November 15, 2010

Legal and Policy Reasons to Include
Puerto Rican Plan Trusts Under Rev. Rul. 81-100

Legal Analysis

The express purpose of section 1022(i)(1) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), was to enable certain retirement plan trusts[1] which only cover residents of Puerto Rico and which do not meet the qualification requirements of the Internal Revenue Code,[2] to diversify their portfolios by investing in US securities without paying US income tax on the income derived from such investments. H.R. Rep. No. 807, 93rd Cong., 2d Sess. 163 (1974).[3] Thus, ERISA section 1022(i)(1) states that, for purposes of section 501(a) of the US Code, any trust forming part of a pension, profit-sharing, or stock bonus plan under which all of the participants are residents of the Commonwealth of Puerto Rico shall be treated as an organization described in section 401(a) of the US Code. The intent of Congress in section 1022(i) clearly appears to be aimed at treating qualified plans in Puerto Rico as being equivalent to qualified plans for purposes of section 501(a) of the Code. Because Congress intended for Puerto Rican qualified plans to be treated as being equivalent to qualified plans for purposes of section 501(a) – and not solely for dual qualified plans with Puerto Rico trusts – the Service should provide in its revision of Revenue Ruling 81-100 that Puerto Rican retirement plans may participate in master and group trusts. [4]

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[1] We have assumed that the Puerto Rican retirement plans described in ERISA section 1022(i)(1) meet the requirements of section 1165 of the Puerto Rico Internal Revenue Code ("PR Code") and have received or will receive favorable determination letters from the Hacienda.

[2] The Internal Revenue Code of 1986, as amended, and, in the context of discussions of ERISA, the Internal Revenue Code in effect in 1974, are referred to as the "US Code."

[3] H.R. Rep. 93-807 provides the following: "Puerto Rican pension trusts which satisfy the requirements of the Puerto Rican tax law are unable to *diversify* their portfolio by investing in US securities without paying US income tax on the income derived from such investments since they are not able to qualify for exemption under the US tax law. On the other hand, since the requirements for qualification under US and Puerto Rican law are *roughly comparable*, a Puerto Rican pension plan is able today to establish a trust in the United States which satisfies both the U.S. and the Puerto Rican tax provisions. Since the Puerto Rican Government has established requirements in its tax law for when a trust forming part of a pension plan for participants who are residents of the Commonwealth of Puerto Rico is entitled to be treated as a qualified trust, your committee believes it is appropriate to eliminate the distinction under US law as to the place of organization or creation of a trust entitled to be qualified under US law, if that trust is created or organized in Puerto Rico and if the trust has satisfied the requirements for qualification under the Puerto Rican tax laws" (emphases added).

[4] In GCM 39712, the Service concluded that the investment of assets held in the Pension Benefit Guaranty Corporation's ("PBGC") commingled trust funds in a group trust would not cause the group trust to lose its tax-exempt status under US Code §501(a). Under the facts of GCM 39712, the PBGC would commingle the assets of terminated plans and employer liability payments into two commingled trust funds (one for single employer plans and a second for multiemployer plans). Those trusts would in turn be invested in separate group trusts. In GCM 39712, and as reflected in GCM 39873, the Service ruled that the trust funds administered by the PBGC were exempt, and could invest in a separate group trust without jeopardizing the exempt status of the separate group trust, because they were "equivalent to qualified plans." Whether any trust is exempt should, of course, depend on the intent of Congress.

Based on ERISA section 1022(i), the Internal Revenue Service (the "Service") has issued numerous favorable private letter rulings and various determination letters expressly approving the participation of Puerto Rican trusts in master trust and group trust arrangements.[5] We believe these simply reflect a straightforward application of the statute in the context for which it was intended, *i.e.*, that Puerto Rican retirement plans be treated as equivalent to US qualified retirement plans with respect to retirement plan trust income and investments. Nothing in the statute or its legislative history suggests that the Congressional mandate in ERISA to treat Puerto Rican trusts as exempt under section 501(a) should not extend to collective investments in the United States – including investments with other qualified plans of the same corporate sponsor – as opposed to being limited to the Puerto Rican plan's individually managed trust portfolio.

Further, it is quite clear that Congress intended to provide special benefits for Puerto Rican retirement plans, which can be distinguished from the retirement plans in other US possessions (e.g. Guam, Marianna Islands and the Virgin Islands) due to the specific provision of ERISA section 1022(i)(1) which only applies to Puerto Rican retirement plans. This makes sense because (unlike other territories) US companies have had especially extensive operations in Puerto Rico for decades.

ERISA's legislative history also reflected the intent that "solely for purposes of diversifying investment," the Service would allow Individual Retirement Accounts ("IRAs") to pool their assets with the assets of qualified plans. H.R. Rep. No. 1280, 93rd Cong., 2d Sess. 337 (1974). Such pooling was allowed long before Congress approved rollovers between IRAs and qualified plans. In essence, Congress has approved – and the Service has implemented – group trusts as well-established vehicles for pooling the assets of retirement plans and IRAs for investment purposes. (Indeed, this purpose is expressly cited in the first full paragraph of Rev. Rul. 81-100.) Puerto Rican plans as described in ERISA section 1022(i)(1) have identical investment needs – and fulfill the same retirement purposes – as US qualified retirement plans and should be able to pool their assets in the same vehicles.

Policy Support

Major US employers have established and maintained operations in Puerto Rico for decades, often in response to powerful US and Puerto Rico tax incentives. Consistent with sound human resource policies, these US companies have extended comparable retirement benefits to several hundred thousand Puerto Rican workers, who are mostly US citizens,[6] under plans that are subject to the very same ERISA requirements and protections as US plans.[7] Although it varies by industry, Puerto Rican plans of US companies usually are very small in relation to their US qualified plans – typically less than 1-2% of total ERISA plan assets or comparable percentages of covered participants. In this regard, we understand that federal bank regulators do not break out Puerto Rican plan assets separately for data collection purposes, presumably because such assets are not considered a risk that requires separate tracking.

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[5] *See, e.g.*, PLR 200336034 (June 12, 2003); PLR 9621031 (March 1, 1996); PLR 9243053 (July 30, 1992) .

[6] Generally, individuals born in Puerto Rico are citizens of the United States at birth. See 8 U.S.C. §1402.

[7] For example, Puerto Rican retirement plans must meet the participation, vesting and funding requirements of Parts 1, 2 and 3 of Title I of ERISA and are subject to the reporting and disclosure and fiduciary provisions of Parts 1 and 4 of Title I of ERISA in addition to the requirements of section 1165 of the PR Code.

Pooling Puerto Rican and US qualified plan assets solely for investment purposes achieves many valuable objectives including –

- sound investment diversification practices,
- availability of investment alternatives that may otherwise be denied
  - for DC plans – these include, for example, stable value funds, unitized employer stock funds, and lower cost, professionally managed bank collective investment funds and insurance company separate accounts,
  - for DB plans – these include, for example, real estate, private equity, hedge funds and lower cost professionally managed debt and equity portfolios,
- lower investment and administrator fees – increasingly borne by plan participants,
- conservation of company resources by allowing the same plan officials/committees to make investment decisions for all of the company's US and Puerto Rico retirement programs,
- recognition of Congressional intent to treat Puerto Rican retirement trusts differently from those established in other US possessions, and
- intent of Congress, plan sponsors and plan administrators to maintain lower fees for plan audits, recordkeeping, communications, and many other facets of day-to-day administration and legal compliance.

Institutional sponsors of group trusts very much want to accommodate their corporate clients by offering the same facilities to all of the client's US and Puerto Rican retirement plans, whether large or small. If Puerto Rican retirement plan assets cannot be pooled with US qualified plan assets, these goals will not be achieved. Puerto Rican retirement plan assets are typically too small to meet various minimum investment requirements set by group trust or other vehicles, and typically would not be able to obtain the same investments at the same cost as the US qualified plans of their US parent companies.

Treaty Considerations

In our view, the Service should be willing to certify to foreign countries that Revenue Ruling 81-100 bank collective trusts and other group trusts which contain the assets of Puerto Rican plan trusts are US persons eligible for treaty benefits. In addition to the fact that the assets of PR Trusts typically represent only a de minimis portion of total trust assets, this result appears to flow directly from an analysis of the relevant treaty language.

Under tax treaties concluded with the United States, foreign countries provide tax benefits to "residents" of the United States, as that term is defined in those treaties. Under Articles 4(2)(a) and 3(1)(k) of the United States Model Income Tax Convention of November 15, 2006 ("Model Convention"), a pension fund qualifies as a "resident" of the United States if it

is established in the United States, is generally exempt from income taxation in the United States, and is operated principally either to provide pension or retirement benefits or to earn income for the benefit of such arrangements.[8] Clearly, group trusts meet that definition, since they are limited to retirement plans and IRAs, and are organized to earn income for such plans and accounts. In addition, under the Model Convention, more than 50 percent of the beneficiaries, members, or participants in the pension fund must be US residents in order for the pension fund to be eligible for treaty benefits, s*ee* Model Convention, Article 22(2)(d), a condition which virtually no Revenue Ruling 81-100 group trust should have difficulty meeting. We respectfully submit that the Service should be willing to certify that group trusts established in the US as entitled to US treaty benefits. If Revenue Ruling 81-100 is modified to explicitly provide that group trusts are qualified under section 401(a) even if they include Puerto Rican plan trusts, this conclusion would be all the more clear.[9]

In general, the residency requirement under our tax treaties limits treaty benefits to those who are "liable to tax" or "subject to tax" in the United States on their worldwide income. A policy decision has been made, however, to eliminate the question of whether a US pension fund, which generally is not taxed, is "liable to tax" or "subject to tax," by explicitly defining a pension fund established in the United States as a qualified "resident." The basic policy question here is whether US group trusts that include Puerto Rican pension trusts should be treated the same for treaty purposes as other pension trusts established in the United States. We think it is clear that they should enjoy the same treatment.

Under ERISA section 1022(i)(1), Congress determined that Puerto Rican pension trusts should be treated the same as US pension trusts for purposes of enjoying the exemption from taxation of the trust by the United States. Moreover, the preamble to the foreign trust regulations indicates that those regulations do not alter the provisions of section 1022(i)(1) of ERISA and Treas. Reg. section 1.401(a)-50. 66 Fed. Reg. 41778 (Aug. 9, 2001), 2001-35 I.R.B. 201. Given that Congress and the Treasury have taken these steps towards recognizing Puerto Rican pension trusts as equivalent to pension trusts established in the United States, and given the treaty text and policy analysis set forth above, we believe it is clearly appropriate to treat US group trusts that include Puerto Rican plan trusts the same as other US pension trusts for treaty purposes.[10]

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[8] Although treaties differ, the Model Convention is analyzed for simplicity and because it is published as a reflection of U.S. treaty policy.

[9] The language in the Model Convention's Technical Explanation of Article 3, indicating that "group trusts described in Revenue Ruling 81-100 and meeting the conditions of Revenue Ruling 2004-67 qualify as pension funds because they are covered by Code section 401(a)," should be read as descriptive, not restrictive. The non-restrictive list of entities that are included within the term "pension fund" in the United States under the Technical Explanation include accounts and trusts, such as IRAs and 403(b) trusts, that are not covered by section 401(a).

[10] We note that banks and other financial entities sponsoring group trusts believe it would be virtually impossible to allocate taxes to Puerto Rican plans if that were required. First, the group trusts are priced daily and employees are generally permitted to move in and out of the group trust daily. Contributions are made biweekly, and the allocations would require that every group trust sponsor track participant activity at the plan level on a daily basis, rather than receiving a net feed for contribution and redemption purposes. That kind of tracking is unknown and likely untenable. Allocation under these circumstances would be almost impossible as a practical matter and, even if technically feasible with significant system enhancements, so costly as to adversely affect all participants in the group trust. Thus, if the Service were to agree to permit these plans to commingle assets in Rev. Rul. 81-100 trust,

Recommendations

We respectfully submit that forcing smaller Puerto Rican retirement plans to develop their own investment portfolios and/or line-up of participant investment options will significantly increase costs for plan sponsors and participants and likely produce less favorable investment returns. We cannot identify any legal, tax or retirement policy objectives to support the adoption of such a narrow reading of section 1022(i)(1) of ERISA thirty-six years after its enactment. Such a narrow reading stands in direct conflict with the legislative history of ERISA and decades of interpretation. Moreover, as far as master trusts are concerned, an adverse resolution would be particularly disruptive of longstanding beneficial company practices with no clear justification for doing so.

We strongly urge the Service to issue guidance that expressly includes Puerto Rican plan trusts in Rev. Rul. 81-100 (and any successor ruling, regulation or other guidance). Further, while this issue is under consideration, we strongly urge the Service to announce that (1) it is postponing the December 2010 deadline under Rev. Rul. 2008-40, and that (2) until the issue is resolved and a final decision publicly announced, sponsors of US group trusts and master trusts can continue to pool assets with Puerto Rican plan trusts solely for investment purposes.

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provided that, for certification of US residency and treaty eligibility, tax must be allocated at the plan level, as a practical matter banks and similar financial institutions would need to completely remove Puerto Rican plan trusts from the group trusts. We note also that maintaining a group trust for only Puerto Rican plans would not be economically feasible, because the asset base of these trusts is too small to support a large diversified fund. And, under such a structure, employers who wanted to aggregate the investments of all their plans could not do so.