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In this installment of Practically Speaking: Tax Controversy, the authors revisit the IRS's options for dispute prevention and provide updates and insights on the prefiling agreement and industry issue resolution programs.

This article represents the authors' views only and does not necessarily represent the views or professional advice of KPMG LLP. Any errors remain the authors' own.

In May we provided an overview of the various dispute prevention and resolution options available to taxpayers to resolve federal tax disputes.[1] Since the publication of that *Tax Notes* article, there has been continued turnover at the IRS and reductions in spending. Faced with the need to continue its enforcement efforts, both in closing examinations and opening new ones, the IRS has made a further change to the prefiling dispute prevention option known as the prefiling agreement (PFA) program.

In this article, we examine how taxpayers can use the PFA program to prevent tax disputes and gain certainty for one or more issues before their tax returns are filed. We also address the potential for increased use of the industry issue resolution (IIR) program, which may be more attractive today than in the past.[2]

[1] Andrew R. Roberson, Justin Donatello, and Kevin R. Harkins, "Dispute Prevention and Resolution Options — Which Is Right for You?" *Tax Notes Federal*, May 5, 2025, p. 849.

[2] We recently provided an update on post-filing dispute resolution options and IRS enforcement procedures. *See* Roberson, Douglas O'Donnell, and Kathleen Agbayani, "Dispute Prevention and Resolution Options: Postfiling Update," *Tax Notes Federal*, Oct. 27, 2025, p. 651.

I. Effect of IRS Turnover on Dispute Prevention and Resolution Options

In May we explained the prefiling and post-filing options offered by the IRS to prevent or resolve tax disputes.[3] Since the publication of that article, significant tax legislation has been enacted and the IRS has experienced management changes, employee reductions, and funding challenges affecting those alternative dispute resolution options.

In part because of the deferred resignation program, the voluntary early retirement authority, and the voluntary separation incentive payment program, the number of IRS employees has decreased from over 100,000 in February 2025 to 74,300 in October.[4] According to a report by the Treasury Inspector General for Tax Administration issued on July 18, the effect has been an approximate 27 percent reduction in tax examiners, a 26 percent reduction in revenue agents, and a 23 percent reduction of contact representatives. Overall, this decrease in personnel will affect the availability of prefiling assistance as well as account assistance.[5] The decrease in IRS personnel includes the following breakdown across the following key groups: a 35 percent reduction in the Small Business/Self-Employed Division, a 25 percent reduction in the Tax-Exempt and Government Entities Division, a 20 percent reduction in Taxpayer Services, and a 19 percent reduction in the Large Business and International Division.[6]

On October 9 it was reported that, given the continued IRS employee losses since February and shutdown-induced furloughs, the IRS had only about 39,870 employees on the clock.[7] Of those remaining employees, a large number are now working in taxpayer services, "including those working in submission processing, accounts management, and return integrity and compliance."[8] On October 10 the Trump administration distributed reduction-in-force notices to other IRS employees, following through on its pledge to lay off federal employees during the government shutdown.[9] The exact number and positions of those affected are unclear, but it was reported that almost 1,500 Treasury employees received reduction-in-force notices "related to the lapse in appropriations."[10] The cuts in personnel will likely be combined with a reduction in the IRS's annual operating budget. While the IRS budget for fiscal 2026 has not yet been released, comments by the administration suggest the likelihood that it will be further shrunk.[11]

In light of ongoing attempts to improve taxpayer service in a resource-constrained environment, the IRS has made several recent changes directed at preventing tax disputes. One change concerns improvements to the PFA program. Another is the potential for revitalizing the IIR program.

II. Improvements to the PFA Program

The PFA program was introduced as a pilot program in March 2000 with the publication of Notice 2000-12, 2000-1 C.B. 727. The IRS made the program permanent a year later in Rev. Proc. 2001-22, 2001-1 C.B. 745, with the current PFA process set forth in Rev. Proc. 2016-30, 2016-21 IRB 981. The program involves the following steps by which a taxpayer and the IRS can reach agreement on the federal tax treatment of an item on a return that has not yet been filed:

- The taxpayer initiates the process by submitting a written request to the IRS to examine one or more items before the tax return is filed.
- If accepted, the taxpayer must pay a $181,500 user fee for each separate and distinct item. The parties then work together to reach a resolution for the item or items.

[3] Roberson, Donatello, and Harkins, *supra* note 1.

[4] Bejamin Valdez and Doug Sword, "IRS Furloughs Spark Concerns of a Bumpy Filing Season," *Tax Notes Federal*, Oct. 13, 2025, p. 378; Valdez, "IRS Furloughs Half of Workforce, With Deep Enforcement Cuts," *Tax Notes Federal*, Oct. 13, 2025, p. 379; Treasury Inspector General for Tax Administration, "Snapshot Report: IRS Workforce Reductions as of May 2025," Report No. 2025-IE-R027 (July 18, 2025).

[5] TIGTA, *supra* note 4.

[6] *Id.*

[7] Valdez and Sword, *supra* note 4.

[8] *Id.*

[9] Cady Stanton, "More IRS Layoffs as Trump Follows Through on Shutdown Firings," *Tax Notes Federal*, Oct. 20, 2025, p. 537.

[10] *Id.*

[11] Sword, "House Appropriators Approve Proposed Historic IRS Budget Cut," *Tax Notes Federal*, Sept. 8, 2024, p. 1669 (noting proposal to cut IRS annual funding by $2.8 billion, or 23 percent).

- The process is nonbinding, and either party may end or withdraw at any time.
- If an agreement is reached, the parties memorialize the agreement using Form 906, "Closing Agreement on Final Determination Covering Specific Matters," also referred to as a PFA, that is binding on both parties.
- The PFA can apply to both the current year and up to four future tax years.
- Once the PFA is finalized, the item is generally not examined again and the taxpayer gains a high degree of certainty in its resolution.

Although initial returns under the PFA program were positive, processing times increased and the number of PFA requests declined.[12]

On June 17 the IRS announced improvements to the PFA program,[13] which included the dedicated "Pre-Filing Agreement (PFA) Likely Suitable Issues and Documentation" page on its website to help taxpayers identify when a PFA request is appropriate for their situation.[14] The nonexclusive list of likely suitable issues contains five domestic items and five international items, as shown in the table.[15]

In September the IRS further emphasized the importance of the PFA program by saying it intended to update Rev. Proc. 2016-30.[16]

Certain issues are ineligible for the PFA program.[17] For example, substantive issues involving transfer pricing, certain accounting method changes, penalties and penalty defenses, and employer status are excluded from the PFA process. Other matters are deemed ineligible for procedural reasons, such as an issue that is subject to pending litigation (or designated for litigation) for an earlier tax year and positions contrary to IRS published guidance or that is the subject of pending or proposed requests for a determination letter, technical advice memorandum, or letter ruling.

Among the list of issues that are suitable for a PFA are those concerning the research credit and the worthless securities deduction, examined below.

A. Research Credit

The examination of research credit issues, whether on an original return or an amended return, requires significant resources for both the IRS and taxpayers. Moreover, in our experience, IRS examination teams are increasingly disallowing research credit claims because of IRS-favorable court decisions, an increased emphasis on substantiation, and more detailed requests for information.[18] One need only visit the IRS's "Research Credit" page to see the wealth of information provided for the credit.[19]

The IRS requires a great deal of information to be included with a request for a PFA for the research credit, including the following 20 items that will be reviewed upon acceptance in the program. The IRS recommends including the first five with the PFA request:

- For the three years preceding the PFA request, SEC Forms 10-K for public companies or copies of audited financial statements for private companies.
- IRS Forms 6765, "Credit for Increasing Research Activities," for the prior three tax years before the PFA year and the work papers showing the source (for example, operating units, departments, cost centers, etc.) of the taxpayer's qualified research expenses (QREs).
- A statement of whether the taxpayer intends to follow the Accounting Standards Codification (ASC) 730 Directive[20] in the PFA tax year.

[12] For more background, see Roberson et al., "IRS Announces Improvements to Its Pre-Filing Agreement Program," Procedurally Taxing blog, July 2, 2025.

[13] IR-2025-69.

[14] *Id.*

[15] IRS, "Pre-Filing Agreement (PFA) Likely Suitable Issues and Documentation" (last updated June 18, 2025).

[16] Treasury, "2025-2026 Priority Guidance Plan," at 7 (Sept. 30, 2025).

[17] Rev. Proc. 2016-30, section 3.03(8).

[18] For further discussion of IRS examinations of the research credit, see Roberson et al., "Recent Developments in Research Credit Audits and Compliance," *Tax Notes Federal*, Apr. 7, 2025, p. 135; Roberson, Donatello, and Moore, "Navigating the Shifting Landscape of Research Credit Audits," *Tax Notes Federal*, Jan. 22, 2024, p. 667.

[19] IRS, "Research Credit" (last updated May 21, 2025).

[20] LB&I-04-0820-0016 (Sept. 10, 2020).

PFA Likely Suitable Issues and Documentation

Issue	Description
Domestic	
Research credit	Whether the taxpayer's activities or expenses qualify for the section 41 credit for research activities or section 174 amortization of specified research and experimental expenditures.
Worthless securities deduction and corollary issues	The determination of whether a security became worthless during the eligible tax year and the amount of the loss, for purposes of section 165(g). If applicable, the determination of whether the security is a security in a domestic affiliate under section 165(g)(3).
Limitation on repurchase premium on convertible debt	Whether to apply the limitations provided by section 249 related to the repurchase premium on convertible debt.
Discount rates and costs of required capital	Determine the discount rate and the costs of required capital for valuation of an insurance company.
Long-term contracts	Determine whether a construction or manufacturing contract is required to be accounted for as a long-term contract under section 460.
International	
Qualified business unit	Whether a unit of the taxpayer's trade or business is a qualified business unit within the meaning of section 989(a) and the regulations promulgated under that section.
U.S. trade or business	Whether the taxpayer is engaged in a trade or business within the United States (excluding questions under section 864(b)(2)).
Effectively connected income	The amount of gross income that is effectively connected with the conduct by the taxpayer of a trade or business within the United States.
Deductions against ECI	Factual determinations concerning the extent to which, under section 882(c), deductions are connected with income that is effectively connected with the taxpayer's conduct of a trade or business within the United States.
Permanent establishment	Whether the taxpayer has a PE in the United States for purposes of a bilateral income tax convention to which the United States is a party and, if so, what profits are attributable to that PE.

- For potential qualified research activities (QRAs) performed by the taxpayer for third parties, a description of the types of agreements the taxpayer has with those parties, such as agreements for research services, agreements to furnish finished products, and so on.
- The research credit study used to determine the credit for the three years before the PFA tax year.
- Electronic financial accounting records reconciling with the SEC Forms 10-K, audited financial statements, or other financial reports.[21]
- For potential QREs from computer rental or lease costs, a description of the type of costs identified and included as computer rental or lease costs.
- For potential QRAs related to software development, an explanation of whether the software should be treated as non-internal

[21]The records should also align with the income expected to be reported on the tax return for the PFA year. The records should clearly show research and development expenses and match the amounts reported under ASC 730, or similar standard if the financial statements do not follow generally accepted accounting principles. If this item is not available for the tax year for which the PFA is sought, the information for the preceding tax year should be provided.

use software, internal-use software, or dual-function software.
- A description of types of potential QRAs that are performed on the taxpayer's behalf by third-party contractors.
- The amount of specified research and experimental expenditures for the PFA tax year (if available) and the tax year preceding the PFA tax year, as well as schedules showing how the specified research and experimental expenditures were computed.
- Organizational charts showing the departments and cost centers in which activities having the potential to be QRAs are conducted.
- A description of the research and development that may involve potential QRAs.
- Documentation of the policies and procedures governing product and process development.
- Documentation relied on to substantiate the performance of QRAs and an explanation of how this documentation may be used in assessing the qualification of potential QRAs.
- A description of the method and process used to determine the activities included or excluded in qualified research and the amount of QREs incurred in the conduct of QRAs.
- Documentation for any QREs that are accounted for as production costs or cost of goods sold (with an explanation of any book-to-tax difference for the treatment of these expenses).
- For any research credit that includes QREs from pilot models, a list of business components connected to a pilot model and the documentation used to confirm that the costs for each pilot model were for the conduct of qualified research and are a QRE.
- A summary of the taxpayer's QRE history for three tax years before the PFA tax year, such as a change in method for identifying business components or qualified research.
- Carryback and carryforward schedules for the general business from the most recently filed return and properly completed Forms 6765.
- A brief summary of the IRS's examination history of the research credit for the three tax years before the PFA tax year. If the research credit was adjusted, QREs and research credits as filed, per exam, and as amended, if applicable, should be provided and, for each year, the taxpayer should indicate how the research credit issue was resolved or if it is still pending.

A decade ago, it was common for taxpayers to seek PFAs for discrete topics related to the research credit — such as the base period computation or the method to determine a population of qualified supply expenses — and many received a successful outcome that could be relied on for future years to streamline the scope of an examination. In more recent years, taxpayers became reluctant to pursue PFAs because delays in the review process affected their ability to resolve and receive approval of the contested issue before filing their return or because the level of effort and burden required mimicked that of a traditional IRS examination. Those negative taxpayer experiences, along with denied PFAs, were shared by tax directors and CFOs, which ultimately caused a decline in the number of taxpayers pursuing PFAs for research credit issues.

With the fresh attention paid to the research credit in the 20 items identified above, the IRS has stressed its commitment to providing measures to reinvigorate the PFA program with added transparency and procedures to streamline the process to encourage more taxpayers to pursue PFAs.

Although the burden of providing substantial documentation continues to fall on the taxpayer, this welcome guidance, along with the IRS's communicated commitment to improve the process, provides taxpayers with additional options to reduce the time spent on tax disputes related to the research credit.

B. Worthless Securities Deduction

Unlike research credit issues that generally recur, worthless securities deduction issues are

often a one-off.[22] But for large corporate taxpayers, those issues can involve substantial dollar amounts with a significant effect on a taxpayer's federal income tax liability. For this reason, some taxpayers may find it desirable to attempt prefiling resolution of those issue for certainty and future tax planning purposes.

For the worthless securities deduction issue, the IRS has identified on its "Pre-Filing Agreement (PFA) Likely Suitable Issues and Documentation" page the following four items that the IRS will need to review upon acceptance into the PFA program, and it asks that a taxpayer address the availability of each item in its PFA request:

- Documentation corroborating the taxpayer's description of the transaction, including, but not limited to, tax and legal opinions, transaction presentations, valuations, financial statements, and elections and tax forms filed.
- Documentation to corroborate the basis used in calculating the loss, including, but not limited to, a basis study or analysis, which includes documentation to corroborate all changes to basis reflected on the basis schedule and analysis such as acquisition agreements or general ledger details.
- Documentation to corroborate the business purpose for each step of the transaction (if applicable) and the business purpose of the transaction in its entirety; this may include board of director minutes, emails, and internal and external tax and legal memoranda.
- For a security in an affiliate:
  - the gross receipts calculation used to confirm the worthless affiliate has met the gross receipts test under section 165(g)(3)(B);
  - a statement disclosing the specific tax years, since inception, for which the taxpayer has documentary evidence to corroborate the amounts reported on this calculation; and
  - if such documentary evidence is unavailable, a statement with a detailed description of how the gross receipts calculation was performed, including the specific gross receipts data used in the calculation for the missing years.

In deciding whether to pursue a PFA for a worthless securities deduction, taxpayers must carefully consider the items identified by the IRS and the consequences of providing them. For example, the list says taxpayers need to provide tax and legal opinions and memoranda (as well as minutes and emails) that may contain privileged information. Taxpayers also need contemporaneous documentation to demonstrate a business purpose for both the transaction overall and each step. This implies that the requirement to provide a business purpose for each step might not be applicable. However, in the current enforcement environment in which the IRS is increasingly asserting application of the codified economic substance doctrine under section 7701(o), it is unclear when it will deem a business purpose not applicable to a particular step in a transaction.

In our experience, a critical issue with worthless securities deductions is often whether they qualify for capital loss treatment under section 165(g)(1) — in which case the deductions will have limited use for a taxpayer that does not expect to generate material capital gains — or whether they qualify for ordinary loss treatment under section 165(g)(3) and therefore can be used to offset taxable income. Section 165(g)(3) treatment requires satisfaction of a gross receipts test, which in effect looks to whether more than 90 percent of aggregate gross receipts "for all taxable years" have been from active sources. Reg. section 1.165-5(d)(2)(iii) clarifies that this requires looking to the gross receipts history of the worthless entity "for all the taxable years during which it has been in existence" — a tall order, especially for companies that have been acquired and divested over the course of decades. This historical substantiation requirement means that the gross receipts test is often an impediment to obtaining ordinary loss treatment, even in cases in which the

[22]The worthless securities deduction and corollary issues cover two related issues: (1) whether a security became worthless during the year and the amount of the loss under section 165(g) (also, if applicable, whether the security is a security in a domestic affiliate under section 165(g)(3)) and (2) the investment adjustment rules of reg. section 1.1502-32 and the unified loss rule of reg. section 1.1502-36. Our discussion is limited to the section 165(g) issue.

worthless entity is clearly an operating company that satisfies the spirit of the test. PFAs are well suited to cases in which there is a need for a practical approach to substantiating gross receipts, including how to deal with thorny issues concerning look-through treatment for intercompany payments.

The four items above illustrate the IRS's focus when examining worthless securities deductions — in particular, basis, timing, and gross receipts. In determining whether a PFA is a good route to take, it will be important to evaluate the following:

- How clear is it that the entity in question is in fact worthless? Is the timing observable because of an event or series of events?
- How complicated is the narrative describing the appropriate point in time to claim the deduction?
- How difficult is it to substantiate historical gross receipts or to determine the effect of gross receipts involving intercompany payments?
- How difficult is it to compile documentation supporting basis?
- How material is the item to your company?
- How likely is it that you will be audited, and based on your experience, how likely that the worthless security deduction will be audited?

Like many decisions, this one requires evaluating risk. If there are significant complications with timing and worthlessness, then it may be too difficult to obtain a PFA with a satisfactory outcome. On the other hand, issues around basis and gross receipts may be addressed in a practical and effective manner through the PFA process. In particular, the IRS's acknowledgement — which aligns with our experience — that the PFA program can be used to obtain section 165(g)(3) treatment even in cases in which "documentary evidence is not available for all years" may be welcome news to taxpayers that have a worthless operating subsidiary but would otherwise struggle to demonstrate compliance with the gross receipts test's "all years" requirement.

Of course, completing a PFA on a satisfactory basis (that is, before the return is filed) can be challenging if there are detailed and complex structures to review and questions of privilege involved. Finally, there is the trade-off of exposing one issue while putting the return in play and whether certainty regarding the former is outweighed by the time and effort of a full audit over an extended period with a lack of clarity on both exam team availability and any necessary chief counsel support. That said, in many cases involving material worthless securities issues, a PFA can be a great tool to timely resolve an issue and improve certainty and confidence in financial reporting.

III. The IIR Program

As mentioned above and in our October *Tax Notes* article that updated post-filing dispute resolution options,[23] reductions in the IRS's workforce and funding have created challenges in the enforcement context. And while the IRS has announced changes to better some dispute prevention and resolution programs, that doesn't mean that taxpayers should ignore other long-standing options that haven't been amended, such as the IIR program.

The IIR program began in 2000 (close in time to the stand-up of LB&I) and was made permanent in 2002. It, like the PFA program, was part of the IRS's effort to improve dispute prevention. After reaching resolutions on many issues over the past 20 years, use of the IIR program stagnated, and the IRS's website now indicates that no IIRs are in progress. However, given the current state of the IRS, we believe there is good reason to again consider the IIR program as a viable option for improving dispute prevention.

The IRS fact sheet on the IIR program reports its goal "is to resolve frequently disputed or burdensome business tax issues affecting many taxpayers. This goal is accomplished by providing clear guidance that business taxpayers can use, thus reducing the time and expense of resolving issues on a case-by-case basis during tax examinations."[24] The IIR program is available to all business taxpayers served by the SB/SE, TE/

[23] *See supra* note 2.

[24] IRS, "Fact Sheet: Industry Issue Resolution (IIR) Program (March 2023)" (last updated June 14, 2025).

GE, and LB&I divisions. Business tax issues appropriate for the program will have at least two of the following characteristics:

- the proper tax treatment of a common factual situation is uncertain;
- the uncertainty results in frequent and often repetitive examinations of the same issue;
- the uncertainty results in a taxpayer burden;
- the issue is significant and affects many taxpayers, either within an industry or across industry lines; or
- the issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist the IRS in determining the proper tax treatment.

The submission of issues for consideration may come from industry groups, business associations, or a particular taxpayer. Given the characteristics required for an issue to be appropriate for the IIR program, it is best to have multiple taxpayers participating in the submission to demonstrate the extent of controversy, burden, and uncertainty that published guidance could resolve. Rev. Proc. 2016-19, 2016-17 IRB 497, provides more detailed guidance regarding the program.[25]

In our experience, the primary benefits of the program are twofold: (1) taxpayers affected by the issue work with the IRS and Treasury in a transparent and solution-oriented environment and (2) the result is published guidance that may be relied on by taxpayers when filing their return reporting the impact of the issue in accordance with the relevant guidance.

There are multiple instances in which IIRs delivered results with widespread positive effects and others in which they came up short. Areas particularly prone to an IIR in the past were those involving the capitalization of specific tangible property and the determination of research credit eligibility and amount. The latter continues to be a significant burden for the IRS and taxpayers as it is frequently raised on audit and is deeply fact-intensive. Efforts to improve the administration of research credits through the IIR program have seen progress, but work remains to improve existing guidance arising from an IIR for which financial accounting was the starting point. We also believe that there are industry areas in which procedural guidance regarding the research credit would be beneficial to businesses and the IRS.

We recently learned of industry-specific issues that seem appropriate for the IIR program and will explore whether there is adequate interest to approach the IRS. Stay tuned for that possibility. Despite the level of commitment, transparency, and cooperation the program requires from all parties, we continue to see its value, which is directly linked to reducing disputes and the burden related to the subject of the IIR.

IV. Conclusion

Both the PFA and IIR programs offer an opportunity for taxpayers to reduce compliance burdens and costs (by reaching resolution faster than in a post-filing examination context) and to improve tax department resource allocations (by reducing data gathering and examination time). Further, prefiling resolution can eliminate the potential need for a FIN 48 reserve[26] and the filing of Schedule UTP, "Uncertain Tax Position Statement." Finally, taxpayers might secure a tactical advantage by seeking to resolve issues with the IRS upfront by fostering a collaborative relationship that may lead to a more favorable result than in the post-filing examination context.

Regarding research credit issues, the PFA process may be particularly attractive to taxpayers that are subject to recurring examinations of their research activities. The potential exists to eliminate examinations and gain certainty for up to five years (the PFA year and four subsequent years) while reducing the burden and costs on the tax department and subject matter experts at the taxpayer.

However, these programs come with costs and risks. As mentioned earlier, once a PFA request is accepted, the taxpayer must pay a user fee of $181,500 for each issue, and that fee is not contingent on reaching an agreement. Taxpayers must also be prepared to allocate the necessary

[25] *See also* Internal Revenue Manual 7.40.1; IRM 32.4.3.

[26] FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," (ASC 740-10) is commonly referred to as FIN 48.

time and resources to work with the IRS and respond to information requests during both the PFA and IIR processes. Further, there is no guarantee that the IRS will agree with the taxpayer's position, which could lead to an issue that was resolved through compromise in prior examinations being forced into litigation. In the end, each taxpayer must conduct its own risk and reward analysis. But the current environment — in which the IRS is promoting prefiling and post-filing resolution options — is an opportune time for taxpayers to take a fresh look at dispute prevention and resolution options.[27] ■

[27] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.