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Indiana Benefits, Inc.

February 19, 2015

Ms. Christie Preston
Internal Revenue Service
Room 6129
1111 Constitution Avenue, NW
Washington DC 20224

Re: Comments on Form 5500-SUP

I'm submitting these comments as a long-time practitioner in the field of retirement plans (since 1976), as a practitioner on the front lines of this business (our firm implements new retirement plans, services existing retirement plans and also terminates retirement plans) and as a practitioner who (personally) prepares 5500 Forms. I'm the president of Indiana Benefits, Inc., a pension consulting firm located in Bloomington, Indiana, servicing the retirement plans of approximately 200 small and mid-sized businesses.

My comments address the proposed Form 5500-SUP, the proposed instructions and the commentary contained in the 12/23/2014 Federal Register pertaining to these items. I will offer you my recommendation in summary, give you my observations of the disconnect obvious in the development of this proposal and finally detailed item-by-item support of my recommendation. Fasten your seatbelt - this is going to be a long letter ...

Recommendation

I recommend that you abandon the proposed Form 5500-SUP. The data to be provided on Form 5500-SUP could be gathered more effectively and with much less cost and burden to both plan sponsors and service providers by simply adding new "plan characteristic codes" to the existing Form 5500 or 5500-SF (rather than adding an entirely new filing requirement). Ultimately the costs of plan compliance are borne by plan participants. As regulators (you) and service providers (me), we have a duty to ensure that the retirement security of plan participants isn't eroded by avoidable and burdensome expenses.

Observations of the Disconnect
(This would be the soapbox)

As a practitioner, it's very apparent that the proposed Form 5500-SUP was created in a vacuum. The vacuum in this case is the obvious absence of input (at the early development

stage of this project) from other stakeholders - specifically plan sponsors, practitioners and service providers.

With the evolution in plan reporting from the old IRS Form 4848 to Form 5500 to EFAST1 and now EFAST2, the processes used by practitioners and plan sponsors in gathering the data for these filings, preparing the filings and filing them have changed radically.

In today's environment, we've moved to narrow specialization and automation. Form 5500 preparation may be handled by a dedicated department, compliance testing may be handled by a different department and plan documents may be handled by yet another department (or outsourced). To suddenly require the collection and reporting of data (not included on 5500's since 2008 or earlier) is both burdensome and disruptive to plan sponsors, practitioners and service providers. It ignores the processes widespread in the industry to prepare and file Forms 5500.

Most importantly, when you exclude input from other stakeholders, you often end up with an inferior product. For example, you won't find chicken-fat-ripple gelato in the ice cream case at your grocery store, because the ice cream makers were smart enough to get a reality check from their stakeholders (customers, store owners and maybe the chickens, too).

Furthermore, your stakeholders (especially practitioners and service providers) have a much more intimate knowledge of the real compliance issues of plans. Even if you audited 100% of the retirement plan universe, the average agent might miss issues that would be obvious to practitioners (who deal with it every day). If we collaborate, the end result could be much better and relevant.

Recommendation (with detail, per OMB categories)

- (a) Whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility

The purpose of Form 5500-SUP is to gather additional data to be used for both enforcement and analysis. I strongly believe that 90% of the data could be gathered with the addition of new "plan characteristic codes" to the existing Form 5500 or Form 5500-SF. While the new codes might not capture the most granular information contained in proposed Form 5500-SUP, the new codes could be used to identify the subset of plans to which the granular data would be meaningful in analysis or enforcement. The identified subset could be then surveyed (by the Employee Plans Compliance Unit - as the EPCU did with their "401(k) Survey") or selected for audit. Thus the entire universe of retirement plans is not burdened with providing granular data at considerable expense (ultimately borne by plan participants).

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Here is a detailed analysis of each data item requested on the proposed Form 5500-SUP, as well as comments on the purported need for the data as listed in the table in the Federal Register:

1. Part I (all questions): These items duplicate information already contained on Form 5500 or Form 5500-SF
Recommendation: omit question
2. Part II, items 1 and 2: These items duplicate information already contained on Form 5500 or Form 5500-SF
Recommendation: omit question
3. Part II, item 3: Trust name, Trust EIN, Trustee Name and Trustee telephone number -
In today's retirement plan world, most plan trusts use the plan name.
In today's retirement plan world, most plan trusts do not obtain an EIN, since asset registration and tax reporting are usually done using the EIN of the plan's recordkeeper (often a bank, mutual fund company or insurance company). Ironically, the Ogden IRS Service Center has been responsible for "deactivating" the trust EIN's of many plans
In today's retirement plan world, "passive" or "directed" trustees are the new normal - thus their duties and responsibilities can be very limited
In the IRS plan examinations process, trust taxability is a rarity - when needed, we obtain a separate Power of Attorney for the trust issues, but in the past 5 years (and probably 50 examinations), it's only been needed once.
Recommendation: omit question & substitute by adding plan characteristic codes for "trustee" and "directed/passive trustee" which could be used for focused follow-up by EPCU or examination. Also leave as optional on Form 5500 or Form 5500-SF (since it's rarely applicable)
4. Item 4a - Is plan a 401(k) plan?
Recommendation: omit question- there is already a plan characteristic code for 401k plan
5. Item 4b - 401(k) non-discrimination
Recommendation: omit question & substitute by adding plan characteristic codes for "design-based safe harbor" and "ADP/ACP test"

6. Item 4c - 401(k) current year testing
Recommendation: omit question & substitute by adding plan characteristic code for "current year testing"
7. Item 5a - 410(b) plan coverage
Recommendation: omit question & substitute by adding plan characteristic codes for "ratio percentage test" and "average benefit test" (note that a plan could be using both methods at the same time)
8. Item 5b - permissive aggregation
Recommendation: omit question & substitute by adding plan characteristic code for "permissive aggregation used"
9. Item 6a - timely plan amendment
This question is extremely troubling for a number of reasons:
 1. IRS has never published a complete, clear and understandable listing of all amendments that a plan would have to adopt to remain tax-qualified. Such a list would (for each required amendment) list the law or regulation mandating the amendment, a clear description of what must be amended, the required effective date of the amendment and the required adoption (signing) date of the amendment. I suspect that many practitioners whose primary duty is the preparation of Form 5500 wouldn't be able to list all of these required amendments for the past 6 years, not to mention every amendment that should have been adopted by a plan that's been in existence since 1978. It only follows that an employer trying to complete Form 5500 for his own plan would be totally clueless in this regard.
 2. Most plans have changed service providers (and document providers more than once) - often an unsophisticated client fails to maintain all old document copies.
 3. Forms 5500 are signed under penalties of perjury that they are true, correct and complete. Since this question seems to address document compliance from a plan's inception (often well beyond the statute of limitations for any open tax year), it's quite likely that many signers will be perjuring themselves for the reasons mentioned above.Recommendation: omit question
10. Item 6b - latest plan amendment/restatement
This question is confusing because a plan amendment might include

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only required (compliance) changes, it might include plan design changes or it might include a combination of both - what are you looking for here? The research required to answer this question and locate the adoption date is quite costly. In addition, when plans change service providers it's a common industry practice to restate the plan document. This could very likely skew the data and result in flawed data analysis and targeting.

Recommendation: omit question & substitute by adding 3 plan characteristic codes for "PPA06 ", "EGTRRA" and "GUST"). Since non practitioners will have no idea how to answer this question (short of taking a law course or 2), you will need to provide an expanded explanation if you choose to include these codes.

11. Item 6c - pre-approved plan document

This question is already addressed with an existing plan characteristic code (Code 3E). The research required to gather and enter the IRS Opinion Letter date and serial number will be quite costly.

Recommendation: omit question - if additional research and analysis is required, initiate a targeted EPCU survey or examination sample.

12. Item 6d - individually designed plan document

This question is already addressed with an existing plan characteristic code (Code 3E). If a plan is not a pre-approved document (Code E), then it is considered to be an individually designed plan. The plan sponsor's EIN and Plan Number for all plans without Code E could be matched against the IRS database containing information on favorable determination letters and the determination letter dates could be located without burdening 5500 filers to provide information already in the possession of IRS.

Recommendation: omit question.

13. Item 7a - ESOP dividends

In the universe of plans, ESOP plans constitute a very small percentage. For that reason, the use of characteristic codes for "interesting" ESOP plan features should be sufficient to support either a targeted EPCU survey or examination sample.

Recommendation: omit question & substitute by adding plan characteristic code for "ESOP deductible dividend paid"

14. Item 7b - ESOP dividend financial questions

This information would be included in the independent auditor's report

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(already a required attachment for Form 5500 filers - not required for small plan filers). Also note that this information is easily (and publicly) available for publicly-traded companies.

Recommendation: omit question and if data needed for small plan filers, initiate a targeted EPCU survey or examination sample.

15. Item 8 - USA territory plan

Recommendation: omit question & substitute by adding plan characteristic code for "USA territory plan without 1022 election".

16. Item 9 - Contributions deducted

Items 9a and 9b ask for information already contained on the plan sponsor's Federal Income Tax return. By matching the sponsor's EIN on Form 5500 to the applicable sponsor tax return, this information could be located without burdening 5500 filers to provide information already in the possession of IRS.

Recommendation: omit question.

17. Item 10 - Unrelated business taxable income

An extremely small percentage of the universe of plans has unrelated business taxable income.

Recommendation: omit question & substitute by adding plan characteristic code for "unrelated business taxable income" - if more data is needed, initiate a targeted EPCU survey or examination sample.

18. Item 11 - In-service distributions

This information would be included in the independent auditor's report (already a required attachment for Form 5500 filers - not required for small plan filers). To gather this information for small plan filers would be very costly due to existing recordkeeping systems.

Recommendation: omit question and if data needed for small plan filers, initiate a targeted EPCU survey or examination sample.

19. Part IV - Preparer information - name, address and telephone number

Historically, this information could be provided optionally, but was not required. Form 5500-SUP would make providing this information mandatory. Unlike most other tax forms containing preparer information, Form 5500 is subject to public disclosure and is posted for public viewing on the Department of Labor's EFAST2 website. I have a number of very serious concerns with this item, as proposed:

1. In the "changes chart" published in the Federal Register, it was stated that EP Exam needs this information so they can contact

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preparers for issues relating to the 5500 and plan qualification. The relationship between a practitioner and client is defined and memorialized in a written Service Agreement. Some engagements may be very limited (i.e. preparation and filing of Form 5500), while others might be broader in scope. Accordingly, the 5500 preparer may not be privy or involved in plan qualification matters. Also, the reasoning in the "changes chart" seems to imply that a practitioner has been authorized by the plan sponsor to discuss qualification matters - whether or not this has been authorized by the client (or is even within the terms of the engagement). This might also imply a liability on behalf of the preparer this is not even part of the service agreement! From time to time and for various reasons, there are changes in service providers. After we have terminated our relationship with a client, it would be inappropriate to discuss their tax matters with anyone.

2. I am not aware of any other situation where the identification of a return preparer (for a specific client's return) is made available to the public. This requirement would effectively make my client list publically available. As a small business, what would prevent a large competitor (for example a national payroll company) from identifying all of my clients and aggressively courting them with predatory pricing? I could be out of business in 6 months! This affects not just our firm and our staff members, but all small and medium-sized service providers nationwide. In addition, although we do not serve as a plan fiduciary, we would be exposed to the risk of misdirected lawsuits and threats to the personal safety of our staff by unhappy plan participants.
3. Form 5500 is an "information return" and not a "tax return". As such, preparers of Form 5500 are not required to have a Practitioner Tax Identification Number (PTIN). It is interesting to note that as required annual plan filings have evolved over the years, some (especially larger) service providers have moved to a fully automated 5500 preparation model - where the 5500 Forms are generated "untouched by human hands". Who would be named "the preparer" in this case? If nobody is named, my proprietary client list is made public, but my (fully automated) competitor's client list remains protected!

Recommendation: preparer information may be provided optionally, but not mandated. In the event that EP needs additional information about a return or a plan's compliance, they would follow current

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procedures (which work just fine) of contacting the plan sponsor (who would then engage a practitioner for assistance if needed).

(b) The accuracy of the agency's estimate of the burden of the collection of information

In the discussion in the Federal Register, it was estimated that 822,500 plans would be affected ("Estimated Number of Respondents"). This is the number of retirement plans that would be subjected to the additional reporting requirements. I agree that this is a reasonable estimate.

Also in the Federal Register, it was estimated that the additional burden of this form would be 25 minutes ("Additional Burden per Respondent"). This is in contradiction to the estimates contained in the draft instructions for proposed Form 5500-SUP which total 14 hours and 16 minutes, as follows (stated on page 4 of the instructions):

Recordkeeping: 6 hr., 27 min.

Learning about the law or form: 3 hr. 46 min.

Preparing and sending the form to IRS: 4 hr., 3 min.

It is interesting to note that the time estimate above (4 hours - just for preparing and filing proposed Form 5500-SUP) is **almost twice** the time estimate (2 hours, 32 minutes) for the preparation and filing of Form 5500-SF (to which the SUP is a "supplement")!

For a reality check, I prepared a Form 5500-SUP for an average client's plan. I'm a seasoned practitioner and with gathering the necessary data it took me 65 minutes - I was already familiar with the form and instructions so did not add that time. I'd consider this a "best case" preparation time - almost 3 times the Federal Register estimate.

For an average preparer, it would probably take twice as long. For a plan sponsor who only completes her own 5500-SUP it might take the full 14 hours (per the estimate in the instructions).

If we assume that a blended average time would be 3 hours, the net ANNUAL burden of this form is 2,467,500 hours!

(c) Ways to enhance the quality, utility, and clarity of the information to be collected

Eliminate Form 5500-SUP and replace with new codes per (a) above.

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- (d) Ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology

Eliminate Form 5500-SUP and replace with new codes per (a) above.

- (e) Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information

Nowhere is the estimated cost burden discussed in the Federal Register. An average hourly billing rate for a practitioner might be \$80 to \$150 per hour. For estimate's sake, let's assume an hourly rate of \$80 and the annual time burden of 2,467,500 hours (per (b), above). This results in a **RECURRING ANNUAL cost for this new form of \$197,400,000.00**. Again, this is a cost that will ultimately be borne by plan participants.

It has been documented the costs and burden of tax compliance falls most heavily on small businesses. I've attached the IRS study "Recent Research on Small Business Compliance Burden" (see <http://www.irs.gov/pub/irs-soi/04kinnta.pdf>) which documents this effect.

Summary

The costs associated with the proposed Form 5500-SUP are conservatively estimated to be \$197,400,000 per year. For the most part, these costs will be borne by plan participants, thereby reducing their retirement savings. As proposed above, by eliminating the proposed form and enhancing the plan characteristic code system, 90% of the 5500-SUP data could be captured with a much lower cost. The data captured with enhanced characteristic codes could be used for either analysis, enforcement or to survey selected plans. Preparer information should remain an optional feature per current industry practices.

Thank you for considering my comments.

Yours truly,



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President

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Recent Research on Small Business Compliance Burden^{*}

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^{*} This paper was prepared for the session entitled, "Burden of Tax Compliance," at the Ninety-Seventh Annual Conference of the National Tax Association in Minneapolis, Minnesota on November 11 through 13, 2004. The authors wish to thank Helena Blazic, Michael Chesman, Don DeLuca, Arnold Greenland, Sean Hennessy, Adam Korobow, Peter Lee, Wu-Lang Lee, Sarah Myers, Susan Nelson, John O'Hare, Katarina Ott, Mary Phillips, Michael Stavrianos, Eric Toder, and Binh Tran-Nam for their comments on this and earlier drafts of the paper. The views and opinions in this paper do not necessarily reflect the positions or policies of the Internal Revenue Service nor of the International Business Machines Corporation.

Abstract

The IRS Office of Research is currently developing improved methods to measure and model U.S. small business federal taxpayer compliance burden. Characteristics of this population include having “burden without liability” and suffering “diseconomies of lack of scale”. In addition, much of their burden is associated with activities “behind the forms” not easily linked to details of their tax return data. Recent research initiatives focusing on small business income and employment tax burden present a number of challenges, particularly identifying activities incremental to the federal tax system beyond those foundational to the ordinary course of business, and uncovering the determinants and structure of fees paid to outside tax preparers and other paid professionals. In this paper, we focus on the implications of our qualitative research on small business compliance burden for burden measurement and model design, and discuss some of the challenges of estimating and simulating money burden for this population.

Introduction

As discussed in Stavrianos and Greenland (2002), Arena *et al* (2003), Guyton *et al* (2003), Lerman and Lee (2004), and Holtzblatt (2004), the Internal Revenue Service (IRS) is developing microsimulation models of taxpayer compliance burden, starting with the Individual Taxpayer Burden Model (ITBM). For this research, taxpayer compliance burden consists of the time and money spent by taxpayers to comply with the federal tax system, above and beyond the tax liability remitted to the federal government.¹ This paper provides a discussion of some of the recent research at IRS on designing and developing an analogous microsimulation burden model of small businesses as discussed in DeLuca *et al* (2003) and Kindlon (2004). As defined by IRS, small businesses are corporations or partnerships with under \$10 million in assets.² The research at IRS builds on an extensive body of international research measuring compliance burden surveyed in Evans (2003).³

Each of the IRS compliance burden studies has four major phases. In the research design phase, IRS seeks to identify key research goals, establish functional objectives for the burden model, and develop a research plan. In the data collection phase, IRS (via its contractor) administers a mixed-mode (telephone

and mail) survey to a large sample of taxpayers. Survey responses are merged with IRS administrative data, yielding an analysis data file. In the model design and development phase, relationships are specified that form the underpinning of the burden model. Included in this step are the development of a tax calculator, the mapping of tax system complexity to taxpayer characteristics, and the econometric estimation of compliance burden relationships. Finally, in the model implementation phase, a software tool is developed allowing users to run “what if” simulations and generate summary reports.

Developing a Small Business Microsimulation Model presents several new challenges beyond those encountered in developing the ITBM. The first is the predominance of “burden without liability”. Small businesses typically pass through income/liability to their owners, but most of the burden stays with the entity.⁴ Second is the ability of many businesses to choose how they will be treated for federal income tax purposes (e.g., using the check-the-box rules).

Other challenges are more differences of degree from our previous work. Small businesses are more likely to incur burden associated with multiple types of taxes. Small businesses are more likely to use a variety of paid professionals (e.g. payroll vendors, accountants, lawyers). Small business time burden predominantly consists of activities other than form completion, primarily record keeping and tax planning. We also expect greater variation in burden across industry groups for small businesses than determined for self-employed taxpayers. Widespread use of paid preparers results in much more of the compliance burden to be experienced as an out-of-pocket cost to the taxpayer.

Another difficult problem is determining which activities are “foundational”. Foundational activities (such as tracking revenue) are done primarily to successfully manage the business and would be completed even in the absence of the Federal tax system. Incremental activities are done specifically to comply with the federal tax system. For small businesses, it is difficult to identify which activities are foundational and which are incremental – many foundational activities also facilitate tax compliance. State tax burden is assumed to have little marginal impact beyond federal tax burden. After summarizing the findings from our qualitative research, we will return to the subject of challenges with an in-depth

focus on our plan of estimating out-of-pocket money burden in general and paid professional fees in particular.

Qualitative Research on Small Business Compliance Burden

The implementation phase of this project began by conducting in-depth case studies with small business taxpayers.⁵ The case studies were designed to support four major research objectives: 1) guide questionnaire development by identifying activities that are tax-related and burdensome, 2) assign priorities to different topics, identifying difficult topics that require probes, 3) reveal new issues, and 4) guide development of imputations from administrative data. Combining survey data, administrative data, and case study information will provide a robust set of data inputs. The case studies also were used to guide the modeling effort by supporting simulation of taxpayer behavior and guiding selection of inputs to the burden estimation equations.

Income Tax Qualitative Research Findings: Record Keeping

The majority of small business taxpayers with whom we spoke use a software system such as QuickBooks, Peachtree, or some industry specific package to maintain records. The decision to use software is driven primarily by foundational business reasons. Often this software has to be modified to accommodate tax information. Small business taxpayers exhibit many common tax-related record keeping activities, including obtaining and organizing tax-related records and receipts, entering tax-related information into a software based accounting system, using data from their record keeping system to produce reports needed for tax compliance, and checking inputs into the accounting system for accuracy, identifying and correcting errors.

Nearly all the small business taxpayers included in our study expend time obtaining and organizing tax-related records and receipts, and entering this information into their accounting system. These record keeping activities are cited as among the most time consuming activities by a high number of taxpayers. The types of receipts and records taxpayers mentioned frequently include: meal and entertainment expenses, mileage logs, receipts related to capital purchases, and records of charitable contributions.⁶ The number of receipts or transactions is reported to be a key driver of record keeping burden.

Employment Tax Qualitative Research Findings: Record Keeping

The most frequently mentioned record keeping activities for employment tax are: collecting W-4 information from employees, determining whether workers are properly classified as employees or contractors, determining the tax treatment of certain types of compensation (e.g., benefits), entering information into an employment tax system and checking entries for accuracy. Key drivers of employment tax record keeping burden include: number of employees, whether or not a payroll vendor is used, industry of the business, and presence of certain types of compensation (e.g. tip income, in-kind benefits, supplemental wages, sick pay, reimbursed business expenses).

The majority of taxpayers with whom we spoke use a payroll vendor to complete both payroll and employment tax compliance activities. The key reasons given for using a payroll vendor are:

Cost Savings – Many of the small business taxpayers interviewed explain that it is extremely cost effective for their business to use a payroll vendor. The amount that they pay for payroll, employment tax form preparation, tax deposits, and preparation of information returns is far less than it would cost if they decided to handle these activities in-house. Still, small business bearing these compliance costs suffer from the “diseconomies of lack of scale” described in the literature.⁷

Accuracy of Payroll/Employment Tax Information – Taxpayers also explain that they use a payroll vendor to ensure the accuracy of their payroll, tax withholdings, and employment tax forms, and the timeliness and accuracy of employment tax payments. Using a payroll vendor to handle these tasks increases the accuracy of these activities and reduces the chance that the business will face scrutiny or penalties from the IRS.

Privacy – Some small business owners feel more comfortable having financial information maintained by a vendor outside the company. They believe that this information is kept more securely and accurately than it would be in-house.

Qualitative Research Findings: Tax Planning

Many taxpayers work with a paid professional for tax planning. Preparing for these meetings is cited by many as being time consuming. The most common tax planning activities center on business

structure, capital expenditures, and shifting income between entities or across tax years. Most tax planning occurs near the end of the fiscal year when businesses focus on trying to reduce taxable income. A common characteristic of this population is that they have a taxable income of exactly \$0, thus exhibiting “burden without liability”. For C-Corporations this is typically the result of deliberate end-of-year planning.⁸

Businesses that handle depreciation internally experience significant burden. Key drivers of depreciation burden include types of assets, number of assets, and industry specific depreciation methods. Avoiding the burden of tracking depreciation was cited as one of the factors driving use of external paid professionals.

Small business taxpayers with certain characteristics are more likely to engage in tax planning:

Small businesses that are profitable – Profitable businesses engage in tax planning to reduce their taxable income.

Small businesses with owners sophisticated in finance or accounting – Owners with backgrounds in accounting or finance have a better understanding of tax planning strategies and are more likely to engage in this activity.

Small businesses who use paid professionals that encourage tax planning – Paid professionals have a major influence on the level and types of tax planning that take place.

Small Business Burden Estimation and Simulation

There are a number of major challenges to estimating and simulating small business compliance burden. While guided by theory, separating foundational business costs from costs incremental to the federal tax system can be difficult to operationalize. Another challenge is identifying burden drivers not easily observed from IRS administrative data. Much of small business compliance burden is tied to activities (*e.g.*, record keeping, planning, detailed calculations) “behind the forms”.⁹

Also, jointly estimating time and out-of-pocket money burden within a conceptual framework in which software costs and paid professional fees are seen as substitutes for time burden represents an important challenge to undertake in support of realistic microsimulation functionality. Estimating tax

planning time (and fees for tax planning services) as substitutes for tax liability (or other after-tax costs passed through to the owners) requires the model to consider the interaction between compliance burden and liability burden.

It is also difficult to develop methods both for allocating existing burden across the tax system and for simulating marginal changes in burden given tax system changes. This problem underscores the need for further theoretical development. It is all too easy to find and use proxy drivers of burden that have strong explanatory power but yield poor simulation performance. This problem is particularly challenging for taxpayers using paid professionals (i.e., most of our population of interest). For example, lumpy pricing and competitive pressure among providers makes it very difficult to disentangle the drivers of paid professional fees.

Estimating Out-of-Pocket Costs for Small Business Taxpayers Using Paid Professionals

A key component in building our simulation model is to determine paid professional fees that are incremental to federal tax compliance. This requires uncovering how much small business taxpayers are willing to pay for professionals to comply with the federal tax system.

Most small businesses use a paid professional to prepare their federal income and employment tax returns. These paid professionals include certified financial planners, accountants, tax advisors, and tax lawyers. They provide federal-tax-related services including a variety of activities such as record keeping, tax planning, preparation and submission of tax returns. In addition to the federal-tax-related services, typically, the paid professionals also provide other general accounting services and state and local tax-related services that are foundational to operating a small business.

Although small businesses pay professionals for a variety of services, it's difficult to obtain accurate data on how much they pay for each service separately. It was during our qualitative research that we learned that taxpayers typically pay a lump-sum fee and they either don't know or don't remember precisely the detailed breakdowns. Recognizing this, we focused in our survey on, among other things, the lump-sum amount a small business spent on paid professionals. We also focused on what kind of

services they received, as we believe information on what kind of services that they purchased are more reliable than how much they spent on each one of these services.

In addition to uncovering what portion of the total fee is paid for services related to federal tax compliance, we also need to develop a mathematical relationship between the willingness to pay and some measures of tax law complexity that we can use to run “what-if” simulations with our model. One available and appropriate tool for these two tasks is the hedonic price theory (Rosen, 1974)¹⁰. We plan to investigate application of this theory in building our simulation model. While the focus of this discussion is on paid professional fees, a similar approach will also be considered for other out-of-pocket costs such as for business accounting software¹¹.

Using the hedonic approach, we treat paid professionals as providing a highly differentiated service with numerous characteristics. These characteristics include both general accounting activities foundational to run a small business (such as general accounting, book-keeping, and state and local tax preparation) and activities that are related only to federal tax compliance (such as preparing different federal tax forms, tax planning, federal-tax-related record keeping). In addition to these observable activities, the characteristics also include things that differentiate one paid professional from another, such as type of professionals (*e.g.*, accountant, lawyer, financial advisor, payroll vendor), reputation, accessibility, experience, fee structure, and flexibility in client participation.

According to the hedonic model, the lump-sum amount spent by small business on the paid professional service is a function of these characteristics. Generally, it is defined as a hedonic price function: $P(x) = f(x_1, x_2, \dots, x_k)$, where $P(x)$ is the observed lump-sum amount paid, and x_1, x_2, \dots, x_k are the amounts of the characteristics obtained in the paid professional service. The hedonic price theory shows that the partial derivative of $P(x)$ with respect to x_i is the shadow (or implicit) price of the characteristics of x_i . It measures the small business taxpayers’ willingness to pay for an additional unit of x_i .

We are conducting two independent surveys of small businesses, one for federal income tax and the other for federal employment tax. Based on our research it is not common for one preparer to provide both

services to the same business. Therefore, it is acceptable to treat federal income tax and employment tax separately and consider constructing two similar hedonic price functions. We illustrate the potential approach in discussing federal income tax.

Hedonic Price Function for Federal Income Tax Compliance Services

In this case, $P(x)$ would be the annual spending on paid professional services collected from our small business federal income tax survey. Also collected from the survey are the types of services they purchased for the survey year. These services constitute the characteristics of a particular paid professional service a small business purchased. They are represented as x_1, x_2, \dots, x_k in the hedonic price function. Specifically, they are the following activities:

1. Federal business income return preparation
2. Federal individual income return preparation
3. Employment tax services
4. Payroll services
5. Submission of business federal income tax return
6. Excise tax services
7. State and local tax services including sales and use tax
8. Bookkeeping services
9. Income tax estimated tax payment services
10. Legal services
11. General non-tax business advisory services
12. Assets depreciation calculation and bookkeeping
13. Other accounting services
14. Tax planning.

The variable x_i takes the form of a dummy variable, with a value of 1 if the i^{th} activity is purchased, and 0 if not. Here the goal is to estimate the marginal value of activities that are incremental to the federal business income tax compliance, while controlling other activities (not directly related to the

federal business income tax) that also affect the price. We will also consider replacing the first activity, federal business income tax return, with three variables, each representing which IRS primary income tax form is filed (Form 1120, 1120S, or 1065). These data are available from IRS administrative files.

The hedonic price function could include additional independent variables that describe the characteristics of small business taxpayers and that may also affect their willingness to pay. Additional variables under consideration (available either from our survey or from IRS administrative data):

15. Type of firm legal entity
16. Number of vehicles owned
17. Value of assets with useful lives each in excess of one year
18. Number of assets with a useful life in excess of one year
19. Number of hours spent on business federal income tax
20. Number of employees
21. Number of independent contractors
22. Age of the business
23. Gross revenue
24. Business federal income tax liability
25. Type of industry
26. Real property owner
27. Dividend payer
28. Subsidiary

Remaining econometric issues

In estimating the hedonic price function, we must specify a functional form with an error term. The common choices suggested in the economic literature are linear, exponential (semi log), power (double log), logarithmic, translog, and Box-Cox.¹² Since economic theory does not indicate which functional form is better than another, the common practice in empirical research is to estimate a number of

functional forms and choose the one that fits the data better, or in our case, results in better simulation results.

Another econometric issue is the choice of estimation method. The goal is to have unbiased and efficient estimates. A particular challenge is that some characteristic variables are unobservable or with no data (such as paid professionals' reputation). As a result, we have to either use a proxy or omit them from the hedonic price function. If these omitted variables are correlated with any of the included characteristic variables, the estimates for the included variables will be biased. Such bias must be considered in selecting a suitable estimation method.

Conclusions and Future Research

As discussed above, understanding and modeling the drivers of small business compliance burden is a complex task. We are approaching the task by breaking time and money compliance burden into separately measurable components with distinct drivers. Based on our qualitative research, the most important sources of compliance burden are record keeping time, tax planning time, and out-of-pocket costs for paid professional tax services.

The next steps in completing development of the Small Business Burden Model are to finish data collection, perform burden estimation (with consideration to the econometric issues discussed above), and implement a microsimulation model. We expect completion of this work will be of significant interest to economists and policy analysts. Overall compliance burden for this population is expected to be much larger as a percentage of overall income tax liability than for individuals or large corporations, given that a large percentage of small businesses have no income tax liability at the entity level.

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Endnotes

¹ In addition to completing and submitting tax forms, federal tax compliance burden can include record keeping, tax planning, gathering tax materials, using IRS services, and working with a tax professional. This intuitive definition of compliance burden has the further advantage of eliminating redundancies and potential inconsistencies across burden components (e.g. it avoids double counting tax liability burden that is picked up elsewhere in revenue estimates). Many activities and costs commonly associated with tax compliance are necessary not only to comply with the federal income tax system, but also for other purposes such as state taxes or loan applications. In cases where a single activity is motivated both by federal tax requirements and by other requirements or interests, the joint costs of the activity must be allocated. A reasonable approach is to designate one set of activities as foundational, and assign all joint costs to the foundational activity set. The definition used in this study treats federal tax requirements as foundational to state tax requirements, and other requirements (e.g., financial planning and reporting) as foundational to both federal and state tax requirements.

² Businesses operating as sole proprietorships were previously studied in developing the ITBM.

³ The authors would particularly like to thank Professor Joel Slemrod of the University of Michigan and Professor Binh Tran-Nam of the University of New South Wales for helpful discussion during the design phase of the study.

⁴ This suggests reconsidering how we think about compliance costs as a percentage of revenue yield. The result is not very meaningful when the denominator is zero (or close to zero). For the U.S. small business population we might consider adding the associated compliance burden to that of individuals (and likewise adding the small associated tax to the total individual tax collected) and recomputing a combined compliance-to-yield ratio for the two populations. Such a combined ratio would presumably be higher than the standard compliance-to-yield ratio for individual taxpayers.

⁵ See Kindlon (2004) referenced above.

⁶ Interestingly, we were told by preparers that many of their small business corporate clients keep records only needed for the Alternative Minimum Tax (AMT) even though very few actually pay AMT. Preparers told us their clients do this to be prepared should they be subject to AMT in the future. This information led us to add a question on our income tax survey focusing on record keeping for AMT.

⁷ Evans (2003, p. 72) tells us “most of the studies tell us that smaller businesses carry disproportionately higher compliance costs.”

⁸ This finding was confirmed in our in-depth interviews with tax professionals and in our discussions with small business trade associations.

⁹ The authors would like to thank Susan Nelson of the U.S. Treasury Office of Tax Analysis for this insight.

¹⁰ This theory treats consumers’ demand for a good as an implicit demand for the characteristics that embody the good. The theoretical foundation was formalized by Rosen (1974). For example, the demand for personal computers is a demand for RAM capacity, hard drive size, display resolution, CPU speed, etc. Hedonic techniques have attracted the interest of economists as a means of measuring values, also called shadow price or implicit price, of these characteristics through the market price of the good that is embodied by these characteristics. Examples are applications to the personal computer market (Berndt, etc. 2001), wine industry (Combris etc. 1997), and housing market (Palmquist *et al* 1984). Moulton (2001) surveys the role of hedonic methods in improving official price indices in the United States.

¹¹ Some business accounting software are used for both general business accounting and tax related purposes. Therefore, the issue here is the same: We need to uncover the portion of the total software cost that is used for federal tax compliance. Hedonic price approach could be a tool for this task.

¹² See Blackley *et al* (1984).