KIRKLAND & ELLIS Alert

Employee Benefits Practice Area **February 2003**

"Deemed IRAs" Now Permitted under Qualified Plans

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") added new Code § 408(q) which permits voluntary employee contributions made to qualified employer plans to be treated as IRA or Roth IRA contributions. Pursuant to EGTRRA this provision is first effective for plan years beginning on and after 1/1/03. This Alert discusses the requirements for establishing such a "deemed IRA" and summarizes recently issued IRS guidance.

In General. Code § 408(q) provides that a separate account or annuity in a "qualified employer plan" will be treated as an individual retirement account or annuity (*i.e.*, a deemed IRA) for all purposes under the Code if: (1) the plan permits employees to make voluntary contributions to the separate account or annuity; and (2) the separate account or annuity meets the requirements for a regular IRA or Roth IRA set forth in Code §§ 408 and 408A. However, the Code § 408(a)(5) requirement that IRA assets not be commingled other than in a common trust or investment fund will not apply to deemed IRAs. For deemed IRA purposes, a "qualified employer plan" includes all plans qualified under Code § 401(a) (*e.g.*, 401(k) plans, ESOPs, profit sharing plans, defined benefit pension plans), Code § 403(a) and § 403(b) annuities, and Code § 457(b) government plans.

Deemed IRA vs. Qualified Plan Requirements A deemed IRA must be treated as either a traditional or Roth IRA for all tax purposes, so that regular IRA contribution and deduction limits will apply.[1] In addition, traditional deemed IRAs would remain subject to minimum distribution requirements for participants who have attained age $70^{1}/_{2}$, and only Roth deemed IRAs could accept contributions from such participants. No loans could be made from a deemed IRA, as an IRA loan is a non-exempt prohibited transaction. However, deemed IRAs are not subject to any qualified plan rules such as funding and non-discrimination requirements. Also, a deemed IRA would qualify for early withdrawal excise tax exceptions under Code § 72(t) that are not applicable to qualified plans, *i.e.*, no 10% excise tax would apply if amounts distributed from a deemed IRA are used for (1) medical insurance premiums for unemployed participants, (2) expenses incurred for higher education, (3) certain first-time home purchases, or (4) a series of payments over the lifetime of a participant that begin prior to separation from service. However, the qualified plan 10% excise tax exceptions for separation from service after attainment of age 55 and payments to alternate payees under qualified domestic relations orders would not apply to deemed IRAs. A deemed IRA would be subject to standard IRA reporting and disclosure requirements, but would not be subject to mandatory 20% income tax withholding on distributions. Finally, deemed IRAs are not subject to any provisions of ERISA other than general fiduciary rules, the exclusive benefit rule, and ERISA enforcement requirements (including claims procedures).

IRS Guidance The IRS recently issued Revenue Procedure 2003-13 to provide guidance to employers who wish to amend their qualified plans to include deemed IRAs. The Revenue Procedure states that plan sponsors who want to provide for deemed IRAs must

[1] The IRA contribution limit for 2003 is $3,000 (or $3,500 for those age 50 and over). Roth IRA contributions are not deductible; traditional IRA contributions are subject to deduction limitations based on adjusted gross income for individuals who are active qualified plan participants.

include appropriate provisions in their plan documentation no later than the date deemed IRA contributions are accepted from employees. In order to satisfy the requirements for the EGTRRA remedial amendment period, such provisions must reflect a "reasonable, good-faith interpretation" of the deemed IRA requirements. The Revenue Procedure states that a plan will satisfy the "reasonable, good-faith interpretation" requirement if the plan document includes (1) a sample plan amendment set forth in the Revenue Procedure, and (2) language that satisfies Code §§ 408 or 408A relating to traditional and Roth IRAs. The guidance further provides that a plan will satisfy the IRA language requirement if the plan includes the language contained in the IRS Listings of Required Modifications ("LRMs") published for IRAs. The sample plan amendment contained in the Revenue Procedure is reproduced at the end of this Alert.

Transition Rules for 2003. In order to provide transition relief for 2003, the Revenue Procedure states that plan sponsors who want to implement deemed IRAs for a plan year beginning after 12/31/02 and before 1/1/04 will not be required to have deemed IRA provisions in their plan documentation until the end of such plan year. Thus, solely for plan years beginning before 1/1/04, plan sponsors can adopt the required plan amendments after deemed IRA contributions actually commence.

Potential Impact of New Administration Proposal. As you may know, the Bush administration has in the past few days unveiled a proposal that would make significant changes to retirement plans in general and IRAs in particular. The proposal would create two new types of savings accounts, a "Lifetime Savings Account" ("LSA") and a "Retirement Savings Account" ("RSA"), to each of which an individual could contribute up to $7,500 per year (indexed for inflation). There would be no immediate tax deduction for amounts contributed to either account. However, LSA amounts could be withdrawn tax-free at any time for any purpose; RSA amounts could be withdrawn tax-free without penalty after age 58. The proposal would consolidate Archer medical savings accounts, Coverdell education savings accounts and state tuition savings plans into the LSA. In addition, the proposal would essentially abolish the traditional IRA: a traditional IRA could be converted into an RSA if applicable taxes are paid, but no future contributions could be made to a traditional IRA that is not converted to an RSA.

The practical effect of the proposal would be to replace traditional and Roth IRAs with the new RSA. Thus, a deemed IRA maintained in conjunction with a qualified plan would presumably be converted to an RSA, which could accept annual contributions up to $7,500. However, at this time the treatment of deemed IRAs under the administration's proposal is not clearly established, and indeed the proposal may never become law. We expect that prototype plan sponsors and administrative and financial service providers will be studying the issue while considering whether to offer deemed IRAs as part of their qualified plan services, and you may wish to contact your service provider to inquire whether a deemed IRA product is contemplated.

Sample Amendment. The following is the sample deemed IRA plan amendment contained in Revenue Procedure 2003-13:

The following sample plan amendment may be adopted only by plans trusteed by a person eligible to act as a trustee of an IRA under Code § 408(a)(2) and plans that designate an insurance company to issue annuity contracts under Code § 408(b). Additional language that satisfies Code §§ 408 or 408A must also be added to the plan.

SECTION __. DEEMED IRAs

1. Applicability and Effective Date. This section shall apply if elected by the employer in the adoption agreement and shall be effective for plan years beginning after the date specified in the adoption agreement.

2. Deemed IRAs. Each participant may make voluntary employee contributions to the participant's [insert "traditional" or "Roth"] IRA under the plan. The plan shall establish a separate [insert "account" or "annuity"] for the designated IRA contributions of each participant and any earnings properly allocable to the contributions, and maintain separate recordkeeping with respect to each such IRA.

3. Reporting Duties. The [insert "trustee" or "issuer"] shall be subject to the reporting requirements of Code § 408(i) with respect to all IRAs that are established and maintained under the plan.

4. Voluntary Employee Contributions. For purposes of this section, a voluntary employee contribution means any contribution (other than a mandatory contribution within the meaning of Code § 411(c)(2)) that is made by the participant and which the participant has designated, at or prior to the time of making the contribution, as a contribution to which this section applies.

5. Trust. IRAs established pursuant to this section shall be held in [insert "a trust" or "an annuity"] separate from the trust established under the plan to hold contributions other than deemed IRA contributions and shall satisfy the applicable requirements of Code §§ 408 and 408A, which requirements are set forth in section __ of the plan.

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