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*AUGUST 2001* *BULLETIN NO. 491*

# COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

Department of the Treasury **Office of Chief Counsel** Internal Revenue Service

## *Objection to Jurisdiction Lost by Delay*

By failing to object before the bankruptcy court to its retention of jurisdiction over the debtor's action to determine tax liability, the Government waived the right to contest jurisdiction on appeal, according to the Ninth Circuit in **Kieslich v. United States, 2001 U.S. App. LEXIS 17215 (9th Cir. Aug. 2, 2001)**.

The debtor filed for Chapter 7 bankruptcy in 1986. In 1988, the Service filed a proof of claim for unpaid 1984 and 1985 income taxes, which claim was later denied as time-barred after the trustee objected. The debtor then brought successive actions to determine his tax liability, one of which was pending at the time his bankruptcy case was closed in 1992. Although the debtor received a discharge, his tax debt was nondischargeable under B.C. § 523(a)(1)(A).

In 1996, the bankruptcy court found the debtor was not liable for the tax deficiency. The United States appealed, and before the district court for the first time challenged the subject matter jurisdiction of the bankruptcy court. The district court remanded to the bankruptcy court for the purpose of determining its subject matter jurisdiction. The bankruptcy court held that it properly had continued jurisdiction over the debtor's suit. The Government again appealed, and the district court reversed, holding that the bankruptcy court lacked jurisdiction. The debtor then appealed to the Ninth Circuit.

The Ninth Circuit reversed, holding that the Government waived its right to contest jurisdiction due to its failure to raise the issue at the trial level. The Ninth Circuit reasoned that a district court has discretion to retain supplemental jurisdiction over state law claims even where the federal claim is resolved, and a party must object to such retained jurisdiction at the trial level. The Ninth Circuit considered the bankruptcy court's retention of jurisdiction in this case to be subject to the same rule. The court thus held that the Government waived its objection to the bankruptcy court's discretionary exercise of jurisdiction over related suits by failing to raise it before the bankruptcy court.

**BANKRUPTCY CODE CASES: Jurisdiction of Bankruptcy Court**

***Nonacquiesce in Collection Due Process Case***

**ACTION ON DECISION**

The Commissioner DOES NOT ACQUIESCE in the following decision:

SUBJECT: Mesa Oil, Inc. v. United States
86 A.F.T.R.2d (RIA) 7312 (D. Colo. 2000)

**Issue:** Whether a verbatim recording of a Collection Due Process hearing is required under I.R.C. §§ 6320 and 6330 to create a judicially reviewable administrative record.

**Discussion:** Mesa Oil, Inc., a corporation engaged in processing used oil for industrial use, was delinquent in paying its payroll taxes for several quarters. In an attempt to collect the unpaid taxes, the Service filed a notice of federal tax lien and issued to Mesa Oil a Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC 6320. The Service also issued to Mesa Oil a Notice of Intent to Levy and Your Right to a Hearing. Mesa Oil requested and was given a CDP hearing by the IRS Office of Appeals on the filing of the notice of federal tax lien. Appeals issued Mesa Oil a notice of determination sustaining the lien filing, from which, pursuant to section 6330(d), Mesa Oil appealed to the district court. The district court held the administrative record to be inadequate for judicial review under section 6330(d)(1)(B), because "no record of the hearing was kept, no record of the evidence or arguments presented at that hearing was made, and no analysis of the evidence or arguments was presented in the determination." The district court ordered that the record on remand "may be made" either through audiotape, videotape or stenographic transcription.

We do not believe that sections 6320 and 6330 require a CDP hearing to be recorded verbatim. Congress did not intend CDP hearings to be conducted in a manner different from proceedings with Appeals instituted prior to the passage of the IRS Restructuring and Reform Act of 1998. Davis v. Commissioner, 115 T.C. 35, 41 (2000) ("The references in section 6330 to a hearing by Appeals indicate that Congress contemplated the type of informal administrative Appeals hearing that has been historically conducted by Appeals and prescribed by section 601.106(c), Statement of Procedural Rules"); see H.R. Conf. Rep. No. 105-599, pp. 290-291. The fundamental purpose of proceedings with Appeals is to provide an informal setting in which taxpayers and appeals officers can resolve tax issues. To maintain a productive informal forum for the resolution of tax issues, these procedures do not include a verbatim recording requirement and should not now include such a requirement for CDP hearings.

To the extent the district court in this case intended to hold that CDP hearings must be recorded by videotape, audiotape or stenographic transcription, we disagree. CDP hearings should be carefully documented by appeals officers in determination letters and case memoranda which, with any documents provided by the taxpayers or otherwise obtained by the appeals officers, will constitute the record for review by the court.

**COLLECTION DUE PROCESS; IMPARTIALITY**

# CASES

1. **BANKRUPTCY CODE CASES: Allowance of Claims: Objections**

**<u>In re Sousa</u>, 2001 Bankr. LEXIS 974 (B.A.P. 1st Cir. Jul. 19, 2001)** - Debtor in Chapter 13 bankruptcy filed objection to Service's timely filed proof of claim, but did not serve U.S. Attorney or Department of Justice with notice of hearing. The bankruptcy court ruled that, since the Service had actual notice of the hearing (since the debtor had spoken with a Special Procedures employee about it), it would sustain the objection to the proof of claim. The B.A.P. reversed, holding that as the United States is the real party in interest, service must be properly effectuated to grant the bankruptcy court jurisdiction. Notice to the Service through its Special Procedures staff does not cure the jurisdictional defect, the court held, and any judgment entered without proper service is void.

2. **BANKRUPTCY CODE CASES: Exceptions to Discharge: No, Late or Fraudulent Returns**

**<u>In re Rushing</u>, 2001 Bankr. LEXIS 958 (Bankr. D. Az. Jul. 10, 2001)** - The debtor failed to file tax returns for 1983 - 86, so the Service prepared substitute returns. As part of a subsequent offer in compromise, the debtor submitted returns for those years. After filing for bankruptcy, the debtor moved to determine the dischargeability of its tax debt under B.C. § 523(a)(1)(B). Under the <u>Beard</u> test (<u>Beard v. Commissioner</u>, 82 T.C. 766 (1984)), a document must represent an honest and reasonable attempt to satisfy the requirements of the tax law (among other requirements). Although the court refused to hold as a matter of law that after the Service has prepared a substitute return and assessed a deficiency, a debtor never can meet the "honest and reasonable" requirement, the court found that a return submitted with an OIC based on doubt as to collectibility does not have a tax consequence. Consequently, the debtor's submission of the returns with his proposed OIC was not an "honest and reasonable" attempt, and the taxes were nondischargeable.

3. **BANKRUPTCY CODE CASES: Proofs of Claim**

**<u>In re Pattullo</u>, 2001 U.S. App. LEXIS 15689 (9th Cir. Jul. 11, 2001)** ***(unpublished)*** - In debtor's Chapter 7 case, the Service stipulated to the amounts of its secured and unsecured claims, which did not include interest. The debtor later filed a Chapter 13 case, and the Service objected, claiming the debtor exceeded the jurisdictional limitations under B.C. § 109(e). The Ninth Circuit, upholding the lower courts, found the doctrine of claim preclusion bound the Service to its earlier stipulation. The court found the same claim was involved in both cases, finding the Service could have performed a more thorough investigation of the debtor's collateral in the Chapter 7 case. The appeals court also affirmed that the Service was not entitled to interest not claimed in the earlier case. Although the Service would not have been entitled to the interest in the Chapter 7 proceeding, it could

have included the post-petition pre-stipulation interest in the stipulation. By not doing so, the Service waived its claim to the interest.

4. **BANKRUPTCY CODE CASES: Setoff**
**In re Kadrmas, 2000 Bankr. LEXIS 1764 (Bankr. W.D. Wis. Sep. 19, 2000)** - Debtors argued that the Service was not entitled to setoff their exempt, discharged tax refund. The court, after determining the Service had a valid right of setoff under B.C. § 553(a), held that a creditor's pre-petition right to setoff is unaffected by a debtor's discharge. The court also reviewed cases weighing whether a debtor's right of exemption under section 522(c) trumps the Service's right of setoff. The court concluded that although the majority of cases favor exemption, the better reasoned cases favor setoff. Since a creditor's setoff right is not defeated by exemption under section 542(b) while in bankruptcy, the setoff right is not defeated by exemption under section 553(a) after discharge.

5. **BANKRUPTCY CODE CASES: Subordination (§ 510)**
**Freeland, Trustee v. I.R.S. (In Re White Trailer Corp.),88 AFTR2d ¶ 2001-5144 (N.D. Ind. July 12, 2001)** - Payment for debtor's merchandise, including collected excise taxes, was made to bank lockbox. The bank applied all monies to its outstanding loan, instead of forwarding the taxes to the Service, so the Service filed a claim for the unpaid taxes against the debtor. The trustee argued that as the Service did not pursue collection against the bank, its claim should be equitably subordinated under B.C. § 510(c)(1). The district court, affirming the bankruptcy court, disagreed. The court first found that inequitable conduct by the Government was necessary to subordinate an excise tax claim. Because the Government had a priority claim to the funds in the lockbox, and because the Government did not delay in asserting its claim for the unpaid taxes, the court found no misconduct. Further, the court held that equitable subrogation as suggested by the trustee was inconsistent with the provisions of the Bankruptcy Code, as set out by United States v. Noland, 517 U.S. 535 (1996).

6. **COLLECTION DUE PROCESS**
**Watson v. Commissioner, T.C. Memo 2001-213 (Aug. 10, 2001)** - Court imposed sanctions against taxpayer whose only substantive claim was that he had no tax liability because his tax indebtness had been assumed by the Federal Government. The court also found that the taxpayer had received a notice of deficiency based on a signed return receipt, discounting the taxpayer's assertion that he did not sign the receipt.

7. **COLLECTION DUE PROCESS: LAST KNOWN ADDRESS**
**Lopez v. Commissioner, T.C. Memo 2001-228 (Aug. 20, 2001)** - Service sent Notice of Intent to Levy and Notice of Right to a Hearing to taxpayer's last known address, based on the taxpayer's last filed (1997) return. The taxpayer had sent in a 1998 return with a different address 32 days previously, but it was incomplete.

The taxpayer did not timely request a CDP hearing (although he received an equivalent hearing), and the taxpayer challenged the Service's proposed levy. The court held it lacked jurisdiction to hear the taxpayer's petition because there was no Notice of Determination (from the equivalent hearing) and the notice provided to the taxpayer's 1997 address was sufficient under I.R.C. § 6330.

**8. DAMAGES, SUITS FOR: Against U.S.: Failure to Release Lien**

**Thomson v. United States, 2001 U.S. Dist. LEXIS 12940 (S.D. Fla. Jul. 27, 2001)** - Taxpayer brought suit against United States, claiming an installment agreement where the Service agreed not to file a tax lien against his business. The court dismissed the suit on the grounds of sovereign immunity, finding no cause of action under I.R.C. § 7432 because the taxpayer's liability was not satisfied or legally unenforceable, nor had the taxpayer filed a bond. The court further found the taxpayer's bare allegation that all administrative remedies were exhausted was insufficiently specific to meet the standards of sections 7432 and 7433. Finally, the court found no cause of action under section 6159 because the alleged installment agreement was not in writing, nor under section 6331(k)(2) because the Service filed a lien, not a levy.

**9. LEVY: Forcible Entry**
**SUITS: Against the U.S. or Employees: Tort Suits**

**Rogers v. Vicuna, 2001 U.S. App. LEXIS 19200 (1st Cir. Aug. 28, 2001)** - Taxpayer brought suit under I.R.C. § 7433 against revenue officers who seized his car. The First Circuit determined that IRS agents who enter private property where the taxpayer's vehicle is clearly visible from the street on an unobstructed driveway need no court warrant to seize the vehicle, but may rely on administrative levy.

**10. PAYMENT: Application of Payment**
**TRUST FUND TAXES: Collection**

**Norwalk Liquidating, Inc. v. United States, 2001 U.S. Dist. LEXIS 10722 (N.D. Ohio Jun. 21, 2001)** - Liquidating corporation assessed with taxes, including trust funds taxes, entered into informal installment payment agreement. The debtor then requested an abatement of penalties and interest, asserting that it had reasonable cause for late payment under I.R.C. § 6651(a) and § 6656. The Service disallowed the claims, and the court agreed. Although the debtor urged the court to follow the case-by-case analysis set out by the Second and Third Circuits, the court considered itself bound by the bright line test espoused by the Sixth Circuit in Brewery, Inc. v. United States, 33 F.3d 589, 592 (6th Cir. 1994), which held that financial difficulties can never constitute reasonable cause for nonpayment of withholding taxes by an employer. The debtor also argued that the tax payments were improperly allocated to penalties and interest rather than to the trust fund taxes. The court found the debtor offered no evidence that it had designated, in writing, how the payments were to be applied. Even if it had, the court pointed out,

the Service likely would have levied on the funds, making the payments involuntary and subject to the Service's allocation.

**11. PENALTIES: Failure to Collect, Withhold or Pay Over: Willfulness**
**TRUST FUND TAXES**

In re Nutt, **88 AFTR2d ¶ 2001-5235 (Bankr. M.D. Fla. Aug. 2, 2001)** - Corporate owner who did not participate in daily business operations was assessed with the Trust Fund Recovery Penalty. The owner did not have actual knowledge of the payroll tax delinquency until October 1995, and after that date there were no unencumbered funds with which to pay the taxes, nor did the Service prove the owner knew of creditor payments from unencumbered funds after that date. The court held that as the company had no prior record of tax delinquency, and that when the owner had actual knowledge of the delinquency he made payments and contacted the Service to work out a payment plan, the owner was not willful. The objection to the Service's claim for trust fund taxes was sustained.

**12. SUMMONSES: Privileges: Accountant-Client**

Cavallaro v. United States**, 2001 U.S. Dist. LEXIS 11232 (D. Mass. July 27, 2001)** - Service issued a third-party recordkeeper summons to an accounting firm to obtain documents involving the tax consequences of a merger between two closely-held businesses. The principals of the businesses moved to quash the summonses, arguing that the communications were privileged. As this case predated the 1998 amendment to I.R.C. § 7525(a), the court examined the judicial doctrine of accountant/client privilege, where a communication is made in confidence for the purpose of obtaining legal advice from a lawyer. The court found no evidence that the taxpayers' law firm hired the accounting firm in question, nor that the taxpayers hired the accounting firm to assist in obtaining legal advice from the law firm. The court also considered the taxpayers' contention that a privilege existed pursuant to the "common interest" doctrine, where a communication between two or more clients with a common interest in a matter agree to exchange information on the matter, and are represented by separate counsel. The court found that the taxpayers were not all represented by counsel, and consequently the common interest doctrine did not apply. The court thus denied the motion to quash.

**13. SUMMONSES: Third Party: Right to Intervene or Proceeding to Quash**

United States v. Arnold**, 2001 U.S. Dist. LEXIS 10720 (M.D. Fla. Jul. 9, 2001)** - Court denied motion to quash third-party recordkeeper summonses, brought by attorney and accountant of taxpayer. The court held that: 1) although the third parties could intervene in a proceeding to challenge a third-party summons, they had no independent right to bring such a suit; 2) the attorney and accountant lived in a different judicial district than the court where the petition to quash was filed and 3) the Service stated that the summonses were issued to aid in the collection of tax liability. The court thus lacked subject matter jurisdiction over the petition to quash.

Finally, the court denied the third parties' motion for a protective order, finding no privilege in the fee information they sought to protect.

The following material was released previously under I.R.C. § 6110. Portions may be redacted from the original advice.

# CHIEF COUNSEL ADVICE

**OFFER-IN-COMPROMISE; PROCEDURES FOR COUNSEL REVIEW**

July 2, 2001

CC:PA:CBS:Br2FWSchindler
GL-103449-00
UILC: 17.24.01-00

MEMORANDUM FOR ALL AREA COUNSEL (SB/SE)

FROM: Deborah A. Butler
Associate Chief Counsel
(Procedure and Administration)

SUBJECT: Chief Counsel Notice CC-2001-036, Counsel Opinion in Offer in Compromise Cases

Internal Revenue Code section 7122(a) grants the Secretary the authority to compromise civil or criminal liabilities arising under the internal revenue laws. Ever since that authority was granted, the Code has required that an opinion of Counsel be placed on file in certain cases. See I.R.C. § 7122(b). Chief Counsel Notice CC-2001-036, issued June 29, 2001, sets forth procedures to be followed by Associate Chief Counsel (SB/SE) offices when issuing the statutorily required opinion. This memorandum provides background information that was considered in drafting the Notice. We encourage you to share this information with local offices where review of offers in compromise is performed.

## INTRODUCTION

On July 19, 1999, temporary regulations were issued which expanded the Secretary's authority to compromise tax liabilities under section 7122. See T.D. 8829, Compromises, 64 Fed. Reg. 39020 (July 21, 1999). In addition to the traditional compromise grounds of doubt as to liability and doubt as to collectibility, the temporary regulations authorize the Secretary to compromise when compromise will promote effective tax administration. Specifically, where there is no doubt as to either liability or collectibility, the Service may now compromise on the basis that: 1) collection of the full tax liability would create

economic hardship, or 2) regardless of the taxpayer's financial condition, exceptional circumstances exist such that collection of the full liability would be detrimental to voluntary compliance by taxpayers. See Temp. Treas. Reg. § 301.7122-1T(b)(4).

Since publication of those regulations, questions have arisen regarding the opinion of Counsel when the Service proposes acceptance grounded on the promotion of effective tax administration. At the same time, the Service's increased reliance on compromise as the preferred method of resolving cases has given rise to a number of questions about the role of the Office of Chief Counsel in the offer in compromise program as a general matter. Issues that have arisen include: 1) what form the required opinion of Counsel is to take when asked to review offers in compromise based on the promotion of effective tax administration; 2) whether a negative opinion of Counsel in such cases would preclude acceptance of the offer by the Service; 3) whether Counsel must issue a negative opinion in collectibility cases if the Service proposes acceptance of less than what could otherwise be collected; and 4) whether and to what degree Counsel offices should question offer groups' deviation from Internal Revenue Manual methods or from Service policies in general.

The Chief Counsel Notice is intended to provide clarity on these issues. Although an opinion of Counsel is statutorily required in certain cases, the form and content of that opinion, as well as the force and effect it should be given, are matters which are within the discretion of the Secretary and the Commissioner. The Notice defines Counsel's role in the offer in compromise program with the goals of supporting the Commissioner's compromise policy, improving the quality of the program as a whole, and assisting our client by providing the legal support needed to resolve cases in an efficient and timely manner.

## SECTION 7122(b) AND ITS LEGISLATIVE HISTORY

The Internal Revenue Code requires an opinion of Counsel when certain compromises are made, and establishes the minimum requirements as to what that opinion should contain. The Code provides:

> Record.–Whenever a compromise is made by the Secretary in any case, there shall be placed on file in the office of the Secretary the opinion of the General Counsel for the Department of the Treasury or his delegate,[1] with his reasons therefor, with a statement of—
>
> (1) The amount of tax assessed,

[1] The General Counsel for the Treasury has delegated the functions relative to the review of offers in compromise to the Chief Counsel of the Internal Revenue Service. See General Counsel Order No. 4. (Rev. January 19, 2001).

> (2) The amount of interest, additional amount, addition to the tax, or assessable penalty, imposed by law on the person against whom the tax is assessed, and
>
> (3) The amount actually paid in accordance with the terms of the compromise.
>
> Notwithstanding the foregoing provisions of this subsection, no such opinion shall be required with respect to the compromise of any civil case in which the unpaid amount of tax assessed (including any interest, additional amount, addition to the tax, or assessable penalty) is less than $50,000. However, such compromise shall be subject to continuing quality review by the Secretary.

I.R.C. § 7122(b).

The procedure for obtaining review of offers recommended for acceptance is contained in the Service's IRM Handbook 5.8, Offers in Compromise, Chapter 8, and in the Chief Counsel Directives Manual, Part 34, Chapter 5 (CCDM 34.5). The opinion of Counsel is sought after a recommendation of acceptance has been made but prior to formal acceptance of the offer by the official with delegated authority to accept. IRM 5.8.8.4.3. The Service expects that Counsel's opinion will assess both whether the legal requirements for compromise are met and whether the offer conforms to the Service's policies and procedures. IRM 5.8.8.2(2).

The language of section 7122(b) requires that certain information about the case be included with Counsel's opinion, but it does not give any precise instruction as to what else the opinion should address. The legislative history of the section is even less clear, but does support the notion that Counsel's review will include both legal and policy elements. The idea that the Counsel opinion need not favor compromise is clearly supported by this history, even though the phrase, "with his reasons therefor," implies that the General Counsel will give reasons supporting the decision to compromise. During consideration of the predecessor section to 7122(b), Congress removed language which would have made the concurrence of Counsel a prerequisite to compromise. Section 102 of the Act of July 20, 1868, initially required "the advice and consent of the Solicitor of Internal Revenue" prior to compromise by the Commissioner. <u>See</u> J.S. Seidman, <u>Seidman's History of the Federal Income Tax Laws 1938-1861</u> 1055-56 (1938). The phrase "with his reasons therefor" initially modified "advice and consent," indicating that the solicitor was to give reasons supporting his consent to the compromise. In subsequent debate it was acknowledged that removing the requirement of consent by the solicitor while continuing to require that an opinion be placed on file after the compromise was made resulted in an

"awkward" construction, but no change was made prior to enactment. See Comments of Senator Morton, Cong. Globe, 40th Cong., 2d Sess. 3774 (July 7, 1868).[2]

Other parts of the legislative history suggest that the dual legal and policy role of Counsel is consistent with the intent of the statute. Although it would be reasonable to assume that an opinion by the General Counsel would be legal in nature, Congressional debate suggests that the original purpose of requiring the written opinion of the solicitor was to prevent compromise based on insufficient information. The Senate debate showed concern over both abuse and fraud by taxpayers against the government and abuse and fraud against taxpayers by government officials. One of the stated purposes of requiring that the opinion of the solicitor be placed on file was to ensure that the Commissioner had all of the facts before him. The Commissioner of Internal Revenue was not to make a compromise until after a full and fair investigation. Congress apparently believed it would be good for the compromise process to have a "check" from a source not connected with the assessors and collectors of Internal Revenue. Not that the solicitor was deemed less subject to corruption than the collector and assessor of internal revenue, but it was felt that it would be more difficult to corrupt all three. See Comments of Senator Turnbull, Cong. Globe, 40th Cong., 2d Sess. 3773 (July 7, 1868).

Excerpts from the discussion on this section suggest that Congress was aware that the modified version of the proposed statute made the opinion of the solicitor gratuitous. The Commissioner was required to obtain the assent of the Secretary of the Treasury prior to compromise, but the opinion of the solicitor need only be placed on file after a compromise was made. Thus, the opinion of Counsel would have no effect on the decision to accept or reject an offer to compromise, and could only act as a "check" on the compromise power to the extent the Commissioner was concerned about what the opinion later placed in the record might say. Although there was discussion in the Senate to the effect that it would be more sensible to require that the opinion be rendered before a compromise is accepted, the language was not changed prior to enactment and subsequent revisions of the section

[2] In further support of the idea that a favorable opinion by Counsel is not a prerequisite to compromise, at least one court has concluded that the lack of a Counsel opinion does not render the compromise invalid. See Backus v. United States, 59 F.2d 242, 256 (Ct. Cl. 1932). The court found that, since the provision requires an opinion of Counsel after the compromise has been made, "[i]t is addressed to the officer and is directory, and a failure to comply therewith would not affect the compromise itself or its validity." Id. See also Hamilton v. United States, 324 F.2d 960, 965 (Ct. Cl. 1963) (concurring opinion). If a legally binding compromise can be executed without the need of a Counsel opinion, notwithstanding the requirement in the statute, it is difficult to conclude that a negative opinion by Counsel would prevent compromise, unless the opinion stated that the case could not be compromised at all under the existing statute and regulations.

have not specified that Counsel's opinion be placed on file prior to acceptance of the compromise. See Seidman, supra.

The change made in section 7122(b) in 1996, as part of the Taxpayer Bill of Rights 2 (TBOR2), is the most recent hint as to the role Congress intends Counsel to play in the compromise process. The amount of assessed tax below which an opinion of Counsel is not required was raised from $500 to $50,000 and the final sentence, reading "However, such compromise shall be subject to continuing quality review by the Secretary," was added. The conference report gave no indication as to why the change was made, but the insertion of the final sentence makes it reasonable to assume that Congress believed Counsel review in some way contributed to the overall quality of the compromise program. However, no indication was given as to how or in what way Congress intended Counsel to contribute to the compromise process.

These few indications of the Congressional intent behind section 7122(b) do not provide any particular clarity as to the meaning of the section. The review criteria in the CCDM are, however, consistent with the concerns expressed by Congress in its debate of the original measure, and with the sentence added in 1996. Counsel review that is focused on both the authority to compromise and a full development of the facts is in keeping with Congress's apparent belief that a "check" on the system would guard against corruption, insure that the accepting official is fully informed, and contribute to the overall quality of case resolutions.

## TRADITIONAL ROLE OF COUNSEL IN OFFERS IN COMPROMISE

The scope of the section 7122(b) opinion has traditionally tracked the Service's understanding of the legal bounds of the compromise authority. Arguably, Counsel's review has failed to adjust as our understanding of the legal requirements for compromise has evolved. Based principally on various opinions of the Attorney General, the Service had long taken the position that compromise is authorized only when it is established that there is doubt regarding the amount or existence of the liability or there is uncertainty that the liability could be collected. See generally T.D. 8829, Compromises, 64 Fed. Reg. 39020, 39021-22 (July 21, 1999) (discussing evolution of offer in compromise authority and policy from 1930's to 1990's). In response to a request from Acting Secretary of the Treasury Acheson, Attorney General Cummings considered the scope of the Secretary's authority to compromise, concluding that "where liability has been established by a valid judgment or is certain, and there is no doubt as to the ability of the government to collect, there is no room for 'mutual concessions' and therefore no basis for 'compromise.'" Op. Atty. Gen. 6, XIII-47-7138 (October 24, 1933).

Relying upon this opinion and others which had reached similar conclusions,[3] the Commissioner adopted a policy of compromising only on the bases of doubt as to liability or collectibility. See Commissioner's Statement of Policy with Respect to the Compromise of Taxes, Interest, and Penalties, July 2, 1934. See also Treas. Reg. § 301.7122-1(a) (1960). The Commissioner's statement of policy also provided that the acceptability of an offer to compromise should be determined with regard to the "degree" of doubt present in a particular case. This policy was implemented within the Service by adopting a practice of accepting offers based on doubt as to collectibility only when the amount offered reflected the taxpayer's "maximum capacity to pay."

Pursuant to this 1934 statement of policy, Counsel generally reviewed proposed agreements to verify that the amount offered reflected the maximum capacity to pay. Offers were not regarded as "legally sufficient" unless the maximum capacity to pay standard was met. The Form 7249, Offer Acceptance Report, was revised in 1993 to include a statement that could be checked to indicate that the offer was legally sufficient, thus eliminating the need to place a separate narrative opinion on file. The text of that statement illustrates that doubt as to collectibility and legal sufficiency were defined in near identical terms at that time:

> Doubt as to collectibility. This offer is consistent with the taxpayer's ability to pay, since the offer amount is greater than the value of the taxpayer's current collectable assets. Based upon the taxpayer's projected future income, the Service believes collection of the remaining liability is in doubt.

Form 7249, Offer Acceptance Report (Rev. 6-93) (emphasis added). If the basis for compromise was doubt that any greater amount could be collected, then any offer for less would not only fall short of the standard for acceptance, but would also appear to be ineligible for compromise based on collectibility as a legal matter.

In the early 1990's, the Service began an effort to expand the use of offers in compromise. This led to the adoption of a new compromise policy in 1992. While continuing to base the compromise of cases on a finding of doubt as to liability, doubt as to collectibility, or both, the policy removed references to the "maximum capacity to pay" standard in favor of language stating that a compromise may be accepted if it "reasonably reflects collection potential." Policy Statement P-5-100. This change in terminology was intended to recognize that the collection potential of a case could not always be determined with precision, and to signal a willingness to be flexible in resolving cases. The general rule with regard to acceptances remained unchanged, however, and taxpayers were still expected to make offers consistent with their ability to pay.

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[3] See, e.g., Op. Atty. Gen. 7, XIII-47-7140 (October 2, 1934); 16 Op. Atty. Gen. 617 (1879); 12 Op. Atty. Gen. 543 (1868).

At about the same time, the Office of Chief Counsel made clear its position that collectibility, or lack thereof, is defined by examining the taxpayer's case as a whole. Once it is determined that the taxpayer's assets and future income are insufficient for the government to collect the tax liability in full, the amount accepted to settle the controversy is a matter within the Service's discretion.[4] The Commissioner's delegation of authority was eventually revised to permit certain officials to accept offers from taxpayers notwithstanding the fact that the offer may not reflect the amount that could be collected by other means. This authority, however, was expressed by reference to whether Counsel had issued a negative opinion regarding the legal sufficiency of the proposed acceptance:

> District directors; service center directors; Director, Austin Compliance Center; and Regional Directors of Appeals are delegated the authority to accept offers in compromise in the event Counsel renders a negative legal opinion, regardless of the amount of the liability sought to be compromised. This applies only to offers in compromise - Doubt as to Collectibility. This authority may not be redelegated.

See Delegation Order No. 11 (Rev. 24) (June 21, 1994). Acceptances of an offer for less than full collection potential came to be known as "Delegation Order 11" acceptances. Although the text of the delegation implies that Service officials could accept offers regardless of any negative opinion by Counsel, internal guidance encouraging the use of this authority made clear that this authority could only be used when a basis for compromise had been established.

Current Service procedures authorize acceptance of less than reasonable collection potential to resolve a case when it is necessary to avoid economic hardship. Such cases are now called "special circumstances" cases. The delegation order was revised in 1999 to add a delegation of authority to accept offers based on the promotion of effective tax administration. At that time, a decision was made to specifically delegate the authority to accept offers based on special circumstances criteria, rather than to define the authority by reference to the negative opinion of Counsel. See Delegation Order No. 11 (Rev. 27) (November 1, 1999) (delegating authority to accept offers based on special circumstance criteria to District Directors, Deputy Assistant Commissioner (International), and Chiefs of

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[4] We do not believe that this conclusion was intended to imply that the Service is authorized to resolve all cases that could not be collected in full for merely nominal sums or that the compromise statute authorized the creation of an ad hoc amnesty program. Rather, it is an unspoken assumption that compromise authority will only be exercised in a manner consistent with the Service's other obligations under the Code and in furtherance of its overall mission. See, e.g., I.R.C. § 6301 ("The Secretary shall collect the taxes imposed by the internal revenue laws."); Policy Statement P-5-2, Collecting Principles ("The public trust requires us to ensure that all taxpayers promptly file their returns and pay the proper amount of tax, regardless of the amount owed.").

Appeals); IRM 5.8.8.3 (explaining special circumstances criteria and acceptance authority).

The Commissioner's expanded delegation of authority had not previously been met with a corresponding change in the procedures for Counsel review. Although the CCDM recognized that an affirmative opinion by Counsel is not a prerequisite to compromise, the procedures continued to imply that Counsel must issue a negative opinion whenever the Service intended to accept less than reasonable collection potential, even where the area director identified special circumstances which warranted the acceptance of some lesser amount. Thus, some Counsel offices continued to issue opinions to the effect that offers were "legally insufficient," even though all of the legal requirements for compromise had been met and any disagreements were grounded in policy concerns.

## CHIEF COUNSEL NOTICE CC-2001-036

The Chief Counsel Notice makes clear that Counsel's review consists of both legal and policy elements. The legal standard for establishment of each basis for compromise, as defined by the regulation, is briefly stated. The revised procedure calls for Counsel to sign the Form 7249, Offer Acceptance Report, in all cases, provided the proposed action is within the Service's authority and complies with the requirements of the law. The Notice also briefly outlines the Service's acceptance policy with regard to each basis for compromise. If Counsel is of the opinion that the proposed acceptance is inconsistent with the Service's policies, it should advise the offer group of its concerns by separate memorandum. Conversely, if Counsel recognizes and supports the decision to deviate from normal acceptance standards, the procedures will no longer imply that a negative opinion must be issued.

The revised procedure will allow Counsel to more clearly communicate the nature of any concerns to the area director and staff. Counsel signature on the acceptance report will indicate to the area director that the proposed acceptance is legally permissible under the Code and regulations, notwithstanding any disagreements over policy concerns. The lack of a signature will no longer merely signal that approval of a higher authority is needed, but will indicate more serious problems that call into question the legality of the proposed compromise. Expressly authorizing Counsel to support deviations from normal policy in appropriate cases by issuing a separate memorandum will serve to foster an environment of cooperation and send a message to offer groups that both they and Counsel are working toward the same goals.

The Notice makes a conscious effort to eliminate the "legal sufficiency" terminology from the IRS lexicon. The term legally sufficient appears only in the Internal Revenue Manual and Chief Counsel Directives Manual. The lack of a consistent definition of the term in the CCDM and elsewhere has invited individuals to attach their own meaning. Use of the

term has also perpetuated the misconception that the Service's usual standard for the acceptance of offers is in some way legally mandated, and that a Counsel opinion to the effect that an offer reflects less than could be collected by other means is necessarily a legal determination. Of greater concern, however, is the implication that any negative recommendation of Counsel, even one which concludes that the case could not be compromised at all under the statute, can be disregarded if the proper official signs the letter accepting the offer. Because the legal sufficiency determination in the CCDM contained elements that the Notice divides into separate and distinct inquiries, continued use of the term could potentially cause continued confusion.

We hope that this memorandum will provide useful background for your offices as they implement the revised procedures for Counsel review of offers in compromise.

**OFFERS IN COMPROMISE; OVERPAYMENT; INTEREST**

CC:PA:CBS:RCGrosenick
July 17, 2001 GL-114973-01
UIL 17.22.00-00

MEMORANDUM FOR GEORGE W. BEZOLD, ATTORNEY
ASSOCIATE AREA COUNSEL/MILWAUKEE (CC:SB:4:MIL)

FROM: Joseph W. Clark
Senior Technician Reviewer, Branch 2 (CBS)

SUBJECT: Payment of Interest on Overpayments of Offers in Compromise

This Chief Counsel Advice responds to your memorandum dated April 13, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE:

Whether interest is payable to a taxpayer who, following acceptance of an offer in compromise, remits more than the amount reflected in the offer but less than the actual tax liability?

CONCLUSION:

Under the circumstances described, we agree that the taxpayer is not entitled to interest.

FACTS:

Your memorandum posits three scenarios in which a taxpayer submits an offer in compromise (OIC) for $4,000.00. You ask, under each scenario, whether the taxpayer is entitled to be paid interest.

Scenario #1: The taxpayer pays $500.00 in cash and $4,000.00 obtained through a loan.

Scenario #2: The taxpayer pays $4,000.00. The Service also offsets the taxpayer's income tax refund in both the year of acceptance and (erroneously) the following year.

Scenario #3. The taxpayer pays $4,000.00 in December, then mistakenly pays an additional $4,000.00 the following July.

It is assumed for the purpose of each scenario that the taxpayer's liability has not been fully satisfied because the taxpayer has not fulfilled all of the terms and conditions of the OIC at the time the extra payment was made.[5] It also is assumed that the Service fails to timely repay the taxpayer within 45 days of the claim.[6] You conclude under each scenario that the taxpayer is not entitled to interest. Under the first scenario, you conclude that the additional $500.00 submitted by the taxpayer is a deposit. Under all scenarios, you conclude that the taxpayer's payment of more than the amount provided in the OIC is not an overpayment because the amount submitted is less than the amount of the taxpayer's liability. Therefore, there is no requirement under I.R.C. § 6611 that interest be paid to the taxpayer.

LAW AND ANALYSIS:

I.R.C. § 6611 provides that the Service will pay interest on any overpayment of a tax. "Overpayment" is not defined in the Code,[7] but is treated by the courts as any payment of a tax in excess of what is rightfully due. United States v. Dalm, 494 U.S. 596, 609 n.6 ("The common sense interpretation is that a tax is overpaid when a taxpayer pays more than is owed for whatever reason or no reason at all."); Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947). "There can be no overpayment of tax until the entire tax liability has been satisfied." Treas. Reg. § 301.6611-1(b). Since compromise of a tax liability pursuant to an OIC under I.R.C. § 7122 will always be for less than the total tax liability, the Service has no authority to pay interest on monies paid relative to an OIC.

In the absence of express Congressional consent to an award of interest, the United States is immune from an interest award. United States v. Louisiana, 446 U.S. 253, 264-265 (1980) (in the absence of specific provision by contract or statute, or express consent by Congress, interest does not run on a claim against the United States). Unlike the return of the funds actually collected from a person, the payment of interest will result in the net depletion of Treasury funds. Congress has only authorized the use of appropriated funds for the payment of interest in specific situations, such as where there is an overpayment entitling a taxpayer to a refund under the Internal Revenue Code. See, e.g., I.R.C. § 6611. These specific grants of authority indicate that the Service does not have any general

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[5] Item #8(d) of Form 656, "Offer in Compromise," provides: "I/We will comply with all provisions of the Internal Revenue Code relating to filing my/our returns and paying my/our required taxes for 5 years or until the offered amount is paid in full, whichever is longer." In the situations described, the taxpayer has not fulfilled this condition.

[6] I.R.C. § 6611(e)(2) provides that if the Service refunds an overpayment within 45 days of the taxpayer's filing a claim for credit or refund, no interest will be paid.

[7] Under I.R.C. § 6401, the word "overpayment" includes certain payments and credits, but that section does not provide an exclusive list.

authority to pay interest in cases not covered by the specific grants. See, e.g., Dresser v. United States, 180 F.2d 410 (1950) (no additional interest on replacement refund check, because right to recover interest from Government must come from contract or Congressional enactment). In the absence of specific Congressional authorization, interest cannot be provided to a party when funds are returned to such party.

In Moskowitz v. United States, 285 F.2d 451 (Ct. Cl. 1961), the taxpayer submitted funds along with an offer in compromise to the Service. These funds were deposited in a special account for amounts received other than by collection, such as by compromise. After several months, the Service rejected the offer and returned the taxpayer's money, without interest. The Service later assessed the taxpayer, and the taxpayer sued to recover the purported difference between the amount submitted with his offer, plus accrued interest, and the amount of the assessment. Discussing the taxpayer's demand for interest, the court found no provision of law that would authorize the Service to pay. The court held that the taxpayer's remittance did not constitute an overpayment, relying on several cases[8] in which payments made prior to tax assessments were treated as deposits not subject to interest upon their return. The court concluded that because the amount held by the Government did not exceed the taxpayer's liability, and because the taxpayer could have requested a return of the amounts held at any time, there was no overpayment and no authority to award interest. See also, e.g., I.R.C. § 1311(a) (correction of certain errors by adjustment treated as an overpayment, but specifically excluding compromises under section 7122).

Similarly, under the scenarios described above, the amounts received in excess of what the taxpayer proposed as the compromise amount do not constitute overpayments. Under Treas. Reg. § 301.7122-1T(g), any sum submitted with a proposed OIC or during the pendency of an OIC is considered a deposit.[9] If the OIC is withdrawn, unprocessable or rejected, the Regulation provides that any amounts submitted will be returned to the taxpayer, without interest.[10]

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[8] Rosenman v. United States, 323 U.S. 658 (1944); Manee v. United States, 97 F. Supp. 993 (1951); Busser v. United States, 130 F.2d 537 (3d Cir. 1942).

[9] As a general rule, the gross amount of all taxes and revenues received under the provisions of the Internal Revenue Code, and collections of whatever nature [*footnote 12 con't*] received or collected pursuant to the authority of any internal revenue law, are paid daily into the Treasury of the United States as internal revenue collections. I.R.C. § 7809(a). As one exception to the general rule, sums offered in compromise are deposited in a deposit fund account. Once the offer is accepted, the amount is withdrawn from the deposit account and deposited in the Treasury as internal revenue collections. I.R.C. § 7809(b).

[10] As part of the contractual conditions signed by the taxpayer on Form 656, "Offer in Compromise," item # 8 provides in relevant part, "I/we understand that the IRS

Absent statutory authority, sovereign immunity prevents an award of interest. Library of Congress v. Shaw, 478 U.S. 310 (1986). The Service has no statutory authority to award interest unless there is an overpayment. I.R.C. § 6611. To the extent that the amount received by the Service does not exceed the taxpayer's liability, there is no overpayment. Under the three scenarios described above, the taxpayer is not entitled to interest on the amounts received by the Service in excess of the compromised tax liability.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The foregoing analysis assumes that the taxpayer has not fully satisfied his tax liability at the time the Service receives and holds the excess funds. If, however, the Service has adjusted the taxpayer's account balance so that the monies received on account of the OIC fully satisfied the taxpayer's liability, any funds held by the Service would be considered an overpayment under section 6611 and subject to the 45-day repayment rule under section 6611(e).

**TRUST FUND TAXES**

CC:PA:CBS:Br3
GL-122253-01
UIL: 7512.00-00

June 29, 2001

MEMORANDUM FOR MIRIAM A. HOWE, ASSOCIATE AREA COUNSEL (SBSE) – LAGUNA NIGUEL CC:SB:8:LN:2

FROM: Charles E. Samuel
Acting Chief, Branch 3 (Collection, Bankruptcy Summonses)

SUBJECT: Trust Fund Compliance Initiative (TFCI) Checklist
Your Ref: GL-811406-99; Memo of May 9, 2000

This Chief Counsel Advice responds to your request of April 4, 2001, that we review guidance that was provided by your office to your local Collection function last year and that we advise you whether that prior advice is generally in line with the Service's current thinking on this subject. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

Our advice focuses on how the Collection function may select taxpayer cases that are likely to be appropriate for using the Service's extraordinary civil administrative tools described in IRM 5.7.2 – i.e., the Letter 903 warning notice, Form 941-M monthly filing, and the special tax deposits (STD) requirements of I.R.C. § 7512 –

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will not pay interest on any amount I/we submit with the offer."

where no criminal tax prosecution is anticipated, but a mandatory injunction to stop further employment tax pyramiding under section 7402 may be sought if the taxpayer continues to pyramid after the civil administrative tools have been appropriately used.[11]

While there are strong and clear statutory and historical links between the Collection function first imposing STD requirements on a taxpayer under section 7512 and the CI function later then pursuing criminal prosecution of a taxpayer who failed to comply with these STD requirements (under section 7215 or another criminal tax provision), the causal relationship between the Service imposing STD requirements on a taxpayer and the United States bringing a mandatory civil injunction under section 7402 to stop further pyramiding by a taxpayer who has failed to comply with employment tax requirements is not so rigid. However, the Service's Manual provisions (IRM 5.7.2) and its Law Enforcement Manual provision (LEM 5.4.1) describing STD guidelines have been written to cover both potential paths of follow-up legal action – criminal prosecution or civil injunctive relief – in the same numbered sections. A subtle reading of these provisions is accordingly sometimes necessary for the Service to distinguish between appropriate handling and selection guidelines for a criminal TFCI case and for a civil TFCI case.[12]

GENERAL TFCI CASE SELECTION AND MONITORING GUIDANCE

We are agreed that the TFCI administrative procedures described in IRM 5.7.2 are generally for use with in-business taxpayers which have shown a continuing pattern of failing to pay their full trust fund tax liabilities on a timely basis (i.e., pyramiding).

The Service's use of TFCI administrative and judicial procedures – i.e, issuing the Letter 903 warning notice, imposing monthly Form 941-M filing and STD requirements, closely monitoring a taxpayer's compliance with these requirements, and initiating a criminal prosecution or civil injunctive action in the event of a taxpayer's failure to substantially comply – is not subject to Collection Due Process (CDP) or other administrative appeal

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[11] Nevertheless, we are aware that the headquarters CI function has issued guidance to its field CI offices that is supportive of the Collection function's current Trust Fund Compliance Initiative (TFCI). Upon request, we can provide you the name and telephone number of the headquarters CI analyst who has been working with the Collection function on this project.

[12] Our only prior published guidance in the TFCI area, a General Litigation Bulletin (GLB) summary of a memorandum of July 6, 1995, in case GL:Br3-0411-95 (see 1995 GLB LEXIS 2, 31, with selection tolerance text redactions), may also be confusing to field offices about the substantial differences that we believe exist between a STD case that is potentially appropriate for criminal prosecution and a failure to pay employment tax case that may be appropriate for seeking a civil injunction.

rights within the Service. TFCI administrative procedures generally require a taxpayer to comply prospectively with reporting and paying its federal employment tax obligations already due under the law, albeit on a more structured and strictly monitored basis by the Service, while the judicial process already exists to ensure protection of a taxpayer's rights in the event of a criminal prosecution or civil injunctive action. As your prior advice and our prior TFCI guidance (see footnote 2) indicate, the purpose of TFCI is not to produce any certain number of section 7215 (criminal) or section 7402 (civil) cases to bring to court, but rather to increase overall future collection of revenue and ongoing compliance among a select population of chronic in-business pyramiders.

The first TFCI checklist factor listed in your prior advice is a local dollar tolerance figure that we assume is meant to represent the taxpayer's quarterly trust fund tax liability and that may have been derived by your office from the local criminal tax tolerance figure for another city that was discussed in the 1995 GLB summary referenced in footnote 2 above. The 1995 GLB summary did reflect our concern that local tolerances for criminal tax purposes should be flexible enough to consider the amount of a taxpayer's accumulated total tax liabilities, as well as the amount of the taxpayer's quarterly trust fund tax liabilities. An important tolerance consideration that the 1995 GLB summary perhaps failed to reflect adequately, is that it may often be appropriate to impose TFCI administrative requirements (with no genuine expectation that criminal prosecution may result, but that civil injunctive relief could well be sought as a remedy for the taxpayer's substantial noncompliance) when the quarterly trust fund tax liabilities of the taxpayer are well below those adopted on a local basis for criminal tax prosecution purposes.

In fact, the LEM provision and current TFCI pilot city instruction dollar tolerances for issuing Forms 2481 (to impose STD requirements) are approximately one fifth of the apparent quarterly dollar tolerance amount referred to in your checklist. One of the TFCI pilot cities also persuaded the headquarters Collection function to lower this quarterly dollar tolerance figure even further for the pilot program in that city. In a pending civil injunction case that has been brought by the Tax Division to stop employment tax pyramiding in the San Diego area, the taxpayer's quarterly trust fund tax liability also falls below the suggested LEM tolerance figure for issuing Form 2481, but the taxpayer's pattern of failing to pay its trust fund tax liabilities was a long one and the accumulated unpaid employment tax liabilities of the taxpayer were large by the time injunctive relief was sought.

Accordingly, for civil TFCI purposes, we recommend that your TFCI checklist identify a local, quarterly trust fund tax liability tolerance guide that is closer to the LEM figure for issuing Forms 2481. In accordance with the local Counsel practice in many cities for instituting any kind of affirmative suit, we also believe that your TFCI checklist should identify for revenue officers a local, accumulated employment tax liability tolerance guide that your office would generally expect to be met before your office would forward a civil suit referral to the Tax Division to request that a suit be filed for a mandatory civil injunction to stop the taxpayer from further employment tax pyramiding. In the case of responsible

persons who may have established a pattern of pyramiding for one entity and then moving on to a new entity when the Service begins to take action, this accumulated employment tax liability tolerance may include unpaid employment tax totals for all entities managed or controlled by the responsible person.

In addition to specifying that the taxpayer should be in business, currently pyramiding at a local quarterly dollar tolerance guideline, and have accumulated a total employment tax liability at a suggested local dollar tolerance level, we recommend that your local TFCI checklist consolidate a number of the separate behavior items now identified in your checklist under a new general category along the lines of "Past inability to comply with the law." No single one of your suggested past behavioral items need be present to issue the Letter 903, place the taxpayer on monthly filing, or impose the STD regime, but the overall picture of taxpayers selected for TFCI civil monitoring should be one of past inability to comply with employment tax laws. Either the business taxpayer or the individual(s) actually running the business, should have a demonstrated history of noncompliance with federal employment tax laws. This may include repeated failure to file returns for trust fund taxes, or repeated failure to pay over trust fund taxes even if returns are properly filed. Factors to consider include evidence of: chronic undercapitalization of the business; chronic lateness in filing or paying over taxes (i.e., always trying to play "catch-up," but instead falling further and further behind); past business failures, including bankruptcies where unpaid taxes constituted a major claim against the debtor; abandonment of past business entities, leaving unpaid (and uncollectible) tax liabilities; past section 6672 investigations; past offers in compromise (on basis of collectibility) for either the businesses operated by the responsible individuals or by the individuals themselves for section 6672 assessments.

Next, we recommend that your local TFCI checklist for civil purposes prominently highlight the factor "Service Unable to Collect (Inability to Collect)" and that you explain that both the business and the potentially responsible persons should have no assets (or no assets with more than de minimis equity) from which collection can reasonably be made for the trust fund taxes owed.[13] As a practical matter, this is the TFCI case selection factor for civil purposes that you may expect to be the most critical in determining which of the local Collection field function's (Cff's) chronic/problem employment tax cases will be most appropriate for using TFCI administrative tools and which Cff employment tax cases should continue for the most part to be handled for civil purposes via the Service's traditional lien, levy, and Trust Fund Recovery Penalty (TFRP) tools and procedures, as they have been substantially modified by the IRS Restructuring and Reform Act (RRA). The Service's inability to collect from the business or its responsible persons has been the

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[13] The de minimis equity factor for TFCI procedures is already alluded to in IRM 5.7.2.6:(5) (the first "If ... Then" contingency), in the Note to IRM 5.7.2.11:(1), and IRM 5.7.8.3:(8) (in the chapter describing how to work cases involving an "In-Business Repeater Trust Fund Taxpayer").

factor that has drawn by far the most number of questions from Cff employees in the operation of TFCI in the present pilot cities.

In considering the "Inability to Collect" factor, Cff needs to be mindful that it is looking at the likely "forced sale" value of a taxpayer's assets and there is some local flexibility in determining the range of what is "de minimis" equity in the assets of the taxpayer and its responsible persons. We do not intend to suggest, for instance, that TFCI tools would be inappropriate for a day care provider that is operating out of leased or fully encumbered property, whose primary unencumbered assets may only be used furniture or toys; these are probably circumstances involving de minimis equity. On the other hand, the taxpayer employer may be an undercapitalized medical services provider whose responsible person (already assessed for the TFRP under I.R.C. § 6672) owns a personal residence individually that may reasonably be expected to produce $80,000.00 of net sale proceeds for the Service if a U.S. district court judge approves a levy on the personal residence pursuant to I.R.C. § 6334(e).[14] Before going the TFCI civil route for this taxpayer employer, we would ordinarily expect Cff to pursue the possible personal residence sale of the taxpayer's responsible person for the TFRP, even if the taxpayer employer's accumulated total employment tax liabilities already exceed $500,000.00. In general, the dollar figure that Cff may use as a local tolerance for de minimis equity is not a dollar figure that should rise in proportion to the taxpayer's total unpaid liability.

In general, a taxpayer's present ability to delay the Service's ultimate collection of employment tax liabilities by electing to use the CDP rights created by RRA should not be heavily considered by Cff in determining whether there is an "Inability to Collect" for civil TFCI purposes. On a case-by-case basis, after Cff has fully consulted with local SBSE Counsel, we may agree that TFCI tools are appropriate for civil use where an in-business taxpayer employer has a pending CDP hearing request and is believed to have previously abused and/or is presently abusing its CDP hearing rights to delay levies of a recurring nature on the taxpayer's replenishable property (e.g., levies on bank accounts or accounts receivable) and has pyramided further employment tax liabilities while pursuing its prior and/or present CDP hearing rights. In such cases, due to the pending CDP hearing request, the Service would ordinarily be providing the taxpayer with comparable breathing room (as under TFCI) from enforced collection activity that would allow a willing taxpayer to come into current period employment tax compliance. If a taxpayer of this type loses its CDP appeal to stop a levy and also fails to comply with STD requirements that were imposed while the CDP appeal was pending, then it could be appropriate to levy first (after the CDP appeal is concluded) and follow-up that levy with an immediate request for a

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[14] Co-owner or tenancy by the entireties interests could significantly reduce or eliminate any actual forced sale value in a personal residence, so these interests should be considered carefully by Cff in evaluating whether a responsible person has more than de minimis forced sale equity in a personal residence for TFCI case selection purposes.

mandatory civil injunction against the taxpayer to promote future employment tax compliance. By that time, the taxpayer would have shown its inability or unwillingness to pay current trust fund tax liabilities, even though the Service had followed TFCI procedures and the taxpayer had been free from enforced collection action for as long as this most recent CDP hearing request had been pending until the Service's levy was eventually permitted to go forward and was actually made.

There are several reasons why the Service's "Inability to Collect" is such a critical factor for appropriate TFCI civil case selection, even though there is no statutory or case law prohibition on the Service pursuing enforced collection actions and also making use of its strictly administrative TFCI tools against a taxpayer. As explained further below, follow-up TFCI legal action is likely to be infeasible where the Service's efforts to collect past tax liabilities have arguably, materially impaired the taxpayer's ability to comply with the TFCI administrative procedures that have been imposed for current reporting periods. Effective deterrence and resource use considerations generally tilt against the Service's use of a STD regime and enforced collection action at the same time, if the collection actions are likely to undermine the follow-up legal action options available to the Service for the taxpayer's failure to comply with STD requirements.

TFCI civil case procedures for Cff after initial case selection occurs (e.g., administrative monitoring, referral to Counsel for legal action, participation in legal action as a potential witness, and monitoring a taxpayer's compliance with injunctive relief approved by a court for several years) may potentially be more time consuming (if the taxpayer does not comply quickly) and span a greater length of time than using the Service's traditional enforced collection activity for taxpayers who have assets with equity, even when these taxpayers take full advantage of their CDP hearing and appeal rights.

One of the traditional showings required of a party seeking injunctive relief is that the requesting party has no alternative adequate remedy at law. The Service's traditional administrative collection procedures and its TFCI administrative monitoring procedures,[15] if not futile, probably fall under the general category of potential adequate remedies at law to be considered first, though the boundaries of what various courts may require for injunctive relief in these employment tax pyramiding circumstances have not been well tested yet. On the other hand, it is a well-established principle of equitable jurisprudence that equity does not require the doing of a vain or useless thing, that equity does not

[15] It is also generally more cost effective for the Service to use its revenue officers to achieve taxpayer compliance and its appeals officers to resolve taxpayer disputes, than to involve all of its legal representatives (local SBSE Counsel, CBS to review the suit letter per CCDM 34.6.1.3:(2)n, and the Tax Division to file and argue the case), plus court personnel, before these administrative avenues have been adequately explored or shown to be futile.

require one to do useless or unnecessary acts to obtain relief to which he is otherwise clearly entitled.[16]

Accordingly, where a taxpayer's responsible persons have followed a pattern of pyramiding for one entity and then, when the Service takes notice, moving on quickly to pyramiding under a new entity's name and EIN, our office, the headquarters Collection function, and the Tax Division are now in substantial agreement that the Service may be able to skip TFCI administrative monitoring procedures and move immediately to seek injunctive relief.[17] This is because the taxpayer's behavior in these circumstances has made it futile for the Service to attempt to pursue its typical TFCI administrative progression, which first involves a period of monitoring for compliance after the Letter 903 is issued and then calls for a further period of monitoring for compliance after it has become necessary for Cff to impose STD and monthly filing requirements on the taxpayer. If an employer takes on a new tax identity when TFCI tools are used, the Service may never be able to complete the TFCI administrative progression because the employer will not hold still (keep its tax identity) long enough.

Though not prescribed by IRM 5.7.2 or discussed in your prior advice, our office has often recommended that a standing local TFCI Committee with representatives of several functions (including local Counsel) be used to guide the selection of appropriate local cases for the use of TFCI administrative tools and for providing participating revenue officers with support and advice in following the monitoring procedures and in moving through the various potential phases of the TFCI progression. Multi-functional local TFCI Committees, with representation from local Counsel and serving these purposes, are at

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[16] See 30A C.J.S. Equity § 14 (1992); Stewart v. United States, 327 F.2d 201, 203 (10th Cir. 1964) ("equity will not require a useless thing, or insist upon an idle formality"); School Board of City of Charlottesville, Va. v. Allen, 240 F.2d 59, 64 (4th Cir. 1956) ("equity does not require the doing of a vain thing as a condition of relief"); Union Oil Co. of California v. Reconstruction Oil Co., 66 P.2d 1215, 1221 (Cal. App. 1937) ("equity will not require the performance of an idle act"). See also Kondik v. United States, 76 AFTR 2d 6078, 6084 (N.D. Ohio 1995), aff'd 81 F.3d 655 (6th Cir. 1996).

[17] In circumstances of this type, the new entity may also have more than de minimis equity in assets, but these assets may sometimes only be effectively reached by the Service to satisfy the unpaid tax liabilities of the predecessor entities by first filing a suit (seeking equitable relief) to set aside fraudulent conveyances from the prior entity to the new entity. The Service is not required to exhaust its alternative equitable remedies in court before seeking injunctive relief, so it may likewise be appropriate in these circumstances for the United States to seek an injunction immediately against a new entity (transferee) with more than de minimis assets in order to prevent future employment tax pyramiding and a further transfer of the transferee's assets to another new successor entity.

the heart of the present pilot city initiatives and were critical in the working of earlier TFCI efforts in the mid-1990s. For cases of chronic employment tax pyramiders that are first considered by the local TFCI Committee for inclusion in the initiative but are then rejected (for the time being, at least) because the Service's Inability to Collect has not been appropriately explored yet, the TFCI Committee members may also now serve the especially important function of guiding revenue officers as to how they may still pursue appropriate enforcement actions in a post-RRA environment.

At each TFCI monitoring stage after the Service has made the decision to deliver the Letter 903 warning notice to the taxpayer, Cff (and the local TFCI Committee, if one exists) should consider whether any action by the Service with respect to any of the taxpayer's prior stage tax delinquencies has materially impaired the taxpayer's ability to comply with its current period reporting and payment of employment taxes. See IRM 5.7.2 and LEM 5.4.1. If efforts by the Service to collect pre-Letter 903 tax period liabilities of the taxpayer have impaired the taxpayer's ability to comply with the Letter 903, then it will generally be difficult for the Service to conclude that it afforded the taxpayer with a reasonable opportunity to comply with the Letter 903 requirements before placing the taxpayer on a STD regime, as directed by IRM 5.7.2.5:(1). Once Cff has hand-delivered the Form 2481 to a taxpayer to put the taxpayer under STD requirements, the Service should also generally refrain from taking any enforcement action that would arguably deprive the taxpayer of sufficient funds to comply with STD requirements,[18] unless Cff (and the local TFCI Committee) has finally determined that it will neither pursue criminal prosecution nor civil injunctive remedies if the taxpayer fails to comply with the STD requirements. See IRM 5.7.2.9:(1)c and (3).

A part of the Service's reasoning behind its general policy of refraining from actions to collect past tax delinquencies while a taxpayer goes through the TFCI progression is that

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[18] Although IRM 5.7.2.9:(2) does mention the possibility of the Service obtaining an installment agreement (IA) for tax delinquent accounts after delivering the Form 2481, as long as the taxpayer would be left with sufficient funds to comply with STD requirements, the Service generally will not be entertaining an IA or offer in compromise (OIC) from a taxpayer under the STD regime until after the taxpayer has demonstrated compliance with STD procedures for the preceding two quarters and only if the taxpayer has remained in current compliance with STD in the quarter in which the IA or OIC is made. See IRM 5.7.8.3:(5) and 5.7.8.3.2 (providing guidance for handling the "In-Business Repeater Trust Fund Taxpayer"); IRM 5.8.3.3:(4) (describing when OICs by an in-business taxpayer for employment taxes are considered "not processible"). At this point of a taxpayer's compliance with STD requirements, for two consecutive full quarters and continued compliance, the Service would ordinarily be thinking about when – possibly at the end of the third quarter of full compliance, see the Note below IRM 5.7.2.13:(1)1 – it would become appropriate to move the taxpayer off the STD regime instead of pursuing a request for bringing a civil injunction suit.

a criminal conviction of a taxpayer under section 7215 for failing to comply with STD requirements is unlikely where a taxpayer may credibly argue that the Service's own actions made it nearly impossible or difficult for the taxpayer to comply with the STD requirements. The same logic also applies to how a federal district court is likely to view an initial request by the United States for civil injunctive relief when a taxpayer may credibly argue that the primary or a significant reason that the taxpayer is unable to remain in current federal employment tax compliance is that the Service continues to seize its funds (to satisfy past taxes) that are necessary for the taxpayer to pay its current tax liabilities.[19]

Accordingly, we generally believe that it is a best practice while a taxpayer is under TFCI monitoring procedures for Cff to refrain from levying to collect any past taxes the taxpayer may owe, to avoid the taxpayer's potential defense of material impairment. However, for potential civil TFCI purposes, we do not believe that filing appropriate Notices of Federal Tax Lien (NFTLs) against the taxpayer or continuing CDP hearings requested by the taxpayer are enforcement actions by the Service that could genuinely impair a taxpayer's ability to pay its current tax liabilities while under TFCI monitoring. For potential civil TFCI purposes, on a case by case basis after consulting fully with local SBSE Counsel, we also believe that it may be possible for Cff to levy (without materially impairing the taxpayer employer's ability to comply with the warnings in the Letter 903 and STD requirements) on the
non-essential property of current responsible persons and on the property of former responsible persons (with no continued relationship to the employer's business) that Cff did not know of (or did not know of the equity in the property) when TFCI procedures were instituted,[20] in order to collect assessed TFRP liabilities. There may also be very rare circumstances, for civil TFCI purposes, where a levy could be appropriate, with local SBSE Counsel's concurrence, on property titled in the taxpayer employer's name while the employer was under STD requirements. For instance, Cff could first discover after it

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[19] As you may imagine, the same logic also will likely apply once a civil injunction is issued to require prospective employment tax compliance from a taxpayer; a court will be wary of imposing sanctions for a taxpayer's noncompliance with its prior injunction order if the taxpayer may credibly argue that Cff efforts to collect prior tax liabilities impaired the taxpayer's ability to comply with the current period tax payments required by the injunction.

[20] If Cff knew of the equity in the responsible person's property before TFCI procedures were considered, then it would have been appropriate to levy upon the property before resorting to TFCI procedures, except in the potential case-by-case circumstances alluded to above where the responsible person initiated an abusive CDP hearing request (in the view of both Cff and local SBSE Counsel) to delay the levy and the taxpayer employer has pyramided further employment tax liabilities while the responsible person pursues his/her CDP hearing rights.

placed the employer under STD requirements that the employer had a yacht or airplane titled in its name that the employer's responsible person uses principally for pleasure and that the Service's seizure and sale of the yacht or airplane could be accomplished with no material disruption to the operations or financing of the employer's business but still produce more than de minimis net sale proceeds to pay a portion (but not most)[21] of the employer's past employment tax delinquencies. For potential criminal TFCI purposes, the CI function should be closely consulted in advance with regards to any proposed Cff enforcement actions any time after the Letter 903 warning has been issued to the taxpayer, and the CI function may impose further limits on Cff actions than we have recommended above for civil TFCI purposes. Of course, if Cff (and the local TFCI Committee) have selected "Inability to Collect" cases for the use of TFCI tools before the decision is made to issue the Letter 903, as we recommend, then refraining from collecting past tax delinquencies during TFCI monitoring should not pose a genuine collection risk to the revenues because the past taxes would not be collectible anyway.

Finally, in terms of general TFCI guidance, we believe that the context of the Service using monthly Form 941-M return filing requirements for a taxpayer employer as part of the TFCI progression should be further explained. Issuing the Letter 903 is administratively required by IRM 5.7.2.1:(3) before a taxpayer is recommended by Cff for monthly filing. However, TFCI procedures permit, but do not require that, a taxpayer have first been monitored under monthly filing requirements before STD requirements may be imposed. Apart from the STD regime, monthly filing may be imposed upon a taxpayer, ordinarily as a remedy for the taxpayer's timely tax reporting (return filing) problems as opposed to the taxpayer's timely tax payment problems. When monthly Form 941-M filing requirements are imposed upon a taxpayer apart from the STD regime, a taxpayer is required to continue making required tax deposits electronically or by Federal Tax Deposits (FTDs). See IRM 5.7.2.2:(3)i. Imposing monthly filing requirements upon a taxpayer also imposes additional administrative burdens on the revenue officer monitoring the taxpayer's compliance with monthly filing (see IRM 5.7.2.2 through 5.7.2.4), so apart from the STD regime many revenue officers may be reluctant to impose monthly filing on a taxpayer if the taxpayer's compliance problem is more in the tax "payment" area than in the tax "reporting" area.

When STD requirements are imposed by Cff on a taxpayer, the taxpayer is also ordinarily put under monthly Form 941-M filing requirements. The Form 2481 (Notice to Make Special Deposits of Taxes) for imposing STD requirements contains a box that the revenue officer ordinarily checks to impose monthly filing at the same time. When a taxpayer is under STD requirements, the taxpayer is directed by the Form 2481 (as explained by the revenue officer) to immediately deposit the funds necessary to pay its federal employment

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[21] If the net sale proceeds of the yacht or airplane sale come close to satisfying the employer's delinquent tax liabilities in full, then the probability of the United States seeking a civil injunction in the near term would ordinarily be relatively low.

taxes in the required special bank account and to keep the funds deposited in that special bank account until full payment is made to the Service with the required return. While a taxpayer is under the STD regime, Cff should suppress issuance of FTD Alerts for the taxpayer (see IRM 5.7.2.7:(3)), because the taxpayer should make its deposits in the special bank account instead of continuing to follow ordinary FTD requirements. Accordingly, if STD requirements are imposed upon a taxpayer without also requiring monthly filing of the taxpayer, then the funds to pay the employer's federal employment tax obligations will sit in the special bank account until the end of the quarter instead of the end of each month (under monthly filing, with STD) before being paid over to the Service. See IRM 5.7.2.8:(3)b.

FURTHER SPECIFIC COMMENTS ON YOUR TFCI MEMO & CHECKLIST

In the revised local TFCI guidance that you may prepare for your local Cff use, we recommend that you delete the present references to potential worker classification issues in a TFCI case on your pages 2 (item 3.c.) and 11 (the checklist factor at the bottom of the page). We believe that TFCI procedures are not likely to be of much use to Cff in addressing worker classification disputes with an employer, because STD requirements do not address the correctness of the employer's reporting position; criminal prosecution or a civil injunction for a taxpayer which is allegedly violating STD requirements only because of a non-frivolous reporting position on worker classification is probably not likely.

On your page 3, near the end of the first sentence of item 4, we recommend that you strike the words "should issue Letter 903" and substitute with words along the lines of "should consider whether TFCI procedures are appropriate for this taxpayer and whether to begin the TFCI progression by issuing a Letter 903 to the taxpayer."

We believe the Service should be sparing in its future use of Letters 903, using them only when the Service reasonably believes that it will be willing to follow through on the full TFCI civil progression, if not criminal prosecution, in the event of a taxpayer's substantial non-compliance with the TFCI administrative procedures. We believe that the keys to Cff's effective future use of Letters 903 as a deterrent to future employment tax pyramiding will lie, in large part, with appropriate case selectivity upfront, a genuine commitment to follow through, and effective local and national publicity of its TFCI efforts.

In regard to the potential deterrent effect of properly used Letters 903, you note appropriately on your page 6 that although section 7215 itself refers to a criminal fine of not more than $5,000.00 and imprisonment of not more than one year per violation, the violation is classified as a Class A misdemeanor under federal sentencing guidelines and under these guidelines a Class A misdemeanor is punishable by a fine of not more than $100,000.00 per violation. See 18 U.S.C. §§ 3559(a)(6) and 3571(b)(5). Hence, the present Letter 903 criminal tax warnings to a taxpayer are accurate.

On your page 4, in the second sentence of the second paragraph from the bottom, we recommend that you remove the present references to "consent orders providing for entry and seizure of assets" because it is now uncertain whether the United States will seek consent orders of the type that were obtained in mid-1980 cases with the preliminary injunction, since the Code's requirements for seizures have evolved somewhat in the intervening years.

On your page 5, in the second and third lines of the second paragraph from the bottom, we recommend that you strike the words "corporate income tax." On your page 6, we further recommend that you strike the first full paragraph which describes a potential injunction order requiring a taxpayer to file monthly employment tax returns and to pay with "certified funds." The initial injunctive relief that we expect the United States to obtain by consent in the pending San Diego area injunction case is along the following lines:

> A. Defendants shall timely make all future required federal tax deposits in connection with the operation of their business.
>
> B. Defendants shall each mail an affidavit to the [specified IRS address & revenue officer] on the first day of each month following the entry of this Order, to the effect that they have personally ensured that for each pay period during the prior month federal taxes required to be deposited in connection with their business have been fully deposited.
>
> C. In the event the Defendants comply with the terms set forth in paragraphs A and B above, for a period of five (5) years, this Court shall dissolve this Order, but
>
> D. If the Defendants fail to comply with the terms set forth in paragraphs A and B above, then this Court shall enter a subsequent Order directing that no funds may be disbursed, by check or otherwise, from the business by the Defendants or their agents until any and all federal taxes required to be deposited are, in fact, deposited, and the required affidavits are mailed to the IRS. Under these circumstances, the Court may also grant such other equitable relief as the Court may deem just and appropriate to ensure the Defendants' compliance with the internal revenue laws.

On your page 10, we recommend that you substitute for your checklist factor at the bottom of the page (emphasizing "insolvency") the important TFCI selection factor of "Service Unable to Collect (Inability to Collect)" factor which we discussed previously. We imagine that a very large percentage of Cff employment tax cases involve "insolvent" taxpayers, but a much smaller percentage of these "insolvent" taxpayers will likely be appropriate for Cff to use TFCI tools (i.e., the cases where the Service is unable to collect from assets with more than de minimis equity). As we have emphasized previously, the taxpayer's ability to "full pay" its delinquent tax liabilities is <u>not</u> an appropriate test for resorting to TFCI tools. If the Service has the ability to collect a portion of a taxpayer's delinquent tax liability that

represents more than a de minimis amount, it is still more appropriate for the Service to use its traditional enforcement tools rather than resort to the use of TFCI tools. We are also unpersuaded that taxpayer “insolvency” alone will lead very many courts to order a business shut down at the preliminary injunction stage of a TFCI case. However, a taxpayer’s contempt of a court’s injunction order in a TFCI case may well lead a court, as a sanction, to order the taxpayer’s business sold to satisfy its tax debts and to prevent future violations of the court’s injunction.

## OFFERS IN COMPROMISE; COLLATERAL AGREEMENTS; EFFECTIVE TAX ADMINISTRATION

June 13, 2001

CC:PA:CBS:Br2
GL-114892-01
UILC: 17.10.00-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE), AREA 2, NEWARK

FROM: Joseph W. Clark
Senior Technician Reviewer, Branch 2
(Collection, Bankruptcy & Summonses)

SUBJECT: Collateral Agreements in Effective Tax Administration Offers in Compromise

This Chief Counsel Advice responds to your request dated March 16, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE:

Can the Internal Revenue Service accept, as additional consideration for an offer in compromise, a collateral agreement or other document which will entitle the Government to the proceeds from the sale of a particular asset at some point in the future?

CONCLUSION:

Yes. Although Treasury regulations establish certain conditions that must be satisfied in order to compromise under section 7122 of the Internal Revenue Code, the terms of a compromise agreement, including the amount acceptable to resolve a case, are policy matters within the discretion of the Commissioner. Insistence upon an agreement allowing the Government to collect from particular assets in the future is a permissible exercise of that discretion.

BACKGROUND:

The Compliance Area Director has asked your advice on the following scenario. The taxpayers, an elderly couple who are not employed, have submitted an offer in compromise. An analysis of the taxpayers' financial condition shows that the tax could be collected in full. The major source of potential collection is their home, which has substantial net equity. However, the Service has determined that seizure of the home would cause the taxpayers economic hardship, and that collection in full cannot be accomplished otherwise. Based on the determination that collection in full would create economic hardship, the Service is considering accepting the taxpayers' offer on the basis of the promotion of effective tax administration. The Area Director is concerned, however, that compromise under such circumstances would only serve to create a windfall for the taxpayers' heirs. He has proposed obtaining a collateral agreement in such compromises which would allow the taxpayers to reside in their home until their deaths. Thereafter, the home would be sold with the proceeds going to the Government as part of the compromise.

LAW & ANALYSIS:

Section 7122 of the Internal Revenue Code grants the Secretary the authority to compromise and establishes certain rules to be followed in exercising that authority. Treasury regulations further define the Secretary's authority by establishing permissible bases for compromise. See Temp. Treas. Reg. § 301.7122-1T(b). The regulations provide procedures for the submission and processing of offers to compromise, as well as other rules relating to the acceptance or rejection of offers and how the submission of offers impacts upon the Service's ability to continue collection efforts. See Temp. Treas. Reg. § 301.7122-1T(c)-(i).

None of these rules, however, address how much should be accepted to resolve a case, or what terms or conditions should be included in a compromise agreement. The preamble to the temporary regulations explains this omission, stating:

> Although the temporary regulations set forth the conditions that must be satisfied to accept an offer to compromise liabilities arising under the internal revenue laws, they do not prescribe the terms or conditions that should be contained in such offers. Thus, the amount to be paid, future compliance or other conditions precedent to satisfaction of a liability for less than the full amount due are matters left to the discretion of the Secretary.

T.D. 8829, Compromises, 64 Fed. Reg. 39020, 39023 (July 21, 1999). In exercising this discretion, the Service may request, "[a]s additional consideration, ... that the taxpayer enter into any collateral agreement or post any security which is deemed necessary for the protection of the interests of the United States." Temp. Treas. Reg. § 301.7122-1T(d)(2).

Terms and conditions applicable to all compromises are set forth in Form 656, Offer in Compromise, which must be submitted by all taxpayers offering to compromise with the Service. The Service's procedures recognize that additional terms may be appropriate in some cases. These agreements, commonly known as "collateral agreements," are discussed in Chapter 6 of the Offer in Compromise Handbook, IRM 5.8. Standard collateral agreements include: waivers net operating losses; agreements reducing the basis in particular assets; or agreements to pay a set percentage of future income over a certain base amount. See IRM 5.8.6.3(1). Such agreements allow the Service to recover part of the difference between the amount of the offer and the total liability. However, collateral agreements should not be used to allow acceptance of an amount less than the financial analysis dictates, or to recover amounts that should have been included on the Form 656 as part of the compromise. See IRM 5.8.6.1(3). Similar to the foregoing examples of collateral agreements, an additional agreement like the one proposed by the Area Director is legally permissible, and insisting on such an agreement would be within the Service's discretion.

As with the other types of collateral agreements, whatever obligation a taxpayer undertook (for example, to sell the house and forward the proceeds to the Service) would have to take place within the statute of limitations applicable to the tax to which the proceeds would be applied. Section 6502(a) establishes a ten-year statute of limitations within which a tax liability must be collected or a proceeding in court commenced. Prior to the amendment of that section by the IRS Restructuring and Reform Act of 1998 (RRA), the Form 656 and any collateral agreements provided that the statute of limitations for collection was waived for the period of time that any terms of the compromise or collateral agreement remained outstanding. However, following the amendment of section 6502(a) of the Code by section 3461 of RRA, the ten-year statute of limitations can no longer be extended by agreement for this purpose. As a result, the terms of compromises and collateral agreements can last only for the period remaining on the collection statute.

An agreement for the limited amount of time remaining on the collection statute would not appear to address the concerns raised by the Area Director. One alternative might be the acceptance of some other type of debt instrument granting the Service the ability to collect as a state-law creditor rather than through the administrative collection provisions of the Internal Revenue Code. Courts have long recognized that the Service may accept bonds, letters of credit, or mortgages as a means of securing the payment of taxes, and have upheld the Service's right to collect on such instruments as separate debts not subject to the administrative collection procedures set forth in the Internal Revenue Code. See Royal Indemnity Co. v. United States, 313 U.S. 289 (1941), Gulf States Steel Co. v. United States, 287 U.S. 32 (1932), United States v. John Barth Co., 268 U.S. 370 (1929) (bonds); United States v. Citizens Bank, 50 F. Supp. 2d 107 (D.R.I. 1999) (promissory note secured by mortgage); Julicher v. Internal Revenue Service, 95-2 U.S.T.C. ¶ 50,379 (USDC, E.D. Pa. 1995) (irrevocable letter of credit).

In each of those cases, the taxpayers attempted to defeat the Government's right to collect on the debt instrument by arguing that the statute of limitations for collection under the Code had expired. Each court held that the instrument executed in the Government's favor created a new debt not subject to the period of limitations for taking administrative collection action or bringing suit. See Royal Indemnity, 313 U.S. at 283; Gulf States, 287 U.S. at 39; Barth, 279 U.S. at 374. The court in Citizens Bank summed up the reasoning in this line of cases as follows:

> The principle to be derived from Barth and Julicher is that where the government suspends the collection of a tax at the request of a taxpayer, who in turn provides the government with security for later payment, the government is not thereafter bound by the statute of limitations applicable to the original obligation. Instead, the government may proceed against the security provided to it in consideration of its earlier forbearance.

Citizens Bank, 50 F. Supp. 2d at 111.

Thus, a mortgage on the taxpayers' personal residence may give the Service an enforceable agreement of the sort contemplated by the Area Director. There is no mention of this kind of arrangement in the offer in compromise handbook, but mortgages, bonds and other similar arrangements are discussed in IRM 5.6, Collateral Agreement and Security Type Collateral. That handbook contemplates the use of mortgages not as a replacement lien on property already subject to the lien arising under section 6321 of the Code, but as a means of securing the Government's right to collect from property the assessment lien does not attach to, such as real property held as a tenancy by the entirety. See IRM 5.6.1.2.3(4).[22] The handbook further states: "The Service should never obtain a consensual lien in lieu of filing a notice of federal tax lien and reducing the tax claim to judgment or requiring the taxpayer post a bond." IRM 5.6.1.2.3(5). This instruction is in keeping with the handbook's recognition that the filing of a notice of federal tax lien provides the Service greater protection than a debt instrument enforceable only under state law. See IRM 5.6.1.1(3)a.

Although the IRM authorizes the use of mortgages and other consensual security arrangements in certain limited circumstances, the offer in compromise handbook does not appear to have considered the use of such instruments as part of a compromise. Because of the novelty of such an arrangement, we recommend that the Area Director consult with the Office of Compliance Policy, SB/SE, for guidance as to whether and under what

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[22] It is significant that the mortgage in Citizens Bank gave the Service a security interest in property that was not already subject to the lien created by the failure to pay the tax liability. The personal residence used as an example in the Area Director's question is already subject to the Government's lien and is reachable by levy.

circumstances a collateral agreement allowing the Service to collect from a personal residence in the future can be secured as consideration for a compromise.

**OFFERS IN COMPROMISE; COLLATERAL AGREEMENTS; SECURITY INTERESTS**

July 17, 2001

CC:PA:CBS:Br2
GL-127696-01
UIC: 17.10.00-00

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE), AREA 3, FT. LAUDERDALE

FROM: Joseph W. Clark
Senior Technician Reviewer, Branch 2
(Collection, Bankruptcy & Summonses)

SUBJECT: Collateral Agreements with Mortgages and Offers in Compromise

This Chief Counsel Advice responds to your e-mail dated June 25, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

Whether the Service can accept an offer to compromise a tax liability which is already secured by a mortgage under an existing collateral agreement, and whether acceptance of such an offer requires the Service to release the mortgage.

CONCLUSIONS

The Service may accept an offer to compromise a tax liability even though it is independently secured by a mortgage under a collateral agreement. A collateral agreement, in which a taxpayer grants additional security to the Service, creates an independent cause of action separate from any action to collect on the underlying tax debt. Thus, the Service is not required to release the mortgage unless it otherwise agrees to in the compromise.

FACTS

Taxpayer failed to pay several years worth of tax liabilities. As a result, a statutory lien attached to Taxpayer's home and the Service filed notices of federal tax lien in the proper county records. Taxpayer then wished to sell her home and purchase a new property. She approached the Service seeking to discharge the lien on her home in order to facilitate its sale. Taxpayer and the Service entered into a collateral agreement. Under

the terms of the agreement the Service issued a Certificate of Discharge for the property Taxpayer was selling and in return Taxpayer executed a promissory note for the full amount of the statutory liens plus statutory additions secured by a mortgage on the new property. The Service further agreed to forebear from exercising its rights under the mortgage until the Taxpayer (1) dies, (2) sells the property or (3) defaults under the collateral agreement, the promissory note or the mortgage. Taxpayer agreed to waive the statute of limitations on collection and the Service refiled its notices of federal tax lien.

Now Taxpayer wishes to compromise her tax liabilities, including an additional liability incurred after the collateral agreement was signed. Taxpayer submitted an offer to compromise conditioned on the Service's release of its mortgage.

LAW AND ANALYSIS

The Collateral Agreement

In certain cases, a taxpayer with an outstanding tax liability may wish to offer additional security in exchange for an agreement from the Service to refrain from foreclosing its existing liens. These agreements are provided for in the Service's IRM Handbook 5.6, Collateral Agreements and Security Type Collateral. In rare situations, the Service is authorized to accept mortgages in exchange for extending the amount of time for the collection of taxes. IRM 5.6.1.2.3; See I.R.C. § 7101; Treas. Reg. § 301.7101-1(2)(iii).[23]

Collateral agreements are designed to create additional security for the Service, not to replace any statutory liens the Service may have. In those cases where mortgages are accepted, Service policy is clear that the mortgage should never be used in lieu of filing a notice of federal tax lien. IRM 5.6.1.2.3(5).

A collateral agreement does not compromise tax liabilities and should not be confused with collateral agreements in the context of offers in compromise. In the offer context, collateral agreements provide the Service with additional consideration beyond what is secured in the offer. IRM 5.8.6.1(1). In that context, the offer and the collateral agreement together make up the compromise agreement. See United States v. Lane, 303 F.2d 1 (5th Cir. 1962). A collateral agreement such as the one at issue here is different because it gives the Service an alternate means for collecting the full amount of the overdue taxes. Indeed, in this case Taxpayer agreed to remain liable for the entire amount of her outstanding tax debt. Clearly, no compromise was intended.

It is well settled that a collateral agreement secured by a mortgage, bond or some other surety creates an independent cause of action separate from one to collect taxes. Royal

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[23] Preferably, the tax claim will be reduced to judgment thus extending the time for collection.

Indem. Co. v. United States, 313 U.S. 289, 293-94 (1941) ("It is not denied . . . that [the bond] created a new cause of action distinct from that on the taxpayer's obligation."); Gulf States Steel Co. v. United States, 287 U.S. 32, 39-40 (1932) ("[A] bond made in such circumstances affords a cause of action separate and distinct from one to collect the tax."); United States v. John Barth Co., 279 U.S. 370, 375 (1929) ("The making of the bond gives the United States a cause of action separate and distinct from an action to collect taxes which it already had."); United States v. Oswego Falls Corp., 113 F.2d 322, 325 (2nd Cir. 1940) ("The bond gave the United States a cause of action entirely separate and distinct from the one to collect taxes."); Julicher v. Internal Revenue Service, 95 U.S.T.C. ¶ 50,379 (E.D. Penn. 1995) ("The taxpayer in the instant case . . . provided the Service with another means to collect the money owed.").

Most recently, the long-standing rule that a collateral agreement, similar to the one at issue here, gives the Service an independent means for collecting overdue taxes was affirmed in United States v. Citizens Bank, 50 F.Supp. 2d 107 (D.R.I. 1999). In that case, a delinquent taxpayer executed a promissory note secured by a mortgage on his father's property in order to prevent the Service from immediately seizing his assets. Ten years passed and the taxpayer failed to make any payments on the note. Id. at 108. The Service began to foreclose on the mortgage and the taxpayer objected, arguing that the action was barred by the statute of limitations. Id. The court disagreed and in granting summary judgment to the government it concluded "that the promissory note and the mortgage gave the government an independent means for collecting the taxes owed, and the statute of limitations bar cannot be extended by implication to that note and mortgage." Id. at 111-112 (emphasis added).

As the above quote highlights, further evidence that collateral agreements are separate obligations comes from the court's treatment of the statute of limitations. Courts have been exceedingly concerned with the issue of fairness with regard to collateral agreements. Recognizing that taxpayers enter into collateral agreements in order to delay the collection of taxes, courts have noted that it is only fair for the Service to get something out of the deal. Citizens Bank, 50 F.Supp. 2d at 111 ("For the government to defer its collection efforts at the request of the taxpayer, it must have gotten something more in return than what it already had."). Thus, because the collateral agreement gives the Service more than what it already had, i.e., more than a statutory lien, the collateral agreement is unaffected by the statute of limitations. As the Supreme Court noted, once a taxpayer secures for himself a temporary reprieve from the collection of his taxes "he should not object to making good the contract by which he obtained the delay he sought." John Barth Co., 270 U.S. at 376.

In this case, Taxpayer agreed to waive the statute of limitations on collection of her tax liabilities. Due to changes instituted by IRS Restructuring and Reform Act of 1998 this extension will expire on December 31, 2002. 105 P.L. 206, 112 Stat. 655 § 3461(2). After that date, the Service will be barred from collecting under its statutory liens. However, because the mortgage creates a separate cause of action, the Service is not prevented by

the statute of limitations from collecting under it. Royal Indem. Co., 313 U.S. 289; Gulf Steel Co., 287 U.S. 32; John Barth Co., 279 U.S. 370; Oswego Falls Corp., 113 F.2d 322; Citizens Bank, 50 F.Supp. 107; Julicher, 95 U.S.T.C. ¶ 50,379.

The Offer in Compromise

Because the collateral agreement creates an independent cause of action, the original unpaid taxes giving rise to the statutory liens remain as separate liabilities. If the Service wishes to compromise those liabilities, it is within its discretion to do so. I.R.C. § 7122, Temp. Treas. Reg. § 301.7122-1T. Absent language in the compromise agreement to the contrary, the mortgage will remain unaffected.

Compromise agreements that conform to the statutory requirements are construed as contracts and thus are subject to the general rules governing contracts. United States v. Feinberg, 372 F.2d 352 (3rd Cir. 1967); Lane, 303 F.2d 1 (5th Cir. 1962); Kurio v. United States, 429 F.Supp. 42 (S.D. Tex. 1970). Taxpayer has submitted an offer containing a term requiring the Service to release the mortgage. If the Service were to accept this offer it would be bound by that term because an acceptance cannot change the terms of an offer. Restatement (Second) of Contracts §§ 59, 61. If Compliance does not want to release the mortgage, it should request Taxpayer to amend her offer.

When evaluating whether an offer to compromise is acceptable, the Service takes into account reasonable collection potential. IRM 5.8.4.2(1). The reasonable collection potential in this case should include what could be collected under the mortgage. Further, it should include what can be collected under the Service's statutory liens. Although your e-mail does not address any liens, under the collateral agreement the Service expressly retained its statutory liens and in fact refiled the notices of federal tax lien after Taxpayer waived the statute of limitations. The Certificate of Discharge only affected the property then covered by the tax lien that the Taxpayer subsequently sold. I.R.C. § 6325(f)(1)(B). A lien would have automatically attached to Taxpayer's subsequently purchased home. Glass City Bank v. United States, 362 U.S. 265 (1945). This is something to be taken into account before accepting any offer.