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# New York State Bar Association

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July 13, 2005

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
2208 Rayburn Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
2354 Rayburn Office Building
Washington, DC 20515

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
511 Hart Senate Office Building
Washington, DC 20510

Re: Offer in Compromise Legislation in Highway Bill (H.R.3)

Dear Sirs:

I am writing on behalf of the Tax Section of the New York State Bar Association* to express our concerns relating to Section 5534 of the Highway Bill (H.R.3), which would amend Section 7122 of the Internal Revenue Code to require nonrefundable partial prepayments as a condition for the submission to the Internal Revenue Service of an offer in compromise. This provision was recently approved by the Senate and is currently being reviewed by the House and Senate Conferees.

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* This letter was drafted by Sherry Kraus, a member-at-large of the Tax Section's Executive Committee. Helpful comments were received from Patrick Gallagher, Kimberly Blanchard, David Hariton, David Miller and Michael Schler.

We write to you now to urge that you withdraw this provision from consideration in the Highway Bill. We believe that the requirement of potentially substantial up-front payments as a condition for processing of an offer in compromise, with no guarantee that the offer will be accepted, will have a substantial and deleterious impact on the federal offer in compromise program.

*Offer in Compromise Program*

The present offer in compromise program is implemented by the Internal Revenue Service under the enabling authority of Section 7122 of the Internal Revenue Code. The program has been in place for many years and is generally regarded as having worked well in achieving its primary objectives of:

1) resolving tax liabilities that cannot be collected in full;

2) effecting collection of what can reasonably be collected at the earliest time possible and at the least cost to the government; and

3) giving taxpayers a fresh start to enable them to voluntarily comply with the tax laws.

The program provides for relief in appropriate cases to taxpayers who are not likely to be able to pay their assessed liabilities in full. The program benefits the Internal Revenue Service by eliminating the burden and expense of administering a collection file that has little likelihood of ever being paid in full. Without an effective offer in compromise program, collections now made by the Internal Revenue Service through the program may be lost altogether to the Internal Revenue Service. Taxpayers may instead look for relief in bankruptcy (many tax liabilities are dischargeable) or by managing their income and assets to avoid the reach of the Internal Revenue Service's collection powers.

The regulations under Code Section 7122 currently impose a $150 "application fee" to process an offer in compromise. This fee is waived for offers based on "doubt as to liability" (where the underlying tax liability is disputed) and for indigent taxpayers who would otherwise be denied an opportunity to submit an offer.

*Proposed Legislative Changes*

Section 5534 of the Highway Bill amends Section 7122 of the Code to impose an "up-front" partial payment requirement as a condition for having the Internal Revenue Service review an offer in compromise. For "lump sum offers" (i.e., payments made in five or fewer installments), twenty percent of the amount of the offer must be paid with the submission of the offer in compromise. For "periodic payment offers" (payments made in more than five installments), the offer in compromise must be accompanied by the payment of the first installment, and each installment that comes due during the period that

the offer is being evaluated must be timely paid. Failure to make any of these required payments will result in a "deemed withdrawal" of the offer or a rejection of the offer as unprocessable. These partial payments are applied against the tax liability and are not returnable to the taxpayer, even if the offer is rejected. Section 5535 of the Highway Bill, in turn, creates a Joint Task Force to review aspects of the offer in compromise program.

It has been reported that these changes are intended to reduce the number of "frivolous" offers processed by the Internal Revenue Service – that is, offers that either fall significantly below the amount required under Internal Revenue Service guidelines or are intended only to forestall Internal Revenue Service tax collections – as well as to raise additional revenue for the Treasury Department and to improve the effectiveness of the offer program.

*Comment*

While the current offer program now imposes a $150 "application fee" to help defray the expenses of the Internal Revenue Service in reviewing the offer in compromise, there is no requirement that the applicant pay an up-front deposit or partial payment with the initial submission of the offer. If such a payment is made and is designated as a "deposit", the amount is returnable to the applicant if the offer is not accepted.

Most offers submitted to the Internal Revenue Service are from taxpayers seeking relief on the grounds of "doubt as to collectibility" (i.e., their assets and income are such that payment of the full liability is unlikely) or to "promote effective tax administration" (i.e., economic hardship). Such taxpayers rarely have the financial means or borrowing ability to make up-front payments with their offers.

We are concerned that the proposed legislation, with its potential for requiring significant up-front payments, will preclude offer-in compromise consideration for the very taxpayers most in need of relief from this program. To require up-front payments in an amount which is likely to be substantially in excess of the current $150 application fee not only will place the offer program beyond the reach of many otherwise qualifying taxpayers, but also will deprive the Internal Revenue Service of collections from many otherwise adequate offers.

Furthermore, we are concerned that the requirement of submitting a twenty percent up-front payment will discourage lump sum offers. The Internal Revenue Service has long encouraged the submission of lump sum offers over deferred payment offers. This is understandable since, in lump sum offers, full payment of the offer amount is made within ninety days of acceptance of the offer. In contrast, deferred payment offers are paid in monthly installments over periods that could extend as long as the remaining life of the collection statute. Because deferred payment offers require continued monitoring and administrative oversight by the Internal Revenue Service throughout the installment payment period, taxpayers are often counseled, where possible, to submit lump sum offers

to improve their chances of having their offers accepted. Lump sum offers are also viewed as being more desirable to the taxpayer since there is an immediate release of all federal tax liens on the taxpayer's property and the taxpayer does not bear the risk of defaulting the offer by missing a future installment payment.

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 offer 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.

This is not to say that taxpayers are likely to find submitting a periodic (deferred) payment offer a more desirable option than a lump sum offer. Given the long timeframe generally required for consideration of an offer in compromise, especially where the taxpayer exercises appeal rights, the taxpayer could end up making even more significant partial payments to process this type of offer. Under Section 5534, the taxpayer must continue an uninterrupted stream of monthly installment payments of the proposed offer amount during the consideration of a periodic payment offer.

Whether the offer is a lump sum or periodic payment offer, the fact that the up-front payments will not be returned to the taxpayer if the offer is rejected will likely discourage the submission of an offer. The process for acceptance is well known to be stringent and the likelihood of a denial of the offer must always be taken into account. If a taxpayer is weighing whether to seek relief through the offer in compromise program or through some other option such as bankruptcy, the additional requirement of making a nonrefundable pre-payment ensures that the offer program will be more difficult to access and may result in the taxpayer's electing bankruptcy relief instead.

It should also be noted that, unlike the present application fee now in place, the proposed legislation does not make any exception for offers based on "doubt as to liability" or for offers submitted by taxpayers who are indigent and cannot meet the partial payment requirement. For offers based on "doubt as to liability", the prospect of making a nonrefundable payment on a liability that is disputed will be a particularly difficult decision for the taxpayer.

Nor do we believe that the partial payment requirements now proposed will necessarily discourage the submission of frivolous offers. In recent years, the Internal Revenue Service has apparently experienced a substantial increase in the number of offers

that must be processed that have little likelihood of acceptance because the offers are well below the amounts required under Internal Revenue Service guidelines. Many of these frivolous offers are submitted by "offer mills" which may be attracting business by making unrealistic representations to their clients regarding the relief that can be expected from the offer in compromise program.

If, in fact, the intent of the underlying legislation is to discourage the submission of frivolous offers by substantially increasing the cost for submission of the offer, we question whether this is the right approach to accomplish this goal. In fact, the result of this legislation may be just the opposite: encouraging the submission of unrealistically low offers in an attempt to minimize the upfront, non-refundable payment[s] required to have the offer processed. Upward revisions of the offer to meet Internal Revenue Service guidelines might well be viewed as negotiable later with the offer evaluator and/or appeals. If that were the result, the proposed legislation could have the counter-productive effect of discouraging the submission of offers that, in the first instance, equal or exceed the minimum amounts required by the guidelines and result instead in the submission of increased numbers of frivolous offers.

As to the concern that the offer program is being used by some taxpayers to forestall income or asset levies, it should be noted that the Internal Revenue Service has the ability to protect its interest during the pendency of an offer by the filing of a tax lien and by going forward with jeopardy collections (i.e., where the offer is submitted to delay collection and the delay will jeopardize the Service's ability to collect the tax). Furthermore, any installment agreement in place prior to the submission of an offer must continue to be paid during the consideration of the offer and the statute of limitations on collection is suspended during the pendency of the offer.

Given these protections to the Service, we question the merits of any proposal intended to discourage the submission of any offer made to forestall income and asset executions. It is well known that levy action by the Service can have severe consequences to the taxpayer and can be costly to the Internal Revenue Service. In recent years, Congress has seen fit to give taxpayers an increasing number of protections from Internal Revenue Service levy, including the significantly expanded appeal rights granted by Congress to taxpayers in the IRS Restructuring and Reform Act of 1998 which added Collection Due Process (CDP) and Collection Appeals Program (CAP) appeals prior to the Service's proceeding with a levy. In short, taxpayers have a number of avenues available to forestall forced collection action by the Service over and above the submission of an offer in compromise. In these instances, there are good reasons for placing a hold on collection to allow for consideration of, in CDP and CAP appeals, a taxpayer's case against forced collection action and, in offers in compromise, the taxpayer's financial offer to resolve the tax liability.

We also question whether the proposed changes, to the extent they discourage submission of bona fide offers, will raise additional revenue for the Treasury Department

or improve the effectiveness of the program. The offer program is intended to grant the Internal Revenue Service the power to negotiate a dubious receivable (e.g., a taxpayer's collection file) in the same business-like manner that a bad debt can be compromised in the private sector. Many of these collection files are already in "uncollectible" status or have low level installment payment agreements in place. There are costs to the Internal Revenue Service in administering a file which has little chance of collection. If the taxpayer makes an offer that exceeds the collection potential of the file, the Service will likely accept the offer.

There are also significant benefits from the offer program that are not easily quantifiable. Acceptance of an offer is conditioned upon the taxpayer staying in full tax compliance with all filing and payments for a five year period after acceptance of the offer. If there is any default, the original liability is reinstated (less any payments made under the offer). Accordingly, the offer program promotes future tax compliance.

In our view, raising the bar for participation in the offer program, as proposed in Section 5534, will significantly decrease the number of taxpayers participating in the program. While this may (or may not) reduce the number of frivolous offers submitted, it almost certainly will reduce the number of fully adequate offers which would have been submitted by taxpayers who simply cannot pay the substantial up-front cost required for consideration of their offers. The loss to the Internal Revenue Service of "good" offers, as well as the loss of the indirect benefits of bringing delinquent taxpayers back into tax compliance and the costs of having to administer more noncollectible files may well exceed any savings gained from not having to process frivolous offers.

*Alternative Approaches*

We have also considered whether the prepayment requirement would be objectionable even if it included exceptions for hardship cases and for disputed liabilities (i.e., offers based on doubt as to liability). We believe that the addition of such exceptions would not remove our objections.

Any meaningful hardship exception will likely apply to most offers submitted on the ground of "doubt as to collectibility". Such offers are accepted by the Internal Revenue Service only after it determines that it is highly doubtful that the total liability will be collectable from the taxpayer in the remaining statutory period for collections. For the offer to be acceptable, the taxpayer must make a minimum offer which reflects the total of the taxpayer's net assets and the value of the taxpayer's income (i.e., the value of an installment payment agreement paid over a forty-eight to sixty month period, depending on the type of offer made).

To pay the "equity" component of the offer, the taxpayer must be able to access the value of both liquid and illiquid assets. "Equity" often includes assets, such as old vehicles, which cannot realistically be used for a further borrowing. The taxpayer's liquid

assets, such as bank accounts, are often needed to pay ordinary and necessary living expenses or to keep a business going.

The offer must also include the value of the taxpayer's future income, which is basically a prepayment of a forty-eight to sixty month installment payment agreement. Coming up with the cash to pay the income component of the offer can be difficult for a taxpayer since there is no asset for a traditional lender to secure in a borrowing.

The taxpayer will often face significant financial challenges in coming up with the funds to pay an accepted offer in compromise. For this reason, the Internal Revenue Service asks the taxpayer to identify the source of the payment for the offer at the time the offer is submitted. In many cases, the taxpayer's credit will be so bad that all or a significant part of the payment will be from the proceeds of a loan from a relative since no institutional lender will make a loan on the taxpayer's assets. Frequently, the funds identified for payment of an accepted offer will come from a combination of sources such as an institutional borrowing on the equity of a home (or other piece of real property), loans from relatives and cashing out investments, IRA accounts or pension plans.

Accessing funds for payments by the taxpayer at the beginning of the offer process will, in most cases, prove an even greater financial challenge and impose an even greater personal financial hardship than at the end, after the offer is accepted. For example, where the offer payment will come from a loan from a non-institutional lender such as a non-liable spouse, a relative or a friend, such loans are far easier to obtain by the taxpayer if the lender knows that the borrowing will be used to clear the taxpayer from the federal debt. If the loan proceeds are used, on the other hand, to make a non-refundable pre-payment, where the funds will not returnable if the offer is denied, the loan will be harder for the taxpayer to obtain.

Any meaningful hardship exception will apply as well to offers based on "effective tax administration" or "special needs". In those offers, the taxpayer is so financially strapped that an exception is granted to the requirement that the offer at least equal the taxpayer's net assets and value of income. These offers are difficult to obtain and intended to cover only special cases.

For many taxpayers, even coming up with the application fee of $150 is a hardship. A larger prepayment requirement, even if it were refundable, would preclude these taxpayers from making the offer.

The fact that the prepayment is non-refundable will, in a large number of cases, weigh against a professional recommendation to submit an offer. While it may be difficult to understand why there would be any detriment to the taxpayer in requiring a non-refundable prepayment so long as the payment is applied against the taxpayer's liability, it should be noted that, under the proposed legislation, unless the taxpayer designates the application of the payment at the time of the offer, the payment will be generally applied to

the oldest liabilities first – the very liabilities that are likely to have the greatest amount of interest and penalty. These are also the liabilities that are most likely dischargeable in bankruptcy or about to expire under the collection statute of limitation. In weighing the pros and cons of an offer in compromise in that situation, the taxpayer may not consider it to be in his or her best interest to take the chance that the offer will be denied and the taxpayer's scarce resources applied in this manner.

But the greatest problem in adding a hardship exception to the prepayment requirement is that it will introduce a new threshold level of proof for offers on the very issue that is central to the final offer analysis, i.e., financial status. At present, each offer in compromise is initially reviewed for "processability" by a screening reviewer at the Internal Revenue Service. This is simply an administrative check of whether the offer includes the required application fee, offer forms, financial statements and certain supporting attachments. This review is undertaken at the service center level and does not require a complex financial analysis of whether the offer is adequate under Internal Revenue Service guidelines. The adequacy of the offer is left to the evaluation of the trained offer specialist.

To introduce a "hardship" exception to the proposed prepayment requirement will require that the initial screening include a determination of whether a taxpayer has demonstrated the required financial hardship to qualify for a waiver of the prepayment. This would vastly complicate the administration of the offer program. Furthermore, if the hardship exception is made simple by modeling it on the hardship exception used for the application fee, the exception will be too narrow to offer meaningful relief. For the application fee exception to apply, the taxpayer must demonstrate that total monthly income is at or below levels based on federal poverty guidelines.

As a final matter, while adding an exception for offers based on "doubt as to liability" would address our concern that a prepayment requirement will vastly reduce these types of offers, this type of offer represents only a small percentage of the offers submitted to the Internal Revenue Service.

For the reasons stated above, our objections to the proposed prepayment requirement for offers in compromise would not be removed by the addition of exceptions for offers based on "doubt as to liability" and for offers where financial hardship is demonstrated.

*Deemed Acceptance*

A further provision in Section 5534 of the Highway Bill deems as accepted any offer in compromise which has not been fully processed with an acceptance or a denial by the Internal Revenue Service within twenty-four months after the submission of the offer. Five years after passage of the law, the timeframe for "deemed acceptance" is reduced to twelve months.

*Comments*

Under extensive guidelines that have been modified and refined over the years, the Internal Revenue Service undertakes a stringent review of each offer in compromise. Because of the "facts and circumstances" nature of the inquiry, these reviews can be time consuming. In cases where the taxpayer and the Internal Revenue Service reviewer differ on the adequacy of the offer, the taxpayer may request a review of the proposed denial at the appeals level of the Internal Revenue Service. Many offers are resolved favorably at appeals.

We have concerns about imposing upon the Internal Revenue Service a timeframe for processing an offer which, in complicated cases or in cases on appeal, may be unreasonably short. A taxpayer has no "right" to acceptance of an offer in compromise, and the Internal Revenue Service may reject an offer if it is not in the best interest of the Service from a collection standpoint.

We are concerned that imposing time limits on the Internal Revenue Service in evaluating offers may lead to offers being denied for reasons other than the merits. If the Internal Revenue Service is coming to the end of its time for making a decision on the merits of an offer, it might understandably lean toward a denial of the offer rather than risk a "deemed" acceptance of an offer that has not been fully and completely evaluated.

In summary, we do not believe it is advisable to impose a timeframe for Internal Revenue Service processing of an offer that does not take into account the full range of circumstances that could lengthen the time needed by the Service to process an offer.

*Conclusion*

The offer in compromise program benefits both the Internal Revenue Service and taxpayers. It is an important program to preserve and an important program to monitor to ensure that it continues to achieve its goals.

Some might underestimate the importance of this program in the mistaken belief that it only benefits delinquent taxpayers who are trying to avoid paying what they owe in taxes at the expense of taxpayers who pay their fair share. To view the program in this way would overlook the vast range of circumstances that give rise to a taxpayer liability. The offer in compromise program has taken on increased importance in recent years after several legislative changes, including the lengthening of the statute of limitations on collection from six to ten years and an increase in penalties. These changes, when combined with the relatively short timeframe for taxpayers to respond to proposed deficiency assessments, often result in liabilities far in excess of the original deficiency amount. In some cases, the liability would be significantly less, or perhaps non-existent, had the taxpayer timely responded to Internal Revenue Service notices.

The offer in compromise program provides an avenue for resolving these liabilities in situations where the deficiency protest and/or refund routes are not available. The program also provides motivation to taxpayers to find a way to settle the tax debt – often from assets, such as loans from relatives, that the Internal Revenue Service would not be able to reach through its collection powers.

We acknowledge the Congressional concern regarding the operation, effectiveness or fairness of the present offer in compromise program, and we concur with the approach set forth in Section 5535 of the Highway Bill, which creates a Joint Task Force to review aspects of the offer in compromise program. Because of the importance of this program to taxpayers, we recommend that any future proposals for legislative or regulatory changes to this program be subject to public review and comment. We also stand ready to assist in making future recommendations to address any concerns relating to frivolous offers that may have prompted the proposed legislation. For the present, however, we strongly urge the removal of Section 5534 from the proposed Highway Bill.

Respectfully submitted,

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