"BUT MY NEIGHBOR PAID ONLY 5 CENTS ON THE DOLLAR" —IRS OFFER IN COMPROMISE PRACTICE TIPS

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WHAT IS AN OFFER?

An offer in compromise is an agreement between a taxpayer and the IRS that resolves the taxpayer's tax liability. The Internal Revenue Code gives the IRS the authority to compromise liabilities by accepting less than the full amount due and owing. A liability can be compromised for one of three reasons—doubt as to collectibility, doubt as to liability, and effective tax administration. This outline provides a general checklist for offers in compromise based on doubt as to collectibility.

1. CONFIRM THAT AMOUNT IS OWED

- where do the numbers come from?
  - from taxpayer's own return or from audit deficiency?
  - consider audit reconsideration, refund claim, offer based on doubt as to liability or collection due process (CDP) appeal
  - request transcript of taxpayer's account
- assessed properly?
  - proper "determination" made?
  - 90-day letter sent?
  - 90-day letter sent to last known address?
  - assessment made with proper notice given?
  - assessment made prior to assessment statute of limitations expiring?
- collection statute of limitations expired?
- proper credit for all payments?
- innocent spouse defense?

2. CONSIDER ALTERNATIVES

- an offer is not for everyone

- alternatives: currently not collectible; bankruptcy; installment agreement; part-pay installment agreement; doing nothing and waiting for levy

- may not be desirable to submit an offer if statute of limitations is about to expire because SOL suspended while offer pending

- don't bother with offer if client can pay in full through installment agreement

- although not dischargeable in bankruptcy, trust fund recovery penalty and civil fraud penalties can be compromised

- criminal conviction does not preclude an offer

- penalty abatement

3. ANALYZE FINANCES –DOES AN OFFER MAKE SENSE?

- not based on how much others have paid

- Policy Statement P-5-100 instructs that an offer in compromise will be accepted when it is unlikely the tax liability can be collected in full and the amount offered reasonably reflects collection potential

- not based on how much owed

- basic formula: quick sale value of assets plus a "future income" component

- goal is to determine the "reasonable collection potential" (that is what IRS will want)

- amount of offer must at least equal the reasonable collection potential

- see attached tables used by offer specialists to determine minimum offer amount (see Attachments 9 and 10)

- IRS Form 656 instructions generally helpful in analyzing whether offer appropriate (see pages 10 and 11 of Attachment 5)

- from IRS perspective, full payment, whether now or over time, is preferable

- one objective of offer program is to provide the taxpayer a fresh start toward future voluntary compliance with all filing and payment requirements

4. EVALUATE ASSETS

- include all assets no matter where located or how titled (don't turn civil matter into criminal)
- determine quick sale value of assets (generally 80% of fmv)
- quick sale value is the expected proceeds if sold quickly, typically in ninety days or less
- not all assets discounted–e.g., cash, bank accounts
- consider whether reasonable to discount more than 20%–e.g., house needs new roof, joint ownership, minority interest
- take into account encumbrances at 100%
- net realizable equity is what is important (quick sale value less any encumbrance on the asset that has priority over the federal tax lien)
- no quick sale value determination if asset has been or will be sold to fund offer; in such case, actual sale value is reduced by costs of sale and the expected current year tax consequence
- take into account exemption amounts—furniture and personal effects ($7,040); tools of trade ($3,520) (updated annually)
- discount retirement account—for current year taxes and early withdrawal penalty
- discount retirement account to zero if client can't get hands on funds through distribution or borrowing, and the client is not eligible to retire until after the period for which future income is being calculated
- consider aggressively discounting asset IRS can't reach (foreign asset)
- be sure client not valuing too high based on sentimental value or unreal expectations
- determine value of artwork, jewelry, antiques, collections
- don't overlook "toys"—four wheelers, snowmobiles, boats, jet skis

5. DETERMINE FUTURE INCOME COMPONENT–INCOME AND EXPENSES

A. Income

- amount by which income exceeds necessary living expenses on a monthly basis
- consider pay period—every two weeks (factor of 2.17 to determine monthly amount), twice per month, weekly (factor of 4.3 to determine monthly)
- use gross figure not reduced by reductions from pay check
- difficult to project income for self-employed person
  - IRS factors include taxpayer's education, age, experience, profession or trade, health, and past and present income level
  - if downward trend, emphasize most recent years
  - if upward trend, emphasize average income over several years
- consider potential drops in income such as retirement or for some other reason beyond the taxpayer's control

B. Expenses

- use as starting point IRS guidelines—national standard expense (food, clothing, miscellaneous); housing and utilities; transportation
  - standard expense amount obtained without supporting documentation; housing and transportation amounts get lesser of actual or allowable and must be documented
  - housing amount includes mortgage or rent payment, property taxes, home owner's or renter's insurance, maintenance, dues and fees and utilities
  - utilities include gas, electricity, water, fuel, oil, other fuels, trash collection and telephone
  - transportation expenses include lease or purchase payments, insurance, registration fees, normal maintenance, fuel, public transportation, parking and tolls
- guidelines may be modified if appropriate to taxpayer's circumstances

- IRS prohibited from using guidelines if results in taxpayer not having adequate means to provide for basic living expenses

- consider debt that will soon be "retired" (e.g., child support coming to end)

- tuition for private schools, public or private college expenses, charitable contributions, voluntary retirement contributions, payments on unsecured debts such as credit card bills, cable television charges and other similar expenses generally not included as necessary living expenses unless necessary for health and welfare of family or for production of income

- repayment of student loans secured by the federal government is allowed only for the taxpayer's higher education

- education expense is allowed for the taxpayer if required as a condition of employment

- repayment of delinquent state or local tax liabilities is not allowed as a necessary expense unless the state or local government's lien has priority in the taxpayer's income stream

- include attorney/accountant fees to be paid for help with offer

- apply appropriate factor: 48 if to be paid within 90 days; 60 if paid within 2 years

- factor is the number of months remaining on the collection statute if the remaining life on the collection statute is less than 48 or 60, as the case may be

- curb urge to exaggerate in order to leave room for negotiation (Form 433-A is signed under penalty of perjury); don't want to be seen as playing games with the numbers

6. BE ALERT FOR REASONS IRS SHOULD ACCEPT LESS

- serious illness

- advanced age

- unemployment or retirement

- bankruptcy option (the legitimate threat of bankruptcy may result in an offer being accepted)

7. CONSIDER DIFFERENT TYPES OF OFFERS AND PAYMENT TERMS

- doubt as to collectibility —different payment terms (within 90 days; more than 90 days and up to 2 years; monthly payments until statute of limitations expires)
- effective tax administration —an exceptional circumstance exists (economic hardship exists or unfair or inequitable to collect)
- can be based on more than one ground —if so, collectibility determined first

8. DETERMINE SOURCE OF OFFER AMOUNT

- IRS wants to know source
- IRS not supposed to unnecessarily inquire into the private finances of third parties
- put money on table not otherwise available to IRS, if possible
- disabuse client of notion that the offer money can be saved
- funds generally borrowed from family or friend, sometimes a bank

9. PREPARE THE CLIENT

- **not simple** –deal with client's perception that this is simple process; client has seen tv and newspaper ads (clients should put themselves in the shoes of the IRS –if you were the IRS, would you accept the offer?)
- **burdensome**–taxpayers are expected to provide reasonable documentation re their ability to pay and <u>may have to provide it more than once</u> if offer gets stale (but investigative actions that are less than 12 months old may be used to evaluate offer)
- **unpleasant**–their dirty laundry will be aired
- **lengthy process**–unless simple offer, figure on one year or more
- **fluid situation**–might not be an offer candidate by time IRS considers the offer/ may have stronger case one year from now
- **SOL suspended**–10-year collection SOL suspended while pending

- **no refunds**–no refunds for tax periods extending through the calendar year the IRS accepts the offer (consider adjusting withholding accordingly)

- **must comply**–must be in compliance (at time offer is submitted, while offer is pending and for five years thereafter)

- **publicity**–information regarding offer may become publicly known

- **tax lien**–must be considered and may be filed by offer specialist

- **collateral agreement**–extra "incentive" for IRS may be required (but appropriate only in rare circumstances)

10. RETAINER

- if your client hasn't paid the IRS, what makes you think you will get paid?

- nonrefundable; otherwise included as asset for offer purposes

11. REFINE THE NUMBERS

- consider reviewing the following:

  - IRS transcript of account

  - real estate records

  - credit report

  - previous offer(s)

  - previous financial statement(s) submitted to IRS, banks

  - IRS collection file (FOIA request)

12. FILL OUT THE FORMS

- Form 656 plus financial statement (Form 433-A or B); internet availability (see Attachments 2, 3 and 4)

- on Form 433-A pay attention to questions regarding expected increases in household income (17f); whether beneficiary of trust or estate (17g)

- IRS wants <u>actual</u> monthly living expenses (exception for national standard expense?)
- attach documentation required by financial statement form
- goal: aggressive without being dishonest or misleading
- have client sign offer even if have POA
- have client initial and date all pages of substitute form

13. SUBMIT THE OFFER

- new $150 filing fee unless poverty income level
- include power of attorney
- send to Memphis
- IRS discourages deposits (refundable if rejected) unless substantial doubt the funds will be available in event offer accepted
- collection generally put on hold unless offer submitted for purposes of delay

14. BEWARE THE PROCESSING STAGE

- two reasons returned: noncompliance and taxpayer in bankruptcy
  - noncompliance means all required returns have not been filed
  - compliance for in-business taxpayer means all employment taxes filed and deposited on time for the two quarters preceding offer as well as timely deposits during quarter offer submitted
- complex offers shipped from Memphis to offer specialist locally
- offers can be returned if defects not perfected (e.g., financial information not provided)
- emergency processing available if agreement, as a condition, requires taxpayer to resolve a tax liability by a specific date; money for offer available for limited time only; terminal illness may affect ability to complete payment terms

- estimated tax payments do not have to be current for offer to be processable (but may be returned later)

- when offer determined to be submitted solely to delay collection, offer is returned

15. CLIENT NEEDS TO BE PRUDENT WHILE OFFER PENDING

- rule of thumb: don't do anything you would not want to explain to offer specialist

- offer is waste of time if don't stay current from time offer is filed, including estimated payments (if taxpayer fails to make estimated payments, the offer may be closed)

- installment agreements remain in effect while offer pending

- prohibition on levy while offer pending does not extend to filing federal tax liens

16. IRS OFFER PERSONNEL

- Memphis Service Center– Centralized Offer in Compromise (COIC) has responsibility for making initial processability determinations and for case building and initial investigation

- local offer specialist– usually a revenue officer–works more complex offers

- Settlement or Appeals Officer–handles appeals of rejected offers

- Counsel's Office–Counsel is required to review offers with total liability amounts of $50,000 or more

- Brookhaven Service Center used for person with foreign address

17. NEGOTIATE WITH THE OFFER SPECIALIST

- much discretion re value of asset/future income stream

- listen to what is being said: although there are rules to be applied, they are not always applied consistently

- collateral agreement is exception rather than the rule

18. APPEAL WHEN NECESSARY

- automatic independent administrative review if offer rejected at first level

- beyond that, Appeals can overturn decision of offer specialist

- 30 days to appeal from date of IRS rejection letter

- appeal will add 6 months to a year to process

- possible Tax Court review through Collection Due Process (CDP) appeal but not otherwise

- offer otherwise acceptable can be rejected on public policy grounds (e.g., public reaction would be negative or suspicion that the financial benefits of a criminal activity are concealed or the criminal activity is continuing)

19. MAKE SURE ACCEPTANCE NOT REVOKED

- pay by agreed date

- five years of subsequent compliance–filing and paying

- an accepted offer is a contract that is binding and conclusive unless there is fraud or a mutual mistake

- IRS has authority to compromise its compromise

20. FOLLOW UP RE LIEN RELEASE

- should happen automatically

- include request with certified check to speed process

- consider making sure taxpayer's record with credit reporting companies is cleared

21. EFFECTIVE TAX ADMINISTRATION (ETA) OFFER

- 1998 Tax Act gave IRS authority to compromise cases involving equity, hardship and public policy

- ETA basis for acceptance applies only if neither doubt as to collectibility nor doubt as to liability exist

- ETA offer will not be accepted unless IRS establishes that the liabilities are valid and that taxpayer can full pay the liabilities

- although a taxpayer is not eligible for ETA offer, hardship factors may result in a doubt as to collectibility offer with special circumstances using the same hardship factors as for ETA

- for ETA offer, key is to establish that collection of full liability would create economic hardship or would be detrimental to voluntary compliance

- economic hardship is defined as an inability to meet reasonable basic living expenses

- economic hardship factors include long-term illness, medical condition or disability that renders the taxpayer incapable of earning a living; liquidation of assets to pay the liability would render the taxpayer unable to meet basic living expenses; and taxpayer is unable to borrow against the equity in assets and sale of the assets would have sufficient adverse consequences that enforced collection is unlikely

- collection is detrimental to voluntary compliance where it would likely have an adverse effect on compliance by other members of the taxpaying public

- the IRS anticipates using this authority when collection would be so unfair or inequitable that other taxpayers would lose confidence in the system and therefore refuse to comply; compromise on these grounds will be rare

EXAMPLE

Sam and Diane are your clients. They are married and owe income taxes from 1998, 1999 and 2000, on account of Sam's starting his own lawnmowing and gardening business and not being familiar with estimated payment obligations. The returns were all filed in May of 2001. Assessments were made in June of 2001 and, with penalties and interest, now total $85,000. Sam makes $64,900 per year. Diane works part-time and earns $29,000 per year. They live in King County and have two children, 9 and 7. Clients have a house worth $350,000 and a mortgage of $280,000. Sam and Diane lease one car and are making payments on a Volvo. Their Volvo is worth $20,000 and they owe approximately $18,000 on it. They have a boat worth $5,000. Clients have $2,000 in the bank and $10,000 in a retirement account. Furniture and personal effects amount to $8,000. There are no antiques, oriental rugs, coin collections or the like. Sam has tools and equipment valued at $10,000 which he uses in his business. Sam and Diane's income exceeds "necessary living expenses" by $200 per month. They have credit card debt of $8,000. Sam's mother wants to help and is willing to loan money for an offer in compromise. Sam and Diane have offered the IRS $10,000.

ASSET SUMMARY	**F.M.V.**	**DEBT**
House	$350,000	$280,000
Car	$20,000	$18,000
Furniture and personal effects	$8,000	0
Boat	$5,000	0
Tools and Equipment	$10,000	0
Bank Accounts - Checking	$1,000	
- Savings	$1,000	
Retirement Account	$10,000	
TOTAL	$405,000	$298,000

INCOME SUMMARY

Sam: $64,900/yr

Diane: $29,000/yr salary

Monthly total = $7,825/month

EXPENSE SUMMARY

National Standard	**$1,561**
Housing & Utilities	**$2,035**
Transportation	
• **Car 1 (Lease)**	**$432**
• **Car 2**	**$324**
• **Operating Costs**	**$325**
Health Insurance	**$436**
Taxes	**$1,800**
Childcare	**$400**
Life Insurance	**$212**
IRS Representation	**$100**
	$7,625/month