

ANSWERS: TAXES, DEBTS TO THE IRS, AND OFFERS IN COMPROMISE

Like other forms of debt, back taxes can create a significant financial burden. Filing bankruptcy can be an effective way of reducing or eliminating that burden but a debtor has other options as well.

Generally, a debtor is eligible for discharge in bankruptcy of personal income taxes – debts to the government shown on a 1040 form – three years after they accrue. This means that debt for taxes due for tax year 2005, which were filed before April 15, 2006, can be eligible for discharge starting April 16, 2009.

Specifically five conditions must apply to discharge federal income taxes in Chapter 7:

- You did not file a fraudulent return or try to evade paying taxes.
- The liability is for a tax return (not a Substitute or Return) actually filed at least two years before you file for bankruptcy.
- The tax return was due at least three years ago.
- The taxes were assessed at least 240 days before you file for bankruptcy.
- The IRS has not recorded a tax lien against your property. (If all other conditions are met, the taxes may be discharged, but even after your bankruptcy the lien remains against all property you own, effectively giving the IRS a way to collect.)

The taxpayer must have timely and properly filed all of the returns for the tax years in question. If the taxpayer has not done so, the IRS will likely object to the dischargeability of the tax debt.

If the taxpayer has not properly filed or if the proper amount of time has not passed, the debt to the IRS is given priority status. This means that it is not dischargeable in Chapter 7, would be paid in full, and before unsecured creditors in Chapter 13.

People who have very little debt and a large tax burden to the IRS may wish to file an Offer in Compromise (OIC) to the IRS instead of filing bankruptcy or before filing bankruptcy. An OIC involves complete disclosure of your financial situation – your assets, debts, and budget – and an offer that involves either a lump sum or a monthly payment plan depending on your circumstances. If accepted, the IRS settles the taxpayer's liabilities for less than the full amount owed.

The IRS examines your OIC and makes a decision based on relatively stringent standards. The IRS will not accept the OIC if the IRS believes that the taxes can be paid in full, either as a lump sum or through a payment agreement.

In most cases the IRS will not accept an OIC unless the amount offered by the taxpayer is equal to or greater than the Reasonable Collection Potential (RCP). The RCP is how the IRS measures the taxpayer's ability to pay and includes the value that can be realized from the taxpayer's assets such as real property, automobiles, bank accounts, and other

property. The RCP also includes anticipated future income, less certain amounts allowed for basic living expenses.

The IRS may accept an offer in compromise based on three grounds:

- **Doubt as to Collectability:** If it appears doubtful that the taxpayer could ever pay the full amount of tax liability owed within the remainder of the statutory period for collection, the OIC may be accepted.
- **Doubt as to Liability:** If legitimate doubt exists that the assessed tax liability is correct, the IRS may accept an OIC. This may arise where the IRS made a mistake interpreting the law, failed to consider a taxpayer's evidence, or the taxpayer has new evidence.
- **Effective Tax Administration:** The IRS will consider hardship where an exceptional circumstance exists that would allow the IRS to consider an OIC even where the tax liability is to some extent collectible. To be eligible for compromise on this basis a taxpayer must demonstrate that the collection of the tax would create an economic hardship or would be unfair and inequitable.

You are required to pay a \$150 fee and a deposit with a lump sum OIC and the IRS will keep that deposit even if it rejects your offer. If your OIC involves a payment plan, the \$150 fee still applies but a lump sum payment is not required.

While the IRS only accepts about 20% of the OIC's it receives, the chances of acceptance increase with an offer prepared by a tax or legal professional. This is not a prejudice against the layperson but rather a nod to the diligence and documentation that will accompany a professionally prepared offer.

We sometimes recommend that a client try an OIC before filing bankruptcy.

Because the work involved in preparing an OIC is comparable to that in a bankruptcy petition, the bankruptcy "reform" act of 2005 created a means test for debtors that is based on the standards used in approving an OIC. We are able and willing to provide OIC preparation services to our clients. Please contact us for details.