

Financial Institution Tax-Favored Savings Accounts

QUALIFIED RETIREMENT PLANS ■ INDIVIDUAL RETIREMENT ACCOUNTS ■ 403(b) PLANS ■ 457 PLANS
529 PLANS ■ COVERDELL EDUCATION SAVINGS ACCOUNTS ■ ARCHER MEDICAL SAVINGS ACCOUNTS

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Deemed IRAs Become Effective January 1, 2003

The Economic Growth and Tax Relief Act of 2001 introduced two new tax-favored savings account opportunities for individuals: (i) the Roth 401(k)/403(b) plan, a tax-qualified, employer-sponsored retirement plan that provides for after-tax employee contributions and tax-free distributions, which will become effective January 1, 2006, and (ii) deemed individual retirement accounts (“Deemed IRAs” sometimes also referred to as “Sidecar IRAs”), which will become effective on January 1, 2003 and which are the focus of this Alert.

Deemed IRAs 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. (For this purpose, qualified retirement plans include traditional qualified retirement plans such as 401(k) plans and profit sharing plans, as well as 403(a) annuity plans, 403(b) plans and government-sponsored 457 plans.)

It is, as yet, unclear how popular Deemed IRAs will be. Congress’s last attempt to permit IRA-like accounts in qualified retirement plans—the qualified voluntary employee contribution (QVEC) concept from the early 1980s—failed in large part because QVECs were subject to many of the same rules as qualified retirement plans. By divorcing Deemed IRAs from the qualified plan rules, the Deemed IRA may be much more popular than the QVEC. It could give employees a cost-effective and convenient way to establish an individual retirement account. It also could give financial institutions an opportunity to leverage their qualified retirement plan business to attract new individual retirement account customers.

To date, neither the Internal Revenue Service nor the Department of Labor has issued any regulations or other guidance regarding Deemed IRAs. However, new Section 408(q) of the Internal Revenue Code makes clear that contributions to Deemed IRAs are treated as either Traditional or Roth IRA contributions and not as qualified plan contributions.

For example:

- An employee who elects to contribute to a Deemed Traditional IRA established as part of his or her employer’s qualified retirement plan may deduct those contributions, subject to the active retirement plan participation and earnings limitations otherwise applicable to Traditional IRA contributions.
- An employee who elects to make after-tax contributions to a Deemed Roth IRA established as part of his or her employer’s qualified plan may exclude distributions of earnings on those contributions from his or her gross income only to the extent the distributions are “qualified” distributions within the meaning of the Roth IRA rules (*i.e.*, distributions that are made more than five years after the Deemed Roth IRA is established and following the individual’s attainment of age 59-1/2, death or disability).
- The Roth IRA income limits apply to Deemed Roth IRA contributions. Accordingly, married individuals who file jointly with annual earnings in excess of \$160,000 and single individuals with annual earnings in excess of \$110,000 are not eligible to make Deemed Roth IRA contributions.

- Deemed IRA contributions (referred to by EGTRRA as “voluntary employee contributions”) are subject to the same contribution limits as regular Traditional and Roth IRA contributions. For 2003, the maximum is \$3,000 (\$3,500 for individuals age 50 or older by December 31, 2003).
- Deemed IRA contributions are not treated as annual additions for purposes of Section 415 of the Internal Revenue Code, which limits annual qualified retirement plan contributions to the lesser of \$40,000 or 100% of the individual’s annual compensation.
- Contributions to a Deemed IRA established as part of a 401(k) plan are not subject to or included in the so-called “ADP” and “ACP” discrimination tests, which prevent highly compensated employees from making disproportionately greater contributions to a 401(k) plan than nonhighly compensated employees.
- Deemed IRA contributions are not counted against the limits in Sections 402(g) and 414(v) of the Internal Revenue Code, which prohibit annual pre-tax 401(k) contributions in excess of \$12,000 (for 2003, \$14,000 for individuals age 50 or older by December 31, 2003).
- Unlike employee contributions to a 401(k) plan, Deemed IRA contributions are not deductible by the employer.
- IRA reporting, disclosure and withholding rules apply to Deemed IRAs. As a result, Deemed IRAs will not be included in the employer’s annual Form 5500 filing and will not be subject to the other reporting, disclosure and withholding rules applicable to qualified retirement plans, such as the mandatory 20% withholding applicable to most qualified retirement plan distributions. On the other hand, qualified plan trustees will need to report Deemed IRA contributions on Form 5498 and the 10% voluntary withholding rule applicable to IRAs will apply to Deemed IRA distributions.

Notably, the prohibition against the commingling of IRA assets with other property except in a common trust fund or common investment fund does not apply to Deemed IRAs. As a result, Deemed IRA funds can be commingled with other funds in the qualified plan for investment purposes.

Unlike regular Traditional and Roth IRAs, Deemed IRAs will be subject to the general fiduciary rules and claims procedures generally applicable to qualified retirement plans. Employers may perceive the imposition of fiduciary obligations with respect to Deemed IRAs as a significant disadvantage.

Deemed IRAs become available January 1, 2003. However, like most new tax-favored savings accounts, Deemed IRAs will likely not become widely available, if at all, until after the publication of regulatory guidance by the Internal Revenue Service and the Department of Labor. That guidance will be useful in resolving outstanding issues regarding the implementation of these accounts.

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