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DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR SOUTHERN CALIFORNIA DISTRICT COUNSEL, LAGUNA NIGUEL

FROM: Mitchel S. Hyman
Acting Senior Technical Reviewer, Branch 2
(General Litigation)

SUBJECT: Request for Field Service Advice Regarding Offer-in-Compromise in Bankruptcy

This memorandum responds to your memorandum dated August 3, 1999. This document is not to be cited as precedent.

ISSUES:

Your memorandum asks the following questions:

(1) What kind of a claim should the Internal Revenue Service ("Service") file in a Chapter 13 bankruptcy case when the tax liabilities have been compromised in a pre-petition offer in compromise ("OIC")?

(2) Is the answer to the aforesaid question any different if the bankruptcy is filed under Chapter 7 or 11?

(3) Should the language in the OIC Form 656 be changed to better protect the Service's interests?[1]

CONCLUSIONS:

[1] You also ask whether the Service should reconsider its position that it will not consider OICs from taxpayers in bankruptcy in light of In re Mills, 240 B.R. 689 (Bankr. S.D. W.V. 1999), and In re Chapman, 1999 Bankr LEXIS 1091, 99-2 U.S. Tax Cas. (CCH) P50,690, 84 A.F.T.R.2d 5271 (S.D. W.V. June 23, 1999). Because this question is beyond the facts of the case at issue in this advisory, we will not address it in this memorandum. However, we are currently working with Collection and the Department of Justice on this matter and will inform you when we have reached a resolution.

(1) When a taxpayer with an accepted but uncompleted OIC files a Chapter 13 petition, the Service has a tax claim for the entire underlying liability, unless the debtor assumes the OIC in the plan. The Service should therefore file a protective claim for the underlying tax liabilities to protect the Service's interests in the event that the debtor fails to assume the OIC in the plan.

(2) The answer is generally the same in Chapter 7 and Chapter 11 cases. In Chapter 7 cases the debtor cannot assume the OIC contract, so the Service's claim will not be a protective claim.

(3) We do not recommend any change to the language of Form 656.

BACKGROUND

Your request for advice asks for a post-review of a case in which debtors with accepted offers in compromise filed a Chapter 13 petition. Debtors were husband and wife. The husband had entered into a compromise for one tax year, but had not paid the principal due under the OIC agreement. The taxes compromised under this agreement are general unsecured claims in the bankruptcy case. Though the OIC was in default for nonpayment, the Service had not terminated the agreement as of the petition date.

The debtors had also jointly entered into another compromise for other tax years, and had paid the full amount of the principal due. They had not, however, paid interest on the compromised amount as provided for in the OIC form, though the amount of interest due was small. The taxes compromised under this agreement are entitled to secured claim status. The Service also had not terminated this agreement as of the petition date.

The Service filed a proof of claim with the bankruptcy court for the full amount of the unpaid tax liabilities, notwithstanding the accepted OICs. The amount of the Service's claim entitled to full payment in a Chapter 13 case as a secured claim greatly exceeded the amounts due under the OICs. The debtors filed an objection to the Service's claim, arguing that the tax liabilities had been compromised and paid (even though the husband's offer remained unpaid).

The objection to claim was resolved through a stipulation in the bankruptcy court whereby the debtors would pay an amount approximately equal to the unpaid principal and interest due under the OICs through their Chapter 13 plan as a priority tax claim. The stipulation required the debtors remain in compliance with the Internal Revenue Code as was required under the OIC agreements. The settlement also provided that any default on the payment or tax compliance provisions of the settlement agreement would result in reinstatement of the full

unpaid tax liability, including penalties and interest, which could be collected administratively without any further action to have the automatic stay lifted.

DISCUSSION:

I. What Kind of a Claim Should the Service File in a Chapter 13 Bankruptcy Case When the Tax Liabilities Have Been Compromised in a Pre-petition Offer in Compromise?

A. The Service's Claim in the Chapter 13 Bankruptcy Case and the Bankruptcy Code's Treatment of the Executory Contracts

In your memorandum, you state that a bankruptcy court will most likely conclude that an OIC agreement in full compliance as of the date a bankruptcy petition was filed is an executory contract. Therefore, you conclude, the IRS would have a general claim under the contract, as opposed to a priority tax claim, in the bankruptcy case, and the Service's proof of claim should reflect the balance of the compromised amount.

We agree that an uncompleted OIC is an executory contract. See Black's Law Dictionary (6th ed. 1991) ("In the context of Bankruptcy Code, [an executory contract] is a contract under which [the] obligation[s] of both bankrupt and the other party to contract are so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of either"). See also, 3 Collier on Bankruptcy § 365.02, 365.02[1] (15th ed. 1999). When an OIC agreement has not been completed, performance remains due on both sides. The taxpayer has to comply with the payment and compliance provisions of the contract, after which the Service must remove any tax liens, abate the tax liability, and refrain from further collection.

However, the conclusion that the Service has a claim under a contract which has not been breached is problematic. Generally, a party to a contract under which the debtor's performance is prospective does not have a right to payment, and therefore a claim, until such time as the contract is repudiated or breached. We, instead, conclude that the Service has a tax claim entitled to general, priority or secured status, as the case may, for the full amount of the unpaid liabilities, rather than a general claim for the balance due under the contract.[2] A taxpayer's

[2] Your conclusion that the Service has a contract claim, as opposed to a tax claim, was based upon previous advice from this office. Memorandum to Director of Operations dated May 4, 1993. In that memo we advised that until such time as the OIC Form 656 is modified to provide that the filing of a petition in bankruptcy will result in the termination of the OIC, the Service should file a proof of claim for the amount due

obligation to pay income taxes arises out of the Internal Revenue Code, not the OIC, and is therefore a tax liability.

Courts have repeatedly recognized an OIC as a contract. See, e.g., United States v. Feinberg, 372 F.2d 352 (3rd Cir. 1967); United States v. Lane, 303 F.2d 1 (5th Cir. 1962). In spite of this fact, courts have rejected arguments that the compromise amount is a new, contractual liability. For many years the Service argued that the amounts agreed upon in a compromise represented a contractual liability "in lieu of" the underlying taxes. These disputes about the nature of the unpaid liability arose when taxpayers who had compromised liabilities attempted to claim interest deductions for the amount paid which they believed had gone to pay the interest portion of the total debt. In I.T. 3852, 1947-1 C.B. 15, the Service took the position that no part of the payment made on a lump sum OIC could be considered a payment of income tax, penalties, or interest, but are payments made on a contract in lieu of the tax liability. In cases where the facts were in all material respects identical to the discussed in the ruling, courts generally accepted the ruling. See William C. Atwater & Co. v. Bowers, 5 F.Supp. 916, 918 (S.D.N.Y. 1934); Petit v. Commissioner, 8 T.C. 228, 236 (1947). However, where the Service sought to deny deductions based on the "substituted contractual obligation" theory in cases where payments exceeded the underlying principal tax, courts rejected the theory, finding that payments in compromise should be deductible to the extent of the deductibility of the liability to which they were applied. See, e.g., Finen v. Comissioner, 41 T.C. 557 (1964); Lustig v. United States, 138 F. Supp. 870, 873 (Ct. Cl. 1956). As the court in Lustig pointed out, and the Service later acknowledged, courts upholding the Service's position did so not because they adopted the Service's characterization of the liability as contractual, but because the amount of interest included in the payment had lost its identity. 138 F. Supp. at 873. See also Brink v. Commissioner, 39 T.C. 602 (1962); Automatic Sprinkler Co. of America v. Commissioner, 27 B.T.A. 160 (1932).

The substituted contract liability theory was finally rejected, for all types of cases, in Robbins Tire & Rubber Co. v. Commissioner, 52 T.C. 420 (1969) and 53 T.C. 275 (Supplemental Opinion) (1970), acq. 1973-3 C.B. 3, the case which led the Service to reconsider its prior position on the nature of compromised liabilities. In Robbins, the court held that because the agreement applied payments to the underlying tax liability, and other portions of the agreement plainly contemplated that the liability

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under the OIC, and also file a motion under Bankruptcy Rule 6006 for a determination as to whether the OIC agreement is an executory contract. Although this specific language was not added to Form 656, other language was added that clarified that the Service will continue to have a tax claim in bankruptcy, and that the underlying tax liabilities will not be abated until the terms of the OIC have been completed. This language is discussed infra.

would survive, it could not be said that the parties to the contract contemplated the construction urged by the Service. Id. at 436-437. Because the payments were tax payments and the agreement was silent as to their application to specific liabilities, the court found that the normal IRS procedure for application of payments should be used to determine what portion of payments was applied to interest, and was therefore deductible. Id. at 437. In response to Robbins, the Service reconsidered and abandoned the substituted contractual liability theory. In Rev. Ruling 73-304, 1973-2 C.B. 42, the Service ruled that payments made on an OIC would be applied just as any other tax payment, unless the agreement provided otherwise. Thus, a deduction for interest would be permitted, to the extent allowed by I.R.C. § 163, for that portion of the compromise payment that was applied to interest.

The language in the present version of OIC Form 656 reflects that the taxpayer with an accepted OIC remains liable for the underlying tax, and that payments made on the OIC are tax payments. Form 656 (Rev. Feb. 1999), paragraph (j), provides that the taxpayer remains responsible for the full amount of the tax liability, and the Service will not remove the original amount of the tax liability from its records unless and until the taxpayer has met all the terms and conditions of the offer. Paragraph (k) of Form 656 provides that the tax being compromised remains a tax liability until the taxpayer meets all the terms and conditions of this offer, and if the taxpayer files bankruptcy before the terms and conditions of the offer are completed any claim the IRS files in bankruptcy proceedings will be a tax claim. The OIC forms used in the present case also contained such provisions. Thus, the underlying tax liability still existed when the taxpayers filed bankruptcy, and the Service was entitled to file a claim for the underlying tax liability.

While we conclude that it is clear that the an OIC does not convert the Service's claim from a tax claim to a contract claim, the more difficult issue to be resolved is whether the Service's claim in bankruptcy should be for the entire underlying unpaid tax liability or for unpaid amount under the OIC. Because the Service is entitled to collect the full amount of the unpaid underlying tax liabilities if the OIC is breached, we conclude that the proof of claim should list the full unpaid underlying tax liability.

The debtor, however, can choose to assume the OIC as an executory contract in the plan, in which case there will be no breach and the full tax liabilities will not be payable under the plan. The following is an explanation of the applicable executory contract provisions of the Bankruptcy Code. The bankruptcy trustee may accept an executory contract and render it a post-petition contract of the estate, or may reject it and render the contract breached. B.C. § 365(a), (g).[3] Debtors in Chapter 9, 11,

[3] We see no reason why a Chapter 13 trustee, rather than the debtor, would ever wish to assume an OIC contract. We also do not believe that a trustee could assume an OIC contract without the Service's consent. See footnote 8.

12, and 13 cases can also assume executory contracts in their plans, subject to § 365. B.C. §§ 1123(b)(2), 1222(b)(6), 1322(b)(7).[4] If the contract is rejected by the trustee, it is deemed to have been breached immediately before the date of the filing of the petition. B.C. § 365(g). The breach gives rise to a claim which is deemed to have arisen before the date of the filing of the petition. B.C. §§ 365(g), 502(g). In Chapter 13, debtors may also chose to cure any default and maintain any payments on secured or unsecured claims on which the last payments are due after the date on which the final payment under the plan is due. B.C. § 1322(b)(5). Such claims are nondischargeable. B.C. §§ 1328(a)(1).

Thus, if a debtor expressly assumes an OIC in the debtor's Chapter 13 plan, the OIC should be treated as not breached and the tax claim payable pursuant to the Service's proof of claim should be the amount due under the OIC. This is because having assumed the OIC as an executory contract, the debtor has agreed to pay in full the remaining obligation under the OIC, and the Service accordingly must honor the OIC by accepting such payment as satisfying the tax liability. If, however, the OIC is not expressly assumed in the plan, the OIC should be considered breached and the amount payable pursuant to the Service's proof of claim should be the full tax liability listed in the claim.[5]

Based on the foregoing, we conclude that in Chapter 13 cases where payments have not been completed under a pre-petition OIC, the Service should file a proof of claim reflecting the full amount of the unpaid tax liabilities. A note should be added to the proof of claim to reflect that it is being filed as a protective claim in the event that the debtor does not assume the OIC as an executory contract in the plan. The Service should then object to the Chapter 13 plan if it does not either, (1) expressly assume the OIC, or (2) provide for full payment of the Service's priority and secured tax claims as provided for in Bankruptcy Code §§ 1322(a)(2) and 1325(a)(5), and any payment on its general unsecured claim that it may be entitled to in the case. In this way the Service will be honoring the OIC, while protecting its rights should the debtor chose not to assume the OIC. The debtor will have a choice, based on an evaluation of what is in the debtor's best interests, to either assume the OIC or be liable for the full underlying tax liability.

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[4] Section § 1107(a) also provides that a debtor in possession in a Chapter 11 case has the right of a trustee to assume or reject an executory contract.

[5] The Service should also be paid pursuant to the full tax liability listed on the proof of claim (as a pre-petition claim) if the OIC is assumed in the Chapter 13 plan, but the case is subsequently converted to Chapter 7. See B.C. § 348(c), § 365(d), § 502(g), and our explanation of the Service's claim in a Chapter 7 case infra.

In the present, case, we conclude that the Service properly filed a proof of claim for the entire underlying unpaid tax liability, although consistent with our advice in this memorandum, we believe that such proofs of claim in the future should be labeled as "protective claims" should the OIC not be assumed in the plan. Pursuant to the stipulation in this case, the debtors effectively assumed both OICs by agreeing to pay the amounts remaining due under the OICs. This result is consistent with our conclusions in this memorandum.

B. What If the Taxpayer Is in Default on the Petition Date, but the Service Has Not Terminated the OIC?

Your memorandum also asks about situations where a taxpayer is in default under the terms of the OIC at the time the bankruptcy petition was filed, but the Service had not yet sent a default letter terminating the OIC.[6] We agree with your conclusion that the Service will continue to be bound by the OIC. Terminating the OIC once the bankruptcy case has commenced could be considered a violation the automatic stay, as it is an act to collect the pre-petition tax liability. See § 362(a). Further, the Bankruptcy Code provides that an executory contract in default can be assumed as long as the default is promptly cured. B.C § 365(b)(1).[7] This implies that the Service remains bound by the OIC for purposes of the bankruptcy case until it is rejected. Of course, if the OIC has been terminated before the bankruptcy case is commenced, there is no contract for the trustee or the debtor to assume.

C. What If All Payments Have Been Made Under the OIC, But the Debtor Is Still Subject to the Future Tax Compliance Provision on the Petition Date?

Our analysis has thus far assumed that the courts will find that uncompleted OICs are executory. Though we have found no case law on this point, we are confident in asserting the executory nature of uncompleted OICs when payments were not completed under the OIC. As we have said, performance remains due on both sides. The taxpayer must comply with all terms of the OIC, and thereafter the Service must abate the compromised tax liability. Payment of the agreed amount is

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[6] If an accepted OIC is to be defaulted, the Service prepares a default letter signed by the appropriate official declaring that the OIC is in default and terminated. I.R.M. 5.8.9.4(5) and Exhibit 5.8.9-4.

[7] Section 365 (b)(1) provides that if there has been a default in an executory contract, the trustee may not assume the contract unless the default is cured (or adequate assurance is provided that it promptly will be cured), and adequate assurance of future performance is provided. A debtor's assumption of an executory contract is also subject to the provisions of § 365. See B.C. §§ 1107(a), 1123(b)(2), 1222(b)(6), 1322(b)(7).

clearly a material term that renders the contract executory. However, it is less clear whether courts would be willing to consider an OIC contract executory when a taxpayer has completed payments under the OIC, but remains responsible under the future tax compliance provisions of the OIC.

The present version of the OIC Form 656 (Rev. Feb. 1999), paragraph (d), provides that the taxpayer agrees to comply with all provisions of the Internal Revenue Code relating to the filing of returns and paying the required taxes for 5 years or until the offered amount (plus accrued interest) is paid in full, whichever is longer. The OIC agreements in the present case also contained such a provision. A court would have to decide whether this provision is a material term of the contract that renders the taxpayer's performance executory.

We believe that the future compliance provisions are material to the contract, rendering the contract executory even though all payments have been made. One of the primary purposes of the OIC program, and therefore the OIC contract, is to allow delinquent taxpayers who could not otherwise comply with the tax laws, to pay what they can afford to pay and come back into compliance with the federal tax system. Thus, a material part of the bargain for the Service is that the taxpayer remain in compliance with the Internal Revenue Code.

However, as a practical matter, we do not recommend filing a proof of claim in these cases, assuming the future tax compliance provisions have not been breached and the OIC terminated prior to bankruptcy. Such a proof of claim would be, in essence, a contingent claim which a bankruptcy court would probably estimate to be zero. If after confirmation the taxpayer fails to comply with the future compliance provision by failing to file post-petition tax returns or paying post-petition tax liabilities, the Service could use the normal remedies available to the Service during a Chapter 13 plan. That is, the Service could file a § 1305 claim for the post-petition liability, or seek conversion or dismissal of the bankruptcy case.

II. Is the Answer to the Aforesaid Question Any Different If the Bankruptcy Is Filed under Chapter 7 or 11?

Our advice as to the preparation of the proof of claim in a Chapter 13 case would be generally the same in a Chapter 11 case. In a Chapter 7 case, there is no mechanism whereby a debtor could assume an executory contract. See B.C. § 365. Recall that a debtor's ability to assume an executory in their plan was provided for by chapter specific provisions in the reorganization chapters. It is also unlikely that a Chapter 7 trustee could or would assume an OIC contract.[8] Thus,

[8] Notwithstanding § 365(a), we do not believe trustees can assume OIC contracts. We believe that the future compliance provision of the OIC contract renders

OIC contracts in Chapter 7 cases will typically be deemed to have been rejected on the 60th day after the order for relief. B.C. § 365(d)(1). Rejection will result in a breach of the OIC contract that is deemed to have occurred immediately before the filing of the petition. B.C. § 365(g). As in Chapter 13 cases, a claim for the unpaid tax liabilities resulting from the rejection and breach is treated as a pre-petition claim. B.C. § 502(g). Accordingly, the Service should file a proof of claim for the full amount of the unpaid underlying tax liabilities, and the claim should be treated in the bankruptcy case as if the OIC never existed. However, we see no reason why the Service should not still honor the OIC if the taxpayer has not otherwise defaulted. Any amounts collected pursuant to the proof of claim could be applied against the balance due under the OIC. This would protect the interests of both the Service and the debtor.

III. Should the Language in the OIC Form 656 Be Changed to Better Protect the Service's Interests?

Your memorandum also asks whether language should be included in the OIC contract Form 656 providing that the filing of bankruptcy case prior to fulfillment of all the terms of the contract would terminate the contract, and reinstate the full unpaid tax liability. You are concerned that absent such language, the Service could not file a proof of claim for the entire unpaid tax liability. However, any such language would not be enforceable pursuant to § 365(e)(1)(B), which provides that an executory contract cannot be terminated based upon a provision in the contract that is conditioned upon the commencement of a bankruptcy case. In any case, we believe such language is not necessary in light of our conclusion that the Service can file a proof of claim for the entire underlying tax liability.

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

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the contract unassignable under contract law, because performance could only be accepted from the taxpayer. See 2 Restatement of the Law Second (Contracts) § 318, § 319 (1981). Such contracts cannot be assumed by the trustee under the Bankruptcy Code without the Service's consent. B.C. § 365(e)(1)(2)(A). We also do not believe that a bankruptcy trustee would want to assume an executory OIC contract, as there is no value to the estate in the right to assume the taxpayer's tax liabilities. While a trustee may conceivably consider accepting an OIC contract and paying it to increase the payout to other creditors, we believe this runs counter to the trustee's duty to maximize the value of the estate for the benefit of all creditors. A possible exception could be a chapter 11 trustee seeking to reorganize the debtor.

cc: Assistant Regional Counsel (GL), Western Region