Announcement and Report Concerning Pre-Filing Agreements

Announcement 2005–42

Introduction

This Announcement is issued pursuant to the Conference Report to H.R. 4577 (Pub. L. No. 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the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to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. This is the fifth annual report. It provides information concerning activity under the permanent PFA program (Rev. Proc. 2001–22, 2001–1 C.B. 745), during calendar year 2004.

Background

The Large and Midsize Business Division (LMSB) of the Internal Revenue Service serves 170,000 of America's largest corporate and partnership entities — businesses with assets of over $10 million. Their tax issues are among the most complex, and their collective annual tax liability approaches $159 billion. The largest of these 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 resolve issues of tax controversy on a more current basis. This includes, but is not limited to, increasing the efficiency of the examination process and seeking alternative issue resolution tools. The PFA program was designed to support LMSB's issue management initiative. LMSB believes the PFA program reduces taxpayer burden and makes more effective use of IRS resources by resolving or eliminating controversies before the tax return is filed.

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 produce agreement on factual issues and apply settled legal principles to those agreed-upon facts. A PFA is a specific matter closing agreement under § 7121 of the Internal Revenue Code and resolves the subject of the PFA for a specified taxable period. Execution of a PFA that resolves issues prior to filing permits taxpayers to avoid costs, burdens and delays that are frequently incident to post-filing examination disputes between taxpayers and the IRS.

PFA Program

The IRS established a permanent PFA program with the issuance of Rev. Proc. 2001–22 and revised it on December 22, 2004, with the issuance of Rev. Proc. 2005–12, 2005–2 I.R.B. 311. Although many of the procedures remained the same, there were some significant changes and clarifications:

- PFAs may cover the current and up to four future taxable years;
- PFAs are available to determine the appropriate methodologies for determining tax consequences affecting future years;
- PFAs are for completed transactions only; and
- PFAs with international tax issues require concurrence of the Director, International; certain international issues listed in Rev. Proc. 2005–12 also require concurrence of the Associate Chief Counsel (International) in acceptance and execution.

PFA Process

The PFA process is managed and conducted by LMSB Industry Directors and field staff, with support from the Office of Pre-Filing and Technical Guidance in LMSB Headquarters. The PFA Program Manager receives all applications and, with the assistance of the Technical Advisors and the Office of Chief Counsel, ensures that the issues presented are appropriate for inclusion in the PFA program.

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

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 availability of IRS resources;
d. The ability and willingness of the taxpayer to dedicate sufficient resources to the process;
e. The likelihood that the PFA may result in contrary positions with respect to an item or transaction ("whipsaw"); and
f. The probability of completing the examination of the issue and entering into a PFA by the target date.

For the cases selected for participation in the PFA program, a mandatory orientation session for the examination team and the taxpayer is conducted. Subsequently, the taxpayer and the examination team convene a joint planning meeting to reach 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 examination team conducts the factual determination and issue development consistent with IRS auditing standards. Based upon an examination of the issue, the Team Manager prepares a PFA recommendation for the Industry Director. The Industry Director's decision to execute a PFA closing agreement is based on the Team Manager's recommendation and discussions with the PFA Program Manager, Chief Counsel attorneys, appropriate Technical Advisors, and the taxpayer. Following Chief Counsel review to ensure that the proposed PFA closing agreement conforms with guidance provided in Rev. Proc. 68–16, 1968–1 C.B. 770 (regarding closing agreements), the Industry Director will execute a PFA if he or she determines that:

a. Entering into the PFA is consistent with the goals of the PFA program as stated in Rev. Proc. 2001–22 (or Rev. Proc 2005–12 for applications received after December 22, 2004);
b. The resolution in the PFA reflects settled legal principles and correctly applies those principles (or positions authorized under Delegation Order Nos. 4–24 or 4–25) to facts found by the examination team; and

c. There appears 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 shows 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 § 301.7121–1(a) of the Procedure and Administration Regulations).

Program Oversight

A designated PFA Program Manager assigned to the Office of Pre-Filing and Technical Guidance in LMSB Headquarters provides oversight for the PFA program. The PFA Program Manager provides assistance to taxpayers, Industry Directors, and Team Managers throughout the process.

Pre-Filing Agreement Program Accomplishments

Statistical Overview of PFA Program — Calendar Year 2004

The tables below reflect the status of PFA applications received in calendar year 2004.

PFA Applications Received in Calendar Year 2004	**Totals**
Applications Withdrawn before Acceptance/Rejection in 2004	2
Applications Rejected in 2004	12
Applications in Screening Process on 12–31–04	1
Applications Pending Acceptance/Rejection on 12–31–04	1
Applications Accepted in 2004	22
Total Applications Received in 2004	*38*

Disposition of PFA Applications Accepted in Calendar Year 2004	**Totals**
Applications Withdrawn after Acceptance in 2004	1
Applications for Which There Were Closing Agreements in 2004	8
Applications In Process on 12–31–04	13
Total Applications Accepted in 2004	*22*

Description of Applications Received in Calendar Year 2004

The applications received by the PFA program in calendar year 2004 came from taxpayers in each LMSB industry segment and involved a variety of issues as provided in the tables below.

Number of Applications Received and Accepted by Industry Segment

Industry Segment	***Received***	***Accepted***
Financial Services	12	6
Retailers, Food, Pharmaceuticals & Healthcare	7	4
Natural Resources & Construction	6	5
Communications, Technology & Media	6	3
Heavy Manufacturing & Transportation	7	4
Total	**38**	**22**

Types of Issues Covered

Issue	**Received**	**Accepted**
Donation of Property	4	1
Research and Experimental Credit	9	7
Estimated Basis of the Stock of a Subsidiary	1	1

Type of Merger/Reorganization	1	0
Valuation of Stock of a Target Corporation	1	1
Worthless Securities and Bad Debts	6	4
Income from Intercompany Notes	1	0
Amount and Character of Partnership Investment Losses	1	0
Deductibility of Fines and Penalties	2	2
Deductibility of Interest to Purchase Tax Exempt Securities	1	1
Merger — Tax Free Reorganization	1	0
Tax Free Split-off	1	0
Treatment of Transfer and Sale of Stock	1	1
Cost Segregation Study — Asset Class Life and Recovery Period	2	2
Synthetic Fuel Credit	1	1
Taxability of Transfer of Rights to an LLC	1	0
Apportionment of General and Administrative Expenses	1	1
Characterization of Remuneration as Wages versus Partnership Distribution	1	0
Transfer Pricing — Royalty	1	0
Transfer of Stock under IRC § 83	1	0
Total	**38**	**22**

Reasons Why Applications Received in Calendar Year 2004 Were Not Accepted

Reasons for Non-acceptance	**Applications**
Not Well-Settled Law	5
Not Enough Time to Complete	2
Issue Not Suitable or Ineligible	4
Currently in Litigation with Taxpayer on the Issue	1
Total	**12**

PFA Program Summary (2004 and Prior Calendar Years)

Forty accepted applications (including applications accepted in prior years) were resolved or withdrawn in 2004.

Taxpayer Withdrawals (4)

In accordance with procedures set forth in Rev. Proc. 2001–22, four taxpayers withdrew from the PFA process in 2004 after their requests had been accepted (three of these were accepted before 2004). In one case the taxpayer and the Service agreed that the timeline was too burdensome. In the other cases, no explanation for the withdrawal was given by the taxpayer.

IRS Withdrawal (8)

In 2004, the Service withdrew from the PFA process in eight cases accepted before 2004. In one case, the taxpayer did not have adequate records to substantiate a deduction for the Research and Experimental Credit. In the other seven cases, the taxpayer and the Service were unable to reach agreement.

Mutual Withdrawal (1)

The Service and the taxpayer mutually agreed to terminate the PFA process in one case. They agreed that it would be more efficient to roll the issue into the normal examination process rather than continuing with the PFA process.

PFAs Executed (27)

Twenty seven PFAs were completed in calendar year 2004 that resulted in the execution of closing agreements. Eight of these were for applications received and accepted in 2004.

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

PFAs Executed in 2004

The PFAs executed in 2004 involved the following issues:

PFAs Executed by Issue

Year Application Received	Issue	Number
2002	Deductibility and Fair Market Value of Donated Property	1
2003	Deductibility and Fair Market Value of Donated Property	4
2004	Deductibility and Fair Market Value of Donated Property	1
2003	Amount of Qualified Research and Experimental Credit	4
2004	Amount of Qualified Research and Experimental Credit	2
2003	Fair Market Value of Stock Exchanged	1
2004	Cost Segregation for Asset Class and Recovery Periods	1
2003	Treatment of License Fee Income	1
2004	Deductibility of Fees to Purchase Tax Exempt Securities	1
2002	Gain or Loss on Sale of Stock	1
2002	Worthless Securities and Bad Debts	1
2003	Worthless Securities and Bad Debts	3
2004	Worthless Securities and Bad Debts	2
2002	Fuel Credit	1
2003	Ordinary Versus Capital Loss on Property Sale	1
2003	Writedown of Inventory	1
2004	Deductibility of Fines and Penalties	1
	Total	**27**

Deductibility and Fair Market Value of Donated Property (6)

In each of these unrelated cases, the taxpayer sought an agreement as to the fair market value of property donated to qualified organizations. Patents and technology were donated in four cases and land was donated in two other cases. In three of the cases, a closing agreement was executed specifying the fair market value of the property contributed. In the other three cases, both fair market value and deductibility were addressed, and in one of these, no deduction was allowed.

Amount of Qualified Research and Experimental Credit (6)

The taxpayers requested an agreement regarding the proper amount of qualified research expenses and the research credit under IRC § 41. Closing agreements were executed with all taxpayers. The closing agreements did not address the methodology to be used for subsequent years.

Fair Market Value of Stock Exchanged (1)

The taxpayer requested an agreement concerning the value of preferred stock in transactions intended to qualify as transfers to a controlled corporation under IRC § 351. A closing agreement was executed that specified the fair market value of the transferred stock and provided that the IRS would not challenge the value under IRC § 482 or other Code sections.

Cost Segregation for Asset Class and Recovery Periods (1)

The taxpayer requested an agreement concerning the proper class lives and recovery periods of property placed in service during the tax year. The taxpayer and Service agreed to use statistical sampling techniques and came to agreement on the depreciation deduction amount. A closing agreement was executed specifying the amount allowed.

Treatment of License Fee Income (1)

The taxpayer requested an agreement regarding the treatment of periodic fee income from software licenses. A closing agreement was executed specifying that the licenses shall be treated as leases rather than sales of software and that the fees shall be included in income in the year due and payable.

Deductibility of Fees to Purchase Tax Exempt Securities (1)

The taxpayer requested an agreement regarding the deductibility of periodic interest and other costs on debt. Some of the proceeds of this debt were temporarily invested in tax exempt securities. A closing agreement was executed specifying that the interest and costs are not to be disallowed under IRC § 265.

Gain or Loss on Sale of Stock (1)

The taxpayer requested an agreement concerning the sale of the stock in its subsidiary for cash. A closing agreement was executed specifying the amount of the IRC § 338 aggregate deemed sales price.

Worthless Securities and Bad Debts (6)

The taxpayers requested an agreement regarding amounts deductible as ordinary losses on the worthlessness of stock in its subsidiary. A closing agreement was executed for each of the PFAs specifying that the stock was worthless and the amount to be deducted.

Fuel Credit (1)

The taxpayer requested an agreement regarding its fuel credits through consideration of the "placed in service" question and other issues bearing on the credits. A closing agreement was executed specifying the amount of the fuel credit to be allowed and how that amount was to be allocated to the partners.

Ordinary Versus Capital Loss on Property Sale (1)

The taxpayer requested an agreement concerning the tax consequences of the sale of two parcels of property. A closing agreement was executed specifying the amount of the losses and that they are to be characterized as ordinary losses under IRC § 1231.

Writedown of Inventory (1)

The taxpayer requested an agreement regarding the proper treatment of inventory write-downs. A closing agreement was executed specifying the amount allowable as a deduction reflected in the determination of the cost of good sold.

Deductibility of Fines and Penalties (1)

The taxpayer requested an agreement regarding the proper treatment of amounts paid to the U.S. government in restitution, civil damages, and fines. A closing agreement was executed specifying the amount allowable as restitution under IRC § 162 and the amount determined to be a fine or penalty and therefore not allowable as a deduction.

Closing Agreements

There is not a *pro forma* or model agreement for a PFA closing agreement. A PFA represents a specific matter closing agreement under IRC § 7121. The closing agreements entered into under the PFA program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68–16.

PFA Program Utilization

The PFA program is available to all taxpayers under the jurisdiction of LMSB. During calendar year 2004, 38 taxpayers submitted PFA applications. These taxpayers included both Coordinated Industry Case (CIC) taxpayers that are typically subject to examination on a continuing basis and Industry Case (IC) taxpayers that are subject to examination on a less frequent basis. Of the 38 applications, 30 were from CIC taxpayers and 8 were from IC taxpayers. Of the 27 cases that resulted in closing agreements during calendar year 2004, 25 were with CIC taxpayers and 2 were with IC taxpayers.

Processing Statistics

The average elapsed time to resolve the 27 cases that resulted in closing agreements in calendar year 2004 was 360 days.

Processing Time for Twenty Seven Closing Agreements Executed in 2004	Range (Elapsed Days)	Average (Elapsed Days)
Application Screening Process	29–359*	76
PFA Evaluation Process	62–716	285
Total Time to Close a PFA Case	99–773	360

*One case took 359 days to screen because the taxpayer had not yet completed the transaction and the Service waited for the transaction to be completed before accepting the PFA. The next highest number of days for screening was 163.

Application Screening Process

The application screening process is the process to determine if an application is appropriate for inclusion in the PFA program. This screening process includes obtaining comments from various LMSB functions and Chief Counsel, the review of these comments, and the acceptance or 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 76 days.

PFA Evaluation Process

The PFA evaluation process is the second (and final) phase in the PFA program. This phase begins when the Industry Director accepts an application into the PFA program and ends when a PFA closing agreement is executed or the process terminates as a result of a withdrawal. The average elapsed time during the PFA evaluation process for the 27 cases that resulted in closing agreements in calendar year 2004 was 285 days.

Program Evaluation

The PFA Program Manager ensures that an evaluation of all of the PFA program cases, based on feedback from LMSB employees and taxpayer participants, is solicited. As part of this program evaluation, LMSB and taxpayer participants were asked to provide 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. The table below indicates the results for those that provided a response since the program's inception.

Cumulative Hours on Executed PFAs	Taxpayer (Hours)	LMSB (Hours)
Actual Hours Expended — PFA Process	20,243	16,897
Estimated Hours Required To Be Expended — Post-Filing Process	38,615	22,978
Time Savings — Actual PFA Process versus Estimated Post-Filing	18,372	6,081
Average Percentage Savings — Actual PFA Process versus Estimated Post-Filing	47.6%	26.5%

Comparative Analysis — Processing Statistics

The average total time to conclude the 27 cases that resulted in closing agreements in calendar year 2004 was 360 days. Illustrated below are the processing statistics for the cases that resulted in closing agreements since the inception of the program.

Average Processing Time (Days)	Overall Pilot (11 cases)	Program CY 2001 (7 cases)	Program CY 2002 (12 cases)	Program CY 2003 (18 cases)	Program CY 2004 (27 cases)
Application Screening Process	38	47	53	59	76
PFA Evaluation Process	242	126	183	240	285
Total Time to Complete a PFA	281	173	235	299	360

The increased processing time can be attributed to the greater degree of complexity of the issues and the time necessary to develop the factual background. Generally, the more complex and fact intensive the issue is, the greater the time necessary to complete the process.

Taxpayer Satisfaction Survey

An additional aspect of the evaluation process is soliciting feedback from taxpayers regarding satisfaction with the PFA process through a questionnaire. Responses to the questionnaire were received from 11 of the 27 taxpayers who executed closing agreements for calendar year 2004. Taxpayers were asked to rate the PFA process on a scale of 1 to 5. The responses are summarized below.

Overall level of satisfaction with the PFA process.						**Average 4.7**
	Very Dissatisfied	Dissatisfied	Neither	Satisfied	Very Satisfied	Does Not Apply
number				3	7	1
percentage				27.3	63.6	9.1
Likelihood of taxpayer recommending the PFA process to others.						**Average 4.6**
	Very Unlikely	Unlikely	Perhaps	Likely	Very Likely	Does not Apply
number				4	7	
percentage				36.4	63.6	
The PFA process was clearly communicated during the orientation session.						**Average 4.4**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				6	4	1
percentage				54.5	36.4	9.1

During the orientation, questions regarding the PFA process were completely addressed.						**Average 4.4**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				7	4	
percentage				63.6	36.4	

The PFA audit plan was developed with input from both the IRS and the taxpayer.						**Average 4.5**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				6	5	
percentage				54.5	45.5	

The IRS requests for information were relevant to resolve the PFA issue.						**Average 4.4**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number				7	4	
percentage				63.6	36.4	

The time taken by the IRS to review information during the entire "Factual development" stage of the PFA process was appropriate.						**Average 4.3**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number		1		5	5	
percentage		9.1		45.5	45.5	

The time taken by the IRS to complete the "Closing Agreement" stage of the PFA process was appropriate.						**Average 4.0**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number		1	1	6	3	
percentage		9.1	9.1	54.5	27.3	

IRS team members were accessible during the process to resolve the PFA issue.						**Average 4.5**
	Strongly Disagree	Disagree	Neither	Agree	Strongly Agree	Does Not Apply
number			1	4	6	
percentage			9.1	36.6	54.5	

The total number of staff days or hours actually expended as compared to expected staff days or hours. **Average 4.0**

	Significantly More	More	About the Same	Less	Significantly Less	Does Not Apply
number		1	2	4	4	
percentage		9.1	18.2	36.4	36.4	

The total elapsed time to complete the PFA process as compared to the expected time to complete the process. **Average 3.8**

	Significantly More	More	About the Same	Less	Significantly Less	Does Not Apply
number	1	1	1	3	4	1
percentage	9.1	9.1	9.1	27.3	36.4	9.1

The spirit of cooperation between IRS and the company as a result of the PFA process. **Average 4.1**

	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	6	3	
percentage			18.2	54.5	27.3	

The ability to reach agreement at the lowest (managerial) level. **Average 4.1**

	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	6	3	
percentage			18.2	54.5	27.3	

The ease of effort in reaching agreement compared to the expected ease on post-filing. **Average 4.0**

	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	7	2	
percentage			18.2	63.6	18.2	

Monetary costs incurred to resolve the issue compared to expected costs to resolve issues through the post-filing process. **Average 3.6**

	Significantly More	More	About the Same	Less	Significantly Less	Does Not Apply
number		2	2	5	2	
percentage		18.2	18.2	45.5	18.2	

The ability to present an accurate tax return for financial statement purposes as a result of the pre-filing process.						Average 4.1
	Significantly Less	Less	About the Same	Improved	Significantly Improved	Does Not Apply
number			2	5	3	1
percentage			18.2	45.5	27.3	9.1

Pre-Filing Agreement Program Summary

Overall, the PFA program is meeting the LMSB strategic program objectives as provided in its issue management strategic initiative. The following benchmarks reflect the overall progress of the PFA program:

- The increasing number of issues resolved through the PFA program, which has grown steadily since the program became fully operational;
- The high degree of overall satisfaction of taxpayers participating in the PFA program and the likelihood that those participants would recommend this process to other taxpayers.

Although the number of cases resolved in the PFA program increased in 2004, the total processing time has also increased. Revenue Procedure 2005–12 now imposes short time frames for evaluating a PFA, so we expect the time for the application screening process to decline significantly. The time during the PFA evaluation process continues to increase. This trend, which is due in part to the increasing complexity of issues presented by taxpayers for PFA consideration, has continued since the PFA program became fully operational in 2001.

The principal author of this announcement is Melanie Perrin, Office of Pre-Filing and Technical Guidance, Large and Mid-Size Business Division. For further information regarding this announcement, contact Ms. Perrin at (202) 283–8408.