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Deemed IRAs – A Welcomed New Plan Design Feature

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PUBLISHED
11/18/2002

SERVICES

Deemed IRAs – A Welcomed New Plan Design FeatureÁ

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") added a new plan design feature to qualified employer plans with the enactment of Section 408(q) of the Internal Revenue Code of 1986, as amended (the "Code"). This new section, entitled deemed IRAs under qualified employer plans, permits participants to make IRA contributions to a "qualified employer plan," beginning for plan years after December 31, 2002. This means that traditional or Roth IRA contributions can be made to an employer's qualified plan (including a 401(a), 401(k), ESOP, 403(a) annuity, and governmental 401(a) plan), governmental 457(b) plan, or a 403(b) annuity. All the same IRA rules apply to a deemed IRA, but employers get the advantage of commingling investments and employees get one-stop shopping for their retirement savings needs.

Deemed IRAs promise to become an important plan design feature because they offer benefits to the entire employee benefits community ¯ to plan sponsors, plan service providers, and employees.

- Plan Sponsors/Service Providers: Deemed IRAs will allow IRA and qualified plan funds to be commingled for investment purposes within a single plan. This results in an ability to offer a full benefit package to customers and employees, including allowing employees to invest their IRA and employer plan assets in the same investment options. Also, deemed IRAs will increase plan assets by:
(1) permitting additional employee contributions to qualified plans, including both regular deemed IRA contributions and, presumably, rollover contributions from an employee's existing IRA into the deemed IRA, and
(2) retaining plan assets in the plan by allowing distributions from the plan to be rolled over into the plan's traditional deemed IRA, and in the future, using the deemed IRA as the default IRA for automatic cashouts. This should result in reduced plan investment costs, provided that "break points" are met.

- Employees: Deemed IRAs will encourage employee savings by simplifying the process, allowing one-stop shopping for retirement savings, coordinating pension and IRA investments, and possibly making IRAs less expensive for employees. Most importantly, it will provide additional tax and ERISA protection for retirement savings and should help shield IRA assets from claims of creditors in bankruptcy proceedings.

It is expected that service providers will undertake to do most of the work in administering deemed IRA accounts for employers that are willing to include this feature in their plans.

While group IRA arrangements and payroll deduction IRAs currently exist, none of these arrangements allow IRA funds to be maintained as part of a qualified plan. Nor do they enjoy the same special exclusion from ERISA's reporting and disclosure requirements. The predecessor to the deemed IRA, so-called qualified voluntary employees contributions ("QVECs"), was developed in the early 1980s. These contributions generally were subject to the qualified plan rules and limits, which made them unattractive, and as a result, QVECs were short-lived. Unlike its predecessor, deemed IRAs, with some help from regulatory guidance, should prove to be a welcomed savings tool. Neither the IRS nor the DOL has issued any guidance to date, but the IRS has it on its business plan for this year, and we expect guidance in the relatively near future. While we wait for the pending guidance, set forth below is a summary of the key Code and ERISA provisions that will apply to the deemed IRAs, followed by a list of unresolved issues and key implementation issues for offering deemed IRAs.

Internal Revenue Code Provisions ÁÁ

In order to establish a deemed IRA, only three requirements must be satisfied:

1. only voluntary "employee" contributions can be made (e.g., the plan cannot make participation mandatory and both deductible and nondeductible contributions will be permitted);

2. the contributions must be made to a separate account/annuity that is established under the tax-favored arrangement; and

3. the account/annuity must meet the requirements for either a traditional or Roth IRA, except it is exempt from the commingling restrictions. Code ¤408(q)(1). This should mean that neither a common investment fund, common trust fund, nor a group trust is needed to commingle deemed IRA and qualified plan assets. If a plan is already part of a Rev. Rul. 81-100 group trust, the addition of a deemed IRA should not affect the qualification of the group trust; the deemed IRA account should, however, include a provision that expressly adopts the group trust.

It appears that plan sponsors have wide discretion in determining who is eligible to make deemed IRA contributions because there are no coverage or nondiscrimination requirements. For example, it appears that this option could be limited to (1) only active participants in the plan, (2) all current employees, even employees who are not participants in the plan or who are currently prohibited from making 401(k) deferrals due to a hardship distributions, (3) only employees who satisfy minimum age and/or service requirements, or (4) active and former employees, whether or not they have plan accounts.
General IRA Rules Apply: The deemed IRA will be treated as either a traditional or Roth IRA, as applicable, for all tax purposes (but not as a SIMPLE, SEP, or Education IRA). Code ¤408(q). This means that the regular IRA contribution and deduction limits apply. For example,

Contribution Limits: Aggregate contribution limits will apply to all IRAs (including all deemed IRAs). Therefore, for 2003, $3,000 ($3,500 if age 50) can be contributed, in total, to a traditional or Roth IRA and a deemed IRA. Code ¤219(b). Presumably, catch-up contributions to a deemed IRA will be permissible even if the underlying employer plan does not allow catch-up contributions. Any contribution over these limits is an excess contribution, which is subject to a 6% excise tax until corrected. Code ¤4973. The participant must file Form 5329 to report and pay the tax.

Amount and Timing of Contribution: In general, the deductible amount contributed to a traditional deemed IRA will be limited based upon the participant's adjusted gross income ("AGI") because the participant will generally be an active participant in a pension plan. Code ¤219(g). (However, deductible contributions to a deemed IRA by a participant in a governmental 457(b) plan will not be limited by AGI.) For 2003, a phase-out of the deduction begins at AGI over:

$60,000 (married filing joint return),
$40,000 (single/married filing separately (MFS) and living apart), or
$0 (MFS and lived together for any part of the year).

Of course, the participant could still make non-deductible contributions to the IRA. Alternatively, the participant could elect to make a non-deductible contribution to a Roth IRA. But again, to be able to make Roth IRA contributions, the participant's AGI cannot exceed

$160,000 ($110,000, if single or MFS and living apart), and no contributions can be made if the participant files MFS and lived together for any part of the year. Code ¤408A(c).

The age of the participant is also important because only deemed Roth IRAs will be able to accept contributions by participants who have reached age 70_. Code ¤¤408A(c)(5); 219(d)(1). Lastly, the participants should have until April 15th of the following year to make deemed IRA contributions for the prior year. Code ¤¤219(f)(3); 408A(c)(7).

Taxation of Distributions: The timing and taxation of distributions from a deemed IRA (including the rollover rules) will also be based upon the IRA rules, and not the qualified plan rules. For example, traditional deemed IRAs must commence distributions at 70_ (with no suspension of benefit distributions based upon active employment status); however, no minimum required distributions ("MRDs") during life are required for deemed Roth IRAs. The IRA aggregation rules should allow a participant to make a MRD from any of his or her traditional IRAs or deemed IRAs (but not from a qualified plan). Moreover, upon death, the IRA MRD rules apply, which although similar to qualified plans, should allow a spouse to treat the deemed IRA as his or her own (e.g., "stretch IRA"). A failure to take an MRD from the deemed IRA will result in a 50% excise tax on the participant, but it will not affect the qualified status of the plan. Code ¤4974.

Traditional deemed IRA contributions (and earnings) are taxed when distributed, similar to qualified plans. But deemed Roth IRA contributions (and earnings) may be distributed tax-free after 5 years if paid on account of reaching age 59_, death, disability, or first home purchase. In addition, special early withdrawal tax exceptions apply for IRAs that are different from qualified plans. Code ¤72(t). For example, no 10% additional tax would apply if amounts distributed from a deemed IRA are used for (1) health insurance premiums for unemployed individuals, (2) higher education expenses, (3) first-time home purchases (up to $10,000), or (4) a series of lifetime payments that begins prior to an employee's separation from service. Code ¤¤72(t)(2)(D), (E), (F); 72(t)(3)(B). However, the qualified plan exceptions to the 10% tax for separation from service after age 55 and for payments to alternate payees will not apply. Code ¤72(t)(3)(A).

- Reporting and Disclosure: IRA reporting and disclosure requirements will apply to deemed IRAs. Code ¤408(i); Treas. Reg. ¤¤1.408-5, -6, -7, and 1.408A-7. For example, Form 5498 is used to report contribution amounts, MRD amounts, and fair market values. See Notice 2002-27, I.R.B. 2002-18 (May 6, 2002). Form 1099-R, used for reporting payouts from qualified plans, also applies for reporting deemed IRA distributions. However, it is likely that two 1099-Rs will need to be issued for a total plan distribution — one for the deemed IRA amount and another for the pension distribution — because different withholding rules (no mandatory 20% withholding for deemed IRAs) and distribution codes (box 7) may apply (e.g., due to Code ¤72(t) differences, described above). Also, when establishing a deemed IRA, participants will have to be given a disclosure statement that explains the basic IRA information (including any eligibility requirements) and a copy of the governing documents. They also must be given at least 7 days after receipt to revoke the deemed IRA. Treas. Reg. ¤1.408-6.

Qualified Plan Limits and Rules: The deemed IRA contributions (and earnings thereon) will not be subject to any qualified plan limits (e.g., ¤402(g) elective deferral limits, ¤415 plan contribution limits, ¤404 deduction limits, ¤457(b) deferral limits), and will not affect the applicability of qualified plan limits to amounts held under the qualified plan. Presumably, the plan limits don't apply even if excess IRA contributions are made. It is unclear whether a participant will be able to correct excess IRA contributions (and avoid a 6% excise tax) by reclassifying the amount as qualified employer plan pre-tax or after-tax contributions (if the plan allows such contributions).
In addition, other qualified plan rules will not apply to a deemed IRA contribution or distribution, and a deemed IRA will not be taken into account for purposes of those rules. For example,

- Spousal Benefits: The spousal consent/benefits requirements (QJSA/QPSA) under Code ¤¤ 401(a)(11) and 417 will not apply to a deemed IRA.
- Involuntary Cashouts: The deemed IRA is not taken into account in applying the $5,000 cashout provisions under Code ¤ 411(a)(11). This not only indicates that plan sponsors may apply the cashout rules to plan balances without regard to the deemed IRA accounts, but also suggests that institutions can distribute without consent rules for such accounts.
- Coverage and Nondiscrimination Rules: The coverage and nondiscrimination rules of Code sections 401(a)(4) and 410(b) will not apply. However, to the extent that a participant has limited funds to save for retirement, it is possible that contributions to the deemed IRA may have an indirect effect on nondiscrimination testing by otherwise reducing the participant's contributions to a qualified plan. For example, a non-highly compensated employee may choose to make a Roth deemed IRA contribution instead of 401(k) deferrals or regular after-tax contribution to the plan, which may negatively affect nondiscrimination testing. But this would not be a factor for governmental plans or most 403(b) annuities.

- In-service Distributions and Loans: Pension plans (including money purchase pension plans) generally prohibit in-service distributions. Treas. Reg. ¤1.401-1(b). Section 401(k) plans also must restrict withdrawals of elective deferrals. However, these rules do not apply to deemed IRAs. Therefore, it appears that a plan can permit, restrict, or prohibit in-service withdrawals of deemed IRA amounts. Of course, the IRA rules will prohibit participants from borrowing from a deemed IRA generally.
- Special Tax Treatment: Qualified plan distributions have special tax treatment for certain stock distributions (net unrealized appreciation ("NUA") treatment) and lump sum distributions (grandfathered 10-year averaging and capital gain treatment). Because these special rules do not apply to IRAs, they will not be available to deemed IRA distributions. However, the presence of a deemed IRA account should not prevent the application of these rules to qualified plan distributions.

Although for certain purposes some plan sponsors may advocate applying the qualified plan rules, as a matter of plan design, to ease administration (e.g., reporting and withholding), the statute should tie the IRS's (and plan sponsors') hands.
ERISA Requirements

EGTRRA, as amended by the Job Creation and Worker Assistance Act of 2002 ("JCWAA"), expressly amended ERISA to provide that deemed IRAs are only subject to the following Title I provisions: (1) the exclusive benefit rule, (2) general fiduciary (and co-fiduciary) rules, including the application of ERISA Sec. 404(c), and (3) ERISA's enforcement requirements, including claims procedures. These provisions apply in the same manner as they would apply to a simplified employee pension ("SEP") under Code Sec. 408(k). ERISA ¤4(c). Importantly, the following ERISA rules do not apply: (1) reporting and disclosure provisions (e.g., no separate SPD requirements/Form 5500s), (2) participation and vesting requirements, or (3) funding provisions. The prohibited transaction ("PT") provisions under ERISA also do not apply, but the parallel provisions under the Code apply (but perhaps not for governmental plans). ERISA ¤406; Code ¤¤4975(e), 4975(g)(2), 503.

Under current law, two similar arrangements — the payroll deduction IRA and group IRA — can be established, but without the same automatic ERISA pass on reporting and disclosure requirements. To avoid these requirements (and the ERISA fiduciary and enforcement provisions), the employer's involvement in these arrangements must remain very limited. For example, it cannot endorse the IRA sponsor or receive compensation other than for its collection services, and it cannot exercise any influence over the IRA investments. See DOL Reg. ¤2510.3-2(d), ERISA Op. Ltrs. 82-53A, 82-13A, 81-80A, 77-29A. These same restrictions do not apply to deemed IRAs; however, the price for unlimited employer involvement in deemed IRAs is compliance with limited ERISA fiduciary protections and enforcement provisions.

Unresolved Issues

As with any new plan design feature, there are many issues that are unresolved prior to the issuance of regulatory guidance. A few of the key issues are noted below. Hopefully, these and other issues will be addressed by the IRS, DOL, and SEC in future guidance.

- Plan Qualification. Will a failure to satisfy the IRA provisions result in a qualification defect for the plan, and if so, can this defect be corrected through EPCRS? Can a plan establish a "negative election" for deemed IRA contributions on the same basis as for elective deferrals? Can a single plan establish both a traditional and a Roth IRA, with the type of contribution at the election of the participant? Can a existing prototype IRA be used as a deemed IRA? Can you permit spousal deemed IRAs? Can you correct excess deferrals, excess contributions, and excess aggregate contributions to the employer plan by reclassifying them as deemed IRA contributions (up to IRS limits)? How can you correct excess IRA contributions? Can a plan that adds a deemed IRA still invest in life insurance and collectibles? Can an employer match deemed IRA contributions? To what extent do the anti-alienation provisions apply and how does this impact domestic relation orders? How is a deemed IRA impacted by a plan merger or plan termination? What are the procedures for designating voluntary employee contributions?
- Prohibited Transactions. Will a PT from one employee disqualify all the participants' IRAs? We anticipate that, just like group IRAs, exposure will be limited to the one account.
- Fees. What administrative fees can be charged and how should plan expenses be allocated between deemed IRAs and other plan assets? Can an employer get reimbursed from the deemed IRA for directly related expenses of maintaining a deemed IRA?
- Various Fiduciary Responsibilities. What is the responsibility of plan fiduciaries for "abandoned" deemed IRAs? Is the offer of unregistered investments (e.g., collective trust funds, stable value funds, separate account interests) under a deemed IRA exempt from SEC registration on the same basis as for other qualified plan interests? (We anticipate the answer will be yes.) How will plans segregate (or exclude) deemed IRA assets from other assets for audit and Form 5500 reporting purposes? Alternatively, can plans simply treat the deemed IRA as any other qualified plan asset for Form 5500 reporting? Does the plan's SPD (or a separate SMM)

need to describe this new plan feature and, if so, how much detail is required? Can a plan sponsor/administrator simply track the source of the deemed IRA contribution and allocate a pro rata share of the investment return of the fund to the deemed IRA?

Implementation Procedures

Despite the uncertainties described above, it appears that many plan sponsors will offer this new design feature next year and in the years to come. There are many preliminary steps that must be taken before deemed IRAs can be "rolled out" to employees. The key steps are outlined below, which include modifying administrative systems to track the deemed IRA contributions and complying with the applicable IRA rules. Once guidance is issued, plan sponsors and service providers can work together to develop a consolidated system to implement this new feature.

Plan Amendment: To establish a deemed IRA, the plan sponsor must amend the tax-favored arrangement to include a deemed IRA.3 Although a model IRS amendment has not yet been issued, plan sponsors should have until at least the end of the 2003 plan year to include a "good-faith" EGTRRA amendment. Notice 2001-42, I.R.B. 2001-30 (June 28, 2001). This should look similar to the model catch-up amendment, which includes very basic language that references the Code provision. However, the IRS may require a detailed amendment following the IRS LRMs on traditional/Roth IRAs or the model IRA documents (Form 5305 series).4 In any event, it may be advisable to include eligibility requirements and references to other plan provisions, if any, that the employer elects to have apply to the deemed IRA (e.g., in-service withdrawal restrictions, distribution forms, consent requirements, beneficiary designation). In addition, the plan sponsor should amend the rollover distribution provisions of the Plan to allow plan distributions to the deemed IRA, by adding a reference to Code Sec. 408(q).

If a good-faith amendment is adopted, the plan's EGTRRA remedial amendment period should extend to until at least the end of the 2005 plan year. Until the IRS opens up its determination letter process for EGTRRA amendments, a plan sponsor cannot get an IRS tax-qualification letter that covers the deemed IRA.

Election Procedures: In addition to amending the tax-favored arrangement, participant election procedures must be developed. A separate election (either written or electronic) should be established for deemed IRA contributions. An election form should be distributed at least annually, which should include the following provisions: (1) type of contribution: traditional or Roth IRA (assuming plans can accept both kinds of contributions), (2) amount of contribution: either use a flat-dollar amount or as a percentage of compensation, (3) timing of contribution ¯ for current year or prior year (if before April 15), (4) certification that the participant is eligible to make these contributions (within IRS contribution and AGI limits), (5) payroll deduction authorization on an after-tax basis, (6) certification that the participant is responsible for any excess contributions (which are subject to 6% excise tax), (7) procedures for correcting excess contributions, and (8) for the initial contribution, an IRA disclosure statement (including a copy of the governing documents) and a disclosure of participant's right to at least 7 days to revoke the election.

Conclusion

Time will tell how popular deemed IRAs become, but initial reactions are favorable. Helpful IRS, DOL, and SEC guidance will go a long way toward making deemed IRAs a powerful new savings tool. Their success may well foretell the fate of Roth 401(k) and Roth 403(b) arrangements once the provisions enacted in EGTRRA become effective in 2006.

ÁThe author wishes to thank Louis T. Mazawey and Brigen L. Winters for their guidance and helpful comments.

ÁÁ Like all other EGTRRA provisions, the deemed IRA will be eliminated after 2010 unless Congress eliminates the "sunset" provision.

ÁÁÁ However, a participating employer in a master and prototype plan or volume submitter plan should be careful not to adopt a deemed IRA without the plan sponsor offering the feature because it may result in the employer's loss of reliance of the favorable IRS letter on the tax-qualified status of the plan.

Áv Typically, an IRA document either follows the IRS's model language (Form 5305) and does not receive an opinion letter, or a prototype IRA is used (Form 5306), which receives an IRS opinion letter. The extent to which these existing documents can be used for deemed IRAs, and whether the deemed IRA could (or should) obtain an IRS opinion letter, is still unclear.