Client ALERT

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Deemed IRAs: An Opportunity to Encourage Employees to Deposit All of their Retirement Savings with a Single Institution

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The Internal Revenue Service (IRS) on May 20, 2003 issued proposed regulations that will allow financial institutions and investment management firms, as well as employers, to implement "deemed IRAs." Deemed IRAs are individual retirement accounts or annuities that are established within employer-sponsored tax qualified retirement plans. These new vehicles will enable covered employees who take advantage of the deemed IRA feature to place much or all of their retirement savings with a single institution.

Background

Deemed IRAs are a new vehicle that was authorized by 2001 tax legislation, effective for retirement plans for their plan years beginning in 2003. Section 408(q) of the Internal Revenue Code, the enabling provision, states that if a qualified employer plan elects to allow employees to make voluntary employee contributions to a separate account or annuity established under the plan, and the separate account or annuity meets the applicable requirements under the Internal Revenue Code that apply either to regular IRAs or to Roth IRAs, then the account or annuity will be treated for purposes of the Code as an IRA and not as a qualified plan.

Deemed IRAs are exempt from most of the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), except for certain fiduciary rules and ERISA's enforcement rules.

In addition to the proposed regulations on deemed IRAs, the IRS has issued a sample plan amendment employers may use to add deemed IRA features to their retirement plans, as well as a List of Required Modifications ("LRMs") providing additional drafting guidance on how to do so.

Advantages of Deemed IRAs

Until now, IRA funds could generally not be rolled over into a qualified retirement plan, except for IRA funds that were rolled into the IRA from another qualified retirement plan. As a result, most employees' IRAs are maintained under entirely separate arrangements from their employer-provided retirement plans, and invested differently with different financial institutions. Employers that add deemed IRA features to their qualified retirement plans will enable their employees to consolidate their qualified plan and IRA savings together.

Deemed IRAs will benefit financial institutions that have a substantial "captive" qualified retirement base by enabling them to capitalize on that base by capturing substantial IRA assets held at other institutions. In addition, distributions from an employer's qualified plan could be rolled over to the deemed IRA, and the deemed IRA could be used as the default rollover vehicle where the employee's account is cashed out. It is likely, given the substantial advantages to financial institutions, that they will amend their prototype defined contribution retirement plans to include a deemed IRA option.

It is too early to tell whether employers will perceive sufficient advantages in deemed IRAs to establish them in large numbers or whether they will perceive this feature as adding administrative burdens and possibly additional liabilities. Employers may be concerned that a deemed IRA feature will encourage eligible employees to contribute to a deemed Roth IRA and adversely affect the ability of the employer's 401(k) plan to satisfy nondiscrimination testing for salary reduction contributions. Others may worry about increasing their potential fiduciary liability under ERISA. Still others may be concerned about exacerbating "lost participant" problems by encouraging ex-employees to leave their funds behind in deemed IRAs. Many of these issues can be resolved by proper drafting and design.

Internal Revenue Code Requirements Applicable to Deemed IRAs

Section 408(q) of the Internal Revenue Code imposes only three requirements for deemed IRAs:

> (i) Only "voluntary employee contributions" may be made to the deemed IRA.

(ii) The contributions must be made to a separate account or annuity established under the qualified employer plan.

(iii) The separate account or annuity must meet the requirements for a traditional IRA under Section 408 of the Code or a Roth IRA under Section 408A of the Code, except for the prohibition on commingling of assets outside of a common trust or common investment fund that applies to other IRAs.

If the above requirements are met, contributions are treated as contributions to a traditional or Roth IRA, and not as contributions to a tax qualified plan. All tax qualified retirement plans may include a deemed IRA, and so may Section 403(a) and (b) plans as well as governmental Section 457(b) plans.

Separate Entities

As a general matter, a qualified plan and its deemed IRA feature are treated as separate entities under the Internal Revenue Code and are subject to the rules applicable to qualified employer plans and IRAs, respectively. Issues regarding eligibility, participation, disclosure, nondiscrimination, contributions, investments and plan administration are generally to be resolved under the separate rules applicable to each entity under the Internal Revenue Code.

Assets of the deemed IRA may be commingled for investment purposes with those of the qualified plan, but the restriction on commingling those assets with other assets applies.

Traditional IRA and Roth IRA Rules Apply

The ordinary tax rules applicable to traditional or Roth IRAs apply to deemed IRAs. Thus, the regular IRA contribution and deduction limits for traditional or Roth IRAs apply.

Timing and Taxation of Distributions

The minimum distribution rules applicable to non-Roth IRAs, which slightly differ from the minimum distribution rules applicable to qualified plans, apply to deemed non-Roth IRAs. Under these rules, distributions from a deemed traditional IRA must commence by the time the participant reaches the age of 70 ½ even if the individual is still employed by the plan sponsor.

Similarly, the taxation of deemed IRA distributions will be based the rules for IRA distributions.

Tax Impact of Deemed IRA to IRA Owner

Deemed IRA contributions will not reduce the IRA owner's W-2 income. However, the contribution will be deductible to the IRA owner to the extent it would have been deductible if made to a real IRA. Of course, employees may elect more withholding exemptions to anticipate that tax benefit.

Trust and Trustee

The trust or custodial account holding deemed IRA assets must be separate from the trust holding other assets of the qualified employer plan. In addition, the trustee or custodian of a deemed IRA must be a bank or other entity approved by the IRS. Hence, plans that do not have institutional trustees or custodians may not be able to offer deemed IRA features.

A separate trust is not necessary for each individual deemed IRA owner. Rather, the deemed IRAs of multiple individuals may be held in a single trust, with separate accounting for each individual's interest.

Disqualifying Defects

Proposed IRS regulations take the position, perhaps somewhat controversially, that disqualifying defects in either the tax qualified plan or the deemed IRA can disqualify both vehicles, but the IRS will permit those defects to be corrected under rules similar to those in its Employee Compliance Resolution System, thereby precluding disqualification.

Applicability of ERISA to Deemed IRAs

Section 4(c) of ERISA provides that deemed IRAs are subject only to a limited number of ERISA provisions: the exclusive benefit rule of Section 403, fiduciary rules of sections 404 and 405 and the enforcement requirements of Part 5. Section 4(c) of ERISA provides that the foregoing provisions of ERISA are intended to apply to a deemed IRA in a manner similar to a Simplified Employee Pension (SEP). The Department of Labor (DOL) takes the position that a SEP is an ERISA plan.

The following provisions of ERISA do not apply to deemed IRAs: (1) reporting and disclosure, (2) substantive provisions of ERISA, such as participation and vesting and (3) funding requirements. The prohibited transaction provisions of ERISA Section 406 do not apply to the deemed IRAs, although the parallel provisions under the Internal Revenue Code, found in Section 4975, are applicable.

The proposed IRS regulations do not address what information the annual report of the retirement plan on Form 5500 will require with respect to the deemed IRA feature. However, the summary plan description for the tax qualified retirement plan should clearly include a description of the deemed IRA feature since it will be implemented via a plan amendment.

Deadline for Establishing a Deemed IRA within a Plan

Plans must be amended to offer deemed IRAs before deemed IRA contributions are first accepted from employees, but for 2003 only, the authorizing amendment can be adopted thereafter at any time before the end of the plan's 2003 plan year.

Optional Features

Plan sponsors can specify whether their deemed IRAs are traditional or Roth IRAs, or both; limit deemed IRA eligibility; expand eligibility to employees not eligible for the plan; limit in service deemed IRA withdrawals; or designate the deemed IRA as the default rollover IRA.

Incentives that Financial Institutions Could Use to Attract Additional Funds into Deemed IRAs

In order to attract deemed IRA funds, financial institutions should consider the offering additional incentives.

First, the deemed IRA feature should ideally be designed so that the employer/ plan sponsor does not have additional administrative burdens. For example, the financial institution could process all required forms for deemed IRA participants who have terminated employment, locate lost deemed IRA participants and handle compliance with the minimum distribution rules. The employer's fiduciary liability for the deemed IRA would potentially be reduced if the financial institution offered a package to assist the employer in Section 404(c) compliance.

Second, a fee arrangement that provides the potential for reduced administrative or investment fees would encourage employers to sign on.

Finally, the financial institution could offer other services that would be helpful for participants with potentially larger account balances in a deemed IRA, such as investment education that does not constitute investment advice under existing DOL interpretations or investment advice for individual participants, consistent with ERISA's prohibited transaction rules.

The ERISA Group at Paul Hastings can assist clients in the implementation process with respect to deemed IRAs, including the preparation or review of relevant plan and IRA documents, IRA disclosure statements and sample summary plan descriptions. Paul Hastings can also provide assistance in the ERISA fiduciary area and in the design of an attractive deemed IRA product, consistent with the provisions of the Internal Revenue Code and ERISA.

If you have any questions about the issues discussed in this Alert, please contact any of the following members of our Institutional Investment, Benefits & Compensation practice group.

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