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Legal Update
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# IRS Issues New Guidance on Group Trusts

The US Internal Revenue Service (IRS) recently issued Revenue Ruling 2011-1[1] (the "Ruling"). This Ruling consolidates and modifies, in certain respects, existing guidance under Revenue Ruling 81-100, and related guidance, that address the requirements that must be satisfied by a group trust in order to qualify for tax-exempt treatment under the Internal Revenue Code (the "Code"). The Ruling is generally effective on or after January 10, 2011. Importantly, the new Ruling does not affect the administration requirements under the federal banking laws, or the federal securities law exemption requirements, applicable to bank-sponsored collective investment funds (CIFs) that are qualified as group trusts.

## New Qualification Requirements

Prior rulings generally limited eligibility to invest in a Revenue Ruling 81-100 group trust to retirement plans qualified under Section 401(a) of the Code, individual retirement accounts (IRAs) and certain governmental deferred compensation plans. The new Ruling changes the existing guidance in several significant respects:

- Custodial accounts under Code Section 403(b)(7) (tax-deferred custodial accounts maintained by certain tax-exempt entities) are now eligible to invest in a group trust if the group trust limits its investments to the stock of regulated investment companies.
- Retirement income accounts under Code Section 403(b)(9) (defined contribution programs maintained by church organizations) are also eligible to invest in a group trust.
- Governmental plans providing retiree welfare benefits are confirmed to be eligible investors in a group trust, provided that the plan is not subject to federal income taxation and satisfies the other requirements of the Ruling, including the new "exclusive benefit" condition described below.
- Pending further guidance from the IRS, a Puerto Rican plan qualified solely under the Puerto Rican tax code may no longer be admitted as a new investor to a group trust. A group trust, however, will not fail to be qualified merely because a qualifying Puerto Rican plan is an existing investor as of January 10, 2011. It appears that a group trust may continue to admit as investors Puerto Rican plans that are the product of a spin off from a dual-qualified (US and Puerto Rico) plan in accordance with guidance issued by the IRS in 2008.
- The group trust instrument must expressly provide for separate accounting for the interest that each plan has in the group trust and appropriate records reflecting such accounting, including that the accounts of participating plans making investments into and withdrawals from the group trust are adjusted at fair market value.
- The governing document for each plan that adopts the group trust must expressly and irrevocably provide that it is impossible for any part of the corpus or income of the plan to be

used for purposes other than for providing benefits under that plan.

## Model Amendments

Revenue Ruling 2011-1 includes two model amendments that reflect the new qualification requirements: Model Amendment 1 to add the separate accounting language and Model Amendment 2 to amend the qualified investor language. It appears that each group trust relying on Revenue Ruling 81-100 that does not already expressly provide for separate accounting as described in Model Amendment 1 must be amended to incorporate this language by no later than January 10, 2012, although the Ruling is generally effective on or after January 10, 2011.

For situations where the group trust instrument provides that amendments to the group trust will automatically pass through to the plans participating in the group trust, the Ruling provides that the trustee of a group trust will not lose its right to rely on a favorable determination letter previously issued to the group trust merely because one or both of the model amendments is adopted in a form that is substantially similar in all respects to the language in the Ruling. However, if the group trust instrument does not include a pass-through provision, the trustee may need to seek a new determination letter if it makes amendments to the trust declaration in response to the Ruling.

Model Amendment 2 is not required to be adopted at all, or within any particular time frame. To the extent that a group trust sponsor wants or needs to amend its definition of qualified investor, for example to add custodial accounts under Code Section 403(b)(7) as eligible investors or to modify the eligibility of Puerto Rican plans as future investors, it could consider adopting Model Amendment 2 in order to avoid the need to request a new determination letter (assuming that the group trust instrument already includes pass-through language). However, the definition of qualified investor in the model language is not as comprehensive as the definition in many CIF declarations. For example, it does not specifically permit other group trusts, CIFs or insurance company separate accounts as investors (although it does permit commingled trust funds maintained by the Pension Benefit Guaranty Corporation in its capacity as statutory trustee to invest in group trusts). Accordingly, such CIFs could not rely on Model Amendment 2 without narrowing the scope of eligible investors beyond what may be permitted.[2]

## Separate Accounting Requirement

As mentioned above, Revenue Ruling 2011-1 states that in order to be qualified, a group trust instrument must expressly provide for separate accounting for the interest that each retiree benefit plan has in the group trust and appropriate records reflecting such accounting. These provisions must include separate accounting for contributions to the group trust from the plan, disbursements made from the plan's account in the group trust and the investment experience allocable to the plan's account. In addition, all changes in the relative allocation among the plan investors in a group trust resulting from contributions and withdrawals must be effected at fair market value, determined in accordance with generally recognized valuation procedures.

## Insurance Company Separate Account Investors

Although the IRS has previously issued determination letters to group trusts that expressly permit insurance company pooled separate accounts as investors, the Ruling indicates that the IRS is seeking comments on whether pooled separate accounts and other tax-favored accounts held by plans described in Code Sections 401(a) and 403(b) should be permitted to invest in a group trust, indicating that additional guidance on group trust eligibility may be expected in the future.

## Banking and Securities Law Issues

Interested persons should note that Revenue Ruling 2011-1's expansion of the types of accounts that qualify for inclusion in a group trust does not affect federal banking law requirements (primarily reflected in Office of the Comptroller of the Currency collective investment regulations) applicable to CIFs that are qualified as group trusts under the Code. Moreover, the new Revenue Ruling does not change the types of accounts that can participate in a CIF qualified as a group trust that is exempt from registration under the Securities Act of 1933 and the Investment Company Act of 1940. For example, certain accounts that qualify under section 403(b) of the Code may now participate in a group trust under the new Ruling, but these accounts continue to be ineligible for participation in an exempt CIF that is qualified as a group trust. Accordingly, bank CIF sponsors/managers must remain vigilant in assuring that only those types of accounts that are permitted under the federal securities laws to participate in an exempt CIF are allowed to be admitted to a CIF that seeks to rely on Revenue Ruling 2011-1.

## Endnotes

[1] Available at http://www.mayerbrown.com/public_docs/IRS-2011-1.pdf.

[2] Neither the Ruling nor prior guidance specifically authorized group trusts to include as investors other group trusts, CIFs or insurance company separate accounts comprised of eligible investors. However, the IRS has, in the past, issued determination letters to group trusts that expressly permit such investors. As discussed under "Insurance Company Separate Account Investors," the Ruling indicates that the IRS is seeking comments on the eligibility of such investors, indicating a possible reconsideration of that policy.

*If you have any questions about the Revenue Ruling or any other matter raised in this Legal Update, please contact any of the following lawyers. For information on more publications of interest, please visit www.mayerbrown.com/privateinvestmentfund.*

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