

## Puerto Rico Plans and Insurance Company Separate Accounts Permitted in US Group Trusts

IRS has ruled that Puerto Rico plans may participate in US group trusts even if they are only qualified under Puerto Rico law. The ruling provides a limited transition period for transfers from US to Puerto Rico plans and certain favorable US coverage requirements for plans that were participating in an 81-100 group trust on January 10, 2011. In addition, the ruling clarifies the status of insurance company separate accounts holding retiree benefit plan assets as legitimate investors in these group trusts.

### Background — Puerto Rico Qualified Plans

Employers with Puerto Rico operations face a number of hurdles when providing retirement benefits to island and mainland (US) employees:

- Transfers between US and Puerto Rico plans are not permitted because Puerto Rico plans are not qualified under US law. A transfer from a US qualified plan to a plan that does not satisfy US qualification rules is treated as a taxable distribution under US law. Thus, unless the employee for whom funds are transferred incurred a distributable event at the time of the transfer, the transfer would be an impermissible distribution that could disqualify the US plan.
- US qualified plans that exclude Puerto Rico employees cannot exclude those employees from coverage and nondiscrimination tests because they are citizens and not “nonresident aliens”.
- The US and Puerto Rico have similar, but not identical, qualification rules, making it difficult to pass both sets of rules at the same time.
- Options for investing US and Puerto Rico plan assets within an “81-100 group trust” are uncertain. These trusts (originally described in Revenue Ruling 81-100) include master trusts (trusts that commingle the assets of more than one plan of a single employer or controlled group) and bank collective trust funds (trusts that commingle the assets of plans of more than one employer).

The IRS issued Revenue Ruling 2008-40 to explain the transfer limitation described above and provide transition relief for employers that wanted to transfer participants who were Puerto Rico residents to a plan that would only satisfy the qualification rules under the Puerto Rico tax code. The ruling also allowed certain US qualified plans

making these transfers to exclude employees covered by the Puerto Rico-only plan when applying the US coverage tests for pre-2011 plan years. [Revenue Ruling 2011-1](#) extended the deadline until December 31, 2011; [IRS Notice 2012-6](#) announced a further extension to December 31, 2012.

Revenue Ruling 2011-1 provided a temporary special rule for the inclusion of plans that only meet the Puerto Rico qualification requirements in an 81-100 group trust because of controversy about whether they could be treated as US qualified trusts for this purpose. Plans in Puerto Rico that had been transferred from US plans as described above or Puerto Rico plans that had been participating in a group trust as of January 10, 2011 were permitted to stay in the group trust until the IRS provided further guidance. This allowed the plans to continue to benefit from the investment advantages of pooling their assets with those of US plans.

Although all of the transition rules noted above remain available for transfers involving group trusts, the IRS has not extended the relief for transfers that don't involve group trusts.

## Group Trust Decision

In [Revenue Ruling 2014-24](#), IRS has concluded that Puerto Rico qualified plans may continue to enjoy the benefits of group investments in 81-100 group trusts. IRS reached this conclusion by acknowledging that the purpose of the ERISA section governing these plans was to enable plans, qualified only under the Puerto Rico tax code, to diversify their investments using US investments on a tax-favored basis. Retirement plans that cover Puerto Rico employees must satisfy qualification requirements under the Puerto Rico tax code and meet the exclusive benefit requirement of ERISA. These plans will need to meet the remaining list of requirements in Revenue Ruling 2011-1 imposed on all plans that participate in group trusts — they are not excluded simply because they are only qualified under Puerto Rico law.

**Comment.** All Puerto Rico qualified plans that meet the group trust requirements are permitted to participate — not just those that had been spun off from a US plan or that already had funds in a group trust.

## Transition Relief for Plans in Group Trusts Only

With the final resolution of group trust status for Puerto Rico plans comes the end of the transition period for moving accounts from US qualified plans to Puerto Rico qualified plans. This transition relief had been extended for qualified plans that participated in an 81-100 group trust on January 10, 2011; it expired for other plans on December 31, 2012. Through 2015, IRS will continue to allow these transfers without US income tax ramifications for the plan or the participant. Beginning in 2016, such a transfer is treated as a distribution from the US plan with resulting taxation of trust earnings and the portion of the account attributed to services rendered with the US — and disqualification of the plan if the distribution is made when there is no distributable event under the Code.

## Special Coverage Rule

One additional element of transition relief is also available to US qualified plans participating in a group trust and will end January 1, 2016. Under this transition relief, the US plan is permitted to apply the US coverage requirements (e.g., the 70% ratio test) by treating the employees participating in the Puerto Rico transferee plan as excludable employees. This relief is only available if one of these conditions is satisfied:

- The US plan would satisfy the coverage requirements if the US plan and the Puerto Rico transferee plan were aggregated for coverage testing purposes, and the US plan by itself would satisfy the 401(k) average deferral percentage test and the 401(m) average contribution percentage test, if applicable.
- In the case of a defined contribution plan that provides for contributions other than elective contributions, for employees benefiting under the Puerto Rico transferee plan, the rate of contributions after the date of the transfer is not reduced from the rate of contributions prior to the date of transfer.

## Background — Insurance Company Separate Accounts

In Revenue Ruling 2011-1, IRS had solicited comments on whether tax-favored accounts held by qualified plans and tax-sheltered annuity plans that are treated as trusts under the IRC should be permitted to invest in 81-100 group trusts. This had come as a surprise to insurance companies already invested in these arrangements. Assets in separate accounts maintained by an insurance company are beneficially owned by the plans invested in the separate accounts and insulated from the claims of the insurer's creditors. The tax treatment of a group trust and of the plans investing in the trust through a separate account are the same. The insurance company separate account's income is not subject to income tax if only group trust retiree benefit plans participate in the account.

## Separate Accounts — OK to Invest in Group Trusts

In Revenue Ruling 2014-24, in light of the above factors, IRS has specifically clarified that insurance company separate accounts may invest in group trusts provided:

- All the separate account assets are assets of retiree benefit plans that are eligible to participate in group trusts.
- The insurance company enters into a written arrangement with the trustee consistent with the group trust requirements, including the exclusive benefit rule.
- The separate account assets are insulated from the claims of the insurance company's general creditors.

For existing separate account group trust arrangements in place as of December 8, 2014 that do not currently satisfy the written arrangement requirement, the ruling allows for the adoption of such a written arrangement by December 31, 2015. All others are required to enter into such an arrangement no later than the time of the investment.

## In Closing

Revenue Ruling 2014-24 removes uncertainty for group trusts when they accommodate insurance company separate accounts and Puerto Rico qualified plans. Plan sponsors will be able to enjoy providing the same investment options to both US and Puerto Rico plans, which should ease administration and lower fees. For Puerto Rico plans in group trusts, the ruling also signals the end to the transition period and the coverage testing relief. Employers will want to evaluate their next move — transition Puerto Rico employees to their own plan while the specter of US plan disqualification due to the transaction is held in abeyance, or keep the group in the mainland plan to address the potential coverage failure that could otherwise arise. Our [January 29, 2013 For Your Information](#) provides additional thoughts on dealing with the transition.

Insurance companies and group trusts that have existing relationships will need to assure compliance with all of the group trust requirements, including the new written arrangement rule.

**Authors**

Marjorie Martin, EA, MAAA, MSPA

Joanne Jacobson, JD, LLM

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