

by Lacey Strachan and Michael Greenwade

# Close It Out— Past, Present & Future

In 2021, the Tax Court ruled against the IRS in *Crandall v. Commissioner*, holding the IRS to the finality of a closing agreement

**A TAXPAYER HAS SEVERAL METHODS** to resolve a tax dispute with the Internal Revenue Service. One such method is a closing agreement.<sup>1</sup> A closing agreement is a written agreement entered into with the IRS Commissioner by a taxpayer (or a taxpayer's fiduciary) relating to the tax liability of the taxpayer for a taxable period. Available to individuals, partnerships,<sup>2</sup> corporations, trusts, and estates in a variety of circumstances, a closing agreement can be an effective tool to bring certainty to a dispute or question with IRS over a taxpayer's tax liability.<sup>3</sup>

Authorized under Section 7121 of the Internal Revenue Code, the primary feature of closing agreements that distinguishes closing agreements from some other means of resolving a tax dispute with the IRS is the finality that comes with closing agreements. A

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closing agreement allows the parties to “permanently and conclusively close” an issue or a tax liability in dispute for a given year, or years, barring a showing of fraud, malfeasance, or misrepresentation of a material fact.<sup>4</sup> Issues resolved in a closing agreement will not be reopened, annulled, modified, set aside, or disregarded by the federal government or the courts for tax years covered by a closing agreement.<sup>5</sup> This finality allows closing agreements to be a strategic option for taxpayers to keep in mind when trying to resolve a tax issue with the IRS.

#### Common Uses

Closing agreements have broad application. They can be used to conclusively determine a taxpayer’s tax liability for a given year or just the tax treatment of a specific item impacting a taxpayer’s tax liability. They also can address past years or future years,

including years that may be barred by the statute of limitations. Moreover, they can be used to resolve an ongoing audit or, outside of an examination, to voluntarily correct a past mistake.<sup>6</sup>

Closing agreements are not limited only to resolving income tax matters. Section 7121 specifies that a closing agreement may be entered into with respect to a taxpayer’s liability for “any internal revenue tax,” such as estate and gift taxes, as well as payroll taxes.<sup>7</sup> In addition, closing agreements can be used to address any penalties applicable under the Internal Revenue Code for a given tax period, including specifying the inapplicability of certain penalties at a taxpayer’s request.<sup>8</sup> This broad authority has been used by the IRS in voluntary disclosure cases to impose “a title 26 miscellaneous offshore penalty.”<sup>9</sup>

In years past, Section 7121 only allowed the IRS to use closing agreements for time

periods ending before the date of the agreement.<sup>10</sup> Currently, however, Section 7121 allows for closing agreements that relate to any taxable period, meaning that they can also cover issues that affect future years and issues not yet transpired at the time of the agreement.<sup>11</sup> When used for future periods, they can only be used to address the treatment of a specific item, not the overall tax liability, and they must specify that the agreement is subject to any change in, or modification of, the law enacted subsequent to the date of the agreement and made applicable to such taxable period.<sup>12</sup>

There are several reasons a taxpayer may want to enter into a final determination of the taxpayer’s tax liability by a closing agreement. The taxpayer may wish to definitively establish its tax liability in order that a transaction may be facilitated, such as a sale of its stock. A corporation

in the process of liquidation or dissolution may desire a closing agreement in order to wind up its affairs. A taxpayer may wish to fulfill creditors' demands for authentic evidence of the status of its tax liability. The fiduciary of an estate may want a final determination of the estate tax liability so the fiduciary can be discharged by the probate court. Yet another reason may be when proposed assessments are contested on the theory that the years are barred and the taxpayer wishes to agree to some portion or all of the assessments. Also, following an audit, the taxpayer may want assurance that the issue will not be reaudited.<sup>13</sup>

Additionally, a taxpayer may want to enter into a final determination of the tax treatment of specific matters by closing agreement because the taxpayer wishes to: 1) determine the cost, fair market value, or adjusted basis of an asset as of a given date; 2) ensure finality and consistency in disposing of cases involving divisions of community property between spouses incident to divorce; 3) determine the amount of net operating loss, tax credit, or capital loss for the given tax period and for carryover years; 4) determine the amount of income or deductions or the year of includability or deductibility; and 5) resolve potential "whipsaw" situations to avoid inconsistent tax treatment.<sup>14</sup>

Closing agreements may also be valuable in criminal cases. In a criminal context, plea agreements typically include the requirement that the defendant file amended returns. As an alternative, an attorney should consider requesting closing agreements for the relevant years. This avoids the risk of the attorney being considered a preparer of the amended returns, prevents the client from having to sign an amended return under penalty of perjury when other issues unknown to the attorney may be lurking, and precludes a follow-up civil examination.

It should be noted that Section 7121 does not require the IRS to enter into such agreements.<sup>15</sup> In fact, the IRS has stated that it is generally reluctant to enter into such agreements.<sup>16</sup> Rather, Section 7121 merely authorizes the IRS to approve of such agreements at the IRS's own discretion,<sup>17</sup> meaning the IRS has the right to reject a closing agreement request or impose conditions on the party seeking the agreement before executing it.<sup>18</sup> The regulations specifically require the IRS to determine that the "United States will sustain no disadvantage through consummation of such an agreement" for the IRS to be authorized to enter into a closing agreement.<sup>19</sup>

A taxpayer requesting a closing agreement may need to demonstrate for the IRS why a closing agreement would be advantageous for the IRS in the taxpayer's particular situation. The IRS has recognized that in practice if a taxpayer shows good reasons for requesting the agreement and furnishes necessary facts and documentation, and the government will sustain no disadvantage, a closing agreement will ordinarily be entered into so long as the content of the agreement can be agreed upon.<sup>20</sup>

### Legal Effect

Once a closing agreement is accepted by the IRS, it is final and conclusive. This finality can raise many issues if the agreement is not drafted carefully. Essentially, closing agreements are interpreted using contract law<sup>21</sup> and are construed according to the intent of the parties inferred from the four corners of the agreement at the time of execution.<sup>22</sup> If a closing agreement contains an ambiguity, the ambiguity is resolved against the drafter.<sup>23</sup> Absent fraud, malfeasance, or misrepresentation of material fact, courts have prevented both the IRS and the other party to the agreement from trying to reopen, amend, or modify it.<sup>24</sup> A closing agreement will not be set aside even if a taxpayer entered into the agreement with the IRS based on the IRS's erroneous belief in a law that, for example, was not in effect at the time of the agreement.<sup>25</sup>

To avoid unexpected ramifications, it is important to carefully consider the language used in the agreement regarding the scope of the agreement. In *United States v. National Steel Corp.*,<sup>26</sup> a closing agreement was not interpreted as "freezing the methodology" for which the IRS was required to compute a taxpayer's income tax refund, allowing the IRS to recompute the refund under a later version of the applicable statute. Had the agreement mentioned that the refund would be calculated in accordance with existing law at the time it was executed, the IRS may have been required to calculate the refund according to the previous statute.

Even an individual's potential defenses can be waived if they are not preserved in a closing agreement. For example, the court held in *In re Hopkins*<sup>27</sup> that a taxpayer may not avoid tax liabilities arising out of a valid closing agreement by asserting an innocent spouse defense when that defense was not included in the text of the agreement.<sup>28</sup> In *Rockafellor v. Commissioner*,<sup>29</sup> the taxpayer entered into a "final and conclusive" closing agreement

that determined the taxpayer's tax return preparer penalties and, as part of the agreement, expressly relinquished the taxpayer's chance to seek abatement or refund of the penalties determined therein.<sup>30</sup> In signing the agreement, the taxpayer effectively consented to assessment and gave up the procedural requirement that allowed for post-assessment challenge. Any error relating to verification of compliance with the procedural requirement was found to be harmless because neither respondent nor the court could have set aside the closing agreement that implicitly consented to the assessment.<sup>31</sup>

### *Crandall v. Commissioner*

In 2021, the Tax Court came out with a decision addressing the interpretation of a closing agreement entered into between taxpayers and the IRS following an offshore voluntary disclosure, a common situation in which closing agreements are used by the IRS. In *Crandall v. Commissioner*,<sup>32</sup> the Tax Court held the IRS to the finality of a closing agreement addressing the tax adjustments and penalties associated with the taxpayers' undisclosed foreign income and accounts even though the agreement omitted the agreed-upon amount of the allowable foreign tax credit (FTC) for one of the tax years.

The taxpayer had immigrated to the United States from Italy and received a pension resulting from the taxpayer's work in Italy. The taxpayer failed to report the income from the pension or disclose the existence of foreign bank accounts. The taxpayer made a submission to the IRS as part of the Offshore Voluntary Disclosure Program in order to resolve the tax issues resulting from her undisclosed foreign income. As a part of that program, the taxpayer filed amended returns and paid the amounts shown as due on the amended returns. The IRS did not accept the amended returns and commenced an examination that resulted in a revenue agent's report and subsequently a closing agreement.

While the closing agreement stated that the taxpayers were entitled to a FTC for years 2003 through 2011, the agreement did not specify the allowable amount for 2011. The agreement also stated that it did not prevent the IRS from proposing adjustments "unrelated to offshore financial arrangements" or "related to offshore financial arrangements not included" in the taxpayer's voluntary disclosure. The taxpayers argued that the closing agreement meant that the parties agreed not to adjust the FTC on their 2011 return

while the IRS argued that the absence of a stated adjustment indicated the agreement did not prohibit a subsequent adjustment to that item.

The Tax Court looked at other provisions in the closing agreement to interpret the true intention of the parties. Ultimately, the Tax Court disagreed with the IRS and refused to limit the scope of the agreement. The Tax Court reasoned that the agreed upon accuracy-related penalties for 2011 addressed in another paragraph and the language in the agreement regarding the finality of the agreement indicated that the IRS intended to “accord finality to the tax consequences (including penalties and additions to tax) arising from their disclosure of foreign-source income and assets for 2003 through 2011,”<sup>33</sup> including FTCs, even though the agreement failed to specify the allowable amount for 2011. The Tax Court refused to interpret the agreement to mean that the absence of a specified amount meant that the IRS could subsequently adjust the item after the agreement, finding that such an interpretation would nullify the agreement’s finality.

## Procedure

An individual must overcome several hurdles to obtain approval of a closing agreement by the IRS. The party seeking the agreement must show that there is an advantage for the government to have a case permanently and conclusively closed,<sup>34</sup> furnish sufficient facts and documentation that show good reasons for the agreement such that the government will not sustain a disadvantage as a result of entering into it,<sup>35</sup> and negotiate terms that both sides agree upon,<sup>36</sup> being sure to remember that, as discussed above, the IRS has the discretion to determine whether the government will sustain such a disadvantage.

Typically, closing agreements are drafted to determine tax liability, specific matters, or both. For tax liabilities, the IRS will generally use Form 866;<sup>37</sup> for specific tax matters, Form 906;<sup>38</sup> and for agreements that address both tax liabilities and specific matters, a combined agreement, which should be prepared in accordance with the Internal Revenue Manual.<sup>39</sup>

Per Form 866, a final closing agreement covering a full year’s tax liability will be entered into only if the tax year has ended and the tax liability has been determined. The agreement is available even if there is no additional tax due, there is no reduction in the deficiency claimed, or more than one tax year is being closed.<sup>40</sup>

Per Form 906, a final closing agreement on a specific item is made when the IRS agrees to be bound as to a particular transaction by a particular taxpayer.<sup>41</sup> This agreement helps to ensure consistent treatment (of the specific item) in other tax years.<sup>42</sup> It is not necessary that any immediate tax liability be involved, and there may be a series of final closing agreements relating to different items in one tax year.<sup>43</sup>

If a taxpayer needs to have a closing agreement determine both tax liability and specific matters, a combined agreement can be used. Because a determination of tax liability alone does not determine the considerations used to ultimately arrive at such liability, a combined agreement can be important when the amount of one or more items affecting the taxpayer’s tax liability will affect the computation of taxable income in other tax years, such as the amount of a charitable deduction carryover or depreciation.<sup>44</sup>

When it would be advantageous to have a client’s tax liability or the treatment of a tax item determined with finality, attorneys should consider the option of requesting a closing agreement with the IRS. Before doing so, it is important to understand these procedural implications of doing so to avoid any pitfalls and to ensure it is in the client’s best interest. Although subject to the discretion of the IRS, with the broad authority granted to the IRS to enter into these agreements, closing agreements can be particularly useful in unusual situations to reach a resolution or achieve a desired result. ■

<sup>1</sup> MERTENS LAW OF FEDERAL INCOME TAXATION, *Technical requirements for closing agreements*, citing Aetna Life Ins. Co. v. Eaton, 1930-2 C.B. 263, 43 F. 2d 711, 9 A.F.T.R. (P-H) P 160 (C. C.A. 2d Cir. 1930).

<sup>2</sup> While closing agreements are possible to resolve tax disputes involving partnerships under the new Bipartisan Budget Act of 2015 audit procedures, they are used only in unusual circumstances and “must be thoroughly vetted through senior management and Division Counsel.” I.R.M. 4.46.5.6.2(1) (Dec. 13, 2018).

<sup>3</sup> Treas. Reg. §301.7121-1(a).

<sup>4</sup> Treas. Reg. §301.7121-1(a), (c).

<sup>5</sup> Treas. Reg. §301.7121(c).

<sup>6</sup> Treas. Reg. §301.7121-1(b).

<sup>7</sup> See, e.g., I.R.M. Ex. 8.13.1-12 (sample Information Reporting Program Closing Agreement for understatement of income on Form 1099).

<sup>8</sup> I.R.M. 8.13.1.3.17.4 (Nov. 9, 2007).

<sup>9</sup> See, e.g., Crandall v. Commissioner, TC Memo 2021-39.

<sup>10</sup> MERTENS LAW OF FEDERAL INCOME TAXATION, *Historical developments*, citing 45 Stat. 795, Title I, ch. 29; see *Wolverine Petroleum Corp. v. Commissioner*, 29 B.T.A. 1236 (B.T.A. 1934), *aff’d*, 1935-2 C.B. 256, 75 F. 2d 593.

<sup>11</sup> *Id.*, citing Report of the House Ways and Means Committee, describing the 1938 Act, HR Rep. No.

1860, 75th Cong, 3d Sess. 67 (1938): “By virtue of this change it will be possible for the Commissioner and a taxpayer to enter into a closing agreement with respect to matters already occurred which will affect tax liabilities for future years.... Closing agreements will also be possible concerning transactions not yet consummated at the time of the agreement. The authority given to the Commissioner under this section to execute such closing agreements is discretionary. Since closing agreements of this type will constitute a new method of settling controversies, it is contemplated that the Commissioner will exercise his discretionary power only where such exercise is in the interests of a wise administration of the revenue system.”

<sup>12</sup> Treas. Reg. §301.7121-1(b), (c).

<sup>13</sup> I.R.M. 8.13.1.2.2(1) (May 25, 2018).

<sup>14</sup> I.R.M. 8.13.1.2.2(2) (May 25, 2018).

<sup>15</sup> I.R.S., FIN 48 Implications - LB&I Field Examiners’ Guide (May 2007), available at <https://www.irs.gov/businesses/corporations/fin-48-implications-lbi-field-examiners-guide> [hereinafter FIN 48 Implications.]

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*; MERTENS LAW OF FEDERAL INCOME TAXATION, *General policy regarding authorization of closing agreements*, citing Reg. §§301.7121-1, 601.202.

<sup>18</sup> FIN 48 Implications, *supra* note 15.

<sup>19</sup> Treas. Reg. §301.7121-1(a).

<sup>20</sup> I.R.M. 8.13.1.2.1(2) (May 25, 2018).

<sup>21</sup> See *Estate of Duncan v. Commissioner*, 112 T.C.M. (CCH) 505 (2016), *aff’d*, 890 F. 3d 192 (5th Cir. 2018); *Long v. Commissioner*, 93 T.C. 5, 10 (1989).

<sup>22</sup> *Coca-Cola Co. & Subsidiaries v. Commissioner*, 155 T.C. 145, 204 (2020).

<sup>23</sup> I.R.M. 8.13.1.2.2(1) (May 25, 2018).

<sup>24</sup> See *Davis v. United States*, 811 F. 3d 335, 339 (9th Cir. 2016); see also I.R.M. 32.3.4.5(1) (Aug. 11, 2004).

<sup>25</sup> 34 AM. JUR. 2d *Federal Taxation* ¶ 70353.

<sup>26</sup> *United States v. National Steel Corp.*, 75 F. 3d 1146 (7th Cir. 1996).

<sup>27</sup> *In re Hopkins*, 146 F. 3d 729 (9th Cir. 1998).

<sup>28</sup> *Id.*

<sup>29</sup> *Rockafellor v. Commissioner*, 118 T.C.M. (CCH) 462 (T.C. 2019).

<sup>30</sup> *Id.*, citing *McAvey v. Commissioner*, T.C. Memo. 2018-142, at 22-23.

<sup>31</sup> *Id.*, citing I.R.C. §7121 (“providing that closing agreements generally are final and conclusive as to the matters agreed upon”).

<sup>32</sup> *Crandall v. Commissioner*, T.C. Memo. 2021-39.

<sup>33</sup> *Id.* at \*22-\*23.

<sup>34</sup> MERTENS LAW OF FEDERAL INCOME TAXATION, *General policy regarding authorization of closing agreements*, citing Reg. §§601.202(a)(2), 301.7121-1(a), added by T.D. 6450 and republished in 32 Fed. Reg. 15241 (1967).

<sup>35</sup> MERTENS LAW OF FEDERAL INCOME TAXATION, *General policy regarding authorization of closing agreements*, citing Rev. Proc. 68-16, 1968-1 C.B. 770. See also §§52:04, 52:08, 52:09. Section 601.202(b), Statement of Procedural Rules, provides that “generally” the IRS will use one of two forms for closing agreements.

<sup>36</sup> I.R.M. 8.13.1.2.1(2) (May 25, 2018).

<sup>37</sup> *Goldberg v. Commissioner*, 119 T.C.M. (CCH) 1211 (T.C. 2020), *aff’d*, No. 20-2333, 2021 WL 5102870 (7th Cir. Nov. 3, 2021) (“Agreement as to Final Determination of Tax Liability”).

<sup>38</sup> *Id.* (“Closing Agreement on Final Determination Covering Specific Matters”).

<sup>39</sup> I.R.M. 8.13.1.2.1(10) (May 25, 2018).

<sup>40</sup> 34 AM. JUR. 2d *Federal Taxation* ¶ 70355.

<sup>41</sup> *Goldberg*, 119 T.C.M. (CCH) 1211.

<sup>42</sup> 34 AM. JUR. 2d *Federal Taxation* ¶ 70356.

<sup>43</sup> *Id.*

<sup>44</sup> I.R.M. 8.13.1.3.3(2) (May 25, 2018).