Make a Deal with the IRS

Guide 3 of 7 Tax Guides

Robert G. Nath, Tax Attorney
Concentrating in IRS and State Tax Controversy Matters

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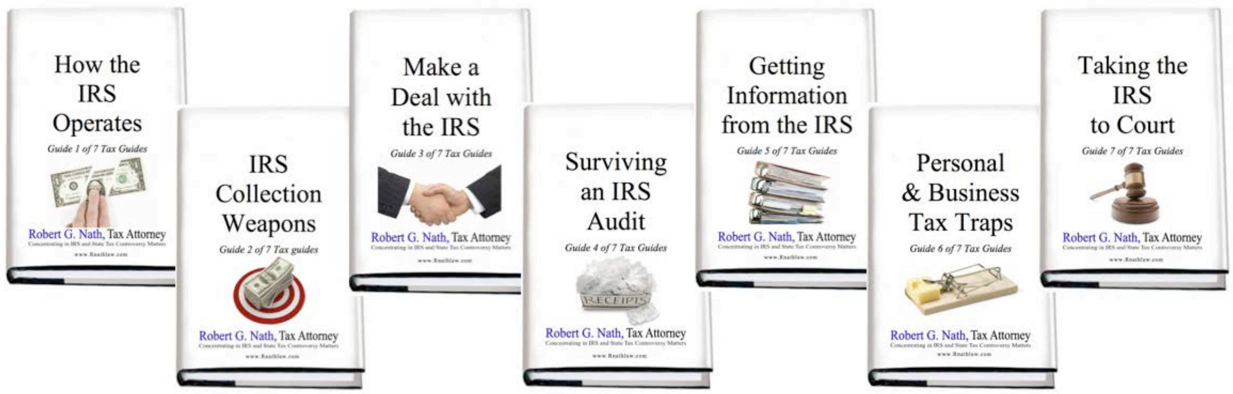

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3 of 7 Tax Guides

Written by

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"Let's Make a Deal": Offers in Compromise

Why offers are so important…What are your alternatives?...How the IRS thinks about your offer… What makes an accepted offer so helpful…The downside of making an offer…The nitty-gritty of making a processible offer than can be accepted…Appealing a rejected offer

This chapter describes probably the single most effective way anyone can nullify a big tax bill-the offer in compromise. It is no surprise that the IRS is willing to compromise back taxes. Millions of Americans owe up to $385 billion in back taxes (the estimates depend on whose numbers you use), and that's only the part the IRS knows about. The total does not include the underground economy, where billions more flow unnoticed and untaxed.

Every few years, when Congress feels like smacking the IRS around a bit, it hauls the Commissioner of Internal Revenue before one of its committees to grill him or her for not collecting the billions it has on the books. The IRS dutifully recognizes, publicly, that it will never collect all of that money, but says that it's "doing the best it can." Besides, even with increased collections, the dollars it collects this year are often replaced by fresh accounts receivable next year.

For decades, the agency has had the statutory authority to settle any tax debt for less than full payment, but the authority was seldom used. In February 1992, this offer in compromise program woke up from a deep coma and became a real, honest-to-goodness alternative for settling tax debts. In short, the IRS got serious about cleaning up its accounts receivable; it advertised a new willingness to take less than one hundred cents on the dollar. New "Fresh Start" rules in 2012 made the offer program even more attractive.

A 1998 tax law broadened the IRS' offer authority as well with a mild offer-friendly provision. Still, even today, the program is not the Filene's Basement of tax collection. The IRS' goal is to give you a fresh start by accepting an offer, but only after it has squeezed out the last dollar it can get from you now or in the near future. If that's 90 percent of what you owe, so be it. If that's 10 percent, so be it.

<u>Fun Fact</u>: That's the reality. The theory, from the IRS Manual is: "The purpose of the [offer] investigations is to determine whether the amount offered reasonably reflects collection potential." IRM 57(10(12).1.

Nationwide, the IRS received about 64 thousand offers in fiscal 2012 and accepted about 24 thousand. The average amount of accepted offers was about $8,000. The percentage of the total tax bill varies year to year, but it has been as low as 13%.

This chapter guides you on how the compromise program works and how to make a successful offer. You do not always need professional tax help such as that of a lawyer, accountant, or enrolled agent. Many taxpayers make their own offers; many are successful. But tax professionals can make the difference between success and failure, and they can often save you thousands of dollars on the amount you eventually have to pay.

How the IRS Thinks About Offers

The offer program is premised on this logic: The IRS generally has three years from the time you file a tax return to "assess" a tax and ten years to collect that assessment.

The IRS could choose to hound you for ten years-levy your bank accounts, file notices of lien, sell your property, and levy your wages-but the agency knows people can not live that way. Politically it is also unacceptable, and in any event, the IRS is just not that efficient in keeping the pressure on you all the time.

Rather than endure that slow agony (for both sides), if you can't pay the full amount in the ten years, the agency is better off taking what it can get now and forgetting the rest. In this sense, the IRS is like any other creditor with good business judgment.

When the IRS looks at your finances to evaluate how much you should offer, it focuses on two main baskets of value or payment: (1) your *current* assets and (2) your "*future income potential*" (the money you might expect to pay the IRS in the future). Logically, those two baskets of assets are all anyone has to offer. An acceptable offer must equal or exceed the total of these two sets of assets.

The IRS will also see whether the taxes can be collected from others. Examples would include the Trust Fund Recovery Penalty (See Guide 2) and assets beyond the reach of the IRS but in which the taxpayer has an interest (e.g., tenancy by the entireties property or foreign real estate).

Caution: The tenancy by the entirety rules have come under IRS attack in the past two decades. After the *Craft* case in 2002, the IRS may be authorized, legally, to sell the interest of one tenant by the entirety even if the other does not owe taxes.

Still, even if you meet these financial tests, you are not guaranteed an acceptance.

The IRS also looks at your age, health, employment history, and any other factor that might bear on whether it can collect more in the future. Is the tax liability fresh, giving the IRS up to ten years? Are you young, with potential earning capacity, even if the IRS can't exactly pinpoint your future success? Can the full amount of the tax be paid within the period of limitations (up to

10 years)? If so, your offer may be rejected even if it is acceptable on paper. But it still may be worth a try because of the big tax break you may get with an accepted offer.
Helpful Hint: On irs.gov, check out “Form 656” from the search box. That Form will include all the forms necessary to make an offer, as well as fill-in versions and thorough instructions.

- Current Assets. Current assets include everything you own except your income stream. List your current assets at current “market value” in the IRS’ Form 433-A (sometimes, Form 433-A (OIC) and 433-B (for businesses). In the offer process, you normally take a discount from current market value for “forced sale value.” The default discount is 20%. However, this is not guaranteed; for example, in real estate markets swing up and down, so you and the IRS can debate whether 20% is the correct discount for “forced sale” value.

  You must offer an amount equal to the equity in your current assets. Details will follow below, but as an example let's say Tom Taxpayer owns a car worth $10,000, with a first lien of $6,000. In theory, the IRS could seize the car, sell it, pay the $6,000 first lien and pocket the difference of $4,000 toward Tom's back taxes. But the sale would never yield $10,000. As a rule of thumb, the IRS would net only $2,000. The forced sale value of a $10,000 car might be only $8,000. After paying off the first lien of $6,000, that leaves $2,000 for Tom's taxes. So, in this example, the "equity" for offer purposes is $2,000. Similar reasoning applies to other assets, with varying discounts. Liquid assets such as bank accounts merit no discount. Extremely unsaleable assets such as household goods and furniture are subject to deeper discounts.

- Future Income Potential. The second source of equity is your future earning power. Here, the theory goes, the IRS asks hypothetically, "If Tom paid us a fixed amount of money per month, how much could we get over the remainder of the ten years we normally have to collect?" Since some tax debts have only a few years left for collection and others are fresher, the IRS uses a 12 or 24 month multiplier. Then it calculates a one-time, lump-sum payment amount that represents the present value of what it could hope to get over those 12 or 24 months.

  Example: Tom Taxpayer makes an offer to compromise a $10,000 tax bill. Looking to the future, he can afford to pay the IRS $100 per month after paying his necessary living expenses. If he paid that for five years (sixty months), he would pay $6,000. Instead of putting Tom on a payment plan for sixty months, he could offer a discounted lump sum, now, that would equate to the present value of that stream of sixty $100 payments. The new Fresh Start rules effective May, 2012 would require either $1200 or $2400 to be offered for this stream of income.

- Putting It All Together. Adding up the two baskets, the equity in Tom's car for offer purposes is $2,000. The present value of his future earning potential is $4,800. So Tom must make an offer of at least $6,800.

  Fun Fact: The likely most famous successful offer like this by the singer Willie Nelson, who offered $17 million to satisfy a $34 million tax debt, according to the Wall Street Journal.

Apply the same logic to all other assets you own, add them up, and you have your offer amount. It sounds simple, but, in the real world, there is plenty of room for maneuver, negotiation, and slippage. And, like any other smart creditor, the IRS won't always take the first offer that comes along. Remember, the agency's job is to find every dollar it can. Also, if it is prepared to give up much of its claim, it wants to be sure there is no more.

How Bankruptcy Affects Offers

You can sometimes use the bankruptcy laws to discharge some, or even all, of your back taxes. It's a complex subject; some types of taxes are dischargeable, others not. Some are dischargeable if certain time frames are met, others not. And, there are exceptions to all of the bankruptcy rules. The IRS knows that everyone has the right to file bankruptcy. You can also file an offer either before or during bankruptcy. Caution: the IRS normally does NOT consider offers while you are in bankruptcy. Several court cases have ruled against the IRS, however.

Tip: Legally, you can file for bankruptcy to discharge some taxes, then file an offer to compromise the rest. This double-whammy takes guts, but in theory the IRS should evaluate any post-bankruptcy offer on the merits.

In theory, if you are actually threatening to file a bankruptcy that would discharge taxes, the offer examiner is supposed to take that into account in negotiating the proper offer amount. In the real world, most do not. They do not take bankruptcy threats fully seriously, and if you actually file bankruptcy to discharge some or all of your taxes, they rarely care. They simply ship the case to a different office for processing of the IRS' bankruptcy claim. They rarely consider the threat of bankruptcy in making a "calculated business decision."

Moreover, as noted above, the IRS is not required to consider offers you make while in bankruptcy. The IRS has lost this issue in a couple of court cases, but still adheres to that rule. So, offers during bankruptcy are not favored.

Caution: Making an offer within 240 days after a tax was assessed extends one of the rules for discharging taxes in bankruptcy.

Look Before You Leap

Offers sound good, so what's the catch? Actually, there are at least eight "catches." Some you may be able to live with, others may be too onerous.

1. <u>Statute of limitations on collection</u>. The act of making an offer suspends the IRS' ten-year statute of limitations on collection, for the time the offer is pending (including the appeal of a rejected offer), plus 30 days. So if your offer is rejected, you've accomplished nothing but adding time to the IRS' already-long collection period. An offer is officially "pending" when the authorized IRS official signs it on page 4 of the offer form (Form 656).

2. Timing and results vary around the country. An offer can be processed in as few as sixty days or it can take as long as a year. The official IRS offer guidelines restrain this variability, however. Most offers are now worked centrally from the Holtsville or Memphis centralized OIC offices, an effort to standardize the process.

   Caution: The official IRS Manual says: "Rejection of an offer solely based on narrow asset and income evaluations should be avoided. The Service should attempt to negotiate offer agreements which are in the best interest of all parties. Included in determining the government's interests are the costs of collection." IRM 57(10(10).1. But don't hold your breath. Agents almost always follow the "guidelines" in the Internal Revenue Manual and rarely deviate from them. Exceptions are for offers that come under the "Effective Tax Administration" provisions.

   The best course is to ask the revenue officer with whom you are dealing whether an offer is possible, or likely, and whether he or she will help. If the answer is, "Forget it. Not in this century," you have your answer. The party line you will likely hear is, "Well, every taxpayer has the right to file an offer." Don't settle for that-you already know that much. Ask the Revenue Officer whether he or she really believes there is a chance to make a successful offer in your case. The question is worth a try.

   Helpful Hint: Ask the revenue officer or offer examiner whether he/she will agree to a "pre-offer review," a quick look at your preliminary financial papers to see if you're in the ballpark. If the RO agrees to review it, this can save you hours of time and much agony.

3. You've shown your cards. You must disclose your finances completely to make a successful offer in compromise, and that disclosure must be truthful. If your offer fails, look what you've voluntarily revealed: your entire financial picture. Now, agents can go out and collect to their hearts' content. So, by making an offer, you take a real chance that the IRS will use the information against you if the offer is rejected.

   Do revenue officers invite an offer just to get you to open up about your assets, then lower the boom on you? Possibly, but such cases must surely be extremely rare. Revenue officers can get all the information anyway, either by asking you directly or using their summons (subpoena) power to drag you into their office to complete an interview about your finances. So they really have no need to use the offer program as a subterfuge to discover your assets.

   Moreover, their oath, training, and personal integrity would normally dissuade them from such a course. Also, if you do not make an offer and still refuse to cooperate, a revenue officer has ways of rearranging your attitude-a wage levy here, a seizure there. These steps often make the most reluctant taxpayer suddenly eager to get the revenue officer off his back by disclosing finances and working out a deal.

4. The IRS keeps refunds and credits. If the IRS owes you a refund or you have a tax credit due from a past year, the IRS keeps these (for past years and the year the offer is accepted) as a condition to accepting any offer. So do not count on making an offer using a $5,000 refund from last year's taxes. The IRS figures it's got that money anyway; you need to offer more.

   Hint: If you anticipate a refund for the year in which you file the offer, the IRS will keep that money. Consider whether to adjust your withholding or estimated tax payments accordingly.

5. Five-year compliance. You must agree to be a model tax citizen for five years after the offer is accepted. That means filing your returns on time and paying your estimated and any other taxes on time. If you don't, the Service can revoke ("default") the offer, keep the money you've paid, and collect the rest of what you originally owed. This condition does not mean that after five years you're free to default again. The Service reasons that if you can obey the law for five years, you have a reasonable chance of remaining on track.

6. Collateral agreement. You may have to sign a "collateral agreement." This is a side agreement, not something to do with collateral on your tax debt. A collateral agreement, as part of the offer, binds you to pay more money in the future if you strike it rich. The IRS reasons that it can accept an offer for the most money it can get right now, but if your income suddenly and unexpectedly goes way up, the Service wants a piece of it. These collateral agreements are not favored, but a few offer examiners require them. When used, they usually last for five years and take only certain percentages (usually up to 45 percent) of your "net income" above your current level.

7. Bankruptcy impact. Making an offer can also disarm one of your main weapons against taxes-bankruptcy. One of the many rules for discharging taxes in bankruptcy is the requirement to file the bankruptcy petition more than 240 days after the IRS bills you. Making an offer in compromise during that 240-day period suspends that rule for the time the offer is pending, plus thirty days (and possibly longer if a hearing appeal is filed). Filing bankruptcy also suspends the IRS' period of limitations on collection for the entire bankruptcy, plus six months. If you are thinking about making an offer, it is critical to get accurate legal advice about if an when to use the bankruptcy alternative.

8. Public record. An accepted offer is a public record. That means your wife, husband, partner, local newspaper, and so on, can find it and publish it. Every once in a while you run across a newspaper feature about some prominent citizens who compromised their taxes.

9. Hard to Get an Offer Accepted. In recent years the acceptance rate has varied. Currently the offer atmosphere is more favorable, but still it's no giveaway. The IRS uses the offer guidelines strictly. Many times the "future income potential" theoretically available to you will sink a lump sum offer, though you may be able to pay over time. Moreover, a recent change in the law requires a 20% down payment for "lump sum" offers. And, if the offer is rejected, the IRS keeps the deposit! That requirement alone tanked the number of filed offers.

The Good News about Offers

So much for pessimism. There is good news, too.

1. Easy to do. The paperwork for an offer is relatively easy. You need only a few forms. These are well-designed, understandable, and easy to complete.

2. Collection suspended. When you make an offer, the IRS suspends its collection efforts (except for periodic payments you are making) while the offer is being considered. This informal policy became law in 1998. If the offer is rejected, collection does not resume right away. The IRS waits to see if you appeal the rejection, holding off while the appeal is being considered. This gives much-welcome peace of mind to many taxpayers. And, while there are some slipups, generally the IRS is as good as its word about suspending collection.

3. An accepted offer wipes out the debt. This is the best news of all. The threat of the IRS sword hanging over your head, impacting your job, your marriage, your livelihood and other important life issues, is totally relieved by an accepted offer. The debt is reduced to the offer amount, which you then pay. The IRS releases the lien and forgets about you. Moreover, the amount of an acceptable offer is sometimes quite small. Any amount justified by the required financial statements is acceptable to make.

Making a Processible and Acceptable Offer

The process is straightforward: get the forms, fill them out, pay the filing fee ($186 in 2014) mail them in, and when the IRS contacts you, answer its questions. Work with the offer examiner to see if your original offer is acceptable or what other amount might work. Try in every possible way to come to an agreement. If you can't and the offer is rejected, consider appealing the rejection. You can also withdraw an offer at any time before it is accepted or rejected.

You need at least two forms: Form 656 (Offer in Compromise) and Form 433-A (Collection Information Statement for Individuals). You can also use Form 433-A (OIC) which is specifically intended for offers, but the IRS still accepts the regular Form 433-A. If you own all or part of a business, you also need a financial statement for that business, Form 433-B. Samples of these forms are found on the IRS website.

The offer is made on Form 656 (current version: May, 2012). This is a four-page form, actually one of the easiest of all IRS forms to understand and fill out. Complete all parts that apply except for the offer amount. You will not know this until you complete your financial statements.

Section 1 requires identifying information and is self-explanatory.

In Section 2, fill in all the tax periods for which you owe (example: income taxes for 1994, 1995). This means everything-even taxes that you may owe but for which you have not yet been billed. It's in your interest to be complete anyway. The offer is a contract. If you do not list a tax debt, the IRS hasn't compromised it. It can still collect. Nor is the IRS "scared off" by how much you owe, or for what tax periods. You may be making a $10,000 offer on a $100,000 liability, but in theory, if the IRS concludes that this is all you can pay, it should not matter whether you owed $100,000 or $1,000,000. So list every tax period for which you owe or may owe taxes, assessed or not. The IRS checks its computer records anyway and will make you refile the offer if you have omitted any tax.

If you don't know exactly how much you owe, or for what periods, call the IRS at 1-800-829-1040. IRS representatives are always pleased to remind you of how much you owe. The IRS now also sends you an annual remainder of the taxes you owe.

If your case is already being handled "in the field," that is, by a living, breathing revenue officer at the local IRS office, you may be sure that she will tell you exactly what you owe. In fact, the revenue officers and other collection personnel are required to help you make your offer, if you ask.

Section 3 of the form asks whether you are offering to compromise because you can't pay the taxes (doubt as to collectibility) or because your case is one of hardship (effective tax administration). Liability offers are rare, collectibility offers common. So in almost every case, check the box marked "doubt as to collectibility." Doubt as to liability offers are made on Form 656-L. Section 3 also allows you explain your circumstances. Do not hesitate to use this space if you believe it will help your offer gain acceptance.

Section 4 is for low income individuals. If you qualify, you do not have to submit a filing fee or periodic payments while the offer is pending.

Section 5 asks how much and when you want to pay. In “Lump Sum Cash” offers, the form normally is written for payment up to 5 months after acceptance. This means that from the time you make the offer, you may have as long as one year or more to come up with the money: one to two months for the IRS to log the offer in and assign it to an agent, two to six months to negotiate the offer, another one to two months to process the acceptance, and five months to pay after acceptance.

Helpful Hint: If you can’t pay by a lump sum, ask for the 24-month “Periodic Payment” offer. This often costs more, but payments are spread over 24 months. Also, you can negotiate for other-than-even payments if the facts warrant.

If you know you'll have trouble coming up with the offer amount, start lining up resources when you make the offer. Then they are ready when it comes time to pay. The IRS wants you to pay from sources it can't otherwise access. These would include family, friends, relatives, and other lenders.

The form also allows you to designate where you want the deposits or payments applied. (Section 6) If you do not designate, the IRS will apply them in the agency’s best interest.

Section 7 requests that you identify the source of funds for the offer. This need not be very specific, but it must be real and credible. “Family loan” or “friends” or “business colleagues” would all be sufficient if true. Sometimes agents will ask you to provide proof that the money will be available.

Section 8 is the “fine print” – literally. The IRS summarizes the points, but be sure to read this carefully. Among other things, you are agreeing to give up your tax refunds for all years through the year the IRS accepts the offer.

Sections 9, 10 and 11 require signatures. The offer is officially “pending” only on the date the IRS signs its part of the form. The Service will enter your offer on its computer system, so you'll have a firm "offer made" date. That could become important when you calculate how long the collection statute of limitations has to run.

Filling Out the Collection Statement

FORM 433-A (Collection Information Statement for Wage Earners and Self-Employed Individuals) and Form 433-A (OIC).

Now comes the heart of the offer process-filling out your personal financial statement. The IRS provides two types, the “normal” form and one designed specifically for individual offers in compromise. Currently the IRS will accept either statement for the offer.

Remember that you are making this statement under the penalties of perjury. You may not lie. You may present the facts in the most favorable light-and you should not hesitate to do so. In this process, you are not likely to “get away” with hiding information even if you were inclined to do so. IRS offer examiners are very experienced and perceptive. They have seen it all. So if your facts are not favorable, you are free to explain them in your best interest.

Form 433-A

Page 1 (sections 1-2) asks for personal and employment information (lines 1 through 5). The IRS will check its computers to see whether you are current in your tax payments and filing requirements. It makes no sense to discuss your past defaults if you can't even keep current. And if you can't agree to stop the tax bleeding now, the IRS reasons, there is no point in settling the past by an offer. Inevitably, you will be back again.

Sections 3-6 are the heart of this form, the places where your offer sinks or swims. List all assets at their current market value. The IRS allows discounts from these assets for “forced sale value”; the IRS wants you to offer only the equity it could get by forcibly selling your assets.

<u>Helpful Hint</u>: In the "Give It a Try Department," note this statement from the official IRS Manual: "Asset values are generally subject to market forces and interpretation. Therefore, a flexible negotiation position should be taken when negotiating an offer." IRM 57(10(10).2. In the real world, practitioners see little of this “flexibility” on the part of offer examiners.

Section 3 asks for some information on unusual circumstances, such as whether you are party to a lawsuit, or expect money from increases in business or a trust, etc. Line 11 is especially important- it asks whether you have made asset transfers for "less than their full value." That concept includes gifts and bargain sales. The IRS wants to "undo" those transfers for offer purposes.

Section 4 deals with personal asset information. Line 12 asks for cash on hand, that is, greenbacks in your pocket.

<u>Line 13: Personal Bank Accounts</u>. This Line includes online accounts, money market accounts, and other items including mobile accounts.

This one seems easy. After all, we all spend everything we make, so, if you're a normal American, you'll have a checkbook balance of zero or close to it. But sometimes, the IRS goes by "average daily collected balance," the average amount the bank shows in your checking account. The average daily balance reflects the checks that have cleared into your account minus the checks you have written that have "cleared" (been paid). The average daily balance is usually higher than your checkbook balance. The IRS reasons that if it seized your bank account, it would get that collected balance, not your checkbook balance. So list what the IRS could get anyway-the average daily balance. The form requires you to provide the latest three months of bank statements (from all banks), from which they will figure the average daily balance.

Tip: The more homework, substantiation, backup, and analysis you do on these forms, the more credible is your offer. This also means less work for the offer examiner to perform, and increases the chances of acceptance.

<u>Line 14: Investments: Stocks, bonds, mutual funds, CDs, IRAs, Keoghs, 401(k)s</u>.

State the face amount, and any loans against the property. If the "current value" is less than face, state the current value.

<u>Example</u>: Your retirement plan has $10,000. The penalty for early withdrawal is $1,000. The federal and state taxes that will be due on withdraw total $3,000, for an overall total of $4,000. State the $10,000 but note the $4,000 of embedded expenses.

A pension or profit-sharing plan has no equity for offer purposes if you are required by your employer to contribute and you can't tap the plan until retirement. In a voluntary plan, your "equity" is the gross amount minus the employer's contributions and minus the federal and state taxes if liquidated.

<u>Securities, including stocks, bonds, mutual funds, money market funds, government securities, and others</u>. You can easily find the value of publicly traded stocks from newspapers, brokers, or on-line services. The form expects you to list and offer the net equity in those stocks, that is, their market value minus any sales fees or other charges. If the value declines substantially between the time of the offer and its acceptance, bring that to the IRS' attention and ask for a reduction in the offer amount.

Stock that is not publicly traded poses a very different and troublesome problem. Stock in a closely held corporation such as a family business normally has a limited market or no market at all. Tight rules restrict its sale; the net worth of the company may be zero or negative if you owe back taxes. Sometimes, the balance sheet will show a positive number for "retained earnings" (generally the business's accumulated profit from its start). Some offer examiners calculate the value of this stock at the amount of retained earnings multiplied by your ownership percentage.

If you own all or part of such a business, you are in any case required to complete Form 433-B (Collection Information Statement for Businesses), so the IRS can evaluate your small business from that financial statement, too.

<u>Example</u>: Wonder Widget, Inc. has been in business eight years. It made money in the first three years and lost money in the last five. At the end of the eighth year, when the offer is made, it had an accumulated profit of $100,000. Willy Wonder owns 40 percent of the stock. The IRS may require Willy to include $40,000 ($100,000 times 40 percent) in his offer for his interest in Wonder Widget. This may overstate the true forced sale value of Willie's stock.

For small business stock, the Internal Revenue Manual takes into account such factors as the net worth of the business's assets, its record of earnings, dividend policy, current financial condition, future prospects, and value as a going concern. But if you can show you have a truly minimal interest in the business, no control over its affairs, and your stock can't be liquidated, the IRS considers your stock to have no value.

Assemble 3 years of all available financial data about the closely-held corporation: tax returns, financial statements, etc. Then consider having an independent expert render an opinion on the market value of the stock. The agent may welcome this as backup for his conclusion as to the stock’s value, and it may avoid drawn-out argument.

If you own an unincorporated business (a sole proprietorship) or a partnership, list the assets elsewhere on this form (Sections 6-7).

Line 15 asks for your charge cards and lines of credit. In most cases, that's charge cards only, but if you also have an unsecured line of credit, list it here. A secured line of credit such as a home equity loan goes on line 17.

Caution: Often people have "credit available" on their charge cards. A worry is that offer examiners will ask you to borrow up to the hilt, pay that amount down on your past taxes, and then talk about an offer. Try to resist this unless it's clearly in your best interest. Instead, suggest borrowing the credit available as a down payment on the offer, rather than to reduce the tax you are trying to compromise.

Do a little trading. If the offer examiner insists that you borrow to the max, counter that the extra monthly payments you will be forced to make are an allowable expense for future income potential calculations. After all, the IRS is insisting you borrow the money, and for a clearly "necessary" expense-the back taxes. The same reasoning applies if the offer examiner requests you take out a home equity loan or other loan.

Line 16 calls for life insurance. For offer purposes, the IRS is interested only in policies with cash or loan value, not term policies.

List the loan value of each policy. For example, a $10,000 policy may have $1,000 of loan value. Include $1,000 for this asset in your offer amount. The form requires listing of policy number, owner, current cash value, and any loan balance.

Line 17 deals with real property. You must list the current market value. Depending on the state of the market, you can argue for a discount. The default discount for real estate is 20%. Note the level of discount you are seeking and your reasoning. Then list all secured debts against the property, including the date pledged and the payoff date. List the monthly payment in the appropriate column.

Be sure to include all arrearages: late fees, accrued, unpaid taxes, interest on all of these, fines, etc. Check your area’s Master Plan to see if an overriding government plan for your area or environmental regulations affect market value.

How much to offer for these real estate assets? If you have borrowed against them to the maximum, and they have no equity after you have taken the 20 percent (or more) discount, then offer nothing. But if they have equity after this analysis, something must be offered. If you own the home or rental property by yourself (not jointly with anyone else), the equity for offer purposes is simply the debt minus the (discounted) fair market value.

What if you own jointly with others? If Tom Taxpayer and his wife, Tina, own as tenants by the entirety and both owe income taxes (or other federal taxes), the equity is deemed equal to forced sale value (if discounted from market value) minus the secured debt. If only Tom owes taxes, the offer guidelines require some amount even though the IRS would have legal difficulty selling the property. Unfair? Possibly, and a violation of the spirit of the offer guidelines. After all, if the idea is to offer only what the IRS could forcibly collect, then Tom should offer zero for a home owned as tenants by the entirety where only he owes taxes. But the IRS guidelines still require something. The amount is usually 50 percent of the net equity.

<u>Example</u>: Tom and Tina's house is worth $100,000. The mortgage is $20,000. Only Tom owes taxes. Tom discounts the market value to $80,000, making the total equity for offer purposes $60,000 ($80,000 discounted value minus $20,000 debt). Of that $60,000 of potential equity, Tom must offer somewhere between $12,000 and $30,000 (20 percent and 50 percent).
The lower figure could apply if Tina paid the mortgage over many years, the higher one if Tom paid it. The default choice is 50%.

What about other properties, such as rentals? Here again, the rules allow a discount from fair market value to arrive at current market value for offer purposes. Then subtract the debt on the property. Then figure your share of the net equity, and that is the offer amount for that asset.

Usually, you don’t need a formal real estate appraisal, though a recent one may help your presentation. Try using comparables or a statement of value (in letter form) from a knowledgeable real estate agent.

Line 18 asks about your vehicles, both leased and owned. As a rule of thumb, the liquidation value of a car, truck, van, or similar asset is at least 20 percent less than fair market value.

<u>Example</u>: Tina Taxpayer owns a car worth \$10,000. For offer purposes, its current market value is \$8,000. If the car has body damage, rust, broken glass, and so on, the discount may be even deeper. If the car loan is \$3,000, Tina would have to offer \$5,000 for this car. The form also asks for the lienholder, the date the asset was pledged, and the payoff date.

Line 19 calls for "personal assets." This includes household goods, rings, jewelry, art, and anything else of value.

Section 5 continues with the critical “Monthly Income and Expense Analysis.”

<u>Monthly Income and Expense</u>. This section determines the “future income potential” (sometimes called “future income value”) portion of the offer. The IRS reasons that if you can afford to pay, say, \$100 a month after allowing for these expenses, that's \$6,000 in its pocket over five years. Instead of that dragged-out solution, it will take the present value of that stream of payments in a lump sum immediately, or slightly higher payments over longer periods of time (described in the offer, Form 656).

Helpful Hint: The “Fresh Start” rules of May, 2012, lowered substantially the future income potential calculation, as follows.

As a rule of thumb, for every \$100 of net positive income per month, you must offer to pay either \$1200 or \$2400. (The latter is for 24-month offers.) Because of this multiplier effect, this income and expense analysis scuttles many offers in compromise. So it is to your advantage to argue for every expense dollar as being "necessary" or “allowable.” What the IRS considers necessary, and what you consider necessary, can be quite different. And when the Service gets finished reducing "necessary" living expenses, many taxpayers sadly discover that they suddenly have hundreds or thousands of hypothetical "extra" dollars per month. Because of that, they never make an acceptable offer.

The 1998 tax reform act required the IRS to develop national and local "allowances," a law that codified prior practice. These are available at www.irs.gov/individuals/collection financial standards. The IRS updates them at least annually. Still, the whole idea is to be more flexible in offers and to take "facts and circumstances" of you, the individual taxpayer, into account, rather than to apply even "local" standards rigidly. One example might be a real estate agent who "needs" a high-priced car, or frequent changes of expensive suits, to impress clients and where such spending is normal in the trade. A disallowable expense would be a physician who "needs" a second home and boat in Florida to "chill out" from a grueling work schedule.

In all events, the law requires that the taxpayer’s expenses not be denied as "necessary" where that would leave him without "adequate means to provide for basic living expenses."

Basically, the left side of page 4 (Lines 20-34) asks for all sources of money, the right side (Lines 33-50) for living expenses. The difference between the two is the amount of disposable income that you could theoretically pay the IRS each month. It's that amount from which the IRS figures your future income potential.

Let's look at each item. Your expenses must meet two overall rules: (1) they must be within the IRS' guidelines, and (2) they must be necessary for health and welfare, or for the production of income.

INCOME SOURCES

Wages (spouse)	________
Wages (other spouse)	________
Interest-Dividends	________
Net Business Income	________
Net Rental Income	________
Distributions	________
Pension/Social Security	________
Child Support	________
Alimony	________
Other (rent subsidy, e.g.)	________
Other	________
Total	

NECESSARY LIVING EXPENSES

National Standard Expenses (Food, clothing, misc.)	See IRS charts
Housing and Utilities (This includes rent, mortgage (PITI) property taxes, insurance, dues, maintenance, fees, utilities such as gas, water, telephone, internet, cable)	See IRS charts
Transportation (Includes all vehicle-related costs	See IRS charts for ownership and operating costs

Public Transportation	________		
Health Insurance	________		
Out of Pocket Health Care Costs	________	(medical services, prescription drugs, etc.)	
Child/dependent care	________		
Life Insurance	________		
Current year taxes	________	(federal, state income taxes)	
Secured Debt	________		
Past Due Taxes (incl. state)	________		
Other Expenses	________		_________
			Subtotal

Court-Ordered Payments

Alimony	________	
Child Support/dependent care	________	
Other	________	________
		Subtotal

Child/Dependent Care

Elderly	________	
Invalid	________	
Handicapped	________	
Baby-sitting	________	
Day Care	________	
Nursery	________	
Preschool	________	________
		Subtotal

Other Expenses

Accounting/Legal Fees	________	
Other	________	________
		Subtotal

GRAND TOTAL _________

The first item is national standard expenses (line 35). National standard expenses are expenses for:

1. apparel and services (shoes, clothing, laundry, dry cleaning, and shoe repair)

2. food (all meals, home or away)

3. housekeeping supplies (postage, stationery, laundry and cleaning supplies, household products, cleansing and toilet tissue, paper towels and napkins, lawn and garden supplies, and miscellaneous household supplies)

4. personal care products and services (including hair care, hair cuts, oral hygiene products, shaving needs, electric personal care products and repairs of these, and similar items)

5. miscellaneous expenses

Add these up, and you have your National Standard Expenses. How much is "necessary" depends on your gross income and the number of people in your household. The IRS website shows the details. For example, a single person is allowed $583. A family of four earning is allowed $1465. Households with more than four get more of an allowance. To find the amount you qualify for, consult the chart.

These guidelines are required under the IRS Restructuring and Reform Act of 1998. These guidelines are to allow "adequate means . . . for basic living expenses" based on national and local conditions. Individual circumstances are to be used where "appropriate." Currently, the IRS uses Bureau of Labor Statistics. But in the real world, the "allowable amounts" are almost always inadequate. In the above example, the family of four would have an average of $366 per person per month. That is supposed to be enough to cover food, clothing, personal care products, and miscellaneous items.

You can usually allocate the expenses within this category without much problem. For instance, if you spend a little more on clothing and a little less on food, that is OK, as long as the totals are within the overall limit.

The second big expense is housing and utilities (line 36). This includes almost everything you would associate with housing: the rent or mortgage payment, insurance, parking, necessary maintenance and repair, homeowner or condominium dues, and utilities. Utilities means gas, electric, water, fuel, trash, and telephone, and similar items. Again, if you are within the government's limit, the amounts are usually accepted. Here, the IRS sets a local (by county), not national, limit, because these expenses vary so widely around the country.

Again, the allowable amounts are available on the IRS website. Most people find these amounts well under the real-world expenses, even for mortgage payment alone.

<u>Example</u>: Tom and Tina have a first mortgage of $1,400 per month. This is at the high end of what the IRS will allow as "necessary" in their part of the country. They took out a second mortgage for a new wing, making their total monthly payments $2,500. Then Tom incurred a separate $50,000 tax liability. Even though the second mortgage is superior to the IRS' tax claim (because it was recorded before the lien arose), the IRS will allow only $1,400 per month. This limit is enforced even though in theory the IRS would not sell the home or force the couple to move. The IRS reasons, "We may not be able to sell your home and force lower monthly mortgage payments with a smaller home, but we don't have to accept your offer, either."

The third big expense item is transportation (lines 37- 39). The standards here are a combination of national and regional: a national standard for "ownership cost" and a regional standard for "operating costs." The IRS tables list these for one and two vehicles, or for no vehicle (for a person who uses public transportation). Once again experience reveals these as inadequate to account for the average person's true expenses.

This category includes car payments (either lease or purchase), insurance, maintenance, fuel, registration fees, inspection fees, parking fees, tolls, license fees, and public transportation. But, like anything else, if you spend money on transportation that does not produce income or ensure health and welfare, the expense is not "necessary." If you have two cars, the IRS will allow costs for only one; if you are married and the spouse has a second car, the IRS will allow the expenses if within the published limits.

After these three big expense categories, the IRS does not set national or local standards, but the expense still has to be necessary for health or welfare or for the production of income, or meet other criteria described below. Otherwise, it's a "conditional" expense and not normally allowable for offer purposes.

Line 40 lists your health insurance. If your employer pays your health care insurance, you may not list this as an expense.

Line 41 lists out of pocket health care costs. This includes the deductible, co-pays, doctor and dentist visits (including psychological therapy), prescription drugs, and medical supplies (including eyeglasses and contact lenses). It also means special items such as guide dogs, and probably also includes stair climbers and other medical devices necessary for health and welfare. Non-prescription drugs (aspirin, etc.) are also included.

Next come court-ordered payments (line 42). These can certainly be necessary for the production of income, such as a judgment that a supplier has against you. They may be necessary for health and welfare, such as suit by a doctor for past fees. Court-ordered payments also include alimony and child support. It is up to you to prove that the expense meets the "necessary" test. The IRS also normally balks at allowing such payments if the court order post-dated the IRS lien.

Tip: Court-ordered payments that pre-date the IRS lien may have priority over it. If so, argue in favor of these being considered a "necessary" living expense. Such judgments may also have “priority” over the IRS lien, a point to consider when arguing for their allowability.

Child and dependent care expenses go on line 43. Day care and baby-sitting, nursery and preschool expenses can be included, but only where they meet the health and welfare or production of income tests. For instance, a mother who drops junior at day care so she can work would incur "necessary" day care or sitters' fees. But only "reasonable" amounts are allowed. The IRS knows children are costly, but it also warns that costs can vary greatly. The examiner will ask if there are alternatives to private tutors or one-on-one day care.

Line 44 lists your life insurance as a necessary expense. Only the premiums on term policies are deemed necessary (or the term component of a whole life policy). Some IRS districts restrict this to small policies only. The IRS does not publish allowable amounts for this category, so you must consult the agent and possibly negotiate.

Line 45 makes your current year taxes a necessary expense. (What a relief!) Here, the IRS has in mind your current federal, state, and local tax payments (including FICA and Medicare).

Line 46 allows for “other secured debt” as an expense. This means judgments other people have against you, or other secured debts such as secured lines of credit, or commercial liens. Once again, the debt must meet the health, welfare, or production of income tests. And, the secured position must have legal priority over the IRS claim. See Chapter 3 for a discussion of lien priority.

Line 47 - If you owe taxes to a state or local government for past periods and are paying them, these can also be "necessary," but you must work this out with the IRS. The IRS has a formula for these taxes to determine how much of your monthly payment to a state is “allowable.”

Finally, there are the "other expenses" that life always throws your way. List these on Line 48.

How about education? For your children, the IRS seems to draw the line at private schools. It's unclear whether the "extras" many people pay, even in public schools, would be included, but you can certainly argue the extras are necessary for your health and welfare.

For handicapped children, expenses would normally be allowable, but prepare to show that no public school or other public alternatives are available.

How about adults? Education expenses are "necessary" if they help your production of income. Examples would be real estate courses for real estate brokers or continuing professional education courses.

What else might the IRS allow? Accounting and Legal Fees. (Did you think the IRS would forget the struggling tax professional trying to help you out of all this?) The IRS lets you pay your tax lawyer, accountant, or enrolled agent for representing you before the IRS. But the allowable amount is negotiable; there is no published standard. Other legal or accounting fees must meet the health and welfare or production of income tests.

Tip: Try to keep good records of all your professional bills, and write down the business, health or welfare purpose of each. Most people do not keep receipts or other records of items such as health care expenses. Start keeping them the moment you know you are going to make an offer; by the time the offer is ready for consideration, three or more months may have elapsed, so you will have good current records to prove expenses.

Charitable Contributions. The IRS does not consider these necessary unless they promote your health and welfare, or that of your family, or unless they are required for your job. Items like “tithes” are normally not allowed.

Other Expenses. Do not bother calling some expenses necessary since the IRS will disallow them almost automatically. For instance, in some districts, the IRS disallows all entertainment expenses ("Go read a book."). It usually disallows college tuition payments, private school payments, and pet expenses.

Summary

The total of your equity in assets, plus the present value of your net monthly income, will dictate the amount of your offer. That's where to start and, you hope, end. To figure present value, subtract your allowable expenses from your gross income. If the result is a positive number, the default choice is to multiply by 12 or 24 to arrive at a lump sum of “future income potential.” If you are making a “periodic payment” offer, use a 24-month multiplier. See IRS Form 656 (Offer in Compromise).

Proving Your Finances

Would you like to gain instant and impressive credibility with the offer examiner? It's easy. Anticipate his or her request for proof of your financial statement, and supply it with the offer itself. Here are some guidelines on what to supply with your Form 433-A.

1. Bank statements. Last three months, for all accounts over which you have signature authority or control (business or personal).

2. Investments. Current statement, such as IRA account statement, brokerage statement, and so on.

3. Credit card debt. Last statement.

4. Insurance. Copy of the face of each policy of any kind (life, health, disability, and so on), plus statement of premium. Also include latest statement of cash value, if that applies.

5. Home. The deed, mortgage, evidence of recordation, monthly mortgage coupon, or other evidence of payment, and latest statement of equity. Also, if you have it, include a statement of the market value of the home, such as from the county land records or an appraisal.

6. Other real estate. The deed, the mortgage, and current statement of fair market value and amount owed. If you own real estate in a partnership, supply the same information.

7. Cars. Copy of title, latest statement of the amount of the lien, copy of payment coupon, copy of the "blue book" page on which your car is listed (actually, the NADA Used Car Guide has an orange cover).

8. Household goods. Make an informal list of your furniture, by room. Do not include every stick, but be sure to cover all the main items, including any valuable artwork, antiques, jewelry, etc. Make an estimate of the value of each on a market value and forced sale basis. You need not engage an appraiser or some other expert to evaluate the items unless the IRS requests.

9. Other debts. Any documentation, such as promissory notes, for other debts you owe. If your uncle loaned you $10,000 and there is no note, see if you can get the check. If not, write up a statement for the uncle to sign that demonstrates that he lent you the money, the date of that loan, and the terms of repayment.

10. Income items. The latest pay statement for you and your spouse (including year-to-date), and other evidence of income such as bank interest, brokerage statements, distributions from estates or trusts, and similar items.

11. National standard expenses. These normally do not have to be proved, unless the IRS requests. Be prepared to prove any unusual items.

12. Housing expenses. Be prepared to prove utility bills, telephone bills, repair bills, and other housing type expenses, in addition to rent or mortgage payment. Sometimes, the offer examiner will not ask for proof (beyond mortgage payments) if the amount you claim on Form 433-A is within the IRS' guidelines.

13. Transportation expenses. Aside from showing title to the cars, be prepared to prove expenses, such as lease payments, repair bills, gas, etc.

14. Court-ordered payments or secured debts. Copy of the court order, such as alimony or child support order. Supply a copy of any judgments against you, and executions on those judgments, or security instruments you gave to others. Be prepared to show cancelled checks or bank statement that show the payments.

15. Other. Provide the past year’s tax return for yourself and your spouse. Also provide a statement of health, education and work experience.

If You Own a Business – Pages 5-6 of Form 433-A

If you own a business that you operate as a partner, or corporation, complete and submit Form 433-B or 433-B (OIC) (Collection Information Statement for Businesses).

For a sole proprietor, the IRS uses Form 433-A, pages 5-6.

Lines 51-61 ask for identifying information, any payment processor, credit cards your business accepts, and other business information.

Line 62 requests information on credit cards your business uses.

Line 63 and 64 identify your cash on hand and your business bank accounts.

Line 65 calls for your accounts receivable (money you have billed but is still owed to you). Note that under the Fresh Start rules, income-producing “machinery” has no equity for offer purposes. The same logic would apply to accounts receivable and notes receivable, though that point is not explicit in the Fresh Start rules.

Line 66 requires a list of business assets, such as tools, equipment (trucks, cars, computers, machines). Be sure to include any liens such as UCC liens.

Section 7 requires a statement of your proprietorship’s income and expenses. These categories are self-explanatory. In the real world, the IRS now accepts your normal Profit and Loss and Balance sheets, generated by your in-house accounting software. However, be sure to explain any “assets” in terms of market value and liens.

Form 433-A (OIC)

The IRS developed Form 433-A (OIC) specifically for offers in compromise for "wage earners" and "self-employed individuals." You can still use the other Form 433-A, but the Form 433-A (OIC) is a shorter form, somewhat easier to fill out. It also self-guides you to an offer amount.

Section 1 – requires personal and household information, including employment information. It is somewhat more detailed than the equivalent in Form 433-A.

Section 2 – asks for business information if you are self-employed. The boxes are self-explanatory.

Section 3 – Personal Asset Information. Lines 1-5. This is a very important section in that it requires you to list all of your financial accounts. This includes checking, savings, money market, online accounts, stored value cards, investments, retirement accounts, stocks, bonds, you name it. The online version of Form 433-A (OIC) then calculates, for you, the "discount" the IRS uses (such as 20%) for some of these assets. Cash has no discount. Investment accounts merit a 20% discount (not always accurate if you have built-in gains on which tax would have to be paid). Retirement accounts have a 30% discount, again not always reflective of reality since there could be early withdrawal penalties as well as income taxes if you were to tap these accounts. The cash value of life insurance merits no discount for offer purposes. The online version of this form will calculate the offer values for you.

Section 3 – Vehicles. The form asks for make, model, purchase information, mileage, and payments (loan, lease, or monthly payment). The form assumes a 20% discount for "forced sale value."

Section 3 – Line 7. This part captures your other valuables, such as artwork or jewelry, items in safe boxes, etc.

Section 4 – This is for business information of self-employed persons. Lines 8-11 call for bank account information and business asset information. The form also asks for accounts receivable and notes receivable (that is, money owed to you by customers or clients for which you have billed).

Section 5 – This is for business income and expenses. Again this only for *business* income, not personal. The Lines 13-30 are self-explanatory. Often people use their tax return information from Schedule C for this purpose.

Section 6 – Lines 31-38. This is for your *personal* (household) income and expenses. It asks for all income starting with wages for both spouses, as well as other categories such as rental, distributions, child support, alimony and "other."

Section 6- Lines 41-53. These are for your household expenses. See discussion above regarding what is included in these "allowable" expense categories. You are required to list the actual expenses, even if they exceed the "allowable" amount.

Section 7 – This guides you to a “minimum offer amount.” One problem with this form is that your information often does not quite “fit” all the boxes and categories in the form itself. So the form may not reflect true “collection potential.” If so, be sure to file what you believe to be the correct offer amount on Form 656, the actual offer form. You are not “bound” by form 433-A (OIC) but prepare to explain why your offer amount is different.

Section 8 – This asks for other assets sources – trusts, estate, lawsuit proceeds. It also asks for assets you transferred for “less than their full value,” meaning gifts or bargain sales.

Section 9 – This is the signature block. Below that is a “check the box” list to help ensure your presentation is complete.

Offers for Other Businesses

Corporations, partnerships, and sole proprietors that owe back business taxes (this is usually payroll taxes), can also qualify for an offer. Here, the process is usually easier than with an individual who seeks to compromise income taxes. Paying is not easier, acceptance is not easier. Only making the offer is easier. The same number of forms are involved, but there is normally less debate over which expenses are "necessary."

A "C" corporation commonly owes income or employment taxes. Partnerships, limited liability companies and "S" corporations do not owe income taxes since their profits (or losses) pass through to the owners individually. But these enterprises can owe payroll taxes. Also, an unincorporated proprietor can have employees and owe payroll taxes.

Caution: The IRS can and does collect delinquent payroll taxes in part from the responsible officers (see Guide 2) as well as from the corporation. So in that case, you should expect the agent to ask for personal financial data from the officers as well as from the business.

For all these business taxes, use Form 433-B, Collection Information Statement for Businesses, or Form 433-B (OIC).

The IRS looks at the business similarly to the way it looks at an individual: What is the business's maximum ability to pay (which IRS calls “reasonable collection potential)? Businesses are different from individuals in that their assets are directly involved in the production of income and the business may not be able to borrow against or sell them. Moreover, they often need a cash flow cushion, particularly if they have seasonal ups and downs. Many times the IRS takes this into account; other times you may need to argue for it.

Sections 1 and 2 of Form 433-B asks for typical introductory information: the name, ID numbers, general employment information, owners, partners, officers, and major shareholders.

Section 3 requests “other financial information,” such as related businesses, loan information, liens, judgments, bankruptcy, other affiliated businesses, transfers of assets within last 10 years for less than full value, and anticipated increases in revenues.

Section 4 comprehensively surveys the enterprises assets and liabilities. Line 16 calls for cash and safe contents. Line 17 asks for all bank accounts. This includes payroll accounts. Line 18 requires a listing of accounts receivable. This section does not specifically have space for liens, but the column marked “Status (e.g., age, factored, other)” allows you to list the liens against the receivables. Such liens could include bank loans. You must include federal, state and local government contracts and grants.

Line 19 calls for investments. These are investments in the business’ name, not the owner’s name. Stocks, bonds, mutual funds, and other investments are examples. Line 20 requires listing of credit cards and lines of credit.

If the business owns realty, list this in line 21 with the other information required, such as the market value and the liens. Leased and owned vehicles go on line 22. Be complete. In many cases, the loans against the vehicles will exceed their value, so be sure to list these. Your business “equipment” goes on line 23, including again any loans, liens, etc. One shortcut is to print a copy of the company’s depreciation schedule, often part of the tax return, and use on of the columns to note the market value of each asset or category of assets.

Line 24 is the place to list liabilities, including notes and judgments. Do not worry if this in part repeats prior information. Pay close attention to whether the loan is “secured” and supply any requested supporting information and documentation.

Section 5, the Monthly Income/ Expense Statement for Business, is the most important part of this form. First, check “cash” or “accrual” as your accounting method. Normally the IRS wants to see these statements on a cash basis. If you are in doubt, consult your accountant.

Lines 25 through 34 require listing the gross receipts of the business from all sources. Lines 36-46 call for the expenses. The IRS usually assumes that all business expenses are "necessary." But if an expense is personal, out it goes. For example, if the company pays for your personal Cadillac, the IRS may not see that expense as "necessary." If your salary, as president, is too high, the IRS could hypothetically “reduce” it for purposes of calculating an offer amount. Be prepared to prove all of these expenses; see below. The IRS will also review your compensation to determine whether the lack of profit in the business is caused by your being overpaid.

The form also asks for a period of time covering the income and expenses. Many businesses choose one year. Others use six months. Pick a range in which income and expenses are typical, especially if you have a seasonal business. And try to choose a time period that ends within two to three months of the date you sign the statement.

The IRS often accepts your in-house Profit and Loss for purposes of Section 5.

If all of the income and expenses check out, the IRS totals them. The income minus the expenses is a net number, which the Service uses for the future income potential calculation.

Can the business afford it? Often it cannot, because of problems related to cash flow or seasonal fluctuations. You must argue these points to the offer examiner.

Form 433-B (OIC)

The IRS invented Form 433-B (OIC) to help you plan for business offers (like Form 433-A (OIC) for individuals and self-employed). You can use this form, or Form 433-B (which IRS still accepts for offers). Who uses this form? Corporations, partnerships, LLCs, including single-member LLCs.

Section 1 – Asks for business information, including all identifying information.

Section 2 – Lines 1-2. This part is for all financial accounts, including checking, savings, money market, online, stored value cards, and all types of investment accounts. Line 3 requires listing of real estate owned by the business. This includes any type of real estate, such as buildings, vacant lots, and commercial property. The form requires full information including market value. The form then discounts the FMV by 20% (plus any loans against the property) to determine the value of these assets for offer purposes.

Lines 4-5 perform the same analysis for business vehicles and other business equipment.

Section 3 (Lines 6-10) requires all business income. See above discussion on this point.

Section 4 (Lines 11-20) asks for business expenses. See above discussion for what is included here, and how best to assemble the business expenses.

Section 5 provides an offer calculation. Section 6 asks for other business information, such as bankruptcies, business affiliations, and other data.

Finally, there are the required signatures and “check the box” lists.

Proving Your Business Expenses

Be prepared to prove your business expenses, as with offers for individuals. Normally, this is easy. You have your checkbook and your canceled checks. But you consider supplying other information to the offer examiner, such as:

1. Inventory. A detailed statement of your inventories, including date of purchase and liquidation value.

2. Accounts receivable and notes receivable. Copies of these, including an aging report, may be helpful to your offer.

<u>Helpful Hint:</u> Under the May, 2012 "Fresh Start" rules, business equipment that is essential to the production of income is not counted as an "asset" for offer purposes even if it has equity. The same argument should apply to accounts and notes receivable.

3. <u>Machinery and equipment</u>. These are often obtained from your depreciation schedule. Otherwise, make a list, including date or year of purchase, description of the item, and fair market value (including the debt on any equipment).

Making the Offer

Make the offer on IRS Form 656. That form is generally self-explanatory, but read the "fine print." Among other things, those "conditions" include waiver of the period of limitations on collection, the IRS keeps refunds for all years including the year the offer is accepted, you agree to behave yourself (tax-wise) for 5 years, and other conditions.

The two payment options are (1) cash offer and (2) periodic payment. The cash offer requires a down payment of 20% of the lump sum amount. The law does not allow the IRS to return this deposit to you if the offer is rejected, but you can designate the particular tax or period to which you want this down payment applied.

A periodic offer requires the agreed sum to be paid within 24 months of the date of acceptance. This does not mean your payments are required to be equal. You can pay a lower or higher amount along the way, then the balance in the 24th month. Normally the IRS insists on equal 24 month payments, but this point is negotiable.

Appealing a Rejected Offer

You've negotiated. You've dug up and produced reams of supporting data. You've argued, cajoled, even begged. Still, the offer examiner wants $50,000, not the $10,000 you offered nor the $20,000 you could possibly pay if you robbed a bank. What happens then? You can either withdraw the offer or appeal the upcoming rejection. Tell (and write) the offer examiner that you want to appeal, and she will be more than happy to accommodate you. You'll soon receive a rejection letter that gives you sixty days to appeal. The deadline is hard and fast.

The rejection letter instructs you how to prepare a protest and where to send it.

> **<u>Very Important Hint</u>**: The IRS will usually send you a "counteroffer" before rejecting the offer you made. If you can meet the counteroffer, no problem. If not, you must negotiate more. That counteroffer, and the rejection letter, will both contain two charts: the Asset/Equity Table, and the Income/Expense Table. <u>These are critical documents</u>; they contain an item by item list of the elements of the offer. ***Focus only on those with which you and the agent differ.*** If you can make an argument that some expense should have been higher, or some asset lower, that is where you can make progress when you appeal.

A timely appeal is soon followed by a letter from the office of appeals telling you who is assigned to the case and letting you know if a conference date has been scheduled. To prepare for the appeal, assemble as much supporting data as you can, or review what you've already sent. Prepare to argue each point (or at least each point you can think of), based on the charts described above.

Often months will have elapsed between the rejection and the appeals conference. Use that time to gather more data. For example, suppose you told the offer examiner that you were about to be downsized, that is, lose your job or take a cut in pay, but he did not believe you. By the time of the appeals conference, you may be on unemployment. Or, suppose that your health insurance went up by $200 per month after the rejection. That is new evidence the appeals officer can and will consider. The worst the appeals officer can do is to sustain the rejection, so there is little downside to appealing a rejected offer. The only legal downside is that the ten-year statute of limitations on collecting your tax remains suspended. The upside is that collection may also be suspended.

Is There Life After Appeals?

If the appeals officer sustains the rejection, you are back to square one. The Collection Division regains a live account receivable it is required to try to collect. Sometimes you can then work out an installment agreement. Offer examiners will sometimes suggest that alternative in their rejection letter. But you are still back at the beginning.

On the other hand, the appeals officer could overturn the offer examiner's finding, or suggest some other figure for a compromise. If you agree, the appeals officer will write this up and send it forward for final review. Statistically, the chances of a reversal are small, but in the real world appeals officers try hard to obtain an acceptable compromise figure.

The Bankruptcy Option

What if you threaten the IRS with bankruptcy? In theory, the offer guidelines require bankruptcy to be considered and "negotiated" if some or all of your taxes can be discharged in a Chapter 7 or Chapter 11 liquidation. The official Internal Revenue Manual says: In a liquidating bankruptcy case it is "almost certain" the IRS will collect more through an offer.

Still, don’t hold your breath that the agent will keel over when the words "bankruptcy" pass your lips. In the real world, offer examiners are reluctant to take bankruptcy into consideration at all. This is unfortunate, but true. They don't take these threats seriously enough. Actually, if you file bankruptcy, offer examiners and revenue officers may be secretly relieved-it's a case off their inventory; they send it to another unit, which deals with “insolvencies.” So, do not count on a bankruptcy threat to help your offer, even though it should.

Effective Tax Administration Offers

This relatively new type of offer, and its cousin, the “special circumstances” offer, are creatures of a recent tax reform act. The Effective Tax Administration (ETA) offer assumes you can in fact pay the entire amount of the liability if all assets were called upon to do so. However, ETA then concludes that if all of your assets were liquidated or used for the offer, you would then be unable to live with adequate or minimal means. Therefore, in the interests of "effective tax administration," the IRS will take less. "Special circumstances" means you can't pay in full, but the same extenuating circumstances hold and the IRS should, in fairness, take less than what it theoretically can collect from you.

In both of these types of offers, you must prove your expenses, and then show why collection in full would leave you without the minimal means of living. This means, in many cases, a "basket case" analysis: advanced age, illness, unemployability, lack of means of living where the home or IRA or pension assets are sold. Each case is different; each is judged on the individual facts and circumstances.

The subtleties and permutations in taxpayers' offers are many and varied, as varied as people's personal and business affairs. No one chapter can address all of them, but every taxpayer who owes taxes owes it to himself or herself at least to consider making an offer to resolve-permanently-a nagging tax problem.

Summary of Good Offer Practices

1. Always consider an offer to solve your tax problems.
2. Never look at an offer in isolation – compare against the other choices; doing nothing, installment agreement, bankruptcy, full payment.
3. Be prepared – Pre-review your offer with the IRS if possible, with your tax advisor if you have one.
4. Be prepared – Assemble all your backup data and keep it up to date
5. Don't be afraid to appeal a rejected offer. Often you get a good deal.
6. Be aware that suspending the collection statute of limitations is one of several prices you pay for making an offer.

2

The Installment Agreement

Chose your poison: The types of installment agreements available to you…Your best strategy on when to apply for one…Tips on getting the best deal...Filling out the required forms… Revising the agreement…Appealing denials up the chain and in court.

A big IRS bill can be unnerving at best, paralyzing at worst. Sometimes you see it coming, like a bill following a three-year audit. Other times, the IRS bill can be a total shock, leaving you with the terrifying question – "How am I ever going to pay this?" That's what the installment agreement is for. The IRS has long had the legal authority to allow past-due taxes to be paid in installments. With one exception, the installment agreement is not a legal right you can enforce, but the Service can and does grant these agreements.

<u>Fun Fact</u>: The IRS grants several million of these installment agreements each year, covering billions of dollars.

The installment concept seems helpful on the surface; the tax bill is too big to swallow all at once, so you pay in digestible chunks. And in fact, most parts of an installment agreement are negotiable: the time period, the amount per month, the date of payment. Its biggest advantage is to allow you breathing room to pay a bill you cannot pay in full right away. But it has drawbacks, too. First, the effective "interest" rate of some installment agreements is more than 20 percent. That 20 percent combines the normal interest rate on back taxes, in recent years as high as 8-10 percent (in 2014 4%), plus a late-payment penalty of up to 12 percent a year (1 percent a month in some cases).

Tip: The 1998 tax reform act gives some relief here. It lowers the failure-to-pay penalty to half the usual rate if you enter into an installment agreement.

The magic of daily compounding (in effect since 1982) can really run up that total. So if you can possibly borrow the money to pay the IRS, even from a high interest credit card issuer, you may be even and possibly better off.

Second, the IRS usually files a Notice of Federal Tax Lien while you are paying. That notice is like a mortgage on all your property, a legal charge or encumbrance to secure the tax debt. The lien ties up almost everything you own until the debt is paid.

> <u>Helpful Hint</u>: However, sometimes you can discharge certain property from the lien. See Guide 2. The 1996 Taxpayer Bill of Rights also allows you to ask the IRS

to "withdraw" the notice of lien if you agree to installment payments. But don't hold your breath on this one: the IRS will be very reluctant to withdraw its lien, and that decision is in the agency's sole discretion.

Third, the IRS sometimes asks you "voluntarily" to extend the period of limitations on collection as the price for an installment agreement. The agent may not insist on this extension if you can pay in a relatively short time such as three years. But if your agreement stretches longer than that, especially past the ten years the IRS normally has to collect, the IRS may demand a waiver, or else no installment agreement.

Caution: Sometimes this waiver can last for five more years. That's the current legal limit. The IRS will also file a Notice of Federal Tax Lien for such long-term agreements. So if your choice from the tax collection "menu" is the installment agreement, watch out for the aftertaste.

The IRS' menu also includes the installment agreement, but it's way down on the Service's list. First on the list is always: Pay in full, and now! Sell assets if you have to. Borrow money if you can. But pay now, and in full. The IRS manual explicitly emphasizes collecting the back taxes from "available assets," a phrase that contemplates forced sales of your valuable properties. Other methods such as installment agreements are considered only if the IRS cannot collect in full, quickly. So, when you propose to pay with an installment agreement, bear in mind it is not the IRS' first choice. In fact, the default rate on installment agreements often hovers near 80 percent, sometimes higher. No wonder the agency is reluctant to grant them.

The Installment Agreement Menu

<u>There are five main types of installment agreements</u>. Ask for the one that is right for you.

The first is a regular installment agreement, nothing more or less than a monthly payment plan. Once the agreement is in place, the IRS normally sends you a payment coupon each month; you send it back with a check.

The second type is a Direct Debit Installment Agreement. Here, you give the IRS the authority to debit your bank account each month for the payment. (Don't play the bank float on this one!) The third type is the Payroll Deduction Installment Agreement, in which the money is deducted directly from your paycheck, just like current taxes.

Then there is the "streamlined" installment agreement, for balances under $25,000 (individuals) and $50,000 (businesses). Finally, there is the "name your own," The IRS established this one in 1994 for people who owed less than $10,000. In 1998, Congress made this a legal right. But you can demand this type of installment agreement only if you meet these conditions:

- The tax (not penalties, etc.) is no more than $10,000.
- You've filed all required tax returns for the past 5 years

- You've paid all the taxes on those returns
- You have no prior installment agreement for those 5 years
- The IRS finds you can't pay in full, now
- You agree to pay in full within 3 years, and
- You agree to be fully tax-compliant for the period of your installment agreement

If you qualify, use Form 9265 and put down the amount you think you can pay per month. As long as you pay within thirty-six months and the other conditions are met, the IRS automatically accepts it. Some agents use informal installment agreements, requiring a fixed monthly payment but without the formality of a written agreement.

Where to Get an Installment Agreement

If you qualify for the "name your own" agreement, all you need is Form 9265. You can find this from an on-line computer service, the IRS' website (irs.gov), a local IRS office and some libraries. Fill out the form, attach it to your tax return, and send it in. (Keep a copy!) That should be the end of the matter after you receive written confirmation from the IRS.

The more complicated agreements, involving more than $10,000 or several years of taxes, usually find their way to the IRS' service centers or the Automated Collection System (ACS). Still more complex ones are referred to revenue officers "in the field."

Here's how the process generally works at any of these levels. The IRS computers catch up with you for past taxes by sending a number of letters. You also get an annual update of your tax bill. Most people take the hint and respond to the letters. You can propose an installment agreement by return mail in this way.

> Helpful Hint: The earlier you decide an installment agreement is for you, the better off you are. Jumping on the IRS notice averts later collection notices and possibly levies. It also positions you for an offer in compromise.

At whatever level you discuss an installment agreement within the IRS, you will often be interviewed. This is known as the "TDA Interview," standing for "Taxpayer Delinquent Account." Remember that the IRS is after the most money in the shortest possible time. So the Automated Collection System representative, or the revenue officer, will demand full payment up front. For this interview, it's best to use IRS Form 433-F.

That's step one. Failing that, in step two you will be quizzed on all of your assets and liabilities. If the agent sees that you can sell something quickly, such as a stock, bond, or savings account, he or she will demand that this be done. He may also demand that you liquidate a retirement account, despite the penalty for early withdrawal and the income tax you have to pay on it. He will look for sources of borrowing-credit cards, home equity loans, family loans, you name it.

Often the agent will ask you to apply for one or two loans, and to send evidence that you have done so, even if you know you can't qualify and are sure to be rejected.

Tip: The telephone interview carries inherent pressure to settle, or to avoid levies and liens by "giving in." Try to avoid this pressure by putting your finances in writing first. Use Form 433-F. Then you are negotiating from a more solid foundation of facts.

When all "quick money" sources are exhausted, in step three the agent moves on to review your monthly income and expenses to arrive at an installment amount. An agent will ask questions in interview form to see how much you can pay. Figure on spending up to one hour on the telephone. Essentially, the agent goes through the same financial data, verbally, that she would have asked you to put in writing. This includes verifying your name, address, employment, family circumstances, where you bank, assets and liabilities, income, and expenses.

The agent first asks how much you earn from all sources, taxable or not. She then catalogs your necessary living expenses. Review Form 433-F before responding, so you are prepared when the IRS calls. Often that IRS call scares people. As a result, they underestimate their living expenses. This mistake is as costly an error as if you overestimated them. Be accurate. That accuracy depends on thinking through your expenses, item by item, category by category, in advance of the IRS' call. Later, this chapter provides a guide to this process.

At the end of the interview, the IRS adds up your "necessary" living expenses (according to its standards) and subtracts these from your pay and other income. If the result is a positive number, the agency will expect you to pay that amount or close to it.

<u>Example</u>: Tanya Taxpayer works at Enormous Securities, Inc. as a salaried stockbroker. Her gross pay is $6,000 per month. She has necessary living expenses of $1,500 for taxes, $1,000 for rent, $1,000 for food, $1,000 for child care, and $1,000 for all other items. These total $5,500, so she has $500 left. The IRS will expect Tanya to pay $500 per month. Possibly it may shave that to $450 or $400 if it's near Christmas. The agent must also decide whether to file a Notice of Federal Tax Lien. If you owe less than $5,000 generally a lien will not be filed. Between $5,000 and $10,000, a lien is not required if you use the streamlined installment agreement. In all other cases, the IRS will almost always file a Notice of Federal Tax Lien. The actual rules for lien filing are more complex, but these may be your general guides.

Tip: You can always ask the agent not to file the notice of lien. Be prepared with a good reason. Be ready to file an appeal if notice of the lien is filed. You may also request withdrawal of the notice if you enter into an installment agreement that will full-pay the tax debt.

Ignoring the Service's past-due notices is usually futile. Agents will begin calling either from the Service Center where you filed your returns or from the Automated Collection System if the case has been transferred to that function after the service center gives up. The representative goes through the same interview process described above. She enters the information on the computer screen and proposes an installment agreement based on your net monthly income. You can agree or disagree, and you can even appeal, but normally the figures will not change much.

The third way you can get an installment agreement is to delay, hide, or stall long enough to prompt "the field" into action. This means your case has merited the personal attention of a revenue officer of the Collection Division. Millions of people adopt this "head in the sand" attitude toward paying their past taxes. This only makes things worse; after all, when an ostrich sticks its head in the sand, remember which part of its anatomy is likely to be kicked.

Revenue officers have the same menu as the other collectors. They call, visit, or otherwise find you. They are out to get the taxes, so they also demand full payment, up front. But they, too, recognize that you may not be able to pay in full right away. Certainly they will ask you to borrow from lines of credit or credit cards, refinance assets, or liquidate assets, before an installment agreement can be granted. In other words, they will try to get the most money in the shortest time and save the installment agreement for any balance.

Tip: The 1998 tax reform act made IRS collectors subject to The Fair Debt Collection Practices Act: no harassing calls, no threats, no calls at odd hours, no calls to workplace if that's not allowed, etc.

Finally, you also ask for an installment agreement simply by walking into your local IRS office. The same interview process will occur, and often you get quick, one-stop service in this way. If you negotiate with the Automated Collection System representative, you can often obtain a short-term payment of sixty days or less. It's often in your best interest to look around everywhere for those dollars, because interest and penalties mount up very quickly.

Tips on Negotiating the Agreement

- Tip Number 1: Know your finances; don't guess. The IRS agent, at whatever level, will usually try to keep you on the phone (or in an interview) to get as much personal and financial information as she can on the first contact. If you are nervous or unsure about information, say so: you do not know, you need to verify, or you are unsure. Don't guess, and don't try to please the agent by stabbing at a number you think the agent might want to hear. Most people know what they pay for rent or mortgage, but few know the figure for transportation, food, or medicine without looking at bills and receipts. Official policy allows this breathing room if you ask for it. In fact, it is perfectly acceptable to tell the agent (if true), "Please let me know all the categories of expense you want me to research. I will call you back with the exact figures, which I can't recall now." Then be certain you call back on or before the next deadline. Otherwise, the IRS will feel free to collect, such as by levying your wages, filing a Notice of Federal Tax Lien, or seizing other assets. Try to ask for a date far enough ahead that you know for sure you can have all the information. This leads us to …

- Tip Number 2: Meet all deadlines. If you cannot, call the agent back anyway ***before*** the deadline and say you cannot meet the deadline. Then set another one. If your account is in ACS, you'll get a different agent each time you call, but all have access to the same computer screen and data bank. Each agent notes what you say every time you call. So the first agent notes that you promised to call back on November 1. The second agent sees that deadline, and checks whether you met it.

- Tip Number 3: Appeal. Let's say that at the end of the interview the agent proposes $1,000 per month, a figure you just can't meet. You can afford only $200. You don't have to accept $1,000, at least not right away. You can appeal. Tell the agent you want to appeal to her supervisor. Ask details about the appeals process is and how long it takes. In the meantime, show good faith by sending in what you think you can afford. Often such appeals take several weeks. In the meantime, you have generated a track record of paying what you think you can afford. This good-faith pattern can work in your favor when you try to negotiate a lower number.

- Tip Number 4: If you decide to borrow money against an asset, get credit for the repayment amounts. Borrowing means your monthly expenses go up, which should reduce your installment agreement. After all, you are borrowing for a “necessary” expense: the payment of federal taxes.

  Example: You owe $15,000 in taxes. At the IRS' request, you borrow $10,000 against your home, leaving $5,000 for the installment agreement. The IRS wants you to pay $500 per month, but because of your new home equity loan, you can pay only $250. The IRS should give you credit for that new loan payment as an additional "necessary" living expense, and ask for only $250 per month. The same reasoning should apply if you borrow on your credit cards, even though the credit card debt is not "secured" as a home loan would be.

- Tip Number 5: Stay current. The agent always looks at your compliance and tax history before granting you an installment agreement. If you have defaulted once or more in the past, if you are behind on your current taxes, if your expenses have recently increased without justification or explanation, she may be reluctant to let you pay over time.

- Tip Number 6: Ask for lien withdrawal. Ask the IRS to withdraw any Notice of Federal Tax Lien it has filed against you. Since the agency will be reluctant to do this, you need to have a solid, business or personal reason for asking for the withdrawal. This withdrawal must be considered a long shot, but may be worth a try. If the IRS agrees to the withdrawal, you may also write the agency, asking it to notify your credit reporting agencies and banks and other creditors of the withdrawal of the notice.

- Tip Number 7: Request nonfiling of Notice of Federal Tax Lien. If you believe the filing of a notice of lien will hurt your credit, or otherwise damage your finances, you can always request that it not be filed. The IRS has wide discretion here. But even in cases in which the lien appears "mandatory," it doesn't hurt to make the argument.

  Helpful Hint: You can always appeal to the Office of Taxpayer Advocate if the agent says that the lien notice must be filed. See Guide 3. Note that even if the notice of lien is filed, the law allows the lien to be withdrawn if you enter into an installment agreement. This is not a right, but it certainly rises to the level of a strong congressional suggestion.

Filling Out the Collection Information Statement

The heart of the installment agreement is the Collection Information Statement, Form 433-A for individuals, 433-B for businesses. Often agents now use the short form, Form 433-F.

Computer geeks: You can get all of these forms (and many others) on interactive format from a number of vendors. The IRS website, irs.gov, also contains fill-in forms.

Completing these forms is relatively easy as IRS forms go, but heed the old expression, "The devil is in the details." Remember also that you sign both forms under the penalties of perjury.

Let's start with…

FORM 433-A (Collection Information Statement for Wage Earners and Self-Employed Individuals)

Now comes the heart of the process-filling out your personal financial statement. Remember that you are making this statement under the penalties of perjury. You may not lie. You may present the facts in the most favorable light-and you should not hesitate to do so. In this process, you are not likely to "get away" with hiding information even if you were inclined to do so. IRS examiners are very experienced and perceptive. They have seen it all. So if your facts are not favorable, you are free to explain them in your best interest.

Form 433-A

Page 1 (sections 1-2) asks for personal and employment information (lines 1 through 5). The IRS will check its computers to see whether you are current in your tax payments and filing requirements. It makes no sense to discuss your past defaults if you can't even keep current. And if you can't agree to stop the tax bleeding now, the IRS reasons, there is no point in granting an installment agreement. Inevitably, you will be back again.

Sections 3-6 are the heart of this form. List all assets at their current market value. The IRS allows discounts from these assets for "forced sale value"; the IRS may ask you to sell assets, but only if there is equity.

> Helpful Hint: In the "Give It a Try Department," note this statement from the official IRS Manual: "Asset values are generally subject to market forces and interpretation. Therefore, a flexible negotiation position should be taken when negotiating an offer." IRM 57(10(10).2. In the real world, practitioners see little of this "flexibility" on the part of offer examiners.

Section 3 asks for some information on unusual circumstances, such as whether you are party to a lawsuit, or expect money from increases in business or a trust, etc. Line 11 is especially important- it asks whether you have made asset transfers for "less than their full value." That concept includes gifts and bargain sales.

Section 4 deals with personal asset information. Line 12 asks for cash on hand, that is, greenbacks in your pocket.

Line 13: Personal Bank Accounts. This Line includes online accounts, money market accounts, and other items including mobile accounts.

This one seems easy. After all, we all spend everything we make, so, if you're a normal American, you'll have a checkbook balance of zero or close to it. But sometimes, the IRS goes by "average daily collected balance," the average amount the bank shows in your checking account. The average daily balance reflects the checks that have cleared into your account minus the checks you have written that have "cleared" (been paid). The average daily balance is usually higher than your checkbook balance. The IRS reasons that if it seized your bank account, it would get that collected balance, not your checkbook balance. So list what the IRS could get anyway-the average daily balance. The form requires you to provide the latest three months of bank statements (from all banks), from which they will figure the average daily balance.

Tip: The more homework, substantiation, backup, and analysis you do on these forms, the more credible is your offer. This also means less work for the offer examiner to perform, and increases the chances of acceptance.

Line 14: Investments: Stocks, bonds, mutual funds, CDs, IRAs, Keoghs, 401(k)s.

State the face amount, and any loans against the property. If the "current value" is less than face, state the current value.

Example: Your retirement plan has $10,000. The penalty for early withdrawal is $1,000. The federal and state taxes that will be due on withdraw total $3,000, for an overall total of $4,000. State the $10,000 but note the $4,000 of embedded expenses.

A pension or profit-sharing plan has no equity for offer purposes if you are required by your employer to contribute and you can't tap the plan until retirement. In a voluntary plan, your "equity" is the gross amount minus the employer's contributions and minus the federal and state taxes if liquidated.

Securities, including stocks, bonds, mutual funds, money market funds, government securities, and others. You can easily find the value of publicly traded stocks from newspapers, brokers, or on-line services. The form expects you to list and offer the net equity in those stocks, that is, their market value minus any sales fees or other charges. If the value declines substantially, bring that to the IRS' attention and ask for a reduction in the amount the IRS is asking for.

Stock that is not publicly traded poses a very different and troublesome problem. Stock in a closely held corporation such as a family business normally has a limited market or no market at all. Tight rules usually restrict its sale; the net worth of the company may be zero or negative if you owe back taxes. Sometimes, the balance sheet will show a positive number for "retained earnings" (generally the business's accumulated profit from its start). Some examiners calculate the value of this stock at the amount of retained earnings multiplied by your ownership percentage. In the real world, if your closely held stock is not marketable, ask the IRS to value it at zero.

If you own all or part of such a business, you are in any case required to complete Form 433-B (Collection Information Statement for Businesses), so the IRS can evaluate your small business from that financial statement, too.

For small business stock, the Internal Revenue Manual takes into account such factors as the net worth of the business's assets, its record of earnings, dividend policy, current financial condition, future prospects, and value as a going concern. But if you can show you have a truly minimal interest in the business, no control over its affairs, and your stock can't be liquidated, the IRS considers your stock to have no value.

Assemble 3 years of all available financial data about the closely-held corporation: tax returns, financial statements, etc. Then consider having an independent expert render an opinion on the market value of the stock. The agent may welcome this as backup for his conclusion as to the stock's value, and it may avoid drawn-out argument.

If you own an unincorporated business (a sole proprietorship) or a partnership, list the assets elsewhere on this form (Sections 6-7).

Line 15 asks for your charge cards and lines of credit. In most cases, that's charge cards only, but if you also have an unsecured line of credit, list it here. A secured line of credit such as a home equity loan goes on line 17.

Caution: Often people have "credit available" on their charge cards. A worry is that offer examiners will ask you to borrow up to the hilt, pay that amount down on your past taxes, and then talk about the rest. Try to resist this unless it's clearly in your best interest. Instead, suggest borrowing the credit available as a down payment.

Do a little trading. If the offer examiner insists that you borrow to the max, counter that the extra monthly payments you will be forced to make are an allowable expense for future income potential calculations. After all, the IRS is insisting you borrow the money, and for a clearly "necessary" expense-the back taxes. The same reasoning applies if the examiner requests you take out a home equity loan or other loan.

Line 16 calls for life insurance. For offer purposes, the IRS is interested only in policies with cash or loan value, not term policies.

List the loan value of each policy. For example, a $10,000 policy may have $1,000 of loan value. Include $1,000 for this asset in your offer amount. The form requires listing of policy number, owner, current cash value, and any loan balance.

Line 17 deals with real property. You must list the current market value. Depending on the state of the market, you can argue for a discount. The default discount for real estate is 20%. Note the level of discount you are seeking and your reasoning. Then list all secured debts against the property, including the date pledged and the payoff date. List the monthly payment in the appropriate column.

Be sure to include all arrearages: late fees, accrued, unpaid taxes, interest on all of these, fines, etc. Check your area's Master Plan to see if an overriding government plan for your area or environmental regulations affect market value.

What about other properties, such as rentals? Here again, the rules allow a discount from fair market value to arrive at current market value. Then subtract the debt on the property. Rentals which generate positive income are required to be listed. If the real estate is cash-flow negative, list that too, but the agent may suggest a sale to "free up" more money for IRS.

Line 18 asks about your vehicles, both leased and owned. As a rule of thumb, the liquidation value of a car, truck, van, or similar asset is at least 20 percent less than fair market value.

Line 19 calls for "personal assets." This includes household goods, rings, jewelry, art, and anything else of value.

Section 5 continues with the critical "Monthly Income and Expense Analysis."

<u>Monthly Income and Expense</u>. This section determines the "future income potential" (sometimes called "future income value"). **This is by far the most important section of this form for installment agreement purposes,** since the "net" theoretically available to you is what the IRS may demand per month. The IRS reasons that if you can afford to pay, say, $100 a month after allowing for these expenses, that's $6,000 in its pocket over five years.

The 1998 tax reform act required the IRS to develop national and local "allowances," a law that codified prior practice. These are available at **www.irs.gov/individuals/collection financial standards.** The IRS updates them at least annually. Still, the whole idea is to be somewhat flexible and to take "facts and circumstances" of you, the individual taxpayer, into account, rather than to apply even "local" standards rigidly. One example might be a real estate agent who "needs" a high-priced car, or frequent changes of expensive suits, to impress clients and where such spending is normal in the trade. A disallowable expense would be a physician who "needs" a second home and boat in Florida to "chill out" from a grueling work schedule.

In all events, the law requires that the taxpayer's expenses not be denied as "necessary" where that would leave him without "adequate means to provide for basic living expenses."

Basically, the left side of page 4 (Lines 20-34) asks for all sources of money, the right side (Lines 33-50) for living expenses. The difference between the two is the amount of disposable income that you could theoretically pay the IRS each month. It's that amount from which the IRS figures your installment agreement amount.

Let's look at each item. Your expenses must meet two overall rules: (1) they must be within the IRS' guidelines, and (2) they must be necessary for health and welfare, or for the production of income.

INCOME SOURCES

Wages (spouse)	________
Wages (other spouse)	________
Interest-Dividends	________
Net Business Income	________
Net Rental Income	________
Distributions	________
Pension/Social Security	________
Child Support	________
Alimony	________
Other (rent subsidy, e.g.)	________
Other	________
Total	

NECESSARY LIVING EXPENSES

National Standard Expenses (Food, clothing, misc.)	See IRS charts
Housing and Utilities (This includes rent, mortgage (PITI) property taxes, insurance, dues, maintenance, fees, utilities such as gas, water, telephone, internet, cable)	See IRS charts
Transportation (Includes all vehicle-related costs	See IRS charts for ownership and operating costs

Public Transportation	________		
Health Insurance	________		
Out of Pocket Health Care Costs	________	(medical services, prescription drugs, etc.)	
Child/dependent care	________		
Life Insurance	________		
Current year taxes	________	(federal, state income taxes)	
Secured Debt	________		
Past Due Taxes (incl. state)	________		
Other Expenses	________		________
			Subtotal

Court-Ordered Payments

Alimony	________	
Child Support/dependent care	________	
Other	________	________
		Subtotal

Child/Dependent Care

Elderly	________	
Invalid	________	
Handicapped	________	
Baby-sitting	________	
Day Care	________	
Nursery	________	
Preschool	________	________
		Subtotal

Other Expenses

Accounting/Legal Fees	________	
Other	________	________
		Subtotal

GRAND TOTAL _________

The first item is national standard expenses (line 35). National standard expenses are expenses for:

- apparel and services (shoes, clothing, laundry, dry cleaning, and shoe repair)
- food (all meals, home or away)
- housekeeping supplies (postage, stationery, laundry and cleaning supplies, household products, cleansing and toilet tissue, paper towels and napkins, lawn and garden supplies, and miscellaneous household supplies)
- personal care products and services (including hair care, hair cuts, oral hygiene products, shaving needs, electric personal care products and repairs of these, and similar items)
- miscellaneous expenses

Add these up, and you have your National Standard Expenses. How much is "necessary" depends on your gross income and the number of people in your household. The IRS website shows the details. For example, a single person is allowed $583. A family of four earning is allowed $1465. Households with more than four get more of an allowance. To find the amount you qualify for, consult the chart.

These guidelines are required under the IRS Restructuring and Reform Act of 1998. These guidelines are to allow "adequate means . . . for basic living expenses" based on national and local conditions. Individual circumstances are to be used where "appropriate." Currently, the IRS uses Bureau of Labor Statistics. But in the real world, the “allowable amounts” are almost always inadequate. In the above example, the family of four would have an average of $366 per person per month. That is supposed to be enough to cover food, clothing, personal care products, and miscellaneous items.

You can usually allocate the expenses within this category without much problem. For instance, if you spend a little more on clothing and a little less on food, that is OK, as long as the totals are within the overall limit.

The second big expense is housing and utilities (line 36). This includes almost everything you would associate with housing: the rent or mortgage payment, insurance, parking, necessary maintenance and repair, homeowner or condominium dues, and utilities. Utilities means gas, electric, water, fuel, trash, and telephone, and similar items. Again, if you are within the government's limit, the amounts are usually accepted. Here, the IRS sets a local (by county), not national, limit, because these expenses vary so widely around the country.

Again, the allowable amounts are available on the IRS website. Most people find these amounts well under the real-world expenses, even for mortgage payment alone.

> Example: Tom and Tina have a first mortgage of $1,400 per month. This is at the high end of what the IRS will allow as "necessary" in their part of the country. They took out a second mortgage for a new wing, making their total monthly payments $2,500. Then Tom incurred a separate $50,000 tax liability. Even though the second mortgage is superior to the IRS' tax claim (because it was recorded before the lien arose), the IRS will allow only $1,400 per month. This limit is enforced even though in theory the IRS would not sell the home or force the couple to move. The IRS reasons, "We may not be able to sell your home and force lower monthly mortgage payments with a smaller home, but we don't have to accept your offer, either."

The third big expense item is transportation (lines 37- 39). The standards here are a combination of national and regional: a national standard for “ownership cost” and a regional standard for “operating costs.” The IRS tables list these for one and two vehicles, or for no vehicle (for a person who uses public transportation). Once again experience reveals these as inadequate to account for the average person’s true expenses.

This category includes car payments (either lease or purchase), insurance, maintenance, fuel, registration fees, inspection fees, parking fees, tolls, license fees, and public transportation. But, like anything else, if you spend money on transportation that does not produce income or ensure health and welfare, the expense is not "necessary." If you have two cars, the IRS will allow costs for only one; if you are married and the spouse has a second car, the IRS will allow the expenses if within the published limits.

After these three big expense categories, the IRS does not set national or local standards, but the expense still has to be necessary for health or welfare or for the production of income, or meet other criteria described below. Otherwise, it's a "conditional" expense and not normally allowable for installment agreement purposes.

Line 40 lists your health insurance. If your employer pays your health care insurance, you may not list this as an expense.

Line 41 lists out of pocket health care costs. This includes the deductible, co-pays, doctor and dentist visits (including psychological therapy), prescription drugs, and medical supplies (including eyeglasses and contact lenses). It also means special items such as guide dogs, and probably also includes stair climbers and other medical devices necessary for health and welfare. Non-prescription drugs (aspirin, etc.) are also included.

Next come court-ordered payments (line 42). These can certainly be necessary for the production of income, such as a judgment that a supplier has against you. They may be necessary for health and welfare, such as suit by a doctor for past fees. Court-ordered payments also include alimony and child support. It is up to you to prove that the expense meets the "necessary" test. The IRS also often balks at allowing such payments if the court order post-dated the IRS lien.

Tip: Court-ordered payments that pre-date the IRS lien may have priority over it. If so, argue in favor of these being considered a "necessary" living expense. Such judgments may also have "priority" over the IRS lien, a point to consider when arguing for their allowability.

Child and dependent care expenses go on line 43. Day care and baby-sitting, nursery and preschool expenses can be included, but only where they meet the health and welfare or production of income tests. For instance, a mother who drops junior at day care so she can work would incur "necessary" day care or sitters' fees. But only "reasonable" amounts are allowed. The IRS knows children are costly, but it also warns that costs can vary greatly. The examiner will ask if there are alternatives to private tutors or one-on-one day care.

Line 44 lists your life insurance as a necessary expense. Only the premiums on term policies are deemed necessary (or the term component of a whole life policy). Some IRS districts restrict this to small policies only. The IRS does not publish allowable amounts for this category, so you must consult the agent and possibly negotiate.

Line 45 makes your current year taxes a necessary expense. (What a relief!) Here, the IRS has in mind your **current-year** federal, state, and local tax payments (including FICA and Medicare).

Line 46 allows for "secured debt" as an expense. This means judgments other people have against you, or other secured debts such as secured lines of credit, or commercial liens. Once again, the debt must meet the health, welfare, or production of income tests. And, the secured position must have legal priority over the IRS claim. See Guide 2 for a discussion of lien priority.

Line 47 - If you owe taxes to a state or local government for past periods and are paying them, these can also be "necessary," but you must work this out with the IRS. The IRS has a formula for these taxes to determine how much of your monthly payment to a state is "allowable."

Finally, there are the "other expenses" that life always throws your way. List these on Line 48.

How about education? For your children, the IRS seems to draw the line at private schools. It's unclear whether the "extras" many people pay, even in public schools, would be included, but you can certainly argue the extras are necessary for your health and welfare.

For handicapped children, expenses would normally be allowable, but prepare to show that no public school or other public alternatives are available.

How about adults? Education expenses are "necessary" if they help your production of income. Examples would be real estate courses for real estate brokers or continuing professional education courses.

What else might the IRS allow? Accounting and Legal Fees. (Did you think the IRS would forget the struggling tax professional trying to help you out of all this?) The IRS lets you pay your tax lawyer, accountant, or enrolled agent for representing you before the IRS. But the allowable amount is negotiable; there is no published standard. Other legal or accounting fees must meet the health and welfare or production of income tests.

Tip: Try to keep good records of all your professional bills, and write down the business, health or welfare purpose of each. Most people do not keep receipts or other records of items such as health care expenses. Start keeping them the moment you know you are going to make an offer; by the time the offer is ready for consideration, three or more months may have elapsed, so you will have good current records to prove expenses.

Charitable Contributions. The IRS does not consider these necessary unless they promote your health and welfare, or that of your family, or unless they are required for your job. Items like “tithes” are normally not allowed.

Other Expenses. Do not bother calling some expenses necessary since the IRS will disallow them almost automatically. For instance, in some districts, the IRS disallows all entertainment expenses ("Go read a book."). It usually disallows college tuition payments, private school payments, and pet expenses.

Proving Your Finances

Would you like to gain instant and impressive credibility with the examiner? It's easy. Anticipate his or her request for proof of your financial statement, and supply it with the offer itself. Here are some guidelines on what to supply with your Form 433-A.

16. <u>Bank statements</u>. Last three months, for all accounts over which you have signature authority or control (business or personal).

17. <u>Investments</u>. Current statement, such as IRA account statement, brokerage statement, and so on.

18. <u>Credit card debt</u>. Last statement.

19. Insurance. Copy of the face of each policy of any kind (life, health, disability, and so on), plus statement of premium. Also include latest statement of cash value, if that applies.

20. Home. The deed, mortgage, evidence of recordation, monthly mortgage coupon, or other evidence of payment, and latest statement of equity. Also, if you have it, include a statement of the market value of the home, such as from the county land records or an appraisal.

21. Other real estate. The deed, the mortgage, and current statement of fair market value and amount owed. If you own real estate in a partnership, supply the same information.

22. Cars. Copy of title, latest statement of the amount of the lien, copy of payment coupon, copy of the "blue book" page on which your car is listed (actually, the NADA Used Car Guide has an orange cover).

23. Household goods. Make an informal list of your furniture, by room. Do not include every stick, but be sure to cover all the main items, including any valuable artwork, antiques, jewelry, etc. Make an estimate of the value of each on a market value and forced sale basis. You need not engage an appraiser or some other expert to evaluate the items unless the IRS requests.

24. Other debts. Any documentation, such as promissory notes, for other debts you owe. If your uncle loaned you $10,000 and there is no note, see if you can get the check. If not, write up a statement for the uncle to sign that demonstrates that he lent you the money, the date of that loan, and the terms of repayment.

25. Income items. The latest pay statement for you and your spouse (including year-to-date), and other evidence of income such as bank interest, brokerage statements, distributions from estates or trusts, and similar items.

26. National standard expenses. These normally do not have to be proved, unless the IRS requests. Be prepared to prove any unusual items.

27. Housing expenses. Prepare to prove utility bills, telephone bills, repair bills, and other housing type expenses, in addition to rent or mortgage payment. Sometimes, the examiner will not ask for proof (beyond mortgage payments) if the amount you claim on Form 433-A is within the IRS' guidelines.

28. Transportation expenses. Aside from showing title to the cars, be prepared to prove expenses, such as lease payments, repair bills, gas, etc.

29. Court-ordered payments or secured debts. Copy of the court order, such as alimony or child support order. Supply a copy of any judgments against you, and executions on those judgments, or security instruments you gave to others. Be prepared to show cancelled checks or bank statement that show the payments.

<u>Other</u>. Have available your past year's tax return for yourself and your spouse, and also provide a statement of health, education and work experience.

If You Own a Business – Pages 5-6 of Form 433-A

If you own a business that you operate as a partner, or corporation, complete and submit Form 433-B

For a sole proprietor, the IRS uses Form 433-A, pages 5-6.

Lines 51-61 ask for identifying information, any payment processor, credit cards your business accepts, and other business information.

Line 62 requests information on credit cards your business uses.

Line 63 and 64 identify your cash on hand and your business bank accounts.

Line 65 calls for your accounts receivable (money you have billed but is still owed to you). Note that under the Fresh Start rules, income-producing "machinery" has no equity for offer purposes. The same logic would apply to accounts receivable and notes receivable, though that point is not explicit in the Fresh Start rules.

Line 66 requires a list of business assets, such as tools, equipment (trucks, cars, computers, machines). Be sure to include any liens such as UCC liens.

Section 7 requires a statement of your proprietorship's income and expenses. These categories are self-explanatory. In the real world, the IRS now accepts your normal Profit and Loss and Balance sheets, generated by your in-house accounting software. However, be sure to explain any "assets" in terms of market value and liens.

Make Your Financial Statement The "Quick and Easy" One – Form 433-F

Form 433-F is a simplified financial statement that is routinely used by the Service Centers and other IRS personnel. It is available at irs.gov and may be filled out on line and saved. Let's review the details.

The first part calls for identifying information. Then, Box A asks for your accounts and lines of credit. This includes banks, S&Ls, brokerage accounts and retirement accounts. Use a continuation sheet if necessary.

Box B requests a listing of your real estate, including the value, equity, and monthly payment.

Next, in Box C, come "other assets," including boats, RVs, etc. Again the liens are requested on these. Finally, in Box D come the credit cards.

Box E requests “business information,” that is, for your business if you are not a wage earner. Minimal information is all the form requests. Box F asks for employment information (for wage earners).

Box G requires non-wage household income. This includes alimony, child support, net self-employment income, and other types of income. The IRS is aiming here to review **all** of your income sources.

Box H requires you to state “monthly necessary living expenses.” See above discussions for what is considered “necessary.” Complete lines 1-5 as best you can, claiming all other expenses as the form requests. The form directs you to an irs.gov reference for information on the IRS’ “allowable” standards.

Finally, sign and date the form. If you fill in this form in advance of any discussion with IRS personnel, you will always be better prepared and therefore better off in the end.

Revising the Installment Agreement

What if circumstances change? What if you default? If your income goes down or necessary expenses increase, call and write the IRS immediately. Ask for a lower installment agreement. Send whatever information the agent requests. If your income goes up or your expenses decline, you are not legally required to let the IRS know you can pay more. But you may want to. Paying more sometimes makes sense because of the high penalty and interest charges that accrue on your tax bill. In any event, the IRS has the right to review your agreement periodically, and often does.

What if your amount will **never** pay the tax in full (within the statute of limitations)? The IRS may ask for a waiver. Such waivers are not routine but are available. If the agent fails to request one, the unpaid tax debt will simply expire. The normal period of limitation on *collection* of a tax bill is 10 years.

The worst course is to default. In fact, most installment agreements (up to 80%) default, with dire consequences. A default opens the door to full collection by the IRS, with its levy and seizure powers. True enough, you may reinstate a defaulted installment agreement at least once without much problem, but probably not more often than once. You get a small break on these defaults, courtesy of the 1996 Taxpayer Bill of Rights. The IRS must give you thirty days' warning before terminating or changing your installment agreement. The agency routinely did this even before the new law. In fact, the default notice invites you to reinstate the agreement.

If Only One Spouse Owes Taxes

It's quite common for only one of two spouses to owe taxes. If both list their income on Form 433-A as the IRS requires, it looks like the IRS is collecting from the spouse who does not owe taxes by making one earner pay part of the other's tax bill. Still, the Service requires listing total household income and expenses. The only exception occurs where you and your spouse handle and track expenses separately, such as where spouse live apart. Note that fact on Form 433-A and separate your income and expenses as best you can.

Helpful Hint: If your tax bill results from an audit increase, one spouse may be eligible for the “innocent spouse” relief called “separate liability election.” See Guide 6.

Installment Agreements for Businesses

Corporations, partnerships, and sole proprietors that owe back taxes (usually employment taxes) can also qualify for an installment agreement. The process is usually much simpler than with an individual. Paying is not easier, only the process. The same number of forms must be completed, but there is less debate over which expenses are "necessary."

A "C" corporation can owe income or payroll taxes. Partnerships and "S" corporations normally have no income taxes since their profits pass through to the owners individually. But they can owe payroll taxes, as can an unincorporated proprietor. All these businesses must complete Form 433-B, the Collection Information Statement for Businesses. The IRS looks at the business the same way it looks at an individual: what is the business' maximum ability to pay? But businesses in tax trouble are different from individuals in that they cannot always or easily sell assets to pay back taxes and still operate. Borrowing against business assets may also be hard. Moreover, a business often needs a cash flow cushion, especially when it has seasonal ups and downs. Many times, the IRS takes this into account; other times, you must argue long and hard for it.

Also, the Service often pressures a business by investigating the officers and directors for their personal liability for payroll taxes. As a corporate officer, you may feel somewhat more motivated to find those past-due payroll taxes if the Service is reaching for your personal wallet at the same time.

Let’s Look at…

Form 433-B

The IRS looks at the business similarly to the way it looks at an individual: What is the business's maximum ability to pay (which IRS calls “reasonable collection potential)? Businesses are different from individuals in that their assets are directly involved in the production of income and the business may not be able to borrow against or sell them. Moreover, they often need a cash flow cushion, particularly if they have seasonal ups and downs. Many times the IRS takes this into account; other times you may need to argue for it.

Sections 1 and 2 of Form 433-B asks for typical introductory information: the name, ID numbers, general employment information, owners, partners, officers, and major shareholders.

Section 3 requests “other financial information,” such as related businesses, loan information, liens, judgments, bankruptcy, other affiliated businesses, transfers of assets within last 10 years for less than full value, and anticipated increases in revenues.

Section 4 comprehensively surveys the enterprises assets and liabilities. Line 16 calls for cash and safe contents. Line 17 asks for all bank accounts. This includes payroll accounts. Line 18 requires a listing of accounts receivable. This section does not specifically have space for liens, but the column marked “Status (e.g., age, factored, other)” allows you to list the liens against the receivables. Such liens could include bank loans. You must include federal, state and local government contracts and grants.

Line 19 calls for investments. These are investments in the business’ name, not the owner’s name. Stocks, bonds, mutual funds, and other investments are examples. Line 20 requires listing of credit cards and lines of credit.

If the business owns realty, list this in line 21 with the other information required, such as the market value and the liens. Leased and owned vehicles go on line 22. Be complete. In many cases, the loans against the vehicles will exceed their value, so be sure to list these. Your business “equipment” goes on line 23, including again any loans, liens, etc. One shortcut is to print a copy of the company’s depreciation schedule, often part of the tax return, and use on of the columns to note the market value of each asset or category of assets.

Line 24 is the place to list liabilities, including notes and judgments. Do not worry if this in part repeats prior information. Pay close attention to whether the loan is “secured” and supply any requested supporting information and documentation.

Section 5, the Monthly Income/ Expense Statement for Business, is **the most important part of this form**. First, check “cash” or “accrual” as your accounting method. Normally the IRS wants to see these statements on a cash basis. If you are in doubt, consult your accountant.

Lines 25 through 34 require listing the gross receipts of the business from all sources. Lines 36-46 call for the expenses. The IRS usually assumes that all business expenses are "necessary." But if an expense is personal, out it goes. For example, if the company pays for your personal Cadillac, the IRS may not see that expense as "necessary." If your salary, as president, is too high, the IRS could hypothetically “reduce” it for purposes of calculating an installment payment amount. Be prepared to prove all of these expenses; see below. The IRS will also review your compensation to determine whether the lack of profit in the business is caused by your being overpaid.

The form also asks for a period of time covering the income and expenses. Many businesses choose one year. Others use six months. Pick a range in which income and expenses are typical, especially if you have a seasonal business. And try to choose a time period that ends within two to three months of the date you sign the statement.

The IRS often accepts your in-house Profit and Loss for purposes of Section 5. Cash basis P&L is best.

If all of the income and expenses check out, the IRS totals them. The income minus the expenses is a net number, which the Service uses for the future income potential calculation.

Can the business afford it? Often it cannot, because of problems related to cash flow or seasonal fluctuations. You must argue these points to the offer examiner.

Rules of the Road

Installment agreements can be like slow medieval torture, or they can be a real blessing. It depends on your particular circumstances, the total to be paid, and the amount of the monthly payment. The big advantage of such an agreement is the peace and quiet it gives you. You know exactly how much you will have to pay, and when. As long as you comply, the IRS will leave you alone. That itself is worth a lot in terms of daily living and mental stability. But whether you want an installment agreement or the IRS forces you into one, remember these rules:

1. Be prompt. Don't miss deadlines. If you run up against a deadline, call and write the IRS in advance to request an extension. Give the IRS the data it wants on time.

2. Be truthful. You are signing these financial statements under the penalties of perjury. You can go to jail for a willfully false statement. You'll rarely get away with falsehoods anyway, since the IRS knows all the tricks. Be sure your data are complete.

3. Don't take no for an answer. Don't let one agent pressure you into an agreement you can't fulfill. Consider an appeal, or signing on for a short time, then appealing or asking for a reduced payment.

4. Request courtesy and respect. And give the same to the agents you deal with. Try not to be intimidated by threats that the agency will immediately start collection if you don't agree to the number it wants.

5. Be patient. These agreements can take weeks or months to negotiate, and years to pay.

6. Prepare for tax lien filing. If you owe more than $5,000 or you will take more than four months to pay in full, the IRS will likely file a Notice of Federal Tax Lien. Be prepared for this. If it will cause hardship, tell the agent why and ask for a delay. Under the 1996 Taxpayer Bill of Rights, you may request that the agent withdraw the notice of lien in exchange for an in-place installment agreement. It's not mandatory; but give it a try.

7. Always look carefully at installment agreements as a way of paying your tax debt in full or in part.

8. Work through the alternatives: doing nothing, offer in compromise, part payment followed by installment agreement, bankruptcy.

9. Be sure you know the statute of limitations effect of any choice you make; it can change with each choice.

10. Be accurate with your expenses when negotiating an installment agreement.

11. It’s usually in your best interest to get the lowest possible monthly payment to avoid default. You can always "voluntarily" pay more.

12. Don’t hesitate to appeal an unfavorable decision on your installment agreement request.

3

The Bankruptcy Alternative

Myths, Lies and Truths about Taxes in Bankruptcy…
How a Bankruptcy Case Works…Discharging Your Taxes Through Chapter 7…
Managing Your Tax Debt in chapters 11 and 13

Can bankruptcy solve your tax problem? Maybe. But there are more myths, errors, and misconceptions about managing taxes through bankruptcy than there are politicians making election-year promises to lower your taxes. Bankruptcy is so detailed and complex a subject that it cannot be fully treated in one chapter or even one book. Bankruptcy is not for the fainthearted or the uncounseled. You need an experienced bankruptcy lawyer to advise you whether, when, and how to file a bankruptcy petition. From this chapter you may learn only whether it makes sense to think about bankruptcy to handle all or part of your taxes. If so, the next step would be to see a bankruptcy lawyer.

Fun Fact: More than one million personal bankruptcies are filed each year; the IRS has a tax claim in about one-third.

With this caution, let's start by looking at the most common myths or misconceptions about taxes in bankruptcy.

Bankruptcy Fiction and Fable

The first misconception centers on the bankruptcy "discharge," the technical term for legal relief of a debt through bankruptcy. Most normal debts are "dischargeable" by the simple act of filing a petition under Chapter 7, the liquidation chapter of the Bankruptcy Code. (Some child support, student loans and other debts may not be dischargeable.)

The first tax myth is: "Taxes aren't normal debts. You can never discharge a tax in bankruptcy." In fact, taxpayers discharge millions of dollars of taxes in bankruptcy every year.

Myth #2: "I can always discharge my taxes in bankruptcy-just file and forget." This is another misconception. The technical, detailed bankruptcy rules relating to taxes are monuments to poor writing and confusing syntax. Yes, some types of taxes are in fact dischargeable; others never are. Even if a tax may possibly qualify for discharge, the timing and detail can derail you.

Myth #3 is often stated like this: "If I file for bankruptcy, I'll lose everything." True enough, some bankruptcies require you (or a trustee) to sell your assets, but other types of bankruptcies assume precisely the reverse: they anticipate you will not sell at all, but will rehabilitate yourself by negotiating your way out of burdensome debt, including tax debt. And many a person considering bankruptcy has thought: "If I file for bankruptcy, the IRS will get everything, including my home and pension." Not so. In fact, in many cases, the IRS gets very little on its tax claim. Sometimes you can even save a pension or a home in the aftermath of a bankruptcy.

These are just some of the common misconceptions that surround taxes in bankruptcy. The good news is this: Bankruptcy is a powerful, effective instrument you can often use to manage an otherwise impossible tax collection problem. It always stops the IRS in its tracks for at least some period of time, giving you much needed breathing room.

It sometimes stops the IRS completely and forever. The bad news is: You won't always be able to discharge your taxes. Bankruptcy also can trigger other financial problems, and a bankruptcy on your credit record is like a scarlet letter “B” you wear for years.

Caution: While the IRS can’t seize assets after you file for bankruptcy (and while the case is pending), they can still audit a return, send a deficiency notice, or file a notice of lien.

How Bankruptcies Work

Individuals and businesses normally file one of three types of bankruptcies: Chapter 7, Chapter 11, or Chapter 13. In a Chapter 7 case, you throw in the towel: it's a liquidation. A court-appointed trustee takes title to your assets, sells them, and pays your creditors with the proceeds. So you're cleaned out; but in return, you get a fresh start from your debts, paid or not. At least, that's what Chapter 7 is supposed to do. It doesn't always work out that way, especially for taxes.

Chapter 11 and Chapter 13 are the converse of Chapter 7. They are not liquidations; they are rehabilitations, or "reorganizations" in the language of the Bankruptcy Code. Both of these chapters presume that you intend to continue on in business (whether as a corporation, partnership, proprietor, or wage earner – Chapter 11), or personally (Chapter 13), that you want to compromise some of your debts and stretch out others, but that you intend to pay something on your debts without liquidating all of your assets.

When you file a petition in bankruptcy, no matter which chapter you use, by law the mere act of filing puts an immediate, automatic stop to all your creditors' collection efforts (the “automatic stay”). That includes everyone from the phone company to credit card companies to the IRS. From the instant you file, the IRS and other creditors are forbidden from seizing assets and taking most other creditor-type actions. They know this rule and obey it in most cases.

Caution: But you have to let them know you have filed! The best way is a phone call to 1-800-829-1040. You can also alert the local IRS collection office, or the Office of

Technical Services. Your bankruptcy lawyer should do this in all cases (by mail or electronically).

Special rules allow the IRS to perform a few tax-related actions even after a bankruptcy filing. For instance, it may mail a Notice of Tax Deficiency (see Guide 7), investigate some claims, and conduct some audits. But if you are really afraid for your assets and you fear the IRS is about to lower the boom, any bankruptcy filing will stop collection, at least for the pendency of the case. This "automatic stay" of creditors' attempts to collect is the strongest weapon you have as a taxpayer. In fact, it's usually the only legal weapon you have the power to exercise. In other cases, when the IRS forbears from collecting against you, it's because the agency chose to forbear-its decision, not yours. So, filing for bankruptcy calls a big "time out" to the creditor versus debtor contest. You have breathing room, time to think, time to plan. For taxes, you also need to plan before you file because the timing of bankruptcy as an instrument to handle your tax problem is absolutely critical.

Discharging Taxes in Bankruptcy

Only a few types of taxes are dischargeable at all (if you meet certain rules), but two are big ones: federal and state income taxes. Also dischargeable are gross receipts taxes and certain excise taxes. Some taxes are never dischargeable: employment taxes, Trust Fund Recovery Penalty taxes (see Guide 2), and others. To discharge a federal or state income tax, you must meet certain strict rules.

First, the bankruptcy petition must be filed more than three years after the due date of the tax return involved. For example, if you filed your return on April 15, 2012 (for 2011), you must file bankruptcy petition April 16, 2015, or later. If you went on extension to file, measure the three years from the extended date. That doesn't mean the date you actually filed, but the true extended date.

<u>Example</u>: In one court case, a taxpayer extended his filing date to October 15, 1990 (for 1989), and filed his bankruptcy petition October 10, 1993, five days too soon. He missed the three-year rule and could not get a discharge.

The second rule is: If your return was filed late, file the bankruptcy petition more than two years after you actually filed your return. Again, this rule is ironclad: either you meet it or you don't. If you are planning for this rule, it's usually wise to find out from the IRS when it **received** your return so you don't get into a dispute as to when you actually filed.

Third, file the bankruptcy petition more than 240 days after the IRS' assessment of the taxes you want to discharge.

<u>Example</u>: Nina Nopay filed her 2012 tax return on April 15, 2013. She owed $10,000 on the return, which the IRS assessed against her on April 17, 2013. Nina must wait until December 16, 2013 (the 241st day after the assessment), to file her petition. Now, let's say she files on December 16 but the IRS audits her return on December 18, 2003, and finds she owes another $5,000. Nina's discharge won't extend to the new $5,000 bill.

Caution: Watch out for offers in compromise. If you filed one, this 240-day time period is suspended while the offer is being considered, plus thirty days.

Fourth, you cannot have evaded your taxes. That means you can't have filed a fraudulent return or evaded the payment of the taxes.

Fifth, you cannot discharge a tax that is "still assessable" when you file. For example, if your return is under examination and the IRS proposes more taxes, those taxes can't be discharged (the Nina Nopay example above). But the taxes you reported on the return are dischargeable if you meet the other rules described above. Penalties and interest can also be dischargeable, though not always. A good rule of thumb is: A late-filing, late-payment, or negligence penalty (the most common penalties the IRS imposes) is dischargeable if the underlying tax is dischargeable. Even if this is not the case, the penalty is dischargeable if it relates to conduct that is more than three years old.

<u>Example</u>: In 1990, Thaddeus Thumbnose committed civil tax fraud by failing to include $100,000 in gross income on his tax return. He filed the return promptly on April 15, 1991. The IRS caught him in 1993 and assessed $30,000 in tax and a $22,500 civil fraud penalty (75 percent). Thaddeus filed for Chapter 7 (liquidating bankruptcy) on April 16, 1994. The taxes were not dischargeable because of the tax fraud, but the fraud penalty was dischargeable because Thaddeus committed the fraud more than three years before he filed his bankruptcy petition.

Getting the Discharge from Taxes

Here's how it works. Let's say you have satisfied all the rules and have carefully planned for your Chapter 7 liquidating bankruptcy. You then file your Chapter 7 petition. A "bankruptcy estate" springs into being automatically when you file the petition. It's an artificial entity, something like a trust in which you might put assets. In a Chapter 7 case, by law everything you own (with a few exceptions) automatically becomes part of this bankruptcy estate. The assets are not yours anymore. They belong to the estate.

A trustee is assigned to handle your case. The trustee's job is to sell any assets that might raise cash, distribute these to your unsecured creditors, and close the estate. The trustee may decide that some assets can't be sold for cash, or would not yield enough after paying off the prebankruptcy liens. The trustee will “abandon” such assets back to you. The trustee might also abandon a home if it has no equity. (All states also have a homestead exemption that varies in amount.)

What about the taxes? The IRS is often at or near the top of the food chain in bankruptcies. In such cases, the IRS may get paid first, or it might be paid after other, prior secured creditors. But if there's not enough to go around, the unpaid taxes are discharged by law IF they meet the time periods described above. If the IRS has filed a notice of lien, you still get the discharge of taxes, but the lien remains attached to the assets that went into your bankruptcy estate. Usually, the bankruptcy court will not specifically rule that your taxes (or any debt) have been discharged. It

will simply grant a "general discharge," a one-page document. That document is your legal "fresh start" as to any debt that was legally dischargeable, including taxes.
The IRS then decides, on its own, whether your particular taxes have in fact been discharged. The IRS office that handles bankruptcy cases is the Insolvency Unit in your locality. When you file your case, this office gets the case file and looks over the assessments, the due dates of the returns, the liens on file, and the rules described above. If you meet all the rules, in almost every case the agent will note the file for discharge and close it. You will never hear from them again. Your account in the IRS computers will be adjusted to "zero" tax for each tax year involved.

Sometimes the IRS determines that your taxes are not dischargeable, or the computer makes a mistake and continues to try to collect against you. Then you have to convince the agency that it made a computer mistake (if that is what it was), or that your taxes were in fact legally discharged. If worst comes to worst, you can always reopen your bankruptcy and ask the bankruptcy court to declare formally that your taxes have been discharged.

How Chapter 11 and Chapter 13 Work

Since these are not liquidations but rehabilitations, you handle taxes a little differently. In both types of cases, you propose a "plan of reorganization." This is a written plan that tells the court how much you intend to pay all of your creditors. As with any type of bankruptcy, in Chapters 11 and 13 you file your petition and make a complete statement of assets and liabilities. Then, you propose a plan to pay your debts.

In such a plan, some debts are more "equal" than others. At the top of the heap in any bankruptcy are secured creditors. These are creditors who have a valid, perfected lien against one or more of your assets. An example is the bank that loaned you money for your home mortgage. Another might be a receivables financier for a business. The IRS becomes a secured creditor in a bankruptcy whenever it files a Notice of Federal Tax Lien. As Guide 2 explains, that Notice of Federal Tax Lien ties up all your property and rights to property, wherever located. As against real estate, the lien is valid if it is filed in the place required by state law, usually the county land records. When it is filed, all the equity in your property is tied up by this federal tax lien.

If the agency has not filed a notice of lien, the taxes are “unsecured.” They may be "priority" taxes or "general unsecured" taxes, depending on how old they are and whether they met the discharge rules described earlier in this chapter. Priority taxes must also be paid in full according to the plan, unless the IRS compromises them. General unsecured taxes have the same low standing as any other unsecured debt. You must propose a plan that will pay as much or more as would be received if the case were a Chapter 7 liquidation.

Chapter 13 plans are intended for wage earners and other persons with periodic income. Basically, you propose a plan to pay your priority taxes (and other debts) over 3-5 years according to the rules of the Bankruptcy Code. Once you are finished with your plan payments, that's it. You receive a discharge from all the debts that are “provided for” in the plan. In most cases, the tax debts are all "provided for," because the IRS has filed a proof of claim in your case. But that's not universally true. Sometimes it fails to file a proof of claim, often losing its claim because of this failure.

Chapter 13 plans are specifically geared toward paying your debts out of future income. Moreover, you can be flexible in designing a Chapter 13 plan (or Chapter 11 plan). Payments must start "as soon as practicable" after confirmation of the plan, but nothing in the code says they have to be equal. So, debtors have designed plans that deferred some debts for a while, and paid others that were in arrears. The most common example is a mortgage in arrears. Even tax debts can be deferred until later years this way. The IRS doesn't like it, and it often opposes these postponements, arguing that it should be paid equally and evenly along with everyone else. But the courts are sometimes lenient about approving Chapter 13 plans that defer some types of creditors, including the IRS.

The 2005 Bankruptcy Changes

In 2005 Congress passed a massive reorganization of the bankruptcy laws. The most important part of this is the so called "means testing" procedure. The basic idea is that if you have sufficient "means" to pay some of your debts over time, that should be done, rather than simply walking away from them in a straight Chapter 7 discharge. So debtors who earn enough will be forced into Chapter 13 plans more often.

The means testing provisions apply in cases of "primarily consumer debt." Normally that means more "consumer debt" than non-consumer debt. Consumer debt includes principally credit card debt. Taxes have been ruled not to be "consumer debt." Therefore, if taxes are the majority of your debts, you will probably NOT have to endure means testing and you can likely take advantage of the older rules in obtaining you discharge.

If you do have to endure the "means testing" procedures, the Bankruptcy Code now says this means testing starts with the IRS' already-published financial standards as the testing standard. Then the Bankruptcy Code goes on to make numerous exceptions to the IRS standards.

Installment Agreement Defaults

What if things don't work out, and you lose your job or suffer other "hardship" during the five years you had proposed in your confirmed plan? You can apply for a hardship discharge. The result? You get your discharge even though you have not paid for the full three to five years.

The bankruptcy laws can be important tools in other respects as well. Let's say you dispute a tax, such as an income tax or even the Trust Fund Recovery Penalty. The bankruptcy courts have wide discretion to try many types of tax cases. You don't have to go to Tax Court or federal district court if you think you can do as well or better in bankruptcy court. Traditionally, bankruptcy courts are pro-debtor, though you should not count on any particular bias in your favor from the bankruptcy judge simply because you have come to him or her for help. Still, the bankruptcy courts are open and available to adjudicate your tax disputes in most cases.

Chapter 13 plans are simpler than those in Chapter 11, and less expensive as well. They have other advantages over Chapters 7 and 11 that your bankruptcy attorney can review with you.

Putting These Concepts into Practice

Always seek professional help when planning for a bankruptcy. A bankruptcy attorney, especially one familiar with the tax rules, should plan your bankruptcy, file it, and advise you as it goes along. Preplanning is absolutely essential: the casebooks are littered with the financial corpses of people who thought they were getting a fresh start from their taxes by filing bankruptcy, only to awake the next day to tax liens and levies. But if you plan it well, a bankruptcy can be a satisfactory solution to your tax problems, either through discharge or reorganization.

Summary of Hints

1. Use Chapter 7 to discharge income taxes, Chapter 11 or 13 to pay them over time.

2. Be aware of the opportunities bankruptcies can afford to manage your tax debts.

3. Never file for bankruptcy without full evaluation of the effects on your taxes, your other debts and your credits.

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The Taxpayer Advocate Program and the Taxpayer Bill of Rights

Count'em – Four Taxpayer Bills of Rights… What's Useful – and What's Not…
The New "Superman" of Taxes – The National Taxpayer Advocate

If you have developed a headache from reading how one-sided the balance of power is between you and the IRS, you are not alone. In fact, in an agency with so much legal power, it's almost inevitable that there will be bureaucratic slip-ups, red-tape snafus, abuses of power, some merely negligent, others occasionally deliberate.

The last decade has seen the mantle of secrecy lifted from the IRS, and also from the occasional abuses, intended or not, that inevitably accompany the exercise of the IRS' wide and deep authority. The result has been numerous administrative changes and four "Taxpayer Bills of Rights," though they go by various names. There likely will be more. The thrust of all of these statutes, and all of the administrative changes, has been to give you, the taxpayer, a true ally within the IRS and to set clear, mandated, enforceable standards by which the agency must operate. This chapter will guide you through these helpful ways of dealing with the IRS when all else seems to fail.

"Help!!" – The Taxpayer Advocate Service ("TAS")

About twenty-five years ago, the Swedish word "ombudsman" came into popular usage. This ombudsman had a license to seek out and destroy bureaucratic red tape, snafus and other incomprehensible messes wherever they existed in government agencies. Many private corporations now use ombudsmen, too. The federal and state governments have them aplenty.

The IRS has had an ombudsman for 30 years. It was even in the name-the Office of Ombudsman, changed in 1996 to the Office of Taxpayer Advocate and now, the Taxpayer Advocate Service (TAS). The National Ombudsman had charge of thirty-three sub offices, one in each of the IRS' districts around the country. A list is available on the IRS website, irs.gov. The local office of the Taxpayer Advocate exists for one purpose: to untangle the mess you are in because some part of the IRS has shut the steel trap of bureaucracy on you. TAS' job description actually includes taking your side over the IRS' when the bureaucracy overwhelms you. If that means the IRS will get less money, so be it.

Fun Fact: The 1998 tax reform act changed the name to the Office of Taxpayer Advocate. The name change was deliberate, and part of a massive effort to make the IRS more answerable, or at least more user friendly. In fiscal 2012 the Taxpayer Advocate Service received over 219,000 requests for assistance.

Are You in Collection Trouble? File "911"

When you truly have the IRS blues, when collection officers threaten your business, when you just can't pay but the revenue officer insists on it despite the hardship it will create, the Taxpayer Advocate can come to the rescue. TAS has wide authority to intervene and stop all collection action when you file an Application for a Taxpayer Assistance Order.

The Taxpayer Assistance Order came into the law in 1988 as part of the Taxpayer Bill of Rights. At first it was not widely used. In fiscal 2012 only 322 actual Taxpayer Assistance Orders were granted out of 219,000 requests made. However, the Taxpayer Advocate reported that about 178,000 were granted some type of relief, even if not an actual TAO. In short, it's a big and useful club. The halt is usually short, but it gives you a chance to work things out with the Collection Division.

Disturbing Fact: In fiscal 2012, of the 219,000 requests for assistance, over 54,000 involved identity theft, three times the next category.

Caution: An Application for a Taxpayer Assistance Order has only one drawback. It suspends the period of limitations on collection for the time the application is pending. Usually that suspension is very short, and well worth it, especially if you get the relief you want.

Relief from a too-harsh tax collector is spelled "Form 911." Yes, it is true; they actually have Form 911, intentionally so numbered, for situations of "significant hardship" in the collection of taxes. In Form 911 you tell the IRS what hardship the collection officer is causing or threatening, and the relief you want. Under the 1998 changes, the law authorizes TAS to intervene when it determines you are about to suffer or are suffering a significant hardship as a result of the manner in which the Internal Revenue laws are being administered. For this purpose, the law defines "significant hardship" to include:

1. An immediate threat of adverse action
2. A delay of more than 30 days in resolving taxpayer account problems
3. The incurring by the taxpayer of significant costs if relief is not granted (including professional fees) or
4. Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted.

In your application for a TAO, you must invoke one or more of these standards. Show exactly how the threat of adverse action is immediate, or why you will have irreparable injury, or other negative effects by a levy or a threatened seizure. In the real world, the TAS is very reluctant to intervene, but the remedy is available and often you can use this legal right to effect some accommodation with the Collection Division.

The Application for a Taxpayer Assistance Order is a legal remedy you can invoke, reserved for true collection emergencies where you've tried your best through the normal channels.

Example: Roger and Rosetta have been married for twenty-five years. For the last three years, Roger has been clinically depressed, in and out of hospitals, on and off medications. He also has terminal cancer. As a result, he did not file tax returns for those three years. The IRS filed substitute returns for each year and assessed the taxes. Then it levied on the couple's bank account for a much larger amount than they actually owed. They needed time while another branch of the service considered their request for abatement of tax and penalty. They filed Form 911, claiming undue hardship. TAS released the levy. But it also ensured that Roger and Rosetta filed tax returns of their own.

Example: Your restaurant is behind on payroll taxes for six months. It's now summer, the slow season. You know you can catch up in the fall, but cash is even tighter now than usual. The revenue officer demands immediate payment and threatens to close your business or seize your bank accounts. Suppliers may get wind of this. Customers may flee, and the whole enterprise may come crashing down. You file Form 911, asking for a delay of three months on collection of the back taxes while you stay current on present taxes. The TAS has the authority to grant your request over the opposition of the Collection Division.

Example: You owe $10,000 in back taxes on last year's return. The Automated Collection System representative calls you. She is abusive and threatening. She demands you stay on the phone, even after you ask for a time-out to consult a professional. She demands information from you upon penalty of immediate collection. After you hang up, you are nervous and shaky. You file Form 911. The TAS should again intervene to help get you courteous treatment and a reasonable time to respond.

The "hardship" the TAS looks for in this type of case must be "significant," a standard that leaves room for discretion. Often this means they won't intervene just because you are upset at the revenue officer-her job is to get the money, not to make you feel good. But the revenue officer crosses the line in such areas as depriving you of necessary living expenses (for example, rent, utilities, groceries, and other necessities). Hardship may be “undue” if she threatens to file a Notice of Federal Tax Lien, if that would unnecessarily ruin your credit, cause a default on loans, or force a bankruptcy, all without giving you a fair chance to pay. The revenue officer also could cross the hardship line by threatening to levy your business or personal accounts, depriving you of the necessary cash flow to continue, when you could easily pay in large installments.

The TAS officer will also look at every category of necessary living expense to determine whether the collection action threatens those necessities. This would include food, clothing, housing, medical supplies, utilities, even education. She will take notice if the collection action will threaten your job or business, if the action is imminent, even if you become "so overwhelmed" or overcome by the pressure from the revenue officer that you begin crying. In theory, she is not supposed to "blame" you if you are the one whose intransigence or fault caused the problem. In practice, TAS officers are human beings; they take that into account.

How to File 911

You can get the form from any local IRS office, download it from the IRS' address at irs.gov on the Internet, or obtain a copy from many libraries. You can even call the local IRS office, whose representative will send or fax you a copy. Form 911 also can be "filed" by telephone.

Before you file Form 911, you are required to exhaust at least one level of review. So if the revenue officer was nasty to you or threatened to levy your business accounts, appeal to her immediate boss, the Group Manager. Usually, this is a waste of time; the boss will nearly always back her revenue officer. All of this takes time, but it can be done by phone. Take notes on all the calls you make. If hours count, call the Group Manager directly, or ask the revenue officer if she has pre-cleared the levy, lien, or other seizure action with her group manager (as the 1998 law newly requires). If so, you have "exhausted" your appeal responsibilities, and you can now go to the TAS. If the Group Manager is absent, ask for the Acting Group Manager. If that person is unavailable, immediately call the Office of Taxpayer Advocate and explain that the internal appeal was futile because everyone was absent or unavailable. That is usually enough to give jurisdiction. They will see you have tried to work it out, but the bureaucracy stood in the way.

Once the TAS representative will listen, the next step is to call, mail, or fax your Application for Taxpayer Assistance Order to the Office of Taxpayer Advocate.

Most of the form is self-explanatory. Your job is to complete page one only. The most critical sections are blocks 12a and 12b, though all parts must be completed. Block 12a asks what the problem is. Be clear, concise, and detailed. State facts, not opinions. Tell what the revenue officer did or threatened to do. Start with a summary paragraph, such as, "The revenue officer is threatening to levy on my retirement account when I need this money for the care of my elderly parents, who are otherwise without support." Then start a new paragraph. Begin at the beginning and tell what happened. Your story need not be more than one typewritten page, though many good applications are longer. Spare no detail, but do not ramble. This is not the place to state your candid opinion of the revenue officer or to editorialize about the tax system. Just state what she did or is threatening that you believe to be unduly harsh.

Block 12b is equally critical. Tell the Taxpayer Advocate what relief you want. Do you want the Collection Division to stop collection forever? For a time? Do you want the revenue officer to release or withdraw a lien? To release a levy?

Under the 1998 Tax Act, a Taxpayer Assistance Order may require the IRS to release property that has been levied upon or to cease any action, or refrain from taking any action, relating to collection, bankruptcy, discovery of liability, or any other provision of law that the Office of Taxpayer Advocate may describe. This wide-ranging authority is greater than you could get from a court, since courts are not permitted to enjoin the IRS from doing its job.

Tip: However, the TAS officers typically have a more narrow view of their authority. They look for cases of “significant hardship” usually involving necessities of living.

Do not be concerned about legalisms or fancy language. State in plain English what you want TAS to do. If the officer accepts the application, she immediately calls the revenue officer's Group Manager and tells her to stop everything. This halt-in-place is like a bolt of lightning: it strikes fast and hard, but it lasts for only a short time, usually no more than forty-eight hours. But it gives you, TAS, and the Collection Division time to work things out. At this point, the Office of Taxpayer Advocate becomes a mediator. Experience shows that this mediation helps in many cases, though not all. In some IRS districts, the officers interpret "significant hardship" very narrowly, almost always taking the side of the revenue officer. At the end of the process, with any luck you will have worked out a livable deal with the Collection Division. If not, there is nothing more TAS can do for you, and you are on your own once again.

This Application for Taxpayer Assistance Order is a fantastic weapon at your command when it is truly merited. Everyone hopes that things never get that hot between you and the Collection Division, but it happens.

Other Red-Tape Issues

The Office of Taxpayer Advocate also helps you slash red tape in every other area where it threatens strangulation. By and large, TAS does this extremely well. The types of problems and snafus they encounter are dizzying in their variety. After all, the IRS is so big and complex that things can go wrong almost anywhere. And once a problem occurs, it's hard to fix. But the majority of these cases fall into several classes.

The first is your <u>tax refund</u>. The IRS usually sends your refund within six weeks after you file your return, faster if you file electronically. But sometimes refunds are lost or delayed. Other times, when you file a separate claim for refund after your return has been filed, the claim can get lost. If you get no action after your second request. TAS has jurisdiction to help.

Second, if you make any other <u>request for information</u> to the IRS and forty-five days pass without action, it's now a job for TAS. Many people do not realize they can ask for help in virtually any procedural IRS matter after this forty-five-day period. Often they make call after frustrating call through normal channels, or write letter after unanswered letter, getting nowhere for months or years at a time.

Third, if you receive <u>two collection notices</u> from the Automated Collection System, or two other notices that you owe taxes from an IRS service center, and you answer them but the Service fails to respond to you, TAS can take action. It can stop the notices, conduct a "prayer session" with the collection agent who is harassing you, and take other helpful action. Beyond these examples, TAS can help with a wide variety of bureaucratic problems. These are too varied to be fully described here, so recall the basic rule: When all else fails, call the Taxpayer Advocate. In fact, call them *before* all else fails; they will help you through the worst of IRS gridlock.

The Taxpayer Bills of Rights

A popular myth has pervaded the country for years: People have few if any rights against the IRS. In fact, you have plenty of rights. The myth persists because the IRS' powers sometimes seem arbitrary and overwhelming. Other times people may not appreciate the powers, legal rights, and procedures they can exercise to defend themselves. Congress tried to help in 1988 by passing the first Taxpayer Bill of Rights and three similar laws after that.

That law had a few useful features. One in particular can be a blockbuster-the Taxpayer Assistance Order, described above. To supplement the 1988 act, in 1996 Congress enacted the Taxpayer Bill of Rights 2. The 1997 Taxpayer Relief Act and the IRS Restructuring and Reform Act of 1998 added yet additional important rights to the list of weapons you can use to protect yourself against an overzealous IRS.

Let's review these “Bills of Rights” as a group.

When You Are Audited

1. <u>Right to an Explanation</u>. The IRS must explain its audit procedures and findings in simple, nontechnical language. This right applies to the taxes and penalties it proposes and to your audit and appeal rights. By and large, the Service succeeds in this obligation. True enough, audit notices can sometimes confuse. But generally, the IRS' notices are now clearer, simpler, more understandable, and more complete than at any time in the past.

2. <u>Right to Interest Abatement</u>. The Service can also abate interest if it unreasonably delays your case. Let's say the IRS concludes you owe $1,000 after an audit. What if they don't send a bill for ten months ("Sorry, it fell through the cracks.")? For many years, the Service has been able to abate interest if it made such a "ministerial" error. With the 1996 act, the Agency can also abate interest if it makes a "managerial" error, that is, if one of its agents or managers unreasonably delays a computation or a bill. On top of that, if the Service refuses your request for abatement, you can now take it to court. Before the 1996 act, you were stuck with the fact that the IRS got to judge itself; no one could judge the IRS. But now, if your case is strong enough for interest abatement, you can ask a United States Tax Court judge for an independent ruling.

   Those tax court judges are very independent. They call cases as they see them. Still, the track record of such cases is not pro-taxpayer. You are, after all, asking the agency that delayed your matter to rule on itself; the IRS is reluctant to do this. Moreover, courts typically give such internal rulings a great deal of deference.

3. <u>Right to Abate Penalty and Interest If You Rely on IRS</u>. The IRS is required to abate tax and penalty if you reasonably relied on advice from the IRS in preparing an item on your return. Of course, there are several catches. The advice has to be in writing. The IRS agent has to have acted in his official capacity (verbal or informal advice doesn't count). And you must have given adequate and accurate information to the IRS about your

transaction. If the tax and penalty are abated, the computers will automatically abate all of the associated interest.

4. Right to Record Interview. It's hard to believe anyone actually uses this right, and for the most part it's unnecessary and counterproductive. Congress put it in the law for that occasional audit where the revenue agent or tax auditor truly misunderstands your position or misquotes it (either deliberately or inadvertently). As a matter of strategy, it's normally unwise to record an interview with an IRS agent. Think how you would feel. Recording hardens attitudes, stiffens and formalizes communication, and therefore undermines your ability to get the best result. The IRS publishes no statistics on how many people ask to record interviews.

When the IRS Comes to Collect Your Taxes

5. Right to a Clear Explanation. The IRS must give you a clear and complete explanation of its enforcement procedures and your rights against them. Its vehicle is Publication No. 1 "Your Rights as a Taxpayer." This is an excellent publication, clearly written, fair, and informative. If you follow its advice and exercise all your rights, you will rarely have an IRS problem you cannot address. The explanation of rights in Publication No. 1 covers four topics: (1) your rights and the IRS' duties in an audit, (2) appeal rights within the IRS and to the courts, (3) procedures for filing refund claims and taxpayer complaints, and (4) the IRS' enforcement powers to collect a tax that is past due. The publication explains the right to negotiate with the revenue officer, the availability of an appeal to her boss, the right to legal and accounting representation, the right to appeal within the IRS, and your right to contest some matters in court. The IRS sends this flyer with almost every collection notice. If you read nothing else, read this publication.

6. Installment Agreement. The IRS has explicit legal authority to let you pay your taxes in installments. With one exception, it's not a right - you cannot force the IRS to accept such an agreement, but at least the authority is now clearly part of the law.

   The 1998 tax act contains a limited right to demand an installment agreement. The IRS is required to grant one if you owe no more than $10,000, and in the preceding five years, you didn't fail to file a return or fail to pay a tax, or enter into another installment agreement. Also, you must agree to pay the full liability within 3 years and be tax compliant for the entire time. Guide 2 tells you how and when to ask for one, and how to negotiate a livable payment plan.

   The 1996 Taxpayer Bill of Rights requires the IRS to notify you thirty days before terminating your installment agreement. The agency had come around to doing this anyway, but now the law requires it. The Service can default an installment agreement if you don't pay, if the information on which you based the agreement turns out to be wrong, or if you strike it rich and the IRS determines you can pay more. Now, this thirty-day window gives you a chance to renegotiate. You can also ask for an "independent" review of that termination.

7. Right to Thirty-Day Cooling-Off Period Before a Levy. By law, the IRS has to tell you in advance that it is about to seize your assets. Ten days used to be all the notice it had to give; now it's thirty days. That may not sound like a lot, but it's an eternity if you are moving fast to convince the IRS to lift a wage or other levy.

   The 1998 Act added an extremely important right: the right to a pre-levy hearing to determine whether the levy should be issued. All it takes is a letter to the agent and the Office of Appeals demanding the right to a hearing, or Form 12153. In fact, IRS levy notices must now advise you of this right and even provide the suggested form. You are entitled to one hearing for each tax period, although the law encourages consolidation of such hearings.

   At the hearing, you may raise the following issues:

   - Appropriate spousal defenses (such as innocent spouse)
   - Challenges to the appropriateness of collection actions
   - Offers of collection alternatives, including posting a bond, substituting other assets, an installment agreement, or an offer in compromise
   - Whether the tax liability is correct.

   Moreover, the IRS is required to withhold levy action while that hearing is pending, and if you lose, you can ask the Tax Court to review the decision (if the underlying liability is in dispute). The hold on collection stays in place if the underlying tax liability is in dispute. Of course, this dispute must be in good faith. The price for this “Collection Due Process Hearing” is a suspension of the period of limitations on collection for the pendency of the process, plus 90 days.

8. Right to Post-Lien Notice Hearing. When the IRS files a Notice of Lien, you will now have a right, within 30 days after the filing, to request a hearing on the Notice of Lien. The hearing is similar to the pre-levy hearing. The remedies available include withdrawing the Notice of Lien.

When You Sue the IRS

9. Right to Attorneys' Fees and Other Costs. If you beat the IRS in court, you can sometimes win attorneys' fees, accountants' fees, and other costs and fees. Not all the time, but sometimes. Naturally, the IRS fights these attorney fee requests with all its strength, heart, and soul. So it's hard to win. However, experience shows that courts award attorneys' fees in many cases the taxpayer wins.

   The 1996 Taxpayer Bill of Rights made your job easier. The burden is shifted to the IRS to show that its position in your case was "substantially justified." These rights were expanded in the 1998 legislation to include certain "wins" where the IRS rejected your offer to settle.

10. Right to Sue for Damages. If the IRS abuses its authority by publicly disclosing information about you it should not, failing to release a lien when it should, or otherwise not following the collection laws, you now can sue for damages. Most of these suits are thrown out, but a few succeed. To win, you have to show the IRS agent acted recklessly or intentionally, or negligently outside the law. Also, you can now recover your actual, direct economic damages, or $1,000,000, whichever is less ($100,000 limit for negligence). You normally have to bring your claim to the IRS first, and you must try to minimize your damages. If you sue, the limitations period is two years after the IRS' violation, whether you knew of that violation or not. These are high hurdles to overcome so it's no wonder most of these suits fail. Still, everyone needs to know of this right for the rare case where the IRS greatly oversteps its authority.

11. Right to Representation. You have the right to ask a tax practitioner or other representative to do battle on your behalf with the IRS. It can be a lawyer, accountant, enrolled agent, enrolled actuary, or other type of representative. People were aware of this right even before these recent laws, but sometimes the IRS worked around the representative. Either it ignored her or required the taxpayer personally to attend one or more meetings with the IRS agent. Now, the agent can require that you attend an interview only by issuing an administrative summons. This rejuvenated right to representation has made agents more respectful of taxpayer representatives, and the agents generally allow the full range of representation the law permits and encourages.

12. Right to Twenty-One-Day Wait. Banks must wait twenty-one days after receiving an IRS levy before sending the money. They used to jump the gun all the time, often even before you knew a levy had been served. As a courtesy, many banks now notify you if an IRS levy or other garnishment or judgment is served, but the law does not require this. So, when you learn of a bank levy, you have twenty-one days to try to get the levy released. This doesn't mean your account is useless, because, in theory, any money you deposit after the levy is served is not subject to it.

    Tip: Some banks understand that rule, others do not. It is best to call your bank to be sure it understands how the levy is supposed to work.

    The IRS must also now send you simple, nontechnical explanations of how the levy works. The Service routinely does this. Its explanation is clear and concise.

13. Right to Quick Appeal for Some Property Seizures. Sometimes the IRS will seize a business to stop the business from bleeding away payroll taxes or simply to collect the past-due taxes. Under the Taxpayer Bill of Rights, if property is essential to your trade or business, the IRS must grant an accelerated appeal to determine whether the levy should be released. It is hard to think of any business property as unessential, but that is the way the new rule reads. Appeals, even quick ones, are not often successful. Where they are, the IRS can extract major concessions or big payments in exchange for releasing the

property. In other words, this provision of the Taxpayer Bill of Rights does not give you quick relief; it just gives you a quick appeal. The only way you can force the IRS to give back your business property is by filing for bankruptcy.

In addition, the 1998 law requires that the seizure of business assets must be approved by a high official in the local IRS area, personally and in writing, before a seizure can be made (except in cases of “jeopardy”). The official may not approve the levy unless he or she determines that the taxpayer’s other assets subject to collection will be insufficient to pay the amount due.

Personal residences are even harder to seize. There must be a review, as described above. In addition, the IRS must now go to court to seek the approval of the United States District Judge or a magistrate before a residence may be seized.

Short of that, you can appeal threatened seizures by telephone right up the chain of command and at least get a quick answer. Sometimes the IRS' middle or upper management is more sympathetic to working a deal than the agent who is intent on collecting the tax. So after you speak with the agent and his group manager, consider calling the area manager, or territory manager.

14. Right to Review of Liens. The IRS is supposed to release a lien against you if the lien has expired or the tax has been paid. In the past, the agency often delayed, but now you have a legal right to a quick release. The idea is to let you begin repairing your credit as quickly as possible. You can't use this new law to "unpay" your taxes, only to finish the lien release process if the IRS has balked for some bureaucratic reason. This new right to review the lien simply forces the IRS to file the release. You can sue for damages in federal court if the IRS fails to release a lien when it should. What type of damages? Let's say you're on the verge of a big business deal, but closure depends on a lien release. If the deal falls through because the IRS delayed, you might have damages and be able to sue.

Tip: Form 9423, Collection Appeal Request, and Publication 1660, "Collection Appeal Rights for Liens, Levies, and Seizures," are intended to guide you through this process.

Nationally, most of these appeals are rejected, but give it a try if you feel the revenue officer has gone beyond his or her authority.

More Rights from the 1996 Act

15. "But My Ex Promised to Pay!" How many times do we hear that one spouse of a broken marriage has fled to parts unknown, leaving the other squarely in the gun sights of the Collection Division? The revenue officer may be sympathetic, but he or she still must get the money from whatever source is available. Often your protests that "my divorce agreement requires my ex to pay these taxes" go unheeded. The 1996 act changed this situation-but only a little. You may find out from the IRS what efforts it has made to

collect from your ex, and how much. That can be very helpful when you press the right to payment in divorce court as well.

16. Withdrawing a Public Notice of Lien. Filing a Notice of Federal Tax Lien used to be a permanent, irrevocable act, even if the revenue officer acknowledged that it was wrong. That Notice of Federal Tax Lien also had a tendency to frighten lenders and buyers away from your real estate. True enough, with much pushing and shoving, you might be able to discharge property from the lien, or subordinate the lien, but you could not "unfile" the lien notice (unless you paid in full). Now, you can - maybe. You must convince the IRS that the withdrawal of the lien will facilitate collection or would be in the best interests of you (the taxpayer) and the IRS. You may also try to persuade the IRS that the lien should be removed because you have entered into an installment agreement.

17. Trust Fund Taxes. When a corporation fails to pay its employment taxes, the IRS can go after its officers as well as the corporation. Guide 2 discusses this concept in detail. The 1996 Taxpayer Bill of Rights makes no change in that rule, but does give a few more protections. You can ask the IRS to tell you what it has done to recover the taxes from other officers. Also, you can now sue those other officers in federal court for "contribution." The 1998 law expanded these rights by allowing you to sue the government without having to deal with the Collection Division: all collection actions are stopped while your appeal works its way through the courts. Also, the 1996 law protects volunteer, unpaid members of the boards of directors of tax-exempt organizations, but only if they did not participate in the day-to-day financial operations of the organization and did not know of that charity's failure to pay the taxes.

Totally Useless or Nearly Useless Provisions Enacted in 1998

18. IRS Oversight Board. Don't count on this new creature to help you in any particular case. While the original idea was to have an outside Board to ride herd on an overreaching IRS, the law just didn't turn out that way. Instead, the new Oversight Board will have wide-ranging but quite diluted authority to help the IRS manage itself on a national level. This new Board has no line authority to help you in your case.

19. Reversal of the Burden of Proof. In certain cases, the IRS will now be required to bear the burden of proof. But those cases will be narrow. In fact, to achieve a reversal of the normal burden of proof, which is on the taxpayer, you will now have to prove that you were entitled to a deduction in the first place, and that you followed all the required rules and regulations. If you do that, courts generally grant a reversal of the burden of proof anyway, so the provision is useless. Moreover, it may be counterproductive, because it may force the IRS to be more intrusive in its requests for information, just to avoid the threat of just such a reversal.

20. Right to Confidentiality. The 1998 law enacted a so-called "Accountant/Client Privilege." This was advertised as being important to keep your discussions with your non-attorney representative confidential. However, in practice it will also be more narrow than

advertised. That's because the attorney/client privilege is itself a narrow privilege and does not cover most items. For example, nothing that goes on a tax return is confidential. And once disclosed on a return, it's unlikely that the underlying back-up data would also be confidential. Also, the new "privilege" does not apply in certain types of cases. So don't count on this one to keep your information private.

Summary of Tips and Hints

1. Get familiar with the Taxpayer Assistance Order and be ready to use it when necessary.

2. Get to know your Office of Taxpayer Advocate for any problem that lasts more than 30 days.

3. You have many new rights to hold the IRS in check - be familiar with them.

4. Don't be afraid to appeal within the IRS from any threatened seizure action.

About the Author

Robert Nath is nationally recognized as an authority on tax matters. He holds degrees from Yale, the University of Pennsylvania, and Georgetown University. After clerking for a federal judge, Mr. Nath litigated tax cases for 8 years with the Tax Division, U.S. Department of Justice. Since 1984, he has been in private practice advising taxpayers, accountants, and attorneys on tax procedure and controversy matters, as well as representing them before the IRS and in court in tax collection, audit and tax litigation matters.

Mr. Nath is the author of numerous publications, including:

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