



*The Offer in Compromise Program Is
Beneficial but Needs to Be Used More
Efficiently in the Collection of Taxes*

July 17, 2006

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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 17, 2006

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The Offer in Compromise Program Is Beneficial
but Needs to Be Used More Efficiently in the Collection of Taxes
(Audit # 200530005)

This report presents the results of our review of the Offer in Compromise¹ (OIC) program. The overall objective of this review was to determine whether the OIC program efficiently and effectively collects tax liabilities that may not be otherwise collected and whether the taxpayers remain compliant once an offer is accepted.²

Synopsis

The OIC program³ provides taxpayers and the Internal Revenue Service (IRS) with a collection alternative when it is unlikely the taxpayers can fully pay outstanding tax liabilities or the payment of those liabilities could cause an economic hardship. Although the program as implemented by the IRS is expensive to administer and burdensome for taxpayers, it has benefits for both the IRS and the taxpayer. However, the IRS accepts only a small portion of the offers submitted (24 percent for Fiscal Years (FY) 1996 through 2005).

¹ Appendix VII includes definitions of terms used in this report.

² Since Fiscal Year 1999, we have conducted a series of reviews to evaluate the OIC program. Reports from those reviews are listed in Appendix VI. The purpose of this review was to provide an overall assessment of the efficiency and effectiveness of the OIC program. This review includes data and results reported in prior audits of the OIC program but also presents additional information about the OIC program's costs and benefits, taxpayer compliance after terms of the accepted offers are completed, and taxpayer compliance when offers were not accepted.

³ The OIC program is also referred to as the offer program in this report.



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The OIC program generated direct revenue in excess of the direct cost of administering the program. In addition, many taxpayers who had their offers accepted took advantage of the “fresh” start toward compliance and remained compliant both during and upon completion of offer monitoring.

The offer program could, however, be more effective at getting the appropriate taxpayers to apply for the program. Between FYs 1996 and 2005, approximately 50 percent of about 1.1 million offers closed either did not meet the preconditions of filing an offer or were returned to the taxpayer (e.g., for missing information) during the offer evaluation. This increases the IRS workload because the IRS must evaluate processing requirements for all offers received and often must take other actions before the offer evaluation can begin (e.g., requesting information not submitted with the offer). Frustration and burden is increased for those taxpayers whose offers are returned, and the IRS’ service to other taxpayers in the offer program is affected. The high rates of returned offers occurred because requirements of the OIC program were not always clear to taxpayers.

The financial analysis used in the offer evaluation could also be improved. The full evaluation of an offer involves indepth review of the taxpayer’s assets and ability to pay. This process is complex, requiring IRS employees to pay close attention to details and to make numerous calculations. We found errors on 32 percent of the 187 cases reviewed. These errors affected the outcome of 13 percent of the accepted offers reviewed but did not change the final decision in any of the rejected or withdrawn offers.

The IRS should also more effectively use financial information developed during an offer evaluation. When the offer evaluation results in a decision not to accept, the IRS generally returns the taxpayer’s delinquent account to the normal collection process. The systemic processes involved, in effect, suspend the IRS’ contact with the taxpayers while accounts await assignment to other collection functions. In some instances, due to IRS collection priorities and workload, the taxpayers’ accounts may not receive the IRS’ attention other than through routine notice procedures. Through this process, the information developed in the offer evaluation may not be associated with collection actions taken by other IRS functions.

Recommendations

The Commissioner, Small Business/Self-Employed (SB/SE) Division, should develop a strategy to identify potential candidates for the OIC program and then determine how to get these taxpayers into the program; provide a payment matrix, similar to the Payment Options Comparison Chart, to show the payment alternatives and provide examples of when the offer program should be used; and develop an Internet application for the Offer in Compromise (Form 656), Collection Information Statement for Wage Earners and Self-Employed Individuals (Form 433-A), and Collection Information Statement for Businesses (Forms 433-B) to screen out taxpayers whose offers are not-processable and to alert taxpayers about what documents must be



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submitted to the IRS. Finally, the Commissioner, SB/SE Division, should evaluate the effectiveness of the Centralized Offer in Compromise sites' collection efforts on accounts for which offers were not accepted and determine whether collections from these cases are comparable to results achieved by Automated Collection System collections and whether resources should be used to produce collections on these cases.

Response

IRS management agreed with three of our four recommendations and has initiated corrective actions on those recommendations. The IRS is conducting a pilot to evaluate whether taxpayers who are in compliance and whose accounts are in currently not collectible status are good candidates for the OIC program. The IRS has identified a target population and will be providing the taxpayers with the information necessary to submit an OIC. To assist taxpayers in making an informed decision, the IRS will provide taxpayers with information on payment alternatives in a revised Form 656 and will include this information on the IRS Internet site. In addition, the IRS is evaluating the use of a Hand-Off Unit at the Brookhaven, New York, campus to initiate collection procedures on rejected or withdrawn cases. The IRS will evaluate the effectiveness of this Unit through operational reviews and will determine whether the Unit should be made permanent.

However, IRS management believes implementation of an Internet application for the OIC program is premature. The IRS is developing an Internet application for installment agreements; once that application is fully functional, the IRS will evaluate the feasibility and cost-effectiveness of similar applications for other programs, including the OIC program. We agree with the IRS' decision to evaluate the feasibility and cost-effectiveness of an Internet application on installment agreements prior to developing an Internet application for the OIC program. This will benefit both the IRS and taxpayers through reduced development and implementation costs. Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at 202-622-8500.



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The Offer in Compromise Program Is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes

Background

The Internal Revenue Service (IRS) is responsible for collecting taxes when taxpayers file tax returns but do not fully pay the tax liabilities. The IRS has the authority to settle or compromise Federal tax liabilities by accepting less than full payment under certain circumstances. This is accomplished through an Offer in Compromise (OIC) (Form 656). The OIC is an agreement between a taxpayer and the Federal Government that settles a tax liability for payment of less than the full amount owed. Currently, the IRS is authorized to compromise a liability on any one of three grounds:

- Doubt As to Collectibility (DATC) – the taxpayer’s assets and income are less than the full amount of the liability.
- Effective Tax Administration (ETA) – although collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship or inequitable treatment.
- Doubt As to Liability – there is a genuine dispute as to the existence or amount of the correct tax liability under the law.

A taxpayer initiates the OIC process by submitting a Form 656. For offers filed on the grounds of DATC or ETA, the IRS requires the taxpayer to also complete a collection information statement and provide supporting documents, such as wage and earning statements, to verify information reported on the financial statements. The IRS requires the taxpayer to complete a financial statement and provide documents to verify the amounts reported on the financial statement. The IRS evaluates the acceptability of each offer by calculating the reasonable collection potential (RCP) based on the financial information provided by the taxpayer and some internal sources (e.g., the Integrated Data Retrieval System) and by considering the taxpayer’s special circumstances.

To maximize revenue, the OIC program must provide flexibility to taxpayers in the evaluation of offers while ensuring offers are granted to legitimate candidates. A recent poll by the IRS Oversight Board shows that a growing number of adults are not tolerant of any cheating on taxes. An overwhelming majority of the United States adults believe it is the duty of all Americans to pay their taxes.

Since Fiscal Year (FY) 1999, we have conducted a series of reviews to evaluate the OIC program.¹ Those reviews were based upon concerns of the IRS Commissioner, the IRS Oversight Board, and/or Congress. Reports from the prior reviews are listed in Appendix VI.

¹ The OIC program is also referred to as the offer program in this report.



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The purpose of this review was to provide an overall assessment of the efficiency and effectiveness of the program. This review includes data and results reported in prior audits of the OIC program but also presents additional information about the OIC program's costs and benefits, taxpayer compliance after terms of the accepted offers are completed, and taxpayer compliance when offers were not accepted.

This review was performed at the IRS National Headquarters in New Carrollton, Maryland, in the Office of Campus Filing and Payment Compliance of the Small Business/Self-Employed (SB/SE) Division during the period December 2004 through January 2006. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II, and a Glossary of Terms is included in Appendix VII.



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Results of Review

The Offer in Compromise Program Is Costly to Both Taxpayers and the Federal Government; However, This Program Has Benefits for Both

The IRS' goal for the OIC program is to collect what is reasonable at the least cost, at the earliest possible time, and to promote future filing and payment compliance. Taxpayers whose offers are accepted receive the benefit of a "fresh" start toward compliance. The full benefit of the fresh start is generally realized upon payment of the offer amount and completion of a 5-year period of postcompliance or until the offer amount is paid in full, whichever is longer. The IRS writes off the remaining unpaid tax liabilities, penalties, and interest. However, the OIC program has significant costs to both taxpayers and the Federal Government.

- The program includes costs of taxpayer burden in terms of preparation of the applicable OIC forms, gathering required documentation for the offer, and the impact of IRS processing time. In addition, a significant number of taxpayers who enter the OIC program do not have their offers accepted.
- The Federal Government's cost for administering the program includes direct labor involved in processing offers and monitoring the terms of accepted offers. The IRS estimated that even the simplest offer request costs approximately \$500 to process, and a complex offer costs much more.

The OIC program generated direct revenue in excess of the direct cost of administering the program. In addition, many taxpayers who took advantage of the fresh start toward compliance remained compliant both during and upon completion of offer monitoring.

Taxpayer cost and benefits of the offer program

Taxpayers initiate the OIC process by submitting a Form 656. For offers filed on the grounds of DATC or ETA, the IRS requires the taxpayer to complete a financial statement and either pay a \$150 application fee or prepare an Income Certification for Offer in Compromise Application Fee (Form 656-A). A substantial amount of supporting documentation is also required, which may seem burdensome to taxpayers but is necessary for the IRS to reach the proper decision to accept or reject the offer. The documentation required is dependent upon the information on the financial statement as prepared by the taxpayer or the information developed by the IRS during the offer evaluation. The supporting documentation required may include:

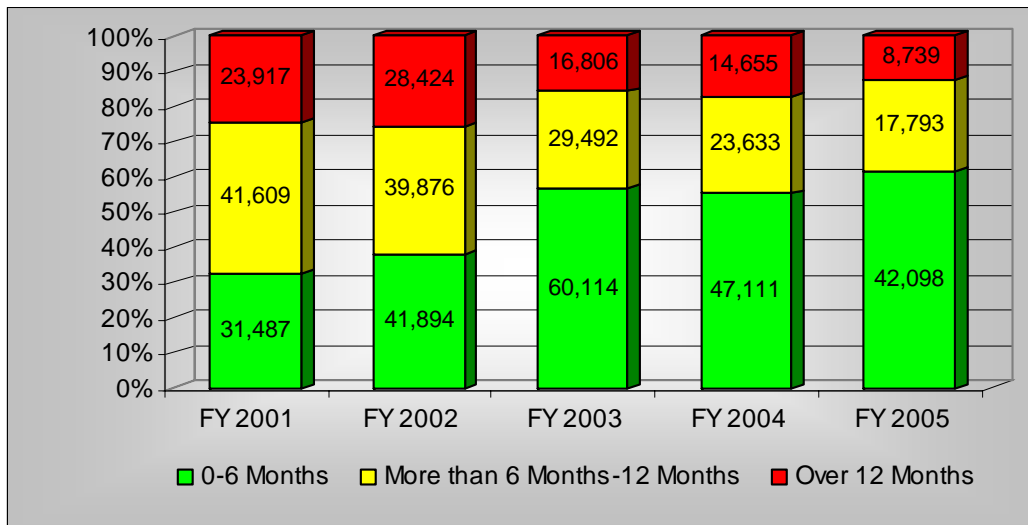


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- Wage, earning, or income statements.
- Bank statements.
- Support for expenses (e.g., personal expenses such as health care).
- Court-ordered payments (e.g., child care, alimony).
- Loan information (e.g., mortgage, automobile loans) including payment information and loan balance.

In addition to the amount of paperwork required, a 2003 Nationwide Tax Forum focus group with practitioners indicated that their biggest problem with the OIC program was the IRS delays² in administrating the program. However, Figure 1 shows the timeliness of offer processing has generally improved since FY 2001. During FY 2002, over 28,400 offers were in process for over 12 months. This declined to approximately 8,700 offers in FY 2005 (a decrease of approximately 69 percent). However, offers closed during FY 2005 that were in process for over 12 months continue to represent a substantial cost in terms of time to approximately 13 percent of taxpayers in the offer program.

Figure 1: Age of Processable Dispositions - FYs 2001 Through 2005³



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Collection Reports 5000-108 (Monthly Report of Offer in Compromise Activity).

² Customer Satisfaction Issues of Practitioners, 2003 Nationwide Tax Forum Focus Groups, Project 01.08.005.03 Brooklyn/Hartford & Seattle/San Jose Research.

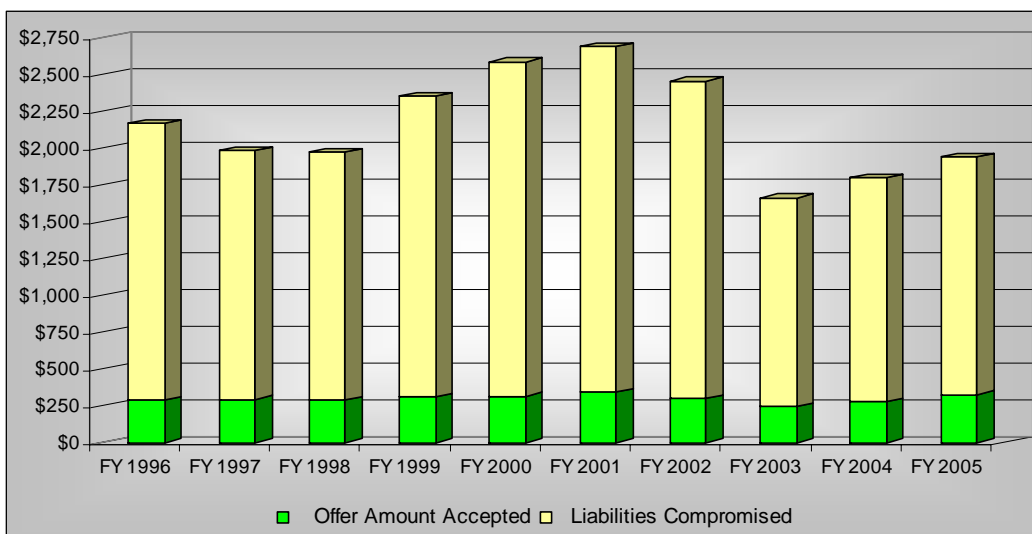
³ For FY 2005, the IRS offer data include not-processable offers in the age of dispositions. These data showed that, during FY 2005, 64,811 of the dispositions were closed in 6 or fewer months. For comparability with prior fiscal years, we excluded 22,713 not-processable offers from the number of offers disposed of in 6 or fewer months (to arrive at the figure shown in the last column of Figure 1).



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The benefit to those taxpayers whose offers are accepted can be significant. IRS data show that, during FY 2005, over 19,000 offers (totaling almost \$326 million) were accepted for liabilities of \$1.9 billion. Figure 2 shows a comparison of the offer amount to the liabilities compromised for FYs 1996 through 2005. For the 10-year period, the IRS accepted almost 270,000 offers, compromising \$21.6 billion in balances due in exchange for offers totaling almost \$3.0 billion. These accepted offers represent approximately 14 cents paid per dollar owed.

Figure 2: Comparison of Offer Amounts Accepted to Liabilities Compromised - FYs 1996 Through 2005 (in millions of dollars)



Source: TIGTA analysis of Collection Reports 5000-108.

Federal Government cost and benefits of offer processing

The Federal Government’s cost for administering the OIC program includes direct labor for processing offers. The labor costs include:

- The compliance functions at the Centralized Offer in Compromise (COIC) sites and the field offer groups. These functions are responsible for evaluating offers.
- The IRS Campus OIC units. The OIC units are responsible for monitoring accepted OICs to ensure taxpayers comply with the OIC payment terms and the 5-year compliance requirements of the accepted offers.
- The IRS Office of Appeals. The Appeals function is responsible for reviewing rejected offers for which taxpayers appeal the decision and for evaluating offers filed during the collection due process.
- The IRS Office of Chief Counsel. The Office of Chief Counsel is responsible for reviewing accepted offers with liabilities of \$50,000 or more. The purpose of the review



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is to determine whether the offers meet the legal requirements for compromise and conform to IRS policy and procedures.

We identified the cost of labor applied by the IRS compliance functions for the field offer groups, the COIC sites, and the IRS campuses for accepted offer monitoring for FY 2004. We did not obtain the cost of labor applied to the offer program in the IRS Office of Appeals or the IRS Office of Chief Counsel because the necessary data were not readily available. In FY 2004, the 3 compliance functions used approximately 1,346 Full-Time Equivalents (FTE) costing \$78.5 million to evaluate and monitor offers.

The benefits for the Federal Government from the OIC program include revenue received from offer application fees, offer payments, refund recoupments, and collateral payments. During FY 2004, the revenue from the program exceeded the cost. As shown in Figure 3, the IRS labor cost for the 3 compliance functions was approximately \$78.5 million, while direct revenue from the compliance functions was approximately \$201.7 million. Although this represents a return of less than \$3 for each dollar spent, it does not include future filing and payment compliance discussed later in this report.

Figure 3: OIC Program Cost Versus Benefits for FY 2004

Cost			Benefits	
Function	FTE	Cost	Revenue Item	Amount
COIC Sites	633	\$ 34,023,000	Offer Payments	\$ 180,608,000
Field Offer Groups	365	27,585,000	Refund Recoupment	13,718,000
IRS Campus OIC Units	348	16,939,000	Application Fees Paid	6,928,000
			Collateral Payments	453,000
Estimated Labor Costs	1,346	\$ 78,547,000	Estimated Revenue	\$ 201,707,000

Source: TIGTA analysis of IRS cost and benefits data obtained from the SB/SE Division Finance and Wage and Investment Division Compliance Finance functions. Benefits were obtained from the Automated Offer in Compromise database.

Other costs and benefits

Other costs of the program include the opportunity cost of using IRS staff resources for the OIC program rather than collection enforcement.⁴ The OIC program can and has taken away from other collection work. The Government Accountability Office noted that, between FYs 1997 and 2001, the IRS increased staffing to manage the growing offer inventory and processing time. However, the growth in staffing was outpaced by the increases in demand and the complexity of case processing. The number of direct collection field staff hours charged to the OIC program more than doubled, from about 728,000 hours in FY 1997 to about 1.6 million hours in FY 2001. At the same time, the number of direct hours charged to all field collection activities declined by

⁴ IRS management believes the opportunity cost is substantial. In the SB/SE Division discussion document, *Offers in compromise: HOW MUCH DOES THIS PROGRAM COST?*, August 2004, the IRS estimated that the potential opportunity cost of the lost resources may be over \$1.1 billion per year.



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about 30 percent, from about 12.7 million hours in FY 1997 to about 8.9 million hours in FY 2001.⁵

In April 2001, 1,078 revenue officers were dedicated to the OIC program. Implementation of the COIC sites in August 2001 and the lower number of offer receipts during FYs 2004 and 2005 have allowed the IRS to reduce the number of revenue officers dedicated to the OIC program. IRS management indicated that, by the end of FY 2005, this number had been reduced to approximately 300. During FY 2006, the IRS plans to further reduce this number to approximately 150 offer specialists working out of 3 Area Offices.

We did not quantify the increase in revenue from future compliance for the taxpayers “brought back” into the tax system because of complexities in determining the amount of revenue generated. For example, taxpayers who earn wages may have tax withholding paid by their employers; these withholdings should occur regardless of whether the offers were accepted.

Taxpayers were compliant after offer acceptance

Taxpayers generally do remain in compliance when offers are accepted. The IRS effectively monitored accepted offers to ensure compliance with the terms of the offers. In our sample of 84 taxpayers whose offers were accepted during FY 1999, the IRS identified noncompliance in 33 (39 percent) instances and took appropriate action to resolve the noncompliance.⁶ At the time of our review, 96 percent of the 84 taxpayers were in compliance with the OIC payment terms and the 5-year compliance requirements for filing their returns and paying the taxes due.

The SB/SE Division Office of Campus Filing and Payment Compliance and the Office of Program Evaluation and Risk Analysis (OPERA) conducted a more comprehensive analysis⁷ of individual taxpayer compliance with filing and paying requirements for offers accepted during Calendar Years 1995 through 2001. Their analysis determined that approximately 80 percent of the individual taxpayers remained in compliance. This includes taxpayers who received the first collection notice but did not receive any subsequent notices.

Also, taxpayers remain in compliance after the 5-year monitoring period. Our review of a sample of 245 taxpayers whose offers were accepted between October 1, 1994, and December 31, 1998,⁸ determined that 220 taxpayers (90 percent) were compliant with filing and payment requirements on tax periods subsequent to the 5-year monitoring period.

⁵ TAX ADMINISTRATION: *IRS Should Evaluate the Changes to Its Offer in Compromise Program* (GAO-02-311, dated March 2002).

⁶ For more information, see Appendix VI, report 5.

⁷ *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, September 2004.

⁸ The number of tax years for which taxpayers were compliant after completion of the offer monitoring period varies based on offer acceptance date. At the time of our review, taxpayers in our sample had been compliant from 1 to 5 tax years after the offer monitoring period.



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Various Program Changes Over the Past Several Years Affected Offer in Compromise Inventory and Timeliness of Processing

Since FY 1992, the OIC program has undergone significant changes. These changes have resulted in fluctuations in participation by taxpayers in the OIC program. The IRS was not initially equipped to handle the increase in offer receipts, and a growth in ending inventory and delays in offer processing (i.e., a backlog) occurred. However, recent changes have helped the IRS to work offers more quickly, and the implementation of an application fee has contributed to a reduction in the number of offer filings. The result has been a significant reduction in yearend inventories, improvement in the timeliness of offer processing, and a significantly reduced backlog of offers. Some of the major changes include the following:

- Increased emphasis on accepting OICs in FY 1992.
- Implementation of the IRS Restructuring and Reform Act of 1998 (RRA 98).⁹
- Initiation of the COIC program during FY 2001.
- Implementation of the OIC application fee and revision to Form 656 during FY 2004.

Increased emphasis on accepting OICs

In FY 1992, the IRS began to actively encourage taxpayers to use the OIC provision to settle past liabilities and get a fresh start in tax compliance. The IRS liberalized its policy on accepting OICs in response to a significant increase in the IRS accounts receivable. The growth in the IRS accounts receivable caused considerable concern to Congress, the Office of Management and Budget, the Department of the Treasury, and the IRS. The goal was to increase the use of offers to increase the collection of revenue, while creating for the taxpayer a fresh start toward compliance with future filing and payment requirements.

A review conducted during FY 1993 by the IRS Inspection Division¹⁰ showed the publicity and increased emphasis on the new program resulted in a substantial increase in offers. Due to this increase, the IRS field offices were concerned about diverting resources from working taxpayer delinquent accounts to working offers. Because no national directive was issued, the field offices were using various assignment practices.

As a result of the change in policy, the number of offers received substantially increased and ending inventories began to build. As shown in Figure 4, the number of offers submitted increased from approximately 17,200 in FY 1992 to 132,500 by FY 1996 (an increase of approximately 670 percent). During this same period, the yearend inventory increased from

⁹ Pub. L. No. 105-206, 112 Stat. 685, 765.

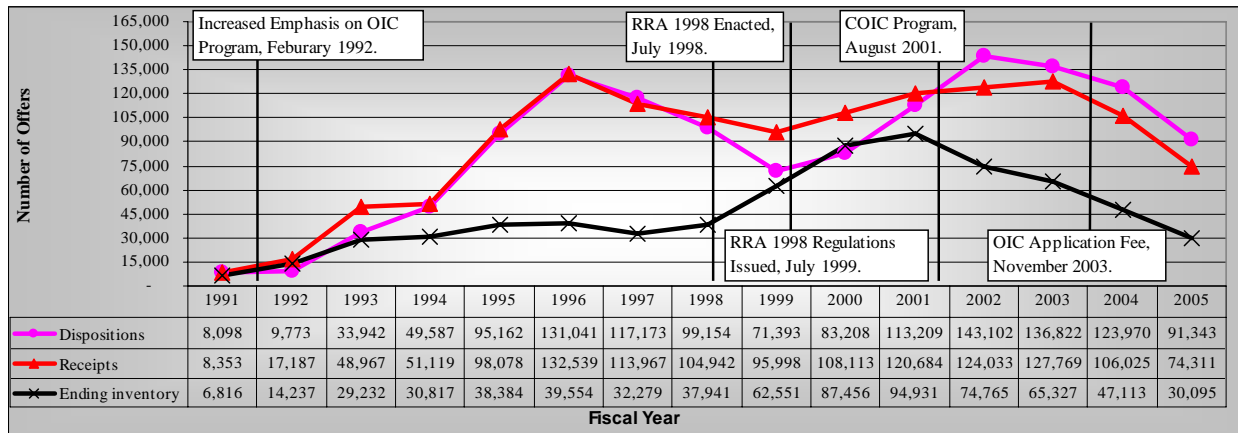
¹⁰ Before implementation of the RRA 98, the functions of the TIGTA were conducted by the IRS Inspection Division. Inspection report *Review of the Service's Implementation of the New Offer in Compromise Policy* (Reference Number 92070, dated April 5, 1993).



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approximately 14,200 offers at the end of FY 1992 to over 39,500 at the end of FY 1996 (an increase of approximately 178 percent).

Figure 4: Analysis of Offer Inventories - FYs 1991 Through 2005¹¹



Source: TIGTA analysis of Collection Reports 5000-108.

In the FY 1997 *Taxpayer Advocate’s Annual Report to Congress*,¹² the OIC program was highlighted as 1 of the 20 most serious problems facing taxpayers. The *Report* stated that tax practitioners ranked “Offer in Compromise Issues” as the fourth most serious problem facing taxpayers and IRS management ranked “Delays in OIC Processing” as the fifteenth most serious problem. In addition to the delays, the *Report* also noted there was a lack of clarity and consistency in the program.

Implementation of the RRA 98

The RRA 98 included taxpayer rights and protections applicable to the OIC program. The RRA 98 added “effective tax administration” as a factor in determining whether to accept an offer. The Act also provided an independent administrative review of any proposed offer rejection. However, RRA 98 Section 3462 was vague about the effective date and did not specify how to expand the program. Temporary Department of the Treasury regulations were issued on July 21, 1999, 1 year after the law was passed.

Our review of the IRS’ implementation of the provisions of the RRA 98 showed that the IRS modified the OIC process to comply with the requirements of the RRA 98 and had taken steps to expand access to the program. However, the IRS needed to develop guidelines to better prepare taxpayers to supply information for the offer process, allow further flexibility when determining

¹¹ The ending inventory does not equal beginning inventory. This is due to inventory corrections affecting beginning inventory. For example, beginning inventory can be increased to reflect instances in which previously closed cases are reopened.

¹² IRS Publication 2104 (Rev. 1-98).

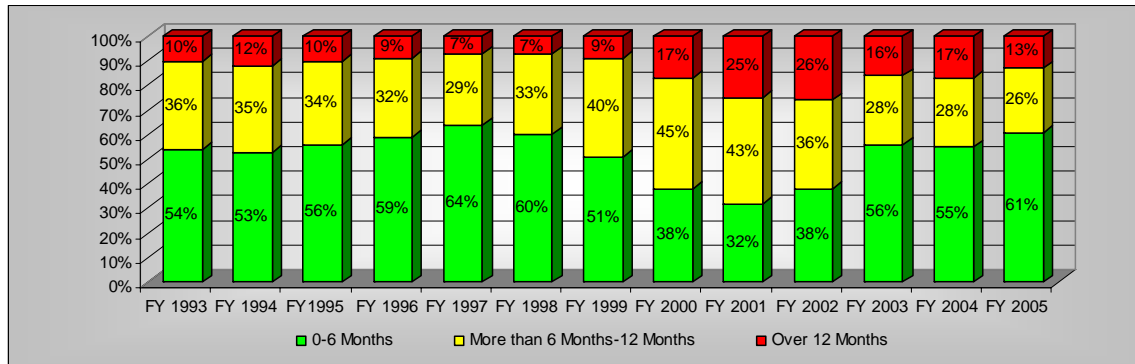


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an acceptable offer amount, and encourage taxpayer access to the appeal process. A management information system was also needed to monitor and manage both the acceptance of OICs based on special circumstances and the results of the independent administrative review of rejected offers.¹³

After enactment of the RRA 98, the number of offers accepted in FY 2001 was 50 percent higher than in FY 1997, and a significant inventory backlog developed. During the same period, there was a 200 percent increase in yearend offer inventory. As shown in Figure 4, during FY 2000, the yearend inventory exceeded the number of offer dispositions during that entire year. The yearend inventory increased from approximately 32,000 offers at the end of FY 1997 to approximately 95,000 at the end of FY 2001. Also, the age of both offers in inventory and offers at disposition grew. As shown in Figure 5, dispositions taking longer than 12 months increased from approximately 7 percent to 25 percent during this same period.

Figure 5: Age of Processable Offer Dispositions - FYs 1993 Through 2005¹⁴



Source: TIGTA analysis of Collection Reports 5000-108.

Initiation of the COIC program

The IRS initiated the COIC program in August 2001. The concept was to control, gather required information for, and evaluate offers at two centralized sites (Brookhaven, New York, and Memphis, Tennessee). The more complex offers (e.g., business and self-employed taxpayers) were forwarded to field offer groups where experienced revenue officers, known as offer specialists, conduct the offer evaluations. The expectations were that offers could be worked more quickly and the growing backlog of offers would be reduced.

¹³ For more information, see Appendix VI, report 1.

¹⁴ For FY 2005, the IRS offer data include not-processable offers in the age of dispositions. These data showed that, during FY 2005, 71 percent of the dispositions were closed in 6 or fewer months. For comparability with prior fiscal years, we excluded not-processable offers from the number of offers disposed of in 6 or fewer months (to arrive at the percentage shown in the last column of Figure 5).



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After implementation of the COIC sites, the yearend inventories of offers declined and the timeliness of offer processing improved. Yearend inventories declined from approximately 95,000 at the end of FY 2001 to approximately 65,000 by the end of FY 2003 (see Figure 4). Over this same period, the overall timeliness of offer processing improved. The number of offers closed within 6 months of receipt improved from 32 percent in FY 2001 to 56 percent in FY 2003 (see Figure 5).

However, our review of the implementation of the COIC program showed the reduction was primarily due to significantly more offers being returned to taxpayers. Taxpayers and their representatives contributed to the increase in returned offers by submitting offers even though they were not eligible for an OIC or because they did not stay current in filing tax returns and making estimated tax payments while their offers were being evaluated.¹⁵ For FYs 2002 and 2003, approximately 163,000 (58 percent) of 280,000 offers were returned to taxpayers either as not-processable offers or as processable returned offers.

Implementation of an OIC application fee and revision to Form 656

The IRS implemented an OIC application fee at the beginning of FY 2004. The fee was intended to reimburse the IRS for part of the expense of running the OIC program. In addition, the IRS expected that the OIC application fee would deter unreasonable or frivolous offers, thus allowing the available OIC staff to better handle the workload. In addition, the IRS revised Form 656 in July 2004 to clarify processability requirements. The revised Form 656 provided space for taxpayers to include an explanation if they were not legally required to file a tax return.

Our review of the implementation of the OIC application fee showed offer receipts declined at all income levels. However, we noted that taxpayers whose income was below the poverty level were more affected than taxpayers above the poverty level. Since poverty-level taxpayers are exempt from the \$150 OIC application fee, it was not clear why there was a more significant decline in offer filings by this group of taxpayers. It is possible that initially some poverty-level taxpayers were not aware of the exemption. However, beginning in early 2004, the IRS conducted a media campaign to advise taxpayers of the OIC eligibility requirements and the exemptions.¹⁶

After implementation of the OIC application fee and revisions to Form 656, offer receipts declined from approximately 128,000 during FY 2003 to approximately 74,000 in FY 2005 (a 42 percent decrease). Also during this time, the number of offers closed within 6 months of receipt improved from 56 percent in FY 2003 to 61 percent in FY 2005.¹⁷

¹⁵ For more information, see Appendix VI, report 4.

¹⁶ For more information, see Appendix VI, report 7.

¹⁷ IRS data showed 71 percent of the dispositions were closed in 6 or fewer months. This included not-processable offers. For comparability, we excluded not-processable offers from the number of offers disposed of in 6 or fewer months.

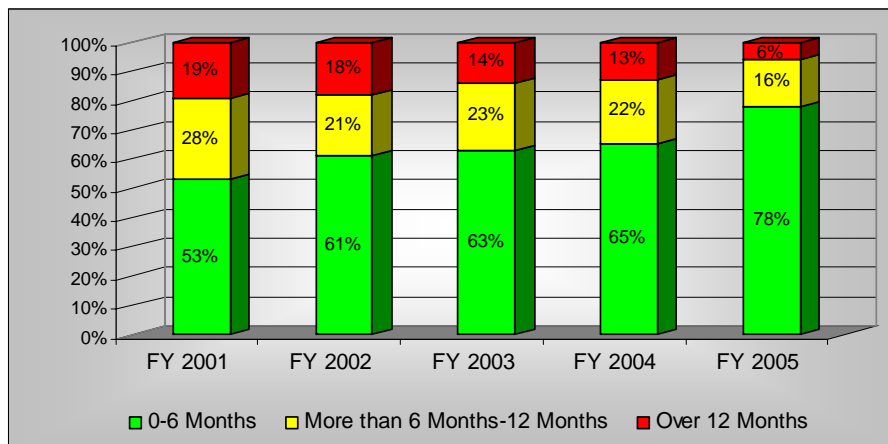


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Inventory backlog

Implementation of the COIC program and the OIC application fee had significantly reduced inventory backlog by the end of FY 2005. As shown in Figure 4, the overall number of offers in inventory had decreased 68 percent, from approximately 95,000 at the end of FY 2001 to approximately 30,000 by the end of FY 2005. Figure 6 shows that the ending inventory of all offers over 12 months old decreased from approximately 19 percent at the end of FY 2001 to approximately 6 percent by the end of FY 2005. See Appendix V for a detailed comparison of COIC sites with field offer groups.

Figure 6: Age of Yearend Inventory - FYs 2001 Through 2005



Source: TIGTA analysis of Collection Reports 5000-108.

Other changes to the OIC program

In addition to the changes noted above, the following recent changes may affect participation levels in the OIC program and the timeliness of offer processing:

- The American Jobs Creation Act of 2004.¹⁸ This Act provided the IRS with the authority to enter into partial payment installment agreements. Through these agreements, the IRS may accept an installment agreement when the tax liability will not be fully satisfied within the collection statute expiration date.
- An expanded role for the COIC sites. The IRS piloted an expansion of the COIC program by including offers from taxpayers that filed a U.S. Individual Income Tax Return (Form 1040) Schedule C (Profit or Loss From Business). The IRS limited the expansion to taxpayers that reported gross receipts under \$100,000 and showed no

¹⁸ Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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employees. The IRS considered the pilot to be successful and plans to fully implement the expanded role during FY 2006.

We have not evaluated the impact of these changes on the OIC program. However, we are currently conducting a review of the partial payment installment agreements and have scheduled a review of the COIC sites' evaluation of offers from taxpayers filing Schedule C.

Improvement Is Needed in Attracting Potential Candidates for the Offer in Compromise Program

The IRS needs to improve methods of identifying candidates for the OIC program. Between FYs 1996 and 2005, approximately 24 percent of the 1.1 million offers received were accepted. Over this same 10-year period, 50 percent either did not meet preconditions of filing an offer or were returned to the taxpayer (e.g., for missing information) during the offer evaluation.

Currently, taxpayers who wish to participate in the program initiate an offer; however, this attracts offer applications from taxpayers that do not qualify for the program or taxpayers that do not fully understand the depth of financial verification the IRS conducts before accepting an offer. Our analysis of offer dispositions determined:

- A significant number of offer applications do not meet the preconditions of filing an offer. Those offers not meeting the preconditions are returned to the taxpayers (as not-processable returned offers) without further consideration. However, the IRS must evaluate the processability of all offers received except those based upon Doubt As to Liability.¹⁹
- A substantial portion of the offers determined to meet the preconditions are returned to taxpayers during the offer evaluation process without being fully evaluated. This occurs, for example, when taxpayers no longer meet the preconditions of offer filing or did not provide information requested during the course of the offer evaluation. The IRS closes these cases as processable returns.

The submission of offers that are returned increases taxpayer frustration and burden as well as the IRS' workload. It also degrades service to other taxpayers who submit offers that meet all requirements and more realistically represent their ability to pay.

The high rates of returned offers occurred because requirements of the OIC program were not always clear to taxpayers. In addition, taxpayers had little to lose; if their offers were not accepted, collection of their taxes was, in effect, delayed. The OIC application fee implemented by the IRS during FY 2004 was intended to reduce the number of frivolous offers; however, this

¹⁹ This is because offers submitted on the basis of Doubt As to Liability represent disputes as to the existence or amount of the tax liability and apply to the specific tax periods that are in question.



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fee is not applicable to offers that are considered to be not-processable. Also, in light of the potential benefit of a fresh start, the fee may not be significant to some taxpayers.

A significant number of offer applications are determined to be not-processable

As of November 2003, the processability requirements (preconditions) for filing an offer included the following criteria. The taxpayer:

- Cannot be in bankruptcy.
- Has filed all required tax returns.
- Has timely filed and deposited all employment taxes for the prior 2 quarters and remained current with Federal tax deposit requirements, if applicable.
- Used the most current version of Form 656, Collection Information Statement for Wage Earners and Self-Employed Individuals (Form 433-A), and/or Collection Information Statement for Businesses (Form 433-B).²⁰
- Submitted the \$150 application fee²¹ or, for low-income taxpayers, a Form 656-A.

The initial processing for offers, including determining whether the offers are processable, is conducted at the COIC sites. We determined the COIC sites generally followed IRS procedures when returning not-processable offers.²² During FYs 1996 through 2005, approximately 33 percent of the 1.1 million offer dispositions were not-processable. Not-processable dispositions ranged from 56 percent in FY 1996 to approximately 14 percent in FY 2001. Figure 7 shows the not-processable determination as a comparison to total dispositions for FYs 1996 through 2005. Some of the processing changes that affect the not-processable disposition include the following. The IRS:

- Modified the processable criteria and reduced the number of reasons why an offer would be returned as not-processable during FY 2000 (not-processable cases reduced).
- Implemented a requirement that offers be filed on the current version of Form 656 in May 2002 (not-processable cases increased).
- Implemented the OIC application fee in November 2003 (FY 2004, not-processable cases increased).

²⁰ The IRS eliminated this from the not-processable return criteria during FY 2005.

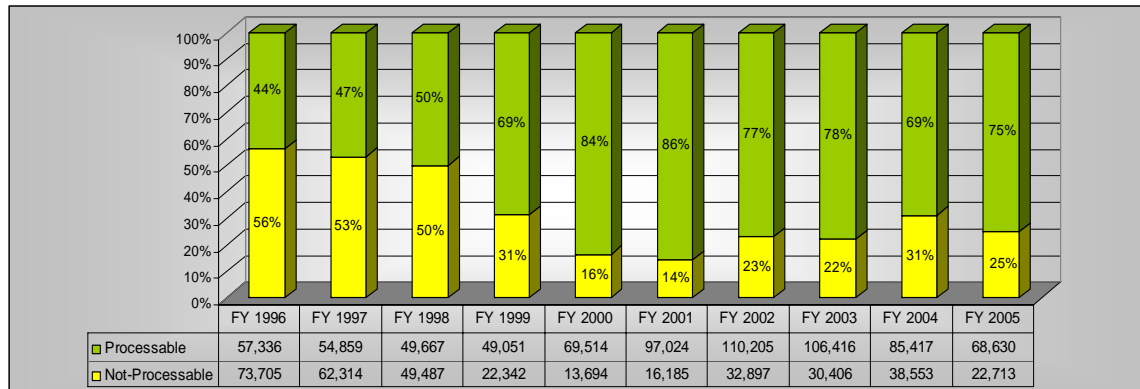
²¹ The application fee is not required for offers filed solely on the basis of Doubt As to Liability.

²² We reviewed a judgmental sample of 53 offers closed as not-processable during our visits to the 2 COIC sites. We reviewed 30 offers returned by the Memphis COIC site in August 2002 and 23 offers returned by the Brookhaven COIC site in September 2002. For more information, see Appendix VI, report 4.



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Figure 7: Analysis of Not-Processable Dispositions - FYs 1996 Through 2005



Source: TIGTA analysis of Collection Reports 5000-108.

The IRS maintains data to identify the reasons offers are classified as not-processable. For FYs 2000 through 2005, our analysis of that information showed failure to file returns was the most frequent reason for returning offers to taxpayers. The percentage of not-processable offers due to failure to file ranged from approximately 41 percent in FY 2004 to approximately 80 percent in FY 2001. Appendix IV provides more details on the reasons why offers are returned to taxpayers.

A substantial portion of the processable offers are also returned

Once an offer is found to be processable, the IRS may return the offer without a full evaluation of the offer proposal. The processable return category was established in FY 2000 when the IRS changed the criteria for determining the processability of offers. Some conditions previously considered to make the offer not-processable were changed to perfection issues. This allowed more offers to be considered past the initial processing; however, the perfection issues generally need to be addressed before the offer can be accepted.

The IRS may return offers when:

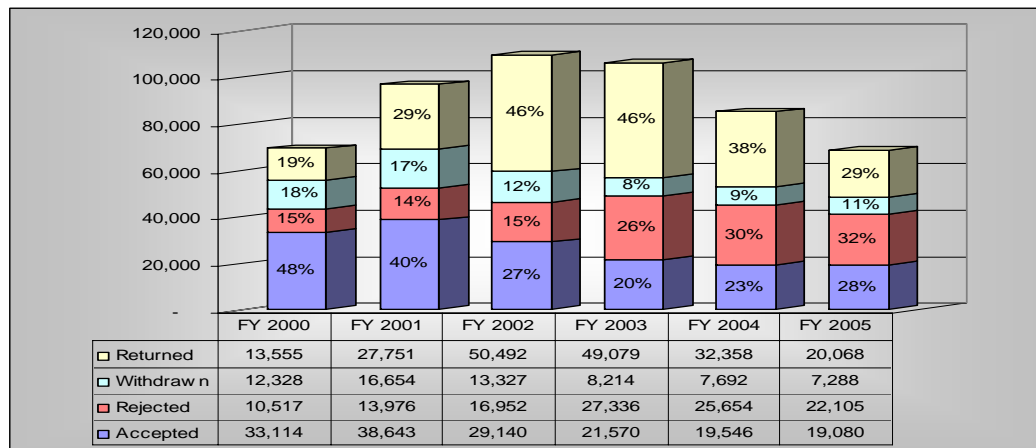
- The taxpayer fails to fulfill a request for information necessary to complete a full evaluation.
- The taxpayer fails to remain in compliance with the filing of required tax returns while the offer is under evaluation.
- The taxpayer fails to make required estimated tax payments or Federal tax deposits while the offer is under evaluation.
- The IRS determines the offer was filed solely to delay collection actions.



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IRS data show that, during FYs 2000 through 2005, 36 percent of approximately 536,000 processable offers were closed as returned offers. Figure 8 shows processable dispositions during FYs 2000 through 2005. Processable returned offer dispositions were approximately 29 percent of the total offer dispositions in FY 2005 and have ranged from approximately 19 percent in FY 2000 to 46 percent in FYs 2002 and 2003.

Figure 8: Analysis of Processable Dispositions - FYs 2000 Through 2005



Source: TIGTA analysis of Collection Reports 5000-108.

Our reviews of 83 offers returned to taxpayers by the COIC sites (33 offers) and the field offer groups (50 offers) determined that IRS procedures were generally followed.²³ We identified errors on only 5 (6 percent) of 83 offers returned. The errors were identified on cases processed by the COIC sites and primarily involved administrative issues such as information not being associated with the case file or the information request was not mailed to the taxpayer.

Recent changes affect the OIC program, but more could be done

When developing the July 2004 revision to Form 656, the IRS obtained comments from both the Taxpayer Advocate Service and tax practitioner groups. In addition to providing direction for the new application fee, the revised Form 656 included space for taxpayers to include an explanation if they were not legally required to file a tax return.²⁴ The not-processable returned offer dispositions declined from 31 percent of dispositions during FY 2004 to approximately 25 percent during FY 2005. Because of the timing between the implementation of the application fee and the revisions to Form 656, we could not determine the extent to which the improvements to the Form 656 assisted in this reduction; however, it is crucial that the processing requirement be clearly stated so taxpayers can evaluate their situations prior to filing an offer.

²³ For more information, see Appendix VI, reports 4 and 6.

²⁴ National Taxpayer Advocate report entitled *2004 Annual Report to Congress* (Reference Volume 1, page 319).



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During FY 2004, the IRS also attempted to reduce the number of processable returned offers by revising procedures for evaluating responses to information requests. Under the revised procedures, a nonresponse to a request for information may no longer result in a routine decision to return the offer to the taxpayer. For example, when a taxpayer's response to a request for information is incomplete, the IRS will determine whether:

- The omission of information is material enough to prevent an RCP calculation.
- The taxpayer's response addressed all requested items even if the response did not exactly and/or specifically include the information requested. If so, the IRS will provide the taxpayer with an opportunity to supply the information needed.

Discussions with COIC site management indicate these new returned offer procedures have produced more communication between taxpayers and IRS examiners than in the past. Our review of disposition data showed the percentage of processable offers returned to taxpayers declined from 46 percent in FY 2003 to 29 percent in FY 2005. In addition, offers returned because taxpayers did not provide financial information declined from approximately 67 percent in FY 2003 to 48 percent in FY 2005. See Appendix IV for more details on reasons processable offers are returned to taxpayers.

The IRS' authority to enter into partial payment installment agreements provided by the American Jobs Creation Act of 2004 may also decrease the number of offers received. These agreements are similar to offers accepted on a long-term payment basis, known as deferred payment offers. For these offers, the offer amount will be paid over the remaining life of the collection statute. Due to the similarities between these payment alternatives, it is not clear to us which payment method would be in the best interest of the Federal Government and the taxpayer. A June 2005 training topic provided a Payment Options Comparison Chart²⁵ that showed various payment alternatives. This information could be beneficial to taxpayers and tax practitioners in determining which payment alternative to use. Some modification may be necessary, such as including all offer bases and providing direction or examples to help taxpayers choose among the payment options.

Past changes to the offer program have resulted in significant receipts in potential offers. The IRS was not equipped to deal with the increase in receipts, and a backlog of unprocessed offers ensued. Changes in the offer program are needed to increase the appropriate use of the OIC collection alternative. However, caution is needed to ensure the increase in the use of the program does not exceed the IRS' ability to promptly and accurately evaluate proposed offers. We believe the IRS should better identify the taxpayers for whom the offer program is intended and actively pursue getting the taxpayers into the program. Taxpayers for whom the OIC program is intended may include:

²⁵ See Appendix IV, Figure 3.



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- Taxpayers who have demonstrated compliance with filing and payment requirements over an extended period (e.g., 3 years).
- Taxpayers whose accounts are in the Queue for extended periods, or are considered currently not collectible, including those accounts that are shelved.

Our review of accounts in the Queue and shelved accounts²⁶ determined that, as of April 18, 2005, taxpayer accounts with balances due totaling more than \$3.9 billion had been in the Queue for more than 1 year and more than \$1.6 billion in balances due had been in the Queue longer than 2 years.²⁷ In addition, 798,783 taxpayer accounts with balances due totaling \$6.2 billion were shelved between October 1, 2000, and September 30, 2004.²⁸

Recommendations

The Commissioner, SB/SE Division, should:

Recommendation 1: Develop a strategy to identify potential candidates for the OIC program and then determine how to get these taxpayers into the program. This may include, for example, taxpayers whose accounts are considered currently not collectible and/or taxpayers who have a demonstrated filing compliance.

Management's Response: IRS management agreed with this recommendation. The IRS is currently conducting a pilot called the OIC Candidate Study. The pilot will evaluate whether taxpayers who are in compliance and whose accounts are in currently not collectible status are good candidates for the OIC program. The IRS has identified a target population and will be providing the taxpayers with the information necessary to submit an OIC.

Recommendation 2: Provide taxpayers a payment matrix, similar to the Payment Options Comparison Chart, to show the payment alternatives and provide examples of when the offer program should be used. The matrix may be made available on the IRS Internet site and the instructions to Forms 656.

Management's Response: IRS management agreed with this recommendation. The IRS will provide taxpayers with information on payment alternatives in a revised

²⁶ For more information, see Appendix VI, report 8.

²⁷ The Individual Master File data were not limited by type of tax, but the Business Master File data include only trust fund taxes.

²⁸ For this analysis, we excluded some shelved tax modules that may have limited collection and/or lien potential. These are criteria we defined during this audit, not IRS criteria. The Individual Master File tax modules include only those taxpayers that were alive (no date of death on the Master File) and between 20 and 65 years old. Business Master File tax modules exclude estates and include only those businesses that did not have a business-closed date entered on the Master File.



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Form 656 and will include this information on the IRS Internet site to assist taxpayers in making an informed decision.

Recommendation 3: Develop an Internet application for Forms 656, 433-A, and 433-B. The Internet application should screen out taxpayers whose offers are not-processable (e.g., those taxpayers in bankruptcy or those who have not filed all required tax returns). It should also alert taxpayers about what documents must be submitted to the IRS, depending on the items reported.

Management's Response: IRS management believes this recommendation is premature and will not be implementing corrective actions. The IRS is developing an Internet application for installment agreements; once that application is fully functional, the IRS will evaluate the feasibility and cost-effectiveness of similar applications for other programs, including the OIC program.

Office of Audit Comment: We agree with the IRS' decision to evaluate the feasibility and cost-effectiveness of an Internet application on installment agreements prior to developing an Internet application for the OIC program. This will benefit both the IRS and taxpayers through reduced development and implementation costs.

Inconsistent Financial Analyses Could Alter Offer in Compromise Decisions

Our review of judgmental samples of 187 closed offers (96 accepted, 81 rejected, and 10 withdrawn) showed appropriate determinations were not always made and improvement was needed in the accuracy and documentation of financial analyses conducted during offer evaluations. The samples included 87 offers evaluated at the COIC sites (46 accepted, 31 rejected, and 10 withdrawn)²⁹ and 100 offers evaluated by the field offer groups (50 accepted and 50 rejected).³⁰

In the analysis of offers based on DATC, the offer specialist compares the amount the taxpayer offered with the amount the IRS determines could be legally collected from the taxpayer (i.e., the RCP). When offers are submitted based on ETA, the offer specialist determines if the RCP is greater than the amount owed before considering the taxpayer's special circumstances.

The RCP is based on the taxpayer's equity in assets and future income in excess of necessary living expenses. The IRS requires the taxpayer to complete a financial statement and provide documents to verify the amounts reported on the financial statement. The offer should be accepted when the offer amount reasonably reflects the RCP or the offer amount adequately reflects the consideration of economic hardship when a special circumstance exists.

²⁹ For more information, see Appendix VI, report 4.

³⁰ For more information, see Appendix VI, report 6.



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We identified errors or combinations of errors in the financial analysis for 59 (32 percent) of the 187 cases reviewed. The errors identified affected the outcome of 12 (13 percent) of the 96 accepted offers reviewed but did not change the final decisions in any of the 91 rejected or withdrawn offers reviewed. These errors involved:

- Monthly income in 36 instances. These included the calculation of income for wage earners (19), business income of self-employed or business taxpayers (8), and unemployed persons (9).
- Monthly expenses in 15 instances. These included calculation of the allowable tax expense (seven), national standard or local housing standard (five), or other allowable expenses (three).
- The calculation of net equity in assets in eight instances. These included the valuation of equity in investments (five) and the valuation of other assets such as real estate or residence (three).

The IRS implemented the use of standards for three general categories of expenses. The intent was to provide a consistent and reasonable basis when determining the amounts of some common necessary expenses. National standards are used for food and clothing expenses. Local standards are used for housing and utilities expenses and transportation expenses (e.g., ownership and operating expense of automobiles).

The use of these standards has met with some criticism from tax practitioners and the National Taxpayer Advocate.³¹ The standards have been cited as being inflexible. IRS procedures indicate these standards are guidelines and can be exceeded if they are inadequate to provide for a specific taxpayer's basic living expenses. In our reviews of these 187 cases, we identified errors in the application of the standards but did not identify any examples of unreasonable adherence to the standards.

Improper decisions were caused by insufficient evaluation of data and inadvertent errors in calculations

Insufficient analysis of documentation provided by taxpayers and/or inadvertent errors in calculations occurred because offer determinations involve indepth evaluation of a taxpayer's assets and ability to pay. This process is complex, requiring employees to pay close attention to details and to make numerous calculations. While managers reviewed and approved the final decisions in the offers included in our sample, the errors were not always identified. This is due to the managers' workloads and an emphasis on reasonableness of the offer conclusion rather than a recalculation of the offer.

³¹ National Taxpayer Advocate report entitled *2005 Annual Report to Congress* (Reference Volume 1, Topic number 16).



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We identified errors in the determinations of monthly income in 36 (19 percent) of the 187 cases reviewed. Inaccurate income determinations were significant contributing factors in 9 of the 12 instances in which the offer determination was adversely affected.

IRS procedures provide that the income calculation is based on an estimate from current earnings information (e.g., wage statements for employed taxpayers or income statements for business and self-employed taxpayers) or from an average of the taxpayer's earnings from prior years, when the taxpayer is temporarily unemployed or employment is sporadic.

Income errors occurred because employees used incorrect sources of information (e.g., income of an unemployed person based on unemployment benefits) or made inadvertent mathematical or other calculation errors, such as not adjusting business or self-employed income for asset depreciation expense. In addition, guidance in the Internal Revenue Manual did not adequately cover many circumstances encountered in evaluating the various types of earning statements. As a result of our review of the COIC program,³² the IRS revised the Internal Revenue Manual procedures for financial analysis on May 1, 2004. These procedures included additional details for the calculation of income, which should help employees analyze financial information more consistently.

We made additional recommendations in our review of the field offer groups. These recommendations have not been fully implemented, or we have not verified the implementation of the corrective actions due to the limited amount of time since we made the recommendations.³³ Our recommendations included:

- *Consider requiring the use of a standardized tool, such as Decision Point,³⁴ or analysis tools in the offer evaluation process. This would help reduce errors involving miscalculations.* The IRS indicated the Decision Point program is currently being analyzed and upgraded to include applications for business-related financial statements. Once upgrades are completed, the IRS intends to require the program's use on OICs evaluated by field offer groups. This program should not only help reduce calculation errors but also serve as a helpful guide to OIC specialists when analyzing the financial conditions of businesses.
- *Evaluate alternative case file documentation techniques for organizing the supporting documentation and calculations. This would assist with managerial review of the cases so calculations could be more easily reviewed for accuracy.* The IRS indicated the implementation of Decision Point will assist in providing more consistency and quality assurance in OIC calculations and reports. In addition, operational review plans will

³² For more information, see Appendix VI, report 4.

³³ For more information, see Appendix VI, report 6.

³⁴ Decision Point is a Microsoft Excel® spreadsheet application developed by the IRS to guide IRS employees through the financial evaluation of offers.



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include an objective to review current methods of case file organization, which will lead to Internal Revenue Manual direction to standardize best practices in this area.

- *Identify and provide additional training on financial analysis techniques used in support of the offer determinations. Based on our limited review, training topics should include income determination issues.* The IRS indicated the financial analysis training was provided to revenue officers in August 2005.

Better Use of Financial Analysis Is Needed

As previously discussed, offer determinations involve an indepth evaluation of the taxpayer's assets and ability to pay. The IRS requires the taxpayer to complete a financial statement and provide supporting documents. In terms of time and resources by both the IRS and taxpayers, this represents a substantial investment. However, when an offer evaluation results in a decision not to accept, the IRS generally returns the taxpayer's delinquent account to the normal collection process.

The systemic processes involved, in effect, suspend the IRS' contact with the taxpayers while delinquent accounts await assignment to other collection functions (e.g., the Automated Collection System (ACS) or the Collection Field function (CFf)). In some instances, due to IRS collection priorities and workload, the taxpayers' accounts may not receive the IRS' attention other than through routine notice procedures. Through this process, the information developed in the offer evaluation may not be associated with collection actions taken by other IRS functions.

We determined many taxpayers whose processable offers were not accepted were compliant with subsequent filing and payment requirements. Other studies also show that the quicker a delinquent account is actively pursued for collection, the higher the success rate on collecting the delinquency.

Offers returned to the collection process

The IRS is generally prohibited from taking collection action while an offer is being considered and for 30 calendar days after an offer is rejected. Following the rejection of an offer, the IRS maintains the offer in a suspense file for 45 calendar days. This provides the taxpayer 30 calendar days to appeal the determination and an additional 15 calendar days for the administrative process of associating an appeal request with the offer case file.

Our review of 100 (50 COIC site and 50 field offer group) offers rejected between October 1, 2002, and June 30, 2003, determined collection actions were not promptly resumed following the determinations to reject the taxpayers' offers, even though the taxpayers attempted to resolve their liabilities by filing OICs. Figure 9 shows a comparison of the collection status of



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taxpayers' accounts prior to the offer filings and the collection status³⁵ following the offer rejections. In 16 of the 100 rejected offers, the taxpayers' accounts were put in either the Queue or Currently Not Collectible (CNC) status following the decision to reject the offer. In seven other instances, the taxpayers' accounts were not reactivated for collection due to bankruptcy [redacted], subsequently filed offers [redacted], or [redacted].

Figure 9: Collection Status Following Offer Rejection

Prior Collection Status	Collection Status Following Offer Rejection							Total
	Fully Paid	Installment Agreement	ACS	CFf	Queue	CNC	Other	
Notice								10
ACS								35
CFf								5
Instal. Agreement								15
CNC								7
Other								7
Other								9
Total	12	15	45	5	9	7	7	100

Source: TIGTA review of 100 rejected offers.

In addition, the 50 cases put into active collection status in the ACS (45) and the CFf (5) averaged approximately 102 calendar days (ranging from 39 calendar days to 220 calendar days) from the issuance of the disposition letter to the reactivation of the active collection status. This includes an average of 51 calendar days to close the cases on the Automated Offer in Compromise Database (a minimum of 45 calendar days is generally provided to allow the taxpayer to appeal) and an average of approximately 51 calendar days to resume active collection after the cases were closed on the Automated Offer in Compromise Database.

While some cases experienced delays in the OIC functions, much of the time required to resume active collection is due to standard processing routines. While taxpayers' accounts are often placed into the collection status they were in prior to the offers being filed, cases may also be placed in final notice status³⁶ after offers are closed. This occurred, for example, when the taxpayers' accounts had not had a final notice issued within the last 18 weeks.

Collections after offer rejection

The RCP calculation offers a reasonable approach to identifying collection potential, but it did not always accurately predict subsequent collections (i.e., collections after an offer has been

³⁵ This analysis shows the collection status other than notice status (e.g., final notice).

³⁶ The final notice is the last notice the taxpayer receives before the IRS will take collection action on the taxpayer like the filing of a lien, levying on the taxpayer, or seizing property.



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rejected). Overall, our analysis of the 100 rejected offers³⁷ showed that subsequent collections exceeded the offer amounts by approximately \$272,000.

For the 100 cases reviewed, subsequent collections were less than the amounts offered in 36 cases, including no subsequent collections from 13 cases. In total, the offer amount exceeded the subsequent collections on the 36 cases by almost \$204,000. In contrast, 64 cases had subsequent collections that exceeded the offer amount. The liabilities included in the offer for 32 cases had been fully paid, and the taxpayers for 16 other cases were currently making payments through installment agreements. In total, the subsequent collections exceeded the offer amount on these 64 cases by approximately \$476,000.

We compared the subsequent collections with the following RCP groupings:

- **Full Pay - Assets**: the RCP calculation indicated the taxpayer's equity in assets was sufficient to fully pay the liabilities (28 instances).
- **Full Pay - Future Income**: the RCP calculation indicated the taxpayer's future income was sufficient to fully pay the liabilities (46 instances).
- **Full Pay**: the RCP calculation indicated the taxpayer could fully pay through a combination of assets and future income (10 instances).
- **Less Than Full Pay**: the RCP calculation indicated a DATC; however, the offer amount was less than the RCP (16 instances).

The taxpayers with equity in assets more often had subsequent collections in excess of the offer amount than those taxpayers in the other groupings. Figure 10 shows the account status at the time of our review and the results of the RCP calculation. In 22 (78 percent) of the 28 cases in the Full Pay - Assets grouping, the taxpayers either had fully paid the liabilities (64 percent) or were participating in installment agreements (14 percent). In addition, 89 percent of these cases had subsequent collections in excess of the offer amount.

In comparison, only 2 (12 percent) of the 16 cases in the Less Than Full Pay grouping had either fully paid the liabilities or were currently participating in installment agreements. Of these 16 taxpayers, only 44 percent had subsequent collections in excess of the offer amount.

³⁷ We reviewed the taxpayers' account information between February 28, 2005, and March 4, 2005. This was approximately 20 to 29 months after the offers had been rejected and closed on the Automated Offer in Compromise Database.



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Figure 10: Subsequent Collections on a Sample of 100 Rejected Offers³⁸

Current Status	Full Pay - Assets		Full Pay - Future Income		Full Pay		Less Than Full Pay		Total	
	Count	Percentage	Count	Percentage	Count	Percentage	Count	Percentage	Count	Percentage
Total	28	100%	46	100%	10	100%	16	100%	100	100%
Subsequent Collections Exceeded Offer Amount	25	89%	28	61%	4	40%	7	44%	64	64%

Source: TIGTA review of 100 rejected offers.

The SB/SE Division Office of Campus Filing and Payment Compliance function and the OPERA conducted a more comprehensive analysis³⁹ of subsequent collections from offers rejected. This analysis showed that the IRS collected less than 80 percent of what individual taxpayers were offering in 54 percent of the offers rejected. This includes no subsequent collections from 21 percent of the individual taxpayers.

The IRS report also indicated a high percentage of rejected or returned offers were not actively worked and resolved. The report recommended conducting an analysis to determine how the processing system can be modified to ensure taxpayers whose offer requests are not accepted are offered the appropriate collection alternative treatments. Our tests supported this conclusion.

Compliance after offer nonacceptance

We reviewed a sample of 93 nonaccepted offers from taxpayers who did not have a subsequent offer accepted. The sample was selected from offers closed between October 1, 1994, and December 31, 1998. Our review of the taxpayers' accounts determined that many of these taxpayers remained in compliance with IRS filing and payment requirements. For the 5 tax years after the offers were closed, the taxpayers:

- Were compliant with filing and payment requirements on or before receipt of the final notice in 69 instances (74 percent).
- Were compliant with filing and payment requirements, but required some collection action beyond final notice, in six instances (6 percent).
- Were not compliant with filing and/or payment requirements in 18 instances (19 percent).

³⁸ The percentage calculation by current status in the Full Pay – Future Income grouping was affected by rounding and does not total 100 percent.

³⁹ *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, September 2004.



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The IRS changed its process for determining RCP in FY 2005, in conjunction with procedural changes in installment agreements and the results of the SB/SE Division and OPERA analysis. Previously, IRS procedures allowed the Collection Statute Expiration Date to be extended for 5 years to obtain a full payment through an installment agreement. Following these guidelines for the evaluation of offers, the IRS generally did not accept the offer when the taxpayer could fully pay the tax liability (i.e., the time remaining until the Collection Statute Expiration Date, plus 5 years).

The IRS analyzed its practice of including the “plus 5 years” in the analysis of the taxpayer’s ability to make future payments and discontinued that practice. The IRS believes this change should improve the accuracy of the RCP calculations and the overall quality of offer decisions and result in more accepted offers.

Also, the IRS is testing a new concept at the COIC sites by taking subsequent collection actions on accounts for which offers were not accepted. This appears to be a positive step in collecting tax liabilities and allows for dialog to continue relative to resolving the delinquency with financial information already obtained. The collections from accounts for which offers were not accepted may not offer significant financial benefits to the overall collection program; however, many taxpayers whose offers were not accepted appear to have a desire to resolve their account problems. The IRS should determine how the information developed in OIC evaluations could be used to assist taxpayers in resolving their tax accounts.

Recommendation

Recommendation 4: The Commissioner, SB/SE Division, should evaluate the effectiveness of the COIC sites’ collection efforts on accounts for which offers were not accepted and determine whether collections from these cases are comparable to results achieved by ACS collections and whether resources should be used to produce collections on these cases.

Management’s Response: IRS management agreed with this recommendation. The IRS is currently evaluating the use of a Hand-Off Unit at the Brookhaven campus. This Unit initiates appropriate collection procedures on rejected or withdrawn cases. The IRS will evaluate the effectiveness of this Unit through operational reviews and determine whether the Unit should be made permanent.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Offer in Compromise¹ (OIC) program efficiently and effectively collects tax liabilities that may not be otherwise collected and whether the taxpayers remain compliant once an offer is accepted.² During the review, we relied on data from the Automated Offer in Compromise (AOIC) Database to identify closed offers and the monitoring status of accepted offers. We evaluated the reasonableness of the data through comparison with selected information from the Internal Revenue Service (IRS) Collection Reports 5000-108 (Monthly Report of Offer in Compromise Activity). We also compared various samples selected throughout the course of our review with information on the AOIC Database and determined the data were sufficiently reliable for sample selection and inventory analysis. Additionally, unless otherwise noted, we used judgmental or random sampling techniques to minimize time and because we did not intend to project the results. To accomplish this objective, we:

- I. Determined whether the OIC program effectively identifies potential candidates for offer acceptance.
 - A. Analyzed data from the AOIC Database and Collection Reports 5000-108 to identify the timeliness with which offer evaluations are completed.
 - B. Evaluated the appropriateness of 187 offers closed in the Centralized Offer in Compromise (COIC) sites and field offer groups. We obtained and evaluated the IRS case files to determine whether correct conclusions were reached and evaluated the accuracy of the financial analyses used to determine equity in assets and future income.
 1. Reviewed a judgmental sample of 87 offers (46 accepted, 31 rejected, and 10 withdrawn) processed by the COIC sites. The samples of rejected and withdrawn offers were randomly selected from July 2002 closures; they included 31 of 351 rejected offers for which the taxpayers did not exercise appeal rights and 10 of 224 withdrawn offers. We selected a judgmental

¹ Appendix VII includes definitions of terms used in this report.

² Since Fiscal Year 1999, we have conducted a series of reviews to evaluate the OIC program. Reports from those reviews are listed in Appendix VI. The purpose of this review was to provide an overall assessment of the efficiency and effectiveness of the OIC program. This review includes data and results reported in prior audits of the OIC program but also presents additional information about the OIC program's costs and benefits, taxpayer compliance after terms of the accepted offers are completed, and taxpayer compliance when offers were not accepted.



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- sample of 46 of 194 accepted offers awaiting shipment to the designated campuses during our onsite visits in August and October 2002.³
2. Reviewed a judgmental sample of 100 offers (50 accepted and 50 rejected) processed by the field offer groups between October 1, 2002, and June 30, 2003. The sample included 50 of the 10,000 offers accepted and 50 of the 5,369 offers rejected (the taxpayers did not exercise appeal rights).⁴
- C. Determined whether the IRS procedures were accurately and consistently followed for 83 processable offers returned to taxpayers.
1. Reviewed a random sample of 33 of the 3,502 processable offers returned to taxpayers by the COIC sites in July 2002.⁵ The sample of returned offers was randomly selected from July 2002 closures.
 2. Reviewed a random sample of 50 of the 12,844 processable offers returned to taxpayers by the field offer groups between October 1, 2002, and June 30, 2003.⁶
- D. Determined whether the Reasonable Collection Potential (RCP) calculation realistically represents collections from taxpayers whose offers have been rejected.
1. Obtained from the AOIC Database a computer extract of all 1,117,629 offers closed between October 1, 1994, and September 30, 2004 (a 10-year period).⁷
 2. Reviewed a judgmental sample of 100 rejected offers closed between October 1, 2002, and June 30, 2003. We used the sample of 50 cases closed by the field offer groups discussed in Step I.B.2. We reviewed a random sample of 50 of 10,807 rejected offers closed by the COIC sites between October 1, 2002, and June 30, 2003. The sample was identified from the data extract discussed in Step I.D.1. to provide a consistent time period for our sample.

³ See Appendix VI, report 4. Step I.B.1. was conducted during that review.

⁴ See Appendix VI, report 6. Step I.B.2. was conducted during that review.

⁵ See Appendix VI, report 4. Step I.C.1. was conducted during that review.

⁶ See Appendix VI, report 6. Step I.C.2. was conducted during that review.

⁷ The total dispositions (1,114,234) shown on the Collection Reports 5000-108 for FYs 1995 through 2004 do not equal the total number of offers in our data extract (1,117,629). The difference in the number of dispositions between these two sources occurred because of the use of cutoff dates to obtain the Collection Reports 5000-108 data and inventory corrections recorded on the AOIC Database. Based on our data validation tests, we determined the data extract was sufficiently reliable for sample selection and inventory analysis.



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- a. Obtained the IRS closed case files and determined the components and amounts of the RCP calculations as determined by the IRS employees.
 - b. Reviewed the Integrated Data Retrieval System (IDRS) between February 28, 2005, and March 5, 2005, and identified amounts collected after the closing of the offers on the AOIC Database.
3. Evaluated proposed IRS changes to the RCP calculation process.
- E. Analyzed the impact of the COIC program on the IRS' offer program. We evaluated the ratios of disposition types and the length of time required to process offers at the COIC sites and field offer groups.
- F. Reviewed a judgmental sample of 53 of approximately 800 not-processable offers on hand at the time of our visits to determine whether processability determinations complied with policy. We reviewed 30 offers returned by the Memphis COIC site in August 2002 and 23 offers returned by the Brookhaven COIC site in September 2002.⁸
- II. Determined the effectiveness of the offer program in getting taxpayers to remain compliant after offers have been accepted.
- A. Obtained from the AOIC Database a computer extract of all 30,439 accepted OICs with a legal disposition date of Fiscal Year (FY) 1999.
 - B. Reviewed a statistical sample of 84 of the 28,018 Doubt As to Collectibility offers identified from Step II.A. that were still open in acceptance status⁹ at the time of the computer extract. The sample was based on a 95 percent confidence level, a precision level of ± 4 percent, and an expected error rate of 3.57 percent.¹⁰
 - C. Determined whether taxpayers remained compliant after the terms of the offer were completed.
 1. Reviewed a random sample of 245 of the 95,080 accepted offers that were not defaulted by the IRS campus OIC units that monitor offer compliance. The sample was randomly selected from offers closed between October 1, 1994, and December 31, 1998, from the data extract discussed in Step I.D.1.
 - a. Reviewed the taxpayers' accounts on the IDRS and determined whether the taxpayers remained compliant with filing and payment

⁸ See Appendix VI, report 4. Step I.F. was conducted during that review.

⁹ Accepted offers being monitored by the IRS campus OIC units that monitor offer compliance.

¹⁰ See Appendix VI, report 5. Step II.B. was conducted during that review.



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requirements while the offer was pending and after the monitoring period.

- D. Determined whether collection actions were timely resumed on nonaccepted offers.
 - 1. Discussed with IRS management the process and procedures for placing nonaccepted offers back into the collection process.
 - 2. Reviewed a sample of the 100 rejected offers closed by the COIC sites and field offer groups between October 1, 2002, and June 30, 2003. For this test, we used the cases selected in Step I.D.2.
- E. Determined the level of taxpayer compliance after offers had been determined to be not acceptable (e.g., rejected, returned, or withdrawn).
 - 1. Selected a random sample of 93 of the 83,158 nonaccepted processable offers closed on the AOIC Database between October 1, 1994, and December 31, 1998, for taxpayers who did not subsequently have an offer accepted.
 - 2. Reviewed the taxpayers' accounts on the IDRS and determined whether the taxpayers were compliant with filing and payment requirements for the 5 years after their offers had been determined to be not acceptable.
- III. Determined the cost and benefits of the offer program for FY 2004.
 - A. Determined the cost of labor used in the evaluation of all offers and the cost of labor used in the monitoring of accepted offers.
 - B. Obtained from the AOIC Database a computer extract of all 2,486,190 liability adjustments, offer payments, refund recoupments, and collateral payments recorded on the AOIC Database as of April 11, 2005. For this data extract, our validation testing involved various analyses and a comparison with taxpayer account information through the IDRS. We determined the data were sufficiently reliable for the purpose of estimating revenue from offer payments, refund recoupments, and collateral payments.
 - 1. Analyzed the data extract discussed in Step III.B. to identify the revenue secured through offer payments, collateral payments, and refund recoupments for FY 2004.
 - C. Obtained from the AOIC Database a computer extract of all 178,279 payment transactions related to the OIC application fee recorded on the AOIC Database as of December 13, 2005. For this data extract, our validation testing involved various analyses, including a comparison with the AOIC Database data reflecting



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receipts and dispositions. We determined the data were sufficiently reliable for the purpose of estimating revenue from OIC application fee.

1. Analyzed the data extract discussed in Step III.C. to identify the revenue secured through the OIC application fee for FY 2004.
- IV. Identified historical trends of offer processing, including acceptance rates, and inventory fluctuations in conjunction with significant OIC program changes (e.g., implementation of the IRS Restructuring and Reform Act of 1998¹¹ and implementation of the COIC sites).

¹¹ Pub. L. No. 105-206, 112 Stat. 685, 765.



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Appendix II

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Collection, Small Business/Self-Employed Division SE:S:C
Director, Collection Policy, Small Business/Self-Employed Division SE:S:C:CP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Reasons Offers in Compromise Are Returned to Taxpayers

Our analysis of Internal Revenue Service (IRS) Collection Reports 4196 (Monthly Offer in Compromise Activity) showed failure to file returns was the most frequent reason for returning offers to taxpayers. Figure 1 provides the various reasons offers were returned to taxpayers as not-processable. The total number of reasons recorded exceeds the total number of offers returned as not-processable because offers can be returned to taxpayers for multiple reasons. The percentages were calculated by dividing the number of returned offers in each category by the total number of offers returned as not-processable. Therefore, these percentages exceed 100 percent.

Figure 1: Not-Processable Returned Offers Reason Codes - Fiscal Years (FY) 2001 Through 2005¹

Not-Processable Reasons	FY 2001		FY 2002		FY 2003		FY 2004		FY 2005		Total	
Tax Returns Not Filed	13,010	80%	22,047	67%	21,752	72%	15,905	41%	10,947	48%	83,661	59%
Fee Not with Offer	0	0%	0	0%	0	0%	20,687	54%	8,044	35%	28,731	20%
Open Bankruptcy Proceeding	1,149	7%	4,378	13%	4,893	16%	3,501	9%	2,259	10%	16,180	11%
Form 433-A Not Included	49	0%	2,710	8%	2,855	9%	3,823	10%	2,434	11%	11,871	8%
Previous 2 Quarters of Employment Tax not Filed and/or Paid	2,070	13%	2,409	7%	1,969	6%	1,664	4%	1,091	5%	9,203	7%
Obsolete Offer in Compromise, (Form 656)	56	0%	3,043	9%	1,137	4%	333	1%	453	2%	5,022	4%
Obsolete Form 433-A or Form 433-B	0	0%	3,111	9%	1,111	4%	320	1%	92	0%	4,634	3%
Current Employment Tax Deposits Not Timely	697	4%	806	2%	880	3%	694	2%	504	2%	3,581	3%
Returns Not Filed - Both Spouses	0	0%	0	0%	0	0%	1,020	3%	1,618	7%	2,638	2%
Form 433-B Not Included	20	0%	210	1%	164	1%	353	1%	466	2%	1,213	1%
Not a Verbatim Duplicate	10	0%	50	0%	33	0%	125	0%	221	1%	439	0%
Total Reasons Recorded	17,061		38,764		34,794		48,425		28,129		167,173	
Total Not-Processable Offers	16,185		32,897		30,406		38,553		22,713		140,754	

Source: Treasury Inspector General for Tax Administration Analysis of IRS Collection Reports 4196.

¹ Form 433-A is a Collection Information Statement for Wage Earners and Self-Employed Individuals. Form 433-B is a Collection Information Statement for Businesses.



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The primary reason the IRS returned offers after the offers were determined to be processable was because financial verification was not provided. Figure 2 provides the various reasons offers were returned to taxpayers. The percentage of total offers returned because financial verification was not provided substantially declined during FY 2005. The total number of reasons recorded exceeds the total number of offers returned because offers are sometimes returned for multiple reasons. Percentages were calculated by dividing the returns in each category by the total number of offers returned as not-processable. Therefore, these percentages exceed 100 percent.

Figure 2: Processable Return Reason Codes - FYs 2001 Through 2005²

Reason	FY 2001		FY 2002		FY 2003		FY 2004		FY 2005		Total	
Financial Verification Not Provided	13,828	49.80%	33,370	66.10%	32,909	67.10%	19,645	60.70%	9,672	48.20%	109,424	60.90%
Returns Not Filed	4,699	16.90%	5,833	11.60%	4,621	9.40%	2,910	9.00%	1,952	9.70%	20,015	11.10%
Estimated Payments Not Made	57	0.20%	4,258	8.40%	4,732	9.60%	4,330	13.40%	3,833	19.10%	17,210	9.60%
Missing Periods	2,503	9.00%	1,816	3.60%	1,271	2.60%	682	2.10%	428	2.10%	6,700	3.70%
No Basis for Compromise	1,423	5.10%	1,900	3.80%	1,069	2.20%	776	2.40%	585	2.90%	5,753	3.20%
Untimely Tax Deposits	794	2.90%	968	1.90%	1,033	2.10%	855	2.60%	526	2.60%	4,176	2.30%
Open Bankruptcy Proceeding	958	3.50%	969	1.90%	804	1.60%	479	1.50%	293	1.50%	3,503	1.90%
Previous 2 Quarters Not Filed/Paid	717	2.60%	782	1.50%	903	1.80%	608	1.90%	458	2.30%	3,468	1.90%
Other Investigations Pending	-	0.00%	304	0.60%	1,053	2.10%	1,131	3.50%	873	4.40%	3,361	1.90%
Form 433-A Missing Information	1,298	4.70%	834	1.70%	618	1.30%	289	0.90%	220	1.10%	3,259	1.80%
To Delay Collections	423	1.50%	416	0.80%	749	1.50%	783	2.40%	844	4.20%	3,215	1.80%
Obsolete Form 656	1,534	5.50%	1,035	2.00%	296	0.60%	75	0.20%	60	0.30%	3,000	1.70%
Erroneous Periods Included	1,161	4.20%	848	1.70%	448	0.90%	242	0.70%	166	0.80%	2,865	1.60%
Form 433-A Not Included	1,208	4.40%	952	1.90%	400	0.80%	177	0.50%	90	0.40%	2,827	1.60%
Offer Amount Not Entered	1,138	4.10%	535	1.10%	293	0.60%	118	0.40%	76	0.40%	2,160	1.20%
Form 433-B Not Included	982	3.50%	567	1.10%	233	0.50%	165	0.50%	103	0.50%	2,050	1.10%
Resubmission of Prior Rejected or Returned Offer	2	0.00%	362	0.70%	511	1.00%	583	1.80%	472	2.40%	1,930	1.10%
Financial Verification Nonliable Party	-	0.00%	177	0.40%	758	1.50%	520	1.60%	274	1.40%	1,729	1.00%
Other	3,965	14.30%	2,475	4.90%	1,842	3.80%	1,716	5.30%	2,363	11.80%	12,361	6.90%
Total Reasons Recorded	36,690		58,401		54,543		36,084		23,288		209,006	
Total Processable Returned Offers	27,751		50,492		49,079		32,358		20,068		179,748	

Source: Treasury Inspector General for Tax Administration Analysis of IRS Collection Reports 4196.

² In our analysis, we grouped return reasons in the category “Other” when the FYs 2001 through 2005 percentage totals were less than 1 percent.



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Figure 3 provides an example of the Payment Options Comparison Chart provided during a June 2005 training topic. The Chart shows various installment agreement alternatives and the deferred offer payment basis. This information could be beneficial to taxpayers and tax practitioners in determining which payment alternative to use.

Figure 3: Payment Options Comparison Chart

Payment Options Comparison Chart		Total of All Liabilities	Time Frame for Full Payment	Other Basic Requirements	Financial Information	Verification of Financial Information
98% of all IA taxpayers	Guaranteed Installment Agreement (IA)	Below \$10,000	Within 36 months	Must stay current with all future taxes	Limited	No
	Streamlined IA	Below \$25,000	Within 60 months	Must stay current with all future taxes	Limited	No
	Full Pay IA < 60 months*	No limit	Up to 60 months	Leverage equity in assets Must stay current with all future taxes Conditional expenses may be allowed	Complete	Yes
	Full Pay IA > 60 months*	No limit	61 months and up Prior to expiration of Collection Statute	Leverage equity in assets Must stay current with all future taxes Transition period for conditional expenses may be allowed for up to 12 months	Complete	Yes
	Partial Pay IA	No limit	Payments made until Collection Statute expires	Leverage equity in assets Must stay current with all future taxes No conditional expenses allowed No transition period	Complete	Yes
	Deferred Payment Offer In Compromise	No limit	Payments made until statute date or until accepted offer amount received	Net realizable equity must be accounted for in amount offered No conditional expenses allowed Must stay current with all future taxes	Complete	Yes

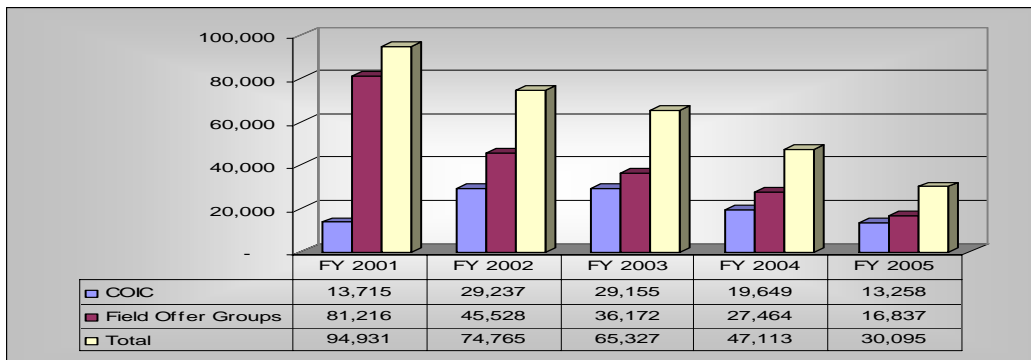
* Length of installment agreement determined by the financial analysis



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Since implementation of the COIC concept in August 2001, the IRS inventory of offers has declined. Figure 2 shows the total offers in ending inventory declined from approximately 95,000 in Fiscal Year (FY) 2001 to approximately 30,000 in FY 2005. For the same period, the total offers in ending inventory of the field offer groups declined from approximately 81,000 in FY 2001 to approximately 17,000 in FY 2005.

Figure 2: Ending Inventories - FYs 2001 Through 2005



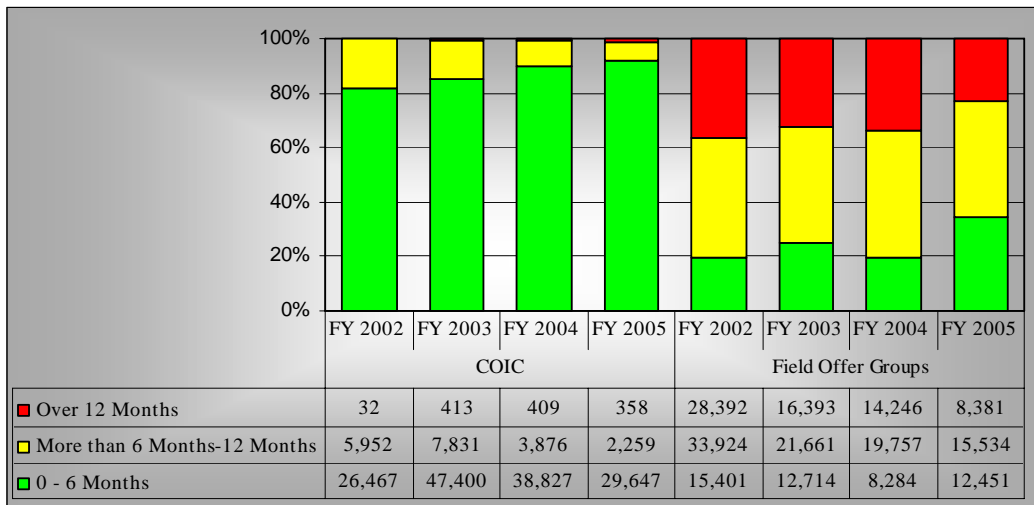
Source: TIGTA analysis of Collection Reports 5000-108 (Monthly Report of Offer in Compromise Activity).



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FY 2002 was the first full year of the COIC concept. Figure 3 shows the majority of processable offers worked by the COIC sites (ranging from 82 percent in FY 2002 to 92 percent in FY 2005) were processed in 6 or fewer months. However, offers processed by the field offer groups took longer to process. In FY 2002, approximately 37 percent took longer than 12 months to process; however, this percentage had declined to approximately 23 percent in FY 2005. Some of the time spent on processing cases in the field offer groups could be attributable to the backlog of offers that developed prior to implementation of the COIC concept.

Figure 3: Timeliness of Offer Dispositions - FYs 2002 Through 2005²



Source: TIGTA analysis of Collection Reports 5000-108.

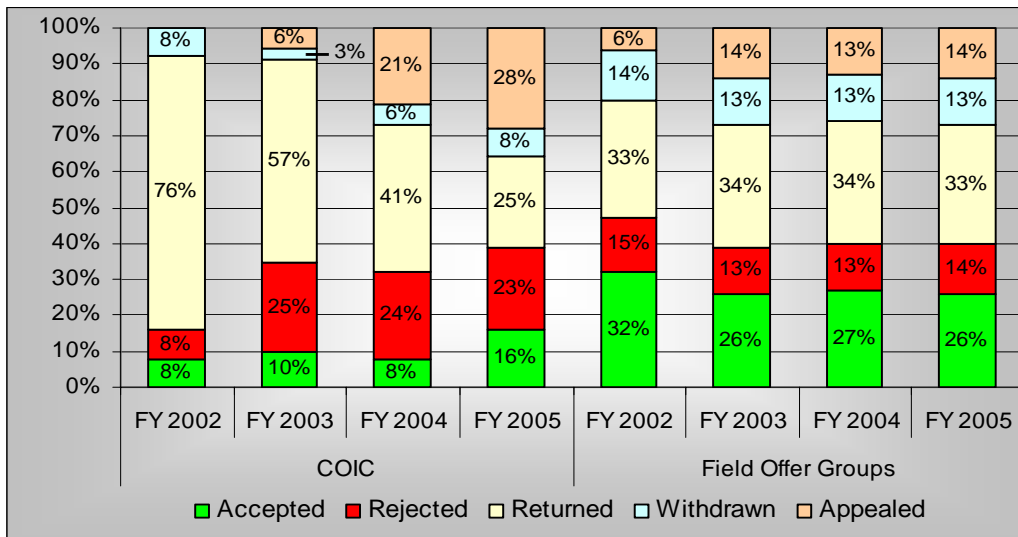
² For FY 2005, the IRS offer data include not-processable offers in the age of dispositions. For comparability with prior fiscal years, we excluded not-processable offers from the number of offers disposed of in 6 or fewer months.



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While the overall inventory and timeliness of case actions show improvement, few offers are accepted. Figure 4 shows processable dispositions at the COIC sites and field offer groups. In the analysis, we included offers closed by appeal (whether accepted or rejected) as “Appealed.” Acceptance rates were lower for offers evaluated at the COIC sites than for offers evaluated at the field offer groups. Returned offer rates were generally higher at the COIC sites; however, the COIC sites conduct case-building activities, including requests for information, for some offers that are fully evaluated at the COIC sites and offers that are eventually sent to field offer groups.

Figure 4: Processable Offer Dispositions - FYs 2002 Through 2005



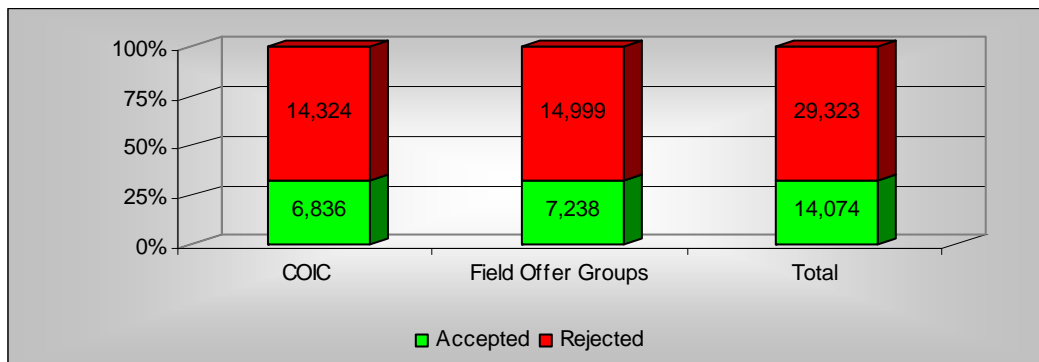
Source: TIGTA analysis of Collection Reports 5000-108.



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From FYs 2002 through 2005, approximately 43,000 (12 percent) of 370,000 processable offers were closed by the IRS Appeals function. Figure 5 shows the result of the IRS Appeals function offer evaluation based on where the offers were initially evaluated. The Appeals function accepted approximately 14,074 (32 percent) of the 43,397 offers it closed.

Figure 5: Offers Accepted in the IRS Appeals Function - FYs 2002 Through 2005



Source: TIGTA analysis of Collection Reports 5000-108.

Figure 6 shows the ratio of total dollars accepted to total dollars compromised was higher for offers accepted in the Appeals function (18 percent) than for offers accepted in the compliance functions (i.e., the COIC sites and field offer groups) (14 percent). In addition, the average offer amount accepted was approximately \$19,000 in the Appeals function versus approximately \$12,000 in compliance functions.

Figure 6: Analysis of Accepted Offers - FYs 2002 Through 2005

	COIC		Field Offer Groups		Total	
	Compliance	Appealed	Compliance	Appealed	Compliance	Appealed
Offers Accepted	16,690	6,836	58,572	7,238	75,262	14,074
Liabilities	\$ 662,297,572	\$ 325,486,919	\$ 5,696,677,242	\$ 1,170,454,652	\$ 6,358,974,814	\$ 1,495,941,571
Offer Amount	\$ 83,922,119	\$ 59,633,126	\$ 788,032,769	\$ 213,620,185	\$ 871,954,888	\$ 273,253,311
Average Offer Amount	\$ 5,028	\$ 8,723	\$ 13,454	\$ 29,514	\$ 11,586	\$ 19,415
Offer Amount by Liability Compromised	13%	18%	14%	18%	14%	18%

Source: TIGTA analysis of Collection Reports 5000-108.



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Appendix VI

Related Treasury Inspector General for Tax Administration Audit Reports

1. *More Taxpayers Can Benefit From the New Offer in Compromise Provisions* (Reference Number 2000-40-093, dated June 2000).
2. *The Internal Revenue Service Needs to Consistently Use Special Circumstances in the Offer in Compromise Program* (Reference Number 2001-30-096, dated May 2001).
3. *The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise* (Reference Number 2002-30-181, dated September 2002).
4. *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program* (Reference Number 2003-30-182, dated September 2003).
5. *Monitoring of Accepted Offers in Compromise Is Generally Effective, but Some Improvement Is Needed* (Reference Number 2004-30-043, dated January 2004).
6. *Improvements Are Needed in the Timeliness and Accuracy of Offers in Compromise Processed by Field Offer Groups* (Reference Number 2005-30-013, dated December 2004).
7. *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (Reference Number 2005-30-096, dated June 2005).
8. *High-Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management's Attention* (Reference Number 2006-30-030, dated February 2006).



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Appendix VII

Glossary of Terms

Area Office – A geographical organizational level of the Internal Revenue Service (IRS) Small Business/Self-Employed Division.

Automated Collection System (ACS) – A telephone contact system through which telephone assistants collect unpaid taxes and secure tax returns from delinquent taxpayers who have not complied with previous notices.

Automated Offer in Compromise Database – The IRS database used to monitor Offer in Compromise (OIC) case processing; it was designed to control, track, and monitor offers.

Business Master File – The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

Campus – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Centralized Offer in Compromise – The IRS units located in the Brookhaven, New York, and Memphis, Tennessee, Campuses that complete initial processing and work less complicated offers to completion.

Collateral Payment – Payment from a collateral agreement. A collateral agreement enables the Federal Government to collect funds in addition to the amount actually secured by the offer or to add additional terms not included in the standard Offer in Compromise (Form 656) agreement, thereby recouping part or all of the difference between the amount of the offer or additional terms of the offer and the liability compromised.

Collection Due Process – Allows taxpayers a right to a hearing before the IRS Appeals function regarding proposed collection enforcement actions or filed Notices of Federal Tax Lien.

Collection Field function (Cff) – The unit in the field offices consisting of revenue officers who handle personal contacts with taxpayers to collect delinquent accounts or secure unfiled tax returns.

Collection Information Statement – A financial statement listing assets, income, liabilities, and expenses submitted by the taxpayer.

Collection Statute Expiration Date – A time period established by law to collect taxes; it is normally 10 years from the date of the tax assessment.



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Doubt As to Collectibility – Basis for acceptance of an offer when there is doubt that the tax can be paid in full.

Field Offer Group – The IRS units staffed with experienced revenue officers, known as offer specialists, that work more complicated offers to completion.

Financial Statement – A statement listing assets, income, liabilities, and expenses.

Full-Time Equivalent (FTE) – A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For Fiscal Year 2004, 1 FTE was equal to 2,096 staff hours.

Income Certification for Offer in Compromise Application Fee (Form 656-A) – The IRS form used by taxpayers to request an exception to the OIC application fee because of income.

Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.

Inequitable Treatment – Due to exceptional circumstances, collection of the tax liability in full would undermine public confidence that the tax laws are being administered in a fair and equitable manner.

Integrated Data Retrieval System – The IRS computer system capable of retrieving or updating stored information; it works in conjunction with taxpayer account records on the Master File.

Master File – The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Not-Processable – A disposition category used by the IRS for an offer in which the taxpayer does not meet one or more of the minimum established criteria for offer consideration.

Offer in Compromise – An agreement between a taxpayer and the Federal Government that settles a tax liability for payment of less than the full amount owed. The IRS has the authority to settle or compromise Federal tax liabilities by accepting less than full payment under certain circumstances. This is accomplished through an Offer in Compromise (Form 656).

IRS Oversight Board – An independent body responsible to provide the IRS with long-term guidance and direction.

Poverty-Level Guidelines – A poverty measure established by the Department of Health and Human Services.

Processable Disposition – Offers that are closed after the IRS determined the taxpayer met the minimum established criteria for offer consideration. This includes offers that are accepted, rejected, withdrawn, or returned to taxpayers.



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Processable Return – Offers that are returned to taxpayers closed after the IRS determined the taxpayers met the minimum established criteria for offer consideration.

Queue – An automated holding file for unassigned inventory of low-priority delinquent cases that the Collection function does not have enough resources to immediately assign for contact.

Reasonable Collection Potential (RCP) – The amount the IRS determines could reasonably be collected from the taxpayer. The RCP equals the total realizable value of the taxpayer's assets plus future income.

Refund Recoupment – The refund for the year in which an OIC was accepted. Part of the OIC agreement is that the taxpayer agrees to allow the IRS to keep any tax refund for the year in which the OIC was accepted.

Revenue Officer – Employees in the CFf who attempt to contact taxpayers and resolve collection matters that have not been resolved through notices sent by the IRS campuses (formerly known as service centers) or the ACS.

Tax Period – Refers to each tax return filed by the taxpayer for a specific period (year or quarter) during a calendar year for each type of tax.

Solely to Delay – A processable return reason referring to offers that were submitted for the purpose of avoiding or delaying collection activity. This may include the resubmission of an offer after a prior offer has been returned or rejected and the new offer is essentially the same as the prior returned or rejected offer.

Shelved Accounts – Delinquent unpaid accounts that have been taken out of Collection function inventory because they are lower priority than other available cases.

Special Circumstance – The facts and circumstance surrounding the taxpayer's financial situation, such as advanced age or serious illness.



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Appendix VIII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

June 26, 2006

RECEIVED
JUN 26 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown *KL*
Commissioner Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Offer In Compromise Program Is Beneficial, but Needs to be Used More Efficiently in the Collection of Taxes (Audit # 200530005)

We have reviewed the report and generally agree with the findings. Your report provided a good historical background on the Offer in Compromise (OIC) program and acknowledged significant changes in the program. As you noted, these changes helped improve the timeliness of OIC processing and significantly reduced the inventory backlog.

We are pleased that your report recognizes the benefits of the OIC program for both the IRS and taxpayers. It acknowledges that many taxpayers who took advantage of the fresh start toward compliance remained compliant both during and upon completion of the offer monitoring. Your report also acknowledges the OIC program is an expensive program for the IRS to administer. In addition to the costs outlined in your report, the IRS believes there is a significant opportunity cost in applying IRS resources to the OIC program rather than to collection enforcement programs.

We agree that Recommendations 1, 2, and 4 will positively impact the OIC program. Recommendation 1 is in progress as the pilot "OIC Candidate Study". If successful, this program will help identify taxpayers who are good OIC candidates. Recommendation 2 will be incorporated into the next revision of Form 656. Recommendation 4 is in progress as the pilot "Hand-Off Unit". If successful, this program will increase collection after OICs are rejected or returned to the taxpayer. While your third recommendation, development of an Internet application for OICs, may be feasible at a future date, we believe it is premature at this time.

Our comments on your recommendations follow:

RECOMMENDATION 1

The Commissioner, SB/SE Division should develop a strategy to identify potential candidates for the OIC program and then determine how to get these taxpayers into the program. This may include, for example, taxpayers whose accounts are considered currently not collectible and/or taxpayers who have a demonstrated filing compliance.



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CORRECTIVE ACTION

We are currently conducting the pilot "OIC Candidate Study" that will evaluate whether taxpayers who are in compliance and in a currently not collectible (CNC) status are good OIC candidates. We have identified a target population and will be providing them with all the information necessary to submit an OIC. The data resulting from this pilot may assist us in identifying potential OIC taxpayers.

IMPLEMENTATION DATE

December 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The National OIC Program Manager will advise the Director, Collection Policy, SB/SE Division of any delays.

RECOMMENDATION 2

The Commissioner, SB/SE Division should provide a payment matrix, similar to the Payment Option Comparison Chart, to show the payment alternatives and provide examples of when the offer program should be used. The matrix may be made available on the IRS Internet site and the instructions to Forms 656.

CORRECTIVE ACTION

We are revising Form 656, Offer in Compromise, to include instructions on submitting an OIC and which form to submit. The new revision will include a comparison of the three types of OICs and provide information on each. To assist taxpayers in making an informed decision, we will also explain payment alternatives. We will post this information on the IRS Internet site for further accessibility.

IMPLEMENTATION DATE

December 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The National OIC Program Manager will advise the Director, Collection Policy, SB/SE Division of any delays.

RECOMMENDATION 3

The Commissioner, SB/SE Division should develop an Internet application for Forms 656, 433A, and 433B. The Internet application should screen out taxpayers whose offers are not-processable (e.g. those taxpayers in bankruptcy or those who have not



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filed all required tax returns). It should also alert taxpayers about what documents must be submitted to the IRS, depending on the items reported.

CORRECTIVE ACTION

The Commissioner, SB/SE Division has a comprehensive "E Strategy". All new Internet applications must be prioritized and aligned with this strategy. We are in the process of implementing an Internet application for installment agreements. Once this application has been rolled-out and is fully functional, we will be able to evaluate the feasibility and cost-effectiveness of similar applications for other programs, including OICs. Therefore, the recommendation to develop such an application for OICs is premature and we will not be implementing a corrective action.

IMPLEMENTATION DATE

NA

RESPONSIBLE OFFICIAL(S)

NA

CORRECTIVE ACTION MONITORING PLAN

NA

RECOMMENDATION 4

The Commissioner, SB/SE Division, should evaluate the effectiveness of the COIC sites' collection efforts on accounts for which offers were not accepted and determine whether collections from these cases are comparable to the results achieved by ACS collections and whether resources should be used to produce collections on these cases.

CORRECTIVE ACTION

The IRS is conducting a pilot "Hand-Off Unit" in the Brookhaven Campus. The hand-off unit takes rejected or withdrawn cases and initiates appropriate collection procedures with the taxpayer using the financial information obtained during the OIC process. We will continue to evaluate the effectiveness of this unit through the operational review process and determine whether it should be made permanent.

IMPLEMENTATION DATE

December 15, 2006

RESPONSIBLE OFFICIAL(S)

Director, Collection Policy, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The National OIC Program Manager will advise the Director, Collection Policy, SB/SE Division of any delays.



*The Offer in Compromise Program Is Beneficial but Needs to Be
Used More Efficiently in the Collection of Taxes*

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If you have any questions, please call me at (202) 622-0600 or Brady R. Bennett,
Director, Collection, Small Business/Self-Employed Division, at (202) 283-7660.