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Tax Professionals' Perceptions of Small Business Tax Law Complexity

Laura R. Ingraham
San Jose State University, laura.ingraham@sjsu.edu

S. S. Karlinsky
San Jose State University

TAX PROFESSIONALS' PERCEPTION OF SMALL-BUSINESS TAX LAW COMPLEXITY

By Laura R. Ingraham and Stewart Karlinsky

Laura R. Ingraham is an associate professor of accounting and information systems, and Stewart Karlinsky is a professor of accounting and taxation at San Jose State University and senior fellow at Monash University School of Law's Taxation Law and Policy Research Institute.

The author's report in this article on their study in questionnaire format that tested the perception of 89 small-business tax practitioners regarding the complexity of 37 tax provisions. They found overwhelming consistency on the five most complex and five least complex small-business tax provisions with partnerships, estate and gift valuations, tax-deferred exchanges, frequency of law changes, and retirement plans topping the hit parade. Progressive tax rates, estimated taxes, Social Security/self-employment taxes, corporate capital gain provisions, and cash versus accrual method were uniformly and consistently perceived as the least complex. These results have tax policy implications. According to the authors, for example, a House bill to move S corporations to a partnership regime may not be optimal from the simplification perspective. The authors question whether familiarity with an issue results in lower perception of complexity. There is some discussion in the tax policy literature about tiering (different tax rules for small versus large companies). That policy seems to have made certain tax areas (cash versus accrual, depreciation, installment sales, and possibly corporate alternative minimum tax and uniform capitalization (UNICAP) less complex for small-business practitioners.

Table of Contents

I. Introduction

There is significant attention paid to tax law complexity, its causes and effects, by government officials,[1] but little has been done to implement simplification measures. Other organizations have likewise called for tax law simplification.[2] One of the comments often heard is that there is no constituency for tax simplification and that although there is a lot of smoke, there is not much fire. A good example of this is that the Bush administration proposed issuing white papers on tax simplification and then enacted laws that make tax law significantly more complex or focuses solely on rate reduction. See, for example, a report by the Democratic staff of the House Small Business Committee, which notes that President Bush's budget ''does little to provide adequate funding to support this nation's small businesses and places a priority on a massive tax cut.''[3] The report also notes that of the $674 billion tax cuts, small business would receive only $18 billion of targeted tax relief. That is in stark contrast to a recent American Institute of Certified Public Accountants poll (Virtual Grassroots Panel, February 2004) that shows that healthcare and taxes were two top issues for small business. Within the tax category, complexity was one of the most discussed issues. Often tax reduction for a particular group is shrouded in the simplification coat, which makes it even more difficult to enact simplification measures. Indicative of the political importance of simplicity is a comment by former IRS Commissioner Fred Goldberg: ''Tax simplification remains everyone's favorite orphan. All of us involved in the tax system — Congress, the executive branch, practitioners and taxpayers — proclaim our affection for this

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[1]*See Tax Notes*, July 22, 2002, p. 490, reporting that Rob Portman, R-Ohio, a member of the House Ways and Means Committee, introduced a tax simplification that would be potentially implemented when there are budget surpluses. *See also Tax Notes*, Feb. 11, 2002, p. 676, reporting that the Bush administration requested Treasury's Office of Tax Policy to issue white papers on tax simplification.

[2]*See* New York State Bar Association Tax Section, ''Simplification of the Internal Revenue Code,'' *Tax Notes*, Apr. 22, 2002, p. 575; AICPA, ''Tax Policy Concept Statement #2 Guiding Principles for Tax Simplification 2002'' and ''Blueprints for Tax Simplification 1992''; C. Eugene Steuerle, ''The Simple Case for Tax Simplification,'' *Tax Notes*, Dec. 10, 2001, p. 1497; William G. Gale, ''Tax Simplification: Issues and Options,'' *Tax Notes*, Sept. 10, 2001, p. 1463.

[3]*Doc 2003-7066*, *2003 TNT 53-18* (Mar. 18, 2003).

child of our dreams, but few are willing to adopt her as our own.''[4] A recent positive trend on the simplification fight is that the IRS has developed a microsimulation model[5] within its Office of Research that estimates the compliance burdens of current law and tax law changes.

The importance of tax law complexity is evident from the tax policy research investigating its effect on compliance, tax evasion, fairness, equity, and so forth. For example, there is evidence that complexity is associated with taxpayer noncompliance.[6] There is countervailing evidence[7] that there may be a disconnect between complexity and taxpayer compliance because taxpayers don't necessarily view complexity as unfair. Either way, the Karlinsky-Koch[8] line of research has demonstrated that a high level of complexity leads to reduced technical accuracy by both tax professionals and future tax practitioners (students).

The importance of the small-business sector of the economy is clear not only from the statistics of jobs, gross domestic product generated, and the like, but also from the tax law itself. For example, section 7802, as amended in 1998, established the IRS Oversight Board to oversee the administration, management, and strategic direction of the IRS. One of the qualifications to be a member of the board is to have ''professional experience and expertise'' in the ''needs and concerns of small business.'' Similarly, the concerns about undue administrative burden for small businesses, which is a major identification goal for this current research, has led to section 7805(f), which requires the Secretary of the Treasury to forward all proposed and temporary regulations to the Small Business Administration's (SBA) Office of Chief Counsel for Advocacy. The chief counsel may comment on the effect of those rules on small business within four weeks.

Some recent studies have tried to measure the cost of compliance with federal regulations (including taxes) on an overall basis and on various sectors of the economy. The SBA Office of Chief Counsel for Advocacy did the first study of its kind in 1995 and issued a report to Congress entitled ''The Changing Burden of Regulation, Paperwork and Tax Compliance on Small Business.'' The aggregate regulatory burden was found to be increasing, but the relative burden compared to the size of the economy was constant. The agency also discovered that the cost for small business to comply with tax regulations was 50 percent higher per employee than for large companies (over 500 employees). They found that large businesses incurred a cost of $3,400 per employee, while small businesses were burdened with a $5,500 per employee cost. Using conservative numbers they found that small businesses bore 63 percent of the compliance burden but only generated 50 percent of the employment and sales.

In August 2001 W. Mark Crain and Thomas D. Hopkins took the 1995 study a few steps further and probed overall regulatory costs including tax regulations elements in their SBA study ''The Impact of Regulatory Costs on Small Firms.'' They distinguished small businesses from the 1995 survey by bifurcating them into two subgroups: those with less than 20 employees and those with 20 or more employees but fewer than 500. They estimated that Americans spent $843 billion in 2000 to comply with federal regulations. They also found for the year 2000 firms with less than 20 employees face a total regulatory burden of almost $7,000 per employee, which is 60 percent higher than the cost per employee of a large company. The tax compliance burden was found to be more than twice as large per employee for a small business than for a large business. Interestingly, a midsize (20-499 employees) firm's tax compliance costs were only 10 percent higher than a large one. The main reason for that was the essentially fixed nature of regulatory costs. In their study, Crain and Hopkins suggested that tiering (providing special rules for a targeted group) may be a way to reduce the small-business burden. One of the motivations for our study was to see if the extant tiering imbedded in the income tax laws has reduced the complexity of those rules.

As will be shown below, the answer is that tiering, or special exceptions — particularly cash method versus accrual method and depreciation — have been rated at the lower end of the complexity scale by small-business tax practitioners. For example, the recent allowance[9] of the cash method for small businesses based on average gross receipts of less than $10 million or $1 million may have resulted in this category being rated fifth least complex in the overall ratings (1.8539) and 31st, 34th, and 31st complex based on experience level, as explained below. Also, depreciation for small businesses is fundamentally eliminated with the section 179 first-year expensing allowance now at $100,000 (even at $25,000 it eliminated much of the small-business recordkeeping requirements).

II. Research Method

In most of the dialogue related to tax simplification, there is little research or discussion regarding what tax practitioners, who are on the front line of the complexity battle, perceive are the complex areas that need to be addressed.[10] Given that small business is a significant

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[4]''It's Tax Time Again, at Least for Extenders,'' *The Wall Street Journal*, Aug. 5, 2004, p. D2.

[5]*Tax Notes*, Nov. 25, 2002, p. 1013.

[6]Milliron and Toy, ''Tax Compliance: An Investigation of Key Features,'' 9 *J. Am. Tax'n Assoc.* 84 (Spring 1988); Collins et al., ''Determinants of tax compliance: A Contingency Approach,'' 14 *J. Am. Tax'n Assoc.* 1 (Fall 1992).

[7]Forest and Sheffrin, ''Complexity and Compliance: An Empirical Investigation,'' *Nat'l Tax J.*, March 2002, p. 75.

[8]Karlinsky and Koch, ''Impact of Tax Law Complexity on Professionals,'' 9 *J. Am. Tax'n Assoc.* 24 (Fall 1987).

[9]Rev. Proc. 2002-28, 2002-18 IRB 815, *Doc 2002-9029*, *2002 TNT 72-6*; Rev. Proc. 2001-10, 2001-2 IRB 272, *Doc 2000-31536*, *2000 TNT 236-9*.

[10]One study that tangentially addresses this issue is Karlinsky, ''Complexity in the Federal Income Tax Law Attributable to the Capital Gain and Loss Preference: A Measurement Model,'' 1981 dissertation, New York University, in which the author surveys 10 tax professionals as to which areas of the tax law are the most complex. This study examined the total income tax system and not any particular segment of the market. O'Neil et

(Footnote continued on next page.)

driver of productivity, jobs, and economic activity,[11] the authors examined the top areas of perceived complexity affecting small businesses by surveying several small-business tax professionals. A test instrument was designed to be as simple as possible. A list of 37 areas of the tax law (encompassing individual and corporate federal and state income, estate, employment taxes, and so forth) were presented to the small-business tax practitioner to identify the relative complexity of the tax area or provision that affect small business (see Appendix A). Small businesses included Schedule C, E, and F filers, as well as partnerships, LLCs, LLPs, S corporations, and C corporations, with average gross receipts of less than $10 million over the past three years. That criterion is used because it is a frequently used demarcation of small versus large business.[12]

The 37 areas of tax law to be tested were derived from five different sources. A 1981 study identified the 10 most complicated tax sections of the law by a panel of large-business and small-business tax practitioners. Those provisions that affect small business were included in the study.[13] Second, a 2003 panel of four small-business tax partners with extensive experience was asked whether the list was complete. One is the managing partner of a three office firm in a large California city, one is a tax partner of a national accounting firm, one is a partner in a large Arizona city, and the fourth is a local sole practitioner. Third, the AICPA Tax Division study findings were included in this list of potential complex tax areas that affect small business. Fourth, various small-business panel congressional hearings, JCT papers, and simplification proposals by AICPA, ABA, and so forth were analyzed for factors to include in this study's list of potential complicating small-business provisions of the tax law.[14] Fifth, the experiences of the authors in dealing with small-business tax issues over a 30-year period were included as well. To account for any major items that may have been omitted, there was room provided in an Other space.[15]

The test instrument (see Appendix A) was designed to be completed in less than 10 minutes and to be simple and clear. A five-point Likert scale was used with one slight variation: a sixth box for Not Applicable to Small Business Clients. The five discrete points on the Likert scale ranged from Not Complex (1) to Somewhat Complex (2) to Complex (3) to Very Complex (4) to Extremely Complex (5). The list of 37 items was randomized with eight variations on the theme to minimize any potential built-in response or immediacy bias.

The test instrument was administered during the summer of 2003 to 89 professionals. The survey also included a demographics section that asked about gender, tax experience, level of education, job title, geographic location, and experience with small-business clients. We expected that tax experience and job title would be highly correlated. We also expected that certain states (Texas, Florida, Nevada, and Washington) would rank individual state income taxes as lower in complexity or as not applicable, because those states do not have an individual income tax, although their clients may have multistate or nonresident state tax returns to file.

We report the standings of each of these provisions on an overall basis and by subject group. The test instrument had six job title description categories: Partner, Senior Manager, Manager, Supervising Senior, Senior, and Staff. In the study we were able to analyze the complexity of issues according to the job title/experience levels of the participants surveyed by collapsing several of the categories. That resulted in three levels: Partners/Senior Managers (Group 1), Managers (Group 2), and Super Senior/Senior/Staff (Group 3).

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al. investigated the Schedule C Sole Proprietor form only, which omitted coverage of partnerships, LLCs, S corporations and small-business C corporations, a significant segment of the market. O'Neil, Samelson, and Harkness, ''Simplification of Schedule C for Sole Proprietorships: Results from a Survey of Tax Practitioners,'' *19 J. Am. Tax'n Assoc.* 19 (Spring 1997). Davies et al. looked at the broad spectrum of federal income taxes but did not focus on small business nor did it include state and local taxes, and so forth. Davies, Carpenter, and Iverson, ''Issues in Federal Income Tax Complexity,'' *S.D. Bus. Rev.*, March 2001, p. 1.

[11]*See, e.g.*, the Democratic staff report, *supra* note 3, which points out that small business creates 75 percent of all new employment opportunities, almost half of all sales in the United States, and constitutes half of the U.S. GDP. Likewise, an SBA study suggests that small business accounts for 58 percent of nonfarm workforce, 43 percent of all U.S. sales, and 51 percent of private GDP (*see* http://www.sba.gov).

[12]*See* Rev. Proc. 2002-28, *supra* note 9 and discussion; section 460(e)(1) for the completed contract method rules related to small businesses; and section 263A(b)(2) dealing with uniform capitalization rules. It also would more than cover small businesses subject to the AMT exception rules of section 55(e).

[13]*See* Karlinsky, *supra* note 10.

[14]*See, e.g.*, IRS, ''Report to Congress on Tax Law Complexity,'' *Doc 2000-18027, 2000 TNT 128-40* (June 29, 2000); ABA, AICPA, and Tax Executives Institute, ''Recommendations of the Task Force on Tax Simplification,'' *Doc 2002-21696, 2002 TNT 185-16* (Sept. 13, 2002); Guyton et al., ''Estimating the Compliance Costs of the U.S. Individual Income Tax,'' presented at the 2003 National Tax Association Spring Symposium; William G. Gale, ''Tax Simplification: Issues and Options,'' *Tax Notes*, Sept. 10, 2001, p. 1463; statement of Pamela F. Olson on behalf of the ABA Tax Section, ''Impact of Complexity in the Tax Code on Small Business,'' before the House Small Business Committee, *Doc 2000-23353, 2000 TNT 175-62* (Sept. 7, 2000); statement of Lindy Paull, Joint Committee on Taxation chief of staff, and statement of Scott Moody on behalf of the Tax Foundation, before the joint hearing of Ways and Means Subcommittees on tax complexity, *Doc 2001-19033, 2001 TNT 141-66* (July 17, 2001); statement of Claudia Hill on behalf of the National Association of Enrolled Agents at Senate Finance Committee hearing on tax code complexity, *Doc 2001-12743, 2001 TNT 90-34* (April 26, 2001).

[15]Of the 89 subjects, there were only three Other categories filled out: Choice of Entity Type (complex), Doing Business Internationally (complex), and Nonprofits Issues (very complex).

Table 1. Demographics	
Male	51
Female	38
CPAs	74
Non-CPAs	13
Nonreporting	2
Educational Background	
J.D.	3
Master's	24
Bachelors	31
Nonreporting	31
Years of Experience	
< 6	44
> 5 but < 11	17
> 10 but < 16	8
> 15 but < 21	6
> 20	13
Percent of Time Spent on Tax vs. Other Areas of Accounting	
< 26%	2
> 25% but < 51%	13
> 50 but < 76%	9
> 75%	65
Percent of Time Spent on Small Business Clients' Tax Issues	
< 26%	12
> 25% but < 51%	22
> 50 but < 76%	20
> 75%	35
Job Title	
Partners	24
Senior Managers	5
Managers	12
Super Seniors	11
Seniors	24
Staff	13

III. Results

A. Demographics

The experiment was administered to 89 professionals, of which 38 were female and 51 were male (see Table 1). There were 24 partners, 5 senior managers, 12 managers, 11 supervising seniors (super seniors), 24 seniors and 13 staff personnel. Forty-four of the 89 participants had less than 5 years experience, while 19 had more than 15 years experience. More than 80 percent were CPAs and more than 30 percent had advanced degrees. The percent of time spent on tax versus consulting, compilations, reviews, or auditing showed 2 with less than 25 percent of their time devoted to tax and 65 with more than 75 percent of their time devoted to tax. More than 83 percent spent more than half their time on tax work. More than half (55) of the participants spent more than half their time working on small-business clients' tax issues.

We did not have a significant number of participants from states with no individual income tax (one from Florida and one from Texas) to make any statement regarding the complexity of the issues in those states. The demographics indicated there were 13 participants from California; 8 from both Indiana and Ohio; 7 from both South Carolina and Wisconsin; 5 from Illinois; 4 from Minnesota, North Carolina, New York and Tennessee; 3 from Idaho, Iowa, and Kentucky; 2 from Oregon, and Utah; and 1 from Alabama, Arizona, Florida, Georgia, Hawaii, Mississippi, New Jersey, South Dakota, Texas, Virginia, Vermont, and West Virginia. Respondents' home states made no significant difference as to their perception of complexity on individual state income tax.

B. Overall Results

The 37 factors in order of complexity from Extremely Complex (5) to Not Complex (1) are listed in Table 2. Although individual subjects rated certain issues Very Complex (4) or Extremely Complex (5), the average listed in Table 2 below showed no average score at or above Very Complex (4). Interestingly, Partnerships (3.4167) are perceived by tax practitioners as the most complex small-business provision of the 37 listed factors. Also interesting is that S Corporations are perceived as almost one whole point less complex at 2.5281. This calls into question recent legislative proposals[16] to make S corporation tax rules more like partnerships, if simplification is the goal.

The 10 most complicated small-business tax provisions identified by the experiment lead to some interesting reflections. By far, Partnerships was rated the most complex small-business tax provision. Estate and Gift Tax Valuation was the second most complex area, which makes sense given the complexity of valuing stock options, family limited partnership interests, closely held companies, real estate, and so forth. Interestingly, Frequency of Tax Law Changes was perceived by the test subjects as being more complex than AMT, Retirement Plan tax rules, or even Passive Activity Losses. It is hoped Congress and the administration will heed the call by letting small-business practitioners have time to assimilate the rush of tax law changes that have been enacted over the last three years.

Interestingly, depreciation and home office tax issues were found to be extremely complex in the O'Neil[17] and the Carnes and Cuccia[18] studies but were rated very low in the current complexity rankings. In our study, home office issues were rated overall 32nd out of 37 tax provisions (1.8764) and consistently rated between 28th and 33rd by different experience groups. Similarly, depreciation was ranked 22nd overall (2.1685) and between 19th and 26th by group. One explanation may be that the Carnes and Cuccia subjects were students, and their lack of familiarity with the rules may have made it seem more

[16]*See* former Rep. Amo Houghton's H.R. 4137, ''Small Business Tax Modernization Act of 2004,'' which would have 'simplified' by essentially eliminating the S status and tax those entities under the partnership subchapter K rules.

[17]*Supra* note 10.

[18]Carnes and Cuccia, ''An Analysis of the Effect of Tax Complexity and its Perceived Justification on Equity Judgments,'' 18 *J. Am. Tax'n Assoc.* 40 (Fall 1996).

Table 2. 37 Factors in Descending Order of Complexity — Overall Sample				
		Group 1	Group 2	Group 3
1. Partnerships	3.4167	1	2	1
2. Estate and Gift Tax Valuation	3.1910	2	1	4
3. Tax Deferred Exchanges	3.1058	5	3	3
4. Frequency of Tax Law Changes	3.1023	4	8	2
5. Retirement Plans	2.9772	3	10	7
6. AMT — Individuals	2.9333	6	11	5
7. Accumulated Earnings Tax	2.8539	12	4	6
8. AMT — Corporate	2.7159	18	5	8
9. Inventory (FIFO, LIFO, UNICAP)	2.7079	9	9	9
10. Passive Activity Losses	2.6897	7	6	12
11. Constructive Ownership	2.5814	8	13	11
12. S Corporation Tax Rules	2.5281	14	15	13
13. Revenue Recognition	2.5114	16	17	10
14. Carryover Utilization	2.3932	15	16	15
15. Personal Holding Company Tax	2.3810	10	25	19
16. State Franchise Taxes	2.3563	11	24	20
17. Carryovers	2.3483	17	27	16
18. Phaseouts/Phase-Ins of Tax Provisions	2.3034	13	30	21
19. Debt vs. Equity Classification	2.2976	22	12	17
20. Taxable Fringe Benefits	2.2809	21	19	18
21. Section 1244 Loss	2.2024	27	7	22
22. Depreciation	2.1685	19	26	23
23. Installment Sales	2.1685	32	21	14
24. Revenue vs. Capital Expenditure (*INDOPCO*)	2.1591	20	22	28
25. Sales Tax	2.1573	24	18	24
26. Sale of Assets Used in a Trade or Business	2.0778	26	23	27
27. Character of Interest Expense	2.0455	33	20	25
28. Independent Contractor vs. Employee Status	2.0337	23	14	32
29. Reasonable Compensation Deduction	2.0114	29	33	26
30. State Income Taxes — Individuals	1.9667	25	32	30
31. Capital Gains and Losses — Individuals	1.9333	28	29	29
32. Home Office Deduction	1.8764	30	28	33
33. Cash vs. Accrual Method of Accounting	1.8539	31	34	31
34. Capital Gains and Losses — Corporations	1.6279	36	35	34
35. Self-Employment and Social Security	1.5778	34	31	36
36. Estimated Taxes	1.4545	35	36	37
37. Progressive Tax Rates	1.3750	37	37	35

complicated than it seems for those involved in small business. The conflict with the O'Neil findings, which used tax practitioners, may be attributable to the fact that over the past seven or eight years tax professionals may have more experience with the provisions and thus perceive less complexity. Also, our demographics show that less than 5 percent of our subjects were attorneys while the O'Neill study surveyed 15 percent lawyers. Also, only 34 percent of those subjects identified their practice as small business, while over 55 percent of ours had greater than 50 percent exposure to that segment of the market.

The least complex small-business tax provisions identified by the participants in the study was Progressive Tax Rates (1.375), which is interesting given that some politicians and tax policy makers have been pushing for a flat tax in the name of simplification. What this probably shows is that multiple rates do not contribute heavily to complexity, but complex rules to compute small-business taxable income do.

Another interesting finding, and what might be viewed as a good validity or consistency check, is that the cash vs. accrual method of accounting is the sixth simplest of the 37 items on the overall list. Given Treasury's recent rulings and procedures in 2001 and 2002 allowing more small businesses (under $1 million blanket rule or $10 million past three years gross revenue factor, depending on your line of business) to use the cash method of accounting, it would seem to be paying off in reducing tax complexity for small businesses. Capital Gain or Loss — Corporations was viewed by the subjects as relatively simple (1.6279), which makes sense because there is no special tax rate for long-term capital gains. Capital Gains and Losses — Individuals was rated as slightly more complex at 1.9333. The closeness of those two applications of the capital gain rules is a little surprising given the relatively recent 15 percent, 20 percent, 25 percent, and 28 percent capital gains tax rates that apply to individuals but not corporations. Nonetheless, the individual rules are significantly more complex than the corporate rules at a .05 confidence level.

C. Testing for Demographic Differences

When one does a study like this, one wonders if the results are affected by the demographic background of the subjects.[19] It was expected that geographic location (other than possibly state and local issues) would not be a discriminating factor and for the most part that was true.[20]

It was not unexpected that some of the listed items would be perceived as more complex by experienced people and other areas would be perceived as more complex by less experienced professionals. That factor was found to be significant in 24 of the 37 issues. Table 3 provides a list of the issues that experienced versus less experienced people found complicated.[21]

D. Job Title Analysis

When examining perceived complexity of the 37 tax issues by job title, we found that there is a high correlation between job description and years experience, and we decided to analyze the data on the basis of job description. The test instrument had six job title description categories: Partner, Senior Manager, Manager, Super Senior, Senior, and Staff. Not surprising, Partners and Senior Managers formed one group (24 partners plus 5 senior managers), which we call Group 1. The Manager category (12 people) was statistically different than the Senior Manager group, and therefore, Group 2 comprises Managers only. The means for Super Seniors, Seniors, and Staff (48 subjects) were all statistically very similar, so they constitute Group 3.

Table 3. Areas Of Significant Differences in Perception of Complexity by Experience Level

Panel A — Partners/Senior Managers vs. Managers
Phaseouts
AMT — Individual
State Income Taxes — Individuals
Carryover Utilization
Carryovers
Cash vs. Accrual
Constructive Ownership
Depreciation
S Corporation Tax Rules
Estimated Taxes
Tax Law Changes
Partnership Tax Rules
Personal Holding Company Tax
Reasonable Compensation Deductions
Retirement
Revenue Recognition
Revenue vs. Capital Expenditure
State Franchise Taxes
Panel B — Partners/Senior Managers vs. Super Senior/Senior/Staff
Independent Contractor vs. Employee Status
Phaseouts
Sales Tax
Capital Gains — Individual
Sale of Assets Used in Trade or Business
Self-Employment and Social Security Tax
State Income Tax — Individual
Carryover Utilization
Carryovers
Cash vs. Accrual Method
Constructive Ownership
Depreciation
Estate and Gift Tax
S Corporation Tax Rules
Estimated Taxes
Home Office Deduction
Partnership Tax Rules
Passive Activity Losses
Personal Holding Company Tax
Retirement
Revenue Recognition
Revenue vs. Capital Expenditures
State Franchise Taxes

Table 4 (next page) shows the perceived complexity of tax provisions by group. It is interesting to note that Group 1's mean perception of tax law complexity was 2.7057, which was significantly higher than either Group 2 (2.0849) or Group 3 (2.1754).

(Text continued on page 87.)

[19]A regression analysis of the differences is available from the authors.

[20]Only two issues were significantly different based on location: Estate and Gift Taxes and Tax Deferred Exchanges. In examining the latter factor, states where real estate prices have appreciated significantly (*e.g.*, California and New York) might be the geographic factor. Similarly, in those same states where extensive real estate appreciation occurred, estate and gift consequences would also be more commonly found and perceived to be more complicated.

[21]It is interesting to note that there was no statistical difference in perceived complexity on any of the issues between the Managers and the Super Senior/Senior/Staff levels. While this could suggest that we should collapse the two levels, it should also be noted that while there are 18 issues (Table 4 — Panel A) in which there is a statistical difference in perceived complexity between the Partners/Senior Managers and Managers levels, there are 23 issues (Table 4 — Panel B) between the Partners/Senior Managers and Super Senior/Senior/Staff levels. Therefore, we elected not to collapse two levels.

Table 4. Perceived Complexity by Job Title — Descending Order of Complexity	
Panel A — 37 Factors in Descending Order of Complexity — Group 1 (Partners/Senior Managers)	
Partnerships	4.1429
Estate and Gift Tax Valuation	3.7142
Retirement Plans	3.5862
Frequency of Tax Law Changes	3.4643
Tax-Deferred Exchanges	3.4137
AMT — Individuals	3.3103
Passive Activity Losses	3.1724
Constructive Ownership	3.0714
Inventory (FIFO, LIFO, UNICAP)	3.0345
Personal Holding Company Tax	3.0000
State Franchise Taxes	2.9643
Accumulated Earnings Tax	2.9310
Phaseouts/Phase-Ins of Tax Provisions	2.9310
S Corporation Tax Rules	2.9286
Carryover Utilization	2.8929
Revenue Recognition	2.8929
Carryovers	2.8276
AMT — Corporate	2.7586
Depreciation	2.6786
Revenue vs. Capital Expenditure (*INDOPCO*)	2.6429
Taxable Fringe Benefits	2.5862
Debt vs. Equity Classification	2.5357
Independent Contractor vs. Employee Status	2.5172
Sales Tax	2.5172
State Income Taxes — Individuals	2.4828
Sale of Assets Used in a Trade or Business	2.3793
Section 1244 Loss	2.3214
Capital Gains and Losses — Individuals	2.3103
Reasonable Compensation Deduction	2.2857
Home Office Deduction	2.2069
Cash vs. Accrual Method of Accounting	2.2069
Installment Sales	2.1786
Character of Interest Expense	2.1724
Self-Employment and Social Security	1.9310
Estimated Taxes	1.8966
Capital Gains and Losses — Corporations	1.7586
Progressive Tax Rates	1.4138
Panel B — 37 Factors in Descending Order of Complexity — Group 2 (Managers)	
Estate and Gift Tax Valuation	3.0833
Partnerships	3.0000
Tax-Deferred Exchanges	2.8333
Accumulated Earnings Tax	2.7500
AMT — Corporate	2.6667
Passive Activity Losses	2.6667
Section 1244 Loss	2.5000
Frequency of Tax Law Changes	2.4167
Inventory (FIFO, LIFO, UNICAP)	2.4167
Retirement Plans	2.3636
AMT — Individuals	2.3333
Debt vs. Equity Classification	2.3000
Constructive Ownership	2.1667
Independent Contractor vs. Employee Status	2.1667
S Corporation Tax Rules	2.1667
Carryover Utilization	2.0833
Revenue Recognition	2.0833
Sales Tax	2.0833
Taxable Fringe Benefits	2.0833
Character of Interest Expense	2.0833

Table 4. Perceived Complexity by Job Title — Descending Order of Complexity

Panel B — 37 Factors in Descending Order of Complexity — Group 2 (Managers) (continued)	
Installment Sales	1.9167
Revenue vs. Capital Expenditure (*INDOPCO*)	1.9167
Sale of Assets Used in a Trade or Business	1.9167
State Franchise Taxes	1.9167
Personal Holding Company Tax	1.9091
Depreciation	1.8333
Carryovers	1.8182
Home Office Deduction	1.8182
Capital Gains and Losses — Individuals	1.7500
Phaseouts/Phase-Ins of Tax Provisions	1.6667
Self-Employment and Social Security	1.6667
State Income Taxes — Individuals	1.6667
Reasonable Compensation Deduction	1.6364
Cash vs. Accrual Method of Accounting	1.5000
Capital Gains and Losses — Corporations	1.3333
Estimated Taxes	1.2727
Progressive Tax Rates	1.0833
Panel C — 37 Factors in Descending Order of Complexity — Group 3 (Super Senior/Senior/Staff)	
Partnerships	3.0652
Frequency of Tax Law Changes	3.0625
Tax-Deferred Exchanges	2.9773
Estate and Gift Tax Valuation	2.9184
AMT — Individuals	2.8571
Accumulated Earnings Tax	2.8333
Retirement Plans	2.7500
AMT — Corporate	2.7021
Inventory (FIFO, LIFO, UNICAP)	2.5833
Revenue Recognition	2.3958
Constructive Ownership	2.3913
Passive Activity Losses	2.3913
S Corporation Tax Rules	2.3878
Installment Sales	2.2245
Carryover Utilization	2.1837
Carryovers	2.1837
Debt vs. Equity Classification	2.1522
Taxable Fringe Benefits	2.1458
Personal Holding Company Tax	2.1304
State Franchise Taxes	2.1064
Phaseouts/Phase-Ins of Tax Provisions	2.0833
Section 1244 Loss	2.0455
Depreciation	1.9592
Sales Tax	1.9583
Character of Interest Expense	1.9575
Reasonable Compensation Deduction	1.9388
Sale of Assets Used in a Trade or Business	1.9388
Revenue vs. Capital Expenditure (*INDOPCO*)	1.9375
Capital Gains and Losses — Individuals	1.7551
State Income Taxes — Individuals	1.7347
Cash vs. Accrual Method of Accounting	1.7292
Independent Contractor vs. Employee Status	1.7083
Home Office Deduction	1.6939
Capital Gains and Losses — Corporations	1.6222
Progressive Tax Rates	1.4255
Self-Employment and Social Security	1.3469
Estimated Taxes	1.2292

If one compares the top 10 most complex small-business tax provisions identified overall versus by each experience group in Table 4, there is a striking consistency across groups. If you take the overall results as a benchmark, you find that the results of the Partners and Senior Manager (Group 1) include 8 out of 10 Overall tax provisions, while the Managers (Group 2) and the Super Senior/Senior/Staff (Group 3) both include 9 out of the same 10 items. Clearly Partnerships is the most complex provision surveyed as it was ranked either first or second in complexity by all three groups. Similarly, Estate and Gift Tax Valuation was listed as first, second, or fourth. Tax Deferred Exchanges was ranked third, third, and fifth, respectively. The Frequency of Tax Law Changes registered fourth (Group 1) and second (Group 3), but eighth by Group 2. There were only 4 items that made a group's top 10 that was not in the overall list or any other group's list, and may be a function of the experience level discussed above. Group 3 included Revenue Recognition as their 10th most complex and surprisingly left out Passive Activity Losses; Group 2 included section 1244 as their seventh most complex and left out AMT — Individual; and Group 1 included Constructive Ownership (eighth most complex) and Personal Holding Company (10th most complex) and left out Accumulated Earnings Tax and AMT — Corporate.

Similar to the results in the 10 most complex, the 10 least complex also exhibited a striking consistency with each other and the overall ranking. Again, if the overall ranking is used as a benchmark, Group 1 had 8 out of the 10 items and Groups 2 and 3 showed 9 out of the same 10 items. Progressive Tax Rates was clearly on everyone's hit parade as the least complex being ranked first, first, and third, respectively. Estimated Taxes has been a relatively stable area recently and it showed by being ranked third (Group 1), second (Group 2), or first (Group 3). Corporate Capital Gains and Losses was ranked second, third, and fourth (Groups 1, 2, and 3 respectively) while Self-Employment/Social Security was ranked fourth (Group 1), seventh (Group 2), and second (Group 3). The most experienced group did not have Independent Contractor/Employee or State Individual Income Taxes in their 10 least complex ranking but included instead Character of Interest Expense (fifth) and Installment Sales (sixth). Group 2 Managers also excluded Independent Contractors/Employee status from their simple list and included Phaseouts/Phase-Ins of Tax Provisions as their No. 8. The least experienced group (3) excluded Reasonable Compensation and included Revenue vs. Capital Expenditures (*INDOPCO*) as number 10.

One rationale that fits many of the items that rank as least complex is that they are issues that the tax practitioner deals with on a regular basis. For example, estimated taxes are common to individual and closely held business entities and are encountered by the tax practitioner several times per year per client. Similarly, capital gains and losses (individual or corporate) as well as sale of assets used in a trade or business are dealt with many times during the year. An inexperienced student finds those provisions difficult to deal with, but all levels of experienced practitioners rate them as relatively low in complexity (see Table 2).

IV. Conclusions and Limitations

The results of this study are limited by the fact that we had only 89 participants involved. There were 41 participants at a managerial rank or higher. Of those 41 subjects, only 12 were managers. The participants were not as geographically dispersed as we would have liked and that may have biased the results regarding the perceived complexity of issues such as State Franchise Taxes and State Income Taxes — Individual. For example, we only had two participants from states with no state income taxes. Thirty-six of the participants were from the Midwest (most heavily from Indiana, Ohio, and Wisconsin), while 13 were from California. However, a strength of this study is that we did not use students but used experienced tax practitioners on the front line of dealing with small-business tax issues. Another strength of our study is that the subjects matched the subject matter better than many past studies. For example, more than 55 percent of the subjects identified as spending more than 50 percent of their time on small-business issues.

From the results of our study, it is obvious that Partnership Tax Rules are perceived as the most complex issue facing small businesses. This has significant policy implications. If practitioners perceive Partnership Tax Rules as the most complex issue facing small businesses, it would be a mistake to move S corporations to partnership rules. Several of the other areas of perceived complexity bear no surprise: Estate and Gift Tax Valuation and Tax Deferred Exchanges. The Frequency of Tax Law Changes speaks for itself with regard to perceived complexity, as well as the fact that there was no significant difference between the groups on that issue.

It is also interesting to note that Progressive Tax Rates are not perceived as complex. That would suggest that if a primary motivation for moving to a flat tax was simplifying the tax law, its alleged rationale would not be particularly persuasive. Several of the small-business provisions may be perceived as simpler because the government has tiered some provisions to exclude small business. For example, cash accounting method, section 179 depreciation, section 263A, and installment sales have different rules that apply to small businesses but not large businesses and these provisions have been found in this study to be relatively simple (33rd, 22nd, 24th, and 23rd, respectively). Even for complex areas such as UNICAP, the tiering effect has likely caused them to be perceived as somewhat simpler as shown by the Inventory (including UNICAP) rankings being lower than a reversed tiered[22] provision, Accumulated Earnings Tax. Similarly, AMT — Corporate has a significantly lower perception rating (2.7159) than AMT — Individual (2.9333) possibly because of the section 55(e) small-business exemption and the minimum tax credit being automatically created for corporations, but a temporary versus permanent calculation being required for individuals.

[22]Reversed tiering is the concept that a targeted group, in this case small business, is the focus of a rule that complicates its life, almost to the exclusion of large business.

Another interesting observation from the results is that it seems that when tax practitioners are familiar with a tax provision and deal with it on a frequent basis, the level of complexity is diminished. For example, estimated taxes is something that tax practitioners at all levels of experience deal with on an almost daily basis for their individual and corporate clients. It was consistently ranked among the three least complex tax provisions. Similarly, progressive tax rates is a concept that is frequently dealt with at the individual and closely held business levels. It was ranked by all experience levels as the bottom one, two, or three. Capital gains and losses (individuals and corporations) as well as sale of assets used in a trade or business are historically difficult for students to understand. Yet, for those in practice who deal with them on a daily basis, they are rated 31st, 34th, and 26th overall in complexity perception, respectively.

A. Future Research

It would be very interesting to use the same type of instrument (but with different large-business tax provisions) and see which issues complicate a different segment of the market. The authors would guess that international, state and local, *INDOPCO*, and other capitalization issues may be perceived as more complicated than found in the current study. It would also be interesting to determine complicating factors in other developed countries to see which complex provisions frustrate their tax practitioners.

Appendix A
Test Instrument

We are two academics doing a study on tax professionals' perceptions of the degree of complexity of selected small-business tax issues. Thank you in advance for taking five or ten minutes out of your busy schedule to share your thoughts with us.

Since we are only interested in your judgment, there are no right or wrong answers. So, please just tell us how you honestly feel about each issue's tax complexity. Please note that your responses are totally anonymous.

To make full use of your responses, we need you to answer all judgment and background questions.

Thank you,

Laura Ingraham
S.J.S.U.

Stewart Karlinsky (Contact Author)
San Jose State University
(408) 924-3482

For purposes of this study, we are defining Small Business as having Average Gross Receipts of the Past Three Years < $10MM; It would include Form 1040 Schedule C, E and F's, as well as partnerships, LLCs, LLPs, S corporations and C corporations. This criterion is commonly used in the tax law.

In your experience of working with small businesses, how complex is each tax item listed below? Put a check mark or X in the column that represents the level of complexity of that particular small-business issue. If a small-business item that you view as complex is not listed, add it in the Other row and check its level of complexity.

Demographics:

Check or Fill in the Applicable Responses			
Male ___	Female ___		
CPA ___	Masters in Tax ____	JD ___	Bachelors in Business ____
________	# Years Tax Experience		
________	% of Time Spent on Tax (versus audit/consulting/compilations/reviews)		
_________	% of Time Spent on Small Business Clients' Tax Issues		
Job Status:	Partner/Director/Principal _____	Senior Manager ____	
Manager ____	Supervising Senior ____	Senior ____	Staff ____
Geographic Location: In which U.S. State do you primarily practice? _____			

Description of Area	N/A to Small Business Clients	Not Complex	Somewhat Complex	Complex	Very Complex	Extremely Complex
Progressive Tax Rates						
Sale of Assets Used in a Trade or Business (1231, Recapture)						
Phase-Outs & Phase-Ins of Tax Provisions						
Home Office Deduction						
Tax Deferred Exchanges (e.g. 1031, corp/partnership formation, reorganizations)						
Inventory (FIFO, LIFO, Unicap)						
Sales Tax						
Retirement Plans						
Carryovers (e.g. NOL, C/L, FTC, GBC)						
Constructive Ownership (e.g. 318, 267, 1563, 544)						
Character of Interest Expense (business, investment, tax exempt, passive or personal)						
Alternative Minimum Tax — Corporate (Section 55(e) Small Business Exemption)						
Capital Gain or Loss — Corporations						
Accumulated Earnings Tax						
Estimated Taxes						
State Income Taxes — Individuals						
Self-Employment & Social Security Tax						
Section 1244 Loss						
Taxable Fringe Benefits						
Passive Activity Losses (469)						
Cash vs Accrual Method of Accounting						
Alternative Minimum Tax-Individuals						
Frequency of Tax Law Changes						
State Franchise Taxes (including multi-state returns)						
Estate and Gift Tax Valuations						
Personal Holding Company Tax						
Depreciation (e.g. 179, 30% Bonus, MACRS, listed property)						
S Corporation Tax Rules						
Installment Sales						
Independent Contractor vs. Employee status						
Debt vs. Equity Classification (Section 385)						
Revenue vs. Capital Expenditure (*INDOPCO*)						
Partnership Tax Rules						
Revenue Recognition (e.g. percentage completion, prepaid service income)						
Reasonable Compensation deductions						
Capital Gains and Losses — Individual (e.g. 1202, real estate, stock sales)						
Carryover utilization (381-384)						
Other						