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PLAN DISTRIBUTIONS

Providing Enhanced Communications Regarding Eligible Rollover Distributions Beyond the Minimum Required Explanations

Decisions concerning rollovers of retirement plan distributions can be overwhelming, especially when they must be made in a short time frame. Plan participants in employer-sponsored retirement plans would benefit from receiving periodic, enhanced educational materials concerning eligible rollover distributions rather than in the short time before such a distribution decision must be made.

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Retirement investors are a special class of investor. Their retirement investments, if managed appropriately, should at least provide enough funds to cover their basic costs of living in their nonworking years. Successful achievement of the goal of retirement savings has underlying societal implications so that individual citizens can live in a dignified manner after a lifetime of work and avoid economic peril. The accumulation of retirement savings during the working years, however, is only part of the equation. As expressed by the Department of Labor (DOL) in the Preamble to the further proposed regulatory amendments to the definition of an investment advice fiduciary in the Retirement Security Rule: Definition of an Investment Advice Fiduciary, and as noted in prior DOL rulemaking on this issue, decisions by retirement investors to take a benefit distribution or engage in rollover transactions are among the most, if not the most, important financial decisions that plan participants, Individual Retirement Account (IRA) owners, and beneficiaries are called upon to make. [88 Fed. Reg. No. 212 (November 3, 2023) (2023 Guidance)]

As noted by the DOL in the 2023 Guidance, individuals, regardless of their financial literacy, have become increasingly responsible for their own retirement savings with the shift away from professionally managed workplace pension plans to participant-directed retirement plans such as 401(k) plans. While ERISA plan sponsors and fiduciaries must adhere to fiduciary standards in selecting and monitoring investments that are available to plan participants in participant-directed retirement plans, individuals are not necessarily provided with such fiduciary protections when rollover distribution recommendations are given to them by investment advice providers. The final outcome of the 2023 Guidance on the fiduciary rule for investment advice fiduciaries remains to be seen, including whether rollover recommendations would be considered fiduciary investment advice. Yet, aside from investment considerations for rollover distributions, there are many other issues surrounding rollover distributions that are not well understood by plan participants. This may be a reason why Section 324 of the SECURE 2.0 Act (under Division T the Consolidated Appropriations Act, 2023) requires that sample forms be issued by the Secretary of Treasury no later than January 1, 2025, to simplify and standardize the rollover process for direct rollovers to eligible retirement plans and transfers to IRAs. In light of these types of concerns, there are actions that plan sponsors and fiduciaries can take to further assist retirement plan participants and beneficiaries with eligible rollover distribution education well in advance of the time when such decisions must be made.

The Pew 2021 Survey

Retirement plan participants do not necessarily have a clear course of action with respect to the handling of their retirement accounts once they have retired. In a 2021 survey by The Pew Charitable Trusts (Pew) on Consumer Trends to Roll Over Workplace Savings into IRA Plans (Pew 2021 Survey), Pew questioned 536 currently retired workers and 589 full time workers ages 55 to 75 with at least $30,000 in retirement savings investment accounts including 401(k)s, IRAs, or other defined contribution retirement accounts, who were representative of roughly around the same numbers of men and women of similar educational backgrounds. The survey included a series of questions concerning how they planned to handle their retirement savings or what they had already done with their savings. The Pew 2021 Survey found that a quarter of those nearing retirement said they did not know what they planned to do with their retirement plan savings, more than a third said they planned to leave their savings in their current plan and take a periodic monthly withdrawal (where permissible), 16 percent thought they would roll over at least some of their savings into an IRA, 18 percent reported that they would annuitize a portion of their savings, and 4 percent said they would take a lump sum distribution.

Of those surveyed, at least 73 percent reported that they had considered leaving their savings in their current workplace retirement plan because they liked the investment options under the plan and 56 percent reported that it would also be convenient to do so. For those participants who considered a rollover to an IRA, the strongest motivating factor in this decision was the ability to have greater control over their investments. More than a third of workers mentioned their desire to consolidate accounts, while others cited a preference for the IRA investment options and gaining access to professional management and advice as reasons to roll savings into an IRA. Among the actual retirees surveyed, roughly half of retirees said that they had left at least some of their savings in their workplace plan when they retired and about 46 percent rolled at least some of their savings into an IRA.

Overall, the Pew 2021 Survey found that the fees associated with the different rollover options were not an overwhelming deciding factor. Although some survey respondents said that they would continue a rollover into an IRA with higher fees than their workplace plan, previous research by Pew showed that many people continue to struggle to fully understand their investment fees, where only 25 percent of workers in an earlier Pew survey said that they had read and understood the fee disclosure of their retirement account. [The Pew Charitable Trusts, "Many Workers Have Limited Understanding of Retirement Plan Fees" (2017)] In the Pew 2021 Survey, Pew noted that, while it is unclear why few of those who plan to roll over their retirement savings are concerned about fees, a possible explanation is that any potentially higher fees are perceived as worth the cost in order for the investor to have greater control over investments and access to investment advice. Yet, Pew observed that, if those nearing retirement and retirees are not fully aware of the fees associated with their current retirement plan, they may not take steps to avoid paying higher fees.

Given the fact that even small differences in fees can have large impacts over the accumulation of retirement savings, as well as lasting consequences throughout retirement, Pew recommended in its Pew 2021 Survey that:

1. Future research should more deeply explore the trade-offs between fees and the receipt of other services in rollover accounts;
2. Workers should be provided with more information to better understand the effects of fees on their retirement savings; and
3. Those nearing retirement should be provided with targeted education concerning the options related to their retirement savings accounts and rollovers.

Pew suggested policy changes to provide plan participants with enhanced reminders or illustrations concerning fees, especially when rolling over accounts to IRAs, creation of default options to maintain savings in a low-cost account after retirement unless a retiree chooses another option, and increased access to financial advice while avoiding unnecessary products and services, and fees, to better preserve retirement savings. Overall, Pew advocated for investors, employers, policymakers, and retirement plan designers to consider how to facilitate the transition from work to retirement to preserve as much savings as possible.

The Need for Enhanced Education on Eligible Rollover Distributions

As reflected in the Pew 2021 Survey, at least 25 percent of plan participants nearing retirement do not know what they plan to do with their retirement accounts in workplace retirement plans, and it is reasonable to conclude that this percentage would likely be much higher across a larger survey of plan participants. Yet, the time for taking a plan distribution might not always be as far off in the distance as the normal retirement age of 65. Plan participants may be faced with an involuntary separation from service over the course of their careers, a plan may be terminated unexpectedly due to a corporate transaction, or a participant may experience an untimely death, any of which could force retirement plan distribution decisions to be made. Plan participants, and their beneficiaries, are faced with complex decisions concerning the distribution of retirement savings accounts from employer-sponsored retirement plans, and educational materials should be made available periodically.

Plan sponsors and fiduciaries are familiar with the Special Tax Notice (402(f) Notice) that is provided to retirement plan participants and beneficiaries when they are eligible to take a plan distribution, such as upon separation from service, which explains the direct rollover rules, withholding rules when a distribution is not directly transferred to an eligible retirement plan, and the tax consequences of receiving a distribution. An eligible rollover distribution under Section 402(c)(4) of the Internal Revenue Code (Code) includes any qualified plan distribution, except for: (i) a distribution that is one of a series of substantially equal periodic payments of 10 years or more, or over the life of the employee or the joint lives of the employee and his or her designated beneficiary; (ii) a required minimum distribution; and (iii) a hardship distribution. Section 402(f) of the Code requires the plan administrator of a tax qualified plan under Section 401(a) of the Code to provide the written explanation described in Section 402(f)(1) of the Code to any recipient of an eligible rollover distribution defined under Section 402(c)(4) of the Code. This written explanation is also required to be provided for plans under Section 403(a) and 403(b) of the Code, and for governmental 457(b) plans under Section 457(e)(1)(A) of the Code. The 402(f) Notice must be provided to the plan distributee within a reasonable period of time (that is, no less than 30 days (subject to waiver by the participant to permit a faster payout) and no more than 180 days) before the date on which the distribution is made before making an eligible rollover distribution. The requirements of the 402(f) Notice can be satisfied by using the model safe harbor explanations set forth in IRS Notice 2018-74, which modified earlier IRS Notices and was modified by IRS Notice 2020-62, or by providing an explanation that is different from the safe harbor explanation so long as it includes the information required by Section 402(f) of the Code and is written in a manner designed to be easily understood.

The current model 402(f) Notices include further explanations on several issues, including types of retirement accounts that may accept a rollover, how to process a rollover distribution, the potential 10 percent early distribution tax if a rollover is not processed, special rules for after-tax contributions, loans and payments of employer stock, distributions from Roth accounts, rollovers to Roth IRAs, and beneficiary distributions. Plan administrators are not required to use these model explanations and should customize them to meet the plan's design, and also update any notice used for changes in the law. New sample rollover forms will be issued by the Secretary of Treasury no later than January 1, 2025, pursuant to the SECURE 2.0 Act, and these forms will need to be considered in making overall updates to existing plan distribution packages for the law changes.

Receiving the plan's 402(f) Notice in anticipation of making a distribution election may be the first time that many plan participants are exposed to this type of information. Prior to this time, they may have been familiar with the few sentences that appear in a summary plan description that described the retirement plan's distribution and rollover options upon a separation from service. Yet, many plan participants do not appreciate the complexities involved in their plan distribution decisions and there is not much time to digest the information when a 402(f) Notice is received in close proximity to a distribution date. Provision of a 402(f) Notice also does not comprehensively explain to a plan participant or beneficiary the evolving plan distribution landscape around auto-portability, and the Retirement Savings Lost and Found to be created under Section 303 of the SECURE 2.0 Act, nor substantively connect with other concepts such as small balance cash-outs and automatic IRA rollover issues, required minimum distributions that are ineligible for rollover, or fee disclosure considerations.

What Can Plan Sponsors and Fiduciaries Do?

Plan sponsors and fiduciaries should consider developing plan distribution communications that can be available to plan participants and beneficiaries at any time for their review and consideration. In effect, they could serve as a comprehensive resource for plan participants to remind them that, while they are managing their savings goals in their employer-sponsored retirement plan, they also should be thinking about how to manage their ultimate plan distribution. These communications might be made available in an educational packet posted on a plan intranet site. The goal would be to provide enhanced education well in advance of the time that a plan participant or beneficiary would need to make a decision about a plan distribution, while also still providing the required disclosures that may be part of this enhanced package in accordance with their respective due dates. This type of package would also serve to connect the dots between the other moving parts often involved in plan distribution decisions. These educational materials could provide simplified explanations concerning such issues as:

- What is and is not an eligible rollover distribution and an eligible retirement plan;
- Differences between a sixty-day rollover and a direct rollover and the withholding implications of choosing the former;
- Special considerations regarding rollovers and Roth accounts, after-tax accounts, employer stock issues, outstanding plan loans, and distributions from special investment options;
- Reminders for participants to consider issues related to initiating rollovers from prior employer-sponsored plans to a current plan, and weighing pros and cons related to leaving accounts in the current plan when separating from service;
- How to review and evaluate plan fee disclosures and understanding fees for terminated plan participants;
- Explanation of any plan auto-portability provisions;
- Overview of automatic IRA rollover provisions for small balance cash-outs;
- Explanation regarding the new Retirement Savings Lost and Found database and related considerations such as the plan's reporting to the database of deferred vested participants with benefits under the plan, participants with small balance cash-outs that were automatically rolled to an IRA, and participants with deferred annuities and annuity provider information;
- Information regarding any investment advice services available under the plan;
- Explanation of any plan annuity distribution options for consideration;
- Explanation of required minimum distributions;
- Considerations for participants who do not maintain updated contact information with the plan, such as consequences for missing participants and uncashed benefit checks;
- Rules regarding eligible rollover distributions for non-spouse beneficiaries being directed only to an IRA;

- Importance of maintaining updated beneficiary designations;
- Reminder of the plan sponsor's ability to terminate the retirement plan at any time, which would require the participant to obtain a distribution from the plan; and
- A statement that plan participants and beneficiaries should consult with their own professional tax and/or investment advisors before taking a distribution from the plan, and links to other resources, such as available IRS publications regarding federal tax treatment of payments from employer plans.

Plan service providers may be able to assist plan sponsors and fiduciaries in organizing the educational materials (and required disclosures) that are already available to plan participants into a comprehensive, coordinated packet to address these issues, and any other issues that plan sponsors and fiduciaries have found to be of concern for their plan participants. Often, these types of materials can also be packaged to speak in a tailored fashion to the various demographics of plan participants. Any existing materials should also be reviewed and updated for changes in applicable law.

Concluding Thoughts

There is an ongoing need to assist plan participants and beneficiaries in understanding the various rules concerning employee benefit plans in general. Many initiatives have been undertaken to simplify disclosures on a myriad of issues. For the retirement plan participant/investor, there is also a need to enhance their understanding of the various moving parts involved in plan distributions and rollovers, which are becoming increasingly complex. Plan sponsors and fiduciaries that provide their plan participants with comprehensive, coordinated educational materials concerning eligible rollover distributions and the interplay of related considerations will certainly act in the best interest of their plan participants and beneficiaries. ■