

## **ANNOUNCEMENT AND REPORT CONCERNING PRE-FILING AGREEMENTS**

### **Announcement 2002-54**

#### **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the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to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. This is the second annual report and provides information on the four remaining PFA pilot program cases that closed in calendar year 2001. This report also provides similar information concerning case activity that started with the permanent program (Rev. Proc. 2001-22, 2001-9 I.R.B. 745).

#### **Background**

The Large and Mid-Size Business Division ("LMSB") within the Internal Revenue Service serves corporations and partnerships with assets greater than \$10 million. In 2001, approximately 170,000 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 reported a total tax liability of \$350 billion during 2001. 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 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 Pre-Filing Agreement program was designed to support LMSB's issue management strategy. LMSB believes the Pre-Filing Agreement program reduces taxpayer burden and make more effective use of IRS resources by resolving or eliminating tax controversy before the tax return is filed.

## **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 produce agreement on factual issues and apply settled legal principles to those 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 taxable period. Execution of a PFA that resolves issues prior to filing permits 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, the pilot program was implemented which resulted in the execution of seven PFAs. Four cases remained in process at the end of calendar year 2000 and all four cases were closed during calendar year 2001. A PFA was executed in three of the four cases. Based upon input from internal and external participants in the pilot program, the IRS expanded the PFA program and made it permanent.

### **Pilot Pre-Filing Agreement Program Completion**

#### *PFA Pilot Program*

The PFA pilot program was open to Coordinated Examination Program ("CEP") taxpayers that had a CEP examination team currently on site (CEP cases have been renamed Coordinated Industry Cases (CIC)). Notice 2000-12, 2000-9 I.R.B. 727, dated February 11, 2000, 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. During the PFA pilot, eleven cases were accepted into the pilot program. Of the eleven, seven were closed during calendar year 2000 and reflected in the first report (Announcement 2001-38, I.R.B. 2001-17, dated April 23, 2001). The remaining four cases were closed during calendar year 2001. This report reflects the activity of the four pilot cases closed in calendar year 2001.

The taxpayers and the respective Industry Directors, in accordance with the provisions of Notice 2000-12, agreed to continue discussions relating to the four PFAs that were in process at December 31, 2000.

<b>Industry Segment</b>	<b>Issue</b>	<b>In-Process @12/31/00</b>
Heavy Manufacturing & Transportation	Research Credit	1
Heavy Manufacturing & Transportation	Valuation of Assets	1
Communications, Technology & Media	Research Credit	1
Retailers, Food, Pharmaceuticals & Healthcare	Expense vs. Capitalization	1

During calendar year 2001, the four pilot cases were closed in the following manner:

Status of PFAs	Issue
Executed PFA	Research Credit
Executed PFA	Valuation of Assets
Executed PFA	Research Credit
PFA Withdrawn	Expense vs. Capitalization

#### *Executed PFAs - Research Credit*

Two applicants sought PFAs regarding the amount of research credit each could claim as a result of various activities undertaken to improve products. In both instances, IRS specialists and other non-Service outside experts were involved in the process of ascertaining what activities qualified for the credit. In one case, the analysis involved consideration of the activities of over 1,500 different departments. Closing agreements were executed in both cases.

#### *Executed PFA - Valuation of Assets*

This case involved a determination of value related to the sale of assets and stock of a subsidiary to an unrelated party. An allocation of the net selling price among the assets and stock sold, the basis of the assets sold, and the taxable gain or loss were at issue. A closing agreement was executed regarding all of these issues.

#### *PFA Withdrawn - Expense vs. Capitalization*

The issue in this case related to whether certain repairs and maintenance expenditures were deductible or should be capitalized and depreciated over their useful life. A closing agreement with multi-year application which was sought by the taxpayer could not be provided under the terms of the Delegation Order for the PFA program. Consequently, both the Service and the taxpayer mutually agreed to withdraw from the PFA process.

#### Closing Agreements

The above three PFAs were executed during 2001. 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 program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68-16, 1968-1 C.B. 770.

#### Processing Statistics

The average elapsed time to resolve the four cases described above that were closed in calendar year 2001 was 482.75 days.

Average Processing Time for Four Cases Closed in 2001	Range (Elapsed Days)	Average (Elapsed Days)
Phase I -Application Screening Process	21-86	44.5
Phase II - PFA Evaluation Process	292-533	438.25
Total Time to Close a PFA Case	322-574	482.75

### Phase I - Application Screening Process

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 elapsed 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 44.5 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 program and ended when a PFA was executed or the case was otherwise closed. The average elapsed time for the four cases was 438.25 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 conducted. As a part of this program evaluation, participants were asked to provide the actual 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 (Executed PFAs)	Taxpayer (Hours) (2 executed PFAs)	LMSB (Hours) (3 executed PFAs)
Actual - PFA Process	25,920	17,192
Estimated - Post-Filing Process	59,500	31,860
Estimated Savings	33,580	14,668
Estimated Savings Percentage (Average)	56.4%	46%
Estimated Savings Percentage (Range)	(28%) - 59%	(12.4%) – 61%

One taxpayer who executed a PFA did not participate in the program evaluation phase of the PFA process.

## **Pre-Filing Agreement Pilot Program Summary**

After evaluating the PFA pilot program and receiving input from internal and external participants, the IRS concluded that the PFA program supports the LMSB issue management strategy by assisting taxpayers to resolve issues in a cost efficient and cooperative environment. Accordingly, the IRS issued Rev. Proc. 2001-22, which expanded the PFA program and made it permanent.

## **Permanent Pre-Filing Agreement Program**

### PFA Program

As a result of the success of the pilot program, the Service established a permanent PFA Program with the issuance of Rev. Proc. 2001-22. Although many of the procedures remained the same, there were some significant changes, including:

1. All taxpayers within the jurisdiction of LMSB are eligible to participate;
2. More issues are considered appropriate;
3. There are fewer excludible circumstances;
4. Certain international issues are now considered appropriate; and
5. A user fee was implemented for those taxpayers accepted into the program.

### 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 Service 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, a mandatory orientation session for the examination team and the taxpayer is conducted. Subsequently, the taxpayer and 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 enter into a PFA 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 conforms with guidance provided in Rev. Proc. 68-16 (regarding closing agreements), the Industry Director could 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;
- b. The resolution in the PFA reflects settled legal principles and correctly applies those principles (or positions authorized under Delegation Order Nos. 236 or 247) 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 and an analyst assigned to the Office of Pre-Filing and Technical Guidance in LMSB Headquarters provide 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**

### Applications Received

Twenty-six applications were received for the permanent PFA program in calendar year 2001. Applications were received from each LMSB industry segment and involved a variety of issues.

***Number of Requests Received by Industry***

<b><i>Industry Segment</i></b>	<b><i>Received</i></b>
Financial Services	10
Retailers, Food, Pharmaceuticals & Healthcare	3
Natural Resources & Construction	4
Communications, Technology & Media	3
Heavy Manufacturing, Construction & Transportation	6
Total	26

***Types of Issues Received***

<b><i>Issue</i></b>	<b><i>Received</i></b>
Deductibility of interest	1
Fair Market Value of Assets	3
Expense vs. Capitalization	1
Tax Basis & Holding Period	1
Excise Tax Allocation	2
Reorganization & Stock Basis	1
Research & Experiment Credit	3
Bad Debts & Worthless Securities	1
Gain on Sale	1
Amortization of Intangibles	1
Class Life Determination	2
Deductibility of Indemnification Payments	1
Acquiring parent - method of accounting	1
NOL Determination	1
Demutualization & IPO	2
Foreign Business Cessation	1
Acquisition & Liquidation	1
Cost Basis Determination	1
Complete Liquidation & Bankruptcy	1
Total	26

**Applications Not Accepted**

Eight applications were not considered appropriate for the PFA program.

Reasons for Non-acceptance	Applications
Issue Not Suitable or Ineligible	4
International Issue Not Listed in Rev. Proc. 2001-22	1
Not Well-Settled Law	1
Change of Accounting Method (Form 3115)	1
Not Under Jurisdiction of LMSB	1
Total	8

### Applications Accepted

Eighteen applications from the twenty-six taxpayer submissions were accepted into the permanent PFA program. The status of these applications on December 31, 2001, was as follows:

Status of PFAs @ 12/31/01	Applications
PFA Request Withdrawn by Taxpayer	1
PFA Request Withdrawn by IRS	1
PFAs In-process	11
PFAs Executed	5
Total	18

### Taxpayer Withdrawal (1)

One taxpayer, in accordance with the procedures set forth in Section 8 of Rev. Proc. 2001-22, withdrew from the PFA program after its request had been accepted. This withdrawal was necessitated, in the view of the taxpayer, due to adverse economic conditions within the company causing a reduction in staffing required to successfully continue the PFA process.

### IRS Withdrawal (1)

The Service withdrew from the PFA process in another instance where all issue and factual development had been completed and, after considerable discussions with the taxpayer, it was determined that a closing agreement could not be reached on the issue of the amount of allowable research credit.

### PFAs In Process (11)

The taxpayers and the respective Industry Directors, in accordance with the provisions of Rev. Proc. 2001-22, have agreed to continue the PFA process in an effort to reach a closing agreement concerning the 11 in-process cases.



### PFAs Executed (5)

Five PFAs were completed in calendar year 2001 under the permanent program.

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. The executed PFAs covered the following issues:

#### ***PFAs Executed by Issue***

Deductibility of Interest	1
Class Life Determination	1
Expense vs. Capitalization	1
Amortization of Intangibles	1
Deductibility of Indemnification Payments	1
Total	5

### Deductibility of Interest (1)

An agreement was reached between a taxpayer and the Service that, on the basis of the facts presented, the taxpayer was not subject to disallowance of its interest deductions under § 265(a)(2) because its investment in tax-exempt securities was less than 2 percent of its average total assets and therefore it satisfied the 2 percent safe harbor under § 3.05 of Rev. Proc. 72-18.

### Class Life Determination (1)

Taxpayer requested a determination whether they had properly assigned class lives and recovery periods for assets capitalized and placed into service during the taxable year (the PFA year). Additionally, the taxpayer requested a determination as to whether certain assets placed in service in prior periods were properly classified. A closing agreement was executed concerning the assets placed in service during the PFA year. Separately, the taxpayer submitted a request for a change of accounting method to the Office of Chief Counsel concerning the reclassification of assets placed in service in prior tax periods which was consistent with the determination in the PFA year.

### Expense vs. Capitalization (1)

Taxpayer requested consideration whether certain expenditures for repairs made during the PFA year were properly deductible or should be capitalized and depreciated over the appropriate recovery period. A closing agreement was executed establishing which portion of the total expenditures was properly expensed and which portion was properly capitalized and subject to depreciation.

### Amortization of Intangibles (1)

During the PFA year, the taxpayer entered into a taxable transaction in which it acquired certain amortizable intangible assets. The taxpayer requested a determination as to the value of the intangibles acquired. A closing agreement was executed as to such value.

### Deductibility of Indemnification Payments (1)

A majority shareholder made certain payments in settlement of litigation on his own behalf and on behalf of a corporate taxpayer. The corporate taxpayer agreed to indemnify the shareholder a negotiated amount. The corporate taxpayer requested a determination concerning the deductibility of the indemnification payments made to the shareholder during the PFA year. A closing agreement was executed regarding the amounts of deductible and non-deductible payments.

### Closing Agreements

Five PFAs were executed in the permanent PFA program during calendar year 2001. 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 program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68-16.

### Processing Statistics

The average elapsed time to resolve the seven cases (five executed PFAs and two withdrawals) described above that were closed in calendar year 2001 was 172.7 days.

Average Processing Time for Seven Cases Closed in 2001	Range (Elapsed Days)	Average (Elapsed Days)
Phase I -Application Screening Process	16-65	46.6
Phase II - PFA Evaluation Process	54-188	126.1
Total Time to Close a PFA Case	105-253	172.7

### Phase I - Application Screening Process

Twenty-six applications were received for the PFA program during calendar year 2001. The initial phase was the screening process to determine if an application was appropriate for inclusion in the PFA 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 63.96 days for all twenty-six applications received in the calendar year 2001 and 46.6 days for the seven cases closed in that year.

## Phase II - PFA Evaluation Process

The second (and final) phase in the PFA program process was the evaluation phase. This phase began when the Industry Director accepted an application into the PFA program and ended when a PFA was executed or the case was otherwise closed. The average elapsed time for the seven cases closed in calendar year 2001 was 126.1 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 conducted. As a part of this program evaluation, 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.

Cumulative Hours (5 Executed PFAs)	Taxpayer (Hours)	LMSB (Hours)
Actual - PFA Process	4,583	6,252
Estimated - Post-Filing Process	13,708	11,873
Estimated Savings	9,125	5,621
Estimated Savings Percentage (Average)	66.6%	47.3%
Estimated Savings Percentage (Range)	50%-98.4%	(8.9)%-92.5%

### Comparative Analysis - Processing Statistics

Illustrated below are the average elapsed time (in days) processing statistics for the seven pilot cases that closed in calendar year 2000, the remaining four pilot cases closed in calendar year 2001, and the seven permanent program cases closed in calendar year 2001. In the pilot program, the average total time to conclude the first seven cases, as indicated below, was 164.8 days. The range was from a low of 91 days to a high of 186 days. The four pilot cases that started in calendar year 2000 and closed in calendar year 2001 were concluded in an average total time of 482.75 days. Those cases had a range of 322 to 574 days. The average total time to conclude the seven permanent program cases that started and closed in calendar year 2001 was 172.7 days. The range was from 105 to 253 days.

With regard to the four pilot cases completed in calendar year 2001, the increased time can be attributed to the degree of complexity of the issue and the time necessary to develop the factual aspects of the issue. Generally, the more complex and examination intensive the issue is, the greater the time necessary to complete the process.

Regarding the Phase I - Application Screening Process, we have noted the slight increase in average processing time. With respect to the Phase II and Total Time, the results meet our expectations and may be a positive consequence of the slightly

increased Phase I time. Other than the contributing factors stated above, our analysis thus far has not revealed any systemic issues giving rise to this phenomenon.

Average Processing Time for PFAs (Days)	Pilot CY 2000 (7 cases)	Pilot CY 2001 (4 cases)	Overall Pilot (11 cases)	Program CY 2001 (7 cases)
Phase I - Application Screening Process	34.7	44.5	38.3	46.6
Phase II - PFA Evaluation Process	130.1	438.25	242.2	126.1
Total Time to Complete a PFA	164.8	482.75	280.5	172.7

### **Pre-Filing Agreement Program Summary**

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 now includes certain international issues. Generally, the operational procedures used during the PFA pilot program were adopted and enhanced in the permanent PFA program.

Overall, the PFA program is meeting the LMSB strategic program objectives as contained in its issue management strategic initiative. Issues of potential controversy are being resolved more efficiently and on a more current basis yielding benefits to taxpayers and the IRS.

The principal author of this announcement is J. Michael Mann, in the Office of Pre-Filing and Technical Guidance, Large and Mid-Size Business Division. For further information regarding this announcement, contact Mr. Mann at (202) 283-8424 (not a toll-free call).