POINTS TO REMEMBER

IRA Rollovers

By David Pratt*

"Roll over Beethoven and tell Tschaikowsky the news."—Chuck Berry (1956)

According to the Investment Company Institute, total U.S. retirement assets were $21.9 trillion as of September 30, 2013. The largest single component of that total was the $6.2 trillion held in individual retirement accounts (IRAs), an increase from $3.7 trillion in 2008 and $2.6 trillion in 2000. http://www.ici.org/research/stats/retirement/ret_13_q3. Most of the increase represents tax-free rollovers, of amounts previously held in employer-sponsored plans, rather than direct contributions by the individual account owner. The Employee Benefit Research Institute found that in 2011, rollover amounts were almost 13 times the amount of contributions. IRA Contribution Flows Dwarfed by Rollovers, June 6, 2013, www.ebri.org. A recent study by Cerulli Associates found that annual rollover contributions are expected to be $451 billion in 2017. Jill Cornfeld, Annual IRA Rollovers to Surpass $450B by 2017, Feb. 8, 2013, http://www.planadviser.com/Annual_IRA_Rollovers_to_Surpass_450B_by_2017.aspx.

Lump Sum Distribution Options

Defined benefit pension plans traditionally paid benefits in annuity form, and annuity payments may not be rolled over. I.R.C. § 402(c)(4). However, participants in defined contribution plans, and in an increasing number of private sector defined benefit plans, have the option of taking a lump sum distribution on termination of employment, at any age. A participant who receives a lump sum distribution typically has the following four options:

1. Leaving the money in the former employer's plan. Many employers do not want the trouble and expense of maintaining accounts for former employees and discourage use of this option, for instance by limiting investment choices, restricting the availability of future distributions or charging higher fees than to current employees.
2. Transferring the funds to a new employer's plan. Some plans do not accept rollovers or make rollovers difficult because of concerns that acceptance of a rollover from a plan that is not fully in compliance with the Code may taint their plans.
3. Transferring the funds, directly or indirectly, to the participant's IRA. A direct rollover is generally preferable as it avoids the 20% mandatory income tax withholding that would otherwise apply. I.R.C. § 3405(c).
4. Keeping the money and paying income tax on the amount distributed in the year of receipt plus, in most cases where the participant is under age 59½, a 10% additional income tax under section 72(t).

Advantages and Disadvantages of Rollovers

An IRA rollover has several advantages. It severs the tie with the former employer, gives the participant the greatest degree of control, and makes it possible for the participant to take irregular distributions or to stretch out distributions to the greatest extent allowed by the age 70½ minimum distribution rules. However, there are also significant disadvantages, which are often not fully understood by the participant. First, the participant is now responsible for the successful long-term investment of the funds, generally with no review of available options by a fiduciary. Second, the participant must avoid engaging in any prohibited transaction, as that would trigger immediate taxation of the entire account. I.R.C. § 408(e)(2). Figuring out how the prohibited transaction rules apply to IRAs is fiendishly difficult, and many IRA owners succumb to the siren calls of exotic investment vehicles (bull semen, anyone?). Third, the individual no longer has the benefit of the ERISA fiduciary responsibility rules, as many victims of Ponzi schemes discovered to their chagrin. Most cases have held that the duties of an IRA custodian are limited to those it accepted in its contract with the IRA owner, a contract almost always drafted by the custodian. Attempts by the DOL and the SEC to extend fiduciary rules to IRAs and broker-dealers are highly controversial and appear to be bogged down for the time being. Fourth, employer plans often offer lower fees, typically provide more transparent fee disclosures, and give better access to advice.

* Professor of Law, Albany Law School, Albany, NY.

Suggestions for Improvement

A March 2013 General Accountability Office report (GAO 13-30, *401(k) Plans—Labor and IRS Could Improve the Rollover Process for Participants*, http://www.gao.gov/assets/660/652881.pdf) found that rollover processes are inefficient, that IRAs are heavily marketed, and that participants are often given incomplete, misleading, or false information about IRA rollovers. In some cases, the advice was given by a party that had a direct financial interest in steering the participant to a particular IRA provider. The report recommended action by DOL and the Service, including (1) standard guidance for participants about distribution options and (2) guidance for plans about accepting rollovers that are later found not to be qualified. In a letter to the GAO, Assistant Secretary of Labor Phyllis Borzi said that, "We believe our work regarding the definition of fiduciary is key to addressing conflicted investment advice and related problems your report identifies." *See* Hazel Bradford, *401(k) rollover study triggers call for action*, Pensions & Investments, Apr. 15, 2013, http://www.pionline.com/article/20130415/PRINT/304159962/401k-rollover-study-triggers-call-for-action.

The Center for Retirement Research at Boston College issued a report on this topic in February 2013. Alicia H. Munnell, Anthony Webb & Francis M. Vitagliano, *Will Regulations to Reduce IRA Fees Work*?, http://crr.bc.edu/briefs/will-regulations-to-reduce-ira-fees-work/. Its recommendations included:

Making all rollover transactions subject to ERISA: "Such a change would mean that an adviser could recommend a rollover only when it was solely in the client's interests, as the adviser would be subject to the higher standard required of 401(k) fiduciaries."

Extending ERISA protections to all rollover IRAs: "The rationale is that rollover money has been accumulated in the employer plan arena, which is protected by ERISA's fiduciary standards and fee disclosure, and that the concern for protecting these funds is not lessened by their movement into another form of account."

Controlling Fees: "options include: establishing benchmarks for 401(k) fees; requiring reporting and benchmarks for IRA fees; requiring 401(k) plans to offer index funds; and eliminating high-cost, actively-managed funds."

The GAO report also suggests that plan fiduciaries may have duties relating to rollovers, particularly where the rollover advice comes from a provider of services to the ERISA plan, such as a record keeper. Plan participants are likely to assume that the advisor has been endorsed by the plan fiduciaries. In the absence of clear guidance, it may be prudent for plan fiduciaries to monitor the services and advice provided to participants in connection with plan distributions.

The Financial Industry Regulatory Authority (FINRA), which regulates broker-dealers, recently issued an investor alert, *The IRA Rollover: 10 Tips to Making a Sound Decision*, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/RetirementAccounts/P436001. In December 2013, FINRA issued Regulatory Notice 13-45, *Rollovers to Individual Retirement Accounts*, which notes that a recommendation to roll over plan assets to an IRA typically involves securities recommendations subject to FINRA rules regarding suitability, and that related marketing must be "fair, balanced and not misleading." https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p418695.pdf. FINRA released its 2014 regulatory and examination priorities on January 2, 2014, http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf, and the SEC released its examination priorities on January 9, 2014, http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf. Both sets of priorities include practices related to recommendations to roll over assets from an employer-sponsored plan to an IRA.

In its examination priorities, FINRA stated that it "shares the GAO's concerns that investors may be misled about the benefits of rolling over assets . . . to an IRA," and that it will evaluate securities recommendations to determine whether they comply with FINRA's suitability standards. The SEC's examination priorities indicate that it will focus on the practices of broker-dealers, as well as investment advisers, with respect to IRA rollovers. *See generally* John V. Ayanian, Lindsay B. Jackson, Daniel R. Kleinman & Michael B. Richman, *FINRA and SEC to Focus on IRA Rollover Practices in 2014*, Feb. 6, 2014, http://www.morganlewis.com/pubs/EB_IM_LF_FINRAandSECFocusOnIRARolloverPractices_06feb14?source=homepg.

Conclusion

What conclusions should we draw? First, a decision to make a rollover IRA should not be made lightly, wantonly or unadvisedly: the decision has very important ramifications for the individual's future financial security. Even a modest rollover by a young individual may feature largely when he or she comes to retire. Second, plan fiduciaries should consider taking steps to explain better the options available to a participant taking a distribution and to monitor the types and sources of advice he or she receives in connection with the distribution. Such precautions may help the participant make a better decision and may also protect the fiduciary against claims that it failed to satisfy its responsibilities under ERISA. ■