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The Right Way to Manage Taxed Uncashed Retirement Checks

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There is one effective solution for making participants whole, although its cost is measured in time spent.

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Here it is, 2018, and the financial industry is still doing a poor job of handling uncashed retirement plan checks. In fact, despite growing awareness of the problem among plan sponsors and financial institutions (judging by the plethora of articles and white papers published on this topic over the last few years), the problem appears to be getting worse, not better, in large part because today's workers change jobs so frequently.

According to an article published by the Society for Human Resource Management, the median tenure at a job now ranges from 1.42 years for workers between the ages of 25 and 35 to 2.53 years for workers between 55 and 65. [Wilkie, Dana, "Who's Job-Hopping Now?, *https://www.shrm.org/resourcesandtools/hr-topics/employee-relations/pages/job-hopping-.aspx*] When people change jobs, they often leave their 401(k) plans behind (usually because the account is too small to bother with or they simply forget about it), and they often fail to leave a forwarding address. These small accounts are subject to involuntary cash-out by the plans, or they may be paid out automatically if the plan terminates. The checks associated with these distributions can go uncashed—either because the affected participant never actually receives them or because he or she fails to negotiate them once received.

As a result, the number of uncashed checks and the amount of unclaimed assets that require management continue to increase. No one knows the exact amount involved, but most estimates put the total unclaimed assets in the billions of dollars. Furthermore, the Department of Labor (DOL) and Internal Revenue Service (IRS) continue to exacerbate the problem by failing to provide the regulatory guidance needed to clear up the uncertainty and confusion, particularly in relation to uncashed checks on which withholding taxes have been paid.

What Is Meant by the Phrase "Uncashed Checks"?

An uncashed check comes about anytime a distribution is issued to a participant, and the distribution check is never negotiated by the participant. If the plan administrator maintains a checking account for the plan and issues a regular check, the distribution funds are not taken "off the books" until the check is cashed. However, if the plan uses a financial institution to administer distributions, the amount is shown as paid to the participant (and thereby removed from the plan's financials) at the time the check is issued. As a result, when a participant fails to cash that check, it ends up and remains in financial limbo—neither in the plan's coffers nor in the participant's pockets, but in the financial institution's "float."

Most often, these distributions are the result of automatic cash-outs of terminated participants' benefits, which are permitted for accounts of less than $1,000. The plan may, if the terminated participant takes no action in relation to his or her account, issue a check for such account, less 20 percent mandatory federal tax withholding that is remitted to the IRS. On occasion, the participant has requested a distribution but fails to cash the check once it is received. On still other occasions, the participant has requested a rollover to an individual retirement account (IRA) or other employer's plan and has been provided with a check made payable to the recipient IRA or plan trustee for the full account but fails to forward the check to the intended recipient. Unlike the first two situations (*i.e.*, intended cash distributions that are never consummated), the participant has paid no taxes on that type of distribution, and it is believed by the distributing plan and the IRS, which has received a Form 1099-R from the distributing plan attesting to the fact, to have been properly rolled over to another tax-sheltered vehicle.

How Are Uncashed Checks Handled Today?

Despite the obstacles caused by a lack of government guidance, a consensus seems to be growing within the retirement plan industry about how to manage both uncashed checks that have not been taxed and those that have in a way that, hopefully, protects the interests of plan participants, plan sponsors, and institutions, while satisfying both the DOL and IRS. It goes like this:

The institution that issued the check to the participant (who has not, within a reasonable time, cashed the check) likely has a fiduciary obligation to find the participant and reunite him or her with the funds—or, at least, to make a "reasonable attempt" to do so. The institution attempts to fulfill this obligation by calling the former employer to request updated contact information. If the former employer cannot provide that information, the institution then attempts to locate the participant using a variety of search tools.

If a reasonable attempt, as defined by the DOL [*see* DOL Field Assistance Bulletin 2014-01] fails to locate the participant, the institution then transfers the participant funds into an Auto Rollover IRA account, provided the account value is $5,000 or less. (If the funds come from a terminating plan, the $5,000 cap does not apply). Proceeds from a required minimum distribution (RMD) under Internal Revenue Code (Code) Section 401(a)(9) cannot be transferred to an Auto Rollover IRA.

Placing the funds in an Auto Rollover IRA protects the participant by retaining the qualified and tax-deferred status of the assets in the account. It also removes fiduciary responsibility from the distributing institution and the plan sponsor that prudently chooses the recipient account for the rollover by transferring the funds to the custodian of the selected rollover IRA account.

The current volume of activity with service providers specializing in the Auto Rollover IRA area, including increases in new Auto Rollover IRA accounts, suggests that more plan sponsors and institutions are rolling over uncashed checks and account balances under $5,000 into IRA accounts. This solution may protect these funds from both loss and taxation for their participants, but this does not solve the other half of the "uncashed checks" problem: What to do with uncashed checks that have already been taxed.

Taxed Distributions Create New Problems

When financial institutions and plan sponsors transfer uncashed check assets into an Auto Rollover IRA account, it offers several benefits, including:

- This practice has been approved by both the DOL and IRS as a means of prudently and fairly getting the participants' benefits out of the plan;
- This practice has been approved by the DOL as fulfilling the fiduciary obligations of sponsor and administrator of the distributing plan and the trustee of the plan; and
- This practice safeguards the participant's assets until s/he comes forward to claim them.

The bad news is that this approach does not solve several problems associated with *uncashed checks that have been taxed*. In spite of this fact, it seems to be a widely used practice to roll those funds into an Auto Rollover IRA account, similar to what is done with untaxed amounts.

How Do Uncashed Checks Come to Be Taxed?

Taxed uncashed checks are the result of intended cash distributions, rather than rollovers, that are never negotiated. As noted above, taxes are paid because cash distributions of more than $200 are subject to mandatory 20 percent federal tax withholding. Therefore, whether the distribution was made as a cash-out of a small account (less than $1,000) of a terminated participant or because the participant elected a cash distribution, the amount in the check that is ultimately uncashed is net of tax payment.

What Is the Status of the Uncashed Checks?

Under the general rules of constructive receipt, the actual deposit of a received check is not needed for the recipient to incur taxable income. [Treas. Reg. § 1.451-2] If we presume that an uncashed check was actually received by the participant, it is taxable income. Once there is a taxable distribution of funds from a retirement plan, such distribution may be rolled over to an IRA or other qualified plan only if such action is taken within 60 days. [IRC § 402(c)(3)] After the 60-day period is over, the funds are no longer eligible for tax-free rollover. (Beginning in 2018, the rollover deadline is extended for qualified loan offsets to the due date of the taxpayer's return (including extensions).)

It makes sense, therefore, that the issuing of a distribution check by a plan creates taxable income and sets the clock running for the 60-day rollover period. Revenue Procedure 2016-47 permits the waiver of the 60-day period for a misplaced check, but the waiver requires actions by the affected taxpayer. And, as discussed below, just because a check is uncashed does not mean it is misplaced.

In absence of taxpayer action pursuant to the Revenue Procedure, an uncashed check ceases to be eligible for rollover to an IRA after the 60-day period has elapsed. It is possible that the "rollover" of the uncashed check to an IRA after that point could be considered to be a new IRA contribution by the former plan participant, but there is no way for the entity making the rollover to know if the participant is eligible for a tax-free IRA deposit and no way for the unfound participant to actively claim this deduction, and the amount of the "rollover" may exceed that year's eligible deductible IRA limit.

The reasonable conclusion, therefore, is that the redeposit of uncashed funds into a qualified plan or an IRA is improper and can threaten the qualification of the plan or IRA. Furthermore, unless the deposit is treated as an after-tax contribution by the employee, the redeposit of the funds into a tax-sheltered vehicle runs the risk of the money being mistakenly retaxed when it is removed from the recipient account, which is an unfair result of a process that is likely inappropriate to begin with.

Why Should the Payor of an Uncashed Check Take Any Action at All?

DOL representatives have informally indicated that account balances after taxes have been taken out of uncashed retirement checks are still considered plan benefits. Unfortunately, many in our industry have misinterpreted this to mean that the monies also remain qualified funds, even if the withheld taxes have not been restored. This appears contrary to the above discussion, particularly in relation to amounts intended to be distributed, not rolled over.

If uncashed checks are plan benefits, the fiduciaries of the plan—both the plan administrator and the trustee—have fiduciary duties to the participant to safeguard the funds. Should not something be done to protect the participant's interest in the money? And, if the uncashed check remains plan assets, should the fiduciary do something to reunite the participant with the withheld taxes on an account that has never "left the plan"?

Furthermore, when a check goes more than 90 days without being cashed, there is an argument under banking rules that the issuing entity has a fiduciary obligation to start paying interest on those funds. The law does not require this, but it is consistent with banking and financial industry practice to do so, and at least two institutions have been known to do exactly this. When it comes down to brass tacks, it is hard to imagine a situation where it is appropriate for a financial institution holding funds in a fiduciary capacity on behalf of another to use such funds without paying some form of interest for such use.

IRS/DOL Formal and Informal Statements (or Lack Thereof)

To date, neither the IRS nor DOL has issued any formal guidance on how to manage uncashed checks that have been taxed. Moreover, they have shown no sign of working together to resolve the problem.

If the IRS were to put in writing that taxed distributions would remain qualified and not jeopardize a plan's qualified status if the funds were returned, it would solve the problem very quickly. (Of course, the recordkeeper would then need to keep track of the after-tax funds to avoid double taxation upon redistribution.) Recently, the IRS published a field directive stating it will not challenge a qualified plan or levy a penalty for failure to commence or make a required minimum distribution under Code Section 401(a)(9) to a missing participant or beneficiary (as long as the plan has taken the required search steps). [IRS Audit Memorandum, *https://www.irs.gov/retirement-plans/minimum-distributions-for-missing-participants-and-beneficiaries-of-retirement-plans*] How wonderful it would be if the IRS offered similar guidance regarding the taxes from uncashed checks!

If the IRS audits a plan that has redeposited amounts from uncashed checks that were distributed, rather than rolled over, on which withholding has been applied, what will be the result? What if it audits a rollover IRA that has received taxed distributions from uncashed checks? Would the IRS seek to charge an excise tax against the funds for being nondeductible IRA contributions? Would the qualified plan be subject to disqualification? If the DOL investigated the plan, would it impose a penalty on the transferring sponsor or institution for providing plan assets to an improper recipient or for improper use of participant funds? Is it a breach of fiduciary duties? A prohibited transaction?

For now, this remains a very gray area. Therefore, it is no wonder that many in our industry remain uncertain about what to do with uncashed checks from plans with which they are involved.

A Simple Solution That Most Are Not Using

There is a solution for handling taxed uncashed checks in the current environment that is, unfortunately, unduly time consuming.

Checks That Are Deemed Uncashed During the Year of Payment

If a check goes uncashed during the year in which it was initially issued (and during which withholding was first reported), the paying institution can adjust its quarterly Form 945 filings, which verify the amount of taxes withheld during the quarter. Therefore, if a check is deemed uncashed during the same year, the institution can reduce the amount of taxes being reported to the IRS in the quarter the check is deemed to be uncashed by the previously withheld amounts on the original distribution and credit both the distribution and the previously withheld taxes back to the participant's account in the plan.

Checks That Are Deemed Uncashed During a Subsequent Tax Year

The above solution evaporates if the check is deemed to be "uncashed" in a subsequent calendar year. In this circumstance, the Form 945 adjustment is no longer available, because the withheld taxes have been reported and filed with the IRS in a prior tax year.

Once the Form 945 option is off the table, plan sponsors and institutions can petition the IRS to restore the taxes to the account, and then replace the uncashed distribution and restored taxes to the plan. At that point, the plan could transfer the totally restored account to an Auto Rollover IRA. This scenario requires plan sponsors and institutions to individually petition the IRS for each uncashed check that has been taxed, a laborious process. However, the IRS allows up to three years from the date the check was issued to restore the money. Doing so protects the qualified status and the value of the participant's account, ensures the money is properly managed, and removes fiduciary responsibility from the plan sponsor and paying institution.

If financial institutions all know about this solution, why are not more doing it?

One reason is that, in large part, most institutions are not geared up to engage in this process for qualified plans. Although uncashed checks represent a small fraction of all the retirement plan checks processed, most institutions lack sufficient staff or efficient processes to manage the uncashed check anomalies. Probably more compelling, petitioning the IRS to return taxes withheld from a qualified plan distribution involves a time-consuming process for which the institution receives no compensation. As a result, it is uncommon for institutions to volunteer to perform this task. And, one must imagine that the financial institution's use of the funds that are represented by uncashed checks, without the requirement of an interest payment to the check owner, is a strong motivation for the institution to take no action that is not legally mandated.

What About the Plan Sponsors and Administrators?

Plan sponsors and plan administrators often are unaware that the uncashed check problem even exists. If the payment to the participant is made from a financial institution (such as a plan's recordkeeper), the money is removed from the plan's financial statements once the check is issued. It is not within the plan sponsor's or administrator's ken whether such check is actually cashed by the participant, unless it endeavors to ask the financial institution for this information, or if the financial institution provides the information on its own initiative. Neither course of action happens commonly.

Nonetheless, just because the plan sponsor receives a report indicating a participant's account has been liquidated and a check issued does not mean the distribution has been fulfilled. As noted above, it is possible that the plan remains liable for the benefits represented by uncashed checks and has a fiduciary duty to verify that all payments emanating from the retirement trust have been received and cashed by the participants. If that is so, it logically follows that the plan sponsor or administrator has a fiduciary obligation to restore the account, obtain the withheld taxes from the IRS, and potentially secure for the participant interest from the holding institution.

By not taking action to investigate uncashed checks, plan sponsors and administrators are helping to deny plan participants and heirs the total value of the money that rightfully belongs to them. By not notifying the IRS to restore the withheld taxes, once the three-year time limit on such petitions expires, that window is closed forever. Furthermore, funds sitting in an uncashed check pool could also be escheated to the state by the financial institution, which the DOL has also indicated is improper.

Do the Right Thing

The solution would become even simpler *if* the IRS and DOL would step up to the plate and offer clear guidance on how to handle uncashed checks in general and, in particular, those that have been taxed. This guidance could include allowing plan sponsors and institutions to put these funds into an Auto Rollover IRA and could provide a streamlined method by which the IRS could be petitioned to return the funds and restore them to the account.

Until this happens, many participants will continue to lose at least 20 percent of the value of their account (and possibly the full account) and never get it back. I believe that we, as individuals and as an industry, need to start doing the right thing, which is to make the participant whole in situations where their account has been taxed. As an industry whose purpose is to help America's workers plan and save for a secure retirement, we need to decide which is more important—taking the short cut or making every effort to restore the funds to their rightful owner.

Even without clear guidance from the IRS, we can still do the right thing. We can still adjust our Forms 945, petition the IRS to restore the taxes, make the account whole, and roll it into an IRA account. Or, if the account balance exceeds $5,000, restore the funds back to the plan. In the meantime, working with our elected officials to help them understand the scope of the uncashed check problem and the need for a clear solution will benefit all those who put their trust in us to help provide a secure, comfortable retirement.

One Final—and Related—Point

As much as it makes perfect sense to end my article here, I cannot leave without mentioning another practice that has always disturbed me when I see it being used. That practice is using the forfeiture provisions in the Treasury Regulations as the justification for forfeiting funds from uncashed checks.

Treasury Reg. § 1.411(a)-4(b)(6) permits the forfeiture by a qualified plan of funds on behalf of a lost participant or beneficiary, so long as the account is restored if the individual is found. This section has been used to justify plans forfeiting accounts prior to distribution, as well as simply treating uncashed checks as forfeited. It stands to reason that, if the plan can forfeit the benefit of a lost participant, so can a financial institution that is holding funds as a result of an uncashed check.

The fallacy to this argument is two-fold. First, when a plan forfeits a benefit, it remains in the plan, is subject to ERISA's exclusive benefit rules, and so is used for the benefit of other participants. In comparison, a forfeiture by the financial institution results in the money being kept by the financial institution for its own benefit—a clear violation of the fiduciary rules of ERISA. Second, whereas a participant likely can find the plan to claim his or her benefits, the ability of a participant to know that a financial institution (and which financial institution) holds funds that belong to him or her is probably nonexistent. Therefore, it is, in the author's opinion, an inappropriate action by the financial institution and should be halted. ■