



A FairTaxSM White Paper

What the federal tax system is costing you – besides your taxes! Tax compliance facts

The tax gap affects all taxpayers.

In her testimony before Congress, Nina Olson, the National Taxpayer Advocate, said the following regarding the impact of noncompliance on taxpayers, in general:

“If we divide the 2001 net tax gap estimate of \$255 billion by 130 million individual taxpayers, we can see that each of those taxpayers in 2001 paid, on average, an extra \$2,000 to subsidize the unwillingness or inability of some taxpayers to pay their fair share.”¹

In 2001 the average taxpayer paid \$8,265 in taxes. With an estimated tax gap – which is the difference between what taxpayers should pay and what they actually pay on a timely basis – of \$345 billion,² this means that the 130 million taxpayers paid on average \$2,649 *more* in taxes to subsidize the unwillingness or inability of some taxpayers to pay their fair share.

In other words, if everyone paid the taxes they owed, average individual income taxes paid per taxpayer could have been 32.1 percent *less*.

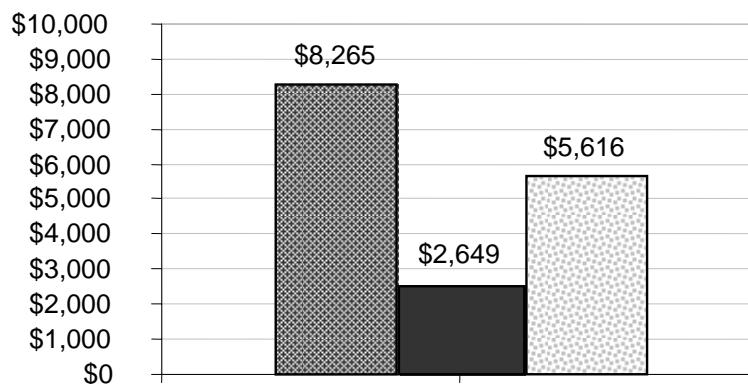
Individual tax return data, 2001	Amounts	Average taxes	Percent change
Individual income taxes	\$1,076,500,696,000	\$8,265	
Number of returns	130,255,237		
Tax gap	\$345,000,000,000	\$2,649	
Taxes w/o tax gap	\$731,500,696,000	\$5,616	-32.1%

¹ Olson, Nina E., National Taxpayer Advocate, “The Tax Gap and Tax Shelters,” Taxpayer Advocate Service, Testimony before the Senate Committee on Finance, July 21, 2004.

² These revised tax gap findings for 2001 come from a three-year study called the National Research Program (NRP), which audited 46,000 individual income tax returns for 2001. See “IRS Updates Tax Gap Estimates,” IR-2006-28, February 14, 2006.

Average tax burden with and without the tax gap

■ Average taxes ■ Tax gap ■ Average taxes w/o tax gap



Without the tax gap, average taxes would be 32% less.

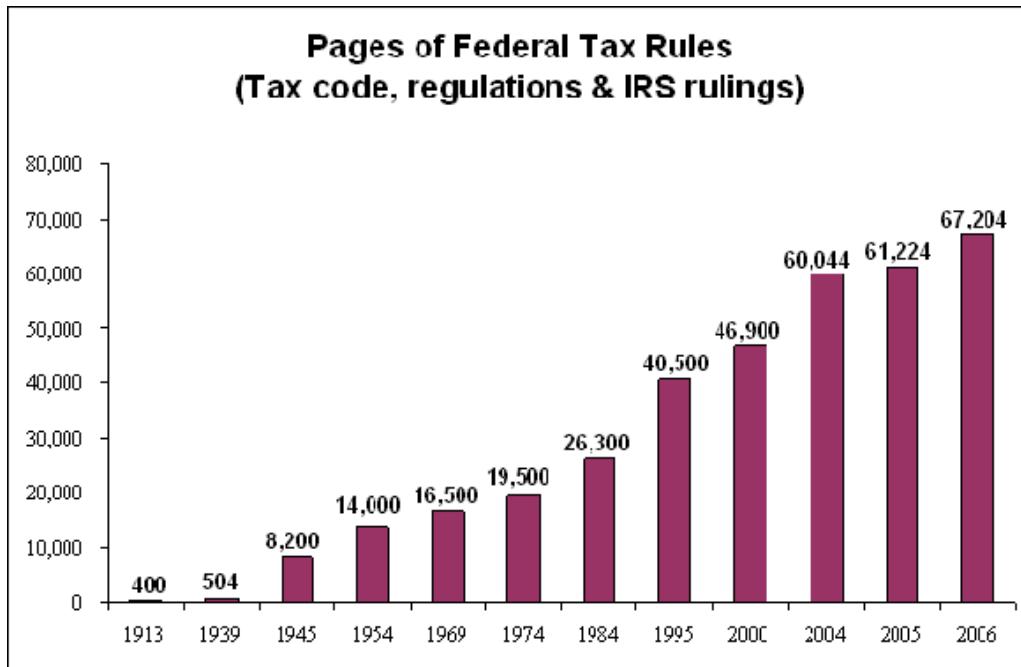
The cost of compliance

Income tax compliance costs as a percentage of revenue have been estimated as 18 percent by the Tax Foundation's Art Hall, 10 percent by Joel Slemrod of the University of Michigan's Business School, 24 percent by author James Payne, and 22 percent by the Tax Foundation.

Who pays?

The compliance burden is the total time and money wasted on filling out tax forms, keeping records, learning tax rules, and other tax-related chores. According to Commerce Clearing House, since the inception of the income tax in 1913, the number of pages of tax code, regulations, and IRS rulings that individuals and businesses must comply with has grown from 400 pages to a whopping 67,204! Just since 2000, it has increased 43 percent.³

³ Commerce Clearing House, Inc., www.cch.com/wbot2006.



Time is money.

According to a detailed study by the Tax Foundation, in 2005 individuals, businesses, and non-profits spent an estimated 6 billion hours complying with the federal income tax code at an estimated cost of over \$265.1 billion. This amounts to imposing a 22.2-cent tax compliance surcharge for every dollar the income tax system collects.

A compliance burden of 6 billion hours per year represents a work force of over 2,884,000 people: Larger than the populations of Dallas (1,210,393), Detroit (900,198), and Washington, D.C. (553,523) combined; and more people than work in the auto, computer manufacturing, airline manufacturing, and steel industries combined.

Projections show that by 2015 compliance costs will grow to \$482.7 billion.⁴

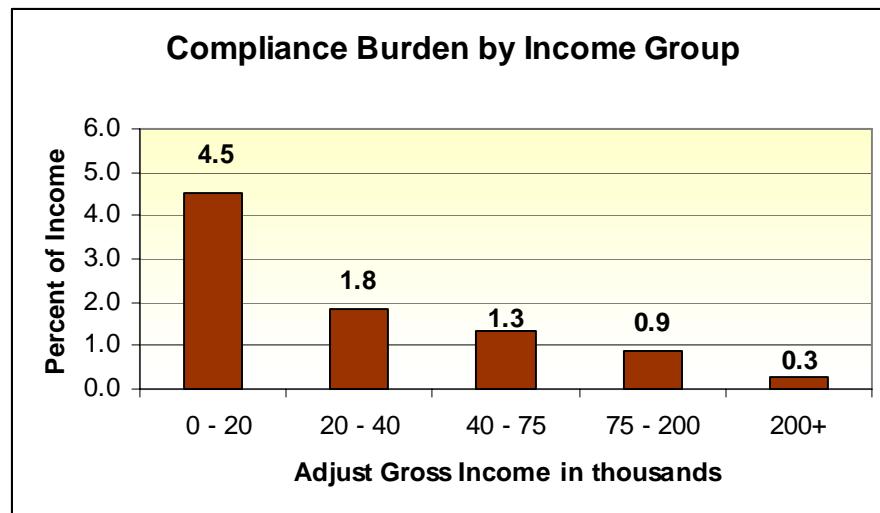
Compliance costs are regressive.

Business pays 55.7 percent of compliance costs, individuals 41.7 percent and non-profits 2.5 percent.

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

⁴ Moody, J. Scott, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation, Special Report No. 138, December 2005.

⁵ Ibid.



The working poor

No less than 72 percent of Earned Income Tax Credit (EITC) filers used paid tax preparers for their 2004 tax returns. They were forced into this expense because even the EITC, created to help the working poor, has a taxpayer guide that is 55 pages long. In fact, in 2001, fully \$1.9 billion or 6 percent of the \$32.4 billion in total EITC claimed went to the payment of tax preparation services, filing fees, and payments for refund anticipation loans. (These are loans made to EITC filers in the amount of their expected tax refund.) Because of the complexity of this program, it has a high level of noncompliance. Of the \$30.3 billion in EITC payments in 1999 (according to a 2001 GAO report), 27 to 31.7 percent were overpayments. This amounts to \$8.5 to \$9.9 billion, enough money to fund the entire operation of the IRS for a year.

Compliance costs hit small businesses hard.

“In 1991, for example, the last year the cost of the system was examined in depth, businesses spent three-fourths as much to comply with the tax laws as they paid in actual tax. The compliance burden is especially heavy on small corporations. Corporations with assets of \$1 million or less (more than 90 percent of all corporations) paid a minimum of \$382 in compliance costs for every \$100 they paid in income taxes (\$14 billion in compliance costs for \$3.7 billion in income taxes). That represents about 90 percent of compliance costs for all corporations and about 4 percent of all corporate income taxes. Corporations with \$250 million or more in assets paid about \$3 in compliance costs for each \$100 they paid in income taxes.”⁶

In 2004, the average American business taxpayer spent \$894 per employee on tax compliance activities, but small employers (with less than 20 employees) spent \$1,304 per employee.⁷ The average cost per employee for small businesses was almost twice the per-employee cost for the average large business.

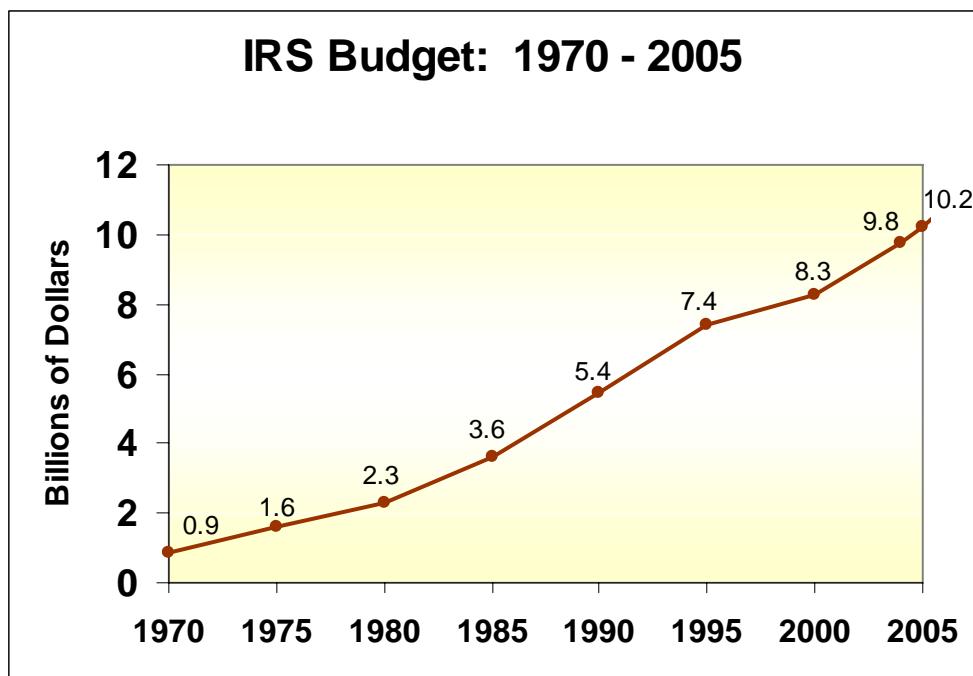
⁶ Mastromarco, Dan R., and David R. Burton, “The Internal Revenue Code: Unequal Treatment Between Large and Small Firms,” a study commissioned by the National Small Business Association, May 1, 2001, p. 46 from data by Hall, Arthur P., “The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws,” Tax Foundation Special Brief, January 1995.

⁷ Crain, W. Mark, “The Impact of Regulatory Costs on Small Firms,” Office of Advocacy, U.S. Small Business Administration, Small Business Research Summary No. 264, September 2005.

To quote the 2005 report to the President from the Small Business Administration: “One reason for the high per-employee cost to small businesses is the level of complexity in the tax code. There is a substantial burden in paperwork and recordkeeping for any firm with a payroll, even before the first paycheck is cut.”⁸

IRS administration and enforcement costs

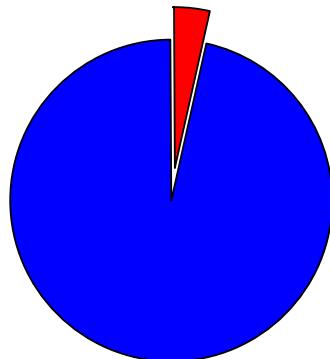
In addition to the private sector cost of tax compliance, is the government spending to administer and enforce the tax code: The IRS budget.



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

⁸ “Chapter 6: A Discourse on Tax Complexity and Uncertainty and their Effects on Small Business” in *The Small Business Economy: A Report to the President*, Office of Advocacy, U.S. Small Business Administration, September, 2005, pp. 145-146.

2005 IRS Budget & Compliance Costs



■ IRS Budget = \$10.2 ■ Compliance Costs = \$265.1 billion

The FairTax slashes compliance costs.

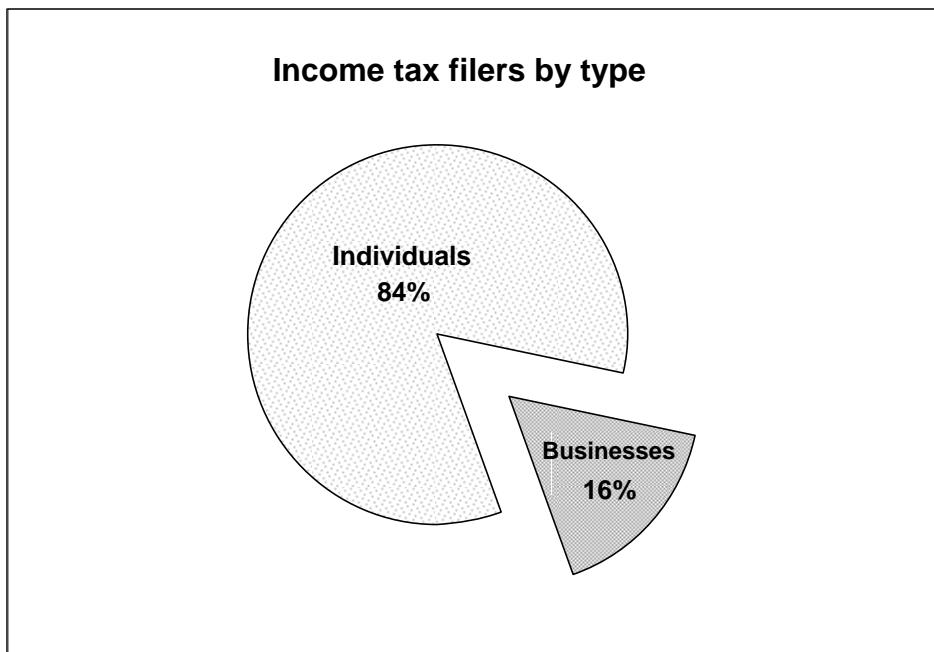
Of the 508 million income tax forms that were filed in 2005, at least three out of four were filed by individuals (387 million). Under the FairTax, individuals do not file tax returns. Only businesses who sell goods or services at retail are required to file tax returns. They remit the FairTaxes they collect on consumer purchases along with their state sales taxes once per month. They no longer have to administer income tax withholding and payroll tax deduction on wages paid to their employees on behalf of the federal government.

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

Income tax filers by type

Type of filers	Number of filers	Percent of total
Individuals	130.3 million	83.8%
Businesses	25.2 million	16.2%
Sole proprietorships	19.8 million	12.7%
Partnerships	2.4 million	1.5%
Corporations	3.0 million	1.9%
Total	155.5 million	100.0%

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

**And that's not all.**

The efficiency costs of the federal tax system dwarf compliance costs. Efficiency costs occur when tax rules distort the decisions of individuals and businesses regarding work, savings, consumption, and investment. By changing the relative attractiveness of highly taxed and lightly taxed activities, taxes alter decisions such as what to consume and how to invest. When taxpayers alter their behavior in response to tax rules, they often end up with a combination of consumption and leisure that they value less than the combination they could have achieved if they made decisions free of any tax influences. This reduction in value is a welfare loss or efficiency cost. According to research by the Government Accountability Office, efficiency costs are on the order of magnitude of two to five percent of Gross Domestic Product (GDP).¹⁰ Based on GDP of \$13.259 trillion in 2006, efficiency costs are an additional \$265 billion to \$663 billion.

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



What the federal tax system is costing you

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

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

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

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(AFFT Documents\Papers on a specific subject\What the federal tax system is costing you)