How Do IRS Resources Affect the Tax Enforcement Process?

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Recent cuts to the Internal Revenue Service's (IRS) budget have reduced its resources by 18 percent and resulted in 13,000 (14 percent) fewer employees, 10,000 (20 percent) fewer enforcement staff, and the lowest level of individual and business audits in a decade (Marr and Murray (2016)). These cuts have occurred despite a 4-percent increase in the number of returns filed since 2010 and other increased IRS responsibilities related to the implementation of the Foreign Account Tax Compliance Act and the Affordable Care Act. Numerous media articles provide anecdotal evidence of the negative repercussions that have already occurred and speculate about potential future consequences (e.g., Rubin (2015); Russell (2015)). In this study, we use confidential IRS data to examine the effect of IRS resources on each stage of the enforcement process including: (1) the rate of audit; (2) the incidence and magnitude of proposed deficiencies conditional on audit; and (3) the percentage of proposed deficiencies collected by the IRS. In doing so, we provide the first large-sample evidence on how IRS resources affect each stage of the enforcement process—particularly among large corporations.

While prior research documents a negative association between audit probabilities and corporate tax avoidance (Hoopes, Mescall, and Pittman (2012)), there is limited evidence regarding how IRS resources affect enforcement outcomes. Although conventional wisdom might suggest greater resources are associated with better enforcement outcomes, this need not be the case for at least two reasons. First, over the last 15 years, the IRS has enhanced the tools it uses to detect potential noncompliance. For example, a joint IRS and Department of Treasury work group created the Schedule M-3 in 2003 to require greater disaggregation of firms' book-tax differences. The increased quantity and standardization of book-tax difference disclosures was intended to enable the IRS to better analyze book-tax differences for compliance risks, while simultaneously reducing the likelihood that the IRS will pursue a return based on an incorrect assumption about aggressive tax reporting (Boynton and Mills (2004)). Other initiatives include the creation and implementation of: (1) the Modernized e-File system and mandatory electronic tax return filing for certain corporations; (2) the Compliance Assurance Process (CAP), which facilitates resolution of questionable issues prior to the return filing; (3) Forms 8886 and 8918, which require a taxpayer and material advisors to the taxpayer to disclose reportable transactions; and (4) Schedule UTP, which requires additional disclosures related to a taxpayer's uncertain tax positions. These initiatives are intended to reduce the time and costs of identifying and resolving uncertain and/or more aggressive tax positions and could enable the IRS to maintain the level of tax collections despite resource reductions.[2] Second, House Appropriations Committee Chairman Rogers suggested that the rationale for recent IRS budget cuts was an effort to streamline "inefficient" operations (Bedard (2014)). This characterization reflects the belief that lower IRS resources will not hamper—and could potentially enhance—the enforcement process.

We focus our analysis on how IRS resources affect IRS enforcement after the tax return is filed. The IRS faces a number of decisions when allocating enforcement resources, including the number of returns to audit,

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[2] The Treasury Inspector General for Tax Administration (TIGTA) concluded that the Modernized e-File system and mandatory electronic filing: (1) reduced the time and costs associated with processing tax returns; (2) decreased the amount of time needed to complete audits; and (3) increased deficiencies proposed during audits (TIGTA (2011)).

the scope of the audits (which influences the incidence and magnitude of proposed deficiencies), and the level of resources dedicated to collecting proposed deficiencies. Because the IRS' budget is fixed for any fiscal year, resource allocation is a zero sum game: resources consumed in early stages of the enforcement process affect resources available for later stages. As such, it is unclear how the level of IRS resources affects each stage of the enforcement process or whether any changes in collections stem from agents examining a different number of returns and/or altering the resources devoted to uncovering, investigating, and challenging potential noncompliance.

To test the effect of IRS resources on enforcement, we use confidential corporate audit examination data for audits conducted from 2002 through 2014 of tax return years from 2000 through 2010.[3] To construct our sample, we use employer identification numbers to merge public financial statement data from the Compustat Fundamentals Annual database with three IRS datasets: (1) the IRS Business Return Transaction File (BRTF), which contains corporate income tax return data; (2) the IRS Audit Information Management System (AIMS), which contains proposed tax deficiencies; and (3) the IRS Enforcement Revenue Information System (ERIS), which contains deficiencies collected by the IRS. We restrict the sample to publicly traded firms so that we can include a more comprehensive set of control variables than we could if the sample included both public and private firms. We obtain data on IRS resources from the *IRS Annual Data Book*. Our primary measures of IRS resources are the IRS' total enforcement budget and the number of revenue agents. When examining the probability of IRS audit, we scale each measure by the number of returns filed. When examining later stages in the enforcement process that are contingent on a firm being audited, we scale each measure by the number of returns audited.

We first provide descriptive information about our sample. Approximately 29 percent of return years not in the Coordinated Industry Case (CIC) program are audited by the IRS. For the sample of audited returns, roughly 49 percent receive a proposed deficiency from the IRS, and the average magnitude of the proposed deficiency is almost $5.2 million, which represents approximately 6.8 percent of the tax savings claimed on the originally filed return. On average, corporate taxpayers pay 73 percent of proposed deficiencies—most of the shortfall due to proposed deficiencies not being assessed as payable.

We conduct our primary analyses in three stages. First, we examine the impact of IRS resources on the probability of audit among corporations. Using a sample of 31,549 tax return-years, we find a positive association between IRS resources and the probability of audit. A one standard deviation reduction in the IRS enforcement budget is associated with a 2.3-percent reduction in the probability of audit relative to the base rate. Second, we examine the impact of IRS resources on the incidence and magnitude of proposed deficiencies. We find a positive association between IRS resources and both the incidence and magnitude of proposed deficiencies within a sample of 11,899 audited corporation tax return-years. A one standard deviation reduction in the IRS enforcement budget is associated with an 11.1-percent decrease in the magnitude of proposed deficiencies relative to the mean level of proposed deficiencies. These results are consistent with the prospect that lower levels of IRS resources weaken the initial stages of the enforcement process, with the IRS auditing fewer returns and proposing fewer and smaller deficiencies.

Finally, we examine the impact of IRS resources on negotiated settlement outcomes. We measure settlement outcomes as the proportion of proposed deficiencies collected by the IRS (the settlement ratio). A higher (lower) settlement ratio indicates better outcomes for the IRS (taxpayer). Using a sample of 5,840 audited tax return-years with a proposed deficiency, we find a negative association between IRS resources and settlement ratios. A one standard deviation reduction in the IRS enforcement budget is associated with a 1.7 percentage point increase in the proportion of proposed deficiencies retained by the IRS among our sample of corporation return-years with proposed deficiencies. This result is consistent with the IRS targeting weaker taxpayer positions when it has fewer resources. We further decompose total settlements into settlements collected following the initial examination and settlements collected following an appeal. Our results suggest that the IRS collects a larger portion of proposed deficiencies after the initial examination stage when it is has fewer resources. We find no effect of IRS resources on collections after appeals.

[3] We limit the sample to returns through the 2010 tax year to allow sufficient time for tax return examinations to be completed.

This study is important to Congress, tax authorities, and taxpayers because our results inform the ongoing political debate about IRS funding. Although we provide evidence that settlement ratios are higher when the IRS has fewer resources, we also report a reduction in the rate of audit and in the incidence and magnitude of proposed deficiencies. Our estimates collectively suggest that a reduction in IRS resources is associated with a net loss in revenue collected via the corporation tax enforcement process. Taxpayers should also be aware of IRS resources during the tax enforcement process because the IRS proposes fewer adjustments when it has fewer resources but sustains a larger proportion of those proposed adjustments.

Our study also contributes to the stream of academic research examining the interaction between corporations and the tax authority. Studies in this area often focus on taxpayer strategy in deciding which positions to claim (e.g., Mills, Robinson, and Sansing (2010); De Simone, Sansing, and Seidman (2013); Ayers, Seidman, and Towery (2017)) or on the determinants of proposed deficiencies (Mills (1998); Mills and Sansing (2000)). Nearly all models of taxpayer-tax authority interaction assume that noncompliance detected by the tax authority necessarily results in additional tax payments (Slemrod, Blumenthal, and Christian (2001) is a notable exception). In contrast, we conduct a comprehensive analysis of how IRS resources affect each stage in the enforcement process, including the outcomes of negotiations between corporations and the IRS *after* noncompliance is alleged. These negotiations are a significant aspect of the interaction between taxpayers and the tax authority and have important implications for government collections and taxpayer cash flows.

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