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

OFFICE OF
CHIEF COUNSEL

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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 reconsideration dated February 18, 1999. 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:

For the reasons stated in our advisory memorandum to you dated January 12, 1999, and the reasons listed below, we believe our position, which reflects long-standing Service policy, is correct. 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. However, because in this case Form 656 was incorrectly filled out to include the collateral payments, the taxpayers in this instance should be allowed to deduct those payments from annual income.

FACTS:

The taxpayers entered into an Offer and Compromise with the Service, using Form 656 (Rev. 9-90). In conjunction with, and as consideration for the acceptance of their offer, the taxpayers made a cash payment. As additional consideration, the

taxpayers agreed to pay a percentage of their future income to the Service. This agreed future payment was memorialized in a collateral agreement on Form 2261, but also listed under item #2 on Form 656. In computing their annual income using Form 3439, the taxpayers deducted the collateral agreement payments.

LAW AND ANALYSIS:

Your original conclusion was that the taxpayers properly computed annual income by deducting the collateral agreement payments. You reached this conclusion because, in your view, the offer in compromise and the collateral agreement together comprise a single, contractual agreement. You observed the sole purpose of the collateral agreement is to provide additional consideration for the offer in compromise, and that such collateral payments often are necessary for the acceptance of a given offer. Because, in this case, payment of the collateral agreement also was listed under item #2 on the offer in compromise Form 656, you argued that the Service is contractually bound to honor the collateral agreement payments as a "payment[s] made under the terms of the offer in compromise." Such payments therefore would be deductible from annual income as provided under item #2 of form 2261.

In our response, we explained that your analysis differed from the interpretation that the Service has long adopted as its policy. This policy, as indicated by IRM 57(10)(15).4, is that a taxpayer may not exclude payments on future income agreements from "annual income" on the collateral agreement, Form 2261.

You have now asked that we reconsider our position. You make three points:

1. Form 2261 states "[t]he purpose of this collateral agreement ... is to provide additional consideration for acceptance of the offer in compromise... ." As consideration is a necessary contractual element, the collateral agreement payments must be a contractual part of the offer in compromise.

2. Payments listed under item #2 of Form 656, including collateral agreement payments, are specifically deducted from annual income by the language of item #2 in Form 2261.

3. Form 2261 does not contain independent default language. If the collateral agreement is not a part of the offer in compromise, the Service could not treat nonpayment of amounts listed in the collateral agreement as a default of the offer in compromise, contrary to current policy.

We agree that neither the Code nor the Regulations definitively answer whether payments made pursuant to Form 6651, Collateral Agreement, are made under the terms of Form 656, Offer in Compromise and, thus, are deductible in computing

annual income. [1] Lacking such legislative guidance, the Service has chosen to exclude such payments as a matter of administrative policy. The rationale for this policy is that, to be consistently enforceable, an offer in compromise must be a complete agreement, standing by itself. Historically, the Service seldom collects amounts listed on a collateral agreement. Because of this, the Service takes the position that it does not want offers in compromise linked to uncollectible, and therefore unenforceable, collateral agreements.

The instructions to Form 656 make clear that the Service intended the OIC be an obligation that is separate and distinct from any collateral agreement. Under "Basis for Compromise," the instructions provide:

> If your offer is acceptable we may require in addition to the above:
>
> (1) a written collateral agreement to pay a percentage of future earnings as part of the offer,
> (2) a written collateral agreement to relinquish certain present or potential tax benefits.

This wording shows that only if the offer is acceptable, i.e., a binding contractual obligation in itself, may a collateral agreement be requested. The collateral agreement was not intended to be a pre-requisite for acceptance of the OIC. Supporting this interpretation is the example provided for calculating the total amount offered in item 2 (item #5 of the "Specific Instructions"). There is no reference to payment of a percentage of future earnings, a relinquishment of tax benefits, or any mention of a collateral agreement.

You cite United States v. Lane, 303 F.2d 1 (5th Cir. 1962) for the proposition that Forms 656 and 2261 comprise one agreement. So the court held. However, the Service recognized that Lane adopted a contrary position on this issue, and consequently Form 2261 was revised in September 1963, specifically to negate the holding in Lane.

As to your third point, item #7 of Form 2261 provides default provisions for the failure to pay any installment of, or not carrying out any provision of, the collateral agreement:

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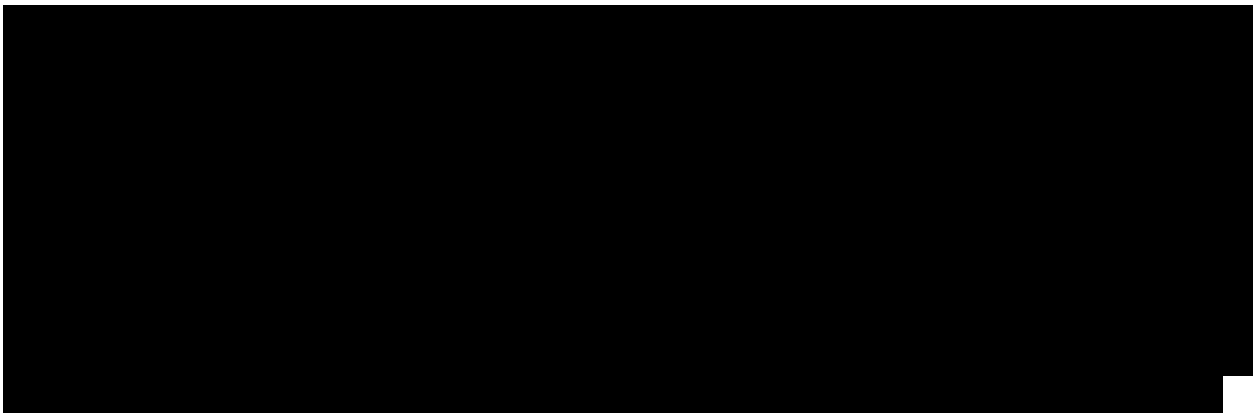
[1] Offers in compromise are authorized by I.R.C. § 7122. Collateral agreements are provided for by Treas. Reg. § 301.7122-1(d)(3), which states, "As a condition to accepting an offer in compromise, the taxpayer may be required to enter into any collateral agreement or to post any security which is deemed necessary for the protection of the interest of the United States."

> [I]n the event of such default or noncompliance ... the United States [may] ... (c) disregard the amount of such offer and this agreement, apply all amounts previously paid thereunder against the amount of the liability sought to be compromised and, without further notice of any kind, assess and collect by levy or suit ... the balance of such liability.

Even here, the offer in compromise is mentioned apart from the collateral agreement. Again, although an argument certainly can be made that the offer in compromise and the collateral agreement are a single contract, the Service has chosen not to adopt that position.



If you have any questions, please call

cc: Deputy Regional Counsel (GL), Midstates Region