**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

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subject: HR 1424 as it relates to AMT/ISO and Offers in Compromise

This Chief Counsel Advice responds to your request for assistance dated October 30, 2008. This advice may not be used or cited as precedent.

## ISSUES

1. What effect does H.R. 1424, Emergency Economic Stabilization Act of 2008 (EESA) have on a taxpayer who has entered into an Offer in Compromise (OIC) to settle a tax liability owed under I.R.C. § 53?
2. What options are available to a taxpayer who is making deferred payments on an accepted offer to compromise a tax liability under I.R.C. § 53?
3. Where EESA has abated tax liabilities owed pursuant to I.R.C. § 53, can a taxpayer obtain a refund of taxes paid under an OIC?

## CONCLUSIONS

1. EESA provides relief to taxpayers by abating tax liabilities caused by the provisions of I.R.C. § 53. If a taxpayer facing a tax bill under I.R.C. § 53 agreed to an OIC with the IRS prior to enactment of EESA, that portion of the OIC that pertains to I.R.C. § 53 is not enforceable after the date of the enactment of EESA because the I.R.C. § 53 liability was abated by Congress. The taxpayers need not take any action to avail themselves of the relief provided under EESA.
2. If the OIC relates to only a tax liability under I.R.C. § 53, a taxpayer need not make any further deferred payments pursuant to an OIC to settle a tax liability under I.R.C. § 53 because that liability is abated from the enactment date of EESA. But if the OIC involves tax liabilities in addition to the AMT/ISO liability

under I.R.C. § 53, the taxpayer must continue to make deferred payments under an OIC modified to reflect the abated I.R.C. § 53 liability.

3. A taxpayer who has made payments under a valid OIC prior to the enactment date of EESA cannot obtain a refund of those payments. Where an issue covered by the OIC involves I.R.C. § 53, payments made on or after the enactment date may result in a refund if the abatement of the I.R.C. § 53 tax liability results in an overpayment. Such an overpayment may be refunded to the taxpayer or credited to other outstanding tax liabilities.

FACTS

Many companies offer Incentive Stock Options (ISOs) as compensation. For regular tax purposes, ISOs are not taxed upon exercise. Under the Alternative Minimum Tax (AMT), however, a taxpayer must pay tax on the stock value when the option is exercised. The economic downturn in 2000 resulted in many individuals having to pay tax on "phantom income" because the stock prices dropped dramatically since the date of exercise; the taxpayers were taxed on paper profits which were never actually realized if the stock wasn't sold before the value declined. Some individuals ended up with tax bills that exceeded the value of the stock.

In 2006, Congress provided relief for these situations but determined that additional relief is needed to correct this problem. Many individuals who owed tax as a result of exercising ISOs have entered into OICs with the Service and have begun payments pursuant to those OICs. Congress amended section 53 of the Internal Revenue Code on October 3, 2008, as part of EESA to provide further relief to these taxpayers.

LAW AND ANALYSIS

1. What effect does H.R. 1424, Emergency Economic Stabilization Act of 2008 (EESA) have on a taxpayer who has entered into an OIC to settle a tax liability owed under I.R.C. § 53?

Congress amended section 53 of the Internal Revenue Code on October 3, 2008 (enactment date), as part of EESA, Pub. L. 110-343, sec. 103(b), 122 Stat. 3765. As is relevant to the instant inquiry, section 103 of EESA amended section 53 of the Internal Revenue Code, in pertinent part, as follows:

(f) TREATMENT OF CERTAIN UNDERPAYMENTS, INTEREST AND PENALTIES ATTRIBUTABLE TO THE TREATMENT OF INCENTIVE STOCK OPTIONS.--

(1) ABATEMENT.—Any underpayment of tax outstanding on the date of the enactment of this subsection which is attributable to the application of section 56(b)(3) for any taxable year ending before January 1, 2008, and any interest or penalty with respect to such underpayment which is outstanding on such date of enactment, is hereby abated.

Under new section 53(f), any underpayment of tax and any corresponding interest or penalty that is attributable to the treatment of ISOs for tax years ending prior to January 1, 2008, and remains outstanding on October 3, 2008, shall be abated. The statutory language does not state how payments made prior to EESA's enactment should be treated, i.e., whether the taxpayer should be eligible for a refund of taxes paid under an OIC. EESA was enacted expeditiously as a result of the national financial crisis. As a result, very little legislative history exists regarding the changes to I.R.C. § 53.

Section 7122 governs OICs and authorizes the Commissioner to compromise a taxpayer's outstanding liabilities. I.R.C. § 7122(a). Generally, an acceptance of an OIC will conclusively settle the liability of the taxpayer specified in the OIC, absent fraud or mutual mistake. Dutton v. Commissioner, 122 T.C. 133, 138 (2004); Treas. Reg. § 301-7122-1(e)(5). See also Estate of Jones v. Commissioner, 795 F.2d 566, 573–74 (6th Cir. 1986), aff'g, T.C. Memo. 1984-53; Timms v. United States, 678 F.2d 831, 833 (9th Cir. 1982).

An accepted offer in compromise is properly analyzed as a contract between the parties. United States v. Donovan, 348 F.3d 509, 512–13 (6th Cir. 2003); Roberts v. United States, 242 F.3d 1065 (Fed. Cir. 2001); Timms v. United States, supra at 833–36; United States v. Lane, 303 F.2d 1, 4 (5th Cir. 1962); Robbins Tire & Rubber Co., Inc. v. Commissioner, 52 T.C. 420, 436 (1969). Consequently, an OIC, like certain other agreements between the Commissioner and taxpayers, is governed by general principles of contract law. Cf. Duncan v. Commissioner, 121 T.C. 293, 296, (2003) (contract law applied to stipulated arbitration agreement); Bankamerica Corp. v. Commissioner, 109 T.C. 1, 12 (1997) (contract law applied to stipulations of fact); Dorchester Indus., Inc. v. Commissioner, 108 T.C. 320, 330 (1997) (contract law applied to settlement agreement), aff'd without published opinion, 208 F.3d 205 (3d Cir. 2000); Woods v. Commissioner, 92 T.C. 776, 780 (1989) (contract law applied to agreement to extend the period for making assessments). Courts have routinely held that OICs are valid and binding contracts. See Timms v. United States, supra at 492; Waller v. United States, 767 F. Supp. 1042, 1044–45 (E.D. Cal. 1991); Seattle-First Nat'l Bank v. United States, 44 F.Supp. 603, 610 (E.D. Wash. 1942), aff'd, 136 F.2d 676 (9th Cir. 1943), aff'd, 321 U.S. 583 (1944); Lang-Kidde Co. v. United States, 2 F. Supp 768, 769 (Ct. Cl. 1933).

In the situation of a taxpayer affected by the portion of the EESA discussed in this memorandum, the IRS properly assessed the I.R.C. § 53 tax against the taxpayer, and the parties entered into a valid OIC. But Congress, through the language of EESA, abated the underlying I.R.C. § 53 tax liability. After the date of the enactment of EESA, the portion of the OIC pertaining to I.R.C. § 53 is not enforceable. Enforcement of the OIC after that date would be contrary to the intent of Congress as expressed in the statute.

2. What options are available to a taxpayer who is making deferred payments on an

accepted offer to compromise a tax liability under I.R.C. § 53?

If an OIC involves tax liabilities in addition to the AMT/ISO liability under I.R.C. § 53, the IRS should modify the OIC to reflect the abated liability. A modification of a contract is a change in one or more respects which introduces new elements into the details of the contract and cancels others but leaves the general purpose and effect undisturbed. Int'l Business Lists, Inc. v. American Telephone and Telegraph Co.,147 F.3d 636, 641 (7th Cir. 1998). A valid modification must satisfy all the criteria essential for a valid contract: offer, acceptance, and consideration. Id. Only the abatement of the I.R.C. § 53 tax liability should be modified in the OIC.

Once a taxpayer receives an OIC with the necessary modifications, the taxpayer must decide between two available options. The taxpayer could agree to the modified OIC; this modified OIC simply recalculates the original OIC, and all of the usual OIC rules will apply. Or the taxpayer could refuse to agree to the modified OIC. Although refusal to agree to the modified OIC does not excuse the taxpayer from fulfilling the obligations of the original OIC, the taxpayer could cease to make payments pursuant to the original OIC. Generally, if a taxpayer ceases to make payments under an OIC, the IRS defaults the offer and the liability is reestablished in full (minus any payments made under the OIC). However, as discussed above, EESA abates any liability resulting from the application of I.R.C. § 53 so defaulting an OIC will not reestablish any liability owed under I.R.C. § 53. But defaulting the original OIC will in fact reestablish the full tax liability owed under any other provision. See I.R.M. Exh. 5.8.9-4, Default Letter; Form 656, Offer in Compromise.

3. Where EESA has abated tax liabilities owed pursuant to I.R.C. § 53, can a taxpayer get a refund of taxes paid under an OIC?

As previously stated, under section 7122, a compromise is generally considered to be final and binding. Since the OIC is valid and binding, taxpayers cannot escape its conclusive bar to their refund suit. Waller v. United States, supra at 1044–45. See also Timms v. United States, supra at 492 (holding that taxpayer cannot obtain a refund of amounts previously paid under and compromise agreement); Cooper Agency v. United States, 301 F. Supp. 871 (D.S.C. 1969) (refusing to allow the taxpayer to recover payments made pursuant to a compromise settlement that settled the tax liabilities of the taxpayer and fourteen other parties); Seattle-First Nat'l Bank v. United States, supra at 610 (holding that because compromises are "binding and final," the taxpayer could not get a refund of amounts paid under a compromise settlement even though the tax liability was improperly assessed); Duncan v. United States, supra at 962 (dismissing a taxpayer's petition for refund of payments made pursuant to a compromise even though the Supreme Court later held the tax should not have been charged against the taxpayer); and Lang-Kidde Co. v. United States, supra at 769 (dismissing a taxpayer's claim for refund because the taxpayer's offer in compromise, when accepted by government, constituted settlement in full of entire tax liability).

Even in cases in which the United States Supreme Court has held a tax should not have been charged against a taxpayer, courts have not allowed taxpayers to obtain a refund of payments made pursuant to a compromise agreement with the government. Duncan v. United States, supra; Seattle-First Nat'l Bank v. United States, supra at 610. In Duncan, the government accepted an offer in compromise to settle the taxpayer's liability resulting from certain stock rights. Approximately four months later, the United States Supreme Court held that the stock rights were not taxable income in a separate case, Palmer v. Comm'r, 302 U.S. 63 (1937). Duncan v. United States, supra. The taxpayer subsequently filed claims for a refund of the amounts paid under the compromise which the court dismissed. Id. Similarly, in Seattle-First Nat'l Bank, the government assessed transfer taxes against the taxpayer pursuant to a consolidation of a state bank and trust company and a national banking association. The district court dismissed the taxpayer's request for recovery of the amount paid on a compromise settlement of criminal liability because compromises are final and binding. Seattle-First Nat'l Bank, supra at 610.

Based on the foregoing, we conclude that a taxpayer cannot obtain a refund of payments made pursuant to an OIC. Additionally, the taxes owed pursuant to section 53 were not abated under EESA until October 3, 2008, and there could not be an overpayment with respect to those taxes prior to that date. Therefore, payments made pursuant to an OIC and received by the Service prior to the enactment date of EESA are not refundable.

Where the tax liability pursuant to I.R.C. § 53 is the sole issue covered under the OIC, EESA abated any tax outstanding on October 3, 2008. Under those circumstances, payments made by the taxpayer but not received by the Service before October 3, 2008, will constitute an overpayment. That overpayment may be refunded to the taxpayer or may be credited against another liability in lieu of a refund. Payment is deemed to occur on the date the payment is received. See I.R.M 20.2.1, Exh. 20.2.1-2.

However, where there are additional issues covered by the OIC, those outstanding tax liabilities remain. Therefore, payments made by the taxpayer on these outstanding tax liabilities but not received by the Service prior to the enactment date of EESA may not constitute overpayments. Payments under that OIC should continue to be made by the taxpayer and the Service should continue to apply them to the outstanding balance under the terms of the OIC. The Service will need to apply the abatement relief provided in EESA and recalculate OICs containing issues in addition to the section 53 issue. Only after this occurs can overpayment be identified. The increase in the credit for certain interest and penalties already paid under section 53(f)(2) as enacted under EESA, does not affect whether or not payments made by the taxpayer on these outstanding tax liabilities but not received by the Service prior to the enactment date of EESA constitute overpayments.

In conclusion, any remaining balance outstanding for a tax liability under I.R.C. § 53 on the date of enactment of EESA shall be abated. If the offer compromised only I.R.C. §

53 liabilities, the OIC is not enforceable after the date of the enactment of EESA. If the OIC involves tax liabilities in addition to the AMT/ISO liability under I.R.C. § 53, the IRS should modify the OIC to reflect the abated liability.

To effectuate EESA, the IRS should notify any and all such taxpayers with OICs involving I.R.C. § 53 tax liabilities that the portions of the OICs regarding the I.R.C. § 53 liabilities are no longer enforceable. The taxpayers need not take any action to avail themselves of the relief provided under EESA.

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Please call 622-3620 if you have any further questions.