Pension Plan Fix-It Handbook

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GAO Report Asks IRS, DOL to Cooperate On Retirement Fund Rollovers

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A Government Accountability Office report issued earlier this year raised concerns about the rollover process for participants leaving employer-sponsored 401(k) plans. The report to Congress, "401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants," was based on an audit conducted from May 2011 to March 2013 (See May *Handbook* newsletter story.) Among its key findings:

- a lack of standardization of plan sponsor practices for plan-to-plan transfers exists;
- potential misunderstandings about ineligible rollovers may prevent plan sponsors from accepting transferred retirement savings from new hires;
- regulators should revisit the "archaic" process of issuing distribution checks to terminating participants who must then deposit them in a new plan, especially given current technological capabilities;
- more participant education is needed regarding potential rollover distribution choices and the choices' consequences; and
- disclosures need to be clearer to help participants understand any financial interest a service provider may have in making recommendations.

Background

Rollovers from qualified plans are the largest source of contributions to individual retirement accounts. With the shift in the United States to defined contribution plans, whose assets now total more than $3 trillion, there is a potential for continued flow of large amounts of retirement savings into IRAs.

Tip

The GAO report noted that:

"Approximately 95 percent of money contributed to traditional IRAs in 2008 was from rollovers, primarily from employer-sponsored retirement plans."[1]

The GAO findings are supported by a recent Employee Benefit Research Institute Issue Brief on rollovers that indicated that in 2011 "…almost 13 times the amount of dollars were added to IRAs through rollovers than from contributions."[2]

[1]In this case, employer-sponsored retirement plans included defined contribution and defined benefit plans. Investment Company Institute, The U.S. Retirement Market, Second Quarter 2012 (September 2012). http://www.ici.org/info/ret_12_q2_data.xls

[2]http://www.ebri.org/pdf/briefspdf/EBRI_IB_05-13.No386.IRAs.pdf

Decisions about how and where to invest retirement savings have enormous consequences. The GAO study found that participants, plan sponsors and financial institutions all need more education and guidance about this process.

The Distribution Process

Plan participants generally face four choices for their plan-sponsored retirement accounts when terminating employment:

1) Leave the account with the former employer (subject to the size of the account balance).

See *Rollovers*, p. 2

Rollovers (continued from p. 1)

2) Roll over the account balance to the new employer's plan, if the new employer's plan accepts rollovers.

3) Roll over the account balance to an IRA.

4) Cash out.

The GAO report found rolling account balances over to an IRA is often faster and easier than rolling that money over to the new employer's plan. Some plans impose waiting periods before a new hire can roll over existing 401(k) balances, but IRAs do not. Concerns about accepting ineligible rollovers have led plan sponsors to implement a verification process with the participants' accounts that can be complex and lengthy.

Many plans issue the distribution check to the participant who's changing jobs, requiring him or her to forward the funds to their new plan or IRA. This process leads to delays in investing the funds and can lead to participants, especially those relocating, misplacing checks. Often, rolling over to an IRA becomes the easiest and quickest option because many IRA providers will assist participants in the process. Many plan participants need help in understanding and completing the paperwork required to roll their retirement savings over to a new employer. Material in a distribution packet can exceed 15 pages at times. A standardized process could help simplify and speed up this distribution process, the report says.

In addition, the report said, industry experts interviewed said that plan sponsors do not have strong incentives to accept the assets of new participants and may not promote the option.

GAO said in the report that it is concerned that participants take the path of least resistance, without fully understanding consequences, such as:

- potentially higher fees for the participant. Staying in a qualified plan allows the participant to benefit from institutional share-class investing, while an IRA generally offers retail share-class investments that may cost more;
- lost ERISA protection when the retirement account balance is transferred to an IRA; and
- financial benefits enjoyed by the IRA service provider, and in some cases the service provider representative, from placing the participant's account balance with that IRA service provider.

Another concern raised in the report is that if the service provider is the same as the plan's recordkeeper, the participant may believe that the plan sponsor is actually endorsing the service provider as an IRA repository.

Bottom line: Comparing options and making investment choices with transferring 401(k) balances are complex.

Call for Action from IRS, DOL

GAO in the report made recommendations for both IRS and the U.S. Department of Labor, including urging DOL to finalize a joint definition of "fiduciary," which ultimately would affect the plan sponsor and the service provider.

Recall that DOL pulled its proposed fiduciary regulations (see November 2011 newsletter story), which would have included many individuals and activities not previously deemed to be fiduciaries or of a fiduciary nature.

IRS

The current federal tax Code notice for plan participants changing jobs does not mention the option of leaving funds in the plan after leaving the company or other important factors a participant should consider. In particular, the notice does not mention that IRA fees could be higher than employer-sponsored retirement plan fees. Lack of understanding about fees has been a critical focus of the new fee disclosure requirements for both plan sponsors and their service providers, but providing complete fee information during the rollover process is just as critical.

Currently, IRS requires that distribution information be provided within a specified period before distribution, but again, not at the time of distribution; such a requirement would be beneficial. Many plan sponsors and service providers do provide any information on rollovers at the time of the employee's departure.

The report recommends that IRS review the lack of standardization for the plan-to-plan rollover process, including some employer plan sponsors' refusal to accept rollovers. IRS and DOL should work together to communicate guidance to plan sponsors to help them avoid plan disqualification for accepting a rollover that may not be eligible. Finally, IRS should revise the rule that allows plans to send distribution checks directly to the participant, rather than to a new plan or service provider.

DOL

DOL provides valuable material on its website. However, many participants are not aware of these DOL resources. In addition, DOL does not reach out directly to plan sponsors or plan participants.

See *Rollovers*, p. 3

Rollovers (continued from p. 2)

The current process does not highlight for participants the financial interests of the service provider that motivate it to obtain rollover account balances for placement in their IRA offerings. Also in question is the fiduciary responsibility of service providers in making recommendations about their own funds (See Figure 4 in the GAO report for excerpts of real call-center conversations with participants). Requiring service providers to disclose to participants rolling over funds their financial interests (for example, fees) as well as the extent of their fiduciary responsibility would be beneficial.

The report recommends that DOL develop a concise summary of a participant's four main options (retain, roll over to an IRA, roll over to new employer plan or cash out) and the implications of each. GAO further recommends that DOL finalize its definition of plan fiduciary.

Plan Sponsors

Some plan sponsors' policies on accepting rollovers present obstacles to participants. As noted, plan sponsors are concerned with accepting ineligible plan rollovers. The GAO report notes that IRS and DOL should work together to make it easier for employer plans to accept rollovers. The report recommends restricting the practice of issuing a check to the participant that requires the participant to send the check to the new service provider. Ending this practice could help participants avoid misplacing these checks while shortening the rollover process.

Practical Implications for Sponsors

Retaining rollovers in the plan for terminated participants requires that the employer track addresses, and could add to recordkeeper fees. Because these fees often are allocated across all plan participants, this could result in active participants subsidizing the cost of the departed-participant accounts. But at the same time, the retained account balances maintain or increase plan assets, which ultimately could result in lower fees for all.

Although waiting periods imposed for rollovers were cited in the report as an obstacle, many employers have legitimate business reasons for setting waiting periods, especially in industries with high turnover. In this situation, clearly explaining the option to leave account balances with the current employer presents a more viable option for the participant.

In closing, DOL and IRS, in their responses to the GAO report, agreed with the need to improve the retirement rollover process. DOL reiterated its intent to issue this year new proposed rules regarding the definition of fiduciary, which surely will add clarity and possibly some new options for participants ready to roll over retirement assets.