SUMMER 2014 NEWSLETTER
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METHODS TO RESOLVING FEDERAL TAX DEFICIENCIES FOR LESS THAN FULL PAYMENT

Clients have many times asked me to analyze the benefits and drawbacks of various methods at resolving federal tax debt. This summer 2014 Newsletter compares and contrasts two main options for reducing and potentially eliminating valid federal income tax liabilities. The first option, commonly referred to as "Offer in Compromise," allows a taxpayer to settle his or her tax debt for a specified sum with the IRS. When evaluating a taxpayer's offer, the IRS engages in a formal evaluation process that includes a thorough review of the taxpayer's financials and the consideration of several factors. The second option, bankruptcy, may be an easier alternative for eliminating tax debt. Yet filing bankruptcy is not a solution for all, and, to discharge taxes in bankruptcy, the taxpayer must satisfy several requirements.

COLLECTING "UNCOLLECTABLE" FEDERAL TAX DEBT • Collecting tax liabilities from the "uncollectable" can be an impossible and costly task for the IRS. When dealing with an unresponsive taxpayer, the IRS may levy bank accounts or wages, and file a tax lien in order to protect the government's interest. However, not all taxpayers have significant assets or wages that can be seized, and realistically, many taxpayers are unable to pay a substantial amount, if anything, towards their tax debt during the IRS's 10-year period that the IRS can collect the debt. For taxpayers such as these, the IRS takes one of two simple approaches.

Currently Not Collectible
If the IRS is unable to collect from the taxpayer at a specific time, the taxpayer may be temporarily classified as "Currently Not Collectible." Though the IRS may place taxpayers into this status for a variety of reasons including the inability to locate the individual or assets, taxpayers are often placed into "Currently Not Collectible" when "the collection of the liability would create a hardship for taxpayers by leaving them unable to meet necessary living expenses." After an account is placed into "Currently Not Collectible" due to hardship, it is reviewed on an annual basis by cross checking through its computer base the taxpayer's recent tax return to determine whether the taxpayer's income has increased. In some cases, the IRS requests a mandatory follow-up if it is determined that there is revenue potential in the near future.

Despite these follow-ups and reviews, a taxpayer with no future earning potential or assets to liquidate may be in "Currently Not Collectible" for several years, or even the remainder of the collection statute. Although not the most ideal solution considering the IRS primary role of the collection of taxes, the IRS utilizes "Currently Not Collectible" to avoid the costs of collection from exceeding the taxes actually collected.

Partial Payment Installment Agreement
Although a taxpayer is expected to immediately pay all delinquent tax liabilities, many taxpayers cannot pay these liabilities in full over the duration of the collection statute, as previously mentioned. When the IRS determines that a taxpayer has an ability to pay but cannot make full payment by the collection statute expiration date, the IRS may grant a partial payment installment agreement.

OFFER IN COMPROMISE PROGRAM
Whether a taxpayer is placed into "Currently Not Collectible" or is making monthly payments through a partial payment installment agreement, the taxpayer still remains liable for the total tax deficiency until the end of the collection statute period. As a result, many taxpayers are interested in an option that settles their

tax debt for a specified amount and would like to determine if they are good candidates for what is commonly known as "Offer in Compromise." The Offer in Compromise Program allows the IRS to accept a reasonable sum from the taxpayer when a doubt as to collectability or even doubt as to liability exists.

Factors Considered For an Offer in Compromise

Offers are most commonly submitted on the basis of doubt as to collectability. When submitting an offer, the taxpayer will provide a detailed collection information statement that shows the taxpayer's as-sets, liabilities, income and expenses. Additionally, the taxpayer must submit a non-refundable application fee and an initial payment, which is applied to the tax liability if the offer is declined.

While considering an offer of this nature, the IRS evaluates several factors. First, the IRS calculates the taxpayer's total tax liability and determines whether it can be paid in full through an installment agreement. Through a thorough financial analysis, the IRS may believe that full payment is possible, and, if so, the offer is immediately rejected. The IRS will often request three months of bank statements, paystubs, and other substantiation for expenses and assets. After evaluating the taxpayer's ability to pay over a reasonable period of time, the IRS will take into account the taxpayer's future earning potential and any equity shown in the taxpayer's assets. As for the taxpayer's future earning potential, the IRS will consider age, health, education, work experience, family size, economic climate, and any other factors that may affect the IRS's ability to collect from the taxpayer.

When determining a taxpayer's monthly disposable income, the IRS will look at the taxpayer's gross income over the past three months (or sometimes over the past year if the taxpayer is involved in a seasonal business) minus the taxpayer's necessary living expenses for a specified period of time in the future. For events, such as an imminent retirement, temporary unemployment, or illness, the IRS will take into account the taxpayer's current income and adjust for anticipated income changes resulting from these events. When examining necessary living expenses, the IRS will follow their national and local standard expense guidelines. Typically, the IRS will allow expenses for food, clothing, transportation, healthcare, housing, utilities, certain student loans, life insurance premiums, and court-ordered judgments. However, if the expenses fall above the allowable standard amounts, the IRS will request that the taxpayer provide substantiation and reasoning as to why the taxpayer's higher amounts should be allowed. As for the taxpayer's assets, most equity is considered, and assets otherwise no collectable become fair game in an offer in compromise.

A Taxpayer making an offer in Compromise must submit a nonrefundable deposit that is 20 percent of the offer amount with the initial offer request if the taxpayer wants to pay the offer off in five payments or less. If the taxpayer would prefer to make periodic payments, the taxpayer will submit monthly payments for up to 24 months until the offer is accepted or rejected. Though a decision is usually made on an offer within nine months or less, the IRS must make a decision on the offer within two years of submission or else the offer is automatically accepted. These payments are also nonrefundable if the offer is rejected; however, they will be applied to the taxpayer's underlying tax liability.

Advantages of an Offer in Compromise

The Offer in Compromise program provides several benefits to a taxpayer. In the same way a bankruptcy offers a "fresh start" to debtors, the Offer in Compromise program offers a "fresh start" to taxpayers when it comes to their tax debts.

Through the Offer in Compromise Program, taxpayers can settle their tax debt for less than they owe and can ultimately obtain relief from a filed federal tax lien. Taxpayers with significant, insurmountable tax debt may encounter problems with filed federal tax liens, which negatively affects their credit. With a federal tax

lien, a taxpayer may have trouble obtaining property on credit, refinancing a home or getting approved for a mortgage modification. Additionally, the federal tax lien may affect job opportunities. By settling their tax debt through the Offer in Compromise, taxpayers can improve their credit...

Disadvantages Of An Offer In Compromise

Though the Offer in Compromise is advantageous to a taxpayer in many ways; it also has disadvantages that vary with the offer's acceptance or rejection.

If the offer is ultimately rejected, the taxpayer will lose his or her deposit, which may have been a loan from a friend, family member, or other source. Though the deposit is ultimately applied to the taxpayer's underlying tax liability, the effect of the deposit on the underlying tax liability may not be helpful if the taxpayer has an insurmountable tax debt. Also, from the time the taxpayer submits the offer, the collection statute is suspended. Once the offer is declined, the taxpayer's collection period will be extended by the time he or she was in the offer plus an additional 30 days. If an additional tax assessment is made while the taxpayer is in the Offer in Compromise, its ability to be discharged in bankruptcy will be further delayed pursuant to the bankruptcy rules, discussed later.

If the offer is ultimately accepted, the taxpayer must ensure that he or she does not accrue additional tax debt in the near future. The Offer in Compromise program has a five-year probationary period in which the taxpayer's offer may be reversed if the taxpayer fails to make proper estimated tax payments or under-withholds and cannot pay the tax debt in full by the filing date during the next five years.

BANKRUPTCY • For individual debtors overburdened by debt, bankruptcy offers an opportunity to get a "fresh start." Though Title 11 of the United State Bankruptcy Code consists of several bankruptcy chapters, Chapters 7 and 13 are most commonly used by individual debtors. In a Chapter 7 bankruptcy, the bankruptcy trustee essentially liquidates any non-exempt property to pay the individual's creditors and discharges most unsecured debt with few exceptions, such as child support, student loans, and certain taxes. In a Chapter 13 bankruptcy, the individual undergoes a financial reorganization and a plan is developed to repay all or a portion of his or her debts. Most tax debt is discharged through Chapter 7 bankruptcies.

Bankruptcy Tax Rules

In order to be eligible for a Chapter 7 consumer bankruptcy, the debtor must pass a means test showing income below median state income for the debtor's family size. Pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the means test intended to prevent high income filers from easily discharging their debts. Yet, when it comes to taxes, the rules are slightly different. Tax debt is considered to be non-consumer debt. Therefore, if the debtor has primarily tax debt that exceeds his or her consumer debt, then the debtor can file a Chapter 7 non-consumer bankruptcy, which is not subject to the means test.

The due date for filing a return was at least three years ago. The Bankruptcy Code addresses unsecured tax claims of governmental units. The rule states that income taxes associated with a return that was last due within three years of the petition filing date will be classified as priority tax claims not dischargeable in bankruptcy. Therefore, if a return was timely filed, a debtor must wait three years before the taxes can be classified as non-priority and eligible for discharge in a bankruptcy.

Limitations on the types of taxes that can be discharged in Bankruptcy.

Several types of taxes cannot be discharged in a bankruptcy regardless of when and how the return was filed. Some of these taxes include sales tax, excise tax, withheld payroll tax, and the trust fund penalty

under Code section 6672. However, excise tax, employment tax, property tax, income tax or gross receipts tax can be both priority and non-priority tax debt depending on the rules shown in 11 U.S.C. §507(a)(8)(A).

Advantages of Bankruptcy

There are several advantages to filing a bankruptcy in order to obtain relief from tax debt. First, attorney fees plus filing fees usually average between $1,500 and $3,000 for a Chapter 7 and Chapter 13 bankruptcy, and therefore, as compared to the Offer in Compromise program, in which the debtor may request a higher amount from the taxpayer, the debtor typically knows the amount the attorney will charge for the entire bankruptcy and the overall cost involved is more predictable. If a debtor is eligible for a Chapter 7 "No Asset" bankruptcy, it is very likely that there will be a complete discharge of his or her tax debt if he or she meets the bankruptcy rules. Additionally, a Chapter 7 "No Asset" debtor will most likely receive a discharge on other unsecured debts, such as medical bills and credit cards, if he or she has any.

Bankruptcy also offers federal and state exemptions for certain assets, such as cars, household furnishings, jewelry, homes, etc. As long as a debtor filing a Chapter 7 bankruptcy falls below these limitations, then he or she can discharge unsecured non-priority debts without the liquidation of any assets. Once the bankruptcy is discharged, the IRS insolvency unit will remove all dischargeable tax debt from the taxpayer's account. After this occurs, the debt cannot be reinstated and, unlike an Offer in Compromise, the debtor is not subject to a five-year probationary period, which reverses the offer if future tax debt is owed.

Disadvantages of Bankruptcy

One of the main disadvantages with a bankruptcy is that it may stay on a debtor's credit report for seven to 10 years from the petition filing date. Therefore, if a debtor is worried about his or her credit, then an Offer in Compromise would be a better option. Other disadvantages of filing for bankruptcy include the potentially forced liquidation of assets to pay off (nontax and tax) debts and the inability to discharge all tax debt.

CONCLUSION • While there are several ways to address tax debt, the Offer in Compromise program and bankruptcy offer the best options for permanently obtaining relief.