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Internal Revenue Service
CC:PA:RU (REG-157302-02), Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Proposed Regulations on Deemed IRA's

Dear Sir or Madam:

On behalf of the Retirement & Savings Committee of the Securities Industry Association ("SIA"), I would like to take this opportunity to comment on recently issued proposed regulations interpreting Internal Revenue Code ("Code") section 408(q) which governs Deemed IRA's. SIA has been a frequent contributor to employee benefit plan issues as identified by the Internal Revenue Service.

The proposed regulations on Deemed IRA's (Proposed Regulation section 1.408(q)-1) provide important guidance and it is anticipated that much of the impetus for this important retirement planning opportunity will come from the financial institutions that sponsor prototype retirement plans and that also serve as custodians or trustees for Individual Retirement Account arrangements, including Deemed IRA's.

Statutory Interpretation

Code section 408(q)(1) requires that a Deemed IRA must be part of a plan that is qualified under Code section 401(a), 403(a), 403(b) or 457(b). If the plan does not maintain its qualification, the Deemed IRA will lose its status as such, although a participant would be considered as maintaining either a traditional or a Roth IRA (Proposed Regulation section 1.408(q)-1(g)), assuming that the requirements for either of these IRAs has been met, including the requirement that the assets have not been commingled with any other non-IRA assets and that the participant has signed the IRA Agreement offered by an approved IRA Custodian, which is required for the establishment and maintenance of an IRA. We also note that the regulations permit commingling of Deemed IRA assets with the host plan trust assets (provided a separate

record keeping system is in place) and that signing a separate IRA Agreement issued by a sponsoring IRA trustee is not required. Even with this latitude, it is highly unlikely that a Deemed IRA maintained by a plan participant would independently satisfy the requirements of Code section 408 (and 408A) and the regulations thereunder. Thus the disqualification of the "host" plan would inevitably also disqualify the Deemed IRA, notwithstanding the provisions of 1.408(q)-1(g)).

Similarly, Code section 408(q)(2) requires that the qualified plan that contains the Deemed IRA provisions must be considered separately from the Deemed IRA and be subject to the distinct rules that govern the qualification and administration of that particular type of plan. The maintenance of a Deemed IRA has never been a requirement for continued qualification of an employer plan. Yet, Proposed Regulation section 1.408(q)-1(g) inexplicably provides that, "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." This disqualification of the qualified plan by the Deemed IRA does not have any apparent statutory support. In fact, Code section 408(q)(2) states, "For purposes of this title, a qualified employer plan shall not fail to meet any requirement of this title solely by reason of establishing and maintaining a program described in paragraph (1)."

We believe that the disqualification of the "host" qualified plan by a Deemed IRA that was not maintained properly would serve as a deterrent to potential sponsors. The explanation of provisions states, "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." (Emphasis supplied). Suppose one of the employees maintaining a Deemed IRA engages in a prohibited transaction involving a Deemed IRA or that the employer inadvertently processes a loan from the Deemed IRA instead of the employee's host retirement plan account, thereby disqualifying that IRA. This would apparently disqualify the employer's plan, as well, which can certainly be viewed as a harsh result when the "host" plan has presumably met all other qualification requirements for that type of plan. As discussed above, the reverse situation does not result in the disqualification of the underlying IRA because the regulations provide that if the sponsoring plan no longer meets the requirements of Code section 401(a), the Deemed IRA will no longer be a Deemed IRA but may still be treated as a traditional or Roth IRA.

Trustee Requirement

While Code section 408(a)(2) provides that the trustee of an IRA must be a bank or a nonbank trustee or custodian approved by the Internal Revenue Service, requiring the trustee or custodian of a Deemed IRA to meet this requirement poses certain problems. If the employer who desires to offer a deemed IRA is using a prototype plan that is sponsored by a company that is not a nonbank trustee or custodian it will be impossible to offer the Deemed IRA unless the employer switches prototype sponsors. This could cause disruption in participants' investment programs or more likely, cause the employer to refrain from offering the Deemed IRA program. Perhaps a more viable

solution would be to permit the plan trustee or prototype sponsor to offer the Deemed IRA program but to be able to delegate the custodial function or, if possible, the custodial reporting responsibilities to a bank or approved nonbank custodian.

If a bank or approved non-bank trustee is not available or is unwilling to serve as trustee of the Deemed IRA portion of a plan, small and mid-sized employers, which frequently self-trustee their retirement plan, would be reluctant to undergo the arduous process of obtaining approval under this regulation section (assuming that they could) for the benefit of what may potentially be just a few participants that might want to make contributions to Deemed IRA accounts under their plans. If, as a result, the current trustee of the plan cannot serve as the trustee of Deemed IRA accounts due to the absence of approval to serve in this capacity, such trustees (who are often also the employers) will not offer a Deemed IRA program. Likewise, it may not be financially or operationally feasible for an existing approved non-bank trustee that currently sponsors traditional and Roth IRAs, to implement the provision of trustee services for the Deemed IRA portion of an employer plan because it might then be obligated to account for commingling IRA funds with the other funds of the employer's plan for investment purposes and perform the separate accounting that is required under Proposed Regulation section 1.408(q)-1(e)(2) because current IRA record keeping systems cannot perform these functions.

Further, the approval granted most non-bank trustees and custodians to serve as an IRA trustee/custodian expressly prohibits the commingling of funds (except in a common fund) and may in addition limit the role of the non-bank trustee custodian to that of a passive custodian (Regulation section 1.408-2(e)(6)). In this case, the IRA trustee/custodian is not approved to serve in an active trustee role with regard to any Deemed IRA program within an employer qualified plan and thus would not be able to serve as the trustee of any trust containing an aggregation of participant Deemed IRAs. Given these legal and operational complications and the costs associated with their resolution, it is unlikely that any currently approved nonbank trustee/custodian would reopen their custodial application/file to expand its responsibilities or liabilities to incorporate Deemed IRA services.

The consequence of the above and the likelihood that the employer/trustee of the plan sponsoring a Deemed IRA program also be an approved non-bank trustee or that an existing approved non bank trustee take ownership of the Deemed IRA portion of a plan, e.g. perform the required services, interact with an employer, allow the commingling of IRA funds, revamp all systems to accommodate these efforts and obligations, will, we believe, serve as a substantial impediment to the creation/implementation of any Deemed IRA program in the small to medium size employer environment.

If it is the intent of the Service and Congress to promote the formulation of Deemed IRAs, the SIA recommends that the requirement that the trustee of a Deemed IRA program be an IRS approved nonbank trustee under regulation section 1.408-2(e) be revised and that the designated trustee of the employer sponsored plan be permitted to

likewise serve as the trustee of the Deemed IRA portion of the plan being sponsored. We believe that there are sufficient restraints within both the existing employer plan language and the presumed plan amendments that will be added to a plan before it can offer Deemed IRAs, to allow the current trustee to also oversee/direct the funds in the Deemed IRA portion of a plan. Alternatively, if the Service is not convinced that sufficient trustee guidance or language exists, it could require that the language/provisions of Regulation section 1.408-2(e) also be incorporated into the plan document along with the Deemed IRA provisions. This recommendation should not be construed to preclude a bank or trust company or an approved nonbank trustee or custodian from serving as the trustee for a Deemed IRA program, if it so chooses.

Administrative Concerns

With both the Deemed IRA and its "host" qualified plan being administered together certain administrative concerns will undoubtedly arise and guidance in this respect will be needed.

- Transfer/rollover Status - Presumably, if the "host" qualified plan loses its qualified status, resulting in the reclassification of a Deemed IRA as either a traditional or Roth IRA, the Internal Revenue Service would regard this as a direct transfer of the IRA and not a rollover which would otherwise be limited to the once every 12 months rule. In addition, for purposes of the 12-month rule, distribution reporting and other rules, would the Service take the position that an Employer would be obligated to monitor the utilization of a Deemed IRA distribution issued to a participant from his/her Deemed IRA account? For instance, if a participant requests more than one distribution in a 12-month period and the Employer knows or has reason to know that the participant rolled over the first such distribution, would the Employer be required to, or have the authority to, refuse to issue the second distribution? If the Employer did refuse, this could be a violation of Code section 408 or 408A. If the Employer did not refuse to issue the second distribution and the participant rolled over this second distribution, would the Deemed IRA portion of the plan then be disqualified? Or, alternatively, to what extent, if any, would the Employer be responsible for obtaining or advising a correction? Finally, the SIA requests that the Service confirm that transfers from Deemed IRAs, to their counterpart traditional or Roth IRAs can be performed on an unlimited and nonreportable basis. The SIA also requests that the Service provide express guidance with respect to rollovers from Deemed IRAs to traditional or Roth IRAs and the reporting to be required for these by both the distributing and receiving parties respectively.

- Beneficiary Designations - Unlike qualified plans, IRAs do not have a spousal beneficiary requirement. Therefore, clarification is needed as to whether this qualified plan requirement will or can be extended to the Deemed IRA portion of a plan. Guidance is also needed as to whether an employer could require that a participant designate the same beneficiary for both the qualified plan and the Deemed IRA in an effort to simplify its administrative records. Alternatively, if the trustee of the Deemed IRA portion of a plan is separate and distinct from the plan trustee and the Deemed IRA trustee has its own Beneficiary designation requirements, which set of requirements take precedence, those included in the Employer's plan document or the document and procedures of the Deemed IRA trustee or can the differences coexist?

- Excess Contributions - If excess contributions are made to a Deemed IRA within a plan and if the Employer's plan has a CODA provision, could the employer automatically apply the excess contributions as after-tax plan contributions or alternatively as catch-up contributions, rather than require that they be returned to the participant? Can the reverse also be permitted, i.e., can excess deferrals, excess contributions or excess aggregate contributions be reclassified as Deemed IRA contributions in the year in which the excess was determined? In addition, if a participant is making contributions to a Roth Deemed IRA, is the Employer responsible for determining if the participant is eligible to make such contributions, i.e. whether the participant's AGI is within the permissible limits? For instance, if the participant's compensation from the Employer exceeds $160,000, it would be reasonable to assume that the participant is not eligible to make contributions to a Roth Deemed IRA. Is it the employer's responsibility to refuse to allow such excess contributions to occur and/or to actively monitor eligibility to make contributions in this case?

- Document Concerns - If a new employee becomes a participant in both the employer's qualified plan and the Deemed IRA, can the Summary Plan Description also contain the IRA Disclosure Statement or must they be separate documents? Likewise, if the Deemed IRA Trustee is separate from the Employer plan sponsor/trustee, will the Deemed IRA trustee still need to obtain a signed IRA Agreement from the participant (the IRA holder) as is required under the rules governing IRAs or do the provisions of Regulation section 1.408(q)-1(d)(1) relieve the Deemed IRA trustee of this requirement? If this regulation section does not relieve the Deemed IRA trustee of the requirement to provide an IRA Agreement and obtain the consent of the participant to same, in writing, and the provisions of the IRA Agreement provided are

inconsistent with the Deemed IRA provisions contained in the Employer's plan document, such as with regard to Beneficiary designations and section 401(a)(9) defaults and provisions, which provisions should prevail?

- Reporting Obligation Concerns - At the other end of an employee's employment cycle, if a participant terminates service and receives a distribution, we would assume that the employee would receive two 1099-R's – one for the qualified plan distribution and another for the Deemed IRA distribution. More importantly, can it be assumed that the mandatory 20% withholding requirement for eligible rollover distributions from Employer plans that are not directly rolled over to an eligible retirement plan would apply only to that part of the distribution to the participant not attributable to the Deemed IRA? Similar reporting concerns arise for early withdrawals from a Deemed IRA that would not otherwise be subject to the 10% excise tax – e.g., health insurance premiums for unemployed individuals, first time home purchases, etc., but that the exception for qualified plan distributions for participants who separate from service after age 55 or payment to alternate payees would not apply to distributions from Deemed IRAs. Finally, can it be assumed that the Deemed IRA trustee would be required to comply with the Required Minimum Distribution reporting requirements outlined in IRS Notices 2002-27 and 2003-43 respectively? Guidance with regard to the reporting requirements applicable to the Employer and Deemed IRA trustee, irrespective of whether they are the same or separate, is needed.

- Deductibility Concerns - The SIA believes that it would be helpful and prudent for the Service to clarify or to confirm that an Employer that includes a Deemed IRA provision and operates a Deemed IRA program for the benefit of participants is not also responsible in any way for determining or monitoring the deductibility of any contributions made by participants; that this responsibility rests exclusively with the participant. It might also be helpful for the Service to confirm in writing that Deemed IRA contributions made by means of payroll deduction continue to be subject to federal income tax and FICA withholding, notwithstanding the eventuality that such contributions may be deductible by a participant.

- Expense Concerns - Can it be assumed that the Employer and/or Deemed IRA trustee, if separate, can directly deduct annual maintenance expenses from a participant's Deemed IRA account? Conversely, can an Employer choose to pay and deduct the fees charged by a separate Deemed IRA trustee pursuant to sections 162 and 212 of the Code?

- Discrimination Concerns - Finally, Proposed Regulation section 1.408(q)-1(c) provides that the Deemed IRA and the qualified employer plan are treated as separate entities and issues regarding eligibility, participation, nondiscrimination, required distributions, etc. are resolved under separate rules. Would it be correct to interpret this provision to mean that an employer can offer Deemed IRAs to what would have otherwise been a discriminatory classification of employees?

Conclusion

The SIA appreciates this opportunity to comment on the Proposed Regulations and would be pleased to respond to any questions or provide comment at any public hearing that is held. You may contact the undersigned at (202) 216-2000 or SIA's counsel, Edwin Leavitt-Gruberger, Esq., Pepper Hamilton at (609) 951-4217.

Sincerely,

Liz Varley

Cc: Bill Sweetnam
Tom Reeder