Legislative Recommendation #18

Require the IRS to Refund Any Payment Collected Pursuant to a Federal Tax Lien That Exceeds the Amount of an Accepted Offer in Compromise

SUMMARY

- *Problem:* Before the IRS agrees to accept an offer in compromise, it carefully evaluates the taxpayer's financial condition and calculates the amount it believes the taxpayer can reasonably afford to pay while leaving the taxpayer with enough funds to pay his or her basic living expenses. If the taxpayer sells property subject to a tax lien after the offer is accepted but before paying the agreed amount in full, however, the IRS may keep more than the amount it calculated the taxpayer could reasonably afford to pay.
- *Solution:* Require the IRS to return to the taxpayer any amount collected in excess of the amount the IRS determined the taxpayer could reasonably afford to pay (unless the IRS determines that the taxpayer materially misrepresented his or her financial condition).

PRESENT LAW

IRC § 7122 authorizes the Secretary to sign an agreement (an "offer in compromise" or OIC) with a taxpayer to settle the taxpayer's tax liabilities for less than the amount owed. OICs take one of two forms: (i) the taxpayer may pay the agreed amount in a single lump-sum[1] or (ii) the taxpayer may pay the agreed amount through periodic payments, generally monthly.[2] Treas. Reg. § 301.7122-1(b) provides that the IRS may compromise liabilities to the extent there is doubt as to liability or doubt as to collectibility, or to promote effective tax administration. With respect to offers based on doubt as to collectibility, the IRS has a legal basis to compromise when the taxpayer's equity in assets and future income potential are less than the taxpayer's liabilities.

The IRS follows guidelines set forth in Internal Revenue Manual (IRM) 5.8.5 to evaluate a taxpayer's equity in assets and future income potential. According to IRS Policy Statement 5-100, an OIC is considered a "legitimate alternative to declaring a case as currently not collectible or to a protracted installment agreement," and the goal is to "achieve the collection of what is potentially collectible at the earliest possible time and at the least cost to the government."[3]

Taxpayers seeking an OIC must complete Form 656, Offer in Compromise. Taxpayers seeking an OIC based on Doubt as to Collectibility must also complete a Collection Information Statement on Form 433. Section 7 of Form 656 includes certain terms and conditions a taxpayer must accept when submitting an OIC. In Paragraph (o) of Section 7, taxpayers agree that failure to meet the terms of an OIC, such as by missing payments, may cause default of the offer, possibly resulting in reinstatement of the full tax liability, plus penalties and interest. In Paragraph (q) of Section 7, taxpayers agree that:

> The IRS may file a Notice of Federal Tax Lien during consideration of the offer or for offers that will be paid over time. If the offer is accepted, the tax lien(s) for the periods and taxes listed in Section 1 will be released within 35 days after the payment has been received and verified. The time it takes to transfer funds to the IRS from commercial institutions varies based on the form of payment. If I have

1 *See* IRC § 7122(c)(1)(A).
2 *See* IRC § 7122(c)(1)(B).
3 IRM 1.2.1.6.17, Policy Statement 5-100, Offers will be accepted (Jan. 30, 1992).

> not finished paying my offer amount, then the IRS may be entitled to any proceeds from the sale of my property. The IRS will not file a Notice of Federal Tax Lien on any individual shared responsibility debt.

IRC § 6331(a) authorizes the IRS to "levy upon all property and rights to property," but the IRS generally cannot levy while an offer is pending, for 30 days following the rejection of an offer, or during any period when an appeal is being considered.[4] The IRS may maintain a lien on any property owned by the taxpayer until all payments are made.[5]

REASONS FOR CHANGE

When the IRS accepts an OIC, the IRS contracts to settle a tax liability for less than the full amount of the liability. Prior to accepting an OIC, the IRS carefully reviews and verifies the taxpayer's financial condition.[6] It calculates the taxpayer's "reasonable collection potential" (RCP) based on the taxpayer's net realizable equity in assets plus future income, reduced for allowable living expenses.[7] Generally, an OIC is not accepted unless the offer proposed by the taxpayer is equal to or greater than the RCP, as calculated by the IRS.

In certain situations where the IRS has filed a lien on taxpayer property, the IRS may end up collecting more than the amount originally calculated as the taxpayer's reasonable collection potential. IRC § 6325 and IRS internal guidance call for a lien on property to remain in place until the taxpayer has made all payments.[8] If a taxpayer sells property subject to a lien prior to completing payment on the OIC, liens superior to the federal tax lien must be satisfied and the costs of sale must be paid. Thereafter, the IRS may take the remaining sale proceeds up to the full amount of its original lien, as provided by IRC § 6321 and stated in Section 7, Paragraph (q), of Form 656.[9] As a result, the IRS may collect more than it determined the taxpayer could reasonably afford to pay when it accepted the OIC.[10]

RECOMMENDATION

- Amend IRC § 7122 to require the IRS to return to the taxpayer any amount collected pursuant to a federal tax lien in excess of the payment amount of an accepted OIC, unless otherwise agreed upon, provided the taxpayer disclosed all material income and assets to the IRS on his or her application and made all payments in accordance with the terms of the agreement.

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4 *See* IRC § 6331(k).
5 IRS, Form 656-B, Offer in Compromise (Apr. 2022).
6 IRM 5.8.5, Financial Analysis (Sept. 24, 2021).
7 IRM 5.8.4.3.1, Components of Collectibility (Apr. 30, 2015).
8 IRM 5.8.10.6, Discharge and Subordination Requests (Mar. 10, 2022).
9 IRM 5.8.10.6(4), Discharge and Subordination Requests (Mar. 10, 2022) (providing an example).
10 In some cases, the IRS enters into collateral agreements in which the IRS and the taxpayer agree that if real property is sold, the IRS will automatically receive a certain percentage of the sale price, even if the OIC offer amount is paid in full.