



A FairTax® Whitepaper

## Tax Compliance Facts

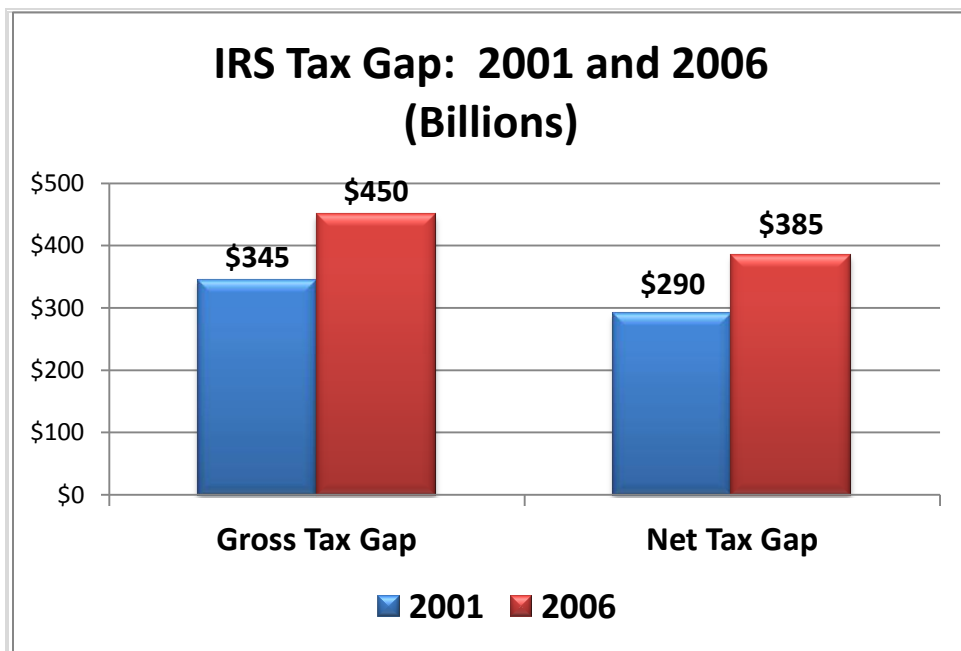
### What the federal tax system is costing you – besides your taxes!

#### The Tax Gap affects all taxpayers.

The Tax Gap is the difference between the amount of tax due and the amount actually collected. In her *2011 Annual Report to Congress*, Nina Olson, the National Taxpayer Advocate, said the following regarding the negative impact of income tax noncompliance on the average household:

“Dividing the most recent tax gap estimate of \$290 billion by the number of households in the United States suggests that the average household is being assessed an annual “surtax” of about \$2,680 to enable the federal government to raise the same level of revenue it would collect if all taxpayers were to report their income and pay their taxes in full. That is not a burden we should expect our nation’s taxpayers to bear lightly.”<sup>1</sup>

Using the most recent IRS tax gap data (released within days after Ms. Olson’s report was published), the IRS estimated the gross tax gap—the difference between taxes owed and taxes paid on time—to be \$450 billion, an increase of 30% over 2001.<sup>2</sup> The net tax gap (which subtracts enforced tax collections) has likewise risen to \$385 billion, an increase of 33%.

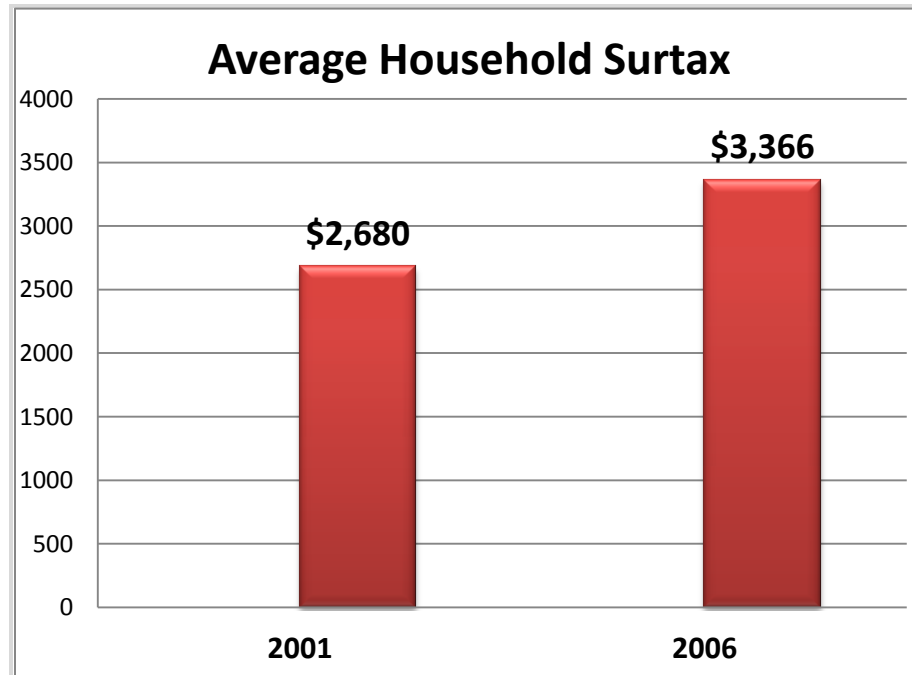


This means that the average annual “surtax” Ms. Olson referred to in the opening quote has now exploded to \$3,366 per household, an increase of 26%, in just five years. Incredibly, the

<sup>1</sup> National Taxpayer Advocate, 2011 Annual Report to Congress, “Executive Summary”, Dec. 31, 2011, page 3.

<sup>2</sup> Press Release, Internal Revenue Service, January 6, 2012.

average taxpayer must pay an additional \$3,366 in taxes to “pick up the tab” for those individuals who are either unwilling or unable to pay their fair share.



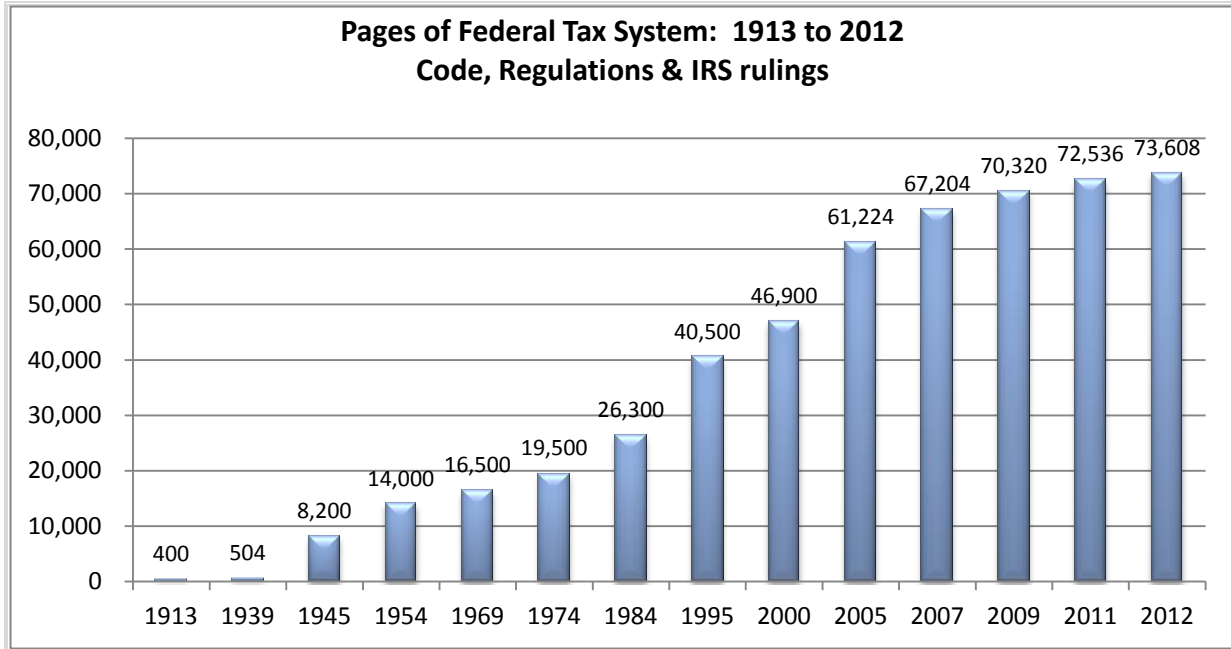
### Who pays?

The compliance burden is the total time and money wasted on filling out tax forms, keeping records, learning tax rules, and other tax-related chores. According to Commerce Clearing House, since the inception of the income tax in 1913, the number of pages of tax code, regulations, and IRS rulings that individuals and businesses must comply with has grown from 400 pages to a whopping 73,608! Just since 2000, it has increased 57 percent.<sup>3</sup>

And this figure does not include the pages of code and IRS regulations and rulings to be added as a result of the passage of the massive health care legislation in March of this year, which includes numerous tax provisions.

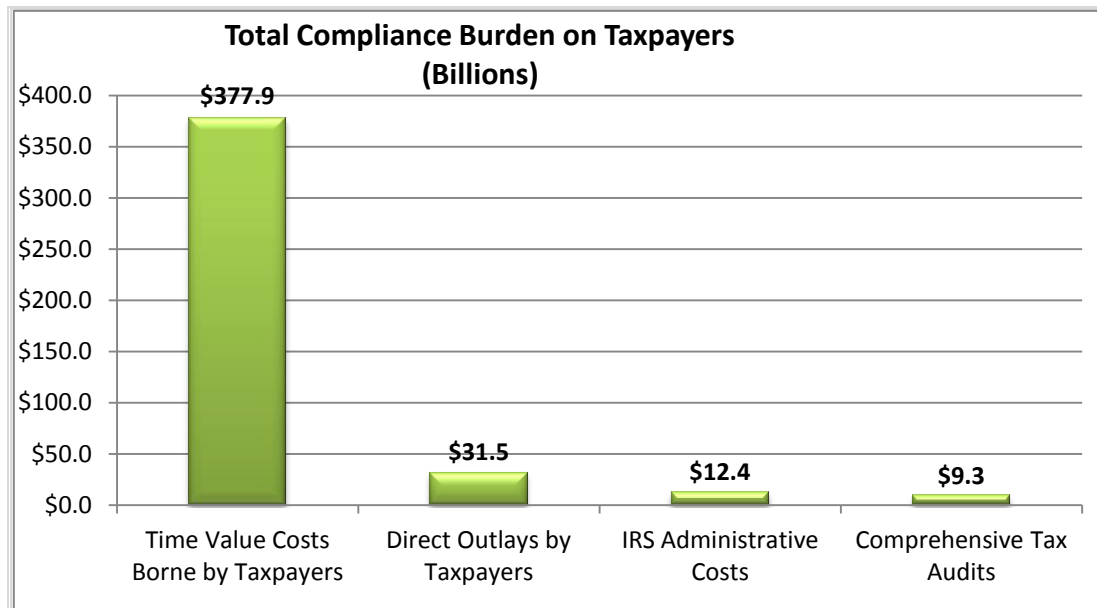
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<sup>3</sup> Source: Commerce Clearinghouse, 2012. <http://www.cch.com/TaxLawPileUp.pdf>



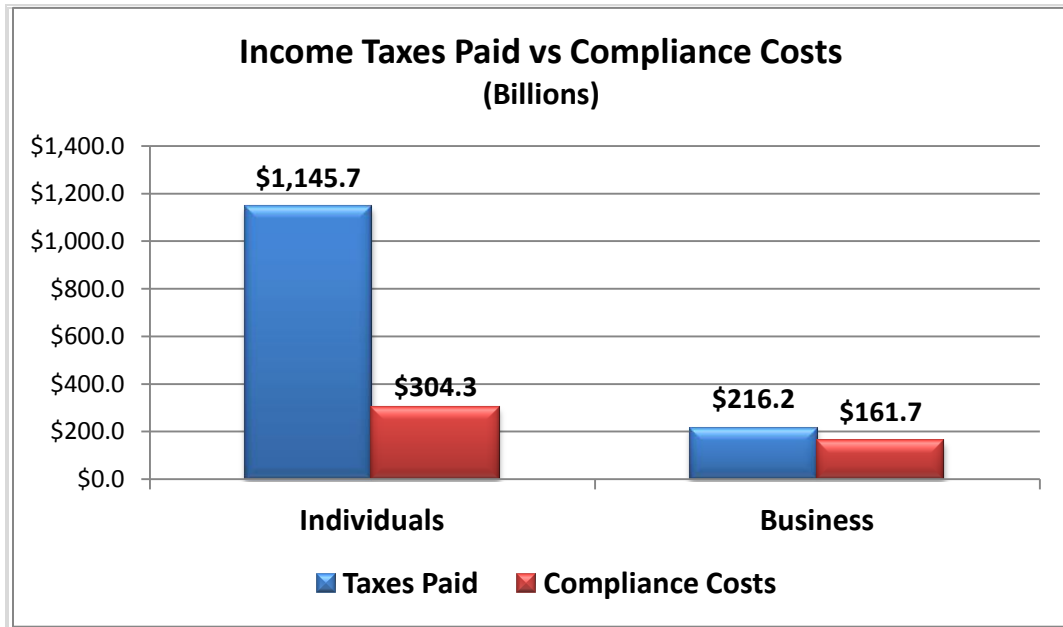
**Time is money.**

While the economic burden occasioned by compliance has been estimated many ways by many researchers, with a correspondingly large range of values (to be glib, depending upon how much the research tends to like the income tax), the most recent credible study shows that U.S. taxpayers waste an astounding \$431.1 billion annually on tax compliance.



Based on these figures, US taxpayers spend about 30 percent of total income taxes

collected, just to ... well ... pay those taxes.<sup>4</sup> Paperwork is the most visible compliance cost, but it is clearly not the only cost, and perhaps not the largest cost. Return processing, determining liability, record keeping, and other burdens are an estimated 13 to 22 percent of the total revenue raised by the income tax system. Of the \$431.1 billion, 88% is the time value costs borne by taxpayers: \$161.7 billion by businesses and \$216.2 billion by individuals.

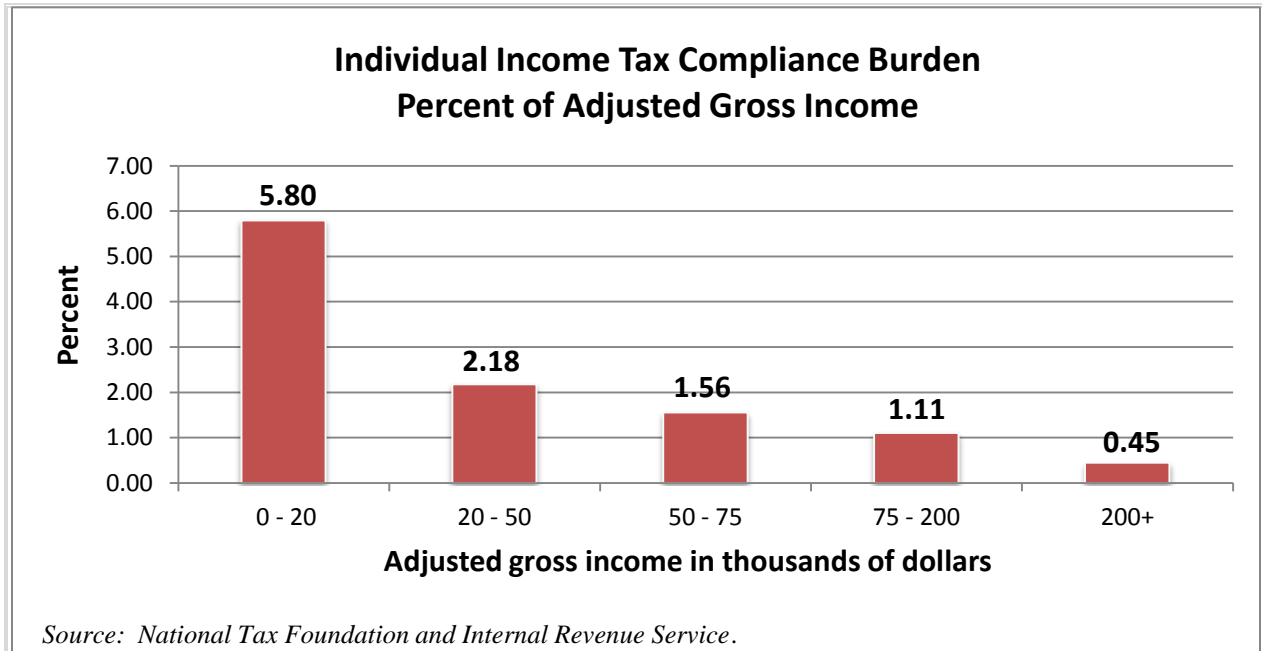


**Compliance costs are regressive.**

Compliance costs are found to be highly regressive. Taxpayers with adjusted gross incomes under \$20,000 incur a compliance cost of 5.8 percent of income. Taxpayers with AGI over \$200,000 incur a compliance cost of only 0.45 percent. Over 54 percent of all the tax surcharge savings resulting from tax simplification would go to taxpayers with less than \$50,000 in adjusted gross income.<sup>5</sup>

<sup>4</sup> Laffer, Winegarden, and Childs, “The Economic Burden Caused by Tax Code Complexity, April, 2011.

<sup>5</sup> Moody, J. Scott, Wendy P. Warcholik, and Scott A. Hodge, “The Rising Cost of Complying with the Federal Income Tax,” Tax Foundation, Special Report No. 138, December 2005.



**The working poor.**

No less than 72 percent of Earned Income Tax Credit (EITC) filers used paid tax preparers for their 2004 tax returns. They were forced into this expense because even the EITC, created to help the working poor, has a taxpayer guide that is 66 pages long. In fact, in 2001, fully \$1.9 billion or 6 percent of the \$32.4 billion in total EITC claimed went to the payment of tax preparation services, filing fees, and payments for refund anticipation loans. (These are loans made to EITC filers in the amount of their expected tax refund.) Because of the complexity of this program, it has a high level of noncompliance.<sup>6</sup> Of the \$59.2 billion in EITC payments to 27 million individuals in 2009, \$16.9 billion or 28.5 percent were overpayments. The GAO attributes the overpayments to the high turnover of eligible claimants, confusion among eligible claimants overwhelmed by the complexity of the law, unscrupulous tax return preparers who exploit this confusion, and fraud. This amount would more than fully fund IRS for an entire year.

**Compliance costs hit small businesses hard.**

Not surprisingly, small firms absorb the lion’s share of these fixed costs that stem from paperwork and record keeping, tracking wages, and interpreting the law – costs which, while disproportionately falling upon them, cannot be passed along. In 2007, researchers at the IRS estimated the total costs of complying with the income tax for businesses of varying sizes.<sup>7</sup> They found that the cost of compliance consumed from 15 to 18 percent of revenues for very small businesses—those with receipts of \$50,000 to \$100,000. For businesses with receipts between \$100,000 and \$500,000, that ratio fell to about 5 percent. For businesses with receipts between

<sup>6</sup> General Accountability Office, “Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges, April 15, 2011, page 4.

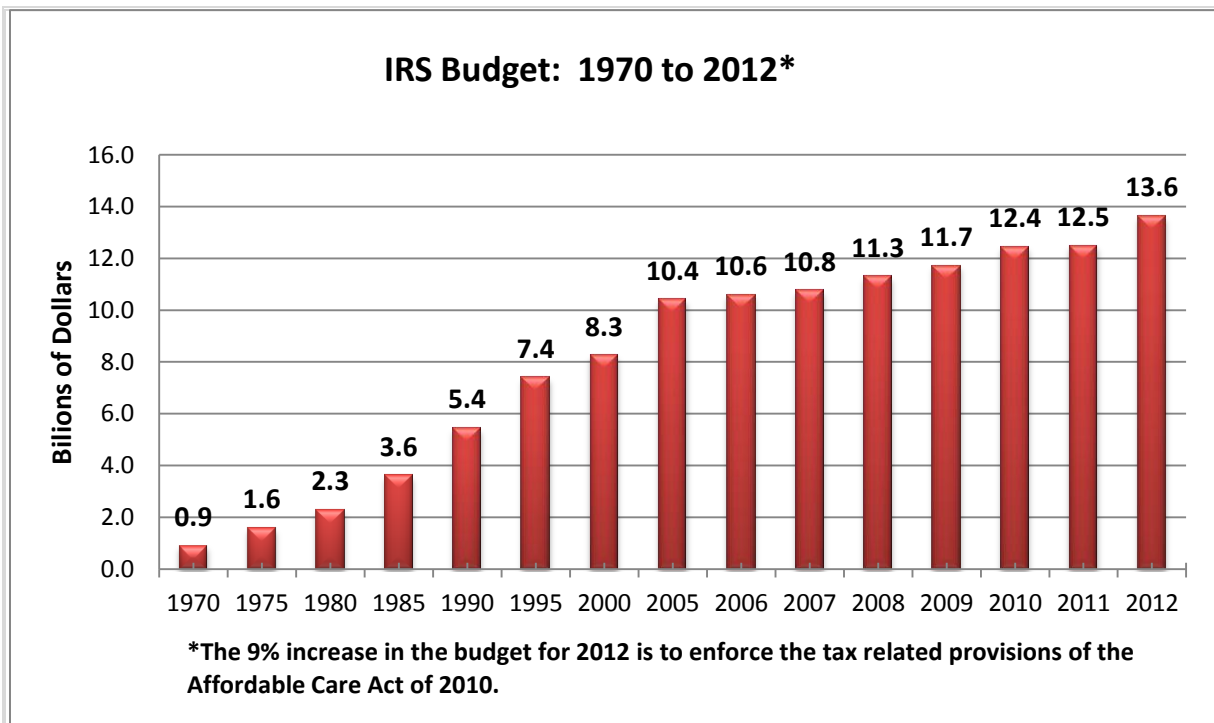
<sup>7</sup> Donald B Marron, “Tax Policy and Small Business,” Testimony before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 3, 2011 citing research by DeLuca, et.al., “Estimates of U.S. Federal Income Tax Compliance for Small Businesses.” Paper presented at the 2007 National Tax Association meetings, Columbus, OH.

\$500,000 and \$1 million, it was about 2 percent. And for businesses with receipts greater than \$1 million, it was only 0.5 percent.

A 2010 study by the Small Business Administration Office of Advocacy found that the per employee annual cost of tax compliance came in at \$1,584 for firms with fewer than 20 workers, \$760 per employee for firms with 20-499 workers, and \$517 per employee for businesses with 500 or more workers.<sup>8</sup>

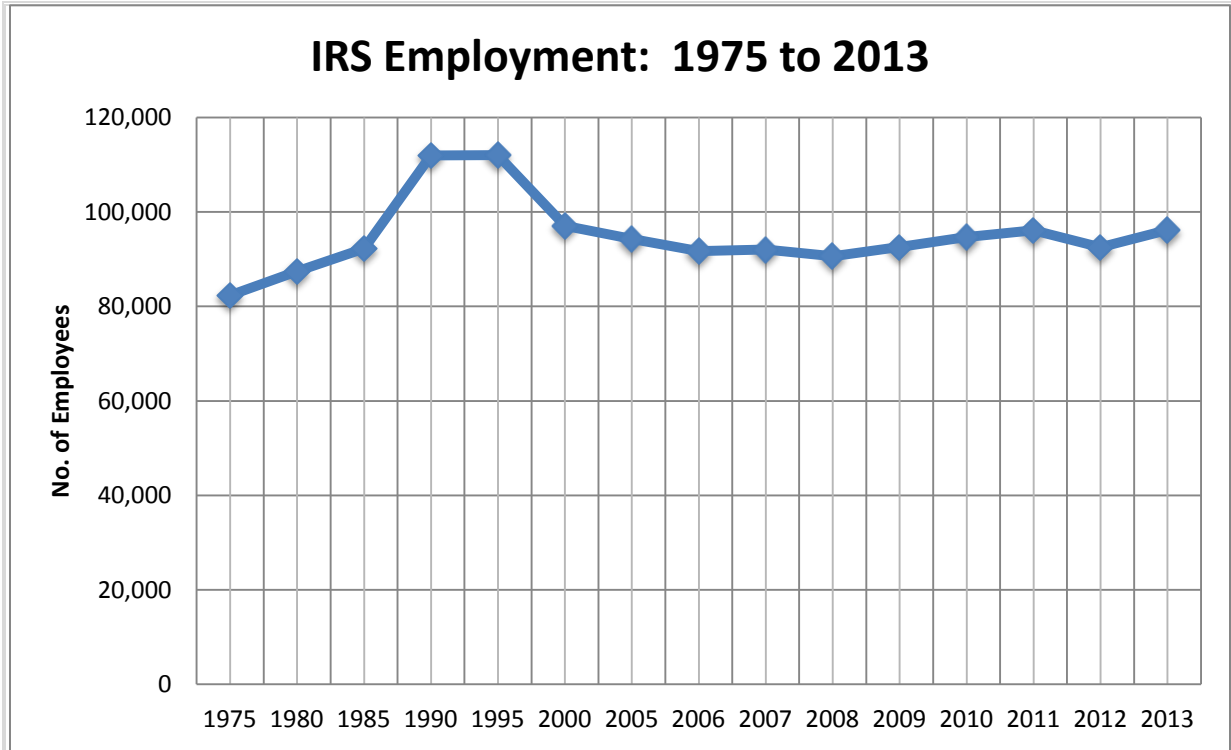
**IRS administration and enforcement costs.**

In addition to the private sector cost of tax compliance is the government spending to administer and enforce the tax code: The IRS budget. The chart below shows the steady climb of the IRS budget, estimated to grow by 10 billion over the next ten years to administer the tax provisions of the health care legislation and the individual mandatory coverage requirement.

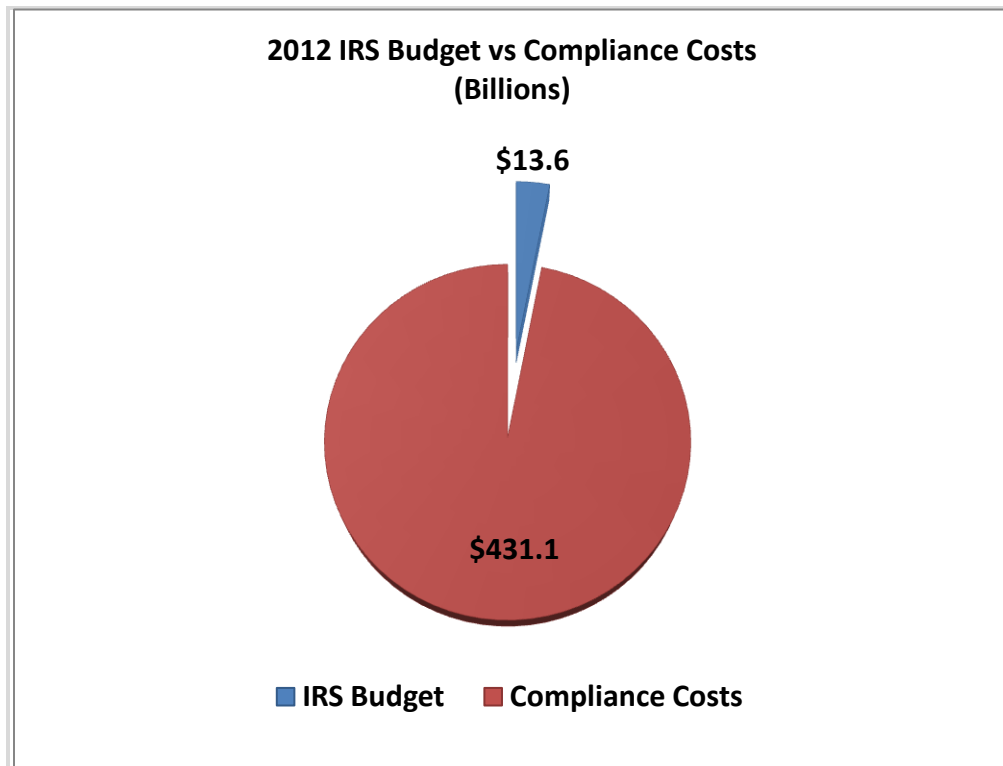


IRS employment also grows accordingly. It has been projected that the IRS may need as many as 16,500 addition agents over the next ten years to enforce the health care legislation.

<sup>8</sup> Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," Small Business Administration, Office of Advocacy, September 2010.



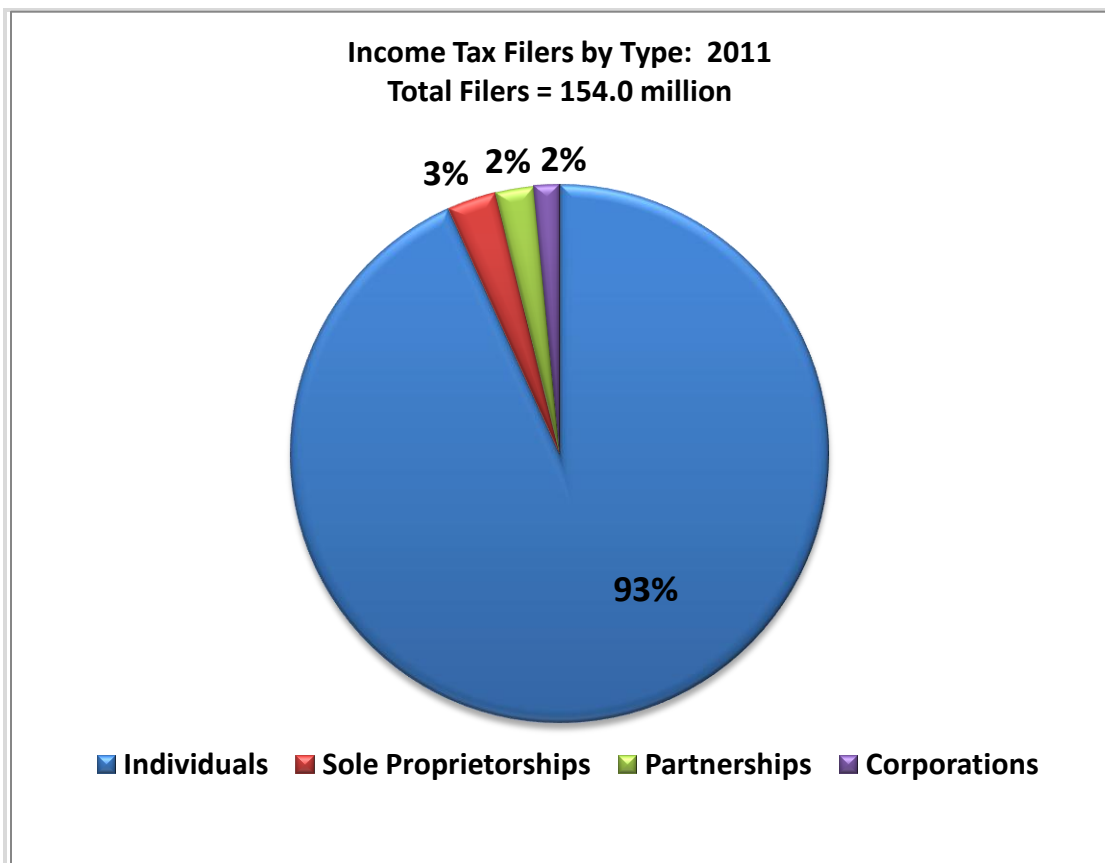
However, as the following chart clearly shows, the private sector costs of compliance dwarf the amount that is in the IRS budget.



**The FairTax slashes compliance costs.**

Of the 154 million tax returns that were filed in fiscal year 2011, over nine out of ten were filed by individuals (143.6 million). Under the FairTax, individuals do not file tax returns. Only businesses that sell goods or services at retail are required to file tax returns. They remit the FairTaxes they collect on consumer purchases along with their state sales taxes once per month. They no longer have to administer income tax withholding and payroll tax deduction on wages paid to their employees on behalf of the federal government.

Under the FairTax, the number of tax filers decreases by at least 80 percent. According to an estimate by the Tax Foundation, the replacement of the income tax with a national retail sales tax would reduce compliance costs by 95 percent.<sup>9</sup>

**And that's not all.**

The efficiency costs of the federal tax system dwarf compliance costs. Efficiency costs occur when tax rules distort the decisions of individuals and businesses regarding work, savings, consumption, and investment. By changing the relative attractiveness of highly taxed and lightly taxed activities, taxes alter decisions such as what to consume and how to invest. When

<sup>9</sup> Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation, Testimony before the House Ways and Means Committee, June 6, 1995.



taxpayers alter their behavior in response to tax rules, they often end up with a combination of consumption and leisure that they value less than the combination they could have achieved if they made decisions free of any tax influences. This reduction in value is a welfare loss or efficiency cost. According to research by the Government Accountability Office, efficiency costs are on the order of magnitude of two to five percent of Gross Domestic Product (GDP).<sup>10</sup> Based on GDP of \$ 15.075 trillion in 2011, efficiency costs are an additional \$302 to \$754 billion. Is it any wonder why the US economic engine has run out of gas!

### **What is the FairTax Plan?**

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll taxes with an integrated approach including a progressive national retail sales tax, a rebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, repeal of the 16<sup>th</sup> Amendment. This nonpartisan legislation (HR 25 / S122) abolishes all federal personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes and replaces them with one simple, visible, federal retail sales tax – collected by existing state sales tax authorities. The FairTax taxes us only on what we choose to spend, not on what we earn. It does not raise any more or less revenue; it is designed to be revenue neutral. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

### **What is Americans For Fair Taxation® (FairTax.org)?**

FairTax.org is a nonprofit, nonpartisan, grassroots organization dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: [www.FairTax.org](http://www.FairTax.org) or call 1-800-FAIRTAX.

Authored by Karen Walby, Ph.D. 2007. Updated January 25, 2013.

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<sup>10</sup> “Tax Policy: Summary of Estimates of the Costs of the Federal Tax System,” U.S. Government Accountability Office Report No. GAO-05-878, August, 2005, p. 20.