

# Notice of Proposed Rulemaking

## Deemed IRAs in Qualified Retirement Plans

### REG-157302-02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding accounts or annuities added to qualified employer plans where such accounts or annuities are to be treated as individual retirement plans. These regulations reflect changes made to the law by the Economic Growth and Tax Relief Reconciliation Act of 2001 and by the Job Creation and Worker Assistance Act of 2002. These regulations will affect administrators of, participants in, and beneficiaries of qualified employer plans.

DATES: Written and electronic comments and requests for a public hearing must be received by **August 18, 2003**.

ADDRESSES: Send submissions to: CC:PA:RU (REG-157302-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-157302-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Linda C. Phillips or Robert M. Walsh at (202) 622-6090; concerning submissions and delivery of comments, LaNita Van Dyke (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has

been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by **July 21, 2003**. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.408(q)-1(f)(2). This collection of information is required by the IRS to ensure that the separate requirements of qualified employer plans and individual retirement plans are satisfied. The collection of information is required to obtain a benefit. Specifically, this information is required for a taxpayer who wants to include individual retirement plans as part of its qualified employer plan.

Estimated total annual reporting and/or recordkeeping burden: 40,000 hours

Estimated average annual burden hours per respondent and/or recordkeeper: 50 hours.

Estimated number of respondents and/or recordkeepers: 800.

The estimated frequency of responses is on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 408(q) of the Internal Revenue Code (Code) relating to the addition of separate accounts and annuities to qualified employer plans. Section 408(q) was added to the Code by section 602 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Public Law 107-16 (115 Stat. 117) and amended by section 411 of the Job Creation and Worker Assistance Act of 2002 (JCWAA), Public Law 107-147 (116 Stat. 21).

#### Explanation of Provisions

Section 408(q) provides that, if a qualified employer plan allows employees to make voluntary employee contributions to a separate account or annuity established under the plan and under the terms of the qualified employer plan such account or annuity meets the applicable requirements of section 408 or section 408A for an individual retirement account or annuity, then such account or annuity shall be treated for purposes of the Code in the same manner as an individual retirement plan rather than as a qualified employer plan. It further provides that contributions to such a "deemed IRA" shall be treated as contributions to the deemed IRA rather than to the qualified employer plan. Section 408(q) also expressly provides that the prohibition of commingling IRA assets with other property except in a common trust fund or common investment fund shall not apply to deemed IRAs. These proposed regulations define *qualified employer plan* and *voluntary employee contribution* as they are defined in section 408(q) of the Code.

Rules regarding deemed IRAs are also provided in section 4(c) of the Employee Retirement Income Security Act of 1974, Public Law 93-406 (88 Stat. 829) (ERISA), 29 U.S.C. 1003(c), as amended by Public Law 107-147 (116 Stat. 21). Section 4(c) provides that if a pension plan allows an employee to make voluntary employee contributions to a deemed IRA under section 408(q) of the Code, then the deemed IRA shall not be treated as part of such plan (or as a separate pension plan) for purposes of any provision of Title I of ERISA other than section 403(c), 404, or 405 (relating to exclusive benefit, and fiduciary and co-fiduciary responsibilities). Section 4(c), as amended by JCWAA, further provides that the enforcement and administration rules of part 5 of subtitle B of Title I of ERISA apply to deemed IRAs and that the applicable ERISA provisions shall apply to deemed IRAs in a manner similar to their application to a simplified employee pension (SEP) under Code section 408(k). Because Title I of ERISA is within the jurisdiction of the Department of Labor, these regulations do not address the application of Title I to deemed IRAs. Also, these regulations do not address the application of Code section 4975 to deemed IRAs. Section 102 of Reorganization Plan No. 4 of 1978 provides that the authority to interpret section 4975 has been transferred to the Department of Labor.

In general, these proposed regulations provide that a qualified employer plan and a deemed IRA are to be treated as separate entities under the Code and that each entity is subject to the rules generally applicable to that entity for purposes of the Code. Thus, a qualified employer plan (excluding the deemed IRA portion of the plan), whether it is a plan under section 401(a) (including defined benefit plans), 403(a), or 403(b), or a governmental plan under section 457(b), is subject to the rules applicable to that type of plan rather than to the rules applicable to IRAs under section 408 or 408A. Similarly, the deemed IRA portion of the qualified employer plan is generally subject to the rules applicable to traditional and Roth IRAs under sections 408 and 408A, respectively, and not to the rules applicable to plans under section 401(a), 403(a), 403(b), or 457.

Accordingly, these proposed regulations provide that issues regarding eligibility, participation, disclosure, non-

discrimination, contributions, distributions, investments, and plan administration are generally to be resolved under the separate rules (if any) applicable to each entity. In addition, these regulations specifically address several issues regarding the separate applicability of plan and IRA rules. For example, these proposed regulations provide that the availability of a deemed IRA is not a benefit, right or feature of the qualified employer plan under §1.401(a)(4)-4. Thus, the availability of a deemed IRA is not subject to §1.401(a)(4)-1(b)(3) which requires that benefits, rights, and features be available in a plan in a non-discriminatory manner.

Similarly, these proposed regulations provide that the rules applicable to deemed IRAs with respect to the trusteeship of the IRA and deductibility of IRA contributions are the rules applicable to traditional IRAs and Roth IRAs under the Code. Thus, for example, taxpayers with compensation in excess of the limits imposed by sections 219 and 408A may either not be able to make contributions to deemed IRAs or the deductibility of such contributions may be limited. For deemed IRAs that are traditional IRAs, as with other traditional IRAs, the employee must make a determination as to whether a particular contribution is deductible and make the proper entries on his or her tax return. Pursuant to section 219(f)(3), a contribution made on account of the preceding taxable year will be treated as made on the last day of such taxable year if the contribution is actually made to the IRA not later than the time prescribed by law for filing the return for such taxable year (not including extensions). However, section 219(f)(5), regarding the taxable year in which amounts paid by an employer to an individual retirement plan are includible in the employee's income, is not applicable to deemed IRAs. Thus, amounts withheld from an employee's compensation and contributed to a deemed IRA, and which are treated as made on the last day of the preceding taxable year pursuant to section 219(f)(3), shall be includible in income in the year in which they are withheld rather than in the preceding taxable year.

The proposed regulations also provide that the minimum distribution rules of section 401(a)(9) of the Code must be met separately with respect to the qualified employer plan and the deemed IRA. The de-

termination of whether a qualified employer plan satisfies the required minimum distribution rules is made without regard to whether a participant satisfies the required minimum distribution rules with respect to the deemed IRA.

Although section 408(a) provides that an individual retirement account is a trust, these regulations do not require that a separate trust be created for each deemed IRA that is an individual retirement account. Rather, the regulations provide that all such deemed IRAs may be held in a single trust as long as that trust is separate from the trust that holds the other assets of the plan. Where a single trust is created for the deemed IRAs, the regulations also provide that there must be separate accounting for each deemed IRA and each deemed IRA must satisfy all of the requirements of section 408(a) (except the prohibition of commingling under paragraph (a)(5) of that section). These proposed regulations also provide a comparable rule for deemed IRAs that are individual retirement annuities.

These regulations provide three exceptions to the general rule that the qualified employer plan and the deemed IRA are separate entities subject to their separate rules for purposes of the Code. First, the regulations state that the qualified employer plan document must contain the deemed IRA provisions. In general, the plan document must provide for a deemed IRA and a deemed IRA must be in effect at the time the deemed IRA contributions are accepted. However, plan sponsors who want to provide deemed IRAs for plan years beginning in 2003 are not required to have such provisions in their plan document before the end of such plan years. See Revenue Procedure 2003-13, 2003-4 I.R.B. 317.

Second, pursuant to section 408(q)(1), the prohibition of section 408(a)(5) on the commingling of IRA assets with other property except in a common trust fund or a common investment fund is not applicable to the assets of a deemed IRA. Thus, the assets of the deemed IRA may be commingled for investment purposes with the assets of the other portion of the plan. Where the assets are commingled, the regulations require that separate accounts be maintained and that gains and losses must be allocated to these separate accounts. For example, if a deemed IRA is established under a defined contribution plan that is quali-

fied under section 401(a) and the assets of the plan and the deemed IRA are commingled for investment purposes, then any gains or losses from the investment of the commingled assets of an employee must be allocated to the separate accounts of the employee under the deemed IRA and the plan.

Third, these proposed regulations provide that the failure of any of the deemed IRAs maintained by the plan to satisfy the applicable requirements of section 408 or 408A will cause the plan as a whole to fail to satisfy the plan's qualification requirements. Section 408(q) states that if a qualified employer plan elects to allow voluntary employee contributions to a separate account or annuity and that separate account or annuity meets the applicable requirements of section 408 or section 408A, then the account or annuity will be treated as an individual retirement plan rather than as a qualified employer plan. Section 408(q) applies only if the deemed IRAs maintained by the plan meet the requirements of section 408 or section 408A. If any of the deemed IRAs do not meet the applicable requirements, then section 408(q) does not apply, and the qualified employer plan will fail to satisfy its qualification requirements.

These proposed regulations provide a different rule where the portion of the plan that is not a deemed IRA fails to satisfy the qualification requirements of section 401(a). In that case, the deemed IRA is not a deemed IRA because section 408(q) does not apply where the plan is not a qualified employer plan. The regulations provide, however, that although the account or annuity that was intended to be a deemed IRA is not a deemed IRA, it may still be treated as a traditional or a Roth IRA if it satisfies the applicable requirements of section 408 or 408A (including the prohibition of commingling under paragraph (a)(5) of section 408).

If, as discussed above, a qualified employer plan or a deemed IRA fails to satisfy the applicable qualification requirements, it may nevertheless be treated as satisfying those requirements if the Employee Plans Compliance Resolution System (EPCRS), Rev. Proc. 2002-47, 2002-29 I.R.B. 133, or other administrative practice is used to correct the qualification failures. In this regard, the IRS intends that when Rev. Proc. 2002-47 is updated, it will include provisions permitting submissions for deemed IRAs.

These regulations also provide that a deemed IRA may be either a traditional IRA under section 408 or a Roth IRA under section 408A. However, because contributions to deemed IRAs are limited to employee contributions, while SIMPLE IRAs under section 408(p) and SEPs under section 408(k) may only receive employer contributions, the regulations provide that SIMPLE IRAs and SEPs may not be used as deemed IRAs.

As noted above, these regulations provide a general principle that a qualified employer plan and the deemed IRA feature are generally treated as separate entities under the Code and each is subject to the rules applicable to that entity. This principle can be applied to address a variety of issues which might arise with respect to deemed IRAs and, as a result, the regulations do not contain specific provisions addressing these issues. For example, as noted in Announcement 99-2, 1999-1 C.B. 305, employers may permit employees to contribute to traditional or Roth IRAs by direct deposits through payroll deduction. In addition, employees making direct deposits to traditional IRAs of deductible contributions may be able to adjust their federal income tax withholding to receive a more immediate tax benefit from their contributions. Because the IRA rules apply to deemed IRAs as they would to traditional and Roth IRAs, the provisions of Announcement 99-2 apply to deemed IRAs.

Similarly, these regulations expressly provide that the rules applicable to rollovers and transfers to and from IRAs also apply to rollovers and transfers to and from deemed IRAs, but the regulations do not address all of the aspects of such rollovers or transfers. For example, because section 408(c)(3) permits the surviving spouse of an IRA owner to treat the IRA as his or her own, the same rules apply to deemed IRAs although not expressly stated in these regulations. Thus, in accordance with section 408(c)(3), a qualified employer plan may permit a surviving spouse to treat a decedent's deemed IRA as his or her own. However, the surviving spouse, as a non-employee, may not make voluntary employee contributions to that deemed IRA.

Also, because the qualified employer plan and the deemed IRA are generally treated as separate entities, the early distribution rules of section 72(t) are applied separately to the two entities. Thus, a de-

termination as to whether a distribution is a part of a series of substantially equal periodic payments under section 72(t)(2)(iv) will be determined separately for the qualified employer plan and for the deemed IRA.

### **Proposed Effective Date**

The regulations are proposed to apply beginning on or after, August 1, 2003. Taxpayers may rely upon these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. The collection of information in the regulations is in §1.408(q)-1(f)(2) and consists of the requirement that deemed IRAs must be held in trusts or annuity contracts separate from the trust or annuity contract of the qualified employer plan. This certification is based on the fact that the cost of maintaining these separate trusts and annuity contracts is small, particularly for small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal authors of these regulations are Robert M. Walsh and Linda C. Phillips, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in the development of these regulations.

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

§1.408(q)–1 also issued under 26 U.S.C. 408(q). \* \* \*

Par. 2. Section 1.408(q)–1 is added to read as follows:

*§1.408(q)–1 Deemed IRAs in qualified employer plans.*

(a) *In general.* Under section 408(q) a qualified employer plan may permit employees to make voluntary employee contributions to a separate account or annuity established under the plan. If the requirements of section 408(q) and this section are met, such account or annuity is treated in the same manner as an individual retirement plan under section 408 or section 408A (and contributions to such an account or annuity are treated as contributions to an individual retirement plan and not to the qualified employer plan). The account or annuity is referred to as a deemed IRA.

(b) *Types of IRAs.* If the account or annuity meets the requirements applicable to traditional IRAs under section 408, the account or annuity is deemed to be a traditional IRA, and if the account or annuity meets the requirements applicable to Roth IRAs under section 408A, the account or annuity is deemed to be a Roth IRA. Simplified employee pensions (SEPs) under section 408(k) and SIMPLE IRAs under section 408(p) may not be used as deemed IRAs.

(c) *Separate entities.* Except as provided in paragraph (d) and (g) of this section, the qualified employer plan and the deemed IRA are treated as separate entities under the Internal Revenue Code and are subject to the separate rules applicable to qualified employer plans and IRAs, respectively. Issues regarding eligibility, participation, disclosure, nondiscrimination, contributions, distributions, investments, and plan administration are generally to be re-

solved under the separate rules (if any) applicable to each entity under the Internal Revenue Code.

(d) *Exceptions.* The following exceptions to treatment of a deemed IRA and the qualified employer plan as separate entities apply:

(1) The plan document of the qualified employer plan must contain the deemed IRA provisions and a deemed IRA must be in effect at the time the deemed IRA contributions are accepted. Notwithstanding the preceding sentence, employers that want to provide for deemed IRAs for plan years beginning before January 1, 2004, (but after December 31, 2002) are not required to have such provisions in their plan documents before the end of such plan years, and

(2) The requirements of section 408(a)(5) regarding commingling of assets do not apply to deemed IRAs. Accordingly, the assets of a deemed IRA may be commingled for investment purposes with those of the qualified employer plan. However, the restrictions on the commingling of plan and IRA assets with non-plan assets apply to the assets of the qualified employer plan and the deemed IRA.

(e) *Application of distribution rules.* (1) Rules applicable to distributions from qualified employer plans under the Internal Revenue Code and regulations do not apply to distributions from deemed IRAs. Instead, the rules applicable to distributions from IRAs apply to distributions from deemed IRAs. Also, any restrictions that a trustee, custodian or insurance company is permitted to impose on distributions from traditional and Roth IRAs may be imposed on distributions from deemed IRAs (for example, early withdrawal penalties on annuities).

(2) The required minimum distribution rules of section 401(a)(9) must be met separately with respect to the qualified employer plan and the deemed IRA. The determination of whether a qualified employer plan satisfies the required minimum distribution rules of section 401(a)(9) is made without regard to whether a participant satisfies the required minimum distribution requirements with respect to the deemed IRA that is established under such plan.

(f) *Additional rules.* (1) *Trustee.* The trustee or custodian of an individual retirement account must be a bank, as required

by section 408(a)(2), or, if the trustee is not a bank, as defined in section 408(n), the trustee must be an entity that receives approval from the Internal Revenue Service to serve as a nonbank trustee or nonbank custodian pursuant to §1.408–2(e) of the regulations.

(2) *Separate trusts and annuity contracts.* (i) Deemed IRAs that are individual retirement accounts may be held in a single trust (rather than in separate, individual trusts), provided the trust would qualify as a single plan within the meaning of §1.414(l)–1(b). See also §1.410(b)–7(a) and (b). However, any trust holding deemed IRA assets must be separate from the trust holding the other assets of the qualified employer plan. A deemed IRA trust must be created or organized in the United States for the exclusive benefit of the participants. In addition, the written governing instrument creating the trust must satisfy the requirements of paragraphs (1), (2), (3), (4), and (6) of section 408(a), and there must be separate accounting for the interest of each participant.

(ii) Deemed IRAs that are individual retirement annuities may be held under a single annuity contract or under separate annuity contracts. However, any such contract must be separate from any annuity contract or contracts for the qualified employer plan. In addition, such contract must satisfy the requirements of section 408(b) and there must be separate accounting for the interest of each participant.

(3) *Deductibility.* The deductibility of voluntary employee contributions to a deemed traditional IRA is determined in the same manner as if it were made to any other traditional IRA. Thus, for example, taxpayers with compensation that exceeds the limits imposed by section 219(g) may not be able to make contributions to deemed IRAs, or the deductibility of such contributions may be limited in accordance with sections 408(a) and 219(g). However, section 219(f)(5), regarding the taxable year in which amounts paid by an employer to an individual retirement plan are includible in the employee's income, is not applicable to deemed IRAs.

(4) *Rollovers and transfers.* The same rules apply to rollovers and transfers to and from deemed IRAs as apply to rollovers and transfers to and from other IRAs. Thus, for example, 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 in accordance with section 408(d)(3), regardless of whether that employee may receive a distribution of any other plan benefits.

(5) *Nondiscrimination.* The availability of a deemed IRA is not a benefit, right or feature of the qualified employer plan under §1.401(a)(4)–4 of the regulations.

(g) *Disqualifying defects.* If the qualified employer plan fails to satisfy its qualification requirements, either in form or in operation, section 408(q) does not apply. Accordingly, any account or annuity maintained under the plan as a deemed IRA is not a deemed IRA, and its status as an IRA will be determined by considering whether the account or annuity satisfies the applicable requirements of section 408 and 408A (including the prohibition of commingling under paragraph (a)(5) of section 408). Also, if any of the deemed IRAs fail to satisfy the applicable requirements of section 408 or 408A, section 408(q) does not apply and the plan will fail to satisfy the plan's qualification requirements.

(h) *Definitions.* The following definitions apply for purposes of this section:

(1) *Qualified employer plan.* A *qualified employer plan* is a plan described in section 401(a), an annuity plan described in section 403(a), a section 403(b) plan, or a governmental plan under section 457(b).

(2) *Voluntary employee contribution.* A *voluntary employee contribution* is any contribution (other than a mandatory contribution within the meaning of section 411(c)(2)(C)) which is made by an individual as an employee under a qualified employer plan that allows employees to elect to make contributions to deemed IRAs and with respect to which the individual has designated the contribution as a contribution to which section 408(q) applies.

(i) *Effective date.* These regulations are applicable beginning on or after August 1, 2003.

David A. Mader,  
*Assistant Deputy Commissioner  
of Internal Revenue.*