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MEMORANDUM FOR DISTRICT COUNSEL, GULF COAST DISTRICT

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

SUBJECT: Request for Advice: Application of Payments Made Pursuant
to Installment Agreements

This memorandum is in response to your request for post-review of a memorandum regarding the right of taxpayers to designate payments made pursuant to an installment agreement. The Appeals Office asked whether a taxpayer making payments under an installment agreement could designate the application of those funds to specific tax liabilities. You concluded that installment payments are "voluntary" and are thus subject to designation in the manner the taxpayer directs. While we agree that such payments are voluntary, we do not agree that taxpayers can dictate how they are applied. We conclude that these payments must be applied in a manner consistent with the regulations governing installment agreements. Therefore, the Service should apply payments in the manner which best serves the interests of the United States, the taxpayers' instructions to the contrary notwithstanding.

DISCUSSION

The law of debtors and creditors generally provides that a debtor voluntarily making payment on a debt may indicate the manner in which the payment is to be applied. In contrast, when a creditor collects funds through judicial collection procedures, such payments are "involuntary" and can be applied by the creditor in whatever manner he chooses. See Restatement (Second) of Contracts § 258 (1981).

The law governing how to apply payments made to satisfy tax liabilities has followed this general principle of debtor-creditor law. In re Avildsen Tools & Machine, Inc., 794 F.2d 1248, 1251 (7th Cir. 1986). A taxpayer can designate the application of voluntary payments to whichever tax liability he chooses. Muntwyler

v. United States, 703 F.2d 1030, 1032 (7th Cir. 1983). There has been considerable case law dedicated to determining whether a payment is voluntary or involuntarily and whether, as a result of this classification, the taxpayer can specify the way in which the payment is applied to his various tax obligations. See, e.g., Stevens v. United States, 49 F.3d 331, 334 (7th Cir. 1995), and cases cited therein. The most commonly cited definition of involuntary payment comes from Amos v. Commissioner, 47 T.C. 65, 69 (1966): “An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.” Thus, a payment is involuntary if it results from enforced collection action. A payment made pursuant to an agreement, regardless of what legal action was threatened at the time the agreement was reached, is made voluntarily. See Bierhaelder v. Commissioner, T.C. Memo. 1995-307 n.4.

Although payments made pursuant to an installment agreement are voluntary under established case law, this does not dispose of the question of whether the taxpayer may direct application of the funds. We take the position that where payments are made pursuant to an installment agreement, the taxpayer’s rights are determined under the regulations authorizing and governing such agreements.

The Service has the discretion to enter into an installment agreement with a taxpayer “if the Secretary determines that such agreement will facilitate collection of such liability.” I.R.C. § 6159(a). Such an agreement is not a “contract” between the Service and the taxpayer because there is no consideration given on the part of the taxpayer. The Service has many rights and powers which it can use to collect delinquent taxes. By executing an installment agreement, the Government agrees to take the payments over time and collection activity is suspended. In exchange, the taxpayer merely agrees to pay that which is already owed. A promise to perform on a pre-existing legal or contractual obligation cannot be consideration for a contract. 17A Am.Jur.2d Contracts § 144 (1991). Thus, no contract can be formed by the taxpayer’s promise to make payments.

The Service can extract certain promises from the taxpayer not on a contract theory, but because the regulations authorize such conditions. Treas. Reg. 301.6159-1(b) (1) (i) specifically provides that “[a]s a condition to entering into an installment agreement with a taxpayer, the director may require that . . . [t]he agreement contain terms and conditions that protect the interests of the government.” One such condition is contained in the Installment Agreement, Form 433-D, which states that all payments on the agreement will be applied “in the best interest of the United States.”

Furthermore, an agreement struck on the eve of court ordered collection action stretches the concept of “voluntary” payment as it is commonly understood.

This is precisely why voluntariness should not be the determining factor where an installment agreement has been entered into. As is stated above, the transaction is not governed by the common law of debt collection, or on case law on the application of voluntary tax payments, but by the terms established by the regulations. Under those terms, the Service retains the right to apply the payments in the way that best insures future collection and compliance.

As a matter of both administrative convenience and fulfilling the Service's statutory mandate, any other conclusion would be untenable. As is noted above, section 6159 limits the Secretary's authority to accept these agreements with the requirement that they "facilitate collection" of the taxes at issue. A construct which allowed taxpayers to apply payments in such a way as to avoid liability in the future would run counter to this statutory limitation. Taxpayers could insist that payments be applied to tax debt which is least likely to be discharged in bankruptcy, or to debt for which the statute of limitations has the longest to run. If the taxpayer were to default after payment, the interests of the Government may not be adequately protected.

If you have any questions, you may contact the attorney who handled this matter at (202) 622-3620.