The "Effective Tax Administration" Offer in Compromise

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Despite a Congressional mandate made nearly seven years ago that authorized the Internal Revenue Service to accept Offers in Compromise based on equity, hardship and public policy to promote effective tax administration, the IRS has not widely embraced this concept. Less than one percent of the total Offers that the IRS have accepted are "Effective Tax Administration" Offers. What are the conditions for accepting these Offers? Why is the IRS so reluctant to accept them? Have the courts decided any cases involving these types of Offers? This article explores these issues and others, and recommends that the IRS accept "Effective Tax Administration" Offers from certain investors in a well-known cattle tax shelter.

Background

Section 7122 of the Code permits the IRS to compromise a taxpayer's tax liability. A taxpayer may submit an Offer in Compromise ("Offer") on Form 656 to settle unpaid tax accounts for less than the full amount owed, and the IRS has discretion either to accept or reject such an Offer.

Before the IRS Restructuring and Reform Act of 1998[1] ("RRA '98"), the IRS accepted Offers if there was doubt as to the liability, or doubt as to the collectibility, of the amount owed[2]. However, in RRA '98, Congress mandated that the IRS "take into account factors such as equity, hardship and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration."[3] Congress said that the IRS could, for example, accept such Offers in order to "resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability."[4] Consequently, the "Effective Tax Administration Offer" or "ETA Offer" was born.

Conditions for Acceptable ETA Offers

In 2002, the IRS issued regulations listing the requirements for an acceptable ETA Offer[5]. To qualify, the taxpayer must first have the ability to pay the liability in full and not be eligible for one of the other two types of Offers—doubt as to liability ("DATL") or doubt as to collectibility ("DATC")[6]. A taxpayer who submits an ETA Offer can't just *waive* eligibility for a DATL or DATC Offer. Rather, the IRS requires a taxpayer to prove that he or she is not eligible for a DATL or DATC Offer by submitting the same financial information that is necessary for those other types of Offers[7].

Second, the IRS will not accept an ETA Offer if compromising the liability would undermine compliance by taxpayers with the tax laws[8]. The regulations state that compromising a taxpayer's liability will undermine compliance with the tax laws if the taxpayer either has a history of not complying with the filing and payment requirements, or has taken deliberate actions to avoid the payment of taxes, or has encouraged others to refuse to comply with the tax laws[9].

This "compliance" requirement tends to invalidate all ETA Offers. Most taxpayers who file an Offer have built up large tax liabilities over multiple years, which is the result of not complying with the filing and payment requirements. Many IRS Collection personnel would tend to view their noncompliance as a deliberate act to avoid the payment of taxes. To exclude these taxpayers from eligibility for an ETA Offer is contrary to Congress' intent in helping them re-enter the taxpaying community[10].

Types of ETA Offers

The regulations essentially provide two types of acceptable ETA Offers—one based on hardship, and one based on equity or public policy.

An ETA Offer based on hardship will be accepted if full collection of the liability would result in economic hardship, *i.e.*, that full collection of the liability would render the taxpayer unable to pay basic living expenses[11]. Basic living expenses are those expenses that provide for health and welfare and production of income of the taxpayer and the taxpayer's family, and will vary according to the unique circumstances of the individual taxpayer[12].

An ETA Offer based on equity or public policy will be accepted if there are no other grounds for compromise and due to exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner[13]. The regulations provide that *all of the following conditions must exist* before the IRS will accept such a non-hardship ETA Offer—

- Compelling public policy or equity considerations must be present to justify compromise;
- Collection of the full liability would undermine public confidence in the fair and equitable administration of the tax laws; and
- Circumstances exist to justify compromise even though a similarly situated taxpayer may have paid the liability in full[14].

Examples of Hardship ETA Offers

The regulations list three nonexclusive examples of situations where the IRS will accept an ETA Offer based on hardship—

- The taxpayer has an illness, medical condition or disability that exhausts the taxpayer's financial resources and that prevents the taxpayer from working;
- The taxpayer's monthly income is exhausted in providing for the care of dependents; and
- The taxpayer cannot borrow against the equity in assets, and sale of the assets would render the taxpayer unable to pay basic living expenses[15].

Examples of Non-Hardship ETA Offers

The IRS's regulations include two examples where an ETA Offer will be accepted based on public policy or equity provisions[16]. Neither example is particularly helpful.

One example describes a taxpayer who developed a serious illness requiring nearly continuous hospitalization for several years, was unable to manage financial affairs, did not file returns, recovered from the illness and found that with penalties and interest, the amount owed for the unfiled returns was three times the tax owed. This is a bad example. Most likely, the taxpayer's continuous hospitalization and inability to manage financial affairs would have caused an economic hardship, so the taxpayer's ETA Offer would probably be based on hardship, not public policy or equity.

The other example involves a taxpayer who was misinformed in writing by an IRS employee that after withdrawing funds from an IRA, the taxpayer had 90 days to reinvest the funds in another IRA (Code sec. 408(d)(3)(A) allows only 60 days). The taxpayer kept the funds for 63 days before reinvesting, and as a result, owed additional tax, interest and penalties. First, it is not likely that the IRS would impose penalties in this situation since the IRS is required by statute to abate penalties due to its erroneous written advice[17]. Second, this example seems far too specific to be of much help.

The IRS has provided additional examples in its training materials provided to Offer specialists and in its manual[18]. The IRS is instructing its Collection personnel to reject non-hardship ETA Offers based on taxpayer claims that the liability resulted from acts of third parties (including acts of a Tax Matters Partner in a unified partnership proceeding), that the tax law is unfair, where the liability results from the taxpayer's investment in a tax shelter, and where the IRS issued an erroneous notice of the balance due and the taxpayer, relying upon that notice, paid the balance in full[19]. These examples do not help IRS Offer specialists understand the situations in which such ETA Offers should be accepted, it simply broadens the list of situations where such Offers should not be accepted and therefore tends to discourage Offer specialists from accepting ETA Offers.

IRS's Track Record of Accepting ETA Offers

Despite Congress' mandate, the evidence suggests that the IRS has a poor track record of accepting ETA Offers. The IRS has rarely accepted an ETA Offer based on public policy or equity considerations. According to the Taxpayer Advocate's annual report, in fiscal year 2004, the IRS's ETA Offer Group, which is responsible for processing offers based upon equity and public policy, accepted ***only one*** such Offer[20]. The IRS's track record for accepting ETA Offers based on hardship is not much better. In fiscal year 2000 and 2001, the IRS accepted 261 and 272 ETA Offers, respectively[21]. This is less than one percent of the total Offers that the IRS accepted during these years[22].

Why is the IRS so reluctant to accept ETA Offers, especially those based upon equity and public policy considerations? There are several reasons. First, it seems clear that the IRS disagrees with Congress' mandate. In RRA '98, Congress stated that the IRS could, for example, accept ETA Offers in order to "resolve long-standing cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." In its manual, the IRS concluded that compromising penalties and interest that have accrued for several years would undermine the purpose of the penalty and interest provisions of the Code[23]. Thus, IRS's manual directly contradicts Congress' mandate.

Second, the IRS has made it as difficult as possible to accept an ETA Offer. The IRS has imposed strict conditions in its regulations that make it nearly impossible for taxpayers to qualify for an acceptable ETA Offer. Also, in its training materials and manual, the IRS has discouraged Offer specialists from accepting ETA Offers.

Third, IRS Collection personnel are trained to collect outstanding tax liabilities, so they normally would be reluctant to allow a taxpayer to settle an outstanding liability for less than the entire amount particularly if the taxpayer has the financial ability to pay it in full[24]. The IRS probably doesn't want to have a track record of allowing a taxpayer to build up a large unpaid tax liability, and then compromise that liability where the taxpayer has the ability to fully pay it. Such a policy would simply encourage noncompliance, especially since accepted Offers are open to public inspection[25].

Court Cases Involving ETA Offers

RRA '98 added Code section 6330 giving taxpayers the right to appeal certain IRS collection actions, such as the rejection of an Offer. In general, the taxpayer has the right to appeal a collection action to the IRS's Office of Appeals and to seek judicial review in the U.S. Tax Court or a U.S. District Court[26]. Such cases are commonly known as "Collection Due Process" or "CDP" cases.

In the context of a CDP case, a taxpayer may discuss with Appeals the appropriateness of a Revenue Officer's rejection of an Offer. If Appeals determines that the Offer should still be rejected, Appeals will then issue a Notice of Determination allowing the taxpayer the opportunity to pursue the case to court.

A taxpayer who seeks judicial review of a rejected Offer must prove that the IRS abused its discretion in rejecting the Offer. This imposes a higher burden of proof on taxpayers than the usual "preponderance of the evidence" standard of review used in civil cases.

As far as I can determine, only three court cases have addressed whether the IRS abused its discretion in rejecting an ETA Offer[27]. All three cases involved ETA Offers based on hardship, and strangely, all three cases involved taxpayers living in El Paso, Texas.

In *Razo v. Commissioner*[28], a couple who owed $7,833 for the years 1995, 1996 and 1997, argued that the IRS abused its discretion by rejecting their Offer of $100. The couple argued that because of their limited income and poor health, full collection of the liability would cause an economic hardship. Mr. Razo was employed as a manual laborer, and Mrs. Razo was not employed. The couple had two cars, one of which could have been sold to pay the liability in full. Under these circumstances, the court ruled that the IRS did not abuse its discretion in rejecting the Offer. The court inferred that selling one of the cars would not cause an economic hardship.

In *Siquieros v. United States*[29], the taxpayer, who was the office manager for a trucking company, was held liable for $40,511 in unpaid withholding taxes owed by the trucking company[30]. She submitted an ETA Offer of $100 on the grounds that payment of the full liability would cause her an economic hardship. She argued that due to her age (67 years), limited income and assets, and health problems, she needed to keep her income and assets for basic living expenses. The IRS rejected her $100 Offer and suggested an Offer of about $13,000 representing the net realizable value of her assets. In calculating this amount, the IRS did not include the taxpayer's home, vehicle or bank accounts, which it excluded as "hardship protected" (sale of these assets would cause an economic hardship), but it included an insurance policy worth about $5,000, an IRA worth about $5,000, and about $3,000 in potential net earnings. Without explaining its reasoning, and describing the taxpayer's $100 Offer as "*de minimus*," the Tax Court concluded that the IRS did not abuse its discretion in rejecting the Offer.

And in *Alaniz v. Commissioner*[31], a couple who owed $221,372 in income tax, penalties and interest for the tax years 1994, 1996 and 1997 submitted an Offer of $2,000 based on doubt as to collectibility and effective tax administration. The taxpayers' assets and income indicated that at least $37,000 could reasonably be collected. The couple's effective tax administration portion of the Offer was based on Mr. Alaniz's advanced age (73 years) and "deteriorating" health. Despite his age and medical conditions, Mr. Alaniz remained active as an insurance salesman. Describing the couple's $2,000 Offer as "*de minimus*," the Tax Court held that the IRS did not abuse its discretion in rejecting the Offer.

Cattle Tax Shelter Cases

In California, Nevada and Oregon, several thousand taxpayers became involved in a cattle tax shelter for whom ETA Offers would be most appropriate.

Walter J. Hoyt II and members of the Hoyt family were prominent breeders of Shorthorn cattle in California and Oregon. In order to expand the business and attract investors, starting in the late 1960s and continuing into the late 1990s, the Hoyt family organized and operated numerous cattle and sheep breeding partnerships. They attracted thousands of investors and operated more than 100 partnerships. They also operated tax return preparation companies that prepared the investors' individual income tax returns.

In the early 1980s, the IRS began to audit the partnerships' and investors' tax returns. Among other items, the IRS found that depreciation and tax credits had been claimed for cattle and sheep that did not exist. Deficiencies in tax, penalties and interest, all owed by the investors, amounted to several hundred million dollars. After the enactment of the unified partnership audit procedures in the Tax Equity & Fiscal Responsibility Act of 1982 ("TEFRA")[32], the IRS's audits focused upon the Hoyt cattle and sheep breeding partnership returns. Walter J. Hoyt III

was the tax matters partner of each partnership, responsible for representing the partnerships before the IRS.

Much litigation ensued over the validity of the partnerships' tax deductions. The first Tax Court decision in 1989[33] left open many issues. It was not until a decade later that the courts upheld the IRS's disallowance of the partnership deductions and tax credits[34]. In 2001, Walter J. Hoyt III and others were convicted of fraud and money laundering by the U.S. District Court for the District of Oregon[35]. Hoyt was sentenced to nearly 20 years in prison and was ordered to pay $102 million in restitution representing the amount that investors had paid to the Hoyt organization.

Investors in the Hoyt cattle and sheep partnerships were typically middle class, hard working wage earners who were not wealthy. Most lived in California, Oregon and Nevada and were just trying to make an honest living. These people had invested in the Hoyt partnerships from the late 1970s to the early 1990s. They believed the Hoyt organization's reports that their partnership deductions and tax credits were valid. Once the IRS started auditing the partnership returns, Walter J. Hoyt III repeatedly signed extensions of the statute of limitations. Investors were not aware that in so doing, the 3-year statute of limitations of their individual returns had also been extended for any taxes attributable to the partnership returns[36].

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Fifteen to twenty years after making their investments, taxpayers who had invested in a Hoyt partnership began receiving bills from the IRS with penalties and interest amounting to five to ten times the income tax deficiencies. They are financially unable to pay these huge bills. In addition, since their homes have substantially appreciated in value, they do not qualify for a DATC Offer. And since they are wage earners or have since retired, they don't have the monthly income that's needed to qualify to refinance their home mortgages which might give them funds to pay off the large tax liabilities. Many of the investors have tried to get the penalties and interest removed, hoping then to be able to pay the income tax liabilities, but they haven't been successful[37].

Aren't these taxpayers ***exactly*** who Congress wanted to be affected by its RRA '98 mandate concerning ETA Offers? These taxpayers have "longstanding" collection cases pending with the IRS. Congress wanted the IRS to use the new hardship, equity and public policy authority to settle with these people by "forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." To any reasonable person, fifteen to twenty years after filing tax returns certainly seems like a "delay."

Unfortunately, in its manual, the IRS has provided an example that describes a Hoyt investor's situation exactly, and has concluded that an ETA Offer submitted by such an individual should be rejected[38]. The IRS reasons that to compromise penalties and interest in such a situation would essentially be the same as rewriting the statute based on a perception of unfairness and therefore, compromise would not promote effective tax administration. Additionally, the IRS has concluded that it would not promote effective tax administration to compromise interest unless the delay satisfies the abatement-of-interest requirements of the Code[39]. These conclusions misinterpret Congress' mandate. It seems clear that Congress wanted the IRS to go ***beyond*** the statutory penalty and interest relief provisions when it considered an ETA Offer.

The Hoyt investors should qualify for ETA Offers because their predicament is exactly the type of situation that Congress described in its mandate. In my opinion, the IRS ought to provide these folks with every possible consideration in working out a compromise.

National Taxpayer Advocate's Views on ETA Offers

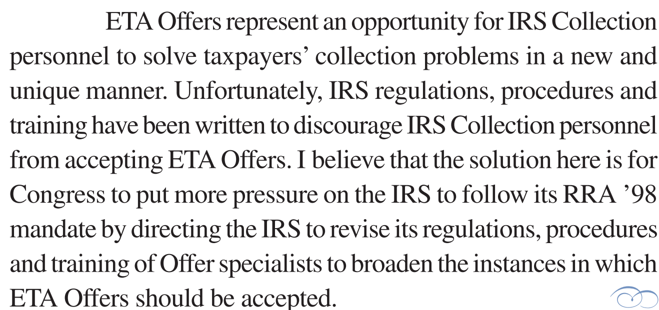
According to Nina E. Olson, the National Taxpayer Advocate, the IRS remains unable or unwilling to accept ETA Offers based on equity or public policy considerations, and the IRS Office of Chief Counsel has declined her request to revise IRS regulations to provide more specific guidance[40]. Like many tax practitioners, Ms. Olson believes that IRS policies have interpreted the equity and public policy basis for compromise too narrowly, and that the circumstances under which non-hardship ETA Offers should be accepted are unclear[41]. As for ETA Offers based on hardship, Ms. Olson indicates that more specific guidance is needed to assist IRS employees in determining when an ETA Offer based on hardship should be accepted, and how future expenses should be projected and evaluated[42].

Ms. Olson has proposed legislative changes that she believes will resolve these problems[43]. For ETA Offers based on equity or public policy, Ms. Olson proposes to amend the Code to require the IRS to compromise a liability when it is inequitable to collect it, to make it inequitable to collect more than the economic benefit that the transaction produced, and to list the facts and circumstances that the IRS should consider in determining whether it is inequitable to collect a liability. For ETA Offers based on hardship, Ms. Olson proposes to amend the Code to provide that the IRS may compromise a tax liability if it causes a hardship for the taxpayer or for a third party.

Although I agree with Ms. Olson's analysis of the problems concerning ETA Offers, I don't agree with her legislative

solutions. In my opinion, Ms. Olson's legislative proposals cause more problems than they solve.

Conclusion



ETA Offers represent an opportunity for IRS Collection personnel to solve taxpayers' collection problems in a new and unique manner. Unfortunately, IRS regulations, procedures and training have been written to discourage IRS Collection personnel from accepting ETA Offers. I believe that the solution here is for Congress to put more pressure on the IRS to follow its RRA '98 mandate by directing the IRS to revise its regulations, procedures and training of Offer specialists to broaden the instances in which ETA Offers should be accepted.

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[1] Public Law No. 105-206.
[2] Treas. Reg. §301.7122-1(b)(1) and (2).
[3] H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess., 289 (1998).
[4] *Id.*
[5] Treasury Decision 9007 (July 19, 2002).
[6] Treas. Reg. §301.7122-1(b)(3).
[7] See Internal Revenue Manual ("IRM") sections 5.8.11.3 and 5.8.11.4.2 (May 14, 2004).
[8] Treas. Reg. §301.7122-1(b)(3)(iii).
[9] Treas. Reg. §301.7122-1(c)(3)(ii).
[10] Joan L. Rood, "The IRS Offer-in-Compromise Program: How Should the IRS Apply the *Effective Tax Administration* Criterion?" *Journal of Tax Practice & Procedure*, August–September 2004, p. 10 (CCH Incorporated, 2004).
[11] Treas. Reg. §§301.7122-1(b)(3)(i) and 301.6343-1(b)(4)(i).
[12] Treas. Reg. §§301.6343-1(b)(4)(i) and (ii); IRM section 5.8.11.2.1.
[13] Treas. Reg. §301.7122-1(b)(3)(ii).
[14] Treas. Reg. §§301.7122-1(b)(3)(ii) and (iii).
[15] Treas. Reg. §301.7122-1(c)(3)(i).
[16] Treas. Reg. §301.7122-1(c)(3)(iv). See also IRM section 5.8.11.2.2, paragraphs 5 and 7, which contain the same two examples.
[17] See IRC §6404(f). See also Treas. Reg. §301.6404-3 and IRM section 120.1.1.3.2.4.
[18] See IRS Commissioner's letter to Senator Baucus dated October 28, 2004 responding to requests about the Offer in Compromise program, p. 7, 2004 *Tax Notes Today* 231-25 (Tax Analysts, Inc. 2004); IRM section 5.8.11.2.2.
[19] *Id.*, IRS Training Document, "Offers in Compromise: Promotion of Effective Tax Administration", pp. 19–24.
[20] Nina E. Olson, National Taxpayer Advocate, *2004 Annual Report to Congress*, December 31, 2004, p. 433.
[21] *Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate*, "IRS Should Evaluate the Changes to its Offer in Compromise Program," General Accounting Office, p. 17 (GAO-02-311, March 2002). It is assumed that all or nearly all of these accepted ETA Offers were based on hardship.
[22] The IRS accepted a total of 38,643 Offers during fiscal year 2001. *2004 Annual Report to Congress*, *supra* at p. 315.
[23] IRM section 5.8.11.2.2, paragraph 3, second example.
[24] See *infra*, note 10.
[25] Code secs. 7122(b) and 6103(k)(1).
[26] Code secs. 6330(b) and (d).
[27] In an additional case, *Orum v. Commissioner*, 123 T.C. 1 (2004), the IRS rejected the taxpayer's Offer that had been based on DATC and ETA, but the court did not address the ETA aspect of the Offer.
[28] *Razo v. Commissioner*, T.C. Memo. 2004-101.
[29] *Siquieros v. United States*, No. EP-03-CA-0478-FM, 94 AFTR 2d 2004-5518 (W.D. Tex. 2004) (taxpayer's appeal to 5th Cir. pending, Case No. 04-50980).
[30] Code sec. 6672 imposes personal liability for unpaid withholding taxes ("trust-fund taxes") on persons who were responsible for ensuring that such taxes are paid over to the government.
[31] *Alaniz v. Commissioner*, T.C. Memo. 2005-4.
[32] Public Law No. 97-248, adding Code secs. 6221 through 6232.
[33] *Bales v. Commissioner*, T.C. Memo. 1989-568.
[34] See, for example, *Durham Farms #1, J.V. et al. v. Commissioner*, T.C. Memo. 2000-159, affd. in an unpublished opinion, 2003-1 USTC ¶50,391, 59 Fed.Appx. 952 (9th Cir. 2003) (cattle breeding partnerships) and *River-City Ranches #4, J.V. et al. v. Commissioner*, T.C. Memo. 1999-209, affd. in an unpublished opinion, 2002-1 USTC ¶50,105, 23 Fed.Appx. 744 (9th Cir. 2001) (sheep breeding partnerships).
[35] *United States v. Barnes, et al.*, No. CR 98-529-JO-04 (D.Ore. 2001), aff'd. sub nom. *United States v. Hoyt*, 47 Fed. Appx. 834 (9th Cir. 2002).
[36] Lynn Anderson, CPA, "The More You Lose The Better" (www.crimes-of-persuasion.com, May 24, 2001)
[37] See, for example, *Mekulsia v. Commissioner*, T.C. Memo. 2003-138, affd. 389 F.3d 601 (6th Cir. 2004) (no abatement of interest); *Hitchen v. Commissioner*, T.C. Memo. 2004-265 (penalties and tax-motivated interest upheld); *Barnes v. Commissioner*, T.C. Memo. 2004-266 (penalties and tax-motivated interest upheld); *Hansen v. Commissioner*, T.C. Memo. 2004-269 (penalties upheld); *Van Scoten v. Commissioner*, T.C. Memo. 2004-275 (penalties upheld); *Jaroff v. Commissioner*, T.C. Memo. 2004-276 (penalties upheld); and *Mortensen v. Commissioner*, T.C. Memo. 2004-279 (penalties upheld).
[38] IRM section 5.8.11.2.2, paragraph 3.
[39] *Id.*, paragraph 4. IRC §6404(e) permits the IRS to abate interest if there was a delay in assessing a tax deficiency, and the delay was due to a ministerial act (or a managerial act for tax years after 1996) performed by an IRS employee.
[40] *2004 Annual Report to Congress*, *supra* at p. 329.
[41] *Id.*
[42] *Id.*
[43] *Id.*, at pp. 435–436 and 445.