LR #3

LEVIES ON RETIREMENT ACCOUNTS: Amend IRC § 6334 to Include a Definition of Flagrancy and Require Consideration of Basic Living Expenses at Retirement Before Levying on Retirement Accounts

TAXPAYER RIGHTS IMPACTED[1]

- *The Right to Be Informed*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

PROBLEM

Taxpayers rely on Individual Retirement Accounts (IRAs) or defined contribution plans, such as 401(k) plans, or Thrift Savings Plans (TSP) for federal employees, to fund living and other expenses after retirement. Understanding the importance of U.S. taxpayers having sufficient retirement savings, Congress has encouraged retirement savings and formulated statutes to protect the rights of individuals to pensions.[2] Similarly, the IRS acknowledges the long-term importance of retirement assets to individuals' future welfare by regarding retirement levies as "special cases" that require additional scrutiny and managerial approval.[3]

Nevertheless, the IRS guidance that explains the steps required before a retirement account can be levied contains inadequate detail and is insufficient to protect taxpayer rights.[4] For instance, the determination of whether "flagrant behavior" has occurred is an important prerequisite for levying on a retirement account.[5] According to that guidance, if the IRS determines that a taxpayer has engaged in flagrant conduct, it may consider levying on a retirement account. The guidance also provides that if a taxpayer has not engaged in flagrant conduct, then the levy should not occur. Thus, the determination of flagrant behavior is critical in determining whether to levy on a retirement account.

However, there is no on-point definition of what constitutes "flagrant behavior" in the Internal Revenue Code (IRC), accompanying regulations, or the Internal Revenue Manual (IRM). As a result, the determination of flagrancy is left to subjective judgment by individual IRS employees. Furthermore, the IRS is not required to consider the taxpayer's ability to pay basic living expenses at the time of retirement. This could lead to inconsistent treatment of similarly situated taxpayers, which could erode taxpayers' confidence in a fair tax system and decrease voluntary compliance. More importantly, the IRS's approach undermines Congress' goal to have people able to afford basic living expenses while in retirement.

1 *See* Taxpayer Bill of Rights, *available at* www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

2 For example, the Employee Retirement Income Security Act of 1974 (ERISA) was enacted to provide protection for participants in pension and health plans in private industry. *See* Pub. L. No. 93–406, 88 Stat. 829 (1974).

3 IRM 5.11.6.2(3) (Sept. 26, 2014).

4 *See* IRM 5.11.6.2(4)-(7) (Sept. 26, 2014). For a more detailed discussion, see Most Serious Problem: *Levies on Assets in Retirement Accounts: Current IRS Guidance Regarding the Levy of Retirement Accounts Does Not Adequately Protect Taxpayer Rights and Conflicts with Retirement Security Public Policy*, *supra*.

5 IRM 5.11.6.2(5) (Sept. 26, 2014).

EXAMPLE

A taxpayer is 57 years old and has worked at her current job for over ten years. For much of that time she has had five percent of her wages automatically contributed to her retirement account, which has been matched with an equal contribution by the employer. Prior to working at her current job, the taxpayer was self-employed. The taxpayer fell behind on her tax liabilities while she was self-employed and now owes over $50,000. As part of the routine collection process, a revenue officer (RO) assigned to her case has identified the retirement account as the taxpayer's only asset that can fully pay the liability. Using the current internal guidance, the RO determined that the taxpayer's continued retirement account contributions, while she has an outstanding tax liability, constitutes flagrant conduct. The RO also determined that, despite the taxpayer being 57 years old, she still has adequate time to save for retirement. In making that determination, the RO did not consider the taxpayer's basic living expenses at retirement, nor did he consider the taxpayer's life expectancy or the actual amount she would realistically be able to save from age 57 to retirement. As a result, the IRS levies the entire amount of the taxpayer's retirement account to fully satisfy her tax liability. The taxpayer is left without retirement savings less than a decade before she will retire.

RECOMMENDATION

To protect taxpayer rights and to further retirement security public policy, the National Taxpayer Advocate recommends that Congress:

Amend IRC § 6334 to define flagrant conduct as willful action (or failure to act) which is voluntarily, consciously, and knowingly committed in violation of any provision of chapters 1, 61, 62, 65, 68, 70, or 75, and which appears to a reasonable person to be a gross violation of any such provision; and to require the IRS to issue regulations describing a full financial analysis of the taxpayer's projected basic living expenses at retirement prior to allowing a determination to levy on a retirement account.[6]

PRESENT LAW

IRC § 6331 authorizes the IRS to levy on a taxpayer's property and rights to property. This power allows the IRS to levy on funds held in retirement accounts.[7] Generally, the levy on a retirement account will only reach the assets over which the taxpayer has a present withdrawal right (*i.e.*, a levy will not attach until the taxpayer has a present right to withdraw funds from the plan).[8] IRM guidance explains a "current levy can reach a taxpayer's vested present rights under a plan, but a levy does not accelerate payment and

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6 A bill has been introduced in the House and Senate that recommends a stricter standard for defining flagrant conduct. The proposed definition includes: "(A) the filing of a fraudulent return by the taxpayer, or (B) that the taxpayer acted with the intent to evade or defeat any tax imposed by this title or the collection or payment thereof." Taxpayer Rights Act of 2015, S. 2333, 114th Cong. § 307 (2015); Taxpayer Rights Act of 2015, H.R. 4128, 114th Cong. § 307 (2015). The proposed language also provides a statutory change by making retirement plans (including TSP accounts) exempt from levy unless "(A) the amount of tax (excluding interest and penalties) owed by the taxpayer exceeds $10,000, (B) the Secretary determines that the taxpayer has committed a flagrant act, and (C) the Secretary determines that such levy will not create an economic hardship due to the financial condition of the taxpayer (as described in [IRC] section 6343(a)(1)(D))." Taxpayer Rights Act of 2015, S. 2333, 114th Cong. § 307 (2015); Taxpayer Rights Act of 2015, H.R. 4128, 114th Cong. §307 (2015). For more information on the bill, see Senator Ben Cardin, *Cardin and Becerra Introduce Plan to Protect Taxpayers' Rights*, *available at* http://www.cardin.senate.gov/newsroom/press/release/cardin-and-becerra-introduce-plan-to-protect-taxpayers-rights. The National Taxpayer Advocate believes this is another way to address the concerns involving retirement account levies.

7 For information on what constitutes a retirement plan, see IRC § 4974(c).

8 IRM 5.11.6.2(8) (Sept. 26, 2014).

is only enforceable when the taxpayer is eligible to receive benefits."[9] If a taxpayer has a defined benefit plan and has no present right to withdraw the account balance, the IRS will have no corpus (the main part of the retirement plan) to levy upon at the present time. Rather; the IRS can only levy the monthly distributions or the corpus of the account once a taxpayer reaches retirement age, subject to allowances for reasonable basic living expenses, which are calculated based on circumstances at that time. However, recent changes in the TSP regulations allow a levy on a TSP account to reach up to the entire vested account balance.[10]

The IRS has established three steps that must be taken before it can issue a notice of levy on a taxpayer's retirement account:

- Determine what property (retirement assets and non-retirement assets) is available to collect the liability;
- Determine whether the taxpayer's conduct has been flagrant; and
- Determine whether the taxpayer depends on the money in the retirement account (or will in the near future) for necessary living expenses.[11]

REASONS FOR CHANGE

It is important to make sure that the determination to levy on a retirement account is correct.[12] Once removed, funds levied from a retirement account cannot be returned to that retirement account, even in the event of a wrongful levy.[13] Second, when a distribution occurs as the result of levy action, the taxpayer will experience tax consequences. Pursuant to IRC § 408(d), generally, the entire amount paid from a retirement account or any distribution, is considered gross income and is subject to taxation. In the instance of a levy on a retirement account, the payor would be required to withhold ten percent.[14] However, this amount of withholding is not guaranteed to be sufficient to cover the federal tax liability created by the distribution, and the taxpayer may be liable for a state income tax as well.

Even with the gravity of a retirement levy and the need for a correct decision, current internal guidance does not ensure that a taxpayer's unique facts and circumstances will be considered prior to levy of his or her retirement account. For instance, there is no on-point definition of flagrancy, which is a prerequisite

9 IRM 5.11.6.2(8) (Sept. 26, 2014). For instance, a taxpayer is fully vested in his retirement plan account balance of $10,000, but he is not yet entitled to a withdrawal. In this instance, a levy may attach to the taxpayer's present right to the $10,000, but no money can be collected until the taxpayer has a right to withdraw those funds. Assuming the balance has grown to $30,000 by the time the taxpayer is eligible to withdraw the funds, the IRS will only be able to collect $10,000 because this was the taxpayer's present right at the time of the levy.

10 5 U.S.C. § 8437(e)(3), 5 C.F.R. § 1653.35, and IRM 5.11.6.2.1, *Thrift Savings Plan* (July 17, 2015).

11 IRM 5.11.6.2(4)-(7) (Sept. 26, 2014).

12 *See* Most Serious Problem: *Levies on Assets in Retirement Accounts: Current IRS Guidance Regarding the Levy of Retirement Accounts Does Not Adequately Protect Taxpayer Rights and Conflicts with Retirement Security Public Policy*, *supra*.

13 The National Taxpayer Advocate recommended legislative changes to IRC § 401 (for Qualified Pension, Profit Sharing, Keogh, and Stock Bonus Plans), IRC § 408 (for IRAs and SEP-IRAs), and IRC § 408A (for Roth IRAs) to authorize the reinstatement of funds to retirement accounts and other pension plans where the IRS levied upon the plans in error or in flagrant disregard of established IRS rules, procedures, or regulations and the funds were returned under IRC § 6343(d). National Taxpayer Advocate 2001 Annual Report to Congress 202-9. 5 C.F.R. § 1653.36(g) states that distributions made to satisfy an IRS levy may not be returned to a participant's TSP account.

14 IRC § 3405(b)(1). The payor generally is responsible for making this withholding, but the plan administrator may be liable in the case of certain plans. IRC § 3405(d)(1).

to making the levy determination. Instead, IRS employees receive their guidance in this area through various examples. Two particularly troublesome examples include:

- Taxpayers who continue to make voluntary contributions to retirement accounts while asserting an inability to pay an amount that is owed; or
- Taxpayers who voluntarily contributed to retirement accounts during the time period the taxpayer knew unpaid taxes were accruing.[15]

The examples described above are overly broad in terms of discouraging retirement savings for *any* taxpayer with an outstanding liability. The guidance also goes against strong public policy that encourages saving for retirement.[16] By statute, federal employees, without their consent, are automatically enrolled to have a certain percentage (typically three percent) of their salary contributed to the TSP.[17] This is done to encourage saving for retirement and to take advantage of employer matching; federal employees must take an affirmative step to stop these automatic contributions.[18] Other employer plans adopt a similar "opt-out" approach to automatically enroll employees.[19]

Another example of flagrant conduct includes taxpayers who have demonstrated a "pattern of uncooperative or unresponsive behavior," which includes, "failing to meet established deadlines, failing to attend scheduled appointments, failing to respond to revenue officer attempts to contact."[20] This guidance relies on a subjective determination by an IRS employee. For instance, one employee may determine that if a taxpayer is 30 days late in submitting documentation, then the taxpayer has been uncooperative, whereas another employee may consider a taxpayer uncooperative after 60 days. Without clear guidance, the IRS employee's determination is subjective and susceptible to personal judgment.

The IRS could adopt a definition of "flagrant" similar to the definition found in Treasury regulation § 1.507-1(c)(2) related to excise taxes on exempt organizations, which reads:

> a willful and flagrant act (or failure to act) is one which is voluntarily, consciously, and knowingly committed in violation of any provision of chapter 42 (other than sections 4940 or 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision.

This definition contains the necessary elements of willful and voluntary conduct as well as gross violation. This definition balances the government's interest in the efficient collection action with the government's interest in retirement security for individuals and protection of taxpayer rights.

Additionally, while the IRM does mention extenuating circumstances may exist to mitigate a taxpayer's behavior, it does not contain any examples of such extenuating circumstances.[21] Nor does the IRM require the IRS employee to identify mitigating circumstances, which could include IRS delays, IRS failures

15 IRM 5.11.6.2(6) (Sept. 26, 2014).

16 Congress has focused its efforts on improving retirement savings for Americans. Senator Orrin Hatch recalled in 2014 that, "[t]he retirement policies we have pursued have always been about helping Americans help themselves save more of their hard-earned money, not less." *Retirement Savings 2.0: Updating Savings Policy for the Modern Economy, Hearing Before the Committee on Finance*, 113th Cong. (2014) (statement of Orrin Hatch, ranking member, Committee on Finance).

17 5 U.S.C. § 8432(b)(2)(A). *See also* Thrift Savings Plan, *Summary of the Thrift Saving Plan* 2, *available at* https://www.tsp.gov/PDF/formspubs/tspbk08.pdf (last visited June 30, 2015).

18 *Id.*

19 Automatic enrollment in 401(k) and similar plans was one of the most highly touted changes in the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

20 IRM 5.11.6.2(6) (Sept. 26, 2014).

21 IRM 5.11.6.2(5) (Sept. 26, 2014).

to meet appointments or take promised actions, or IRS failures to follow its own published procedures.[22] Again, this internal guidance is susceptible to subjective interpretation by an individual IRS employee.

Without an on-point definition for flagrancy and an inquiry into whether the taxpayer voluntarily committed a gross violation, the IRS employee could find flagrancy where there was an unconscious and involuntary, or unknowing violation. This means the IRS could be reducing a taxpayer to poverty in retirement because of an unconscious or unknowing act.

The last step in determining if a levy on a retirement account is appropriate is to decide if the taxpayer depends on the money in the retirement account (or will in the near future) for necessary living expenses.[23] To conduct this analysis, employees are instructed to use the standards in IRM 5.15, *Financial Analysis*, to establish necessary living expenses and the life expectancy tables in Publication 590-A, *Individual Retirement Arrangements* (IRAs), to estimate how much can be withdrawn annually to deplete the retirement account in the taxpayer's remaining life.[24]

While the guidance refers the employee to IRM 5.15 to determine necessary living expenses, there is no requirement to calculate the taxpayer's projected retirement income when he or she retires. Additionally, there is no requirement to document the actual calculations, making it impossible to verify that a consistent method is used in all retirement levy cases. The financial analysis handbook does not take into account cost of living increases or adjustments for increased expenses due to advanced age either, such as rising health care or hospice costs. Finally, the guidance lacks a safeguard that, if the IRS determines a 50-year-old taxpayer does not currently rely on the retirement account (and will not rely on it in the near future), the taxpayer has sufficient opportunity to rebuild the retirement account back up to a level that provides for a stable retirement.[25]

EXPLANATION OF RECOMMENDATION

This legislative change will balance the need to efficiently collect taxes with the strong and longstanding public policy supporting financially secure retirements. A taxpayer cannot adequately challenge the decision to levy without being provided a detailed analysis of the basis for levy, a situation which impacts the taxpayer's *right to challenge the IRS's position and be heard*. Similarly, without clear guidance, taxpayers do not know what they need to do to comply with tax laws, so they can avoid a determination of "flagrant behavior," which diminishes the *right to be informed*.

22 When an IRS employee has not followed published administrative guidance (including the IRM), the National Taxpayer Advocate may construe the factors in a light most favorable to the taxpayer when deciding to issue a Taxpayer Assistance Order. IRC § 7811(a)(3).

23 IRM 5.11.6.2(7) (Sept. 26, 2014). Employees are instructed not to levy on the retirement account if it is determined that the taxpayer depends on the money in the retirement account (or will in the near future).

24 *Id*. When conducting this financial analysis, employees are reminded to consider special circumstances that may be present on a case-by-case review.

25 There are tools publicly available to help taxpayers estimate their retirement earnings. The IRS could use such tools to compute an estimate of benefits. For instance, the Social Security Administration (SSA) provides an online tool to estimate Social Security retirement benefits. *See* SSA, *Retirement Estimator*, *available at* https://www.ssa.gov/retire/estimator.html. The TSP website offers an online calculator to figure out how a TSP contribution will affect account savings over time. *See* TSP, *Paycheck Estimator*, *available at* https://www.tsp.gov/PlanningTools/Calculators/paycheckEstimator.html.

The proposed legislative change would provide a clear definition of flagrancy which would be consistent with the interpretation provided by the Tax Court and the current IRS regulations in exempt organizations' context.[26]

Finally, the proposed legislative change would require the IRS to issue formal guidance regarding a full financial analysis of the taxpayer's projected income and basic living expenses at retirement, prior to allowing a levy on a retirement account based on the taxpayer's ability to meet necessary living expenses upon retirement.

Another acceptable approach to address the deficiencies associated with retirement account levies is presented in the recently proposed Taxpayer Rights Act of 2015. This bill proposes that retirement plans (including TSP accounts) should be exempt from levy unless "(A) the amount of tax (excluding interest and penalties) owed by the taxpayer exceeds $10,000, (B) the Secretary determines that the taxpayer has committed a flagrant act, and (C) the Secretary determines that such levy will not create an economic hardship due to the financial condition of the taxpayer (as described in [IRC] section 6343(a)(1)(D))."[27] The bill also proposes a definition for flagrant act that includes, "(A) the filing of a fraudulent return by the taxpayer, or (B) that the taxpayer acted with the intent to evade or defeat any tax imposed by this title or the collection or payment thereof."[28]

26 *See* Treas. Reg. § 1.507-1(c)(2); *Thorne v. Comm'r*, 99 T.C. 67, 108-109 (1992). In particular, the court found that the trustee engaged in "willful conduct" by knowing that certain procedures should be followed but not requiring them to be followed. Also, the court found that the trustee did not act reasonably by relying on oral assurances of his tax advisor after he received a notice of deficiency. Furthermore, making grants to himself and trustees' family members for their own travel to conferences was seen as a gross violation.

27 Taxpayer Rights Act of 2015, S. 2333, 114th Cong. § 307 (2015); Taxpayer Rights Act of 2015, H.R. 4128, 114th Cong. § 307 (2015).

28 *Id*.