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Why don't I qualify for an offer in compromise? - by Michael Duffy

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When a new client with back taxes reaches out to me, inevitably the first question out of their mouth is whether the Internal Revenue Service (IRS) is willing to compromise on the amount owed. In what almost certainly sounds like a lawyer's answer, my response is always, "It depends."

That's because it does depend on a bunch of factors the IRS evaluates when an offer in compromise – an agreement where the IRS accepts a set payment from the taxpayer in exchange for eliminating a larger tax assessment – is received from a taxpayer. For whatever reasons, many accountants and attorneys do not really understand what drives success in this area. The reality is that the process is much more mechanical than many would consider fair, but also that the rigidity of the guidelines the IRS must follow actually makes success much more predictable for qualifying taxpayers.

Why the IRS won't settle: There are a lot of reasons the IRS does not liberally grant offer in compromise requests. First and foremost, the IRS generally has a priority position ahead of unsecured creditors in a taxpayer's assets. From the date on which taxes are assessed, a lien is automatically created in favor of the government. This lien may then be recorded against a taxpayer in a personal capacity or as a claim on property they own. In addition to liens, the IRS has the legal power to garnish wages, intercept payments from contractors, and even reach out to banks and drain accounts in order to collect. Although taxpayers benefit from a lot of procedural safeguards that are in place to ensure they do not fall victim to sudden and overzealous collections tactics, the IRS's power to enforce collections is expansive.

The IRS also has a big job on its hands. Annually, the IRS collects approximately \$3.5 trillion in receipts. Individual income taxes alone make up \$2 trillion of this total. This is an astronomical amount of funds, especially considering a significant portion of collections depends on whether folks voluntarily file their annual income tax returns. It is pretty clear the voluntary compliance system would be fundamentally undermined if taxpayers could reasonably expect each year that they can

ultimately compromise away significant portions of their tax liability.

For these important reasons, the IRS has carefully circumscribed the criteria under which an offer in compromise will be granted. Although rigid, the guidelines are fair in the sense that the IRS must adhere to its own rules in evaluating offers and granting relief.

When the IRS will settle: Preparing an offer in compromise requires that the taxpayer comes up with an offer amount which the IRS measures against its internal collection potential guidelines. The IRS will either accept or reject the offer, or alternatively request more information. The process requires taxpayers pay an application fee, and for some types of offers, up to 20% of the amount of the proposed settlement amount. In the event the IRS declines to accept the offer, the 20% down payment on the offer is not returned and is instead applied to the outstanding tax due. Consequently, the cost of making an ill-conceived offer can be high, especially considering a rejected offer may still take up to eighteen months to resolve.

Where most taxpayers or inexperienced practitioners fail is in their understanding of the offer guidelines. For example, the IRS will not even consider accepting an offer in compromise if the taxpayer is able to fully pay all of the debt due before the statute of limitations on collections closes. This is a deal breaker if the taxpayer has a relatively modest amount of debt relative to their current income. A taxpayer also will not qualify if they are not caught up on their current filing and payment obligations, excluding the old debt.

The IRS does not have a lot of secret procedures that are used to evaluate offers. These guidelines and procedures are public information. If an offer is at or above the amount the IRS estimates is collectible on an account, then the offer is in the government's interest and will be accepted. It's that simple. Where folks seem to disagree with the IRS is in measuring the amount of collectability on an account.

For starters, the IRS will want an offer to include a certain amount of the taxpayer's available net equity in assets. This contrasts with the process for obtaining an installment agreement, which is typically based on current income alone. Net equity is also an IRS term of art in this context; it is not simply the fair market value of a taxpayer's assets minus debts.

The IRS will additionally apply a very rigid analysis to determine whether a taxpayer has net income available for collections. The income and expense analysis is primarily cash-flow based, but the expense portion takes into consideration the lesser of a taxpayer's actual living expenses or IRS standard allowances. The catch here is that the expense allowances used by the IRS are spartan; many affluent taxpayers find that the IRS wants a piece of their monthly income that is already being applied to credit card minimum payments or a sizeable mortgage. Unfortunately, the IRS does not deviate from these expense allowance standards. Taxpayers who are truly overextended on various consumer debts may find that an offer under these circumstances is simply too high to be acceptable.

Together, the net assets and net income of a taxpayer over a certain time frame are used to come

up with an acceptable offer amount. Unless the amount of collection potential on an account shows a taxpayer can fully pay over the life of the debt, the total amount of debt owed is not part of the equation.

What can you do?

A basic understanding of the offer in compromise rules is frequently not enough. Knowing net assets are considered in the equation by the IRS, taxpayers sometimes develop the mistaken belief that they should engage in actions to spend their net assets down before making an offer. The IRS will respond to this behavior by instead denying the offer. This does not mean, however, that taxpayers can't take financial actions in order to increase the chances their offer will be accepted.

Although giving the answer "it depends" is usually an out a professional will use to avoid the possibility of being wrong, with offer in compromise work, this is always the right answer when taking on a new matter. A competent advisor in this area of practice should be able to determine the amount a taxpayer owes, whether they are ready and able to make an offer, and the amount of the offer needed to satisfy the IRS's guidelines. There is additional work in getting the IRS to actually follow through and process the offer correctly, but a lot of wasted effort can be avoided if taxpayers are advised not to make offers that will automatically be rejected.

If you would like to know whether you or your business are a candidate for an offer in compromise, please reach out to us. We can usually determine whether this is an option for you after an initial consultation. We are also equipped to discuss alternative workout arrangements.

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