

MEMO# 16095

May 20, 2003

TREASURY RELEASES PROPOSED DEEMED IRA REGULATIONS; REQUEST FOR COMMENTS

[16095] May 20, 2003 TO: PENSION COMMITTEE No. 14-03 PENSION OPERATIONS ADVISORY COMMITTEE No. 29-03 RE: TREASURY RELEASES PROPOSED DEEMED IRA REGULATIONS; REQUEST FOR COMMENTS Treasury and the Internal Revenue Service (the "Service") have released proposed regulations under Code section 408(q)¹ that permit a qualified employer plan² to allow employees under the plan to make voluntary employee contributions to a new savings vehicle called a "deemed IRA." If the deemed IRA meets the requirements applicable to either a traditional individual retirement account ("IRA") or a Roth IRA, then the deemed IRA will be treated as either a traditional IRA or Roth IRA, as applicable, for all purposes of the Code. Additionally, if statutory requirements are satisfied, then the deemed IRA will not be treated as part of the qualified employer plan. Separate Rules Apply to Qualified Plan and Deemed IRA As suggested by the Institute in its comment letter to Treasury³, the proposed regulations generally treat a qualified employer plan and a deemed IRA as separate entities under the Code and apply the rules applicable to each entity. The regulations state that issues regarding "eligibility, participation, disclosure, nondiscrimination, contributions, distributions, investments, and plan administration are generally to be resolved under the separate rules (if any) applicable to each entity under the Code." Prop. Reg. 1.408(q)-1(c). Also as suggested by the Institute, the proposed regulations specifically provide that the rules applicable to rollovers and transfers to and from IRAs also apply to rollovers and transfers to and from deemed IRAs, even though the regulations do not address all situations that arise with respect to such rollovers or transfers. For example, the preamble to the proposed regulations states that because Code section 408(c)(3) permits the surviving spouse of an IRA owner to treat the IRA as his or her own, the same rules apply to deemed IRAs, although this

¹ All section references are to the Internal Revenue Code of 1986, as amended.

² For purposes of the proposed regulations, a "qualified employer plan" is a plan described in section 401(a), an annuity plan described in section 403(a), a section 403(b) plan, or a governmental plan under section 457(b).

³ See Institute Memorandum No. 15295, dated November 15, 2002. ² issue not expressly addressed in these regulations. Thus, in accordance with section 408(c)(3), a qualified employer plan may permit a surviving spouse to treat a decedent's deemed IRA as his or her own. However, the surviving spouse, as a non-employee, may not make voluntary employee contributions to that deemed IRA. The preamble states that because separate rules generally are to apply to each entity except for specific exceptions, the regulations do not directly address numerous situations that have already been addressed by existing rulings. These existing rules should be referenced for guidance regarding specific issues involving deemed IRAs. Under Announcement 99-2 (1999-1 C.B. 305), for example,

employers may permit employees to contribute to traditional or Roth IRAs by direct deposits via payroll deduction. Such employees who use the payroll deduction method to make contributions to a traditional IRA may be able to adjust their Federal income tax withholding in order to receive a more immediate tax benefit from the IRA contributions. Because the IRA rules apply to deemed IRAs as they would to traditional and Roth IRAs, these same provisions would apply to deemed IRAs.

Distribution Rules The rules applicable to distributions from IRAs apply to distributions from deemed IRAs. Any restrictions that a trustee, custodian or insurance company is permitted to impose on distributions from traditional and Roth IRAs may be imposed on distributions from deemed IRAs, e.g., early withdrawal penalties on annuities. The required minimum distribution (“RMD”) rules of Code section 401(a)(9) must be met separately with respect to the qualified employer plan and the deemed IRA; and satisfaction of the RMD rules applicable to qualified plans will not affect a determination of whether such rules are satisfied with respect to the deemed IRA, and vice versa. The preamble elaborates that whether a distribution is a part of a series of substantially equal periodic payments under Code section 72(t) will be determined separately for the qualified employer plan and for the deemed IRA.

Specific IRA Rules Applicable to Deemed IRAs The proposed regulations clarify certain IRA rules that are applicable to deemed IRAs. For example, the deductibility of voluntary employee contributions to a deemed traditional IRA is determined in the same manner as if it were made to any other traditional IRA. If an employee’s compensation exceeds applicable limits, then he or she may not be able to make any deductible contributions to a deemed IRA, or the deductibility of such contributions may be limited in accordance with the rules applicable to stand-alone traditional IRAs. As with stand-alone IRAs, the trustee or custodian of a deemed IRA must be a bank, as required by Code section 408(a)(2); or, if the trustee is not a bank, as defined in section 408(n), the trustee must be an entity that receives approval from the Internal Revenue Service to serve as a nonbank trustee or nonbank custodian pursuant to 1.408-2(e) of the regulations.

Exceptions to General Rule Regarding Deemed IRAs The proposed regulations specifically describe certain exceptions to the general rule that separate rules will apply to a qualified employer plan and a deemed IRA and the rules applicable to stand-alone traditional IRAs or Roth IRAs will apply to deemed IRAs.

3 Deemed IRA Provisions in Qualified Plan. The proposed regulations require that qualified employer plan document must contain the deemed IRA provisions. In general, the plan document must provide for a deemed IRA and a deemed IRA must be in effect at the time the deemed IRA contributions are accepted. However, plan sponsors who want to provide deemed IRAs for plan years beginning in 2003 are not required to have such provisions in their plan document before the end of such plan years. Rev. Proc. 2003-13 (2003-4 I.R.B. 317).

Commingling of Assets. The prohibition of Code section 408(a)(5) on the commingling of IRA assets with other property except in a common trust fund or a common investment fund is not applicable to the assets of a deemed IRA. Thus, the assets of the deemed IRA may be commingled for investment purposes with the assets of the other portion of the plan. Where the assets are commingled, the regulations require that separate accounts be maintained and that gains and losses must be allocated to these separate accounts.

Taxable Year of Deductions. The rule applicable to stand-alone traditional IRAs regarding the taxable year in which amounts paid by an employer to an IRA are includible in the employee’s income is not applicable to deemed IRAs. Thus, amounts withheld from an employee’s compensation and contributed to a deemed IRA, and which are treated as made on the last day of the preceding taxable year, shall be includible in income in the year in which they are withheld rather than in the preceding taxable year.

Special Deemed IRA Rules The proposed regulations address some specific situations created by the fact that the deemed IRA is part of the qualified plan.

Nondiscrimination. As suggested by the Institute, the availability of a deemed IRA is not a benefit, right or feature

of the qualified employer plan under 1.401(a)(4)-4 of the regulations. Thus, the deemed IRA is not subject to qualified plan rules regarding the continued and nondiscriminatory availability of benefits, rights and features under the plan. Combined Trust or Annuity Accounts. While deemed IRAs must be held in a trust account, the proposed regulations permit all deemed IRAs to be held in a single trust, rather than in separate, individual trusts. Any trust holding deemed IRA assets must be separate from the trust holding the other assets of the qualified employer plan; and there must be separate accounting for the interest of each participant. A deemed IRA trust also must be created or organized in the United States for the exclusive benefit of the participants. In addition, the written governing instrument creating the deemed IRA trust must satisfy the requirements generally applicable to stand-alone IRAs. Deemed IRAs that are individual retirement annuities may be held under a single annuity contract or under separate annuity contracts. Any such contract must (1) be separate from any annuity contract or contracts for the qualified employer plan, (2) satisfy the requirements generally applicable to stand-alone annuities and (3) separately account for the interest of each participant. 4 SIMPLE IRAs and SEPs. Because contributions to deemed IRAs are limited to employee contributions, while SIMPLE IRAs under section 408(p) and SEPs under section 408(k) may only receive employer contributions, the regulations provide that SIMPLE IRAs and SEPs may not be used as deemed IRAs. Disqualification Issues The proposed regulations provide that if the qualified employer plan fails to satisfy its qualification requirements, either in form or in operation, section 408(q) does not apply. Accordingly, any account or annuity maintained under the plan as a deemed IRA is not a deemed IRA, and its status as an IRA will be determined by considering whether the account or annuity satisfies the applicable requirements of section 408 and 408A (including the prohibition of commingling under paragraph (a)(5) of section 408). If any of the deemed IRAs fail to satisfy the applicable requirements of section 408 or 408A, section 408(q) does not apply and the plan will fail to satisfy the plan's qualification requirements. The preamble elaborates that if a qualified employer plan or a deemed IRA fails to satisfy the applicable qualification requirements, it may nevertheless be treated as satisfying those requirements if the Employee Plans Compliance Resolution System (EPCRS), Rev. Proc. 2002-47 (2002-29 I.R.B. 133), or other administrative practice is used to correct the qualification failures. In this regard, the IRS intends that when Rev. Proc. 2002-47 is updated, it will include provisions permitting submissions for deemed IRAs. Effective Date The proposed regulations are intended to be effective beginning on or after August 1, 2003. Request for Comments The Service must receive written and electronic comments and requests for a public hearing by August 18, 2003. Please provide me with any comments on these proposed regulations by Friday, July 11, 2003. You may call me at 202-326-5835 or e-mail me at lrobinson@ici.org. Lisa Robinson Assistant Counsel
Attachment (in .pdf format)