

Measuring and Modeling the Federal Income Tax Compliance Burden of Small Businesses

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Background

Federal regulations of all types weigh heavily on American small businesses, but the burden of complying with federal income tax requirements is of particular concern. A 2009 Congressional Research Service report notes that the burden of complying with the federal tax system represents approximately 80 percent of the overall paperwork burden imposed by the federal government.

The federal tax compliance burden has been defined as the time and money taxpayers expend each year to comply with federal tax rules and regulations. Attempts to quantify the compliance burden for businesses in the United States must take into account a number of challenges. Accurate data on compliance costs are difficult to obtain. Businesses organize in a variety of forms (sole proprietorships, partnerships, limited liability companies, S corporations, or C corporations), each of which has different federal income tax filing requirements. Existing research has attempted to quantify the number of hours that taxpayers spend complying with federal tax laws, but estimates of hours must then be translated to dollars to give a better picture of the overall impact of the federal tax system.

Overall Findings

Federal tax compliance burdens increase as the size of a small business increases and vary by industry and other factors. This makes sense, as the complexity of business operations is likely to be positively correlated with the size of business receipts. Small businesses spend more than 5.5 billion hours fulfilling their income tax obligations.

Highlights

- Compliance burdens vary significantly by industry. Some industries have more complicated federal tax form filing requirements and this is reflected in the overall compliance burden.
- The burden by industry is also affected by the fact that businesses in some industries are more likely to be organized as a particular type of entity.
- The results are also affected by how businesses in a particular industry are distributed by size among the different entity types. For example, businesses in the finance, insurance, and real estate industry that are organized as C corporations are likely larger businesses, with more complex tax filing requirements, than businesses organized as partnerships.
- Compliance burdens are lowest for small businesses organized as sole proprietorships. This makes sense because the basic filing requirement for sole proprietorships (Schedule C of Form 1040) is significantly less complex than the basic filing requirements for other types of entities.
- There is less disparity in the compliance burdens for the other entity types. These disparities are more likely explained by differences in entity size and industry filing requirements.

Scope and Methodology

This paper measures federal income tax compliance costs for small businesses—the annual cost, in dollars, for small business taxpayers to comply with the federal income tax system. For purposes of this study, a small business is one with less than \$10 million in gross receipts.

Because small businesses can be organized as different types of entities with different tax filing requirements, the study measures the federal income tax compliance costs for small businesses by form of business, receipts size, and industry. Thus, the research allows for comparison of how the compliance costs differ for businesses of different types, sizes, and industries.

Using a forms-based approach, the study calculates the burden as the estimated time involved in completing each federal tax form times the number of taxpayers who actually complete the form. The research is unique because it (1) attempts to isolate the impact of federal tax compliance on small businesses only, (2) includes a more comprehensive list of forms, which allows it to capture the effects of compliance burden on an industry-by-industry basis, (3) extends prior research by providing burden estimates for all small business entities, including businesses organized as sole proprietorships, and (4) provides estimates of the monetized burden for each type of entity to facilitate comparison with other measures of tax burden, such as taxes paid.

This report was peer reviewed consistent with Advocacy's data quality guidelines. More information on this process can be obtained by contacting

the director of Economic Research at advocacy@sba.gov or (202) 205-6533.

Ordering Information

The full text of this report and summaries of other studies performed under contract with the U.S. Small Business Administration's Office of Advocacy are available on the Internet at www.sba.gov/advo/. Copies are available for purchase from:

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