All the Things the IRS Can Take…Even Retirement Accounts!

The power of the IRS *to take* is limited by the issuance of a Final Notice of Intent to Levy. But what are the limits on the power of *what can be taken by the IRS*? One of the most surprising and contentious items that the IRS can take is retirement accounts. If your client can get to it, the IRS can too.

Determining what can be taken consists of first knowing what property the Internal Revenue Code identifies as protected from IRS collection activity. If the property is not protected by the Internal Revenue Code, then a determination must be made as to whether there is enough equity in the item to result in a net recovery to the IRS. If there is no equity, seizure is prohibited.

<u>Property listed as protected by the Internal Revenue Code</u>

Section 6334 of the Internal Revenue Code lists the property that is protected from IRS collection activity.

The protected property list is short, and chances are your client's property is not on it. Section 6334 primarily provides for the protection of some basic living essentials and property to which there is an overriding public policy interest, as follows:

1. Furniture and household goods up to $7,720 in value;
2. Tools necessary for the trade, business or profession up to $3,520 in value;
3. Clothing and school books that are necessary for the taxpayer's family;
4. Undelivered mail;
5. Wages necessary to pay court-ordered child support; and
6. Personal residences if the balance owed to the IRS is $5,000 or less.

Although Section 6334 appears to exempt public assistance benefits, unemployment benefits and worker's compensation benefits, Section 6331(h) allows for a levy of up to 15% on them. The IRS can levy up to 15% of any Federal payment provided that eligibility is *not* based on income or assets.

Internal Revenue Manual 5.11.7.2.1 states that the IRS will not levy unemployment benefits, workman's compensation and public assistance payments, even though they can.

Social security payments for retirement, survivor or disability insurance are based on social security taxes paid, not income or assets, and are commonly levied by the IRS at the 15% continuous rate. The IRS considers supplemental social security to be need based and by policy will not issue a levy on those payments.

Everything else, the IRS can take, provided that it has equity that will result in a net recovery to the IRS if it is sold.

Equity

If your client's property is not protected by Section 6334, the second part of your review will likely provide relief. This is a determination of whether the seizure would yield a net recovery to the IRS. This is where most taxpayers find protection for their property.

The IRS is prevented from taking property that would not result in any reduction of the liability. This is referred to as the net recovery rule, and can be found in IRC Section 6331(f).

The Internal Revenue Manual adopts and incorporates this rule. Section 5.10.1.2 of the IRM prohibits any "seizure where the taxpayer has insufficient equity in the property - there must be sufficient net proceeds from the sale to provide funds to apply to the taxpayer's unpaid tax liabilities."

To determine equity, find the fair market value of the asset, deduct any loans that are outstanding, and the costs of sale. What if the IRS is threatening to seize a pick-up truck valued at $12,500, and the truck is "upside down" as it has an outstanding loan of $14,000 against it? An IRS seizure will only get the bank paid on its priority financing loan. The result is the truck has no equity for the IRS, and will not be seized. The same analysis applies to business equipment and machinery.

In determining equity, the IRS often reduces value by as much as 20% to arrive at the expected return at a forced auction sale.

The IRS will also tend to shy away from items of small value that may individually have equity. For example, it is unlikely the IRS will seize used office equipment, such as desks, phones, tables, etc. This type of equipment may not have a loan against it, but its overall value makes it unattractive when compared with the effort and costs of sale.

The rule against no equity seizures eliminates the many potential asset seizures, including those involving automobiles, houses, business equipment and machinery. If a Revenue Officer is threatening to take your client's property, whether it is business or personal, and there is no equity, respectfully question the authority to do so.

And remember one simple rule: "If your client can get to it, the IRS can get to it." This applies to everything within the imagination – from receivables to insurance policies - but who could imagine this includes retirement accounts?

Retirement Accounts – Surprise, Fair Game!

Most everyone considers retirement accounts to be the holy grail of protected investments. Retirement accounts are indeed protected by law from creditors under the terms of ERISA, most state laws and the 1992 U.S. Supreme Court decision of Patterson

v. Shumate. Retirement plans are sacred, right, the one bastion of American savings? Wrong.

If your client can get to his or her retirement account, the IRS can. Retirement accounts are not listed as protected assets under IRC Section 6334, and they have value and equity. Retirement accounts that the IRS can reach include qualified pension, profit sharing, and stock bonus plans, IRAs, and self-employed plans like SEP-IRAs and Keogh plans.

Section 5.11.6.2 of the Internal Revenue Manual provides for a three step IRS process that a representative should be aware of to determine if conditions warrant seizure of the contents of a retirement plan.

The first step the representative should take is to offer collection alternatives to the retirement plan, including other property available. The IRS is authorized to consider monthly payments rather than seizing a retirement account.

The second step is to present facts illustrating that the conduct leading to the tax liability was not flagrant. The IRS instructions are to levy retirement plans in cases of egregious behavior.

If your client contributed to the retirement account while the unpaid taxes were accruing, the IRS will consider the liability to be based on flagrant conduct. A history of severe employment tax problems is also considered to be flagrant. An individual who continues to incur trust fund taxes or was found to be responsible for the Trust Fund Recovery Penalty on more than one occasion has a high risk of losing a retirement plan to the IRS.

Other examples of flagrant conduct that could result in the seizure of retirement accounts include uncooperative or unresponsive behavior (failing to meet established deadlines, to attend scheduled appointments, or to respond to Revenue Officer attempts to make contact). Those who make frivolous arguments that taxes are illegal or unconstitutional or are involved in tax fraud or tax evasion are obviously involved in flagrant conduct.

The last step of defense for the representative is to determine whether the taxpayer depends on the money in the retirement account, or will depend on it in the near future, to pay necessary living expenses. The IRS will use its standard collection financial allowances and life expectancy tables in Publication 590 (Individual Retirement Arrangements) to estimate how much can be withdrawn annually to deplete the retirement account in the taxpayer's remaining life to pay future expenses. Be sure to factor in extraordinary expenses, such as a wheelchair ramp or special living arrangements.

The most effective method of defending retirement plans is found in Section 5.11.6.2 of the Internal Revenue Manual, stating that "a levy only reaches the taxpayer's present rights" to money in a retirement plan. In other words, if the taxpayer can't get to it, the IRS can't get to it.

Many retirement plans do not give taxpayers present rights to the money, allowing access only at separation from service, retirement or death/disability. If your client has no ability to withdraw the retirement money, the IRS has no ability to seize it. Review the terms of the plan – if your client is still employed, for example, and has no right to access the money, neither does the IRS.

Case Studies on Retirement Plans

The author has had several case experiences where the IRS sought to seize a client's retirement account. Although every case stands on its own, and discrepancies may exist for personalities, the author has found the IRS to be either reluctant or aggressive as to retirement accounts. The approach tends to vary with the facts.

In one recent large-dollar case, a client gave the IRS permission to seize a retirement account, primarily to avoid the 10% early withdrawal penalty, which does not apply to seizures of retirement assets. The client had the right to access to the funds in the account, which was valued at over $250,000.

Liquidation without the 10% penalty would have resulted in an extra $25,000 remittance to the IRS. Even though the client gave permission, the IRS inexplicably declined to seize the account as the liability was not based on flagrant conduct. Despite the irony of the situation, the client chose to voluntarily liquidate the account and pay the 10% penalty. This illustrates a general reluctance on the part of the IRS, as permission was given but seizure was declined.

In another case, IRS sought to enforce a tax lien post-bankruptcy on a retirement account. The IRS can pursue equity in property post-bankruptcy to which a tax lien attached, and has recently made a concerted effort to increase its attention to these situations. The taxes could not be collected against the client because of the bankruptcy, save for the enforcement of the lien on the equity in the retirement account.

The retirement account was maintained through the client's employer, and the client had no right to the money until she separated from employment, reached retirement age or death/disability. The IRS did not seize the account, making a determination that the government had no right to the money because the client had no right to it.

Conclusion

Although virtually all property that will result in a net recovery to IRS is fair game, the reality is that property seizures are running at an all-time low across the country. In fiscal year 2006, the IRS made 590 seizures of property, compared to 3,742,276 garnishments. Property seizures are being enforced only in egregious cases when there is substantial equity in property and a lack of cooperation. The real risk is the loss of wages, bank accounts, benefits, stock, receivables or even retirement plans, all of which can be reached by garnishment.

About the Author: Howard S. Levy, a former trial attorney for the IRS, has over 18 years experience in IRS collection proceedings, U.S. Tax Court litigation, IRS administrative appeals and the use of bankruptcy to resolve IRS controversies. Howard is a member of Voorhees & Levy LLC in Cincinnati, Ohio and can be contacted at (513) 489-2555.