

The Tax Compliance Burden of Small Businesses—A Profile of 50 Businesses

Donald DeLuca, Arnold Greenland, Sean Hennessy, Audrey Kindlon, and Michael Stavrianos, IBM Consulting

Introduction

In 1998, the Internal Revenue Service (IRS) contracted with IBM Business Consulting Services (IBM) to develop an improved methodology for measuring and modeling the compliance burden imposed by the Federal tax system. At that time, the IRS estimated that taxpayers spent approximately 6 billion hours each year on tax compliance activities, such as tax planning, recordkeeping, and form completion. This burden cuts across several types of tax (e.g., income tax, employment tax, excise tax), each with a unique set of compliance requirements that can generate burden in the prefiling, filing, or postfiling time period. Moreover, compliance burden can mean different things to different subgroups of taxpayers (e.g., individuals, businesses, tax-exempt entities). To identify administrative practices that can reduce compliance burden, the IRS must understand how each group is affected by Federal tax rules and regulations.

In light of the complexity and scope of this issue, the IRS is building the capacity to measure and model compliance burden in incremental steps. In March 2002, IBM delivered the first burden simulation model, addressing the Federal income tax compliance burden of Wage and Investment (W&I) taxpayers. The second model, addressing analogous burdens for Self-Employed (SE) taxpayer burden, was completed and integrated with the W&I model in January 2003.

IRS's Office of Research now seeks to complement these prior studies of individual taxpayer burden with a study of compliance burden among Small Business (SB) taxpayers. As with the previous studies, this new study focuses on compliance burden incurred in the prefiling and filing time periods. Unlike the previous studies, the scope of this new research extends beyond Federal income tax compliance burden to include compliance burdens associated with employment taxes.

Each of the burden studies has encompassed four major phases—research design, data collection, model design and development, and model implementation. A brief description of each phase is provided below:

- ❑ Research Design—IBM works with the IRS and other stakeholders to identify key research goals, establish functional objectives for the burden model, and develop a plan for conducting the research.
- ❑ Data Collection—IBM administers a mixed-mode (telephone and mail) survey to a large sample of taxpayers. Survey responses are merged with IRS administrative data, yielding a comprehensive data file that contains information on taxpayer characteristics, activities, and burden.
- ❑ Model Design and Development—IBM specifies the relationships that form the underpinning of the burden model. Included in this step are the development of a tax calculator; the mapping of taxpayer characteristics to tax system complexity; and the estimation of statistical relationships between taxpayer characteristics, taxpayer behavior, and taxpayer burden.
- ❑ Model Implementation—IBM develops a software tool that: (1) applies the estimated relationships to a nationally representative sample of taxpayers (i.e., a production data file), (2) gives users access to simulation levers (e.g., tax parameters, forecast parameters), and (3) generates summary reports that describe the level and distribution of burden under different scenarios.

In order to better understand the tax compliance activities that small businesses engage in and which activities are most burdensome (i.e., time and money incurred by taxpayers to comply with Federal tax rules and regulations), IBM conducted extensive qualitative research during the design and implementation phases of the project. During the design phase (Spring 2003), twelve focus groups were conducted—ten with small business taxpayers and two with paid professionals who provide accounting and other services to small businesses.

In August 2003, IBM presented the implementation plan for Phase II of the SB Taxpayer Burden Study to the IRS. This plan included an approach for conducting additional qualitative research to augment and enhance the survey data and to guide the modeling effort. Specifically, the plan called for conducting four facilitated sessions with small business (SB) taxpayers and paid professionals, and 50 in-depth “case study” interviews with small business taxpayers.

This additional targeted data collection was necessary for three reasons. First, it is difficult for small businesses to report some types of information in a brief quantitative survey (e.g., information on the allocation of joint costs). Second, it is more efficient to study certain complex processes through tar-

geted, indepth studies (e.g., decisionmaking processes that are complex, but relatively homogenous across different taxpayer groups). That is, the indepth research affords us a more detailed perspective on the complexity of certain decisionmaking processes undertaken by SB taxpayers, without having to expend significant time resources on such areas in the large-scale survey effort. Third, by conducting this qualitative research in advance of the large-scale survey, we can uncover new and unknown elements of the burden generation process, which provides important guidance into questionnaire, sample, and model design.

Methodology

In each facilitated session, an IBM researcher thoroughly explored various tax topics by asking a small group of participants a series of open-ended questions. In each case study, a trained IBM interviewer conducted an indepth outlined discussion with one or more SB respondents, while a second IBM team member recorded notes and asked followup questions as needed. The key topics of the qualitative research were:

- ◆ Recordkeeping
- ◆ Tax planning
- ◆ Allocation of joint tax and business costs
- ◆ Industry-specific characteristics
- ◆ Paid professional fees
- ◆ Use of tax and accounting software

Facilitated Sessions

IBM conducted four facilitated sessions in October 2003 in two different cities. Figure 1 below details the location of each session, the composition of the group, and the main topics covered during each session.

Facilitated sessions are structured discussions where respondents are free to express their own opinions and interact with other group members. The goal is to encourage contribution to the discussion in the participants' own words; therefore, all responses are open-ended. A moderator guides the group, asking questions and probing responses to solicit indepth feedback. Participants are asked to provide candid answers to questions and are guaranteed confidentiality in all responses provided. Not only do facilitated sessions provide important information, they also provide an avenue for respondents to ask questions of each other. Often, this format allows conversations to progress

Figure 1 - Facilitated Sessions

Location	Composition of Group	Topic
Chicago	Paid professionals	Fees, Record Keeping
	SB Taxpayers (Bookkeepers, Controllers, Accounting Staff)	Record Keeping
Boston	Paid professionals	Fees, Tax Planning
	SB Taxpayers (Owners)	Tax Planning

to topics originally not planned by the moderator, thus allowing for the collection of additional, relevant data not anticipated.

IBM developed three different interviewer guides used to moderate these discussion sessions. Each guide was divided into sections, corresponding to the main topics covered within each group, and contained a series of open-ended questions that were asked of group participants. Participant recruitment was based on specifications provided by IBM and handled by staff at the research facilities where the discussion groups were held. We aimed to speak with a diverse group of businesses in different geographical locations (Midwest and Northeast) who varied in their industry, asset size, and number of employees. Eight to ten individuals participated in each of the four facilitated sessions; two IBM staff collaborated to moderate each group.

One of the main findings from the Phase I qualitative research and our discussions with members of the IRS Working Group¹ was that recordkeeping and tax planning are the two most burdensome activities for small businesses. This drove our decision to concentrate on each of the topics separately in our two facilitated sessions with SB taxpayers. During the session in Chicago with SB taxpayers, we spoke with bookkeepers, controllers, and members of SB accounting departments about their recordkeeping activities; in our session in Boston with SB taxpayers, we spoke with SB owners about their tax planning activities. We felt that these were the appropriate people to speak with because participants in the recordkeeping group spend most of their time maintaining and updating company books and records, while business owners are most often involved in tax planning, either alone or working with a paid professional.

Case Studies

On completing the four facilitated sessions, we set forth to complete 50 case studies. We actually ended up completing 51 case studies and exceeding our target. These case studies were in-depth interviews conducted with individu-

als responsible for tax compliance activities at small businesses. Each interview lasted between 45 minutes and 2 hours. The indepth, case study format allowed IBM staff to establish a rapport with the business owner or employee they were interviewing, enhanced communication channels between the interviewer and the respondent, and allowed for collection of detailed information.

Prior to beginning the interviews, IBM held a training session with all staff to familiarize them with the interviewer’s guide—a reference document for the case study interviews—and to teach them important interviewing and probing techniques that allowed the proper information to be collected. IBM assigned two staff members to each interview: one served as the primary interviewer, and the other was responsible for taking notes and asking important followup questions. This arrangement ensured that information was recorded consistently and that key topics were discussed during each case study. Following the interview, staff would discuss the interview, share notes, and produce a final transcript of the interview.

Seventeen interviews were conducted in person, while the remaining thirty-four were conducted via telephone. Prior to each interview, respondents were sent a letter describing the SB Taxpayer Burden Project and its importance to the IRS, along with a set of lists enumerating tax compliance activities in which businesses are known to engage. Respondents were instructed to look over these lists prior to the interview and mark those activities that they undertake, as well as which activities are most burdensome. Sending information to respondents in advance served two purposes: (1) it prompted them to think about their tax compliance activities prior to the interview, thereby enhancing the discussion, and (2) it allowed IBM to collect information concerning respondents’ most burdensome activities and focus on those activities during the interview.

While we did not aim to conduct these case studies with a statistically representative sample, we did seek diversity across several dimensions: industry, business structure, and geographic location. Figure 2 presents the distri-

Case Study Industry	Frequency
Total	51
Agriculture/Farming	2
Construction	6
Finance and Insurance	5
Manufacturing	5
Professional, Scientific, and Technical Services	13
Real Estate	5
Restaurant	5
Retail	7
Other Services	3

bution by industry for the 51 case studies, and Figure 3 presents the geographic distribution of the small businesses that participated in the case studies.

Region	Frequency
Total	51
East/Northeast	22
Midwest	14
Southeast	5
West	10

For purposes of this study, IBM has adopted the IRS definition of a small business. Only businesses that file a Form 1065 or one of the Form 1120's and have assets of \$10 million dollars or less are under the purview of this study. Figure 4 presents the distribution of business structure for the case studies.

Region	Frequency
Total	51
S-Corporation	29
C-Corporation	17
LLC	4
Partnership	1

IBM used three primary means to recruit businesses to participate in the case study interviews. First, IBM staff recruited business owners who were friends and family to participate in the study. Second, IBM teamed with individuals from the IRS Partners and Stakeholders Office to recruit businesses from a number of business organizations like the National Association of Manufacturers, National Association of Convenience Stores, and Associated Builders and Contractors, as well as several others. Finally, IBM hired a market research company to recruit businesses from certain industries that were difficult to locate.

Representativeness of Results

Readers should exercise caution when generalizing the results presented in this report to the greater SB population. Participants were not selected using statistical sampling techniques, and they represent a very small and nonran-

dom number of individuals relative to the population of interest. Moreover, we did not attempt to secure a sample of participants that mirrors the geographic or demographic distribution of all SB taxpayers. This was a qualitative research study, the purpose of which was to give us a detailed understanding of the decisions and choices made by small businesses with regard to the tax compliance process. As a result, the information obtained is considered descriptive rather than predictive.

Allocating Joint Costs

One of the most difficult challenges in this study is devising a method to allocate the joint costs of tax compliance. Small businesses engage in numerous activities that are important both for effective business management and for Federal tax compliance. For example, most businesses maintain an accounting system and keep records of their transactions. This allows the owners to understand how their businesses are performing at any given time. In addition, these accounting records are used to complete their tax forms and properly figure their tax liabilities.

In order to accurately measure and model burden, IBM must determine which activities are foundational to running a business and which activities are incremental activities solely done for Federal tax purposes. The principal area where this challenge exists is with recordkeeping activities. Foundational business recordkeeping activities are those that the firm undertakes for business reasons and are not necessarily related to taxes (e.g., keeping a chart of accounts). Even if the Federal income tax system were to disappear, these recordkeeping activities would likely continue. In contrast, incremental tax-related activities are those the business undertakes only to support the tax compliance process (e.g., logging exact miles). To make matters even more complex, it is often the case that some portion of an activity is foundational to running a business, while the remaining portion is incremental to filing Federal taxes.

Another dimension where joint costs must be allocated is distinguishing what activities are completed to comply with the Federal tax system versus the State tax system. This is an extremely difficult problem, as many activities that are completed to comply with the Federal tax system also allow taxpayers to comply with State tax regulations.

IBM explored this topic in detail during the qualitative research. We determined that the case study interviews were the best environment to investigate this topic. Therefore, we asked a limited number of questions on this topic during the facilitated sessions, while we engaged in more detailed discussions with taxpayers during the case study interviews. IBM asked participants open-ended questions to better understand which activities taxpayers

believed to be foundational versus incremental, as well as the reasoning behind this distinction. IBM then used the information collected during the interviews along with expert opinion from IBM staff and the IRS Working Group to determine what portion of recordkeeping is attributable to the tax system (i.e., incremental). This allowed us to design survey questions to measure the burden associated with these incremental activities. Key findings related to this topic are reviewed in the Facilitated Session and Case Study sections of this paper.

Small Business Taxpayer Facilitated Sessions

IBM conducted two facilitated sessions, consisting of about 10 participants each, with SB employees and owners to discuss various aspects of their business tax compliance burdens. Discussions centered around two broad themes: (1) burden associated with income tax compliance, and (2) burden associated with employment tax compliance. Participants discussed their experiences with recordkeeping, form completion, making tax payments, tax planning, and working with a paid professional, for both income and employment tax compliance.

The facilitated sessions served as a precursor to the case studies and guided us in selecting the topics to cover in the case studies and the questions to ask about these topics, as well as the types of businesses we wanted to interview. The sections below detail some of the key findings from the facilitated sessions and how the information we collected influenced the design of our case studies.

Recordkeeping

During the facilitated sessions, we spoke with small business employees who were responsible for maintaining records for small businesses, such as bookkeepers, controllers, and accounting staff. The information we collected from this group allowed us to attain a more complete understanding of the set of recordkeeping activities small businesses complete for income and employment taxes throughout the year. We used this information to produce activity lists that guided the interview process during our case studies, allowing us to focus on the most time-consuming activities.

Allocating Joint Costs

We asked several open-ended questions during the facilitated sessions aimed at understanding the ability of taxpayers to differentiate between foundational activities of the business and incremental tax compliance activities. We found

that many taxpayers answered at one of the extremes, explaining either that every activity was foundational to the business, or that every activity was done to comply with the tax rules and regulations. However, a number of taxpayers seemed to grasp the concept more clearly and were able to classify different activities as either foundational or incremental.

Generally speaking, the facilitated sessions taught us that the topic of incremental versus foundational burden is a difficult one for taxpayers to conceptualize. Therefore, we devised some techniques to probe on this topic during the case studies, including: (1) asking taxpayers to distinguish between foundational and incremental components of individual activities (e.g., payroll processing); (2) asking taxpayers to give us the proportion of time that is foundational versus incremental; and (3) asking them how their activities would change if certain portions of the tax law ceased to exist.

Tax Planning

Taxpayers we spoke with during the facilitated sessions engaged in many forms of tax planning. Tax planning activities can be categorized into those that are done exclusively (or primarily) when a business is first started and those that are done on a more consistent basis (e.g., every year). Tax planning activities that are done at startup include deciding how to structure the business, choosing a fiscal year, and choosing an accounting method. Tax planning activities done on a more consistent basis include making investment and financing decisions, considering capital purchases, shifting income between entities or over time, forecasting future tax liabilities, creating employee benefit plans, and devising other tax minimization strategies. We also learned how taxpayers work with different paid professionals for tax planning. We used this information to produce activity lists that guided the interview process during our case studies, allowing us to focus on the most time-consuming activities. In addition, our discussions during the facilitated sessions provided some initial insights into what types of taxpayers engage in different types of tax planning. We designed case study questions to investigate this topic in greater depth because we anticipated its importance in modelling taxpayer burden.

Industry-Specific Burden

The taxpayers we spoke with during the facilitated sessions were from a variety of industries. Our conversations with these taxpayers reinforced our belief that taxpayers from different industries experience unique types of compliance burden. For example, retail businesses have a higher number of transactions than businesses in other industries, and this often leads to more in-

tense recordkeeping activity. Residential developers and construction businesses typically use more complex accounting methods than businesses in other industries; manufacturing businesses are subject to industry-specific capitalization rules; and restaurants must keep records of the tip income collected by their employees. In order to find out more about these and other industry-specific compliance activities, IBM made sure to recruit businesses from certain high-burden industries for the case study interviews.

Small Business Case Studies

To complement the data collected from the four facilitated sessions, we conducted case studies with either the owners or employees of 51 small businesses. These indepth, personal interviews made it possible for us to probe the responses of individuals more deeply than was permitted in the facilitated sessions, given the number of participants in each group and the short time frame. This tactic allowed us to accomplish two main goals: (1) to explore the range of activities the SB taxpayer engages in to comply with Federal income tax and employment tax obligations, and (2) to more thoroughly understand which activities are completed for general business purposes and which are completed for tax compliance purposes. The section below discusses the results of these conversations.

Income Taxes

The following section addresses those activities that SB taxpayers engage in to comply with their income tax obligations. Recordkeeping, income tax form completion and submission, making tax payments, and working with a paid professional were all topics of discussion, and are reported in the sections below. Summaries from certain case studies are also presented to help illustrate the nature and extent of the tax compliance process.

Recordkeeping

Previous studies of SE and W&I taxpayers revealed that recordkeeping is one of the more burdensome undertakings in the tax compliance process. In addition, preliminary research had pointed to recordkeeping activities of SB taxpayers as an area of high compliance burden as well. Thus, one of the primary goals of the case study interviews was to acquire a deeper and more thorough understanding of the small business recordkeeping process. For the purposes of the study, income tax recordkeeping activities encompass all the

activities that the case study respondent (or others at the business) undertook to create, maintain, and store records needed to complete small business Federal income tax forms and pay the firm's Federal income tax obligations.²

According to the case study results, the most often cited burdensome income tax recordkeeping activity for small business taxpayers was:

- Obtaining and organizing tax-related records for such items as automobile, travel, and meals and entertainment expenses.
- Though not nearly as common, a few firms reported the following activities as time-consuming or burdensome as well:
- Using data from the company's recordkeeping system to produce information needed for tax compliance purposes; and
- Extracting data from the recordkeeping system for use in income tax compliance.

SB taxpayers exhibited some common recordkeeping activities. Almost all firms indicated that they:

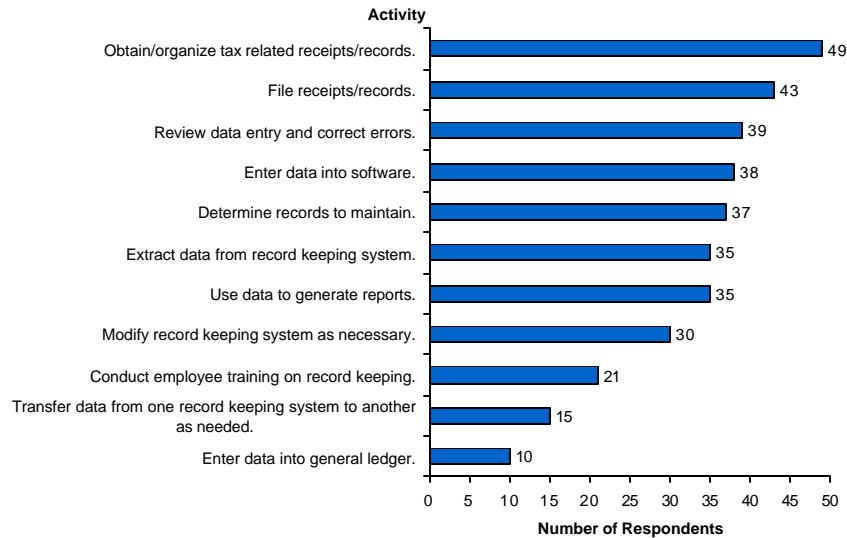
- Obtained and organized tax-related records and receipts; and
- Filed hard copy receipts and records for future use in tax compliance activities.

A majority of small business taxpayers indicated that they:

- Entered income tax information into a software-based recordkeeping system;
- Used data from their recordkeeping systems to produce information needed for tax compliance purposes (e.g., reports of business expenses, reports detailing quarterly taxes paid, etc.);
- Checked inputs into the accounting system for accuracy and identified and corrected errors;
- Determined what records and receipts must be maintained specifically for Federal income tax purposes; and
- Modified their respective recordkeeping or accounting systems to accommodate data necessary for income tax purposes.

Figure 5 presents the distribution of the income tax recordkeeping activities completed by the 51 case study respondents.

Figure 5 - Number of Respondents Who Completed Income Tax Recordkeeping Activities (N=51)



In general, most small businesses have at least one person who is directly responsible for maintaining tax records and documents used for the compliance process. In several instances, this primary tax record keeper had some degree of support from another person at the company.

Most SB taxpayers use some type of automated software to track the daily functions of their respective businesses. Thus, they are able to enter expenses, and record sales and receipts in one central system. Many businesses use software such as QuickBooks or Peachtree, and, in some cases, industry-specific software is employed. The decision to use software, however, is primarily driven by foundational business reasons, rather than solely by tax reasons. A majority of firms reported that they had indeed modified their recordkeeping or accounting systems to accommodate income tax data.

For the purposes of the case study research, recordkeeping activities were separated into three sections. The first section examined what small businesses do to learn about income tax rules in order to determine recordkeeping requirements. The second section focused on what small firms do to create, obtain, and organize or file income tax records. The third section focused on activities that relate to maintaining an accounting system for income tax information. Respondents were asked to give an estimate of the total time they allotted for all of these income-tax-related activities.

When asked about time spent on all these activities, respondents provided a wide range of estimates. While some SB taxpayers estimated that all income-tax-related activities took them 1 or 2 hours per year, others indicated

that such efforts required as much as 40 hours per month. One respondent noted that their fulltime bookkeeper devoted 50 percent of his time on activities pertaining to income tax recordkeeping. In many cases, SB taxpayers experienced a once a year jump in their income tax recordkeeping activities (above normal monthly activities) as they spent more time organizing and collecting items in preparation for the firm's tax return at the end of their tax year.

In general, most small business respondents undertook the task of determining what records and receipts had to be maintained for Federal income tax purposes. While most carried out this particular activity, it was rarely, if ever, viewed as being a burdensome or time-consuming process. A far smaller number of businesses—less than half of those studied—made an effort to educate their employees to ensure that they maintain records necessary for income tax purposes. As might be expected, SB taxpayers did not highlight this as a burdensome activity and rarely reported spending a lot of time on these activities.

Almost every SB taxpayer participating in the case study research obtained and organized tax-related records and receipts. In addition, this particular area was frequently identified as being the most time-consuming of all income tax recordkeeping activities. Tracking meal and entertainment expenses, keeping a daily log of travel miles, and maintaining copies of expenses on capital purchases are examples of common activities respondents considered time-consuming. Respondents suggested that increasing the volume of transactions in this particular category would increase the time needed for tax-related recordkeeping.

A vast majority of firms also reported filing hard copy receipts and records for future use in tax compliance activities, but most SB taxpayers did not report this as a time-consuming element of income tax recordkeeping. Some respondents, though, highlighted the length of time that records need to be kept as a somewhat arduous task (see Firm A).

All SB taxpayers interviewed had some form of system for recording tax information. The case studies revealed that the majority of businesses entered income tax information into a software-based recordkeeping system, while the remainder entered this information into a ledger or other hard-copy recordkeeping system. Furthermore, most respondents reported making some changes or modifications to their recordkeeping or accounting systems in order to accommodate data necessary for income tax purposes. Most SB taxpayers also reported having to check inputs into the accounting system for accuracy while identifying and correcting errors. Additionally, most respondents used or extracted data needed for tax compliance purposes from their respective recordkeeping systems. Fewer businesses reported transferring data from a recordkeeping system to another software package for use in income tax compliance.

Firm A. Tracking Miles, Maintaining Documents for Extended Periods, and Keeping Separate Books

Background: Firm A is a second-generation family owned and operated trailer business that sold its first trailer in the mid 1980s. Their product line consists of small utility trailers, car trailers, skid loader trailers and all sizes of enclosed trailers. Structured as an S-Corp, the firm has 7-8 full time employees, reports sales of roughly \$3 million per year, and has an external accountant assist in generating the corporate tax return at year's end.

Tax Compliance Activities: Firm A conducts the routine process of determining what records and receipts need to be kept for the tax compliance process. The company has an accounting system that houses foundational business operating data as well as records incremental tax compliance data. At year's end, these data are extracted from the company's system and used for the corporate tax return. In all, the respondent (owner) estimated that he spends 4 hours a week on total record keeping activities, one hour of which is dedicated to income tax record keeping.

Most Burdensome Activities: The owner pointed to a number of burdensome activities. In general, obtaining and organizing tax related records and receipts are time consuming. However, within this category, the respondent noted that the "tracking of miles" is particularly time-consuming. The respondent keeps a daily log of personal and business miles. "I would not keep track of miles at all if there were no tax system," he noted. Secondly, Firm A keeps records and documents for at least seven years—a time period driven by tax system requirements. "I have boxes all over the place," the respondent remarked. "If there were no tax system, I would not keep this stuff as long," he added. Finally, Firm A maintains two separate files for inventory and depreciation. If the tax system did not exist, the respondent noted that he would not take inventory as much, and additionally, would not have to "keep his depreciation file open all year around." Lastly, extracting data from the firm's accounting system at year's end to assist the company's tax preparer is viewed as time consuming.

While almost all of the small businesses participating in the case studies used some form of accounting system and interacted with this accounting system for tax compliance purposes, few respondents noted anything in this category that was particularly time-consuming or burdensome. A few businesses pointed to using data from their respective recordkeeping systems as burdensome, while a handful remarked that entering income tax information into a software-based recordkeeping system or extracting data from the system for tax compliance purposes was time-consuming (see Firm B).

Firm B. Depreciation and “Look-back”

Background. Firm B is a construction firm that undertakes long-term projects such as the building of roads, airports, and landfills. The firm varies in size from 10 employees during off-peak work seasons to as many as 150 workers during the summer. The case study respondent for this particular firm was well-versed in dealing with the tax code; he is a CPA and holds an MBA.

Tax Compliance Activities: Firm B uses a software accounting system that costs approximately \$25,000 per year. The respondent also works intensively with the firm’s accountant—with whom he meets with weekly—to determine what receipts and records must be maintained for tax purposes. In addition, the respondent takes time each day to educate employees about what records need to be maintained for tax reasons. The firm spends approximately \$30,000 per year on an external auditor, of which \$12,000-\$15,000 is designated explicitly for preparing the firm’s 1120 form. The firm’s book and accounting system are integrated, and the respondent noted that, conceptually, the separation of the two “cannot be done.” When examining the list of questions used in the case study to describe income tax record keeping activities, the respondent remarked, “this list is three-quarters of my job.”

Most Burdensome Activities: The SB taxpayer in this case pointed to two particularly burdensome activities. First, the respondent noted that depreciation is one of the most difficult and time consuming activities in their tax accounting process. The depreciation process involves three different methods, is done in house, and is then reviewed by the external auditor. The depreciation process was estimated to consume about 100 hours per year of the respondent’s time. The second most burdensome task noted by this particular SB taxpayer involves performing “look-back,” which is associated with the *percentage completion method* of accounting. The respondent reported paying his external auditor \$3,000 to \$4,000 per year to complete the forms associated with the look-back process.

Allocating Joint Costs

As stated previously, an important distinction in the SB recordkeeping process is the division between foundational and incremental tax-related recordkeeping activities. Undoubtedly, and as the case study research on recordkeeping revealed, there are many foundational activities that concurrently facilitate the income tax compliance process; however, one goal of the qualitative research was to isolate incremental recordkeeping activities that are solely attributable to the tax compliance process.

Accordingly, many open ended questions in the case studies focused on having the respondents disentangle what they believed to be tax-related recordkeeping versus foundational business recordkeeping. In several cases, respondents could not identify the difference between foundational and tax-incremental recordkeeping activities. One SB taxpayer noted, “tax accounting and book accounting are the same,” while another respondent remarked, “I don’t think it’s dividable” [referring to the difference between foundational and tax-driven recordkeeping activities].³ By and large, many respondents—while pointing out that business accounting supports the income tax compliance process—engaged the question and tried to separate the amount of time they spent on foundational business recordkeeping from the amount of time they spent on incremental tax-related recordkeeping. Some respondents believe that there would be no changes in their income tax recordkeeping activities if the Federal tax system no longer existed. Other respondents did identify activities that they currently complete only for income tax reasons, such as figuring certain types of depreciation, tracking specific expenses, tracking charitable contributions, keeping records for alternative minimum tax, and maintaining mileage logs for their vehicles.

Form Completion

The case study research sought to draw out possible high burden activities associated with income tax form completion. For the purposes of this study, income tax form completion was defined to include the time that SB taxpayers spent reviewing instructions and publications, completing tax forms, and checking their respective returns. Form completion included activities conducted to complete Form 1120 (U.S. Corporation Income Tax Return), Form 1120S (Federal Income Tax Return for U.S. S-Corporations), or Form 1065 (U.S. Partnership Income Tax Return). As noted earlier, most respondents either worked with a paid professional in the form completion process or had the paid professional undertake the form completion process entirely.

Most SB taxpayers who worked with a paid professional reported reviewing a final version of the firm’s income tax return. Many reported spending more time with paid professionals prior to the end of the tax year in order to give them the information needed to complete the forms. A minority of firms reported making changes to the forms completed by the paid professional. While some respondents reported spending as little as 30 minutes or less, others took several hours or more to review their completed tax forms (see Firm B on page 111). Overall, very few firms highlighted the form completion process as being particularly time-consuming. As most of the firms we spoke with use a paid professional, the burden of form completion appears to be primarily a monetary (i.e., out-of-pocket) burden.

Form Submission

Income tax form submission includes all the activities associated with submitting an annual income tax return to the IRS. Most small businesses we interviewed use a paid professional to help complete Form 1120, Form 1120S, and Form 1065. Generally, these taxpayers have a strong desire to review and verify their income tax returns before submitting them. For this reason, the paid professional will typically provide the taxpayer with a copy of the completed and assembled return. From there, the small business will obtain any necessary signatures, submit the return, and store a copy for its records. In contrast, small businesses tend to be more “hands off” with employment tax forms and often authorize their payroll vendors to submit the required materials on their behalf.

For a number of reasons, small businesses overwhelmingly elect to mail their income tax returns—rather than to e-file. First, most taxpayers do not believe they possess the technical capability to e-file themselves (i.e., “the accountant has to do that”). Since small businesses typically receive their income tax forms to review, they find it easiest to simply mail in the final, checked copy—rather than pass the forms back to the paid professional to e-file. Second, there are restrictions on e-filing that prevent businesses with certain characteristics from submitting electronically (e.g., certain types or combinations of schedules cannot be e-filed). Third, for some business structures such as an S corporation, income tax forms are, in many ways, analogous to information returns. Since these taxpayers typically do not stand to pay taxes or receive a refund, they do not feel compelled to use e-file to accelerate the form submission process (particularly if it involves out-of-pocket costs). Fourth, some taxpayers are simply resistant to change and prefer to mail their income tax returns because they have “always done it that way.”

The SB taxpayers we interviewed engage in a fairly predictable set of activities associated with submitting their Federal income tax forms. The following list includes the most frequently mentioned activities:

- ◆ Obtain signatures for the tax return;
- ◆ Mail the tax return to the IRS; and
- ◆ Store a copy of the return in files.

Taxpayers consistently reported spending very little time or money submitting their income tax forms. Small businesses estimate the whole process takes from as little as 5 minutes to as long as 2 hours. However, on average, it seems most companies spend between 15-45 minutes. Costs also tend to be fairly constant at a few dollars (\$1.00-5.00)—primarily expenses related to

postage and photocopying fees. The vast majority of taxpayers we interviewed do not believe submitting their income tax returns is at all time-consuming. In fact, the little burden that was reported does not seem to be significantly influenced by anything other than the form submission method itself—either mail or e-file.

Making Tax Payments

For the purposes of the case study research, making income and estimated tax payments was defined to include calculating and depositing these payments with the U. S. Treasury. Activities in this area might include applying with the IRS to use EFTPS, making Federal income tax payments by writing a check and sending it to the IRS, making Federal income tax payments electronically by using EFTPS, depositing estimated income tax payments using Form 1120-W, or filing electronically through EFTPS.

Most firms, however, did not undertake activities in this category. Rather, they relied on a paid professional to make tax deposits on their behalf. For the handful of firms that did undertake activities in this category, the most common activity was applying to use EFTPS to make their Federal tax payments. Almost none of the SB taxpayers we spoke with reported spending much time making tax payments. Thus, the extent of the compliance burden in this category seems to be predominantly monetary.

Working with a Paid Professional

Working with a paid professional encompasses all interactions with the professional, including meetings, telephone calls, and paying expenses. Paid professionals include certified financial planners (CFP), accountants, tax advisors specializing in tax planning, tax lawyers, and others who are paid for tax-related services.

Small business taxpayers are motivated to seek professional assistance for a number of reasons. First, they report that staying abreast of all the tax rules and regulations can be difficult and time-consuming. Second, they are concerned about making mistakes or missing opportunities—the consequences of which could lead to stiff penalties or an audit. Third, they may lack the technical resources or tax system knowledge to effectively deal with their income tax obligations. As a result, a high percentage of small businesses hire paid professionals and work closely with them throughout the year.

Small businesses typically select a paid professional based on referrals from friends, colleagues, and business associates. Once an acceptable professional has been selected, small businesses remain very loyal and do not tend to switch. In the case study interviews, the most common reasons given

for changing preparers were: (1) relocating to a new area, (2) differing business or personality styles, and (3) desiring greater communication and interaction. However, more commonly, small businesses indicated that they have worked with the same accountant for the entire life of the business. Over time, it seems the small businesses and their paid professionals develop a strong working relationship that extends beyond just completing forms. Not only does the paid professional help with tax planning activities, he or she also provides business advice and acts as a sounding board for many types of decisions. Often, the paid professional also handles individual income tax returns for the owner and employees of the small business. Taxpayers like this integration because they believe the paid professional understands their situations and can make recommendations that are good both for the business and for the individual. In many cases, paid professionals are paid on a monthly, retainer-type basis (in addition to a one-time yearly charge for preparing the income tax return). This further reinforces the idea that these professionals are trusted advisors and consultants for the small business throughout the year.

With respect to preparation of the Federal income tax return, the paid professional and the small business generally adopt one of two approaches. In the first, the preparer meets with the taxpayer up-front to provide a checklist of required documentation and to discuss any income-tax-related issues. After this meeting, the small business obtains and delivers the required materials, and the paid professional begins to independently complete the return. As questions arise, he or she contacts the taxpayer as needed. Once the forms have been prepared, the paid professional once again meets with the small business to review and revise the assembled return. From there, the final tax return is submitted to the IRS. Throughout the process, meetings can be conducted either face-to-face or through phone or e-mail conversations. In general, the communications are limited to a few hours (e.g., 1 hour for the upfront meeting and 1 hour for the review session).

In the second (and less common) approach, the paid professional sends the small business a checklist with items needed for the return. The paid professional and the taxpayer then hold an interactive meeting where the return is jointly prepared. These meetings can last from a few hours to a full day and involve the paid professional preparing the required forms with input provided along the way by the small business.

The SB taxpayers we interviewed reported engaging in a variety of activities related to interacting with their paid professionals. The following list includes some of the most frequently mentioned activities:

- Compile and arrange records/documents/information for the paid preparer;

- Receive other services from a paid professional (tax planning, preparation of State/local taxes, financial audit, amended return);
- Meet and work with a tax advisor or other paid professional (CPA/CFA, lawyer);
- Meet and work with the paid professional to prepare the return; and
- Review tax return with the preparer.

The amount of time spent working with a paid professional on income tax return preparation ranges from 2 hours to the equivalent of several weeks each year. On average, it seems most taxpayers spend around 2-5 days on their income tax returns—the bulk of which can be attributed to compiling and arranging the required records, documents, and information. The fees charged by the paid professional can vary. This cost usually reflects two types of charges: (1) a monthly, retainer fee, and (2) a one-time, end-of-year fee for return preparation.

During the case studies, small businesses reported the following activities to be the most time-consuming, difficult, or expensive:

- Compile and arrange records/documents/information for the paid professional; and
- Complete a checklist or organizer for the paid professional.

The taxpayers we interviewed reported that these activities are highly burdensome, based both on the degree of difficulty and the time involved. For some, knowing what information is needed and where they can find it can be very troublesome. They worry that misplaced or insufficient documentation may be a “red flag” that increases the likelihood of an audit or penalty. These concerns contribute to perceptions of difficulty and stress among some taxpayers. For others, the real burden lies in the amount of time necessary to compile all the required information. This is particularly true of businesses fitting certain profiles or operating in specific industries. For example, companies that incur nontrivial travel and entertainment expenses must maintain significant amounts of documentation (i.e., receipts, mileage logs, etc.) in order to write off portions of the costs as business expenses. In either case, these burdensome activities were among the most frequently mentioned by our respondents.

Employment Taxes

Employment tax compliance burden can also be considerable and is affected by whether or not a company chooses to employ a payroll vendor or other

paid professional to assume some or all of the responsibilities. Recordkeeping, employment tax form completion and submission, employment tax payments, preparing information returns, and working with a payroll vendor were all topics under discussion during our case study interviews; highlights of each are presented below.

Recordkeeping

Federal employment tax recordkeeping includes all the activities that a small business engages in to create, maintain, and store records needed to complete Federal employment tax forms and pay Federal employment tax obligations. Examples of these records include Form W-4, Form W-5, and data on withholding or payment of FICA, FUTA, and Federal income taxes. However, it does not include general employment tax-related recordkeeping, such as maintaining basic demographic information on employees, maintaining compensation data, and completing Form I-9.

During our case studies, SB taxpayers were asked about four main types of employment tax recordkeeping activities:

- Learning about employment tax rules in order to determine recordkeeping requirements;
- Creating, obtaining, organizing, or filing employment tax records;
- Creating, obtaining, or organizing records needed to determine the tax treatment of various expenses; and
- Maintaining an accounting system for employment tax information.

After interviewing 51 small businesses, two main employment tax recordkeeping approaches have emerged. Most small businesses report that they either: (1) use a payroll vendor, along with a software-based accounting method, or (2) use a software package, but handle the employment tax processing internally. Only in rare cases do small businesses maintain a manual or hard copy ledger accounting system.

The vast majority of small businesses rely on a software-based accounting system to handle their income and employment tax recordkeeping. Many of these taxpayers believe software packages are advantageous because they reflect the most current tax rules and regulations (including recent changes), and they are less prone to computational error. Examples of common applications are Quick Books and Peach Tree. Generally, small businesses use these “off the shelf” software packages; however, sometimes, the company may use an industry-specific product. In these cases, the unique or complex na-

ture of business recordkeeping needs may drive them toward the product that best addresses their particular situations. Most of the time, though, the decision to choose one software package over another is based on cost, features, past experience, or the recommendation of a payroll vendor. After selecting a software package, taxpayers typically receive software updates throughout the year that reflect recent changes to the tax law and, occasionally, new technical features.

Since software use is so prevalent, the primary differentiator with respect to employment tax recordkeeping appears to be the decision to use a payroll vendor. Small businesses that outsource their payroll functions will typically use a software package to generate a report summarizing the hours worked by each employee. From there, they submit this report (or similar paperwork specified by the payroll vendor) to the payroll vendor for processing. Sometimes, this information is submitted via the Internet by entering information in the payroll vendor's web application. As needed, the vendor will make determinations regarding how to treat certain expenses or which are subject to special tax rules. Often, small businesses will even authorize their payroll vendors to make payments on their behalf. As a result, small businesses may need to only review previously-posted payments and deposits made by the vendor to confirm their accuracy. Many small businesses that use a payroll vendor view these end-to-end employment tax services as a significant advantage of this approach. As such, these small businesses can effectively outsource much of the employment tax recordkeeping responsibility and feel reasonably confident that everything is handled correctly.

Another group of SB taxpayers chooses to handle its employment tax recordkeeping without the help of a payroll vendor. In most cases, these businesses continue to leverage their software applications; however, they satisfy tax requirements in different ways. In some cases, small businesses contract with a single accountant or paid professional to handle both employment tax issues and preparation of their income tax returns. In other cases, the business makes employment tax determinations inhouse without the aid of a professional. This situation typically presents itself in one of two cases: (1) the situation is so simple that involving outside help is unnecessary, or (2) the situation is so complex that payroll vendors could not effectively handle the business requirements.

Small business employment tax recordkeeping processes can depend on a number of factors, including maturity of the company, technical expertise, and industry. For example, companies in certain industries, such as agriculture, construction, or services, tend to have work cycles that fluctuate based on seasonal factors or on project-oriented staffing. These conditions will affect the number of employees working at a given time, as well as compensation methods and employee classifications (e.g., full-time, part-time or contract-based). The recordkeeping practices for these small businesses must be suited to their particular needs. Generally though, one individual within the

business typically will hold primary responsibility for overseeing recordkeeping activities, working with the software package (if applicable), and managing the overall payroll process. In the restaurant industry, maintaining records to account for tip income may or may not be a major source of recordkeeping burden, depending on the method used to maintain tip income information (see Keeping Records on Tip Income below).

Keeping Records on Tip Income

Tracking tip income is a recordkeeping activity that is specific to businesses in certain industries such as restaurants and cosmetologists. The paragraph below describes the experience of one of the small businesses IBM interviewed for a case study:

The respondent explained their processes with respect to tip income. Each server is assigned a number in the POS (point of sales) system. At the end of the day, a server cannot clock out without claiming his or her tip income, and the point of sales system has an embedded rule that does not allow claimed tips to be less than what is shown on the summation of credit card slips linked to that particular server. At the end of a pay period, the business analyzes what employees are tipped. If they believe that an employee is underreporting tips, they will issue a warning to that employee (and if the behavior continues, terminate the employee). Any tip allocation issues are handled by the POS system.

If there were no federal tax system, the business would not track tips -- it is only done so that they, "do not get in trouble" with the IRS. But the respondent didn't view the tracking of tip income as a major burden for the business, since the POS system produces all the reports he needs to verify that tip income is being reported correctly. – *Restaurant from the West*

The SB taxpayers we interviewed engaged in a variety of specific recordkeeping activities associated with employment tax compliance. The following list includes some of the most frequently mentioned activities:

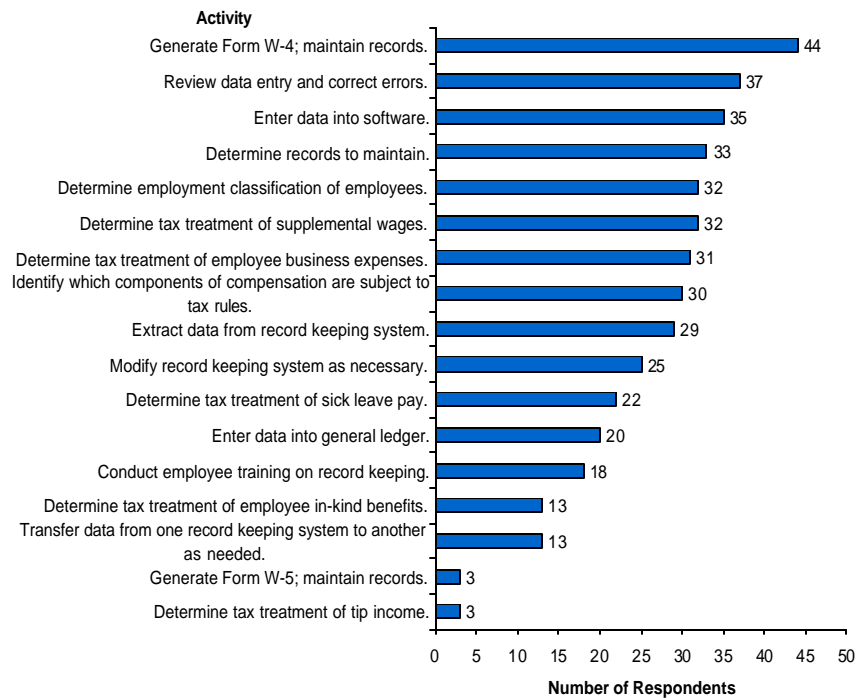
- Creating, obtaining, organizing, or filing Form W-4 (Employee's Withholding Allowance Certificate);
- Entering employment tax information into a software-based recordkeeping system;
- Checking inputs into the accounting system for accuracy and errors; and
- Determining whether workers are classified as employees for employment tax purposes.

Figure 6 presents the number of case study respondents who completed various employment tax recordkeeping activities.

Almost all small businesses spend time coordinating W-4's for their employees. In addition, since a high percentage of small businesses use software, many of the frequently mentioned activities are related to interactions with the accounting system (e.g., entering information, checking inputs, extracting data, etc.). Finally, small businesses often need to make determinations on various issues, such as what records to keep, how to classify workers, and whether special tax rules apply. Therefore, a number of common activities relate to this decision process.

The amount of time small businesses spend on these employment tax recordkeeping varies widely. Of the taxpayers we interviewed, time estimates ranged from as little as a couple hours a month up to 20-30 hours per week. In a few cases, some taxpayers seemed to have trouble keeping employment tax recordkeeping separate from general employment-related recordkeeping. On average though, taxpayers report spending between 2-5 hours per week on their employment tax recordkeeping activities. When asked, small businesses reported the following activities to be the most time-consuming:

Figure 6 - Number of Respondents Who Completed Employment Tax Recordkeeping Activities (N=51)



- Entering employment tax information into a software-based recordkeeping system;
- Extracting data from the recordkeeping system for use in employment tax compliance; and
- Checking inputs into the accounting system for accuracy and errors.

Interestingly, although many taxpayers evidently spend considerable time on employment tax recordkeeping, the number that view these activities as “most burdensome” is actually fairly low. In particular, no one activity is cited as being “most burdensome” more than 20 percent of the time.

Most small businesses report that having a greater number of employees will increase employment tax recordkeeping time and effort—although they indicate that the increase is modest. The biggest jump in burden seems to occur when the business has to send information on the first employee to the payroll vendor or generate a payroll report for the first employee. Thereafter, there is a small marginal increase in burden for repeating the process for multiple employees. Some respondents pointed to further increases in recordkeeping burden that can arise when employees have unusual withholding situations—as is the case with exempt-status employees and certain foreign workers (see Firm C).

Form Completion

Federal employment tax form completion includes reviewing the instructions associated with Federal employment tax forms, completing the forms, reviewing the forms, and making any adjustments to produce final versions of the forms. The primary employment tax forms that small businesses file are Form 941 (Employer’s Quarterly Federal Tax Return) and Form 940 (Employer’s Annual Federal Unemployment Tax Return). Small businesses in the agriculture industry file Form 943 (Employer’s Annual Tax Return for Agricultural Employees) in place of Form 941.

The form completion activities of small businesses are very different depending on whether they self-prepare their employment tax forms or outsource form completion to a paid professional or payroll vendor. While the majority of the SB taxpayers we spoke with use an accountant or payroll vendor, those who keep the activity inhouse often encounter significant time burdens when they complete their employment tax forms.

For the majority of SB taxpayers whose employment tax forms are completed by a paid professional or a payroll vendor, form completion does not

Firm C. Employment Tax Record keeping, Form Completion and Hiring workers from overseas (H-1B visas)

Background: Founded in 1994 and structured as a C-Corporation, Firm C is a high technology company that manufactures products with advanced thin film coatings and nano-materials designed to enhance the performance of next generation products. The firm has about 50 employees and reports roughly \$3.5 million in assets.

Tax Compliance Activities: The firm employs a fulltime comptroller and an accounts payable person, though they use an accounting firm, which costs about \$25,000 per year in a typical year. The accounting firm retained by Firm C provides an array of tax planning services in addition to completing the corporate return. The firm maintains a software accounting system that is leased yearly, and requires upgrades twice per year. The respondent noted that this particular software procurement was "motivated by tax reasons." The comptroller spends about 300 hours per year in preparing what he dubbed "a tax package" which is then sent to the paid preparer who then uses the information to complete the company's return.

Most Burdensome Activities: Of several particularly burdensome activities, the firm's comptroller focused on one. In particular, he pointed to the employment tax recordkeeping and form completion processes associated with employees who are from overseas, and working in the United States on H-1B visas. The respondent noted that there are many cases where it is difficult to determine if these workers are exempt or non-exempt from employment tax. The comptroller spends time researching tax treaties with other nations that determine the withholding status of certain employees. In all, the respondent noted that he can spend 32 hours per year on employment tax recordkeeping items, while the form completion activities can range from 16-80 hours per year—many of these hours involve correctly addressing the H-1B visa workers. The respondent noted that the wide range in estimated hours is due to the fact that if there are errors in a prior quarter or year on the 940, 941 and W-2, it can take hours to do the correction adjustments. In the case of no errors, the respondent would spend very little time on form completion items. Though the firm uses a payroll vendor, that, as the respondent noted, "tries to track these workers," they do not "do a great job." In some cases the comptroller has had to refer to a labor lawyer. In sum, the time spent on employment tax recordkeeping and form completion is largely driven by the H-1B visas employees, thus the compliance burden associated with these activities is directly related to the number of these persons working at the firm.

appear to be particularly burdensome. In these cases, the taxpayer's primary responsibility is to review the completed forms. Owners typically spend less than a ½ hour reviewing these forms on a quarterly basis (Form 941) or an annual basis (Form 940). A number of small business owners spend almost no time reviewing their employment tax returns because they trust that their payroll vendors or paid professionals are providing accurate returns. In fact, some taxpayers were under the misperception that they were not liable for any inaccuracies reported on their behalf by a payroll vendor. The box below illustrates the sentiment expressed by many taxpayers who use payroll vendors when asked about reviewing their employment tax forms (see Taxpayers' Attitudes on page 123).

Naturally, for those SB taxpayers who do not employ a payroll vendor or a paid professional to prepare their employment tax returns, there is a much larger burden associated with form completion. Most small businesses use software packages to do the accounting and recordkeeping for their business.

Taxpayers' Attitudes about Reviewing Employment Tax Forms

While some SB taxpayers who use a payroll vendor or an accountant review their completed employment tax returns, many more spend little or no time reviewing these returns. This is evident in some of their responses:

"E-checks does all this and I believe that they are 100% reliable." – *Retail store from the South*

"I have looked at one employment tax form in the past six months." – *Restaurant from the East*

"I review the forms I receive from my accountant, but don't look at them closely." – *Consulting business from the Midwest*

"With Tilson [a new payroll vendor], I do not even see these forms [940, 941]. With Paychex I used to get quarterly reports, but now I do not review these at all." – *Consulting business from the Midwest*

The most commonly mentioned package is QuickBooks, but some small businesses use such lesser known packages as Great Plains, Solomon 4, or industry-specific packages like Timberline. Businesses that self-prepare their employment tax forms often handle payroll inhouse as well, using the payroll modules of their particular software packages. Businesses provided a number of different reasons why they choose to handle payroll inhouse, several of which are described in the exhibit presented below. The payroll module in software packages will calculate the amount of employment tax (e.g., income, FICA, and FUTA) due for each employee during each payroll period (see *Businesses that Handle Payroll In-House* on page 124).

Some SB taxpayers also use their software to automatically generate their employment tax returns, while others use it only to produce reports that help them prepare their employment tax returns by hand. These reports detail total wages, tax withholdings, and other information, which they then manually transfer to the appropriate line of the employment tax form. The example presented in the box below describes the situation of one taxpayer who prefers to prepare employment tax returns manually (see *Self-Preparing Employment Tax Returns by Hand* on page 124).

Small businesses told us about several burdensome aspects of self-preparing their employment tax forms:

- Software packages generally cannot calculate tax adjustments due to tip income, insurance premiums, sick pay, or prior-period corrections; this becomes a time-consuming and cumbersome task for any SB dealing with these payments;

Businesses that Handle Payroll In-House

A number of taxpayers that we spoke with handle payroll in-house. These taxpayers have diverse reasons for doing so, and here are some of the more interesting justifications:

One taxpayer handles the company payroll in house using QuickBooks Do It Yourself Payroll. She told us that it takes some time to initially set up this system to handle the company payroll, but now it is a relatively easy process. Each year she has to download the tax tables so she is able to withhold the proper amount of tax from each employee's pay. The employees track their own hours and write these hours down everyday and turn timesheets in at the end of the week. The main reason the respondent said she handles payroll in-house is it is relatively easy using QuickBooks and she likes to have control over the timing of payroll (she can issue an employee their check early if necessary, or adjust the timing of payroll in other ways). – *Retail business in the South*

Another taxpayer handles the company payroll in-house using Great Plains software. She does this because in her business, workers are paid varying wages dependent on the job they perform and the client they are servicing. This complicates working with a payroll vendor and the respondent felt it easier to handle this issue in-house. – *Construction business in the Midwest*

Self-Preparing Employment Tax Returns by Hand

Some taxpayers have software that can generate employment tax forms, yet they fill these forms out by hand. One taxpayer explained her reasons for doing this:

The taxpayer told us that the company's software package (Solomon 4) can generate employment tax forms automatically, but the forms often contain errors. As a result, she prefers to use Solomon 4 to produce inputs into the employment tax form (payroll reports), but fill in the return herself so she can verify the accuracy of the information and calculations. – *Consulting company from the Midwest*

- When completing tax forms without the aid of a paid professional, it is often difficult for a small business to understand and review IRS instructions and publications associated with Forms 940 and 941; and
- One respondent found computing FUTA credit for contributions made to State unemployment funds difficult because “rules regarding unemployment funds can change quickly.”

The time it takes taxpayers to self-prepare their employment tax returns varies from business to business: estimates for preparing the quarterly Form 941 range from 30 minutes to 8 hours, while the time it takes to complete Form 940 annually ranges from 15 minutes to 8 hours. Some of this variation may be attributable to differences in the amount of time the business spends reviewing and checking information in completed returns.

Form Submission

Form submission in and of itself does not appear to generate significant burden. Payroll vendors often submit forms on behalf of their clients and mail a copy of the return to the client for their records. Taxpayers who use a paid professional to prepare their returns often receive a file that contains completed employment tax returns (including a copy for their files) that are ready to be reviewed and submitted. On average, it takes these taxpayers a couple of minutes per quarter to complete this task.

Those companies that self-prepare their employment tax returns have the option of mailing their paper returns to the IRS or filing them electronically. E-filing reduces the burden of tax form submission (by reducing travel time to the bank or post office); however, our research found that the majority of businesses interviewed did not file electronically. There are a number of reasons that taxpayers choose not to e-file their employment tax returns, including inertia, low burden associated with mailing the return, and lack of knowledge that e-filing exists. The quotes contained in the box below illustrate these reasons (see *Why Don't More Taxpayers E-file?* below).

Why Don't More Taxpayers E-file?

The quotes below provide insights into why so few small businesses e-file employment tax returns:

"I don't care to e-file my forms because mailing them is not labor intensive and only takes a couple of minutes a quarter." – *Construction company from the Northeast*

"[My] company never considered e-filing because [the] owner is not comfortable with electronic/internet payment methods." – *Construction business from Northeast*

"My company has always submitted via paper. I have not signed up for e-filing because I thought it was restricted to larger companies." – *Consulting business from the Midwest*

Making Tax Payments

Employers must withhold taxes from employees' compensation each pay period and are responsible for depositing this tax to the IRS periodically. The frequency of deposits is determined by the amount of tax liability the business reported on Form 941 in a 4-month look-back period. Small businesses engage in very different payment activities depending on whether they use a payroll vendor or make tax payments themselves.

Typically, taxpayers who use a payroll vendor authorize them to make employment tax payments on their behalf. For these taxpayers, making employment tax payments consumes no time whatsoever. Many taxpayers who authorize their vendors to make these payments explained that they verify payments by looking at their checking account balances. Taxpayers who submit employment tax payments themselves may use several methods to do so. Those who use software systems report that the system will remind them when it is time to make payments. They can make payments by mailing a check along with Form 8109 to the IRS. Alternatively, they can submit payments electronically by using the EFTPS system. Taxpayers must apply to use the EFTPS system, and some taxpayers are required to use it because of the size of their liabilities. EFTPS payments can be made via telephone or online or by calling a financial institution like a bank that participates in the system.

Some taxpayers told us that applying to use EFTPS was somewhat burdensome, while others explained that the process was very simple. However, it seems that almost all taxpayers agree that making tax payments via EFTPS is extremely simple and reduces burden by saving them a trip to the bank. As one Consulting firm from the Midwest stated, "The process of applying to use EFTPS was difficult, but it only had to be done once." She had to provide her name and address multiple times, and she noted that she had to call and get her PIN numbers. There was significant paperwork and phone calls to the IRS. It seemed like a cumbersome process to her. "All in all, the whole process was difficult to set up, but ended up being better in the long run."

Taxpayers told us that making tax payments using either EFTPS or mailing a check and submitting Form 8109 takes less than a ½ hour each time deposits are made; most spend 5 minutes or less on this activity.

Information Reporting

Following the end of the calendar year, small businesses are responsible for furnishing Form W-2 to all employees and Form 1099 to all contractors em-

ployed during the year. Once again, businesses that use payroll vendors have different experiences than businesses that handle payroll inhouse.

Businesses that use payroll vendors typically spend very little time on information reporting. The payroll vendor prepares and provides the SB taxpayer with Form W-2 for each employee, and all that is required of the SB taxpayer is to review these forms and distribute them to his or her employees. However, should an error be found when checking their W-2s, SB taxpayers must spend a significant amount of time working with the payroll vendor to correct the mistake. Businesses that use contractors to complete certain projects typically receive completed Form 1099's from their vendors as well.

Those companies that do not use a payroll vendor typically use their software systems to generate Forms W-2 for employees and Forms 1099 for contractors. They spend time producing, reviewing, and distributing these informational returns. Taxpayers reported devoting a wide range of time to this activity, from 1 to 20 hours annually. One taxpayer explained that the most difficult thing about preparing Form 1099 is tracking down identification and contact information for each contractor (see Burden Associated with Form 1099 below).

Burden Associated with Form 1099

One respondent reported that in his business, he uses numerous vendors particularly for specialty food items. If he does not record them at first, the respondent reported that at the end of the year his accountant will provide him with the vendor's SSN and require the respondent to track down the vendor in order to gain information to prepare a 1099 form. He reported that this is an extremely time consuming process that he goes through at the end of each year.
- *Restaurant on the East Coast*

Similarly, those companies with high turnover and numerous employees also have difficulty finding employees to furnish W-2's to at the end of the year (see Burden Associated with Form W-2 below).

Burden Associated with Form W-2

One respondent finds it frustrating to track down employees who have moved in order to send them their W-2 information.-*Restaurant Owner from the West*

Working with a Payroll Vendor

The SB taxpayers we interviewed reported using a variety of different payroll vendors, with the most popular being ADP and Paychex. In addition to these nationally known firms, several businesses use small regional or local vendors whom they feel provide an equally high level of service at lower cost to their businesses. Through our interviews, three primary reasons for using a payroll vendor emerged. These are presented in Reasons for Using a Payroll Vendor below.

Reasons for Using a Payroll Vendor

1. Cost Savings – Many of the SB taxpayers we interviewed explained 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.

2. Accuracy of Payroll/Employment Tax Information – Taxpayers also explained 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.

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

While most of the burden of using a payroll vendor is monetary, SB taxpayers do report devoting some time to payroll activities themselves. These ongoing activities can take anywhere from a few hours a month to a much greater amount of time. The primary activities they engage in are:

- Transferring employee data to the payroll vendor (e.g., Form W-4 information and other payroll-related information such as hourly wages, deposit information, etc.);
- Transferring employee hours and other compensation information (e.g., commissions, tips, bonuses, etc.) to the vendor each payroll period;
- Reviewing and filing reports received from the vendor following each payroll period;

- Reviewing and filing tax forms prepared by the vendor on a monthly and quarterly basis;
- Reviewing informational returns prepared by the payroll vendor; and
- Contacting the vendor to discuss any mistakes that occur during a payroll period or on a tax form or informational return.

Depending on the types of services received from their payroll vendors, respondents reported paying between \$60 and \$500 per month. Some payroll companies charge by the number of W-2's processed. This can be a costly measure for those companies with high turnover or seasonal employees. One respondent reported that her payroll vendor charges \$25 per employee, per pay period, but she is comfortable paying this fee as most of her employees are contractors; she has very few full-time employees. Some vendors prepare an itemized bill for their clients, while others provide only a total amount.

In addition to the basic fees noted above, there can also be significant startup costs when a business begins working with a vendor. These include fees for training sessions, setting up software, and consolidating and transferring information to the payroll vendor. Some SB taxpayers found this to be a small task, while others experienced significant burden.

Regardless of the costs associated with particular services, most respondents see significant value in using a payroll vendor. Small business owners do not mind paying what they see as a nominal monthly charge to save them time in the long run.

When asked to consider how their behavior might change in the absence of a Federal employment tax system, respondents were split on the decision of whether or not they would continue to use a payroll vendor. One respondent of a business strategy firm explained that his primary motivation in using a payroll vendor is to ensure accuracy in his withholdings and eliminate the time associated with completing employment tax forms and making tax payments. As a result, he sees the entire fee as a tax compliance cost. Other businesses felt that they would continue to use a payroll vendor in the absence of taxes because it is a business function that is better handled by a third party vendor.

Tax Planning

From our qualitative research conducted during the design phase of this project and discussions with the IRS Working Group, IBM learned that, along with recordkeeping, tax planning compliance activities are considered to be among the most time-consuming that a SB taxpayer can engage in. Interviews with

SB employees and owners during our case study research confirmed this finding.

Tax planning encompasses a wide range of activities, including evaluating tax-related aspects of the business, performing related calculations, and making decisions on these issues. Tax planning is very different from all other tax compliance activities because there are no rules governing what type of tax planning must be done or when to complete it. For example, the types of records that small businesses keep, the schedule for completing and submitting forms, and the schedule for making tax payments are all mandated by the tax code. Conversely, the level of tax planning conducted by a small business and the timing of these activities are determined by the preference of the business owner and his or her paid professionals.

The 51 case studies that we completed with small businesses allowed us to better understand the following:

- The major types of tax planning that small businesses engage in and when they are performed;
- The types of small businesses that are most likely to engage in tax planning; and
- How small businesses work with paid professionals to conduct tax planning.

The following sections will highlight our key findings on these topics.

Major Tax Planning Activities

During the case study interviews, we asked taxpayers about the various tax planning activities that they complete. As presented in Figure 7, the most common tax planning activities completed by businesses are:

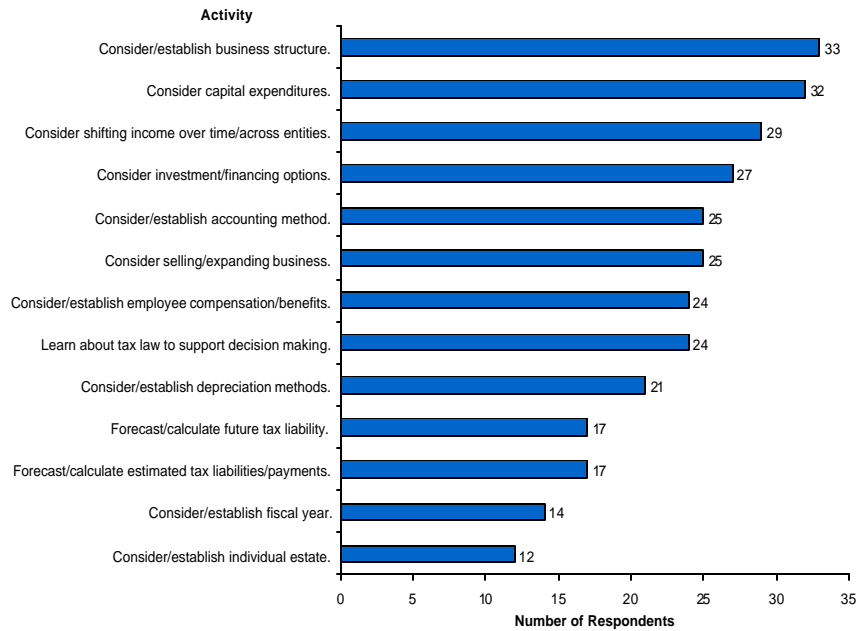
- Tax planning to decide how to structure the business; and
- Considering the tax implications of capital expenditures.

The majority of businesses also completed the following tax planning activities:

- Tax planning related to shifting income over time or across entities;
- Tax planning in regard to investment and financing decisions;
- Considering the tax implications of business accounting methods;

- Considering the tax implications of alternative compensation and benefit packages for employees; and
- Considering the tax implications of selling or expanding the business.

Figure 7 - Number of Respondents Who Completed Tax Planning Activities (N=51)



Structuring the Business and Choosing an Accounting Method

When small businesses are born, the owners have numerous decisions to make. Among these are general business decisions, such as where to locate the business, how to market the business, and how many employees to hire—as well as tax planning decisions, such as how to structure the business, what accounting method to use, and what fiscal year to operate within.

Deciding how to structure the business has important tax consequences, as it determines whether income is passed through to individual owners (e.g., S corporations and Partnerships), the rates at which income is taxed, what

types of tax deductions and credits the business can take, and the types of tax compliance activities the business will have to engage in. Through the case studies, we discovered that most businesses make these types of decisions with the assistance of a paid professional. The new business owner sits down with a paid professional who presents different options and typically recommends a particular structure to the owner. The owner, in turn, makes the final decision concerning how to structure his or her company. Once these fundamental decisions are made, there appears to be a significant amount of inertial behavior. Small businesses avoid revisiting these structural decisions, regardless of how their tax situations or business environments change. This inertial behavior is evident in some of the responses we received when we asked SB owners if they ever considered changing their structures.

Another type of tax planning that occurs during the startup of a business is deciding what accounting method to use for the business. This is another decision where paid professionals typically advise businesses, as it can be fairly complicated. Often the business accounting method is dictated by tax rules, and, in this case, there is no tax planning involved. We discovered that businesses often use different accounting methods for book and tax purposes. This hybrid approach is most common in cases where the businesses use accounting software that allows the owner to switch between a cash or accrual accounting method with the click of a button.

A third tax planning decision that businesses make at startup is determining the fiscal year. This decision is usually based on a number of factors. The taxpayers we spoke with provided the following reasons for deciding to use a fiscal year other than the calendar year:

- They did not want their individual returns and business returns to be due at the same time; so, they chose a different fiscal year for the business; and
- Their business is seasonal and they wanted to avoid cash flow problems in paying their income tax liabilities; so, they chose an appropriate fiscal year.

As with the other important tax planning decisions discussed above, paid professionals often assist taxpayers in choosing a proper fiscal year.

Capital Purchases, Investment and Financing Decisions, Compensation Plans, Shifting Income, and Expanding the Business

In addition to the tax planning that is done when a business is born, many businesses engage in regular tax planning on an annual basis. The most com-

mon types of tax planning completed on a yearly basis are:

- Tax planning related to making capital purchases;
- Considering the tax implications of investment and financing decisions;
- Shifting income over time or across entities;
- Forecasting future tax liability under alternative scenarios; and
- Tax planning related to compensation of owners and distributions from the business (S corporations and Partnerships).

Several of these activities go hand in hand. For example, most businesses engage in tax planning toward the end of the year (e.g., the end of the third quarter) by forecasting their tax liability for that year under various scenarios (e.g., strong fourth quarter versus weak fourth quarter). If they have tax liability that they want to reduce, one option is to make a capital purchase or some other type of purchase to fulfill a business need. The SB taxpayers we spoke with provided numerous examples of purchases they have made at yearend to reduce their tax liabilities. Many businesses told us that they try to reduce their taxable incomes to either zero or below a particular threshold (see Examples of End of Year Capital Purchases below).

Examples of End of Year Capital Purchases

Businesses that we interviewed made many different types of end of year capital purchases to reduce their taxable income. Here are a few examples:

Apple iMac computer and monitor equipped with the latest graphic design software – *Graphic design business from the Midwest*

Chevy Yukon Denali sport utility vehicle that is used strictly for business and can be expensed under Section 179 – *Consulting business from the Northeast*

Renovations to the restaurants kitchen and dining room as well as a new oven – *Restaurant from the West*

Another technique used by businesses to reduce tax liability is shifting income over time or across entities. Throughout the case studies, businesses explained that they often shift income over time, waiting until the following tax year to collect payments from their customers and clients. Similarly, businesses can also reduce their taxable incomes by shifting income to other

businesses that they own, or to the individual owners of the business (see Investment and Financing Decision in the Real Estate Industry below).

Investment and Financing Decision in the Real Estate Industry

Description of the Company: IBM interviewed a real estate development/city planning business located in the West. The business finds underutilized pieces of land owned by state and local governments and develops plans in conjunction with these municipalities to redevelop and revitalize these underdeveloped areas. The respondent described a typical project as one where they construct a new city hall for the municipality with shops, restaurants, and parking nearby. The respondent's business produces the development plan, hires the engineers, architects, and any other necessary workers and manages the project to completion. They have projects in cities in several states including CA, ID, and IA.

Tax Planning Activities: This business engaged in some sophisticated, industry specific tax planning strategies. For example, they are often interested in acquiring properties and many of these properties are acquired through like-kind exchanges, where one property (e.g. a building) is exchanged for another similar property. By using a like-kind transaction the business does not have to recognize a gain or loss on the transaction (Section 1031 of the Internal Revenue Code). Similarly, when they are interested in disposing of an asset like a building the sometimes use installment sales to do so. This results in tax planning to decide how to properly report income from these installment sales.

In addition to the tax planning activities mentioned above, many taxpayers also engage in tax planning related to providing alternative compensation and benefit packages for their employees. This is not typically done on an annual basis, but can occur as often as every few years. The businesses that we spoke with considered offering a number of different compensation and benefit plans, and the tax implications of these plans often influence owners in deciding what plan to offer.

For those businesses that engage in tax planning on a regular basis, the majority explained that they begin tax planning activities near the end of their fiscal years—usually between the end of the third quarter and the beginning of the fourth quarter. In many cases, the first step is a meeting with their paid professionals to assess where the business is and to consider different tax planning strategies. These meetings typically involve high-level officers of the company and can take place over lunch or in the office. After plans are made, the business will implement the plan with the assistance of the paid professional. Respondents estimated that they spent between 2 and 40 hours annually on tax planning.

Businesses Most Likely to Engage in Tax Planning

While most small businesses engage in some degree of tax planning, we found that businesses with certain characteristics are more likely to engage in extensive tax planning. The first characteristic is whether or not the business is profitable. Businesses that are making money are more likely to have taxable incomes and thus have greater incentives to engage in tax planning to limit their tax liabilities. Conversely, businesses that are not making money seem less inclined to engage in tax planning (see quotation directly below).

“If the financial position of the company solidifies, I foresee engaging in more tax planning and using our CPA along with another tax specialist to assist with this planning.” – *Manufacturing business from the West*

A second characteristic that influences the level of tax planning is the sophistication of the owner and other company executives. We found that businesses with executives who have extensive business or accounting backgrounds are more proactive when it comes to tax planning. Finally, the accountant that a business uses has a strong influence on the level and type of tax planning a business engages in. Some accountants are especially creative in developing tax planning ideas for their clients and regularly initiate conversations to discuss these options. This encourages business owners to engage in more tax planning. Some SB owners expressed dissatisfaction with the tax planning services they are receiving from their paid professionals.

Achieving Research Objectives

The qualitative research completed in this phase of the SB taxpayer burden study was designed to support three major research objectives. First, it was intended to guide development of the taxpayer and tax professional questionnaires by providing more detailed information on activities that compose the tax compliance process. Second, it was intended to augment and enhance the data that will be available for model estimation and production. Third, it was intended to guide the modeling effort by shedding light on the decisionmaking process and the burden generation process for SB taxpayers. This section explains how key findings from our qualitative research are helping us to achieve these three research objectives.

Guide Questionnaire Development

Careful questionnaire development should begin with some form of qualitative research. This research—whether in the form of facilitated discussions, case studies, or some other technique—allows the researcher to gain a deeper insight into the research question at hand prior to writing the questionnaire. When studying a new population, as we are with SB taxpayers and their paid professionals, interviews of some sort should be conducted to better understand their issues and practices. Armed with this qualitative information, researchers can write survey questions that are targeted to the population under study. Without this information, researchers are likely to write questions that are extraneous or unfocused, rendering the resulting data less useful.

The qualitative research conducted during this phase of the SB taxpayer study helped us to: (1) assign relative priorities to different topics and activities in the questionnaire, (2) determine which activities taxpayers perceived to be tax-related and burdensome, (3) identify which concepts were difficult for taxpayers to understand, thus requiring additional context or probes, and (4) revealed new relationships and issues that were not previously apparent.

In sum, the qualitative research allowed us to uncover facts about SB taxpayers and their paid professionals that we could not have divined on our own. In addition, it confirmed many of our intuitions and working hypotheses. This research has already proven beneficial, and it will continue to contribute to the quality of the questionnaire and the survey data as we go forward.

Enhance Survey and Administrative Data

The qualitative information collected in this task will also provide a foundation from which to evaluate other data, such as IRS administrative data and the data collected in our forthcoming survey. In cases where we would like a more complete picture of the data, we will be able to review the facilitated discussions and case study interviews to gain a better understanding of the underlying taxpayer behaviors and perceptions. By combining IRS administrative data, survey data, and qualitative data, we will have a very robust and comprehensive set of information to use throughout the course of the project.

Our qualitative research also offers useful context when interpreting quantitative data that seem to provide ambiguous or incomplete information. This context is particularly useful in the model development process for a variety of reasons. For example, qualitative findings can provide a “reality check” on misleading patterns in the quantitative data. Conversely, it can assist in the identification, simulation, and calibration of subtle but important patterns in the quantitative data.

Guide the Modeling Effort

The primary objective of the SB Burden Model is to provide accurate estimates of total time burden and total out-of-pocket burden for the SB population under a variety of scenarios. While much of the model will be developed using quantitative data, there are a number of important elements of the model that can be developed only with the use of our qualitative research results.

Several “behavioral” simulation levers will be incorporated into the model to reflect the importance of taxpayer decisions and behaviors in the burden generation process. These behavioral levers will be used to simulate changes in the characteristics or distribution of the small business taxpayer population—changes that can occur over time as a result of economic conditions, policy changes, or administrative initiatives. Although taxpayer behavior will be measured in the survey, the qualitative research we have conducted will supplement this information, allowing modelers to fully understand why certain behaviors are present in the SB taxpayer population and what factors influence these behaviors.

The qualitative research has also provided insights that will inform the attribute development and estimation. For example, the case studies have confirmed our belief that the intensity or volume of an activity will impact the corresponding burden—and it has pointed to potential measures of intensity that could be used in model estimation and production (e.g., number of employees, number of transactions, and number of depreciable assets).

Endnotes

- ¹ The IRS Working Group is a group of stakeholders from IRS, OTA, GAO, and SBA that IBM meets with approximately once a month to discuss key project issues.
- ² Specific examples of income tax recordkeeping include keeping records of expenses that are used for tax purposes, such as capital purchases and tax-deductible expenses.
- ³ Still, the latter respondent did go on to render an estimate of the amount of total recordkeeping time that he devoted to tax-related activities.