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August 26, 2014 www.groom.com

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IRS Clears the Way for Puerto Rico Plans and Insurance Company Separate Accounts to Invest in Group Trusts Under the IRS Code

Rev. Rul. 2014-24 (released on August 21, and to be included in the Sept. 8 *IRS Bulletin*) puts to rest – and favorably resolves – the federal income tax issues affecting the ability of plans covering only Puerto Rico residents and qualified only under Puerto Rico law ("PR-Only Plans"), and of certain life insurance company separate accounts ("Separate Accounts"), to invest in group trusts (also known as collective investment trusts) under Rev. Ru. 81-100. And the IRS guidance takes a remarkably straightforward approach to doing so.

While PR-Only Plans and Separate Accounts are obviously very different entities, they have each had a rather tortured history as potential investors in group trusts:

- Several IRS private letter rulings (and some IRS determination letters) treated PR-Only Plans described in section 1022(i)(1) of ERISA as "qualified investors," but the letters could not be relied upon generally. Rev. Rul. 2008-40 then signaled that an adverse official IRS position might be emerging. (This does not affect "dual-qualified" PR plans, i.e., plans that satisfy both US and PR laws.)

- Separate Accounts are not plans at all, but a number of financial institutions obtained IRS determination letters allowing them to invest in group trusts where the accounts only held the assets of tax-qualified plans. In IRS Notice 2012-6, the IRS asked for comments aimed at the ultimate release of official guidance, raising questions about existing arrangements.

In light of the uncertainty, different financial institutions adopted different positions on whether they would allow PR-Only Plans and/or Separate Accounts to invest in their group trusts. Moreover, as explained below, while Rev. Rul. 2011-1 provided helpful transition relief (for PR-Only Plans investing as of January 10, 2011, and for PR-Only plans formed after that date as a spinoff from a US plan (under Notice 2008-40) before 2013), PR-Only Plans generally have been unable to make new group trust investments since then.

We summarize below the favorable new IRS guidance on both fronts, which we have been advocating for plan sponsor and financial institution clients for some time. We also comment on two unrelated issues where IRS has provided helpful clarifications to Rev. Rul. 2011-1.

We note that the discussion that follows does not attempt to summarize the regulatory history, including Rev. Rul. 2011-1, which restated and updated the longstanding group trust requirements of Rev. Rul. 81-100, Rev. Rul. 2008-40, and Notice 2012-6 (which provided additional transition relief).

A. PR-Only Plan Guidance

Rev. Rul. 2014-24 clearly provides that plans that are only qualified under Section 1081.01(a) of the Puerto Rico Internal Revenue Code of 2011, as amended (i.e., "PR-Only Plans"), are eligible to participate in group trusts. In addition, the IRS grants additional limited relief for the spin-off of the assets of Puerto Rico participants from plans qualified in the U.S. ("U.S. Plans) to PR-Only Plans. The rather messy "back story" and the new guidance are summarized briefly below.

Background – Rev. Rul. 2011-1, as modified by IRS Notice 2012-6 ("Notice 2012-6"), includes a list of "group trust retiree benefits plans" eligible to participate in group trusts. In Rev. Rul. 2011-1, the IRS granted temporary relief providing that a group trust would not be treated as failing to satisfy the requirements for group trusts included in Rev. Rul. 2011-1 merely because the trust included assets of a PR-Only Plan to the extent the PR-Only Plan:

- was participating in the trust as of January 11, 2011, or
- holds assets that had been held by a U.S. Plan prior to the spin-off to the PR-Only Plan pursuant to Rev. Rul. 2008-40.

Rev. Rul. 2008-40, as modified by Rev. Rul. 2011-1 and Notice 2012-6, granted a relief period for the tax-free spin-off of the assets of Puerto Rico residents in U.S. Plans to PR-Only Plans. In general terms, Rev. Rul. 2008-40 ruled that assets could not be transferred between US and PR plans without adversely affecting plan qualification. However, it provided limited relief: (i) from a spin-off from a U.S. Plan to a PR-Only Plan being treated as a taxable distribution; (ii) for the treatment under US Code Section 933 of a distribution from a transferee PR-Only Plan that received a spin-off from a U.S. Plan during the relief period; and (iii) under the minimum coverage rules of US Code Section 410(b) for a U.S. Plan that made a spin-off to a PR-Only Plan. The relief period for most plans ended on December 31, 2012. However, the relief period was extended by Notice 2012-6 for PR-Only Plans that participated in group trusts on January 10, 2011, until a deadline to be set after the issuance of guidance by the IRS.

New Guidance – Rev. Rul. 2014-24 clearly states that a PR-Only Plan is a "group trust retiree benefit plan" eligible to participate in a group trust if the requirements of Rev. Rul. 2011-1, as modified by Rev. Rul. 2014-24, are satisfied. This means that the assets of any PR-Only Plan may be invested in group trusts without jeopardizing the tax-exempt status of the trust. Importantly, this position applies not only to PR-Only Plans holding assets that had been held by a U.S. Plan immediately prior to the spin-off to the PR-Only Plan pursuant to Rev. Rul. 2008-40, but also to any other PR-Only Plan, including a newly established PR-Only Plan.

Rev. Rul. 2014-24 also provides that, on or before December 31, 2015, Puerto Rico participants in U.S. Plans that participated in a group trust on January 10, 2011 may be spun-off under Rev. Rul. 2008-40 without the adverse consequences noted above.

B. Separate Account Guidance

Separate accounts are an insurance company's functional counterpart to a bank's collective investment trust. Both investment vehicles are generally limited to tax-qualified plan investors, and both allow the pooling of the assets of unrelated plans solely for investment purposes. A major difference is that the Separate Accounts themselves are not trusts at all – their assets are legally owned by (and are taxed as part of) the life insurance company. Accordingly, IRS requested comments on the issue in Rev. Rul. 2012-6.

In response to comments received, Rev. Rul. 2014-24 notes that the key characteristics of Separate Accounts are consistent with those of group trusts, including the absence of any commingling with the financial institution's own assets, protection from its creditors, and general insulation from tax liability. Accordingly, IRS states that Separate Accounts are now permitted "group trust retiree benefit plan" investors as long as –

- the Separate Account itself includes only qualified group trust retiree benefit plans under Rev. Rul. 2011-1,

- the insurer enters into a "written arrangement" with the trustee of the group trust that is consistent with the requirements for group trusts, including separate accounting for each plan's interest, and

- the Separate Account's assets are insulated from the insurer's general creditors.

Separate Accounts have until January 1, 2016 to enter into the "written arrangement" with the trustee of current group trust investors. Effective December 8, 2014, new Separate Account investors must have the arrangement in place no later than when the investment is made. There is no IRS guidance on what the "written arrangement" must provide.

C. Two Helpful Footnotes

Rev. Rul. 2014-24 includes two footnotes that provide the following helpful clarifications to Rev. Rul. 2011-1.

- ***Exclusive Benefit Requirement for Governmental Plans*** – Qualified plans under Code section 401(a) and custodial accounts under Code section 403(b)(7) (whether governmental plans or not), and Code section 457(g) trusts (which are only for governmental plans) are required to contain the "for the exclusive benefit of employees" language mandated by Code section 401(a)(2), which is also a prerequisite to participating in a group trust under Rev. Rul. 2011-1. However, governmental plans – often created by state or local statutes – may not have traditional plan documents or trust agreements. Further, governmental retiree welfare benefit plans under Code section 401(a)(24) may not otherwise be subject to an exclusive benefit requirement under the Code, although adopting an exclusive benefit provision is a prerequisite to their participation in a group trust. Footnote 2 in Rev. Rul. 2014-24 clarifies that a governmental plan may include the required language in "regulations, ordinances, or other state or local rules or policies binding on the plan under state or local law."

- ***Trust Separate Accounting Concept*** – Rev. Rul. 2011-1 states that group trusts must provide for "separate accounts" that reflect the interest of each adopting plan. Some institutions have been concerned that this requirement might not allow for the "unitized" accounting method often used in collective trusts. Footnote 3 in Rev. Rul. 2012-24 clarifies the language to address such concerns.

D. Observations

Rev. Rul. 2014-24 should be the last time IRS has to revisit the subject of group trusts for some time (hopefully, a long time). The benefits of this new guidance for the retirement plan and investment communities include –

- facilitating use of the same investment platform by a plan sponsor's US and PR Plans, with resulting lower expenses,
- allowing Separate Accounts to use group trusts instead of creating their own investment portfolios for particular asset categories, and
- promoting the consistency of eligible plan investors among trust companies sponsoring group trusts.

Going forward, the investment community, participating plans, and plan participants and beneficiaries should all benefit from this helpful IRS guidance.