

NEGOTIATING AN OFFER IN COMPROMISE

By Thomas F. DiLullo, Esq.

The government, like other creditors, encounters situations where an account receivable or tax liability cannot be collected in full or where there is a legitimate dispute over the amount of tax owed. The Internal Revenue Service (IRS) may resolve these cases where the taxpayer can not afford to pay the tax liability in full through negotiation and compromise. An Offer in Compromise is an agreement between a taxpayer and the government where a tax liability is settled for less than the full amount owed.

There are three grounds on which a tax liability may be compromised: Doubt as to Collectibility (DATC), Doubt as to Liability (DATL), or to promote Effective Tax Administration (ETA). A detailed discussion of each of these grounds is beyond the scope of this article. Generally DATC means that the tax can not be paid in full as a lump sum or be paid under current installment agreement guidelines.

DATL offers are in effect a request for reconsideration of whether or not the taxpayer is liable for the subject tax. The IRS will review the administrative tax file to determine whether it supports the tax assessment. New information, such as documents or testimony presented by the taxpayer, will be analyzed to determine the effect on the tax assessment against the taxpayer. If new information is presented that raises doubt or the existing information supporting the assessment is weak, the IRS may accept an offer to avoid the hazards of litigation.

An ETA offer can only be considered when the IRS has determined that the taxpayer does not qualify for consideration under DATL and/or DATC.

The IRS Restructuring and Reform Act of 1998 (RRA 98), added ETA offers as a ground for acceptance of an Offer in Compromise. Section 7122(c) was added to the Internal Revenue Code providing that economic hardship, public policy, and equity situations should be considered when determining the acceptability of an offer in compromise.

ETA offers are unique in that the tax liability can be collected in full from the taxpayer but collection from him would create an economic hardship. Economic hardship occurs when a taxpayer is unable to pay reasonable basic living expenses. The taxpayer's financial information and special circumstances must be examined to determine if he qualifies for an ETA offer based on economic hardship. In addition to the basic living expenses, other factors impact upon the taxpayer's financial condition including the taxpayer's age, employment status, the cost of living in the area where the taxpayer resides, and the number, age, and health of the taxpayer's dependents. Special education expenses, a medical catastrophe, or a natural disaster are other extraordinary circumstances that may be considered. This list is not all-inclusive.

Acceptance of the ETA under the hardship provision must not undermine tax compliance. The public should not perceive that the taxpayer whose offer is accepted benefited by not complying with the tax laws.

In economic hardship cases, an acceptable offer amount is determined by analyzing the financial information, supporting documentation, and the economic hardship that would be created if certain assets were used to pay the liability. The existence of economic hardship criteria does not dictate that an offer must be accepted.

An acceptable offer amount must still be determined based on a full financial analysis and negotiation with the taxpayer.

Taxpayers may qualify for an ETA offer when their reasonable collection potential (RCP) is **greater than** the tax liability, but there are economic or public policy/equity circumstances that would justify accepting the offer for an amount less than full payment. When their RCP is **less than** their tax liability but there are economic hardship or public policy/equity factors that would justify accepting the offer for an amount less than the RCP, the offer would be accepted under Doubt as to Collectibility with Special Circumstance (DCSC).

For Example, the taxpayer owes \$20,000. However his RCP is \$15,000. The offer does not meet the legal basis for an ETA offer because the RCP is **lower than** the tax liability. However, applying the same factors of economic hardship, or public policy/equity, an offer could be accepted for less than the RCP (\$15,000) under DCSC provisions.

ETA offers may be compromised based on public policy and equity considerations. Where there is no DATL, no DATC, and the tax liability could be collected in full without causing economic hardship, the IRS may compromise to promote ETA where compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for accepting **less than** full payment. Compromise is authorized on this basis only where, due to exceptional circumstances, collection in full would undermine public confidence that the tax laws are being administered in a fair and equitable manner. Because the IRS assumes that Congress imposes tax liabilities only where it is fair to do so, compromise on these grounds will be rare.

Absent special circumstances, a DATC offer amount must equal or exceed a taxpayer's reasonable collection potential (RCP) in order to be considered for acceptance. The exception is that if special circumstances exist, ETA and DCSC offers may be accepted on the basis of hardship or effective tax administration.

A detailed discussion of the process by which a taxpayer's reasonable collection potential is determined is beyond the scope of this article. Generally, RCP is the sum of the taxpayer's equity in his assets plus an amount equal to an estimate of the taxpayer's gross income less necessary living expenses for a specific number of months into the future. The number of months used depends on the payment terms of the offer. For cash offers the number of months is the next 48 months; for short term deferred offers of two years or less, it is 60 months; for deferred payment offers, greater than two years, it is the number of months remaining on the statutory period for collection.

RCP may be affected by the nature of property, as well as how title to the property is held, e.g., as tenants in common or joint tenants with rights of survivorship, etc. Generally, for offer purposes, assets are valued at net realizable equity (NRE) which is defined as quick sale value (QSV) less amounts owed to secured, priority lien holders. QSV is defined as an estimate of the price a seller could get for the asset where financial pressures motivate the owner to sell in a short period of time, usually 90 calendar days or less. Generally, QSV is an amount less than fair market value (FMV) but greater than forced sale value (FSV). FSV is defined as no less than 75% of FMV. Normally, quick sale value (QSV) is calculated at 80% of fair market value (FMV).

A higher or lower percentage may be applied in determining QSV depending on the type of asset and/or current market conditions. If, based on current market and area

economic conditions, it is believed that the property would quickly sell at full FMV, it may be appropriate to consider QSV to be the same as FMV. This is occasionally found to be true in real estate markets where real estate is selling quickly at or above the listing price. As long as the value chosen represents a fair estimate of the price a seller could get for the asset in a situation where the asset must be sold quickly (usually 90 calendar days or less) then it would be appropriate to use of a percentage other than 80%. Generally, it is the policy of the Service to apply QSV in valuing property for offer purposes.

The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered **reasonably reflects collection potential**. An offer in compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government. The ultimate goal is a compromise which is in the best interest of both the taxpayer and the government. Acceptance of an adequate offer will also result in creating a fresh start for the taxpayer. The offer agreement includes provisions that require a taxpayer to file and pay taxes timely for a five year period. Failure to comply with the five year requirement may result in a breach of the offer in compromise agreement and a resulting resurrection of the full tax liability.

Offers will not be accepted if it is believed that the liability can be paid in full as a lump sum or through installment payments extending through the remaining statutory period for collection (CSED), unless the special circumstances permitted in an ETA or DCSC offer exist.

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