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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR KANSAS-MISSOURI DISTRICT COUNSEL

FROM: Kathryn A. Zuba
Chief, Branch 2

SUBJECT: Computation of Annual Income

This document responds to your request for advice dated October 1, 1998. This document is not to be cited as precedent.

ISSUE:

Whether payments made pursuant to a collateral agreement may be deducted in computing "annual income" on Forms 2261, *Collateral Agreement - Future Income* and 3439, *Statement of Annual Income (Individual)*?

CONCLUSION:

Only payments submitted with Form 656, *Offer in Compromise,* are allowed as a deduction in computing "annual income." Payments made pursuant to a collateral agreement (as listed on Forms 2261 or 3439) are not deductible.

FACTS:

Taxpayers wished to compromise certain income tax liabilities. Their proposal included a cash payment accompanying a Form 656 *Offer in Compromise* and payment of future income with a Form 2261 *Collateral Agreement*.[1] In computing

[1] The offer in compromise, Form 656, states that additional agreements requiring the taxpayer to pay a percentage of future earnings may be required before the Internal Revenue Service will compromise a tax liability. See Treas. Reg. § 301.7122-1(d)(3). Where additional consideration is required for acceptance of an offer in compromise, the taxpayer submits a collateral agreement using Form 2261.

their annual income on Form 3439 *Statement of Annual Income (Individual)*, the taxpayer deducted the collateral agreement payments.

LAW AND ANALYSIS:

The position that amounts paid under a collateral agreement are deductible on Form 3439 is based on the conclusion that these payments are "payments made under the terms of the offer in compromise" as provided by item 2 of the Form 2261. Thus, the issue here is whether the collateral agreement is such an integral part of the compromise that the terms of the collateral agreement and the Form 656 should be read together. While this would be one way to structure an offer in compromise, that is not the agreement the Service intended. For the reasons discussed below, we think that the documents signed by the taxpayer can be reasonably construed to support the position that payment made under the collateral agreement are not deductible.

An offer in compromise is a contractual obligation between the Service and the taxpayer, authorized by I.R.C. § 7122. See Robbins Tire & Rubber Co., Inc. v. Commissioner, 52 T.C. 420 (1969). By contrast, a collateral agreement is a one-sided commitment by the taxpayer to enhance his opportunity to obtain an offer in compromise. See IRM 8662(2)(b); IRM Handbook Title 8(13)10 § 123(3). As a non-statutory, administrative device neither entered into nor signed by the Service, a collateral agreement is not contractually binding on the Service. Even though the acceptance of the collateral agreement may be essential to acceptance of the offer in compromise, the two documents are separate and distinguishable.

Since 1963, the Service's position has been that only payments made with the offer in compromise (Form 656) itself, for the year in which such payments are made, are allowed as deductions in computing "annual income." IRM 57(10)(15).5(2)(b)2. Taxpayers may not exclude payments on future income agreements from "annual income" on the collateral agreement, Form 2261. IRM 57(10)(15).4(2). This interpretation is consistent with the language of the forms used by the taxpayer, which indicate that where reference to both is intended, the terms identifying both agreements are used. The terms "offer" or "offer in compromise" are not used in referring to both agreements. [2] Form 2261 was revised in September 1963, specifically to resolve any ambiguity in this regard.
Although a taxpayers' compromise agreement may consist of both an offer in compromise agreement and a collateral agreement, [3] their collateral agreement

[2] For example, items 5 and 7 - 9 on Form 2261 refer disjunctively to "offer in compromise" and "this agreement" (the collateral agreement).

[3] See, e.g., United States v. Lane, 303 F.2d 1 (5th Cir. 1962) (offer in compromise and collateral agreement together make up compromise agreement);

payments are made pursuant to Form 2261, not Form 656. Form 2261 itself defines “annual income” in relevant part as “any payment made under the terms of the offer in compromise (Form 656), as shown in item 5, for the year in which such payment is made.” Thus, Form 2261 limits payments made under the terms of the offer in compromise to Form 656.

Language in Form 3439, used to prepare the statement of annual income required for an acceptable offer in compromise, also supports this interpretation. Line 3(b) of Form 3439 provides a subtraction from annual income for “[p]ayments made under terms of offer on Form 656 during the above tax year (do not include amounts paid on your collateral agreement).” A separate computation of payment due under the collateral agreement is required on Line 5, but this is not a deduction from annual income.

Accordingly, the provision in item #2 on Form 2261, permitting a deduction from annual income of payments made on the offer in compromise, refers only to the payment made in liquidation of the amount of the offer in compromise submitted on Form 656 and not to payments made under the terms of the related future income collateral agreements. The taxpayers thus cannot deduct collateral payments in computing “annual income” on Form 3439.

If you have any questions, please call (202)622-3620.

cc: Deputy Regional Counsel (GL), Midstates Region

Waller v. United States, 767 F. Supp. 1042 (E.D. Cal. 1991) (Form 656 and collateral agreement together treated as offer in compromise).