New York State Bar Association
Tax Section

Report on Draft Regulations for New York State Offers in Compromises

Report No. 1251

TABLE OF CONTENTS

Page

Report No. 1251

New York State Bar Association
Tax Section

Report on Draft Regulations for New York State Offers in Compromises

I. Introduction.

The Tax Section of the New York State Bar Association has been asked by the New York State Department of Taxation and Finance (the "Department") to comment on draft regulations to implement recent changes in the Commissioner's authority to compromise taxes under Section 171 (fifteenth) of the New York Tax Law ("Subdivision Fifteenth"),[1] the law which empowers the Commissioner to accept a payment of less than the full amount of the liability for tax, interest and penalty, so long as the taxpayer can demonstrate that the full amount of the liability is not collectible (*i.e.*, "doubt as to collectibility").

We commend the Department for the quality and content of the draft regulations. The amendments to the existing regulations incorporate the letter and spirit of the law. This Report (1) summarizes the changes included in the draft Offer in Compromise regulations as they relate to Subdivision Fifteenth and (2) makes suggestions for additional changes that we believe will be helpful both to taxpayers and the Department in the Offer in Compromise program.

The New York Offer in Compromise program has long been compared unfavorably to its counterpart at the federal level, which is widely viewed as a more effective program for resolving tax liabilities not likely to be collectible in full. This has been, in part, the result of underlying differences in the enabling statutes for the respective New York and federal programs. Indeed, the legislative Memorandum in Support for the recent changes to the New York Offer in Compromise statute notes that overly restrictive language in the New York Offer in Compromise law has contributed to the failure of the New York Offer in Compromise

[1] The principal drafter of this Report was Sherry Kraus, Co-Chair of the Individuals Committee, with substantial contributions from Yvonne Cort, Eugene Fisher, Maria Jones, Robert Levinsohn, Elliot Pisem, Michael Schler and Diana Wollman. Helpful comments were received from David Sicular. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

program to reach its public policy goals,[2] as well as depriving the State of revenue from the compromise of tax liabilities that are not likely to be collectible in full. *See* New York State Senate Memorandum in Support of Bill #3945A (the "Senate Memorandum"). The Senate Memorandum further states:

> The compromise provisions in Subdivision Fifteenth of section 171 of the Tax Law, along with those in subdivision Eighteenth-a, are outdated and do not reflect current realities or the experiences of the Tax Department in administering the offer in compromise program. These provisions of the Tax Law deprive the Commissioner of Taxation and Finance of the authority to provide relief to all deserving taxpayers and inhibit the Department's ability to generate revenue on otherwise uncollectible liabilities. In addition, the offer in compromise process is often an ineffective or futile avenue for relief of overwhelming tax debts.

The recent changes to the Offer in Compromise statute,[3] which became effective on August 17, 2011, were intended to address the long-standing concern that the New York State Offer in Compromise program has not provided adequate relief to debtors in resolving overwhelming tax liabilities. While there continue to be differences between the wording of the federal Offer in Compromise enabling statute and its state counterpart, both programs are trying to accomplish the same thing; that is, to collect "what is potentially collectible at the earliest possible time and at the least cost to the government." *See* Senate Memorandum.

The Tax Section has long supported statutory and regulatory changes that would make the New York State Offer in Compromise program more effective.[4] Since the federal and state Offer in Compromise programs have the same basic goals, we have urged that the federal Offer program be utilized as a model for the New York Offer program. The federal program has been

---

[2] The public policy goals were stated in the New York State Senate Memorandum in Support of Bill #3945A to include: (1) resolving tax liabilities that cannot be satisfied in full; (2) collecting what can reasonably be collected at the earliest time possible and at the least cost to the State; (3) giving taxpayers with overwhelming liabilities a fresh start, enabling them to comply voluntarily with the tax laws and become productive, taxpaying members of society; and (4) collecting funds that may not be collectible by other means, thereby encouraging taxpayers to stay, and keep their productive assets, in New York. These are the same public policy goals as set forth in the Internal Revenue Manual for federal Offers in Compromise. *See* IRM 5.8.1.1.4 (09-25-2000).

[3] Hereafter, all further references to New York State Tax Law will be to "Tax Law §"; references to Treasury regulations promulgated under the Internal Revenue Code will be to "Treas. Reg. §"; references to the Rules and Regulations of the State of New York will be to "NYCRR §"; references to the Internal Revenue Manual will be to "IRM"; and references to "the Commissioner" are to "the Commissioner of Taxation and Finance."

[4] *See*, *e.g.*, Tax Report #913, "Report on Proposed Regulations for New York State Offers in Compromise" (Oct. 2, 1997) and Tax Report #983, "Conformity of Federal, State and City Offers in Compromise Statute" (Nov. 29, 2000). Many of the suggestions made in this Report were contained in these previous reports.

in place for many years and is generally viewed as working well. This is due, in part, to the Internal Revenue Service's development of extensive guidelines to assist the taxpayer in submitting an offer and to assist the Internal Revenue Service in the uniform implementation of the program.

Arguably, New York State has always had even greater incentives than the federal government to have in place an effective Offer in Compromise program. The State can sustain losses in collections because (1) State tax liabilities often have a lower assessment priority to those of the Internal Revenue Service and other creditors and (2) statutory collection restrictions limit access to the tax debtor's assets (*e.g.*, pension plans are exempt from levy) and/or income (*e.g.*, maximum 10 percent gross wage levy). With the State's long collection statute,[5] tax debtors can face overwhelming and insoluble tax debt resulting from years of accrued interest and penalties. If the debt is too large and the collection measures too harsh, otherwise law-abiding taxpayers who would never have considered taking evasive steps or being noncompliant can be forced, through desperation, to find ways to avoid collection. If resolving the tax debt through an effective Offer in Compromise program is not an option, tax debtors quickly learn the limitations on New York's power to collect taxes and find ways to become collection-proof. This might mean working "off the books," not owning assets, not maintaining bank accounts or changing banks frequently. Alternatively, the tax debtor may choose simply to move out of the State, severing all financial ties, as a means of avoiding the debt. While extraterritorial collections for New York have improved over the years, there still can be enormous revenue loss by reason of tax debtor flight from the State. Any of these reactions by tax debtors results in losses to the State—not only in the potential for collection on back liabilities, but also any future revenue from that person's earnings, investment and future tax compliance.

The greater vulnerability of the State to losses in collection heightens the importance of putting in place effective regulations to implement the recent statutory amendments to the State's Offer in Compromise program. A fair and effective Offer in Compromise program benefits the State and its taxpayers.

[5] Section 174-b of the New York State Tax Law establishes a twenty-year time limit to collect any tax liability as measured from the first date the Commissioner could file a warrant for the tax liability.

II. Summary of the Changes in the New York Offer in Compromise Statute.

- **Broadening of eligibility for relief under the Offer in Compromise program.** Under the former version of Subdivision Fifteenth, a taxpayer had to demonstrate that he/she had been discharged in bankruptcy or was insolvent as a threshold requirement for eligibility to be considered for a New York State Offer in Compromise. This requirement eliminated from the New York Offer program all tax debtors who were technically "solvent" at the time of submission of their offers, even though they may have had no likelihood of ever paying the tax liability in full. The recent changes to the law allow the Commissioner to accept offers from a broader pool of applicants, including those who may be "solvent," so long as they can demonstrate that collection in full would cause "undue economic hardship."

- **Minimum Offer amount.** The former version of Subdivision Fifteenth required that the amount payable in the Offer in Compromise equal or exceed what the Department could recover through legal proceedings. This requirement often resulted in the Department's requiring an unrealistically high offer amount from the tax debtor because the Commissioner had to assume a full exercise of the Department's levy and garnishment powers over the remainder of the collection period (up to twenty years), even if circumstances rendered enforcement of the debt impractical, contrary to public policy, or unlikely to succeed. The recent changes to the law eliminate the requirement that the Commissioner must evaluate the adequacy of an Offer in Compromise by assuming the full exercise of the Department's collection powers over the duration of the collection statute. Under the amended law, the Commissioner may evaluate the adequacy of the Offer in Compromise by determining the reasonable collection potential of the file. In determining the reasonable collection potential of a file, the Commissioner may now take into account factors other than collectability, such as whether an exercise of full collection powers would leave the taxpayer without sufficient resources to pay basic living expenses.

These changes in the enabling statute allow the Commissioner to modify the New York Offer in Compromise program to one more similar to the federal Offer in Compromise program. The proposed changes to the Offer in Compromise regulations are intended to implement the recent changes to the statute. The regulations have, for over a decade, constituted the primary source of information to taxpayers and to the Department on the Offer in Compromise program.[6] Accordingly, in order to administer a uniform and fair Offer in Compromise program, it is important that the amended regulations provide as much detailed guidance as possible to taxpayers and practitioners as well as to the Department.

III. Background.

A. *Statutory Framework for Offers in Compromise*.

- Federal Offers in Compromise.

The authority underlying the Internal Revenue Service's ability to compromise federal tax, interest and penalties derives from Section 7122(a) of the Internal Revenue Code which provides:

> The Secretary may compromise any civil or criminal case arising under the internal revenue law prior to reference to the Department of Justice for prosecution or defense; and the Attorney General or his delegate may compromise any such case after reference to the Department of Justice for prosecution or defense.

The Internal Revenue Service has developed extensive and detailed guidelines in the Internal Revenue Manual for the submission and evaluation of Offers in Compromise. *See* IRM 5.8.1 (Offers in Compromise). The policy underlying the federal Offer in Compromise program is stated in the Internal Revenue Manual as follows:

> 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 OIC 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. IRM 5.8.1.3 (03-16-2010)

[6] In contrast, the Internal Revenue Service regulations for implementing the Commissioner's compromise authority are brief (*i.e.*, less than five pages). The bulk of the guidance is contained in extensive non-regulatory guidelines (*see* IRM 5.8 Offers in Compromise). The Department has not published detailed guidelines to supplement its regulations.

- New York State Offers in Compromise.

The authority of the Commissioner of Taxation and Finance to compromise state taxes, interest and penalties after a tax liability has become final, and with respect to which warrants or judgments have been filed, derives from Section 171 (fifteenth) of the New York Tax Law. The regulations implementing the statute are contained in Part 5005 of Chapter VIII of 20 NYCRR.

Under the previous statutory wording of Subdivision Fifteenth, the Commissioner had the authority to compromise any tax, warrant or judgment if:

> the tax debtor has been discharged in bankruptcy, or is shown by proofs submitted to be insolvent, but the amount payable in compromise shall in no event be less than the amount, if any, recoverable through legal proceedings, and provided that where the amount owing for taxes, penalties and interest or the warrant or judgment is more than one hundred thousand dollars, such compromise shall be effective only when approved by a justice of the supreme court. *Emphasis added.*

The recent legislative amendments to Subdivision Fifteenth modify this law to grant the Commissioner the authority to compromise any tax, warrant, judgment or other imposition if:

> the tax debtor has been discharged in bankruptcy, is shown by proofs submitted to be insolvent or shows by proofs that collection in full would cause the tax debtor undue economic hardship, provided that the amount payable in compromise reasonably reflects collection potential or is otherwise justified by the proofs offered by the tax debtor. Provided further, the commissioner shall not accept any amount payable in compromise that would undermine compliance with the taxes or other impositions administered by the commissioner, nor shall the commissioner enter into any offer of compromise that would be adverse to the best interests of the state. Where the amount owing for taxes or other impositions or the warrant or judgment, exclusive of any penalties and interest, is more than one hundred thousand dollars, such compromise shall be effective only when approved by a justice of the supreme court. The commissioner shall promulgate regulations defining what constitutes undue economic hardship. The inability to maintain an affluent or luxurious lifestyle shall not constitute undue economic hardship. *Emphasis added.*

These amendments to Subdivision Fifteenth broaden the class of taxpayers who are eligible for relief under the Offer in Compromise program. Formerly, a taxpayer had to demonstrate that he/she had been discharged in bankruptcy or was insolvent as a threshold requirement to be eligible for consideration of a New York State Offer in Compromise.[7] As stated earlier, this requirement eliminated from the New York Offer program all tax debtors who were technically "solvent" at the time of submission of their offers, even though they may have had no likelihood of ever paying the tax liability in full. At the same time, the statute deprived the State of revenue from the receipt of the equity of solvent taxpayers. For these reasons, the former provisions of the Offer in Compromise statute were viewed as not advancing the overall goals of the New York Offer program. *See* Senate Memorandum. The change to the law allows the Commissioner to accept offers from a broader pool of applicants, including those who may be "solvent" so long as they can demonstrate that collection in full would cause "undue economic hardship."

Another significant change to the law was to alter the required minimum amount needed to compromise the liability. The former version of Subdivision Fifteenth required that the amount payable in the Offer in Compromise equal or exceed what the Department could recover through legal proceedings.[8] This requirement often resulted in an unrealistically high offer amount required from the tax debtor because the Commissioner had to assume a full exercise of the Department's levy and garnishment powers over the remainder of the collection period (up to twenty years) even if circumstances rendered enforcement of the debt impractical, contrary to public policy or unlikely to succeed. The former statutory provisions of Subdivision Fifteenth left the Commissioner with little flexibility to compromise a liability (a) for an amount that more accurately reflected the true collection potential of the file or (b) for an amount that would take into account factors other than collectibility, such as whether an exercise of full collection

[7] In contrast, under the federal Offer in Compromise program, there is no restriction on taxpayer net worth in order to be eligible to seek an Offer in Compromise relief. IRM 5.8.4.3 (06-01-2010). Since a federal tax debtor must make a minimum offer, which equals or exceeds his/her net equity in assets, the tax debtor is brought to the point of "insolvency" if the federal Offer is accepted but does not have to demonstrate insolvency before that time.

[8] In determining collection potential, all legal collection proceedings available to the Department had to be considered, including the collection rights of the Department against the debtor's personal and real property under Article 52 of the Civil Practice Law and Rules, *i.e.*, the results of a seizure and sale of the taxpayer's real and personal property, including, but not limited to, the seizure of money from the debtor's bank account, seizure of motor vehicles, debts owed to the taxpayer by third parties, and income executions of up to 10% of the taxpayer's gross wages. NYCRR § 5005(b)(1) and (b)(3).

powers would leave the taxpayer without sufficient resources to pay basic living expenses. The recent changes to the law eliminate the requirement that the Commissioner must evaluate the adequacy of an offer by assuming the full exercise of the Department's collection powers over the duration of the collection statute. Under the amended law, the Commissioner now may evaluate the adequacy of an offer by determining (a) the "reasonable collection potential" of the file or (b) by taking into account "other proofs" submitted by the taxpayer that support that the offer is fair and adequate.[9] These changes in the enabling statute allow the Commissioner to modify the New York Offer in Compromise program to be more similar to the federal Offer in Compromise program.

IV. Summary of Draft Regulations Amending NYCRR § 5005.1.

A. *Undue Economic Hardship*.

- Undue economic hardship is defined as "an inability to pay reasonable basic living expenses."
- The inability to maintain an affluent or luxurious lifestyle does not constitute undue economic hardship.
- The determination of a reasonable amount for basic living expenses will be made by the Department and will vary depending on the unique circumstances of the taxpayer.
- The taxpayer's income and basic living expenses must be considered in determining if the taxpayer qualifies for an Offer in Compromise due to undue economic hardship.
- Basic living expenses are those expenses that provide for the health, welfare or production of income of the taxpayer and the taxpayer's family.

[9] As stated in the Senate Memorandum: "The provisions of the bill that will permit the Commissioner to accept a lesser amount in compromise are designed to bridge the gap between the collectibility requirement and accepting a fair offer in extraordinary cases. The recognition that there is a need for flexibility to craft compromises based on the unique facts of a particular case derives from actual cases where, in the Tax Department's experience, current standards do not allow it to reach a fair result, given the extraordinary financial circumstances of the taxpayer."

- The Department will look to national and local standard expense amounts used by the Internal Revenue Service as a guideline to provide accuracy and consistency in determining a taxpayer's basic living expenses.

- Basic living expenses that will not generally be allowed include:

  (a) tuition for private schools;

  (b) public or private college expenses;

  (c) charitable contributions;

  (d) voluntary retirement contributions;

  (e) payments on unsecured debt, such as credit cards;

  (f) cable television bills; or

  (g) other similar expenses.

- Other factors that will be considered that can impact a taxpayer's financial condition, include:

  (a) taxpayer's age, employment status and history, and the taxpayer's ability to earn;

  (b) number, age and health of dependents;

  (c) cost of living where the taxpayer resides;

  (d) extraordinary circumstances, such as special educational expenses, a medical catastrophe, or a natural disaster;

  (e) any other facts that the taxpayer claims bears on economic hardship.

- Factors that support an undue economic hardship determination may include:

    (a) The taxpayer is incapable of earning a living because of a long-term illness, medical condition, or disability, and it is reasonably foreseeable that the taxpayer's financial resources will be exhausted providing for care and support during the course of the condition.

    (b) The taxpayer has a set monthly income and no other means of support, and the income is exhausted providing for the care of dependents.

    (c) The taxpayer has assets, but is unable to borrow against equity in assets, and liquidation to pay the outstanding liability would render the taxpayer unable to meet basic living expenses.

- The draft regulations limit eligibility for relief under the "undue economic hardship" provision to individuals and "sole proprietor entities." Corporations and "non-individual entities" are not eligible for relief under this provision, although still eligible for relief under other provisions of the Offer in Compromise program.

B. *Reasonable Collection Potential*.

- Reasonable collection potential is based on the total realizable value of the taxpayer's assets and the amount that could reasonably be expected to be collected from the taxpayer's anticipated future income, after giving effect to all priorities granted to New York State and applicable statutes.

- The realizable value of the taxpayer's assets is the amount that could reasonably be expected from the sale of the assets within 90 days or less, *minus* any amount owed to a secured creditor.

- The amount that could reasonably be expected to be collected from the taxpayer's future income is determined by taking into account the taxpayer's basic living expenses if the amount that could be collected from anticipated future income would leave the taxpayer unable to meet basic living expenses.

- Anticipated future income is generally limited to a period of ten years, but may be longer or shorter depending on the circumstances, including the age of taxpayer, the age of the liability, and the best interests of the State.

C. *Removal of Requirement of Upfront Payment*.

- The regulations remove the former provisions requiring an upfront payment of the full offer amount upon submission of the offer. *See* amendment to Paragraph (1) of subdivision (c) of NYCRR § 5005.1.

V. Summary of Recommendations.

- Clarify that the listing of "expenses not generally allowed" for determining "undue economic hardship" is subject to change, particularly if the Internal Revenue Service guidelines change. Consistent with the present Internal Revenue Service Collection Standards, modify the listing to remove "cable television bills" as an example of an expense not generally allowed as a "necessary living expense."

- In determining "reasonable collection potential,"

  - Value "assets" by reference to the more familiar terminology of "quick sale value."

  - Value "income" by limiting the period of anticipated collections to "no more than the lesser of ten years or the remainder of the collection statute" unless there are circumstances indicating that a significant recovery can reasonably be expected if the longer period is used.

- In valuing future income collections for cash offers,
  - The projected income stream should be “discounted to present value.”
  - The Department should place on its website, in the Offers in Compromise section, a calculator that would calculate for the taxpayer the “discounted present value” of the monthly income.
- Include a provision to allow taxpayers to cure defaults rather than require that an Offer in Compromise be voided on a default.
- Discourage the use of “collateral agreements” as a condition of approval of an Offer in Compromise.

VI. Our Comments.

A. *Undue Economic Hardship*.

The amendments to the regulations defining “undue economic hardship” are modeled on the Internal Revenue Service “effective tax administration offer”—which similarly allows for the acceptance of an Offer in Compromise upon a showing of “economic hardship” by the taxpayer. Treas. Reg. § 301.7122-1(b)(3). While not expressly stated in the New York legislative history of the amendments to Tax Law § 171 (fifteenth), we believe that this reflects the legislative intent of the law and that the Internal Revenue Service guidelines for “effective tax administration offers” are an appropriate model for the amended regulatory language. The draft regulations not only are modeled on the Internal Revenue Service guidelines for the federal “effective tax administration” offers, but also incorporate by reference the Internal Revenue Service guidelines for determining a taxpayer’s “reasonable basic living expenses”—which will be used in the New York Offer in Compromise program to determine whether the taxpayer qualifies to participate in the Offer in Compromise program on the ground of “undue economic hardship.”

It makes sense for the amended New York Offer in Compromise regulations to draw upon the relevant federal Offer in Compromise guidelines, which have been refined over many years of experience by the Internal Revenue Service. In this manner, the New York Offer in Compromise program incorporates a consistent framework for evaluating a taxpayer’s ability to pay under the new “undue economic hardship” standard. The Internal Revenue Service has developed a series of financial analysis procedures (“Collection Financial Standards”) to determine the basic living expenses that should be allowable to a taxpayer seeking an Offer in Compromise, an Installment Payment Agreement or a release of levy. *See* IRM 5.15.1, Financial Analysis Handbook. These IRS Collection Financial Standards are updated frequently. *See* IRM 5.15.1.7 (10-2-09) and IRM 5.8.5.20.1 (10-22-2010). It is reasonable and desirable for the Department to adopt these standards to ensure consistency and fairness to taxpayers participating in the New York Offer in Compromise program and to assist the Department in evaluating offers in compromise under the amended law. The Tax Section has long supported increased conformity of the New York Offer program to the federal Offer program. However, we recommend that the provision describing “Expenses not generally allowed” in paragraph (3) of subdivision (b) of NYCRR § 5005.1 be clarified to state that the list is an example of “expenses not generally allowed” under <u>current</u> Internal Revenue Service guidelines and is thereby subject to change as the IRS guidelines change. This will provide the Department with additional administrative flexibility. We also note that the Internal Revenue Service “Collection Financial Standards” currently allow cable, internet service and cell phone service in the category of allowable “Housing and Utilities” costs. For this reason, we recommend removal of “cable television bills” as an example of an expense not generally allowed as a “basic living expense.”

We agree with the draft regulations limit of the “undue economic hardship” provisions to individuals and “sole proprietor” entities only. This limitation is consistent with the provisions under the IRS “effective tax administration offer” where only “individuals” may qualify by showing that payment in full of the liability would create “economic hardship.” Treas. Reg. § 301.7122-1(b)(3).[10] Accordingly, we believe that this is a proper interpretation of the changes to Subdivision Fifteenth.

B. *Reasonable Collection Potential.*

Guidance is set forth in the draft regulations to assist the taxpayer in determining the minimum dollar amount that must be offered to obtain relief under the Offer in Compromise program. Just as with the Internal Revenue Service Offer program, the amount is described as

[10] In the Internal Revenue Service “effective administrative offer,” if the taxpayer in not an individual, the taxpayer must demonstrate that it would be against public policy or inequitable to require payment of the tax in full.

the sum of the taxpayer's equity in assets (after subtraction of prior liens) and the value of amounts collectible from future income (such as a wage garnishment).[11] Under the former law, the State had to use a minimum offer formula that looked strictly at what the State could collect under its CPLR Article 52 powers to levy assets and garnish income (without regard to allowances for reasonable basic living expenses). This was removed in the recent amendment to Subdivision Fifteenth and replaced with a requirement that the amount payable in compromise "reasonably reflects collection potential or is otherwise justified by the proofs offered by the tax debtor." This change adds flexibility to the Commissioner's power to compromise a liability.

The draft regulations incorporate this new flexibility with a directive that in determining the realizable value of future income, "the taxpayer's future income shall be determined by taking into account the taxpayer's basic living expenses if the amount that could be collected from anticipated future income would leave the taxpayer unable to meet basic living expenses." This potential downward adjustment in the valuation of future income is a new concept in the New York Offer program. While not expressly stated, it appears that the regulations intend that "basic living expenses" be the same as "reasonable basic living expenses" as defined under the "undue economic hardship" provisions.

We believe this is an appropriate interpretation of amended Subdivision Fifteenth. The definition of "reasonable collection potential" in the draft regulations interprets the law in a manner consistent with the statutory amendment expanding eligibility for relief to tax debtors who show that a " collection in full would cause … undue economic hardship." If, for example, a tax debtor is now eligible for participation in the Offer in Compromise program upon a showing that a full collection of the liability would render him/her "unable to pay reasonable basic living expenses" [as provided in the definition of "undue economic hardship"], it would be inconsistent not to take those circumstances into account in determining the adequacy of his/her offer. Any other result would undermine the effect of the relief intended by the amendments to the Offer statute.

[11] The Internal Revenue Service provisions are set forth in IRM 5.8.4.2 (06-01-2010).

The following are our suggestions for changes to the draft regulations that we believe will improve the guidance in determining "reasonable collection potential":

- *Conform the definition of "basic living expenses" in determining "reasonable collection potential" to the definition of "reasonable basic living expenses" in determining "undue economic hardship."* This would necessitate only a small wording change from "basic living expenses" to "reasonable basic living expenses," with an incorporation by reference of the provisions under "undue economic hardship."

- *Value assets at "quick sale value."* This is consistent with the way the Internal Revenue Service values such assets in the federal Offer in Compromise program. *See* IRM 5.8.5.4.1 (10-22-2010). We believe the term "quick sale value" will be more familiar to taxpayers and practitioners than the statement in the draft regulations that sets the value of an asset at "the amount that could reasonably be expected from the sale of the assets within 90 days or less"—even though both descriptions are generally recognized as equivalent.[12] We recommend that the regulation add a further explanation that the "quick sale value" of assets such is real property, personal and business assets, and vehicles will generally be calculated at "80% of fair market value"[13] [IRM 5.8.5.4.1(3) (10-22-2010)]. Such will make the evaluation of assets easier for the taxpayer and more administrable for the Department. Not only is "quick sale value" a more familiar term because it is used in the Internal Revenue Service Offer program, but it starts with the more familiar concept of "fair market value"—which is easily obtainable by the taxpayer by an informal evaluation or tax assessment records. Otherwise, the taxpayer may conclude that he/she has to hire an expert to figure out what the value of the asset would be under the "90 day or less" valuation formula. We believe

[12] Under the IRS guidelines, "quick sale value" is defined as an estimate of the price a seller could get for the asset in a situation where financial pressures motivate the owner to sell in a short period of time, usually 90 calendar days or less. IRM 5.8.5.4.1 (10-22-2010).

[13] We should note, however, that the Internal Revenue Service guidelines do not apply the "80% rule" to determine "quick sale value" for assets such as stocks or securities. *See* IRM 5.8.5.7 (10-22-2010).

that this small change will eliminate confusion and unnecessary costs to the taxpayer as well as reduce disputes between the taxpayer and the Department over valuation.

- *Value "income" by limiting the period of anticipated collections to "no more than the lesser of ten years or the remainder of the collection statute unless there are circumstances indicating that a significant recovery can reasonably be expected if the longer period is used."* While the draft regulations state that the period for valuing future income should generally be no more than ten years, it also states that the period could "be longer or shorter depending on the circumstances, including the age of taxpayer, the age of the liability, and the best interests of the State."

  Of all the factors that are taken into account in determining the minimum Offer in Compromise amount, the valuation of future income collections is potentially the most critical since an overvaluation of this asset can easily make the minimum Offer in Compromise amount out of reach of most taxpayers. The draft regulation properly allows for flexibility in valuing future income over less than a ten-year period if circumstances warrant, such as the age of the taxpayer (who may not be able to work for ten more years) or the impending expiration of the statute of limitations on collection. However, we believe that the directive in the regulation should emphasize more strongly that the period for projecting future earnings should never be longer than ten years unless there are exceptional circumstances.

  By way of contrast, collection against income projected to be earned after five years is not taken into account by the Internal Revenue Service in evaluating "collection potential" for Offer in Compromise purposes even if the statute of limitations on collection extends beyond five years. This is because the

Internal Revenue Service has found that the collection potential of a file falls off precipitously after three years.[14]

The Department has long had an informal policy of not taking into account a period of more than ten years in its income projections even though its collection statute might exceed that period.[15] This policy for valuing future income has never appeared anywhere in the regulations, instructions or publications and is likely only known to practitioners who have worked frequently with the Offer in Compromise program. We agree with the approach of the draft regulations to state this policy in the regulations to promote consistency, transparency and fairness in the Offer in Compromise program.

However, we recommend that the regulations state that the valuation period for future income shall, as a general rule, be for no more than the lesser of the remaining collection period or ten years, *and that valuation for a longer period should be made only if there are circumstances indicating that a significant recovery can reasonably be expected if the longer period is used.*

- *Discount to Present Value. We recommend that the regulations specifically set forth that in valuing future income collections for cash offers,[16] the projected income stream should be "discounted to present value."* Over the years, there have appeared to be differing policy positions by the Department on whether a projected income collection stream should be discounted to present value or be simply additive. In the case of a cash offer, we believe

[14] The experience of the IRS is that any significant delay in collection on the tax reduces the likelihood of full collection of the liability. As noted in the 2007 National Taxpayer Advocate Annual Report to Congress, IRS data demonstrates that collection efforts for any tax debt owed for more than three years is not cost effective. This experience has long been the basis for the "five-year rule" used by the IRS to evaluate the "collection potential" of a file in the federal Offer in Compromise ("OIC") program. See former OIC Guidelines at IRM 57(10)(13).(10) (9-22-94). For this reason, the IRS evaluation of a taxpayer's future income "collection potential" approximates the discounted present value of a five-year installment payment agreement.

[15] Section 174-b of the New York State Tax Law establishes a twenty-year time limit to collect any tax liability for which a warrant has been filed.

[16] A cash offer must be payable within 60 days of final approval of the offer. NYCRR § 5005.1(d)(2).

that it is appropriate for the Department to discount to present value (based on the current rate charged on underpayments)[17] the projected future income collections to reflect the benefit that the Department receives from securing those payments now rather than stretched out over a number of years.

The Internal Revenue Service has historically used the “discount to present value” concept in valuing income for its Offer in Compromise program. To make the concept more user friendly to taxpayers, it has substituted a numerical computation that approximates the “discount to present value” concept so that taxpayers may make the calculation without the necessity of a calculator. In the case of IRS cash offers,[18] the valuation of income is the amount determined to be payable per month under an installment payment agreement (taking into account reasonable living expenses) multiplied by 48. This factor would yield an income evaluation of $19,200 for a $400/month payment plan over five years. If instead, the Internal Revenue Service were to apply its former “discount to present value” rule with the current (underpayment) discount rate of 4%, the income would have been valued at a slightly higher amount of $21,720. The current Internal Revenue Service approximation technique gives a slight benefit to the taxpayer over its former “discount to present value” rule.

We believe that this recommended change to the New York Offer regulations will encourage taxpayers to make “cash” offers rather than deferred payment offers (which can be paid over 24 months).[19] Cash offers are administratively less costly to the Department and give needed closure to both the Department and the taxpayer.

---

[17] Formerly, when the IRS still provided tables to taxpayers to determine the “present value” of a five-year installment payment agreement in evaluating income for an Offer in Compromise, it computed “present value” of income by using the “current interest rate charged for **underpayments** as of the date the computation is made.” Former IRM 57(10)(13).(10)(2).

[18] Cash offers must be paid in five months or less. IRM 5.8.4.3 (06-01-2010).

[19] NYCRR § 5005.1(d)(2).

The following example demonstrates the difference in amount that would need to be offered by a taxpayer, depending on whether the future income stream is simply added or discounted to present value. Any valuation of future income stream that does not discount to present value adds substantially to the amount required from the taxpayer for the Offer in Compromise.

Example: Assume, for example, a tax debtor who currently earns an annual wage of $48,000. The State could now garnish up to $400 a month under a 10% income execution to collect on tax debts. If the concept of "discount to present value" for evaluation of future income collections is used, the future collections over a ten-year period would be valued at $39,508, *i.e.*, the discounted present value of a ten-year garnishment at $400 a month using a discount rate of 4% (the present underpayment rate). If, however, the income collection evaluation assumes a continuation of the existing wage levy of $400 per month for the entire ten-year period without discounting to present value, the valuation would be placed at $48,000, *i.e.*, $400 a month for ten years.

Because the period for calculating the income stream collectible by New York may often exceed the five-year period for which the IRS has determined approximation factors, we recommend that New York simply adopt the former IRS concept of "discount to present value." The Department could place on its website, under Offers in Compromise, a calculator that would calculate for the taxpayer the "discounted present value" of the monthly income found to be collectible. This calculator could be updated each quarter by the State to reflect the current "underpayment rate" as the discount factor. A similar type of calculator is present on the New York State website to assist taxpayers in calculating interest, penalties and other liabilities.

C. *Removal of Upfront Payment Requirement for Cash Offers.*

We commend the Department for including in the draft regulations a removal of the language that stated that an offer should be accompanied by a remittance representing the amount of the Offer in Compromise. While not strictly enforced by the Offer in Compromise unit, this language has been counterproductive to the effectiveness of the program and has discouraged the submission of cash offers. At the federal level, the 2006 change in the Offer in Compromise statute to require a 20% (of the offer amount) up-front nonrefundable payment in order for the Internal Revenue Service to process an offer has severely undermined the federal Offer program and placed relief from the program out of reach for many taxpayers who would otherwise make good offers. The National Taxpayer Advocate has commented repeatedly on this concern and has noted the dramatic reduction in offers submitted since that change in the law.[20]

The Tax Section similarly has expressed its opposition to this change in the federal Offer in Compromise law. In a letter sent on July 13, 2005 commenting on the Offer in Compromise Legislation in Highway Bill (H.R.3) (Letter #1092), we stated that:

> The requirement of submitting a twenty percent up-front payment for lump sum offers, will, in our view, discourage such offers. Taxpayers seeking relief from this program will generally have tax liens against their assets and have few potential sources for borrowing, especially at the outset of making the offer. For example, if the source of funds for the offers will be the equity in a taxpayer's home, few lenders will be interested in assisting the taxpayer in tapping out a part of that equity to cover the partial payment required to submit an offer that has no guarantee of acceptance. Until the offer is accepted and full payment is made, the tax lien will remain in place as a superior encumbrance on the home. In contrast, if the borrowing is done at the end of the offer process after the offer has been accepted, the prospects for borrowing are much improved since the proceeds of the loan will be used to pay off the offer and the tax lien will be removed.

We believe that the removal of this provision reflects current practice at the Department and is an appropriate and beneficial change to the regulations.

D. *Grace Period to Correct Defaulted Offers*.

In a previous report, the Tax Section had recommended that the State modify its policies on defaulted offers to conform to the federal approach. *See* Report # 913, "Report on Proposed Regulations for New York State Offers in Compromise" (Oct. 2, 1997). The regulations have long provided that the Department may deem the Offer in default, thereby reimposing the full tax

---

[20] *See, e.g.*, The National Taxpayer Advocate's Report to Congress, Fiscal Year 2008 Objective at xvii et seq. (June 30, 2007).

liability and proceeding immediately to collect the balance of the original liability, upon the occurrence of any default in the terms of the Offer in Compromise, no matter what the circumstances. For example, as a condition of acceptance of a New York Offer in Compromise, the taxpayer must agree to stay in compliance with the tax laws for a five-year period.[21] There is a similar condition imposed for acceptance of a federal Offer in Compromise. If, for example, the taxpayer files a return late or makes a late payment in the five-year period after acceptance of the offer, he/she is technically in "default," thus allowing both the State and the Internal Revenue Service to void the Offer in Compromise.

Under the federal Offer in Compromise guidelines, there is a procedure for notifying the taxpayer of the "default" and allowing the taxpayer to cure the default so as not to lose the benefit of the Offer in Compromise. *See* IRM 5.8.9.3 (04-15-2011). However, in the case of New York State Offers, some practitioners report instances where the Department has nullified an Offer in Compromise immediately no matter what the circumstances causing the default and no matter how quickly cured by the taxpayer. Other practitioners report that the policy on defaulted offers is not so rigid.

Given the time and effort expended by the Department in evaluating an Offer in Compromise for acceptance and the time, effort and costs to the taxpayer in submitting and paying an offer, we believe that the regulations should be modified to allow the Department to adopt a more flexible approach similar to the approach currently utilized by the Internal Revenue Service that would allow for the taxpayer to cure the default rather than require that the Department proceed immediately to the severe remedy of termination of the Offer in Compromise. Such a change will introduce a uniform policy within the Department for dealing with defaulted offers and encourage taxpayers to comply with the terms of their Offer in Compromise. This recommendation will require changes to proposed NYCRR § 5005.1(f) of the regulations.

[21] NYCRR § 5005.1(c)(3)(v).

E. *Collateral Agreements Should be Discouraged*.

We have long recommended that the Department discourage the use of "collateral agreements" as a condition of approval of an Offer in Compromise.[22] The regulations that, in an appropriate case, the Department may require as a condition of approval of the Offer in Compromise a "signed agreement wherein the taxpayer agrees to pay over a fixed percentage of the taxpayer's future earnings or other income for a specific period of time." NYCRR § 5005(c)(2)(i).

The Internal Revenue Service strictly limits the use of collateral agreements as a means to collect additional amounts to be paid over and above the amount accepted in an Offer in Compromise. The reason stems from the costs and difficulties in administering such agreements. As stated in the Internal Revenue Manual:

> Future income collateral agreements must be monitored annually for the life of the agreement. The cost of monitoring and the difficulty in tracing income structured through other entities should be considered when deciding whether such an agreement is warranted. IRM 5.8.6.1.

The advantage to this approach is clear. A major benefit to the government in securing an Offer in Compromise is to achieve collection now of an account unlikely to be collectible in full. To the extent the account must continue to be overseen or managed for several years, either by reason of an installment payment of the Offer in Compromise or the need to oversee compliance with a collateral agreement, the government continues to incur costs in connection with that account. Closure of the account upon receipt of payment of the Offer in Compromise frees up personnel to pursue accounts with higher collection potential. The focus of the Offer in Compromise program should be to secure lump sum payments upfront without the necessity of continued costs to the government.

From the taxpayer's standpoint, the imposition of a collateral agreement adds considerable uncertainty regarding the amount to be paid to resolve the liability. The collateral agreement also undermines the objective of the Offer in Compromise program to grant a "fresh

[22] *See* Tax Report #913, "Report on Proposed Regulations for New York State Offers in Compromise" (Oct. 2, 1997).

start" to the taxpayer in rebuilding assets or increasing earnings for the duration of the collateral agreement and prevents closure of the case for both the taxpayer and the Department. Accordingly, we urge that the regulations adopt the approach of the federal Offer in Compromise guidelines under IRM 5.8.6.1 and state that collateral agreements are generally inappropriate.

VII. Conclusion.

We congratulate the Department on its excellent effort in crafting the amendments to the Offer in Compromise regulations under Part 5005.1 to reflect the statutory changes made to Section 171 (fifteenth) of the New York Tax Law. We hope that our suggestions for additional changes to the regulations will be helpful to you. We are confident that the changes in the law and the regulations will make the New York State Offer in Compromise program work more effectively.