V. COLLECTIBILITY SETTLEMENTS

A. General considerations

The ability or inability of a taxpayer to pay the United States' claim against the taxpayer is a factor which should be taken into account in considering settlement. When a compromise is reached for the sole reason that it is unlikely that the full amount of a judgment or the Service's claim can be collected, in Division terminology we have entered into a "collectibility settlement." Sometimes a settlement will take into account both doubt as to collectibility and litigating hazards. For example, the Government's chances of winning a $500,000 case may be 60% but the taxpayer is unable to pay fully even a judgment for $300,000, plus interest, so additional negotiation may occur to take into account the taxpayer's inability to pay.

The goal in negotiating a collectibility settlement is first to collect from the taxpayer an amount which closely approximates the value of the taxpayer's net equity in assets that would be legally and practically obtainable through available enforced collection procedures, either administrative or judicial. Second, looking at the taxpayer's likely financial situation in the upcoming five to 10 years (the period depending on such factors as the age of the taxpayer), we attempt to collect additional amounts from taxpayer's annual income over and above that income necessary to pay the taxpayer's reasonable living expenses.

A settlement based on a taxpayer's inability to pay the entire amount of the liability may be entered into either before or after entry of judgment. Of course, if a case can be settled on a collectibility basis after judgment, it is likely that it was amenable to settlement on that basis before judgment was entered. Thus, it makes a great deal of sense to determine whether a collectibility settlement is possible before instituting discovery or doing other work designed to advance the case toward resolution on the merits. For example, frequently in responsible person cases where the liability is large, the assessed parties are unable to pay fully the entire amount, including statutory interest. In these cases and in other cases which seem susceptible to settlement on a collectibility basis, it is helpful early in the proceedings to ask the opposing counsel whether he or she will be considering settlement as the case progresses. The Trial Attorney may use the conversation as an opportunity to explain that the Tax Division settles cases on two bases, litigating hazards and collectibility, or a combination of these factors. Stress from the very beginning that Division policy on collectibility is based on <u>inability</u> to pay, not mere difficulty in paying.

In order to lay the proper foundation for a collectibility settlement that is in the Government's best interests, the Trial Attorney should advise the opposing counsel that, before beginning the negotiation process, the taxpayer should accept the premise that all assets not required to maintain a reasonable standard of living will be disposed of and paid over to the Internal Revenue Service pursuant to the settlement and that a commitment will likely be made to pay additional amounts from future income. Also, the Trial Attorney should explain that an essential part of the process will be identifying and verifying the taxpayer's assets. Before negotiating the terms of a settlement, the Trial Attorney must obtain information as to the taxpayer's financial situation and the taxpayer will be required to cooperate in providing bank records and other information needed to verify the statement.

B. Sources of financial information

1. Statement of financial condition and other information

Before negotiating a settlement based on collectibility, or if the taxpayer makes an unsolicited offer on a collectibility basis, the taxpayer should be asked to submit a Statement of Financial Condition and Other Information (DJ-TD 433 (1996)), set out in the Appendix as Exhibit C. The letter transmitting to the taxpayer a blank Statement of Financial Condition and asking that it be completed and returned <u>must</u> be accompanied by the Privacy Statement which is part of Exhibit C.

The Tax Division uses its own form because Treasury Form 433-A or 433-B is inadequate for our purposes. For example, it does not contain sufficient information about prior transfers--a taxpayer may have no money whatsoever, but the reason may be that everything has been given away to the taxpayer's children. (When considering compromise of a judgment, Rule 69 interrogatory answers containing up-to-date financial information may take the place of a Statement of Financial Condition and Other Information.)

It is not unusual for a taxpayer, inadvertently or by design, to misstate either assets or liabilities. For this reason, you should ask the Internal Revenue Service to verify the financial statement whenever the Government is making a substantial concession based on collectibility. As a rule of thumb, the financial statement should generally be verified where the Government's concession, based on collectibility, is $50,000 <u>or more</u>, including accrued statutory interest, unless the Trial Attorney has determined, as set forth in a memorandum to the file, that the information disclosed by the taxpayer is substantially correct. If the amount of the liability sought to be compromised is less than $50,000, the Service should be requested to verify the financial information only if the information disclosed appears to be inaccurate in light of the other information available to the Trial Attorney, including the taxpayer's income tax returns.

2. <u>Income tax returns</u>

The Trial Attorney should obtain, either from the Service or the taxpayer, copies of the taxpayer's income tax returns for the last five years. In some cases, it may be advisable to obtain copies of the income tax returns for all years beginning with the year to which the liability relates to assist in verifying that fraudulent conveyances have not been made. Fraudulent conveyances are most likely to occur during audit, or shortly before the taxpayer initiates suit drawing attention to taxpayer's situation.

Tax returns can provide very interesting insights into a taxpayer's financial situation, as when the taxpayer reports income from dividends or interest, but no stocks or bank accounts are shown on the financial statement, or where mortgage interest is deducted for real estate not shown on the return. If a taxpayer reports on the tax return a sale of capital assets, ascertain what happened to the proceeds. It is also helpful to see the taxpayer's earnings history. A taxpayer currently without employment may have substantial earnings potential once employment is found, as can be seen from prior years' wage income. Also, a taxpayer may show stock having no or unknown value on the financial statement which turns out to be stock in a closely held business. The tax returns of the closely held corporation may provide information which will assist in evaluating how the income and assets of the business should be taken into account in negotiating the settlement.

3. <u>Applications for loans</u>

If the taxpayer has obtained loans, the Trial Attorney should obtain copies of the loan applications. These applications either will be consistent with the information provided on the financial statement and provide a measure of assurance that the financial statement is correct, or will be inconsistent and helpful for that reason.

4. Taxpayer-owned businesses

If, by virtue of the financial statement or otherwise, the Trial Attorney is aware that the taxpayer owns a controlling interest in a business, the Trial Attorney should immediately request the taxpayer to provide a financial statement for the business so the income and/or the liquidation potential can be taken into account. Asking for this additional financial statement early in the discussions will save considerable time for the Internal Revenue Service and the Division in its consideration of an offer.

C. Terms of settlement

1. Cash payments

In negotiating a settlement, the Trial Attorney should attempt to maximize the amount that the taxpayer will pay shortly after acceptance of the offer and minimize utilization of installment or deferred payment agreements. If the settlement includes an installment or deferred payment agreement, the unpaid amount generally should include statutory interest from the date of acceptance of the offer.

2. Collateral agreements

A collateral agreement should be considered in any proposed settlement based upon the taxpayer's inability to pay. There are two types of collateral agreements commonly used by the Division which enable the Government to recover part or all of the difference between the amount of the offer and the liability settled. They are collateral agreements based on future income and those by which a taxpayer gives up present or future tax benefits. The theory underlying a collateral agreement is that, since the balance of the taxpayer's liability will be abated once the taxpayer satisfies the terms of the offer, it is reasonable to expect that the taxpayer will agree to pay additional sums from future income or to give up potential tax benefits as additional consideration for acceptance of the offer.

The total amount which can be recovered under an offer and collateral agreement is the equivalent of the total liability compromised, plus interest and additions to tax that would have accrued in the absence of the settlement.

a. Contingent payments based on future income

Future income collateral agreements are used most frequently. Copies of the forms Collateral Agreement--Future Income-Individual and Collateral Agreement--Future Income-Corporation are attached as Exhibit T. Under the terms of a future income collateral agreement, a taxpayer is obligated to pay, for each year the agreement is in force, graduated percentages (generally ranging from 20 to 50%) of "annual income" in excess of a threshold amount or floor.

The threshold or floor at which percentage payments begin to be due must be negotiated with an individual taxpayer in each case. Among the factors to be considered by the Government are the number of dependents, expected changes in the size of the family, number of wage earners in the family, FICA taxes withheld, and unusual expenses, such as alimony, child support, and abnormal medical and dental costs. The completed Form DJ-TD 433 (1996) will contain information concerning living expenses. Note, however, that the purpose of the threshold is not to maintain the taxpayer's present living standard, which may be extravagant, but to allow the taxpayer to retain a reasonable amount of income before payments under the collateral agreement become due. Internal Revenue Service Special Procedures should be contacted as they have knowledge of what terms are accepted in a particular area and the local cost of living. A typical provision for an individual taxpayer might be as follows:

(a) Nothing on the first $25,000 of annual income; 21/

(b) 20% of annual income more than $25,000 and not more than $30,000.

(c) 30% of annual income more than $30,000 and not more than $40,000.

(d) 40% of annual income more than $40,000 and not more than $50,000; and

(e) 50% of annual income more than $50,000.

21/ The $25,000 threshold or floor assumes that the taxpayer's current income is $25,000 or more. If a taxpayer is presently unemployed but is still able to work and has an employment history showing the ability to realize substantial earnings, a threshold amount may be set taking all circumstances into account.

For a corporation, the usual threshold or floor is $10,000, and the agreement usually provides for the payment of 30% of annual income more than $10,000 and less than $15,000, and 50% of annual income exceeding $15,000.

Future income collateral agreements, for both individuals and corporations, usually run for a period of 10 taxable years. A shorter period (no less than five years) can be considered in individual cases where, for example, the taxpayer is elderly and retired or will soon retire.

The term "annual income" is defined in the text of the collateral agreement itself to include, inter alia, all nontaxable income, including the fair market value of gifts, bequests, devises and inheritances. Annual income is reduced by federal, state, and local income taxes reportable for the year for which annual income is being computed, provided that such taxes have been reported and paid. Annual income is further reduced by any regular monthly, annual, or other periodic payment made under the settlement for the year in which such payment is made. It is usually advisable to use the standard definition on the collateral agreement form, but in situations where the taxpayer is self-employed there may be additional complexities to be considered.

A future income collateral agreement is appropriate in those situations where it appears reasonably likely that the taxpayer will have future annual income over and above the taxpayer's necessary living expenses during the period of the agreement. Therefore, if a taxpayer is presently unemployed but is still able to work and has an employment history showing the ability to command annual income greater than the threshold amount, a collateral agreement should be negotiated. On the other hand, if the taxpayer has a lengthy work history and has never earned income greater than the threshold amount, a collateral agreement may not be in the Government's best interests. Generally, where the taxpayer is making a lump-sum payment and has no prospects, collateral agreements will not be required merely because an unlikely event may occur, such as the winning of a lottery or the unexpected inheritance of assets in the future (although it may be appropriate if the inheritance is substantial and appears reasonably likely to occur during the period of the collateral agreement).

Under the terms of the future income collateral agreement, each year the agreement is in force the taxpayer is required to submit to Special Procedures a sworn statement of annual income and copies of the taxpayer's current federal, state, and local income tax returns for the year for which annual income is being computed. Copies of the annual income forms for individuals and corporations are attached as Exhibit U.

After the Trial Attorney has received the executed collateral agreement, he or she should send the original and two copies of the executed collateral agreement to Internal Revenue Service Special Procedures for monitoring of the agreement. A copy of a form letter is attached as Exhibit V. Copies of the agreement should be placed in both the DJ file and the Trial Attorney's personal file.

b. Waiver of carryover of losses and credits

Where the taxpayer has incurred net operating losses or capital losses for years ending before the date on which the offer will be accepted, and/or the taxpayer has any unused credits from any such prior years, a collateral agreement waiving any carryover of such losses and credits should be considered. This collateral agreement should be used only when the taxpayer is not executing a collateral agreement as to future income as a part of the settlement, since the collateral agreement as to future income contains a waiver of carryover of losses and credits. A copy of the Collateral Agreement--Waiver of Carryovers is attached as Exhibit W.

3. Taxpayer's residence

There are many factors to be considered in deciding how a residence owned or co-owned by the taxpayer should be taken into account in a collectibility settlement. If the taxpayer co-owns the residence with his or her spouse, it is essential to understand any restrictions imposed by state law on the sale of the house by the Government. In many states, the case law is settled that the residence may be sold and each spouse will share equally in the proceeds. In other states, the law is unsettled. While in many situations a collectibility settlement will not involve the sale of the residence, knowing whether it can be sold and the amount that likely can be recovered from it will provide the Trial Attorney with the necessary understanding of the collection potential with respect to this issue.

The Trial Attorney must analyze the taxpayer's equity in the residence. If the residence is a modest one and is mortgaged for 80% of its value, in many situations a collectibility settlement will not require the sale of the residence. For example, a forced sale may not result in any payment to the Government. Moreover, lodging is a necessary living expense and, normally, it will be less expensive, or no more expensive, for the taxpayer to live in the residence, continuing mortgage payments, than to rent an alternative place to live. Even if the residence is mortgaged to the extent of 80% of value, however, the taxpayer's equity may be significant enough to require the sale of the home and payment of that equity to the Government. This most frequently occurs when the house is a lavish one or where there is less expensive alternative lodging clearly available, such as where the taxpayer also owns other, more modest, residential real estate.

In situations where there is equity in the residence which can be withdrawn by borrowing and the income to support increased mortgage payments exists, it is usually in the Government's best interests to make the taxpayer's borrowing a condition of settlement. This borrowing will enable the Government to receive a greater cash payment up front. This lump-sum payment is preferable to receiving payments over time pursuant to a collateral agreement both because it has more real dollar value and because it is surer to occur.

Generally, the Division will not work out a settlement solely on the basis of collectibility in foreclosure actions and fraudulent conveyance actions brought by the Government in order to reach and sell the taxpayer's residence. That is because the Division has determined, prior to bringing the suit, that the sale of the residence is warranted. The most common exception, however, is where the taxpayer seeks alternative ways, usually by borrowing, to pay over the equity in the property to the Government. The Trial Attorney should always question taxpayer's counsel closely about the source of funds to be used to make payments of this type, and seek verification where appropriate, to assure that hidden taxpayer funds are not the source.

The Trial Attorney must know the value of the property as a starting point in determining the value of the taxpayer's equity. The Internal Revenue Service should be requested to determine the range of amounts the Government would likely receive from the sale. Normally, the Service will determine the fair market value and the forced sale value. The Trial Attorney should inquire how those values have been determined and verify that any discount is appropriate. It is important that the fair market value be determined by a revenue officer or real estate broker or agent familiar with comparable sales in the area in which the property is located. No discount should be allowed for lack of marketability of property with a clouded title when the property would be sold after a judicial foreclosure. Moreover, while it is true that property will probably sell for less at forced sale, this is not always the case. The Trial Attorney should inquire about any special circumstances, such as a known, potential purchaser or particularly favorable market, which nullify or mitigate against the property's being affected negatively by the fact of a forced sale.

Once the Trial Attorney has determined the likely result of a forced sale, it is possible to begin negotiating the buy-out figure which should be around the midpoint between fair market value and forced sale value. Both values are estimates and have elements of risk and opportunity to both parties. It is reasonable that neither party bear entirely either the risk or the opportunity of the sale eliminated by the buy-out.

4. Alternatives to a collateral agreement

Taxpayers sometimes ask what they can do in order to avoid being subject to the terms of a collateral agreement for a period of years. The alternative is for the taxpayer to increase the up-front cash payment to an amount which will fairly substitute for the potential amount that would be paid pursuant to the collateral agreement, reduced to present value.

Normally, the taxpayer will obtain the additional funds by gift or borrowing. A residence in which the taxpayer and his or her spouse have significant equity is often the collateral for the borrowing. A spouse may be willing to provide the taxpayer access to the spouse's equity in the residence, preferring the known quantity of an increased mortgage payment to the contingent nature and reporting requirements of the collateral agreement.

5. Waiver of deductions or credits

If a case is being settled on the basis of taxpayer's inability to pay, an asset that the taxpayer can offer in settlement is waiver for federal tax purposes of: (1) any deduction for the payments made pursuant to the settlement; (2) loss carryovers; or (3) credit carryovers. Additionally, in a bankruptcy settlement, an agreement as to reduction of basis of the assets of a reorganized debtor might provide additional consideration for the settlement.

6. Security for amounts due under compromise

A settlement including deferred or installment payments and/or a collateral agreement should provide for security for the taxpayer's obligations under the settlement. Thus, tax liens should not be released. In negotiating a settlement before judgment has been entered, the Trial Attorney generally should have the taxpayer agree to entry of judgment for the full amount of the Government's claim. If judgment is not to be entered, the taxpayer must waive the benefit of any statute of limitations applicable to the assessment and collection of the liability sought to be compromised and agree to the suspension of the running of the statutory period of limitations on assessment and collection for the period during which the offer in compromise and the settlement are pending, or the period during which any payment due under the settlement remains unpaid, or any provision of the settlement is not carried out in accordance with its terms, and for one year thereafter.

The settlement should provide that the judgment will be marked satisfied after the judgment debtor has completed all obligations under the settlement, including any collateral agreement.

The settlement should cover the Government's options in the event of default by the taxpayer. These options are set forth in the collateral agreement form. If the taxpayer will not be executing a collateral agreement as a part of the settlement, the settlement should set forth the appropriate options.

Abstracts of judgments and other security received for payments, whether received before or after settlement, should be filed and/or recorded in the appropriate districts or other appropriate local offices, except if the settlement provides otherwise. Originals of legal documents, such as mortgages, notes, letters of credit, and insurance policies, should be preserved in a Tax Division safe, and the Trial Attorney should prepare a memorandum to the file setting forth the location of the document.

D. Receipt and monitoring of payments

When the terms of settlement require payments to the Government, the Trial Attorney should give some thought to where the payments should be sent by the taxpayer and who will be responsible for monitoring the receipt.

Taxpayers generally should be directed to send to the Tax Division the following categories of payments:

1. Lump-Sum Payments. A lump-sum payment is a single payment to be made within a specified time, such as 30 days after the date of acceptance or upon the happening of an event, such as the sale of property or the termination of probate proceedings. If the payment is due upon the happening of an event which is not likely to occur within a short period of time, it may be

advisable to direct the taxpayer to send the payment to Special Procedures.

2. Initial Payments. An initial payment is a payment which is to be made within a specified short time, after which installment payments will be made for a prolonged period, e.g., a payment of $30,000 due within 30 days after acceptance, followed by monthly payments of $500 until the liability is paid in full.

3. Installment payments concluding within six months of acceptance.

4. The first installment payment of an installment payment agreement extending beyond six months should be sent to the Tax Division; the remaining installment payments generally should be sent to Special Procedures.

Taxpayers generally should be directed to send directly to Special Procedures the following categories of payments:

1. All installment payments, after the first installment payment, where payments will be made over a period of more than six months.

2. Payments due under a collateral agreement as to future income.

3. Any other payment not specified above as a payment to be sent to the Tax Division.

Addresses and telephone numbers of Special Procedures Offices are attached as Exhibit X.

It is the responsibility of the Trial Attorney, with the assistance of a collection paralegal, to monitor the receipt of payments which are directed to the Tax Division and to take appropriate measures on default.

E. Acceptance letters and closing cases after settlement

Form acceptance letters in cases where payments are due the Government, under the compromise, and forms of stipulations of dismissal and stipulations for entry of judgment in such cases, are set out in the Appendix as Exhibits K, L, and M. Bear in mind that these forms are simply forms, and must be adapted to the particular case. Thus, they must be crafted bearing in mind all the provisions of the settlement, including those providing for security for the amounts due under the compromise, as well as the directions necessary concerning receipt and monitoring of payments.

Upon receipt of all payments due to be paid directly to the Tax Division (or, if all payments are to be made to the United States Attorney or the Internal Revenue Service, then, upon acceptance of the settlement offer), the case should be closed in the Tax Division. Thus, if all payments are to be made to Special Procedures, the case should be closed and referred to Special Procedures for monitoring of the settlement agreement and receipt of the payments, including payments that may be due under a collateral agreement. Special Procedures should be requested to advise the Tax Division upon any default by the taxpayer, or upon receipt of the final payment due so that any judgment entered may be marked satisfied. If all payments pursuant to a settlement are to be made to the United States Attorney, the Trial Attorney should close the case in the Tax Division and refer it to the United States Attorney.

F. When full payment is made

When the taxpayer has fully complied with the terms of the settlement, the Trial Attorney should:

1. File a satisfaction of any judgment involved or request the United States Attorney to do so, or dismiss the Government's claim;

2. Request the Internal Revenue Service to release the liens against the taxpayer for the liability at issue in the case, or discharge the fund or property involved from the liens against the taxpayer for the liability at issue in the case; 22/ and

3. If the case is pending in the Tax Division, close the case as fully paid, with concurrent advice or closing to the Internal Revenue Service and the United States Attorney.

4. Request the United States Attorney to arrange for the release of any existing judgment lien.

22/ A release of liens wipes out the liens; a discharge of property from the liens does not.

G. Default on a settlement

Normally, the Section Chief has the authority to determine when the taxpayer is in default on a settlement. In the event of a default, the Trial Attorney should proceed as follows:

(1) Notify taxpayer's counsel or taxpayer that there has been a default and request that the default be cured, generally within 21 days. (Or, a cure period may be set forth in the settlement agreement.)

(2) If the default is not timely cured, proceed to follow the remedies available upon default.