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MLPs in Unrestricted Brokerage Windows Cause Complications for Plan Sponsors

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Over the past decade, defined contribution plans have trended towards simplification in fund menu design. Plan sponsors have moved towards core investment offerings in stock and bond funds, combined with a suite of target retirement date funds, leaving out more speculative asset classes. For the majority of participants, this core menu and target retirement date lineup provide the investment options they are looking for. However, for a very vocal minority, the simplified fund menu is not enough, and some plan sponsors have chosen to add self-directed brokerage accounts to their defined contribution plans. The self-directed brokerage accounts, also known as SDBAs or brokerage windows, allow a participant to invest in a broad spectrum of investment vehicles that are outside of the plan's core menu.

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Despite the trend towards simplification, brokerage accounts are becoming more common in defined contribution plans. In 2001, only 12% of large employer plans included brokerage windows. That number grew to 29% in 2011 and to 40% in 2015. Although these brokerage windows are being offered more frequently, they are typically used by a very small percentage of participants, with only 1%-4% of participants investing through brokerage windows.[1]

A brokerage window can open up the world of investment options unless restricted by the plan sponsor. One of the major issues that can arise from an unrestricted brokerage window occurs when participants invest in Managed Limited Partnerships (MLPs) and Limited Partnerships (LPs). These types of investment can cause increased fiduciary liability and reporting complications for plan sponsors.

MLPs and LPs conduct business in energy, pipelines, and natural resources. These investments take advantage of a partnership structure, which allows the MLPs to pass income directly to the investor without being taxed at the partnership level. As compared to traditional corporations, taxes are paid at the corporate level, and investors pay taxes on dividends received from the corporation. The partnership structure utilized by LPs and MLPs also allows for tax breaks for items such as depreciation and intangible drilling costs.[2]

When a retirement plan invests in MLPs, the income and tax structure creates Unrelated Business Income. This is defined by the IRS as a business activity meeting three requirements:

- It is a trade or business
- It is regularly carried on
- It is not substantially related to furthering the exempt purpose of the organization[3]

The Unrelated Business Income rules were enacted by the IRS in the 1950s to prevent charitable organizations from gaining an unfair advantage over competitors when engaging in active trades because of their tax status. These rules were later expanded to include all exempt organizations, including retirement plans.[4]

So why does this matter to plan sponsors? If a participant were to use the SDBA to invest in an MLP, Unrelated Business Income Tax would be owed by the retirement plan.

Unrelated Business Income in excess of $1,000 would require a plan to file a form 990-T and potentially owe Unrelated Business Income Tax. Income from MLPs is reported on K-1s, which can be complex and aren't always released in a timely manner. Errors or non-compliance with form 990-T can result in back taxes, penalties and interest being owed. Along with the IRS issues, record keepers may charge additional fees for the reporting and administration that goes along with collecting K-1s and filing the 990-T.[2]

So what should the plan sponsor do? To ensure that there are no UBIT or 990-T issues, the plan sponsor should start with the following steps:

- Verify if the plan offers an SDBA
- Review the SDBA document to see what restrictions, if any, are in place to limit the types of securities and transactions participants can purchase
  - If the SDBA allows for MLPs and LPs, verify if any Unrelated Business Income has been generated
  - If so, verify that all 990-T forms have been filed and all Unrelated Business Income Tax has been paid
- Consult your ERISA counsel to determine if it would be appropriate to limit the type of investments the SDBA allows

Whether or not these types of investments are being utilized by plan participants, the plan sponsor should review brokerage account documents and determine if an SDBA feature is prudent for their plan, and if any restrictions should be placed on the allowable investment types. Limiting the self-directed brokerage accounts to exclude MLPs and LPs may help plan sponsors decrease costs and complications for their year-end reporting.

[1] InvestorsHub. "Why More 401(k) Plans Offer 'Brokerage Windows'" Anne Tergesen, July 1, 2016

[2] Forbes. "MLPs Can Generate Tax Bills in Retirement Accounts" Robert A. Green CPA, November 17, 2014

[3] IRS. "Unrelated Business Income Defined" IRS, November 7, 2016

[4] IRA Financial Group. "Solo 401K and the UBIT Rules" IRA Financial Group

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