Board Report 19-21

Date: June 18, 2019

To: Board of Deferred Compensation Administration (Board)

From: Staff

Subject: Deemed Individual Retirement Account (IRA) Design Features

Recommendation:

That the Board (a) receive and file staff's report and analysis regarding Deemed IRA design features; and (b) direct staff, working with Board Counsel and outside tax counsel, to develop a detailed set of recommended Deemed IRA design features for consideration by the Board.

Discussion:

A. Background

At its **January 16, 2018** meeting, the Board reviewed Board Report 18-04, which identified certain strategic initiatives for the DCP. Among these initiatives was a review of the merits and feasibility of adding a "side car" or Deemed IRA account option to the City's DCP. At the **April 17, 2018** meeting, staff provided the Board a general overview of the regulatory requirements and considerations as well as capabilities of the Third-Party Administrator (TPA), Voya, to offer a Deemed IRA in Board Report 18-16 (**Attachment A**). The Board subsequently directed staff to work with the City Attorney and outside tax counsel to conduct a full review of the regulatory requirements and implications of offering a Deemed IRA and develop recommendations for Board action. Staff has reviewed the Deemed IRA topic with Board counsel. Given its complexity, in this report staff is initially bringing forward certain broad considerations regarding Deemed IRA design features for discussion with, and direction from, the Board before proceeding to develop a final set of recommended design features that would be more fully vetted by Board counsel and outside tax counsel.

B. Review of Deemed IRA Features

A Deemed IRA is a type of IRA that is offered alongside an employer's existing tax-qualified retirement plan. A plan sponsor has the option of offering a Traditional IRA, Roth IRA, or both. IRAs have some unique features that are not shared with Internal Revenue Code (IRC) Section

457 plans. Following is a brief review of Traditional and Roth IRAs as they could be offered within the City's DCP. For additional information regarding the unique features and characteristics of Traditional and Roth IRAs, please see **Attachment B** to this report.

- **Traditional IRA Option:** The Board could design a DCP Deemed IRA to include a Traditional IRA. A Traditional IRA may contain a mix of tax-deductible and non-tax-deductible contributions. A Traditional IRA may have both types of contributions because there are income threshold limits for determining whether a Traditional IRA contribution can be tax deductible. For example, the regular IRA limit in 2019 is $6,000. A person who only qualifies for a $3,000 deduction may still decide to contribute the full $6,000. In this instance, their IRA will receive $3,000 in tax-deductible and $3,000 in non-tax-deductible contributions. However, recordkeepers do not track or report on cost basis (a contribution's deductibility) in an IRA. Tracking cost basis in a Deemed/Traditional IRA is exclusively the responsibility of the IRA owner/participant, whether they take a distribution or directly roll over the money. Per the 1099-R instructions, with the exception of earnings on the distribution of an excess contribution to the IRA, distributions from a Traditional IRA are always reported by the recordkeeper as "taxable amount unknown."

- **Roth IRA Option:** The Board could design a DCP Deemed IRA to include a Roth IRA. Roth contributions consist entirely of after-tax dollars not subject to taxation upon withdrawal. Creating a Deemed Roth IRA would further allow participants to consolidate other Roth IRA assets within the City's DCP. Presently, participants cannot roll over a Roth IRA into the City's DCP because the IRC does not permit rollovers from Roth IRAs to Roth 457 plans. However, with the addition of a Deemed Roth IRA, participants could roll over outside Roth IRA amounts to the City's DCP.

C. Benefits of Offering a DCP IRA

The addition of a Deemed IRA account option could provide DCP participants with a number of benefits that are currently unavailable through an IRC Section 457 account alone:

- **Retirement Saving Option Beyond the 457 Limit:** Participants could make contributions to a DCP IRA in excess of the normal IRC 457 contribution limits. The current IRA contribution limit is $6,000 for individuals under age 50 and $7,000 for individuals age 50 and older. The limit is for total combined IRA contributions for the year. Participants who are presently contributing to the City's DCP at the applicable maximum limit (approximately 8% of the active member population) would have a new and convenient means of directing additional savings into the City's DCP.

- **Making Lower-Cost DCP Funds More Widely Accessible:** By adding Deemed IRA accounts to the DCP, participants would benefit by being able to invest their Deemed IRA funds in any of the core funds already available through the DCP. Currently, if a DCP participant opens an IRA outside the City, they will likely have to pay higher retail pricing for the IRA's investment options as opposed to the DCP's low-cost institutional funds. After reviewing closely with Voya, it appears preferable to, at least initially, exclude the "Self-Directed Brokerage Option" (SDBO) in order to reduce administrative complexity and participant confusion. Currently, participants must open separate SDBO accounts for pre-tax and Roth funds. If a participant wished to invest Traditional and Roth IRA funds in the SDBO, they would be required to open an additional two accounts. Managing more than two accounts (pre-tax and Roth) could present administrative issues and would present a likely challenging and confusing participant experience.

- **Expanded Savings Versatility:** Participants can make contributions to a DCP Deemed IRA while still working or after leaving City service. As long as a participant receives taxable compensation, even after leaving City service, he or she is eligible to contribute to a Traditional IRA until age 70½. There is no age limit for making contributions to a Roth IRA. In addition, the Board has the option of allowing retired participants or even non-participants to contribute to the DCP Deemed IRA. Many retired or soon-to-retire participants have expressed to staff or local counselors that they would like to be able to continue adding to their accounts in retirement. The Deemed IRA would provide them that option. It would also support the Board's asset retention goals by reducing the incentive to open up new IRAs outside the City's DCP, which in turn might encourage them to roll out their 457 account to an outside IRA.

- **Withdrawal Flexibility:** Unlike a defined contribution plan, participants would be able to withdraw funds from the City's Deemed IRA while still employed with the City. The Traditional IRA would be subject to a 10% penalty for participants withdrawing before age 59½. Participants are able to withdraw Roth IRA contributions while working without a 10% penalty once they are over 59½ years old and provided the Roth IRA has been established for five or more years.

- **Spousal IRA:** The Board could include a Spousal IRA option which allows the employee participant to make a contribution to an IRA in the name of a non-working spouse. This means that a married couple could establish two IRAs and contribute to each up to the applicable IRA contribution limit. Contributions would be subject to applicable earnings limits. Married couples could thus more fully take advantage of the low-cost investment options through the DCP. Pursuant to IRC regulations: (1) the City employee/former employee must have established the DCP Deemed IRA account in order to establish the Spousal IRA; (2) spousal accounts must be established prior to the employee's death; (3) the participant and spouse must file a joint tax return; and (4) the spousal IRA is not co-owned; it's in the name of, and owned by, the spouse.

D. Governmental Plans Deemed IRA Landscape

Wendy Young-Carter, the Board's consultant with Segal Consulting, has previously indicated that few governmental plans have adopted Deemed IRAs, which may be due to the additional administrative and communications responsibilities associated with doing so. In researching Deemed IRAs, staff identified the following public sector plans currently providing the option:

- City of New York
- State of Kentucky
- Municipal Employees' Retirement System (MERS) of Michigan
- Sacramento Metropolitan Fire District (SMFD)

Staff reached out to each of these plans and was able to obtain Deemed IRA participation data from plans regarding their current level of Deemed IRA assets and member participation/utilization. These metrics are indicated in the following table.

Plan	Deemed IRA Utilization	Total Deemed IRA Assets	Overall Members In Retirement System
City of New York	4,558	$328 Million	141,179
Kentucky	5,911	$67 Million	89,716
MERS	35	$46,076	113,401
SMFD	13	$1.346 million	489

Additionally, the Wyoming Retirement System (WRS) is currently in the process of implementing a Deemed IRA option with a planned implementation date of January 1, 2020.

Staff, in speaking with representatives of public sector plans that offer a Deemed IRA, found general agreement regarding the valuable benefits attributed to offering participants a Deemed IRA option. Specifically, they noted the benefits of being able to consolidate retirement assets and the ability to contribute more towards retirement. The State of Kentucky was reluctant to recommend implementation of Deemed IRA accounts due to the administrative burden; however, they noted that most of the hardship is due to funding the accounts via payroll deduction. They were more positive toward the notion of only funding accounts via check.

E. TPA Capabilities

As previously reported to the Board, the DCP's TPA, Voya, confirmed that although they do not have any current clients that offer a Deemed IRA, they are fully capable of administering one for the City. Additionally, Voya was recently selected as the TPA for the City of New York's Deferred Compensation Plan. In that capacity, Voya will administer the City of New York's Deemed IRA program. Voya's capabilities related to Deemed IRAs are as follows:

- Administer both Traditional IRA and Roth IRA accounts
- Maintain separate recordkeeping for multiple IRA accounts held by a single participant
- Administer and accept rollovers from external IRAs
- Accept contributions via payroll deduction or via check
- Maintain IRA assets in either a single trust with 457 assets or a separate trust

While Voya is able to administer IRA contributions via payroll deduction, staff would not recommend doing so as part of a final Deemed IRA plan design. Implementing a payroll deduction feature would require additional programming within the City and DWP payroll systems at a time when the City is preparing to replace its payroll system. Additionally, administering Deemed IRA payroll contributions would add a significant layer of administrative complexity and oversight responsibility. Finally, generally when an individual opens an IRA on a retail basis, writing a check to the IRA administrator is a common way of funding it.

F. Regulatory Requirements and Considerations

As previously reported to the Board, staff's research determined that Deemed IRA accounts must meet the requirements under IRC Section 408 and related U.S. Treasury Department regulations (published July 2004). Pursuant to these regulations, the trustee or custodian of an individual retirement account must be a bank or another entity that has received approval from the Internal Revenue Service (IRS) to serve as a nonbank trustee or nonbank custodian. Furthermore, under the IRS regulations, Deemed IRAs may be held in: (a) separate individual trusts; (b) a single trust separate from the trust for the employer plan; or (c) a single trust that includes the employer plan.

Using a separate trust is preferable. If a single trust is used and the Deemed IRA is for any reason found to be noncompliant with Treasury Department regulations, the 457 plan could be dissolved in addition to the Deemed IRA. Implementing separate trusts for the Deemed IRA and the 457 plan would protect the 457 plan if there ever were a regulatory issue with the Deemed IRA.

In December of 2008, the Board sought and obtained a modification to Los Angeles Administrative Code Division 4, Chapter 14, adding a new Section 4.1411 providing the DCP with the authority to administer a Deemed IRA. The rules and operational requirements for offering a Deemed IRA, however, require amendments to the City's Plan Document.

G. Summary and Next Steps

Pending input from the Board regarding certain design feature options identified in this report, staff recommends that the Board direct staff, working with Board Counsel and outside tax counsel, to develop a detailed set of recommended Deemed IRA design features for consideration by the Board. At a high level, these design features would tentatively include:

- Offering both Traditional and Roth IRA accounts
- Offering Traditional and Roth Spousal IRA accounts
- Requiring contributions via check rather than payroll deduction
- Providing that Deemed IRA eligibility include anyone who is a current or former DCP-eligible employee
- Creating a dedicated trust for the exclusive use of Deemed IRA accounts

Adding a Deemed IRA option to the DCP would benefit DCP participants as it would provide a means to contribute more towards retirement. Further, it would support the Board's asset retention goals as participants are provided with additional savings options through the DCP that makes it more attractive as a home for all of their retirement savings.

Submitted by: ______________________
Daniel Powell

Reviewed by: ______________________
Isaias Cantu

Approved by: ______________________
Steven Montagna

Attachment A

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN

BOARD REPORT 18-16

Date: April 17, 2018

To: Board of Deferred Compensation Administration

From: Staff

Subject: Deemed IRA

Recommendation:
That the Board of Deferred Compensation Administration direct staff to work with the City Attorney and outside tax counsel to conduct a full review of the regulatory requirements and implications of offering a Deemed IRA and develop recommendations for Board action.

Discussion:

A. Background

At the Board's March 2017 meeting, staff presented information and sought direction from the Board regarding the potential for offering a Deemed Individual Retirement Account (IRA) option to the City's Deferred Compensation Plan (the Plan). The Board indicated its interest but agreed with staff that the matter should be deferred until after the conclusion of the change in the Plan's Third-Party Administrator (TPA).

At its meeting held on January 16, 2018, the Board reviewed Board Report 18-04, which identified certain strategic initiatives for the Plan for 2018. Among these initiatives was a review of the merits and feasibility of adding a Deemed IRA to the City's Plan.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") amended Section 408(q) of the Internal Revenue Code (IRC) to allow Plan sponsors to issue Deemed IRAs alongside their defined contribution plans. Some of the benefits of offering a Deemed IRA include providing competitive investment management fees, familiar and plan-vetted investment choices, and an additional contribution option for those who are already contributing the maximum amount under IRC Section 457 limits. Both Traditional and Roth IRAs can be established. Although presently participants can roll in fully pre-tax Traditional IRAs to the City's Plan, neither a Roth IRA, nor a Traditional IRA with a mixture of pre-tax and after-tax dollars, can be rolled in to the Plan. A summary overview of the benefits, features, and considerations of offering Deemed IRAs is provided as **Attachment A**.

B. Regulatory Requirements and Considerations

Staff's research determined that Deemed IRA accounts must meet the requirements under IRC Section 408 and related U.S. Treasury Department regulations (published July 2004). Pursuant to these regulations, the trustee or custodian of an individual retirement account must be a bank or another entity that has received approval from the Internal Revenue Service (IRS) to serve as a nonbank trustee or nonbank custodian. Furthermore, under the IRS regulations, Deemed IRAs may be held in: (a) separate individual trusts; (b) a single trust separate from the trust for the employer plan; or (c) a single trust that includes the employer plan.

Wendy Young-Carter, the Plan's consultant from Segal Consulting, indicated that few governmental Plans have adopted Deemed IRAs, primarily because of the additional administrative and communications responsibilities associated with doing so. Some exceptions include the State of Kentucky, New York City Deferred Compensation Plan (NYCDCP), and the Sacramento Metropolitan Fire District.

In December of 2008, the Board sought and obtained a modification to Los Angeles Administrative Code Division 4, Chapter 14, adding a new Section 4.1411 providing the Plan with the authority to administer a Deemed IRA. The rules and operational requirements for offering a Deemed IRA, however, require amendments to the City's Plan Document.

C. TPA Capabilities

The Plan's TPA, Voya Financial (Voya) confirmed that although they do not have any current clients that offer a Deemed IRA, they are fully capable of administering one for the City, and can:

1) Offer a Traditional IRA and/or Roth IRA option
2) Maintain separate recordkeeping for IRA accounts
3) Administer and accept rollovers to and from other IRAs
4) Accept contributions via payroll deduction or via check (although the latter approach may be preferable on the part of the City due to the administrative challenges and burdens involved with establishing payroll deductions)
5) Maintain IRA assets in either a single or separate trust (which would involve either an amendment to the current trust agreement or a creation of a new trust agreement between the City and Voya)

D. Next Step

The next step would involve conducting a more thorough legal review of the regulatory requirements and implications. Staff therefore recommends that the Board direct staff to work with the City Attorney and outside tax counsel to conduct a full review of the regulatory requirements and implications of offering a Deemed IRA and develop recommendations for Board action.

Submitted by: ______________________________
Matthew Vong

Approved by: ______________________________
Steven Montagna

Attachment B

CITY OF Los Angeles
DEFERRED COMPENSATION PLAN (DCP)

Deemed Individual Retirement Account (IRA) Overview

June 18, 2019

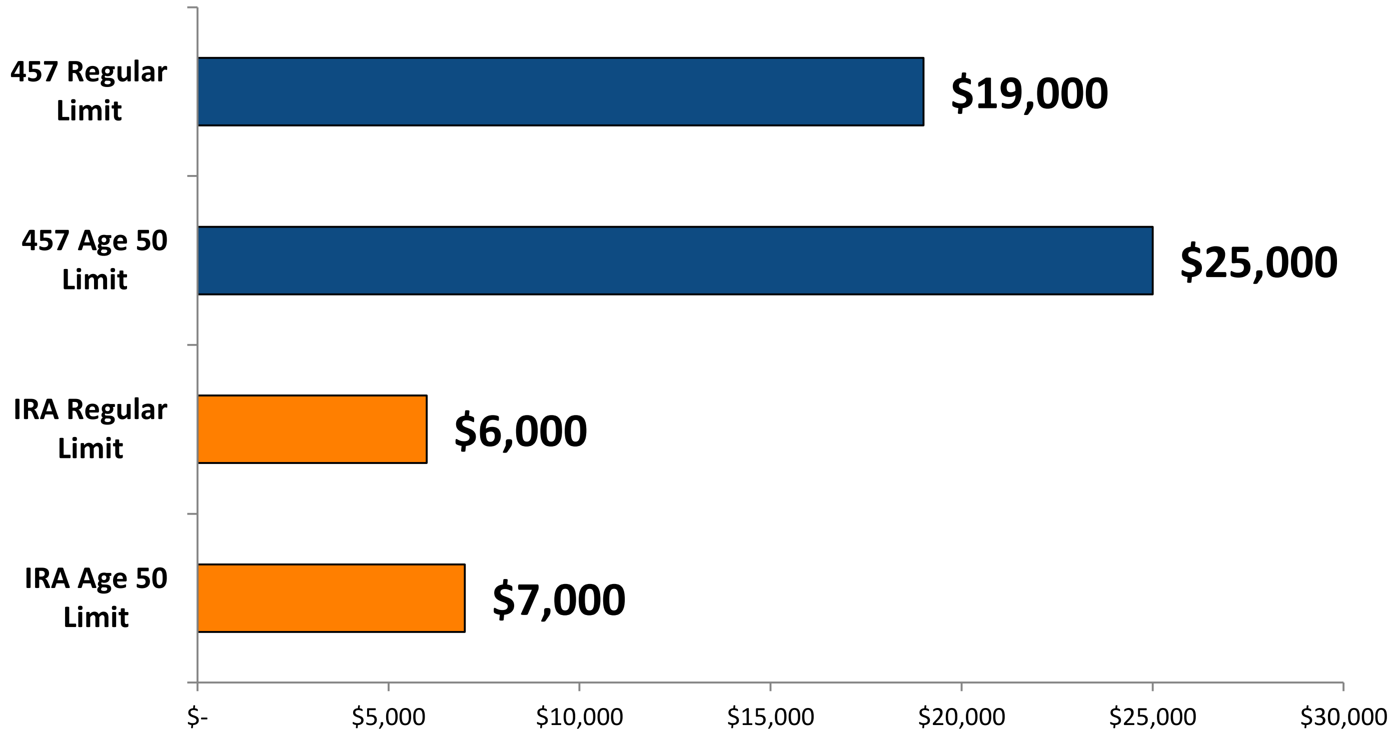
IRAs vs. 457 Plans

	IRAs	457 Plan
Are spousal contributions permitted?	Yes, as long as the couple files a joint return and the account is established before the employee's death.	No.
Eligible for Loans	No.	Yes. Loans up to 50% of vested account balance or $50,000 (whichever is less) are allowed. The balance of the loan must be repaid within five years unless designated as part of purchase of primary residence, in which case repayment is up to fifteen years.
Distribution Restrictions	It depends on the type of IRA. Traditional IRAs: Withdrawals before age 59 ½ include a 10% penalty. Age 59½ to 70½ no restrictions or penalties. Age 70½ and above require an annual Required Minimum Distribution (RMD). Certain exceptions exist for hardships. Roth IRAs: After the 5-year age requirement is met, withdrawals can be taken out tax-free.	No.
Is there a minimum distribution amount for each?	No.	Non-active City employees under the age of 70½ can take out any amount. Non-active City employees older than 70½ years of age must take an annual RMD.
What are the mandatory withholding amounts?	10%	20%
How long does a plan sponsor have to make voluntary corrections?	None. The IRA ceases to be deemed an IRA at the time of the disqualifying event.	Until the first day of the plan year that beings more than 180 days after notification by IRS. Self-correction is also an option.

Traditional vs. Roth IRAs

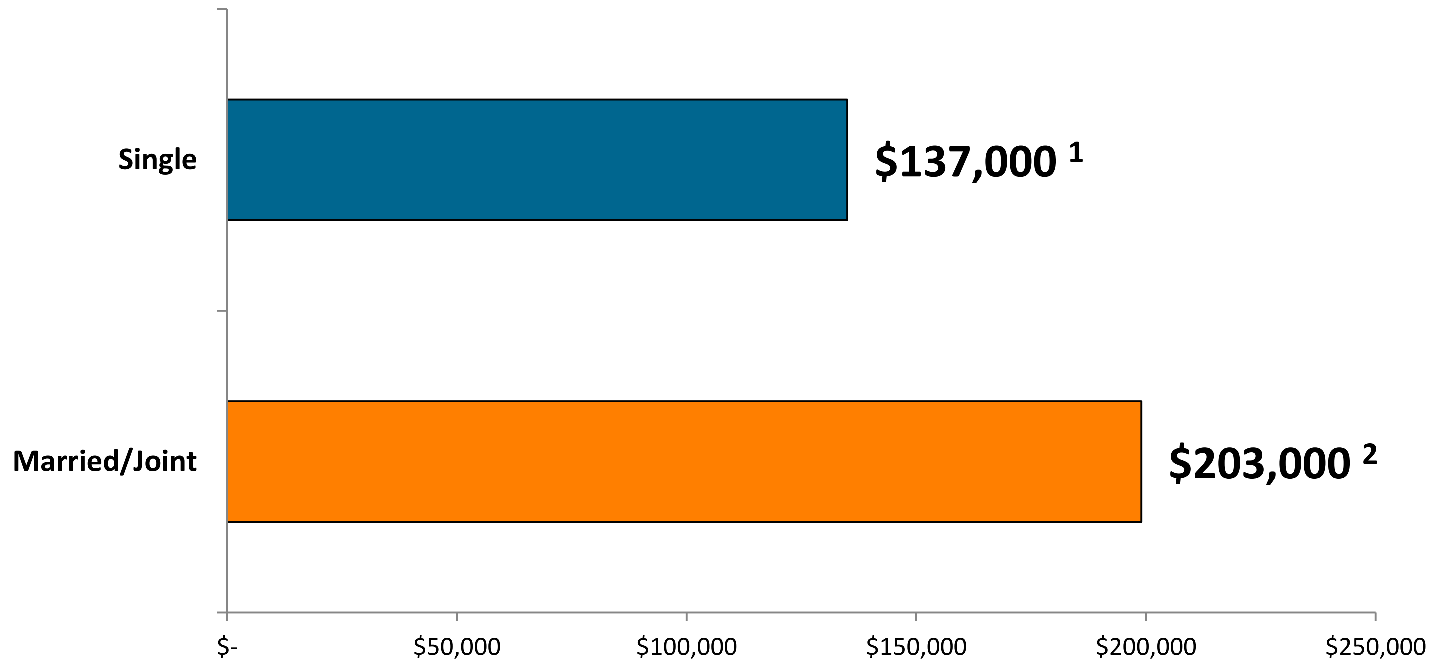
	Traditional IRA	Roth IRA
Maximum Yearly Contribution (2019)	If age < 50: \$6,000 If age > 50: \$7,000	If age < 50: \$6,000 If age > 50: \$7,000
Are there income-based limits?	If you have an income over a certain threshold, you can still contribute but your contributions won't be tax-deductible. See page 6 for more.	Yes, your income must be below the IRS threshold. See page 5 for more.
Is there an age restriction on contributions?	Yes. You cannot make contributions beginning with the year you reach age 70½.	No.
Annual contribution deadline	Tax-filing deadline for the year (not including extensions).	Tax-filing deadline for the year (not including extensions).
Tax Advantage	Traditional IRA contributions may be tax-deductible on both state and federal tax returns for the year you make the contribution depending on the taxpayer's income, tax-filing status, and other factors. Traditional IRAs can hold a mix of tax-deductible and non-tax-deductible funds. Contributions made that aren't eligible for tax-deductibility still benefit from deferred taxation on investment earnings.	Roth IRAs provide no tax break for contributions, but earnings and withdrawals are generally tax-free.
Are there required minimum distributions during my lifetime?	Yes. Distributions must begin by April 1st of the year immediately after you reach age 70½.	No. Distributions are not required during your lifetime.
Is there federal income tax on distributions?	Yes, to the extent that a distribution represents deductible contributions and investment earnings.	Yes. The penalty applies to the earnings portions if you are under age 59½ and do not qualify for an exception.
Do beneficiaries pay income tax on distributions after the IRA owner's death?	Yes, to the extent that a distribution represents deductible contributions and investment earnings.	Generally, no, as long as the five-year aging requirement is met.

457 & IRA Contribution Limits



Roth IRA Earnings Limits on Contributions

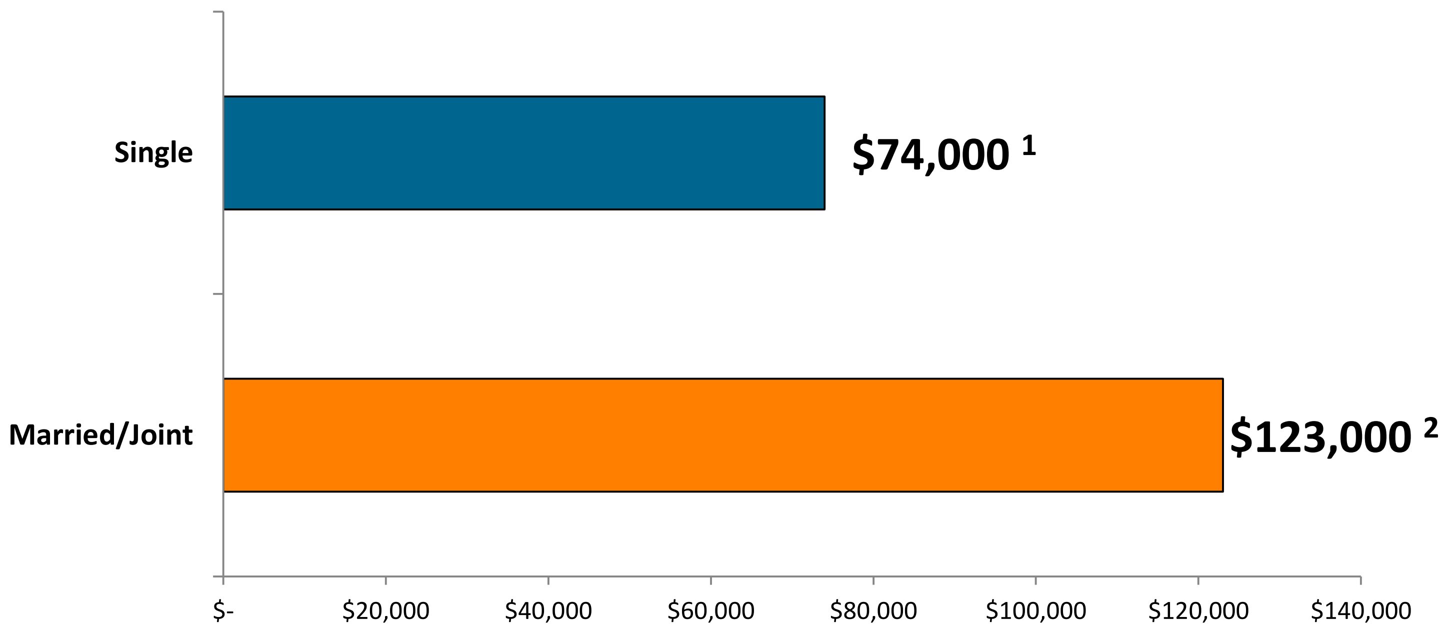
Contribution limitations apply based on Adjusted Gross Income (AGI)



[1] Contribution limit begins to phase out starting at modified AGI of $122,000
[2] Contribution limit begins to phase out starting at modified AGI of $193,000

Traditional IRA
Deductibility Limits on Contributions

No income limit but deductibility of contribution limited to modified AGI



[1] Partial deduction for modified AGI > $64,000 but < 74,000
[2] Partial deduction for modified AGI > $103,000 but < 123,000