PenChecks Position with Respect to Potential Voluntary Transfers of Uncashed Distribution Checks to State Unclaimed Property Funds

PenChecks

As a unique solution provider to the retirement plan industry for a quarter century, PenChecks has been a consistent pioneer and advocate of heightened awareness and increased prudence around uncashed checks from qualified plans.

The Problem With Uncashed Checks

Uncashed checks present many problems but one of the big problems is simply that many of them have gone unresolved for so long. Further exacerbating the problem is the fact that custodians had little motivation to disposition these assets. One could argue that they were, in fact, disincentivized from doing so. Trying to resolve these in hindsight may seem like a daunting task. To be sure, guidance in this area would go a long way to help resolve the many decades of uncashed retirement plan checks that exist. On the upside, we believe that uncashed checks from qualified plans should, and can, be a thing of the past.

Abundant Missing Participant Guidance

Uncashed checks remains an issue for the retirement plan industry because there is very little clear or definitive guidance on the recommended treatment of uncashed checks from qualified retirement plans (QRPs). On the other hand, through the dedicated efforts of the DOL over the past fifteen years, there is an abundance of guidance about how to deal with Missing Participants. This guidance is well thought out, clear, time-tested and has resulted in a healthy, competitive private industry that supports the requirements to comply with this guidance. Furthermore, and most importantly, this guidance is designed to maintain the best interests of missing plan participants while being fair and providing reasonable and useful solutions to the QRP industry that has had to deal with the issue of missing participants.

The Revelation that Simplifies the Matter

The following is the simple, but powerful, realization that makes the issue of uncashed checks from a QRP very simple:

> *Uncashed checks are just another form of Missing Participant.*

In both cases, a former plan participant has a benefit that they are entitled to. However, for any number of reasons, that benefit can't be provided to them because that participant can't be found or is unresponsive. The only difference between a missing participant ***in*** a plan and an uncashed check ***from*** a plan, is when the participant went missing. In the case of a missing participant in a plan, they may

have been discovered missing when a distributable event occurred. They may have been identified as missing when a plan closure took place. Or, they may have been identified as missing when correspondence and mail began coming back as "undeliverable." With an uncashed check, the participant simply went missing between the time they had requested a distribution and the time the distribution was effectuated.

The fact that the former plan participant requested a distribution does not change the reality that these monies were originally set aside for retirement in a qualified employer sponsored plan. These assets were originally under the same federal protections and preemptions of ERISA. The fact that the person went missing after they requested a distribution should not change the nature of how we treat them.

Given this revelation, and the DOL's consistent assertion that uncashed check assets are still plan assets, it seems clear that there should be no need to reinvent the wheel.

<u>No Need to Reinvent the Wheel</u>
The same standard of care for missing participants in a QRP should be applied to uncashed check assets that come from a QRP. Namely, to do what is in the best interest of the plan participant. Just like with missing participants, resolutions to the uncashed check issue should seek to:

- Maintain the greatest possible benefit for participant
- Maintain that benefit in a manner that provides long-term opportunity for funds to be claimed (either by the participant themselves, their heirs or their estate)
- Maintain the principal
- Invest the funds in safe, insurance-backed vehicles
- Provide on-demand liquidity
- Provide a reasonable rate of return

<u>Automatic Rollovers for Uncashed Checks</u>
Individual Retirement Accounts are the most efficient, and widely available vehicles to accomplish the aforementioned critical items. Adhering to the same guideline principles that exist for missing participants will result in the most effective standard of care that is in the best interests of participants with uncashed check funds.

Given that many uncashed checks have already had taxes withheld, there are a couple of nuances that must be contended with as to the treatment of these funds. But, in short, there is no reason that after-tax funds cannot go into a traditional IRA. Before we explore this solution for current uncashed checks, let's us outline our position on how simple it would to eliminate all uncashed checks moving forward.

The End of Uncashed Checks from QRPs

Again, vast and compelling guidance exists for missing participants and it has been proven effective. In FAB 2014-01, the DOL plainly stated:

> *"In the Department's view, in most cases, the best approach in selecting among individual retirement plans will be to distribute the missing participant's account balance into an individual retirement plan in accordance with the Department's regulatory safe harbor…"*

The reasons given are numerous but the DOL points out that selecting alternative methods of distribution would likely result in mandatory income tax withholding which would reduce the amount of money available for retirement, and that a prudent and loyal fiduciary would not subject a missing participant's funds to such negative consequences (without compelling offsetting considerations). They even went so far as to say:

> *"In fact, in most cases, a fiduciary would violate ERISA section 404(a)'s obligations of prudence and loyalty by causing such negative consequences rather than making an individual retirement plan rollover distribution."*

Given the DOL's strong preference to maintain the tax-preferred nature of assets that have been set aside for retirement, above other alternatives, it would be consistent for custodians to implement the regular practice of identifying uncashed checks from QRPs and restoring withheld taxes to those assets so they can be preserved in an individual retirement plan rollover distribution. The functional process to do this is merely more than a true-up recordkeeping entry on the current tax reporting of a custodian that regularly withholds and remits taxes. Once this is effectuated, there is a brightly lit, safe-harbor path for plan sponsor fiduciaries to follow for these, now, missing participant assets (as opposed to uncashed check assets). In the face of a terminated plan whereby the plan sponsor fiduciaries can no longer be contacted, the same safe harbor and well-documented guidance would apply to custodians who effectuate those same IRA rollovers as they would be acting in the best interest of the participants.

Furthermore, this issue would only apply to distributions under $5,000 and for those from terminated plans. In both cases, the restoration of the tax withholding and subsequent establishment of an automatic rollover IRA, would align exactly with the most prudent treatment as opined by the DOL. In cases where an uncashed check is larger than $5,000 and it's from an ongoing plan, again, restoring the taxes and simply returning the funds back to the plan is the most prudent treatment. Additionally, this would squarely put the care of that participant's funds back in the hands of the plan fiduciary(ies) who had the responsibility and they can be held accountable.

To the Department's credit, we understand that in recent years, inquiry into uncashed checks during regular plan audits has become a topic of concern and investigation. Hence, one of the many factors that has led us to where we are today discussing this issue. In short, we believe that additional guidance requiring plan sponsors and custodians to proactively resolve uncashed in a timely manner would eliminate this issue moving forward. And again, there is a clear path and well-defined process of treatment for doing so. Additionally, this would eliminate future claims from other potentially interested state agencies because all the assets would remain firmly within the scope and guidance of ERISA. A three-year window to resolve uncashed and stale-dated checks is more than enough time to eliminate the issue of uncashed checks from QRPs moving forward forever. Simple reporting mechanisms can be put in place between custodian and plan sponsor to convey uncashed check funds. This would allow the plan sponsors to actively search for these uncashed check (effectively now "missing participants") in accordance with current guidance that exists. Furthermore, this would preserve more retirement assets for the long-term retirement goals of plan participants and their heirs. And, it would allow the greatest possible freedom for the recipient to make a decision that best suits their own facts and circumstances. If it is better to maintain those assets in a tax-deferred environment, the participant can continue to do so. Once those funds are removed from a tax-qualified environment however, the participant can never restore the tax-preferred nature of those same funds ever again.

<u>To Be (Qualified) or Not To Be?</u>

As previously mentioned, the DOL has suggested that uncashed check assets are still plan assets. However, in the vast majority of cases, uncashed checks funds have already had taxes withheld and reported. Once funds have been taxed, and are no longer in a tax-advantaged environment, most people no longer consider these "qualified" dollars. It is a common mistake to assume that all "plan" assets must be "qualified" or "pre-tax" assets. This is understandable given the vast majority of plan assets are contributed on a pre-tax basis. However, retirement plans can absolutely house non-qualified (post-tax) money. Therefore, we believe that uncashed distribution check assets should be treated no differently than after-tax money in a qualified retirement plan. Based on this reality – that these assets originated from a QRP and were originally set aside for retirement under the rules and regulations of ERISA – we believe that the industry should aim to protect these funds the same way we protect pre-tax plan assets. We believe the standard of care should be the same.

Thankfully, this issue only applies to uncashed check funds that are more than three years old. As we discussed in the previous section, all uncashed check funds that are less than three years old would fall into what we believe the standard ongoing solution should be for uncashed checks moving forward. Again, because the ability to restore withheld taxes to an uncashed check expires after three years, this is only an issue for outstanding uncashed checks that are older than that. For those

uncashed checks that are more than three years old, if we accept that these funds are "plan assets" but they are no longer "qualified" dollars (because taxes have been withheld), we can still follow the prudent guidance of how to treat these individuals with respect to search standards and the safe-harbor methods in which funds should be invested. This ensures the greatest possibility that these individuals will be found and that their remaining funds will have been preserved without risk to principle.

Additionally, treatment of assets from QRPs will remain consistent then across the board. There will not be instances where some plan assets end up in automatic rollover IRAs while others end up in state unclaimed property funds or other alternative outlets. This will again aid in increasing the greatest possible outcomes in reuniting former participants with their rightful funds.

Investment of after-tax dollars in a traditional IRA does require different treatment of earnings and distributions, but this is an issue that tax-professionals are well-equipped to handle and only become an issue at the time of distribution. Aside from a uniformity in the treatment of unclaimed QRP assets (those emanating from missing participants or uncashed checks), other benefits include the required tax filings that exist each year for IRA assets and the additional proactive searches that all missing participant IRA providers regularly engage in, all should result in higher rates of engagement and further advance the DOL's goal of reuniting participants with their funds.

Issues With Escheatment to State Unclaimed Property Funds

Escheatment of uncashed checks from QRPs to state unclaimed property funds presents many challenges that we believe do not align with the DOL's goal of reuniting missing participants with their retirement savings.

The following are three of the biggest key issues that we believe are problematic with respect to the possibly escheating QRP uncashed check money to the states:

1. Rates of Return

   Based on our initial research of state unclaimed property funds, we could not find a single state that pays any earnings on the use of the participant's assets for the entire time the state holds their funds. For obvious reasons, this is major issue that, in and of itself, is counter to the very point of saving for retirement in the first place. Due to natural inflation, the mere passage of time would erode the value of dollars that were set aside for retirement.

2. Ongoing Search Efforts

   Based on our initial research, proactive efforts to locate account holders of unclaimed property do not exist in many cases. Virtually all private-industry missing participant solution providers engage in active, ongoing efforts to perform outreach and locate account holders. National and independent

directories already exist to serve as central repositories for missing participant account data. Any proactive search efforts for unclaimed property is provided by unregulated third parties called "Abandoned Property Location Service Providers." These third-parties often charge exorbitant interest and have hidden fees. Both the existence and enforcement of any state regulations over these third-parties is varied and lacking, compared with the regulations of QRP custodians.

3. Compliance with Multiple Jurisdictions

   Escheatment periods and treatment of funds range from state to state. The lack of uniformity would subject some missing participants to longer periods before funds might be escheated. The ultimate treatment of funds, including how they are used and what the claims procedure may entail, would be different depending on what state those assets are ultimately escheated to. This effectively would take something that began as a federally protected asset with uniform and equitable treatment for all participants and parse out some of these funds into an environment subject to 50+ different variations on a theme. Moreover, due to reciprocity, the unclaimed property may end up in a state the participant never lived or worked in. The chances a participant would look in a jurisdiction they never lived or worked in presumably would be virtually zero.

These factors and others, weigh against the likelihood that state unclaimed property would advance the DOL's goal of reuniting participants with their retirement savings.

Summary

Participants in QRPs who go missing are an unfortunate reality of the retirement industry. While missing participant situations are regrettable, they are a reality that must be dealt with. Much research, time and effort has been spent to determine the best way to resolve the burdens that missing participants present while still maintaining the ethical treatment and dignity of the former plan participants. The resultant solutions are valuable and provide the best possible outcomes for all parties involved. Uncashed checks are a form of missing participant. The aim should not be to reinvent a new wheel for uncashed check scenarios, but rather to encourage and enforce compliance with the proven guidance that already exists. Moving forward, there is no reason that all uncashed checks cannot be resolved in a timely manner. Doing so will result in far-preferable advantages for former plan participants as well as plan sponsors and custodians. With respect to older uncashed checks where the tax withholdings cannot be restored, again, consistent adherence to the sound guidance that exists will be the easiest, most cost-effective and dependable way to resolve these situations.