

# STA Newsletter

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## IRS Steps into the Unclaimed Property Arena

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On May 29, 2018 the Internal Revenue Service published Revenue Ruling 2018-17 – Withholding and Reporting With Respect to Payments From IRAs to State Unclaimed Property Funds. The ruling clarifies that property in an IRA which is escheated to the state meets the definition of a designated distribution under § 3405 of the Internal Revenue Code (IRC) and therefore is subject to applicable tax withholding and reporting to the IRS.

According to the ruling, the payment of an individual's interest in a traditional IRA to the state unclaimed property fund is a payment from an IRA that is treated as includible in gross income. The analysis in the ruling concludes that under § 3405(e)(3), a nonperiodic distribution is a designated distribution that is not an annuity or similar periodic payment. Therefore, the payor shall withhold 10 percent of the distribution unless the IRA owner has previously established a different withholding rate or opted out of withholding.

Because the escheatment of an IRA account is to be treated as includible in gross income and therefore subject to applicable withholding rules, it is also required that the distribution and withholding be reported on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

Although the position presented in the revenue ruling implies that escheated IRAs have always been considered includible in gross income and subject to withholding and reporting, the ruling provides for an effective date of the earlier of January 1, 2019, or the date it becomes reasonably practicable for the holder/trustee to comply with the requirements.

The ruling has created a multitude of concerns for a variety of IRA holders; mostly those in the securities industry. However, the impacts on each specific industry vary slightly.

Letters to express industry concerns were submitted to the IRS and Department of the Treasury (Treasury) by the Holders Coalition and the Securities Industry and Financial Markets Association (SIFMA) and the Investment Company Institute (ICI) which outlined concerns regarding the liquidation of securities in order to satisfy the 10 percent withholding requirement. The compliance deadline of January 1, 2019 is also of particular concern.

Members of the Holders Coalition, SIFMA, and the ICI attended a very productive meeting with IRS and Treasury department on September 21, 2018 in Washington DC. The purpose of the meeting was to open the lines of communication between the government officials and the industry as well as discussing concerns of each of the groups represented.

The IRS and Treasury officials were given a high level overview of unclaimed property laws and current practices. The government officials present appeared to have a general understanding of the escheatment process and agreed that aggressive state laws and audit enforcement efforts can be disruptive to the investors. However, it was also made very clear that when assets leave an IRA with an IRS approved IRA custodian and are moved to a state unclaimed property account, it is in fact a distribution rather than a transfer in kind.

Prior to the meeting some officials with the IRS had reviewed a sampling of custodial agreements which included contractual language allowing for the liquidation of the assets in order to pay fees and taxes due on the property. The IRS indicated that if such language is present in the custodial agreement, the liquidation of shares should not be an issue for holders. However, they did not

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give guidance on *which* securities should be liquidated if the securities are held in a brokerage account.

Further, the IRS was very clear that assets leaving an IRA held with an IRS approved custodian is a distribution includible in gross income when it is not going to another IRA custodian even though current industry practice is to process the escheatment as a transfer in kind. As such, the IRS is vested in ensuring they receive their portion of the distribution to pay the 10 percent withholding tax.

While there have been discussions about having the states become IRS approved custodians, which would give them the responsibility for tax reporting when they liquidate the securities, it is clear that neither the IRS nor the Treasury department has the authority to compel a state to do so. However, holders may want to think long and hard about the continued practice of escheating retirement property to a state that is not an approved custodian. Internal and/or external legal counsel should be consulted when reviewing this policy decision. To date, only the state of Kentucky is an IRS approved custodian.

Most state unclaimed property laws use an inactivity presumption of abandonment for IRA accounts. There are only seven states that have a return mail component mentioned in either their statute or state guidance. Illinois, Kentucky, Pennsylvania, Tennessee, and Utah all have return mail requirements before a traditional or Roth IRA can be eligible for escheatment. New Jersey requires the return mail notation for Roth IRAs only. Texas has a provision for deceased IRA owners when the location of the beneficiary is unknown to the holder. The IRS believes that the additional withholding and tax reporting will likely reunite more owners with their assets. In theory, the owner will receive their Form 1099-R and be prompted to reach out to the holder to find out more about the disposition of their assets. In reality, it is likely to cause taxable events to be reported to the IRS and not by the owner causing the owners additional complications with the IRS. For states that do have a return mail requirement, it is likely that any Form 1099-R sent out would be going to a bad address and subsequently returned back to the holder.

Additional industry concerns arise with this theory as there is currently only a 60 day time limit for owners to rollover their IRA into a new IRA. Depending on when the account is distributed and escheated to the state, it is likely that the 60 day rollover period will have expired. Additionally, an IRA account owner can only request one rollover per calendar year so if more than one IRA is escheated, they

would not be able to rollover all of the accounts, nor would the owner have 100 percent of the distributed amount to rollover because of the withholding sent to the IRS.

These issues will be further complicated if states prescribe for the escheatment of IRA accounts prior to the owner reaching the age in which a distribution can be done without a tax penalty (59 ½). Currently, the Pennsylvania unclaimed property statute does not include the 70 ½ age requirement to ensure the owner is at the Required Minimum Distribution (RMD) age prior to escheating IRA accounts (although the Treasurer is not currently accepting IRA accounts if the owner is not 70 ½).

The IRS was also asked about updating the Form 1099-R for a distribution code for Box 7 so that the owner and IRS would know that the distribution was a result of the state seizing the property as unclaimed. It is unclear if the IRS/Treasury department will agree to add a new code at this time.

With the compliance date of January 1, 2019 quickly approaching, the government officials were asked if there would be an appetite for delaying that date. It was noted that ideally, holders need approximately 18 months to effectively plan, design, code, and property test their systems. Members of the IRS/Treasury were clear to say they could not tell us what they would decide but appeared to be open to the idea of a delayed compliance date (but not likely more than a year). It was also noted that the NAUPA file layout may also need to be updated to reflect the tax withholding sent to the IRS to reconcile balancing issues with the state unclaimed property departments.

While it doesn't appear that the IRS or Treasury department will reconsider their position taken by the revenue ruling, they are very open to continued dialogue with industry to determine the best way to facilitate compliance with the ruling. Holders of IRA accounts may also want to consider enhanced outreach before escheating IRA accounts including sending due diligence letters for all amounts of property, regardless of what the statutory minimum threshold is.

The meeting with government concluded with all parties agreeing to conduct more research and have ongoing discussions. The IRS has also suggested reaching out to the Securities Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) to resolve the issue of liquidating securities in addition to the possibility of updating the IRA custodial agreements. ■