

Strategies for Compromising Tax Debts

Three lesser-known techniques may improve chances of making a deal.

by Kevan P. McLaughlin, Esq.

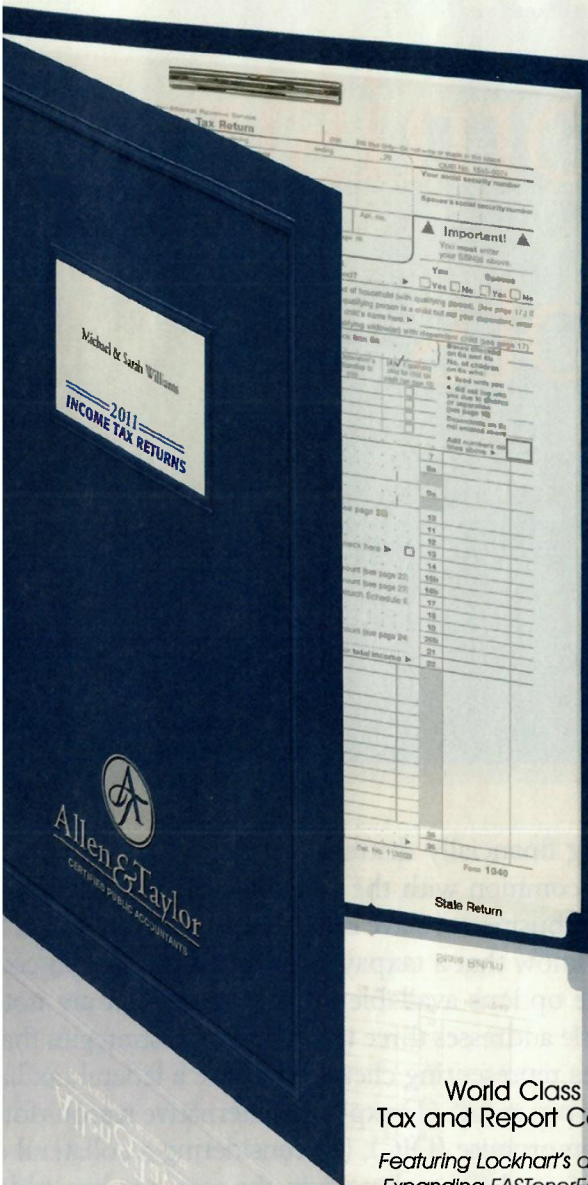
Representing financially distressed individuals is becoming increasingly common with the economic difficulties many individuals and businesses have experienced in recent years. Tax practitioners know that a taxpayer can make an offer in compromise, some of the options available in making an offer are not known. This article addresses three techniques and strategies that may be useful for CPAs representing clients who owe a federal tax liability they are unable to pay in full: (1) exploring alternative reasons for making an offer in compromise (OIC); (2) considering a collateral assignment with the IRS; and (3) making sure the taxpayer has addressed any issues arising from having transferred assets for less than full value on nonpriority items or debts (“dissipated assets”).

STRATEGY 1: CONSIDER ALTERNATIVE REASONS FOR SUBMITTING AN OFFER IN COMPROMISE

When most practitioners think of an OIC,

they think of a “doubt as to collectability” (DATC) offer, where the taxpayer lacks sufficient income and assets to pay the liability and the IRS allows a cash payment on that liability. However, de-

perceived value = Billable value.



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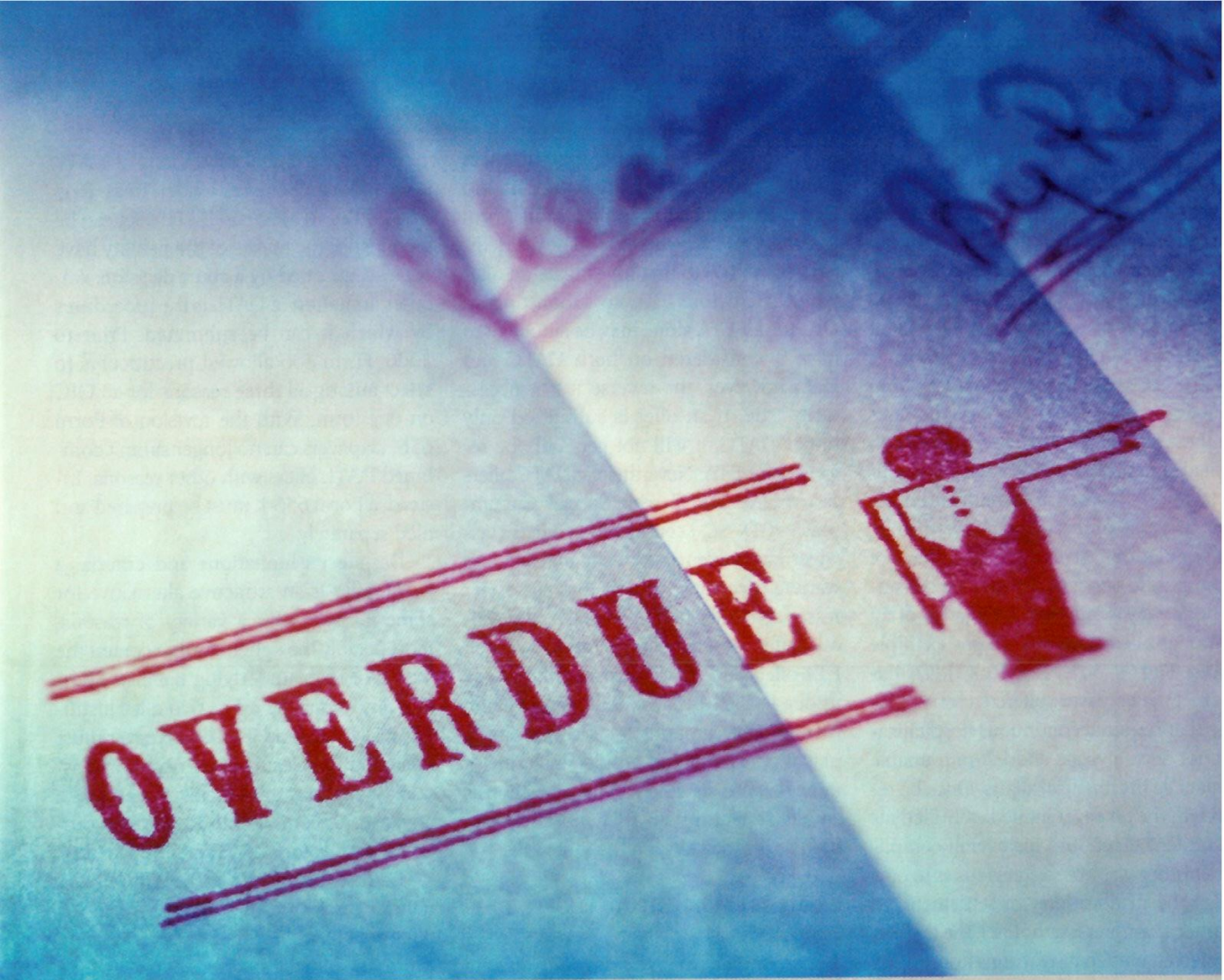
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to collectibility is just one of three possible reasons the IRS can accept an OIC. Practitioners should explore with their clients making an offer under the other two reasons: “effective tax administration” and “doubt as to liability.”

Promoting Effective Tax Administration

Perhaps the most flexible alternative reason for an offer in compromise is to promote effective tax administration, or ETA. When considering ETA as an alternative, practitioners should understand that the Internal Revenue Manual (IRM) instructs IRS employees to consider ETA justifications as a last resort. However, the multiple elements under ETA make it an attractive alternative for many taxpayers. Under Treas. Reg. § 301.7122-1(b)(3), the IRS is allowed to compromise a tax liability based

on ETA if (1) a financial hardship exists; (2) public policy dictates it; or (3) sufficient equitable considerations exist.

Financial hardship. A financial hardship, as it applies to ETA offers under Treas. Reg. § 301.6343-1, exists when a taxpayer is unable to pay reasonable basic living expenses. In most circumstances, the IRS will determine the existence of a financial hardship by reducing a taxpayer’s income (generally consisting of gross wages, interest and dividends, net self-employment and rental income) by the prescribed national and local expense standards (see IRM 5.15.1 and tinyurl.com/6jvozz4). However, the IRM does allow deviations from those standards if taxpayers can show that they are inadequate to provide for the specific situation. Unlike the normal deviation provisions that require reasonable substantia-

tion that an expense is necessary to provide for the taxpayer’s and the taxpayer’s family’s health and welfare and/or production of income, an ETA offer analysis can take into account more factors when departing from those standards.

A practitioner should consider raising as a factor the taxpayer’s age, employment status, dependents, education expenses and any extraordinary circumstances when presenting the existence of a financial hardship. Raising these additional considerations is most successful if included both in a cover letter when filing the C and as an attachment to the financial closure forms, specifically, Form 433 *Collection Information Statement for Wage Earners and Self-Employed Individuals*. Practitioners should also be aware that financial hardship ETA offers are available only for individuals and not corporations.

partnerships or other entities.

Public policy/equitable considerations.

The second and third ETA elements are often lumped together. The IRS can compromise a liability based on public policy and equitable considerations if the taxpayer can show that forcing full payment would undermine the public's confidence at the tax laws are being administered in a fair and equitable manner. Specific cases on these issues are rare, because only in limited situations can the matter receive judicial review, for which the standard of review is abuse of discretion. Nevertheless, the regulations give some examples of when public policy and equitable considerations may justify the acceptance of an OIC offer in compromise. In one example (Example 1), a taxpayer suffered a serious illness that required continuous hospitalization for several years and left him unable to manage his financial affairs. Once he recovered, the taxpayer immediately filed his delinquent taxes, and his overall compliance history was not so egregious as to outweigh the justifications for settlement. In another example (Example 2), the taxpayer received written instructions from an IRS employee related to an IRA rollover period, only to discover during an audit that the instructions were incorrect.

Practitioners should also be aware that OIC offers based on public policy or equitable considerations are considered by a special IRS group only after it is determined that the other reasons do not apply.

If the facts warrant, practitioners should consider including both ETA and DATC as justifications on the same Form 656, *Offer in Compromise*. The IRM instructs the IRS to first investigate an offer for DATC before ETA, so submitting an OIC under ETA alone may be sufficient to have it considered on both DATC and ETA; however, the reverse is not necessarily true. If an offer is submitted only under DATC, it will not generally be reviewed for ETA. Nevertheless, DATC offers can receive DATC with Special Circumstances ("DCSC") consideration when a taxpayer has proven special circumstances to warrant acceptance for less than his or her reasonable collection potential. As a practical matter, most IRS offer specialists overlook ETA offers and instead consider them only under DCSC. Because ETA can provide more flexible grounds for a compromise, practitioners should consider including a more detailed statement of their position as an attachment if both ETA and DATC are used as justifications on the same OIC.

Doubt as to Underlying Tax Liability

The second alternative reason for making an OIC is doubt as to the tax liability, or DATL. A DATL offer can be submitted when there is a genuine dispute as to the existence or amount of a taxpayer's correct liability. A DATL offer has many attractive qualities, but it also has unique criteria and limitations that practitioners should explore with their clients.

One of the initial limitations of DATL is when it can be used. Under Treas. Reg. § 301.7122-1(b)(1), no DATL offer can be sustained if the merits of the liability have been adjudicated by a court decision. Another limitation of DATL is the procedures by which it can be submitted. Prior to 2006, Form 656 allowed practitioners to select among all three reasons for an OIC on one form. With the revision of Form 656, taxpayers can no longer submit combined DATL offers with other reasons. Instead, a Form 656-L must be prepared and filed separately.

Despite its limitations and criteria, a DATL offer is an attractive alternative for some taxpayers for a variety of reasons, most notably the right to further contest the merits of their underlying liability. Additionally, under the other two offer justifications (DATC and ETA), a taxpayer must make a full disclosure of all income and assets. Sometimes this disclosure can make taxpayers uncomfortable. If taxpayers otherwise qualify for a DATC or ETA offer, IRC § 7122(d)(3)(B)(ii) allows them to avoid financial disclosure in submitting a DATL offer, whereas the other reasons do not. Third, the judicial standard of review for a DATL offer is considerably more lenient to taxpayers. The U.S. Tax Court can review ETA and DATC offers in very limited circumstances, for example, when raised during a Collection Due Process Hearing under section 6330, and the standard of review is an abuse of discretion. That requires a taxpayer to show that the IRS' actions were

EXECUTIVE SUMMARY

When pursuing collection alternatives for clients with a tax debt, practitioners may be most familiar with the "doubt as to collectibility" rubric for making an offer in compromise (OIC) to the IRS. Other grounds for an OIC and associated strategies, however, should also be explored.

One alternative reason, "effective tax administration," may

offer greater flexibility, since it can be based on the client's financial hardship or on public policy or equitable considerations. Another alternative grounds for an OIC, "doubt as to tax liability," should be pursued if the existence or amount of the underlying tax debt is in dispute.

■ A second strategy that may be used to improve chances

of acceptance of an OIC is to negotiate a collateral agreement with the IRS. A collateral agreement may be based on the taxpayer's prospect of greater future income or a waiver of unused losses.

■ Practitioners should also aid clients by reckoning at an early stage with any issue that might arise concerning a "dissipated asset," one that has been

sold or otherwise transferred on nonpriority items or debts.

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arbitrary, capricious or without sound basis in fact. However, if the tax liability itself is an issue, that standard is *de novo*, meaning the IRS' actions and fact finding could be reviewed from the beginning.

In this way, a DATL offer may in some situations allow a taxpayer a cheaper alternative to contest a tax liability than going to a U.S. district court or the U.S. Court of Federal Claims. If taxpayers miss the statutory period for filing a petition to the Tax Court under section 6213, their remaining judicial remedies require that they pay the tax and file a claim for refund before the court that has jurisdiction. A DATL offer can in some cases allow an offer to be submitted based on the merits of the case without first fully paying the liability and filing a claim for refund.

In reviewing a DATL offer, the IRS treats the matter much like an audit reconsideration. In so doing, the IRS evaluates the hazards of possible litigation and the extent of doubt created in the offer. As a result, practitioners should consider including a thorough summary of their legal position as both an attachment to Form 656-L, *Offer in Compromise (Doubt as to Liability)*, and an accompanying letter, including an analysis of the risk to the IRS.

STRATEGY 2: CONSIDER A COLLATERAL AGREEMENT

Sometimes a practitioner will reach an impasse with the IRS when representing a financially distressed taxpayer. The problem could arise for any number of reasons, and a practitioner should be aware of options to break a potential stalemate by adding conditional or supplemental terms not typically included in offer negotiations. The use of a collateral agreement can provide such a mechanism by making an offer more attractive to the IRS with additional, and sometimes noncash, consideration.

In the context of an OIC, the need for a collateral agreement arises in several situations, most often when the IRS anticipates a taxpayer's income will substantially increase in the future, but there is disagreement about its likely extent. For example, a self-employed taxpayer working

in a volatile industry may have demonstrated a high earning potential in prior years but has recently fallen on hard times, making it difficult to agree on his or her future income levels for determining a reasonable collection potential. In this situation, a future-income collateral agreement could be procured. The purpose of a future-income collateral agreement is to allow for a fixed percentage of the taxpayer's annual income over a certain base-level amount to be paid in addition to the originally offered sum.

Returning to the example, a practitioner could present additional consideration to make acceptance of the OIC more desirable to the IRS, whereby the taxpayer will agree to pay out of net income 10% of the amount that exceeds \$50,000 for the next three years. Such an agreement may alleviate IRS concerns about accepting an OIC only to watch a taxpayer receive a windfall in the near future, but still achieve a taxpayer's goal in compromising his or her liability.

Future-income collateral agreements are generally monitored annually during the five-year future compliance term for income fluctuations. Future-income collat-

er or loan from family. The motivation for IRS to accept an offer is reduced when external assets can be brought in; however, if a taxpayer has an NOL or capital carryforward, the potential for relinquishing it becomes an attractive alternative. In this situation, a collateral agreement could be reached in which the taxpayer waives any NOL and/or capital loss deduction in future years. This provides an incentive for the IRS to accept a current settlement in exchange for higher revenue from the taxpayer in future years.

If a taxpayer does not have attractive attributes like an NOL or capital loss carryforward but still faces an impasse, practitioners could consider structuring a collateral agreement to offer a downward basis adjustment to specific assets. Like a waiver of tax attributes, this will provide an additional motivation for the IRS to accept a taxpayer's OIC because of higher-than-otherwise-attainable taxable gains upon sale, exchange or other disposition of specific assets in the future.

Similar to future-income collateral agreements, waiver-of-tax-attribute and basis-adjustment collateral agreements should be discussed early to familiar-

“Doubt as to collectibility” is one of three reasons the IRS can accept an OIC. The others are “effective tax administration” and “doubt as to liability.”

eral agreements are not widely offered by the IRS and are not widely known about among taxpayers, in part because Form 2261, *Collateral Agreement: Future Income—Individual*, is not available at www.irs.gov. If one appears appropriate and necessary, a practitioner should present the issue to the IRS and ask the Service to begin preparing it.

Another application of collateral agreements in OIC negotiations is when a taxpayer is sitting on attractive tax attributes such as a net operating loss (NOL) or capital loss carryforward. OICs are most successful when funded with assets not otherwise attainable by the IRS, such as a gift

the IRS representative with the issue, and a request to procure Form 2261-B, *Collateral Agreement: Adjusted Basis of Specific Assets*, or 2261-C, *Collateral Agreement: Waiver of Net Operating Losses, Capital Losses, and Unused Investment Credits*, early is recommended. Practitioners should consider including information on the additional consideration both in a cover letter and attachment to the filed Form 656 to achieve this. Loss-waiver collateral agreements are generally limited to prior-year losses, but practitioners should make sure they are not drafted in a way that prohibits the deduction of losses that arise in years after an OIC is accepted.

A practitioner may also use a collateral agreement similarly to break through a negotiating roadblock in installment agreement negotiations. In addition, an agreement can be an advantageous tool in negotiating the deferral or forbearance of a notice of federal tax lien, since the IRS instructs IRS employees to withhold a notice of federal tax lien if a taxpayer entered into a collateral agreement. In these circumstances, a collateral agreement does not provide additional consideration and prompts acceptance of a collection alter-

ation. If an asset has been transferred for less than full value in the last 10 years. In choosing how to respond, practitioners should carefully assess whether the IRS might view an asset transfer as for less than full value and, if so, consider attaching a statement explaining the taxpayer's position. If a dissipated-asset issue cannot be avoided, the financial analysis and offered amount should be adjusted accordingly. The alternative to a practitioner's addressing the asset in an original filing is for an IRS employee to find it through investigation, creating a situation

where arguing for the asset's noninclusion often becomes more difficult.

Finally, a practitioner should consider when the asset was dissipated in relation to the assessed tax liability at issue. A recent Tax Court decision, *Larry E. Tucker v. Commissioner* (TC Memo 2011-67), highlights this approach. Although the Tax Court ultimately upheld the IRS' determination to reject the taxpayer's offer for other reasons, it did explain in detail the dissipated-asset calculation. The taxpayer sought to compromise his 1999 through 2003 tax liabilities. The IRS attempted to classify \$44,700 as a dissipated asset because the taxpayer had transferred that amount into an E-Trade account in early 2003, eventually losing all but roughly \$22,000 of the deposit. The court rejected the IRS' calculations, explaining that the amount to be included as a dissipated asset could not exceed the tax liability at the time the asset was disposed of. Because, the court held, Tucker's 2002 and 2003 liabilities had not at that point accrued, the amount to be included as a dissipated asset could not exceed his 1999 through 2001 liabilities, which were only \$14,975. ❖

OICs are most successful when funded with assets not otherwise attainable by the IRS, such as a gift or loan from family.

but rather calls for some performance that is ensured by collateral security. Marketable stocks, bonds and letters of credit are generally acceptable collateral security for an agreement to prevent a notice of federal tax lien filing.

STRATEGY 3: ADDRESS DISSIPATED-ASSET ISSUES

As to subsequent or continued noncompliance, a "dissipated asset"—one that has been sold, gifted, transferred or otherwise disposed of on nonpriority items or debts—is one of the most frequent issues that can deny a taxpayer's chance at a compromise. If the IRS succeeds in classifying an item as a dissipated asset, its whole value could be included in a taxpayer's reasonable collection potential. By its very definition, a dissipated asset is no longer available to satisfy the tax liability; thus, its inclusion in a taxpayer's reasonable collection potential determination can spell certain doom for any collection alternative.

The best place to avoid a dissipated asset issue is at the front end. When preparing a taxpayer's financial statements using Form 433-A (or 433-B, *Collection Information Statement for Businesses*), the practitioner should pay careful attention to answering question 16 (on Form 433-A) or question 16 (on Form 433-B), which ask if an asset

where arguing for the asset's noninclusion often becomes more difficult.

If an asset is disclosed, or if a dissipated-asset issue arises through an IRS investigation, a practitioner should consider several possible arguments against its inclusion. First, consider the purpose behind transferring the asset. A practitioner can usually argue successfully that an asset did not go toward a nonpriority item or debt if the item was a necessary expense, that is, one that is reasonably necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income. For example, a taxpayer may have no choice but to sell an automobile before filing an OIC, using the sale proceeds to help pay for ordinary living expenses like rent and groceries. If a practitioner can demonstrate that the sales proceeds went to pay these expenses, the equity of the automobile will generally not be included as a dissipated asset.

Second, practitioners should bring up when the asset was dissipated, relative to submitting the offer. Even though Forms 433-A and 433-B request disclosure of assets transferred within the last 10 years, absent unusual circumstances, an asset will be included in a taxpayer's reasonable collection potential only if it was dissipated within five years of submitting an OIC.

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