

Real Costs (and Benefits!) of Tax Audits: Evidence from Firms Randomly Selected for IRS Examination

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Disclaimer

All data work for this project involving administrative tax data was done at IRS facilities, on IRS computers, by IRS employees, and at no time was administrative tax data ever outside of the IRS computing environment. The views expressed here are those of the authors alone, and do not reflect the views of the Internal Revenue Service.

How to Survive an IRS Tax Audit

Don't panic during a federal tax audit.



By Susannah Snider, Senior Editor, Personal Finance May 14, 2019, at 10:01 a.m.





How to Survive an IRS Audit

It's slightly less enjoyable than a root canal, but you can do it.

We all dread the thought of having the IRS tell us it wants to review a previous year's tax return. If you get audited, your best bet is to seek out a qualified tax professional. But if you're a do-it-yourself type of person, here are a few tips you can use to help you survive the audit process.

Don't ignore the notice. You generally have 30 days to respond to an audit notice. If you don't respond, the IRS can take action, such as automatically adjusting your tax liability, and the next correspondence you'll receive is a bill.

Read and follow the notice. The audit notice will give you specific information as to what items are being examined. Knowing what's being scrutinized will help you determine what you need to bring to the audit, so you can substantiate the items in question.

Organize your records. Making the auditor's job easier will win you some points. The auditor will at least believe that you're an [organized person](#) and that all of your items are documented and justified. Don't be afraid to group the items in question, or attach an adding-machine tape that matches the tax return. That will allow the auditor to quickly review the important issues. Don't believe those who tell you that you can just throw your records in a bag, drop it on the auditor's desk, and shout, "You figure it out!" That just doesn't work. Remember, it's *your* legal responsibility to prove your deductions.

How to survive an IRS tax audit

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Just because IRS audits are at a 15-year low doesn't mean it can't happen to you.



Paramount / Courtesy Everett Collection



By
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REPORTER



Audits are on the decline, but it could still happen to you. Here are some tips for surviving.

The Internal Revenue Service is auditing fewer taxpayers than it used to, but that doesn't mean it's out of the question for you.

The number of taxpayers the IRS audited declined

<https://www.wsj.com/articles/the-irs-is-auditing-a-lot-fewer-americans->

4 Ways To Survive A Dreaded IRS Audit



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Entrepreneurs

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FILE - In this photo March 22, 2013 file photo, the exterior of the Internal Revenue Service (IRS) building in Washington. Politicians love trying to use the tax code to highlight their goals to voters. This year, it's a battlefield between Hillary Clinton, who wants to boost levies on the rich to pay for expanding social programs and Donald Trump, who says cutting taxes would gird the economy. The clash has consequences for the rich, poor and those in the middle. (AP Photo/Susan Walsh, File)

There are certainly horror stories in which IRS audits have led to the closure of businesses. Yet these are really worst-case scenarios. The

Four reasons why an IRS Audit isn't the end of your business

By CM Guest Columnist · February 20, 2019 · 1 Comment · 28

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It's nearly that time of year when businesses need to complete their annual Internal Revenue Service (IRS) tax returns. The IRS may decide to audit your tax return, and there

Program Alert

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Posted March 15



- Do IRS audits of small businesses result in business failure?
 - Driven by noncompliance or the administrative burden of the audit?
- Do IRS audits of small businesses provide benefits to some firms?

Motivation

- Tax audits are a necessary component of a tax system, but can impose costs on firms.
- Prior studies examine firms' compliance behavior following audits. Yet very little is known about “real effects” that impact a firm's underlying operations.
- Especially important in a time when the fragility of some small businesses is apparent, and when as a society we are going to great lengths to preserve them.
- Limited IRS resources, selection in audits.

Two types of audits

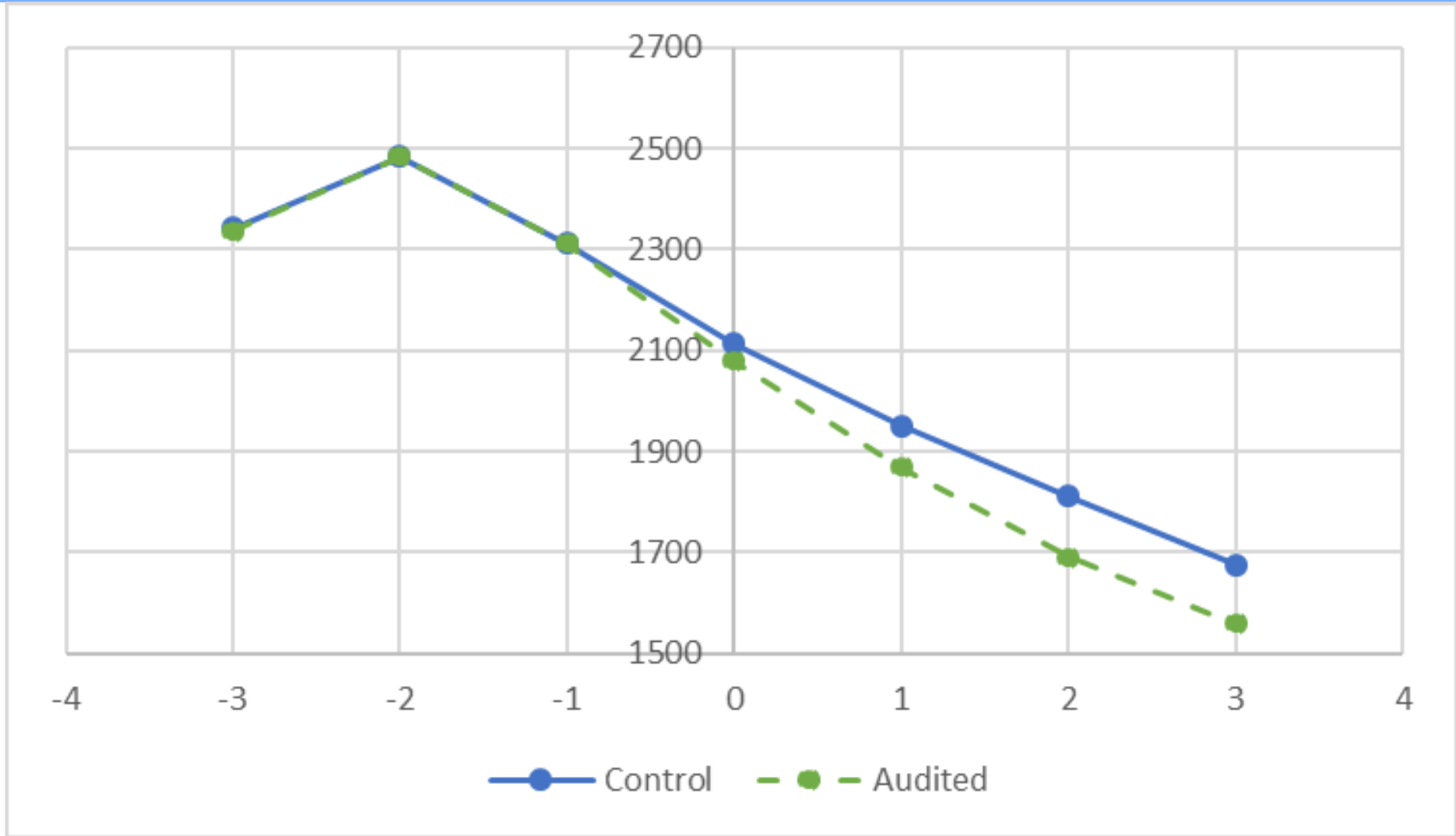
- National Research Program.
 - Most have been conducted on individuals.
 - First (and only) audit of C-Corporations, Form 1120, NRP was conducted on tax year 2010 returns.
 - Stratified random sample of small Form 1120 filers.
 - \$0 - \$250,000 assets.
- Operational audits
 - Firms are selected for operational audit based on indications of tax under-reporting.
 - Generally, less comprehensive examinations of the tax return than NRP audits.
 - (Regular old audits like you dealt with when you had a real job)

- NRP.
 - 2,508 audited firms.
 - 2,508 control firms, propensity-score matched on receipts, taxable income, wages, financial distress and DIF, from same strata of each treatment firm.
- Operational.
 - Select audit and control firms from same population of NRP.
 - 4,555 audit firms.
 - 4,555 control firms, propensity-score matched to audit firms on receipts, taxable income, wages, financial distress and DIF.

- Two primary measures of going concern.
 - *Exist.*
 - A firm still exists if it continues to file Form 1120, converts to an S-corp and continues to file Form 1120-S, or the owner of the firm applies for a new EIN and that new entity continues to file a tax return.
 - *Defunct.*
 - A firm that is identified as “defunct” in the Accounts Receivable Dollar Inventory (ARDI) database.

- Two primary measures of benefits
 - *Convert to S-corp.*
 - A firm that begins filing Form 1120-S after being audited.
 - *Change preparer.*
 - A firm that changes its tax preparer after being audited.

Results – Going Concern (file an income tax return)



7 percent increase in going out of business

Results – Going Concern (file an income tax return)

	(1)	(2)	(3)	(4)	(5)	(6)
	<i>Dependent Variable: Exist</i>					
<i>Audited</i>	-0.060*** (-3.86)	-0.126*** (-4.67)	-0.028 (-1.49)	-0.060*** (-3.96)	-0.126*** (-4.79)	-0.028 (-1.50)
<i>Size</i>				0.010*** (4.12)	0.021** (2.48)	0.012*** (4.56)
<i>Net Income</i>				0.000 (0.16)	-0.006 (-1.24)	0.001 (0.57)
<i>Wages</i>				0.009*** (5.73)	0.015*** (5.19)	0.006*** (2.77)
<i>DIF</i>				0.018*** (4.74)	0.009 (1.43)	0.021*** (4.44)
<i>Distress</i>				-0.008*** (-3.54)	-0.005 (-1.28)	-0.009*** (-3.11)
<i>Intercept</i>	0.696*** (65.74)	0.734*** (40.99)	0.678*** (51.83)	0.519*** (21.71)	0.376*** (4.13)	0.510*** (20.31)
<i>Sample</i>	Full sample	Noncompliant firms	Compliant firms	Full sample	Noncompliant firms	Compliant firms
<i>N</i>	5,016	1,596	3,420	5,016	1,596	3,420
<i>R-Squared</i>	0.004	0.018	0.001	0.051	0.077	0.048

Cross Equation Tests on Audited Coefficient

(2) vs (3): -0.098***
(-2.98)

Results – Going Concern (File Form 1120)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	<i>Dependent Variable: Exist</i>							
<i>Audited</i>	-0.050** (-2.30)	-0.070*** (-3.25)	-0.002 (-0.08)	-0.119*** (-5.47)	-0.047** (-2.20)	-0.076*** (-3.57)	-0.005 (-0.22)	-0.116*** (-5.43)
<i>Size</i>					0.008*** (2.74)	0.014*** (3.04)	0.012*** (3.57)	0.009** (2.44)
<i>Net Income</i>					-0.001 (-0.64)	0.003 (1.04)	0.001 (0.39)	-0.000 (-0.17)
<i>Wages</i>					0.010*** (4.35)	0.008*** (3.56)	0.008*** (3.59)	0.010*** (4.34)
<i>DIF</i>					0.021*** (3.78)	0.015*** (2.79)	0.019*** (3.48)	0.018*** (3.34)
<i>Distress</i>					-0.008** (-2.39)	-0.008*** (-2.64)	-0.008** (-2.35)	-0.007** (-2.22)
<i>Intercept</i>	0.669*** (44.45)	0.727*** (49.06)	0.672*** (43.73)	0.720*** (49.56)	0.520*** (18.42)	0.503*** (10.67)	0.490*** (15.56)	0.541*** (14.76)
<i>Sample</i>	Low audit hours	High audit hours	Low audit length	High audit length	Low audit hours	High audit hours	Low audit length	High audit length
<i>N</i>	2,502	2,514	2,504	2,512	2,502	2,514	2,504	2,512
<i>R-Squared</i>	0.003	0.006	0.000	0.016	0.050	0.049	0.054	0.056

Cross Equation Tests on Audited Coefficient

(1) vs (2): -0.020
(-0.66)

(3) vs (4): -0.117***
(-3.79)

Results – Going Concern and Administrative Costs

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	<i>Dependent Variable: Exist</i>							
<i>Audited</i>	-0.143*** (-3.12)	-0.115*** (-3.49)	-0.021 (-0.86)	-0.038 (-1.34)	0.013 (0.26)	-0.187*** (-5.82)	-0.005 (-0.22)	-0.062** (-2.12)
<i>Intercept</i>	0.706*** (23.00)	0.753*** (34.56)	0.657*** (38.10)	0.708*** (35.40)	0.697*** (20.14)	0.750*** (36.22)	0.666*** (38.79)	0.695*** (34.45)
<i>Sample</i>	Noncompliant, low hours	Noncompliant, high hours	Compliant, low hours	Compliant, high hours	Noncompliant, low length	Noncompliant, high length	Compliant, low length	Compliant, high length
<i>N</i>	552	1,044	1,950	1,470	486	1,110	2,018	1,402
<i>R-Squared</i>	0.022	0.016	0.000	0.002	0.000	0.039	0.000	0.004

Cross Equation Tests on Audited Coefficient

(1) vs (2):	0.028 (0.50)	(1) vs (3):	-0.122** (-2.34)
(3) vs (4):	-0.017 (-0.46)	(2) vs (4):	-0.077* (-1.75)
(5) vs (6):	-0.199*** (-3.42)	(5) vs (7):	0.018 (0.33)
(7) vs (8):	-0.057 (-1.49)	(6) vs (8):	-0.124*** (-2.85)

Results – Going Concern (Defunct)

	(1)	(2)	(3)	(4)	(5)	(6)
	<i>Dependent Variable: Defunct</i>					
<i>Audited</i>	0.012*** (3.11)	0.027*** (3.37)	0.004 (1.10)	0.013*** (3.38)	0.025*** (3.16)	0.007* (1.65)
<i>Size</i>				-0.000 (-0.31)	-0.001 (-0.61)	-0.000 (-0.34)
<i>Net Income</i>				0.000** (2.16)	0.000 (0.19)	0.000** (2.15)
<i>Wages</i>				0.000 (0.41)	0.001 (1.24)	-0.000 (-0.08)
<i>DIF</i>				-0.001 (-1.04)	-0.002 (-1.02)	-0.001 (-0.55)
<i>Distress</i>				0.007*** (6.98)	0.007*** (4.31)	0.006*** (5.39)
<i>Intercept</i>	0.010*** (4.66)	0.009** (2.52)	0.010*** (3.92)	-0.004 (-0.77)	0.004 (0.19)	-0.001 (-0.23)
<i>Sample</i>	Full sample	Noncompliant firms	Compliant firms	Full sample	Noncompliant firms	Compliant firms
<i>N</i>	5,016	1,596	3,420	5,016	1,596	3,420
<i>R-Squared</i>	0.002	0.008	0.000	0.036	0.036	0.038

Cross Equation Tests on Audited Coefficient

(2) vs (3): 0.022**
(2.52)

Results – S Corporation Conversions

	(1)	(2)	(3)	(4)	(5)	(6)
	<i>DV: Convert to S-Corp</i>			<i>DV: Apply for Another EIN</i>		
<i>Audited</i>	0.010 (1.10)	0.043*** (2.63)	-0.006 (-0.61)	-0.007 (-0.58)	0.048** (2.19)	-0.033** (-2.33)
<i>Intercept</i>	0.068*** (11.39)	0.063*** (6.12)	0.070*** (9.60)	0.169*** (19.74)	0.154*** (10.36)	0.176*** (16.81)
<i>Sample</i>	Full sample	Noncompliant firms	Compliant firms	Full sample	Noncompliant firms	Compliant firms
<i>N</i>	5,016	1,596	3,420	5,016	1,596	3,420
<i>R-Squared</i>	0.000	0.006	0.000	0.000	0.004	0.002

Changing Preparers

	(1)	(2)	(3)
<i>Dependent Variable: Change Preparer</i>			
<i>Audited</i>	-0.004 (-0.27)	0.012 (0.42)	-0.012 (-0.63)
<i>Intercept</i>	0.445*** (38.68)	0.474*** (23.10)	0.431*** (31.04)
<i>Sample</i>	Full sample	Noncompliant firms	Compliant firms
<i>N</i>	5,016	1,596	3,420
<i>R-Squared</i>	0.000	0.000	0.000

Results – Operational Audits

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
	<i>DV: Exist</i>			<i>DV: Convert to S-Corp</i>			<i>DV: Apply for Another EIN</i>			<i>DV: Change Preparer</i>		
<i>Audited</i>	-0.068*** (-6.877)	-0.124*** (-9.15)	0.001 (0.06)	0.035*** (4.82)	0.062*** (6.20)	0.002 (0.22)	0.036*** (4.30)	0.046*** (4.01)	0.023* (1.92)	0.027*** (2.589)	0.030** (2.10)	0.025 (1.60)
<i>Size</i>	0.009*** (2.633)	0.001 (0.14)	0.019*** (4.24)	0.003 (1.36)	0.010*** (3.53)	-0.003 (-1.20)	0.000 (0.07)	0.005 (1.11)	-0.002 (-0.58)	0.004 (1.120)	0.004 (0.80)	0.005 (1.06)
<i>Net Income</i>	-0.209 (-1.545)	-0.178 (-0.97)	-0.254 (-1.28)	0.421*** (4.47)	0.473*** (3.64)	0.384*** (2.83)	0.003 (0.15)	0.023 (0.63)	-0.007 (-0.21)	-0.023 (-0.165)	-0.195 (-1.03)	0.190 (0.92)
<i>Wages</i>	0.015*** (13.624)	0.017*** (11.93)	0.011*** (6.43)	0.001 (0.67)	0.001 (1.22)	-0.000 (-0.06)	-0.009*** (-9.43)	-0.008*** (-6.84)	-0.009*** (-6.37)	0.004*** (3.201)	0.006*** (3.86)	0.001 (0.37)
<i>DIF</i>	0.009** (2.318)	0.012** (2.56)	0.001 (0.17)	0.009*** (4.26)	0.006* (1.92)	0.015*** (4.49)	0.007** (2.38)	0.006 (1.54)	0.008* (1.73)	0.003 (0.683)	0.002 (0.48)	0.003 (0.53)
<i>Distress</i>	-0.008*** (-6.668)	-0.007*** (-4.02)	-0.008*** (-4.69)	0.002** (2.13)	0.002 (1.36)	0.001 (1.14)	0.005*** (5.05)	0.005*** (3.90)	0.004*** (3.02)	0.007*** (5.133)	0.008*** (4.50)	0.005*** (2.60)
<i>Intercept</i>	0.399*** (10.701)	0.466*** (7.50)	0.337*** (7.13)	0.010 (0.47)	-0.085*** (-2.61)	0.077*** (2.76)	0.203*** (6.27)	0.140*** (2.86)	0.241*** (5.61)	0.369*** (9.682)	0.343*** (5.53)	0.383*** (7.87)
<i>Sample</i>	Full sample	Noncompliant firms	Compliant firms	Full sample	Noncompliant firms	Compliant firms	Full sample	Noncompliant firms	Compliant firms	Full sample	Noncompliant firms	Compliant firms
<i>N</i>	9,110	4,084	5,026	9,110	5,026	4,084	9,110	5,026	4,084	9,110	5,026	4,084
<i>R-Squared</i>	0.046	0.037	0.061	0.012	0.018	0.010	0.017	0.016	0.055	0.046	0.078	0.044

Other analyses

- Examine impact on investment, revenues, employment, and wages.
- Examine whether non-filing represents an attempt to hide.
 - Likelihood of receiving Forms 1099 after firms stop filing.
 - Likelihood of new EIN applications for firms in same industry and/or with the same employees as the old corporation.

Conclusion

- The enforcement of correct tax liabilities through IRS audits has on tax noncompliant firms' increases firms' chances of business failure
 - Results driven by non-compliant firms.
- IRS audits can produce benefits, in some cases.
 - S corporation conversions
 - Overall similar results between random and nonrandom audits.