7 Misconceptions About Compromising Tax Debts

We are bombarded by commercials on television, radio and the internet by firms claiming to be able to virtually eliminate tax debts. These commercials often mislead people into thinking that tax debts can be avoided with relative ease. Even though it is possible that the professional chosen by you to represent you before the IRS can achieve excellent results, that professional is often limited in what he or she can achieve on your behalf by IRS regulations. Your results will depend to a great extent on your particular circumstances. Below are some of the misconceptions regarding Asettling@ (compromising) tax debts.

Misconception #1 – What the IRS says you owe is always correct. **Correction: Not necessarily. The IRS often makes many mistakes when it assesses additional penalties and taxes against taxpayers, and correcting these mistakes can sometimes be as easy as providing them with the necessary documentation.**

Unfortunately, many taxpayers believe whatever the IRS says. This is often due to the complexity of the tax laws. To compound problems, many of the "tax settlement" companies will not take steps to ascertain whether the additional taxes and penalties assessed against you by the IRS are correct or incorrect. Too often, their goal is to submit an "Offer in Compromise" straight away because they are paid most handsomely from that service.

The indispensible first step for you or your tax advisor is to determine the correct amount that is owed. Often you can simply provide proper documentation to the IRS to reduce or eliminate the additional taxes assessed. You may also qualify for remission of assessed penalties in certain situations. The important point to keep in mind is that you should not enter into an "Offer in Compromise" or tax settlement arrangement until you and your tax advisor are absolutely sure that the amount of additional taxes, interest and penalties that the IRS has assessed against you is correct. This is a valuable service which is often not provided by many national "tax settlement" companies.

Misconception #2 - AThe IRS will Asettle@ for pennies on the dollar.@
Correction: This is often true, but may not be true in your case. Results achieved are highly dependent on your circumstances and the manner in which your tax advisor presents your overall financial situation to the IRS.

By statute and tax regulations, IRS employees are prohibited from Asettling@ (compromising) your tax debt if you have sufficient income or assets to pay the debt. This process is called an AOffer in Compromise@ and effectively takes the form of an offer by you to pay something (either in a lump sum immediately, or in installments over time) in lieu of the IRS agreeing to write off a portion of your outstanding tax debt.

For the IRS to Asettle@ your tax debt, you must first file an IRS Form 656 which contains the Aoffer.@ A Form 433-A (for an individual) and/or 433-B (for a business) must also be filed which discloses in detail all of your income and assets. Search IRS Forms here: http://www.irs.gov/app/picklist/list/formsInstructions.html. If the form indicates enough assets and/or income to pay the liability, you will likely be required to pay the liability, at least in part.

First Component: Your Assets. If you have significant assets, the IRS may require you to sell some of them to pay the tax debt. IRS Treasury regulations will permit you to retain assets necessary to live (such as costs for transportation, including automobiles, household items, including furniture, fixtures and appliances), and enough income to pay for other expenses to support your family based upon certain specified criteria. See http://www.irs.gov/individuals/article/0,,id=96543,00.html

Second Component: Your Income. The IRS will permit you to use a certain amount of your income to pay for minimum costs of living. Any income above that threshold will be used to pay the tax liability over time. For example, if you earn $50,000 per year, and pursuant to IRS guidelines,$30,000 of that amount will be necessary to pay your food, clothing, medical care, housing, and future taxes (based primarily on your family size), then the remainder of your income, $20,000, must be used to pay the tax liability each year over a fixed number of years. This is usually up to five years.

Any amount that cannot be paid pursuant to these two components can be written off by the IRS. It must be kept in mind that the tax advisor you select must understand your finances in sufficient detail so that you get Acredit@ for all of your allowable expenses. Providing your tax advisor with more (rather than less) information is highly preferable. Therefore, it is important that you or your advisor present your financial situation in such a manner as to reflect your inability to pay the entirety of your tax debt, while at the same time being truthful about your financial situation. That way, you should be able to convince the IRS representative that at least a portion of your tax debt can be reduced.

Taxpayers who achieve the best results through the Offer in Compromise process are those taxpayers who have little or no income (or significantly reduced income) or assets in relation to the entirety of the tax debt.

Misconception #3 - AI can avoid IRS collection actions indefinitely.@
Correction: Probably not.

The truth is, although it may take several years for the IRS to get around to collecting your tax debt, the IRS will eventually come calling in one way or another.

This can take the form of *liens* placed on your name or a *levy* of your property or income. A *lien* is similar to a mortgage or encumbrance which effectively prohibits you from transferring your property. For example, if the IRS places a lien under your name at your parish courthouse, then a purchaser of your property would take title to the property Asubject@ to the lien. A wary purchaser will search for any liens under your name before purchasing to avoid this from happening. This can effectively prevent you from selling your property. Accordingly, a lien is meant to Aprime@ the IRS= interest in the property. A *levy*, on the other hand, is similar to a seizure of your property or income. With respect to your income, the IRS can *levy* your paycheck, retirement check, or social security check. This is similar to a garnishment. With respect to your property, the IRS can levy (seize) your property and sell it in satisfaction of your tax debt.

Misconception #4 - AI cannot have any tax debts discharged in bankruptcy.@
Correction: Wrong.

Most often, bankruptcy may be a better choice than an IRS tax settlement (Offer in Compromise) if (1) most or all of your tax debts are in excess of three years old, and (2) you and your bankruptcy attorney find it advisable to petition for bankruptcy for reasons other than your tax debts. In other words, bankruptcy merely to achieve a discharge of your tax liabilities can be a mistake. If your only significant debts in arrears are tax debts, than an IRS Offer in Compromise may be a better alternative than bankruptcy. However, if you decide to petition for bankruptcy regardless, you may be able to have all or a significant portion of your tax debts discharged in bankruptcy. See Misconception #4 below for more information.

Misconception #5 - AI can have all of my tax debts discharged in bankruptcy.@
Correction: This may be true, but it is probably wrong.

Only ordinary tax debts that have been Aassessed@ in excess of three years from the date you file for bankruptcy can be discharged in bankruptcy. Any tax debt that was Aassessed@ within three years of the date you file for bankruptcy cannot be discharged. In addition, certain other tax debts, such as the Atrust fund recovery taxes@ (applicable to employers who withhold employment taxes from their employee=s wages), or criminal tax penalties, cannot be discharged until the collection statute of limitations has expired (10 years from the date the tax was assessed). In general, the term Aassessed@ and Aassessment@ means the date which is the latest of (A) the due date of your return (usually April 15th); (B) the date you voluntarily file your return if filed after the due date; or (C) the date the IRS make an Ainvoluntary assessment@ if you failed to file your return. This is a general rule, however. The Aassessment date@ can be extended indefinitely if you file a fraudulent return.

Misconception #6 - AAn IRS AInstallment Agreement@ is the best option because the IRS representative I spoke with said so.@ Wrong. An Offer in Compromise most often achieves better results for the taxpayer, and the installment agreement framework is effectively considered part of the Offer in Compromise process anyway.

An Ainstallment agreement@ is an agreement that a taxpayer makes with the IRS whereby the taxpayer makes payments over time to satisfy his or her tax liabilities. In exchange, the IRS will forego levying (seizing) the taxpayer=s property or garnishing the taxpayer=s wages. When the taxpayer is fully able to pay the tax debts over time, this is often the only available method of handling the overdue taxes, interest and penalties. However, it is often not the best choice. When speaking with IRS representatives over the phone, taxpayers are first coaxed into an installment agreement. But if the taxpayer simply does not have the income or assets to pay the debt, than an Offer in Compromise will be a better alternative than an installment agreement. An Offer in Compromise will often remove a significant portion of the tax debt outright, assuming certain conditions are met. Any remaining tax debt that the taxpayer can satisfy through installments will effectively be subject to an installment agreement under the OIC process.

Misconception #7 - The IRS will Asettle@ (compromise) the tax debt only if there is Adoubt as to collectability.@ Wrong. The IRS is authorized to compromise a tax debt if there is Adoubt as to liability.@

The Offer in Compromise process applies in two broad situations. The first situation has been addressed above; that being that the IRS decides that there is Adoubt as to collectibility.@ That means that the IRS believes that it will not be able to collect the amount that is owed in full, and therefore, the IRS will be willing to accept something less than the full amount owed. The second situation is where the IRS decides that there is Adoubt as to liability.@ That means that the IRS must be convinced that you do not (or may not) owe all or a portion of the debt that the IRS has assessed against you pursuant to the interpretation of the Internal Revenue Code, Treasury Regulations, and other authority. In both situations, the IRS must weigh its chances of getting some money now versus getting all or less of it at a later date.

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