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# Legal Alert:

# IRS ISSUES PROPOSED REGULATIONS ON DEEMED IRAS

**May 20, 2003**

As described in previous Sutherland Legal Alerts, beginning in 2003, the sponsor of a qualified employer plan may allow employees to make voluntary employee contributions to a separate Deemed IRA account under the plan that meets the applicable requirements for either a Traditional or Roth IRA. In this case, the contributions to the Deemed IRA are treated as IRA contributions, rather than as contributions to the employer plan. In Rev. Proc. 2003-13 (which we described in a prior Legal Alert), the IRS provided guidance regarding the amendments to be made to a qualified retirement plan to include a Deemed IRA in the plan. On May 20, 2003, the IRS published proposed regulations providing further guidance on Deemed IRAs.

The proposed regulations reiterate that, under the Deemed IRA provisions of section 408(q) of the Internal Revenue Code of 1986 ("Code"), the types of "qualified employer plans" that may offer Deemed IRAs include qualified retirement plans under Code section 401(a), annuity plans under Code section 403(a), tax-sheltered annuity plans under Code section 403(b), and governmental deferred compensation plans under Code section 457(b).

In general, the proposed regulations provide that the qualified plan and the Deemed IRA feature are treated as separate entities under the Code, with each being subject to the rules otherwise applicable to that entity under the Code. Thus, issues regarding eligibility, participation, disclosure, nondiscrimination, contributions, distributions, investments and plan administration for the plan and the Deemed IRA are generally to be resolved under the separate rules applicable for those arrangements. For example, the proposal provides that the minimum distribution rules must be met separately with respect to the qualified plan and the Deemed IRA, and the Deemed IRAs are subject to the IRA minimum distribution rules, rather than the minimum distribution rules that apply to the qualified plans. Similarly, the 10% penalty for early distributions under Code section 72(t) is applied separately to a Deemed IRA and the qualified plan. For Deemed IRAs maintained as part of a Code section 401(a) qualified retirement plan, the rules specify that the availability of a Deemed IRA will not be a benefit, right or feature of the qualified plan under Treasury regulation section 1.401(a)(4)-4.

The proposed rules allow all Deemed IRA contributions to be made to a single trust or single annuity contract, rather than to separate trusts or separate annuity contracts for each IRA participant, provided that (1) there is separate accounting for each participant's interest in the

Deemed IRA held in the single trust or single annuity contract, and (2) the Deemed IRA trust is separate from the trust that holds the other plan assets. However, the proposed rule also permits Deemed IRA assets to be commingled with the qualified plan assets in investments other than a common trust fund or common investment fund.

Under the proposed rule, generally, the plan document of the qualified plan must contain the Deemed IRA provisions at the time the Deemed IRA contributions are accepted. An exception allows plan sponsors to establish Deemed IRAs for plan years beginning in calendar year 2003, but adopt a good-faith plan amendment after the end of the 2003 plan year; presumably, however, the employer must adopt the Deemed IRA amendment before the plan accepts the first Deemed IRA contributions in the 2004 plan year. These rules also seem to require amendments to Code section 403(a) or 403(b) annuity contracts to the extent these arrangements do not have "plan documents."

For Traditional or Roth IRAs, Code section 219(f)(5) provides that employer contributions to an employee's IRA are treated as compensation includible in the employee's gross income in the taxable year for which the amount is contributed to the IRA or Roth IRA. Thus, a contribution made by an employer to the employee's IRA after the end of the year and before April 15th could be includible in the employee's gross income for the prior year if the amount is treated as contributed to the IRA or Roth IRA for that prior year. The proposed rules provide, however, that for Deemed IRAs, any amounts withheld from an employee's income will be includible in income in the year in which the amounts are withheld.

**Perhaps most significantly, under the proposed regulations, if any Deemed IRA fails to satisfy the applicable requirements to be a Traditional or Roth IRA under Code section 408 or 408A, the entire plan will be treated as failing to satisfy the plan's qualification requirements.** In addition, if a qualified plan fails to satisfy its qualification requirements, either in form or in operation, then no account or annuity maintained under the plan will be treated as a Deemed IRA; instead, the status of the account or annuity will be determined by considering whether it meets the applicable requirements for a Traditional or Roth IRA. The preamble further says that if a qualified plan or a Deemed IRA fails to satisfy any applicable qualification requirements, the plan or Deemed IRA may continue to be treated as qualified by correcting the error through the Employee Plans Compliance Resolution System ("EPCRS") or any similar administrative practice. The preamble also indicates that the IRS will update EPCRS to include provisions for correcting qualification defects in Deemed IRAs.

Comments on the proposed rule, including requests for a public hearing, must be received by the IRS by August 18, 2003.

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If you have questions concerning this memorandum or proposed regulations regarding Deemed IRAs, please contact any of the following members of our Employee Benefits and Executive Compensation practice.


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