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Unclaimed Property ADVISORY ▪

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IRS Ruling on IRAs Raises Numerous Unclaimed Property Issues for Holders, Owners, and States Alike

In a recent Revenue Ruling, the IRS concluded that a traditional individual retirement account (IRA) remitted to a state as unclaimed property will be subject to federal income tax withholding and reporting requirements consistent with other nonperiodic distributions from IRAs. This is the first time the IRS has directly addressed the income tax implications associated with the escheatment of an IRA to a state.

Revenue Ruling 2018-17

In particular, Rev. Rul. 2018-17 was published on May 29, 2018, and addresses the federal income tax withholding and reporting requirements associated with the escheatment of an IRA to a state as unclaimed property. At a high level, Internal Revenue Code § 3405 requires federal income tax withholding on a designated distribution, which is broadly defined in Section 3405(e)(1) as "any distribution or payment" from an IRA. The definition does exclude a few distributions and payments, including the portion of a distribution or payment for which it is reasonable to believe that it is not includible in gross income, but Section 3405(e)(1)(B) clarifies that "any distribution or payment from or under an individual retirement plan (other than a Roth IRA) shall be treated as includible in gross income."

Based on this language in the Code, the IRS concludes in Rev. Rul. 2018-17 that the escheat of an individual's interest in a traditional IRA to a state is a designated distribution includible in such individual's gross income for withholding purposes. Therefore, unless the IRA owner has elected to opt out of withholding under Section 3405(b)(2), a trustee must withhold federal income tax at the 10% rate for nonperiodic distributions upon escheatment.

Moreover, the IRS concluded that the IRA trustee must report the designated distribution of the escheated IRA to the IRS on Form 1099-R, consistent with the trustee's duty to report any other type of distribution from the IRA during the calendar year under Treasury Reg. § 1.408-7(a).

The ruling does not take effect until the earlier of January 1, 2019, or the date it becomes reasonably practicable for the trustee to comply.

Impact on Holders of IRAs

As a result of this ruling, it is clear that holders of IRAs will bear federal-tax-related burdens upon escheating IRAs to states. In other words, not only will holders be obligated to comply with state unclaimed property laws and all that they entail in terms of escheating IRAs, but holders also must ensure that the federal withholding and reporting rules are met. These additional compliance burdens would seem to maximize the need for holders to ensure that an IRA has satisfied all requirements for escheatment (including consideration of any applicable legal defenses) before remitting the property. Otherwise, if a holder escheats an IRA that is not technically subject to being reported as unclaimed property, the holder will also be obligated to withhold income tax and report to the IRS.

Impact on Owners and States

This ruling is also directly relevant to owners, particularly in states that would require the escheatment of IRAs before the owner achieves a required minimum distribution (RMD) event (i.e., turning 70½ years old). In particular, Pennsylvania has recently amended its unclaimed property law applicable to IRAs to eliminate the requirement that the owner reach age 70½. Instead, an IRA is potentially escheatable simply because a mailing to the owner has been returned as undeliverable. Although Rev. Rul. 2018-17 does not address this specific fact pattern, it seems clear that the escheatment of an IRA that results in an early distribution (generally, before age 59½) would implicate the Code's additional tax on early distributions.

Indeed, upon revision of its statute, the Pennsylvania Treasury Department issued guidance stating that the revised provisions "directing the transfer of abandoned and unclaimed retirement accounts into the custody of the Commonwealth are not anticipated to implicate early distribution related taxes. Upon the transfer of an IRA … the Commonwealth will act solely as custodian of those assets until such time as the owner or beneficiary is located and reclaims the abandoned and unclaimed property. *Because neither the owner nor the beneficiary will have constructive possession or control of the account, the transfer to the Commonwealth's custody should not be taxable, reportable or potentially penalize a premature distribution to the account owner, but instead should be treated as a non-reportable transfer of retirement assets*." This conclusion is directly contradicted by Rev. Rul. 2018-17.

In its guidance, the department did note that it would undertake an "extensive review of the various tax implications" associated with the revision "to ensure that IRA and other retirement account owners will not be negatively impacted from a tax perspective upon any escheatment of retirement assets to the Commonwealth." It is unclear whether withholding income tax from an IRA upon escheatment would be considered a negative tax implication, though it certainly contradicts the department's conclusion. However, it is clear that the imposition of an additional tax on an IRA that is escheated, and therefore distributed, early is a significant negative impact to the owner – and, we believe, the owners of IRAs that are escheated to Pennsylvania before the owner reaches the RMD age will be vocal in their recitation of those harms as they file claims with the state. Presumably, owners will demand full restoration of the IRA's value from the state, including any applicable penalty that has been incurred. Thus, to avoid unnecessary complication and expense, it is incumbent upon the department to revisit its guidance and take the position that IRAs should not be reported before the occurrence of an RMD event.

It is also important to understand that this issue is not limited to Pennsylvania. Many states have recently begun to aggressively audit IRA property and have taken the position that (1) an RMD is triggered for a particular IRA after the owner reaches age 70½ even if the owner may have taken the requisite RMD from another IRA; and (2) an RMD is triggered upon a *presumed* death of the owner (based on information in the Social Security Death Master File or state vital statistics databases), even if the holder has received no actual confirmation of death. Though it appears that these positions are incorrect as a matter of law, the fact that the owner will be taxed on escheatment in these situations is yet another reason for holders to push back on states asserting such positions.

Conclusion

Rev. Rul. 2018-17 is yet another illustration of the principle that holders must constantly consider sources of law outside of unclaimed property statutes in assessing all of the relative burdens and obligations associated with the escheatment of IRAs. Indeed, the escheatment of IRAs was already a particularly sensitive area for holders, as these accounts are a creation of federal law, carry particular federal (and state) tax advantages, and represent individual savings that by nature are not actively transacted upon. Indeed, owners may have multiple IRAs they are taking distributions from, and so what appears to be an inactive IRA may simply represent a conscious decision by an owner to not take a distribution. Rev. Rul. 2018-17 adds another compliance wrinkle to holders, which must strike the balance between preserving customer savings and compliance with state unclaimed property laws.

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