October 7, 2010

MEMORANDUM TO CLIENTS

RE: <u>IRS Now Questions Puerto Rico Trust Investments in the US</u>

<u>Background</u> – In response to recent IRS guidance, many plan sponsors are in the process of spinning off assets and liabilities associated with Puerto Rico resident employees covered by their US/Puerto Rico dual tax-qualified plans to new plans qualified only in Puerto Rico. These spinoffs are intended to avoid several potential US tax compliance problems –

- IRS rulings generally require US tax to be withheld (and reported) on the US-source earnings component of the benefit when distributions are made to Puerto Rican residents (<u>see</u>, <u>e.g.</u>, Rev. Proc. 2004-37); and

- the transfer of assets and liabilities to a Puerto Rico-only qualified plan (described in Section 1022(i)(1) of ERISA, i.e., a plan which has not made the election under Section 1022(i)(2) to be treated as a US trust) potentially disqualifies the US plan and results in immediate US tax to the participant (Rev. Rul. 2008-40).

Rev. Proc. 2004-37 and Rev. Rul. 2008-40 came to this conclusion by interpreting Section 1022(i)(1) of ERISA – which provides that, "for purposes of section 501(a)," a trust forming part of plan all the participants of which are residents of Puerto Rico and which is exempt from Puerto Rico tax, "shall be treated as an organization described in section 401(a)" – as not extending qualified status under section 401(a) (1) to the plan itself, (2) favorable tax treatment under section 402(a) for distributions to participants, or (3) favorable treatment under section 404(a) for deductions of employer contributions – in other words, it generally was to be treated as a nonqualified plan for US tax purposes. Presumably because this was not previously understood to be the interpretation of Section 1022(i) of ERISA, Rev. Rul. 2008-40 provided transition relief, permitting spinoffs from US plans to Puerto Rico-only qualified plans to be made on or before December 31, 2010, without adversely affecting qualified status and without future taxation to Puerto Rico residents.

The IRS policy change reportedly reflects concerns about what it believes to be substantial non-compliance with US tax withholding on plan distributions under Rev. Proc. 2004-37 and with the plan qualification rules in Puerto Rico. It is part of a recently formed working relationship between the IRS and Hacienda (the IRS' counterpart in Puerto Rico).

<u>A New Concern</u> – A September 14, 2010 IRS letter to Senator Arlen Specter (D-PA) suggests that the new tougher IRS policy may go even further – extending to the mere collective investment of the assets of Puerto Rico trusts with the assets of US trusts solely for investment purposes. Such collective investments are very common among Fortune 500 companies who often use master trusts to pool the assets of all of their plans, including their Puerto Rican plans, on an efficient basis, as permitted in several private letter rulings (<u>see</u>, <u>e.g.</u>, PLR 200336034).

While the context (and legal status) of the new IRS letter is not entirely clear, it contains the following statement of concern –

> Puerto Rico plans that satisfy the special rule under ERISA, regardless of whether the interpretation of the rule includes US trusts, are not among the qualified plans or similar arrangements that are permitted to invest in group trusts on a tax-favored basis. Therefore such plans cannot pool their trust assets for investment purposes without jeopardizing the tax-favored status of all of the other plans participating in the group trust.

The above statement appears to contradict the language and intent of the "special rule" of ERISA section 1022(i)(1) described above. Moreover, nothing in Rev. Rul. 2008-40 expressly prevents the mere collective investment of US and Puerto Rican trusts, as long as no assets and liabilities are being transferred between such plans and trusts. Though somewhat conjecture on our part, based on the reasoning of Rev. Rul. 2008-40, the IRS appears to have developed such a narrow application of the reference to "for purposes of section 501(a)" in section 1022(i)(1) of ERISA so that it does not extend qualified trust or qualified plan treatment for any purpose or section whatsoever.

Beyond the treatment of master trusts, the recent IRS letter also raises the question of whether group trusts described in Rev. Rul. 81-100 and Code section 401(a)(24) may include such Puerto Rican trusts. Our firm has requested that Treasury allow such trusts to be group trust participants. In this regard, we understand that some institutional sponsors of collective trusts allow such Puerto Rican trusts to participate – often as an accommodation to US plan sponsors that have invested assets of their larger plans in such trusts – and some have received IRS determination letters covering that practice.

Conclusion – We recently urged the Service to avoid disrupting the beneficial collective investment practices that have long been followed in this area. In our view, neither Rev. Rul. 2008-40 nor any other policy we are aware of should overrule the clear intent behind Section 1022(i)(1) of ERISA to allow investment pooling that includes Puerto Rico trusts. We have also indicated to the Service that it would take considerable time to unwind these investments – certainly more than the barely three months remaining before the end of 2010 – and will be detrimental to companies and their Puerto Rican workers. We understand that the Service is considering these issues.

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