
LEGAL UPDATE

IRS New Guidance on State Unclaimed Property Laws and IRS Helpful Reminders on Missing Participants

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After years of public commentary, the Internal Revenue Service (IRS) addresses, for the first time, whether a plan should withhold income tax when making a transfer of a participant's accrued benefit to a State unclaimed property fund, and whether, after such a transfer

occurs, the participant is barred from making a rollover of those amounts.

There is great need for this guidance because retirement plans have a perennial problem with missing participants, especially when the plan is required to make a distribution.

The Department of Labor (DOL) has historically taken the position that State unclaimed property laws are preempted by Title I of the Employee Retirement Income Security Act (ERISA), and hence are unenforceable. In 2014, however, the DOL permitted the limited voluntary use of such laws for missing participants in a terminated defined contribution plan. Subsequently, in the absence of further guidance, some ongoing retirement plans have also resorted to such transfers. Now the IRS addresses the tax consequences when these transfers occur, although not whether such transfers in ongoing plans are permissible under Title I.

Revenue Ruling 2020-24 addresses the situation where a participant has not made a withholding election and the plan transfers the participant's accrued benefit to a State unclaimed property fund. The IRS instructs retirement plans to issue 1099-Rs covering any amounts so transferred, and instructs the plan to deduct appropriate income tax and to include the amount withheld on the 1099-R as well. The revenue ruling gives plans a grace period to come into compliance, and does not address any other applicable law.

In Revenue Procedure 2020-46, the IRS announces that a plan participant may be eligible for a conditional waiver of the 60-day rollover restriction if the participant self-certifies that the reason for the inability to "complete" the rollover was due "to the distribution made to a state unclaimed property fund." Without explanation, the revenue procedure instructs that the participant, once the reason no longer prevents, should then be able to roll over "the amount distributed (which includes any amount withheld for income tax)."

Both of these guidance documents leave unanswered more questions than they answer. For instance, neither provides any detail as to why, and in what form, the amounts were transferred from a plan to a State fund. Does the guidance refer to transfers due to a plan termination? Or to account transfers of missing participants (*i.e.*, collectively, unlocated or unresponsive participants) in ongoing plans? The ERISA Advisory Council and the Government Accountability Office (GAO) each pointedly examined similar unanswered questions directed to the IRS, the DOL and the Pension Benefit Guaranty Corporation (PBGC) (the responsible Agencies) in recent reports. The IRS and PBGC tacitly acknowledge that the DOL has the authority for, but has not answered, the biggest question of all—whether ongoing retirement plans are ever permitted, under Title I of ERISA, to transfer plan assets attributable to missing participants to State unclaimed property funds.

There is now some indication that the Agencies have heard and are considering additional guidance on missing participants. For now, the focus should be on reducing a plan's number of missing participants.

Recent IRS Procedures Regarding Searching for Missing Participants and Beneficiaries

IRS backs up these important changes by issuing a "Snapshot" (a public reminder of other recent IRS guidance) that may assist ongoing retirement plans to avoid using transfers to these State Funds at all. The Snapshot highlights IRS guidance for locating missing participants when a retirement plan is required to take certain actions. The Snapshot also offers helpful cross references to search methods described in DOL Field Assistance Bulletin (FAB) 2014-01 for terminating defined contribution plans, and the PBGC search standards for terminating defined benefit and defined contribution plans intending to use the PBGC program for missing participants.

As many defined benefit plans know, and individual account plans are learning, the DOL appears to expect ongoing plans to make a sea change in how they handle missing participants. According to the DOL, the Department used its enforcement arm to collect, in 2018, over \$1.1 billion on behalf of 21,000 previously "missing" participants in ongoing defined benefit plans. The DOL obviously expects plans, both defined contribution and defined benefit, to pick up the tempo.

Fiduciaries of ongoing plans are still on their own as to permissible next steps after a prudent search, so until there is further guidance, ongoing plans are well advised to focus on best practices for locating missing participants.

IRS Missing Participant Guidance

The publications highlighted in the Snapshot provide that the IRS will not challenge a plan's qualified status if the plan has followed the IRS guidance:

1. **Required Minimum Distributions**—The IRS will not disqualify a plan for failing to commence or make a required minimum distribution if the plan has done a diligent search which must include searching plan and related plan records, sponsor or publicly available records or directories for alternative contact information; using a commercial locator service, a credit reporting agency, or a proprietary Internet search tool for locating individuals; and attempting contact via USPS certified mail to the last known mailing address, or through other appropriate means, for any address or contact information (including use of email addresses and telephone numbers). IRM 4.71.1.4 (15).
2. **EPCRS Corrections**—When additional benefits are owed, the IRS guidance calls for a "reasonable" search for current or cashed out former participants not located after a mailing to the last known address. These

reasonable actions include, but are not limited to, mailing to the individual's last known address using certified mail, and, if that is unsuccessful, using an additional search method, such as a commercial locator service, a credit reporting agency, or Internet search tools. If the reasonable search fails, the IRS reminds plans that the search is only reasonable if the additional benefits will be available if the individual is later located. Proc. 2019-19, Section 6.02(5)(d)(1).

- 3. Suspension of Benefits Notices from Multiemployer Plans**—The search guidance for multiemployer suspension of benefits notices calls for similar reasonable actions, but also includes contact with bargaining parties for the plan and other related plans. The examples indicate that a plan needs to get near perfect notice delivery (fail rate of no more than 50 out of 5,000 participants) to the affected participants, even if it means using commercial locator services. 26 CFR 1.432(e)(9)-1.

Department of Labor Guidance on Missing Participants in Terminating Defined Contribution Plans

Some plan administrators have effectively extrapolated search methods for ongoing plans from DOL FAB 2014-01 which describes search steps that would be prudent for a plan fiduciary to take to make the distributions necessary to terminate a defined contribution plan with missing participants. The FAB recognizes that these plan fiduciaries have no choice but to make the necessary distributions and describes what the Department believes would be reasonable and prudent alternatives given that a plan fiduciary's choice of a distribution option for a missing participant's account balance is a fiduciary decision.

The FAB first suggests that some search methods are so effective as to be the first prudent steps to locate a missing participant: 1) use certified mail; 2) check the records of the employer and of "related plans" for up-to-date information; 3) attempt to identify and contact any beneficiaries designated under the employer's plans to obtain contact information; and 4) use free electronic search tools (such as Internet search engines, public record databases, and social media). If these methods fail to locate a missing participant, the FAB suggests that a plan fiduciary, after considering the size of the account balance and the cost of additional search efforts, could, but is not absolutely required to, use commercial locator services, credit reporting agencies, information brokers, investigation databases, Internet search tools and similar services that may involve charges.

Because the DOL recognizes that plan administrators are compelled to follow through on a direction to terminate a plan, the DOL offers alternatives if all of the search methods

fail to locate or establish contact with a missing or unresponsive participant. First, the FAB encourages plans to make use of the IRA safe harbor direct rollover provision described in the Department's regulation for distributions from terminating individual account plans at 29 C.F.R. 404a-3. In order to encourage use of this option, because it preserves tax deferred status for the participant's account, the FAB suggests that a plan fiduciary's choice of a provider would be considered prudent if the standards described in the regulation are followed.

If the fiduciary cannot find a provider to accept a direct rollover, or chooses not to use that option for some other "compelling" reason, the FAB permits two other options; transferring the benefit to an interest-bearing account (in the name of the missing participant) in a federally insured bank, or transferring the account balance to a State unclaimed property fund. The FAB cautions that the plan fiduciary must consider whether either of these options is prudent, considering the adverse tax consequences to the participant.

Analysis

A retirement plan with missing participants should be able to construct a prudent search approach using a combination of factors from the Agencies' guidance. Clearly, mailing a notice or check to a participant's last known address is not sufficient (and DOL has indicated that routinely returned plan mailings should alert the prudent plan administrator to employ other methods on a regular basis). It appears that a plan may take graduated steps, perhaps next resorting to certified mail, or using alternative addresses located by making contact through other related plans, or perhaps through related organizations, if relevant, or by contacting any beneficiaries designated in the plan or related plans. The Agencies all suggest using free Internet tools as well—the DOL noting success with such simple methods.

If all this fails? In describing further methods that may be necessary for the search to be deemed reasonable, diligent or prudent, the Agencies all include using commercial locator services, and/or credit reporting agencies. At this step, it does not seem unreasonable for a plan administrator to follow the DOL's guidance for terminating plans and consider the cost of this type of service for locating missing participants with very small account balances. Also, although the IRS seems to imply only a very low fail rate is acceptable, at least for suspension of benefits notices, it seems reasonable to assume that the Agencies will understand that every plan will have a certain number of permanently missing participants.

Conclusion

Assuming that an ongoing retirement plan may be able to reduce the burden of missing participants on plan administration, plans still need guidance on next steps. Until the DOL, or the Agencies together, provide guidance on the

handling of plan assets attributable to missing participants, some plans will continue doing what the IRS guidance suggests they are already doing, but others will hold on to plan assets indefinitely.

However, perhaps the PBGC approach is an indication of the direction in which the government is moving, perhaps with the encouragement it has received from the ERISA retirement plan community. DOL FAB 2014-01 acknowledged the upcoming PBGC program authorized under the Pension Protection Act of 2006 and noted that the Department intends to reevaluate the FAB guidance for terminating plans after the PBGC program is in place because “. . . the ability to transfer missing participants’

benefits to . . . a PBGC administered program will change the decisional environment fiduciaries face when choosing among distribution options.” The same may be true for treating missing participant benefits in ongoing retirement plans as well, if Congress follows through on the bipartisan and industry-supported Retirement Savings Lost and Found Act of 2020, and the Securing A Strong Retirement Act of 2020.

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