DAVIS & HARMAN LLP

ERISA ADVISORY COUNCIL
PERMISSIVE TRANSFERS OF UNCASHED CHECKS FROM ERISA PLANS TO STATE UNCLAIMED PROPERTY FUNDS
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My name is Michael Hadley, and I am a partner in the law firm Davis & Harman LLP, here in Washington, D.C. It's my pleasure to testify before the Council once again. I had the pleasure of testifying in 2012, 2017, and 2018, both for clients and on my own behalf. This year I am testifying on behalf of the SPARK Institute ("SPARK"), which represents defined contribution recordkeepers, mutual fund companies, brokerage firms, insurance companies, banks, consultants, trade clearing firms and investment managers. My testimony will reflect the views of SPARK's members, including a working group formed in 2018 to study and address issues related to missing and unresponsive participants. But this issue touches many of our clients, as our firm represents a range of financial institutions, other large corporations (both public and private), trade associations, tax-exempt entities, and advocacy organizations.

Sizing the Uncashed Check Problem

In 2018, SPARK worked for more than five months with operations, legal and technical experts from our member firms to research and identify current processes for missing and unresponsive participants. Ten SPARK members shared their missing participant search process.[1] SPARK also collected data on uncashed checks, summarized below.

A significant portion of checks issued from defined contribution plans are not initially cashed. The table below shows 2017 data from SPARK members:

	Number of Checks	
	2017 Industry Average	
Issued	**4,098,684**	
Cashed	**3,913,166**	**95.47%**
Uncashed	**185,518**	**4.53%**

The clear majority of uncashed checks in defined contribution plans are associated with very small balances, typically less than $100. Often, the address does not appear to be incorrect, but the check is simply not cashed. In the next table, we break down the size of uncashed checks to get a better understanding of how they originated.

[1] While we did not specifically ask members to provide information solely as to their defined contribution plan business, for most of our members, this is the primary market that they serve.

Uncashed Check information: Industry Average			
Amount	**# of checks**	**Total Dollar Value**	**Percent of Uncashed Checks**
>$100,000	37	$ 5,811,529	0.020%
$20,000 - $100,000	313	$ 11,972,080	0.169%
$5,000 - $20,000	1,013	$ 9,643,554	0.546%
$1,000 - $5,000	2,720	$ 6,198,042	1.466%
$100 - $1,000	36,766	$ 11,534,164	19.818%
<$100	144,669	$ 1,877,102	77.981%
TOTALS	**185,518**	**$ 47,036,472**	**100.000%**

Because of these data, a key recommendation that the SPARK Institute made to the Department of Labor, and which I repeat here, is that there is a need for a *de minimis* threshold under which required search actions are less significant. We believe it is consistent with the duty of prudence not to engage in expensive searches for very small amounts. We recommended $200 as an appropriate threshold, because this is the threshold for offering a direct rollover.[2]

Most uncashed checks fall into the following categories:

- Loan repayments received after loan had been fully paid off
- Contributions or company match received after account had been fully distributed (Many plan sponsors allocate employee matches quarterly or annually or make “true-up” matching contributions.)
- Cash dividends for plans with company stock that allow for dividend pass through
- Trailing dividends received after full distributions

In addition, there are two other situations under which a distribution will occur even though not specifically requested by the participant. First, under current law, when a participant terminates employment with a vested balance of $1000 or less, the plan may provide that the participant’s benefit will be distributed in lump sum.[3] Second, once the participant reaches his or

[2] Treas. Reg. § 1.401(a)(31)-1 Q&A-11.

[3] IRC § 401(a)(31). In contrast, if the account is greater than $1000, the account must be placed in an IRA unless the participant elects to receive the distribution in cash or in a rollover. The plan can decide to transfer these amounts into an IRA, but that is not required. If the account is $5000 or greater (excluding rollover contributions), the account generally cannot be distributed without consent until normal retirement age. IRC § 411(a)(11).

her required beginning date, the required minimum distribution must be distributed whether or not the participant specifically requests a distribution.[4]

You will notice that all of the situations above involve situations in which the participant did not actively request a distribution. Generally, when a participant requests a distribution in cash, the participant is waiting for the check and will cash it. This is not universally true, of course, and from time to time a participant or beneficiary will request a distribution and, for one reason or another, the check is not cashed.

Eliminating the Problem Before it Occurs

Plan fiduciaries, namely plan sponsors, ultimately retain the responsibility to make sure there are prudent administrative procedures and practices to:

1. Limit the number of missing participants[5] to ensure they receive the benefits they are entitled to under the plan (even if a participant comes forward to claim assets at a future date) and
2. Safeguard these plan assets

SPARK members reported to us that, with respect to missing participants, there are often warning signs that typically precede the problem; there are often events that indicate a plan sponsor may be losing contact with a participant. We believe that a plan sponsor should implement steps as soon as there is any indication the participant has relocated. Participants also bear the burden to stay in touch, and prudent administrative procedures would establish practices and reminders to facilitate participants staying in touch.

We recognize that recordkeepers play an important role in this process, and that keeping in touch with participants is most successful when the plan fiduciary and the recordkeeper have clearly defined their roles, the recordkeeper communicates its experience for the best mechanisms for success, and the plan fiduciary takes its responsibility seriously.

Procedures for Dealing with Uncashed Checks

Each SPARK member reported slightly different procedures to address uncashed checks. Some SPARK members, for example, operate a banking affiliate; others work with third party banks which may have specific procedures for payment accounts. In our discussions with SPARK members, however, the following best practices emerged:

- If a check is *returned*, then the participant is treated as missing and the procedures for missing participants should be undertaken. But if the check is not returned, and is simply uncashed, the participant should be viewed as "unresponsive."

[4] IRC § 401(a)(9).

[5] It is also important to note that fiduciary obligations do not require that all participants and beneficiaries are located. As with all fiduciary obligations, the key is putting in place reasonable procedures and effective internal controls.

- The plan sponsor should still be diligent to follow up on these situations using multiple communication channels, since there is the potential for these unresponsive individuals to become actual missing participants.

- When a check is not cashed, a notification is sent to the participant at two intervals (for example 90 and 180 days) to inform the participant that the check is still outstanding.

- When a check is issued, 1099-R reporting occurs, which means there is withholding and taxable income. Returning the amounts to the participant's account is somewhat unsatisfactory because the amounts have now been reported to the IRS as taxable income. We recommend the Department work with the IRS on a solution to this issue.

- After a set amount of time (one member uses 225 days), then the next steps in the procedures are applied.[6] The action taken depends generally on instructions from the plan sponsor, consistent with the terms of the plan document. In some cases, the plan sponsor directs that the funds be returned to the participant's account. In other cases, pursuant to IRS rules, the check is forfeited to the plan's forfeiture account, subject to reinstatement if the participant later comes forward. Finally, the assets may be transferred to an automatic rollover IRA provider (which will often set up a taxable account invested in the same principal-protected investment that applies to IRA cash-out rollovers).

Use of State Unclaimed Property Funds

In our experience, it is not currently common for uncashed checks to be entered into the state escheatment process, with one exception: Our members also serve non-ERISA plans, including governmental and church plans. For non-ERISA plans, the check might be entered into the state escheatment process.[7]

This is confirmed by the limited studies on the topic. On January 18, 2019, the Government Accountability Office, or GAO, released a study entitled "Federal Action Needed to Clarify Tax Treatment of Unclaimed 401(k) Plan Savings Transferred to States."[8] GAO reached out to the SPARK Institute and, as detailed in the report, the SPARK Institute worked with GAO to connect GAO with 32 401(k) plan service provider companies who completed the survey. GAO also conducted surveys of IRA providers and of states.

Although not highlighted in the report, it appears that the amount of assets from active retirement plans that are currently being transferred to state unclaimed property funds is fairly small. The GAO states: "In 2016, $22.4 million was transferred from employer plans to those states. The average dollar value of transfers was generally small—$628 from plans and $301

[6] We do not currently have a recommendation as to how long a check should be outstanding before further actions are taken.

[7] Many non-ERISA qualified plans contain the IRS-approved forfeiture procedure.

[8] GAO-19-88.

from retirement plan checks." But it is not clear from the report the extent to which these amounts are coming from *active ERISA* plans, rather than non-ERISA plans and terminating ERISA plans. In fact, the data GAO collected from 401(k) service providers indicated that most of the funds that are coming from retirement plans to state unclaimed property funds are coming from *terminating* plans: "Survey data from the seven service providers responding to our survey—whose plan assets under management make up more than 13 percent of the 401(k) marketplace (one survey respondent did not report the amount of assets managed)—show that the majority of savings these providers transferred to states in 2016 included savings from terminating 401(k) plans. Specifically, survey data from the three providers that could supply such detail show that, of $2.25 million transferred to states, $2.19 million involved savings from terminated plans." In fact, in a footnote, GAO reports that only five responding 401(k) service providers stated that they transfer unclaimed savings to states; and of the three that actually could provide data, two of them stated they transferred savings from terminated plans.

These data are consistent with what SPARK members informed us: plan sponsors of active plans generally do not direct them to transfer uncashed checks, or accounts of missing participants, to state unclaimed property funds. Where this does occur, it tends to occur in the context of non-ERISA or terminated plans.

SPARK Member Views on Use of State Escheatment Funds

As stated above, for ongoing plans, there are four commonly applied methods to deal with uncashed checks, after efforts to get the participant to take action have failed:

1. The check is canceled and the funds are placed back into an account under the plan for the participant. (This approach only delays having to deal with the missing or unresponsive participant.)
2. The check is canceled, the amount forfeited and placed back into the plan, to be used under the plan's procedures for unallocated amounts. If the participant ever shows up, the employer will typically reinstate the balance and cut a new check.
3. The amount is transferred to an automatic rollover IRA provider following the procedures for automatic rollover IRAs, although it may be placed in a taxable interest-bearing account.[9]
4. The amount is transferred to a state unclaimed property fund.

SPARK members generally follow the plan document or the direction of the plan fiduciary with respect to which method to be used. But as stated above, the fourth approach (transferring to the states) is the *least* common approach, except in the case of non-ERISA plans and terminated plans.

In discussing *why* this is the case, SPARK members generally made the following points:

Dealing with multiple states increases costs and complexity. Among the options available, sending uncashed checks to state unclaimed property funds means dealing with 50

[9] DOL Reg. §2550.404a-2.

states and the District of Columbia. While there are many similarities in each state's rules, there is also significant variability. It is a hallmark of regulation of retirement plans since the enactment of ERISA that a plan can be administered without regard to the location of the employer or the participant. For SPARK members, who administer plans throughout the country, any aspect of plan administration that is state-specific greatly enhances the cost and complexity of providing the service. In contrast to escheatment, all of the other available procedures to address uncashed checks can be administered identically regardless of the last known address of the participant.

State unclaimed property funds are less advantageous to the participant than other options. A number of SPARK members expressed concern that state unclaimed property funds do not make an active effort to locate participants, that the funds are not provided earnings of any kind, and that, unlike ERISA fiduciaries, state unclaimed property fund administrators owe no duty to participants. Others pointed out that if the uncashed check is forfeited, it can be used to offset the fees and expense of the plan or provide additional services, whereas state unclaimed property funds are used to pay for the state's expenses or close a budget gap. For those plans that use an automatic IRA rollover provider, the plan will have a relationship with the provider which allows for oversight and a single location for the uncashed checks. One SPARK member stated that escheatment moves the responsibility of reuniting the assets with the rightful owner to the participant or beneficiary, who must (a) know assets exist, (b) make the effort to search, and (c) follow the state rules for claiming. A fiduciary cannot provide any meaningful oversight of a state treasury.

In contrast, a number of SPARK members, including some from whom the Council will be hearing testimony today, *specialize* in handling the funds of missing and unresponsive participants and compete with each other on the basis of being able to reunite participants with their retirement savings. States do not have a competitive reason to provide a good experience for the participants whose assets are transferred out of the plan.

Voluntary escheatment by a plan would likely require plan amendments. SPARK members pointed out that many plan documents already provided procedures for dealing with missing and unresponsive participants and uncashed checks. Before a process of voluntary escheatment could be undertaken, a plan amendment is likely required. Importantly, the vast majority of 401(k) plans now operate under a pre-approved plan document (previously called a master & prototype or volume submitter plan). These plan documents are generally not amended in-between the cycle for submission to the Internal Revenue Service for an opinion letter.

Guidance from IRS is sorely needed, but sufficient lead time is a necessity. The IRS has provided no guidance on a multitude of reporting, withholding, and other issues associated with missing and unresponsive participants. Recent IRS guidance addressing the reporting and withholding requirements for payments from traditional IRAs to state unclaimed property funds was a helpful step, but this guidance does not, by its terms, apply to qualified plans.[10] In addition, the guidance was issued with very little lead time for IRA custodians to implement

[10] Revenue Ruling 2018-17.

significant changes to their systems, and the IRS was forced to provide transition relief.[11] Before escheatment would ever become common, the IRS would need to provide guidance on reporting, withholding, and related tax issues.

States and their agents have been described as "aggressive" in their audits. In the past decade or so, 401(k) and IRA service providers have repeatedly described to me their experiences with state unclaimed property funds – particularly their interactions with collection agents hired to seek out sources of funds – as an unpleasant experience. The audits conducted in this regard have been described as "aggressive" and "over the top." In some cases, states have taken indefensible positions, including seeking escheatment of ERISA plan assets, or seeking to escheat IRA assets prior to an individual reaching age 70 ½. The result, in my view, is that the relationship with states has somewhat deteriorated and financial services firms perceive states as not acting in the interests of retirement savers.

A few SPARK members stated that they would like to have escheatment as an option. We did hear from a few SPARK members who stated that they would like to have escheatment to state unclaimed property laws as an option to deal with uncashed checks. The SPARK members who expressed this point of view tended to provide services in the non-ERISA or IRA plan market, and thus felt they already had procedures in place in the various states to comply with mandatory escheatment for non-ERISA plans. Accordingly, I would not want to leave the Council with the impression that all of the SPARK members that reached out to us were opposed to escheatment of uncashed checks to state unclaimed property funds, although those that supported it agreed that it should occur only as directed by the plan document or the plan fiduciary. (SPARK members in almost all cases do not exercise discretion over plan administration.)

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On behalf of the SPARK Institute, I want to thank the Council for seeking our input, and I am happy to take any questions.

[11] Notice 2018-90.