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# TAX SYSTEM

## Issues in Tax Compliance Burden

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# Tax System: Issues in Tax Compliance Burden

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As business and individual taxpayers strive to comply with federal, state, and local tax requirements, they expend time, incur costs, and experience frustrations. GAO refers to this time, cost, and frustration as taxpayer compliance burden. In this testimony GAO identified the sources of compliance burden identified by businesses and examined the feasibility of obtaining reliable dollar estimates of the compliance costs borne by businesses. GAO collected information on compliance burden from the management and tax staffs of selected businesses, tax accountants, tax lawyers, representatives of tax associations, and officials of the Internal Revenue Service. The focus of GAO's efforts was the federal tax system.

Several themes emerged from GAO's analysis. First, according to those GAO interviewed, the complexity of the Internal Revenue Code, compounded by the changes frequently made to the code, is the driving force behind federal business tax compliance burden. Second, a reliable estimate of the overall costs of business tax compliance would be costly and in itself burdensome on businesses to obtain.

GAO is currently studying the impact of two return-free filing alternatives used in other countries on reducing individuals' tax compliance burden. While these alternatives offer promise in individual burden reduction, employers, the tax preparation industry, and state tax systems may experience burden increases or be otherwise adversely affected and IRS' capacity to implement such systems may need further study. Reducing the tax compliance burden on businesses and on individuals will be a difficult undertaking because of the various policy trade-offs, such as revenue impact and taxpayer equity, that must be made.

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**Summary**  
**Tax System: Issues in Tax Compliance**  
**Burden**

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# Tax System: Issues in Tax Compliance Burden

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Mr. Chairman, Representative Shadegg, and Members of the Subcommittee:

We are pleased to be here today to discuss with the Subcommittee the results of work done on the burden that business and individual taxpayers face in complying with federal tax requirements. Because of concerns about business taxpayer burden, we identified sources of compliance burden and examined the feasibility of obtaining reliable dollar estimates of the compliance costs borne by business taxpayers. We have defined burden as the time taxpayers spend, monetary costs they incur, and frustrations they experience in complying with tax requirements. Because individual taxpayers may also face compliance burdens, we are currently reviewing alternative tax filing procedures to identify possible benefits to taxpayers and challenges presented by such alternatives. Although that work is incomplete, we can share some information about individual tax burden issues.

To provide a perspective on business taxpayer burden, we collected information on compliance burden from the management and tax staffs of selected businesses, tax accountants, tax lawyers, representatives of tax associations, and officials of the Internal Revenue Service (IRS). The corporate businesses we met with varied by geographical location, size, and industry type.<sup>1</sup>

There are several points we will discuss today. First, according to the businesses we interviewed, the complexity of the Internal Revenue Code, compounded by the frequent changes made to the code, is the driving force behind business tax compliance burden. Second, a reliable estimate of the overall costs of tax compliance would be costly and in itself burdensome on businesses to obtain. Finally, reducing the compliance burden on businesses and individual taxpayers will be a difficult undertaking because of the various policy trade-offs, such as revenue and taxpayer equity, that must be made.

While discussing with us the many issues associated with compliance burden, the business officials and tax experts also acknowledged the legitimate purposes and requirements of the tax system. They said that filing tax returns and paying taxes were all part of doing business. But most firmly believed there must be easier ways to achieve the goals of the federal tax system.

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<sup>1</sup>While the businesses we interviewed were selected to provide a range of perspectives, they were not selected to provide a statistically valid sample. As a result their input cannot be generalized to all businesses. Appendix I provides detailed information about the scope of our work and methodology.

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## Complexity of the Federal Tax Code

Business officials and tax experts told us that, overall, the federal tax code is complex, difficult to understand, and in some cases indecipherable. They also said it was burdensome to comply with the code because of the additional record-keeping and calculations that the code requires. More specifically, they said businesses have difficulty with the code because of numerous and unwieldy cross-references and overly broad, imprecise, and ambiguous language. Such language, they said, appears to be designed to cover every conceivable case but leads to much taxpayer confusion and frequent misinterpretation of the code.

Frequent legislative changes, including the effects of these changes on other sections of the code, were also cited as problematic. Respondents said that the frequent and large number of legislative changes make it difficult for businesses to keep current on provisions that apply to their specific situations. For example, 1 year after the expansive Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1987 changed about 50 provisions that potentially affected business tax compliance. Business officials and tax experts said it was their perception that these frequent changes were designed to fix loopholes or perceived abuses; yet, in making these changes, Congress appeared not to have considered the impact they have on other sections of the code.

These same parties expressed frustration about provisions with finite lives being left to expire but later reauthorized. These are tax provisions that may contain sunset clauses to encourage future reevaluation. And while recognizing the value of these provisions, business officials and tax experts said informed business decisions are difficult to make without knowing a provision's fate. Each of these concerns about changes to the tax code added to the uncertainty businesses face in attempting to understand and comply with the tax code.

The tax code also can create the need to establish and maintain numerous and sometimes duplicate sets of financial records. For example, all of the 17 businesses we spoke with said depreciation requirements caused them to maintain detailed records solely for tax purposes. For a given set of assets, some companies need to produce one set of computations and records for the regular federal tax and two additional sets for the federal Alternative Minimum Tax (AMT).<sup>2</sup> Many businesses are also required to produce additional depreciation computations and records for state and local income and property tax purposes.

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<sup>2</sup>The Omnibus Budget Reconciliation Act of 1993 repealed the adjusted current earning depreciation adjustment for AMT purposes, effective for property placed in service after 1993. Consequently, only one set of depreciation records will be required for such property for AMT purposes.

Complexities in the code can also result in the need to complete time-consuming calculations. Among these, respondents frequently mentioned the calculations associated with the uniform capitalization rules, the AMT, and other provisions that force taxpayers to trace the many categories of interest expense and apply a separate tax treatment to each category.

Our respondents also indicated that the compliance burden imposed by the federal tax system was made greater by the interplay of state and local tax requirements that at times were inconsistent with each other as well as with the federal code. Among the problems cited by businesses were different definitions of wages, income, and certain deductions; different methods for calculating depreciation; and inconsistent requirements for payroll reporting and timing of deposits. While the focus of our discussions was on the federal tax burden, some of the business respondents said that the compliance burden associated with state and local tax requirements exceeded the burden of the federal system.

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## **IRS' Administration of the Tax Code**

Some business officials and tax experts also cited IRS' administration of the federal tax code as contributing to business compliance burden, although to a lesser extent than the complexity of and frequent changes to the code. Of those who cited difficulties with IRS, problems identified were with the tax knowledge of IRS auditors, the clarity of IRS' correspondence and notices, and the amount of time IRS takes to issue regulations.

The complexity of the code has a direct impact on IRS' ability to administer the code. The volume and complexity of information in the code make it difficult for IRS to ensure that its tax auditors are knowledgeable about the tax code and that their knowledge is current. Some business officials and tax experts said that IRS auditors lack sufficient knowledge about federal tax requirements, and in their opinion this deficiency has caused IRS audits to take more time than they otherwise might. However, other respondents said that IRS auditors were reasonable to work with. IRS recognizes the difficulty of maintaining a workforce of auditors who fully understand all tax requirements. IRS is developing a program to encourage auditors to become industry specialists so that they can increase their understanding of industry environments, accounting practices, and tax issues.

IRS also encounters difficulties in communicating with taxpayers, in part due to the need to ensure technical accuracy while at the same time presenting information clearly and concisely. Business taxpayers and tax

experts said that the complexity of the forms and publications and the lack of clarity of correspondence and notices resulted in frustrating and burdensome experiences for the taxpayers. They said that business compliance burden is increased as businesses attempt to understand and respond to those notices and letters. Our last detailed examinations of IRS notices, forms, and publications, in December 1994, revealed continuing problems with these documents.<sup>3</sup> IRS has been making efforts to resolve some of those problems.

Respondents also identified difficulties in complying with the code because regulations were not always available from IRS in a timely manner. IRS officials said that the amount of time that passes before a final regulation is issued varies, but it can take several years or longer. According to the officials, the amount of time is a product of the complexity of the particular tax provision, the process of obtaining and analyzing public comment on proposed regulations, and the priority IRS assigns to issuing the regulation.

For many tax provisions businesses depend upon IRS regulations for guidance in complying with the code and correspondingly reducing their burden. Without timely regulations, according to some respondents, businesses must guess at the proper application of the law and then at times amend their decisions when the regulations are finally issued.

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## **Reliable Estimate of Overall Business Tax Compliance Costs Would Be Difficult to Develop**

Moving next, Mr. Chairman, to the overall cost to businesses of complying with the tax code, we did not identify a readily available, reliable estimate of such costs. While there was a general consensus that compliance is burdensome and some businesses offered anecdotal examples of their costs, our discussions with businesses and review of available studies indicate that developing a reliable estimate would require that several practical and severe problems be overcome. These problems include working with a broad spectrum of businesses to accurately separate tax costs from other costs and obtaining accurate and consistent responses from businesses on tax burden questions. This kind of inquiry would be an expensive and burdensome process in itself.

In our interviews with business officials and tax experts, we found that business tax compliance strategies usually were not done in isolation from other business operations; few of their activities were done solely or even

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<sup>3</sup>Tax Administration: IRS Notices Can Be Improved (GAO/GGD-95-6, Dec. 7, 1994); Tax Administration: IRS Efforts To Improve Forms and Publications (GAO/GGD-95-34, Dec. 7, 1994).



primarily for tax reasons. More often, tax considerations affected the timing or structure of a business action not whether the action would occur. For example, in acquiring a business equipment would consider tax implications in terms of whether to buy or lease the equipment.

Few of the businesses we spoke with could readily separate tax compliance costs from other costs of doing business. The integration of the tax compliance activities with other business activities makes it difficult and time-consuming to collect the information necessary from businesses to generate reliable cost estimates. For example, businesses said it would be difficult to take payroll expenditures and isolate those associated with tax compliance.

Further, business respondents said that they do not routinely need, thus it does not make sense for them to collect, information on compliance costs. And, to separate tax compliance costs from other costs of doing business would be burdensome and of questionable usefulness to them.

A few business officials provided estimates of some compliance costs, such as legal fees, payroll management fees, and tax software expenditures, but expressed limited confidence in their ability to provide accurate, comprehensive cost data. In addition, those few businesses that said they could isolate some of their tax compliance costs indicated that even in their cases, it would be difficult to separate federal compliance costs from state and local compliance costs.

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## **The Challenge of Reducing Business Tax Compliance Burden**

While we did not identify existing reliable business tax burden cost estimates, there was consensus among the business respondents, tax experts, and the literature that tax compliance burden is significant and that it can be reduced. Although some gains can be made by reducing administrative burden imposed by IRS, the greatest potential for reducing the compliance burden of business taxpayers is by dealing with the complexity of the tax code.

One approach to simplifying the tax code would be to tackle particularly burdensome provisions individually. The business officials and tax experts we talked with identified several provisions that they perceived to be especially problematic. These included the AMT, uniform capitalization, and pension and payroll provisions. In addition, others have identified the foreign tax credit as needing simplification. Simplification of any of these

provisions has the potential for reducing the compliance burden of many businesses.

Another approach that has been proposed is to completely overhaul the tax code by replacing the current income tax with some form of consumption tax. In considering changes to the tax code, whether they be limited in nature or comprehensive, legislators need to weigh several sometimes competing concerns. These include the revenue implications of any change, the need to address equity and fairness, and the desire to achieve social and economic goals. The tension in achieving balance among these trade-offs and at the same time making it easier for taxpayers to comply presents a significant challenge to Congress.

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## **Reducing Individual Tax Compliance Burden Faces Similar Challenges**

The tax system is burdensome for many individuals as well as for businesses. Almost 100 million American taxpayers currently must file individual tax returns, even though most have fully paid their taxes through the withholding system. To assist the Congress in identifying options for reducing taxpayer burden and IRS paper processing, we are in the process of studying return-free filing systems and the potential impact they would have on the federal income tax system.

While we are still finalizing our results, we can provide some preliminary information on (1) the two most common types of return-free filing used in other countries, (2) the number of individual American taxpayers that could be affected by these two types of return-free filing, and (3) some of the issues that would need to be addressed if these systems were to be considered.

In countries with return-free filing, the most common type of system we identified was one that we termed “final withholding.” Under this system, the withholder of income taxes—for example an employer—is to determine the taxpayer’s liability and withhold the correct tax liability from the taxpayer. With the final year-end payment to the taxpayer, the withholder is to make a final reconciliation of taxes and adjust the withholding for that period to equal the year’s taxes.

Another type of return-free filing—referred to as “tax agency reconciliation”—depends entirely on information reporting to the tax agency by employers and other payors and allows the tax agency to determine the taxpayer’s taxes based on these information documents. The tax agency is to send the taxpayer either a refund or a tax bill based

on the tax liability and the amount of withholding. We identified 36 countries that use one of these two forms of return-free filing—34 with final withholding and 2 with tax agency reconciliation.

Given the extent of withholding and information reporting that exists under our current tax system, we estimated that about 18.5 million American taxpayers whose incomes derive from only one employer could be covered under a final withholding system. An estimated 51 million taxpayers could be covered under an agency reconciliation system.

We estimated that taxpayers could save millions of hours in preparation time and millions of dollars in tax preparation costs under either the final withholding system or the tax agency reconciliation system. We also estimated that IRS would save about \$45 million in processing costs under the final withholding system, and about \$36 million under the tax agency reconciliation system, in processing and compliance costs. However, employers would face substantial additional burden and costs under the final withholding system and the tax preparation industry could be adversely affected under either system.

Furthermore, several changes to the current tax system would be needed in order to implement either form of return-free filing. Under both systems, taxpayers would continue to provide information to IRS on their filing status and number of dependents. Employers would need to be authorized by law to compute and remit tax liabilities under final withholding and they would have to set up payroll procedures to do so.

Consideration would also need to be given to the impact of these systems on certain states where the state income tax is tied to the federal income tax return. For example, IRS would have to speed up the processing of information documents under the tax agency reconciliation system so that tax liabilities could be determined before April 15, which is also the tax filing deadline for some states. IRS' own 1987 study of return-free filing recognized this processing problem and recommended against a tax agency reconciliation return-free filing system for that reason. As IRS improves its information processing capabilities, return-free filing may become more feasible.

In summary, reducing the tax compliance burden on businesses and on many individuals will be a difficult undertaking because of the various policy tradeoffs, such as revenue impact, taxpayer equity, and shifting compliance obligations, that must be made. However, continued

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evaluation of ways in which tax compliance burden can be reduced is an important contribution to improving our tax system.

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Mr. Chairman, Representative Shadegg, this concludes our prepared statement. We would be pleased to answer any questions.

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# Methodological Approach and Limitations

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Our approach for (1) identifying the sources of compliance burden for businesses and (2) determining the feasibility of obtaining reliable estimates of the compliance costs borne by businesses was to review and assess the literature on tax compliance burden to identify issues and to conduct in-depth interviews of businesses and tax experts to obtain their views on compliance burden.

We reviewed about 25 commonly recognized studies from the literature on compliance costs and tax simplification. These studies provided information on how businesses comply with tax laws, the areas they find more difficult to comply with, causes for some of the tax compliance burden experienced by businesses, and suggestions for reducing compliance burden.

We interviewed business officials and tax experts to obtain detailed information on actual taxpayer experiences in complying with federal, state, and local tax requirements and to determine if companies could collect reliable taxpayer compliance cost data. These included interviews with tax and management officials of 17 businesses, three panels of tax accountants from the American Institute of Certified Public Accountants (AICPA), and a panel of tax lawyers from the American Bar Association (ABA) Tax Section. We also talked with representatives of tax associations and IRS officials to obtain their views on the reasons for tax compliance burden.

We selected the 17 businesses to include a variety of geographic regions, industry types, and sizes, rather than to construct a statistical sample of businesses. The 17 companies were headquartered in 6 states across the country—California, Georgia, Maryland, New York, Ohio, and Virginia. They included a wide variety of industry types, such as manufacturing, services, telecommunications, and retail operations. We chose to focus, for the most part, on medium-sized companies because, among other things, relatively little past research has focused on this subgroup. Our sample included, however, a few large corporations and some relatively small businesses. Most of the 17 businesses were judgmentally selected from public databases that list publicly traded and privately held corporations. Table 1 summarizes the characteristics of the 17 companies we interviewed.

Although our results do not necessarily represent the business community at large, the AICPA, or the ABA tax section, they provide qualitative information on actual experiences—good and bad—that the companies

**Appendix**  
**Methodological Approach and Limitations**

encountered while complying with federal, state, and local tax systems. Moreover, our results on the sources of tax compliance burden are consistent with the information found in the literature we reviewed.

**Table 1: Characteristics of Businesses Interviewed by GAO**

Company information <sup>a</sup>		
Type of industry	Number of employees (rounded)	Number of states
Printing	3,000	11
Manufacturing - paper products	8,500	50
Manufacturing - heavy equipment	1,300	4
Restaurant operations	2,300	6
Media operations	30,000	14
Real estate operations	20,000	47
Restaurant operations	5,000	5
Information technology	4,000	20
Retail & wholesale operations	1,400	3
Contractor	100	N/A
Importer/exporter	3,000	35
Retail operations	1,000	26
Retail operations	4,000	30
Food processing	800	N/A
Automotive car operations	1,200	11
Information management	3,000	35
Distributor medical equipment	100	2

Note: N/A means not available.

<sup>a</sup>Company assets ranged in size from around \$50 million to almost \$4 billion. There were 7 companies with less than \$100 million in assets; 5 companies with between \$100 million and \$250 million in assets; and 2 companies with more than \$1 billion in assets. The asset size was not available for three companies.

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