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CPA Financial Planners: Fiduciary Standards of Excellence

Impact of the FPA's Lawsuit Against the SEC

By Leslie Michael, CPA/PFS CFP®

As we all know by now, on March 30, the U.S. Court of Appeals for the District of Columbia Circuit ruled in favor of the Financial Planning Association's lawsuit against the SEC, striking down the so-called "Merrill Lynch Rule." The court held that the SEC exceeded its authority under the Investment Advisers Act of 1940 by granting an exemption from investment adviser registration to stockbrokers who charge asset-based fees for their services.

While there was much speculation as to what action the SEC might take, we now know it will not appeal the decision to the Supreme Court. In a press release dated May 14, 2007, the SEC stated it will not seek further review of the court's decision, but it did ask the court for a 120-day stay of the ruling in order to allow time for investors and brokers to respond to the court's decision. In time, we'll learn how the brokerage houses will adapt to the court's decision. I suggest that all CPAs who practice financial planning use the court's decision and the SEC's action as an opportunity to raise awareness. We should make our voices heard and educate our clients and the public about fiduciaries and the responsibilities they hold. One by one, our voices together will be heard loudly and clearly.

The Investment Advisers Act

To provide a bit of background, the Investment Advisers Act of 1940 was enacted by Congress to provide for the regulation and registration of investment advisers so that consumers would receive the benefits of full disclosure from the people who were providing them financial advice. It was recognized that investment advisers could only provide unbiased financial advice if all conflicts of interest between the investment adviser and the client were fully disclosed.

By operation of law, investment advisers are considered to be fiduciaries under the Investment Advisers Act of 1940. As a result, the client's interest must be placed ahead of the adviser's interest. Even though stockbrokers are held to a suitability standard under the Securities and Exchange Act of 1934, the difference for the consumer and the adviser between suitability and fiduciary is significant. When the Securities and Exchange Act of 1934 was enacted, stockbrokers provided their services through transaction-based accounts, but that is no longer the only type of account or service model they offer to the public. Those offering financial planning advice, no matter under what umbrella, should be held to the same fiduciary standard. This is the only way to protect the consumer—the Act's original intent.

The exemption to the Investment Advisers Act that the Court of Appeals struck down allowed stockbrokers to encourage clients to accept their advice and services under fee-based accounts. At the same time, the Act allowed them to place a disclosure in the statements and account documents, essentially stating that they did not have a fiduciary obligation to their clients, through the use of the following statement:

"Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please

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ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligation to disclose conflicts of interest and to act in your best interest. We are paid both by you and sometimes by people who compensate us based on what you buy. Therefore our profits, and our salespersons' compensation, may vary widely by product and over time."

Who knows how many consumers really understand what this disclosure means? It is very easy to imagine a consumer sitting across the table from a salesperson who is encouraging the consumer to open an account to hold their lifetime's retirement savings. Does the salesperson understand and appreciate the consumer's concerns? After the consumer is given the account documents with the disclosure, is he or she confused by the conflicting messages—assuming that the consumer actually *reads* the disclosure language (and we all know we're not too good at that)?

We can all speculate as to how the brokerage houses will react to the SEC's decision not to appeal the court's decision in March. While houses may reorganize their businesses, major players also may reorganize, pushing for Congressional action to limit their fiduciary responsibility—but speculation will be only that and not a good use of our time.

Enhancing Client Relationships

As CPAs and financial planners, we have a responsibility to our clients. As CPAs, we are expected to maintain objectivity and discharge our professional responsibilities with integrity, objectivity, professional care, and in a manner that honors the public trust. This means honoring the regulatory bodies under which we provide services. As financial planners who are CPAs, our code of conduct is not enough.

CPAs who provide financial planning in more than an infrequent manner (for this article, we will assume independently and not as an employee of a brokerage) must be registered under the Investment Advisers Act of 1940. Always consult your state Securities Division for specific registration requirements. The Investment Advisers Act of 1940 demands a fiduciary responsibility. We should promote that message to our clients and the public, loudly and clearly. With our strength, we can educate the public so that they will be the ones demanding fiduciary responsibility of all those who provide valuable financial planning services.

Financial planners registered under the Investment Advisers Act of 1940 are required to provide their clients with Form ADV disclosure. To name a few requirements, these planners must disclose in an affirmative manner any and all conflicts of interest, provide an education and experience background, affirmatively state their fiduciary responsibility, and clearly disclose fees.

All of this is very positive for our client relationships. Rather than focus on the court case specifically, this is an opportunity to highlight our practices and what sets us apart. By clearly and openly discussing our fiduciary responsibility, our code of conduct, and policies and procedures, we bring the issue to the forefront, thereby educating our clients and the public to demand no less than an adviser with a fiduciary obligation to them.

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Thus far, it seems the only places we are reading about the court's and SEC's decisions are the financial planning media. Perhaps we can change that.

Resources

There are excellent publications, articles, and resources available to help us meet our fiduciary responsibility. One of these is the *Prudent Practices for Investment Stewards*, written by the Foundation for Fiduciary Studies with a technical review by the AICPA's PFP Executive Committee Fiduciary Task Force. This publication is a series of 22 practices designed to identify the process for delivering informed, consistent decisions by investment stewards. You can access this resource in electronic format via the PFP Web site (*www.aicpa.org/pfp*). You may also purchase this publication in hard copy format at *www.fiduciarystore.com*. Note that you can receive a 33 percent discount (code: CPA) for being an AICPA member.

Prudent Practices for Investment Advisors, also written by the Foundation for Fiduciary Studies, is currently under review by the AICPA's PFP Executive Committee Fiduciary Task Force and will be available in hard and electronic copy to Section members at no charge upon completion.

The PFP Web site (*www.aicpa.org/pfp*) also includes numerous articles on fiduciary responsibility, as well as articles previously published in *Planner.* All of these resources are an invaluable benefit to each of us as we deliver a valuable service to our clients and educate them and the public about the fiduciary standard of care that they should expect and demand of their financial advisers. ●

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PFP Practice Management with Jimmy J. Williams, CPA/PFS

Choosing the Right Compensation Model for Your Financial Planning Practice

COMMISSIONS! No! A conflict of interest! FEE ONLY! No! Insufficient and inappropriate for some services rendered! COMBINATION of COMMISSIONS and FEES! How can you serve two masters?

Many of those who write about the activities and practice functions of the financial planning profession attempt to instruct their readers on the "right" method of compensation for their services. This article is not written with such a prescription in mind, but rather to provide CPA financial planners with objective information so they may better decide for themselves.

The method of client billing a practitioner selects should reflect his or her education, ability, and service levels, as well as the general market in which he or she operates. To assume a particular model based on the understanding of someone other than the practitioner is a recipe for disaster.

Commission-Based Billing

Many financial planners began their careers understanding one method of payment—commissions. The process for billing was rather simple: Sell something and you get paid. As additional products, some with increasing sophistication, arrived in the marketplace, practitioners adopted other methods of compensation to reflect the new products' benefits and structure.

Most clients understood the commission-based billing model due to its initial adoption in the industry. Clients understood that

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Correction

There was an error in Gary Lesser's article, "Making Contributions to Health Savings Accounts," in the May/June 2007 *Planner.* The article *incorrectly* states that "tax-free distributions may be made for *any* reason after age 65" in the second paragraph.

According to Lesser, "Distributions made to an account owner after he or she becomes eligible for Medicare (currently age 65) are not subject to the 10 percent additional tax. However, such amounts *are* subject to federal income tax *unless* the amounts are used to pay or reimburse an individual for qualified medical expenses."

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purchasing a product came with an additional price tag. The typical commission ranged from less than 1 percent for money market products to more than 10 percent for limited partnership units. The product sponsor determined commissions, and the broker had little discretion as to compensation.

Over a period of years, the SEC and the NASD sought more disclosures of fees to clients. The purpose was to communicate the exact price paid by the customer for the particular product desired. Confirmations and Explanation of Investment Forms were implemented to provide evidence of the fee and agreement with the client for the amount of markup or commission charged.

The most compelling argument against accepting commissions is the existence of the conflict of interest in selling a product which has a stated commission or "load." In my experience, in order to provide more transparency in the process the issue of commissions, including the amount and ultimate effect on the client's account, must be disclosed at the time of the sale of the product—not after the transaction has taken place.

Another issue that arises in assisting clients of all socioeconomic levels requires flexibility in the billing process. For example, clients with minimal investable assets would be disallowed from certain fee-based platforms due to the lack of a minimum investment amount. However, most mutual fund families now provide multiple asset class funds to address the issue of diversification. Further, funds provide a "breakpoint" or discount in the commission based on anticipated or actual investment by the client. The process continues to evolve with the current discussion of the appropriateness of marketing fees assessed to mutual fund accounts (known as "12b-1" fees).

Commissions are the primary method of compensation for most life insurance and variable annuity products. To exclude their potential benefits to the client based merely on the compensation method is unacceptable, in my opinion. With proper disclosure and sufficient education provided to the client, you can provide a valuable long-term benefit.

Fee-Based Billing

Beginning in the 1980s, financial planners sought another means of compensation other than commissions. The premise was to provide a more objective stance as to the financial planning process and the use of products. Fee-based billing models are used in different formats: assets under management (AUM), hourly rates, flat fees, or a combination of all three.

In my experience, it is possible to use all three types of fee-based billing methods to provide certain client demographics with much needed financial planning assistance. For example, our firm established a policy of performing comprehensive financial planning services and using an hourly rate for the development of the financial plan and a percentage of AUM for investment management services.

However, exceptions can (and must) be made to the policy for clients possessing a certain level of assets. For example, we do not charge for the financial plan if a client possesses $1.5 million of assets under management with us.

A financial planner should evaluate the most appropriate method of billing based on the target market and services to be provided. Our firm has been very successful in using a combination of billing methods depending upon the products and/or services the client requires.

The key to a good experience between the practitioner and the client is to clearly communicate the billing methods and terms at the beginning of the relationship. An engagement letter should be provided to the client that details the arrangement to minimize potential disagreements and control client expectations.

One last area of client billing used by our firm is referrals. Our firm continues to grow exponentially due to the referrals received from satisfied clients. As we tell our clients, "We are paid with commissions, fees, and referrals."

Jimmy J. Williams, CPA/PFS, owns his own practice in McAlester, Oklahoma, and is an editorial advisor for Planner. *This article is the first in a recurring column he now writes for* Planner *on practice management issues. To suggest a topic for a future column, or if you have a question, contact him at* jimmy@jimmyjwilliamspc.com.

HSA Eligibility and Qualifying Individuals

By Gary S. Lesser, J.D.

Part I of this series, "Making Contributions to Health Savings Accounts," appeared in the May/June 2007 issue of Planner. *In this second part, author Gary Lesser covers HSA eligibility.*

Health Savings Accounts (HSAs) are great tools to help individuals and employers take back control of rising medical costs. However, not everyone is eligible to participate in HSAs. The term *eligible individual* means, with respect to any month, any individual who:

- is covered under a high deductible health plan (HDHP) as of the first day of such month;
- is not covered by any other non-HDHP, except for certain permitted insurance and coverage for accidents, disability, dental care, vision care, or long-term care;
- is not enrolled in Medicare (generally, has not reached age 65); and
- cannot be claimed as a dependent on another person's tax return.

However, an individual can be eligible to contribute to an HSA if his or her spouse has non-HDHP *family* coverage, provided the spouse's coverage does not cover the individual.

Consider this example. John and Sally are married, and both are age 35. Throughout 2007, John has self-only coverage under an HDHP. John has no other health coverage, is not enrolled in Medicare, and may not be claimed as a dependent on another taxpayer's return. Sally has non-HDHP family coverage for herself and for John and Sally's two dependents, but John is excluded from Sally's coverage. Because John is not covered under Sally's non-HDHP family coverage, he is, therefore, an eligible individual and may contribute $2,850 (the maximum annual contribution limit for self-only coverage for 2007).

Note: The special rules for married individuals that treat both spouses as having family coverage do not apply because Sally's non-HDHP family coverage does not cover John. As a result, John remains an eligible individual. However, John may not make the catch-up contribution because he is not age 55 or older in 2007. Sally has non-HDHP coverage and is, therefore, not an eligible individual.

Caution: If a spouse has a health care flexible spending account (FSA) that covers an HSA account owner, the HSA account owner's eligibility to make HSA contributions may be affected.

Here's another example. Consider the same facts as in the first example, except that John has HDHP family coverage for himself and for one of John and Sally's dependents. Sally has non-HDHP family coverage for herself and for John and Sally's other dependent. John is excluded from Sally's coverage. Because the non-HDHP family coverage does not cover John, the special rules that treat both spouses as having family coverage do not affect John's eligibility to make HSA contributions. Sally has non-HDHP coverage and is, therefore, not an eligible individual.

Note: A state could have laws that mandate certain benefits be included in an insured HDHP. These laws, for example, require certain benefits to be covered under an HDHP without regard to whether the deductible is satisfied. Unless a state's mandated benefits satisfy the definition of preventive care for federal purposes, this would cause the HDHP to fail to satisfy the Code Section 223 requirements. If so, an individual in a state with those laws could not contribute to an HSA. Other state laws may require that an insurer or HMO must comply with limits on deductibles, which similarly could conflict with federal requirements.

The IRS has addressed this issue by promulgating transition guidance for months before January 1, 2006, for state requirements in effect on January 1, 2004. The guidance states that during this time period, an HDHP will not be considered to violate federal requirements if the sole reason it does not comply with federal requirements is because it is complying with state benefit mandates. However, after January 1, 2006, individuals covered by insured HDHPs or HMOs subject to state laws that conflict with Code Section 223 requirements will not be considered eligible individuals able to contribute to HSAs.

Generally, a health plan may not reduce existing benefits before the plan's renewal date. As a result, even though a state may amend its laws before January 1, 2006 to authorize HDHPs that comply with Code Section 223(c)(2), non-calendar-year plans still fail to qualify as HDHPs after January 1, 2006.

Distributions from an HSA to pay for the account owner's qualified medical expenses or those of the owner's spouse or dependents may be made without regard to their status as eligible individuals. Thus, it is not necessary for an individual to be covered by an HDHP to have his or her qualified medical expenses reimbursed from an HSA on a tax-free basis. However, distributions made for expenses reimbursed by another health plan are not excludable from income, regardless of whether the other health plan is an HDHP.

HDHP Coverage Beginning Mid-Month

An eligible individual generally must have HDHP coverage as of the first day of the month. An individual with employer-provided HDHP coverage on a payroll-by-payroll basis becomes an eligible individual on the first day of the month on or following the first day of the pay period when HDHP coverage begins.

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For taxable years beginning after 2006, a new law allows an HSA account owner to make a full-year HSA contribution, even if such individual becomes an HSA-eligible individual after January 1. Note that there are some exceptions.

Steven, an employee, begins HDHP coverage on the first day of a biweekly payroll period, which is August 6, 2007, and continues to be covered by the HDHP throughout 2007. For purposes of contributing to an HSA, Steven becomes an eligible individual on September 1, 2007. However, under an exception for taxable years beginning after 2006, a new law allows an HSA account owner to make a full-year HSA contribution even if such individual becomes an HSA-eligible individual after the first day of his or her taxable year (generally January 1).

If Steven uses the exception allowing him to be treated as eligible for the entire year, his maximum contribution amount will likely increase (up to the statutory limit of $2,850 for 2007). However, Steven will have to remain an eligible individual during a testing period that will not end until December 31 of the following year. Steven must maintain his HDHP and otherwise remain eligible during the testing period.

Chart 1

	2008		*2007*	
	Self-Only Coverage	***Family Coverage***	***Self-Only Coverage***	***Family Coverage***
HSA Maximum Annual Contribution	$2,900	$5,800	$2,850	$5,650
HSA Catch-Up Contributions (age 55 by end of year)	$900		$800	
HDHP Minimum Annual Deductible	$1,100	$2,200	$1,100	$2,200
HDHP Maximum Out-of-Pocket	$5,600	$11,200	$5,500	$11,000

Exceptions for Non-HDHP Coverage

There are two exceptions to the rule that requires that the employee not be covered under any other non-HDHP:

- coverage for any benefit provided by "permitted insurance"; and
- coverage, whether through insurance or otherwise, for accidents, disability, dental care, vision care, or long-term care.

Spouse Eligibility

Although the special rule for married individuals in Code Section 223(b)(5) generally allows a married couple to divide the maximum HSA contribution between spouses, if only one spouse is an eligible individual, only that spouse may contribute to an HSA.

Joint HSA for Married Couples

An HSA may be established on behalf of only one individual. So, if a husband and wife are eligible to contribute to an HSA, they are both eligible to establish separate HSAs. Note that if both spouses are age 55 or older, and they both want to make "catch-up" contributions, they must each establish an HSA.

Eligibility in U.S. Territories and Hawaii

Bona fide residents of the U.S. Virgin Islands, Guam, and the Commonwealth of the Northern Mariana Islands may establish HSAs. However, bona fide residents of Puerto Rico and American Samoa may establish HSAs only after statutory provisions similar to Code Sections 223 (relating to HSAs) and 106(d) (relating to employer-provided medical expense coverage) are enacted.

Hawaiian residents are not prohibited from having HSAs. However, an HDHP offered by an employer in Hawaii would have to satisfy Hawaii's Prepaid Health Care Act (PHCA), which sets forth various requirements concerning plan benefits and cost sharing, and would have to be approved as a qualified plan by Hawaii's Prepaid Health Care Council. The Hawaii Department of Labor and Industrial Relations staff has informally indicated that while Hawaii may be willing to approve HDHP/HSA plans as satisfying PHCA requirements, the state likely would require significant employer HSA contributions as a condition for approval. Accordingly, at the present time HSAs are generally established only by Hawaiian residents who do not have employer-provided health coverage (for example, sole proprietors, self-employed individuals, and those working as part-time employees).

For taxable years beginning in 2008, the HSA maximum annual contribution limit for an eligible individual with self-only coverage is $2,900 and $5,800 for family coverage. For taxable years beginning before 2007, the annual contribution amount could not exceed the annual deductible under the HDHP. The repeal of the annual plan deductible limit is effective for taxable years beginning after 2006. Chart 1 reflects the HSA limits for 2007 and 2008. ●

About the Author: Gary S. Lesser, J.D., is president of GSL Galactic Consulting in Indianapolis, Indiana. He recently coauthored The Adviser's Guide to Health Savings Accounts *(product #091020), as well as* The CPAs Guide to Retirement Plans for Small Businesses *(product #017237). Both titles are available at* www.cpa2biz.com. *Contact Mr. Lesser at* qpsep@aol.com.

New Poll Sheds Light on Home Ownership, Retirement Savings

According to a recent poll conducted by Harris Interactive for the AICPA, two out of every five Americans believe they can't afford to buy a home.

"A home is one of the most significant investments you can make, and it's widely associated with achieving the 'American Dream,'" says Carl George, CPA, chair of the AICPA's National CPA Financial Literacy Commission. "It's troubling that so many Americans believe their financial position prevents them from owning such an important asset."

Poll results also showed that the spending and savings habits of American adults deter them from pursuing higher education, medical procedures, marriage, parenthood, and retirement. These and other concerns compel 16 percent of the respondents to consider a second or part-time job.

Nearly half of respondents who are not retired indicated that they expect to retire *with* a pension. Recognizing this expectation, George emphasizes the need for a shift in perspective in order to achieve retirement goals.

"Despite all evidence to the contrary, pensions are still regarded as a safety net for retirement," he says. "Americans have to understand that many of the entitlements of their predecessors are not guaranteed. It is up to them as individuals to prepare for retirement. Otherwise, they may find themselves working far longer than they had intended."

As more and more companies shift from defined benefit plans to defined contribution plans, the safety net of a pension plan may not be there for many Americans. However, the Harris survey discovered that only 14 percent of American adults mentioned their company's 401(k) plan as a means to save. George says that being knowledgeable about these plans is vital to saving effectively.

CPA financial planners and CPA/PFS credential holders know that their clients should seek out alternative ways to protect savings for retirement and learn how to save money.

"It's interesting that the 401(k) isn't top-of-mind when people think of key ways to save," says Michael Eisenberg, CPA/PFS, member of the National CPA Financial Literacy Commission. "This is where they can truly maximize savings. It is automatically deducted from their paycheck, the dollars are pre-tax, and their employer's matching contribution is essentially free money."

This concept also applies to younger workers; the study showed that only 11 percent of Americans under age 35 indicate that they participate in their company's plan. By waiting to take advantage of the tax-deferred savings and compound interest offered by vehicles such as 401(k)s, younger workers are missing out on the advantages of starting early and saving over time. CPA financial planners are in a unique position to assist their clients with this planning, as well as to encourage them to talk with their families about money and passing along good financial habits.

Many free tools and resources to help understand and accomplish these goals—and become educated in personal finance—are available through the AICPA's 360 Degrees of Financial Literacy program. Young Americans' unique savings needs are specifically addressed through podcasts and Weekly Tips available at *www.feedthepig.org*, the dedicated Web site for the Feed the Pig campaign. For example, here are three tips that are part of the 360 program:

1. **Set goals and establish priorities.** Consumers may not be able to achieve every financial goal they may have, so it is critical that they decide which goals are most important and why they matter. The most important ally in reaching goals is *time*. Money deposited in savings accounts will grow and compound. The more time consumers have, the more chances for success.
2. **Build a Nest Egg—Start Saving.** After consumers calculate how much money they will need, their next goal is to save that amount. Map out a savings plan that

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> **"Poll results also showed that the spending and savings habits of American adults deter them from pursuing higher education, medical procedures, marriage, parenthood, and retirement."**

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works. Assume a conservative rate of return and determine approximately how much must be saved every year between now and the time they want to reach the goal. It is never too early to get started.

3. **Understand Investment Options—Use the Right Savings Tools.** Consumers need to understand the types of investments that are available and decide which are right for them. If they do not have the time, energy, or inclination to do this themselves, they should think about hiring a professional financial planner or advisor. A qualified financial planner will explain the options that are appropriate for their goals, risk tolerance, and time horizon.

For more information on these and other materials, visit

www.360financialliteracy.org

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