



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

OFFICE OF
CHIEF COUNSEL

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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).¹ 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 circumstances a collateral agreement allowing the Service to collect from a personal residence in the future can be secured as consideration for a compromise.

If you have any questions or need further assistance, please contact the attorney assigned to this matter at 202-622-3620.

¹ 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.