Session Two:

The Tax Behavior of Corporations

IRS

2009 IRS Research Conference

Preliminary Results of the 2003/2004 National Research Program

S Corporation Underreporting Study

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IRS Research, Analysis, and Statistics
2009 IRS Research Conference
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Overview of Presentation

- Introduction to S corporations
- The TY03/04 NRP S corporation study
- Preliminary estimates
- Comparison with sole proprietors
- Conclusions and future research

Overview of S Corporations

- Domestic flow-through entity
- No more than 75 shareholders (100 after TY04)
  - individuals and married couples,
  - not nonresident aliens,
  - certain estates and trusts, and
  - certain exempt organizations
- 90% have 1 or 2 shareholders

Why Study S Corporations?

- Last S corporation study in 1984
- Returns grew over 300% from 826 thousand for TY86 to 3.5 million for TY04
- Flow-through income (Partnership, S corporation, and Estates and Trust) contributed an estimated $22 billion to the TY01 Individual Underreporting Tax Gap
- Potential avoidance of employment taxes

TY03/04 NRP S Corporation Study

- Random audits of 4,815 Form 1120S tax returns (about 25% for TY03 and 75% for TY04)
- **Stratified on:**
  - audit code (return characteristics that may indicate compliance issues)
  - level of assets
- **Post-stratified on:**
  - region,
  - industry, and
  - reported ordinary income

Shareholder Returns also Audited

- Flow-through errors related to S corporation income
- Limitations on losses (Basis, Passive Activity, and At-Risk Rules)
- Distributions may generate tax
  - Distributions in excess of basis
  - Distributions from accumulated earnings and profits

Caveats

- All results are **preliminary**.
- Results are **not adjusted for noncompliance that went undetected**.
- Results presented include **only misreporting at the entity level**, which may not necessarily result in misreporting by the shareholder
- Statements and opinions are those of the presenter, not necessarily the IRS.

Compliance Measures

- **Net Misreported Amount (NMA):**
  - Total underreported and overreported income (deductions) for a line, weighted to the population.
  - Positive for underreported income and overreported deductions.
- **Net Misreporting Percentage (NMP):**
  - Ratio of NMA to the sum of the absolute values of the amounts that should have been reported.
- **Error Rate (ER):**
  - Ratio of the number of returns with errors on a line to the number of returns that should have reported that line.

Preliminary Findings

Total Net S Corporation Income

Tax Year	NMA	NMP	Error Rate
2003	$50B	12%	69%
2004	$56B	16%	68%

Ordinary Business Income

Tax Year	NMA	NMP	Error Rate
2003	$48B	14%	69%
2004	$51B	15%	68%

Preliminary Findings, continued

Net Receipts (Less Returns and Allowances)

Tax Year	NMA	NMP	Error Rate
2003	$19B	<0.5%	26%
2004	$16B	<0.5%	28%

Deductions from Ordinary Business Income

Tax Year	NMA	NMP	Error Rate
2003	$27B	2%	64%
2004	$25B	2%	62%

“Other Deductions”

- Total is reported on Line 19
- Classified into 40 categories by NRP

Tax Year	NMA	NMP	Error Rate
2003	$18B	4%	60%
2004	$16B	4%	56%

- Net depreciation expenses had next highest error rate amongst expenses
  - 24% in TY03 and 25% in TY04

“Other Deductions”, continued

Five categories with the highest NMPs

Expense Category	**TY03**	**TY04**
Car and Truck	17%	16%
Travel	18%	11%
Meals and Entertainment	12%	11%
Miscellaneous Expenses	8%	10%
Tools and Factory Supplies	9%	8%

“Other Deductions”, continued

Four Expense Categories with the largest NMAs and Error Rates

	NMA ($B)		Error Rate	
Expense Category	**TY03**	**TY04**	**TY03**	**TY04**
Car and Truck	$3	$3	42%	41%
Other Expenses	$2	$3	23%	26%
Insurance	$2	$2	26%	27%
Travel	$2	$1	31%	28%

Officers' Compensation (OC)

Errors typically offset at shareholder level, but contribute to employment tax gap

Tax Year	NMA	NMP	Error Rate
2003	-$11B	-6%	22%
2004	-$12B	-7%	23%

S corporations with assets under $200,000

Tax Year	% of Reported OC	% of Misreported OC
2003	38%	78%
2004	42%	71%

TY03/04 Average Reporting Of Ordinary Business Income by Level of Reported Assets

Reported Assets	Share of Reported Amount	Share of NMA	NMP
Under $200,000	24%	55%	26%
$200,000 to $10M	36%	38%	14%
Over $10M	40%	8%	4%

Small S Corps. and Sole Proprietors

- Hypothesis that compliance of the smallest, closely held S corporations is similar to the compliance of sole proprietors.
- **Fewer shareholders**
  – less collusion needed
  – greater opportunity to underreport
- **Smaller businesses**
  – may be less formal businesses with poorer records management
  – increased opportunity to make mistakes and underreport

NMPs of TY03/04 S Corps. with less than $200,000 of Reported Assets and 1 or 2 Shareholders and TY01 Sole Proprietors (Schedule C)*

	S Corporations		Schedule C
	TY03	TY04	TY01
Gross Income	3%	3%	8%
Total Expenses	5%	4%	12%
Net Profit(Loss)	26%	29%	27%

** Estimates are based on the raw findings from NRP underreporting studies and not adjusted for noncompliance that was undetected during the audit.*

Conclusions

- S corporations underreported $50B(12% NMP) and $56B(16% NMP) of total income in TY03 and TY04, not accounting for income not detected.
- Underreported officers' compensation was over 20% as large as all other misreporting.
- Closely held smaller S corporations misreported their net profit or loss at a similar percentage as TY2001 sole proprietors.
- Net profits may be a strong factor driving the misreporting of gross income and expenses.

Future Research

- Analyze shareholder results
- Compare S corporation study results to the TY01 Schedule E tax gap estimates
- Explore methodologies for combining the two years of the study
- Estimate employment tax gap related to underreported officers' compensation

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Does FIN 48 Benefit the Tax Authorities through an Increase in Taxpayer Compliance?

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Accounting Uncertainty in Income Taxes

- Concern with transparency in companies' financial reporting has been growing in order to protect investors
  - There were minimal standards and companies had flexibility in accounting for uncertain tax positions
  - This affected the public's ability to compare companies' financial statements

Financial Interpretation No. 48 (FIN 48)

- FIN 48 was introduced to provide guidelines on calculating tax costs under uncertain tax positions

Policy concerns

- FIN 48 should increase companies’ tax payments
  - FIN48 employs a more strict standard to defend tax positions (“more-likely-than-not”)
  - Companies need to disclose more detailed information regarding their tax positions

Objective

- We examine the effects of FIN 48 on companies’ tax payments
  - While the literature discusses FIN 48’s effects on financial reporting strategies (e.g., tax reserves), its effect on tax payments are not yet explored

Hypothesis 1

- Introducing FIN 48 has increased tax payments by companies
  - FIN 48 disclosures may benefit tax authorities
    - With reduced information asymmetry, the tax authorities can raise the efficiency in selecting companies for tax audits and focus attention to specific tax issues within a tax audit

Companies of different sizes may react differently

- Different exposure to tax audits
  - Very large companies are continuously audited, while smaller companies are only exposed to tax audit lottery

- Different levels of resources needed for creative tax planning and tax audit defense
  - Larger companies generally have more resources to gain access to more sophisticated tax strategies and high-quality tax professionals

Hypothesis 2

- There is a trade-off effect between tax audit lottery and resources for tax saving
- Effects of FIN 48 should vary depending on which factor is more dominant

Hypothesis 2-a

- With FIN 48, smaller companies increased their tax payments, while larger companies were unaffected
  - Larger companies with continuous tax audits are less likely to alter their behavior with FIN 48 relative to their smaller counterparts

Hypothesis 2-b

- With FIN 48, larger companies increased tax payments and smaller companies unaffected
  - Larger companies may have had more aggressive tax positions prior to FIN 48 by utilizing sophisticated tax strategies

Data

- The S&P Compustat North American database
- Our analysis focuses on U.S. companies in relevant industry sectors during 1989-2008
  - We eliminated observations not sensitive to the introduction of FIN 48 (e.g., the government, agriculture, forestry, and fishing sectors)
- All monetary measures are deflated with producer price index to 2007 dollars

Size categories

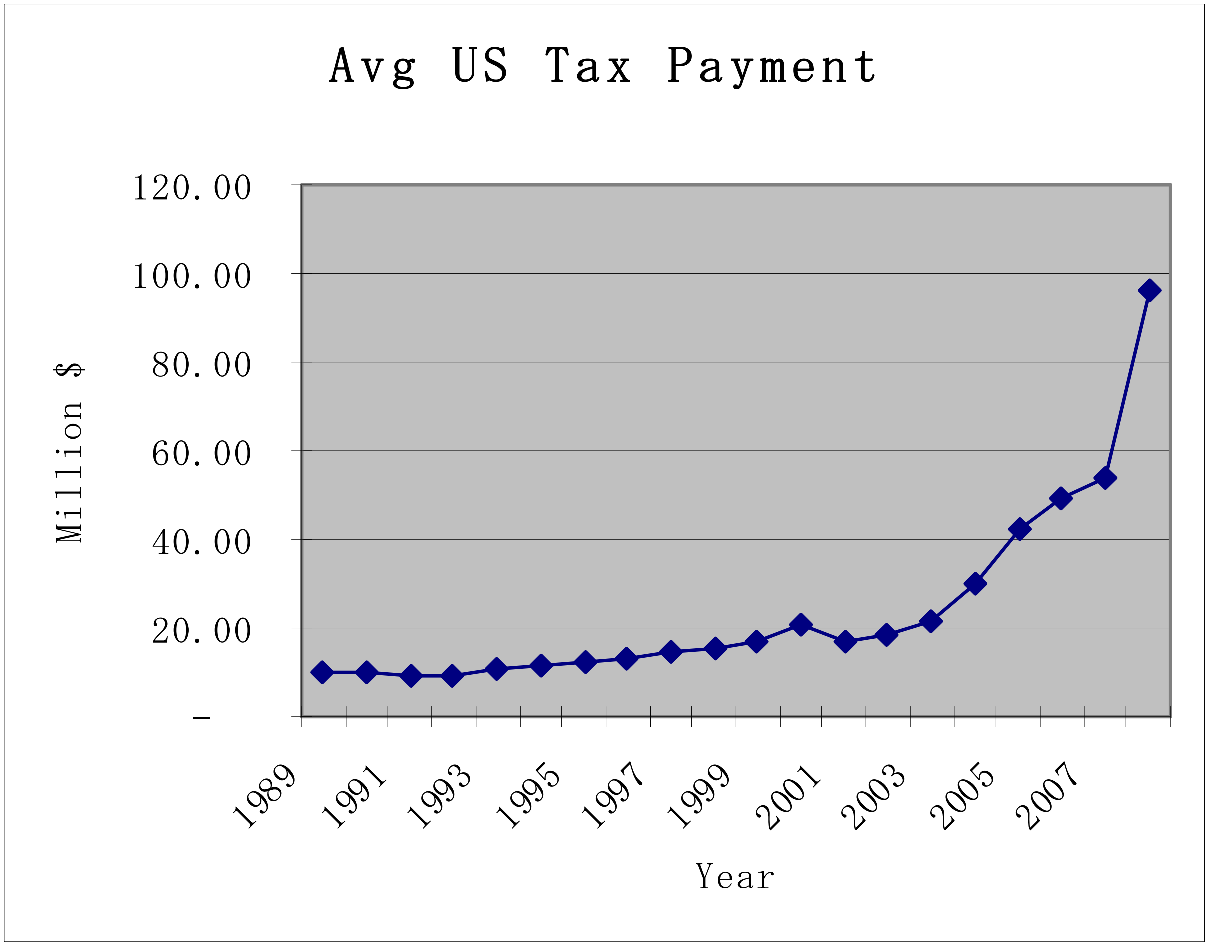
- Large: companies with total assets greater than $250 million
- Medium: companies with total assets between $10 and $250 million
- Small: companies with total assets less than $10 million
- Non-Large=Medium + Small
  - This classification follows the one in the IRS Data Books

Two types of tax payments

- Federal income tax payment in levels

- Ratios of the federal income tax payment to total pre-tax income

Level of tax payments

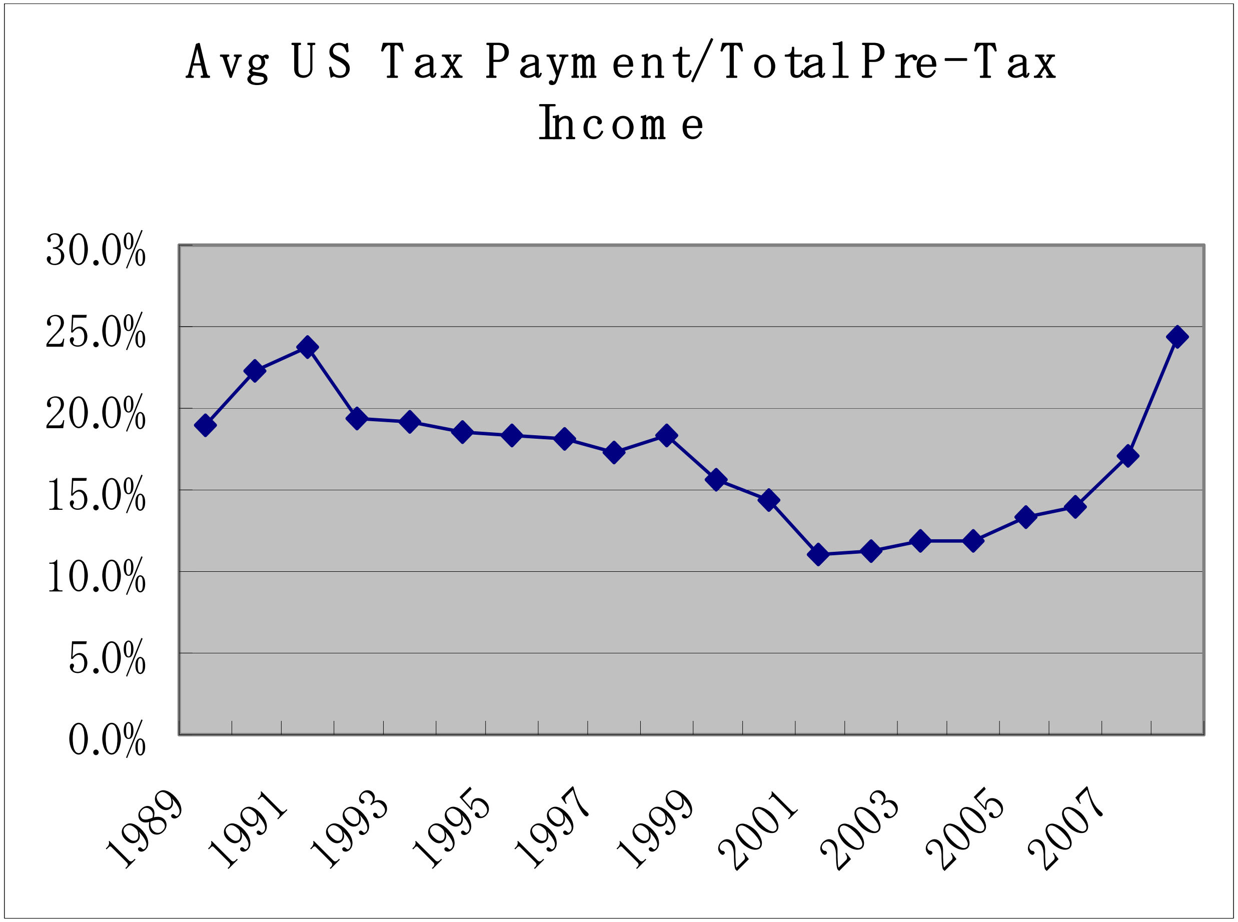


Level of tax payments

- Upward trend except recession years when the level of tax payments dropped

- Increased tax payments, from $48.8 million to $54.9 million, for the fiscal year prior to the mandatory adoption of FIN 48 and the fiscal year FIN 48 was instituted

Ratio of tax payments



Ratio of tax payments

- We compared ratios of the federal income tax payment to pre-tax income (alleviates an economic growth issue)

- Average company increased federal tax payment in ratios, from 13.98 percent to 17.29 percent, right before FIN 48 and right after FIN 48

Trends show sizes matter

- Tax increase is obvious for Large companies but not for non-Large companies
- Results should be interpreted cautiously
- Other factors are controlled

Empirical Model

- Our analysis compared companies' tax payments before and after FIN 48
- Control for company characteristics, and (unobserved) industry and time factors.

  - More formally, we examine a one-shot effect of FIN 48 (how Fin 48 affected the tax payments of companies that experienced FIN 48 for the first time).

Results

- Average tax rate is the ratio of U.S. federal income tax payment to total pre-tax income
- Average tax rate of Non-Large companies did not change after FIN 48
- Difference in this rate between Large companies and Non-Large companies increased by 6.9 percentage points after FIN 48

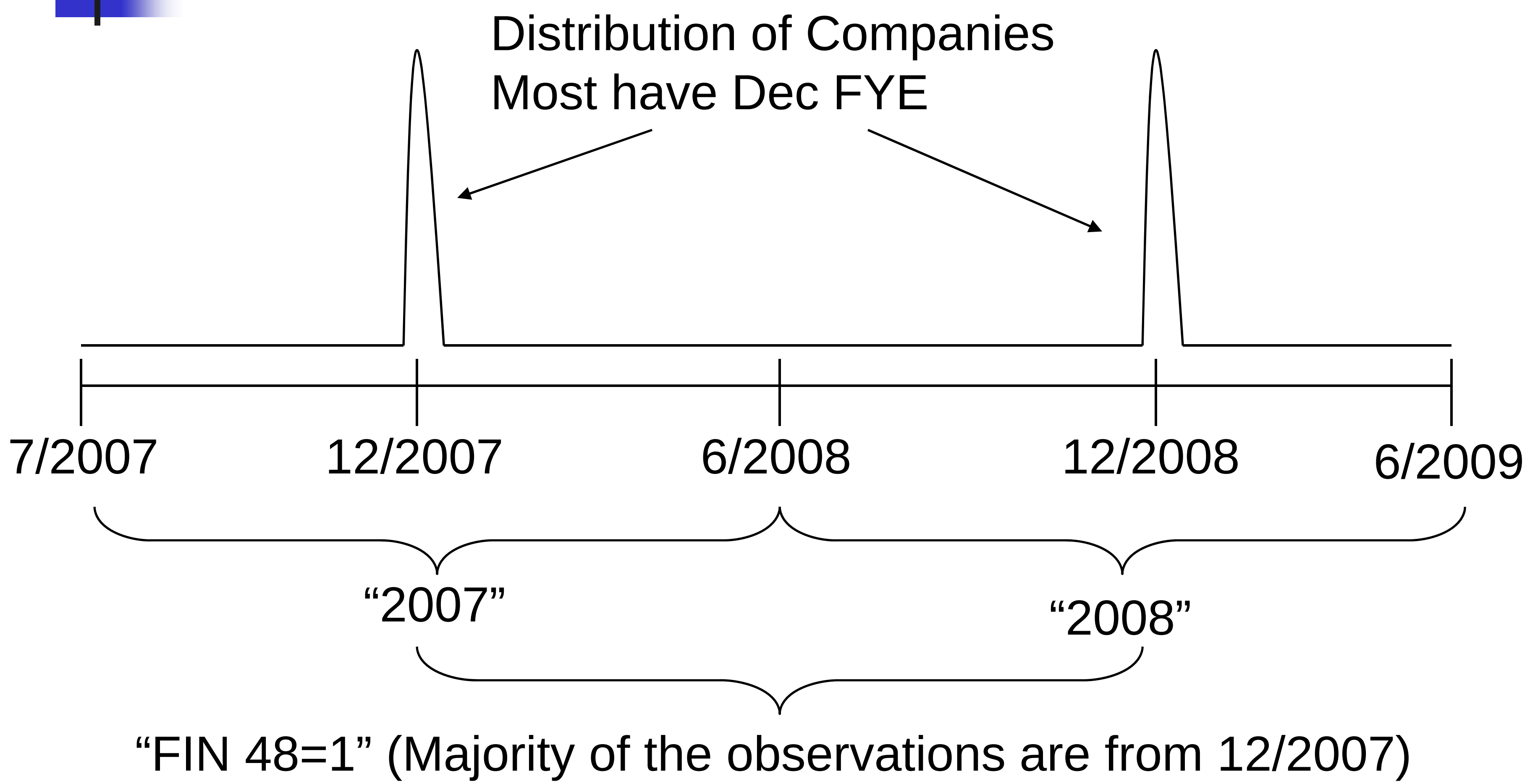
Conclusion

- Only larger companies increased tax payments and smaller companies appears unaffected
  - Larger companies were discouraged to use aggressive tax saving strategies due to FIN 48’s disclosure requirements

Extensions

- Our analysis focused on one-shot effects of FIN 48 on tax payments
  - i.e., the transitional period right before and right after the implementation of FIN 48
- One possible extension is to examine if FIN 48 has permanent effects on tax payments
  - We suspect that larger companies are creative enough to develop new tax saving strategies; thus, the effects of FIN 48 on tax payments will fade out.

FIN 48 Dummy and Company Distribution



FIN 48 Dummy and Company Distribution

- FIN 48 must be adopted for companies that have Fiscal Year **Beginning** December 16, 2006.

- This means that all companies with FYE from December 16, 2007 to December 15, 2008 would have their first mandatory experience with FIN 48.

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Analyzing the Enhanced Relationship between Corporate Taxpayers and Revenue Authorities: a UK Case Study

Judith Freedman, Geoffrey Loomer & John Vella
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Overview

Managing Tax Risk and Relationships

- Revenue authorities internationally seeking new ways to manage tax risk & relationships with large business taxpayers
- UK Varney Review is one example
- Surveys by Oxford University Centre for Business Taxation explored business perspective on Varney Review

Outline of Discussion

1. Brief Comparative Review
2. Survey Methodology
3. Summary and Analysis of Survey Results
4. New Developments

1. Brief Comparative Review

Enhanced Tax Relationship Programs

- 2008 OECD Study
- Australia – “responsive regulation”
  - Compliance Model (1998)
  - Forward compliance arrangements
- Netherlands – “horizontal monitoring”
  - Dutch Polder model of dialogue
  - Enforcement agreements

Comparative Review (cont'd)

V Braithwaite (2002)

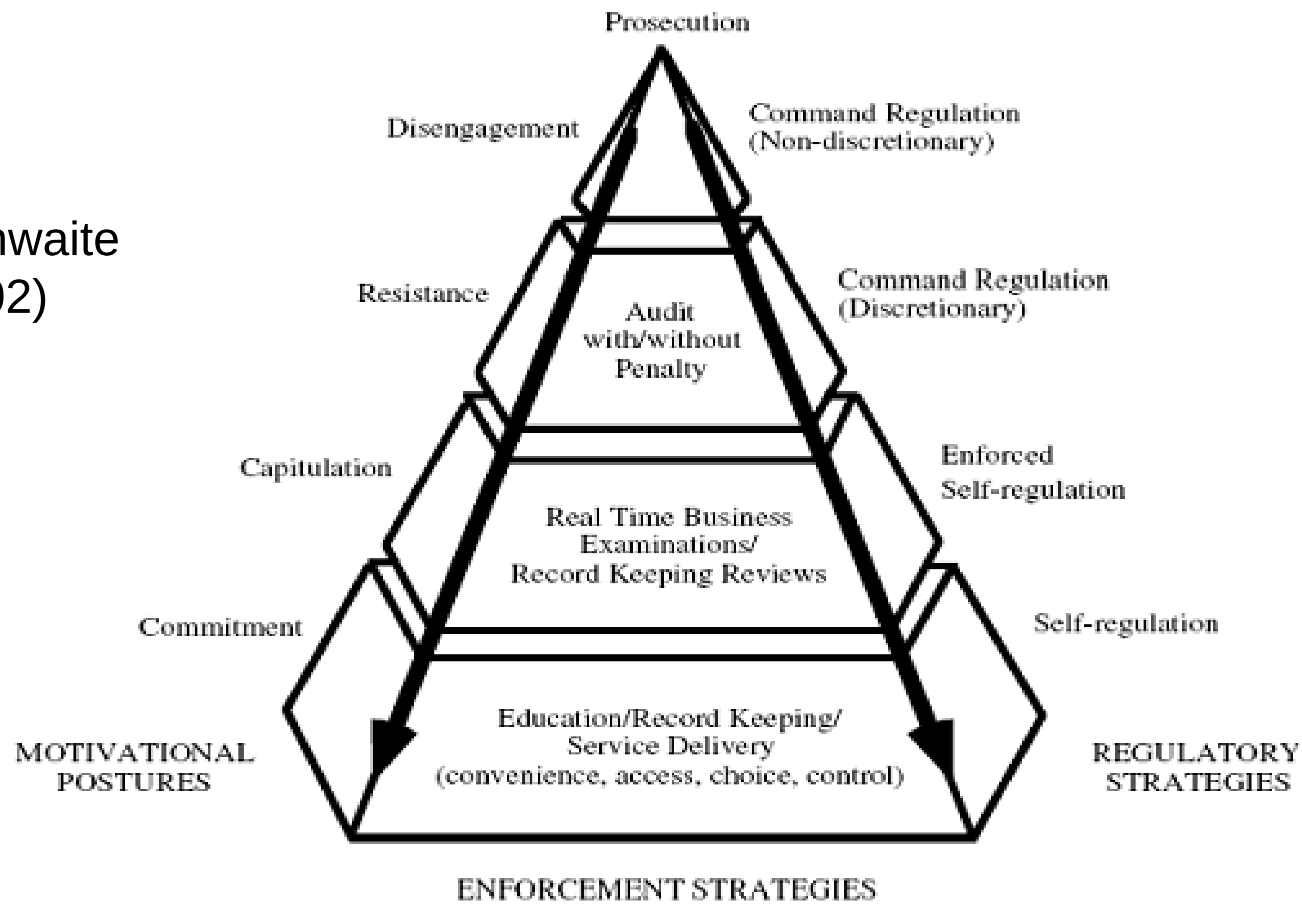
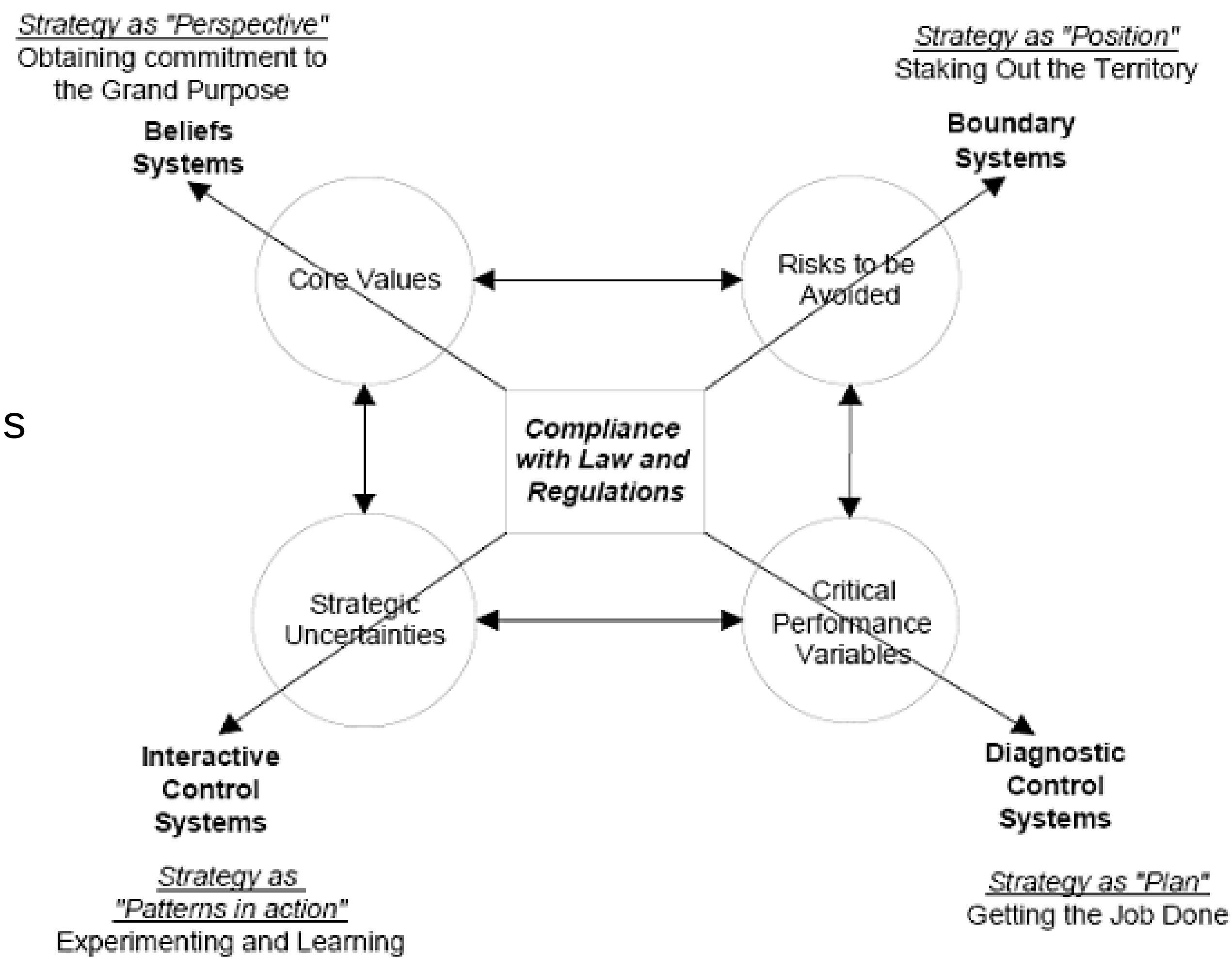


Figure 1.1 Example of regulatory practice with ATO Compliance Model

Comparative Review (cont'd)

R Simons
(1995)



Comparative Review (cont'd)

US Approaches

- Programs include CAP and LIFE
- CAP
  - Taxpayer to make full disclosure through year
  - Try to resolve all material issues before filing tax return (no post-filing examination)
- LIFE
  - Formal agreement between IRS & taxpayer
  - Focus on key issues
- IRSAC 2008 report recommended monitoring UK initiative

Comparative Review (cont'd)

UK Varney Review

- Program initiated in 2006
- Four desired outcomes, all contributing to enhanced relationship with large businesses
- One objective: efficient risk based approach to dealing with tax matters
  - Risk Rating Approach (RRA)
  - Risk means "compliance risk"

2. Survey Methodology

Sampling

- 2007 Pilot – 9 companies, all FTSE 100 volunteers
- 2008 Survey – Broader sample (30)
  - 8 of 9 from 2007 Pilot
  - 21 selected randomly from FTSE 350
  - 1 unlisted
- Focus on larger companies
  - Smaller firms had limited knowledge or interest

Methodology (cont'd)

Conduct and Analysis of Interviews

- Face-to-face, in-depth interviews
  - Questions on risk rating approach, relationships with HMRC, new legislative approaches to tax avoidance
- Use of detailed tax-planning scenarios
- Two interviewers with knowledge and experience of relevant legal issues
- Interviews transcribed and coded independently by interviewers

3. Survey Results

Overview of Risk Rating Approach

- RRA is “an efficient risk based approach to dealing with tax matters” (Varney 2006)
- Two Objectives:
  - “more cost effective use of resources and efficient resolution of issues”
  - means to incentivize companies to alter behaviour in terms of transparency, governance, and tax planning

Survey Results (cont'd)

Reported Risk Ratings

- Companies rated on number of criteria & given overall rating
- Companies could be "low" or "higher" risk
- Respondents spread fairly evenly along spectrum
  - 16 gave overall rating: 7 low, 2 "moderate", 7 high
  - 10 referred to different ratings for different criteria: 5 seemed lower, 5 seemed mid/higher
  - Remaining 4 had not been risk assessed

Survey Results (cont'd)

Reported Risk Ratings

- Results in line with HMRC's expectation that 40% would be low risk by March 2008
  - By June 2008, actual number of LBS firms with low risk rating was 238 (of about 700)
  - Most recent figure is 30%
- Loose correlation in survey between higher risk rating & large complex companies
  - Will HMRC provide data of ratings based on size and sector?

Survey Results (cont'd)

Risk Rating Criteria

- Criteria are (i) structural (ii) behavioural
- Previously there was lack of clarity about weight given to different criteria
  - Can large, complex firms ever be low risk?
- Majority of respondents said more weight now being given to behavioural criteria
  - Opinions and evidence suggest that large, complex firms *can* be low risk
- Minority of respondents remain sceptical

Survey Results (cont'd)

Risk Rating Criteria

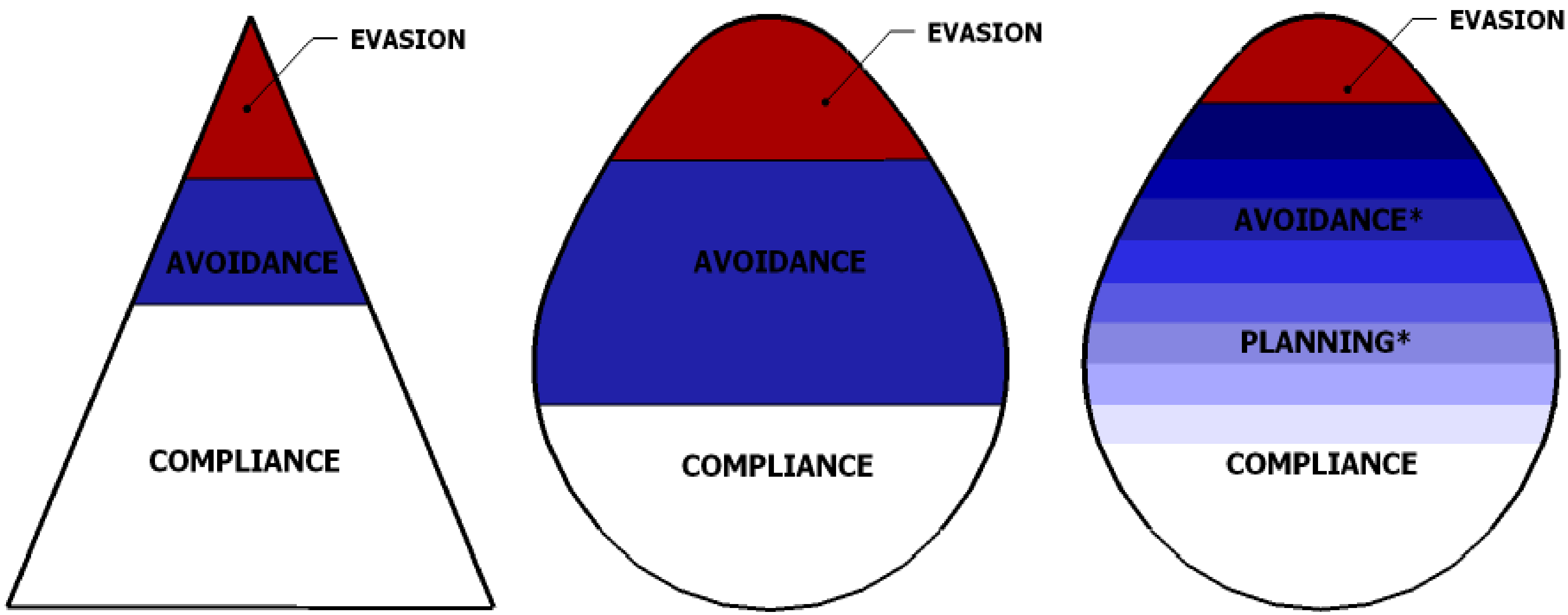
- Behavioural criteria under RRA are governance, "delivery" and tax strategy
- Virtually all respondents said they aspire to good governance, internal systems, transparency and disclosure
- Survey suggests that "tax strategy", specifically **tax planning/avoidance**, could be pivotal criterion in many cases

Survey Results (cont'd)

Benefits of Being Low Risk?

- Previous lack of clarity about alleged benefits
- About ½ of respondents said benefits clear
  - Fewer interventions
  - Formal/informal clearances
  - Quicker resolution of issues
  - Generally better relationship with HMRC
- Others could not see tangible benefits or thought benefits insufficient to lead them to curtail tax planning

Survey Results (cont'd)



INDIVIDUAL TAX COMPLIANCE
(J Braithwaite, 2002)

CORPORATE TAX COMPLIANCE
(J Braithwaite, 2002)

LBS TAX COMPLIANCE
(OUCBT Survey, 2008)

* Transactions ranging from "aggressive avoidance", e.g. transactions with "artificial" steps and no commercial purpose, through to "planning", e.g. transactions with commercial purpose but where meaning of legislation ambiguous.

Survey Results (cont'd)

Anti-Avoidance Rules (TAARs and PBL)

- Some support, but significant concern about certainty, clarity & consistent application
- Concerns about HMRC not understanding or allowing "commercial" tax planning
- Are RRA and enhanced relationship enough to create taxpayer trust?

4. New Developments

- May 2009 Guidance
  - Change from 2007 Guidance not clear
  - Importance of behavioural factors
  - Tax strategy factors contentious
- Finance Bill 2009
  - Certification requirement for sr accounting officer
  - “appropriate tax accounting arrangements”
- Code of Practice on Taxation for Banks
  - Consultation document issued 29 June 2009

Conclusions

- Varney Review has brought valuable developments, including RRA
- Effect of RRA on reducing compliance risk remains uncertain
- Rule of law limitations exist

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Tax Systems and Taxpayer Behavior

Discussant: George Plesko

University of Connecticut

2009 IRS Research Conference

The Tax Behavior of Corporations

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Analyzing the Enhanced Relationship between Corporate Taxpayers and Revenue Authorities: A United Kingdom Case Study, Freedman, Loomer, and Vella

Common themes

- The papers provide excellent introduction to their areas, important institutional descriptions, and new insight into either the behavior, or the *behaviour*, of businesses.

- All provide new data and perspectives on compliance.

- Nicely complement each other.

S Corporations, Johns

Highlights

- S corp underreporting of $50 ($56) billion in TY2003 (TY2004).
- Misclassification of compensation as distributions
  - Affects employment tax underreporting
- “Other” is large (auto/truck and travel expenses)
- Smaller S corps less compliant
- Compliance similar to sole props

S Corporations, Johns

Observations

- Demonstrates the importance of the NRP
- Critical need to understand and examine the interrelations of all related returns.
- Provides a nice foundation for other compliance work being done by the IRS

S Corporations, Johns

Suggestions

- Provide some links to the academic literature on organization form (another paper?)
- More analysis of the (1 v 2) v 3 shareholders
- In addition to the comparisons to sole props, can you extend to closely-held C corps and partnerships

FIN 48, Lee, Lee, and Tomohara

Highlights

- Key empirical conclusion is that FIN48 increased tax payments of the largest firms

FIN 48, Lee, Lee, and Tomohara

Observations

- Compliance with FIN48 has conflicting predictions for overall tax payments.
- Larger companies increasing their payments is a potentially counter-intuitive result.
  - While they may be more aggressive, they also have more resources to defend aggressive positions.

FIN 48, Lee, Lee, and Tomohara

Data

- May have included *too many* years – accounting and other regulatory changes affect the data in ways that are difficult to control (e.g. stock options, R&D, repatriation rules) and excluded too many industries (e.g. agriculture)
  - 2008 is incomplete – but the key effects will bracket 12/2006
- Compustat doesn't always accurately capture taxes when compared to tax returns, it may systematically overstate liability
- Be careful that you only measure domestic liability on domestic income, but this can dramatically reduce observations.
  - Cash paid, total pretax income, and total tax include all jurisdictions.

FIN 48, Lee, Lee, and Tomohara

Suggestions

- Provide a complete presentation of the data (including Compustat identifiers) and the full regression output
  - May have overcontrolled for firm characteristics
- Financial accounting data, and FIN48, work off of nominal *accounting* relations, and may not have direct implications for real payments.
- Given that *all* publicly-traded firms are affected by FIN48, the 2nd part of Table 3 needs to be carefully specified in the difference-in-differences specification.

UK Case Study, Freedman, Loomer, and Vella

Highlights

- Field study interviewing corporate tax directors for reactions to Risk Rating Approach (RRA)
  - Parallels to CAP, M-3, and FIN48 regarding allocation of enforcement and corporate resources.

UK Case Study, Freedman, Loomer, and Vella

Observations

- The RRA provides a structure to think about tax complexity and compliance
  - "inherent" v "structural" risk: maps into the way that academic researchers think about planning and the detection of aggressive taxpayers
- Develops an explicit link between governance and tax reporting that I don't think has been established in the policy discussions in the US (though touched upon in academic research)

UK Case Study, Freedman, Loomer, and Vella

Suggestions

- More information about the sample, especially since they self-select into your study.
  - This is partially done in footnotes 66 & 67 but more might be provided if it is available from public sources (you may be more representative than you think).
  - Summary statistics by risk category of firms.
- Help us develop some large-sample hypotheses.

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During the break, please visit the SOI Booth in the upper lobby.