Uncashed Checks: The Billion Dollar Question?

By Ilene H. Ferenczy and Peter E. Preovolos

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Ilene H. Ferenczy and Peter E. Preovolos tackle a vexing new problem for plan administrators—unclaimed benefits. Neither ERISA law nor DOL regulations adequately address this issue, so the burden is on the fiduciary to determine the appropriate course of action.

Everyone who engages in plan administration knows that everything relating to plan distributions involves some kind of frustrating process that is far more complex than it should be. We have all struggled with developing distribution packages that clearly communicate all the distribution options to participants and yet still meet all of the IRS and Department of Labor (DOL) rules for these communications, while at the same time being intelligible to the participants. We have all reviewed rollover options and contemplated how to properly determine whether to roll over the benefits of lost participants or to maintain them in the plan. We have all dealt with missing participants in connection with a plan termination.

However, there is a distribution-related issue that is only now coming to the forefront that involves millions, if not billions, of dollars around the country: what to do about unclaimed benefits?

Consider this scenario: Paul Departicipant completes his distribution package and requests that his $10,000 account be paid to him in cash. The plan administrator authorizes the distribution of the $10,000, minus $2,000 withholding that is sent directly to the federal government, through the issuance of a check for $8,000. The trustee issues a check from the plan checking account for the $8,000, and sends it to the participant's last known address. But, surprisingly enough, Paul never cashes the check. The plan continues to show the $8,000 among its assets, as the issuance of the check is only paperwork until it is cashed. Nonetheless, the IRS has received $2,000, and, in all likelihood, the plan trustee has issued a Form 1099-R showing that the $10,000 was paid and is taxable income in the year of distribution. This latter step is entirely correct; an individual may not delay the taxability of income simply by not cashing the check. However, as years go by, it is clear that Paul has really never "received" the money that the plan sent to him.

Scenario #2: Patricia Zeemployee completes her distribution package and requests that her $10,000 account be paid to her in cash. The plan administrator authorizes the fundholder/recordkeeper—a financial institution—to distribute $10,000, minus $2,000

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withholding, to Patricia. The fundholder issues what is tantamount to a cashier's check to Patricia for $8,000, pays the withholding to the IRS, and shows the entire $10,000 as being removed from the plan accounts. Patricia never cashes the check. The fundholder issues a Form 1099-R reflecting that the $10,000 was paid and is taxable income in the year of distribution.

Final scenario: Patsy Teworker terminates employment with an account balance of $950. The plan administrator sends her a distribution package, but Patsy never files distribution paperwork. In accordance with the Plan's provisions, the trustee issues Patsy a check for $950, less $190 withholding, and sends it to her last known address. The check is never cashed.

If the plan issues the check, the trustee is in a position to know that Paul and Patsy have not cashed their checks. Some plans might continue to credit the account with earnings, and effort is taken on an ongoing basis to try to find the unresponsive participant. However, many simply remove the participant's account from the books, showing the amount as a payable on the financial accounting. Under Treasury regulations, accounts for unlocatable participants can be forfeited at some point, subject to restoration if the participant reappears, if the plan so allows. The participant may contact the plan whenever he or she wakes up, and can get the undistributed funds. So, at some point, the plan will let the payable go into the forfeitures, and all recordkeeping about the participant virtually disappears.

On the other hand, Patricia is not even this lucky. Her plan reflected that her full benefit was paid years ago, regardless of whether she received the money. Where did the money actually go? It is likely still sitting in the fundholder's coffers, unidentified and unaccounted for by the plan trustee (or likely any other oversight authority). The participant is not receiving investment return credits on the money, is not receiving participant statements identifying the funds still on deposit for him or her, and may remain oblivious of these monies forever. Furthermore, if the plan determines to change the fundholder/recordkeeper to another entity, the trail from the plan to this participant is basically obliterated, as she will be reflected as having been paid out years earlier.

In the meantime, the 20% withholding has been forwarded to the IRS, and the participant may not have realized that he or she had some obligation to claim the income and get the prepaid tax credited to his or her tax return. Barring a notice from the IRS, which could be generated by the Form 1099-R (that the taxable income was not included in the participant's tax return for the relevant year), the participant remains unaware of the entire issue. And, once three years have expired, the participant is unable to amend his or her tax return to claim this unrecognized withholding and realize the distribution still due to him or her.

There is one other similar circumstance that gives rise to an uncashed check concern: the uncashed IRA rollover. IRS guidance permits a plan trustee to effect a direct rollover at a participants' request by sending a check made payable to the recipient plan trustee to the participant for forwarding to the trustee. If the participant takes no further action when the check is received, the rollover is never consummated, and the check is never cashed.

Is it really possible that the participant's monies are so unprotected? You betcha. Is there any fiduciary liability here? That's literally the $1 billion question.

Are Uncashed Amounts Plan Assets?

If the uncashed checks are plan assets, the plan fiduciaries retain some level of duty to the participants for these funds. Certainly in Scenario 1 above, if the money remains in the plan's coffers, the participant's benefits continue to be plan assets until the check is cashed. Even if the plan takes the account off the plan records and shows the amount as a payable, every time the plan accounting is performed, someone makes note of this amount still due to the now unresponsive participant. But, are the funds that are taken from the plan and provided to a financial institution to be paid in a cashiers-type check still plan assets? And, are the funds that were withheld and sent to the federal government plan assets?

ERISA does not specifically define what constitutes a plan asset, but refers to Labor Regulations on the subject. However, those regulations concentrate more on noting what is *not* a plan asset than on identifying what is included in this phrase. It seems reasonable that the funds that are allocated to provide benefits for a specific participant should be plan assets and that such funds would remain plan assets until they are securely in the participant's hands or until a proper default automatic IRA is established on his or her behalf. There are exceptions to this, such as when a fiduciary transfers plan assets to a recipient plan in a merger or rollover transaction. In such exceptions, however, the procedures outlined by the DOL

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are intended to ensure that the funds are properly directed from the hands of the initial fiduciary into another responsible party's hands on the participant's behalf.

In the case of an uncashed cashier's or fundholder's check, the plan trustee is literally washing its hands of these funds, without in any way ensuring that they are safeguarded for the participant's benefit. In fact, the funds are unceremoniously held by the issuing entity, which benefits from the float on the money, without any real accountability to anyone thereafter. So, are these still plan funds, over which the fiduciary has some responsibility?

What About the Fact That the Money Was Considered Distributed for Tax Purposes?

Even though the check that was issued remains uncashed, the plan has considered it to be distributed for three important purposes: for removing it from plan accounts (if a financial institution issued a cashier's check), for the payment of withholding taxes, and for the issuance of a Form 1099-R. Having treated these funds as distributed in this context, can the plan then redeposit the funds in the pretax accounts?

Suppose that, two years after a distribution check was issued, the recipient participant finds the old check in the bottom of his or her desk drawer. If the participant wanted the funds to retain their tax-sheltered status, it would not be possible. The period for a rollover of distributed monies ends 60 days after the check is issued unless the IRS grants an extension for the participant. The participant would have no choice but to cash the check, possibly amending his or her tax return for the year in which the check was issued to reflect the receipt of the income and the withholding of taxes. If the check is stale (generally after six months), the participant would need to go back to the financial institution that generated the check and have the check reissued.

A secondary issue is the status of the receipient. If the plan paid out all plan benefits to the individual, he or she generally ceases to be a participant. He or she will likely no longer be an employee of the company.

These arguments militate in favor of a finding that these funds are no longer plan assets. Furthermore, they lead one to question whether, reasonably, the funds may be redeposited into the plan, or if they are now after-tax dollars that belong to someone who is no longer a participant.

Does a Fiduciary Have Ongoing Responsibility for Unclaimed Funds?

If the uncashed funds are plan assets, the fiduciary has responsibility under ERISA for them. What are those responsibilities? Again, this is not fleshed out in the law or regulations. However, it is hard to imagine that a plan trustee may blithely turn participant funds over to a financial institution that has no further obligation than to use the money for its own gain while it waits for the participant to cash the check. That seems inconsistent with all other duties under ERISA.

Even if these funds are not plan assets, as we have argued above, it is still possible that a failure to take some action could be considered to be a breach of fiduciary duties. For example, it is possible that the fiduciary breached its responsibilities at the outset, when the trustee transferred the employee's money to the financial institution without taking steps to ensure that the funds would be safeguarded for the employee.

If a fiduciary uses a financial institution to issue a cashier's check (or a similar negotiable instrument), is the fiduciary done with its responsibility, even if the participant receives nothing? Has any responsibility passed to the financial institution? While there is no specific guidance regarding uncashed checks, it is hard to imagine that simply handing over the money terminates all fiduciary obligations when fiduciaries are held to such higher standards in all other transactions—that is, as one court expounded, the highest responsibility known to law. The idea that these funds are no longer protected in any way is directly contrary to the DOL's analogous guidance in regard to automatic rollovers, where the plan administrator is responsible for identifying a reliable rollover account provider that meets significant criteria, as well as for providing notice to participants and beneficiaries about where to find these rollover accounts. Similarly, the DOL's regulations relating to the plan administrator's responsibility to attempt to locate a missing participant places a burden on the administrator to try to connect a participant with his or her benefit dollars. It just does not seem reasonable that ERISA would demand so little of a plan fiduciary vis-à-vis a participant in pay status.

Who Benefits from the Uncashed Check?

There is one final consideration in regard to this problem. As noted above, when a plan issues a regular check, the funds do not leave the plan until the check is cashed. If the plan treats the account as continuing, it will be credited with its appropriate share of earnings and will be available to the participant

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whenever he or she comes calling for them. It appears that such treatment is very rare. If the plan takes the account off the books—either as a payable or as a forfeited amount—the earnings that those funds generate are allocated to accounts of the other participants. The participant is, therefore, denied his or her proper benefit, and the other participants are unfairly enriched.

The situation is even worse when a cashier's or fundholder check is issued. In that case, the money comes off the plan books entirely—even as a payable—and enters the financial institution's coffers. It is common that the financial institution is permitted to retain the float on these types of funds, but it is logical that this is intended to be for a relatively short period of time while the exchange of funds is pending. If the time under which the exchange occurs is longer—perhaps years—it is clear that the financial institution is gaining an unintended benefit at the participant's cost.

If one stops to think about how much money there must be in uncashed checks around the country, it is clear that there is a huge treasure trove that is sitting in the possession of financial institutions, possible in perpetuity. The only one not benefitting, ironically enough, is the participant to whom these funds belong.

What About Escheat?

States have escheat laws that require unclaimed funds to be forwarded to the state after a certain period of time. There are penalties that may be assessed against holders of funds who do not remit the money for escheat on a timely basis.

The DOL has opined that a plan should not escheat funds that belong to an unresponsive participant [ERISA Opn. Ltrs. 79-30A (May 14, 1979); 94-41A (Dec. 7, 1994)]. If the funds at issue are really plan assets, it is hard to imagine that the DOL would not approve of escheating participant monies if the plan cannot find the participant, but would approve of the practice in relation to the same participant circumstance, but where the funds are held by a different entity.

If the funds are not plan assets, escheat may be more appropriate. But this process also raises serious questions. First, what state should be the recipient of the escheat—the state in which the plan is resident, the state in which the institution is resident, or the residence of the participant? How is the participant to find his or her benefit?

What About the Tax Withholding and Income Reporting?

It is common that laypeople believe that the IRS computer system is a well integrated monolith, so that an amount withheld from a pension distribution will be matched up with the participant's Form 1040, and the income and withholding will be reconciled. In fact, that is not the case. A distribution or withholding that does not make it to the participant's tax return usually goes undiscovered by the IRS. After three years (six, if the amount of the distribution produces a significant understatement of taxable income), the return may not be amended, and the withheld amounts cannot be recaptured.

As a result, a participant (for whom withholding is paid by a plan fiduciary) suffers a detriment if he or she does not know to claim the withholding on the relevant tax return. That detriment becomes permanent when the tax return's statute of limitations closes.

It is impossible for the plan fiduciary to know with any certainty what the participant has done taxwise with the distribution that remains unclaimed. Is it possible that a participant would have claimed the income and the withholding on his or her return without actually cashing the check? Probably not, and probably only if the individual was audited by the IRS or at least received an adjustment to his or her taxes from the IRS. On the other hand, it is *possible*, and that raises the issue of what the prudent fiduciary should do.

If the fiduciary believes that the participant is unaware of either the income or the withholding, it may try to revoke the Form 1099-R and reclaim the withholding from the IRS. This could be done by filing an amended Form 1099-R, and then filing a request to the IRS for a refund of the withheld amount back to the Plan to be joined with the funds remaining in the plan or that will be reclaimed from the financial institution.

The concept that the distribution was not income is counter to the tax principle that a participant cannot defer taxation by not depositing a check that was received. Nonetheless, there is some reasonable likelihood that the participant never actually received the check. Therefore, the fiduciary has some basis for taking this action on behalf of the participant.

There may be some argument that, once the withholding amount has been paid by the plan, the funds that should have gone to the participant represent after-tax amounts. This could have qualification

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ramifications to a plan that does not permit after-tax accounts. However, in all likelihood, this is not the case. First, and most important, these are not amounts contributed by the participant. Second, there are other circumstances where plans that do not permit after-tax contributions may maintain an after-tax basis, such as when a partially-vested participant who is rehired repays the prior distribution, or when the plan has insurance and participants have been taxed historically on their term costs.

What Should the Fiduciary Do?

ERISA and the DOL regulations do not specifically address this conundrum. It is arguable that the funds left the plan, are no longer plan assets, and the fiduciary has no responsibility whatsoever. However, as discussed above, if one reviews fiduciary duties under the law, it seems questionable that it is appropriate for the plan fiduciary to sit on its hands while participants are routinely deprived of their retirement benefits. Turning over plan assets to a financial institution as a conduit to pay the participant is at least arguably unreasonable if there is no plan of attack if they are unclaimed other than to benefit the financial institution. This shows a disregard for ensuring that the plan benefits find their way to the participant, which is inconsistent with a fiduciary's obligations to carry out its duties in the exclusive interest of the participants and beneficiaries.

What is an appropriate course of action for a prudent and concerned fiduciary? Think about the following possible steps that a fiduciary can take, both to protect itself and to offer the best opportunity for the participant to be reunited with his or her benefits, which, after all, is what ERISA is all about:

- Step One: Periodically, get the financial institution to identify the uncashed checks. One thing we know for sure: the money does not belong to the financial institution.
- Step Two: Try again to find the participant. Go through the IRS's or Social Security Administration's procedures for unlocatable participants to renew the search for the participant [Rev. Proc. 94-22, 1994-1 C.B. 608 (Feb. 28, 1994)]. If the participant can be located, he or she can be notified of the pending benefit and, if necessary, have the check reissued. If the original distribution was intended to be a direct rollover, contact the financial institution that was to be the recipient of the rollover to see if the funds were ever received, and, if not, determine whether the intended recipient will accept the rollover now.
- Step Three: If the participant cannot be found, consider setting up an Internet site or accessing a site set up by an organization or governmental entity, which can be accessed by participants seeking lost benefits. An example is the National Registry of Unclaimed Retirement Benefits (www.unclaimedretirementbenefits.com), which is a public service company that charges no fees to keep a record of unclaimed amounts. Of course, a terminating defined benefit plan may take advantage of the PBGC's missing participant program.
- Step Four: Have the financial institution transfer the funds to an account for the participant. Assuming that taxes were previously withheld, the account should be an after-tax account in the participant's name. If the amount was intended to be a direct rolllover, the account should be a regular IRA rollover account, because no withholding will have been removed from the rollover amount. Because the fiduciary will have to select the investment medium for these funds, it should likely follow the most analogous guidance issued by the DOL: the rules regarding default investments for automatic IRAs.

If the unclaimed amount is an unconsummated rollover, and the amount is more than $5,000, transferring the funds to an automatic IRA rollover is not permitted. Although the participant did elect a distribution of these funds, the election was not to a rollover IRA of the fiduciary's choice. If the fiduciary can find a way to roll over the funds to the institution or plan originally requested by the participant, it may do so. Otherwise, the funds must be returned to the plan and the participant's account reestablished.

Of course, none of these steps is needed if the financial institution that handled the distribution had contracted to take these steps on behalf of the fiduciary. For example, suppose the institution that issued the check contracted with the plan fiduciary to ensure that uncashed checks were accounted for and to either notify the plan administrator regarding uncashed checks so that the plan administrator could take action or, even better, provided the services reflected above on behalf of the plan. In that case, the initial premise of the situation—that participants' monies were being abandoned by the plan fiduciary at the time that the benefit check was issued—would be incorrect. ERISA permits a fiduciary to delegate

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tasks to a service provider, so long as such delegation is prudent and the services provided are monitored on a reasonable basis by the plan fiduciary. Therefore, the concerns about fiduciary responsibility in this matter could be alleviated entirely by the fiduciary deciding at the outset to entrust the payment of the benefit to an institution that will be thorough in its payment process. One organization that provides such a service is PenChecks.

Conclusion

Uncashed checks commonly represent a transfer of plan funds from the plan to a financial institution. These funds rightfully belong to the participant, not the financial institution. Yet, there is no procedure outlined in the law or DOL regulations for a fiduciary to follow to protect the participant's rights in this matter. In the absence of any guidance, the fiduciary has a choice of putting its head in the sand and hoping that no one sees it, or of taking some level of affirmative action to help the participants. It seems that the latter course of action is more in line with the philosophies behind ERISA. It is also likely that the latter course of action is more in line with the goals of the employer, which are to provide benefits to the employees and not have funds sit in limbo. Therefore, a very prudent fiduciary may want to seek assistance from a distribution fiduciary that will follow up on uncashed checks so that he or she will sleep soundly, knowing that his or her actions have been directed at meeting the goal of providing benefits to participants. ■

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