
Tax Administration at the Centennial: An IRS-TPC Research Conference
Urban Institute, 2100 M Street, N.W., Washington, DC • June 20, 2013

Abstracts of Papers

9:15 – 10:45 **Session 1: Individual Income Tax Dynamics**

Older Taxpayers' Responses to Taxation of Social Security Benefits

Len Burman and *Liu Tian* (Syracuse University), *Norma Coe* (University of Washington), and *Kevin Pierce* (IRS:RAS)

Social Security benefits are taxed under a complex regime that raises marginal effective tax rates by up to 85 percent. This paper investigates whether older taxpayers respond to this tax by lowering their Modified Adjusted Gross Income (MAGI) using a nonparametric graphical methodology. We find little evidence of a response. We examined married and single individuals with and without self-employment income. Only single, self-employed people show any evidence of reducing income to avoid the tax and the response is much smaller and less precisely estimated than the response Saez (2010) found to the phase-out of the Earned Income Tax Credit. Overall, the findings suggest that older taxpayers have little understanding of the incentive effects of taxing Social Security.

Preparer Industry Dynamics and the Return Preparer Initiative

Pat Langetieg, *Mark Payne* and *Melissa Vigil* (IRS: RAS)

In 2010, the IRS adopted regulations aimed at establishing standards among tax return preparers. The objective was to improve voluntary compliance by supporting the paid preparer community and providing oversight of the industry with the goal of reducing errors on tax returns. By January 1, 2011, preparers were required to register with the IRS in order to receive a preparer tax identification number, or PTIN, that is to be entered on the returns completed by the preparer. Preparers pay an annual fee for the PTIN. Many PTIN holders have already been registered for a year and have gone through one renewal period. Concurrently, the IRS also instituted electronic filing requirements for larger preparers. The e-file mandate required preparers in processing year 2011 to electronically submit returns if they expected to prepare and file at least 100 returns. This threshold was lowered to 11 or more returns in processing year 2012.

This report summarizes preparer industry trends and examines whether any changes in return accuracy can be observed related to the changes in the pattern of return preparation and submission, or in the preparer industry brought on by these initiatives.

Changes in EITC Eligibility and Participation, 2005-2009

Maggie R. Jones (Census Bureau)

The rate of participation in the Earned Income Tax Credit (EITC) has been widely studied, but changes over time in eligibility for the credit have received less attention. One question of importance to policy-makers is whether (or by how much) eligibility might increase during economic downturns. The EITC is fundamentally tied to work. During periods of high unemployment, eligibility may decrease due to a lower number of workers (especially low-skilled

workers) filing for a given tax year. On the other hand, family structure and underemployment may lead to increases in eligibility. For example, earners may become eligible when a two-earner family loses one job or when an earner works part of the year or fewer hours. Using IRS tax data linked with the Current Population Survey Annual Social and Economic Supplement (CPS-ASEC), I examine changes in EITC eligibility and take-up between tax years 2005 and 2009, during which time the Great Recession began and ended. Employing fixed-effects models, I assess patterns of eligibility among demographic groups based on characteristics that also predict labor market outcomes. Results indicate that, in a period when overall EITC eligibility rates increased, the state unemployment rate had a significant positive effect on eligibility and a significant negative effect on take-up. Meanwhile, although joint filers, those with more children, and men experienced increasing rates of eligibility, those with less education experienced decreasing rates. Results point to the possibility that labor market groups who experienced the highest rates of unemployment in the recession may have become ineligible due to full-year job loss.

11:00 – 12:30 Session 2: Business Compliance Behavior

Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

Tom Beers, Eric LoPresti, and Eric San Juan (IRS:Taxpayer Advocate Service)

The Taxpayer Advocate Service (TAS) surveyed sole proprietors to understand factors that may affect income tax reporting, linking survey responses to IRS estimates of the respondent's actual tax compliance. Because factors influencing compliance could be affected by local conditions and attitudes, TAS also surveyed geographic communities where a disproportionate number of taxpayers were in a high- or low-compliance group. TAS designed survey questions about factors such as deterrence, tax morale, compliance norms, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of preparers. Generally, the survey results associate distrust of the national government and the IRS with low compliance. All respondents agreed that it is morally wrong to cheat and that they would feel embarrassed if others learned they were not reporting all of their income. Surprisingly, those in the low-compliance group were more likely than those in the high-compliance group to believe that the IRS detects and penalizes noncompliance. The community survey selection process revealed that those with low compliance levels clustered in geographic communities, while those with high compliance levels were more dispersed. These preliminary findings may suggest that traditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behavior (which may be deterred) is prevalent.

Transfer Pricing: Strategies, Practices, and Tax Minimization

Kenneth Klassen (University of Waterloo, Canada), Petro Lisowsky (University of Illinois), and Devan Mescall (University of Saskatchewan, Canada)

We investigate the extent to which transfer prices are a tax avoidance tool for multinational corporations. We survey tax executives from 219 multinational corporations to explore their approaches to cross-border transfer pricing. Contrary to common generalizations of multinational firms as chronic tax avoiders, we document diversity in both transfer pricing practices and strategies.

We then explore more deeply firm characteristics associated with the use of transfer prices for tax avoidance. We find evidence that the use of transfer prices to achieve a tax minimization goal is associated with greater tax resources overall, more experienced tax personnel, more resources employed in transfer pricing tax planning, and greater emphasis on cash taxes paid when assessing transfer pricing success. However, firms that use compliance-related measures to assess their transfer pricing success pay higher amounts of tax. Importantly, our survey shows that more multinational firms assess their transfer pricing functions on compliance-related measures than on cash taxes paid, which is contrary to implications of multinational company stereotypes portrayed in the current news media. Regression analyses confirm these results. Collectively, our study suggests that differences in transfer pricing practices and strategies determine the extent to which transfer prices aid tax reduction

Demand for Aggressive Tax Planning

Peter Bickers, Michael Slyuzberg, Tracey Lloyd, and Bhaskaran Nair (Inland Revenue, New Zealand)

Aggressive tax planning (ATP) is tax planning that is calculated to gain maximum financial advantage in tax while not breaking the letter of the tax laws. ATP can be deemed tax evasion if the tax authority decides that contrived or artificial means have been used for gaining tax advantages.

This study was initiated to determine the customer characteristics and factors associated with ATP. A mixed-method approach was used that: (a) quantitatively profiled and clustered all customers that Inland Revenue had investigated regarding ATP from 2001 to 2010, and (b) explored the motivations and perceptions regarding ATP through in-depth, qualitative interviews with a sample of customers, tax agents and Inland Revenue staff.

This paper will present the profiles of customer characteristics related to ATP arising from a Latent Class Analysis, and the discriminators are identified from canonical discriminant function analysis. It will also present the qualitative findings indicating customer attitudes regarding tax and tax avoidance, the relationship between customers and tax agents, and the changing context for ATP in New Zealand over recent years.

The key findings cover:

- The demographic characteristics and tax compliance behaviours associated with ATP;
- The factors associated with ATP for Individual and Business customers;
- How customers investigated for ATP describe their business success focus, their tax morale and their reactions to the tax authority requiring them to take the ‘intention’ of tax law into consideration; and
- The relationships between customers and tax agents in relation to ATP, including how ATP activity is prompted and enabled, and the level of cooperation between the customer and agent.

Inland Revenue will use these findings to better target and tailor its ATP initiatives and to direct its ongoing discussions with the tax agents representative organisations on addressing ATP.

Analysis of Ten-Year Trends in Large Business Examination Results (2001-2011)

Dave Macias and *Kimmy Wang* (IRS: LB&I)

Since the “stand up” of the new Large Mid-Size Business (“LMSB”), Large Business International (“LBI”) business division, examination results doubled in 2005 and remained at a higher level through 2011.

This paper discusses the reasons for the increase in examination results through research and analysis of various IRS databases, review of related financial information from SEC filings and interviews with selected examination teams. The authors have used a panel study for most of the analysis. They have concluded that the increase in examination results are attributable to the following factors:

1. The FY04 LB&I special initiative to decrease cycle time on examinations;
2. Tiering techniques introduced in FY06 to focus IRS resources on the most significant issues;
3. Increases in the exam adjustments of a small number of sub-industries beginning in FY 2005;
4. Increases in transfer pricing and capitalization exam adjustments; and
5. A small group of 147 CIC examinations that drove results from FY 2001 through FY 2011.

The results of this study will provide insights into factors that may have contributed to increased exam results and can be used by LB&I in understanding prior results and for consideration in future decision making.

The Impact of Legal Enforcement: An Analysis of Corporate Tax Aggressiveness After an Audit

Jason DeBacker (Middle Tennessee State University), *Bradley Heim* and *Anh Tran* (Indiana University), and *Alexander Yuskavage* (U.S. Treasury: Office of Tax Analysis)

Contrary to common expectations, this paper shows that legal enforcement may increase subsequent corporate misbehavior. Using IRS data, we find that corporations gradually increase their tax aggressiveness after an audit for a few years and then reduce it sharply. We show that this U-shaped impact is consistent with strategic responses on the part of firms and Bayesian updating of audit risk. This adverse effect on corporate behavior calls for reexamining the theory of legal enforcement.

IRS Enforcement and State Corporation Income Tax Revenues

Margot Howard (University of North Carolina)

I investigate the relation between IRS enforcement and state corporate income tax revenues. My results suggest that higher levels of federal tax enforcement are associated with higher levels of state corporate income tax collections in the same year, even after controlling for state tax rates and sales factor weighting. These results hold for a variety of proxies for IRS enforcement, including IRS corporate income tax return audit rates, various IRS employment levels, and number of fraud proceedings. In examining how federal enforcement matters in a post-FIN 48 environment, I find that the positive relation between IRS monitoring and state corporate income tax revenues is attenuated during the time period that FIN 48 has been in effect for public companies. Overall, these results suggest that the discussion on state revenues needs to extend beyond state tax policy to

include the more broad enforcement and financial reporting environment. This policy implication is particularly important given that so many states are currently facing severe financial crises.

3:15 – 4:45 Session 4: Lessons From Other Tax Administrations

Why Evasion Under a National Sales Tax Would Explode the Tax Gap: Lessons Learned from the States

Cary Christian (Georgia Southern University)

There have been a number of proposals for replacing virtually all taxes at the federal level of government with a national sales tax. These proposals rely heavily on various assumptions regarding sales tax compliance that have little grounding in evidence, primarily due to a conspicuous lack of consumption tax enforcement research. This paper examines four of these assumptions in light of more recent research on both income and sales tax compliance enforcement:

1. Collection, reporting, and remittance of sales taxes by businesses as agents of the government guarantees compliance.
2. The amount of sales taxes collected by organizations with a propensity toward sales tax theft is relatively immaterial in amount.
3. Published state estimates of sales tax non-compliance represent an estimate of the amount of sales tax lost to evasion or theft.
4. The Internal Revenue Service would be unnecessary if our tax system were refocused on consumption rather than income.

The author explains why these assumptions are wrong and why compliance with a national sales tax would be much lower than with the current income tax system.

The Influence of Tax Form Design on Use Tax Compliance

David Merriman (University of Illinois), and Natalie Davila and Hector M. Vielma (Illinois Department of Revenue)

US state tax-collection systems rely on voluntary compliance with limited auditing. The payment of personal income taxes is encouraged by withholding and other required filings as well as cooperation between federal and state tax authorities. Compliance with state sales taxes is encouraged by requiring retailers to collect and remit taxes to state authorities. Compliance with state use taxes is problematic, however, because constitutional restrictions often prevent states from requiring retailers to collect and remit the taxes. With the rise of internet and other remote sales, use tax compliance is an issue of increasing importance to state-tax authorities. In recent years state governments around the country have explored various strategies including changes in filing procedures to encourage use tax compliance.

Like many other states, Illinois imposes a use tax on some goods purchased elsewhere for use in Illinois. Illinois added a use tax line to its 2010 1040 income-tax return. This supplements a system that requires use tax payers to file a separate use tax return. Instructions for Illinois' post 2009 IL-1040 provided a Use tax Worksheet and a Use tax Table. The Use tax table suggests that taxpayers

estimate their use tax liability as a function of their federal adjusted gross income (FAGI). To accommodate this change, the department supplied a table to help filers estimate their use tax liability. This table is available in the 1040 instruction booklet as well as on the Department of Revenue web-file application. In addition, all major tax-software suppliers have made this information available.

We build the first-ever panel of Illinois tax returns by linking the tax returns of individual taxpayers for the years 2010 and 2011. We present descriptive statistics about use tax payments before and after the change in the tax forms. To the extent available data allow, we ask whether Gunter's (2011) findings for Maine generalize to Illinois data. We also ask how the change in use tax filing procedures affected compliance. We find a large increase in individual use tax payments following the change in the IL-1040, although less than 6% of tax filers include a positive use tax payment. About 60% of tax filers who include a use tax payment pay exactly the amount suggested by the use tax lookup table. Persistence is very important—tax filers who paid the use tax in 2010 are much more likely to also pay the use tax in 2011. The probability of a use tax payment rises gradually with FAGI.

Filling in the Black Hole: Research and Evaluation into the Hidden Economy

Alice Cleland (Inland Revenue, New Zealand)

The Hidden or Cash Economy undermines the integrity of the tax system. Moreover, evidence from the literature suggests that in times of economic recession, Hidden Economy activity is likely to increase with taxpayers opting out of the system. To this end, a comprehensive programme of work was developed by the National Research & Evaluation Unit, Inland Revenue New Zealand, to: better understand the Hidden Economy risk; identify the enablers and barriers to compliance; inform the design of interventions to mitigate/treat those risks; assess the effectiveness of the implemented interventions, and evaluate whether these interventions have resulted in long-term behaviour change.

The purpose of this paper is to provide an overview of Inland Revenue New Zealand's Hidden Economy Research & Evaluation Programme. The conceptual basis of the Programme is first discussed, followed by an outline of the components of the Programme, highlights of key research and evaluation findings; and conclude with the lessons learned and implications of these findings.