

# Compliance Assurance Process

By Loren M. Oppen

## History

In 2003, Mark Everson, then Commissioner of Internal Revenue, commented ruefully that it took the IRS five years to complete an audit of a corporate tax return.<sup>1</sup> To address the delay, the Internal Revenue Service expanded the pre-filing agreement (PFA) process<sup>2</sup> to accelerate corporate income tax audits. The PFA agreement process was designed to resolve the tax treatment of a specific item before the filing of the tax return in which the tax treatment of the item appeared. If the IRS agreed with a taxpayer's PFA request, the IRS engaged in fact-finding for the item. The taxpayer and the IRS then sought to agree on the return position for the item. If the IRS and taxpayer agreed, and if the taxpayer reported the position in accordance with the agreement, the issue was spared any post-filing review. The taxpayer thus was certain about the tax treatment of the item.

Donald Korb, then IRS Chief Counsel, said that if the pre-filing concept could be applied to all material tax items occurring during a taxable year, the application would be the "ultimate pre-filing agreement."<sup>3</sup> The IRS decided to test the concept in 2005 by establishing the compliance assurance process (CAP) pilot program.<sup>4</sup> The pilot program initially had 17 participants. To evaluate the effectiveness of CAP for participants in the pilot program, the IRS had to develop measures that were different from those typically used by the IRS to evaluate the effectiveness of post-filing audits. The effectiveness of post-filing audits may be measured by the magnitude of audit adjustments, but the CAP program produced no audit adjustments. Instead, the effectiveness of CAP depends on a taxpayer's disclosure and resolution of issues in a pre-filing environment, which saves the IRS resources when compared with the resources that it uses for post-filing audits.

Having decided that the CAP program is effective, the IRS moved CAP in 2011 from a pilot program to a permanent program.<sup>5</sup> The permanent program applies for taxable years beginning after December 31, 2011. At the time of the IRS decision to make CAP a permanent program, the program had 140 participants. A taxpayer participated in the pilot program by invitation from the IRS. In contrast, a taxpayer participates in the permanent program by filing Form 14234 with the IRS and being accepted into the program.

## Purpose of CAP

The purpose of CAP is to have the IRS and taxpayer collaboratively identify and resolve material issues during the taxable year in which the issues arise so that a post-filing examination, if any, of the tax return for that taxable year may be unnecessary, or if necessary, may be completed promptly. The unique feature of CAP, as contrasted with post-filing audits, is the upfront disclosure by the taxpayer of material issues. A taxpayer does not typically disclose material issues to the IRS in a post-filing audit, subject, of course, to the mandated disclosures that the taxpayer is required to make with the filing of its tax return.

This article discusses the advantages and disadvantages of CAP. An appendix sets forth the procedures for CAP. The weight that a

taxpayer gives to a specific advantage or disadvantage obviously will depend on the taxpayer's own circumstances.

## Advantages of CAP for a Taxpayer FIN 48 (ASC 740)

CAP increases a taxpayer's certainty of its financial position by eliminating or diminishing a need for financial statement tax reserves. FASB Interpretation No. 48, adopted in 2006,<sup>6</sup> specifies standards for recognition and measurement in a taxpayer's financial statement of tax benefits claimed in its tax return. By resolving issues during the taxable year, CAP decreases, even if it not does eliminate, uncertainty about the recognition and measurement of tax benefits, and it decreases the number of tax benefits for which reserves are required.

In some circumstances, a taxpayer may not be able to demonstrate affirmatively to its public accounting firm that it is more likely than not that the taxpayer will recognize a tax benefit. Absent that showing, the taxpayer will reserve for the unrecognized tax benefit and thereby reduce financial earnings. CAP may be an effective means by which to produce the affirmative evidence that supports recognition of the tax benefit.

## Avoidance of Financial Statement Restatement

A taxpayer may reflect a tax benefit from a transaction in its tax return but not appreciate that the IRS has grounds to disallow the benefit. As a consequence, the taxpayer's financial statement will not reserve for any risk that the transaction presents. If, in a post-filing audit conducted some years after the taxpayer engaged in the transaction, the IRS successfully asserts a significant tax deficiency for the transaction, the taxpayer's financial statements for past periods will have overstated earnings because of the absence of the reserve. The overstatement may require the taxpayer to restate its financial earnings for past periods to record the reserve for the tax risk.<sup>7</sup> A restatement of financial statements also may expose the taxpayer to class action litigation for having published incorrect financial statements. The prospect of having to restate financial statements obviously is a burden to be avoided. CAP, of course, avoids this restatement risk.

## Tax Planning

A taxpayer having half a dozen years in examination and almost as many in Appeals often has an impossible task of predicting with accuracy the effect of tax planning for the current year. If CAP is working effectively, a taxpayer will not have many, if any, years open in audit and Appeals and thus will be able to estimate the effect of tax planning with significant precision.<sup>8</sup>

## Participation of IRS in Planning

The IRS's CAP team obviously does not participate in the taxpayer's tax planning. Nonetheless, instances have been reported in which the taxpayer has explained why it was planning to structure a transaction in a particular manner. By providing the CAP team with advance information about the intended structure of the transaction and the

reasons for it, the CAP team could understand the intended tax treatment and readily accept the taxpayer's return position without re-plowing through the entire transaction after it was consummated.

### **Negotiations in Merger and Acquisition Activity**

CAP may benefit a taxpayer involved in negotiating the structure of a merger or acquisition. The structure proposed by the taxpayer's counter-party to the merger or acquisition may pose tax risk, and the counter-party may attempt to shift that tax risk to the taxpayer. A CAP taxpayer's negotiating hand is strengthened in deflecting this attempt by pointing to the certainty that the IRS will examine the merger or acquisition as part of CAP.

### **Acceleration of Audits of Pre-CAP Years**

To be eligible to apply for CAP, a taxpayer is required to have no more than one filed return that has not been closed in examination and one unfiled return for the year most recently ended and for which the return is not yet due. If the taxpayer has several years of filed returns that are currently under examination and wants to accelerate the completion of the examination, the taxpayer might consider applying for Pre-CAP. The Pre-CAP process is designed to facilitate the audit of the filed returns so that the taxpayer will meet the eligibility requirements for CAP. Pre-CAP facilitates the audit process by focusing on material items as spelled out in the Pre-CAP Memorandum of Understanding. An integral feature of Pre-CAP is that the taxpayer discloses to the audit team the material transactions in which the taxpayer engaged during the Pre-CAP years.

### **Resolution of Legal Issues**

The CAP team does not supplant the IRS Office of Chief Counsel, which provides advice on legal issues. Nonetheless, instances have been reported in which participation in CAP facilitated resolution of legal issues. Because of CAP, a taxpayer was able to present its legal position promptly and have it considered directly by representatives of Chief Counsel.

Alternatively, if different constituencies in the Office of Chief Counsel are not in agreement about guidance that should be provided for an issue raised in CAP, the CAP taxpayer nonetheless may find that resolution of the issue with the IRS is attainable. Because of CAP, the IRS may desire resolution of the issue, and the CAP taxpayer may find that this resolution is within reach either at the examination level or with fast-track settlement in Appeals.<sup>9</sup>

### **State Income Tax Returns**

State tax law typically requires a taxpayer to file an amended state income tax return that incorporates changes in federal taxable income resulting from an IRS audit of the taxpayer's federal return for the same taxable year. In ideal circumstances, a CAP taxpayer will not have any federal changes to report to state tax authorities because CAP will have definitively determined federal taxable income for the taxable year. CAP thus may increase a taxpayer's efficiency in preparing and filing state income tax returns because of the absence of federal changes.

Federal changes also may whip-saw a taxpayer on state income tax statute of limitations issues. A federal change may result in a

state income tax deficiency. This deficiency is not time-barred by the state statute of limitations because the state statute typically is extended for state income tax assessments caused by federal changes. At the same time, the taxpayer may then identify a state tax adjustment that is unrelated to federal changes and that would offset the deficiency caused by federal changes. The statute of limitations to assert the offset, however, may have expired. If CAP avoids federal changes, the prospect of paying state income tax on federal changes without being able to bring forward offsets unrelated to federal changes will not eventuate. The taxpayer would, of course, have to identify and file a refund claim for the offsetting item before the general state tax statute of limitations expires.

Finally, federal changes for a number of taxable years may cause overpayments of state income tax for some years and underpayments of state income tax for other years. State income tax laws typically assess deficiency interest from the due date of the return to which the deficiency relates. For interest allowed on overpayments, however, some state tax laws allow overpayment interest, not from the due date of the tax return to which the overpayment relates, but from the date that a refund claim is filed. If the report of the federal change is treated as the state income tax refund claim, the taxpayer will lose overpayment interest until the federal change is filed, which may be a significant number of years after the return to which the overpayment relates was filed.

In the meantime, deficiency interest will be accruing on the state income tax deficiencies from the due dates of the returns to which the deficiency relates, and the amount of this deficiency interest will not be significantly offset by the eventual accrual of overpayment interest. CAP should avoid or minimize this interest mismatch because, ideally, there will be no, or very few, federal changes.

### **Efficient Operation of Tax Office**

In a corporate tax office, the function of tax planning and the function of interacting with the IRS may be handled by different office members. A post-filing audit may not draw in optimal participation of office members engaged in planning because their focus is on current tax planning rather than on an IRS examination of planning for past years. CAP addresses current tax planning, thus offering a greater opportunity for tax planning office members to support interaction with the IRS.

### **Scope of a CAP Review**

A CAP review is expected to be completed in about one year. A post-filing examination may take a number of years. The time limit for a CAP review does not permit issuance of hundreds of information document requests, while a post-filing examination may well permit such issuance. Over a period of CAP years, the resources that a taxpayer devotes to IRS examinations may well be less than the resources needed to service post-filing examinations.

### **Cross-Border Transaction**

CAP may aid resolution of the tax treatment in a foreign jurisdiction of a cross-border transaction. A CAP taxpayer concerned with the tax treatments of a cross-border transaction both in the United States and in a foreign jurisdiction may be able to show the foreign

taxing authority the tax treatment that the CAP team approved for the transaction. The foreign tax authority may agree to this tax treatment in its own jurisdiction because of its understanding of the tax treatment of the transaction that the IRS CAP team accepted. If the taxpayer is not in CAP, the taxpayer will not have persuasive evidence of the federal income tax treatment of the transaction to show the foreign tax authority and might find that the foreign jurisdiction is going to dispute the taxpayer's return position even though the taxpayer reported the position consistently for federal and foreign tax purposes.

### **Best Practices for Time-Consuming Audit Issues**

By their nature, post-filing audits of some items are time-consuming and require a taxpayer to devote considerable resources to management of the audit. CAP gives a taxpayer an opportunity to develop a best-practice for such an item with the CAP team. A best practice is a process pursuant to which the taxpayer determines the amount to be recorded on the tax return for the item. If the CAP team understands and accepts the best practice, the taxpayer has a strong likelihood that the CAP team will accept the tax return amount.<sup>10</sup>

### **Availability of Records and People**

A post-filing audit typically requires a taxpayer to substantiate its return positions with evidence. Substantiation often requires that taxpayer locate documents several years old and elicit information from people whose memories of a transaction engaged in several years before may have faded. If the taxpayer encounters difficulty in finding the documents and people to prove facts relevant to the return position, the taxpayer is at a disadvantage because the taxpayer generally has the burden of proving the facts that it alleges in support of its position.<sup>11</sup>

CAP avoids the taxpayer's concern of failure of proof. Documentation of the transaction and the people who are working on it are available currently. The taxpayer may have to confront substantive tax issues that the tax position raises, but the taxpayer will not be frustrated by the loss of evidence.

## **Disadvantages of CAP for a Taxpayer**

### **General Comments**

Some taxpayers may find the transparency and cooperation required by CAP to be the antithesis of the manner in which they historically conducted their audit functions and reject CAP for that reason. Other taxpayers may be intensely focused on paying no more tax than an amount based on their understanding of the tax law and believe that CAP will risk their incurring a higher liability. Finally, some taxpayers simply may perceive no benefit from CAP that motivates them to move from the customary post-filing audit process.

### **Risk of Increased Tax Liability**

A CAP taxpayer discloses all its material transactions to the CAP review team. Had the taxpayer not been in CAP, and instead been subjected to a post-filing audit, the IRS might not have identified and audited all these transactions. Because application of the tax law is

not always precise and clear, the CAP taxpayer might find that it is incurring a liability to settle an issue relating to a disclosed transaction that the IRS never would identified in a post-filing audit. A taxpayer that engages in one or more transactions that pose significant tax risk may weigh this risk more heavily than the weight that the taxpayer gives to the benefits of participation in CAP.

Of course, federal tax law requires a taxpayer to make disclosures with its returns. Schedule UTP, Form 8275, Form 8275-R, Form 8886, and qualified amended returns are intended to make issues more apparent to the examination team conducting a post-filing examination. Schedule M-3 is intended to prevent the obfuscation of adjustments from book income to taxable income. There are a plethora of other forms that must be filed, for example, corporate liquidations must be reported,<sup>12</sup> as must incorporations.<sup>13</sup> All these disclosures tend to minimize the probability that the IRS will overlook a material transaction during a post-filing audit.

### **Intractable Issues**

Some issues are reported as difficult to resolve in CAP. Transfer pricing and research credit are examples. A taxpayer expecting CAP to facilitate resolution of such an issue may be disappointed. Transfer pricing may be better approached through the advance pricing agreement process,<sup>14</sup> which provides specific IRS resources for such matters. Taxpayers who have had difficulty with research credit should use the IRS's rules of engagement to ensure that the IRS engineer assigned to the CAP audit is knowledgeable about the taxpayer's business so as to avoid findings that are superficial.

### **Insufficient Time to Analyze Tax Positions**

CAP requires that a taxpayer decide its return positions during the CAP taxable year. Of course, tax attributes that arise after the end of the CAP taxable year may show that one or more return positions taken for the CAP year were not optimal. If a CAP taxpayer signs a closing agreement with the CAP team, the taxpayer's opportunity to change a return position for the CAP year is lost. Subject to exceptions that prohibit retrospective tax planning, a taxpayer that is subject to a post-filing examination is not barred from filing an amended return or otherwise advocating more favorable tax positions during the post filing examination, and thus is not disadvantaged by CAP procedures.

### **Examination of Pre-CAP and CAP Years Simultaneously**

An impediment to the pilot CAP program was the double-duty that tax office personnel had to perform in working with the examination team for pre-CAP years and the CAP review team for the CAP year. The permanent CAP program now alleviates much of that stress, but the taxpayer may still have to contend with a simultaneous examination of a year preceding the CAP year and a CAP review until all the pre-CAP years have been examined.

### **Accounting Method Changes**

A taxpayer that is in CAP is under examination for the purpose of requesting consent from the Commissioner to change an accounting method.<sup>15</sup> A taxpayer that is under examination generally has limited

window periods in which to request an accounting method change. By waiting for a post-filing examination, the taxpayer may have a greater opportunity to file a request for an accounting method change.

### A Few Words about Disclosures

The Memorandum of Understanding that a CAP taxpayer and the IRS sign at the beginning of a CAP review requires disclosure not only of transactions that occur during the CAP year but also tax issues within those transactions. Additionally, the taxpayer is required to disclose items and issues that will have a material effect on the tax liability. Taken literally, this language is comprehensive and can be off-putting to a taxpayer that is considering applying for CAP. In practice, the language is not understood as having that broad reach.

It is highly impractical, if not totally impossible, for a CAP taxpayer to disclose its tax treatment of every item and computation that will be recorded in the tax return. Issues might be embedded in almost every such item. The IRS does not, however, expect a CAP taxpayer to make such enormous disclosures. The IRS clearly expects the taxpayer to disclose mergers, acquisitions, dispositions, liquidations, and other structural changes that are occurring during the tax year. At the other end of the spectrum, there are items for which the CAP team should not expect disclosure because the items are self-evident. The CAP team may review these self-evident items if it chooses to do so. For example, it should be no surprise to the CAP team that the taxpayer claims depreciation deductions for machinery and equipment and that it has a method to account for inventories. For items of this nature, the CAP team performs the same typical risk analysis in planning the subjects of review that a post-filing audit team performs in deciding what to audit. CAP is concerned with disclosures of items that are beyond the mundane. The risk analysis should address the items that fall in the gray area between the obviously significant items and the routine, recurring items. If the CAP team becomes interested in an item in this gray area, it should not be treated as a reason for chastising the taxpayer for failing to make a disclosure and removing the taxpayer from the CAP program.

### Advantages and Challenges for the Internal Revenue Service

CAP should permit the IRS to use its resources more efficiently. Taxpayer cooperation and collaboration in identifying and resolving issues should consume less audit time than does the customary post-filing audit in which the IRS shoulders more of the burden in formulating issues.

Efficient utilization of resources is particularly important now because of the profound uncertainty of the budgets of federal departments and agencies. If the IRS receives a large influx of applications for CAP, the IRS will need the resources to allocate to the program. With the budgetary uncertainties, it remains to be seen whether the IRS will be able to expand CAP for all taxpayers who are interested in participation.

### Conclusion

Years ago, few taxpayers would have considered CAP as an alternative to a traditional post-filing examination. Most taxpayers would have taken their return positions, aggressive or otherwise,

filed their returns, and awaited a letter from the IRS scheduling an audit of the returns, if indeed the IRS planned any such audit. Taxpayers dealt with the IRS at arm's length, answering information document requests carefully and precisely and volunteering little.

The IRS also dealt with the taxpayer at arm's length. The IRS did not disclose its audit plan because of a concern that a taxpayer with knowledge of the plan could somehow avoid tax liability. Ineffective communication between the taxpayer and IRS made examinations lengthy and did not foster resolution of issues. Protests to the Appeals Office on a great number of issues were common. Some said that the post-filing examination really began in Appeals.

With the advent of mandated disclosures in tax returns and in financial statements, taxpayers within the jurisdiction of the IRS's Large Business and International Division no longer have the same incentive that perhaps they once had to play the audit lottery in the hope that their returns or transactions will escape examination. Federal tax law has, of course, its vagaries, and a taxpayer has no obligation to resolve doubt about the meaning of a tax provision against itself. CAP does not force a taxpayer to abandon favorable positions, but it does aid significantly in providing certainty.

Clearly, not every taxpayer will be interested in CAP. Corporate cultures vary, and some taxpayers simply will prefer privacy in determining their tax filing positions, privacy that is not available in CAP. Moreover, all CAP teams do not approach CAP in precisely the same manner, even though the IRS makes substantial efforts to achieve uniformity in execution of the process. Nonetheless, the IRS and taxpayers in CAP have seen benefits, and for that reason CAP has a firm foothold in the processes and methods that the IRS has created to ease and accelerate verification of federal income tax returns. 

## Appendix

### The CAP Process Eligibility Requirements

A taxpayer is eligible to apply for CAP if it meets the following requirements:

1. The taxpayer has \$10 million or more of assets.
- 2.a. The taxpayer is publicly held and files with the United States Securities and Exchange Commission Form 10-K, 10-Q, or 8-K. A public company meets this eligibility requirement if its securities are publicly traded and is a reporting company for purposes of the Securities Exchange Act of 1934. A foreign corporation that files Form 1120F also is eligible if it files financial statements with a regulatory body that is equivalent to the Securities and Exchange Commission.
- 2.b. Alternatively, if the taxpayer is not required to file disclosure statements with the Securities and Exchange Commission or with a similar regulatory body, the taxpayer satisfies the filing requirement by agreeing to provide to the IRS either certified, audited financial statements on a quarterly basis or equivalent documentation.<sup>16</sup>
3. The taxpayer may not be under investigation by the IRS or in litigation with the IRS that would limit the IRS's access to cur-



rent corporate records. Similarly, the taxpayer may not be under investigation or in litigation with any other federal agency or state agency that would limit access to the taxpayer's records.<sup>17</sup>

### Application Process

If a taxpayer wants to participate in CAP, the taxpayer files Form 14234. Form 14234 asks if the taxpayer meets the requirements stated above and adds the following:

- a. The \$10 million asset requirement is to be determined from the taxpayer's report of its assets on its prior tax return. The reference presumably is to Schedule L of Form 1120.
- b. With regard to a statement about being investigated or engaged in litigation, the application form asks if the investigation could result in a material tax item.
- c. The taxpayer is required to attach Form 8886 for Reportable Transactions if the taxpayer engaged in a listed transaction for any open taxable year or for any year under examination or in Appeals.
- d. The taxpayer is required to state if it underwent any change that would affect its ability to dedicate resources to CAP or limit the availability of records. An example of a change might be an acquisition followed by dismissal or relocation of the tax office personnel of the acquired company.

The application is submitted to the Pre-Filing and Technical Guidance activity in the National Office, which routes the application to the appropriate Industry Director. For example, if the taxpayer is a heavy manufacturer, the application is routed to the Industry Director for Heavy Manufacturing and Transportation, who reviews the application and recommends acceptance or rejection to the Large Business and International Operations Committee, which acts on the application. If the taxpayer is accepted into CAP, the taxpayer's territory manager informs the taxpayer of the approval.

### Three Phases of CAP

CAP has three phases: a pre-CAP phase, a CAP phase, and a Compliance Maintenance Phase.

#### Pre-CAP Phase

The purpose of the pre-CAP phase is to conclude ongoing examinations of filed returns so that the taxpayer can become eligible for CAP. To be eligible for CAP, a taxpayer currently subjected to an examination must have no more than one filed return that has not been closed in examination and one unfiled return for the year most recently ended and for which the return is not yet due.<sup>18</sup>

The application for Pre-CAP may be made at any time. If the Large Business and International Division accepts the taxpayer into Pre-CAP, a Team Coordinator is assigned to the examination of the Pre-CAP years. Also assigned to the team are a Team Manager, the Territory Manager, and the Director of Field Operations, among others. The assignment as team members of individuals who report to the Industry Director would seem to give the taxpayer's CAP application increased visibility with the Industry Director and ensure that sufficient IRS examination resources are allocated to

the Pre-CAP phase to complete the examination of the older returns. The taxpayer, of course, has to commit resources to responding to the information requests of the examination team so that the examination can be completed timely.

To achieve timely completion, the examination team and the taxpayer develop an action plan. The action plan requires the taxpayer to disclose in writing to the examination team (i) all transactions<sup>19</sup> in which the taxpayer engaged during the years under examination, (ii) material items and issues within transactions, and (iii) other tax return items and issues related to positions taken on the tax return.

Unlike Schedule UTP, which applies to tax returns filed for the 2010 taxable year, the taxpayer is not expressly required to disclose in Pre-CAP the identity of the issues for which it has tax reserves. The IRS's policy of restraint of not requesting tax accrual work papers should apply to Pre-CAP.<sup>20</sup> The IRS's examinations of the Pre-CAP years presumably will rely on the traditional methods that it uses for post-filing examinations to verify completeness of the taxpayer's disclosures.

The taxpayer is required to provide to the Team Coordinator an industry overview, organization charts, financial performance information, information about significant events, access to accounting records, and resources for disclosure of requested information. The IRS examination team most likely has much of this information from the examination that it conducted before the IRS approved the Pre-CAP application. The taxpayer also is required to provide to the Team Coordinator a schedule of rollover and recurring adjustments from previously examined and closed years that affect the Pre-CAP years. The schedule is required to be supplied within 15 days after the opening Pre-CAP conference. Additionally, if issues for years in Appeals or litigation are resolved, the taxpayer is required to notify the Team Coordinator within 15 days after the resolution and discuss the reflection of those resolved items in the Pre-CAP years and in the unexamined CAP year. The taxpayer is charged with the responsibility of answering information document requests timely, and the Team Coordinator is charged with the responsibility of timely analyzing the answer and discussing the analysis with the taxpayer.

During this entire Pre-CAP process, the Team Manager and other members of the Pre-CAP team evaluate the candor and cooperation of the taxpayer. The evaluation is conducted quarterly and discussed with the taxpayer. The evaluation will be unfavorable if the taxpayer did not respond timely to information document requests, if its submissions were non-responsive to the requests, if it did not make a good faith effort to resolve issues, if it did not disclose transactions including tax shelter and listed transactions, or if it did not fulfill other obligations set forth in the Pre-CAP Memorandum of Understanding.

The foregoing description of the obligations of the taxpayer and the IRS are set forth in the Pre-CAP Memorandum of Understanding (Pre-CAP MOU). The Pre-CAP MOU is a formal memorandum that both the taxpayer and the Director of Field Operations who has jurisdiction over the taxpayer sign. The Pre-CAP MOU provides that the IRS and the taxpayer will jointly determine the scope of the Pre-CAP examination and the materiality thresholds, with the IRS making the ultimate decision. Establishment of a material-

ity threshold is generally determined by use of a risk analysis process.<sup>21</sup> The risk analysis process is subjective. It takes into account compliance considerations, adjustment potential, effects on future years, historical examination information, industry issues, coordinated issues, and similar considerations.<sup>22</sup>

Pre-CAP ends when the taxpayer has no more than one year in examination and no more than one unfiled return that is not yet due. If the taxpayer has met the Pre-CAP standards of openness, cooperation, and collaboration, then the taxpayer is eligible for CAP. Care should be taken in filing refund claims. If the refund claims are assigned for examination, the taxpayer may have more than one filed return that is under examination and not be eligible for CAP.

### CAP Phase

To file for CAP, the taxpayer uses Form 14234, the same form that the taxpayer used to apply for Pre-CAP. The CAP application has to be filed between September 1 and October 31 of the year preceding the CAP year. The taxpayer must re-file Form 14234 for each subsequent year for which it wants to participate in CAP.

If the taxpayer's application for CAP is rejected, the Large Business and International Division will inform the taxpayer in writing of the reasons for the denial. The taxpayer may appeal the denial to LB&I's Deputy Commissioner for Operations.

If accepted for CAP, the taxpayer and IRS seek to resolve issues during the CAP year that arise from transactions that have been completed during that year. If agreement is reached on all materials items that have been reviewed, the return will be accepted as filed and no post-filing examination will be conducted.

The IRS appoints an Account Coordinator as the taxpayer's point of contact for CAP. As in Pre-CAP, a taxpayer in CAP is required to make "open, comprehensive, and contemporaneous disclosures of its completed business transactions." As part of the disclosure, the taxpayer must disclose the tax issues within those transactions. Additionally, the taxpayer is required to disclose items and issues that will have a material effect on the tax liability as well as tax shelters, listed transactions, and other issues that the IRS and its operating divisions have publicly identified as subject to scrutiny or challenge. Finally, the taxpayer must disclose the positions that the taxpayer will take on its return for the transactions and items that it has disclosed to the Account Coordinator.

An item has a material effect if the taxpayer is required to reserve for the item in its financial statement for the CAP year or anticipates that it will be required to reserve for the item in a subsequent tax year. The definition omits items for which the taxpayer has no reserve because the taxpayer intends to litigate the item. The item will, however, appear on Schedule UTP and therefore eventually not be unknown to the Account Coordinator if the taxpayer is subject to the Schedule UTP filing requirement.

The taxpayer and the IRS memorialize their obligations under CAP in a CAP-Memorandum of Understanding (CAP-MOU). The taxpayer is required to sign the CAP MOU by January 31st of the CAP year to participate in CAP. The CAP MOU includes materiality thresholds. The same risk analysis process that was used for Pre-CAP is used for the CAP year, but the thresholds may not be the same as for Pre-CAP. Moreover, the IRS may change these thresholds dur-

ing the CAP year. Additionally, as with Pre-CAP, tiered transactions, listed transactions, emerging issues, and coordinated issues are to be disclosed. The IRS website describes all these issues. Clearly, a taxpayer should be familiar with these issues and be prepared to deal with them if the taxpayer intends to apply for CAP.

As with Pre-CAP, the taxpayer is required to provide information about its industry, organization, financial performance, anticipated significant events, access to accounting data, and staff personnel who will make the requisite disclosures. Periodic meetings between the taxpayer and the Account Coordinator are to be held, at least quarterly, to provide relevant information and to discuss the status of CAP. For each quarter, the Account Coordinator prepares a list of items that the taxpayer has disclosed and has the taxpayer verify that the list includes all transactions in which the taxpayer engaged during the quarter, the issues within these transactions, and all other material items.

To ensure that the requisite information is available for submission to the Account Coordinator, the taxpayer's tax staff has to establish reliable lines of communication with its corporate divisions and activities so that its disclosure obligations are met.

When the taxpayer and Account Coordinator resolve an issue, the resolution is recorded in an Issue Resolution Agreement. At the end of the CAP year, the agreed-upon issues are incorporated in a closing agreement. The closing agreement obligates the taxpayer to file its return in accordance with the terms of the closing agreement. The taxpayer cannot subsequently file a refund claim to unwind the terms of the closing agreement.<sup>23</sup> If the taxpayer and the Account Coordinator are not able to agree on resolution of an issue, the taxpayer may request fast track settlement in Appeals.<sup>24</sup> When all issues have been identified, the IRS will give to the taxpayer a Full Acceptance Letter if all issues have been resolved and a Partial Acceptance Letter if all issues have not been resolved. If the taxpayer files its return in a manner consistent with the agreed resolutions set forth in the Full or Partial Acceptance Letter, the IRS will accept those filings positions.

Following the filing of the return for the CAP year, the IRS and the taxpayer will review the return to determine if the issues that were resolved in CAP were reported in the return in a manner consistent with the resolutions. The IRS goal for completion of the review is 90 days from the date of filing. If, in the post-filing review, the IRS finds that a return position deviates from an agreement made in a Issue Resolution Agreement or closing agreement, that the taxpayer failed to disclose transactions or issues during the CAP audit, or that unagreed issues remain, the IRS will address those return positions, undisclosed positions, and unagreed issues in the traditional post-filing examination process. If the return is consistent with the agreed resolutions, all issues were disclosed and none is unagreed, then the IRS will issue a No Change Letter, which will close the audit within the meaning to section 7605(b). That section of the Internal Revenue Code prevents a second examination of the taxpayer's books and records for the CAP year unless the IRS subsequently identifies (i) fraud, malfeasance, collusion, concealment or misrepresentation of material fact, (ii) the closed case involved a clearly defined substantial error based on an established service position existing at the time of the examination, or (iii) other circumstances exist indicating that a failure to reopen the case would be a serious

administrative omission.<sup>25</sup> If none of those circumstances apply, the audit for the CAP year is concluded.

Within 30 days following the filing of the return for the CAP year, a corporate officer of the taxpayer to whom authority to sign the return has been delegated must sign a representation concerning disclosures. The officer must represent that the taxpayer has made all the requisite disclosures and that no transaction or tax position that requires a reserve for taxes in the taxpayer's financial statement has not been disclosed. The officer should make the representation to the best of his or her knowledge and belief and not be an insurer of the completeness of the disclosures.

## Compliance Maintenance

A taxpayer for which the IRS has reviewed at least one income tax return for a CAP year and that has applied for CAP for a succeeding year may be eligible for Compliance Maintenance. Compliance Maintenance differs from CAP in that the level of IRS review for the Compliance Maintenance year is reduced. The IRS will accept a taxpayer for Compliance Maintenance if the taxpayer has demonstrated the requisite openness and disclosure required for CAP. More significantly, the IRS will consider the complexity of tax issues and the number of tax issues that the taxpayer presents in deciding whether to move the taxpayer into Compliance Maintenance. The greater the complexity and the greater the number of issues, the less likely is the taxpayer's prospect of being moved into Compliance Maintenance.

A CAP Memorandum of Understanding is required to be executed for the Compliance Maintenance Year. Materiality thresholds should be increased because the IRS should have determined from review of the prior CAP year or years the items or areas that present little or no risk that the tax due was not paid.

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1. Testimony of Mark W. Everson, Commissioner, Internal Revenue Service, before the Joint Committee on Taxation, Annual Joint Review (May 20, 2003). The Commissioner's criticism about the duration of a corporate income tax audit would have been even more severe had he taken into account the additional time of the Appeals Office in acting on a protest by a corporation of examination results.
2. The current procedure for requesting a pre-filing agreement is set forth in Rev. Proc. 2009-14, 2009-3 I.R.B. 324.
3. Comment of IRS Chief Counsel Donald Korb, 2004 TNT 192-4 (October 4, 2004).
4. Announcement 2005-87, 2005-2 C.B. 1144.
5. IR 2011-32 ((March 31, 2011).
6. Codified at ASC 740.
7. On March 31, 2011, Office Depot reported that it would restate earnings for the second and third quarters of 2010 because the IRS unexpectedly denied a tax benefit that Office Depot had reported in its published financial statement.
8. For example, a taxpayer may be considering a distribution from a controlled foreign corporation. If the earnings and profits of the controlled corporation are uncertain because of unresolved issues, the taxpayer will not know with certainty the amount of deemed paid foreign tax credits that are to be taken into account from the distribution. CAP may be a means to eliminate that type of uncertainty promptly.
9. Rev. Proc. 2003-40, 2003 C.B. 1044.
10. Research credit is an item that is ripe for a best practice approach. Another item for which a best practice may be presented is the domestic production deduction computation. Clearly, other items also may fit well for a best practice presentation, all of which would save the taxpayer time and resources.
11. U.S. Tax Ct. Rule 142(a).
12. Treas. Reg. § 1.332-6.
13. Treas. Reg. § 1.351-3.
14. Rev. Proc. 2006-9, 2006-1 C.B. 278.
15. Rev. Proc. 2011-14, § 3.08(5), 2011-14 I.R.B. 330 (automatic consent procedure); Rev. Proc. 2009-39, § 2.02(6) (non-automatic consent procedure).
16. The SEC adopted a rule requiring a company's independent auditor to "review" the company's financial information prior to the filing of the quarterly Form 10-Q report. SEC Release No. 34-42266. The Rule does not require the independent auditor to "audit" the quarterly report. The requirement for a private company to provide certified, audited financial statement on a quarterly basis appears more stringent than the requirement for public companies, which are required to file "reviewed" financial statements quarterly, but not audited, certified financial statements quarterly.
17. The IRS is prohibited from issuing an administrative summons to a taxpayer if the IRS has made a Justice Department referral for that taxpayer. IRC § 7602(d). The reason is that the summons authority cannot be used solely to aid criminal investigations. In any event, a taxpayer for whom a Justice Department referral has been made is likely not interested in CAP.
18. The Pre-CAP phase does not apply to a taxpayer that is not under examination. The filing of a Form 14234 thus has the effect of inviting the IRS to review the positions that a taxpayer is taking in its returns. A taxpayer not under examination might be reluctant to apply for Pre-CAP when there is no ongoing IRS examination. In practice, no such taxpayer has applied for CAP.
19. The reference to "transaction" presumably means mergers, acquisitions, liquidations, split-ups, and the like rather than routine purchases of goods and services.
20. IRM 4.10.20.3.
21. IRM 4.46.3.2(4)a.
22. IRM 4.46.3.3.2.2.
23. IRC § 7121(b)(2).
24. Rev. Proc. 2003-40, 2003 C.B. 1044.
25. Rev. Proc. 2005-32, 2005-1 C.B. 1206.