GROOM LAW GROUP

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Department of the Treasury
1500 Pennsylvania Avenue, NW
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Re: Puerto Rico Plans – Participation in Group Trusts

Dear Bill,

This is to follow up on the mainly factual questions you asked about Puerto Rico plans towards the end of our October 24 meeting (which primarily focused on insurance company separate accounts in group trusts). Specifically, you asked several questions related to the current participation of Puerto Rico-only qualified plans in group trusts. The questions appear to relate to the tax treaty concerns you previously raised in this area as we understand them, i.e., the potential inability of Treasury to "certify" to foreign treaty partners that all investors in the group trust are "US residents" if one or more Puerto Rico-only plans participate. Our understanding of the questions – and the information we have received – follow.[1]

We note preliminarily that our response also includes information about corporate sponsors' master trusts which typically include assets of both US plans and Puerto Rico-only plans as participating trusts. There has been uncertainty as to whether the IRS concerns about Puerto Rico-only plans investing in the US extend to these domestic master trust arrangements. We respectfully submit that they should not, and recommend clarification to this effect. In any event, the information below supports the application of any de minimis rule that may be adopted to both master trusts and group trusts.

(1) **Question:** Do trustees of group trusts account separately for each plan's assets so that they could allocate investment income to Puerto Rico (and other) plans if foreign tax were required to be withheld on their income?

Answer: Most corporate plan sponsors with master trusts for their plans separately account for the Puerto Rico plan assets. However, that is not the case at the group trust level. One major financial institution provided the following helpful response (which we believe is reasonably representative of industry perspectives on the issues).

[1] The information reflects a variety of sources obtained by key interested parties, including members of ABC and ERIC and clients of Steptoe and Johnson, Goodwin Procter and Groom.

> It will largely depend on what constitutes "income" for these purposes. Except for our stable value trusts, our collective trusts are not required to – and in practice don't – distribute trust income to the participating plans. All dividends, interest, realized gains, etc. are immediately reinvested in additional securities as they are received and increase the trust's NAV [net asset value]. If these reinvested amounts are considered "income," accounting for each Puerto Rico plan's allocable share would be an accounting nightmare because we'd have to assess each Puerto Rico plan's pro-rata share of each income item at the point in time that it is received.
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> If we had to withhold [foreign tax] as income is received, we'd practically be forced to create a separate trust or share class for the Puerto Rico plans (or, more likely, prohibit them from [participating in] the trusts entirely) because there's no systematic way for us to track two NAVs for the same trust, which would be the net effect of the Puerto Rico plans having a different cost structure within the trusts.
>
> In the case of multi-level trusts (trusts that invest in other trusts or mutual funds [which is typical for target date funds among others]), we'd also want confirmation that any withholding obligations apply only to income received by the top-tier trust, i.e., the trust in which the Puerto Rico plan is directly invested.

(2) **Question:** If such separate accounting were done, could it be done quarterly or only annually?

Answer: In general, most trustees of group trusts indicated that an annual, year-end accounting may be achievable, though only with considerable effort and expense (which will of course be an expense of the trust), and reliance on representations of plan sponsors (which may be difficult to obtain).

As noted above, any attempt to allocate the foreign tax burden would be highly problematic. For example, participating plans may cease to hold interests in the group trust, and/or take distributions out, before the tax is collected. This would lead to accounting complexities for group trusts, and to potential inequities among participating plans.

(3) **Question:** Can we confirm that the percentage interest of Puerto Rico plans in group trusts is "de minimis," and what standard should be used to define "de minimis?"

Answer: The vast majority of plan sponsors with Puerto Rico plan assets in their master trusts reported that the Puerto Rico plan assets were less than 1% of total master trust assets – and usually much less than 1%. Group trust sponsors typically could not report this information, primarily because their "books" typically only show each plan sponsor's master trust as the investor (i.e., and not the individual plans participating in each master trust). However, one

major trustee of group trusts indicated that less than .6% of the assets of their largest group trust – a stable value trust – represented assets of Puerto Rico plans, and that Puerto Rico plans had only .01% or .03% of the total assets of group trusts invested primarily in bonds or stocks.

One corporate master trust sponsor explained that the typical, less than 1% share is likely due to many factors, including (1) the Puerto Rico plan often being relatively new compared to the US 401k plan, (2) the small population size in Puerto Rico relative to the US, (3) the lower salaries in Puerto Rico relative to the US, and (4) the plan design offering a smaller match relative to the US. In some industries (such as pharmaceuticals, where there are large numbers of workers in Puerto Rico), the percentage of Puerto Rico assets in the master trust was estimated to be closer to 3% (and, in one very unusual case, 6%).

Recommendation

We understand Treasury can make no commitment to a de minimis approach or any other specifics at this point to address the potential treaty issue. Nevertheless, we strongly recommend a 3% de minimis rule, applied with respect to assets at the end of the group trust's fiscal year, based upon representations from fiduciaries of the participating trust investors, be adopted – for all the policy and practical reasons we have previously advanced. (For example, this would allow room for adjustments when plans withdraw large interests that cause other plans' interests to be larger.) Such a de minimis rule could be applied based on representations that an institutional sponsor periodically (e.g., every three years) obtains from plan sponsors whose participating master trusts include Puerto Rico-only plans.[2]

We appreciate all your efforts in this area, and would be pleased to respond to further questions.

Best regards,

Louis T. Mazawey

cc: Lynn Dudley
Melanie Nussdorf
Kathryn Ricard
Jack Cleary

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[2] We note also that this rule should not be applicable at all (i.e., no certifications should be required) where a group trust does not make investments that call for any treaty protection (e.g., a stable value trust or US government bond trust).