

A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens

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Introduction

Like old age, tax complexity has been creeping up on us. We may not notice it one year at a time, but a review of older tax documents reveals just how shockingly complicated taxes have become today.

The 1040 form is often filed with Schedules A, D, and other forms and schedules where taxpayers report items such as itemized deductions, interest and dividend income, and capital gains. These forms now take an estimated 37.8 hours to complete, and that is if a taxpayer uses a computer and a tax software program. Even the “short” form takes 12.6 hours using the computer. Pity the self-employed taxpayers, as the IRS estimates they have to spend over 80 hours slaving at their computers to do their taxes, enough to rob them of the equivalent of a two-week paid vacation.

Today’s short form, at 48 lines, has double the number of lines on the 1945 version of the standard 1040 tax return.

The increase in the tax law’s complexity alone has added roughly 1 billion hours in annual paperwork burdens over the last 10 years.

Line by Line, Complexity Is Moving Upward

Let’s begin our tour of the tax law’s complexity by looking at the growth of Form 1040 over the years. Seventy years ago its instructions were just two pages long. Even when the income tax became a mass tax during World War II, the instructions took just four pages. Today taxpayers must wade through 142 pages of instructions, well over triple the number in 1975 and more than double the number in 1985, the year before taxes were “simplified.”

Form 1040 - Form and Instructions

Tax Year	Lines/1040	Form Pages/1040	Instruction Booklet Pages/1040
2005	76	2	142
2003	73	2	131
2000	70	2	117
1995	66	2	84
1985	68	2	52
1975	67	2	39
1965	54	2	17
1955	28	2	16
1945	24	2	4
1935	34	1	2

If anything, this table understates the growing complexity of the form. For example, this year many “lines” have their own sub-lines for parts a, b, c, or even d. The form also asks for information without numbering the line item, such as check boxes for Presidential campaign funding and a personal ID number you select for a “third party designee” if you want the IRS to ask someone else about what you included on your tax return.

If you need help beyond the basic form, the IRS now prints over 1,000 publications, forms, and instructions.

Paid Professionals Now Prepare Most Tax Returns

As the tax system’s complexity has grown, more taxpayers are turning to their computers or running to tax professionals to prepare their returns. The number of taxpayers using paid professionals has soared by approximately 60% since 1980 and by 30% since 1990. While some of this increase can be attributed to rising incomes, most of it is likely due to complexity.

The growth in the use of paid preparers can be accurately tracked because beginning in 1977 tax professionals have been required to sign returns they have been paid to prepare.

Tax Returns Signed by Paid Preparers

Tax Year	Paid Preparer Returns (Percent)
1980	38.0%
1985	45.9%
1990	47.9%

1995	49.9%
2000	57.5%
2004*	61.9%
2005*	61.2%

*Through March 18, 2005 and March 17, 2006; both figures calculated from the revised March 17, 2006 Taxpayer Usage Study report of the IRS.

Between 1966 and 1977, anyone who prepared a return was required to sign it in addition to the taxpayer, meaning many unpaid relatives or friends signed the returns. Therefore, the data for the first few years probably overstates paid-preparer participation, because undoubtedly many unpaid people who had signed returns for years kept doing so even after the law had changed.

Tax preparation software has grown in sophistication, enabling more taxpayers to sit in front of a computer and answer a seemingly endless stream of questions while the computer figures out how to prepare the return.

In 1980 no individual taxpayers used computers to prepare their taxes. Yet today, when accounting for paid preparers and computer returns combined, about 90% of all returns are prepared with such assistance.

Use of Paid Preparers and Computer

Tax Year	Paid Preparer plus Computer Prepared Returns (Percent)
1980	38.0%
1996	66.4%
2000	78.4%
2004*	91.2%
2005*	90.4%

*Through March 18, 2005 and March 17, 2006; both figures calculated from the revised March 17, 2006 Taxpayer Usage Study report of the IRS.

Tax Preparation Fees Are Rising Too

Tax preparation fees have also increased substantially, largely due to increased complexity of the average tax return. One way of tracking the trend in fees is to examine the average fees charged by H&R Block, a publicly-traded company. It is the nation's largest tax preparation firm, and alone accounts for about 1 in 7 tax returns filed by all Americans.

This year the company boasted that its “average fee per client served rose 6.3 percent to \$154.24.” Between 1980 and 2006, the average H&R Block tax preparation fee increased by more than double after accounting for inflation.

The rise in fees has occurred despite a huge increase in the capability of tax return software and speed of printers, which may have temporarily cut the inflation-adjusted cost of tax preparation in the late 1980s and early 1990s. The efficiency gain of computers and printers has likely been overwhelmed by the increases in complexity.

Average Fee Charged by H&R Block

Calendar Year	Nominal Dollars
1980	\$27.36
1985	\$45.39
1990	\$49.99
1995	\$61.77
2000	\$101.40
2005*	\$145.08
2006*	\$154.24

*Through March 15. In 2004, H&R Block appears to have changed its method for calculating its average fee. This figure includes other services, such as Refund Anticipation Loans.

The National Society of Accountants “surveyed 1,371 accountants nationwide to find out the mean cost of preparing a variety of tax returns.” They report that the simplest 1040 form would cost \$110 to prepare, while a form with itemized deductions would cost \$201. Accountant tax preparer hourly rates were projected to rise by 6.8% this year.

Tax Complexity to Get Worse

Tax complexity probably will get worse before it gets better. Although the tax relief legislation signed into law in 2001 and 2003 cut tax rates, both increased complexity. The expiration dates of many tax cut provisions and the 2001 law’s long phase-out of the death tax are causing new tax planning headaches.

The Congressional Joint Committee on Taxation (JCT) published its *General Explanation of Tax Legislation Enacted in the 108th Congress* last year. This alone took 593 pages!

Worst of all is the growing prospect that by 2010, more than 30 million taxpayers will be forced to complete a second tax return for the Alternative Minimum Tax (AMT), a parallel and complex tax system once aimed at ensuring the rich paid a substantial tax bill. As if one tax return wasn’t difficult enough already.

This tax complexity monster is already striking unsuspecting taxpayers, some earning less than \$50,000 per year. The IRS National Taxpayer Advocate notes that the AMT is “so complicated that many taxpayers are not aware that they may be subject to it.”

In many cases taxpayers must decipher a separate instruction booklet, and then fill out a 55-line form, only to discover they don't owe the AMT. This exercise is a major detour in tax preparation. No wonder over 80% of taxpayers who owed the AMT paid a tax pro to compute their taxes.

Yet, even the tax pros complain about this strange and complicated tax. The National Association of Enrolled Agents, a leading tax preparation trade group, has labeled the AMT as the most complicated aspect of the tax law, and gave it the "Tax Headache of the Year" citation.

Despite the fact that tax rate brackets, personal exemptions, and the standard deduction rise with inflation, the AMT tax structure remains frozen. With each passing year, the AMT identifies a growing number of taxpayers as "rich" even though their real income hasn't changed.

The best solution for the AMT is to simply get rid of it altogether, a solution even recommended by the IRS National Taxpayer Advocate. But if Congress can't or won't do that, then it should at least adjust the tax's application to avoid a complexity nightmare for taxpayers and the IRS. As of April 2006, Congress had failed to extend the exemption levels that were protecting millions from the AMT, leaving many a taxpayer to ask, "Am I the next target?"

Federal Law Orders Cut in Paperwork, but Tax Paperwork Burden Rises

In an attempt to bring the paperwork burden under control Congress passed the Paperwork Reduction Act of 1995. According to the Office of Management and Budget, the new law "set an annual government-wide goal for the reduction of the total information collection burden of 10% during each of Fiscal Years 1996 and 1997 and 5% during each of Fiscal Years 1998 through 2001. The baseline is the total burden of information collections as of the end of FY 1995."

By that measurement, the law has been a failure, largely due to the increasing burdens at the IRS.

An earlier Paperwork Reduction Act passed in 1980 required federal agencies to track the paperwork burden imposed on citizens and businesses by their forms and recordkeeping requirements. In order to comply with the law, the IRS commissioned Arthur D. Little to undertake a comprehensive estimate of tax compliance costs for the tax year 1983. This survey served as the basis for the methodology used to track tax paperwork burdens that the IRS finalized with the 1988 tax year.

While the Little study is by far the most comprehensive available, James Payne estimated in his 1993 book *Costly Returns* that even it may understate the real burden – "perhaps by about 20-30%."

Recently the government has begun separately publishing paperwork burdens for the IRS. According to the Office of Management and Budget's FY 2004 *Information Collection Budget of the United States Government*, the "Internal Revenue Service (IRS) paperwork [burden] is currently estimated to total approximately 6.5 billion hours ... [and] towers over the entire paperwork burden for the rest of the federal government" Tax form paperwork burdens alone account for 80% of the total federal paperwork load.

**Paperwork Burden Hours
Department of the Treasury**

Fiscal Year	Burden Hours (In Millions)	Paperwork Reduction Act of 1995 Target (In Millions)	Cumulative Increase Since 1995	Compared to Target (In Millions)
1995	5,331.30			
1996	5,352.85	4,798.17	0.4%	554.68
1997	5,582.12	4,318.35	4.7%	1,263.77
1998	5,702.24	4,102.44	7.0%	1,599.80
1999	5,909.07	3,897.31	10.8%	2,011.76
2000	6,156.80	3,702.45	15.5%	2,454.35
2001	6,415.85			
2002	6,750.43			
2003	6,589.76			
2004	6,406.18			
2005*	6,420.32			

From the *Information Collection Budget*, Office of Management and Budget (OMB). Target hours assume Treasury Department reductions meet the law's overall average reduction for all federal paperwork.
* Projected; 2004's total reflects OMB's revised numbers released in 2005 report.

If the Treasury Department were to reduce its burden by the average amount mandated by the 1995 Paperwork Reduction Act, the burden would have declined to 3.702 billion hours in 2000. Instead, the Treasury overshot that target by 1.248 billion hours.

Paperwork burdens aren't the result of IRS bureaucrats mindlessly dreaming up new forms and regulations. Much of the burden increase is due to a flood of new tax laws, including the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Jobs and Growth Tax Relief Reconciliation Act of 2003. These laws did reduce tax bills for middle class taxpayers, but significantly increased their paperwork burdens. For example, the 2003 tax cut law piled on another 38 million hours during FY 2003 alone. The statutory effects in 2004 caused by this 2003 law approached 100 million hours.

Although the chart may indicate a decline in paperwork burdens between 2003 and 2004, much of this drop consists of factors not related to policy decisions – such as economic conditions that affect the number and type of tax returns filed and therefore the aggregate burden. As the Office of Management and Budget’s FY 2004 report indicates:

Often the hours needed for a particular information collection will vary from year to year. . . . These changes are characterized as ‘adjustments.’ Adjustments, while having large effects on estimates, do not represent government efforts either to expand or reduce an information collection.

Indeed, even as overall burdens seem to have declined between 2003 and 2004, the details present a different picture. Agency actions (such as regulatory edicts) helped *reduce* the paperwork load by 137 million hours, but laws passed by Congress *increased* the burden by 101 million hours. “Adjustments” actually had the biggest impact on the bottom line (accounting for over 147 million hours of the change).

These figures apparently only account for the time spent in keeping the necessary records and learning about and complying with the law. Yet, a significant additional but uncounted burden comes from trying to exploit the law’s loopholes to the maximum extent. For example, millions of citizens subscribe to personal finance publications and much of the advice offered deals with taxes. Taxpayers are often advised to consider the tax consequences of any major financial transaction, and this form of tax planning undoubtedly adds many millions of hours to the time spent coping with the tax system.

New Paperwork Estimates Cause Controversy

The IRS has substantially changed the way it calculates tax preparation time this year, adding different estimates for taxpayers who prepare the returns by hand, those who use computers and software and those who use a paid professional.

These changes sent the tax preparer and tax software community into an uproar because taxpayers appear to *take longer* to prepare their taxes if they use computers and software. Specially trained paid preparers such as accountants and enrolled agents thought the IRS estimates of the cost of paid preparers would mislead taxpayers because they make no distinctions between part-timers and experts.

Of course, those who tackle doing their returns without help or computers likely just have comparatively simple taxes. But the IRS publications didn’t explain that factor, leading to controversy.

After the initial furor had died down, *The Arizona Republic* reported that the agency felt compelled to add this note to all online instruction booklets: “Tax preparation fees vary extensively depending on the taxpayer’s tax situation and issues, the type of professional preparer and geographic area. Note that the new approach does not substantiate what a taxpayer should expect to pay for tax preparation services.”

The IRS also notes that “comparisons should not be made between [this year’s estimates] and earlier published estimates.”

So, we won’t make those comparisons here, but we will look at the estimates from last year and prior years, as they show a stunning rise in complexity.

It’s Taking Longer to Prepare and File Tax Returns

Despite the passage of the 1995 Paperwork Reduction Act, the time it takes to file commonly-used individual income tax forms has increased.

The 1040 form is often filed with Schedules A, B, and D, where taxpayers report itemized deductions, interest and dividend income, and capital gains, respectively. From 1988, when the IRS started tracking this information, to 2004, the average paperwork time burden climbed from 17 hours and 7 minutes to 26 hours and 48 minutes, an increase of 57%. The time burden has increased by 26% from 1995 to 2004.

History of Estimated Preparation Time, 1040 Form and Common Schedules

Year	Recordkeeping	Learning about the Law or the Form	Preparing the Form	Copying, Assembling, and Sending the Form to the IRS	Total
Form 1040 and Schedules A, B, and D					
2004	7:18	7:15	10:34	1:41	26:48
2003	7:52	7:25	11:25	1:48	28:30
2000	7:52	7:16	10:05	1:49	27:02
1995	7:04	4:36	7:11	2:21	21:12
1990	7:04	4:04	5:26	1:50	18:24
1988	6:56	3:39	5:02	1:30	17:07
Form 1040 Only					
2004	2:46	3:58	6:17	0:34	13:35
2003	2:46	3:51	6:18	0:34	13:29
2000	2:45	3:25	6:16	0:35	13:01
1995	3:08	2:54	4:43	0:53	11:38
1990	3:08	2:33	3:17	0:35	9:33
1988	3:07	2:28	3:07	0:35	9:17

Even the short forms are much more complicated. The 1040EZ form, the simplest in the IRS inventory, required 3 hours and 46 minutes for the last tax year, up from 1

hour and 31 minutes in 1988, a jump of 148%. The 1040A and Schedule 1 (interest and dividend income) has seen a paperwork burden increase of 44% between 1995 and 2004.

History of Estimated Preparation Time, 1040A Forms

Year	Recordkeeping	Learning about the Law or the Form	Preparing the Form	Copying, Assembling, and Sending the Form to the IRS	Total
Form 1040A and Schedule EIC					
2004	1:10	3:29	5:26	0:54	10:59
2003	1:10	3:35	5:31	0:54	11:10
2000	1:10	3:05	5:11	0:54	10:20
1995	1:04	2:25	3:02	0:40	7:11
1992	1:42	2:24	3:20	1:22	8:48
Form 1040A and Schedule 1					
2004	1:29	3:32	5:26	0:54	11:21
2003	1:29	3:38	5:31	0:54	11:32
2000	1:29	3:08	5:11	0:54	10:42
1995	1:24	2:27	3:08	0:55	7:54
1990	1:42	2:35	3:26	0:55	8:38
1988	1:53	2:16	3:12	1:10	8:31
Form 1040A Only					
2004	1:10	3:28	5:13	0:34	10:25
2003	1:10	3:34	5:18	0:34	10:36
2000	1:10	3:04	4:58	0:34	9:46
1995	1:04	2:23	2:58	0:35	7:00
1990	1:22	2:31	3:16	0:35	7:44
1988	1:20	2:11	2:52	0:35	6:58

History of Estimated Preparation Time, 1040EZ Form

Year	Recordkeeping	Learning about the Law or the Form	Preparing the Form	Copying, Assembling, and Sending the Form to the IRS	Total
2004	0:04	1:41	1:41	0:20	3:46
2003	0:04	1:40	1:39	0:20	3:43
2000	0:05	1:38	1:50	0:20	3:53
1995	0:05	0:55	1:22	0:20	2:42
1990	0:05	0:34	0:40	0:40	1:59
1988	0:07	0:24	0:40	0:20	1:31

As future tax seasons grind their way forward, more comparative data will be available to measure tax complexity's ongoing toll. And while the IRS's new completion-time method may not mesh with past statistics, it seems quite probable from these and other indicators that the tax system hasn't gotten simpler.

The Tax Code is so convoluted that no one inside or outside the IRS understands it. For many years *Money* magazine's annual test of tax preparers for a hypothetical household proved that paid professionals often make huge mistakes. In 1998, the last year *Money* administered the test, all 46 tested tax professionals got a different answer, and not one got it right. The pro who directed the test admitted "that his computation is not the only possible correct answer" since the tax law is so murky. The tax computed by these pros "ranged from \$34,240 to \$68,912." The closest answer still erred in the government's favor by \$610.

Information revealed this month from Congress's Government Accountability Office (GAO) provides little comfort that the inaccuracies among preparers have dramatically improved. GAO auditors, posing as taxpayers, retained the services of major tax preparation firms at 19 outlets in a major metropolitan area, and found:

- 10 of the 19 preparers failed to report business income information.
- In 5 of the 10 instances where the "client" *might* qualify to claim the Earned Income Credit, preparers claimed an ineligible child.
- Preparers filed inadequate deductions or failed to itemize in 7 of 9 applicable cases.

GAO noted that had these mock returns been reviewed by the IRS, several of the preparers could owe serious penalties for their mistakes. Alas, just like *Money* magazine's test, GAO could not guarantee that its own findings were on the mark. After consulting with Congress's JCT to develop "correct" answers to the scenarios the auditors were to pose, JCT "cautioned that a paid preparer might reach a reasonable conclusion different from JCT's on certain issues"

No wonder taxpayers themselves, the majority of whom rely on preparers, fare little better when asked basic tax questions. According to a CCH CompleteTax online poll conducted by Harris Interactive, “the majority of adults don’t understand some of the basic tax rules that may apply to them.” The survey, conducted January 30 - February 1, 2006, recorded responses from 3,002 U.S. adults who had filed a federal tax return within the past two years. Among the results:

- Just 12% of respondents knew the correct maximum amount for the 2005 child tax credit (\$1,000). Incredibly, that fraction did not vastly improve even among those with a vested interest in the issue. Among households with children, 24% could identify the proper level for the credit.
- Nearly two-thirds of those surveyed (64%) didn’t understand that investment losses could be written off against other income.
- Only 14% were aware of the above-the-line deduction for tuition and other certain college expenses.

CCH CompleteTax and Harris Interactive reported equally distressing results in a similar poll taken in early 2005. Only 8% were able to select the correct, most basic definition of the Alternative Minimum Tax from a multiple-choice list; 75% were too uncertain to make a choice of definitions, while the remainder chose incorrectly. Participants were asked to identify the three major federal education tax-savings programs (the Hope credit, Coverdell IRA, and 529 plan option) from a list that contained a fourth, false selection (the “Allendale education fund”). Just 4% correctly weeded out “Allendale” as the non-federal program.

While the 1998 IRS Restructuring and Reform Act requires Congress to at least consider complexity before passing tax legislation, that has not provided enough incentive for Congress to avoid additional complexity or encourage simplification. The tax-writing committees should be required to quantify the burdens of proposals that add complexity or the savings from proposals that simplify the law.

The National Commission on Restructuring the IRS suggested that Congress consider a quadrennial simplification process, and Congress and the President should implement such a process either through legislation or by executive order. The Commission found that many members of the private sector tax community were willing to volunteer substantial time to make suggestions for simplification.

A small demonstration of how valuable this process might be is the Taxpayer Advocacy Panel (TAP), created in 2002 from the remnants of a program initiated in 1998. TAP, according to its website, “is a group of volunteers dedicated to helping the Internal Revenue Service (IRS) identify ways to improve customer service and satisfaction.” Working through committees that obtain feedback from taxpayers (often through field hearings) and from IRS staffers, TAP made 84 recommendations concerning the tax laws and the tax agency in Fiscal Year 2004. Notably, however, not all of these recommendations garnered administrative or legislative enactment.

A quadrennial simplification commission would do a more thorough job of harnessing volunteer activity and give a broad group of people on the inside and outside of government much more incentive to work for the adoption of simplification rules. This quadrennial commission would also give Congress's JCT and the Treasury Department more incentive to suggest simplification of the law.

Conclusion: A New Approach to Taxes Is Needed

Fundamental overhaul of our tax system remains a critically-important goal. As the Internal Revenue Code becomes increasingly incomprehensible, the intrusive measures provided to the IRS for enforcing it seem to become more draconian. Every detail of a taxpayer's private financial life is open for government inspection. IRS employees can make extraordinary demands on taxpayers, and can take extraordinary actions against them. Mixing such broad powers with a vague and complex law is a recipe for a civil liberty catastrophe. The threat of abuse is always present.

Last year President Bush authorized creation of the Advisory Panel on Federal Tax Reform whose deliberations were to include ways to "simplify federal tax laws to reduce the costs and administrative burdens of compliance with such laws." Several of the Panel's recommendations, made public in November, would fulfill this goal, among them repealing the AMT, shortening the 1040 form by half, and consolidating the many savings incentives in the tax law. Yet even this blueprint would still contain potentially complex elements, such as new mortgage interest and health insurance provisions pegged to indices like regional housing values and average premiums.

Policymakers should bear in mind the tremendous burden that tax complexity imposes on the process of filing as well as paying taxes. Until we change how we tax income, we will continue to have an intrusive agency with broad powers. It doesn't have to be that way. Our economy as well as our civil liberties would be better off with fundamental tax reform.

About the Author

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