

Financial Institution Tax-Favored Savings Accounts

QUALIFIED RETIREMENT PLANS ■ INDIVIDUAL RETIREMENT ACCOUNTS ■ 403(b) PLANS ■ 457 PLANS
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MAY 2003

IRS Proposes Deemed IRA Regulations

On May 20, 2003, the Internal Revenue Service proposed regulations regarding Deemed Individual Retirement Accounts (Deemed IRAs). Deemed IRAs, which were authorized in the Economic Growth and Tax Relief Reconciliation Act of 2001, and first became available on January 1, 2003, are separate accounts (or annuities) established by an employer on behalf of employees under its qualified retirement plan that are treated as individual retirement accounts rather than qualified plan accounts. Our previous publications on the subject of Deemed IRAs can be found at:

- http://www.kl.com/files/tbl_s48News/PDFUpload307/8163/fia-1202.pdf and
- http://www.kl.com/files/tbl_s48News/PDFUpload307/8333/fi-update-03-feb.pdf.

The proposed regulations generally confirm the understanding that, for federal income tax purposes, Deemed IRAs and the qualified retirement plan through which they are administered are treated as separate arrangements. However, in a significant departure from this standard, the proposed regulations provide that the tax-favored status of the qualified retirement plan as a whole and the Deemed IRAs are interdependent.

In concluding that Deemed IRAs are separately regulated for federal income tax purposes, the proposed regulations generally conclude that the federal income tax rules applicable to Deemed IRAs are, with certain exceptions, the rules that apply to regular IRAs. As a result, the tax rules that apply to qualified retirement plans do not apply to a plan's Deemed IRAs, and the tax rules that apply to IRAs do not apply to a plan's qualified plan accounts. Thus, for example:

- An employer may discriminate in favor of highly compensated employees in establishing the eligibility rules for Deemed IRAs.
- The trustee or custodian of the Deemed IRA portion of the plan must be a bank or otherwise approved by the Internal Revenue Service as an IRA trustee or custodian.
- The deadline for Deemed IRA contributions is generally April 15th of the year following the year for which the contribution is made. Compensation from which Deemed IRA contributions are withheld is taxable in the year of withholding (not the prior year). The qualified plan rule that permits employer contributions to be made as late as the due date for filing the plan sponsor's federal income tax return for the year for which the contribution is made would not apply.
- The required minimum distribution rules of Section 401(a)(9) of the Internal Revenue Code must be met separately with respect to each participant's qualified retirement plan accounts and Deemed IRA accounts.
- The tax rules applicable to Deemed IRA distributions are those applicable to IRAs generally, and the tax rules applicable to qualified plan account distributions are those applicable to qualified plans generally. So, for example, if a former employee between age 55 and age 59-1/2 receives a distribution of his or her entire interest in a plan, including all qualified plan accounts and Deemed IRAs, the distribution from the Deemed IRA will be subject to the 10% excise tax applicable to IRA distributions prior to age 59-1/2, but the distribution from the

former employee's qualified plan account will not (because distributions from a qualified plan after age 55 and after separation from service are exempt from the excise tax).

- A surviving spouse of a deceased employee can elect to treat the Deemed IRA as his or her own. However, because only an employee may contribute to a Deemed IRA, the surviving spouse would not be eligible to make contributions to the Deemed IRA.

The Proposed Regulations provide that all of a plan's Deemed IRA assets may be held in a single trust, but that a plan's Deemed IRA assets and qualified plan assets must be held in separate trusts. However, the assets of those separate trusts may be commingled for investment purposes. This is an exception to the general IRA rule that IRA assets may not be commingled with qualified plan assets except in a common trust fund or common investment fund.

Perhaps the most problematic aspect of the proposed regulations concerns the impact of a plan's or Deemed IRA's disqualification. In this regard, the Internal Revenue Service states in the proposed regulations that a failure of even one Deemed IRA to comply with the IRA tax rules will disqualify the entire plan. On the other

hand, a disqualification of the plan will not necessarily disqualify the plan's Deemed IRAs. However, the plan's disqualification will cause the Deemed IRAs to be treated as regular IRAs (i.e., ineligible for Deemed IRA treatment). Since regular IRA assets cannot be commingled with qualified plan assets outside a common trust fund or common investment fund (as the assets of Deemed IRAs can), a disqualification of the plan could trigger disqualification of the Deemed IRAs if the employer has commingled qualified plan assets with Deemed IRA assets. The Internal Revenue Service states that qualification errors affecting Deemed IRAs can be corrected under the Internal Revenue Service's Employee Plans Compliance Resolution System.

The Internal Revenue Service proposes to make final Deemed IRA regulations effective August 1, 2003. The deadline for providing comments to the Internal Revenue Service regarding the proposed regulations is August 18, 2003.

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