



What's News in Tax

Analysis that matters from Washington National Tax

IRS Extends CAP Program, Modifying Some Rules and Signaling More Significant Changes May Lie Ahead

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On August 27, the IRS announced both the continuation of and changes to its Compliance Assurance Process (“CAP”) program for 2019.¹ The highly lauded CAP program, begun as a pilot in 2005 and made permanent in 2011, provides for “real-time audits” of taxpayers—i.e., the review and resolution of tax issues through open, cooperative, and transparent interactions between the IRS and taxpayers *before the filing of a return*.

Overview of the CAP Program

From its inception 13 years ago, CAP was intended for a select group of taxpayers under the jurisdiction of the IRS’s Large Business & International Division (“LB&I”)—companies with assets of \$10 million or more, generally publicly traded with audited financial statements (or, if privately held, equivalent financial documentation), and not under investigation or in litigation with the IRS or other federal or state agency that would limit the IRS’s access to current corporate tax records. The program began with 17 taxpayers and currently has 169 participants.

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¹ IR-2018-174, IRS announces adjustments to the Compliance Assurance Process (CAP) program (Aug. 27, 2018), <https://www.irs.gov/newsroom/irs-announces-adjustments-to-the-compliance-assurance-process-cap-program>.

The CAP program consists of three phases: (1) pre-CAP, which resolves intervening years and provides interested taxpayers with a pathway for gaining entry into CAP; (2) CAP, which requires significant transparency and the contemporaneous disclosure of material transactions and tax positions; and (3) CAP maintenance, which is intended for taxpayers that have been in CAP, have fewer complex issues, and have established a track record of working cooperatively and transparently with the IRS. As envisioned, it is possible for taxpayers to toggle back and forth between CAP and CAP maintenance depending on their evolving activities (e.g., mergers and acquisitions) and overall tax posture.

The core elements of CAP are stated simply: During regular meetings with the IRS audit team, the taxpayer fully discloses information on completed transactions and its proposed return treatment of all material issues. The IRS conducts a real-time audit of the disclosed tax positions, with the taxpayer and IRS endeavoring to reach agreement on return positions, which will be recorded in Individual Resolution Agreements (“IRAs”). Assuming the tax return is filed consistent with the IRAs, the IRS accepts the return as filed. (If some issues cannot be resolved through CAP, the IRS will review them in the post-filing audit mode.) Upon acceptance and validation of return, the IRS will issue a “no-change letter” to the taxpayer.

Costs and Benefits of CAP

From the taxpayer’s perspective, a principal benefit of CAP is obtaining earlier certainty on the proper treatment of material positions. This will not only permit the company to avoid setting up financial statement reserves, but could also afford it significant competitive advantages vis-à-vis competitors that are not part of CAP. The “real time” resolution of issues, moreover, could likely be both faster—thereby reducing overall “cycle time”—and less expensive because access to the necessary records, other information, and personnel will be easier. Among other things, participation in CAP may limit the need for taxpayers to file amended state tax returns (following the conclusion of their federal examination). What’s more, participation in CAP undeniably complements current transparency and corporate governance trends, and could yield reputational advantages and permit the taxpayer to “reset” its relationship with the IRS.

The IRS, too, benefits from CAP. By reducing the time and expense required to identify, audit, and resolve issues, CAP can free up resources for the IRS to use for other audits while ensuring compliance among participating taxpayers. The program also provides the IRS with a clear line of sight into emerging activities and issues, thereby potentially giving the IRS advance notice of issues requiring either guidance or specially tailored enforcement action.

The costs of CAP, however, are not insignificant. The program is extremely resource-intensive for both taxpayers and the IRS, and the effort required upfront (during pre-CAP) and on an ongoing basis may dissuade some taxpayers from applying for, or remaining in, the program. Moreover, although feedback from participating taxpayers has been generally favorable, the effective operation of CAP depends on personnel on both sides, and as audit teams change, hiccups and complications in particular cases might occur. More globally, the IRS has been criticized for not better measuring and documenting the

program's overall success from the government's perspective. This is because traditional measures of effectiveness (e.g., dollars raised via an examination) are difficult to apply to the CAP program since the ultimate goal of CAP is a "no change" examination.

In addition, because CAP taxpayers are, almost by definition, among the country's most compliant, questions have been raised, by both IRS officials and external watchdogs, about devoting outsized resources to auditing them instead of focusing the agency's constrained enforcement dollars on arguably more deserving (or "lucrative") targets. Stated bluntly, since LB&I's workforce has shrunk by more than 25 percent since CAP began, can its continued existence be justified? This tax compliance paradox, coupled with the uncertain federal budget environment, has prompted calls from the Government Accountability Office, among others, for the IRS to better track savings from CAP and, indeed, to reconsider the program's overall efficacy.² One result of the increased scrutiny is a freeze on the admission of new companies into the CAP program since 2016. Until the issuance of the IRS's news release on August 27, some commentators were predicting, even lamenting, that CAP could be ended.

Modifications to Improve CAP, with More Changes Likely to Come

In announcing that CAP "continues to provide benefit for taxpayers and tax administration," and accordingly will be continued, the IRS made several changes to the program intended to improve its operation and to make better use of limited government resources; the IRS also identified in broad terms other possible changes that taxpayers might anticipate in the future.

Considered in isolation, none of the changes is material or "game changing," and even collectively (absent more detail), they likely will not affect many taxpayers' desire to participate in CAP. In combination, however, they may well help ensure the sustainability of the program. Here are the key 2019 changes:

- The 2019 application period for existing CAP taxpayers will be delayed one month until October 1, 2018, and run until November 30, 2018. For 2019, no new taxpayers will be admitted into CAP.
- In applying for CAP, taxpayers will be required to provide a preliminary list of material issues for the year and, if applicable, specified transfer pricing issue information and research credit information.
- Both taxpayers and LB&I will be subject to additional requirements in terms of communication and prompt resolution of issues. The IRS news release identified three examples: (1) certain transfer pricing issues may be required to be resolved via the IRS's Advance Pricing

² Gov't Accountability Office, GAO-13-662, *Corporate Tax Compliance: IRS Should Determine Whether Its Streamlined Corporate Audit Process Is Meeting Its Goals* (2013), <https://www.gao.gov/assets/660/657092.pdf>.

Agreement program; (2) LB&I will establish a 90-day goal for issue resolution; and (3) disagreements will be sent to Appeals on a timely basis.

- Taxpayers will be required to provide a representation letter within 30 days of return filing and timeframes will be implemented for IRS post-file review. In addition, taxpayers and the IRS will jointly monitor progress metrics and provide input for subsequent year cycles.
- The maintenance phase of CAP will continue, but will be modified. Thus, some taxpayers determined to be lowest risk may continue in the program without IRS review of a particular year.

The IRS also announced that taxpayers should anticipate at least three additional changes: First, after 2019, CAP will be open to additional taxpayers, though there has been no indication how many. Second, aligning more closely with corporate governance best practices, taxpayers will be required to provide certification of a tax control framework. And third, consistent with LB&I's overall strategic vision (as evidence in its current "Compliance Campaigns" initiative³), CAP may be modified to encompass issue-based resolutions.

Observations

Required List of Material Issues.

The absence of detailed information about changes to the CAP program makes judgments about CAP necessarily preliminary. For example, the CAP application process will now include a requirement that the taxpayer identify "a preliminary list of material issues for the year and, if applicable, specific information related to transfer pricing information and research credit information." Because a taxpayer's CAP application for 2019 is to be submitted no later than the end of November 2018, it is unclear how precise a taxpayer can be about identifying the issues that will arise during the CAP year.

For example, while the required information will no doubt prove helpful to the IRS in allocating resources to particular CAP examinations, the change potentially alters the current CAP dynamic—which obliges the taxpayer to disclose the material transactions and the related return positions *after* those transactions are completed—by imposing an obligation to provide information in advance of a transaction. The IRS news release does not specify what transfer pricing or research credit information will be required, but it seems plausible that a taxpayer's transfer pricing footprint may either disqualify it entirely from CAP or require that the taxpayer pursue an APA in order to stay in CAP.

Similarly, a taxpayer's R&E profile may potentially affect the IRS's assessment of the taxpayer's "suitability" for CAP. To be sure, the IRS could rightly focus on the amount of engineer time required but could also focus on whether the taxpayer plans to submit refund claims for prior years, which may be viewed as less suitable for CAP.

³ <https://www.irs.gov/businesses/large-business-and-international-compliance-campaigns>.

Required Representation Letter

The IRS news release provides that taxpayers must submit a representation letter within 30 days of filing their returns. The significance and scope of this requirement are unclear given current CAP practices. A CAP taxpayer is already required to file a standard post-filing representation confirming that all completed transactions, including transfer pricing issues and items that have a material effect on the taxpayer's U.S. federal income tax liability for the year, have been disclosed. In addition, the CAP taxpayer must confirm that there are no remaining undisclosed transaction or tax positions for the tax year that would require the taxpayer to report reserves for purposes of any financial statement for the CAP year or any other period subsequent to the CAP year.

Effect on Appeals Consideration

The IRS news release states that disagreements “will be sent to Appeals on a timelier basis to encourage quick resolution of issues.” What is not clear from the release, however, is whether the IRS envisions a program such as fast-track settlement⁴ on an issue-by-issue basis or, alternatively, whether it intends to create a new program.

Compliance Maintenance

The news release confirms that the so-called CAP maintenance phase—essentially, a low risk, low interaction status—will continue, and that the rules will be modified to provide that that lowest risk taxpayers may continue in the program without IRS review of a particular year. The potential for CAP taxpayers to matriculate from CAP to CAP maintenance should save both taxpayer and IRS resources.

Tax Control Framework

The IRS news release states that the IRS anticipates the adoption of a future requirement that CAP aspirants provide a certification of a “tax control framework,” which essentially is a set of tools, techniques, and arrangements to ensure all tax risks are identified, assessed, and understood, and that appropriate responses are in place to mitigate the tax risks. This is a concept already in place in the United Kingdom, the Netherlands, and other countries, and the inclusion of the concept in the CAP program may result in the IRS more vigorously exploring governance issues throughout its enforcement programs.

Conclusion

The IRS's announcement that the Compliance Assurance Process program was being continued is welcome news for taxpayers seeking ways to speed the resolution of tax issues and to bring earlier certainty to their tax affairs. More generally, all taxpayers will potentially benefit from the clear line of sight and “early warning” that CAP taxpayers provide to the IRS in respect of the myriad issues raised by H.R. 1, the 2017 tax law, referred to as the Tax Cuts and Jobs Act,⁵ some of which may not become

⁴ <https://www.irs.gov/businesses/fast-track-settlement>.

⁵ H.R. 1, An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, was signed into law on December 22, 2017, as P.L. 115-97, 131 Stat. 2054 (2017).

known until taxpayers endeavor to reflect them on their returns. Finally, the IRS's decision to continue CAP (albeit with some yet to be fleshed out changes) preserves the opportunity for the agency's named but not yet confirmed Commissioner and Chief Counsel to weigh in on this important initiative.

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