Challenges With Escheatment of Tax-Deferred Retirement Assets, Part 2

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In this installment of UP Ahead, the authors discuss potential challenges of a holder's escheat compliance process for traditional and Roth IRAs.

Nuances in IRA Escheatment

In Part 1 of this two-part article, we addressed the fact that although the scope of ERISA preemption of state laws, including unclaimed property laws, is extensive, there may be some limited circumstances when a holder of ERISA-governed plan accounts and distributions could conclude that elective escheatment is appropriate. In this segment, we will identify a variety of nuanced questions that can bedevil a holder's escheat compliance process for traditional and Roth IRAs.

Dynamic Federal and State Regulatory Landscape

Every holder of IRAs must understand and apply the pertinent dormancy standards and triggers for running a statutory dormancy period. The relevance of the existence or lack of returned mail for such assets should not be discounted. The question whether a holder has awareness of the owner's status as deceased and the nature of that awareness can further complicate the escheat process. The promulgation and trending multistate adoption[1] of the Revised Uniform Unclaimed Property Act of 2016 (RUUPA) has added complexity to the making of accurate dormancy determinations for tax-deferred retirement accounts. A prime example pertains to the differential/enhanced owner outreach and dormancy assessment protocols that pertain to IRAs whose owners have elected to receive mail from the IRA custodian electronically. Section 202(c) of the RUUPA establishes in those cases that "if the holder does not send communications to the apparent owner of an account described in subsection (a) by first-class United States mail, the holder shall attempt to confirm the apparent owner's interest in the property by sending the apparent owner an electronic-mail communication not later than two years after the apparent owner's last indication of interest in the property. However, the holder promptly shall attempt to contact the apparent owner by first-class United States mail if: (1) the holder does not have information needed to send the apparent owner an electronic mail communication or the

[1]The RUUPA has been adopted in whole or in part by seven states to date: Colorado (effective in 2020), Illinois, Kentucky, Maine, Tennessee, Utah, and Vermont (effective in 2021). Numerous other states have introduced and considered legislation to adopt the RUUPA, including Minnesota, Nebraska, South Carolina, and Washington.

holder believes that the apparent owner's electronic mail address in the holder's records is not valid; (2) the holder receives notification that the electronic-mail communication was not received; or (3) the apparent owner does not respond to the electronic-mail communication not later than 30 days after the communication was sent."

Congress also recently affected state unclaimed property compliance processes for IRAs. The Further Consolidated Appropriations Act (H.R. 1865) includes provisions from the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019.[2] The relevant provisions increase the age for required minimum distribution (RMD) for IRAs under the Internal Revenue Code from 70-1/2 to 72. In other words, an IRA owner is not required to begin taking RMDs from her account until April 1 following the year in which the owner reaches 72. As provided by the bill, this amendment "shall apply to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70½ after such date." 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. That said, there are exceptions, including notably states that have adopted the RUUPA and expressly reference the date the owner turns age 70-1/2 as one potential trigger (with the exception of Vermont, which enacted the RUUPA after the SECURE Act provisions were adopted and hence reflects an age 72 standard). Because this date will no longer be relevant for tax purposes, it would be logical for these RUUPA states to modify their provisions to reflect age 72. For example, a bill was recently introduced in the Illinois legislature (H.B. 4573) to effectuate the change from an age 70-1/2 to an age 72 trigger date in the IRA provision of Illinois's version of the RUUPA.

Tax Withholding on Escheated IRAs

The IRS published Rev. Rul. 2018-17 on May 29, 2018, to address the federal income tax withholding and reporting requirements associated with the escheatment of an IRA to a state as unclaimed property. In this ruling, 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. The requirement to withhold taxes raises the stakes even further on the escheatment of IRAs.

At a high level, IRC section 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 includable 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 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 percent 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 Treas. reg. section 1.408-7(a). The ruling was to take effect January 1,

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[2] Also, the recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, modifies RMD requirements for IRAs, which could affect escheatment. In particular, the relevant portions of the law provide a waiver of the RMD requirement for 2020. This includes owners who would have been required to take their initial RMD by April 1, 2020; these owners can postpone the initial RMD until April 1, 2021. The CARES Act also provides that the year 2020 is "skipped" for purposes of applying the five-year rule for deceased owners, which means that the five-year rule would be a de facto six-year rule for accounts that had not yet reached the fifth anniversary mark before 2020. IRA custodians should discuss the impact of the SECURE and CARES acts with their legal advisers.

2019, but the IRS delayed implementation of this withholding requirement until January 1, 2020, in response to significant stakeholder concerns.[3]

Liquidation Questions and Concerns

Holders that are required to escheat IRAs may include banks, brokerage firms, mutual funds, and other financial institutions. When an IRA contains only securities and other noncash investment assets, some holders may confront the question 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 discussion later in the article). A holder contemplating this issue could potentially conclude that liquidation of shares to effectuate federal tax withholding violates federal securities laws unless the holder's custodial agreement permits liquidation of the assets to satisfy a withholding obligation. But what if the custodial agreement is not clear in this regard?

Here again, the intersection between state unclaimed property regimes, the federal tax regime, and other federal regulatory regimes poses unwelcome complexity for holders. For example, will the Securities and Exchange Commission view the involuntary liquidation of a shareholder's account as potentially violating the Investment Company Act of 1940, vis-à-vis the act's requirement to protect shareholder interests in their account assets? Or is the statutory due diligence outreach required by state unclaimed property laws sufficient to provide the shareholder notice of the potential liquidation event and an opportunity to act to prevent same?

As the above illustrates, this issue defies easy resolution.

[3]On November 20, 2018, the IRS issued notice N-2018-90 stating that the requirement to comply with Rev. Rul. 2018-17 would be delayed from January 1, 2019, until January 1, 2020.

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

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. The phrasing of these statutory indemnity provisions varies, but the RUUPA indemnity language is a useful reference point:

> (a) On payment or delivery of property to the administrator under this [act], the administrator as agent for the state assumes custody and responsibility for safekeeping the property. A holder that pays or delivers property to the administrator in good faith and substantially complies with Sections 501 and 502 [statutory due diligence mailing requirements] is relieved of liability arising thereafter with respect to payment or delivery of the property to the administrator.
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> (b) This state shall defend and indemnify a holder against liability on a claim against the holder resulting from the payment or delivery of property to the administrator made in good faith and after the holder substantially complied with Sections 501 and 502.[4]

The reason why indemnity must be at the forefront of the holder's consideration is that states routinely — and in many cases, with increasingly brief intervening holding periods — liquidate securities and other investment assets after receipt from holders. When the state liquidates such assets, an owner reclaiming the asset is 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 (though the RUUPA has attempted to remedy this issue

[4]RUUPA section 604. The ULC Comment to Section 604 states, "When property is delivered to the administrator, the holder is relieved of all liability for any delivery made in good faith. *Section 601 sets forth the definition of good faith which inter alia allows the holder to rely on determinations as to reportability made by the administrator.* If after property has been delivered to the administrator, a person or another state makes a claim against the holder for the property, the state, upon request, is required to defend the holder and to provide indemnification against any liability asserted against the holder with respect to the property turned over to the administrator in good faith." (Emphasis added.)

somewhat by allowing an owner to recover current market value or replacement of the security if the state sells it within a specific time frame after receipt). In an "up" market, the potential for owner loss of the value differential is evident; in those cases, owners who do not understand or who object to the holder's escheat and state's post-escheat liquidation of their investment assets may well turn to the holder for satisfaction.

It is true that this question arises whenever investment assets are escheated (that is to say, when non-retirement brokerage or mutual fund accounts are escheated). However, in the context of retirement assets, two questions appear to be particularly compelling and require review:

1. What is the effect of a holder's reporting "foot faults" on its right to statutory indemnity? As this article illustrates, there is a great deal of complexity and ambiguity in the field of escheat pertaining to retirement assets, and a holder may well have intended to "substantially comply" with state law but nevertheless is deemed to have fallen short in various respects.
2. Is "voluntary" escheat covered by indemnity provisions? This question was discussed in Part 1 of our two-part article, and is also arguably relevant when the holder has itself conducted pre-escheat liquidation of assets; 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

As the foregoing illustrates, 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 practices regarding the escheatment of retirement assets and consider that the easiest answer may not be the one that balances the competing concerns. ■