# Proposed Regulations Issued For Deemed IRAs

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On May 20, 2003, the IRS issued proposed regulations on deemed IRAs that provide helpful guidance on the rules applicable to this new design feature. Deemed IRAs, introduced by EGTRRA and effective beginning with 2003 plan years, permit "qualified employer plans" (401(a), 403(a), 403(b), and governmental 457(b)) to maintain a traditional or Roth IRA within the tax-favored plan. Until now, the only IRS guidance on deemed IRAs is a sample "good faith" plan amendment provided in Rev. Proc. 2003-13. The amendment is generally required to be added by the time deemed IRA contributions are accepted, but 2003 adopters have until the end of this plan year to add the provision.

The proposed IRS regulations generally follow the "separateness" principles that Congress intended in creating the deemed IRA. In essence, they are (1) deemed IRAs are IRAs, and as such, the IRA rules, and not the qualified plan rules, apply, and (2) the remainder of the plan is a qualified plan that is subject to plan qualification rules, which do not apply to the deemed IRA portion of the plan. Unfortunately, the proposed regulations diverge from the "separateness" principle for qualification purposes and provide that a failure to meet the IRA requirements for any deemed IRA could result in the plan's disqualification. The IRS position is likely to discourage plans from offering deemed IRA features. (The IRS intends to expand the IRS correction procedures under "EPCRS" to cover deemed IRAs.) On the positive side, if the qualified plan fails to meet an applicable plan rule, the deemed IRA may be treated as a traditional or Roth IRA (at least if investments have not been commingled with the qualified plan in violation of Code section 408(a)(5)).

The remainder of the new IRS guidance is relatively helpful, focusing on the areas noted below.

## Contribution Issues

**No Employer Contributions:** Deemed IRAs cannot accept employer contributions. Therefore, deemed IRAs may not include Simple IRAs and SEPs.

**Payroll Deductions:** Plan sponsors may permit employees to contribute to deemed IRAs by direct deposit through payroll deduction. Employees may decrease their Federal income tax withholding (Form W-4) to take into account expected IRA deductions. Amounts deducted from payroll remain reportable as part of W-2 income.

**Deductible Contributions:** Traditional deemed IRA contributions are deductible if the participant meets the requirements of Code section 219. For example, for 2004, a participant under age 50 can make a deductible contribution of $3,000 to his deemed IRA if AGI is less than $65,000 (if married filing jointly). (If AGI exceeds this limit, the contribution can still be made on a non-deductible basis.)

**Timing of Contribution:** Employees have until April 15th of the following tax year to contribute an amount to the deemed IRA for the prior year. However, if this contribution is made by employer withholding, this amount is taxable W-2 income in the year withheld regardless of the year to which it is attributable on the taxpayer's return.

**Nondiscrimination Testing:** A deemed IRA is not a "benefit, right, or feature" subject to nondiscrimination rules; therefore, plan sponsors can make the feature available to a discriminatory group.

## Distribution Issues

**Early Distribution Rules:** The 10% tax on early distributions (§ 72(t)) applies separately to the deemed IRA and the qualified plan. For example, in determining whether a payment is part of a series of substantially equal payments from the deemed IRA, it is irrelevant that no payments are made from the qualified plan. (Note, there are variations in which exceptions to the 10% tax apply to IRAs and qualified plans.)

**Qualified Plan Distribution Rules:** Rules applicable to distributions from qualified plans do not apply to distributions from deemed IRAs. Therefore, as anticipated, none of the qualified plan rules (*e.g.*, cashout rules, QJSA, in-service restrictions, early distribution rules) apply to IRA amounts or distributions. (This results in having to administer two sets of distribution rules.)

**Minimum Required Distributions (MRDs):** The MRD rules must be met separately with respect to the qualified plan and the deemed IRA. The fact that the deemed IRA satisfied the MRD requirement is irrelevant to the qualified plan. (Presumably, the deemed IRA MRD requirement can be met from any of the taxpayer's IRAs.)

**Rollover/Transfer Provisions:** Deemed IRAs are treated as any other traditional or Roth IRA for transfer/rollover purposes. Therefore, a participant can roll over his qualified plan account to his traditional deemed IRA account on termination of employment. (This may facilitate the ability of employer plans to capture the rollover market for its former employees, particularly when default IRAs are required next year for small cashouts.) Conversely, he can roll over the deemed IRA to an eligible employer plan. Transfers between deemed or regular IRAs are also permitted, so a participant can transfer his existing IRA to his deemed IRA and enjoy the convenience of the payroll deductions for new contributions. A surviving spouse can even treat the deemed IRA as his or her own, but, as a non-employee, cannot make additional contributions.

### Separate Trust/Annuity/Commingling of Investments

**Trust/Annuity Requirement:** A single or separate (*i.e.*, for each participant) trust (or annuity) must be established for the deemed IRA. The trustee or custodian of an IRA must be a bank or IRS-approved nonbank trustee/custodian. Different trustees or custodians can be used for different participants. If a single trust is used for all deemed IRA participants, (1) there must be separate accounting for each deemed IRA, (2) the trust must be created or organized in the United States for the exclusive benefit of the participants, and (3) the written instrument must meet the requirements of Code sections 408(a)(1), (2), (3), (4), and (6). A group annuity contract must satisfy section 408(b) requirements and provide separate accounts for each participant.

**Commingling of Investments:** As long as the separate trust/annuity document requirement is satisfied (and there is proper separate accounting), the assets of the deemed IRA and the employer plan may be commingled for investment purposes (as is the case with "group trusts" under Rev. Rul. 81-100) without any IRA or other IRS problems.

### Effective Date

The regulations are proposed to apply on or after August 1, 2003, but plan sponsors can rely on them now. If the final regulations are more restrictive, they will not be applied retroactively. Comments and request for a public hearing are due by August 18.

### Impact of Regulations

The proposed regulations address many of the tax issues for establishing a deemed IRA and generally give a green light for adopting these features. However, the three main tax issues that plan sponsors will need to understand before offering this feature are (1) an IRA trust/annuity is required to hold the assets (presumably a modified Form 5305 or 5305-R with a bank or approved non-bank trustee can be used for this purpose), (2) IRA rules apply, along with the administrative details in maintaining an IRA (*e.g.*, separate 1099-Rs, disclosure statements, tracking accounts, election procedures, IRA correction procedures), and (3) failure to comply with IRA rules can jeopardize the qualification of the entire plan. We anticipate that third party administrators (*e.g.*, financial institutions, IRA providers, or plan recordkeepers (using a revised administrative services agreement)) will take on most of the IRA-related responsibilities here.

Open issues also remain on the DOL and SEC front and on the day-to-day administrative issues. For example, questions remain regarding the possible fiduciary and prohibited transaction issues that may arise with establishing these accounts, how (and if) the deemed IRA is reflected on the Form 5500, and whether deemed IRA assets can be invested in non-SEC registered securities in reliance on qualified plan exemptions.

Despite the uncertainties, employees interested in one stop shopping for all their retirement savings needs may drive adoption of this new feature. Employers may be inclined to offer the deemed IRA to take advantage of savings generated by increased plan assets and enhanced employee relations, particularly if M&P sponsors take the initiative to offer and run these arrangements.