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## LEGAL DEVELOPMENTS

### *New Escheatment Guidance for Qualified Plans*

*The Internal Revenue Service has offered its guidance for reporting and withholding on distributions paid to state unclaimed property funds via escheatment.*

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Most of the focus on missing participants has been with the Department of Labor (DOL) and its retirement plan audits, but over the last few years, the Internal Revenue Service (IRS) also has been getting into the game with targeted guidance

in this area. The latest rendition of this IRS guidance is Revenue Ruling 2020-24 and Revenue Procedure 2020-46, focused on escheatment. Under Revenue Ruling 2020-24, the IRS addresses the reporting and withholding treatment for qualified plan distributions paid directly to state unclaimed property funds via escheatment. Under Revenue Procedure 2020-46, the IRS expands its indirect rollover hardship relief to apply to escheatment payments that are claimed and returned to a qualified plan or individual retirement account (IRA). A review of this guidance is set forth below, in question and answer format.

#### **Why Is the IRS Issuing Guidance on Escheatment Payments?**

There are two key reasons for issuance of the guidance.

First, a few years ago, the IRS issued reporting and withholding guidance for escheatment payments from IRAs under Revenue Ruling 2018-17. As IRA distributions are subject to the same Form 1099-R reporting requirements and statutory withholding provisions as are qualified plans pursuant to Internal Revenue Code (Code) Section 3405, it makes sense that the IRS would issue similar guidance for qualified plans.

Second, qualified plans are subject to special vesting and nonforfeitability rules under the Code. Once a benefit becomes vested, it cannot be forfeited. However, there is special relief for missing participants under Treasury Regulation Section 1.411(a)-4(b)(6). Specifically, it is permissible to forfeit the vested accrued benefit due to an inability to find the participant or beneficiary to whom payment is due. However, the plan must provide for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. Also, a benefit that is lost by reason of escheatment under applicable state law is not treated as a forfeiture.

Therefore, the new Revenue Ruling is providing guidance in the event that plan benefits, in fact, are escheated.

### **Was This Guidance Coordinated with the DOL?**

Sadly, no. We know that the DOL has been very active in plan examinations to ensure that missing participants are located and their benefits paid out, which typically does not involve simply escheating plan benefits to the states. This is because ERISA-covered plan benefits are generally understood to be beyond the reach of state unclaimed property laws, pursuant to ERISA preemption under ERISA Section 514.

Revenue Ruling 2020-24 expressly states in footnote 1 that it does not address whether the payment to the state unclaimed property fund otherwise complies with applicable law. It makes clear that this guidance addresses neither compliance with any search requirements applicable under state law nor matters arising under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) for which the DOL has subject matter jurisdiction. Therefore, this guidance should not be viewed as a green-light to escheatment.

### **How Should the Escheated Payments Be Reported on Form 1099-R?**

Escheated payments must be reported as distributions to the participant on Form 1099-R. Specifically,

Revenue Ruling 2020-24 extends the general reporting requirements for qualified plan payments on Form 1099-R to escheated pension payments from qualified retirement plans under Code Section 401(a).

The distribution is reportable on Form 1099-R in the year of payment to the state fund. The gross amount of the distribution (including the federal withholding) is reported in box 1, and the applicable federal income tax withholding is reported in box 4. Presumably, the payor would also be required to send a copy to the last known address of the participant.

The new rule applies only to payments made after the earlier of January 1, 2022, or “the date it becomes reasonably practicable for the person to comply.”

### **How Should the Escheated Payments Be Treated for Federal Income Tax Withholding Purposes?**

Escheated payments are subject to federal income tax withholding under Code Section 3405. Specifically, Section 3405(e)(1)(B) defines the term “designated distribution” for purposes of the rules for withholding on pension payments. For this purpose, the term does not include a distribution or payment that it is reasonable to believe is not includible in gross income.

Under the facts of the new ruling, there are no Roth 401(k) amounts, no employer securities in the plan, the plan does not provide health benefits under Code Section 104 or 105, and no investment in the contract by the participant (for example, after-tax contributions). Therefore, it was not reasonable for the employer to believe that the payment of any portion of the participant’s accrued benefit was excludible from gross income. Based on this reasoning, the IRS ruled that the payment from the 401(a) plan to the state fund was subject to federal income tax withholding under Code Section 3405 (presumably, 20 percent mandatory withholding applies if the amounts were eligible rollover distributions).

### **How Does the Indirect Rollover Relief Come into Play?**

Code Section 402(c) requires that, to constitute a tax-free rollover, a participant must deposit the amount received in a distribution to an IRA or another qualified plan within 60-days following receipt of the distribution. Now that we are required to treat the escheatment payment to the states as a distribution to the participant, that starts the running of the 60-day rollover clock. That raises the question:

Is the participant whose funds are escheated prevented from rolling the funds over unless he or she becomes aware of the escheatment and can effect a rollover within 60 days?

Thankfully, several years ago, the IRS issued a self-certification hardship process for relief of this 60-day time period pursuant to Revenue Procedure 2016-47. (Prior to this guidance, the only available relief was through a private letter ruling submission with the IRS.) While the 2016 procedure did not provide the needed relief for escheatment, Revenue Procedure 2020-46 comes to the rescue.

### **What Change Was Made to the Indirect Rollover Relief?**

Revenue Procedure 2020-46 updates this self-certification process for late indirect rollovers set forth in Revenue Procedure 2016-47 to add escheatment to the list of events that justifies a late indirect rollover. This issue was first raised following Revenue Ruling 2018-17, which mandated reporting and withholding on IRA payments made to a state unclaimed property fund. This issue has now become even more pressing following Revenue Ruling 2020-24, under which escheated qualified plan payments start the 60-day clock on an indirect rollover.

As noted above, a taxpayer may only roll over an eligible rollover distribution from an IRA or eligible employer plan to another plan or IRA within 60 days of receiving the distribution. But, beginning in 2016, to ease the burden on many taxpayers who miss the 60-day window for an indirect rollover, the IRS permitted a taxpayer self-certification claiming eligibility for a waiver of that period, if specified requirements are met. The taxpayer may use the model self-certification provided by the IRS (which has been updated), or may use a letter that is materially similar.

The guidance continues to make the point that this relief is limited to the 60-day rollover deadline, and unfortunately does not provide any relief for other IRS rules (for example, one-per-12-month limit on indirect rollovers between IRAs, the inability to rollover of required minimum distributions, and the prohibition on indirect rollovers of payments to non-spouse beneficiaries).

Moreover, the IRS still reserves the right to challenge rollover treatment claimed via self-certification, and to assert claims for interest and penalties. The Form 5498 that is filed with the IRS by the IRA provider flags this late contribution.

### **When Is the New Rollover Relief Effective?**

This updated late rollover relief in Revenue Procedure 2020-46 is effective as of October 16, 2020, and supersedes the prior Revenue Procedure 2016-47. This new guidance largely mirrors the prior guidance, except that it adds the following (number 12 listed below) valid reason for missing the 60-day rollover deadline: “the distribution was made to a state unclaimed property fund.”

### **How Does the Self-Certification Process Work?**

The participant must make a written certification to a plan administrator or IRA trustee that he or she is eligible to make a rollover after the 60-day period, and the following conditions must be met:

- The IRS must not have previously denied a waiver request with respect to any part of the distribution in question;
- The contribution must be made to the receiving plan or IRA as soon as practicable after the barrier to the rollover has been removed. (If the contribution is made within 30 days after the reason(s) no longer prevent the participant from making the contribution, then this requirement is deemed to have been satisfied.);
- At least one of the following valid reasons for missing the 60-day rollover deadline must apply:
  1. An error by the receiving or distributing financial institution;
  2. The check (if applicable) was misplaced and never cashed;
  3. The distribution was deposited into and remained in what the taxpayer mistakenly thought was an eligible retirement plan;
  4. Severe damage to the participant’s principal residence;
  5. The death of a member of the participant’s family;
  6. A serious illness of the taxpayer or a member of the participant’s family;
  7. Incarceration of the participant;
  8. Restrictions imposed by a foreign country;
  9. A postal error;
  10. The distribution was originally made on account of a tax levy and the levy proceeds have been returned to the participant;
  11. The party making the distribution delayed in providing the necessary information to

complete the rollover, despite the participant's reasonable efforts to obtain the information;  
or

12. The distribution was made to a state unclaimed property fund.

For this purpose, the participant may use the model self-certification provided by the IRS, or may use a letter that is materially similar. A copy of the certification should be kept in the participant's files and be available if requested on audit.

A plan administrator (or IRA trustee) may rely on this certification in accepting a rollover that would otherwise be outside of the 60-day window. However, if the administrator (or trustee) has actual knowledge that would contradict the information in the certification then the certification is not sufficient.

### What Should Plan Sponsors Do to Comply with This Escheatment Guidance?

First, all plan sponsors of qualified plans, regardless of how they treat missing participants, should update their rollover procedures to reference Revenue Procedure 2020-46 (and not its predecessor, Revenue Procedure 2016-47), to include escheatment in the

late rollover process, and update the sample certification used accordingly.

Second, plan sponsors of qualified plans that escheat plan benefits should update their reporting and withholding procedures no later than January 1, 2022, to comply with Revenue Ruling 2020-24 to ensure compliance with these rules. Failure to properly report and withhold federal income taxes raises a number of potential reporting and withholding penalties and obligations for the plan sponsor. The withholding requirements may be of particular concern for escheatment that is made in-kind (which was a similar issue for IRA payments). Notably, no corrective action is required for the plan sponsor's prior reporting and withholding position.

Remember, for plan sponsors that do not use the escheatment process, this is not a green-light to adopt these procedures. And these reporting and withholding rules do not extend to missing participant payments that are merely placed in the plan's forfeiture account.

Lastly, stay tuned for more IRS missing participant guidance as the IRS 2020-2021 Priority Guidance Plan includes "guidance on missing participants, including guidance on uncashed checks." ■

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