

THE IRS ISSUES FINAL REGULATIONS ON OFFERING A “DEEMED IRA” OPTION IN QUALIFIED RETIREMENT PLANS AND CERTAIN OTHER RETIREMENT PLANS

The Internal Revenue Service (“IRS”) published, on July 22, 2004, final regulations that describe the requirements that must be satisfied in order to provide a deemed IRA as part of an employer’s qualified retirement plan (e.g., a 401(k) plan) or as part of certain other types of tax-favored retirement plans established by an employer. These regulations clarify several issues that had existed about adding an IRA option to these types of retirement plans, and employers now have the information they need to analyze the advantages and disadvantages of providing such an option to their eligible employees.

What Is a Deemed IRA?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) amended the Internal Revenue Code (“Code”) to allow employers with certain types of tax-favored retirement plans to amend those plans to add an IRA option that could be used by eligible employees to make voluntary employee contributions to IRA accounts established under those plans. This IRA option can be added to the following types of tax-favored retirement plans (“Plans”): (1) qualified retirement plans under Section 401(a) of the Code (e.g., a 401(k) plan, a qualified profit sharing plan, or a qualified defined benefit plan); (2) qualified annuity plans under Section 403(a) of the Code; (3) tax-sheltered annuity plans under Section 403(b) of the Code; and/or (4) governmental eligible deferred compensation plans under Section 457(b) of the Code.

If an employer wishes to add this IRA option to a Plan, it must amend the Plan to allow eligible employees to make voluntary employee contributions to a separate account or annuity that (a) is established under the Plan, and (b) satisfies the applicable Code requirements for a traditional IRA or a Roth IRA. Such an account or annuity will be deemed to be a traditional IRA or a Roth IRA for all purposes of the Code (that is why it is commonly referred to as a “deemed IRA”), and will be subject to the regular contribution limits under the Code for such IRAs. An employee’s contributions to a deemed IRA are not required to be taken into account when determining how much of a contribution may be made on behalf of the employee to the applicable Plan (i.e., the Code contribution limits that apply to the Plan will be applied in the same manner as though the Plan did not have deemed IRAs).

What Contribution Limit Will Apply To a Deemed IRA in 2004?

An eligible employee generally will not be able to make total 2004 contributions to a deemed IRA, a traditional IRA, and/or a Roth IRA (contributions to two or more IRAs will be aggregated for purposes of this limit) in excess of the lesser of:

- \$3,000 (plus a \$500 catch-up amount for eligible employees who have attained age 50 prior to the end of the tax year); or
- 100 percent of the compensation includable in the eligible employee’s gross income for the tax year.

The ability of an eligible employee to be able to deduct contributions to a traditional IRA could be reduced in whole or in part if, among other things (1) the employee or the employee's spouse was covered for any part of the year by a tax-favored employer retirement plan (i.e., a qualified retirement plan under Section 401(a) of the Code, a qualified annuity plan under Section 403(a) of the Code, a tax-sheltered annuity plan under Section 403(b) of the Code, a government plan other than an eligible deferred compensation plan under Section 457(b) of the Code, a simplified employee pension plan, a SIMPLE IRA, or a retirement trust under Section 501(c)(18) of the Code), and (2) the employee's modified adjusted gross income exceeds certain amounts. If an eligible employee in 2004 is covered by such a retirement plan and the eligible employee's filing status is single, a full deduction for contributions to a traditional IRA can be taken if the employee's modified adjusted gross income is \$45,000 or less, a partial deduction can be taken if the employee's modified adjusted gross income is more than \$45,000 but less than \$55,000, and no deduction can be taken if the employee's modified adjusted gross income is \$55,000 or more. If an eligible employee in 2004 is covered by such a retirement plan and the eligible employee's filing status is married filing jointly, a full deduction for contributions to a traditional IRA can be taken if the employee's modified adjusted gross income is \$65,000 or less, a partial deduction can be taken if the employee's modified adjusted gross income is more than \$65,000 but less than \$75,000, and no deduction can be taken if the employee's modified adjusted gross income is \$75,000 or more. Notwithstanding the preceding two sentences, no deduction may be taken for a contribution on behalf of an individual who is age 70 ½ or older by the end of the year.

An eligible employee also may, in certain circumstances, be able to make non-deductible IRA contributions.

What Are Some of the More Important Changes Made By the Final Regulations?

Among the more important changes made by the final regulations on deemed IRAs are the following:

- A Separate Trust For Deemed IRAs is Not Required – The final regulations provide that a trust that holds deemed IRA assets does not have to be separate from the trust holding the other assets of the applicable Plan, as long as the trustee maintains a separate account for each deemed IRA.
- Clarification of Disqualification Issues – The extent to which the use of a deemed IRA feature in a Plan could result in the disqualification of the Plan (i.e., the loss of the tax-favored status of the Plan) has been clarified by the final regulations. If deemed IRAs are maintained in a single trust with the other assets of a Plan, the failure of any of the deemed IRAs maintained by the Plan to satisfy the applicable Code requirements could cause the Plan to lose its tax-favored status. To the extent the deemed IRAs are held in a trust that is separate from the trust that holds the other assets of the Plan and there has been no commingling of assets between the two trusts (except in a common trust fund or common investment fund as permitted by Section 408(a)(5) of the Code), a failure to satisfy the applicable Code requirements with respect to a deemed IRA will not cause the Plan to lose its tax-favored status.
- Guidance As to How the Separate Entity Requirements Apply With Respect To Participation, Reporting, and Withholding – In the preamble to the final regulations the IRS addressed several administrative issues that had arisen regarding the requirement that a Plan and its deemed IRAs be treated as separate entities under the Code, and that they be subject to the separate Code rules applicable to Plans and IRAs, respectively. The IRS said that a deemed IRA portion of a Plan can have different eligibility requirements from the employer retirement plan portion of that Plan (and that an employee is not required to participate in both portions). Reporting and withholding requirements will apply separately to the employer retirement plan portion of a Plan and the deemed

IRA portion of a Plan (e.g., separate Forms 1099-R will need to be issued for distributions from each portion, and different withholding requirements will apply to each portion).

- [The Rules Regarding When Governmental Units Can Be Trustees of Deemed IRAs Have Been Broadened](#) – The final regulations have made it easier for governmental units to act as a trustee of a deemed IRA.

What Are the Major Advantages and Disadvantages of Adding Deemed IRAs To a Plan?

Major advantages of adding a deemed IRA option to a Plan include (1) it offers employees an easier way to make IRA contributions (employees will be better able to coordinate their IRA elections with their elections under the employer retirement plan portion of the Plan), (2) it could allow employees to have the same investment options for their IRA contributions and their contributions under the employer retirement plan portion of the Plan (assuming, of course, an employer decides to coordinate those investment options), and (3) it could encourage greater retirement savings by employees (eligible employees may be more likely to use IRAs if they are reminded of the IRA option on a periodic basis by their employer).

Major disadvantages of adding a deemed IRA option to a Plan include (a) it could increase the threat of the Plan losing its tax-favored status if deemed IRAs are included in the same trust as the other assets of the Plan (the use of separate trusts, although administratively more cumbersome, would eliminate this threat), and (2) it will increase the administrative responsibilities with respect to a Plan (the administrator of the Plan will need to comply with two different sets of administrative requirements, with one set being the rules that must be satisfied for the employer retirement plan portion of the Plan and the second set being the rules that must be satisfied for the deemed IRAs).

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