

Morgan Lewis

webcast

Plan Sponsor Basics

Webinar 3 of 6

# Lost and Missing Participant Issues

**May 21, 2013**

[www.morganlewis.com](http://www.morganlewis.com)

**Presenters:**

John G. Ferreira

Susan D. Lastowski

# Three Types of Participants

- This webinar will address three types of participants:
  - Lost participants;
  - Recalcitrant participants; and
  - Participants who have been paid but have uncashed checks.
- Each group is distinct, although participants with uncashed checks are often lost participants.

# Fiduciary Responsibility

- Fiduciary responsibility under ERISA
  - Plan fiduciaries have a responsibility to pay benefits when due and to operate the plan for the exclusive benefit of participants and their beneficiaries. This responsibility includes taking steps to locate participants and taking reasonable steps to ensure payment of benefits.
  - Reasonable standard applies. Plan fiduciary cannot ensure that payment is received.

# Nonforfeitable Benefits

- IRS requires certain benefits to be nonforfeitable.
- Nonforfeitable right cannot be extinguished by subsequent event.
  - Benefits payable to a participant who is lost cannot be “permanently” forfeited if participant resurfaces.
  - Benefits must be reinstated either through the forfeiture account in a plan or through additional contributions by the sponsor if necessary to reinstate the benefits.

# Lost Participants

- Who is a lost participant?
  - A participant for whom no valid address exists;
  - A participant for whom the plan sponsor has conducted a diligent search;
  - A participant for whom a benefit remains payable from the plan.

# Lost Participants (continued)

- Lost participants can be identified when amounts are payable from the plan and when required notices are sent, e.g., SAR, Annual Funding Notice.
- Sending annual or periodic notices to a participant's last known address is sufficient.
- No requirement that a search be conducted to obtain new address to forward notices to.
- SPD should make clear that participants are responsible for keeping their addresses updated and that they may lose benefits if they don't.

# Lost Participants (continued)

- Differentiate notices from when benefit payment is due.
- Searches should only be mandated when payment is actually required.
- However, rather than wait until a benefit is payable, when notices are returned to the plan sponsor as undeliverable, it may be advisable to initiate a search at that time.
- The more time that elapses between the first evidence of a lost participant and the date a benefit must be paid, the greater the chance of not finding the participant.

# Lost Participants: Searching Methods

- DOL in FAB 2004-02 made it clear that a fiduciary has not discharged his/her obligation to locate a lost participant unless and until all of the following actions are taken:
  - Use of certified mail
  - Check of related plan records
  - Checking with designated plan beneficiary
  - Use of letter-forwarding service
  - Use of other search options, e.g., Internet or private search firm.

# Lost Participants: Searching Methods (continued)

- IRS's letter-forwarding service is no longer in existence.
- Social Security has a letter-forwarding service, but its fee has increased to \$35 per forwarded letter.
- Most companies use a private search firm and perform periodic updates to participant data.
- Despite use of search methods, there will be times when fiduciaries cannot locate participants.

# Lost Participants: Payment Situations

- Lost participant payment situations
  - Plan termination and distribution must be made
  - Participant's benefit is less than cashout threshold in plan and needs to be distributed, e.g., less than \$1,000
  - Participant has reached mandated distribution date – either normal retirement date or age 70 1/2

# Lost Participants: Plan Termination

- Plan Termination Distributions:
  - Defined Contribution (DC) Plan
    - If plan sponsor maintains another DC plan in a controlled group it must transfer account balance of a lost participant to other plan
    - If no other plan is maintained in controlled group, then plan sponsor should (in order of DOL preference) initiate a rollover, set up an account in a federally insured interest-bearing bank account, or consider escheating to state
    - In all cases, distribution of the account balance triggers withholding and a 1099-R
    - Can't do 100% withholding

# Lost Participants: Taxable Event

- A participant is taxable on the distribution even if he/she did not receive the payment
- It is important not to send payments to lost participants without prior verification of address, though it may be unavoidable in some instances
- A participant may claim at a later date, if he/she is located, that he/she never received the check and ask to undo prior tax reporting, but that is difficult to do and impossible if closed year
- It is advisable to maintain a permanent check register or bank payment record to verify whether checks were ever cashed

# Lost Participants: Plan Termination

- Defined Benefit Plan Termination
  - PBGC missing participant program will take benefits of missing participants.
  - Withholding should not be applied in this instance and no 1099-R issued.
  - PBGC or insurer will issue 1099-R and withhold taxes when distribution occurs.
  - Unclear if PBGC will take cashout amounts. If not, it is reasonable to follow DC approach.

# Lost Participants: When Is a Benefit Forfeitable?

- When is a benefit forfeitable?
  - Terms of plan should control.
  - Treas. Reg. section 1.411(a)-11(c)(1) states that “if an accrued benefit is immediately distributable, section 411(a)(11) permits plans to provide for the distribution of any portion of a participant’s nonforfeitable accrued benefit only if the applicable consent requirements are satisfied.”
  - A benefit is immediately distributable if it is payable prior to the later of age 62 or the plan’s normal retirement age.

# Lost Participants: When Is a Benefit Forfeitable? (continued)

- Once a benefit is no longer immediately distributable, a plan may distribute the benefit in the form of a QJSA in the case of a benefit subject to section 417 of the Internal Revenue Code or in the normal form in other cases without consent.
- A cashout is an exception to the above rule.
- If participant consent is required for a distribution prior to NRA or age 62, if later, a forfeiture cannot occur before then because participant consent to distribution is required – a plan cannot assume that a lost participant has consented to distribution until it is no longer immediately distributable.

# Lost Participants: Cashouts

- Cashout Amount
  - If a plan has a cashout provision, and a participant is missing, the plan can provide for a forfeiture of that benefit, i.e., if amount does not exceed \$1,000
  - Forfeited benefit is subject to reinstatement without interest if participant resurfaces and makes a claim for benefit
  - Forfeiture action keeps benefit in plan, and if it is a DB plan, absolves plan of PBGC premium payments on missing participant

# Lost Participants: Cashouts (continued)

- If a benefit is not distributed, then there is no withholding and no 1099-R at this time.
- If the amount exceeds \$1,000 but is less than \$5,000, the plan administrator should roll over the amount to an IRA established for that purpose by plan. No forfeiture – instead, the benefit is now in a vehicle outside of the plan.
- In this case the benefit is distributed and there is no withholding applied because of the rollover, but 1099-R would be issued to the participant's last known address and to the IRS.

# Lost Participants: Payment at NRD or Age 70 ½

- Benefits due to be paid at NRD or age 70 ½
  - Some plans require a distribution to commence at NRD, and others permit participants to defer payments to age 70 ½
  - If a participant is missing, forfeit benefit subject to reinstatement if participant resurfaces
  - Do not issue check, withhold taxes, or issue 1099-R

# Recalcitrant Participants

- Recalcitrant Participants
- Who Is a Recalcitrant Participant?
  - A participant who is not missing, but refuses to return election forms when payment is due
  - This can occur at NRD or at age 70 ½
  - Cashout situation is different because law provides for automatic distribution with 20% withholding if a participant does not elect rollover or cash for a distribution

# Recalcitrant Participants (continued)

- Notify participant regarding payment deadline
- Provide multiple opportunities to elect payment
- Make clear in communications what will happen if participant does not return election forms (e.g., assumptions re: marital status and age of spouse)
- Provide participant with deadline
- If participant still does not respond:
  - Pay participant in the normal form of payment provided under the plan, e.g., lump sum for DC Plan and QJSA for DB Plan

# Recalcitrant Participants: QJSA Payment

- For DB Plan, assume participant is married and assume spouse is same age (or another reasonable assumption) and commence payment of annuity
  - If participant contacts plan administrator to correct spouse's age or to claim single status, adjust benefit going forward based on correct data; however, arguably no requirement to adjust payments already made
- Withhold taxes as required and issue 1099-R

# Uncashed Checks

- Participants with uncashed checks
- Most frustrating and common situation for plan administrators
- Uncashed checks can occur due to participant error or lack of attention by participant
- Uncashed checks often triggered by bad address (hence recommendation that missing participant searches be done frequently to reduce bad addresses)

# Uncashed Checks (continued)

- Can reduce number of uncashed checks by not sending checks to lost participants – conduct search efforts first before sending checks
- Uncashed checks can occur in cashout situations where payment is automatically triggered at termination of employment and if participant does not elect rollover or cash, or at other mandated distribution events, when distribution in cash is automatically made
- Checks treated as distributed in the year paid (not year cashed) and withholding applied and 1099-R issued

# Uncashed Checks: Who Retains?

- Will uncashed checks be retained by the plan or by outside fund holder?
  - If retained by plan, then uncashed checks are returned to the plan and deposited in the trust, and continue to be treated as plan assets. If retained by plan, fiduciary responsibility continues for unpaid amount.
  - If uncashed checks are attributable to a missing participant, then DB Plan can take position that benefit is forfeited and remove participant from PBGC rolls. Not possible if participant is not missing but has not cashed check – no forfeiture can occur if plan has valid address.

# Uncashed Checks: Outside Fund Holder

- Most large companies use outside fund holder to issue checks, and if checks are uncashed the fund holder retains the float on the checks.
  - Not treated as plan assets and not reported on Form 5500
  - Not protected by plan since not plan asset and fiduciary responsibility ceases
  - Can escheat to state since not plan assets
  - Fund holder can try to deposit checks in bank account on behalf of participant

# Uncashed Checks: Outside Fund Holder (continued)

- Fund holder shouldn't hold uncashed checks indefinitely
- Could return to plan for deposit – becomes a plan asset again and participant's account needs to be reopened if DC plan and benefit restored if DB plan with PBGC premiums
- Fund holder can again try to locate participant, or transfer funds to account for participant
- Technically no further fiduciary responsibility, as it becomes fund holder's issue, but since no IRS/DOL solution, can plan fiduciary just ignore accumulating uncashed checks at fund holder?

# Uncashed Checks: Taxation

- Taxation and withholding triggered in year of distribution
  - Taxable event deemed to have occurred in the year of distribution
  - Impermissible to take position that 100% income tax withholding applies to distribution of lost participant
  - 1099-R due with respect to year of distribution

# Uncashed Checks: Taxation (continued)

- If participant resurfaces, participant may be issued new check net of the taxes previously withheld. No new 1099-R issued since taxable event occurred in year of distribution.
- Participants who hold on to checks to cash in subsequent years often surprised that the taxable event is not deferred. Withholding may have been excessive.
- IRS might catch 1040 not completed with correct 1099-R information and withholding, but might not.

# Uncashed Checks: Fiduciary Oversight

- Fiduciary retains responsibility to select fund holder and establish a process for uncashed checks
  - Can delegate responsibility to fund holder subject to prudent selection and periodic monitoring
  - No formal IRS or DOL guidance on how to handle uncashed checks
  - Reasonable documented procedures recommended that should be triggered with each uncashed check without need to submit issue to plan fiduciary for resolution

# Plan Provisions

- Plan document should include section on missing participants, and when a forfeiture is deemed to occur
- Plan should incorporate by reference uncashed-check policy
- Plan should be clear regarding mandated benefit commencement date, i.e., is it NRD or is there a deferral option to age 70 ½
- Plan administration section should include proper delegation authority
- Plan should specify participant responsibility to provide address updates

# Published Guidance

- Published guidance on lost participants:
- [http://www.dol.gov/ebsa/regs/fab\\_2004-2.html](http://www.dol.gov/ebsa/regs/fab_2004-2.html) (DOL guidance on lost participants in a terminating DC plan)
- <http://www.pbgc.gov/prac/terminations/missing-participants.html> (PBGC guidance on missing participants in a terminating DB plan)
- <http://law.justia.com/cfr/title29/29-9.1.5.17.16.html> (Title IV regulations on missing participants in a terminating DB plan)

# Published Guidance (continued)

- <http://www.ihflaw.com/Articles/Penchecks.pdf> (good article on uncashed checks)
- <http://www.irs.gov/pub/irs-drop/rp-12-35.pdf> (IRS announces that plan administrators can no longer use its letter-forwarding program to find lost participants)
- <http://www.dol.gov/ebsa/programs/ori/advisory94/94-41a.htm> (DOL opinion that state escheat law is preempted as applied to amounts in an ongoing plan)

# Published Guidance (continued)

- <http://www.law.cornell.edu/cfr/text/29/2550.404a-2> (DOL automatic rollover regs that allow you to roll over to an IRA for lost participants who have amounts under \$1,000)
- <http://www.ssa.gov/foia/html/ltrfwding.htm> (information on Social Security letter-forwarding program)

# Presenters

**John G. Ferreira**

Partner

Pittsburgh

412.560.3350

[jferreira@morganlewis.com](mailto:jferreira@morganlewis.com)

**Susan D. Lastowski**

Senior Benefits Advisor

Philadelphia

215.963.5950

[slastowski@morganlewis.com](mailto:slastowski@morganlewis.com)

# DISCLAIMER

- This material is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. © 2013 Morgan, Lewis & Bockius LLP. All Rights Reserved.
- **IRS Circular 230 Disclosure**  
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see <http://www.morganlewis.com/circular230>.



## international presence

Almaty Beijing Boston Brussels Chicago Dallas Frankfurt Harrisburg Houston Irvine  
London Los Angeles Miami Moscow New York Palo Alto Paris Philadelphia Pittsburgh  
Princeton San Francisco Tokyo Washington Wilmington