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FOR RETIREMENT STUDIES℠

TCRS 2004-06: A SUMMARY OF THE FINAL RULES ON DEEMED IRAs IN QUALIFIED RETIREMENT PLANS

The Internal Revenue Service ("IRS") issued final regulations relating to deemed individual retirement accounts ("Deemed IRAs") for tax qualified retirement plans under Internal Revenue Code ("Code") section 408(q). At the same time, the IRS issued proposed and temporary rules for governmental units to qualify as non-bank trustees for Deemed IRAs. The final regulations were originally proposed in May 2003, and apply to Deemed IRAs established on and after August 1, 2003.

Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") added Deemed IRA provisions to the Code effective for plan years beginning after December 31, 2002. Under the Deemed IRA rules, employers, rather than employees, assume the burden of setting up the IRAs. Deemed IRA contributions are not included in contribution limits applicable to qualified employer plans. Deemed IRAs are subject to the Employee Retirement Income Security Act's ("ERISA") exclusive benefit and fiduciary rules, but are not subject to ERISA's qualified plan reporting and disclosure, participation, vesting and funding requirements.

Highlights of Key Provisions

- Deemed IRAs can be established under Code sections 401(a), 403(a), 403(b), or governmental 457 plans.
- A Deemed IRA is a separate entity from the qualified employer plan and, therefore, each would be subject to its own rules.
- A Deemed IRA may be an individual retirement account or an individual retirement annuity.
- A plan sponsor must make an affirmative election in its adoption agreement to adopt the Deemed IRA feature.
- Deemed IRA contributions may be held in a trust separate from the trust holding assets of the qualified plan or in the same trust holding qualified plan assets, provided a separate account is maintained for each Deemed IRA. If the assets of the Deemed IRAs and the assets of the qualified employer plan are held in separate trusts, then a qualification failure of the Deemed IRA portion of the plan will not cause the qualified employer plan portion to be automatically disqualified. The reverse is also true; a qualification failure of the qualified employer plan portion will not cause the Deemed IRA portion of the plan to be automatically disqualified.
- Deemed IRA assets may not be invested in life insurance contracts.
- Because a Deemed IRA can be either a Roth IRA or a traditional IRA, the qualified employer plan must allow after-tax employee contributions.
- Deemed IRA contributions must be designated as such on or before the time contributions are made.
- A transitional rule allowed plans to operate during 2003 without Deemed IRA provisions, provided such provisions were adopted by the end of the 2003 plan year. However, in 2004, the plan document of the qualified employer plan must contain Deemed IRA provisions and a Deemed IRA must be in effect at the time Deemed IRA contributions are accepted.
- IRA provisions that satisfy Code section 408 (traditional IRA) or Code section 408(A) (Roth IRA) must be in the plan document. Incorporation of these provisions by reference is not permitted. A sample plan amendment for Deemed IRAs is in Revenue Procedure 2003-13.
- When a single trust is used, there can only be one trustee for both the qualified employer plan and Deemed IRAs.
- The Pension Benefit Guaranty Corporation ("PBGC") as advised IRS and Treasury that Deemed IRAs and Deemed IRA assets will not be covered by Title IV of ERISA. If a qualified employer plan subject to Title IV is terminated, the fiduciary of the Deemed IRAs will continue to be responsible for the operation, transfer and termination of the Deemed IRAs.

- Only banks and other entities approved as non-bank trustees by the Commissioner can serve as Deemed IRA trustees. An exception is granted to governmental units who can act as Deemed IRA trustees for their own plan provided they can demonstrate to the IRS that they can administer the Deemed IRAs consistent with Code requirements.

Advantages of Deemed IRAs

- Saving is simplified for employees through the convenience of payroll deduction.
- Increases asset base under the qualified employer plan.
- Consolidates investing for employees.
- Could reduce overall costs of plan investments.
- Great substitute for traditional after-tax employee contributions since qualified plan discrimination testing and Code section 415 limits would not apply to Deemed IRAs.
- IRA catch-up contributions apply to traditional Deemed IRAs.
- The two portions of the qualified employer plan may have different eligibility requirements.
- If an individual is an employee for purposes of the qualified employer plan, that individual will be treated as an employee for purposes of the Deemed IRA.
- The automatic enrollment principles applicable to Code sections 401(k), 403(b) and governmental 457 plans may be applied to Deemed IRAs.
- The final regulations permit the commingling of assets of traditional Deemed IRAs and Roth Deemed IRAs under a single trust, provided the trustee maintains separate accounts for the Roth Deemed IRAs and traditional Deemed IRAS of each participant.
- The same rules apply to rollovers and transfers to and from Deemed IRAs as apply to rollovers and transfers to and from other IRAs.

Disadvantages of Deemed IRAs

- Tracking separate rules and reporting requirements create additional expense/administrative burden for plan sponsors and plan administrators.
- Depending on an employee's income level, contributions may or may not be deductible for traditional Deemed IRAs and, therefore, Deemed IRAs may not present a new deduction opportunity for an employee.
- If a single trust is used and the Deemed IRA is disqualified, the entire plan's qualified status could be at risk. This is perhaps the biggest impediment to plan sponsors deciding to offer Deemed IRAs under the single trust approach.
- Institutions serving as IRA trustees or custodians normally would have no fiduciary responsibility under ERISA to IRA holders. Unfortunately, the Department of Labor's ("DOL") position included as a footnote in the final regulations changes this significantly. According to the footnote, Deemed IRA trustees have an obligation to monitor compliance with the qualification requirements for IRAs and this imposes a significant additional fiduciary burden for plan sponsors.

Conclusion

The final regulations allow qualified employer plan assets and Deemed IRA assets to be kept in a single trust, which would ease some of the paperwork and administrative burden for plan sponsors. However, a company's retirement plan could be at risk for disqualification if a participant's Deemed IRA violates IRA rules – unless the assets of the Deemed IRA and qualified employer plan are kept in *separate* trusts. In addition, the DOL's opinion, expressed in a footnote to the final regulations, requiring plan fiduciaries to monitor compliance with IRA qualification requirements, imposes additional fiduciary burdens that may ultimately force plan sponsors to just leave their plan "as is" and not adopt a Deemed IRA feature.