COMMENTS

"CHARACTERISTICS OF BUSINESS OWNERSHIP: OVERVIEW FOR PASS-THROUGH ENTITIES AND EVIDENCE ON S CORPORATE OWNERSHIP FROM LINKED DATA" BY NICHOLAS BULL, SUSAN NELSON, AND ROBIN FISHER

"TAXPAYER COMPLIANCE COSTS FOR SMALL BUSINESSES: EVIDENCE FROM CORPORATIONS, PARTNERSHIPS, AND SOLE PROPRIETORSHIPS" BY GEORGE CONTOS, JOHN GUYTON, PATRICK LANGETIEG, AND SUSAN NELSON

"THE TIME-SERIES PROPERTIES OF BOOK AND TAXABLE INCOME" BY GEORGE A. PLESKO AND DAVID P. WEBER

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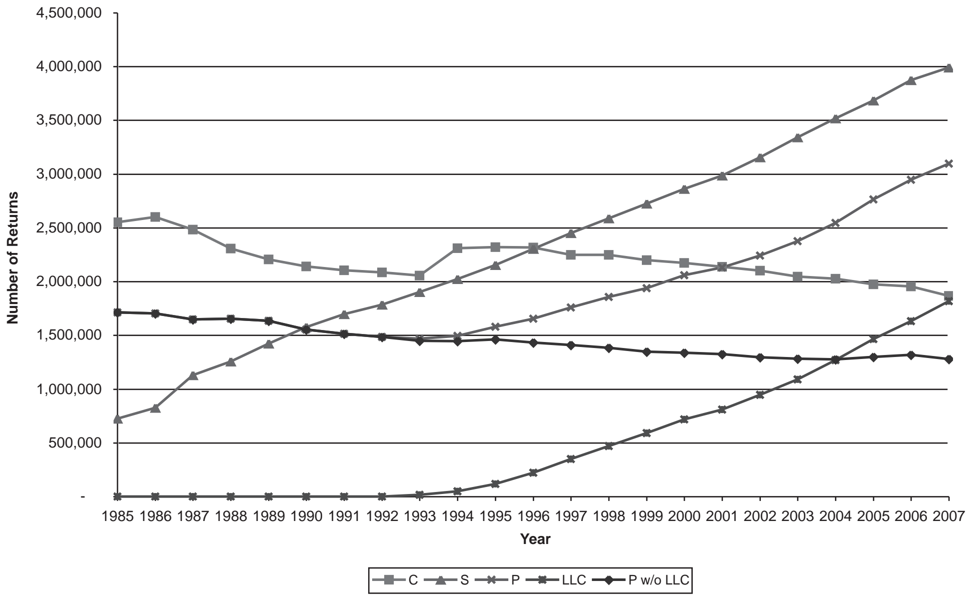
The three papers presented in this session focus on improving our understanding of business taxation using confidential tax return information. Bull et al. provide new information on the characteristics (number of owners, AGI) of owners of flow-through entities using linked data that matches Schedule K-1 income and deduction allocations with the recipients of those schedules. Contos et al. provide more robust estimates of the tax compliance costs imposed on owners of flow-through entities using the IRS-developed Small Business Burden Model. The findings of these two papers provide valuable insights that should help inform policymakers in the debate on tax reform in the coming year.

The Plesko and Weber paper provides valuable information to academic researchers who are searching for a reliable surrogate for C corporation taxable income using financial reporting data available on Compustat. Although their findings do not bear directly on the upcoming tax policy debate, Plesko and Weber aid researchers who are investigating the relation between book and tax differences and a corporation's level of tax aggressive behavior. Such research informs the debate over the appropriate level of tax return or financial statement disclosure required by tax administrators and financial reporting agencies.

The Contos et al. and Bull et al. papers highlight the significant increase in the number of flow-through entities since 1985. Figure 1 illustrates the growth of flow-through entities (S corporations, partnerships, and limited liability companies taxed as partnerships) from 1985-2007 (data are taken from the U.S. Department of the Treasury, 2010). In particular, the growth of S corporations and limited liability companies has been dramatic. The IRS projects that S corporation returns will increase by an average of 3.5 percent per year through 2016, while partnerships returns will increase by 3.9 percent (Collins, 2010). Ironically, when LLCs were sanctioned by the states beginning in 1993, the IRS questioned whether S corporations would become obsolete and unnecessary. Based on the data, it appears that LLCs have replaced partnerships and not S corporations in the entity choice decision (for more technical information on how these entity choices compare, see Keightley, 2009 and Quantria Strategies, 2009). These two papers also remind the reader that entity choice remains sensitive to comparative tax rates, a subject of much research after the Tax Reform Act of 1986 (see Ayers et al., 1996, Gordon and MacKie-Mason, 1991, Nelson, 1993, and Wilkie et al., 1996).

Contos et al. find that a "surprisingly" large amount of U.S. federal tax compliance burden is borne by flow-through entities, estimating that the seven million entities examined account for a combined compliance burden of $60 billion (70 percent of aggregate individual taxpayers) even though they pay little or no federal income tax. Such a compliance burden adds an often overlooked inefficiency to the entity choice decision (see Goolsbee, 1998, Moody et al., 2005, and Moody, 2000). A 2005 Tax Foundation study (Moody et al., 2005) estimated that business tax compliance costs totaled $148 billion, or 22 cents for each $1 of tax collected. Not surprisingly, the Tax Founda-

Figure 1: **Entity Tax Returns 1985-2007**



tion study corroborates Bull et al. in finding that the heaviest tax compliance costs fall on small business (entities with assets less than $1 million).

Some of the increase in tax compliance costs can be attributed to the increased information required by the IRS. For example, the Instructions to filing an S corporation tax return in 2000 listed three forms and estimated the average time to keep records, learn about the law, prepare the forms, and submit them to the IRS at approximately 196 hours. The Instructions to filing an S corporation tax return in 2009 listed four forms and estimated the average time to complete the forms at approximately 283 hours (the addition of Schedule M-3 added 72 hours of compliance time to filing an S corporation tax return). For partnership tax returns, the average time to complete six forms in 2000 was estimated to be 183 hours. In 2009, the average time to complete 10 forms was estimated to be 290 hours. Tax practitioner advocacy groups have emphasized the need to simplify the filing of tax returns in recent testimony before the Volcker Tax Reform Subcommittee (see Bankman, 2008, AICPA, 2009, and Tax Executives Institute, 2009).

The Contos et al. study improves on measures of tax compliance costs developed by the Tax Foundation (Moody et al., 2005) by taking into account tax planning costs. An important cost the study does not attempt to estimate is the potential costs of a tax audit or tax litigation, which should be considered in future work examining the difference in costs between self-prepared tax returns and preparer-prepared tax returns (for example, one of the reasons to use a preparer might be to reduce post-filing costs associated with an audit or litigation).

The authors' finding that there is a higher marginal compliance burden associated with partnerships than for C and S corporations is not surprising given that there is more flexibility in allocating profits and losses to partners than to shareholders and the passive loss rules must be considered with partnerships. When I was a (very) limited partner in the Boston Celtics master limited partnership, my allocation of either a $1 of profit or loss from the partnership necessitated that I report the amount on at least six different tax forms.

Contos et al. make important contributions in the development of a compliance burden model that applies to small businesses (see DeLuca et al., 2003), complementing the individual tax burden models already in use (see Guyton et al., 2005 and 2003) and estimates of compliance in large businesses (Slemrod and Blumenthal, 1996).

Bull et al. add to our knowledge of the characteristics of owners of flow-through businesses by being the first researchers to make use of linked data between Schedule K-1 (the entity allocation of income and deductions to owners) and the tax returns of the owners themselves. Their major contribution is being able to associate AGI levels of owners with different types of flow-through entities. Not surprisingly, they find that owner AGI levels increase with the size of the flow-through entity (as measured by total receipts). Interestingly, they do not find a clear pattern of increasing or decreasing affluence of owners with an entity's number of owners. This study should provide valuable information to policymakers in estimating the revenue implications of imposing a surtax on high-income individuals, as proposed by the Obama Administration. More importantly, these findings could inform the debate as to whether the imposition of a surtax could incent high AGI individuals to convert their flow-through entities to C corporations (see Keightley, 2009 for more discussion on this topic).

Finally, Plesko and Weber use confidential tax return data to provide a descriptive analysis of the time-series properties of various measures of book and taxable income to determine if common assumptions about the pattern of earnings under each reporting system are reasonable. Given the growing research examining the informativeness of book-tax differences (readers unfamiliar with this line of research are encouraged to read Graham et al., 2010 and Hanlon and Heitzman, 2009), their findings should provide comfort and caution as to what inferences can be drawn when estimating taxable income using Compustat data. Although they do not discover the Holy Grail of a proxy for taxable income, Plesko and Weber identify which adjusted book income measures are more reliable estimates of taxable income, which, until tax return information is made public, are the best tax accounting researchers can do (see Mills et al., 2010) for additional measures of current tax liability proxies).

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