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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SB/SE, AREA 7, SEATTLE

FROM: Kathryn A. Zuba
Chief, Branch 2 (Collection, Bankruptcy & Summonses)

SUBJECT: Offer in Compromise -

This memorandum responds to your request for advice dated June 13, 2000. This document is not to be cited as precedent. You have asked our advice as to whether the above referenced taxpayer's tax shelter-related liabilities could be compromised under the Commissioner's new authority to compromise based on the promotion of effective tax administration. We conclude this case does not present exceptional circumstances such that collection of the full tax liability would be detrimental to voluntary compliance by taxpayers.

LEGEND:

X =
Y =
Date 1 =
a =
b =

BACKGROUND:

In 1983, the taxpayer learned of the opportunity to invest in X, a partnership which was itself a partner in several of the nationally marketed Y partnerships. The tax attorney who told him of the investment assured him that the general partners were credible and that the investment was real and substantive as opposed to merely a tax shelter. The taxpayer states that he also sought the advice of his accountant and hired an independent tax attorney to review the materials, and that both advised him that the investment was sound from both a tax and profit potential standpoint. The taxpayer signed on as a limited partner and immediately realized investment tax credits which significantly reduced or eliminated his tax liabilities for 1980, 1981, 1982, and 1983.

In 1988, the taxpayer learned that the Y partnerships were under investigation by the Service and that the investment tax credits would be disallowed. In an attempt to remove the partnership-related items from his return, the taxpayer filed amended returns for the years 1980 through 1985. The Service Center did not process the returns, concluding that the statute of limitations for assessment had run for those years.

In 1989, the taxpayer accepted the Service's settlement offer with respect to the proposed adjustments to the partnership items on his returns. Consistent with this settlement, tax motivated transaction interest under former section 6621(c) was assessed against the taxpayer. In 1996, the taxpayer received a letter outlining the Service's settlement proposal with respect to overvaluation, substantial underpayment, and negligence penalties. Partners accepting the settlement would be assessed only a 10% section 6659 overvaluation penalty. For partners who declined to settle, the letter explained that the Service's litigation position would be that they were liable for both substantial underpayment and negligence penalties. The taxpayer apparently declined to settle, and statutory notices of deficiency were issued shortly thereafter. The taxpayer defaulted on the notices and penalties were assessed in late 1996. As of Date 1 the tax liability totaled more than $a.

The taxpayer has offered to compromise with the Service on terms more favorable than those he declined to accept in 1996. He proposes to pay just over $b in full satisfaction of his liabilities relating to investment in the tax shelter. The collection information statements in the file reveal that this offer represents less than 10% of the current value of his assets, without taking current and prospective income into account. In fact, it is undisputed that the assessed tax liability, including all interest accruals, could be collected in full without causing the taxpayer economic hardship as defined under Treasury regulations. The taxpayer's offer is premised not on any hardship or collectibility grounds, but on the theory that holding him liable for full payment would be unfair and would therefore be detrimental to voluntary compliance.

The taxpayer raises two principal arguments in support of his contention that equity and fairness warrant the acceptance by the Service of less than the previously determined and assessed tax. First, the taxpayer argues that he should not be held liable for penalties or tax-motivated transaction interest because he performed "due diligence" prior to investing in the partnership and signed on as a partner with a legitimate expectation of future profits. Second, the taxpayer argues that the Service erred by failing to process the amended returns he submitted in December of 1988. In addition to these specific allegations, the offer and the supporting documentation imply that the Service should compromise with the taxpayer because he was defrauded by the tax shelter promoters.

In sum, the taxpayer argues that acceptance by the Service of his proposed compromise would promote effective tax administration because collecting the tax in full would be detrimental to voluntary compliance by taxpayers. Your draft memorandum to the offer group concludes that compromise of the taxpayer's tax shelter-related liabilities would not promote effective tax administration. As is explained more fully below, we agree with your conclusion.

DISCUSSION:

The Secretary may compromise any civil or criminal case arising under the internal revenue laws prior to referral to the Department of Justice for prosecution or defense. I.R.C. § 7122(a). Permissible bases for compromise are established by Treasury regulations. Temporary regulations issued July 19, 1999, expanded the Service's authority to compromise beyond the traditional bases of doubt as to collectibility or doubt as to liability. See Temp. Treas. Reg. § 301.7122-1T. Where there are no grounds for compromise on collectibility or liability grounds, a compromise may be entered into to promote effective tax administration, where: (1) collection of the full liability would create economic hardship within the meaning of section 301.6343-1 of the Treasury Regulations; or (2) exceptional circumstances exist such that collection of the full liability would be detrimental to voluntary compliance by taxpayers. Temp. Treas. Reg. § 301.7122-1T(b)(4). No such compromise may be entered into where it would undermine future compliance with the tax laws. Id.

The taxpayer has proposed compromise of this case based on a determination that it would "promote effective tax administration" under the standards articulated in the regulations. The taxpayer argues that even though, as is noted above, the tax liability at issue could be collected in full without causing economic hardship, collection of the full tax liability would be detrimental to voluntary compliance by taxpayers. Where this basis can be established, compromise is authorized regardless of the taxpayer's financial circumstances. See Temp. Treas. Reg. § 301.7122-1T(b)(4)(ii). The regulations do not give a more exact standard or list factors to be considered, but illustrate this basis through two examples. See Temp. Treas. Reg. § 301.7122-1T(b)(4)(iv)(E). The procedures implementing this basis for compromise show that the Service anticipates compromising when collection of the full liability would be unfair or inequitable. See IRM 5.8.11.2.2(3); Form 656, Offer in Compromise (Rev. 1-2000), Instructions at 2.

The taxpayer maintains that his "due diligence" in investigating the partnership before investing demonstrates that his decision to invest was motivated by profit potential. However, his personal profit motive is not relevant to determination of the tax motivated transaction interest he seeks to avoid. Whether a partnership transaction is entered into for profit is determined by the intent of the partnership, based on the intent of the general partners entering into the transaction. See Polakof v. Commissioner, 820 F.2d 321 (9th Cir. 1987); Brannen v. Commissioner, 78 T.C. 741, 501-504 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984). See also Goodwin v. Commissioner, 75 T.C. 424, 437 (1980), aff'd without published opinion, 691 F.2d 490 (3d Cir. 1982); Siegel v. Commissioner, 78 T.C. 659, 698 (1982), acq., 1984-2 C.B. 1 and acq., 1984-2 C.B. 2.[1] As a "partnership item," profit motivation is determined in a partnership level proceeding. Treas. Reg. § 301.6231(a)(3)-1(b); I.R.C. § 6221.

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[1] Similarly, the valuation of partnership assets for purposes of the overvaluation penalty under former section 6659(c) and section 6662(b)(3) is determined at the partnership level. Smith v. Commissioner, T.C. Memo. 1990-510. Such an overvaluation makes tax motivated interest apply under former section 6621(c)(3)(A)(i).

A partner is bound with respect to “affected items” based on the determination of partnership items. Affected items are items that are affected by partnership items. I.R.C. § 6231(a)(5). Affected items include penalties. Temp. Treas. Reg. § 301. 6231(a)(5)-1T. Tax motivated interest under former section 6621(c) is an affected item. White v. Commissioner, 95 T.C. 209 (1990). If a transaction is determined to be a sham at the partnership level because the partnership did not enter into the transaction for profit, tax motivated interest under former section 6621(c) applies irrespective of an individual partner’s personal motive for investing in the partnership. See Thomas v. United States 83 AFTR2d Par. 99-369 (6th Cir. 1999) (section 6621(c) applies because the transactions were shams, regardless of the individual partner’s profit motive). See also Chakales v. Commissioner, 79 F.3d 726, 728 (8th Cir.), cert. denied, 117 S. Ct. 85 (1996); Anderson v. Commissioner, 62 F.3d 1266, 1274 (10th Cir. 1995); Estate of Carberry v. Commissioner, 933 F.2d 1124, 1130 (2d Cir. 1991); Karr v. Commissioner, 924 F.2d 1018, 1026 (11th Cir. 1991); Kozlowski v. Commissioner, 66 T.C.M. (CCH) 754, 755-56 (1993), aff'd, 70 F.3d 1279 (9th Cir. 1995); Klieger v. Commissioner, 64 T.C.M. (CCH) 1624, 1638 (1992).

The taxpayer’s offer makes no effort to dispute any of the foregoing. His offer maintains that these rules are unfair and that his personal profit motive should be taken into account. He is essentially maintaining that Congress has enacted an unfair statutory scheme and that the Service should use its compromise power to rewrite the rules regarding the determination of partnership liabilities. We cannot agree that the authority to compromise under section 7122 is so broad as to allow the Service to disregard or override the considered judgments of Congress.[2] The Service’s procedures for compromise based on the promotion of effective tax administration recognize that the policy choices made elsewhere in the Code must be given due consideration. See IRM Handbook 4.3.21, Exam Offer in Compromise, Section 3.4(3). Where, as here, Congress has enacted an express and comprehensive scheme which dictates a certain result, a decision to categorically disregard that scheme would be beyond the Service’s authority.

As is mentioned above, the taxpayer attempted to amend his returns to remove most of the investment tax credits related to his investment in the subject partnership. Upon receipt of the amendments, the Service Center concluded that the statute of limitations prevented amendment of the returns in question. The taxpayer and the offer examiner

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[2] An analogy to bankruptcy law may help illustrate this point. Congress has granted bankruptcy courts the power “to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].” 11 U.S.C. § 105(a). However, the Supreme Court has held that even this broad grant of power does not exist in a vacuum and cannot be used to disregard or circumvent specific Bankruptcy Code provisions. See Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (stating that a bankruptcy court’s equitable powers “must and can only be exercised within the confines of the bankruptcy code”). It is logical to conclude that the Secretary’s discretionary compromise authority is similarly constrained.

have correctly pointed out that the statute of limitations for assessment of the items the taxpayer sought to amend was held open by the on-going partnership level proceeding. However, it does not follow from this conclusion regarding the statute of limitations that the amended returns should have been processed. The Code requires that all partnership items on an individual partner's return be treated in a manner consistent with the position taken on the partnership return. See I.R.C. § 6222(a). A partner who wishes to amend partnership items can request to do so by filing an administrative adjustment request with the Service within three years of the filing of the partnership return and prior to the issuance of a final partnership administrative adjustment (FPAA) to the tax matters partner. See I.R.C. § 6227(a) & (d). After the time for filing an administrative adjustment request has expired, an individual partner can make a deposit to stop the accrual of interest, but only in the manner specified by Announcement 86-114, 1986-47 I.R.B. 46. Because the taxpayer did not file an administrative adjustment request (Form 8082) with his return, and did not comply with the deposit procedures of Announcement 86-114, the amended returns should not have been processed.[3]

Finally, we address the claim that the fraudulent acts of the tax shelter's general partners create a basis for compromise of this case. We cannot agree with this premise. In directing the Service to consider additional bases for compromise in order to promote effective tax administration, Congress gave no indication that it intended that the Service would adopt a standard under which the Government would act as an insurer or would relieve taxpayers of those risks attendant to business and financial transactions. The regulations expanding the Commissioner's compromise authority are also inconsistent with this idea. They give two examples of potential compromises based on the conclusion that collection would be detrimental to voluntary compliance by taxpayers. In the first, a taxpayer is incapacitated and unable to comply with the tax laws. Upon regaining his ability to do so, the taxpayer immediately attends to his tax obligations. In the second, the taxpayer incurs a liability when he relies on erroneous advice by the Service and it is clear that he could have, and would have, avoided the liability had the advice been correct. See Temp. Treas. Reg. § 301.7122-1T(b)(4)(iv)(E).

Compromise due to the acts of third parties beyond the control of the Service, particularly acts by a taxpayer's partners, employees, or other fiduciaries, is a departure from these examples. In both of the examples in the regulations, the implicit assumption is that the taxpayer would have complied but for some occurrence over which he had no control. That is not so in this case. Here the taxpayer's liability arose out of sham transactions in which he chose to participate as a partner. Regardless of whether the taxpayer knew or had reason to know that the general partners were making misrepresentations or would later fail to perform on their obligations as promised, the taxpayer was the individual in the best position to evaluate those risks.

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[3] It is our understanding that the payment made at the time the taxpayer submitted the amended returns has since been applied as the taxpayer initially instructed, and that interest accruals have been adjusted accordingly.

Under these circumstances, we do not agree that collection would be detrimental to voluntary compliance by taxpayers. To the contrary, compromise on the basis of the general partners' fraud would place the Government in the role of an insurer against poor business decisions by taxpayers, reducing the incentive for taxpayers to thoroughly investigate the consequences of transactions. For the Service to play that role would be particularly inappropriate when the transaction at issue is participation in a tax shelter. Reducing the risks of participating in tax shelters would encourage more taxpayers to run those risks, thus undermining, rather than enhancing, compliance with the tax laws. See Temp. Treas. Reg. § 301.7122-1T(b)(4)(ii) (no compromise based on the promotion of effective tax administration may be entered into where it would undermine compliance with the tax laws). Compromise in this case could also seriously undermine the Service's ongoing efforts to settle large tax shelter litigation on a consistent basis. See I.R.C. § 6224(c) (requiring that consistent settlements be offered to all partners). For these reasons, compromise under these circumstances could not be said to "promote effective tax administration."

If you have any questions, please contact the attorney assigned to this matter at (202) 622-3620.