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The Offers in Compromise

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Abstract: *Due to the economic recession including the high unemployment rates and decreasing investment values in the recent decades, some business and individual taxpayer are not able to afford the full amount of the federal tax liabilities when taxes come to due. Taxpayers try to take advantage from any possible strategies to pay as much less tax as they can. One of the common methods is for the business or individual taxpayer to make an offer in compromise (OIC) to pay a reduced amount of the total tax owed to the Internal Revenue Service (the IRS).This research paper covers the development of OIC, factors to be considered before doing OIC, the qualified conditions to do OIC, the verification of taxpayer income source, controversial issue with related law cases, the chance of OIC to be accepted, and the disadvantages of OIC.*

Key words: *Offer in compromise, OIC, taxpayer, Internal Revenue Service, IRS*

1. The Development of Offers in Compromise

1.1 Historical Review

The Offer in Compromise (or OIC) program, in the United States, is an Internal Revenue Service (IRS) program under 26 U.S.C. § 7122 which allows qualified individuals with an unpaid tax debt to negotiate a settled amount that is less than the total owed to clear the debt. The OIC was originated in 1986 tax reform act, when it made the OIC program became “official”. Three years later in 1989, Washingtong Tax Services came into being sending mailing to people with tax liens and doing Offer as they could[1]. The last huge change happened in May of 2012, IRS lowered the bar for OIC which makes it much more realistic and consistent with the aims of the OIC program.

1.2 Significant changes of “Fresh Start” Program in 2012

In May 2012, the IRS published new guidelines for its offer in compromise program (IR-2012-53) as part of its expansion of the “Fresh Start” program. The major guideline changes included: revising the calculation of the taxpayer’s future income, allowing taxpayers to pay students’ loans and delinquent state and local

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taxes, expanding the types of allowable living expenses; and narrowing the parameters for including dissipated assets in calculating future income[2].

According to IRM 5.8.5, prior to the May of 2012, the minimum offer the IRS would accept was the sum of the net realizable equity of the taxpayer's asset (NRE) and the taxpayer's reasonable collection potential (RCP). To determine the amount of RCP, first thing was the excess of the taxpayer's monthly income over expenses, and then multiplied by 60. The product was RCP. In the case of an individual taxpayer, the expense was not the actual expenses, but the allowable expenses determined by applying collection financial standards[4]. Now, the RCP is the excess of the taxpayer's monthly income over allowable expenses, multiplied by 12 in the case of an offer payable within five months, or multiplied by 24 in the case of an offer payable in six to 24 months. The IRS no longer entertains offers payable in more than 24 months[4].

From the new regime, it benefits taxpayers in many other ways, for instance:

a) NRE in assets is defined as quick sale value, less amounts owed to secured lienholders with priority over the federal tax lien, if any, and applicable exemption amounts.

b) Funds held in a retirement or profit sharing plan are considered an asset and must be valued for the offer.

c) If the taxpayer uses car for work, then $3,450 should be deducted from its QSV, or otherwise determined.

d) If the taxpayer is self-employed, and his income is not stable, then the taxpayer may income average over the last 3 years to determine the RCP.

e) If the taxpayer's vehicle is more than 6 years old or has more than 75,000 miles on it, $200 should be added to the taxpayers' monthly vehicle operating expense, otherwise allowable.

f) The taxpayer may deduct expenses in excess of those allowed by the collection financial standards, by proving that they necessary for the health or welfare of the taxpayer or the taxpayer's family, or for the production of income.

In *Dunn's* Forbes article, he gave two practical cases about how the new regime could change the result of OICs. First client was a couple owed $600,000 in federal taxes. Wife was employed earning $100,000 per year and her husband is self-employed. His income was not stable and in the most recent year it was $150,000. A notice of federal tax lien was recorded against the couple, disabling their credit, and possible influence their employability. Their NRE was zero because they spent all of their net income each month on their family. The family took no vacation and they drove used cars. The excess of the couple's monthly income over their allowable expenses was $9,863; capitalized at 60 months it produces an RCP of $986,300. The couple was not candidates for an OIC. Under the new regime, the couple would be able to compromise their $600,000 federal tax obligation by offering to pay $118,356 on it. They would have five months to come up with the $118,356.

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The second case from *Dunn's* article is the client who was in his late 50's, which is tough period for those who are unemployed, but too young to receive social security retirement benefit. He was force to retired due to serious heart condition. He received month social security disability benefits. He had no formal education beyond high school and no assets. The man's wife worked for low wage and had a child from previous marriage. The client owed up of $100,000 in federal taxes. He had no NRE and he made an offer to compromise the taxes for $5,000. The IRS rejected his offer in compromise. However, under the new regime, the *IRM 5.8.5.20* stated that "Consideration should be given to the taxpayer's overall general situation including such facts as age, health, marital status, number and age of dependents, level of education or occupational training, and work experience." In this situation, the chance of offer being accepted is much high than previous.

In next section, I will discuss the requirement to do OIC and the current procedures.

2. Factors to be considered Before Offers in Compromise

Before individual taxpayers consider the offer in compromise, they need to consider factors first to make them eligible for OIC. The IRS has the strict qualifying factors for OIC. The IRS examines income, asset, and equity in assets whether accessible or not.

In the *IRS Form656-B,* it is stated that "Before your offer can be considered, you must (1) file all tax returns you are legally required to file, (2) make all required estimated tax payments for the current year, and (3) make all required federal tax deposits for the current quarter if you are a business owner with employees. (4) If you or your business is currently in an open bankruptcy proceeding, you are not Eligible to apply for an offer."

Moreover, in the *IRS form 656-B,* the IRS specifically points out other factors need to be considered, including, payment method, the future tax refunds, doubt as to liability, notice of federal tax lien, trust fund taxes, penalties and interest etc. (page4, form 656-B)

3. Qualified Conditions of Offers in Compromise

Under Reg. § 301.7122-1(b), the circumstances in which the IRS may accept less than the full liability include:

3.1 Doubt as to liability

A taxpayer may submit an offer-in-compromise based on doubt as to liability ("DATL") if there is a genuine dispute as to the existence or amount of the correct tax liability under the law. Treas. Reg. § 301.7122-1(b)(2).

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3.2 Doubt as to collectability

A taxpayer may submit an offer based on doubt as to collectability (“DATC”) or doubt as to collectability with special circumstances (“DATC-SC”) if the taxpayer believes that he/she cannot ever pay the full amount of the tax owed. Treas. Reg. § 301.7122-1(b)(3).

3.3 Doubt as to collectability, with special circumstances

In IRM 5.8.11.2.1 (5) other factors that may be taken into account when considering an offer based on DATC-SC are listed that impact the taxpayer’s financial condition other than basic living expenses, including:

a) the taxpayer’s age and employment status

b) number, age and health of taxpayer’s dependents

c) cost of living in area the taxpayer resides

d) any extraordinary circumstances such as special education expenses, medical catastrophe, or natural disaster

In IRM 5.8.11.2.1(6) factors can create economic hardship are including:

a) The taxpayer is incapable of earning a living because of a long term illness, medical condition or disability and it is reasonable that the financial resources will be exhausted.

b) The taxpayer has set monthly income and no other means of support, and the income is exhausted each month in providing for the care of dependents.

c) The taxpayer has assets, but is unable to borrow against the equity in those assets, and liquidation to pay the outstanding tax would render the taxpayer unable to meet basic living expenses.

3.4 Effective tax administration (ETA)

Although the taxpayer can afford to pay tax liability in full, an OIC still entered to promote ETA when:

a) Collection of the full liability would cause the taxpayer “economic hardship” or

b) Compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability, and

c) Compromise of the liability will not undermine compliance by taxpayers with the tax laws [*Treas. Reg. § 301.7122-1(b)(3)(ii)]*

According to form 656-B, the following must be included in an offer in compromise application:

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Form 656, Offer in Compromise

a) Completed Form 433-A (OIC), Collection Information Statement for Wage Earners and Self-Employed Individuals, if applicable

b) Completed Form 433-B (OIC), Collection Information Statement for Businesses, if applicable

c) $186 application fee, unless you meet Low Income Certification

d) Initial offer payment, unless you meet Low Income Certification

The situation may get more complicated when taxpayer and his spouse owe joint and separate tax debts, also when taxpayer owe individual and business tax debt . If taxpayer has joint tax debt with his spouse and one of them also has separate tax debts, then the taxpayer and his spouse will need to send in the second Form 656 with the separate tax debt, for a total of two Forms 565. If taxpayer and his spouse have joint tax debts and each is responsible for separate tax debts, they will each need to file the separate Form 656. If the taxpayer and his spouse or ex-spouse have a joint tax debts and his spouse or ex-spouse does not want to be part of the offer, taxpayer may submit a Form 656 to compromise his responsibility for the joint tax debt. If taxpayer has both individual and business tax debt, taxpayer will need to send two Forms 656.

4. Verification of Income Source

To qualify for the Offers in Compromise, taxpayers must prove that his outstanding tax liabilities exceed the amount of income and assets available to satisfy those tax liability during the time remaining in the collection period. The higher the taxpayer’s reasonable collection potential (RCP), the lower the chance that taxpayer would be qualified for an OIC. When calculating the RCP, the IRS takes into account current and potential earnings, also the value of assets exceeding needed for necessary living expense. The sum of the taxpayer’s income and asset is treat as available to satisfy the taxpayer’s federal tax liability.

According to the IRM 5.8.5.3.1, the IRS conducts verification on taxpayer’s collection information statement (CIS), Form 433-A(OIC) and/or Form 433-B(OIC), involves reviewing taxpayer submitted documentation and information available from internal sources. Major verifications on income and asset including:

a) Compare real estate tax and mortgage interest deductions to the amounts declared on the CIS. Discuss any difference with the taxpayer to determine the reason for the increase or decrease.

b) Identify accounts not reported on the CIS, such as certificates of deposit or investment accounts.

c) Verify sources of income, such as employers, bank accounts, and retirement accounts.

d) Identify recent transferred or disposed of assets, such as stocks and bonds.

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5. Controversial Issue: OIC and dissipated Assets

A dissipated asset is defined as any asset (liquid or nonliquid) that has been sold, transferred or spent on nonpriority items or debts and that is no longer avaialbel to pay the tax liability(IRM 5.8.5.18). Taxpayers who want to dispose of their asset to make qualified are likely to fail, numbers of court cases support the IRS's practice of including dissipated asset in the RCP calculation.

In the year of 2011, The Tax Court decided two cases in supporting the IRS's rejection of OICs where the court found that the taxpayers had disposed of assets that would have been avaiable to satisfy their outstanding tax libility.

5.1 Case: Tucker v. Comm, T.C. Memo. 2011-67 filed March 22, 2011

In this case, the individual taxpayer's request for an OIC was denied when the examiner included dissipated assets in the RCP calculation, as a result, an RCP was sufficient to satisfy the outstanding tax liability within the statutory collection period. The taxpayer was aware of his unpaid tax liabilities when he transferred funds into an online brokerage account to engage in day trading and subsequently lost a portion of the money. The IRS determined, and the tax court held, that the taxpayer lost the money in disregard of his outstanding tax liability. Due to the failed investment, the taxpayer's RCP exceeded his outstanding tax liability and the court held that the settlement officer did not wrongly determine that the taxpayer could fully pay his federal income tax liability.

5.2 Case: Layton v. Comm, T.C. Memo. 2011-194 filed August 11, 2011

In this case, the taxpayer's request for an OIC was denied after the IRS examiner included the excess balance of an IRA distribution in the RCP calculation. The taxpayer had been unemployed for years and had liquidated an IRA account to help her pay the necessary living expenses. The remaining balance of the taxpayer's IRA distribution went to pay other nonessential debts. The taxpayer was not able to demonstrate that the nonessential debts she paid were necessary. The Tax Court ruled in favor of the IRS.

The IRS issued guidelines for all examiner evaluating OICs. The *IRM 5.8.5.16* states the following factors must be analyze to determine whether an asset has been dissipated and should be included in the RCP calucaltion:

a) When an asset was dissipated in relation to the OIC submission (generally, the value of assets dissipated more than five years before the OIC submission will not be included in the RCP);

b) If an asset was used by the taxpayer to pay existing, ongoing business operating expenses, the funds should not be considered a dissipated asset;

c) When the asset was dissipated in relation to the liability;

d) How the asset was transferred;

e) Whether the taxpayer realized any funds from the asset transfer;

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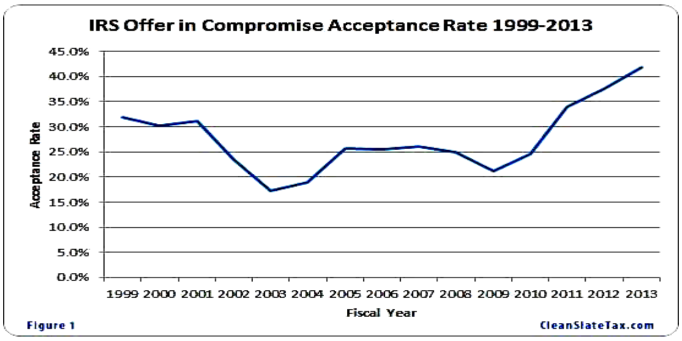
f) How any funds realized from the disposition of assets were used; and

g) The value of the assets and the taxpayer's interest in them.

6. Offers in Compromise Acceptance Rate

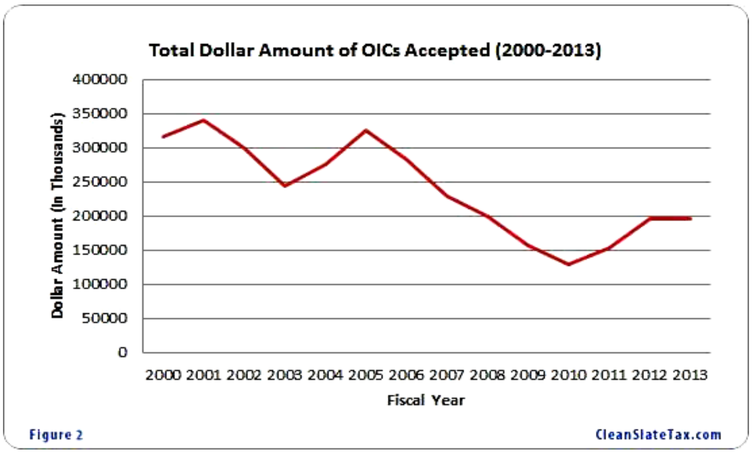
Based on the IRS released data, it showed that the OIC acceptance rate reached 42% in year of 2013 and 38% in the year of 2012. This represents a 10.5% increase in the acceptance rate from 2012 and a significant increase in the OICs acceptance rate from 2009. Below is a table showing OIC acceptance rates since 1999**(*Cleanslatetax*):**



(picture from cleanslatetax)

The IRS Fresh Start Program changes in 2012 are the major cause of the increasing OIC acceptance rate. When the program started in 2008, the IRS created more flexible resolution option for taxpayers. In the year of 2012, IRS lowered the bar again by changing how they calculate a taxpayer's future income. In additional, the IRS now allows for the repayment of student loans, state and local delinquent taxes, and has expanded the Allowable Living Expense category and amount.

However, the total dollar amount of OICs is not at a high as the acceptance rate. From 2012, below is a table showing total dollar amount of OICs accepted since 2000(cleanslatetax):



(picture from cleanslatetax)

7. Disadvantages of Offers in Compromise

Offer in Compromise (OIC) is a good resolution option for taxpayer who is unable to pay their tax debts in full—you just need to submit a few forms to the IRS and your tax liability has the potential to be reduced substantially. Moreover, an OIC will put the collection activities of other creditors on hold, which means ongoing collection activities that began before the filing of the OIC may continue after the filing.

Although this program has many advantages, it also has some disadvantages that the taxpayer should be aware of.

1) The OIC program is not fast.

After mailing an OIC request to the IRS, it takes between 4 and 7 months to receive a response. If the OIC is rejected and must be appealed, it can add as much as 6 months on top of that. The OIC program is not the best option for the taxpayer who is looking for a quick resolution.

2) The IRS requirements for accepting OIC are fairly strict.

The OIC process involves a high level of scrutiny by an IRS examiner to ensure the taxpayer is unable to pay their balances in full. The IRS looks more carefully at financial statements for OIC request than it does for any other resolution request. Thus, the taxpayer may end up wasting time and money on trying to settle with the IRS when that effort could have been applied toward a better resolution.

3) When the IRS accepts an OIC, they request that the taxpayer comply with all provisions of the Internal Revenue Code that detail filing of tax returns and payment of tax for at least five years.

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This can become a problem as the tax code is complex and any little thing perceived by the IRS to be in violation of the tax law would void the OIC agreement. For example, if you so much as owe one penny for the particular period, you have breached the OIC agreement and the IRS has the right to revoke your OIC and seek the entire tax liability from you.

4) In general, the IRS only has ten years from the date of assessment to collect the taxes from the taxpayer.

If the IRS cannot collect within the ten-year period, all taxes, interests, and penalties for that tax year are removed forever. However, when the IRS receives an OIC, the taxpayer is agreeing to suspend the statutory period of limitations for IRS assessment of the tax liability for the tax years that are listed in the OIC. This means that if it has been five years since the IRS assessed the taxes against the taxpayer, there are five years left for them to collect. If the taxpayer files an OIC now and it is being considered for one year, the IRS will still be able to collect against you for five years if your OIC is rejected.

5) Once the OIC is accepted, the taxpayer loses their ability to further contest the amount of the compromised liability in court. Also, if the taxpayer defaults on their OIC, they will still not be able to appeal the liability in Tax Court.

6) The IRS can keep all previous payments even if they are overpayments to the extent of the difference between the taxpayer's total liability and the amount of the OIC.

This works against the taxpayer in two ways. First, when the taxpayer files an OIC, they are required to make a down payment or begin making the monthly payments depending on the type of OIC they submit. If the OIC is rejected in the long run, the IRS will be able to keep all of the money the taxpayer paid in during the review of the OIC. The second way is that if you are due a tax refund in the year your OIC is accepted, the IRS keeps that money and it is not credited toward the amount you owe for the OIC, but rather it goes against your past due tax liability.

7) A taxpayer considering bankruptcy should be aware that filing an OIC could transform some of their compromised tax into non-dischargeable tax unless the prescribed time for assessment of the tax has expired.

If an OIC is submitted, the normal rules that any taxes assessed within 240 days of filing bankruptcy are non-dischargeable is expanded to 270 days plus the number of days the OIC is pending.

8) All OIC agreements are made public for anyone to inspect.

This means that your financial situation will be viewable by anyone who wishes to have a look. Before deciding to move forward with an OIC request, the taxpayer needs to weigh these disadvantages against the advantages. The IRS will not show any sympathy for them in the circumstances that the taxpayer is not aware of these potential pitfalls.

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