

Legislative Analysis



OFFER-IN-COMPROMISE TAXPAYER AGREEMENTS

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House Bill 4003 as enacted
Public Act 240 of 2014
Sponsor: Rep. John Walsh
House Committee: Tax Policy
Senate Committee: Finance

Second Analysis (7-24-14)

BRIEF SUMMARY: The bill amended the Revenue Act to create an "offer-in-compromise" program within the Department of Treasury.

FISCAL IMPACT: If the State of Michigan were to participate in an offer-in-compromise plan, as specified in the bill, it could increase revenue in the short-run, but lower revenue in the long term. This bill would have no direct impact on local units of government.

House Bill 4003 would have an indeterminate fiscal impact on the Department of Treasury. Any administrative cost increases for the department would be covered under current appropriation levels.

THE APPARENT PROBLEM:

The Revenue Act, under which the Department of Treasury administers several tax statutes, provides the department with only a limited ability to compromise tax liabilities; that is to reach a settlement with the taxpayer allowing the taxpayer to pay an amount that is less than the full amount owed in taxes.¹ The Internal Revenue Service (IRS) and most other states are authorized to compromise tax liabilities through what are typically referred to as offer-in-compromise (OIC) programs. OIC programs are seen by many tax practitioners as being necessary for the fair, efficient, and effective administration of state tax laws. Legislation allowing the Department of Treasury to offer an OIC program has been introduced.

THE CONTENT OF THE BILL:

The bill amended the Revenue Act to create an "offer-in-compromise" program within the Department of Treasury. Under this program, beginning January 1, 2015, the State Treasurer (or an authorized representative) can "compromise" all or any part of any payment of a tax subject to administration under the Revenue Act, including any related penalties and interest, if one or more of the following grounds exist:

¹ MCL 205.28. The section provides for an exception to this no compromise requirement for a voluntary disclosure agreement under Section 30c of the Revenue Act (MCL 205.30c), which applies to out-of-state businesses. The department may, however, compromise interest and penalties.

1. A doubt exists as to liability (DATL). A DATL would be based on the evidence provided by the taxpayer that the taxpayer would have prevailed in a contested case if the taxpayer's appeals rights had not expired.
2. A doubt exists as to collectability (DATC). A DATC would have to be established if (a) the amount offered in payment is the most that could be expected to be paid or collected from the taxpayer's present assets or income, and (2) the taxpayer does not have reasonable prospects of increasing the income or assets that would allow for a greater amount of the liability to be satisfied beyond the amount offered.
3. A federal OIC under 26 USC 7122 has been granted for the same tax years. If a state OIC accepted under this provision compromises the individual or corporate income taxes, the state treasurer (or authorized representative) could compromise the outstanding liability for each year by applying the same percentage as the federal liability compromised.

Generally, a tax that is compromised would not be subject to any additional assessment or collection unless the compromised tax is modified or adjusted after additional information is received from the IRS or through a state audit. A taxpayer could not request an informal conference or initial an action in court or the Michigan Tax Tribunal regarding the taxpayer's liability or the compromise.

The Department of Treasury could not levy against property or collect a liability while an offer in compromise is pending unless the state treasurer (or authorized representative) determines that the offer was intended to delay collection or the tax or the department issued a jeopardy assessment.

A taxpayer who submits an offer in compromise would have to pay \$100 or 20% of the offer (whichever is greater), with this amount applied the outstanding liability. This amount would not be refunded if the offer is rejected or reduced.

A rejection of an offer would be final, and not subject to further challenge or appeal, except through an independent administrative review.

If all or part of any payment of a tax is compromised, a written report would be filed (and published on the Treasury website) outlining the basis for the compromise and, at a minimum, a statement of each of the following:

- The amount of tax assessed or other amount due.
- The amount of interest or assessable penalties imposed,
- The terms of the compromise and the amount actually paid.
- The grounds for the compromise.

A compromise is subject to continuing review by the state treasurer. A compromise could be revoked, and any compromised liabilities could be reestablished (irrespective of

any statute of limitations), if (a) it is determined that the taxpayer conceals or provides misleading information of (b) the taxpayer fails to comply with the terms and conditions of the compromise, including filing required returns and remitting payment as required.

Within 180 days after the effective date of the bill, the state treasurer must:

- Establish guidelines for the offer-in-compromise program. If appropriate the guidelines could be modeled on the guidelines of the federal Internal Revenue Service.
- Establish administrative guidelines for officers and employees with the department to use when making decisions on whether an offer-in-compromise is appropriate.
- Establish procedures for an independent administrative review of any rejection of a proposed offer-in-compromise made by a taxpayer before the rejection is communicated to the taxpayer. A request for a review would have to be made within 30 days after the rejection. If appropriate the guidelines could be modeled on the guidelines of the federal Internal Revenue Service.

The department would disclose return information to the members of the general public to the extent necessary to permit inspection of any accepted offer-in-compromise relating the state tax liability.

MCL 205.23a

BACKGROUND INFORMATION:

The IRS's OIC program is authorized under Section 7122 of the Internal Revenue Code (26 USC 7122) and related regulations and guidance materials.² In order to be eligible for the OIC program the taxpayer must file all required tax forms, make all required estimated tax payments for the current year, and (if a business) make all required federal tax deposits for the current quarter. If a taxpayer has the ability to pay the full tax liability through an installment agreement, or other method, the taxpayer is generally not eligible for the OIC program. Generally, the amount paid by the taxpayer under an OIC must be at least equal to an amount that has a reasonable collection potential (RPC), based on the taxpayer's ability to pay, or based on the asserted amount owed if the taxpayer disputes the liability. Payments under an OIC are made in a lump sum payment option³ or a more frequent periodic payment option.⁴ Like HB 4003, there are three basic grounds upon which an IRS may accept an offer-in-compromise:

² See Treasury regulation 26 CFR 301.7122-1 and Part 5 (Collecting Process), Chapter 8 (Offer in Compromise) of the Internal Revenue Manual, <http://www.irs.gov/irm/part5/>. See, also, the IRS Form 656, *Offer in Compromise*, Instructional Booklet, <http://www.irs.gov/pub/irs-pdf/f656b.pdf>. For a legislative history of the OIC program see, Jay Katz, "An Offer in Compromise You Can't Confuse: It is Not the Opening Bid of a Delinquent Taxpayer to Play Let's Make a Tax Deal with the Internal Revenue Service", 81 Miss. L. J. 1673 (2012), http://mississippilawjournal.org/wp-content/uploads/2012/07/4-Katz_FINAL-Rev.pdf.

³ An initial nonrefundable 20% payment remitted at the time Form 656 is filed plus four other payments within a 24 month period after the offer is accepted.

⁴ Under the period payment offer, the taxpayer makes six or more payments over the course of 24 months.

- Doubt as to Liability – A doubt as to liability (DATL) is defined in Treasury regulations as "a genuine dispute as to the existence or amount of the correct tax liability under the law. Doubt as to liability does not exist where the liability has been established by a final court decision or judgment concerning the existence or amount of the liability."⁵ The Internal Revenue Manual further notes, "[g]rounds for compromise may exist when there is legitimate doubt from both the viewpoint of the taxpayer and the IRS. Validity of the DATL-OIC is determined by evaluating the supporting evidence and circumstances. The taxpayer is required to submit documentation and/or other evidence to support his/her DATL-OIC. The evidence available for both parties must be weighed in order to determine the extent of any 'doubt'."⁶
- Doubt as to Collectibility – A doubt as to collectibility (DATC) is defined in Treasury regulations as "any cases where the taxpayer's assets and income are less than the full amount of the liability"⁷ The Internal Revenue Manual further notes that for offers due to a DATC, "the decision to accept or reject usually rests on whether the amount offered reflects the reasonable collection potential (RCP)... RCP is defined as the amount that can be collected from all available means, including administrative and judicial collection remedies....In determining the taxpayer's future ability to pay, full consideration must be given to the taxpayer's overall general situation including such factors as age, health, marital status, number and age of dependents, education or occupational training, work experience and present and future employment status."⁸
- To Promote Effective Tax Administration – Treasury regulations note that a compromise may be entered "when the Secretary determines that, although collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship."⁹ The regulations also allow a compromise to promote effective tax administration "where compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability. Compromise will be justified only where, due to exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner. A taxpayer proposing compromise under this [provision] will be expected to demonstrate circumstances that justify compromise even though a similarly situated taxpayer pay have paid his liability in full."¹⁰

⁵ 26 CFR 301.7122-1(b)(1). See, also, IRS Form 656-L, <http://www.irs.gov/pub/irs-pdf/f656l.pdf>.

⁶ Internal Revenue Manual 4.18.2.2, http://www.irs.gov/irm/part4/irm_04-018-002.html.

⁷ 26 USC 301.7122-1(b)(2).

⁸ Internal Revenue Manual 5.8.4.3, http://www.irs.gov/irm/part5/irm_05-008-004.html. The IRM notes that the taxpayer's RPC is based the amount collectible from the taxpayer's net realizable equity in assets, expected future income after allowance of necessary living expenses, amounts from third parties, and assets to which a lien will not attach.

⁹ 26 USC 301.7122-1(b)(3)(i). Internal Revenue Manual 5.8.11.2.1 provides that "economic hardship occurs when a taxpayer is unable to pay reasonable basic living expenses." Economic hardship is only applicable to individuals and sole proprietorships. See, also, 26 CFR 301-6343-1(b)(1).

¹⁰ 26 USC 301.7122-1(b)(3)(ii)

ARGUMENTS:

For:

Proponents of the bill say that the creation of an offer-in-compromise (OIC) program is a "win-win" situation for taxpayers and the Department of Treasury. One observer notes, "The Offer-In-Compromise procedure has the potential to be an effective and functional program for dealing with the problem of taxpayers who cannot pay. Revenue-based, fairness-based, rehabilitative, and socioeconomic considerations all support the existence of a meaningful tax-debt forgiveness procedure."¹¹

The department wins by being able to collect at least some portion of the tax that would likely otherwise be uncollectible. The IRS's experience with its OIC program shows that most offers in compromise arise out of a doubt as to collectibility.¹² The IRS's experience also shows that the OIC program is an effective collection tool, compared to traditional collection mechanisms.¹³

The department also wins in fostering continued compliance by the taxpayer going forward through a requirement that the taxpayer remain current on tax liabilities for the next five years. This continued compliance requirement has the potential to improve future tax collections.

An OIC program also provides taxpayers with delinquency issues an opportunity for a "fresh start." Under the OIC program, taxpayers make a good faith effort to pay their delinquent accounts, often through installment payments, must pay their current year tax liabilities, and must remain compliant with the tax liabilities for the next five years. This is important in reestablishing the tax structure as one that is efficient and fair, fostering future voluntary compliance among taxpayers. A report by the Council on State Taxation (COST) observes, "Our federal and state tax systems are premised, to a great degree, on voluntary compliance. It is a common truth that taxpayers will more fully and willingly comply with a tax system they perceive to be balanced, fair, and effective. Taxpayers operating in a system they perceive as oppressive, unfair, or otherwise biased are less likely to voluntarily comply. The clear message to state legislatures is that they must be sensitive to the compliance implications and competitiveness concerns created by poor tax [administration]."¹⁴

¹¹ Shu-Yi Oei, "Getting more by Asking Less: Justifying and Reforming Tax Law's Offer-in-Compromise Procedure", 160 Penn. L. Rev. 1071 (2012),

[https://www.law.upenn.edu/journals/lawreview/articles/volume160/issue4/Oei160U.Pa.L.Rev.1071\(2012\).pdf](https://www.law.upenn.edu/journals/lawreview/articles/volume160/issue4/Oei160U.Pa.L.Rev.1071(2012).pdf)

¹² See, National Taxpayer Advocate, 2009 Annual Report to Congress, Volume I, http://www.irs.gov/pub/irs-utl/1_09_tas_arc_vol_1_preface_toc_msp.pdf.

¹³ The 2009 annual report of the National Taxpayer Advocate notes, "[t]he IRS's studies have shown that OICs generally yield a higher rate of return (from 18 to 20 cents for every dollar owed) than other collection enforcement methods (historically 13 cents for every dollar collected on debts over two years old and virtually nothing on debts outstanding for three years or more."

¹⁴ Douglas L. Lindholm and Fredrick J. Nicely, *The Best and Worst of State Tax Administration: COST Scorecard on Tax Appeals & Procedural Requirements*, Council on State Tax Administration, February 2010, <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=75910>.

Response:

The bill, while well intentioned, should initially be limited in scope if the goal is the creation of an effective and efficient OIC program. This would allow the Department of Treasury to better manage its human and financial resources as the program is being established. Perhaps initially, the department should only be required to allow compromise when there is also a compromise offer accepted by the IRS. This would minimize the amount of resources (human, financial, and time) necessary for the department to investigate a compromise offer.

The bill should also limit the taxes that may be compromised to the personal income tax and the state's main business taxes (CIT/MBT/SBT). These two types of taxes better align with the taxes that are likely to be the subject of a compromise offer investigated by the IRS. This again, would limit the amount of resources necessary for the department to investigate a compromise offer. Rather than establishing a new program that runs separate from the existing IRS program and that includes the full range of taxes administered under the Revenue Act (including sales and use taxes), a more limited starting approach could allow the department to develop the institutional capacity to administer a well-run program.

Rebuttal:

The department should not limit itself to allowing compromise offers only where there is also a compromise offer accepted by the IRS. Simply put, others have identified a great number of areas where the IRS's administration of its own OIC program could be improved upon, and delinquent Michigan taxpayers should not be limited by how the IRS administers its own program, which obviously does not take into consideration the Michigan Department of Treasury's interests.¹⁵ Moreover it's certainly possible that the acceptance by the Department of Treasury of a compromise offer could better enable the taxpayer to have a compromise offer accepted by the IRS. In addition, the substitute bill limits the scope of the OIC program to only those taxes that are administered under the Revenue Act, rather than including other debts owed to that state that are also collected under the act.

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.

¹⁵ See the 2009 annual report of the National Taxpayer Advocate, as well as the recent articles by Oei (footnote 12) and Katz (footnote 3). See also, Treasury Inspector General for Tax Administration (TIGTA), *Increasing Requests for Offers in Compromise Have Created Inventory Backlogs and Delayed Responses to Taxpayers*, March 2012, <http://www.treasury.gov/tigta/auditreports/2012reports/201230033fr.pdf>.