Board Report 20-45

Date: December 15, 2020

To: Board of Deferred Compensation Administration

From: Staff

Subject: Deemed IRA Investment Menu

Recommendation:

That the Board of Deferred Compensation Administration (Board) direct the Investments Committee to work with staff and the Deferred Compensation Plan (DCP) investment consultant to develop options and considerations for a potential alternative investment menu design for the DCP Deemed IRA.

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 “sidecar” or Deemed Individual Retirement Account (IRA) account option to the City’s DCP. At its **April 17, 2018** meeting, Board Report 18-16 provided the Board a general overview of the regulatory requirements of a Deemed IRA and other non-regulatory considerations, including a discussion of the capabilities of the DCP’s Third-Party Administrator (TPA), Voya, to administer a Deemed IRA. At its **June 18, 2019** meeting, the Board directed staff to develop a detailed set of recommended Deemed IRA design features for consideration by the Board.

A Deemed IRA is an account or annuity under an employer's tax-qualified retirement plan but treated like a Traditional IRA or Roth IRA with respect to the participants. Accordingly, the Deemed IRA is subject to the tax rules applicable to IRAs rather than those applicable to qualified plans.

The City has the option of offering both Deemed Traditional and Roth IRAs within the City’s DCP:

- **Traditional IRA Option:** A Traditional IRA may accept pre-tax contributions, after-tax contributions, or a mixture of both. The potential mix of pre-tax and after-tax dollars is based on federal income threshold limits on when Traditional IRA contributions can be composed of pre-tax contributions.

- **Roth IRA Option:** Roth contributions consist entirely of after-tax dollars. Unlike traditional IRAs, distributions from a Roth IRA are not subject to taxation upon withdrawal (assuming certain criteria are met for the distribution).

As previously communicated to the Board, the addition of a Deemed IRA account option provides DCP participants with the following benefits:

- **Additional Retirement Saving Option –** Participants could contribute additional amounts to the DCP using the Deemed IRA up to applicable IRA contribution limits. The 2020 IRA contribution limit is $6,000 for individuals under age 50 and $7,000 for individuals age 50 and older. Approximately 4% of the active member population contributes up to the applicable maximum amount to the DCP; these employees are likely to be interested in saving additional amounts in the DCP through a Deemed IRA.

- **Institutional Investment Pricing –** The City's $7 billion program provides certain cost economies by leveraging the DCP's existing investment and administrative pricing; participants would likely avoid higher retail pricing attributable to using external IRA platforms.

- **Post-Separation Saving –** Many retired or soon-to-retire participants have indicated to staff or local counselors that they would like to be able to continue adding to their accounts in retirement. Assuming they otherwise satisfy the earnings and eligibility requirements under the Code, participants could contribute to a Deemed IRA after leaving City service, without any age restriction.

- **Asset Retention –** A Deemed IRA supports the Board's asset retention goals by reducing the incentive for participants to open up new IRAs outside the DCP and thereby potentially roll out their 457 accounts.

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

- **Spousal IRA –** A Deemed IRA can include a Spousal IRA option. This will allow a participant to make a contribution to an IRA in the name of a non-working spouse. A married couple could establish two IRAs and make contributions to both IRAs, subject to the IRA contribution limit and applicable earnings limits. Married couples could thus benefit from low-cost investment options offered through the DCP.

- **Consolidation of Roth IRA Assets –** Establishing a Deemed Roth IRA allows participants to consolidate other Roth IRA assets within the City's DCP. A Deemed Roth IRA provides participants of the City's DCP a rollover option that the Internal Revenue Code (Code) would not otherwise allow.

Deemed IRA accounts must meet the requirements under Section 408 of the Code 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 other 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 should be held in: (a) separate individual trusts; (b) a single trust separate and apart from the trust of the employer plan; or (c) a single trust that includes the employer plan.

To mitigate risk, a separate trust design is preferable. A single trust will serve to insulate the City's DCP from any Treasury Department regulation risk from the Deemed IRA. Any noncompliance violation will be limited to the Deemed IRA and thus not also be attributed to the DCP.

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

Voya, has confirmed it can administer a Deemed IRA. Voya presently administers the NYCDCP IRA. Voya's capabilities related to Deemed IRAs include the following:

- 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
- Maintain IRA assets in either a single trust with 457 assets or a separate trust
- Allow IRA contributions via direct check or Automated Clearing House (ACH) payments

Staff worked with Wendy Young-Carter, the Board's consultant with Segal Consulting, to identify other governmental plans offering Deemed IRAs. Four have been identified:

- City of New York City Deferred Compensation Plan (NYCDCP)
- Kentucky Public Employees' Deferred Compensation Authority (KDC)
- Municipal Employees' Retirement System of Michigan (MERS)
- Sacramento Metropolitan Fire District (SMFD)

B. Implementation Challenge – Stable Value Fund and Collective Investment Trusts

Regulatory Background – An apparent regulatory constraint exists with respect to including Collective Investment Trusts (CITs) within a Deemed IRA, particularly as this relates to the use of CITs within stable value funds. Presently the City's DCP includes the DCP Stable Value Fund (SVF). The DCP SVF holds approximately 20% of DCP assets as a standalone investment option. The DCP SVF is also embedded within the DCP's five risk-based Profile Funds.

Staff reached out to Board counsel, outside tax counsel Ice Miller, Segal Consulting, and Mercer Investment Consulting, for guidance regarding this matter. Following are key points:

- The Code and its associated regulations provide general guidance on which investments are permitted and not permitted for IRA assets. One of the investment vehicles for which limited guidance is provided is a CIT.

- CITs are pooled investment vehicles organized as trusts and maintained by a bank or trust company. CITs facilitate investment management by combining assets from eligible investors (typically corporate and governmental plans, as well as charitable and other tax-exempt trusts) into a single investment portfolio with a specific investment strategy. The pooling of assets allows participants to realize cost benefits by leveraging present cost structure in return for more diverse and innovative investment opportunities than may be otherwise available to retail investors. Each fund is managed and operated in accordance with the applicable trust's governing documents.

- As CITs were originally investment vehicles established for plans and trusts associated with group plans, they have not been explicitly identified as eligible investments for IRAs.

- Because there is no clear guidance on the question of whether CITs can accept Deemed IRA assets, most investment firms have taken the position that they cannot accept them. A few firms have taken the position that CITs may accept Deemed IRA assets based on the view that Deemed IRA assets are part of a tax-qualified plan and trust.

- Although a certain number of governmental plans include CITs within their Deemed IRAs, other governmental plan sponsors have elected to not establish Deemed IRAs because of the CIT issue.

- In addition to the SVF, it may be possible that as part of the current Core Menu RFP process for other DCP investment mandates, other CITs could be added to the City's DCP, replacing some mandates currently held as mutual funds.

- An alternative approach would be to design a custom Deemed IRA investment menu exclusive of CITs.

Future Outlook: NAGDCA and Potential Regulatory Relief – The National Association of Government Defined Contribution Administrators (NAGDCA) has begun conversations with regulatory authorities which might lead to regulatory relief for plan sponsors. On December 4, 2020, staff spoke with NAGDCA's Director of Government Affairs, Paul Beddoe, regarding NAGDCA's efforts with respect to CITs. Mr. Beddoe indicated NAGDCA has begun conversations with the Securities and Exchange Commission (SEC), to be followed at some point by conversations with the Department of Treasury, regarding the potential of an agency "no action" relief. A no action letter is a communication issued by a government agency in response to a regulatory matter indicating the agency will not pursue legal action on a proposed course of action.

Although initial conversations with the SEC have been positive, it appears that one question has arisen relating to whether there's a need to address the CIT issue, given the low prevalence of Deemed IRAs in governmental plans. NAGDCA, however, has noted that, but for the CIT issue, Deemed IRAs would likely be more prevalent, and reached out to its membership for feedback on this issue. Staff has offered to share with NAGDCA this and prior Board reports on this matter for NAGDCA's use in documenting how the CIT issue is problematic for plan sponsors. If NAGDCA's efforts prove successful, the potential for moving forward with establishing a Deemed IRA using the DCP's current investment menu could be explored further.

Custom Deemed IRA Investment Menu – Although regulatory relief might be forthcoming at some point, based on staff's review and analysis, at the present time it appears that there are sufficient regulatory concerns to avoid the use of CITs within a contemplated Deemed IRA. However, there is no requirement that the Deemed IRA investment menu be identical to the menu used in the City's DCP. It is possible, for example, to have a smaller core group of Deemed IRA offerings containing mutual funds only, perhaps in combination with the City's Self-Directed Brokerage Option (SDBO). Such a menu design would provide DCP participants with core offerings with favorable institutional investment and administrative pricing, in addition to access to the same broad investment universe currently available to all retail IRA account holders.

The Investments Committee will shortly be reviewing a broad range of investment offerings within all of the DCP's bond and equity investment mandates. This presents an opportunity to consider potential investment options for a Deemed IRA. Staff therefore recommends that the Board direct the Investments Committee to work with staff and the DCP investment consultant to develop options and considerations for a potential alternative investment menu design for the DCP Deemed IRA.

Submitted by: ____________________________________
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