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Special Challenges With Escheating Tax-Deferred Retirement Assets

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In this installment of UP Ahead, the authors discuss some of the numerous challenges associated with the potential escheatment of tax-deferred retirement assets.

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Most individuals assume that when they establish a retirement account, be it a 401(k) account or other retirement account offered through an employer, or a traditional Individual Retirement Account or Roth IRA, these assets will "sit" until the individual ceases to actively work and be available to fund retirement needs. Ideally, as was Congress's goal in passing laws to create and defer taxation of these assets, the value of these accounts will grow in the interim through sound investment of the corpus of the account. In virtually all instances, this outcome is achieved.

However, all states require the escheatment of traditional IRAs if statutory prerequisites have been satisfied; some states require the escheat of Roth IRAs before the death of the owner; and there are also situations in which even ERISA-governed plan accounts and distributions may be subject to elective escheatment, although the scope of ERISA preemption of state laws — including unclaimed property laws — is extensive.

This two-part article will identify and discuss some of the numerous challenges associated with the potential escheatment of these tax-deferred retirement assets. The first installment addresses the impact of ERISA on the application of state unclaimed property laws as they relate to contribution plans and defined benefit plans. The second installment explores the complications and challenges associated with the escheatment of IRAs.

Does ERISA Preempt Required Escheatment?

Many retirement plans are subject to ERISA, which may either prohibit (that is, preempt) escheatment of unclaimed plan assets/accounts, or may render escheatment permissive under a specific set of circumstances. Retirement plans subject to ERISA fall into two categories: defined contribution plans and defined benefit plans. Generally, under a defined contribution plan an employer agrees to make a certain contribution while an employee is working; under a defined benefit plan, an employer agrees to provide a certain benefit at retirement (for example, based on a dollar amount or formula). Defined contribution plans are frequently referred to as 401(k) plans, profit sharing plans, stock bonus plans, savings plans, money purchase plans, SIMPLE IRAs, SEPs, or employee stock ownership plans. Defined benefit plans are typically referred to as traditional plans, cash balance plans, hybrid plans, pension equity plans, or variable annuity

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plans. Defined benefit plans are also frequently referred to as pension plans, even though under ERISA defined contribution plans and defined benefit plans are categorized as pension plans.

- Any employee pension plan is covered by ERISA's preemption provisions, whether defined benefit or defined contribution, unless explicitly excluded from this aspect of ERISA. Thus, it would be reasonable to conclude that the only retirement assets that may be required by a state to be escheated are those that are held under a plan or arrangement that is either not an employee pension plan or is an excluded employee pension plan.
- Non-preempted plans/accounts include IRAs that are not established by an employer or are part of the funding mechanism for a plan sponsored by an employer for its employees (this includes IRAs established to hold amounts rolled over from an ERISA plan). (IRA escheat challenges will be addressed in the second installment of this series.)

With this grounding, let's consider the potential limits of ERISA preemption, and the concept of "voluntary" escheat of retirement assets. Federal preemption of state law is based on the supremacy clause of the U.S. Constitution.[1] Federal law has generally been held to preempt state law in three distinct circumstances:

- Congress can define explicitly the extent to which its enactments preempt state law.
- In the absence of explicit statutory language, state law is preempted where it regulates conduct in a field that Congress intended the federal government to occupy exclusively.
- Finally, state law is preempted to the extent it actually conflicts with federal law.[2]

Congress enacted ERISA to provide a comprehensive and uniform system for regulating the establishment, operation, and administration of employee benefit plans (including both pension plans and general welfare benefit plans).[3] Congress recognized that there is a vital national interest in providing safeguards for the millions of employees and their dependents affected by these plans because of the "increasingly interstate" scope and impact of them.[4] Thus, 29 U.S.C. section 1001(b) states that the policy of ERISA is "to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries."[5] This general policy of protecting plan participants and their beneficiaries is implemented by ERISA's specific provisions. For example, a fiduciary of an ERISA employee benefit plan must generally "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries."[6] Similarly, a plan's assets are generally required to be "held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."[7]

The Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. section 1001 et seq., expressly preempts "*any and all State laws insofar as they may now or hereafter relate to any employee benefit plan*."[8] The U.S. Supreme Court has specified that ERISA's preemption provision is to be construed broadly, such that a law "relates to" an employee benefit plan "if it has a connection with or reference to such a plan."[9] Not only do state unclaimed property laws relate to ERISA plans in a general sense, these laws would explicitly dictate to those charged with administering these plans — the fiduciaries of these plans — what they must do with assets of the plan in the event that applicable conditions are satisfied, such as in the case that the participant or

[1] "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." Article VI, section 2.

[2] *English v. General Electric Co.*, 496 U.S. 72, 78-79 (1990).

[3] Protecting "the interests of employees and their beneficiaries in employment benefit plans."

[4] 29 U.S.C. section 1001(a).

[5] 29 U.S.C. section 1001(c) adds that the policy of ERISA is also to protect the federal taxing power.

[6] 29 U.S.C. section 1104(a)(1).

[7] 29 U.S.C. section 1103(c)(1).

[8] 29 U.S.C. section 1144(a) (emphasis added).

[9] *Shaw v. Delta Air Lines Inc.*, 463 U.S. 85, 96-97 (1983). *See also Metropolitan Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 739 (1985); *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 46-47 (1987); and *Ingersoll-Rand Co. v. McClendon*, 498 U.S. 133, 138 (1990).

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beneficiary entitled to those assets (benefits) either is unable to be located or refuses to accept those amounts. However, preemption will not apply when a state law affects an ERISA plan in a manner that is "too tenuous, remote or peripheral."[10]

'Voluntary' Escheatment of Assets

While ERISA broadly preempts the application of unclaimed property law, holders may voluntarily escheat ERISA plan assets in some circumstances. Several state and federal courts and the U.S. Department of Labor (DOL) have issued rulings and opinions, respectively, that state escheatment laws are preempted under ERISA section 514 when the escheatment laws interfere with the administration of the ERISA plan.[11] That said, the DOL clarified in Field Assistance Bulletin 2014-01 that distributions of missing participants' account balances and outstanding checks from *terminating* and *abandoned* ERISA-covered plans may be made to a state unclaimed property fund, *provided that* the DOL's requirements imposed to protect and preserve the plan assets are met *before* escheatment.[12] In the same bulletin, the DOL reiterated its prior conclusion that "if a state unclaimed property statute were applied to *require* an ongoing plan to pay to the state amounts held by the plan for terminated employees, section 514(a) of ERISA would preempt the application of that state statute."[13] However, the DOL also stated that the principles underlying that conclusion "would not prevent the fiduciary of a terminated plan from *voluntarily* deciding to escheat missing participants' account balances under a state's unclaimed property statute *to complete the plan termination process*."[14] In other words, the DOL has indicated that a fiduciary may voluntarily send money to a state under an unclaimed property law in the limited and special case of a plan termination (in very limited circumstances, as described more fully in the next paragraph), but a state may not require the fiduciary of an ongoing plan to send money to the state under such a law.

Even in the context of plan termination, the DOL has made clear that the bar on a fiduciary's voluntary use of a state unclaimed property law is very high. Specifically, the DOL stated in that guidance that "in the absence of compelling offsetting considerations," a "prudent and loyal fiduciary would not voluntarily subject" a participant's plan benefits to the "considerable adverse tax consequences" — such as immediate income taxation, mandatory income tax withholding, loss of additional earnings as well as loss of deferred taxation on additional earnings, and potentially an additional tax for early distribution — that would generally result from sending those amounts to the state under a state unclaimed property law. The DOL did provide some guidance to a fiduciary that is considering whether to voluntarily send money to a state under an unclaimed property law to complete the plan termination process, indicating that the fiduciary should "look at the availability of a searchable database maintained by the state, which may help participants find their retirement funds, and any interest payable by the state."

The Advisory Council (to the DOL) on Employee Welfare and Pension Benefit Plans took this dialogue one step further when it recently hosted meetings to address permissive transfers of uncashed checks from *active* ERISA plans to state unclaimed property agencies.[15] The advisory council observed that the likelihood of reuniting plan participants with lost retirement savings could be enhanced through the escheat process because:

- uncashed distribution checks for participants who cannot reasonably be located through appropriate plan searches are unlikely to be reunited with participants through alternative means (for example,

[10] *Shaw*, *supra* note 9, at 100.

[11] *See, e.g.*, *Commonwealth Edison v. Vega*, 174 F. 3d 870 (7th Cir. 1999); *Manufacturer's Life Insurance Company v. East Bay Restaurant and Tavern Retirement Plan*, 57 F. Supp. 2d 921 (N.D. Cal. 1999); *Aetna Life Insurance v. Borges*, 869 F.2d 142 (2nd Cir. 1989); DOL Advisory Opinion 79-30A (May 14, 1979); and DOL Advisory Opinion 94-41A (Dec. 7, 1994).

[12] U.S. Department of Labor, Field Assistance Bulletin No. 2014-01 (Aug. 14, 2014).

[13] *Id.* (emphasis added).

[14] *Id.* (emphasis added).

[15] *See, e.g.*, U.S. Department of Labor, 2019 Advisory Council on Employee Welfare and Pension Benefit Plans: Permissive Transfers of Uncashed Checks From ERISA Plans to State Unclaimed Property Funds.

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involuntary rollovers/taxable transfers and forfeiture-and-restoration);

- state unclaimed property programs have features that increase the probability that missing participants will be reunited with their benefits; and
- the probability of recovery is higher in states that embrace specific practices, particularly data matching with other state agencies such as revenue offices.[16]

That said, the advisory council recognized some challenges with reliance on a nonuniform multistate unclaimed property regime to "solve" the missing participant/uncashed check problem. Ultimately, the council made three recommendations:

- The council recommends that the DOL issue guidance clarifying that uncashed distribution checks are "plan assets" within the meaning of ERISA section 3(42), and *reaffirming that ERISA preempts state unclaimed property laws to the extent of such assets*.
- The council recommends that the DOL issue guidance stating that a transfer of amounts attributable to a missing participant's uncashed check to a state unclaimed property program constitutes a payment of benefits under ERISA.
- The council recommends that the DOL issue guidance stating that:
  - a plan fiduciary will be viewed as having satisfied its fiduciary responsibility under ERISA to the extent the fiduciary transfers amounts attributable to a missing participant's uncashed check to a state unclaimed property program that meets minimum standards, as determined by the DOL (informed by the discussion in the council's report); and
  - in connection with any such transfer, a plan fiduciary may rely on a state program's representation that it meets those minimum standards.[17]

While holders wait for further guidance from the DOL, they should study this issue closely in light of the range of published guidance to assess (1) whether unclaimed funds associated with terminated or abandoned plans may be deemed to no longer be plan assets, and consequently no longer subject to ERISA preemption; and (2) whether uncashed checks to active plan participants should be voluntarily escheated in this interim period. It is possible that other authorities may bear on a holder's determination whether to deem unclaimed assets associated with an ERISA plan as being properly subject to escheat. These might conceivably include the DOL's "fiduciary rule," Office of the Comptroller of Currency guidance, other IRS guidance, and so forth.

Holders will also weigh what action is in the best interests of the owners under general fiduciary/safekeeping principles, in addition to practical considerations (for example, ease of administration, the desire to clean up plan recordkeeping). Holders confronting this situation should consult with legal counsel and, at a minimum, consider documenting and retaining any procedures followed, actions taken, and records generated regarding locating participants with the records of the plan.

Conclusion

The scope of ERISA preemption of state laws, including unclaimed property laws, is extensive. Holders of these assets should make sure preemption is considered in connection with the overall compliance regime. However, even if one assumes that ERISA generally preempts state unclaimed property laws, ERISA-governed plan accounts and distributions may be subject to elective escheatment. As the foregoing illustrates, these issues are numerous and resistant to easy solutions. ■

[16] *Id.*

[17] *Id.* (emphasis added).

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