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IRS OFFERS IN COMPROMISE
By Paul M. Predmore (September 2001)

For the practitioner who has been actively involved in dealing with IRS collection activities over the past ten years, acceptance of an offer in compromise is usually the "home run" solution. While an accepted offer does come with some strings, it brings closure to what is invariably a most unwelcomed chapter in our client's lives. Since its initial substantial overhaul in January, 1992, the IRS's offer in compromise program has seen many modifications. What follows is a brief overview of significant milestones in the evolution of the offer program and a summary of the most recent significant changes implemented.

1. Introduction of the Revised Program.

As part of its Compliance 2000 initiative the IRS issued Policy Statement P-5-100 in early 1992 to announce a new policy towards offers in compromise. At the time, IRS officials professed that the government was adopting a more business-like approach to collecting accounts presently considered not collectible or which had extended installment agreement payments that did not even cover accruals. One explanation for this new attitude was that taxpayers who had an offer accepted under the new program were required to be in compliance with all future filing and payment requirements for a period of at least five years or else lose the benefits of their compromise. This compliance condition was directed to the IRS' goal of bringing more taxpayers back into the tax-paying system by the year 2000. All of these developments were generally received with cautious optimism by tax practitioners

The 1992 modifications to the offer in compromise program were entirely a shift in IRS policy, not a change in tax law. The IRS has been empowered to accept compromise offers under Code Section 7122 for some time. Regulation Section 301.7122-1(a) established the fundamental ground rules for settling a tax debt with the IRS and continued to do so under the new policy: an offer may be accepted only upon a satisfactory showing of doubt as to liability and/or doubt as to collectibility. Before the 1992 changes, however, it was IRS policy to accept an offer only if it represented "maximum collection with the least possible loss or cost to the government."[1] Under the

[1] Internal Revenue Service Manual ("IRM") 57(1) 1.4 (August 24, 1989).

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revised policy, the goal was "to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the government."[2]

The Internal Revenue Manual provisions governing how the IRS evaluates and processes offers were substantially revised in 1992 to reflect the new collection policy. The most significant IRM changes included: (1) IRS personnel were instructed to discuss the possibility of an offer in compromise with taxpayers whose financial position make it unlikely that their tax debt will be paid in full; (2) collectibility offers were to be processed by a Revenue Officer, often one familiar with the account, rather than by Special Procedures Function; (3) simplified financial disclosure forms; (4) more liberal valuation guidelines and considerations for certain property interests; (5) a present value analysis of the taxpayer's current ability to make installment payments over a sixty-month period; (6) a five-year compliance period upon acceptance of the offer; and (7) discouraged use of collateral agreements with the offer.

[2] IRM 57(10) 1.1 (February 26, 1992).

Now almost ten years after the implementation of this revised policy, the data demonstrate that the IRS' change in attitude toward offers in compromise was genuine. In fiscal year 1991, a total of 8,711 offers were submitted for consideration and less than 25 percent were accepted. In fiscal years 1999 and 2000, the IRS considered 74,220 and 82,047 offers, respectively. Out of these offers, 30,542 (approximately 41 percent) were accepted in fiscal 1999 and 33,114 (approximately 40 percent) were accepted for fiscal 2000.[3]

2. The GAO Study.

In 1993, the General Accounting Office reviewed the new program to determine whether it was meeting its stated objectives of increased collections and improved taxpayer compliance. In a report issued in December, 1993,[4] the GAO determined that more information was necessary to evaluate the efficacy of the program as a collection and compliance tool. The GAO found that the IRS had no measure of the yield of the program (revenue collected verses resources expended), revenues collected that would not have been collected through other collection means, the extent to which non-complying taxpayers are returned to the tax system, and the extent to which participating taxpayers remain in compliance after an offer is accepted. Furthermore, the GAO raised the concern that overall taxpayer compliance may be adversely affected by a program where many taxpayers are settling for less than the full tax liability due. Perhaps most significantly, the GAO expressed concern over the wide variability of acceptance rates among the IRS' 63 district offices. For example, in the first ten months of fiscal year 1993, offer acceptance rates ranged from 17 percent in Laguna Niguel, California to 79 percent in Fargo, North Dakota. This concern lead to the first significant modification of the revised offer program, the standardization of the living expenses allowed as necessary expenses on the Collection Information Statement (Form 433-A).

3. Standardized Expense Guidelines.

[3] Los Angeles Times, October 20, 2000

[4] General Accounting Office Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, "Changes Needed to Cope with Growth in Offer in Compromise Program," December, 1993.

In August, 1995, the IRS released IRM 5323 giving collection personnel national guidelines for necessary and conditional living expenses. IRM 5323 identified two types of "allowable" expenses when evaluating a taxpayer's financial situation: necessary and conditional.
Necessary expenses are defined in IRM 5323 as those that provide for a taxpayer's and his or her family's health and welfare and/or production of income. Necessary expenses for food, housekeeping supplies, apparel and services, personal care products and services and miscellaneous were standardized nationally and necessary expense for housing (including utilities) and transportation were standardized by locality.[5] Other expenses not fitting into any of these categories may be considered necessary if they are reasonable in amount.

Conditional expenses are defined in IRM 5323 as any other expense that are not included in necessary expenses. Under IRM 5323, conditional expenses would only be allowed in evaluating a taxpayer's ability to pay if the entire tax obligation, including projected accruals, could be paid in full within three years.[6]

IRM 5323 was not released as part of the offer in compromise program *per se*; its stated goal was to establish a consistent framework for evaluating a taxpayer's ability to pay in all contexts. This addition to the Internal Revenue Manual had a significant impact on the offer in compromise process, however, because collection personnel were instructed to allow only necessary expenses in evaluating a taxpayer's ability to pay when considering an offer in compromise. Certain conditional expenses that may have been allowable in an installment agreement (*e.g.* charitable contributions, education, and voluntary payments into retirement plans) were not permitted in the offer in compromise calculation.

The release of IRM 5323 was a mixed blessing. While on the one hand the detailed guidelines help to simplify and predict the IRS's evaluation of the Form 433-A, the inflexible application of these new guidelines in the evaluation of an offer in compromise lead to unfair results.

4. Congressional Hearings and the 1998 Act.

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[5] IRM 5323.12(1)(a) (August 29, 1995)

[6] *Id. at (1) (b)*.

The IRS' rigid adherence to the guidelines set forth in IRM 5323 when processing an offer became the subject of frequent complaint by practitioners. This issue, along with other concerns about the offer program, gained considerable attention during the 1997/1998 Congressional hearings that scrutinized many practices and procedures of the Internal Revenue Service. As a result of these hearings, the IRS Restructuring and Reform Act of 1998 ("1998 Act") became law on July 22, 1998 (Pub.L. 105-206). A number of modifications to the offer in compromise program were made through the 1998 Act's addition of new Internal Revenue Code Sections 7122(c) and (d) and 6331(k):

(a) More Flexible Expense Allowances.(Code Section 7122(c)(1) and (2)). Congress directed the IRS to adopt more liberal approaches to examining and accepting offers. National and local allowances should be developed but applied with greater flexibility to ensure, based on each taxpayer's facts and circumstances, that the taxpayer has adequate means to provide for basic living expenses.

(b) Elimination of Minimum Offer. (Code Section 7122 (c)(3)(A)). Offers from low-income taxpayers were not to be rejected solely on the basis of the amount of the offer.

(c) Doubt as to Liability Offers. (Code Section 7122(c)(3)(B)). The IRS's inability to locate the taxpayer's return or return information for verification shall not be the sole basis for rejecting a doubt-as-to-liability offer. Furthermore, the taxpayer shall not be required to file a financial statement for such offers.

(d) Rejection Appeal Rights. (Code Section 7122(d)). The IRS must provide an independent administrative review of any rejection of an offer (or installment agreement) before such rejection is communicated to the taxpayer. The taxpayer must be granted an administrative appeal of any such rejection.

(e) Stay of Collection. (Code Section 6331(k)). No enforced collection may occur during the pendency of an offer (or installment agreement) or during the appeal from a rejected offer (or installment agreement).

5. IRS Response to the 1998 Act.

The IRS was relatively quick to respond to the changes to the offer in compromise program mandated by the 1998 Act. By March, 1999 IRS Commissioner Charles O. Rossotti issued a news release[7] to announce that the IRS was "fundamentally changing" its offer program. Commissioner Rossotti spoke of new guidelines, new flexibility and more freedom for IRS employees to evaluate a taxpayer's ability to pay. He also foretold of a new category of compromise offers that will focus on "equity and hardship factors affecting taxpayers seeking compromise."

At the time of this news release, the IRS published a revised Form 656 with comprehensive instructions and worksheets for preparing the form. In May 1999, the IRS revamped the old offer rules in Chapters 57 of the Internal Revenue Manual and created the new "IRS and Compromise Handbook," now contained at Internal Revenue Manual 5.8. (Additional modifications to IRM 5.8 were made in February and November, 2000.) In July, 1999, the IRS released temporary regulations Section 301.7122-1T. These regulations provided the first detailed look at the newest grounds for an offer, to promote effective tax administration.

The temporary regulations, the new IRM provisions and the new Form 656 provide the most comprehensive insight and guidance yet in understanding the process and circumstance under which the IRS evaluates offers. Among the significant new features in the revised IRM offer provisions and the temporary offer regulations are the following:

(a) Effective Tax Administration Offers. (T.R. 301.7122-1T(b)(4); IRM 5.8, Ch. 11) If there are no grounds for compromise on the basis of doubt as to liability or doubt as to collectibility, a compromise may be entered into to promote effective tax administration when collection of the full liability will create economic hardship or, regardless of the taxpayer's financial circumstances, exceptional circumstances exist. Treas. Reg. Section 301.7122-1T(b)(4). In either instance, compromise of the liability must not undermine compliance with the tax laws.

[7] IR-1999-30 (March 29, 1999).

Factors supporting (but not conclusive of) economic hardship include (i) illness, medical condition or disability that renders the taxpayer incapable of earning a living and is likely to exhaust the taxpayer's financial resources; (ii) assets of the type that liquidation would render the taxpayer unable to meet basic living expenses; and (iii) assets of the type that can not be used as security or easily converted for payment. Factors supporting (but not conclusive of) a finding that taxpayer compliance with the tax laws would not be undermined by the compromise include: (i) no history of filing and payment noncompliance; (ii) no deliberate actions to avoid payment of taxes; and (iii) no evidence of encouraging others to refuse to comply with the tax laws.

Both the temporary regulations and IRM 5.8, Ch. 11 set forth a number of examples to illustrate the application of these effective tax administration offer guidelines.

(b) Deferred Payment Option (IRM 5.8.1.5.4.3). In addition to making a cash offer (within 90 days of acceptance) or a short term deferred payment (more than 90 days but within two years from acceptance) the amount offered may now be paid over the balance of the 10 year statutory period for collection. The taxpayer has three options when making a deferred payment offer: (i) payment of the realizable value of assets within 90 days of acceptance and the amount the IRS could collect through monthly payments during the remaining life of the collection statute; (ii) payment of a portion of the realizable value within 90 days of acceptance and the balance of the realizable value and the amount the IRS could collect through monthly payments during the life of the collection statute; or (iii) payment of the entire offer amount over the life of the collection statute. If options (ii) or (iii) are chosen, the taxpayer must substantiate how the additional amount will be paid, *e.g.* assets to be liquidated, family member will provide funds, etc.

(c) Severability of Joint Offers (IRM 5.8.1.7). Taxpayers who are jointly liable for the same tax liabilities are no longer required to submit a joint offer in compromise, although there is still a preference for them to do so. When a joint compromise is accepted and the amount offered has been paid, the failure of one party to remain in compliance with the filing and the payment terms of the agreement will not result in a default of the compliant taxpayer.

(d) Statutory and Collection Waivers (T.R. 301.7122-1T(h); IRM 5.8.3.4). For offers submitted after December 31, 1999, the collection statute will be suspended only while

the offer is pending (which includes any timely filed appeal of the offer rejection or during the thirty day period following rejection of the offer). No longer is a one year period tacked on to this suspense term.

(e) Withholding of Collection (T.R. 301.7122-1T(f); IRM 5.8.3.5). The IRS will withhold collection activity while an offer is being investigated unless collection of the tax liability is determined to be in jeopardy. The taxpayer is expected to continue making payments on any installment agreement in place at the time of an offer is submitted.

(f) Streamlined Investigations (IRM 5.8.4.12). For individual liabilities of $25,000 or less (including accrued penalty and interest), and where the taxpayer is a wage earner or self-employed with no employees and has no real property other than a personal residence, then a streamlined processing of an offer is available. In such cases, no field calls are envisioned and the consideration of the offer should be completed within fourteen days of submission.

(g) National and Local Standards (T.R. 301.7122-1T(b)(3)(ii); IRM 5.8.5.5). National and local standards are to be considered guidelines. If the facts and circumstances of the taxpayer's situation indicate that the use of the scheduled allowances would be inadequate, then the taxpayer is to be allowed an adequate means for providing basic living expenses. The taxpayer must provide documentation to support a determination that use of the national and local standards do not provide an adequate means of providing for basic living expenses.

(h) Shared Household Expenses (T.R. 301.7122-1T(b)(3)(iii); IRM 5.8.5.6). In the case of an offer by one spouse for a joint liability or an offer by one person for a separate liability when household expenses are shared, the income and expenses of the non-liable spouse/housemate are to be disclosed in order to calculate the taxpayer's percent of total household income in order to calculate the percent of allowable expenses. As an alternative, if the individuals pay specific expenses that can be verified, then the taxpayer's share of expenses to total of all household expenses will be used to determine the amount of allowable expenses.

(i) Future Income Evaluation (IRM 5.8.5.7). The taxpayer's monthly ability to pay is the total monthly income minus the allowable necessary living expenses. For cash offers (payable under 90 days), the calculation is based on what the taxpayer can pay in monthly payments over the next 48 months. For short term deferred payment offers (over 90 days

up to two years), the calculation of future income is based on what the taxpayer can pay in monthly payments over the next 60 months. For deferred payment offers, the calculation is based on what the taxpayer can pay in monthly payments over the life of the collection statute.
When the period remaining on the collection statute is less than 48 months for cash offers or 60 months for short-term deferred offers, the value of the future income component in calculating the amount of an offer will be reduced (*See,* IRM 5.8.5.7.1-Calculation of the Offer Amount).

(j) Collateral Agreements (T.R. 301.7122-1T(d)(2); IRM 5.8.6.1). As a general rule, securing a collateral agreement should continue to be the exception. Circumstances under which a collateral agreement is appropriate include (i) the taxpayer anticipates a substantial increase in income; (ii) the taxpayer has real or personal property that will substantially appreciate in value; (iii) the taxpayer has net operating losses, capital losses, or bad debt.