Collin W. Fritz and Associates, Ltd.
"The Pension Specialists"™

CWF Guidance

Tax Consequences of Failing to Cash a Distribution Check From a Qualified Retirement Plan (or a traditional/SEP/SIMPLE-IRA)

The IRS issues Revenue Rulings to assist tax payers in understanding and complying with federal income tax laws. The IRS recently issued Rev. Rul. 2019-19.

At times a 401(k) participant will be mailed a distribution check and the person fails to cash it or cashes it many months after it was mailed. Some individuals would like to believe that because the check was not cashed or it was cashed in a subsequent year that they are not required to include such amount in their income for the distribution year and pay tax at their applicable marginal income tax bracket for such year.

These individuals are guilty of wishful thinking. A tax lesson will be learned the hard way. The IRS has written Rev. Rul. 2019-19 to explain the IRS' position on this situation. The IRS guidance is very basic. This guidance is premised on the fact that a person receives a distribution and then does not cash the check. The IRS added a footnote. "For purposes of this revenue ruling, whether a person keeps the check, sends it back, destroys it, or cashes it in a subsequent year is irrelevant."

For illustration purposes the IRS presents the following hypothetical 401(k) situation as modified by CWF. A person (John Doe) is scheduled to take a $900 distribution in 2019 from the 401(k) plan. He has no basis or non-taxable funds in his 401(k) account. 100% of any distribution to him must be included in his income. The plan administrator withholds 20% of the $900 distribution or $180 for federal income tax purposes. He is mailed a check in the amount of $720. John receives this check in 2019, but for whatever reason he does not cash it. And he does not make a rollover contribution.

The IRS' analysis and position is, a person is required to include a pension distribution in their income for the year of receipt regardless that the recipient fails to cash the check. John's not cashing the check does not give him the right to exclude the distribution from his income.

And a 401(k) administrator has the duty to comply with the withholding rules regardless whether John cashed the check. The 401(k) administrator is not allowed to not comply with the 20% withholding rules because a participant fails to cash the distribution check. That is, with respect to any distribution which is eligible to be directly rolled over, but which is not, the 401(k) administrator is liable to withhold the $180 (20% of the $900) and pay it to the IRS. If this is not done, the plan administrator owes the $180 and must pay it.

The 401(k) administrator also has the duty under Code section 6047(d) to prepare the Form 1099-R to report that a $900 distribution was made to John Doe. The fact that John Doe did not cash the check is not a valid reason allowing the 401(k) administrator to not prepare the Form 1099-R. The IRS' instructions for preparing the Form 1099-R must be followed. Box 1 and 2a must be completed with $900 and the $180 of federal withholding must be reported in box 4.

At the end of Rev. Rul 2019-19, the statement is made that the Department of the Treasury and the IRS continue to analyze issues that arise in other situations involving uncashed checks from eligible retirement plans including situations involving missing individuals.

Note that the above IRS guidance depends upon the fact that the person received the distribution, but did not cash the check. The IRS guidance does not address the situation where a check for 80% is sent to a person (with 20% withheld), but the check is returned as undeliverable or is never received by the individual. In these cases, there has been no actual distribution to the person and there is to be no federal withholding or preparation of the Form 1099-R.

401(k) administrators will want in some distribution mailing situations to use certified mail with return receipt services so that it can prove that a person actually received the distribution. Otherwise, there very well could be mistakes being made with respect to withholding and preparation of the related 1099-R forms.

Also note that the IRS does not mention IRAs expressly in Rev. Rul 2019-19. The IRS should provide additional guidance for IRA custodians and IRA trustees. One can expect the IRS to adopt very similar positions with respect to IRA distributions. The key determination is - did the person receive the TRA distribution check? The duty of the IRA custodian to withhold and prepare the Form 1099-R depends upon an actual distribution being received by a person in a given year (e.g. 2019). Unless an IRA owner or beneficiary has previously instructed not to have federal income tax withheld, the IRA custodian must withhold 10% of the distribution and can mail a check to the individual for the other 90%.