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IRS and corporate taxpayer effects of geographic proximity[☆, ☆☆]

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ABSTRACT

We investigate whether geographic proximity between corporate headquarters and IRS regional offices affects corporate tax avoidance and the likelihood and productivity of IRS examinations. Using geographic distance to represent information asymmetry, we find that corporations avoid more tax when located closer to the IRS unless they are close to an IRS industry specialist. This finding is consistent with taxpayers believing proximity provides them with an information advantage over the IRS. From the perspective of the IRS, we find that the Service is more likely to audit nearby companies and to assess more tax per hour from nearby taxpayers, except during constrained budget years. IRS audit likelihood and productivity are unaffected by the presence of nearby industry specialists, consistent with industry specialist proximity already constraining avoidance. Our tax compliance setting provides dual-party evidence on the proximity-information asymmetry hypothesis.

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1. Introduction

Corporate tax avoidance raises many challenging questions about the appropriate design of a tax enforcement agency (Slemrod et al., 2001). Because data on the actions of IRS auditors are mostly unavailable and because corporations jealously guard tax avoidance strategies, the nature of the relation between corporate tax avoidance and IRS enforcement is not well

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understood. This study adds to our understanding of the relation between corporate tax avoidance and tax enforcement by examining how the information environment, reflected by the proximity between corporate headquarters and IRS supervision, affects both tax avoidance and IRS enforcement. Because actions by taxpayers and IRS auditors are linked over time, we rely on the sequential nature of tax compliance (taxpayers declare income on returns before audits commence) to provide identification in our empirical tests.

Income taxes provide a powerful setting to investigate the effect of information asymmetry on adversarial parties. Multiple studies show information is more abundant and more efficiently disseminated when located closer to the source.[1] In addition, this evidence is consistent with recent research finding that indirect networks influence corporate taxpayer behavior (Brown, 2011; Brown and Drake, 2014). We posit below that proximity can provide information advantages to both corporate taxpayers and the IRS and estimate the benefits to each party. We test our predictions in a setting that provides a unique opportunity to observe the extent to which geography impacts the behavior and outcome of adversarial parties and provides new insights that can be used in the formulation of tax enforcement policies.

From the perspective of corporate taxpayers, we expect that proximity to IRS supervision will affect the abundance and accuracy of information available to corporations about local IRS enforcement methods and priorities. However, the effect of increased information on tax avoidance is uncertain. On one hand, corporations that anticipate a higher likelihood of IRS audit might be inclined to claim less aggressive tax positions to streamline the audit process, reducing expected costs associated with disputes. On the other hand, knowledge of audit priorities and focus, and even local IRS skillsets, could encourage more tax avoidance as corporations can tailor tax strategies to take advantage of areas receiving less IRS scrutiny. Further, nearby corporations could anticipate more frequent IRS audits and claim more aggressive tax positions to provide a lower "opening bid" for negotiation and a cushion for expected settlements. To triangulate our tests, we examine whether the level of information asymmetry is influenced by the presence of a nearby IRS industry specialist for that taxpayer's industry. We conjecture that the closer presence of an IRS specialist would moderate any information advantage otherwise enjoyed by taxpayers from proximity.

From the perspective of the IRS, we predict IRS audit probabilities (the likelihood the IRS selects the corporate return for examination and conducts an exam) and IRS audit productivity (tax assessments generated per examination hour) are higher for nearby corporate taxpayers because IRS personnel have greater access to enhanced information regarding corporate taxpayer behavior.[2] Monitors such as investors, analysts, the SEC, and independent auditors have been found to benefit from geographic proximity, and so, we posit, the IRS might benefit as well.[3] For example, the IRS may know more about the operations and developments in nearby firms because of direct past experience or via indirect connections such as local media coverage. In addition, we conjecture that proximity reduces search and travel costs thereby making nearby tax audits more cost effective for the IRS, and thus, we expect the effect of proximity will be amplified in years when IRS enforcement budgets are constrained.

We employ the distance between the location of firm headquarters and the nearest IRS territory manager office as our measure of proximity to IRS supervision. This distance is relevant because IRS territory managers supervise local managers who, in turn, supervise IRS field agents conducting audits at corporate headquarters. Our sample matches Compustat data with confidential tax return data by Employer Identification Number (EIN) and fiscal year over the period 1996 through 2012. To provide identification, we rely on the sequential nature of tax return filing: corporations first declare taxable income by filing their tax returns. After inspecting the tax return data and considering other information, the IRS then decides which returns to audit and the amount of resources to devote to each audit.

We use multiple broad measures of tax avoidance to capture all reductions in explicit tax paid relative to income earned. We use confidential IRS data for two measures: 1) a tax return ETR that equals the tax reported on the return after credits divided by worldwide pretax income and 2) an adjusted tax return ETR that equals the tax reported on the return after credits plus any proposed deficiency, divided by worldwide pretax income, as an upper bound on total payments to the IRS.[4] This latter measure represents a preliminary estimate of the net effect of tax avoidance and IRS enforcement. We triangulate our IRS avoidance measures by using a financial statement cash effective tax rate (*Cash ETR*) that equals total cash taxes paid scaled by pretax book income.

[1] See Audretsch and Stephan (1996), Audretsch and Feldman (1996), Coval and Moskowitz (2001), Ivkovic and Weisbenner (2005), Malloy (2005), Kang and Kim (2008), Li and Yermack (2014).

[2] We refer to the additional tax assessment (proposed deficiency) per hour spent on the exam as IRS audit productivity. Although we do not specifically observe the IRS reporting productivity directly, the IRS Databook (Table 29) annually reports the cost to collect $100 of tax revenue (https://www.irs.gov/pub/irs-soi/15databk.pdf). In a U.S. Government Accountability Office report (GAO-14-732) concerning Large Partnerships, the GAO refers to productivity or efficiency in the context of how quickly the IRS can close the case, and they analyzed "the hours and days spent on large partnership audits to assess the costs of these audits" (p. 42). They also considered the audit coverage rate (percent of returns subject to audit) and the no change rate (percent of audits that resulted in no change). We combine these concepts and argue that, for the Enforcement Division, the ratio of the proposed deficiency to the time spent on the examination measures productivity in terms of how quickly the IRS closes the examination and whether the time spent is productive. An improvement in productivity as we measure it would decrease the "cost per $100 collected".

[3] See Coval and Moskowitz (1999, 2001), Kedia and Rajgopal (2011), DeFond et al. (2015).

[4] Our results are insensitive to using alternative denominators for the ETRs. In particular, our results are robust to scaling the tax return ETR measures by pretax income using data items obtained directly from the corporate tax return. We also find qualitatively similar results if we scale the tax return based ETR measures by pretax domestic income.

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