OFFICE OF
CHIEF COUNSEL

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

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MEMORANDUM FOR THE OFFICE OF THE TAXPAYER ADVOCATE

FROM: Gary D. Gray
Assistant Chief Counsel (General Litigation)

SUBJECT: Equitable Relief for [redacted]

This is in response to your request for our advice as to whether there is any form of equitable relief available to the above mentioned taxpayers pursuant to the provisions of the Internal Revenue Service Restructuring and Reform Act of 1998. For the reasons explained below, we conclude that there is no relief available to the taxpayers at present. While taxpayers might be able to submit an offer in compromise based on equitable factors pursuant to regulations to be promulgated under I.R.C. § 7122, such an offer cannot be submitted under current law and taxpayers' eligibility for such an offer cannot be determined until the regulations have been promulgated.

Factual Background

[redacted] was a party to a class action suit filed in [redacted] entitled [redacted] brought under Title VII of the Civil Rights Act of 1964, alleging sexual discrimination in [redacted] hiring practices. The [redacted] Circuit's opinion established the fact of liability but did not determine the amount of damages to which each claimant was entitled. In [redacted] settled her claim for $[redacted] [redacted] did not include this amount in gross income on the joint return she filed with her husband [redacted] for the tax year [redacted] based on their reliance on the exclusion of I.R.C. §104(a)(2) for damages on account of personal physical injuries or sickness.

In [redacted] the Internal Revenue Service (Service) began an examination of the [redacted] return. The examination was closed without proposing an adjustment and a "no change" letter was sent to the [redacted] on March 1, 1994. The "no change" letter stated that the Service "could change your tax later if you are a shareholder in a Subchapter S corporation, a beneficiary of a trust, or a partner in a partnership."

In [redacted] the [redacted] District Director's office initiated a project regarding the recipients of awards from the [redacted] class action. The paperwork surrounding the establishment of the project suggests that one of the reasons for the project was confusion among both Service personnel and taxpayers regarding the taxability of the awards. The [redacted] District had received advice from the national office that the awards were taxable.

Presumably as a result of the project, the [redacted] District notified the [redacted] by letter dated April 4, 1995, that the examination of their [redacted] return was being reopened. The [redacted] did not reach an agreement with either Examination or Appeals and a statutory notice of deficiency was issued to them late in [redacted] The statutory notice proposed additional tax due of $[redacted] which comprised both income and self-employment tax on the amount of the award. No penalties were proposed in the statutory notice.

The [redacted] filed a timely petition with the Tax Court on [redacted] In their petition, the [redacted] raised both the substantive issue whether the award was taxable income and the procedural issue whether the respondent should be estopped from making the adjustment because of the issuance of the "no change" letter in [redacted] The case was calendared for trial in [redacted], but a basis for settlement was reached prior to trial. The respondent, consistent with guidance from the national office, conceded the self-employment tax and the petitioners conceded the full amount of income tax. A decision determining a deficiency of $[redacted] was entered on [redacted]

The [redacted] have indicated that they acted to their detriment in reliance on the initial "no change" letter and that their current payments to the Service to satisfy the [redacted] liability (through a Chapter 13 bankruptcy plan) are causing them financial distress. However, we have no specific information about their disposition of the settlement proceeds that they received in [redacted] the current status of their bankruptcy case, nor their current financial situation.

Discussion

We note at the outset that the Tax Court settlement for the [redacted] tax year settled all issues concerning the merits of the tax liability and whether the Service should be estopped from asserting the liability. The doctrine of res judicata prevents the [redacted] from relitigating these issues. The Commissioner, nonetheless, has the discretion to abate the tax assessments if excessive, and the Tax Court decision does not address interest and penalties. We, thus, address the merits of the tax liability, and interest and penalty issues, before we address your specific question as to entitlement to equitable relief.

I. Amount of Tax Due

We have carefully reviewed this case in consultation with the Assistant Chief Counsel (Field Service) and have concluded that the Service correctly determined that the [redacted] damages award was includable in the taxpayers' gross income and that the liability agreed to in the Tax Court settlement is the correct amount of tax owed by the taxpayers. It has long been the position of our office that damage awards under the provisions of Title VII in effect prior to [redacted] are not tort or tort-type damages that may be excluded from income under section 104(a)(2). This position was upheld by the Supreme Court in United States v. Burke, 504 U.S. 229 (1992). This office provided advice that Burke was applicable to the [redacted] settlements as early as [redacted] 1/ The Tax Court has determined that the [redacted] settlements were taxable in a series of memorandum opinions, one of which was recently affirmed by the Ninth Circuit. [redacted] The settlement of the [redacted] case was consistent with this authority. Accordingly, we conclude that the correct amount of tax was determined by the Tax Court, when the decision, reflecting the settlement of the case, was entered by the Tax Court.

II. Equitable Estoppel

We have also concluded that the March 1, 1994, "no change" letter issued by the Service did not bind the Service and did not preclude the Service from reopening the case and redetermining the tax liability. Had taxpayers not conceded the equitable estoppel issue by settling the Tax Court case, they would nonetheless

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1/ Title VII of the Civil Rights Act was amended in 1991 to broaden the scope of damages available. In 1993, the Service announced that some types of awards under the 1991 amendments would be excludable from income. Rev. Rul. 93-88, 1993-2 C.B. 61. This may have caused confusion as to whether pre-1991 awards were similarly excludable. Any possibility that the 1991 amendments could apply to pre-1991 cases such as the cases arising out of the [redacted] settlements was eliminated by the Supreme Court in 1994. Landgraf v. USI Film Products, 511 U.S. 244 (1994).

have no basis for asserting equitable estoppel. The elements of equitable estoppel, as generally applied in tax cases, are as follows:

> (1) [a] false representation or wrongful, misleading silence by the party against whom estoppel is claimed; (2) error in a statement of fact and not in an opinion or statement of law; (3) ignorance of the true facts; (4) reasonable reliance on the acts or statements of the one against whom estoppel is claimed; and (5) adverse effects of the acts or statement of the one against whom estoppel is claimed.

Norfolk Southern Corp. v. Commissioner, 104 T.C. 13, 60 (1995). "Thus, estoppel requires a finding that a claimant relied on the Government's representations and suffered a detriment because of that reliance." Id. However, the Service "ordinarily will not be estopped from correcting retroactively a mistake of law." Id. at 61.

As applied to the [redacted] case, there are two errors that might arguably lead to an estoppel. First, there was the erroneous determination that the damage award was not taxable. Second, there was the "no change" letter which was misleading as to the circumstances under which the [redacted] return would be reexamined.

The erroneous determination regarding the taxability of the pension does not estop the government from later correcting it, because it was an error of legal interpretation rather than one of fact. Automobile Club of Michigan v. Commissioner, 353 U.S. 108 (1957).

Regarding the question whether the language of the "no change" letter itself was sufficiently misleading to warrant the application of estoppel against the government, we note that the language of the letter is not actually erroneous. It states that the tax may later be adjusted if the taxpayer is participating in a flow-through entity, but does not state that this is the only circumstance under which the tax may be later adjusted. Furthermore, the statement is made in a form letter and is clearly not based on the particular circumstances of the [redacted] case.

Moreover, the Service followed the correct procedures for reopening the examination where there has been an error of law. Section 7605(b) provides that a second examination may be made if the taxpayer is notified in writing that such reexamination is necessary. In Rev. Proc. 85-13, 1985-1 C.B. 514, the Service limits the circumstances under which it will reopen an examination to make an adjustment unfavorable to the taxpayer to three. Of relevance here is the second circumstance: "[t]he prior closing involved a clearly defined substantial error based on an existing Service position at the time of the previous examination." In this instance, the Service's position regarding the taxability of Title VII damage awards was clearly established by the Supreme Court's opinion in Burke. Thus, the failure to impose tax on the damage award constituted "a substantial error based on an existing Service position at the time of the previous examination." As described in the facts above, a reopening letter was sent to the [redacted] meeting the requirement of section 7605(b).

We also note that the [redacted] may have difficulty meeting the detriment element of estoppel. 2/ They were liable for the additional tax. Were they to be relieved of this liability, it would constitute a windfall that they would never have been entitled to under the law. In such circumstances courts have refused to find a detriment and apply estoppel against the government. Kennedy v. United States, 965 F.2d 413 (7th Cir. 1992); see also Heckler v. Community Health Services, Inc. 467 U.S. 51, 61-62 (1983). In this regard, the Supreme Court has stated that a party asserting estoppel against the United States has a heavy burden to meet. Heckler, 467 U.S. at 61-62. Additionally, the appellate courts have required that a party raising estoppel against the Government establish affirmative misconduct by the Government going beyond mere negligence. Kennedy; Watkins v. United States Army, 875 F.2d 699 (9th Cir. 1989), cert. denied, 498 U.S. 957 (1990).

As previously discussed, the [redacted] claim of equitable estoppel is precluded because they raised the issue before the Tax Court, but chose not to pursue it, instead settling for the standard settlement offered all [redacted] awardees. The settlement also weakens their equitable claim of reliance because they had the opportunity to have the matter considered by a neutral third party, i.e., the Tax Court, but abandoned the argument when they agreed to settle their tax case.

For the foregoing reasons, we conclude that the taxpayers are not entitled to claim relief from their liability based on the doctrine of equitable estoppel.

III. Abatement of Penalties

No penalties were imposed on the [redacted] by the Tax Court's decision. If, however, the section 6651(a)(3) failure to pay penalty was imposed for the [redacted] failure to pay following the notice and demand that was issued once an assessment was made following the Tax Court's decision, relief may be available. If this penalty was imposed, it could be abated if the [redacted] had reasonable cause for failing to pay the tax due. Lack of funds by itself would not constitute reasonable cause. The [redacted] would need to establish that they exercised "ordinary business care and prudence" regarding their tax debt and nonetheless were unable to pay. Treas. Reg. § 301.6651-1(c)(1). Further factual development would be necessary to make this determination. The Service could

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2/ We note, however, that we do not have sufficient facts to fully analyze whether the taxpayers relied on the Service's statements to their detriment.

certainly determine that the [redacted] exercised ordinary business care and prudence by spending any amount set aside for taxes on the damage award once they received the "no change" letter. Such a determination would be further supported if the funds were spent on day to day living expenses, [redacted] included in the materials you have forwarded to us, rather than on "lavish or extravagant living expenses." A further determination, however, would be required to determine whether the [redacted] had reasonable cause for not assembling sufficient money to pay their tax on the damage award once they were contacted regarding the reopening of the audit and it appeared likely that the tax would be imposed.

IV. Abatement of Interest

We have concluded that there are no grounds for abatement of interest. Section 6404(e) currently provides for the abatement of interest where the Service has made errors or delays in performing "managerial" or "ministerial" acts. The scope of this section was only expanded to include "managerial" acts with respect to tax years beginning after July 30, 1996. Thus, interest abatement will only be available to the [redacted] if the Service unreasonably erred or delayed in performing a "ministerial" act. A ministerial act is "a procedural or mechanical act that does not involve the exercise of judgment or discretion... ." Treas. Reg. § 301.6404-2T(b)(2). There are two actions which may be considered erroneous: the erroneous determination that the award was nontaxable, and the decision to use the form "no change" letter with the language concerning flow through liabilities for general use. The erroneous determination that the award was nontaxable is not a ministerial act because it required judgment. The decision to use the form "no change" letter for general use was also not a ministerial act since this decision involved judgment or discretion.

V. Offer-in-Compromise/ Equitable Relief

We have also carefully considered whether the taxpayers might be eligible for an offer in compromise pursuant to I.R.C. § 7122. Under current law, taxpayers are only entitled to an offer in compromise based on doubt as to liability or doubt as to collectibility. Treas. Reg. § 301.7122-1. In this case, there is no doubt as to liability since the taxpayers' liability has been settled as part of a Tax Court judgment. See Treas. Reg. § 301.7122-1(a). We do not have sufficient information to determine whether there is doubt as to collectibility. Based on taxpayers' representations in the materials you have forwarded to us, however, it appears they may have sufficient assets to fully pay their liability.

You have asked us to consider whether taxpayers might be eligible for equitable relief under the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA). The only potential relief we have identified that may be available is in the offer provisions. Section 7122(c)(1), as amended by section 3462 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), provides that the Secretary shall develop guidelines to determine when an offer in compromise is adequate and should be accepted to resolve a dispute. The legislative history accompanying the RRA explains that Congress intended that factors such as equity, hardship, and public policy be evaluated in the compromise of individual tax liabilities, if such consideration would promote effective tax administration. Our office has drafted temporary regulations under section 7122 which will implement the RRA by adding a third ground for compromise: where the compromise will promote effective tax administration. Pursuant to the most current draft of the regulations, this third ground for compromise will be available if there are no grounds for compromise based on doubt as to liability or doubt as to collectibility. Considerations of equity will be relevant pursuant to this ground for compromise.

Chief Counsel has sought the views of a wide segment of Counsel and Service personnel regarding the types of circumstances that would warrant compromise on equitable grounds. Unfortunately, neither section 3462 of the RRA nor its accompanying legislative history provides clear guidance on this issue and there has been little consensus on the fact patterns that would justify consideration of an offer in compromise on equitable grounds.

DP [redacted] DP

This case is assigned to Mitchel S. Hyman who can be reached at (202) 622-3620. We would be glad to assist you if you have any further questions concerning this case.