Announcement and Report Concerning Pre-Filing Agreements

Announcement 2001–38

Introduction

This Announcement is issued pursuant to the Conference Report to H.R. 4577 (Pub. L. 106–554), *The Community Renewal Tax Relief Act of 2000*, which requires that the Secretary of the Treasury make publicly available an annual report relating to the Pre-Filing Agreement ("PFA") program operations for the preceding calendar year. The Conference Report states that the report is to include: (1) the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to audit, (6) the average length of time required to complete an agreement, (7) the number, if any, and subject of technical advice and Chief Counsel advice memoranda issued to address issues arising in connection with any pre-filing agreement, (8) any model agreements, and (9) any other information the Secretary deems appropriate. The PFA pilot program was announced in Notice 2000–12, 2000–9 I.R.B. 727. This is the first report issued and sets forth information on the PFA pilot program, including information on (i) the applications received for the PFA pilot program, and (ii) the closing agreements entered into pursuant to the pilot program.

Background

The Large and Mid-Size Business Division ("LMSB") within the Internal Revenue Service serves corporations and partnerships with assets greater than $5 million. In 2000, approximately 248,000 corporations and partnerships filed returns reporting assets in this range. The returns filed by these taxpayers present a wide variety of complex issues. Taxpayers served by LMSB paid more than $700 billion in taxes to the federal government during 2000. The largest of the taxpayers deal with the IRS on a continuous basis.

One of LMSB's strategic initiatives is issue management. Through effective issue management, LMSB seeks to reduce the time necessary to complete an examination, to conduct examinations on a more current basis, and to ensure consistency of issue resolution for all taxpayers. The Pre-Filing Agreement program was designed to support LMSB's issue management strategy. LMSB believes the Pre-Filing Agreement program will reduce taxpayer burden and make more effective use of IRS resources by resolving or eliminating tax controversy earlier in the examination process.

Pre-Filing Agreement Program

The PFA program is designed to permit a taxpayer to resolve, before the filing of a return, the treatment of an issue that otherwise would likely be disputed in a post-filing examination. The PFA program is intended to reach agreement on factual issues and apply settled legal principles to those facts. Execution of a PFA that resolves issues prior to filing will permit taxpayers to avoid a portion of the costs, burdens and delays that are frequently incident to post-filing examination disputes between taxpayers and the IRS.

In calendar year 2000, a pilot program was implemented which resulted in the execution of seven PFAs. A PFA is a specific matter closing agreement under § 7121. These PFAs permanently and conclusively resolve the subject of the PFA for a taxable period. Based upon input from internal and external participants in the pilot program, the IRS has implemented the PFA program on a continuing and expanded basis. Rev. Proc. 2001–22, 2001–9 I.R.B. 745.

PFA Pilot Program (Notice 2000–12)

Notice 2000–12, 2000–9 I.R.B. 727, dated February 11, 2000, announced the PFA pilot program, which was administered by LMSB. The PFA pilot program was open to Coordinated Examination Program [1] ("CEP") taxpayers that had a CEP examination team currently on site. The notice provided a description of a PFA, the procedures for requesting a PFA, and the procedures for LMSB to select taxpayers for the PFA pilot program. The IRS believed that this PFA pilot program offered significant benefits for taxpayers, as well as for the IRS, and invited large business taxpayers to participate. Notice 2000–12 requested interested taxpayers to submit applications for the PFA pilot program by March 15, 2000, through the on site LMSB team manager.

PFA Process

The PFA process was managed and conducted by LMSB Industry Directors and field staff, with support from the Office of Pre-Filing and Technical Guidance in LMSB Headquarters. LMSB team managers reviewed all applications and made their recommendations to their respective Industry Directors. The Office of Chief Counsel reviewed all applications to ensure the issues presented were appropriate for inclusion in the PFA pilot program.

The Industry Director with jurisdiction over the taxpayer made the final decision whether to accept a taxpayer's request for participation in the PFA pilot program. The criteria for selecting a request included:

a. The suitability of the issue presented by the taxpayer;
b. The direct or indirect impact of a PFA upon other years, issues, taxpayers, or related cases;
c. The selection of a cross–section of issues and industries for the pilot program; and
d. The probability of completing the examination of the issue and entering into a PFA by the target date.

For the cases selected, a mandatory orientation session for the CEP examination team and the taxpayer was conducted. Subsequently, the taxpayer and CEP examination team held a joint planning meeting to seek agreement on a proposed timeframe, to identify and arrange for IRS access to relevant records and testimony, and to define the potential scope and nature of the PFA.

The CEP examination team conducted the factual and issue development consistent with IRS auditing standards. Based upon an examination of the issue, the Team Manager prepared a PFA recommendation for the Industry Director. The Industry Director's decision to enter into a PFA was based on the Team Manager's recommendation and discussions with the PFA Program Manager, Chief Counsel attorneys, and the taxpayer. Following Chief Counsel review to ensure that the proposed PFA conformed with guidance provided in Rev. Proc. 68–16, 1968–1

[1] This program has recently been renamed. Such cases are now classified as Coordinated Industry Cases.

C.B. 770 (regarding closing agreements), the Industry Director could execute a PFA if he or she determined that:

a. Entering into the PFA was consistent with the goals of the PFA pilot program as stated in the Notice;
b. The tax results in the PFA reflected settled legal principles and correctly applied those principles (or positions authorized under Delegation Order Nos. 236 or 247) to facts found by the Examination Team; and
c. There appeared to be an advantage in having the issue(s) permanently and conclusively closed for the taxable period covered by the PFA, or that the taxpayer showed good and sufficient reasons for desiring a closing agreement and that the United States would sustain no disadvantage through consummation of such an agreement (see section 301.7121–1(a) of the Regulations on Procedure and Administration).

Program Oversight

A designated PFA Program Manager and analyst assigned to the Office of Pre-Filing and Technical Guidance in LMSB Headquarters provided oversight for the PFA pilot program. The PFA Program Manager provided assistance to taxpayers, Industry Directors and Team Managers throughout the process and personally conducted the orientation session at each taxpayer location.

Pre-Filing Agreement Pilot Program Accomplishments

Applications Received

Nineteen applications were received for the PFA pilot program. Applications were received from each LMSB industry segment and involved a variety of issues.

Industry Segment	Received
Financial Services & Healthcare	1
Retailers, Food & Pharmaceuticals	4
Natural Resources	3
Communications, Technology & Media	2
Heavy Manufacturing, Construction & Transportation	9
Total	**19**

Issue	Received
Valuation of Assets	5
Research Credit	7
Expense vs. Capitalization	2
Tax Motivated Transaction	1
Method of Accounting	2
Stock Basis Computation	1
Investigatory Costs	1
Total	**19**

Applications Not Accepted

Seven applications were not considered appropriate for the PFA pilot program.

Reasons for Non-acceptance	Applications
Examination team not on site	1
Absence of Agreement on Controlling Legal Principles	5
Excluded subject (Tax Motivated Transaction)	1
Total	7

Applications Accepted

Twelve applications from eleven taxpayers were accepted into the PFA pilot program. The status of these applications on December 31, 2000, was as follows:

Status of PFAs	Applications
Request Withdrawn by Taxpayer	1
PFAs In-process	4
PFAs Executed	7
Total	12

Taxpayer Withdrawal (1)

One taxpayer, in accordance with the procedures set forth in Section 7 of Notice 2000–12, withdrew from the PFA pilot program after its request had been accepted into the PFA pilot program. This withdrawal occurred after the Director, Field Operations, met with the taxpayer and the CEP examination team to determine whether the objective of the PFA pilot program could be achieved. Several reasons contributed to the taxpayer's withdrawal, including the complexity of the issue, the time required to complete

the analysis and a misunderstanding by the taxpayer of the purpose of the PFA process.

PFAs In Process (4)

The taxpayers and the respective Industry Directors, in accordance with the provisions of Notice 2000–12[2], have agreed to continue discussions relating to four PFA applications in an effort to reach agreement.

PFAs Executed (7)

Seven PFAs were completed in calendar year 2000.

Notice 2000–12, Section 1, *Introduction of Pilot Program* states in part, "In its pilot phase, the program is open to large businesses that currently have a Coordinated Examination Team on site." Each of the taxpayers accepted into the PFA pilot program met this requirement.

The Office of Chief Counsel provided advice to the CEP examination teams and assisted in the drafting and review of the PFAs. No Technical Advice or Chief Counsel Advice Memoranda were issued for issues addressed in the PFA process. The executed PFAs covered the following issues.

[2] Section 6, Continuation of process after filing, coordination with Accelerated Issue Resolution procedures, and Appeals.

PFAs Executed by Issue	
Valuation of Assets	2
Expense vs. Capitalization	1
Method of Accounting	2
Stock Basis Computation	1
Investigatory Costs	1
Total	**7**

Valuation of Assets (2)

One application concerned the valuation of a "covenant not to compete." The other application concerned the valuation of patents contributed to a charity. Each of the taxpayers supported its proposed valuation with a study conducted by an independent appraiser. IRS Engineers and Valuation Specialists assisted the CEP examination team in the review of the issues. In the first application, the CEP examination team and the taxpayer agreed that, in a particular purchase transaction, no amount was allocable to a "covenant not to compete." In the second application, the CEP examination team and the taxpayer reached a determination on the valuation of the patents based on market values.

Expense vs. Capitalization (1)

The taxpayer sought to determine the amount to be capitalized in a large repair expense account. The taxpayer proposed a statistical model for purposes of determining the amount subject to capitalization. An IRS Computer Audit Specialist assisted the CEP examination team in a review of the issue. The issue was resolved on the basis of a methodology that had been utilized in earlier examinations. The CEP examination team and the taxpayer agreed on the portion of the account that would be subject to capitalization.

Method of Accounting (2)

One application concerned whether a contract newly entered into by the taxpayer was required to be accounted for as a long-term contract under § 460. The issue was whether to account for the contract using an accrual method and not a long-term contract method. A technical advisor assisted the CEP examination team. The CEP examination team concluded that an accrual method of accounting was the appropriate method. A change in method of accounting pursuant to § 446 was not required because the change in treatment resulted from a change in the underlying facts.

The other application concerned the determination of the appropriate asset classes for depreciable property placed in service in prior years. The taxpayer proposed to change its method of accounting for certain depreciable property that the taxpayer believed had been misclassified. An IRS Engineer and a Computer Audit Specialist assisted the CEP examination team. The CEP examination team agreed with the taxpayer's revised classifications and with the taxpayer's proposal automatically to change its method of accounting for depreciation pursuant to Rev. Proc. 99–49, 1999–2 C.B. 725. The CEP examination team and the taxpayer reached an agreement as to the appropriate § 481 adjustment.

Stock Basis Computation (1)

This application concerned the tax basis of stock acquired in a transaction that qualified under § 368(a)(1)(B). An IRS Economist and a Computer Audit Specialist assisted the CEP examination team. The CEP examination team agreed with the taxpayer's computation of the amount of the stock basis under § 362(b).

Investigatory Costs (1)

This application concerned costs incurred to acquire a business. The taxpayer proposed that certain of the costs were investigatory in nature and therefore deductible under §162. Based on the principles contained in Rev. Rul. 99–23, 1999–1 C.B. 998, the CEP examination team and the taxpayer agreed as to which items were §162 costs and which were § 263 costs.

Closing Agreements

Seven PFAs were concluded as of December 31, 2000. A *pro forma* or model agreement does not exist for a PFA. A PFA represents a specific matter closing agreement under §7121. The closing agreements entered into under this pilot program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68–16, *supra*.

Processing Statistics

The total average time to complete the seven PFAs executed in calendar 2000 was 166.1 days.

Average Time for PFAs	Number Of Cases	Range (Elapsed Days)	Average (Elapsed Days)
Phase I – Application Screening Process	19	19 – 86	37.2
Phase II - PFA Evaluation Process	7	91 – 186	140.6
Total Time to Complete a PFA	7	110 – 228	166.1

Phase I – Application Screening Process

Nineteen applications were received for the PFA pilot program. The initial phase was the screening process to determine if an application was appropriate for inclusion in the PFA pilot program. This screening process included obtaining comments from various LMSB functions and Chief Counsel, the review of these comments, and the decision making process on the acceptance/rejection of an application by the Industry Director. The average time from the date an application was received by the IRS until the Industry Director rendered a decision to accept or reject an application was 37.2 days.

Phase II - PFA Evaluation Process

The second (and final) phase in the PFA pilot program process was the evaluation phase. This phase began when the Industry Director accepted an application into the PFA pilot program and ended when a PFA was executed.

Program Evaluation

The PFA Program Manager conducted process evaluations of all of the PFA pilot program cases based on feedback from LMSB employees and taxpayer participants. As a part of this program evaluation, participants were asked to provide an estimate of the direct examination time expended to complete the PFA and an estimate of the direct examination time it would have taken to resolve the issue in a post-filing context.

Cumulative Hours (7 Completed PFAs)	Taxpayer (Hours)	LMSB (Hours)
Actual – PFA Process	1,114	1,976
Projected (Issue resolved post-filing)	3,379	7,344
Estimated Savings	2,265	5,368
Estimated Savings Percentage (Average)	67.0%	73.1%
Estimated Savings Percentage (Range)	34.6% - 96.0%	12.9% - 90.4%

Pre-Filing Agreement Pilot Program Summary

After evaluating the PFA pilot program and receiving input from internal and external participants, the IRS has concluded that the PFA program does further LMSB's issue management strategy by assisting taxpayers to resolve issues in a cost efficient and cooperative environment. Accordingly, the IRS issued Rev. Proc. 2001–22, *supra*, dated February 26, 2001, which implemented the PFA program on a continuing and expanded basis.

The PFA program is now available to all LMSB taxpayers, including taxpayers that are not currently under examination. While the PFA program will continue to be limited to issues that involve settled legal principles, the list of recommended issues has been expanded, and will now include certain international issues. Generally, the operational procedures used during the PFA pilot program were adopted and enhanced in the current PFA program.

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