Kennesaw State University
DigitalCommons@Kennesaw State University

Faculty Publications

1-2010

Real-Time Corporate Tax Audits and Their Impact on Financial Reporting

M. Catherine Cleaveland
Mercer University

Kathryn K. Epps
Kennesaw State University, kepps@kennesaw.edu

Cassie F. Bradley
Georgia Gwinnett College

Follow this and additional works at: http://digitalcommons.kennesaw.edu/facpubs

Part of the Accounting Commons, and the Corporate Finance Commons

Recommended Citation
Cleaveland, M. Catherine, Kathryn K. Epps, and Cassie F. Bradley. "Real-Time Corporate Tax Audits and Their Impact on Financial Reporting." CPA Journal 80.1 (2010): 46-47

This Article is brought to you for free and open access by DigitalCommons@Kennesaw State University. It has been accepted for inclusion in Faculty Publications by an authorized administrator of DigitalCommons@Kennesaw State University. For more information, please contact digitalcommons@kennesaw.edu.

Real-Time Corporate Tax Audits and Their Impact on Financial Reporting

By M. Catherine Cleaveland, Kathryn K. Epps, and Cassie F. Bradley

The IRS is testing a program that may represent the future of corporate audits. Since 2005, the IRS has piloted the Compliance Assurance Process (CAP) program in its Large and Mid-Size Business Division. The CAP program is a simultaneous auditing process that aims to significantly reduce, or even eliminate, audit procedures after the corporate tax filing date. Tax professionals should understand how the CAP program works, its advantages and disadvantages, and the likelihood of its expansion as the IRS determines the future of real-time corporate auditing.

How Does CAP Work?

Currently, the IRS invites individual corporations to participate in the CAP program. If a corporation accepts, it signs a memorandum of understanding (MOU) that establishes the materiality thresholds and methods of communication to be used during the program. If, during the course of the CAP cycle, the corporation does not comply with the guidelines set forth in the MOU, it may be removed from the program. Once an MOU has been established, the IRS assigns an account coordinator to the corporation who serves thereafter as the corporation's primary IRS contact and oversees the CAP cycle. The account coordinator familiarizes himself with the corporation's recent transactions via news reports, SEC filings, and annual reports. Combining this information with data provided by the corporation, the coordinator conducts a taxpayer risk analysis.

Throughout the tax year, the corporation and the account coordinator work toward an agreement regarding the tax treatment of material issues such as transfer pricing, foreign earnings repatriation, research and development tax credits, and acquisitions. These material issues may be brought to the attention of the account coordinator by the corporation, by the CAP team, or via transaction review. If an agreement on the tax treatment of a material issue is reached, the account coordinator records it in an issue resolution agreement. If the corporation and the coordinator cannot agree on a material issue, they can utilize the IRS resolution processes currently in place, such as the Fast Track Settlement (FTS) program.

At the conclusion of the tax year, the account coordinator completes Form 906, Closing Agreement on Final Determination Covering Specific Matters, which details the material issues and their resolved tax treatments. Assuming that the corporation adhered to the guidelines of the MOU and the identified material issues have all been resolved, the IRS will issue the corporation a "full acceptance" letter. Alternatively, if the corporation has adhered to the guidelines of the MOU, but an agreement has not been reached on all material issues, the IRS will issue a "partial acceptance" letter. In both scenarios, the tax return, when filed, should not contain any material information that was not disclosed during the CAP cycle. A full acceptance letter indicates that the tax return will be accepted when filed if the tax treatment of the identified material issues corresponds to the closing agreements in Form 906 and if the tax return does not contain information that was not disclosed during the CAP cycle.

When the corporation files its tax return, the account coordinator will perform a post-filing examination. The goal is for this review to be completed within 90 days. The purposes of the post-filing examination are to ensure that the corporation's treatment of the resolved material issues on the tax return is consistent with the closing agreements in Form 906 and that the tax return does not contain material issues which were not properly disclosed during the CAP cycle. If these conditions are met, then the IRS will issue a "no change" letter, concluding the examination. On the other hand, if the tax return is inconsistent with the closing agreements or contains items materially affecting the corporation's tax liability that were not properly disclosed during the CAP cycle, the IRS will examine those items. Furthermore, if the corporation received a partial acceptance letter, any material issues that were not resolved during the CAP cycle will also be examined. Despite its participation in CAP, the corporation is still entitled to all appeals processes for the material issues that are examined at this time.

What Are the Advantages of CAP?

The intended benefits of the CAP program include increased corporate tax compliance, reduced audit cycle time, improved accuracy of reported corporate earnings, and increased efficiencies for both the corporate filer and the IRS. In terms of compliance, the corporate filer undergoes "real-time issue resolution" with the goal of resolving most, if not all, issues prior to the filing date. The IRS notes that the real-time audit can improve compliance, as auditors and filers work together to resolve questionable issues and agree on how those issues will be handled in the return. Because the goal of the program is to reduce the need for post-filing examination, the IRS aims to reach an "acceptable" level of assurance regarding the accuracy of the return prior to the filing date. The speedier resolution of complex corporate issues, such as transfer pricing and advance pricing agreements, is an advantage for corporate filers, as these issues are often the subject of extended audit examination in traditional corporate audits.

The IRS aims to complete the audit of CAP participants within 90 days of the filing of the tax return. This compares to an

average audit cycle time of 60 months for large and medium-sized corporations. This reduction of audit cycle time increases certainty for the corporate filer and may potentially reduce compliance costs, as tax department staff can focus their efforts on current-year compliance and future-year planning rather than responding to past-year audit inquiries. In addition, emerging issues are addressed in a timely manner, which enhances the consistency of their tax treatment and IRS adjudications.

The CAP program has the potential to improve the accuracy and transparency of reported corporate earnings in several ways. First, with guaranteed acceptance of resolved material issues at the filing date, the CAP program can reduce the level of corporate restatements and contingent tax liabilities that often result from traditional IRS audits. Because tax certainty is achieved sooner, the accuracy of financial statement tax reserves is also significantly improved. At a time when corporations are facing pressure to increase disclosure of the impact of taxation on earnings, the CAP program can eliminate a significant source of restatement activity. Since 2006, FASB's Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, has required large and medium-sized corporations to disclose uncertain tax positions. The lower threshold for disclosure of uncertainties required in FIN 48 reduces a major impediment for corporations to participate in the CAP program, as failure to disclose uncertainties can lead to increased scrutiny by the IRS.

Both the IRS and corporations that have participated in the CAP pilot program have reported increased efficiencies and reduced administrative obstacles. Efficiencies for corporate filers include reduced resources devoted to past year audits and tax contingencies, refocused planning resources from domestic to international issues, and improved customer service from IRS agents who share the goal of a timely and efficient audit. The IRS can reduce the resources devoted to corporate audits with the CAP program because its review of tax decisions occurs throughout the tax year. The streamlining of CAP post-filing examinations also saves time and resources for the IRS. Initial reviews of the efficiencies of the CAP program have been positive: A 2008 TEI survey reported that 74% of CAP participants indicated an "open and collaborative" audit experience, compared to only 47% of all survey respondents.

What are the drawbacks of CAP?

While the CAP program can increase compliance and provide timely guidance on tax issues, potential disadvantages exist. First, some corporate tax executives may resist participating in a real-time audit program because of a belief that it might limit aggressive tax planning on the domestic side of corporate transactions. It has become standard procedure for some companies to assume aggressive tax positions, followed by rigid defense of these positions in often adversarial relationships with IRS auditors. The requirements of FIN 48, which increases transparency in both financial reporting and tax reporting, may reduce resistance to real-time auditing.

Another management concern is the treatment of reported tax reserves. Because CAP corporations must attest that there are no reserves for transactions that have not been discussed with the IRS, corporate tax executives may fear that the IRS will open the reserves to further scrutiny once the reserves are finally released.

The transition from traditional to real-time auditing can be challenging. The initial years of participation in CAP can require significant resources, as corporations must respond to traditional audit inquiries for prior years as well as CAP inquiries for the current year. Furthermore, if corporate participants fail to respond in a timely manner to requests by the CAP team, then the IRS may determine that the corporation is a poor candidate and ask the corporation to leave the program.

The number of CAP pilot program participants has increased over fivefold since its 2005 inception. Perhaps due to the internal tax resources required for corporate program transition, the majority of participating companies to date have been large companies, including Wal-Mart, Analog Devices, Weyerhaeuser, and Dell. Many of these companies have chosen to disclose CAP pilot program participation in their annual reports and management disclosures.

What Is the Future of CAP?

Recent IRS announcements indicate that it considers the CAP pilot program to be successful, and it plans to expand the program and its features to a greater number of corporations. In a November 19, 2008, report, the IRS Advisory Council suggested an expansion of the CAP program. The council noted that both IRS and taxpayer participants have expressed general satisfaction with the program, citing improved audit relationships and increased collaboration. IRS Commissioner Douglas Shulman has also recently touted the CAP program as the type of "innovative, forward-thinking program" that represents the future of tax enforcement. Shulman also stressed that the CAP program significantly benefits financial statement users via reduced restatements.

The alignment of the tax audit model with the financial statement audit model may also increase the chances of the program being expanded, as the increased certainty of tax-related financial disclosures serves the needs of financial statement users. CAP participation also may enhance corporate compliance with the governance and accountability requirements of the Sarbanes-Oxley Act, including the requirement to document internal controls over tax transactions. The IRS is currently developing the metrics it will use for voluntary, rather than invitational, enrollment in the CAP program.

The evidence that the CAP program has been successful—including year-to-year program growth, favorable survey results, and recommendations from IRS officials—suggests that the CAP program is likely to be expanded. In addition, efficiencies such as a reduction of audit resources and improved audit relationships as a result of the CAP program are consistent with the current administration's ongoing initiative to examine each federal agency for potential improvements in operational efficiency and a reduction of consumed resources. Corporations of all sizes should welcome, and start preparing for, more timely tax audits and increased transparency of the tax treatment of financial transactions. ❑

M. Catherine Cleaveland, PhD, *is an assistant professor of accouting at Mercer University, Atlanta, Ga.* ***Kathryn K. Epps, PhD,*** *is interim director of the school of accountancy at Kennesaw State University Kennesaw, Ga.* ***Cassie F. Bradley, PhD, CFP,*** *is an associate professor of accounting at Georgia Gwinnett College, Lawrenceville, Ga.*