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Unclaimed Property ADVISORY ▪

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FAQs on Unclaimed Property Aspects of Retirement Assets

Did you know that all states require the escheatment of traditional IRAs if statutory prerequisites have been satisfied? And that there are situations in which even ERISA-governed plan accounts and distributions may be subject to elective escheatment? These outcomes often strike the average person as counterintuitive, given that such accounts are opened with a long view toward an owner's eventual withdrawal/use of the funds in retirement, potentially decades after the account was established.

Does ERISA Preempt the Escheatment of Retirement Plan Accounts?

It depends. Many retirement plans are subject to ERISA, which may either prohibit (i.e., preempt) escheatment of unclaimed plan assets/accounts or permit escheatment under a specific set of circumstances.

This topic is too complicated for a brief answer, but consider the following and consult with your employee benefits advisor:

- Every employee pension plan is covered by ERISA's preemption provisions, whether defined benefit or defined contribution, unless explicitly excluded from this aspect of ERISA. It's 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).
- Federal law has generally been held to preempt state law in three distinct circumstances: (1) Congress explicitly defines the extent to which its enactments preempt state law; (2) in the absence of explicit statutory language, when state law regulates conduct in a field that Congress intended the federal government to occupy exclusively; and (3) when state law actually conflicts with federal law.
- ERISA expressly preempts "any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 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."

(29 U.S.C. §1144(a).) However, preemption will not apply when a state law affects an ERISA plan in a manner that is "too tenuous, remote or peripheral." (*Shaw v. Delta Air Lines Inc.*, 463 U.S. 85 (1983).)

Not only do state unclaimed property laws relate to ERISA plans in a general sense, these laws would explicitly dictate to the fiduciaries charged with administering these plans what to do with assets of the plan if applicable conditions are satisfied, such as when the participant or beneficiary entitled to those assets (benefits) either is unable to be located or refuses to accept those amounts.

Despite ERISA, May a Custodian "Voluntarily" Escheat Certain Retirement Assets?

Only in select 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. 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.

Caveat escheator. On balance, 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, but a state may not require the fiduciary of an ongoing plan to send money to the state under such a law. Do not, however, mistake this guidance for a "permission slip"—even in the context of plan termination, the DOL has made clear 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" (i.e., 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.

What Factors Impact a Custodian's Decision to Voluntarily Escheat Retirement Plan Assets?

The following considerations are certainly relevant to this determination:

- 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.
- Whether uncashed checks to active plan participants should be voluntarily escheated in this interim period.
- Whether other authorities (e.g., the DOL "fiduciary rule," Office of the Comptroller of Currency guidance, other IRS guidance, and so forth) bear on the determination whether to deem unclaimed assets associated with an ERISA plan as being properly subject to escheat.
- What action is in the best interests of the owners under general fiduciary/safekeeping principles.
- Practical considerations (e.g., ease of administration or the desire to clean up plan recordkeeping).

Holders confronting this question should consult with legal counsel; at a minimum, consider documenting and retaining notation of any procedures followed / actions taken and records generated regarding locating participants.

What Controls Must Be Implemented for Escheatment of IRAs?

Any effective IRA escheat compliance program must focus on the following issues:

- Mastery of the multistate dormancy standards and triggers for running a statutory dormancy period.
- The relevance of the existence or lack of returned mail for such assets.
- The question whether a holder has awareness of the owner's status as deceased and the nature of that awareness.
- Special rules introduced by state adoption of the Revised Uniform Unclaimed Property Act of 2016 (RUUPA), including differential/enhanced owner outreach and dormancy assessment protocols that pertain to IRAs whose owners have elected to receive mail from the IRA custodian electronically.

The rules for escheating IRAs are state-specific and must be tracked and implemented in this fashion—a holder embraces considerable risk of compliance deficiencies if it insists on a uniform approach to the escheatment of IRAs without understanding the specific variances in state guidance for IRAs.

Are There Also Federal Rules That Impact IRA Escheatment?

Yes. Congress's passage of the SECURE Act of 2019 and the CARES Act of 2020 affected state unclaimed property compliance processes for IRAs. A majority of state unclaimed property laws premise escheatment of an IRA for a living owner on the owner's failure to take a distribution or otherwise interact with the account after the date a distribution is required under federal law. The required distribution date had for many years been tied to an account owner turning 70-1/2 years of age, but these federal Acts moved this date for most IRA owners to April 1 following the year the owner reaches 72 (SECURE Act) and waived RMD requirements for all IRAs in 2020 and permitted a one-year delay of the initial withdrawal that was otherwise set to begin in 2020 (CARES Act). Many states with fixed reference to 70-1/2 in their acts (i.e., those that have adopted RUUPA, with the exception of Vermont) will need to revise their laws (e.g., Illinois H.B. 4573 was introduced to effectuate the change from an age 70-1/2 to an age 72 trigger date in the IRA provision of Illinois's act). Legislation is currently pending in Congress that would further adjust the RMD beginning date to April 1 following the year in which the owner reaches age 75.

Must a Custodian Withhold Tax on an Escheated IRA?

Yes. In Rev. Rul. 2018-17 (May 29, 2018), the IRS concluded that a traditional 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. IRC 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 concluded in Rev. Rul. 2018-17 that the escheat of an individual's interest in a traditional IRA to a state is a designated distribution includable in the 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. The ruling ultimately took effect on January 1, 2020. The IRS later extended the same conclusion to qualified retirement plan assets in Rev. Rul. 2020-24, effective January 1, 2022, though noting that its ruling "does not address whether the [escheatment] otherwise complies with applicable law" and does "not address matters arising under" ERISA.

Is a Custodian "Safe" if It Liquidates Retirement Account Assets to Effectuate Tax Withholding?

It is not clear / it depends. Holders that are required to escheat IRAs may include banks, brokerage firms, mutual funds, trust/custody companies, and other financial institutions. When an IRA contains only securities and other noncash investment assets, some holders may confront the question of whether—and if so, how—to engage in pre-escheat liquidation in order to fulfill the federal tax withholding obligation. The intricacy of this issue cannot be understated; it implicates the custodian's business model (contractual account terms), customer relationships and expectations, and the specter of post-escheat owner claims (see next FAQ).

Is a Holder That Escheats an IRA Qualified for Indemnity Against Potential Owner Claims?

It depends. Every state's unclaimed property law contains a form of statutory indemnity or release provision regarding property reported to the state by a holder in compliance with state law. State indemnity provisions generally predicate the availability of indemnity against such a claim on the holder's remittance of the IRA "in good faith" and in substantial compliance with the state's unclaimed property Act. The reason why indemnity must be at the forefront of the holder's consideration is that states routinely liquidate securities and other investment assets after receipt from holders. When the state liquidates such assets, an owner reclaiming the asset most often is generally entitled only to the liquidation value of the property, as contrasted with the market value of those assets at the time the owner makes their claim.

What Do the Terms "Good Faith" and "Substantial Compliance" Mean?

Great question! One must consider (1) the effect of a holder's reporting "foot faults" on its right to statutory indemnity (e.g., while a holder may well have intended to "substantially comply" with state law, it might have fallen short in various respects); and (2) whether "voluntary" escheat of retirement assets is covered by the indemnity provision—suffice it to say that in every instance when escheat/pre-escheat liquidation is not explicitly mandated by state law, the holder's ability to rely on statutory indemnity may be thrown into question.

Conclusion

These issues are numerous and resistant to easy solutions. Holders of tax-deferred retirement assets must weigh and balance significant owner-facing risks against a clear set of state-facing compliance requirements and risks (exposure to interest and penalty assessments when assets are not escheated or not timely escheated). In light of these complexities, we encourage holders to review their escheatment of retirement assets practices and consider that the easiest answer may not be the one that properly balances the competing concerns.

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