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"Group Trust" Rules Change: IRS Sends Mixed Bag for the Holidays

The Internal Revenue Service (the "IRS") has announced changes to the rules governing "group trusts." Group trusts are tax-exempt pooled investment vehicles consisting of tax-qualified employee benefit trusts, governmental employee plans, and other eligible plans and trusts (see "Appendix" for Timeline and certain defined terms). Revenue Ruling ("RR") 2011-1, which becomes **effective January 10, 2011**, contains a number of helpful clarifications and changes that will be welcomed by most group trust sponsors. Notably, RR 2011-1 favorably addresses concerns raised recently with respect to the eligibility of Puerto Rico employee benefit plans to participate in group trusts.

However, RR 2011-1 contains a number of new requirements, including a new substantive requirement that all plans participating in a group trust, **including government plans**, must be subject to an "exclusive benefit" rule similar to that described in Section 401(a) of the Internal Revenue Code (the "Code").[1] As discussed below, this appears to be at odds with Section 401(a)(24), the statutory basis for government plan participation in group trusts. ***Pending further clarification or relief from the IRS, this requirement could result in disqualification of privately offered group trusts sponsored by non-bank investment advisers if any government plan participating in the group trust is not subject to an exclusive benefit rule***. Thus, trustees and managers of privately offered group trusts sponsored or managed by non-bank institutions should review the relevant documents promptly to (i) identify participating government plans, and (ii) confirm that such plans are subject to an "exclusive benefit" rule as required by RR 2011-1.

RR 2011-1 also contains "model amendments" for group trust sponsors that have obtained IRS determination letters prior to the publication of RR 2011-1. As discussed below, it is not clear that these amendments should be necessary for most group trusts. However, the somewhat confusing discussion of the purposes and necessity for the amendments introduces a degree of uncertainty.

The new ruling will be of interest to all group trust sponsors, including:

- ***banks maintaining collective trust funds for employee benefit plans;***
- ***investment advisers managing privately offered group trusts; and***
- ***employers sponsoring "master trusts" for affiliated plans.***

Puerto Rico Plans

RR 2011-1 provides relief with respect to two related issues concerning Puerto Rico retirement plans that may have an impact on the participation of such plans in group trusts.

[1] Unless noted otherwise, all Section references below are to the Code.

1. Separation of Puerto Rico Plans and U.S. Plans

The first issue involves "dual-qualified" retirement plans that cover an employer's U.S. participants inside and outside Puerto Rico. Dual-qualified plans are qualified under both Section 401(a) of the Code and Section 1165(a) of the Puerto Rico Internal Revenue Code (the "PR Code"). Because of complications relating to the taxation of distributions from dual-qualified plans, many of these plans are being split into two separate plans, one covering non-Puerto Rico participants (the "U.S. plan"); the other covering Puerto Rico participants (the "Puerto Rico plan"). The U.S. plan would be qualified only under the Code, while the Puerto Rico plan would be qualified only under the PR Code.

In RR 2008-40, the IRS concluded that this type of separation would disqualify the existing plan under the Code because it would be viewed as a transfer from a U.S. qualified plan to a non-U.S. qualified plan, which is impermissible under the Code. However, recognizing the prevalence of dual-qualified arrangements, the IRS, in RR 2008-40, made that conclusion effective January 1, 2011 so that dual-qualified plans could be separated without adverse consequences under the Code through December 31, 2010.

2. Puerto Rico Plan Participation in Group Trusts

The second issue involves plans that are qualified only under the PR Code. Under Section 1022(i)(1) of the Employee Retirement Income Security Act of 1974 ("ERISA"), a plan that is qualified under the PR Code (and not the Code) and that benefits only Puerto Rico residents (a "Section 1022(i)(1) Plan") is treated as exempt under Section 401(a), which means that investment income attributable to the investment of assets of the Puerto Rico plan trust in the U.S. is not taxable to the trust under the Code.

Many banks maintaining collective trust funds and employers maintaining "master trusts" for affiliated plans have permitted Section 1022(i)(1) Plans to participate in their group trust arrangements. This presumably is based on the view that Section 1022(i)(1) of ERISA treats Section 1022(i)(1) Plans as if they are qualified plans under Section 401(a) for all purposes. The IRS, moreover, has appeared to approve the participation of Section 1022(i)(1) Plans in group trust arrangements in Private Letter Rulings.[2]

However, in a letter to Senator Arlen Specter dated September 14, 2010, an IRS official stated that Section 1022(i)(1) Plans cannot participate in group trusts. This conclusion has raised doubts for group trust sponsors that permit Section 1022(i)(1) Plans to participate in their group trusts. In addition to bank and non-bank sponsors that have allowed Section 1022(i)(1) Plans to participate in their group trusts, employers that have been in the process of using RR 2008-40 to separate their dual-qualified plans before January 1, 2011 were uncertain whether they could permit the post-separation Section 1022(i)(1) Plan to continue to participate in their master trusts.

RR 2011-1, however, postpones the effective date of RR 2008-40 until January 1, 2012. This should give employers that desire to do so an additional year to separate their dual-qualified plans. In addition, RR 2011-1 announces the IRS's intention to issue guidance concerning the issue of whether a Section 1022(i)(1) Plan may participate in a group trust (whether pursuant to a separation of a dual-qualified plan or otherwise). Until such guidance is issued, RR 2011-1 states that a Section 1022(i)(1) Plan may participate in a group trust so long as the Plan either (i) was participating in the group trust as of January 10, 2011, or (ii) holds assets that had been held by a U.S.-qualified plan immediately prior to the transfer of those assets to the Puerto Rico plan pursuant to RR 2008-40.

Other Important Changes and Updates

A stated objective of RR 2011-1 is "[t]o ensure that *the assets of a group trust . . . are only commingled with the assets of similar plans or arrangements*" (emphasis added). While the objective itself seems logical, the premise of this statement is unclear to the extent it suggests that the assets of a "group trust," as such (apparently consisting of qualified plans and IRAs only), may somehow be commingled with separate and distinct assets of government plans and other types of plans. Although the practical reality is that the assets of all such plans are commingled *in a group trust*, RR

[2] *See, e.g.*, IRS Private Letter Rulings 200336034, 9621031, and 9243053.

2011-1 seems to assume, but not explain or identify, the existence of a separate investment vehicle in which the assets of a group trust, on the one hand, and such other plans, on the other hand, may be commingled. Regardless of whether any such separate "vehicle" actually is intended, at least some of RR 2011-1's changes seem to be based on this or a similar rationale.

Highlights of these and other changes are detailed in this alert.

1. Adoption Requirement

RR 81-100 requires that the group trust itself be adopted as a part of each participating plan and IRA. RR 2011-1 retains this requirement for all types of eligible plans (see "Participation Requirement" below). Both RR 2011-1, which addresses government plans generally, and RR 2004-67, which dealt specifically with 457 Plans, thus appear to extend the "Adoption Requirement" to government plans, although no such requirement appears in Section 401(a)(24).

2. Participation Requirement

RR 81-100 limits group trust participation to qualified plans and IRAs, and Section 401(a)(24) extends group trust participation to government plans within the scope of that Section. RR 2011-1 modifies and expands the "Participation Requirement" as follows:

Government Plans. While the "holding" of RR 2004-67 specifically addressed 457 Plans only, the "holding" of RR 2011-1 now refers to both 457 Plans and government plans described in Section 401(a)(24). Since 457 Plans are a subset of eligible government plans described in Section 401(a)(24), this aspect of RR 2011-1 introduces ambiguity. The IRS also concluded that government plans providing retiree welfare benefits are within the scope of Section 401(a)(24) and, therefore, are eligible to participate in a group trust. Banks sponsoring collective trust funds structured as group trusts will want to confirm that government welfare plans satisfy the requirements of applicable securities law exemptions.

Section 403(b) Plans. RR 2011-1 provides that "custodial accounts" described in Section 403(b)(7) and "retirement income accounts" described in Section 403(b)(9) may participate in a group trust.[3] (On the other hand, the IRS requested comments on whether "annuity contracts and/or other tax-favored accounts held by plans described in § 401(a) or § 403(b), such as pooled separate accounts supporting annuity contracts that are treated as trusts under § 401(f), should be permitted to invest in the group trusts.") The IRS also stated that a 403(b)(7) custodial account, which by law must be invested exclusively in shares of registered investment companies, may be "commingled in a group trust that solely contains the assets of other § 403(b)(7) custodial accounts." The IRS did not indicate whether a 403(b)(7) custodial account could participate in a group trust open to any eligible participants, so long as the group trust is invested entirely in mutual fund shares. The expansion of group trust eligibility to 403(b) Plans will not be useful to bank-sponsored group trusts to the extent such trusts are operated in reliance on securities law exemptions currently applicable to collective trust funds maintained by banks.

PBGC Commingled Trusts. RR 2011-1 provides that a group trust may hold assets attributable to commingled trust funds maintained by the Pension Benefit Guaranty Corporation for the assets of terminated qualified plans. This codifies a position taken by the IRS's general counsel in 1986.[4]

3. Exclusive Benefit Requirement

RR 81-100 requires that the group trust instrument prohibit the use or diversion of group trust assets for any purposes other than for the "exclusive benefit" of participants under the participating trusts. RR 2011-1 retains this requirement. However, RR 2011-1 also requires that *the governing document of each participating plan* also include an irrevocable "exclusive benefit" restriction. Qualified plans, IRAs, and 403(b) Plans, as well as government plans qualified or described under Sections 401(a) and 457(b), are subject to "exclusive benefit" requirements or similar restrictions under their governing statutes. Other government plans described in Section 401(a)(24), however, are not necessarily subject to an "exclusive benefit" rule.

[3] The IRS had indicated previously that a government-sponsored 403(b) Plan could participate in a group trust. *See* IRS Private Letter Ruling 200303041.

[4] IRS General Counsel Memorandum 39712 (June 17, 1986).

Consequently, the expanded "Exclusive Benefit Requirement" is at odds with Code Section 401(a)(24), which reflects Congress' intention that group trusts not be affected adversely merely because they accept moneys from "a retirement plan of a State or local government, *whether or not the plan is a qualified plan and whether or not the assets are held in trust*, or . . . any State or local government monies intended for use in satisfying an obligation . . . to provide a retirement benefit. . . ."[5]

Bank-sponsored group trusts that rely on securities law exemptions applicable to "collective trust funds maintained by banks" already are required to limit government plan participants to those that are subject to an exclusive benefit rule described in Section 3(a)(2) of the Securities Act of 1933. However, that requirement does not extend to privately offered group trusts sponsored by non-bank advisers. RR 2011-1 does not provide guidance with respect to what actions, if any, are required of the latter category of group trusts that currently includes government plans that are not subject to an exclusive benefit rule, but a reasonable reading of RR 2011-1 indicates that such plans would need to be removed from the group trust by January 10, 2011 in order to avoid disqualification.

4. Trust Requirement

RR 2011-1 adds a new requirement that each participating plan must itself be a trust, a custodial account, or "similar entity" that is tax-exempt under Section 408(e) or Section 501 (or is treated as being tax-exempt under Section 501). IRAs are exempt under Section 408(e), and qualified plans, 403(b) Plans, and 457 Plans are, or are treated as being, exempt under Section 501. All of such plans by law are or are funded by "trusts" or accounts that are treated as trusts under Section 401(f). RR 2011-1 further provides that government plans described in Section 401(a)(24) (other than 457 Plans) are treated as meeting this requirement if the plans are not subject to federal income taxation. This requirement should not result in changes being necessary for most group trusts.

5. "Separate Account" Requirement

"To ensure that the assets of a group trust . . . are only commingled with the assets of similar plans or arrangements," RR 2011-1 adds a new requirement that the group trust must keep separate records of each participating plan's interest. To satisfy this requirement, the group trust instrument must "expressly provide" for "separate accounts" and "appropriate records" to be maintained to reflect the interest of each participating plan in contributions to and disbursements from the group trust, as well as "investment experience of the group trust "allocable to that account." (See further discussion under "Model Amendments" below.)

6. Anti-Assignment Requirement

RR 2011-1 retains essentially unchanged the requirement in RR 81-100 that the group trust instrument prohibit participating plans from assigning their interests in the group trust.

7. Domestic Trust Requirement

RR 2011-1 retains essentially unchanged the requirement in RR 81-100 that the group trust be created in the U.S. and at all times be maintained as a domestic trust in the U.S.

Model Amendments

RR 2011-1 includes two "model amendments" for a group trust that received a determination letter before January 10, 2011: one dealing with the new Separate Account Requirement; the other dealing with the expanded Participation Requirement.

The IRS indicates that, if the group trust instrument provides that amendments to the instrument "automatically pass-through" to each participating plan, the group trust sponsor will not lose its right to rely on the determination letter merely because it adopts the model amendments (or substantially similar amendments), or because it modifies or deletes a pre-existing group trust provision that is "inconsistent with" the model amendment. On the other hand, the IRS states if the group trust "does not contain such a pass-through provision," the sponsor may not adopt the model amendment and automatically continue to rely on its prior determination letter. Although RR 2011-1 is silent on the subject, group trusts in the latter category that need to adopt amendments presumably must add "pass through" language and seek new determination letters.

[5] H.R. Conf. Rep. No. 760, 97th Cong., 2nd Sess. 640 (1982) (emphasis added).

The references to the "pass-through" of group trust amendments are ambiguous. A group trust typically contemplates that participating plans, by virtue of their continued participation in the group trust, are subject to group trust amendments. Whether this means that amendments to such a group trust effectively "pass through" to participating plans for purposes of RR 2011-1 is unclear. Moreover, as discussed below, it is not at all clear in most cases whether such amendments should be necessary in the first place.

1. Separate Account Requirement Amendment

Model "Amendment 1" (consisting of a single sentence) is intended for a group trust that does not satisfy the "Separate Account Requirement." In such case, the amendment must be adopted by *January 10, 2012*.

In our experience, most group trusts provide, specifically or in substance and effect, for "separate accounts" as described in RR 2011-1. RR 2011-1 nonetheless introduces uncertainty as to whether the language of existing group trust instruments "expressly provides" for separate accounts in the particular manner contemplated by RR 2011-1. It also is unclear whether the IRS intended to require industrywide amendments to deal with an issue that ordinarily is considered fundamental to the structure of a group trust or other pooled investment vehicle.

2. Participation Requirement Amendment

Model "Amendment 2" (consisting of two paragraphs) is for a group trust that "intends to permit" 403(b) Plans *or government plans under Section 401(a)(24)* to participate in the group trust. Given that 403(b) Plans will be permitted to participate in a group trust for the first time, it is likely that group trust sponsors wishing to take advantage of this expansion of eligibility would adopt such an amendment in any event. On the other hand, it is unclear why the IRS would suggest an amendment for a group trust that "intends" to allow participation by government plans described in Section 401(a)(24), when such plans have been eligible to participate in group trusts for nearly three decades.

Presumably, group trust sponsors that have "intended" to allow participation by such plans already would have amended their group trust instruments to so provide. Although RR 2011-1 might raise potential questions for group trusts that do not include specific references to Section 401(a)(24) in the manner provided by the model amendment, other language that is "substantially similar" to the model amendment should be sufficient.

Unlike the model amendment for "separate accounts" described above, RR 2011-1 does not specify a date by which this model amendment should be adopted. This suggests, perhaps, the IRS's view that the amendment is appropriate or necessary only for those group trusts that intend to allow government plan participation on a prospective basis.

Appendix

Group Trust Timeline:

1956. RR 56-267 holds that, if certain requirements are satisfied, the status of employee benefit trusts "qualified" under Section 401(a) and exempt from taxation under Section 501 (herein, "qualified plans") will not be affected adversely by the pooling of their funds in a group trust, and the group trust itself will constitute a qualified trust under Section 401(a) and be exempt from tax under Section 501.

1981. RR 81-100 consolidates earlier rulings to permit individual retirement accounts ("IRAs") exempt from tax under Section 408(e) to participate in a group trust. RR 81-100 retains and applies the requirements of RR 56-267 to qualified plans and IRAs participating in group trusts.

1982. Congress enacts Section 401(a)(24), which provides that a group trust that otherwise meets the requirements of Section 401(a) will not fail to satisfy such requirements "on account of participation or inclusion in such trust of the moneys of any plan or governmental unit described in section 818(a)(6)." Section 818(a)(6), in turn, refers to governmental plans within the meaning of Sections 414(d) and 457(b).

2004. RR 2004-67 "extends the holding" of RR 81-100 to government plans described in Section 457(b) ("457 Plans") and clarifies that Roth IRAs described in Section 408A and "deemed IRAs" described in Section 408(q) may participate in group trusts. (Since Section 401(a)(24), enacted 22 years earlier, already permitted group trust participation by governmental plans, including 457

Plans, many industry participants viewed RR 2004-67 to be unnecessary to the extent it purported to "extend" such participation to 457 Plans.)

2011. RR 2011-1 modifies the rules governing group trusts effective January 10, 2011. Among other positive changes, RR 2011-1 extends eligibility for group trust participation to certain plans described in Section 403(b) ("403(b) Plans"). However, RR 2011-1 also establishes a new "separate account" requirement and contains problematic references and requirements relating to government plans described in Section 401(a)(24).