# The Offer In Compromise Program May Offer Tax Relief To Financially Troubled Clients

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**When the taxpayer's loaf is getting thinner and thinner, the IRS may be satisfied with something less than its full share.**

**AS A RESULT OF THE PROLONGED RECESSION** (including the associated high unemployment rates and decreasing investment values), some business and individual taxpayers are not able to pay the full amount of their federal tax liabilities when they come due. For purposes of this discussion, business taxpayers include corporations, partnerships, closely-held business owners, LLCs, and other business entity forms, while individual taxpayers include self-employed individuals, professional practitioners, and employees.

There are several methods that such illiquid business and individual taxpayers may use to pay all or part of their federal tax liability. 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 "Service").

This discussion summarizes the procedures that both business and individual taxpayers can use to take advantage of the OIC program. These OIC procedures are particularly relevant to business and individual taxpayers affected by illiquidity.

The Service may compromise the collection of a federal tax liability under Internal Revenue Code section 7122 based on any one of the following reasons:

1. Doubt as to the amount of the taxpayer's tax liability due;
2. Doubt as to the collectability of the taxpayer's tax liability; or
3. To promote an effective tax administration because either (a) the collection of the total tax amount would cause economic hardship to the taxpayer or (b) there are compelling public policy or equity considerations that provide a sufficient basis for compromising the total amount of that taxpayer's tax liability due.

This discussion focuses on the situation of the taxpayer making an OIC when there is doubt as to the collectability of the total amount of the tax liability. With respect to illiquid clients, the tax lawyer may perceive the OIC program as a practical solution to a practical client problem. Particularly in these troubled economic times, both business/individual taxpayers and their legal advisors should be aware of the procedures related to this OIC option.

**SUBMITTING THE TAXPAYER OFFER IN COMPROMISE** • Either a business or individual taxpayer may make an OIC by filing Form 656, Collection Information Statement for Businesses. This form contains the detailed taxpayer instructions that are necessary for completing the Form 656.

In addition to the OIC application form, the taxpayer must send a $150 application fee with the offer in compromise. This $150 application fee can be abated for an individual if the taxpayer's monthly household income is not more than the Service's low-income guidelines. Moreover, other than for the low-income exceptions, if the business or individual taxpayer makes a lump-sum cash payment offer, then 20 percent of the total compromise amount offered must be included with the OIC application. It is noteworthy that this up-front cash payment is not refundable, even if the Service ultimately denies the taxpayer's OIC application.

This up-front cash payment rule has been in effect since 2006, and it has resulted in a decrease in the number of taxpayers (both business and individual) who have submitted OIC offers since then. One of the Obama administration's legislative proposals is to repeal this OIC initial payment requirement. However, that repeal proposal has not yet been legislated.

If a business or individual taxpayer makes an offer to pay the compromise tax liability amount using installment payments, then the first payment must be paid with the offer. In addition, the proposed installment payments must be made by the taxpayer while the OIC application is still being evaluated by the Service. The Service will return the OIC application without any appeal rights if the taxpayer does not make the installment payments as outlined in the taxpayer's compromise offer.

The Service has to act on the taxpayer's OIC application within two years. If the Service does not accept or reject the OIC within the two years, then the taxpayer's offer is automatically considered to be accepted. In addition, the 10-year statute of limitation on collection regarding the taxpayer's total tax liability is suspended while the OIC is under consideration by the Service.

**OFFER IN COMPROMISE PAYMENT PLANS** • The Service allows the following three types of OIC payment plans:

1. Lump-sum cash offer: The compromise offer amount is paid by the taxpayer in five or fewer installments;
2. Short-term periodic payment option: The total compromise payment is made within 24 months from the date that the taxpayer offer is submitted; and

3. Deferred periodic payment: The compromise payments are made over the remaining statutory period (normally up to a maximum of 10 years) for collecting the taxpayer tax liability.

**SCHEDULE THE OFFER IN COMPROMISE PAYMENTS** • To increase the probability that the Service will accept the OIC, the taxpayer should offer to pay the compromise amount all at once, if possible. This is because the Service usually does not want to wait the two-year short-term payment option period to receive the compromise payment. If the taxpayer cannot make the full compromise payment all at once, then the taxpayer should attempt (1) to pay at least half of the total compromise offer amount shortly after the Service accepts the OIC and (2) to pay the remainder of the compromise amount in monthly installments.

An individual taxpayer should use Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, to list all required financial information. Form 433-B, Collection Information Statement for Businesses, should be used by the business partnership, limited liability company, or corporation.

**CALCULATION OF THE AMOUNT TO OFFER IN THE OIC** • The minimum compromise offer amount that the Service will accept (except in certain special circumstances) is based on what is called the taxpayer's reasonable collection potential (RCP). The RCP is: (1) the total net value of the taxpayer assets minus (2) any allowable exemptions for certain assets plus (3a) the difference between taxpayer monthly income and expenses multiplied by (3b) a numerical factor. This numerical factor is based on (1) the type of the OIC payment plan offered and (2) the time period in which the compromise payments will be made.

Both business and individual taxpayers calculate this RCP amount on a Form 656-B worksheet using financial information taken from Forms 433-A and 433-B. This information is used to determine (1) the current fair market value of all taxpayer assets less any taxpayer liabilities and (2) the difference between the taxpayer monthly income and monthly expenses.

As described below, when investigating the OIC, the Service is free to adjust the RCP as it was calculated by the taxpayer. The Service may adjust the RCP upward or downward, based on the taxpayer's specific facts and circumstances.

**PROCESSABLE OFFERS IN COMPROMISE** • The Service will reject an OIC immediately if it is not considered to be "processable." The Service considers an OIC to be processable when it is received unless one or more of the following conditions exist:

1. The taxpayer or the tax liabilities are not properly identified;
2. An out-of-date Form 656 is used (or the terms on the printed Form 656 are changed);
3. No amount of money payment is offered by the taxpayer;
4. The required taxpayer financial statements are not provided or they are otherwise incomplete or missing the required signatures;
5. The amount offered by the taxpayer is less than the fair market value of the taxpayer's net assets;
6. A social security or employer identification number is missing, incomplete, or incorrect;
7. The offer in compromise is not properly signed; or
8. The offer in compromise is considered to be submitted in order to delay or impede the Service's tax collection efforts.

**INVESTIGATION OF THE OFFER IN COMPROMISE** • In 2010, the Service announced that its employees will be allowed to consider a taxpayer's current income and potential for future income when they (1) investigate an offer in compromise and (2) negotiate a compromise offer amount. The Service's usual practice is to judge the OIC amount based on the taxpayer's earnings in prior years. The Service employee may require that the taxpayer entering into the OIC agree to pay a greater amount of the taxes due if his (its) financial situation significantly improves in the future.

In determining the tax liability collection potential, the *Internal Revenue Manual* Section 5.8.4.3.1 provides that the Service's investigators may consider (1) the assets held by the taxpayer, (2) the taxpayer's earning power, (3) any amounts that are collectible from third parties, and (4) any assets that are available to the taxpayer that are beyond the reach of the Service.

In a doubtful tax collectability case, the Service investigator must consider the taxpayer's ability to pay when calculating the taxpayer's reasonable collection potential. The taxpayer's ability to pay is determined by estimating the taxpayer's allowable expenses (e.g., for an individual, the taxpayer's basic living expenses). Unless there are special circumstances, an individual's allowable expenses for purposes of the ability-to-pay calculation are based (1) on national standards for food, clothing, and out-of-pocket health care expenses and (2) on local standards for housing, utilities, and transportation.

The Service will also consider other factors, including an individual's age, health, education, and career specialty, in determining the taxpayer's RCP. In this procedure, the Service is trying to determine whether the taxpayer's future income may increase. Therefore, an individual taxpayer may want to make a Freedom of Information Act request to see his or her collection administrative file to make sure that the file contains accurate information.

**IF AN OFFER IN COMPROMISE IS REJECTED** • If the Service's investigator decides to reject the taxpayer's offer, then section 7122(d)(1) requires the Service to perform an independent administrative review of the OIC rejection before notifying the taxpayer that the offer is rejected. If the OIC rejection is sustained on review, then the Service will notify the taxpayer by mail that the OIC was rejected.

The taxpayer may request an Appeals Division hearing within 30 days of the date of the OIC rejection letter. An appeal is the last chance for the taxpayer to get the OIC accepted. This is because a taxpayer cannot contest a rejected OIC in the courts. However, if the Appeals Officer sustains the OIC rejection, then the taxpayer can submit an amended compromise offer.

**IF AN OFFER IN COMPROMISE IS ACCEPTED** • After an OIC is accepted by the Service, the business or individual taxpayer must:

1. Promptly pay any unpaid tax amounts that are due under the terms of the OIC agreement;
2. Notify the Service if the taxpayer is not able to comply with the agreed-upon OIC terms; and
3. Timely file all income tax returns for the next five years and pay all income taxes in full when they come due.

The Service will not refund any tax overpayments shown on a tax return during this five-year period. Instead, the Service will apply any tax overpayments toward the outstanding OIC assessment.

The OIC taxpayer's failure to follow these requirements can result in a previously accepted OIC being terminated. In such a situation, the taxpayer will be required to pay the remaining tax liability balance in full.

**SUMMARY AND CONCLUSION** • Many business and individual taxpayers have experienced the illiquidity associated with reduced investment values and increased unemployment rates. The prolonged recession has caused taxpayer illiquidity so that some taxpayers cannot pay the full amount of their federal tax liability. This illiquidity often affects closely held business owners, professional practitioners, and employees. In such a situation, the Service's offer in compromise may provide some measure of tax relief to illiquid business or individual taxpayers.

Particularly during a recessionary period, both business/individual taxpayers and their legal advisors should consider the Service's OIC program procedures. These procedures provide a practical measure of tax relief to a practical client problem—i.e., when a taxpayer cannot pay its tax liability that has come due.