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

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MEMORANDUM FOR DISTRICT COUNSEL, NORTH TEXAS DISTRICT

FROM: Kathryn A. Zuba
Chief, Branch 2 (General Litigation)

SUBJECT: Offer in Compromise -

This memorandum responds to your request for advice dated April 13, 2000. This document may not be cited as precedent by taxpayers.

LEGEND:

Taxpayer
Year 1
Year 2
Year 3
Year 4
Year 5
Year 8
Partnership A
Partnership B
Date A

ISSUE:

Whether the Service can compromise with a general partner for his individual, derivative share of the employment tax obligations of a partnership.

CONCLUSION:

The employment tax obligations of a partnership represent a single liability assessed against the partnership entity. Although the federal tax lien allows the Service to collect from general partners, there remains one tax liability subject to compromise, that of the partnership.

BACKGROUND:

The taxpayer is liable for unpaid income tax liabilities for the years Year 2, Year 4, Year 5, and Year 8. He also owes a trust fund recovery penalty assessed against him for Year 3. Two partnerships of which the taxpayer was a general partner are liable for unpaid employment taxes. Partnership A owes FICA taxes for the first and fourth quarters of Year 1 and the first and second quarters of Year 2, as well as FUTA taxes for both of those years. Partnership B owes FICA taxes for the second quarter of Year 1 and FUTA taxes for both Year 1 and Year 2. On Date A, the taxpayer submitted an offer in compromise intended to cover both his personal income tax liabilities and his portion of the partnerships' liabilities.

The Offer in Compromise Handbook, IRM 5.8, contains no guidance on compromising a derivative portion of a partnership's employment tax liabilities. With regard to compromising the liabilities of a partnership, the handbook provides:

> The amount that must be offered to compromise a partnership tax liability must include the maximum collection potential for the partnership and all general partners. Secure Collection Information Statements from the partnership and all partners before beginning your analysis.

IRM 5.8.1.12(1).

The case history indicates that the revenue officer assigned to process the offer initially inquired as to the status of the partnership and the existence or location of other partners, and requested documentation regarding the potential for collection from partnership assets or the assets of other general partners. The taxpayer's representative responded that the taxpayer was proposing to compromise only his personal share of the liabilities of the two partnerships, not the liability of the partnership or the other partner(s). On this theory, the revenue officer investigated only the collection potential of the taxpayer. Therefore, the file contains no information on the partnerships or any other partners. The revenue officer appears to have proceeded on the assumption that the partnerships are now defunct.

The taxpayer's offer in compromise has been recommended for acceptance by the revenue officer because the amount offered is consistent with the taxpayer's ability to pay, and has been submitted to your office for review so that you can issue the required opinion of Counsel. See I.R.C. § 7122(b). In your proposed response to the district, you agree that the offer is adequate in amount, but suggest several changes intended to insure that the Service adequately protects its rights to proceed against any assets of the partnership or other partners. Most significantly, you suggested that a collateral agreement be secured which clearly states the intent of the parties to compromise only the liabilities of the taxpayer and retains the right to proceed against other partners.

DISCUSSION:

The Internal Revenue Code requires employers to deduct and withhold income and Federal Insurance Contributions Act (FICA) taxes from their employees' wages. See I.R.C. §§ 3402(a) and 3102(a). The Code imposes additional FICA taxes on employers themselves, as well as Federal Unemployment Tax Act (FUTA) taxes. See I.R.C. §§ 3111 and 3301. These taxes are generally referred to collectively as "employment taxes." The Code provides that the "employer" is the entity liable for payment of employment taxes. See I.R.C. § 3403 (employer liable for withheld income taxes); I.R.C. § 3102(b) (employer liable for withheld FICA tax); I.R.C. § 3111 (employer liable for employer's share of FICA tax); I.R.C. § 3301 (employer liable for FUTA tax).

For purposes of income tax withholding, "employer" is defined as the person for whom an individual performs any service as the employee of such person. I.R.C. § 3401(d). The term "person" includes an individual, trust, estate, partnership, association, company, or corporation. I.R.C. § 7701(a)(1). Although the Code gives no comparable definition of employer for purposes of determining liability for FICA and FUTA taxes, courts have held that "employer" for purposes of the FICA and FUTA provisions should be defined the same as the section 3401(d) definition. See Otte v. United States, 419 U.S. 43, 51 (1974); In re Armadillo Corp., 410 F. Supp. 407 (D. Colo. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977).

In the case of employees who work for a partnership, the Service takes the position that the partnership is the employer for purposes of employment tax obligations. However, because under state law the general partners are liable for the debts of the partnership, the general partners are derivatively liable for the partnership's employment tax obligations. Thus, one assessment is made against the partnership, and this one assessment is sufficient to make the general partners liable for the assessed employment taxes. The Service also takes the position that a notice and demand on the partnership is sufficient to create a tax lien on the property of the general partners for the partnership debts. See IRM 5.12.1.18.3. The theory behind these procedures is as follows:

> In a situation in which the partnership as an entity is made liable under federal law for a specific tax, as is true, e.g., with reference to withholding requirements, social security, and certain excise taxes, the added effect of state law, making the partners individually liable for the partnership debts, serves to bring a lien to bear on the properties of both–the partnership and the general partners.

Plumb, Federal Tax Liens 31 (3d ed. 1972).

The courts have generally agreed that where the partnership, as taxpayer, is liable for employment or excise taxes, general partners are also liable pursuant to state law statutes making general partners liable for partnership debts. See Remington v. United States, 210 F.3d 281, 283 (5th Cir. 2000) ("The partnership is the primary obligor and its partners are jointly and severally liable on its debts."); Ballard v. United States, 17 F.3d 116, 119 (5th Cir. 1994); United States v. Hays, 877 F.2d 843, 844 n.3 (10th Cir. 1989); Calvey v. United States, 448 F.2d 177, 180 (6th Cir. 1971); United States v. Underwood, 118 F.2d 760, 761 (5th Cir. 1941). Our longstanding position has been that, although the Code creates a single employment tax liability for which the partnership entity is liable, the application of state law allows the Service to collect the unpaid liability from individual general partners. Texas partnership law, as does the law in most jurisdictions, states that general partners are jointly and severally liable for the debts and obligations of the partnership. See Tex. Civ. Stat. Ann. art. 6132b-3.04.

Relying on the principle that general partners are jointly and severally liable for the unpaid debts of the partnership, the district has proposed acceptance of an offer by Taxpayer which is intended to compromise only his individual, derivative liability as a partner in the two partnerships. The district is apparently treating the joint and several liability of partners as similar to the liability of a husband and wife who elect to file a joint return. See I.R.C. § 6013(d)(3) (if joint return is made, liability for tax shall be joint and several). When spouses are jointly and severally liable for tax, the Offer in Compromise Handbook provides procedures whereby one spouse may reach a compromise with the Service, but the Service preserves its rights to proceed against the spouse who is not party to the compromise. See IRM 5.8.6.2. The compromising spouse must execute a collateral agreement making clear that the offer relates to the offeror's personal liability only, and that the Government may still collect from other co-obligors. See Pattern Letters P-229 and P-230 (Rev. 6-90). The district reasons that the joint and several liability of a general partner can be compromised in the same way and that the Service can later collect from other partners.

The liability of a partnership is fundamentally different than that of a husband and wife who file a joint return. As is explained above, the partnership liability is a single liability, assessed once against the partnership and owed by the partnership itself. The Service's ability to collect from general partners is created not by operation of the Code, but from state law liability for the debts of a partnership, liability which can be enforced through means of the federal tax lien whether or not the Service has obtained a judgment against an individual general partner.[1] This

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[1] Assessment gives the Government the ability to proceed against a taxpayer without reducing a claim to judgment. See Bull v. United States, 295 U.S. 247, 260 (1935). It is said to work a "reversal" of the normal collection process, in that "payment precedes defense." Id. Collection from general partners based on the partnership assessment is a logical extension of this principle, in that a private creditor could no

ability to collect does not alter the nature of the liability itself–it remains a singular debt for which the partnership entity is primarily liable.[2]

The joint and several liability of a husband and wife, on the other hand, is provided for by the Code. Section 6013(a) permits a husband and wife to file a single, joint return for income taxes. Section 6013(d)(1) states that if a joint return is made, liability with respect to the tax will be joint and several. This differs from the partnership liability in that the Code imposes the joint and several nature of the debt.

Compromise of this liability will also necessarily have a different effect. The Secretary has the authority to compromise any "case arising under the internal revenue laws." I.R.C. § 7122(a). Regulations giving effect to that section consider a "case" to be a "civil or criminal liability." See Temp. Treas. Reg. § 301.7122-1T(a)(1). The liability at issue in this case is that of the partnership. , as a general partner, can bind the partnership to a compromise. See Tex. Civ. Stat. Ann. art. 6132b-3.04. The compromise would be binding on the partnership, the Government, and all the partners. See Temp. Treas. Reg. § 301.7122-1T(5). [redacted]

The Offer in Compromise Handbook's instruction to consider the reasonable collection potential of the partnership and all general partners is a recognition that the unpaid employment taxes of a partnership represent one liability which can be collected from several sources. [redacted] Because the Code does not provide that the employment tax liabilities are joint and several, there is no individual liability for Taxpayer to compromise. In contrast, the Code recognizes the tax liability of spouses filing a joint return to be joint and several. As with any joint and several co-obligors, one party to that assessment can reach an accord with the Service without necessarily affecting the Service's right to proceed against the other party.

Furthermore, reliance on the joint and several liability of partners under state law would subject the Service to the vagaries of state partnership law when determining

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doubt execute against a general partner if it obtained a judgment against the partnership.

[2] Note that the Service cannot collect from partners or shareholders where they are not liable for the debts of the business under state law, such as in a corporation, limited partnership, or limited liability company. Each form of business association has advantages and disadvantages which must be weighed before choosing the form a business will take. Treatment of the entity for federal income and employment taxes should be one of these considerations.

whether the Service could still collect from other partners. In United States v. Ross, 176 F. Supp. 932 (D. Neb. 1959), a general partner, Ross, challenged the Service's collection efforts against him after a compromise had been reached between the Service and another partner, Kornfeind. The compromise agreement contained a clause which read as follows:

> This offer is submitted in lieu of my liability to pay balance of said tax, penalty, and interest, remaining after deducting from assessment the amount hereby tendered, collection of which balance shall not be enforced against me by suit or any other proceedings; it is being understood that this undertaking shall not release any other person from liability under said assessment.

176 F. Supp at 934 (emphasis added).

Notwithstanding this clause in the agreement, the court found that the Service's compromise with one partner released the other partner. Because upon dissolution of the partnership the partners had agreed that Kornfeind would be liable for the debts of the partnership, and the Service had knowledge of that arrangement, reaching a compromise with Kornfeind which "materially altered" the nature or time of payment for the tax obligation had the effect of releasing his partner. Id. at 935 (applying the Illinois version of section 36 of the Uniform Partnership Act).

The same section was the law in Texas prior to 1994, so it may directly govern the relationship between the partners in this case. The Texas Revised Partnership Act contains a similar, but broader, provision:

> Material Alteration of Obligation Without Consent Discharges Withdrawn Partner. If a creditor of a partnership has notice of a partner's withdrawal and without the consent of the withdrawn partner agrees to a material alteration in the nature or time of payment of an obligation of the partnership incurred before the withdrawal, the withdrawn partner is discharged from the obligation.

Tex. Civ. Stat. Ann. art 6132b-7.03(d). In this case, it is not known if there were other general partners, the circumstances surrounding the dissolution of the partnership (if there was a dissolution), or whether upon dissolution there was an agreement allocating responsibility for the partnership's debts. [redacted]

Further, an agreement to discharge a partner can be implied from a creditor's course of dealings with a remaining partner. Section 36 of the Uniform Partnership Act states, in part:

> A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or partnership continuing the business, and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business.

This principle was applied in Texas in Victoria Air Conditioning, Inc. v. Southwest Texas Mechanical Insulation Co., 850 S.W.2d 720 (Tex. App. 1993). Notably, the creditor's failure to pursue collection against the other partner and failure to insist that he be made a party to the agreement were seen as evidence from which the jury could have inferred an agreement to discharge the non-contracting partner. Id. at 725. [redacted]

One potential concern about the current procedures for compromising partnership liabilities is that they may prevent one or more partners from compromising with the Service if another general partner is uncooperative. However, that inability to compromise is owing more to the nature of a partnership than anything else. Partnerships have obvious income tax and business flexibility advantages, but carry with them the risks that partners will deadlock over a chosen course of action or that individuals will be held liable for actions of the other partners.

Furthermore, an offer in compromise is a discretionary collection tool which should be used when the Service has judged it to be the appropriate resolution of a particular case. The "ultimate goal" of the compromise program is to reach agreements that are "in the best interest of both the taxpayer and the Service." Policy Statement P-5-100. In any situation where the Commissioner does not believe that a compromise can be constructed so as to adequately protect the interests of the Government, it is within his discretion to exercise other collection methods.

This does not present the only situation in which the nature of the liabilities prevent the Service from compromising despite the apparent willingness of an individual taxpayer to do so. For instance, an uncooperative responsible officer will prevent the Service from determining the reasonable collection potential of a corporation so as to evaluate a proposed compromise of employment taxes. See IRM 5.8.4.10. Also, the Service cannot compromise with one spouse if state law provides no way to preserve the ability to proceed against the non-compromising spouse. See IRM 5.8.6.2(2).

CONCLUSION:

Although the employment tax liabilities of a partnership can be collected from individual general partners, the liability itself is not joint and several under the Internal Revenue Code. For that reason, the Service's procedures allow for compromise of the entire partnership liability and not the derivative liability of individual general partners.

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

cc. Assistant Regional Counsel (GL)