The 'Effective Tax Administration' Offer in Compromise

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Despite a provision of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98) that authorized the IRS to accept offers in compromise based on equity, hardship, and public policy to promote effective tax administration, the IRS has not widely embraced the concept. Less than 1 percent of the total offers that the IRS has accepted are "effective tax administration" offers. What are the conditions for accepting those offers? Why is the IRS so reluctant to accept them? Have the courts decided any cases involving that type of offer? This article explores those issues and others.

Background

Section 7122 of the Internal Revenue Code permits the IRS to compromise a taxpayer's tax liability. A taxpayer may submit an offer in compromise on Form 656 to settle unpaid tax accounts for less than the full amount owed and the IRS has discretion either to accept or reject that offer.

Before RRA '98, the IRS accepted offers if there was doubt as to the liability, or as to the collectibility, of the amount owed.[1] However, in RRA '98, Congress required the IRS to "take into account factors such as equity, hardship and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration."[2] Congress said the IRS could, for example, accept those offers to "resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability."[3] Consequently, the "effective tax administration" offer (ETA offer) was born.

Conditions for Acceptable ETA offers

In 2002 the IRS issued regulations listing the requirements for an acceptable ETA offer.[4] To qualify, the taxpayer must first have the ability to pay the liability in full and not be eligible for one of the other two categories of offers, those based on doubt as to liability (DATL) or doubt as to collectibility (DATC).[5] A taxpayer who submits an ETA offer can't simply waive eligibility for a DATL or DATC offer. Rather, the IRS requires a taxpayer to prove that he is not eligible for a DATL or DATC offer by submitting the same financial information that is necessary for those other types of offers.[6] Accordingly, a taxpayer

[1] Treas. reg. section 301.7122-1(b)(1) and (2).
[2] H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess., 289 (1998), *Doc 98-20863, 98 TNT 125-24*.
[3] *Id.*
[4] T.D. 9007, *Doc 2002-17092, 2002 TNT 145-96* (July 23, 2002).
[5] Treas. reg. section 301.7122-1(b)(3).
[6] *See* Internal Revenue Manual sections 5.8.11.3 and 5.8.11.4.2 (May 14, 2004).

must "jump through the same hoops" as taxpayers who are submitting a DATL or DATC offer.

Second, the IRS will not accept an ETA offer if compromising the liability would undermine compliance by taxpayers with the tax laws.[7] The regulations state that compromising a taxpayer's liability will undermine compliance with the tax laws if the taxpayer has a history of not complying with the filing and payment requirements, has taken deliberate actions to avoid the payment of taxes, or has encouraged others to refuse to comply with the tax laws.[8]

That "compliance" requirement tends to invalidate nearly all ETA offers. Most taxpayers who file an offer have built up large tax liabilities over multiple years, which is the result of not complying with the filing and payment requirements. Many IRS collection personnel would tend to view their noncompliance as a deliberate act to avoid the payment of taxes. To exclude those taxpayers from eligibility for an ETA offer is contrary to Congress's intent in helping them reenter the taxpaying community.[9]

Types of ETA offers

The regulations essentially provide two types of acceptable ETA offers: one based on hardship and one based on equity or public policy.

An ETA offer based on hardship will be accepted if full collection of the liability would result in economic hardship, that is, that full collection of the liability would render the taxpayer unable to pay basic living expenses.[10] Basic living expenses are those expenses that provide for health and welfare and production of income of the taxpayer and the taxpayer's family, and will vary according to the unique circumstances of the individual taxpayer.[11]

An ETA offer based on equity or public policy will be accepted if there are no other grounds for compromise and, because of exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner.[12] The regulations provide that all of the following conditions must exist before the IRS will accept such a nonhardship ETA offer:

- compelling public policy or equity considerations must be present to justify compromise;
- collection of the full liability would undermine public confidence in the fair and equitable administration of the tax laws; and
- circumstances exist to justify compromise even though a similarly situated taxpayer may have paid the liability in full.[13]

Examples of Hardship ETA offers

[7] Treas. reg. section 301.7122-1(b)(3)(iii).
[8] Treas. reg. section 301.7122-1(c)(3)(ii).
[9] Joan L. Rood, "The IRS Offer-in-Compromise Program: How Should the IRS Apply the *Effective Tax Administration* Criterion?" *Journal of Tax Practice & Procedure*, August-September 2004, p.10.
[10] Treas. reg. sections 301.7122-1(b)(3)(i) and 301.6343-1(b)(4)(i).
[11] Treas. reg. sections 301.6343-1(b)(4)(i) and (ii); IRM section 5.8.11.2.1.
[12] Treas. reg. section 301.7122-1(b)(3)(ii).
[13] Treas. reg. sections 301.7122-1(b)(3)(ii) and (iii).

The regulations list three nonexclusive examples of situations in which the IRS will accept an ETA offer based on hardship:

- the taxpayer has an illness, medical condition, or disability that exhausts the taxpayer's financial resources and that prevents the taxpayer from working;
- the taxpayer's monthly income is exhausted in providing for the care of dependents; and
- the taxpayer cannot borrow against the equity in assets, and sale of the assets would render the taxpayer unable to pay basic living expenses.[14]

Examples of Nonhardship ETA offers

The IRS's regulations include two examples in which the IRS will accept an ETA offer based on public policy or equity provisions.[15] Neither example is particularly helpful.

One example describes a taxpayer who developed a serious illness requiring nearly continuous hospitalization for several years, was unable to manage financial affairs, did not file returns, recovered from the illness, and found that with penalties and interest, the amount owed for the unfiled returns was three times the tax owed. That is a bad example. Most likely, the taxpayer's continuous hospitalization and inability to manage financial affairs would have caused an economic hardship, so the taxpayer's ETA offer would probably be based on hardship, not public policy or equity.

The other example involves a taxpayer who was misinformed in writing by an IRS employee that after withdrawing funds from an IRA, the taxpayer had 90 days to reinvest the funds in another IRA (section 408(d)(3)(A) allows only 60 days). The taxpayer kept the funds for 63 days before reinvesting, and as a result, owed additional tax, interest, and penalties. It is not likely that the IRS would impose penalties in this situation because the IRS is required by statute to abate penalties due to its erroneous written advice.[16] Also, the facts of this example are far too specific to be of much help.

The IRS has provided additional examples in its training materials provided to offer specialists and in its manual.[17] The IRS has instructed its collection personnel to reject nonhardship ETA offers:

- if based on taxpayer claims that the liability resulted from acts of third parties (including acts of a tax matters partner in a unified partnership proceeding);
- if based on a claim that the tax law is unfair;
- if the liability results from the taxpayer's investment in a tax shelter; or

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[14] Treas. reg. section 301.7122-1(c)(3)(i).
[15] Treas. reg. section 301.7122-1(c)(3)(iv). *See also* IRM section 5.8.11.2.2, paragraphs 5 and 7, which contain the same two examples.
[16] *See* section 6404(f); *see also* Treas. reg. section 301.6404-3 and IRM section 120.1.1.3.2.4.
[17] *See* "IRS Responds to Taxwriter's Offer in Compromise Concerns," *Doc 2004-22795, 2004 TNT 231-25*, Oct. 28, 2004, pp. 7, 48-54 (Commissioner's letter to Sen. Max Baucus, responding to requests about the offer in compromise program); IRM section 5.8.11.2.2.

- o if the IRS issued an erroneous notice of the balance due and the taxpayer, relying on that notice, paid the balance in full.[18]

Those examples do not help IRS offer specialists understand the situations in which ETA offers should be accepted. It simply broadens the list of situations in which those offers should not be accepted and therefore tends to discourage offer specialists from accepting ETA offers.

IRS's Track Record of Accepting ETA offers

Despite Congress's RRA '98 requirement to take into account equity, hardship, and public policy factors, the evidence suggests that the IRS has a poor track record of accepting ETA offers. The IRS has rarely accepted any ETA offers based on public policy or equity considerations. According to the Taxpayer Advocate's annual report, in fiscal 2004, the IRS's ETA offer group, which is responsible for processing offers based on equity and public policy, accepted only one such offer.[19] The IRS's track record for accepting ETA offers based on hardship is not much better. In fiscal 2000 and 2001, the IRS accepted 261 and 272 ETA offers, respectively[20]. That is less than 1 percent of the total offers the IRS accepted during those years.[21]

Why is the IRS so reluctant to accept ETA offers, especially those based on equity and public policy considerations? There are several reasons. First, it seems clear that the IRS disagrees with Congress. In RRA '98, Congress stated that the IRS could, for example, accept ETA offers to "resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." In its manual, the IRS concluded that compromising penalties and interest that have accrued for several years would undermine the purpose of the penalty and interest provisions of the code.[22] Thus, the IRS's manual directly contradicts Congress.

Second, the IRS has made it as difficult as possible to accept an ETA offer. The IRS has imposed strict conditions in its regulations that make it nearly impossible for taxpayers to qualify for an acceptable ETA offer. Also, in its training materials and manual, the IRS has discouraged offer specialists from accepting ETA offers, as discussed above.

Third, IRS collection personnel are trained to collect outstanding tax liabilities, so they normally would be reluctant to allow a taxpayer to settle an outstanding liability for less than the entire amount, particularly if the taxpayer has the financial ability to pay it in full.[23] The IRS probably doesn't want to have a track record of allowing a taxpayer to build up a large unpaid tax liability, and then compromise

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[18] *Id.; see also* IRS Training Document, "Offers in Compromise: Promotion of Effective Tax Administration," pp. 19-24.
[19] Nina E. Olson, National Taxpayer Advocate, 2004 Annual Report to Congress, *Doc 2005-256, 2005 TNT 9-21*, Dec. 31, 2004, p. 433.
[20] *Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate*, "IRS Should Evaluate the Changes to its Offer in Compromise Program," General Accounting Office, p. 17 (GAO-02-311, March 2002), *Doc 2002-7581, 2002 TNT 60-22*. It is assumed that all or nearly all of those accepted ETA offers were based on hardship.
[21] The IRS accepted a total of 38,643 offers during fiscal 2001. *See* Nina E. Olson, 2004 Annual Report to Congress, *supra* note 20, at 315.
[22] IRM section 5.8.11.2.2, paragraph 3, second example.
[23] Rood, *supra* note 9.

that liability when the taxpayer has the ability to fully pay it. Such a policy would simply encourage noncompliance, especially since accepted offers are open to public inspection.[24]

Court Cases Involving ETA offers

RRA '98 added to the code section 6330 giving taxpayers the right to appeal certain IRS collection actions, such as the rejection of an offer. In general, the taxpayer has the right to appeal a collection action to the IRS's Office of Appeals and to seek judicial review in the U.S. Tax Court or a U.S. District Court.[25] Those cases are commonly known as collection due process cases.

In the context of a CDP case, a taxpayer may discuss with Appeals the appropriateness of a revenue officer's rejection of an offer. If Appeals determines that the offer should still be rejected, Appeals will then issue a Notice of Determination allowing the taxpayer the opportunity to pursue the case in court.

A taxpayer who seeks judicial review of a rejected offer must prove that the IRS abused its discretion in rejecting the offer. That imposes a higher burden of proof on taxpayers than the usual "preponderance of the evidence" standard of review used in civil cases.

As far as I can determine, only three court cases have addressed whether the IRS abused its discretion in rejecting an ETA offer[26]. All three cases involved ETA offers based on hardship, and strangely, all three cases involved taxpayers living in El Paso, Tex.

In Razo v. Commissioner[27], a couple who owed $7,833 for the years 1995, 1996, and 1997, argued that the IRS abused its discretion by rejecting their offer of $100. The couple argued that because of their limited income and poor health, full collection of the liability would cause an economic hardship. Mr. Razo was employed as a manual laborer, and Mrs. Razo was not employed. The couple had two cars, one of which could have been sold to pay the liability in full. Under those circumstances, the court ruled that the IRS did not abuse its discretion in rejecting the offer. The court inferred that selling one of the cars would not cause an economic hardship.

In Siquieros v. United States[28], the taxpayer, who was the office manager for a trucking company, was held liable for $40,511 in unpaid withholding taxes owed by the trucking company[29]. She submitted an ETA offer of $100 on the grounds that payment of the full liability would cause her an economic hardship. She argued that due to her age (67 years), limited income and assets, and health problems, she needed to keep her income and assets for basic living expenses. The IRS rejected her $100 offer and suggested an offer of about $13,000 representing the net realizable value of her assets. In calculating that amount, the IRS

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[24] Sections 7122(b) and 6103(k)(1).

[25] Sections 6330(b) and (d).

[26] In another case, *Orum v. Commissioner*, 123 T.C. 1, *Doc 2004-13692, 2004 TNT 128-17* (2004), *aff'd* 412 F.3d 819, *Doc 2005-13717, 2005 TNT 121-22* (7th Cir. 2005), the IRS rejected the taxpayer's offer, which had been based on DATC and ETA, but the court did not address the ETA aspect of the offer.

[27] *Razo v. Commissioner*, T.C. Memo. 2004-101, *Doc 2004-7947, 2004 TNT 70-5*, *aff'd per curiam* ___ F.3d ___, 95 AFTR2d 2005-1087, *Doc 2005-13593, 2005 TNT 120-16* (5th Cir. 2005).

[28] *Siquieros v. United States*, No. EP-03-CA-0478-FM, 2005-1 USTC par. 50,244, *Doc 2004-16811, 2004 TNT 164-15* (W.D. Tex. 2004), *aff'd per curiam* 124 Fed. Appx. 279, 2005-1 USTC par. 50,245, *Doc 2005-6068, 2005 TNT 56-9* (5th Cir. 2005).

[29] Section 6672 imposes personal liability for unpaid withholding taxes (trust-fund taxes) on persons who were responsible for ensuring that those taxes are paid over to the government.

did not include the taxpayer's home, vehicle, or bank accounts, which it excluded as "hardship protected" (sale of those assets would cause an economic hardship), but it included an insurance policy worth about $5,000, an IRA worth about $5,000, and about $3,000 in potential net earnings. Without explaining its reasoning, and describing the taxpayer's $100 offer as de minimis, the Tax Court concluded that the IRS did not abuse its discretion in rejecting the offer.

And in Alaniz v. Commissioner,[30] a couple who owed $221,372 in income tax, penalties, and interest for tax years 1994, 1996, and 1997 submitted an offer of $2,000 based on doubt as to collectibility and effective tax administration. The taxpayers' assets and income indicated that at least $37,000 could reasonably be collected. The couple's effective tax administration portion of the offer was based on Mr. Alaniz's advanced age (73 years) and "deteriorating" health. Despite his age and medical conditions, Mr. Alaniz remained active as an insurance salesman. Describing the couple's $2,000 offer as de minimis, "the Tax Court held that the IRS did not abuse its discretion in rejecting the offer."

Cattle Tax Shelter Cases

In California, Nevada, Oregon, and Washington, several thousand taxpayers became involved in a cattle tax shelter for whom ETA offers would be most appropriate.

Here is a brief synopsis of the case. Walter J. Hoyt II and members of the Hoyt family were prominent breeders of Shorthorn cattle in California and Oregon. To expand the business and attract investors, starting in the late 1960s and continuing into the late 1990s, the Hoyt family organized and operated numerous cattle and sheep breeding partnerships. They attracted thousands of investors and operated more than 100 partnerships. They also operated tax return preparation companies that prepared the investors' individual income tax returns.

In the early 1980s, the IRS began to audit the partnerships' and investors' tax returns. Among other items, the IRS found that depreciation and tax credits had been claimed for cattle and sheep that did not exist. Deficiencies in tax, penalties, and interest, all owed by the investors, amounted to several hundred million dollars. After the enactment of the unified partnership audit procedures in the Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA),[31] the IRS's audits focused on the Hoyt cattle and sheep breeding partnership returns. Walter J. Hoyt III was the tax matters partner of each partnership and was responsible for representing the partnerships before the IRS.

Much litigation ensued over the validity of the partnerships' tax deductions. The first Tax Court decision in 1989[32] left open many issues. It was not until a decade later that the courts upheld the IRS's disallowance of the partnership deductions and tax credits.[33] In 2001 Walter J. Hoyt III and others were convicted of fraud and money

[30] *Alaniz v. Commissioner*, T.C. Memo. 2005-4, *Doc 2005-756, 2005 TNT 8-13*.
[31] Pub. L. 97-248, adding sections 6221 through 6232.
[32] *Bales v. Commissioner*, T.C. Memo. 1989-568.
[33] *See, e.g., Durham Farms #1, J.V. et al. v. Commissioner*, T.C. Memo. 2000-159, *Doc 2000-14288, 2000 TNT 98-12*, *aff'd in an unpublished opinion* 59 Fed. Appx. 952, 2003-1 USTC par. 50,391, *Doc 2003-8967, 2003 TNT 69-40* (9th Cir. 2003) (cattle breeding partnerships), and *River-City Ranches #4, J.V. et al. v. Commissioner*, T.C. Memo. 1999-209, *Doc 1999-21669, 1999 TNT 120-11*, *aff'd in an unpublished opinion* 23 Fed. Appx. 744, 2002-1 USTC par. 50,105, *Doc 2001-30339, 2001 TNT 237-64* (9th Cir. 2001) (sheep breeding partnerships).

laundering by the U.S. District Court for the District of Oregon.[34] Hoyt was sentenced to nearly 20 years in prison and was ordered to pay $102 million in restitution, representing the amount that investors had paid to the Hoyt organization.

Investors in the Hoyt cattle and sheep partnerships were typically middle-class, hard-working wage earners who were not wealthy. Most lived in California, Oregon, Nevada, and Washington and were just trying to make an honest living. Those people had invested in the Hoyt partnerships from the late 1970s to the early 1990s. They believed the Hoyt organization's reports that their partnership deductions and tax credits were valid. Once the IRS started auditing the partnership returns, Walter J. Hoyt III repeatedly signed extensions of the statute of limitations for the partnership returns. Investors were not aware that in so doing, the three-year statute of limitations of their individual returns had also been extended for any taxes attributable to the partnership returns.[35]

Fifteen to 20 years after making their investments, taxpayers who had invested in a Hoyt partnership began receiving bills from the IRS with penalties and interest amounting to 5 to 10 times the income tax deficiencies. They are financially unable to pay those huge bills. Also, because their homes have substantially appreciated in value, they do not qualify for a DATC offer. And because they are wage earners or have since retired, they don't have the monthly income needed to qualify to refinance their home mortgages, which might give them funds to pay off the large tax liabilities. Many of the investors have tried to get the penalties and interest removed, hoping then to be able to pay the income tax liabilities, but they haven't been successful[36].

Aren't those taxpayers exactly who Congress wanted to be affected by its RRA '98 provision regarding ETA offers? Those taxpayers have "longstanding" collection cases pending with the IRS. Congress wanted the IRS to use the new hardship, equity, and public policy authority to settle with those people by "forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." To any reasonable person, 15 to 20 years after filing tax returns certainly seems like a delay.

Unfortunately, in its manual, the IRS has provided an example that describes a Hoyt investor's situation exactly, and has concluded that an ETA offer submitted by such an individual should be rejected.[37] The IRS reasons that to compromise penalties and interest in such a situation would essentially be the same as rewriting the statute based on a perception of unfairness and, therefore, compromise would not promote effective tax administration. Also, the IRS has concluded that it would not promote effective tax administration to compromise interest unless

[34] *United States v. Barnes, et al.*, No. CR 98-529-JO-04 (D.Ore. 2001), *aff'd sub nom. United States v. Hoyt*, 47 Fed. Appx. 834 (9th Cir. 2002).
[35] Lynn Anderson, CPA, "The More You Lose The Better," www.crimes-of-persuasion.com, May 24, 2001.
[36] *See, e.g.*, *Mekulsia v. Commissioner*, T.C. Memo. 2003-138, *Doc 2003-12301*, *2003 TNT 95-14*, *aff'd* 389 F.3d 601, *Doc 2004-22175*, *2004 TNT 224-16* (6th Cir. 2004) (no abatement of interest); *Hitchen v. Commissioner*, T.C. Memo. 2004-265, *Doc 2004-22415*, *2004 TNT 226-8* (penalties and tax-motivated interest upheld); *Barnes v. Commissioner*, T.C. Memo. 2004-266, *Doc 2004-22412*, *2004 TNT 226-9* (penalties and tax-motivated interest upheld); *Hansen v. Commissioner*, T.C. Memo. 2004-269, *Doc 2004-22616*, *2004 TNT 228-4* (penalties upheld); *Van Scoten v. Commissioner*, T.C. Memo. 2004-275, *Doc 2004-23152*, *2004 TNT 235-21* (penalties upheld); *Jaroff v. Commissioner*, T.C. Memo. 2004-276, *Doc 2004-23309*, *2004 TNT 237-11* (penalties upheld); and *Mortensen v. Commissioner*, T.C. Memo. 2004-279, *Doc 2004-23793*, *2004 TNT 242-9* (penalties upheld).
[37] IRM section 5.8.11.2.2, paragraph 3.

the delay satisfies the code's abatement-of-interest requirements.[38] Those conclusions misinterpret what Congress wanted in its RRA '98 provision concerning ETA offers. It seems clear that Congress wanted the IRS to go beyond the statutory penalty and interest relief provisions when considering an ETA offer.

The Hoyt investors should qualify for ETA offers because their predicament is exactly the type of situation Congress described in its RRA '98 provision. In my opinion, the IRS ought to provide those folks with every possible consideration in working out a compromise.

National Taxpayer Advocate's Views on ETA Offers

According to National Taxpayer Advocate Nina E. Olson, the IRS remains unable or unwilling to accept ETA offers based on equity or public policy considerations, and the IRS Office of Chief Counsel has declined her request to revise IRS regulations to provide more specific guidance.[39] Like many tax practitioners, Olson believes that IRS policies have interpreted the equity and public policy basis for compromise too narrowly, and that the circumstances under which nonhardship ETA offers should be accepted are unclear.[40] As for ETA offers based on hardship, Olson indicates that more specific guidance is needed to assist IRS employees in determining when an ETA offer based on hardship should be accepted and how future expenses should be projected and evaluated.[41]

Olson has proposed legislative changes that she believes will resolve those problems.[42] For ETA offers based on equity or public policy, Olson proposes amendments to the code:

- that would require the IRS to compromise a liability when it is inequitable to collect it;
- that would make it inequitable to collect more than the economic benefit that the transaction produced; and
- that would list the facts and circumstances that the IRS should consider in determining whether it is inequitable to collect a liability.

For ETA offers based on hardship, Olson also proposes code amendments that would enable the IRS to compromise a tax liability if it causes a hardship for the taxpayer or for a third party.

Although I agree with Olson's analysis of the problems concerning ETA offers, I don't agree with her legislative solutions. In my opinion, Olson's legislative proposals would cause more problems than they would solve. For example, requiring the IRS to compromise a liability when it is inequitable to collect it is a subjective determination, and attempting to make it objective by listing in the code certain facts and circumstances that should be considered might inadvertently exclude other facts and circumstances that may be important. Further, making it inequitable to collect more than the economic benefit produced opens up the possibility of a dispute between the taxpayer and the IRS over the amount of the economic benefit.

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[38] *Id.*, paragraph 4. Section 6404(e) permits the IRS to abate interest if there was a delay in assessing a tax deficiency and the delay was due to a ministerial act (or a managerial act for tax years after 1996) performed by an IRS employee.
[39] Nina E. Olson, "2004 Annual Report to Congress," *supra* note 20, at 329.
[40] *Id.*
[41] *Id.*
[42] *Id.*, at 435-436 and 445.

Conclusion

ETA offers represent an opportunity for IRS collection personnel to solve taxpayers' collection problems in a new and unique manner. Unfortunately, IRS regulations, procedures, and training materials have been written to discourage IRS collection personnel from accepting ETA offers. I believe the solution is for Congress to put more pressure on the IRS to follow its RRA '98 requirement to take into account equity, hardship, and public policy factors by directing the IRS to revise its regulations, procedures, and training of offer specialists to broaden the instances in which ETA offers should be accepted.