

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 compared to today's forms and instructions reveals just how shockingly complicated taxes have become today.

In the most recent Fiscal Year (FY), the IRS estimated that individual and business taxpayers spent 6.65 billion hours complying with the tax laws. That is the equivalent of 3.2 million employees working 40-hour weeks year-round without any vacation.

Individual taxpayers alone will spend an estimated 3.18 billion hours complying with the income tax laws this year. Using the Tax Foundation's estimate for the average total hourly compensation rate of \$23.75, this time is worth \$75.5 billion.

Individual taxpayers will spend a lot of money too, an estimated \$26.5 billion this year for tax software, tax preparers, postage, and other out-of-pocket costs, according to an August 2006 IRS regulatory filing.

Counting time and money for individual taxpayers, the compliance burden would total an incredible \$102 billion for individual taxpayers alone. Keep in mind that these costs do not account for tax planning or tax minimization strategies, nor do they account for the huge costs imposed on the nation's economy by high tax rates.

When accounting for all taxpayers, from those who file the simplest 1040-EZ to those filing the long Form 1040 and many schedules, the IRS now puts the average compliance time at 24.2 hours, up from 23.3 hours three years ago. Out-of-pocket costs per individual taxpayer are expected to average \$207, up from \$179 (also three years ago). It is important to remember that out-of-pocket costs include taxpayers who do their own taxes as well as those who go to paid preparers. According to an IRS estimate published last year, self-employed taxpayers who file Form 1040 and associated

schedules toil the equivalent of a two-week paid vacation – over 80 hours in all – working for the IRS to satisfy the requirements of the tax laws.

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

Line by Line, Complexity Is Moving Upward

The IRS National Taxpayer Advocate’s most recent annual report noted, “The most serious problem facing taxpayers today is the complexity of the Internal Revenue Code.” Not surprisingly, it was “Topic #1” in the report.

Seventy-three years ago the Form 1040 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 143 pages of instructions, well over triple the number in 1975 and nearly triple the number in 1985, the year before taxes were “simplified.”

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

Form 1040 - Form and Instructions

Tax Year	Lines/1040	Form Pages/1040	Instruction Booklet Pages/1040
2006	77	2	143
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, lately many “lines” have had 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 for a “third party designee” if the filer wants the IRS to ask someone else about information on the tax return.

If a taxpayer needs help beyond the basic form, the IRS reported in 2005 that it had 195 different tax forms and it now prints over 1,000 publications, forms, and instructions.

The 24,000-Page Tax Return

If you think your tax return is difficult, be thankful you’re not in charge of taxes at General Electric. Last year, this leading corporation filed what is believed to be the nation’s longest tax return, over 24,000 pages long had it been printed on paper. It was filed as part of a new mandate that large corporations file their tax returns electronically.

Corporate Tax Compliance Costs Equal 44 Percent of Corporate Income Taxes

The Office of Management and Budget reports that the IRS’s new and more accurate method of calculating paperwork burdens produces a higher total of estimated hours.

NTU estimates that the cost for compliance by corporations is \$156.5 billion. To put that figure into perspective, it represents 44 percent of the \$353.9 billion of corporate income taxes collected in FY 2006.

Of course, businesses do pay unemployment taxes, collect excise taxes, and withhold federal income and payroll taxes for their employees, in addition to paying half of “social insurance” taxes and all unemployment taxes. The actual liability of the taxes tends to fall on workers, whose wages or benefits would otherwise be higher were it not for the levies. In any event, the compliance burdens for these aspects of the tax system appear relatively small.

Comparing the business compliance burden to *all* taxes collected, other than individual income, social insurance and estate taxes, that \$156.5 billion equals 27 percent of other taxes collected.

Here is how NTU calculated this estimate. IRS testimony to Congress last year indicated that all taxpayers spent 6.65 billion hours in FY 2006 complying with required tax filings. An IRS notice published in the December 20, 2006 edition of the *Federal Register* indicated that individual income tax filings, including various self-employment forms, accounted for 3.18 billion hours. The Tax Foundation estimates that non-profit groups and miscellaneous filings (e.g., estate taxes) accounted for less than 200 million

hours, leaving an implied business paperwork burden of approximately 3.45 billion hours for 2006. The Tax Foundation put the hourly wage for tax accountants at \$45.37 per hour when it analyzed the compliance burden under the IRS's old methodology.

Paid Professionals Now Prepare Most Tax Returns

As the tax system's complexity has grown, more taxpayers have turned to their computers or to professionals to prepare their returns. The number of taxpayers using paid professionals has soared by approximately 60 percent since 1980 and by 25 percent since 1990. While some of this increase can be attributed to rising incomes, most of it is likely due to complexity.

The long-term trend toward using paid preparers appears to have halted, with a slight decline reported in the last few years. This is probably due to the increasing power of home computers and tax preparation software. However, unless something is done soon to stop the growing number of taxpayers subject to the Alternative Minimum Tax (AMT), the use of preparers will likely rise again. Nearly 80 percent of taxpayers with AMT liabilities use paid preparers.

The growth in the use of paid preparers can be accurately tracked because from 1977 onward, 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%
2005*	61.2%
2006*	60.0%

*Through March 16, 2007 and March 17, 2006; both figures calculated from the revised March 16, 2007 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 9 in 10 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%
2005*	90.4%
2006*	90.6%

*Through March 16, 2007 and March 17, 2006; both figures calculated from the revised March 16, 2007 Taxpayer Usage Study report of the IRS.

Tax Preparation Costs and Fees Are Rising Too

Tax preparation fees have also increased substantially, largely due to the increased complexity of the average tax return.

As part of its new estimates of taxpayers' paperwork burdens, the IRS now calculates not only the time spent but the amount of money taxpayers spend to help prepare their forms. Most of this is due to tax preparation fees, but it includes costs for tax software too.

Another way of tracking the trend 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's average fee per client served rose by \$10.19, an increase of 7 percent. 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 the 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
2006*	\$150.06
2007*	\$160.27
*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.	

Preparer Fees Vary Widely for Different Taxpayers

Last year the IRS published an extensive list of typical costs paid by taxpayers who had their taxes prepared by a professional. Here are some of the common combinations of tax forms filed by taxpayers and their estimated out-of-pocket costs. Bear in mind that tax preparation fees can vary widely, according to the IRS, “depending on the taxpayer’s tax situation and issues, the type of professional preparer, and the geographic area.”

Form 1040 and other forms and schedules, but not Schedule A or D	\$121
Form 1040, Schedule A, and other forms and schedules, but not Schedule D	\$174
Form 1040, Schedule D, and other forms and schedules, but not Schedule A	\$215
Form 1040, Schedules A and D, and other forms and schedules	\$313
Form 1040, Schedule C or C-EZ, and other forms and schedules, but not Schedule E or F or Form 2106 or 2106-EZ	\$329
Form 1040, Schedule E, and other forms and schedules, but not Schedule C, C-EZ, or F or Form 2106 or 2106-EZ	\$685
Form 1040, Schedule F, and other forms and schedules, but not Schedule C, C-EZ, or E or Form 2106 or 2106-EZ	\$296

Form 1040, Form 2106 or 2106-EZ, and other forms and schedules, but not Schedule C, C-EZ, E, or F	\$349
Form 1040 and forms and schedules including more than one Schedule C, C-EZ, E, or F, or Form 2106 or 2106-EZ	\$866

Note: Here is a brief explanation of each Schedule listed above: Schedule A – itemized deductions; Schedule C – self-employment income; Schedule D – capital gains and losses; Schedule E – supplemental income from partnerships, rents, royalties, trusts, etc; Schedule F – farm income; and, Schedule 2106 – employee business expenses.

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 109th Congress* earlier this year. This alone took 841 pages, up from 593 pages in the previous Congress!

Worst of all is the rising threat from the specter of the Alternative Minimum Tax, a parallel and complex tax system once aimed at ensuring that the rich paid a substantial tax bill. By 2010, over 30 million taxpayers will have to compute and pay the AMT; that number will rise after 2010 if the current tax rates are extended.

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 about 8 in 10 taxpayers who owed the AMT paid a tax professional to compute their taxes.

Though tax rate brackets, personal exemptions, and the standard deduction rise with inflation, the AMT tax structure remains frozen. Each 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 remedy repeatedly 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. Unless Congress acts soon, 1 in 4 tax filers will pay the AMT, and half of all married filers with dependents will be liable.

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 percent during each of Fiscal Years 1996 and 1997 and 5 percent 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, which accounts for nearly 80 percent of the federal government's paperwork burden.

Yet the IRS is not to blame for the rise in the paperwork. Last year, the Government Accountability Office (GAO) praised the IRS for being one of only two agencies in the entire government that had implemented a procedure that reduced paperwork. Unfortunately, Congress is adding to the tax laws' complexity faster than the IRS can simplify its forms.

The IRS has spent several years updating its methodology to measure the compliance burden of filing tax returns. While the new methods appear to be more accurate, they make comparisons with prior years and decades impossible.

The new method could help taxpayers get a break from the onslaught of complexity if Congress puts it to work. The Office of Management and Budget reports that by using the new tax complexity model the "IRS will now be able to analyze the burden impacts of proposals to revise the Tax Code or IRS administrative procedures. For the first time, the burden implications of achieving policy objectives through new legislative and administrative tax proposals can be estimated and considered *before* the changes are adopted and implemented."

The new methodology resulted in significant revision of the total time spent filing returns, with an increase of 250 million hours added to the burden. This does *not* mean the paperwork burden changed by that amount, but only that the estimate of the burden increased under the new estimation method.

An earlier Paperwork Reduction Act passed in 1980 required federal agencies to track the burden imposed on citizens and businesses by their forms and recordkeeping

requirements. To comply with the law, the IRS commissioned Arthur D. Little to undertake an estimate of tax compliance costs for the tax year 1983. This survey was the basis for the methodology used to track tax paperwork burdens that the IRS finalized with the 1988 tax year.

**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			
2006*	6,690.00			

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; based on IRS testimony, July 18, 2006 and 2006 Information Collection Budget. 2004's total reflects OMB's revised numbers released in 2005 report.

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

Paperwork burdens aren't the result of IRS bureaucrats mindlessly dreaming up new forms and regulations. Much of the new increase is due to a flood of new tax laws. These laws did cut tax bills for middle class taxpayers, but significantly increased their paperwork. Recent legislation keeps adding to the complexity. For example, the IRS

reported that “the Energy Policy Act (Public Law 109-58) required over 600 changes to 107 tax products (tax forms, instructions, and publications) and 7 new forms.”

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 planning undoubtedly adds many millions of hours to the time spent coping with the tax system.

New Paperwork Estimates Make Long-Term Comparisons Impossible

The IRS has substantially changed the way it estimates tax preparation time. In developing the new methodology, the agency also notes that “comparisons should not be made between [this year’s estimates] and earlier published estimates.” Nonetheless, NTU can examine the estimates from 2004 and prior years when the old methodology was used; and, they’ve documented a stunning rise in complexity.

It’s Taking Longer to Prepare and File Tax Returns

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 percent. The time burden increased by 26 percent from 1995 to 2004.

History of Estimated Preparation Time, 1040 Forms 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
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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 1040A and Schedule 1 (interest and dividend income) has seen a paperwork burden increase of 44 percent 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

The 1040EZ form, the simplest in the IRS inventory, required 3 hours and 46 minutes for the last tax year reported, up from 1 hour and 31 minutes in 1988 (a jump of 148 percent).

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, early indicators show that compliance with the tax laws continues to take more time and money.

Experts Agree They Can't Agree on Tax Bills

The Tax Code is so convoluted that no one inside or outside the IRS understands it.

This year, *USA Today* asked five professionals to calculate a family's tax bill. And of course, they all got a different answer! After reviewing each other's work, they couldn't agree on who was right. The newspaper reported, "As the Tax Code turns ever more unwieldy, deciphering it has become more art than science, tax experts say."

The person who designed the test had the highest tax bill for mom and dad, but the lowest overall family tax bill.

He got the biggest refund for the family by having the "23-year-old [son] claim his 16-year-old sister as a dependent." This anomaly is the result of some tax goof-up in Congress, and is entirely legal, if a bit strange.

As *USA Today* reported, “In 2004, Congress sought to clarify the definition of a ‘qualifying child’ for parents and others who claim various tax breaks. In the process, though, lawmakers inadvertently created a loophole: It lets young working adults who are living with their parents claim younger siblings.”

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 none got it right. The professional 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 professionals “ranged from \$34,240 to \$68,912.” The closest answer still erred in the government’s favor by \$610.

Information revealed from a recent Government Accountability Office (GAO) report 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 Joint Committee on Taxation 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... .”

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 lawmakers 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 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 the 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.

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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