

THE US COMPLIANCE ASSURANCE PROCESS: A RELATIONAL SIGNALLING PERSPECTIVE

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Abstract

Cooperative compliance programmes have been introduced in various tax jurisdictions, with its pioneers including Australia, Denmark, Ireland, the Netherlands, the UK and the US. Such programmes are part of a wider trend in regulatory systems that emerged in the 1980s, and attempt to better balance interests between the tax authority and corporate taxpayers, and seek to reflect a more collaborative working method, as promoted by the Organisation for Economic Co-operation and Development (OECD). This paper examines the US cooperative compliance arrangement, known as the Compliance Assurance Process (CAP), and probes the nature of the relationship that ensues between the regulator and regulatee under CAP, the motivations of each party to the arrangement, and the manner in which the relationship is (or is not) sustained. This paper sheds light on such matters pertaining to CAP by examining its evolution and operation through the lens of regulation theory, drawing in particular on the work of Etienne (2013), who develops a typology of ideal type interactions and relational signals in regulatory settings. It is also informed by interview data from two separate studies involving interviews with senior in-house tax executives/advisors. Drawing on Etienne's typology facilitates a better understanding of the limits of cooperative compliance in the context of large businesses, particularly in the US environment. This paper shows the importance of adequately capturing the motivations of regulator and regulatee, demonstrating they do not carry equal weight nor have they remained stable over time, and addresses the implications of these differences for the success of an initiative such as CAP. It also demonstrates that interactions between regulator and regulatee follow multiple logics, and highlights and critiques the high level of interaction required, especially during the initial stage of responsive regulation-based relationships. The paper concludes with some broader considerations around regulator-regulatee relationships, including the potential role for recent technological innovations in this context.

Keywords: cooperative compliance, Compliance Assurance Process, responsive regulation, Etienne

INTRODUCTION

Together with some other Organisation for Economic Co-operation and Development (OECD) countries, including Australia, Denmark, Ireland, the Netherlands, and the UK, the US can be seen as a pioneer in reconfiguring regulatory relationships in the field of corporate taxation into

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one that better balances interests between the tax authority and corporate taxpayers. Whereas the relationship between tax administrations and taxpayers has traditionally been strongly characterised by power asymmetry, cooperative compliance programmes aim to realise a more cooperative relationship, in which compliance should be enhanced by mechanisms other than strict control-and-punishment. Often in parallel with trends across other parts of the public sector, such as New Public Management (NPM) type modernisations, tax administrations have started to introduce enforcement mechanisms that are more responsive to specific profiles of corporate taxpayers, with the expectation that this would generate efficiencies and other benefits for both tax administrations and corporate taxpayers.

In relation to corporate tax administration, the more collaborative working method, strongly promoted by the OECD and initially referred to as the “enhanced relationship” model (OECD, 2008), was renamed and rebranded “cooperative compliance” in 2013 (OECD, 2013). This paper examines one particular form of cooperative compliance arrangement, namely the Compliance Assurance Process (CAP) programme in operation in the US. This programme was introduced in 2003 and differs from similar programmes in other countries by being both voluntary and prescriptive. CAP carves out a particular segment of the taxpaying population – large corporate taxpayers – and creates a distinctive form of regulatory interaction with that group. While the structure and history of CAP is reasonably well understood by practitioners and others with knowledge of tax regulation processes, little research has attempted to probe the nature of the relationship that ensues between the regulator and regulatee under CAP, the motivations of each party to the arrangement, and the manner in which the relationship is (or is not) sustained. This paper sheds light on such matters pertaining to CAP by examining its evolution and operation through the lens of regulation theory, drawing in particular on the work of Etienne (2013), who develops a typology of ideal type interactions and relational signals in regulatory settings. It is also informed by interview data from two separate studies involving interviews with senior in-house tax executives/advisors. By using Etienne’s typology to probe the operation of CAP, we are able to better understand the limits of cooperative compliance in the context of large businesses, particularly in the US environment.

The paper is structured as follows. In the next section, we review the broader field of responsive regulation and describe Etienne’s framework as a basis for evaluating the CAP programme. This is followed by a brief history and description of CAP, before we analyse its operation by reference to Etienne’s model and draw some conclusions about the differences in motivational drivers between regulator and regulatees, and the implications of these differences for the success of an initiative such as CAP.

REGULATORY INTERACTIONS AND THEIR MOTIVATIONS

The area of tax administration has turned out to be one of the most fruitful areas for the practical application of “responsive regulation”. Ayres and Braithwaite set out their regulatory view most comprehensively in their foundational work “Responsive Regulation” (1992). This work provides a “third alternative” (Ayres & Braithwaite, 1992, p. 3) to both the free market and government regulation, and attracted instant interest from practitioners in regulatory bodies. Ayres and Braithwaite’s “Responsive Regulation” (1992) and the substantial amount of subsequent elaborations, however, dedicate limited attention to the underlying motivations of regulators and regulatees throughout their interactions. Scholarship outside the area of responsive regulation demonstrates that motivational factors are critical in order to explain the evolution of relationships between actors (Dijksterhuis & Aarts, 2010; Lindenberg, 2001).

This article identifies major differences in motivational drivers between regulator and regulatees. Arguably, an underestimation of these motivational differences accounts for many of the difficulties occurring in, for example, the Dutch cooperative compliance programme titled Horizontal Monitoring (De Widt, 2017), and it is instructive to consider the CAP programme from this perspective. To identify the relevance of different motivational factors, we draw upon a framework developed by Etienne (2013), which is described in more detail below. A major strength of Etienne's framework compared to other frameworks is that it does not take a preferred view of either side in the regulatory relationship, but can be equally applied to map regulatory relationships from the perspectives of the regulator and regulatee.

The rise of cooperative compliance programmes in tax administrations is part of a wider trend in regulatory systems that emerged in the 1980s. Incentivised by both increasing pressures on regulatory resources and a wish to make the public sector more service-oriented, regulatory systems developed, adopting a more responsive approach towards those being regulated. Ayres and Braithwaite (1992) provided a ground-breaking conceptualisation of the phenomenon. In J. Braithwaite's (2006) own words, "[t]he basic idea of responsive regulation is that governments should be responsive to the conduct of those they seek to regulate in deciding whether a more or less interventionist response is needed" (p. 886). Hence, a gradual sanctioning regime, referred to as the "enforcement pyramid", should enable regulators to make more effective use of their resources and bring regulation more in line with regulatees' risk profiles. Regulatees with low-risk profiles would be subjected to less scrutiny and would enjoy a reduction of administrative burdens (Ayres & Braithwaite, 1992; Lodge, 2015).

Another critical feature of responsive regulation is that regulation is deemed to be more effective if regulated parties do not know exactly what to expect from the regulator. Ayres and Braithwaite (1992) refer to this as the "benign big gun", indicating that, whilst going up in the enforcement pyramid, regulators "bluff" greater power than they actually possess. The uncertainty this subsequently generates amongst regulatees regarding the severity of sanctions that might be imposed upon them is expected to improve regulatees' rule compliance. The idea of responsive regulation has found widespread popularity in tax administrations. A pioneering role was fulfilled by the Australian Tax Office (ATO), which introduced the ATO Compliance Model in 1998 (Murphy, 2004).

While many public administrations put effort into developing a more responsive regulatory style, responsive regulation has faced several criticisms. First, the model has been criticised for being too state-focussed, which may have resulted in inadequate awareness amongst regulators of the mindsets of regulatees, including the manner in which the institutional environment and performance of the regulatory regime affects regulatees' behaviour (Black & Baldwin, 2010). Second, the model pays limited attention to the implementation of responsive regulation, not addressing questions such as what the administrative prerequisites for both regulator and regulatee are and how they are meeting them. Third, responsive regulation has been criticised, on more principled grounds, for providing a regulatory model that would go against generality and equality of rule enforcement (Westerman, 2013). These criticisms also apply to the implementation of responsive regulation by tax administrations. In most responsive regulation-based tax monitoring approaches, including cooperative compliance programmes, the dominant perspective of researchers is that of the regulator, i.e. the tax administration. The recent substantial stream of research which takes a behavioural perspective in order to explain tax compliance concentrates almost exclusively on the tax compliance of individuals (e.g. Kirchler, Hoelzl & Wahl, 2008). Hence, we know little about the behavioural factors that underlie interactions between corporate taxpayers and tax administrations.

It can be assumed that motivational factors play an important role in regulatory interactions, even more so when regulatees are free to join a regulatory arrangement, such as a cooperative compliance programme, like the CAP in the US. However, most research on the relationship between motivations and rule compliance by businesses has been conducted outside the domain of tax. For example, substantial research has been done on motivations underlying environmental behaviour, e.g. for farming (Atari, Yiridoe, Smale, & Duinker, 2009). The literature on environmental regulation suggests three motivations underlying rule compliance. First, rule compliance may follow from the regulatee's expectation of being detected and the likelihood of receiving a fine when demonstrating noncompliant behaviour (Becker, 1968). Second, rule compliance may have a social background and be sustained by shared norms combined with the desire to earn the approval and respect of significant others (Levi, 1988). Finally, rule compliance will be influenced by a regulatee's ability to comply (Winter & May, 2001).

The translation of motivational factors into practical behaviour has been referred to as "motivational postures"; or styles of engagement through which regulatees give meaning to the regulator's message (V. Braithwaite, 2009, p. 20). Hence, motivational postures exhibit the extent to which a regulatee "accepts the agenda of the regulator, in principle, and endorses the way in which the regulator functions and carries out duties on a daily basis" (Braithwaite, Murphy, & Reinhart, 2007, p. 138). Due to this, trust and respect between the regulator and regulatee, and the degree of agreement they share regarding the ends and means of regulation, are fundamental for achieving rule compliance.

A major limitation of motivational frameworks is that they strongly reason from the perspective of either the regulator or regulatee. For example, in the case of risk-based regulation, Power's (2004) work focusses on the regulatees, whereas Black (2005, 2006) and Rothstein, Huber, and Gaskell (2006) take the perspective of the regulator. Due to this, motivational theories not only miss out the regulator's or regulatee's perspective, but are also rather static, lacking analytical concepts by which to analyse how the interactions between regulator and regulatee affect each party's regulatory stance. Etienne (2013), however, provides a framework that puts equal emphasis on the regulator and regulatee, and incorporates the impact of relationship dynamics. Etienne (2013) takes a relational signalling approach to these interactions. The idea of relational signals is derived from Lindenberg (2000); they comprise information exchanged in repeated interactions that may be either positive or negative, and serve to allow each party in the relationship to infer the other's interest, "making certain behaviours meaningful and others less so" (Etienne, 2013, p.35). Etienne observes that regulatory relationships are imbued with ambiguity requiring sensemaking on the part of both regulators and regulatees. He develops a model of ideal types that distinguishes between five different motivations, dynamics or rules of interaction that focus on "which rules of interaction might hold sway in stable, ongoing regulator-regulatee relationships" (Etienne, 2013, p. 36). The five ideal types are as follows:

- *Self-interest*: Relationships of self-interest are built around a shared focus on resources, or gains and cost. In a self-interested relationship, the respective positions of regulator and regulatee are determined by "how resourceful they are and by their ability to put these resources to effective use" (Etienne, 2013, p. 37). Self-interest as a motivation for engagement may not be stable and a relationship built upon this alone may need "continual renegotiation of expectations". Self-interest relationships also tend to discount other motives, for example, "[c]alls to public interest or moral values [which] are considered hypocritical".

- *Legality*: In the case of legality, regulator-regulatee relationships are strongly determined by legal rules, which both the regulator and regulatee are expected to follow. Interactions are built on status, with regulator and regulatee in the positions of superior and inferior respectively. Relationships grounded in legality generally tend to be stable over time, given that it is the legal nature that prompts compliance rather than the content of specific rules.
- *Authority*: Authority relationships are built on status and, like legality relationships, ostensibly put regulator and regulatee in positions of superior and inferior respectively (Etienne, 2013, p. 37). As Lukes (1990, p. 214), quoted by Etienne (2013) states, authority is “a command reason that reduces the significance of other reasons that would otherwise prevail, and removes the point of weighing them”. A relationship sustained by authority addresses unwritten rules and facilitates unquestioned obedience.
- *Judgement*: Another sustaining factor of regulator-regulatee relationships is judgement, in which case the relationship is determined by morality or science, and considerations of truth or right dominate (Etienne, 2013). Values are a critical element of judgment relationships. Here, cooperation is focussed on the content of what each party is expected to do, with disagreements capable of settlement through reasoned argumentation.
- *Solidarity*: Solidarity relationships are horizontal relationships based upon trust, in which “neither party can dictate to the others what she must do” (Granovetter, 2002, p. 40). The elements relevant to solidarity relationships display many similarities with judgement relationships, but solidarity relationships are entirely based upon trust, itself emerging from repeated positive interactions (Blau, 1986).

Having identified five types of motivation for regulatory relationships, Etienne then outlines several hypothetical relational signals derived from empirical literature and theory, observing that these signals are context-dependent in terms of the manner and timing of presentation and expectations of reciprocity. The relational signals identified by Etienne are as follows (with several collapsed for the purpose of this paper):

- *Regulatory relief*: the regulator provides relief from regulatory requirements.
- *Favours*: may take the form of gifts, or bribery.
- *Formalism*: formalising the nature of the relationship through, for example, contracts and other documentation which constrains behaviour.
- *Third-party involvement*: regulatory relationships are dyadic, but it is possible to introduce a third party for a variety of purposes.
- *Monitoring*: implies surveillance, which may be routine or exceptional.
- *Argumentation and bargaining*: as forms of dispute resolution.
- *Threats and sanctions*: most commonly imposed by the regulator.
- *Claims of authority*: again, most commonly imposed by the regulator.

As noted earlier, rather than taking the perspective of either party, Etienne’s ideal types allow us to consider “which rules of interaction might hold sway in stable, ongoing regulator-regulatee relationships” (Etienne, 2013, p. 36). Depending upon their behaviour, actors can either support or undermine these relationships by sending positive or negative relational signals. Whether the signals are perceived as positive or negative depends on the underlying

relationship type. For example, a formalistic approach would strengthen a regulator-regulatee relationship that is focussed on legality, whereas the exchange of gifts would undermine this relationship. While Etienne does not provide an empirical application of the framework, it is to be expected that, in practice, we will more likely find blurred rather than pure versions of the ideal types. In this article, Etienne's framework, alongside other insights deriving from responsive regulation theory, is used to analyse the extent to which relationship features do account for the evolution and operation of CAP. Before analysing CAP, the following section briefly describes CAP and outlines its perceived costs and benefits. Its legal aspects constitute one of the main controversies over cooperative compliance arrangements in the tax arena. The discussion on this concentrates on the model's proposed differentiated approach towards regulatees, which would be at odds with basic assumptions about the generality and equal application of rules (cf. Westerman, 2013).

THE COMPLIANCE ASSURANCE PROCESS (CAP) PROGRAMME

Introduction of US CAP

CAP constitutes the primary cooperative compliance initiative introduced by the US Internal Revenue Service (IRS), with other initiatives, including Limited Issue Focused Examination (LIFE) and Advanced Pricing Agreements (APAs). CAP was introduced in December 2005 in the IRS's Large and Mid-Size Business Division (LMSB) which serves corporations and partnerships with assets greater than \$10 million. The Large Business and International (LB&I) Division of the IRS was established as a new division in the IRS in 2010, superseding LMSB.⁵ CAP started as a pilot programme with 17 voluntary participants.⁶ CAP superseded a previous programme, the "Pre Filing Agreement Program" (PFA), which had operated since 2000 for large taxpayers and allowed for negotiation of specific issues not yet disclosed in a tax return. CAP is consistent with responsive regulation theory, as noted by Osofsky (2012), "a shift away from an adversarial approach towards cooperative compliance partnerships", who also observes that the "list of CAP users is becoming a veritable who's who of major corporations" (p.122-123).

The US tax system of filing returns and paying taxes relies heavily on self-assessment, and filing of tax returns can be followed by auditing by the IRS. Holmes (2011) suggests that the IRS is significantly outgunned by large multinationals in particular, observing "[o]ften understaffed and outwitted, IRS agents have resorted to using every penalty, sanction, procedural tactic, threat and common law doctrine available in their arsenal to capture the elusive [large business entity] income base for the US Treasury chest" (p.1417-1418). Noting the high monetary stakes, Holmes (2011) further characterises the engagement between the IRS and large entities as a game that has developed considerable mistrust and resentment over a long period of time.

A major driver for the implementation of CAP was the increasingly time-consuming process between filing and the closing of a company's tax position for an accounting period, which was perceived as unacceptable both from the perspective of business and government. The Commissioner of the IRS in 2003, Mark Everson, stated that it took the IRS five years to complete an audit of a corporate tax return, which drained IRS resources and capacity

⁵ <https://www.irs.gov/uac/irs-realigns-and-renames-large-business-division-enhances-focus-on-international-tax-administration>. For background to the US large corporate environment and, in particular, the role of in-house tax executives, see Mulligan and Oats (2015).

⁶ <https://www.irs.gov/businesses/corporations/compliance-assurance-process>; accessed January 2017.

(Bronzewska, 2016). In an attempt to reduce this time, the IRS expanded the PFA process to accelerate corporate income tax audits. As Oppen (2011) observes:

The PFA 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.

The then IRS Chief Counsel, Donald Korb, asserted the "ultimate pre-filing agreement" would exist if the pre-filing concept could be applied to all material tax items occurring during a taxable year. From 2003 onwards, the Compliance Assurance Process (CAP) programme was developed as a test of Korb's concept. The LMSB undertook a comprehensive business process review, seeking advice from external stakeholder groups which established guidelines for encouraging collaboration and minimising taxpayer burdens with a single point of contact in the IRS (Nolan, 2006). CAP was then introduced in 2005 on a pilot basis. Corporates could join the CAP pilot on a voluntary basis, following invitation from the IRS. According to Nolan, then Commissioner of the IRS Large and Mid-Size Business Division, the CAP approach leveraged the then new corporate governance and reporting requirements imposed by the Sarbanes-Oxley Act of 2002 (Nolan, 2006). She explained the motivation for the introduction of CAP as originating in the lengthy delays associated with post-filing examinations in which "taxpayers often have to sift through years of old financial and tax records in an effort to provide the requested information or to reconstruct the circumstances leading up to particular business decisions and transactions" (Nolan, 2006, p. 26). An independent research firm commissioned by the IRS to survey CAP taxpayers reported in mid-2005 that the IRS's commitment to CAP was strong and most respondents expressed a desire to continue in the programme.

The pilot period lasted for six years, after which CAP became a permanent feature of the IRS's compliance operations with effect from 31 March 2011.

Main features of US CAP

As of August 2016, there were 181 taxpayers participating in the permanent CAP programme and a critical difference between this and the pilot is that taxpayers have to go through a rather rigorous application process before they are allowed access to the programme. Following the pilot phase, two additional features were added to CAP: first, a roadmap was published of the steps required for gaining entry into CAP; and, second, a new CAP maintenance programme intended for businesses participating in CAP that had fewer complex issues and could demonstrate a track record of working cooperatively and transparently with the IRS was announced. Hence, three stages exist in the programme: Pre-CAP, CAP and Compliance Maintenance.

A taxpayer participating in CAP is expected to work collaboratively with an IRS team to identify and resolve potential tax issues before their tax return is filed each year. In this real-time resolution approach, taxpayers are subject to a shorter post-filing examination period with fewer contentious items to be dealt with. As noted in the CAP Memorandum of Understanding (MOU), which is signed by both the IRS and the corporate taxpayer, the objectives of CAP are

formulated as: to “achieve federal tax compliance [-], to achieve an acceptable level of assurance regarding the accuracy of the Taxpayer’s filed tax return and to eliminate or substantially reduce the need for a traditional examination”. Importantly, however, the CAP pre-filing review conducted by the IRS does not constitute an examination or inspection of the taxpayer’s books of account as part of a routine compliance check.

A core feature of CAP is that it focusses on issue identification and resolution through transparent and cooperative interaction between taxpayers and the IRS. CAP requires a contemporaneous exchange of information related to the proposed return position of a corporate and its completed events and transactions that may affect its federal tax liability. An Account Coordinator is appointed to be the point of contact, review prior tax history, and identify risks and compliance issues. “Throughout the process, the Account Coordinator and IRS Counsel work together to resolve CAP issues and taxpayer concerns” (Nolan, 2006, 30). After the first year of the pilot, CAP teams apparently reported an average of eight issues per taxpayer. Corporates participating in CAP are ostensibly able to achieve tax certainty sooner and with less administrative burden than in the traditional post-filing examination programme, allowing them to better manage tax reserves and ensure more precise reporting of earnings on financial statements. Whilst there is some overlap between the three main phases of the CAP programme in terms of processes and procedures, the following section provides an overview of each phase.

The *Pre-CAP phase* has its own application process and eligibility criteria, including the company having assets of \$10 million or more and not being under investigation by, or in litigation with, the IRS or other federal or state agency that would limit the IRS’s access to current corporate tax records.⁷ A successful Pre-CAP application ends in a signed Memorandum of Understanding (MOU) by the company and the IRS which defines specific objectives, sets parameters for the disclosure of information, describes the methods of communication, and serves as a statement of the parties’ commitment to good faith participation in the Pre-CAP. Both the IRS and the corporate must provide a list of designated personnel to act as points of contact for gathering information and resolving questions or issues. The MOU outlines the requirements for taxpayer disclosures in the following terms:

The IRS and the Taxpayer will work together to develop an action plan to complete all required examinations within an established timeframe. During the Pre-CAP phase, the Taxpayer must exhibit the same level of transparency and cooperation that is required of taxpayers in the CAP phase. The Taxpayer must identify the existence of transactions, its return reporting position, and a description of the steps within the transactions that have a material effect on its federal income tax liability. Further, the Taxpayer must disclose any other item that has a material effect on its federal income tax liability and its return reporting position with regard to those items. It must provide relevant information within the established timeframes. The Taxpayer disclosures described in this paragraph will be in writing.

In addition to transactions, description of steps within a transaction and other material items described above, the Taxpayer will provide the IRS with: the industry overview, current legal, accounting and tax organizational charts

⁷ Examples are the company: having assets of \$10 million or more; being a publicly held entity with a legal requirement to prepare and submit Forms 10K, 10Q, 8K or 20F or other disclosure type forms to the Securities and Exchange Commission; and not being under investigation by, or in litigation with, the IRS or other federal or state agency that would limit the IRS’s access to current corporate tax records.

reflecting all related entities and the flow of relevant information involving those entities, financial performance information, information on any significant events that affected reporting for the tax year, access to accounting records and systems, and necessary resources for disclosure of requested information.

The Taxpayer will provide information and documentation proactively and as requested by the TC [team coordinator]. The TC will promptly review all relevant information provided and will communicate to the Taxpayer whether (1) additional information is required; (2) the IRS disagrees with the Taxpayer's tax treatment; or (3) the tax treatment is appropriate.

Interestingly, the IRS and taxpayers will jointly determine the scope of the Pre-CAP examinations, including materiality thresholds. Materiality thresholds are used as a guide by both parties in determining the transactions to review. However, the ultimate decision of identifying transactions, items and issues for the Pre-CAP examinations remains within the discretion of the IRS. The Pre-CAP phase ends when the taxpayer is eligible for the CAP phase, is terminated from the Pre-CAP or decides to discontinue participation in the Pre-CAP.

The *CAP phase* has the same eligibility requirements as above but additionally, if currently under examination, the taxpayer must not have more than one filed return that has not been closed in examination and one unfiled return for the year that has most recently ended, the return for which is not yet due. Applications for CAP must be completed annually. An annual CAP MOU must be signed by both parties. The IRS and taxpayers will work together during the CAP stage to identify and review material transactions and issues, and regular meetings are standard practice (these could be weekly, monthly or quarterly). At the end of the annual CAP phase, and pre-filing of the tax return, the IRS issues the taxpayer with a Full or Partial Acceptance Letter depending on the extent of compliance with the MOU and resolution of matters raised. In cases where a Full Acceptance Letter is issued, the goal for completing the post-filing review of the filed return is within 90 days of the filing of the return, which is a prompt completion timeline for a taxpayer. Importantly, the IRS may reduce the level of review based on the complexity and number of issues, and the taxpayer's history of compliance, cooperation and transparency in the CAP. Arguably there is reward for "good behaviour" within the CAP framework by way of reduced administrative costs and levels of scrutiny. Notably there are additional provisions within CAP in the area of transfer pricing, which involves significant liaison with the relevant IRS departments.

Upon completion of two full successful CAP cycles, a taxpayer can apply for the *CAP Maintenance Phase*. Companies can apply for the CAP Maintenance Phase annually, together with the annual completion of an MOU, and eligibility depends upon the meeting of expectations as set out in the annual MOUs. Participation in the Maintenance Phase means a lower level of review by the IRS, although disclosure requirements remain unchanged. Depending on the complexity of transactions and volume, it is feasible for a taxpayer to move back and forth between CAP and CAP Maintenance status, and the annual application process facilitates this happening.

The CAP programme has specific provisions governing the termination (by the IRS) or withdrawal from any of the above three phases of the programme. The above phases of CAP put high demands on IRS resources – not only in terms of the number of staff dedicated to deal with CAP cases but also the larger degree of expertise required by IRS staff when interacting on a real-time basis with large, mostly complex, businesses.

Future trajectory of US CAP

Despite CAP now having been in place for more than ten years, there has been limited evaluation of the programme. While the programme is generally considered by the IRS to have been successful at first, its extension to a larger number of corporate taxpayers is not feasible due to resource constraints (Harvey, 2011).

Notably, one review was conducted in 2013 by the Treasury Inspector General Tax Administration (TIGTA), which conducts independent oversight of IRS activities. The review concluded that whilst there was some favourable feedback about the programme, additional analysis of cost and benefits was needed (TIGTA, 2013). The TIGTA review found out that audits under CAP consume substantially more staff hours than those under the traditional audit process, with the hourly revenue rate collected under CAP being around a third of the hourly rate collected under traditional audits (\$2,939 under CAP versus \$8,448 under traditional supervision). Processes and procedures, however, were observed as being followed adequately. Overall, the Treasury Inspector's review suggests CAP represented a very significant drain on IRS resources and charged the IRS's LB&I Division with delivering an evaluation plan. The IRS agreed to do this. The Treasury Inspector also directed LB&I to consider CAP as an IRS user fee source. A user fee can be applied by the IRS to recover the cost of providing certain services to the public that confer special benefits to the recipients.

The most significant recent development, however, happened in September 2016, when the IRS stopped accepting any new businesses into the programme. This "hold" was announced by the IRS in the context of the current comprehensive review which all three phases of the CAP programme are undergoing. According to the IRS, the assessment of CAP is required "given today's challenging environment of limited resources and budget constraints, combined with a business need to evaluate existing programmes to ensure they are aligned with LB&I's strategic vision".⁸ As the review continues, only taxpayers in the current CAP and Compliance Maintenance phases may apply for their annual participation in CAP, whilst current Pre-CAP taxpayers may remain in the Pre-CAP phase. Current CAP taxpayers may be moved into the Compliance Maintenance phase. This review was presumably, at least in part, the IRS's response to the 2013 review by TIGTA. Considering there are fewer than 200 corporates participating in CAP, perhaps the IRS does indeed need to refocus resources. For example, should more resources be directed to those taxpayers not opting into CAP and who are more likely to be non-compliant? However, in response to the IRS's review announcement, KPMG (2016) has stated that CAP exposes the IRS to "extremely useful understanding and visibility concerning the current business and economic environment and transactions that are actually being conducted within specific industries". Of course, such unique knowledge and insight obtained through CAP can be transferred and therefore enhance IRS performance well beyond the CAP programme.

Somewhat unsurprisingly, in September 2018, presumably on the back of the IRS carrying out the evaluation of CAP as requested by TIGTA, the IRS issued a discussion document on CAP recalibration⁹, clearly recognising the resource-intensive nature of CAP to date and the need for change. Interestingly, it calls for changes to be made by both the IRS and the taxpayers involved. Such changes include the need for greater consistency and accountability on both

⁸ <https://www.irs.gov/businesses/corporations/irs-continues-comprehensive-assessment-of-the-cap-program>.

⁹ https://www.irs.gov/pub/irs-utl/CAP_Recalibration.pdf. Interestingly, both Ireland and the UK have recently also "recalibrated" their respective co-operative compliance models; the former has relaunched co-operative compliance and the latter is piloting a new business risk review model.

parts, and greater adherence to the requirements of CAP. With no new applicants being accepted for 2019, the changes suggest new applicants in 2020 must be publicly held C-corporations and have certified tax control frameworks in place. Such changes certainly suggest operational inefficiencies and potentially some breach of the requirements of CAP on both parts heretofore. The suitability of taxpayers for participating in the recalibrated CAP will be based on certain taxpayer behaviour and the IRS provides explicit examples of what would not constitute such behaviour, e.g. failure to disclose a tax shelter, and not engaging in meaningful or good faith issue resolution discussions. This is evidence for trying to ensure the applicants most suitable to CAP are actually accepted, so there is an apparent renewed and greater emphasis on eligibility. The application process will be more rigorous and include a comprehensive Initial Issues List to ensure that there is a greater chance that CAP will succeed and ultimately not be more resource-intensive than the normal post-filing examinations of similarly sized companies. Timeliness of response by the IRS is a critical dimension of the changes required, so a key change will be the introduction of a 90-day target to develop and resolve issues; once the return has been filed, the goal is to review it within 60 days. Training on this recalibrated CAP is ongoing, and the IRS has committed to ongoing monitoring and is open to further changes for improvement of CAP in the future.

Dolan and McCormally (2018) explain the extension of the CAP programme, observing that “[t]he costs of CAP are not insignificant. The programme 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” (p.2).

Whatever one sees as the advantages and disadvantages of CAP, it appears that CAP, by virtue of rolling out a recalibrated version as outlined above, has become embedded in the mechanisms by which the IRS seeks to verify federal income tax returns efficiently. It will be interesting to monitor the uptake of this initiative in 2020 and important to see if the eventual evaluation concludes it is perceived to be a success for both parties. The following section considers the evolution and operation of US CAP to date through the lens of Etienne’s (2013) typology of regulator-regulatee relationships.

CAP: MOTIVATIONS AND RELATIONAL SIGNALLING

The following analysis of CAP by reference to Etienne’s typology is informed by two sets of empirical data. The first (Study 1) is a series of interviews by one of the present authors, which was conducted in the US in 2015. Nine semi-structured interviews were conducted with very senior in-house tax executives/advisors, covering a range of issues related to tax planning and compliance by MNEs. The second set of empirical data is derived from a large project (Study 2), which involved two of the present authors. As part of a larger country comparative research project, five additional interviews were conducted during 2015 and 2016 with tax officials and senior in-house tax executives who had either been involved with the implementation of CAP or had engaged with the IRS in discussions about joining CAP. While the evaluation of CAP was not the exclusive focus of the empirical studies, the CAP-related findings reveal some interesting and relevant insights from participants.

Notwithstanding the somewhat uncertain future of CAP in terms of opening up to new applicants, it currently remains part of a suite of approaches to relationships between the IRS and some large corporate taxpayers. CAP represents a particular form of regulatory intervention that goes against the grain of the IRS tradition of adversarial regulation (see, for

example, Sakurai (2002)). It appears to be an outlier, the adoption of which may have been motivated by simultaneous developments in other countries.

In terms of Etienne's ideal type motivations, *self-interest* would appear to be the prime motivator for entry into, and continued participation in, the CAP programme. Both sides experience potential resource savings, both quantifiable (e.g. timely settlement of outstanding disputes) and non-quantifiable (increased certainty). The ability to acquire faster and greater certainty whilst being in CAP motivates corporates to make the extra effort that is required under CAP in the direction of the tax authority. For the IRS, objectives are more pluriform, but the expectation of realising administrative efficiencies has been a prominent one. CAP's long pilot period and slow roll-out show cautiousness on the side of the IRS to implement a programme when the costs and benefits of that programme are difficult to evaluate from a tax administration perspective. One interviewee said: "It turned out to be extremely personnel intensive. [The IRS] just don't have the people. And it's a burden on companies too" (Study 2: US01).

By viewing the CAP relationship as one primarily of self-interest, we can explain how bargaining is a positive relational signal – used to resolve disputes by way of settlement – and that claims of authority, particularly by the IRS, may not hold much sway. This is consistent with De Simone, Sansing and Seidman's (2011) depiction of CAP from a game theoretic perspective, focussing on the extent of disclosure by the taxpayer to the IRS and finding that, theoretically, a cooperative compliance approach can be beneficial even in the absence of sanctions for violating agreed upon terms of engagement. Regulatory relief is also a positive signal in a self-interest relationship, and is manifested, in the case of CAP, as reduced post-filing audits.

The CAP relationship is governed by a formal Memorandum of Understanding which brings *legality* into the picture, albeit not as strongly as when a statutory mandate exists. Despite the focus of the IRS in CAP on the process by which tax returns are being produced by corporates, CAP has not, in formal legal terms, changed how the IRS determines corporate tax compliance. With the focus on the accuracy and timeliness of the regulatee's tax returns, the same criteria are applied as were in use prior to the implementation of CAP. The key difference for CAP participants is extra-legal benefits in terms of speedier dispute resolution and reduced audit scope, which benefit both taxpayers and the IRS. The MOU requires that the parties interact on a regular basis and that they will "collectively discuss and provide feedback on the level of cooperation and transparency from each Parties perspective".

Beck and Lisowsky (2012) find that CAP participants report larger uncertain tax benefits in their financial statements before entering the programme than non-participants and that participants subsequently experience a reduced magnitude of reported uncertain tax benefit. Formalism is a relational signal with positive connotations in a legality relationship; in the case of CAP, this is represented by the signing of the MOU. Indeed, formalism can serve to protect the regulatee from IRS capriciousness. As the focus of a legality relationship is the law per se, signals such as regulatory relief, favours and threats are negative signals. Monitoring serves as a reminder of hierarchy and is expected, and therefore viewed positively, in legality relationships.

Authority appears to be of less importance in this particular instance of co-operative compliance. The adversarial undertones of interactions between large corporate taxpayers and the IRS have been described as "cat and mouse", with neither side respecting the other's

authority, and it is not entirely clear that those participating in CAP are different in this regard to those who are not participating. One Study 1 interviewee showed a lack of confidence in the IRS's ability to deliver on certainty – i.e. a lack of respect for the regulator's authority – stating: “We can't not do something for months while [the IRS] thinks about it” (Study 1: US01).

Monitoring is viewed as a positive signal in an authority relationship and where regulatees acknowledge the authority of the IRS, accelerated monitoring in the form of real-time disclosures will be more likely to be tolerated.

Judgement is important in the sense that reaching agreement on current and past disputed issues requires a level of compromise from both sides. Reflecting on the introduction of CAP, one of our interviewees said: “When it first started out, it took a long time for each of the two sides to figure out exactly how to deal with each other. In other words, from the company's side, ‘How much do I tell these people? What do I do?’ And from the IRS side, it was more, ‘Am I allowed to ask them for things?’” (Study 2: US01). A Study 1 participant, when asked “would you participate in it?”, said “No... there's an agent sitting there. I've got to tell him all the details, run everything through and go over the whole thing, my position, how I arrived at that, the whole works, forget it, I'll do it on audit” (Study 1: US02).

In judgement relationships, the use of third-party intervention, such as expert advice, can be viewed positively in recognition, for example, of a need for additional technical expertise. Threats, sanctions and monitoring, on the other hand, are perceived as negative signals, undermining the mutual respect arising from the exercise of judgement in what is a highly complex technical environment.

Finally, with respect to *solidarity*, trust is an essential element of the underlying ethos of any co-operative compliance arrangement. Given that new entrants to CAP were those taxpayers with good records of compliance who were willing to be transparent, solidarity in the form of mutual trust that the relationship will benefit both parties is clearly important. Trust includes a measure of acceptance of the difficulties faced by the other party in the relationship. One corporate interviewee commented on the resource constraints faced by the IRS, stating: “These are great programmes in theory but the execution on the ground just isn't happening. The IRS... are not getting the resources they need to effectively execute these programmes” (Study 1: US03). One of the interviewees in Study 2 had chosen not to participate in CAP and observed: “We've had some discussions with others that have signed up to the CAP programme, and they've generally found it positive, so we've always kept thinking about it... But overall, I suppose, we've not seen the benefit of doing it” (Study 2, UK25). In solidarity relationships, threats and sanctions are perceived as negative relational signals. This may explain why, as reported in De Simone et al. (2013), although the IRS has identified firms that are not transparent, no taxpayer has been asked to leave the programme.

In summary, and as predicted by Etienne (2013), categorisation of a live responsive regulation programme (here, CAP) into a single ideal type of motivational position is not possible and is almost certainly not desirable. A complex mix of motivations can be seen, and once relational signals are brought into the picture, the purity of the typology is muddied. The point, however, is not to try to demonstrate a goodness of fit between CAP and Etienne's typology, but rather to use the typology to interrogate the practical features of CAP and illustrate the need for sensitivity to this, more nuanced, picture of regulator-regulatee relationships in designing new policy interventions.

CONCLUSION

The application of Etienne's (2013) framework in this article demonstrates that interactions between regulators and regulatees follow multiple relationship logics. Although motivations are plural, they do not carry equal weight nor have they remained stable over time.

Twenty-five years after the publication of Ayres and Braithwaite's "Responsive Regulation" (1992), responsive-based regulatory systems have further expanded and more empirical information has become available about their performance. In tax administration, responsive regulation is prominent in the area of corporate taxation, with several countries significantly restructuring interactions between the tax administration and corporate taxpayers in line with its principles.

CAP, when analysed drawing on Etienne's model, shows the importance of adequately capturing the motivations of regulator and regulatee, and illuminates the unlikelihood that their interests will synchronise. This can make the successful introduction of initiatives like CAP problematic.

It can be expected that an adequate implementation of a responsive regulatory tax system requires more, rather than less, administrative capacity from the regulator and regulatee, at least during the initial period – an upfront investment of time and resources. To reduce administrative costs on both sides, it is crucial that both the regulator and regulatee develop systems enabling them to deal effectively and efficiently with the high degree of interaction that takes place within responsive regulation-based arrangements. This high level of interaction will occur, in particular, during the initial stage of responsive regulation-based relationships, when a relatively large number of regulatees is likely to be found at the lower end of the regulatory pyramid in the compliant category and hence only need more feedback to improve their level of fiscal control. Ayres (2013) supports Etienne (2013) in her contention that there is inherent ambiguity in how regulatory signals will be received, but also notes that "theory can only go so far in resolving the ambiguities and in predicting their likely interpretation" (p.149).

Obviously, there is no universal responsive regulatory model and specific choices underlie the design of CAP. Despite its specific features, CAP demonstrates many similarities to responsive regulation, such as the emphasis on one-to-one relationships between regulator and regulatees. The CAP case shows that this emphasis is both a strength and weakness of the model: it enables flexibility and relationships based on professionalism, but it also demands a high administrative capacity and potentially causes risk of regulatory capture in the event that Account Managers (in the tax administration) become too close to their respective taxpayer regulatees.

A promising way by which to circumvent some of these weaknesses is to improve aggregate data systems about regulatees, which may help regulators to validate their discretionary decision-making using big data. It would also enable regulators to provide more and better feedback to regulatees, focussing both on features that increase and features that reduce a regulatee's risk of non-compliance. In addition, albeit not addressed here specifically, clearly there is an important role for scholars to play in terms of analysing how recent technological innovations in different countries and industries have and will affect regulator-regulatee relationships.

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