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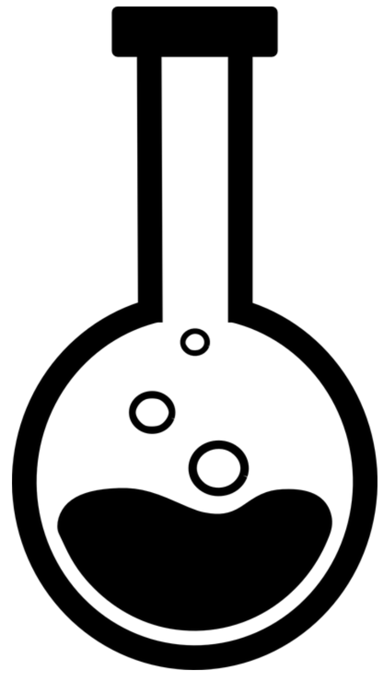
A MEASURABLE DIFFERENCE™

SDBAS: UNDESIRED ELEMENTS FOR PLAN FIDUCIARIES

While the correct formula is crucial for successful chemical reactions, the same is true for healthy retirement plans.



One of my favorite memories from school was when my chemistry lab partner caught our sink on fire and the teacher had to put it out with a fire extinguisher….good times! Chemistry courses teach that desired outcomes can be drastically impacted by adding or changing a single element. Take water for example, which has the chemical compound H_2O. If one additional part of Oxygen is added to water it becomes hydrogen peroxide, which would not be nearly as refreshing as a cold water on a hot day. That being said, having the proper elements in place is necessary to formulate desired results.

Retirement plans also consist of a formula that helps to create successful outcomes from a fiduciary and participant standpoint. The essential elements in producing this formula are working with a nationally recognized recordkeeping platform and highly credentialed third party administrator (TPA). However, some retirement plans are utilizing Self-Directed Brokerage Accounts (SDBAs) as the primary investment vehicle for plan participants but using this element instead of a recordkeeping platform is potentially formulating undesired results. There are numerous fiduciary and participant related considerations that typically outweigh the investment flexibility benefit that SDBAs offer. These potential issues coupled with the recent ***fiduciary regulations,*** which broadens the definition of a fiduciary, have many advisors moving these accounts to a more traditional recordkeeper and TPA plan arrangement. Here are some of the more prominent considerations motivating the shift away from SDBAs.

Fiduciary Concerns for Plan Sponsors and Advisors:

One of the primary challenges of operating a retirement plan for the exclusive benefit of participants is mitigating the liability for all parties involved. The new fiduciary regulations will make this an even bigger point of contention for retirement plan advisors. There are various systems and processes that could be put in place to help insulate plan sponsors and advisors when utilizing a TPA in tandem with a nationally recognized retirement plan platform; however, brokerage accounts do not have the ability to offer the same protections. This creates more risk for plan fiduciaries and can inadvertently make advisors fiduciaries as well. Here are some of the most notable fiduciary concerns when utilizing SDBAs:

- As with any fiduciary related decision (incorporating SDBAs is a fiduciary decision) a validation process must be conducted to show prudency of action taken. This would incorporate vetting procedures of service providers considered, fee structure comparatives, and services being offered.
- Another fiduciary consideration is the investment sophistication of the plan participants. Opening the door to the investment universe could have drastic consequences as there are no guardrails to keep participants from making uninformed investment decisions. This arrangement also has the potential for prohibited transactions to be conducted (such as options - shorting a stock, naked short puts, naked short calls, etc.), which is a huge risk for both plan participants and fiduciaries.
- Providing investment advice to plan participants makes an advisor a plan fiduciary. Considering all of the investment options available (not just a core mutual fund line up, which is typically utilized in most retirement plans) it would be very difficult, if not impossible, for the advisor to not be offering advice.
- Compliance with 404(a)(5) and 408(b)(2) is often very cumbersome and difficult to achieve.

- 404(c) compliance to help mitigate fiduciary liability in regard to the investments is generally not obtainable.
- The DOL has a heightened sense of scrutiny and focus on the usage of brokerage accounts.

Due to the new fiduciary rule, the desire for more fiduciary protections, additional scrutiny from the DOL, and the lack of investment sophistication by most plan participants, many SDBAs are now transitioning to a more traditional recordkeeper and TPA service model.

Taxation, Fees, and Deductibility for Participants*:

Aside from the aforementioned fiduciary concerns related to SDBAs, there are also potential disadvantages in regard to fees, taxation, and deductibility for plan participants. Listed below are some nuances in relation to using SDBAs and traditional taxable brokerage accounts.

- Investment management fees charged directly to the SDBA are not tax deductible, where trading investments in a traditional brokerage account are deductible from your taxable income. These expenses include commissions and flat fees for trades. These fees can drastically erode earnings and assets within SDBAs.
- Investment losses for traditional brokerage accounts can be deducted (up to $3,000 in a given year) and carried forward to subsequent years if in excess of $3,000; however, investment loss is not deductible for SDBAs.
- Assets within an SDBA are contributed tax deferred, grow tax deferred, and are distributed as normal income at retirement, which in some cases could range from 10-40%. Assets related to a traditional brokerage account are contributed after tax and will not have tax implications until a gain or loss is realized, but the cost basis is not taxable as it was taxed prior to going into the brokerage account. If investments in the account are held for more than 12 months, the long-term gain taxation upon liquidation can range anywhere from 0-20%. Again, only the gains are taxed as the cost basis was taxed prior to going into the traditional brokerage account.

**For more information on the tax content mentioned in this article, please consult a qualified tax professional.*

A significantly important aspect to these considerations is that many of the retirement plan participants utilizing SDBAs are highly compensated employees. Deductibility of fees and losses coupled with the taxation structure of assets when distributed is a major component for tax planning purposes and should be vetted very carefully. In most circumstances it would be more beneficial to maximize tax deductible contributions within the core mutual fund holdings of a traditional retirement plan arrangement (TPA and recordkeeper) and invest after-tax money in a standard brokerage account to gain the benefits and flexibility of deductions.If a retirement plan currently utilizes SDBAs, the formula can be reworked by transitioning the SDBAs to an unbundled recordkeeping platform and TPA to help alleviate some of the potential issues and burdens.

Here are some key points to consider when transitioning from SDBAs to a recordkeeping platform:

- <u>Ease of Conversion</u> - Make sure the new recordkeeper and TPA have a strong working relationship along with the right people and processes in place to make the transition go as smooth as possible.
- <u>Plan Document Analysis</u> - This is a great time to review the plan document. This includes reviewing the goals and objectives of the plan sponsor, evaluating employer contribution allocation concepts, creating tax efficient strategies for business owners, and enhancing participant retirement readiness. Make sure your TPA partner of choice has the ability to review these concepts and is providing consultation on how to best optimize the plan design.

- Assurance of Current and Ongoing Plan Compliance - It is vitally important to make sure the administration service provider has highly credentialed (ERPA, QPA, QKA, APA, APR, CBC, GBA, ARPCS, CRPS, etc.) consultants available to not only verify that the retirement plan is currently operationally compliant, but also provides ongoing consulting as well.
- Interim Valuation – Moving from SDBAs to a recordkeeping platform will require an interim valuation to be prepared. Plan sponsors will need to know that services will be conducted during the transition.

As one can see, there is a litany of potential issues when utilizing SDBAs in lieu of using a more traditional TPA and recordkeeping platform approach. Restructuring the formula can help reduce fiduciary risk, increase plan efficiency for the plan sponsor, and offer a more effective investment vehicle for plan participants to save for retirement.

Sources: Turbotax-Intuit & Finacuity

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