

Offer in Compromise: Will It Hurt Your Client's Bankruptcy Opportunity?

By Morgan D. King

Morgan D. King examines the impact an offer in compromise can have on a client's bankruptcy opportunity.

In a great many cases, delinquent taxpayers are eligible to discharge personal income taxes in bankruptcy.¹ Many are also eligible for an offer in compromise (OIC). But the two remedies are not necessarily compatible. A successful offer may be all the taxpayer needs. Before submitting the offer, however, give pause to how an unsuccessful OIC, or a request for a due process hearing, may step on the toes of other potential remedies. In this piece, we look at discharging taxes in bankruptcy.

The Bankruptcy Code² does not specify which kinds of debts may be discharged in bankruptcy. The Code more or less assumes that all debts are dischargeable, and then goes on to list certain categories of debts that are *excepted* from discharge.³ Debts that are listed in the exceptions include, among other things, debts created by the debtor's fraud, delinquent family support, student loans and certain categories of tax liabilities.

The taxes that cannot be discharged include trust-fund taxes such as the withholding portion of payroll taxes; excise and sales taxes under three years old; and personal income taxes for which the taxpayer failed to file a tax return or attempted to "evade or defeat" the tax;⁴ or the failure of the tax liability to satisfy one or more "time rules."

In a nutshell, a personal income tax skirts the exceptions and is dischargeable if it satisfies all of these rules: (1) the most recent due-date for filing the 1040 return is over three years old; (2) the taxpayer filed his/her 1040 for the year in question more than two

years ago; (3) the tax was assessed more than 240 days ago; (4) the tax return was not fraudulent; and (5) the taxpayer did not engage in a willful attempt to evade or defeat the tax (*i.e.*, tax evasion).⁵

Three of these rules are "time" rules. We call them, simply, "the three-year rule," "the 240-day rule" and "the two-year rule."

Two Critical Time Rules

But simply looking at a calendar and finding the relevant dates far enough back in time to satisfy the rules is not enough; there are certain things a taxpayer might do that, if going on during the running of the three-year period⁶ or the 240-day period,⁷ may "toll" the running of the period, that is, stop the clock.⁸ As long as the clock is stopped on one or the other of these time periods, the rule cannot be satisfied⁹ and the tax cannot be discharged in bankruptcy. These are things initiated by the taxpayer that are concurrent with, that is, *overlap*, the running of one or both of the time periods. The period or periods are tolled for the time of the overlap, plus additional time prescribed by the Bankruptcy Code.

The most frequent acts that taxpayers do that may stop the clock are bankruptcy, OIC and request for a collection due process hearing.¹⁰ The public policy behind the rule that the time periods are tolled in connection with these actions is that these acts are initiated at the whim of the taxpayer and prohibit the IRS from collection activity while they are pending; the government should not be deprived of its full allotted time to collect taxes, so the clock should stop on bankruptcy eligibility until the event preventing collection has passed¹¹ and the IRS has had the full

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benefit of the respective time periods in which to collect the taxes.

If the time during which a previous bankruptcy is pending overlaps either the three-year period or the 240-day period, it will stop the clock until the bankruptcy is no longer pending, plus 90 days.¹² Thus, a previous bankruptcy could prevent one or both time periods from having expired, forcing the taxpayer to wait out the time periods if he/she elects to file another bankruptcy to get rid of delinquent taxes.¹³ Of course, waiting out the time means taking a pounding from levies, liens and other collection measures for weeks or months. We can assume the taxpayer would rather avoid such grief.

Looking at OICs and Collection Appeals

Whether or not a taxpayer/client has filed a previous bankruptcy is beyond your control, so let's let a bankruptcy lawyer worry about the tolling effect of a previous filing. But what is within your control is whether or not to advise your client to submit an OIC,¹⁴ or file a request for a due process hearing¹⁵ or other collection appeal.

Let's assume that we have a client with delinquent taxes that, at least at first glance, appear to be short of one or more of the time rules. There is no prior bankruptcy and no prior request for a due process hearing. You are considering making an OIC on behalf of the client.

An OIC May Stop the Clock on the 240-Day Period

The Bankruptcy Code explicitly tolls the running of the 240-day period for the time in which an offer-in-compromise is "pending" or "in effect" during that 240-day period, plus 30 days.¹⁶ If the taxes meet all the other rules for discharge in bankruptcy, they will nevertheless not be dischargeable until the 240-day period resumes ticking and is eventually satisfied.

To put it simply, where the time that an offer is pending or in effect is concurrent with or *overlaps the 240-day period*, the offer prohibits the IRS from conducting collection actions,¹⁷ which stops the running of the bankruptcy period until the offer is no longer pending or in effect, plus 30 days. If the offer is made and is still pending when the tax is assessed, the 240-day period does not start and thus the rule cannot be satisfied. If, on the other hand, the offer is made after the 240-day period has expired, it does not affect it; once satisfied, always satisfied.

The Code states that the period is tolled for the time the offer is *pending* or *in effect*.

When Is an Offer Deemed "Pending"?

For purposes of bankruptcy, the bankruptcy court will probably use the language of the INTERNAL REVENUE MANUAL (IRM) to define the commencement of "pending." The IRM provides that an offer is deemed pending "when a delegated IRS official signs and dates the Form 656 in the appropriate section. This date is the official offer pending date."¹⁸ To clarify that statement, Treasury regulations provide that an offer becomes pending on the date the IRS deems it "processable."¹⁹ It is at that moment that collection must be stopped. The mere act of preparing a Form 656 and a Form 433-A²⁰ and mailing them to the IRS does not constitute the commencement of the pendency of the offer. Once an offer is submitted, the IRS may send it back as unprocessable, typically because the forms were not prepared correctly or clearly do not follow IRS criteria for consideration. So, the time between mailing it and getting it returned as unprocessable is not counted in the pending; pending commences only if deemed processable or, in other words, accepted for consideration.²¹

When is it no longer pending? The pendency of an offer would ordinarily be deemed to continue until it is rejected or withdrawn, plus any time allowed to file an administrative appeal in the event of rejection, plus any time the appeal, if made, is pending,²² plus 30 days. This is so because during this entire period the IRS is prohibited from collection activity.²³

When Is an Offer "In Effect"?

What happens if the offer is accepted? Once accepted, it appears to pass out of the category of "pending" and becomes "in effect." The Bankruptcy Code provides that the tolling continues while the offer is in effect. It is not precisely clear when the "in effect" period expires, but intuitively it seems it would continue in effect at least until the amount accepted by the IRS is paid in full, or defaulted.

When Might That Be?

An offer may be structured several ways, including a lump-sum payment, several payments or a monthly payment plan until the statute of limitations expires or the amount offered is paid.²⁴

If that's all there is to it, it would be simple to determine when the offer is paid off, and thus no longer "in effect." However, there's a catch. One of the terms

imposed on a taxpayer whose offer is accepted is a period of “compliance,” which could be viewed as “probation,” that lasts for five years following the date of acceptance of the offer. Specifically, the IRM says:

The taxpayer must timely file all tax returns and pay all taxes due during the compliance period. The compliance period is five years from the acceptance date or until the offer amount is paid in full, whichever is longer.²⁵

Is the offer deemed “pending” for the entire five-year period? If so, and if the offer was deemed processable at any time during the running of the 240-day period, the 240-day rule for dischargeability would remain unsatisfied for the entire five years, plus the number of months remaining in the 240-day period before tolling began (if any), plus an additional 30 days per the Bankruptcy Code. This could put a serious crimp in the debtor’s opportunity to get full relief for delinquent taxes. Unfortunately, there appear to be no published bankruptcy cases dealing with this question, so it is difficult to predict how it will turn out. At this point all that can be said is that the IRS acceptance of an offer, if made while the 240-day period is running, is a red flag for a potential dischargeability issue.

What if, after the offer is accepted, the debtor defaults?²⁶ In other words, when exactly is it no longer in effect? Upon actual default? Upon the date the IRS mails a notice of default? There is no statutory prohibition of collection activity in the event of default of an OIC. Accordingly, where a taxpayer defaults on the terms, one would probably select the date of the notice of default, and add 30 days per the Bankruptcy Code as the date the clock would resume ticking.

Does the Making of an Offer Toll the Running of the Three-Year Period?

The short answer is: no. The Bankruptcy Code explicitly addresses how the making of an offer may toll the time periods and provides only for tolling of the 240-day period;²⁷ since it’s obvious that Congress, in drafting the statute, had the tolling effect of the making of an offer clearly in its sights, but omitted any reference to the three-year period, the courts will interpret this as meaning that Congress did not intend to make the mere “making” of an offer a tolling event for that period. Nevertheless, somewhere

along the line, the OIC may toll the three-year period, as discussed below.

Will the Appeal of a Rejected Offer Toll Either Time Period?

The best answer is: possibly. While the mere making of an offer does not toll the three-year period, the *appeal* of a rejected offer might. The taxpayer has 30 days to administratively appeal a rejection of an offer;²⁸ the 30 days begin the day after the date of the letter of rejection.²⁹

The Bankruptcy Reform Act of 2005, a barely comprehensible “reform” of bankruptcy, inserted whole paragraphs into the Bankruptcy Code that were assigned no statutory designation or cite, or logical connection with surrounding text. It’s as though Congress simply closed its eyes and tossed some sentences into the Code with no thought as to where they might land.³⁰

As a consequence, whole paragraphs cannot be properly cited, and their location in the Code must be described as “hanging paragraphs.”

One such hanging paragraph was inserted just below subsection “G” of section 507(a)(8). Paragraph “G” has nothing to do with tolling periods, but the paragraph beneath it bears on tolling events for purposes of bankruptcy discharge.

This new language provides that the two time periods are tolled during the time a government entity is prohibited from collection due to a taxpayer’s request for a *hearing* and an *appeal* of a “collection action taken or proposed against the taxpayer,” plus 90 days.³¹ If the taxpayer does not request an appeal during the 30 days, then the clock will not have stopped on the running of the three-year period. In that event, the entire OIC proceedings will have had no tolling effect on the three-year period.

However, if the taxpayer timely requests an administrative appeal of the rejection, the outcome may be different. For the time during the 30-day period in which to request an appeal, and, if an appeal is timely requested, during the pendency of the administrative appeal, the IRS is prohibited from collection action.³² And clearly, appealing the rejection constitutes a request for a *hearing* and an administrative *appeal* within the meaning of the “hanging paragraph,” which arguably tolls the three-year period; if applicable, the period of tolling would commence upon the taxpayer’s making a request for the appeal and continue until the appeal is final, plus an additional 90 days. The administrative appeal is deemed final on the date of the notice of the decision.

But is the appeal of a rejected offer an appeal of a *collection action*? A collection action is ordinarily thought of as an act initiated by the IRS, while an OIC is an act initiated by the taxpayer. If the appeal of a rejected offer is not deemed an appeal of a collection action, it would not fall within the hanging paragraph, and hence would not toll the bankruptcy period. But if it is deemed an appeal of a collection action, then one or both of the bankruptcy periods are tolled.

The question of whether an appeal of a rejected offer constitutes an appeal of a collection action or not is yet another issue for which there is no clear answer, and can only be deemed a red flag to the professional that the question may become an issue in the courts; as of this writing, the author is not aware of any published cases dealing with the issue. The author has discussed it with the IRS office that deals with bankruptcy (the "insolvency" office) and learned that the IRS has no position on it, and in fact probably has not taken much notice of it. But as time goes on, and litigation drills down to the deeper levels of the Reform Act, it is almost inevitable that it will be raised.

Unlike some other actions such as a collection due process (CDP) hearing, an OIC by itself cannot ordinarily be appealed judicially, that is, to the U.S. Tax Court.³³ However, where the taxpayer has requested a CDP hearing, and made an OIC in connection with the hearing, an argument could be made that the appeal is seeking review of the CDP determination, which can be appealed to the U.S. Tax Court. This is another issue waiting for case law development.

Does a Request for a CDP Hearing Toll the Three-Year Period?

The short answer is: yes. Where a taxpayer receives a final notice of intent to levy or notice of lien, he or she has 30 days from the date of the notice in which to request a "collection due process hearing."³⁴ The language of the hanging paragraph appears to have been drafted with the CDP hearing in mind.

If the request for a due process hearing is made, the tax code prohibits collection activity for the pendency of the hearing process, plus 90 days.³⁵ At any time the pendency of the CDP hearing overlaps either of the bankruptcy time periods, the Bankruptcy Code stops the clock on that time period until collection activity may resume, plus 90 days.³⁶

Notice that "90 days" is mentioned in both the tax code and the bankruptcy code *but are not the same 90 days*. The tax code prohibits collection for 90 days following

the conclusion of the CDP hearing; the bankruptcy code then tacks on *an additional 90 days* following the end of the time that collection is prohibited by the tax code.

Arguably, then, the net effect of a request for a due process hearing is that it tolls the bankruptcy period for the time the hearing is pending, plus an additional *180 days*.

In the event the results of such hearing are adverse to the taxpayer, he or she has 30 days following the date of the notice of determination in which to appeal to the U.S. Tax Court.³⁷ However, the judicial appeal to Tax Court does not necessarily suspend levy action pending the appeal proceedings. So, the judicial appeal may, or may not, suspend one of the bankruptcy periods. This is yet another snare for the unwary.

Will a Request for a Collection Appeal Cause Trouble?

The short answer is: I don't think so. The collection appeal program (CAP) is separate and distinct from a CDP hearing and an OIC.³⁸ However, the making of a CAP appeal does not appear to *require* the IRS to cease collection activity. Rather, it is *IRS policy* to hold off on collection.³⁹ Policy is not the same thing as an outright statutory prohibition of collection, as appears in offer and CDP proceedings. Thus, it would appear that a CAP proceeding does not fall within the language of the Bankruptcy Code that applies only where a governmental entity is "prohibited" from collection action, and hence does not toll a bankruptcy period.

What Should a Nonbankruptcy Tax Professional Do?

Bankruptcy lawyers should be aware of the issues discussed above, but many are not, to some extent because there has been little to no adjudication in the bankruptcy courts in connection with them.

Nonbankruptcy tax controversy professionals are even less likely to be on top of these issues. Still, they must be addressed at some level in representation of a taxpayer. I would make the following suggestion:

In any case involving a client with delinquent taxes who is seeking protection from collection action and the tax professional is contemplating an OIC, a CDP hearing or a CAP, one question should be asked:

For any income tax delinquency for which making an OIC, requesting a CDP hearing or filing a CAP is contemplated, would the proceedings

overlap either the three-year period or the 240-day period, for the tax liability in question?

Keep in mind, the three-year period begins at the most recent date the tax return was due,⁴⁰ and the 240-day period begins upon date of assessment. If the answer to the question above is in the affirmative, then a red flag should be raised on this client. The flag is a heads-up that the tax may be eligible for bankruptcy with the passage of a little more time, but undertaking one of the contemplated acts may substantially delay such eligibility. There are often reasons why the taxpayer is not interested in

bankruptcy. If that is the case, it doesn't matter. But, a wise professional will have the client sign an acknowledgment that he or she has been advised of the potential eligibility for a bankruptcy discharge of the tax liability. If, on the other hand the client is amenable to whatever remedy is possible, including bankruptcy, I would suggest you consult with an experienced consumer bankruptcy lawyer, or suggest to your client that he or she consult such an attorney, and have the client sign an acknowledgment that he or she has been so advised. Particularly in connection with this tangled and ambiguous nest of issues, a little precaution can't hurt.

ENDNOTES

- ¹ See Morgan D. King, DISCHARGING TAXES IN BANKRUPTCY, Release 2009 #4, *BankruptcyBooks.com*.
- ² Title 11, U.S. Code.
- ³ 11 USC §523, §1328(a).
- ⁴ 11 USC §523(a)(1).
- ⁵ King, *supra* note 1, at ¶2.4. For bankruptcy purposes these rules apply equally in chapter 7 and chapter 13 bankruptcy, and also determine the dischargeability of state income taxes in bankruptcy. 11 USC §523(a)(1); §507(a)(8).
- ⁶ 11 USC §507(a)(8)(A)(i).
- ⁷ 11 USC §507(a)(8)(A)(ii).
- ⁸ Nothing tolls the running of the two-year period for filed tax returns; however, if the tax return is never filed, the two-year period never commences, and hence that rule will not be satisfied. A substitute-for-return does not qualify as a return for bankruptcy purposes.
- ⁹ But, once the time period has expired, the rule is satisfied and nothing will upset that; in other words, once satisfied, always satisfied.
- ¹⁰ Including any relevant previous bankruptcy, offer, or CDP hearing that overlapped the period.
- ¹¹ *In re Hoppe*, 259 BR 852 (Bkrcty.W.D.Tex. 1999), *In re Evoli*, 258 BR 839 (Bkrcty.M.D.Fla. 2001).
- ¹² 11 USC §507(a)(8)(G) (“hanging paragraph”).
- ¹³ The time allowed between filings of chapter 7 cases is eight years; 727(a)(8).
- ¹⁴ 26 USC §7122; IRM ¶5.8; Reg. §301.7122.
- ¹⁵ 26 USC §6320, 6330; IRM ¶8.22. A garden-variety CAP probably does not toll the running, because the IRS is not prohibited from collection during the pendency of a CAP appeal; IRM ¶8.1, ¶8.24.1.2(9); 26 CFR §601.106, Appeals Functions.
- ¹⁶ 11 USC §507(a)(8)(A)(ii), (iii).
- ¹⁷ IRM ¶8.23.1.2 (Aug. 28, 2009); 26 USC §6331(k).
- ¹⁸ IRM ¶5.8.2.4.1(2) (Mar. 26, 2010).
- ¹⁹ Reg. §301.7122-1(c)(2); 26 USC §6331(k).
- ²⁰ The forms for OIC and Collection Information Statement, respectively.
- ²¹ See Morgan D. King, KING'S LEGAL DESKBOOK FOR OFFERS IN COMPROMISE, Release 2009 # 1, *BankruptcyBooks.com*.
- ²² The taxpayer has 30 days in which to file a request for an administrative appeal of a rejected offer, during which time levy is prohibited. 26 USC §7122(e); Reg. §301-7122-1(f)(5).
- ²³ 26 USC §6331(k).
- ²⁴ IRM ¶5.8.1.8.4 (Mar. 16, 2010).
- ²⁵ IRM ¶5.19.7.23.6 (Jan. 16, 2009).
- ²⁶ Default includes principally failure to pay the full amount agreed to, or failure to file and pay all taxes due for the five-year probationary period.
- ²⁷ 11 USC §507(a)(8)(ii), (iii).
- ²⁸ 26 USC §7122(e); Reg. §301.7122-1(f)(5). This is an administrative appeal, rather than a judicial appeal. The 30-day period starts the day after the date of the rejection letter; IRM ¶5.8.7.6.5(1) (Sept. 23, 2008).
- ²⁹ Reg. §301-7122-1(f)(5).
- ³⁰ This could be because these amendments were largely drafted by lobbyists for various creditor interests, who might have been less than literate.
- ³¹ 11 USC §507(a)(8)(G) (hanging paragraph).
- ³² 26 USC §6331(k)(1)(B); Reg. §301.7122(f)(2)(iv).
- ³³ Some cases have held, however, that a case can be appealed to the U.S. Tax Court on the narrow ground of “abuse of discretion” by the IRS; *E. Sullivan*, 97 TCM 1010, Dec. 57,705(M), TC Memo 2009-4.
- ³⁴ 26 USC §6330(e); 26 USC §6330 (levy) and §6320 (notice of tax lien)
- ³⁵ 26 USC §6330(e).
- ³⁶ 11 USC §507(a)(8)(G) (hanging paragraph).
- ³⁷ 26 USC §6330(d)(1) (notice of levy).
- ³⁸ Reg. §601.106; IRM ¶8.24.1, 8.1.1.
- ³⁹ IRM ¶8.24.1.2.9.
- ⁴⁰ If an extension to file to October 15 was made, the three-year period starts then.

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