

Corporate Tax Compliance: The Role of Internal and External Preparers

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The current corporate tax environment is characterized by a high degree of uncertainty. Uncertainty in the tax law can create opportunities for planning, but can also create challenges in compliance. To evaluate the compliance responsibilities and implications surrounding business transactions, companies employ internal tax specialists and/or hire external advisory firms. The effect of the tax advisor in compliance decisions of corporations is very important, but has not been subject to much archival empirical research due to the lack of available data. This paper begins to overcome that shortcoming by using confidential large-sample data from the Internal Revenue Service (IRS) on who signs the corporation's tax return to study the link between the tax service provider and the compliance decisions involving the corporation's tax positions. We also evaluate the ability of publicly disclosed tax fees to reveal the identity of the corporate tax return preparer.

An extensive literature has examined the relation between auditors providing tax services and their effect on the audit process (e.g., Davis et al., 1993; DeFond et al., 2002; Abbott et al., 2003; Kinney et al., 2004; Francis and Ke, 2006; Pittman and Fortin, 2008; Lim and Tan, 2008; and Zamar et al., 2011). There continues to be a debate over whether auditors providing tax services impair independence, create knowledge spillover, or both. However, the literature remains mostly silent on the role of a broader set of tax preparers—including internal tax departments and non-auditors—and their effect on corporate tax-related decisions.

Examining the relationship between tax preparers and corporate tax aggressiveness is important for several reasons. First, overall tax service work is economically significant yet vastly under-studied due to data limitations. In their 1992 survey of about 1,300 large corporations, Slemrod and Blumenthal (1996) estimate that the average aggregate annual cost of complying with Federal and sub-Federal income taxes is about \$2 billion. Our sample firms alone pay over \$815 million in total to their auditors for tax work in 2008 and 2009; as the results in Slemrod and Blumenthal (1996) suggest, surely this number is higher if we could observe the costs related to internal tax departments or external non-auditor tax work.

Second, the IRS has long been interested in the effect of tax preparers on compliance. However, the focus has mostly been on individual tax compliance (e.g., Slemrod and Sorum, 1984, and Slemrod, 1989). For example, Long and Caudhill (1987) and Christian, et al. (1993) examine the determinants of individuals' choice in hiring a paid preparer using archival data, while in an experiment, Hite and McGill (1992) examine whether individuals retain or dismiss their preparer if they disagree with the preparer's advice to report a tax position aggressively.

More recently, Neuman, et al. (2011) explore the not-for-profit sector where the identity of the preparer is disclosed in publicly available tax returns (i.e., on IRS Form 990). In testing the effect of preparer type on donations (their measure of credibility), they find that external preparers are positively associated with donations. They interpret this evidence to suggest that the public views self-prepared returns as less credible. Although they infer that their results generalize to the for-profit sector, direct evidence on the role of tax preparer type in a corporate setting remains elusive. Our objective is to fill this void. In particular, our research questions ask whether tax preparer type is associated with tax aggressiveness; and how accurately public data on tax fees paid to a firm's auditor capture the actual tax return preparer type.

To answer these questions, we use confidential data from the IRS on who signs the tax return for 1,533 firm-years during 2008 and 2009. The tax return data allow us to focus on whether the compliance activities of the company are primarily administered by the internal tax department, the company's financial statement

auditor, or an external non-auditor preparer. Until now, researchers have been able to observe only the dichotomous choice of a corporation using or not using its auditor for tax services (e.g., Lassila, et al., 2011); and even so, it remains unclear the degree to which the “tax services” pertain to tax compliance or something else.

We extend the theoretical model of Mills, Robinson, and Sansing (2010) to form predictions of the relationship between the type of tax preparer and the observed aggressiveness of the company’s tax-related decisions. Following Mills et al., we define tax aggressiveness as claiming a tax position (e.g., tax credit, deduction, income exclusion, or income character) with relatively weak underlying facts. From this model, we predict that internally prepared tax returns are more aggressive than externally prepared returns, on average, because theory suggests that companies who do not hire an external preparer tend to undertake uncertain positions more frequently if they face lower total reputation costs. We also predict that, in equilibrium, companies are more likely to claim aggressive tax positions with the non-auditor than the auditor preparer when tax law ambiguity is present.

Using current-year changes in FIN 48 tax reserves as our proxy for tax aggressiveness, and linking them to the tax preparer identity from the tax return, our empirical tests support these two hypotheses. In particular, we find that internally prepared tax returns take more aggressive tax positions than externally prepared returns, and that external *non*-auditor-prepared tax returns claim more aggressive positions than returns prepared by the firm’s auditors. We conduct various robustness tests using measures for tax shelter use (also obtained from the IRS), tax haven subsidiaries, and financial reporting aggressiveness, as well as by subsamples of high versus low cash-effective tax rates and discretionary accruals, and find that these inferences hold.

In a final analysis, we examine how accurately tax-preparer type can be inferred from public data on tax fees paid to a firm’s auditor. We do so to assess whether the signal available to investors and researchers in financial reports on tax services is useful to infer tax compliance work. We find that more than 80 percent of our sample firms publicly disclose tax fees paid to their auditor, but only 20 percent of tax returns are in fact prepared by the auditor. Using a variety of proxies using tax fee data to infer preparer type, we attempt to replicate our main results based on actual tax return preparer identities, but are unable to do so. This finding suggests that tax fees have limited use in correctly identifying the tax preparer, and thus the primary tax compliance advisor of the company.

Given the paucity of archival research on tax preparers generally, our study makes a significant contribution in understanding their important role in the U.S. tax system. Specifically, our research is the first to document the identity of tax return preparers for a large sample of U.S. companies, to report its links to tax aggressiveness, and to evaluate how tax fees mostly do not accurately capture tax compliance activities that are observed directly from the tax return.

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