

# Announcement and Report Concerning Pre-Filing Agreements

## Announcement 2003–43

### 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the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to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 third annual report. It provides information concerning activity under the permanent PFA program (Rev. Proc. 2001–22, 2001–1 C.B. 745), during calendar year 2002.

### 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 2002, approximately 150,000 corporations and partnerships filed returns reporting assets in this range. The returns filed by these taxpayers present a wide variety of complex issues. 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 Pre-Filing Agreement program was designed to support

LMSB’s issue management strategy. LMSB believes the Pre-Filing Agreement program reduces taxpayer burden and makes more effective use of IRS resources by resolving or eliminating tax controversy 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 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

As a result of the success of a pilot program, the IRS 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, both Coordinated Issue and Industry cases, 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 deci-

sion 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, 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 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 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 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 2002*

The table below reflects activity concerning those PFA requests which were received in calendar year 2001 and carried over into calendar year 2002.

| <b>Overview of PFA Applications Received in Calendar Year 2001</b> | <b>Totals</b> |
|--|---------------|
| Applications Pending Acceptance/Rejection on January 1, 2002       | 5             |
| Applications In-Process on January 1, 2002                         | 7             |
| Applications Rejected in 2002                                      | 1             |
| Applications Withdrawn in 2002                                     | 0             |
| Applications for Which There Were Closing Agreements in 2002       | 7             |
| Applications Pending Acceptance/Rejection on December 31, 2002     | 0             |
| Applications in-Process on December 31, 2002                       | 4             |

The table below reflects the status of PFA requests received in calendar year 2002.

| <b>Overview of PFA Applications Received in Calendar Year 2002</b> | <b>Totals</b> |
|--|---------------|
| Applications Received in 2002                                      | 44            |
| Applications Accepted in 2002                                      | 25            |
| Applications Rejected in 2002                                      | 14            |
| Applications Withdrawn before Acceptance/Rejection in 2002         | 1             |
| Applications Withdrawn after Acceptance in 2002                    | 4             |
| Applications for Which There Were Closing Agreements in 2002       | 5             |
| Applications Pending Acceptance/Rejection on December 31, 2002     | 4             |
| Applications in-Process on December 31, 2002                       | 16            |

*Description of Applications Received in Calendar Year 2002*

The forty-four applications that were received for the PFA program in calendar year 2002 came from each LMSB industry segment and involved a variety of issues.

***Number of Requests Received and Accepted by Industry Segment***

| <b><i>Industry Segment</i></b>                        | <b><i>Received</i></b> | <b><i>Accepted</i></b> |
|---|------------------------|------------------------|
| Financial Services (FS)                               | 6                      | 3                      |
| Retailers, Food, Pharmaceuticals & Healthcare (RFP&H) | 9                      | 5                      |
| Natural Resources & Construction (NR&C)               | 16                     | 9                      |
| Communications, Technology & Media (CT&M)             | 6                      | 4                      |
| Heavy Manufacturing & Transportation (HM&T)           | 7                      | 4                      |
| Total   | 44                     | 25                     |

*Types of Issues Received*

| Issue   | Received |
|---|----------|
| Original Issue Discount Issue Price                           | 1        |
| Fair Market Value of Assets Exchanged for Stock               | 2        |
| Abandonment Loss  | 1        |
| Sale of Assets – Amount of Built-in Gains and Built-in Losses | 1        |
| Sale of Assets &/or Stock                                     | 2        |
| Allocation of Sales Price                                     | 1        |
| Research & Experiment Credit                                  | 5        |
| Sale – Leaseback  | 1        |
| Bad Debts &/or Worthless Securities                           | 3        |
| Legal/Consulting Fees vs Lobbying                             | 1        |
| Bank Owned Life Insurance                                     | 1        |
| Spin-off & Merger   | 1        |
| Deduction for Dividends Paid to Employee Stock Ownership Plan | 1        |
| Investigatory Costs   | 3        |
| Allocation of Losses  | 1        |
| Restructuring   | 1        |
| Period of Income Inclusion                                    | 1        |
| Tax Motivated Transaction                                     | 2        |
| Donation of Intangibles                                       | 2        |
| Donation of Real Property                                     | 1        |
| Qualified Conservation Donation                               | 1        |
| Liquidation   | 2        |
| Synthetic Fuel Credit   | 9        |
| Total   | 44       |

*Reasons Why Applications Received in Calendar Year 2002 Were Not Accepted*

Fourteen of the applications received in 2002 were not considered appropriate for the PFA program.

| Reasons for Non-acceptance                           | Applications |
|--|--------------|
| Issue Not Suitable or Ineligible                     | 6            |
| International Issue Not Listed in Rev. Proc. 2001–22 | 2            |
| Not Well-Settled Law                                 | 4            |
| Tax Motivated Transaction                            | 2            |
| Total  | 14           |

*Taxpayer Withdrawal (3)*

In accordance with the procedures set forth in Section 8 of Rev. Proc. 2001–22, three taxpayers withdrew from the PFA process — 2 after their requests had been accepted and one prior to acceptance. In two cases, the withdrawals were necessitated, as indicated by the taxpayers, by their inability to devote sufficient resources required to successfully continue the PFA process. In the other instance, the taxpayer withdrew because of the reluctance of the Industry Director to reach agreement on all the issues in the taxpayer’s application.

*IRS Withdrawal (2)*

The Service withdrew from the PFA process in one case where, after significant factual development and legal analysis of all of the issues, the Service concluded that the issues did not involve well settled law. The Service withdrew from the PFA process in a second case where, after factual development, the Service determined that the issues were not suitable for the PFA program and would be more effectively considered during a post-filing examination.

*PFA’s Executed (12)*

Twelve PFA’s were completed in calendar year 2002, resulting in the execution of closing agreements.

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 PFA’s covered the following issues:

*PfAs Executed by Issue*

| Year<br>Application<br>Received | Issue  | Number |
|---------------------------------|--|--------|
| 2001                            | Tax Basis/Holding Period/Reorganization                          | 1      |
| 2001                            | Bad Debts & Worthless Stock                                      | 1      |
| 2001                            | Accounting Method  | 1      |
| 2001                            | Reorganization & Basis of Stock                                  | 1      |
| 2001                            | Donation of Intangibles  | 2      |
| 2001                            | Gain on Sale of Assets   | 1      |
| 2002                            | Treatment of costs associated with acquiring another corporation | 1      |
| 2002                            | Allocation of Sales Price  | 1      |
| 2002                            | Sale of Assets – Amount of Built-in Gains and Built-in Losses    | 1      |
| 2002                            | Spin-off & Merger  | 1      |
| 2002                            | Deduction for Dividends Paid to ESOP                             | 1      |
|                                 | Total  | 12     |

*Tax Basis/Holding Period/Reorganization*

The taxpayer requested a determination concerning the tax basis and holding period of stock acquired in a reorganization described in §§ 368(a)(1)(B) and 368(a)(2)(E). The parties entered into a closing agreement that established the amount of the taxpayer's basis in the stock. The closing agreement also established the date that the taxpayer will have met the five-year holding period prescribed by § 355(d).

*Bad Debts & Worthless Stock*

The taxpayer and the IRS entered into a closing agreement stipulating that the entire debt owed by a subsidiary to the taxpayer had become worthless within the meaning of § 166(a)(1) during the taxpayer's taxable year ending in 2002. In addition, the closing agreement stipulated that the taxpayer's securities in the subsidiary had become worthless within the meaning of § 165(g)(3) during the taxpayer's taxable year ending in 2002.

*Accounting Method*

The taxpayer requested a determination concerning the proper tax accounting treatment of rebates paid to customers. The taxpayer had acquired all the assets and liabilities of another corporation that used a different method of accounting for rebates than the taxpayer. In integrating the two accounting systems, the taxpayer wanted to use the method previously used by the ac-

quired corporation. A closing agreement was executed allowing the taxpayer to use the desired method of accounting.

*Reorganization & Basis of Stock*

The taxpayer requested a determination concerning its basis in stock acquired in a reorganization described in § 368(a)(2)(E). The parties entered into a closing agreement whereby it was agreed that the taxpayer could determine its basis under § 1.358-6 as if the basis in the acquired stock was determined under § 362(b). In addition, the parties agreed to the amount of the basis.

*Donation of Intangibles (2)*

In each of these unrelated cases, taxpayers sought an agreement as to the fair market value of certain intellectual property donated to qualified organizations. In both instances, a closing agreement was reached specifying the fair market value of the property contributed. The closing agreement did not address the deductibility of the charitable contributions.

*Gain on Sale of Assets*

In this case, the taxpayer sold assets to an unrelated third party in a transaction described in § 1060. The purchaser paid cash and assumed liabilities in exchange for the assets. A closing agreement was executed establishing the amount of capital gain and ordinary loss to be reported from the transaction for each asset class under § 1060.

*Treatment of Costs Associated with Acquiring another Corporation*

Taxpayer requested a determination with respect to the treatment of certain costs associated with the acquisition of another corporation. A closing agreement was executed specifying, based on the facts, the amount deductible as ordinary and necessary business expenses under § 162, the amount allowable under § 195 as start-up expenditures and the amount required to be capitalized under § 263.

*Allocation of Sales Price*

In this case, the taxpayer sold assets to a third party. The taxpayer requested an agreement concerning the proper allocation of the sale proceeds among the assets sold. A factual determination was reached concerning the allocation of the sales proceeds and the amount and character of income, gain and loss to be reported.

*Sale of Assets — Amount of Built-in Gains and Built-in Losses*

The taxpayer requested a factual determination regarding the amount of built-in gains and built-in losses, as defined in §§ 1374(d)(3) and (d)(4), recognized from the sale of its qualified subchapter S subsidiaries (QSubs). Under § 1.1361-5, the sale of the QSubs was treated as a direct sale of the assets of the QSubs. The examination consisted of a review of the taxpayer's computations and a review of the

books and records and other information provided by the taxpayer. A closing agreement was entered into specifying the amounts of gain and loss to be recognized.

### *Spin-off & Merger*

The taxpayer distributed all of the issued and outstanding stock of a number of its wholly-owned subsidiaries to shareholders in complete redemption of their shares. Subsequent to the distribution, the subsidiaries merged into another corporation. An agreement was reached indicating the distribution satisfied the requirements of § 355, other than the business purpose requirement (which was not addressed by the closing agreement), and therefore, subject to satisfying the business purpose requirement, no gain or loss was recognized by any of the shareholders or any of the corporations as a result of the distribution and subsequent merger.

### *Deduction for Dividends Paid to ESOP*

The taxpayer requested a determination regarding the treatment of dividends that were paid by the taxpayer to an Employee Stock Ownership Plan (ESOP) and were subject to a distribution/reinvestment election during the first 90 days of 2002. A closing agreement was executed stipulating the amount of dividends that qualified as applicable dividends under § 404(k) and therefore were deductible by the taxpayer.

### *Closing Agreements*

A pro forma or model agreement does not exist for a PFA Closing Agreement. 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.

### *PFA Program Utilization*

The PFA Program is available to all taxpayers under the jurisdiction of LMSB. During calendar year 2002, 44 taxpayers submitted PFA requests. These 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 more limited basis. Of the 44 requests, 38 were from CIC taxpayers and 6 from IC taxpayers. For the twelve cases that resulted in closing agreements during calendar year 2002, 10 were with CIC taxpayers and 2 were with IC taxpayers.

### *Processing Statistics*

The average elapsed time to resolve the 12 cases that resulted in closing agreements in calendar year 2002 (the applications of which were received in 2001 and 2002) and the 5 cases that were withdrawn in calendar year 2002 was 199.1 days.

| Average Processing Time for Seventeen Cases Closed in 2002 | Range (Elapsed Days) | Average (Elapsed Days) |
|--|----------------------|------------------------|
| Phase I – Application Screening Process                    | 23–92                | 53.1                   |
| Phase II – PFA Evaluation Process                          | 8–320                | 146.1                  |
| Total Time to Close a PFA Case                             | 54–392               | 199.1                  |

### *Phase I — Application Screening Process*

Phase I is the screening 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/rejection of an application by the Industry Director. Of the 44 applications received during the calendar year 2002, 39 completed the Phase I Process. For these 39 applications, 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 65 days. For the 12 cases that resulted in closing agreements in 2002, the average time for Phase I was 52.8 days.

### *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 closing agreement was executed or the process ended in a withdrawal. The average elapsed time for the 12 cases that resulted in closing agreements and the 5 cases that were withdrawn in calendar year 2002 was 146.1 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 solicited. As a 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 responded to the solicitation:

| Cumulative Hours (Executed PFAs)       | Taxpayer (Hours) | LMSB (Hours) |
|--|------------------|--------------|
| Actual – PFA Process                   | 3,984            | 8,166        |
| Estimated – Post-Filing Process        | 6,300            | 10,407       |
| Estimated Savings                      | 2,316            | 2,241        |
| Estimated Savings Percentage (Average) | 36.8%            | 21.5%        |

|                                      |                     |                 |
|--------------------------------------|---------------------|-----------------|
| Cumulative Hours<br>(Executed PFAs)  | Taxpayer<br>(Hours) | LMSB<br>(Hours) |
| Estimated Savings Percentage (Range) | 21.4%–85%           | (4.8)%–51.2%    |

*Comparative Analysis — Processing Statistics*

The average total time to conclude the 12 cases that resulted in closing agreements in calendar year 2002 was 235.4

days. The range was from 151 to 392 days. Illustrated below are the average elapsed time (in days) processing statistics for the 12 cases that resulted in closing agreements in calendar year 2002, the 7 cases that resulted in closing agreements in cal-

endar year 2001, and the 11 cases that resulted in closing agreements under the pilot program.

| Average Processing Time for PFAs<br>(Days) | Overall<br>Pilot<br>(11 cases) | Program<br>CY 2001<br>(7 cases) | Program<br>CY 2003<br>(12 cases) |
|--|--------------------------------|---------------------------------|----------------------------------|
| Phase I – Application Screening Process    | 38.3                           | 46.6                            | 52.8                             |
| Phase II – PFA Evaluation Process          | 242.2                          | 126.1                           | 182.6                            |
| Total Time to Complete a PFA               | 280.5                          | 172.7                           | 235.4                            |

The increased processing time for 2002 can be attributed to the degree of complexity of the issues and the time necessary to develop the factual aspects of the issues. Generally, the more complex and examination intensive the issue is, the greater the time necessary to complete the process.

**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 ini-

tiative. 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).