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IRS Finalizes Rules on Deemed IRAs, But Drawbacks Remain

The Internal Revenue Service has issued final regulations regarding "Deemed IRAs" in employer sponsored retirement plans. A Deemed IRA is a retirement savings tool that was added to the tax code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

What is a Deemed IRA?

A Deemed IRA is an account or annuity under an employer's tax-qualified retirement plan that is treated as an employee's traditional IRA or Roth IRA. The Deemed IRA is subject to the tax rules applicable to IRAs rather than to those applicable to qualified plans. Unlike the IRA rollover account, a Deemed IRA is an active savings vehicle to which an employee may contribute on an ongoing basis. The advantages of including the Deemed IRA in the employer's plan are that it allows the employee to consolidate the investment of his retirement savings, facilitates additions to those savings and may give the employee access to more advantageous investment alternatives than are possible in a stand-alone IRA.

Who Can Participate?

Deemed IRAs may be added to the tax-qualified retirement plans of private employers as well as those of not-for-profit and governmental entities. A plan may establish different eligibility requirements for the Deemed IRA than for the qualified portion of the plan. Thus, for example, a profit sharing plan can require an employee to complete a year of service before becoming a participant but allow the employee to begin participating in the Deemed IRA as soon as he is hired.

What Kinds of IRA Contributions Can Be Permitted?

Deemed IRAs can be either traditional IRAs or Roth IRAs. The contribution rules that apply to Deemed IRAs are the same as those that apply to traditional IRAs and Roth IRAs that are not held in a qualified plan. Thus, the dollar limits on contributions that apply to traditional IRAs and Roth IRAs are the same when applied to Deemed IRAs. For example, for some employees, a portion of their contribution to a Deemed IRA may be deductible. In addition, for employees who are at least 50 years old, "catch up" contributions may be made to Deemed IRAs in the same manner as they would to traditional or Roth IRAs. Because the IRA tax rules apply to Deemed IRAs, the non-discrimination testing and the maximum annual additions rules applicable to qualified plans do not apply to contributions to the Deemed IRA.

The rules also permit rollovers and transfers to and from Deemed IRAs under the same rules as rollovers and transfers to and from other IRAs. Thus, for example, the plan may provide that an employee may request and receive a distribution of his or her Deemed IRA account balance and may roll it over to an eligible retirement plan regardless of whether that employee is eligible to receive a distribution of any other plan benefits.

How Does a Deemed IRA Differ from an IRA Rollover Account?

An employee's IRA rollover account holds assets originally transferred from another employer sponsored retirement plan or a contributory IRA or both, but once the assets are rolled into the employer's plan, they are treated as part of the qualified plan and are subject to its tax rules. In contrast, a Deemed IRA is governed by the IRA tax rules. The most important distinction of the Deemed IRA compared to the IRA rollover account is that the employee's IRA rollover account is essentially static—no new contributions may be added to it. A Deemed IRA is an active savings vehicle to which the employee may continue to contribute. The employer may facilitate retirement savings by allowing contributions to the Deemed IRA through payroll deduction.

What Kind of Trustee is Required?

The trustee or custodian of any trust containing Deemed IRA assets must be a bank or some other entity that receives approval from the Commissioner of the Internal Revenue Service to serve as a non-bank trustee. Normally, qualified retirement plans are not subject to this rule and many plans have individuals as trustees. If the plan sponsor wants to provide for Deemed IRAs in such a plan, it will either have to utilize a qualified trustee for the entire plan, or establish a separate trust for the assets that are held in the Deemed IRAs. There is a limited exception to this rule for the plans of governmental entities.

IMPORTANT: The Department of Labor has taken the position that the trustee of a trust that holds Deemed IRA assets has a duty to monitor compliance with the IRA rules. This imposes an expanded fiduciary burden that institutions serving as IRA trustees or custodians do not otherwise have. For example, while IRA trustees have a tax reporting obligation to calculate and notify IRA holders of required minimum distribution amounts, they typically have no fiduciary obligation to ascertain whether the distributions are actually made. The DOL's position changes this and would impose fiduciary liability on the Deemed IRA trustee for the consequent failure of the Deemed IRA to meet the IRA rules. This liability could be significant if the Deemed IRA assets are held in the same trust with the qualified plan assets and the entire plan ceases to be qualified as a consequence.

One Trust or Two?

Deemed IRA assets may be held in a single trust with qualified plan assets as long as separate accounting is maintained for each Deemed IRA. Two significant drawbacks to the single trust nevertheless remain:

- √ The single trust must have a bank (or other qualified entity) as trustee, and
- √ The failure of either the Deemed IRA or the qualified plan to meet their respective qualification rules will disqualify the entire plan.

The latter problem is viewed as a serious impediment to combining qualified plan assets and Deemed IRA assets in a single trust. If a Deemed IRA fails to meet the IRA qualification rules, for example, by failing to make a required minimum distribution, the entire plan can be disqualified if all the assets are in a single trust. This is particularly a problem because some aspects of the operation of Deemed IRAs are not within the control of the plan sponsor.

So, while a plan is no longer required to set up a second trust in order to offer Deemed IRAs, failure to do so could put the entire plan at risk.

Should Your Plan Include Deemed IRAs?

The answer to this question will depend to a large extent on what your plan record keeper is prepared to offer. Including provisions for Deemed IRAs requires record keepers to track separate rules and reporting requirements for Deemed IRAs and qualified plan assets, in addition to separate accounting. Not all record keepers are prepared to do this.

The advantages to the employee of a Deemed IRA is simplification of retirement savings, possibly through payroll deduction, and consolidation of investments at a lower cost. Advantages to the employer may include an increase in the asset base under the plan that reduces the overall cost of plan investments. On the other hand, the cost of maintaining two separate trusts to avoid the potential for disqualifying the entire plan on account of a failed Deemed IRA (or, in the alternative, to avoid disqualifying the Deemed IRAs on account of a disqualifying defect in the employer's plan) may not be justified unless there is substantial interest expressed by employees to take advantage of the Deemed IRA.

Your consultant at Kravitz will be happy to discuss this matter with you.

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