with the IRS has been substantial since our founding in 1944, it has grown greater since the enactment of the IRS Restructuring and Reform Act, which mandated the agency's reorganization along customer segments. For nearly three years, the Institute has had almost daily interaction with the Large and Mid-Size Business Division, which has responsibility over most business enterprises having assets of more than $5 million. (All 2,800 companies represented by TEI's membership fall under LMSB's jurisdiction, and thus we have a keen interest in working to improve business processes in order to facilitate the early resolution of tax disputes.)

In TEI's view, a key to improving tax administration is honestlyassessing the strengths and weaknesses of the current tax system. Accordingly, TEI supports IRS research efforts to quantify the time and money that business taxpayers spend in satisfying their income tax obligations. To this end, the Institute urges you to complete the accompanying questionnaire, which was prepared by the Office of Tax Policy Research at the University of Michigan School of Business. The OTPR, which is conducting the survey under contract with the IRS, has an unsurpassed reputation for conducting fair, dispassionate, and ultimately sound research. I can assure you that your individual responses will be kept confidential. And, I am equally confident, the data collected will contribute to improving the tax system.

If you have any questions about the survey, please feel free to contact Mary Ceccanese of OTPR at 734.763.3068.

Sincerely yours,

Betty M. Wilson

Betty M. Wilson
International President

The Large and Mid-Size Business Division

Compliance Cost Project

Tax Professional Survey

Office of Tax Policy Research

University of Michigan Business School

REMINDER: PLEASE BE ASSURED THAT NO INDIVIDUAL RESPONSES WILL BE REVEALED TO ANY BRANCH OF THE GOVERNMENT.

TABLE OF CONTENTS

PART ONE: HYPOTHETICAL CLIENT COMPANY CHARACTERISTICS

In this section we outline the key tax-related features of a company that is representative of the kinds of companies in which we are interested. In Part Two, we ask you to give us your best estimates of the cost of preparing a tax return for this kind of company.

PART TWO: COMPLIANCE BURDEN

This section refers to the activities carried out on behalf of, and the fee you would charge, the company outlined in Part One to comply with the business income tax.

PART THREE: GENERAL QUESTIONS ABOUT TAX COMPLIANCE

This section aims at addressing the specific provisions of the tax code that contribute to higher compliance costs. We'd like you to answer these questions based on your experiences with clients over the course of your career. Your answers will help us precisely identify the sources of tax complexity.

SURVEY BEGINS ON THE NEXT PAGE

PART ONE: Hypothetical Client Company Characteristics

In this section we outline the key tax-related features of a company that is representative of the kinds of companies in which we are interested. In Part Two, we ask you to give us your best estimates of the cost of preparing a tax return for this kind of company.

Your hypothetical company is engaged in the Communications, Technology & Media industry, in particular, in the business of Amusement Parks & Arcades. The company has total assets of about $25 million. The company reported about $16.5 million in annual gross receipts or sales, and approximately $10 million in total income.

In the past tax year, this company filed a Tax Form 1065, with 7 Schedule K-1(s). The Schedule K information for this partnership is as follows:
Ordinary income: greater than $1 million
Interest income: greater than $0 but less than $1 million

In addition, the company did not file a Tax Form 4626 for the Alternative Minimum Tax. This company is not currently being audited, and is not responding to past audits.

PART TWO: Compliance Burden

This section refers to the activities carried out on behalf of, and the fee you would charge, the company outlined in Part One to comply with the business income tax.

1. In general, what kind of tax-related services would such a firm purchase? Please check all that apply.

- ☐ Audit-related services
- ☐ Collection matters
- ☐ Preparing the tax return
- ☐ Preparing amended returns
- ☐ Record keeping services
- ☐ Responding to IRS notices
- ☐ Tax Planning/tax advice
- Other (Please specify) __________

2. PLEASE GIVE US YOUR BEST ESTIMATE OF THE AMOUNT YOU WOULD CHARGE THIS HYPOTHETICAL COMPANY TO HELP PREPARE THEIR BUSINESS INCOME TAXES.

For your convenience, we outline below what we consider to be components of this billed amount.
It **should include**:
The time and effort spent collecting and processing information needed to process income tax returns.
The time and effort spent on audits, amended returns, etc., even though these activities refer to prior-year returns.
The time and effort spent on any activities relating to state & local or federal taxes.
It **should not include:**
The time and effort involved in dealing with matters not related to the business income tax (for example, payroll taxes, excise taxes, 1099s and W-2s).

TOTAL AMOUNT CHARGED $__________

3. To the best of your ability, please estimate the percentage of the billed amount accounted for by pre-filing, filing, and post-filing costs. We understand that the lines separating these categories are somewhat blurry, so for your convenience we offer the following definitions:

<u>Pre-filing activities</u> include tax planning, obtaining tax guidance and information, and maintaining tax-related records.

Filing activities include the collection of data, preparation of the tax return from financial data, and calculation of the tax owed.
Post-filing activities include preparing amended returns, the audit process (including appeals, litigation, and collection), and responding to IRS notices.

	Percent of Cost
Pre-filing	%
Filing	%
Post-filing	%
Total	**100%**

4. This question breaks down pre-filing, filing, and post-filing costs into smaller categories. Please estimate the percent of the total billed time spent on these activities. If you spent no time on an activity, please insert a zero in the relevant space. Remember that your detailed answers will help us precisely identify the source of compliance costs.

a) Pre-filing

	Percent of Pre-filing Costs
Tax planning	%
Providing tax guidance and information	%
Maintaining tax-related records	%
Other	%
Total	100%

b) Filing

	Percent of Filing Costs
Collecting data	%
Preparing the tax return from financial data	%
Calculation of tax (include time spent dealing with software)	%
Other	%
Total	100%

c) Post-filing (Note: If your hypothetical company did not face an audit and/or did not file any amended returns, please ignore this question.)

	Percent of Post-filing Costs
Amended returns	%
Audit process (including appeals, litigation and/or collection)	%
Responding to IRS notices	%
Other	%
Total	100%

5. In your estimate, what fraction of this total billed amount would be devoted to federal income taxes, and what fraction to state and local income taxes?

Federal	________%
State and Local	________%
TOTAL	**100%**

PART THREE: General Questions about Tax Compliance

This section aims at addressing the specific provisions of the tax code that contribute to higher compliance costs. We'd like you to answer these questions based on your experiences with clients over the course of your career. Your answers will help us precisely identify the sources of tax complexity.

6. What aspect(s) of the current tax code is/are most responsible for the cost of your clients' complying with the federal business income tax? Please check all that apply.

- ☐ Alternative minimum tax (AMT)
- ☐ Basis computation
- ☐ Depreciation
- ☐ Depreciation recapture (Form 1231)
- ☐ Federal-State non conformity
- ☐ Partner-shareholder basis

Other ______________________________

____

7. What suggestions would you make to simplify compliance tax rules dealing with foreign source income?

- ☐ Change the definition of Earnings and Profits to conform to domestic income definitions
- ☐ Change the definition of Earnings and Profits to conform to foreign income definitions
- ☐ Eliminate or simplify the use of "baskets" to calculate foreign tax credit limits
- ☐ Permit excess foreign tax credits to be carried forward indefinitely
- ☐ Provide simplified transfer pricing guidelines
- ☐ Require information entries in Form 5471 to be reported only every other year
- ☐ Simplify the allocation rules for interest, R&D, and other expenses

Other ______________________________

____

8. In general, do you think your firm's interaction with clients has changed significantly over the last four years? How? Check all that apply.

- ☐ Audit process is quicker
- ☐ Fewer filing requirements (due to greater use of planning software by the client)
- ☐ More automation, leading to lower compliance costs

Other ______________________________
____

9. Have you ever: Please check all that apply.
   - ☐ Been approached by clients to look into tax shelters for their businesses?
   - ☐ Been approached by promoters advertising tax shelters?
   - ☐ Looked into real estate and personal property as possible tax shelters?
   - ☐ Set up a tax shelter for a client?

   Other ______________________________
   ____

10. Are there tax provisions that might have reduced your clients' total tax liability, but that you did not consider because of their complexity? Please check all that apply.
    - ☐ Accelerated depreciation
    - ☐ Corporate tax shelters
    - ☐ Inventory account changes
    - ☐ Foreign sales corporations
    - ☐ Foreign tax credits
    - ☐ Other tax credits (for example, business energy tax credit, R&E tax credit, etc.)
    - ☐ Section 179 deductions (Property depreciation)
    - ☐ Not aware of any

    Other ______________________________
    ____

11. Are there business activities that your clients might have undertaken, but chose not to because of the tax complexity involved? Please check all that apply.
    - ☐ Acquire another company
    - ☐ Dissolve/liquidate the company
    - ☐ Establish a foreign subsidiary or branch
    - ☐ Establish e-commerce operations
    - ☐ Expand operations into other states, thereby establishing taxable nexus
    - ☐ Restructure executive compensation (such as offering stock options)
    - ☐ Sell all or part of the company
    - ☐ Undertake a joint venture
    - ☐ Not aware of any

    Other ______________________________
    ____

12. Putting aside the impact on your clients' tax liability, could you rank the following options on a 1-6 scale in terms of their ability to simplify the tax process? [Note: Rank as 1 the option that would *most* simplify the process and as 6 the option that would *least* simplify the process.]

_____ Abolish Section 263A (Uniform capitalization rules)

_____ Abolish the Alternative Minimum Tax

_____ Eliminate depreciation rules, to be replaced by immediate expensing of capital asset costs

_____ Eliminate reporting requirements of all non-tax-computation-related information, such as business activity code, ownership of over 50% of voting stock, and Forms 5471 and 5472 [foreign corporation activity]

_____ Establish complete uniformity among state and local corporate income tax rules as well as conformity to federal rules

_____ Reduce filing requirements to audited financial statements plus Schedule M-1 detail

13. What problems have you encountered in complying with the tax system, which have not been addressed by this questionnaire? (If this space does not suffice, please feel free to attach a separate sheet. We would very much like to hear your views on the subject.)

Contact Person (Optional):

	Name:	____________________
	Title:	____________________
	Phone No.:	____________________
	Email:	____________________

The Paperwork Reduction Act requires the IRS to display an OMB Control Number on all public information requests. The OMB Control Number is 1545-1349. If you have any questions regarding this study, please contact Mary Ceccanese of the Office of Tax Policy Research at (734) 763-3068, or otpr@umich.edu.

September 24, 2001

Dear Tax Professional,

About six weeks ago we wrote to you seeking your participation in a survey concerning the compliance costs associated with federal and state business income taxation. The study is sponsored by the Office of Tax Policy Research of the University of Michigan Business School. The results of this survey will provide the most comprehensive analysis to date of the compliance costs of taxation incurred by businesses, and will be used to shed light on the impact of potential IRS initiatives and tax changes.

As of today, we have not yet received your completed questionnaire. We are writing to you again because your responses to our questionnaire are very important. Without them, our results cannot be truly representative of the U.S. business community.

In the event that your questionnaire has been misplaced, please let us know by calling (734) 763-3068 or e-mailing otpr@umich.edu, and we will provide you with another. We apologize if this postcard and your returned questionnaire have crossed in the mail.

Sincerely yours,

Joel Slemrod
Director, Office of Tax Policy Research
University of Michigan Business School

James R. Hines Jr.
Research Director, OTPR
University of Michigan Business School

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER
LARGE AND MID-SIZE
BUSINESS DIVISION

OCT 29, 2001

Dear Tax Professional:

Recently, the Office of Tax Policy Research at the University of Michigan mailed you a questionnaire to find out how long it takes and how much money it costs businesses to comply with our tax laws each year. The survey emanated from concerns expressed by many business owners and tax professionals that preparing and filing federal tax returns is time-consuming and expensive. Survey content includes:

- Hypothetical client company characteristics;
- Compliance burden with regards to the hypothetical company; and
- Your views on specific tax code sections that contribute to higher compliance costs.

If you have already replied to the survey, I thank you.

If you have not yet responded, I urge you to do so. We do need your help and your real life experiences when it comes to filing taxes. We can use this information to make filing taxes easier for businesses and their tax preparers.

As mentioned in previous communiqué, the survey is confidential. The researchers will keep your answers private. All information you provide will be used **only** for estimating taxpayer burden. The IRS will **not** receive the information you provide, only a report on the findings and conclusions.

In case you have misplaced the previously sent survey, you can request another by contacting the above Office of Tax Policy Research at telephone number (734) 763-3068 or e-mail to *otpr@umich.edu*.

Thank you for your help and assistance. Together we have a great opportunity to improve the way the IRS serves taxpayers.

Sincerely,

Deborah M. Nolan

Deborah M. Nolan
Deputy Commissioner

SURVEY INSTRUMENTS FOR THE TAXPAYERS

Pre-mailing

1. Letter from IRS Commissioner Charles O. Rossotti.
2. Letter from the Office of Tax Policy Research.

Survey

3. Cover letter from the Office of Tax Policy Research.
4. Letter from the Tax Executives Institute, Inc.
5. Tax Professional Survey.

Follow-up

6. Follow-up postcard.
7. Second follow-up postcard
8. Letter from IRS Deputy Commissioner (Large and Mid-Size Business Division) Deborah Nolan.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

Dear Business Taxpayer:

I am writing to ask for your help on a very important project that could benefit you and thousands of other business taxpayers across America.

We hear from many business owners that preparing and filing federal tax returns is time-consuming and expensive. The IRS wants to make this situation better, but we need your help.

We are mailing a questionnaire to you and a number of other business taxpayers to find out how long it takes and how much money it costs for businesses like yours to comply with our tax laws each year.

This confidential survey is being conducted for the IRS by the Office of Tax Policy Research at the University of Michigan Business School. The researchers will keep your answers private, but will give the IRS an overall analysis which we can use to help reduce the burden of our tax system on all business taxpayers.

Please take part in this survey. Your participation is entirely voluntary, and we will have no way of knowing whether or not you participated. However, we do need your help and your real life experiences when it comes to filing taxes. We can use this information to make filing taxes easier for your business and all businesses.

Again, all information you provide will be used <u>only</u> for estimating taxpayer burden, and will be seen <u>only</u> by the university researchers. The IRS will not receive the information you provide, only a report on the findings and conclusions.

In the next two weeks, you will be receiving a letter from the Office of Tax Policy Research, University of Michigan, requesting your participation in this important survey. I hope you will agree to participate. Together we have a great opportunity to improve the way the IRS serves taxpayers. Thank you.

Sincerely,

Charles O. Rossotti

Charles O. Rossotti

May, 2001

University of Michigan Business School

Office of Tax Policy Research
701 Tappan Street,
Room A2120
Ann Arbor, Michigan
48109-1234

Tel 734 763 3068
Fax 734 763 4032
Email otpr@umich.edu

http://taxpolicyresearch.umich.edu

Joel Slemrod
Director

James R. Hines Jr.
Research Director

Mary Ceccanese
Coordinator

Varsha Venkatesh
Project Manager

Dear Business Taxpayer:

The Office of Tax Policy Research, a research office at the University of Michigan Business School, is pleased to be conducting this survey of taxpayers and tax professionals. We are a non-partisan, academic research center that is not affiliated with the IRS. Our office facilitates research on the tax system and serves as a liaison on tax issues among the academic, business, and policymaking communities. We encourage you to visit our web site (www.otpr.org) and learn more about our research projects and other activities.

As stated in the letter from Commissioner Rossotti, the IRS has asked us to conduct this survey in order to measure the time and money that business taxpayers spend in complying with their income tax obligations. The results of this study will help the IRS understand the burden placed on taxpayers, and will help them identify ways to reduce that burden.

Your business has been randomly selected to participate in this survey. While your participation in this study is entirely voluntary, your input is critical to its success. Please be assured that your responses will be kept strictly confidential, and we will not be asking you about any information from your business tax return. We only want to know about the time and money you spend on tax-related activities, such as keeping records, purchasing tax software, completing your return, and dealing with other tax issues that may arise. You can expect to receive our survey in approximately two weeks. We expect that completion of the survey will take less than half an hour of your time.

If you have any questions or concerns about this study, please contact Mary Ceccanese of the Office of Tax Policy Research at (734) 763-3068, or otpr@umich.edu. We join Commissioner Rossotti in thanking you for your cooperation.

Sincerely,

Joel Slemrod

James R. Hines Jr.

University of Michigan Business School

June, 2001

Dear Business Taxpayer,

We, the Office of Tax Policy Research, are writing to enlist your help and cooperation in understanding a crucial aspect of the federal tax system. The enclosed survey, which is being sent to 2500 businesses in the United States, is designed to learn more about the magnitude and extent of the compliance costs borne by businesses like yours. As we mentioned in our earlier letter, this project is designed to enable us to suggest policy and procedural changes which could improve the tax code's efficiency, equity, and simplicity. Once we have analyzed the data, we will prepare for the Internal Revenue Service (IRS) a report that makes use of only summary information, for the purposes of making internal changes and improving their interaction with taxpayers

Office of Tax Policy Research
701 Tappan Street,
Room A2120
Ann Arbor, Michigan
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Tel 734 763 3068
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Joel Slemrod
Director

James R. Hines Jr.
Research Director

Mary Ceccanese
Coordinator

Varsha Venkatesh
Project Manager

It won't take long!

The survey is composed of four parts, and will take about one half hour to complete. The crucial piece of information we are looking for is the cost you incur to comply with the income tax. If you hired someone else to manage your tax affairs, we simply want to know how much you paid them! To be sure, the survey has many more questions, and any additional information you provide us will significantly enhance the quality of our analysis.

Who we are

We are the Office of Tax Policy Research, a research office of the University of Michigan Business School. We are non-partisan, and are not affiliated with the IRS. Our office conducted similar studies on the compliance costs of large corporations in 1992 and 1996, the results of which are now acknowledged to be one of the most reliable guides to corporate compliance cost. You can learn more about our organization by going to our web site, www.otpr.org. While you are there, you can read a summary of our 1996 report on compliance costs.

Who is funding this project?

We are conducting this survey under contract to the Internal Revenue Service.

Why should you participate?

Because we are asking about issues that affect *your* company on a daily basis. Your detailed responses will allow us to make recommendations about specific provisions of the tax code that affect businesses like yours, and will enable us to make recommendations to improve the system. The IRS will not have access to any completed surveys, and there will be no disclosure of taxpayer-specific information to any branch of the government. Furthermore, you can be assured that the survey results will be reviewed only by us and our research assistants.

We hope you will take the time to respond to this survey and return it in the enclosed postage-paid envelope. If, as you complete the survey, you have any questions, please feel free to contact us through Mary Ceccanese at (734) 763-3068, or otpr@umich.edu. We would like to receive all surveys back by August 1, 2001. Your time and effort are greatly appreciated.

Thank you.

Joel Slemrod | James R. Hines Jr.

Tax Executives Institute, Inc.

1200 G Street, N.W., Suite 300
Washington, D.C. 20005-3814
Telephone: 202/638-5601
Fax: 202/638-5607

June 2001

Dear Colleague:

Tax Executives Institute is the preeminent association of business tax professionals in North America, with more than 5,300 members. Most TEI members work for companies who are under continual audit by the Internal Revenue Service and, thus, know first-hand the costs, complications, and consternation of complying with the tax laws. TEI has long supported efforts to improve tax administration and is proud of its record, both nationally and through our 53 local chapters, of working with the IRS to improve compliance, shorten audits, and minimize taxpayer burden.

Although TEI's interaction with the IRS has been substantial since our founding in 1944, it has grown greater since the enactment of the IRS Restructuring and Reform Act, which mandated the agency's reorganization along customer segments. For nearly three years, the Institute has had almost daily interaction with the Large and Mid-Size Business Division, which has responsibility over most business enterprises having assets of more than $5 million. (All 2,800 companies represented by TEI's membership fall under LMSB's jurisdiction, and thus we have a keen interest in working to improve business processes in order to facilitate the early resolution of tax disputes.)

In TEI's view, a key to improving tax administration is honestlyassessing the strengths and weaknesses of the current tax system. Accordingly, TEI supports IRS research efforts to quantify the time and money that business taxpayers spend in satisfying their income tax obligations. To this end, the Institute urges you to complete the accompanying questionnaire, which was prepared by the Office of Tax Policy Research at the University of Michigan School of Business. The OTPR, which is conducting the survey under contract with the IRS, has an unsurpassed reputation for conducting fair, dispassionate, and ultimately sound research. I can assure you that your individual responses will be kept confidential. And, I am equally confident, the data collected will contribute to improving the tax system.

If you have any questions about the survey, please feel free to contact Mary Ceccanese of OTPR at 734.763.3068.

Sincerely yours,

Betty M. Wilson

Betty M. Wilson
International President

The Large and Mid-Size Business Division

Compliance Cost Project

Taxpayer Survey

Office of Tax Policy Research

University of Michigan Business School

REMINDER: PLEASE BE ASSSURED THAT NO TAXPAYER-SPECIFIC INFORMATION WILL BE REVEALED TO ANY BRANCH OF THE GOVERNMENT.

TABLE OF CONTENTS

PART ONE: COST OF HIRING AN OUTSIDE FIRM TO HELP PREPARE YOUR TAX RETURN

This section asks for information about the cost of having a tax professional prepare your business income tax return. Please note that if your company has an internal tax department that handles all tax matters, and if you incur NO costs to any outside firms, you can ignore this section and proceed directly to Part Two. Please also note that while the external firm might handle more than just the preparing of tax returns for your company, we would like information only about the time and cost of complying with the business income tax.

PART TWO: COMPLIANCE COSTS WITHIN THE COMPANY

This section refers to the cost of tax compliance incurred within your company, both inside and outside the tax department, over the previous twelve-month period. If you completely outsource all accounting and tax-related activities, (and you have completed Part One of the survey), please proceed to Part Three.

For your convenience, we outline below what we consider to be components of the compliance cost.

*The time and cost **should include:***

- *The amount spent collecting and processing information needed to process income tax returns.*
- *The amount spent on audits, amended returns, etc., even though these activities refer to prior-year returns.*
- *The amount spent on any activities relating to state & local or federal taxes.*

*The time and cost **should not include:***

- *The cost of activities that would be conducted if the tax system did not exist (so, e.g., the time and cost of preparing a balance sheet should not be reflected).*
- *The time and effort involved in dealing with matters not related to the business income tax (for example, payroll taxes, excise taxes, 1099s and W-2s)*

PART THREE: GENERAL QUESTIONS ABOUT COMPLIANCE BURDEN

This section aims at addressing the specific provisions of the tax code that contribute to higher compliance costs. Your answers will help us precisely identify the sources of tax complexity.

PART FOUR: CHARACTERISTICS OF YOUR FIRM AND TAX SITUATION (OPTIONAL)

This section will help us understand the nature and scope of the tax compliance costs. Your answer to the questions in this section will help us identify our survey population better, and enable us to answer questions such as:

Do some industries face higher compliance costs than others?

Are there particular characteristics of businesses that cause them to have more complex tax returns?

SURVEY BEGINS ON THE NEXT PAGE

PART ONE: Cost of Hiring an Outside Firm to Help Prepare Your Tax Return

This section asks for information about the cost of having a tax professional prepare your business income tax return. Please note that if your company has an internal tax department that handles all tax matters, and if you incur NO costs to any outside firms, you can ignore this section and proceed directly to Part Two. Please also note that while the external firm might handle more than just the preparing of tax returns for your company, we would like information only about the time and cost of complying with the business income tax.

1. Typically, what services does the tax professional provide for your company? Please check all that apply.

   - ☐ Audit-related services
   - ☐ Collection matters
   - ☐ Preparing the tax return
   - ☐ Preparing amended returns
   - ☐ Record keeping services
   - ☐ Responding to IRS notices
   - ☐ Tax planning/tax advice
   - Other (Please specify) __________

2. IN THE PREVIOUS TWELVE-MONTH PERIOD, WHAT WAS THE TOTAL COST INCURRED BY YOUR COMPANY TO OBTAIN OUTSIDE SERVICES (TAX PLANNERS, TAX ACCOUNTANTS, ETC.) TO HELP PREPARE YOUR INCOME TAX RETURN?

   TOTAL COST OF OUTSIDE SERVICES: $__________

3. To the best of your knowledge, what fraction of this total cost was devoted to federal income taxes, what fraction to state and local income taxes, and what fraction to taxes on foreign source income?

Federal	__________%
State and Local	__________%
Foreign	__________%
TOTAL	**100%**

4. Please estimate what percentage of your expenditures on outside tax assistance go to:

Accounting firms	________%
Law firms	________%
Other (specify_______________)	________%
TOTAL	**100%**

5. To the best of your ability, please estimate the percentage of your expenditures on **outside tax assistance** accounted for by pre-filing, filing, and post-filing costs. We understand that the lines separating these categories are somewhat blurry, so for your convenience we offer the following definitions:

   Pre-filing activities include tax planning, obtaining tax guidance and information, and maintaining tax-related records.
   Filing activities include the collection of data for the tax professional, preparation of the tax return from financial data, and the calculation of the tax owed.
   Post-filing activities include filing amended returns, the audit process (including appeals, litigation, and collection), and responding to IRS notices.

Pre-Filing Costs:	________%
Filing Costs:	________%
Post-Filing Costs:	________%
TOTAL	**100%**

PART TWO: Compliance Costs within the Company

This section refers to the cost of tax compliance incurred within your company, both inside and outside the tax department, over the previous twelve-month period. If you <u>*completely*</u> *outsource all accounting and tax-related activities, (and you have completed Part One of the survey), please proceed to Part Three.*

For your convenience, we outline below what we consider to be components of the compliance costs that appear in questions 7 - 12.

The cost ***should include:***

- *The time and effort spent collecting and processing information needed to process income tax returns.*
- *The time and effort spent on audits, amended returns, etc., even though these activities refer to prior-year returns.*
- *The time and effort spent on any activities relating to state & local or federal taxes.*

The cost ***should not include:***

- *The cost of activities that would be conducted if the tax system did not exist (so, e.g., the time and cost of preparing a balance sheet should not be reflected).*
- *The time and effort involved in dealing with matters not related to the business income tax (for example, payroll taxes, excise taxes, 1099s and W-2s)*

---

6. Do you have a separate tax department?

Yes ☐ No ☐

If **Yes**, how many people (in staff-years) do you employ in this department?

____

If **No,** how many people in your company are involved in dealing with tax matters?

☐ None
☐ 1 - 5
☐ 6 - 15
☐ > 15

If you have no separate tax department, and have no other personnel involved in tax matters, please proceed to Part Three.

7. PLEASE ESTIMATE THE AMOUNT OF TIME (IN STAFF-YEARS) DEVOTED TO COMPLYING WITH BUSINESS INCOME TAXES.

Within the tax department:	________
Within company, outside of tax department:	________
TOTAL	________

8. WHAT IS THE TOTAL ANNUAL BUDGET FOR SALARIES (INCLUDING FRINGE BENEFITS) DEVOTED TO COMPLYING WITH BUSINESS INCOME TAXES?

Within the tax department:	________
Within company, outside of tax department:	________
TOTAL	________

9. To the best of your knowledge, what fraction of this total annual budget was devoted to federal income taxes, what fraction to state and local income taxes, and what fraction to taxes on foreign source income?

Federal	________%
State and Local	________%
Foreign	________%
TOTAL	**100%**

10. a) Please estimate your annual *non-personnel* costs for complying with Federal, State, and Local tax requirements. These include costs such as software, data processing, record storage and retrieval, office space, general supplies, copying, faxing, and travel. (Please note that this does not include expenses for external services like accountants and tax lawyers.)

Annual non-personnel costs: $________

b) Do you use tax preparation software?

Yes ☐ No ☐

If **Yes**, which program do you use? ________

Approximately how much does it cost you annually to purchase/use this software?
$________

11. Please estimate the percent of **internal cost** spent on pre-filing, filing, and post-filing. We understand that the lines separating these categories are somewhat blurry, so for your convenience we offer the following definitions:

Pre-filing activities include tax planning, obtaining tax guidance and information, and maintaining tax-related records.
Filing activities include the collection of data for the tax professional, preparation of the tax return from financial data, and calculation of the tax owed.
Post-filing activities include filing amended returns, the audit process (including appeals, litigation, and collection), and responding to IRS notices.

	Percent of Internal Cost
Pre-filing	%
Filing	%
Post-filing	%
Total	100%

12. This question breaks down **internal** pre-filing, filing, and post-filing costs into smaller categories. Please estimate the percent of internal cost your firm spent on these activities. If you incurred no cost with regard to an activity, please insert a zero in the relevant space. Remember that your detailed answers will help us precisely identify the source of your compliance costs!

a) Pre-filing

	Percent of Pre-Filing Internal Cost
Tax planning	%
Soliciting tax guidance and information	%
Maintaining tax-related records	%
Other	%
Total	100%

b) Filing

	Percent of Filing Internal Cost
Collecting data for a tax professional	%
Preparing the tax return from financial data	%
Calculation of tax (include time spent dealing with software)	%
Other	%
Total	100%

c) Post-filing (Note: If you did not face an audit and/or did not file any amended returns, please ignore this question)

	Percent of Post-filing Internal Cost
Amended returns	%
Audit process (including appeals, litigation and/or collection)	%
Responding to IRS notices	%
Other	%
Total	100%

PART THREE: General Questions about Compliance Burden

This section aims at addressing the specific provisions of the tax code that contribute to higher compliance costs. Your answers will help us precisely identify the sources of tax complexity.

13. What aspects of the current tax code and process are most responsible for the cost of complying with the federal corporate income tax? Please check all that apply. [We realize that there are things about the payroll and excise tax or the 1099s and W-2s that may be particularly irksome, but please restrict yourself only to aspects of the income tax.]

- ☐ Alternative minimum tax (AMT)
- ☐ Basis computation
- ☐ Depreciation
- ☐ Depreciation recapture (Form 1231)
- ☐ Federal-State non-conformity
- ☐ Partner-shareholder basis issues

Other ______________________________

____

14. Please answer only if your company has foreign operations.
What suggestions would you make to simplify compliance tax rules dealing with foreign-source income?

- ☐ Change the definition of Earnings and Profits to conform to domestic income definitions
- ☐ Change the definition of Earnings and Profits to conform to foreign income definitions
- ☐ Eliminate or simplify the use of "baskets" to calculate foreign tax credit limits
- ☐ Permit excess foreign tax credits to be carried forward indefinitely
- ☐ Provide simplified transfer pricing guidelines
- ☐ Require information entries in Form 5471 to be reported only every other year
- ☐ Simplify the allocation rules for interest, R&D, and other expenses

Other ______________________________

____

15. What is your best estimate of the percentage growth between 1996 and 2000 in the funds your company spent on income tax compliance?

__________%

For the sake of comparison, what was the percentage growth in total revenues for your business over this period?

__________%

16. In the past four years, what has your company done to cope with increased tax law complexity, given your limited budget? Please check all that apply.

- ☐ Computerization
- ☐ Hired more people to handle taxes
- ☐ Hired outside consultants
- ☐ Lower level of tax compliance

Other ______________________________________

____

17. Are there tax provisions that might have reduced your total tax liability, but that you did not take advantage of because of their complexity? Please check all that apply.

- ☐ Accelerated depreciation
- ☐ Corporate tax shelters
- ☐ Inventory account changes
- ☐ Foreign sales corporations
- ☐ Foreign tax credits
- ☐ Other tax credits (for example, foreign tax credit, business energy credit, R&E tax credit etc.)
- ☐ Section 179 deductions (property depreciation)
- ☐ Not aware of any

Other ______________________________________

____

18. Are there business activities that your company might have undertaken, but did not because of the tax complexity involved? Please check all that apply.

- ☐ Acquire another company
- ☐ Dissolve/ liquidate the company
- ☐ Establish a foreign subsidiary or branch
- ☐ Establish e-commerce operations
- ☐ Expand operations into other states, thereby establishing taxable nexus
- ☐ Restructure executive compensation (such as offering stock options)
- ☐ Sell all or part of the company
- ☐ Undertake a joint venture
- ☐ Not aware of any

Other ______________________________________

19. Putting aside the impact on your tax liability, could you rank the following options on a 1-6 scale in terms of their ability to simplify the tax process? [Note: Rank as 1 the option that would *most* simplify the process and as 6 the option that would *least* simplify the process]

_____ Abolish Section 263A (Uniform capitalization rules)

_____ Abolish the Alternative Minimum Tax

_____ Eliminate depreciation rules, to be replaced by immediate expensing of capital asset costs

_____ Eliminate reporting requirements of all non-tax-computation-related information, such as business activity code, ownership of over 50% of voting stock, and Forms 5471 and 5472 (Foreign Corporation activity)

_____ Establish complete uniformity among state and local corporate income tax rules as well as conformity to federal rules

_____ Reduce filing requirements to audited financial statements plus Schedule M-1 detail

20. What problems have you encountered in complying with the income tax system, which have not been addressed by this questionnaire? (If this space does not suffice, please feel free to attach a separate sheet. We would very much like to hear your views on the subject.)

THIS PAGE IS DELIBERATELY LEFT BLANK.

PART FOUR: Characteristics of Your Firm and Tax Situation (optional)

This section will help us understand the nature and scope of the tax compliance costs. Your answer to the questions in this section will help us identify our survey population better, and enable us to answer questions such as:

Do some industries face higher compliance costs than others?

Are there particular characteristics of businesses that cause them to have more complex tax returns?

21. Which forms did you file in the past twelve-month period?
    - (1) 1065 ______
    - (2) 1120 ______
    - (3) 1120S ______
    - (4) 1120F ______
    - (5) 1120L ______
    - (6) Other (please indicate): __________

22. Please give the year of incorporation or the year your business was started.

    ______

23. Is your company publicly held?

    Yes ☐ No ☐

24. ***Please ignore this question if you filed a Form 1065***

    Did you file a consolidated Federal income tax return in the past twelve-month period?

    Yes ☐ No ☐

    If **Yes**, please record the number of entities included in the consolidated return(s) ___________

    Of this number, how many entities were active?_______

    If you also filed unconsolidated federal returns, please record the number of unconsolidated returns filed______

25. How many pages or inches of documents were submitted as part of your last twelve-month federal income tax return?

_____________ pages **or** _____________ inches

26. Did you choose to e-file your tax return?

Yes ☐ No ☐

27. ***Only answer if you filed a Form 1120.***
Were you subject to the Alternative Minimum Tax in the past twelve-month period?

Yes ☐ No ☐

If **No**, did you calculate the AMT Liability?

Yes ☐ No ☐

28. Please indicate which one of the following industry categories best describes the activities of your primary business:

☐ Communications, Technology and Media
☐ Financial and Professional Services
☐ Heavy Manufacturing and Transportation
☐ Natural Resources and Construction
☐ Retail, Food and Healthcare
Other _________________

If you know the NAICS code description applicable to your business, please list it here: ____

29. **Indices of firm size.** Refer to the latest tax year, if possible; otherwise use the most convenient recent twelve-month period. (If needed, use the following abbreviations: K = thousands, M = millions, B = billions)

a. What was your total number of employees (full-time equivalents)?
U.S. _________________
Foreign _________________

b. What were your total assets?
U.S. _________________
Foreign _________________

c. What were your net receipts or sales?
U.S. ________________
Foreign ________________

30. **Indices of multinationality.**

a. Does your firm operate in countries other than the United States?

Yes ☐ No ☐

b. If **Yes,** in how many different countries? ___

c. Does your company operate in the following countries? Please check all that apply.

- ☐ Canada
- ☐ Japan
- ☐ United Kingdom
- ☐ None of the above

Contact Person (Optional):
Name: ________________
Title: ________________
Phone No.: ________________
Email: ________________

REMINDER: PLEASE BE ASSURED THAT NO TAXPAYER-SPECIFIC INFORMATION WILL BE REVEALED TO ANY BRANCH OF THE GOVERNMENT.

The Paperwork Reduction Act requires IRS to display an OMB Control Number on all public information requests. The OMB Control Number is 1545-1349. If you have any questions regarding this study, please contact Mary Ceccanese of the Office of Tax Policy Research at (734) 763-3068, or otpr@umich.edu.

August 20, 2001

Dear Business Taxpayer,

About six weeks ago we wrote to you seeking your participation in a survey concerning the compliance costs associated with federal and state business income taxation. The study is sponsored by the Office of Tax Policy Research of the University of Michigan Business School. The results of this survey will provide the most comprehensive analysis to date of the compliance costs of taxation incurred by businesses, and will be used to shed light on the impact of potential IRS initiatives and tax changes.

As of today, we have not yet received your completed questionnaire. We are writing to you again because your responses to our questionnaire are very important. Without them, our results cannot be truly representative of the U.S. business community.

In the event that your questionnaire has been misplaced, please let us know by calling (734) 763-3068 or e-mailing otpr@umich.edu, and we will provide you with another. We apologize if this postcard and your returned questionnaire have crossed in the mail.

Sincerely yours,

Joel Slemrod
Director, Office of Tax Policy Research
University of Michigan Business School

James R. Hines Jr.
Research Director, OTPR
University of Michigan Business School

September 17, 2001

Dear Business Taxpayer,

In June, we sent you a survey regarding the compliance costs of federal and state business income taxation. Results from the survey will provide the information for the most comprehensive analysis to date of the tax compliance costs currently incurred by business.

As of today, we have not yet received your completed questionnaire, and so I am writing to you one last time to urge you to respond. To date we have received over 125 surveys, enough to form a general picture of compliance costs, but not enough to accurately assess sectoral variations. Note that all respondents will receive a complete report of the survey results, which may be helpful to your company in benchmarking your tax compliance operations.

In order for your company's experience to be reflected in the report's conclusions, we must receive your survey no later than October 10. If you would like to respond, but have misplaced the questionnaire, please let us know by calling (734) 763-3068 or via e-mail at otpr@umich.edu; we will immediately provide you with another. We apologize if this postcard and your returned questionnaire have crossed in the mail.

Sincerely yours,

Joel Slemrod
University of Michigan Business School

James R. Hines Jr.
University of Michigan Business School

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER
LARGE AND MID-SIZE
BUSINESS DIVISION

OCT 22, 2001

Dear Taxpayer:

Recently, the Office of Tax Policy Research at the University of Michigan mailed you a questionnaire to estimate the amount of time and money that businesses like yours actually spend complying with our tax laws each year. The survey emanated from concerns expressed by many business owners that preparing and filing business tax returns is time-consuming and expensive. Survey content includes such categories as:

- Internal costs;
- Outside tax assistance costs; and
- Demographics.

If you have already replied to the survey, I thank you.

If you have not yet responded, I urge you to do so. We do need your help and your real life experiences when it comes to filing taxes. We can use this information to make filing taxes easier for businesses and their tax preparers.

As mentioned in previous communiqué, the survey is confidential. The researchers will keep your answers private. All information you provide will be used **only** for estimating taxpayer burden. The IRS will **not** receive the information you provide, only a report on the findings and conclusions.

In case you have misplaced the previously sent survey, you can request another by contacting the above Office of Tax Policy Research at telephone number (734) 763-3068 or e-mail to *otpr@umich.edu*.

Thank you for your help and assistance. Together we have a great opportunity to improve the way the IRS serves taxpayers.

Sincerely,

Deborah M. Nolan

Deborah M. Nolan
Deputy Commissioner