

**The Pre-Filing Agreement Program for Large
Businesses Has Yielded Modest Results**

September 2005

Reference Number: 2005-30-151

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 22, 2005

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS
DIVISION

Handwritten signature of Pamela J. Gardiner in cursive.

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Pre-Filing Agreement Program for
Large Businesses Has Yielded Modest Results
(Audit # 200430028)

This report presents the results of our review of the Internal Revenue Service's (IRS) Pre-Filing Agreement (PFA) Program. The overall objective of this review was to determine whether the Large and Mid-Size Business (LMSB) Division¹ PFA process is being administered in accordance with IRS policies and procedures.

In summary, unlike regular examinations where tax issues² are often resolved long after the tax return is filed, the objective of the PFA program is to resolve a potential contentious tax issue before a tax return is filed. The PFA process, according to the LMSB Division, is reducing burden on large business and making more effective use of its resources. Because of these and other benefits, the LMSB Division is seeking to increase the use of PFAs by expanding the length and scope of a PFA. Issued in December 2004, the new revenue procedure (Rev. Proc. 2005-12) expanded and enhanced the original revenue procedure and will provide large business with the opportunity to resolve tax issues for a period of up to 5 years. While the changes are important for attracting large businesses to the program, it will be equally important that the LMSB Division strengthen its ability to resolve more tax issues before returns are filed while ensuring PFA closing agreements fully protect the Federal Government's

¹ The LMSB Division is one of the four Internal Revenue Service operating divisions serving corporations, sub-chapter S corporations, and partnerships with \$10 million or more in assets.

² Tax issues are potential areas of controversy because from the IRS perspective they could represent noncompliance.

interest. Additionally, user fees³ need to be evaluated to provide assurances that they are recovering the costs of a PFA.

The LMSB Division has designed and implemented a system of controls (techniques and procedures) that guide the PFA process through screening and accepting applications, developing tax issues for resolution, and executing PFA closing agreements. However, we identified two control areas that could be strengthened to help reach agreement on more tax issues before returns are due and better protect the Federal Government's interest. To date, the PFA program has experienced only modest success in meeting its primary objective of reaching agreement on tax issues before returns are filed. Also, numerous PFA closing agreements have been executed for tax issues that were accepted into the PFA program against the advice of Office of Chief Counsel technical attorneys.⁴ We believe there are important reasons for strengthening these areas.

Examination teams are responsible for reviewing PFA applications and documenting their recommendations for the Industry Director⁵ to use in deciding whether or not to accept the tax issue for a PFA. They are also responsible for developing and implementing a work plan that develops the tax issues for resolution within the compressed time period available before the tax return is due. We reviewed 91 PFA applications and case files supporting 12 PFA closing agreements and found examination teams' recommendations were documented and forwarded to the Industry Directors for consideration. However, preliminary work plans were not developed until after the Industry Director accepted the PFA application into the program. Additionally, the work plans that were developed did not contain key elements that are used to effectively plan and monitor the process of developing and resolving tax issues as described in the IRS manual. We found little or no documentation outlining the resources needed, procedures to be used, and the milestones and dates that must be met to resolve the tax issue within the overall time period available before the return was filed.

The LMSB Division recently implemented a dispute resolution process for the initial screening of PFA applications that is designed to settle differences between Office of Chief Counsel attorneys and Industry Directors over whether a particular tax issue is suitable for a PFA. This feature was added after concerns were raised that Industry Directors were accepting applications into the PFA program contrary to the advice received from Chief Counsel's technical attorneys. While this feature is an improvement, it may not be enough to fully protect the Federal Government's interest. We found instances, for example, where the examination team's work surfaced

³ User fees are defined as charges individuals and businesses are required to pay for special benefits received beyond those received by the general public

⁴ Chief Counsel's technical attorneys are within the Office of Chief Counsel. They are considered to be technical experts that have substantive tax law knowledge in specific areas of the Internal Revenue Code and are located in Washington, D.C.

⁵ Industry Directors are executive-level managers who oversee the deployment of resources and resolve operational concerns within the LMSB Division's five industry segments.

additional facts that changed the nature of the tax issue originally accepted for a PFA. Despite having substantive tax law knowledge and subject matter expertise, Chief Counsel's technical attorneys have relatively little required involvement in a PFA beyond the initial screening process.

We made three recommendations to the Director, Pre-Filing and Technical Guidance, LMSB Division, that may help reach agreement on more tax issues before returns are due and better protect the Federal Government's interest. First, PFA program guidelines need to include a requirement that examination teams develop preliminary work plans in support of recommendations for accepting or not accepting tax issues for a PFA. Second, actions are needed to establish a process that monitors and evaluates how well concerns raised by Chief Counsel's technical attorneys over tax issues submitted for a PFA are resolved. Third, user fees need to be evaluated to ensure they are recovering the Federal Government's cost of providing a PFA.

Management's Response: The LMSB Division agreed that it needs to address the recommendations we made for developing preliminary work plans and evaluating user fees. The LMSB Division will revise the template used to provide information to the Industry Director to include a section for a brief, high-level, preliminary plan that includes milestones and resources needed. The LMSB Division will also work with the IRS' Enforcement Committee to determine the appropriate user fee to charge for PFAs.

The LMSB Division indicated in its response that, by implementing the new Rev. Proc. 2005-12, it addressed our recommendation to establish a process that monitors and evaluates how well concerns raised by Chief Counsel's technical attorneys over tax issues submitted for a PFA are resolved. The LMSB Division noted that Rev. Proc. 2005-12 requires involvement of Chief Counsel's technical attorneys in the screening process to provide technical expertise and help resolve legal issues. It further noted that participation by the Office of Chief Counsel's technical attorney is not required or necessary throughout the whole process, except for the five issues in Rev. Proc. 2005-12 for which the Associate Chief Counsel (International) concurs on the agreement. The LMSB Division also had some general comments on the draft of this report. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment: While Rev. Proc. 2005-12 expanded and enhanced previous procedures, we do not believe it sufficiently addresses our recommendation to provide assurance that tax issues remain suitable for a PFA beyond the screening process. As we noted in the report, examination teams have surfaced additional facts that changed the nature of the tax issues originally accepted for a PFA.

With respect to the LMSB Division's general comments, we incorporated their suggested technical changes where appropriate. In addition, the LMSB Division commented that the PFA applications and cases reviewed were entirely governed by a previous revenue procedure and that the procedural concerns identified by the Treasury Inspector General for Tax Administration are likely attributable to the prior guidance. We agree that the previous revenue procedure covered all of the PFA applications and

cases we reviewed. However, the concerns we raised are common to both new and old procedures. Additionally, our fieldwork on the review was conducted between October 2004 and April 2005 while the new revenue procedure was issued in December 2004. Therefore, few, if any, PFA applications and cases would have been completed for us to review under the new procedure.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**The Pre-Filing Agreement Program for Large Businesses
Has Yielded Modest Results**

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Background

Unlike regular examinations, where tax issues¹ are often resolved long after the tax return is filed, the objective of the Pre-Filing Agreement (PFA) program is to resolve a potential contentious tax issue before the tax return is filed. The PFA process, according to the Large and Mid-Size Business (LMSB) Division² is reducing burden on large business and making more effective use of its resources. The PFA program was established in January 2001 following a pilot project³ that successfully validated the objective for the program.

The LMSB Division has broad discretion in deciding which tax issues will be accepted into the program. Generally, the tax issues accepted into the program must be factual in nature and related to the application of well-established tax law. The LMSB Division also accepts issues that involve a methodology for determining how an item should be properly reported on a tax return. Among the tax issues specifically excluded from the program are ones where advice is sought before a transaction is completed (i.e., prospective tax issues) or a particular action is taken.

The primary tool used by the LMSB Division to determine which issues to accept into the program is the review of the PFA application. The review is conducted by the PFA program manager; Chief Counsel's technical attorneys;⁴ LMSB Division technical advisors, the LMSB Division examination team, if one is on site; and, if an international tax issue is involved, the Director, International, LMSB Division. Once reviewed, the decision to accept or reject a

¹ Tax issues are potential areas of controversy because from the Internal Revenue Service (IRS) perspective they could represent noncompliance.

² The LMSB Division is one of the four IRS operating divisions. It serves corporations, sub-chapter S corporations, and partnerships with \$10 million or more in assets.

³ Pilot projects are designed to test the effectiveness and efficiency of an approach or idea before full-scale implementation.

⁴ Chief Counsel's technical attorneys are within the Office of Chief Counsel. They are considered to be technical experts that have substantive tax law knowledge in specific areas of the Internal Revenue Code and are located in Washington, D.C.

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tax issue is generally the responsibility of the LMSB Division Industry Director.⁵

Once accepted, a team is formed, which includes the Examination team, representatives of the taxpayer, LMSB Division Counsel field attorneys,⁶ and other personnel appropriate to develop the facts surrounding the tax issue and reach agreement with the large business on how the tax issue will be resolved. Once agreement is reached, a PFA closing agreement is drafted by LMSB Division Counsel field attorneys with the assistance of the examination team and the representative of the taxpayer, and other interested parties, such as Technical Advisors, when appropriate. The PFA closing agreement is signed by a representative of the large business and the Industry Director or designee that contractually binds both parties.

This review was performed at the LMSB Division Headquarters in Washington, D.C., and at Internal Revenue Service (IRS) offices in Chicago, Illinois; New York, New York; San Diego, California; and Tampa/St. Petersburg, Florida, metropolitan areas during the period October 2004 through April 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Expanded Length and Scope of Pre-Filing Agreements Could Boost Interest in the Program

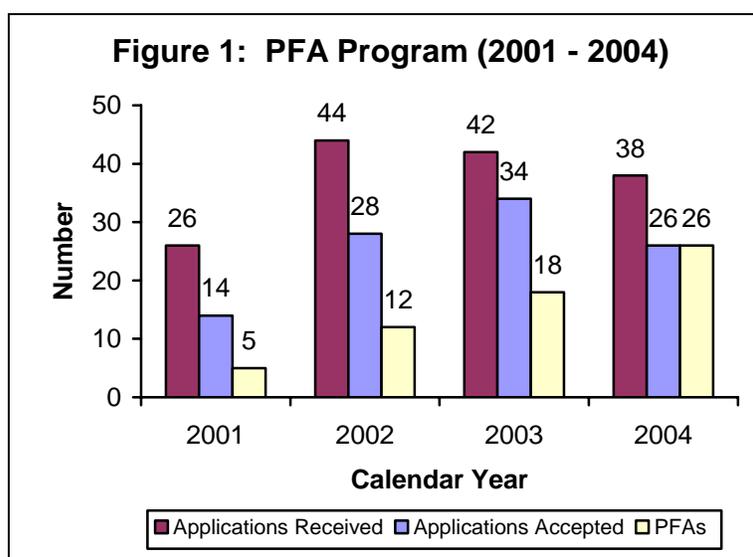
Since its inception in January 2001, the PFA program has, on average, annually received 38 applications, accepted 26 applications for a PFA, and executed 15 PFA closing agreements. The program's modest results are due in part to restrictions placed on the length and scope of a PFA that limited interest in the program.

⁵ Industry Directors are executive-level managers who oversee the deployment of resources and resolve operational concerns within the LMSB Division's five industry segments.

⁶ LMSB Division Counsel is a component of the Office of Chief Counsel that works closely with the LMSB Division on strategy and program planning matters, such as identifying and prioritizing emerging issues and developing published guidance needs, as well as on operations matters, such as day-to-day legal advice and field litigation.

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Under the original revenue procedure⁷ that set forth the rules for the program, a PFA was generally limited to 1 year. However, many large businesses sought to resolve tax issues covering multiple years. The revenue procedure also limited the scope of international tax issues eligible for the program, which further hampered the program's popularity. Figure 1 provides a summary of the program results from January 2001 through December 2004 by showing the number of applications received and accepted, as well as the number of agreements reached.



Source: Treasury Inspector General for Audit Analysis of IRS Data.

To encourage more large business participation in the program, the IRS decided to increase the length and number of issues suitable for a PFA. Issued in December 2004, the new revenue procedure (Rev. Proc. 2005-12) expanded and enhanced the original revenue procedure and will provide large businesses with the opportunity to resolve tax issues for a period of up to 5 years. Unlike the original revenue procedure, the new one also provides that generally any international tax issue requiring a determination of facts or the application of well-established legal principles is “likely suitable for a PFA.” While the changes are important for

⁷ A revenue procedure is an official statement of procedure that, among other things, affects the rights or duties of taxpayers under the Internal Revenue Code. Revenue Procedure 2001-22 set forth the original process and procedures for the PFA program.

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attracting large businesses to the program, it will be equally important that the LMSB Division strengthen its ability to resolve more tax issues before returns are filed while ensuring PFA closing agreements fully protect the Federal Government's interest.

The LMSB Division has designed and implemented a system of controls (techniques and procedures) that guide the PFA process through screening and accepting applications, developing tax issues for resolution, and executing PFA closing agreements. Our evaluation of 91 PFA applications active in Calendar Years 2003 and 2004 found the applications were screened for suitability and forwarded to the Industry Directors with recommendations for deciding whether or not to accept the application for a PFA.

Our review of closed case files supporting 12 PFA closing agreements that involved tax issues totaling \$2.2 billion found examination teams developed and documented evidence to support recommended adjustments of \$76 million to the original PFA application tax issues. The recommended adjustments were discussed and agreed upon with representatives from the large business and accurately incorporated into PFA closing agreements approved by the Industry Director or their designee.

Steps Could Be Taken to Enhance the Planning Process and Better Protect the Federal Government's Interest

Despite the emphasis on resolving tax issues expeditiously, we identified two control areas that could be strengthened to help reach agreement on more tax issues before returns are due and better ensure the Federal Government's interest is protected. As mentioned earlier, the PFA program has experienced only modest success in meeting its primary objective of reaching agreement on tax issues before returns are filed. Also, numerous PFA closing agreements have been executed for tax issues that were accepted into the PFA program against the advice of Chief Counsel's technical attorneys. We believe there are important reasons for strengthening these areas.

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The planning process for developing tax issues for resolution could be improved

For each PFA application submitted, examination teams are required to review the tax issue outlined in the application and document their recommendation for the Industry Director to use in deciding whether or not to accept the tax issue for a PFA. They are also responsible for developing and implementing a work plan that develops the tax issue for resolution within the compressed time period available before the tax return is due.

The PFA applications files we reviewed showed examination teams documented and forwarded recommendations to the Industry Director to consider whether or not to accept the tax issue for a PFA. However, guidelines do not specifically require examination teams to develop a preliminary work plan for resolving a particular tax issue until after the Industry Director decides to accept the tax issue for a PFA. Consequently, the decision process is not as strong as it could be because timeline projections, resource requirements, and other relevant information is not developed showing whether a particular tax issue will in fact be resolved before the tax return is due.

Additionally, we found when work plans were developed they did not contain key elements that are used to effectively plan and monitor the process of developing and resolving tax issues as described in the Internal Revenue Manual (IRM).⁸ We found little or no documentation, for example, outlining the resources needed, specific procedures to be used, and the milestones and dates that must be met to resolve the tax issue within the overall time period available before the return was filed.

As a result of this control weakness, we found only 35 out of the 102 PFA applications accepted into the program were completed before the filing deadline. The results of the remaining 67 PFA applications consisted of 25 PFAs completed after the return was filed, 23 withdrawals from the program, and 19 open PFA examinations of which 16 have already passed the filing deadline.

⁸ The IRM serves as the official compilation of procedures, instructions, and guidelines that govern operations in the IRS.

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Office of Chief Counsel attorney involvement throughout the PFA process is a key element for protecting the Federal Government's interest

The LMSB Division recently implemented a dispute resolution process for the initial screening of PFA applications that is designed to settle differences between Chief Counsel's technical attorneys and Industry Directors over whether a particular tax issue is suitable for a PFA. This feature was added after concerns were raised that Industry Directors were accepting applications into the PFA program contrary to the advice received from Chief Counsel's technical attorneys. While this feature is an improvement, it may not be enough to fully protect the Federal Government's interest.

We found instances, for example, where the examination team's work surfaced additional facts that changed the nature of the tax issue originally accepted for a PFA. Despite having substantive tax law knowledge and subject matter expertise, Chief Counsel's technical attorneys have relatively little required involvement in a PFA beyond the initial screening process. There is no requirement, for example, that Chief Counsel's technical attorneys ensure tax issues remain suitable for a PFA when examination teams are developing and resolving tax issues. While LMSB Divisional Counsel's attorneys are assigned to the PFA team to provide legal advice and assistance during issue development, they are usually not the subject matter experts on the tax issue in question. Additionally, LMSB Division Industry Directors do not need the concurrence of Office of Chief Counsel attorneys before entering into a PFA closing agreement except in the case of certain international tax issues.⁹

Recommendations

To help reach agreement on more tax issues before returns are due and better protect the Federal Government's interest,

⁹ Rev. Proc. 2005-12 Section 3.06 *Eligible international issues requiring Associate Chief Counsel (International) concurrence in execution*. Page 313.

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the Director, Pre-Filing and Technical Guidance, LMSB Division, should:

1. Revise PFA program guidelines to require that examination teams provide Industry Directors with preliminary work plans supporting their recommendations to accept or not accept tax issues for a PFA. We do not envision that developing the work plan will involve an extensive amount of detail or time. However, it should contain estimates of the resources needed, the general audit procedures to be used, and milestones to be met if a particular tax issue is to be resolved before the return is filed.

Management's Response: The LMSB Division will revise the template used to provide information to the Industry Director to include a section for a brief, high-level, preliminary plan that includes milestones and resources needed.

2. Initiate actions to establish a process that monitors and evaluates how well concerns raised by Chief Counsel's technical attorneys over tax issues submitted for a PFA are resolved. The process should be designed to provide assurance that tax issues remain suitable for a PFA and that advice from Counsel's technical attorneys is fully considered before closing agreements are executed.

Management's Response: By implementing the new Rev. Proc. 2005-12, the LMSB Division indicated it addressed our recommendation to establish a process that monitors and evaluates how well concerns raised by Chief Counsel's technical attorneys over tax issues submitted for a PFA are resolved. The LMSB Division noted that Rev. Proc. 2005-12 requires involvement of Chief Counsel's technical attorneys in the screening process to provide technical expertise and help resolve legal issues. It further noted that participation by the Office of Chief Counsel's technical attorney is not required or necessary throughout the whole process, except for the five issues in Rev. Proc. 2005-12 for which the Associate Chief Counsel (International) concurs on the agreement.

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Office of Audit Comment: While Rev. Proc. 2005-12 expanded and enhanced previous procedures, we do not believe it sufficiently addresses our recommendation to provide assurance that tax issues remain suitable for a PFA beyond the screening process. As we noted in the report, examination teams have surfaced additional facts that changed the nature of the tax issues originally accepted for a PFA.

Pre-Filing Agreement User Fees Need to Be Evaluated

User fees are defined by the Office of Management and Budget (OMB) Circular A-25, *User Charges*, as charges individuals and businesses are required to pay for special benefits received beyond those received by the general public.¹⁰ The fees are based on the principle that those who receive special benefit from a Federal Government program or activity should bear the cost of receiving such benefit.

In accordance with OMB's directive, the IRS established a three tier user fee structure for the LMSB Division PFA program. The structure is based on the assets of a business in the following amounts:

- The fee for a business having assets of \$250 million or more is \$10,000.
- The fee for a business having assets of at least \$50 million, but less than \$250 million is \$5,000.
- The fee for a business having assets of at least \$10 million, but less than \$50 million is \$1,000.

Since the program's inception in January 2001 through December 2004, the LMSB Division reported it collected and deposited into the United States Treasury's general fund \$928,000 in user fees related to work on 102 PFAs. We estimate during this time period, the LMSB Division incurred, at a minimum, salary and benefit costs of \$2.9 million or an average of \$35,678 for issue development of each PFA.

¹⁰ OMB's mission is to assist the President in the development and implementation of budget, program, management, and regulatory policies. Its Circulars are used to communicate instruction and information to Federal agencies.

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The \$2.03 million difference between the salary and benefit costs incurred and what was recovered in user fees could be higher. Our estimate does not include other cost factors, such as management and supervisory costs, because the IRS had not determined the direct or indirect costs of providing a PFA due to an oversight. For us to evaluate the additional costs and appropriateness of the fee structure would have required more time and resources than were available.

Recommendation

3. To provide assurances that user fees are charged in accordance with guidelines, regarding recovering program costs, we are recommending the Director, Pre-filing and Technical Guidance, LMSB Division, take the necessary steps to comply with OMB Circular A-25.

Management's Response: The LMSB Division will work with the IRS' Enforcement Committee that is currently working on a Service-wide initiative to evaluate user fees to determine compliance with Circular A-25 to determine the appropriate user fee to charge for PFAs.

Office of Audit Comment: The LMSB Division had some general comments on the draft of this report. With respect to these comments, we incorporated their suggested technical changes where appropriate. In addition, the LMSB Division commented that the PFA applications and cases reviewed were entirely governed by a previous revenue procedure and the procedural concerns we identified are likely attributable to the prior guidance. We agree the previous revenue procedure covered all of the PFA applications and cases we reviewed. However, the concerns we raised are common to both new and old procedures. Additionally, our fieldwork on the review was conducted between October 2004 and April 2005 while the new revenue procedure was issued in December 2004. Therefore, few, if any, PFA applications and cases would have been completed for us to review under the new procedure.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Large and Mid-Size Business (LMSB) Division's Pre-Filing Agreement (PFA) process is being administered in accordance with Internal Revenue Service (IRS) policies and procedures. Work on this review was performed in the IRS Office of Chief Counsel and LMSB Division Headquarters¹ in Washington, D.C., and in LMSB Division offices in the Chicago, Illinois; New York, New York; San Diego, California; and Tampa/St. Petersburg, Florida, metropolitan areas. We chose these metropolitan areas primarily to achieve coverage in geographically dispersed offices.

During the review, we relied on the IRS' internal management reports and databases. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required a significant amount of time. Additionally, we used judgmental sampling techniques unless otherwise noted to minimize time and travel costs. To accomplish the objective, we:

- I. Reviewed extensive source material to gain an understanding of the PFA program, processes, and user fees. These sources included the IRS Internal Revenue Manual, policy statements, training materials, revenue procedures, and the Office of Management and Budget Circular A-25, *User Charges*.²
- II. Analyzed all 91 PFA applications that were opened in Calendar Years (CY) 2003 and/or 2004 (through September 30, 2004) along with a judgmental sample of case files supporting 12 of 28 PFA closing agreements completed in Fiscal Year 2004 to assess if IRS policies and procedures were followed in screening and accepting PFA applications into the program, planning and developing tax issues³ for resolution, and executing PFA closing agreements.
- III. Compared the IRS salary and benefit costs associated with 83 PFA application examinations closed between CYs 2001 and 2004 to the PFA user fee structure to assess the likelihood that user fees were covering the costs of the program.

¹ The IRS Office of Chief Counsel is expected to provide the correct legal interpretation of the tax law, represent the IRS in litigation, and provide legal support the agency needs to carry out its mission. As one of the four IRS operating divisions, the LMSB Division serves corporations, sub-chapter S corporations, and partnerships with assets greater than \$10 million.

² The Office of Management and Budget's mission is to assist the President in the development and implementation of budget, program, management, and regulatory policies. Its Circulars are used to communicate instruction and information to Federal agencies.

³ Tax issues are potential areas of controversy because from the IRS perspective they could represent noncompliance.

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- IV. Interviewed numerous IRS officials who were involved with or affected by the PFA process to obtain their opinions about how well the process was working and learn about the status of any ongoing changes to improve the program.

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Appendix II

Major Contributors to This Report

Curtis W. Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs)

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Earl Charles Burney, Lead Auditor

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Ali Vaezazizi, Auditor

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Appendix III

Report Distribution List

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Director, Pre-Filing and Technical Guidance SE:LM:PFTG
National Taxpayer Advocate TA
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 Deputy Commissioner for Services and Enforcement SE
 Commissioner, Large and Mid-Size Business Division SE:LM
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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Deborah M. Nolan 
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – The Pre-Filing Agreement Program for
Large Businesses Has Yielded Modest Results
(Audit # 2004-30-028)

Thank you for the opportunity to review and comment on the subject draft report on your audit of the Pre-Filing Agreement (PFA) Program to determine whether the Large and Mid-Size Business (LMSB) Division is administering the program in accordance with Internal Revenue Service (IRS) policies and procedures.

As mentioned in your report, the PFA Program was established in January 2001 following a successful pilot project that validated the objectives for the program. Since then, we have designed and implemented procedures to guide the PFA process through screening and accepting applications, developing tax issues for resolution, and executing PFA closing agreements. Each PFA review team consists of the PFA Program Manager; Chief Counsel Attorneys; LMSB Division Technical Advisors; the LMSB Division examination team, if one is on site; and the Director, International (LMSB Division), if an international tax issue is involved. The PFA process engages all parties to determine the most appropriate outcome. The Associate Chief Counsel advises during the screening process and consults with the PFA Team, as needed, during the application review and development of issues.

General Comments on the Draft Report

Appendix I of the draft report indicates that TIGTA analyzed PFA applications opened through September 30, 2004, and examined case files for PFAs executed during Fiscal Year 2004. These applications and cases were entirely governed by the predecessor to the recently issued Revenue Procedure 2005-12, 2005-2 I.R.B. 311. That revenue procedure significantly updated the Pre-Filing Agreement Program. The procedural concerns identified by TIGTA are likely attributable to the prior guidance. As an example, the report stated that the LMSB Division Industry Director solely decides whether to accept an application for the PFA program: "Once reviewed, the decision to accept or reject a tax issue is generally the responsibility of the LMSB Division Industry Director." The new revenue procedure prescribes a coordination and consultative process between LMSB and the Associate Chief Counsel offices during the initial screening process.

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The draft report briefly mentions Revenue Procedure 2005-12 for the purpose of describing how LMSB has expanded the range of years to resolve tax issues, and the scope of international tax issues suitable for the PFA process. We suggest including in the report a discussion of the ways in which the new procedures under Revenue Procedure 2005-12 will likely improve the deficiencies identified under the old procedures.

With respect to your concerns about the continued involvement of Chief Counsel in the PFA process, the IRS has well-established rules concerning general reconciliation and coordination between Chief Counsel Attorneys and IRS personnel contained in the Chief Counsel Directives Manual (CCDM) provisions other than the PFA provisions. Specifically, Parts 31 and 33 of the CCDM contain guidance for all Chief Counsel attorneys when rendering legal advice to both the IRS and other Chief Counsel offices. This guidance contains detailed procedures for Chief Counsel attorneys to follow in analyzing issues, coordinating review among Chief Counsel offices, preparing advice for both Chief Counsel offices and the IRS, and resolving disagreements among offices. We suggest the report cover the use of these procedures in prior PFA cases and how they may be used to address the identified concerns with the PFA Program in future cases.

The report throughout refers to "Chief Counsel's technical attorneys" when describing Counsel Attorneys with substantive tax expertise. A better description for these attorneys is "attorneys in the National Office" or "attorneys in the various Associate Chief Counsel offices."

On page 6 of the report, there is acknowledgement of the involvement of the Office of Associate Chief Counsel (International) in the PFA process for international issues. Under Rev. Proc. 2005-12, only five international issues require the concurrence of that office before a PFA can be executed. Accordingly, we suggest changing the final sentence of the second paragraph on page 6 to indicate that "certain" international issues require such concurrence.

We agree that steps may be taken to improve the PFA planning process and that user fees should be evaluated. Attached is our detailed response outlining the corrective actions that the LMSB Division will take to address your audit recommendations. If you have any questions, please contact Kathy Petronchak, Director, Pre-Filing and Technical Guidance, at (202) 283-8480.

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Attachment

RECOMMENDATION 1:

The Director, Pre-Filing and Technical Guidance (PFTG), LMSB Division, should revise PFA Program guidelines to require that examination teams provide Industry Directors with preliminary work plans supporting their recommendations to accept or not accept tax issues for a PFA. The preliminary work plans should contain estimates of the resources needed, the general audit procedures to be used, and milestones to be met if a particular tax issue is to be resolved before the return is filed.

CORRECTIVE ACTIONS:

Currently, the Audit Team uses a template to provide information and advice to the Industry Director on whether or not to accept the PFA application. LMSB will revise the template to include a section for a brief, high-level, preliminary plan that includes milestones and resource needs. This preliminary plan will not be as extensive as the examination plan required by the Internal Revenue Manual (IRM) 4.45.8.

IMPLEMENTATION DATE:

Proposed: December 31, 2005

RESPONSIBLE OFFICIAL:

Director, PFTG (LMSB Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

The revised template will be used by the Industry Director to decide whether or not to accept PFA applications into the program.

RECOMMENDATION 2:

The Director, Pre-Filing and Technical Guidance, LMSB Division, should initiate actions to establish a process that monitors and evaluates how well concerns raised by Chief Counsel's technical attorneys over tax issues submitted for a PFA are resolved. The process should be designed to provide assurance that tax issues remain suitable for a PFA and that advice from Counsel's technical attorneys is fully considered before closing agreements are executed.

CORRECTIVE ACTIONS:

The new Revenue Procedure 2005-12, issued December 22, 2004, requires that Associate Chief Counsel attorneys get involved in the screening process to provide

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technical expertise and help resolve legal issues. LMSB Field Counsel attorneys coordinate as necessary with the appropriate Associate Chief Counsel as they assist LMSB in the preparation of PFAs. Attorneys from the Associate Chief Counsel offices are involved, but their participation is not required or necessary throughout the whole process, except for the 5 issues in the Revenue Procedure in which Associate Chief Counsel (International) concurs on the agreement. Under the prior Revenue Procedure 2001-22, the Associate Chief Counsel had an advisory role during the screening process when providing an opinion as to acceptance or rejection of a PFA application. The advisory role has changed with Revenue Procedure 2005-12, which now requires Associate Chief Counsel coordination and consultation during the screening process. There are now reconciliation procedures for resolving conflict if there is disagreement over whether or not to accept an issue.

In summary, the PFA process engages all parties, including attorneys in the various Associate Chief Counsel offices, to determine the most appropriate outcome. The Associate Chief Counsel advises during the screening process and consults with the PFA Team as needed during the development of issues.

IMPLEMENTATION DATE:

Completed: December 22, 2004

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A

RECOMMENDATION 3:

To provide assurances that user fees are changed in accordance with guidelines, regarding recovering program costs, the Director, Pre-Filing and Technical Guidance, LMSB Division, should take the necessary steps to comply with OMB Circular A-25.

CORRECTIVE ACTIONS:

The IRS' Enforcement Committee is currently working on a Servicewide initiative to evaluate user fees to determine compliance with the Circular A-25. As part of this initiative, each business unit has been requested to evaluate user fees. In response to this initiative, we will work with the Enforcement Committee to determine the appropriate user fee to charge for PFAs.

IMPLEMENTATION DATE:

Proposed: December 31, 2005

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RESPONSIBLE OFFICIAL:

Director, PFTG (LMSB Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

The PFA Program Manager will brief the Director, PFTG on the progress of the user fees initiative, including recommendations for user fee changes.