Area of Focus #5

IRS Procedures for Levies on Retirement Plan Assets Create Financial Harm and Undermine Taxpayer Rights

TAXPAYER RIGHTS IMPACTED[1]

- *The right to be informed*
- *The right to challenge the IRS's position and be heard*
- *The right to a fair and just tax system*
- *The right to privacy*

The IRS's Authority to Levy Retirement Accounts Must Be Balanced Against the Strong Public Policy to Protect Individuals' Financial Security in Retirement

With rising medical and hospice care costs, many retirees are struggling to cover their basic living expenses. The Employee Benefits Retirement Institute (EBRI) estimates only 56.7 percent to 58.5 percent of Baby Boomers and Gen Xers are sufficiently funded for life after retirement.[2] Social Security benefits account for only about 40 percent of retirees' total income, meaning Americans should be funding other retirement plans (*e.g.,* Individual Retirement Accounts or defined contribution plans such as 401(k) plans) to make up the shortfall.[3]

Understanding the importance of Americans having sufficient retirement savings, Congress has formulated policies to not only provide Social Security income to retirees, but to protect the rights of individuals to pensions and to encourage retirement savings accounts. For example, the Employee Retirement Income Security Act of 1974 (ERISA)[4] was enacted to provide protection for participants in pension and health plans in private industry. To encourage taxpayers to save money for retirement, Congress has provided a myriad of tax-advantaged retirement savings vehicles.[5] One such retirement plan is the Thrift Savings Plan (TSP), which is available to federal employees and operates much like a 401(k) plan available to many employees in the private sector.

Congress has given the IRS broad powers to collect taxes, including the authority to levy on a taxpayer's property and rights to property.[6] This power to levy extends to assets held in retirement accounts, including the TSP. Given the long-term importance of retirement assets to individuals' future welfare, the IRS regards retirement levies as "special cases" that require additional scrutiny and managerial approval.[7] The

1 *See* IRS, *Taxpayer Bill of Rights, available at* http://www.irs.gov/Taxpayer-Bill-of-Rights.

2 Jack VanDerhei, *"Short" Falls: Who's Most Likely to Come up Short in Retirement, and When?*, Employee Benefits Retirement Institute Notes, June 2014, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_06_June-14_ShrtFlls-HSAs.pdf. For purposes of this study, Baby Boomers are defined as the generation born between 1948 to 1964, and Gen Xers are the generation born between 1965 and 1974.

3 *See* Social Security Administration (SSA), *available at* http://www.ssa.gov/policy/docs/ssb/v65n3/v65n3p1.html (last visited June 30, 2015); SSA, *Retirement Planner: Learn About Social Security Programs, available at* http://www.socialsecurity.gov/planners/retire/r&m6.html (last visited June 30, 2015); Association for the Advancement of Retired Persons, *Affording Retirement: Social Security Alone Isn't Enough, available at* http://www.aarp.org/work/social-security/info-06-2010/ss_isnt_enough.html (last visited June 30, 2015).

4 Pub. L. No. 93–406, 88 Stat. 829 (1974).

5 For information on what constitutes a qualified retirement plan, *see* Internal Revenue Code (IRC) § 4974(c).

6 *See* IRC § 6331.

7 Internal Revenue Manual (IRM) 5.11.6.2(3), *Funds in Pensions or Retirement Plans* (Sept. 26, 2014).

IRS has established three required steps before a Revenue Officer can issue a notice of levy on a taxpayer's retirement account:

1. Determine what property (retirement assets and non-retirement assets) is available to collect on the liability;
2. Determine whether the taxpayer's conduct has been flagrant; and
3. Determine whether the taxpayer depends on the money in the retirement account (or will in the near future) for necessary living expenses.[8]

As discussed below, IRS guidance as written is not sufficient to protect taxpayer rights. These concerns have been shared with the IRS. However, over the objection of TAS, the IRS has proposed a pilot within its Automated Collection System (ACS) unit, which could automate much of the decision to levy on a TSP retirement account.[9]

IRS Guidance on What Constitutes "Flagrant" Conduct Is Insufficient to Protect Taxpayers' Rights

Generally, the levy on assets held in 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).[10] 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 is only enforceable when the taxpayer is eligible to receive benefits."[11]

IRM procedures that set forth the steps required before IRS can levy a retirement account are not adequately written to provide clear guidance and insufficiently protect taxpayer rights. For example, the IRS must determine if a taxpayer engaged in "flagrant" conduct prior to issuing a levy on a retirement account.[12] The IRM does not define what constitutes flagrant conduct; rather, the IRS must make this determination based on examples in the IRM guidance. IRS employees are instructed to consider extenuating circumstances that mitigate otherwise flagrant behavior and to review each situation on a case-by-case basis, but examples of extenuating circumstances are not included.[13]

One example of flagrant conduct listed in the IRM is the following: "Taxpayers who continue to make voluntary contributions to retirement accounts while asserting an inability to pay an amount that is owed."[14] 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.[15] This is done to encourage

8 IRM 5.11.6.2(4)-(7), *Funds in Pensions or Retirement Plans* (Sept. 26, 2014).

9 ACS is a computerized system that maintains balance-due accounts and return delinquency investigations. IRM 5.19.5.2, *What Is ACS?* (Aug. 20, 2013).

10 IRM 5.11.6.2(8), *Funds in Pensions or Retirement Plans* (Sept. 26, 2014).

11 *Id.* 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.

12 IRM 5.11.6.2(5), *Funds in Pensions or Retirement Plans* (Sept. 26, 2014). The guidance points out if a taxpayer has not engaged in flagrant conduct, then the retirement account should not be levied. *Id.* Thus, the determination for flagrant conduct is critical in determining to levy a retirement account.

13 *Id.* The IRM guidance does not include any examples of extenuating circumstances.

14 IRM 5.11.6.2(6), *Funds in Pensions or Retirement Plans* (Sept. 26, 2014).

15 *See* 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).

savings for retirement and to take advantage of employer matching; federal employees must take an affirmative step to stop these automatic contributions.[16] Other employer plans adopt a similar "opt-out" approach to automatically enroll employees.[17] Thus, an employee may have been contributing to a retirement plan via automated payroll deductions for years before incurring an IRS debt and may not be aware the IRS views such contributions to be flagrant conduct.

Nevertheless, the IRM guidance does not require the IRS to educate the taxpayer about the effect of making voluntary contributions or not terminating contributions made through automatic enrollment on the decision to levy a retirement account. Moreover, there is no affirmative requirement that the Revenue Officer ask the taxpayer to stop making contributions prior to levying the retirement account. For the government to encourage retirement contributions but also deem those contributions as flagrant conduct, without notice to the taxpayer, is a Catch-22 for the taxpayer.

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Without clear guidance, an IRS employee's assessment of what constitutes flagrant conduct is subjective and susceptible to personal judgment. This could lead to inconsistent treatment of similarly situated taxpayers, which could erode taxpayers' confidence in a fair tax system and decrease voluntary compliance. Moreover, a taxpayer cannot adequately challenge the decision to levy without a detailed analysis of the basis for levy, a situation which impacts the taxpayer's *right to privacy*, which provides that taxpayers have the right to expect any IRS inquiry, examination, or enforcement action will comply with the law and be no more intrusive than necessary. Finally, without clear guidance, taxpayers do not know what they need to do to comply with tax laws, which diminishes the *right to be informed*.

The final step in deciding whether a levy on retirement assets is appropriate is to determine if the taxpayer depends on the money in the retirement account for necessary living expenses (or will in the near future).[18] To conduct this analysis, employees are instructed to use the standards in IRM 5.15, *Financial Analysis*, to estimate how much can be withdrawn annually from the retirement account while leaving enough for necessary living expenses over the taxpayer's remaining life expectancy.[19]

> **Example:** Assume a taxpayer is 50 years old, expects to retire at age 62, and has a $40,000 tax liability with $54,000 in his TSP account. Further assume the taxpayer will begin receiving $2,000 per month from his federal pension and another $1,200 per month from Social Security at age 62, with a life expectancy of 80. The $54,000 TSP corpus divided by 18 years (the years from the taxpayer's retirement age of 62 to 80) leaves an average of $3,000 per year, or $250 per month. Thus at age 62, the taxpayer expects to have $3,450 of monthly income from all sources ($2,000 pension, $1,200 Social Security, $250 TSP). The IRS estimates the taxpayer will have necessary living expenses of $3,300 per month at retirement. Based on this financial analysis, if the IRS were to levy the entire TSP corpus, the taxpayer's monthly retirement income would be

16 *See* 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).

17 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).

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

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

reduced to $3,200, and he could not meet his necessary living expenses of $3,300. An IRS levy should be limited to 60 percent of the TSP corpus, or $32,400, based on the crude estimate that the taxpayer would need to rely on only 40 percent of his TSP corpus to cover necessary living expenses ($100 out of an available $250 per month). However, there are currently no safeguards to prevent the IRS from levying the *entire* TSP corpus, regardless of whether it would leave the taxpayer unable to meet necessary living expenses upon retirement.

The guidelines for completing the financial analysis are woefully insufficient. For example, there is no requirement to document any minimum retirement age for each type of retirement plan the taxpayer is vested in (*e.g.,* Social Security, IRA, 401(k), TSP). A sound analysis would include simulations comparing scenarios where the taxpayer elects to take distributions at the earliest date allowable with scenarios where the taxpayer elects to take distributions at various other dates to determine the optimal age at which the taxpayer should begin taking distributions from various retirement sources. An impartial and equitable investigation into the numerous options available to the taxpayer for future use and distribution of his or her retirement account would demand a level of education and training that is simply not available to ACS employees. This clearly infringes on taxpayers' *right to a fair and just tax system*. Additionally, the financial analysis handbook does not take into account cost of living increases or adjustments for increased expenses due to advanced age, such as rising health care or hospice costs. Finally, there is no provision to ensure 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 build the retirement account back up to a level that provides for a stable retirement.

Furthermore, the proposed plan to levy on the corpus of a retirement plan treats taxpayers disparately, depending on whether they participate in a defined benefit plan (where participants receive a known, fixed amount each month) or a defined contribution plan (where retirement distributions are not fixed, but directly related to the amount of available corpus), such as a TSP. According to the EBRI, retirees are four times more likely to have a defined contribution plan (78 percent) as their primary retirement plan than they would a defined benefit plan (21 percent).[20] If a taxpayer is one of the fortunate few to have a defined benefit plan, the IRS will have no corpus to levy upon at the present time; the IRS can only levy the monthly distributions once a taxpayer reaches retirement age, subject to allowances for basic living expenses, which are calculated based on circumstances at that time. In contrast, the IRS will have the present ability to levy on the corpus of defined contribution plans or IRAs. Recall that the financial analysis required is not sophisticated and is based on conjecture, since it requires the IRS to estimate a taxpayer's necessary living expenses years into the future. Constructing an accurate analysis with so many variables requires a level of financial analysis training ACS employees are not provided.

While the existing IRM guidance is deficient, the procedures written for the pilot provide even fewer protections.[21] For instance, the procedures do not mention extenuating circumstances that could mitigate otherwise flagrant behavior. This type of analysis requires thorough training. The National Taxpayer Advocate is concerned ACS employees participating in the TSP pilot will not receive the necessary training to understand the nuances of a taxpayer's situation, and instead, will use a checklist approach. Procedures for the proposed ACS pilot also water down the ability to determine a taxpayer's reliance on retirement

20 Craig Copeland, *Retirement Plan Participation: Survey of Income and Program Participation (SIPP) Data, 2012*, Employee Benefits Retirement Institute Notes, Aug. 2013, *available at* http://www.ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=5256.

21 IRS, *Draft TSP Levy Pilot ACS Procedures* (June 9, 2015).

funds by instructing ACS employees to simply "document if there is any information that retirement is impending and that the taxpayer will be relying on funds in the TSP for necessary living expenses."[22]

The ACS pilot may also weaken the requirements for documenting the justification for the decision to levy. Under current guidance, the Small Business/Self Employed (SB/SE) Area Director, Field Collection, must approve the notice of levy by signing the form as the Service Representative or by following IRM 5.11.1.3.5 to secure managerial approval.[23] However, any notice of levy that requires the approval of the SB/SE Collection Area Director must include a memorandum explaining the IRS employee's justification for the levy.[24] It is unclear how ACS employees will be able to create the necessary memo for managerial review. In fact, the procedures for the proposed ACS pilot do not reference the required memo but do require a manager's signature.[25] It does not appear the ACS manager will have much information about the taxpayer's financial condition or extenuating circumstances before giving rote approval to a levy that could potentially destroy a taxpayer's retirement income security.

Adoption of the Proposed Pilot Program Would Result in the IRS Treating TSP Participants Disparately from Participants in Other Retirement Plans

As mentioned above, the IRS is in the final stages of approving a pilot program to levy TSP accounts, which ACS employees will administer. More than 115,000 possible TSP account holders (as of the end of 2014) could be impacted if the IRS adopts and expands the pilot program.[26] ACS currently does not levy assets in non-TSP retirement accounts, which means the IRS would be treating one category of retirement plan owners differently from other taxpayers.[27] The IRS has not articulated a reason why it believes levies on federal employees' retirement accounts should receive lesser taxpayer rights protections than levies on non-federal employees' retirement accounts.

Furthermore, the reach of a TSP levy is far more expansive than the levy on a non-TSP retirement account. As discussed above, the levy on a non-TSP retirement account generally only reaches the assets over which the taxpayer has a present withdrawal right. However, recent changes in the TSP regulations allow a TSP levy to reach up to the vested account balance.[28] Thus, the IRS can levy upon the *entire vested balance* of the TSP account, even if the participant has no current right to access the funds.[29] As a result, a levy on a TSP account could be even more damaging to a taxpayer than a levy on a non-TSP retirement plan (*e.g.,* 401(k) plans). This greater risk of harm should cause the IRS to provide more taxpayer rights protections rather than less.

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22 *Id.* ACS employees are instructed to not issue the TSP levy if such documentation is present.

23 IRM 5.11.6.2.1(5), *Thrift Savings Plan* (Dec. 11, 2014). IRM 5.11.1.3.5(2) requires a revenue officer to include certain information in writing when he or she submits a levy for approval. Information includes a summary of information the taxpayer has provided and other collection alternatives considered and rejected.

24 IRM 5.11.1.3.5(6), *Managerial Approval* (Aug. 1, 2014).

25 IRS, *Draft TSP Levy Pilot ACS Procedures* 3 (June 9, 2015).

26 IRS Compliance Data Warehouse, *Accounts Receivable Dollar Inventory for Individuals* (Cycle 201451). Of the 118,507 TSP account holders with delinquent tax accounts, 89,438 had at least one payer Taxpayer Identification Number (TIN) listed on their Form W-2 (box 12) for Tax Year 2013 (61,227 had a single payer TIN). These taxpayers are federal employees, but we have not determined if these employees have TSP accounts. IRS Compliance Data Warehouse, *Accounts Receivable Dollar Inventory for Individuals* and *Information Returns Master File (IRMF) Form W-2 Table.*

27 In an email response to a TAS inquiry, the IRS replied "[w]hile ACS has the authority to issue a levy on retirement accounts, this authority has not been used during the period requested (fiscal years 2014 and 2015)." Email from Senior Advisor to Director, Operations Support, SB/SE (June 23, 2015).

28 5 CFR 1653.35.

29 IRM 5.11.6.2.1(1), *Thrift Savings Plan* (Dec. 11, 2014).

The IRS is administering a legitimate public policy by collecting taxes owed to the federal government, but there must be clear guidance in place to balance the IRS's collection authority against the compelling public policy of encouraging retirement savings and reducing elder poverty, given the harm that can occur with a levied retirement account.

Once the assets in a retirement account are levied upon, they may not be returned in the event of erroneous or wrongful levies.[30] However, as discussed above, the procedures for the TSP levy pilot do not require comparable managerial review of a pre-levy memo prior to approval of the levy.[31] This is just one instance of how a taxpayer in the TSP ACS levy pilot would receive different treatment than a taxpayer working with a Revenue Officer.

ACS employees will not be able to conduct the necessary analysis to make the levy determination because in the ACS unit, cases are assigned to teams, functions, or units rather than individual employees.[32] This is different from the field, where cases are assigned to a specific Revenue Officer. ACS also provides minimal contact with a taxpayer. For instance, ACS uses "predictive dialer" technology, which automatically makes outbound calls to taxpayers or representatives and if contact is made, the call is transferred to a waiting agent.[33] It is unclear to TAS how ACS will ensure necessary contact with the taxpayer. Last, as discussed above, the National Taxpayer Advocate is concerned ACS will not receive sufficient training and have the skills necessary to conduct the detailed financial analysis required to determine whether the taxpayer will be dependent on the funds in retirement.

The IRS is administering a legitimate public policy by collecting taxes owed to the federal government, but there must be clear guidance in place to balance the IRS's collection authority against the compelling public policy of encouraging retirement savings and reducing elder poverty, given the harm that can occur with a levied retirement account. The National Taxpayer Advocate has highlighted several concerns above to show current guidance is not sufficient to protect taxpayer rights. Before the IRS creates a pilot singling out TSP plans, it must develop detailed guidance that provides analysis particular to each taxpayer's facts and circumstances with respect to all proposed levies on retirement accounts. The current IRM procedures and the proposed ACS pilot undermine both taxpayer rights and retirement security policy.

FOCUS FOR FISCAL YEAR 2016

- Continue to work with the IRS to revise IRM guidance to provide a definition of flagrant, require a full financial analysis, and educate taxpayers about this important collection tool;
- Encourage the IRS to track levies on retirement assets and pay particular attention to levies imposed on TSP accounts;
- Continue to push for abandonment of the TSP levy pilot. If the IRS proceeds with the TSP levy pilot, the National Taxpayer Advocate will accept all ACS TSP levy cases as a criteria nine public policy case if they do not otherwise fit TAS case acceptance criteria; and
- Issue guidance to educate TAS employees on how to advocate for taxpayers facing retirement levies, including the issuance of Taxpayer Assistance Orders when necessary.

30 5 CFR 1653.36(g).

31 As mentioned above, IRM 5.11.1.3.5(6) provides that any notice of levy that requires the approval of the SB/SE Collection Area Director must include a memo explaining the information in IRM 5.11.1.3.5(2), which includes the IRS employee's justification for the levy.

32 IRM 5.19.5.3, *Research on ACS* (Jan. 6, 2015).

33 IRM 5.19.5.4.1(1), *Predictive Dialer Procedures* (Feb. 20, 2015). An automated message is left if an answering machine answers, and if there is no answer, the system "updates the account and reschedules the case to the predictive dialer queue for another attempt."