Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: **20084601F**

Release Date: 11/14/08
CC:SB:7:SF:1:BSLaurie
GL-133794-08

UILC: 9300.13-00, 6651.00-00

date: September 16, 2008

to: David Palmer
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(Small Business/Self-Employed)

from: Brooke S. Laurie
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subject: Assessment and collection of the addition to tax under I.R.C. § 6651 for failing to pay the tax agreed upon in the Closing Agreement

Taxpayers: (SSN:) and (SSN:)

Taxable Year:

LEGEND

A =
B =
C =
D =
E =
F =

ISSUE

Does the Closing Agreement signed by the Service and the taxpayers preclude the Service from assessing and collecting the failure to pay addition to tax under I.R.C. § 6651?

CONCLUSION

No. The Closing Agreement is only final and conclusive as to the matters agreed upon. Since the Closing Agreement does not address the assessment and collection of the addition to tax under I.R.C. § 6651, it may be imposed notwithstanding the Closing Agreement.

FACTS

On , (the "taxpayers") signed and on , the Service agreed to the Form 906, Closing Agreement on Final Determination Covering Specific Matters (the "Closing Agreement") regarding taxable year . The purpose of the Closing Agreement was to resolve the dispute between the Service and the taxpayers that resulted from the taxpayers' involvement in the "Son of BOSS" transactions described in Notice 2000-44, 2000-2 C.B. 255. The Closing Agreement was entered into in accordance with the Son of BOSS settlement initiative, Announcement 2004-46, 2004-1 C.B. 964 (the "Settlement Initiative").

In addition to determining the treatment of losses and expenses claimed by the taxpayers, paragraph (8) of the Closing Agreement states, " will pay a penalty under I.R.C. section 6662 of 10 percent of the underpayment of tax attributable to the Son of BOSS transaction." This penalty was included in the Closing Agreement in accordance with Section 2(b)(2)(i) of the Settlement Initiative.

Paragraph (11) of the Closing Agreement states, " shall make full payment of their liability for tax and interest resulting form the application of the foregoing paragraphs, upon returning this executed closing agreement to the IRS." This section was included in the Closing Agreement in accordance with Section 4(c) of the Settlement Initiative which states the following:

> Full payment of the liabilities under this initiative must be made by the date of the closing agreement is executed. Any taxpayer not making full payment must submit complete financial statements and agree to other financial arrangements acceptable to the Service before the Service will execute the closing agreement. A taxpayer will be ineligible to participate in this initiative if an agreement regarding an acceptable financial arrangement cannot be reached.

The taxpayers and the Service entered into an installment agreement as a way for the taxpayers to pay the tax liability resulting from the Closing Agreement. However, the

taxpayers defaulted on the installment agreement before the liability was paid in full. As a result of the default, the addition to tax under I.R.C. § 6651[1] was assessed on the underpayment on . The Service now seeks to collect the balance due on the taxpayers' account which includes the addition to tax for their failure to pay their tax liability.

The Closing Agreement states that it "contains the complete agreement between the parties." Neither the Closing Agreement nor the Settlement Initiative address what would occur if a taxpayer elected to participate in the Settlement Initiative and signed a closing agreement with the Service, but failed to pay the tax in full.

In the letter dated , the taxpayers' argue the Service is precluded from collecting the failure to pay addition to tax because the Closing Agreement limits the Service to assessing and collecting only the penalty specifically addressed in paragraph (8) and the Closing Agreement must be set aside before the Service can assess and collect the failure to pay addition to tax. For the reasons stated below, the Service is able to assess and collect the addition to tax under I.R.C. § 6651 in addition to the penalty under I.R.C. § 6662 agreed upon in paragraph (8) of the Closing Agreement and without setting aside the Closing Agreement.

LAW AND ANALYSIS

Section 7121(a) authorizes the Service to enter into closing agreements.

> If such agreement is approved by the Secretary . . . such agreement shall be final and conclusive, and, except upon a showing of fraud or malfeasance or misrepresentation of a material fact – (1) the case shall not be reopened *as to the matters agreed upon* or the agreement modified by any officer, employee, or agent of the United States, and (2) in any suit, action, or proceeding, such agreement, or any determination, assessment, collection, payment, abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded."

I.R.C. § 7121(b) (emphasis added). Closing agreements are final as to the matters contained within. The Service is not alleging fraud, malfeasance or misrepresentation of material fact by the taxpayers and is not reopening the matters agreed upon in the Closing Agreement. The Service has assessed and is collecting the addition to tax under I.R.C. § 6651 outside of the Closing Agreement.

[1] It is unclear whether the addition to tax was assessed pursuant to I.R.C. § 6651(a)(2) or I.R.C. § 6651(a)(3). The analysis and conclusion stated in this memorandum is applicable regardless of which subsection of I.R.C. § 6651 is applied.

The Service and the taxpayers entered into the Closing Agreement that related to one or more separate items affecting the tax liability of the taxpayers as contemplated in Treasury Regulation Section 301.7121-1(b)(2).

> Closing agreements with respect to taxable periods ended prior to the date of the agreement may relate to the total tax liability of the taxpayer *or to one or more separate items affecting the tax liability of the taxpayer*, as, for example the amount of gross income, deduction for losses, depreciation, depletion, the year in which an item of income is to be included in gross income, the year in which an item of loss is to be deducted, or the value of the property on a specific date."

Treas. Reg. § 301.7121-1(b)(2) (emphasis added). One of the separate items included in the Closing Agreement is the penalty under I.R.C. § 6662, but the addition to tax under I.R.C. § 6651 is not included in the Closing Agreement as a separate item. Since agreements are only final and conclusive as to the matters agreed upon under Section 7121(b) and the addition to tax under I.R.C. § 6651 was not item agreed upon, it may be assessed and collected.

Courts have narrowly interpreted the items agreed upon by taxpayers and the Service in closing agreements. The Court in Zaentz v. Commissioner, 90 T.C. 753, 761 (1988), found that the petitioners and the Service were bound only by the matters agreed upon in the closing agreements and were not bound as to the premise underlying their agreements. In Zaentz, the Service and the petitioners entered into three closing agreements related to the taxpayers' participation in the Argosy trusts. The closing agreements stated the tax treatment of items claimed by the petitioners on their returns that related to their involvement in the Argosy trusts for the years covered by the agreements. Id. 757- 760. Similar to the Closing Agreement at issue here, the closing agreements in Zaentz related to one or more separate items affecting the tax liability of the petitioners and did not relate to the total tax liability of the petitioners.

The petitioners argued that since the closing agreements were premised upon the Argosy trusts being valid entities, the Service was precluded from arguing the Argosy trusts were sham entities in years subsequent to the years agreed upon in the closing agreements. Id. The Court found that the parties were only bound by the matters agreed upon in the closing agreements and since the closing agreements did not specifically address whether the Argosy trusts were valid entities, the parties were not bound by any premise underlying the agreements. Id. at 761.

The Court in Magarian v. Commissioner, 97 T.C. 1 (1991), also narrowly interpreted the closing agreement at issue. The Court found the Service could assess the additions to tax under I.R.C. §§ 6653(a)(1), 6653(a)(2) and 6659 since the closing agreement signed by the parties did not address the additions to tax. Id. The closing agreement at issue in Magarian settled the treatment of specific losses and credits which petitioners had claimed on their return. Id. The Court stated,

> [I]f petitioners had intended to settle with respect to any of the possible additions to tax for the taxable year 1981, they should have insisted upon the inclusion of specific language to that effect in the Closing Agreement. Without such language, and in the absence of an assertion by petitioners that the Closing Agreement should be set aside for fraud, malfeasance or misrepresentation of a material fact, the specific matters agreed upon by the parties must be respected.

Id. at 6-7. The Court also noted, "that as a general rule closing agreements do not relate to additions to tax." Id. at 6.

The Court in Commissioner v. Smith, 850 F.2d 242, 245 (5th Cir. 1988), also found that the closing agreement entered into between the Service and the taxpayers was limited in scope to the issues addressed. The Court found the closing agreement at issue did not preclude the imposition of penalties and interest that were not addressed in the agreement. Id. at 245.

Case law supports the Service's reading of the Closing Agreement and the matters agreed upon within the Agreement. Since the addition to tax under I.R.C. § 6651 was not an item agreed upon by the parties in the Closing Agreement, it may be assessed and collected.

The taxpayers argue that Paragraph (8) imposing the penalty under I.R.C. § 6662 at ten percent of the underpayment bars the assessment of the addition to tax. This is incorrect. Paragraph (8) bars the Service from assessing or collecting a penalty under I.R.C. § 6662 in excess of ten percent of the underpayment. But it does not bar the assessment or collection of the addition to tax under I.R.C. § 6651 because Paragraph (8), and the entire Closing Agreement, does not address the addition to tax. The Closing Agreement is limited in scope and only conclusively settles the issues that it addresses. Because the Closing Agreement does not address the addition to tax, it does not have to be reopened or modified upon a showing of fraud, malfeasance or misrepresentation of material fact as contemplated in Section 7121(b) before the Service can assess and collect the addition to tax under I.R.C. § 6651.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (415) 227-5168 if you have any further questions.

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