



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

OFFICE OF
CHIEF COUNSEL

June 30, 2000

Number: **200043006**
Release Date: 10/27/2000

CC:EL:GL:Br2
GL-810934-99
UILC: 17.00.00-00
9999.98-00

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Kathryn A. Zuba
Chief, Branch 2 (General Litigation)

SUBJECT: Offer in Compromise -

This memorandum responds to your request for advice dated February 4, 2000. This document may not be cited as precedent. You requested our views regarding whether the above referenced case could be compromised under the Commissioner's new authority to compromise based on the promotion of effective tax administration. We agree with your conclusion that collection of the full tax liability would not create economic hardship within the meaning of section 301.7122-1T of the temporary Treasury Regulations.

LEGEND:

Company A
District B
Case 1

Date A
T
U
V
W
X
Y

BACKGROUND:

Company A, in which the taxpayers were limited partners during the taxable year T, was audited at the partnership level by the Service pursuant to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). The Service denied certain deductions and issued a final partnership administrative adjustment, the TEFRA equivalent of a statutory notice of deficiency, to the company.

The tax matters partner petitioned the Tax Court on behalf of the company, arguing that the disallowed deductions were legitimate losses incurred in the purchase and resale of time-share interests in resort properties. The Commissioner asserted that the sales were sham transactions which should not be given effect for tax purposes.¹ The Tax Court examined the suspect transactions in depth, concluding that they lacked economic substance and were a variant on the “shopworn tax avoidance scheme” of purchasing deductions from other property owners. The court upheld the Commissioner’s determination of tax liability in full. See Case 1. As a result of the deficiency assessed against the partnership, the taxpayers now owe over \$U.

The taxpayers first proposed a compromise based on doubt as to liability. They asserted that the TEFRA audit procedures were improperly employed in the company’s case, because it was formed prior to the effective date of TEFRA. In response to a request from the Office of the Taxpayer Advocate, District B, your office advised that there can be no doubt as to liability where the tax liability has been settled by a final court determination concerning the existence of the liability. See Temp. Treas. Reg. § 301.7122-1T(b)(2). You pointed out that the only means for obtaining relief if a partnership has been improperly classified as a TEFRA partnership is a motion to dismiss for lack of jurisdiction. As the tax liability of the partnership was tried in the Tax Court and upheld on appeal, there is no doubt as to liability.

The taxpayers next proposed compromise on the grounds that compromise would promote effective tax administration. Relying on the recently expanded regulations governing compromise, discussed below, they argued that their offer of \$V should be accepted because collection of the liability in full would cause them economic hardship. See Temp. Treas. Reg. § 301.7122-1T(b)(4)(i). Your office has concluded that collection of the full liability would not cause the taxpayers economic hardship within the meaning of the regulations. Applying the standard set forth in the regulations, you concluded that full payment would not render the taxpayers unable to meet their basic living expenses.

DISCUSSION:

The Secretary may compromise any civil or criminal case arising under the internal revenue laws prior to reference to the Department of Justice for prosecution or defense. I.R.C. § 7122(a). Permissible bases for compromise are established by Treasury regulations. Temporary regulations issued July 19, 1999, expanded the Service’s authority to compromise beyond the traditional bases of doubt as to

¹ The company’s prospectus for potential investors projected a loss ratio of 3.67 to one in the first year. The prospectus made clear that “loss ratio” referred to the ratio of each partner’s loss for tax purposes to their respective cash investment.

collectibility or doubt as to liability. See Temp. Treas. Reg. § 301.7122-1T. Where there are no grounds for compromise on collectibility or liability grounds, a compromise may be entered into to promote effective tax administration, where: (1) collection of the full liability would create economic hardship within the meaning of section 301.6343-1 of the Treasury Regulations; or (2) exceptional circumstances exist such that collection of the full liability would be detrimental to voluntary compliance by taxpayers. Temp. Treas. Reg. § 301.7122-1T(b)(4). No such compromise may be entered into where it would undermine future compliance with the tax laws. Id.

In this case, the tax liability has been determined by a court judgment, and there is no doubt that the tax liability could be collected in full. Compromise could therefore only be based on a determination that it would “promote effective tax administration” under the standards articulated in the regulations. The local Taxpayer Advocate has suggested that this case should be compromised because collection by other means would create an economic hardship. As with compromises based on doubt as to collectibility, the individual financial circumstances of the taxpayers must be examined before concluding that compromise is authorized, as well as to determine that the amount offered should be accepted.

Economic hardship is defined as an inability to pay reasonable basic living expenses. Treas. Reg. § 301.6343-1(b)(4). In determining reasonable basic living expenses, the Service must consider relevant information such as a taxpayer’s age, employment status and history, and number of dependents, as well as the cost of living in the taxpayer’s geographic area. See Treas. Reg. § 301.6343-1(b)(4)(i)(A)-(C). Reasonable basic living expenses will vary according to a taxpayer’s unique circumstances. Id. However, unique circumstances do not include the maintenance of an affluent or luxurious standard of living. Id.

The financial analysis conducted by the revenue officer reveals substantial assets from which the tax liability could be collected. After reducing assets to their “quick sale value,” the taxpayer’s net equity is estimated at \$W.² This includes several assets that could readily be liquidated without loss of equity, such as individual retirement accounts and publicly traded securities. The analysis of monthly income

² In reviewing an offer in compromise, Counsel should accept the valuation determinations of the Service unless such determinations appear “patently erroneous.” CCDM (34)521(3)(a)1. We have done so for purposes of this discussion. We note, however, that several assets, such as the IRAs and stocks, have been valued at less than manual provisions dictate, without explanation. Where an asset has been disregarded or reduced in value without explanation, Counsel cannot evaluate the sufficiency of the offer. CCDM (34)521(3)(a)4c. In such cases, the office proposing acceptance of the offer should be contacted for additional documentation.

and expenses shows that they are about equal.³ Thus, the proposed offer \$V represents less than 2% of the taxpayers' net equity in assets after making allowances for reasonable basic living expenses.

We agree with your conclusion that the above facts do not support a finding that collection of the liability at issue would render the taxpayers unable to meet reasonable basic living expenses. As you pointed out, the taxpayers' assets total more the four times the amount of the tax liability. At the time your memorandum was issued, the tax liability could have been satisfied by liquidating less than half of the stock owned by the taxpayers, with no amount raised from other assets or future income. Given that monthly income and expenses are equal, and that more than \$Y in assets would remain after collection of the tax liability, we can see no basis for concluding that collection would create an economic hardship within the meaning of the regulations.

The offer in compromise regulations give guidance beyond that contained in the regulations they cross-reference. They list several non-exclusive factors which support, but are not conclusive of, a finding of economic hardship:

(1) Taxpayer is incapable of earning a living because of a long term illness, medical condition, or disability and it is reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition.

(2) Although taxpayer has certain assets, liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses; and

(3) Although taxpayer has certain assets, the taxpayer is unable to borrow against the equity in those assets and disposition by seizure or sale of the assets would have sufficient adverse consequences such that enforced collection is unlikely.

Temp. Treas. Reg. § 301.7122-1T(b)(4)(iv)(B). These factors do not provide additional, independent bases for compromise. Rather, they supplement the standard of section 301.6343-1, by providing examples of circumstances encountered in the offer in compromise program in the past.

Each of these supplemental factors were intend to convey that the Service now has the authority to compromise in situations where, even though the liability could be collected in full, some exceptional circumstance exists such that full collection

³ Your memorandum noted that the taxpayers became eligible for an \$X monthly Social Security payment effective Date A, but that amount was not included in the analysis. For purposes of this discussion, we have included that amount in calculating monthly income.

would render the taxpayer unable to meet basic living expenses. The factors and examples in the regulations contemplate an identifiable, present situation which leads the Service to conclude that collection in full would more likely than not lead to serious economic hardship in the near future. As has long been the case with doubt as liability and doubt as to collectibility cases, the Commissioner continues to anticipate that the basis for compromise will be investigated and verified, and that anticipation of some future, uncertain set of potential circumstances should not be the basis for compromise.

The offer recommendation report in this case makes mention of several of the unique circumstances of the taxpayers which, though this is not fully explained, appear to suggest that the taxpayers may experience financial hardship at some indefinite time in the future. For instance, it notes the taxpayer-wife has an illness and notes the financial instability of her current employer. However, neither of these facts establishes that the taxpayers are currently experiencing the type of hardship contemplated by the regulations. These facts are, moreover, insufficient to show with any degree of certainty that the taxpayers will suffer any reasonably foreseeable financial hardship in the near term. The file and the report do not support any finding, for example, that the taxpayer-wife will be unable to continue to earn a living or will not be able to obtain other employment should her current employer go out of business. The documentation in the file does not explain how, in the language of the regulation, it is "reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition."

CONCLUSION:

For the foregoing reasons, we conclude that this case is not susceptible to compromise on grounds of promoting effective tax administration. Examination of the taxpayers' case does not support a finding that collection would result in economic hardship, because there has been no showing that collection of the tax liability in full would render the taxpayers unable to provide for reasonable basic living expenses.⁴

⁴ We note that a determination that collection of the full tax liability would create an economic hardship would not end the offer investigation. The offer specialist must still make a judgment as to whether an offer a particular amount should be accepted. The Internal Revenue Manual gives the following guidance with respect to determining an acceptable offer based on considerations of economic hardship:

In offers based on economic hardship, an acceptable offer amount should be determined based on the facts and circumstances of the taxpayer's situation and the financial information analysis. For example, the taxpayer has \$100,000 liability and assets and income of \$125,000. To avoid

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

cc. Assistant Regional Counsel (GL), Western Region

economic hardship, it is determined that the taxpayer will need \$75,000. The remaining \$50,000 should be considered in determining an acceptable offer amount.

IRM 5.8.11.2.1(4). The standard articulated in this manual provision appears very similar to the “reasonable collection potential” standard used for doubt as to collectibility offers, see Policy Statement P-5-100, in that the Service expects a taxpayer to offer an amount equal to that which could be collected after the economic hardship has been accounted for.