

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

July 17, 2001

Number: **200133028** CC:PA:CBS:Br2 Release Date: 8/17/2001 GL-127696-01

ULIC: 17.10.00-00 9999/98-00

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; <u>See</u> I.R.C. § 7101; Treas. Reg. § 301.7101-1(2)(iii).<sup>1</sup>

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.

<sup>&</sup>lt;sup>1</sup>Preferably, the tax claim will be reduced to judgment thus extending the time for collection.

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 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 <u>United States v. Citizens Bank</u>, 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. <u>Id.</u> 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. <u>Id.</u> The court disagreed and in granting summary judgment to the government it concluded "that the promissory note and the mortgage gave the government <u>an independent means for collecting the taxes owed</u>, and the statute of limitations bar cannot be extended by implication to that note and mortgage." <u>Id.</u> 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.

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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. <u>United States v. Feinberg</u>, 372 F.2d 352 (3rd Cir. 1967); <u>Lane</u>, 303 F.2d 1 (5th Cir. 1962); <u>Kurio v. United States</u>, 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.

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