

New Puerto Rico Tax Code Means Significant Changes to Retirement Plans for Puerto Rico Employees

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Employers with Puerto Rico employees should consider significant changes to the requirements for qualified retirement plans made by a new Puerto Rico tax code. Immediate action may be necessary to comply with tax and withholding requirements for plan distributions.

On January 31, 2011, the Commonwealth of Puerto Rico adopted a new Internal Revenue Code (PR Code) that contains numerous changes to sections governing qualified retirement plans. Generally effective immediately for tax years beginning on or after January 1, 2011, the new code requires significant changes to plan administration and updates of plan documents for both dual-qualified plans (*i.e.*, plans qualified under both the U.S. and Puerto Rico Internal Revenue Codes) and Puerto Rico-only qualified retirement plans.

In general, the qualified retirement plan provisions contained in the new PR Code add requirements that mirror the requirements applicable to U.S. qualified retirement plans. However, Puerto Rico continues to have provisions that result in some significant differences from U.S. qualified plans. In addition, a number of the changes simply codify rules that previously had been issued by the Puerto Rico authorities in circulars, notices or other guidance. Interestingly, the new PR Code does not provide for Roth-type contributions, nor pass-through of dividends from employee stock ownership plans.

The following is a summary of some of the major changes to the provisions governing Puerto Rico-qualified retirement plans. Except where noted, the changes are effective for tax years beginning on or after January 1, 2011:

Changes Affecting Taxation and Withholding For Plan Distributions

- Non-Lump Sum Distributions (PR Code Section 1081(b)(3))—Non-lump sum distributions, including partial distributions made after the participant's separation from service and in-service withdrawals made before separation, including hardship withdrawals, are subject to 10 percent withholding on amounts that have not previously been taxed. Unlike similar requirements under U.S. rules, there is no exception from this new Puerto Rico requirement for distributions made after age 59 and a half.

Lump sum distributions continue to be considered long-term capital gains subject to a 20 percent tax and withholding rate on amounts that have not previously been taxed. In addition, the special 10 percent tax and withholding rates for plans with Puerto Rico trusts that are invested at least 10 percent in Puerto Rico

property and meet other requirements continue to apply. Participants in dual-qualified plans will generally not be eligible for the special 10 percent tax and withholding rate.

- **Special Tax Rules (PR Code Section 1081.01(b)(9))**—Participants who prepaid income tax on plan benefits during a 2006 prepayment period are subject to 5 percent withholding on amounts that have not previously been taxed.
- **Withholding Exemption for 2011**—On March 1, 2011, the Puerto Rico Treasury Department issued Administrative Decision 11-01, which exempts withholding for annuity and other periodic payments with respect to the first \$23,500 for taxpayers age 60 or older and the first \$19,500 for taxpayers under age 60. The full amount of this exemption applies only for 2011, but may be reissued with different amounts in future years.
- **Rollovers (PR Code Section 1081.01(b)(2))**—Participants may rollover partial or complete distributions or rollover just the pre-tax portion (without the after-tax portion) of a distribution to an individual retirement account or annuity or to a Puerto Rico qualified retirement plan. This change is a significant improvement for Puerto Rico participants, who previously were only allowed to rollover total distributions.

Changes Affecting All Puerto Rico-Qualified Retirement Plans

- **Annual Benefit and Contribution Limits (PR Code Section 1081.01(a)(11))**—For tax years beginning on or after January 1, 2012, defined benefit plans must provide that a participant's annual benefits cannot exceed the lesser of \$195,000 or 100 percent of the participant's average annual compensation over a three-consecutive-calendar-year period, and defined contribution plans must provide that annual contributions with respect to a participant may not exceed the lesser of \$49,000 or 100 percent of the participant's compensation for the year. This provision is similar to Section 415 of the U.S. Code, but does not contain a cost-of-living-adjustment.
- **Annual Compensation Limits (PR Code Section 1081.01(a)(12))**—For tax years beginning on or after January 1, 2012, annual compensation greater than \$245,000 may not be taken into consideration for purposes of determination contributions or benefits, the application of nondiscrimination tests, and the limits on benefits and contributions. This provision is similar to Section 401(a)(17) of the U.S. Code, but does not contain a cost-of-living adjustment. Dual-qualified plans apply the compensation limit under U.S. Code Section 401(a)(17).

- Controlled Group Provisions (PR Code Section 1081.01(a)(14))—Similar to the provisions of the U.S. Code, employees of all corporations, partnerships or other entities that are members of a controlled group or an affiliated service group are deemed to be employees of the same employer for purposes of qualified retirement plan provisions.
- Determination Letters (PR Code Section 1081.01(a)(13))—For tax years beginning on or after January 1, 2012, plans must request and obtain determination letters regarding the qualified status of the plan under the new code. Applications must be filed at such time as determined by regulations and other administrative guidance expected to be issued.

Changes Affecting Cash or Deferred Arrangements (CODAs)

- ADP Test (PR Code Section 1081.01(d)(3))—The definition of highly compensated employees (HCEs) is made similar to the definition of HCEs in Section 414(q) of the U.S. Code in some respects, but different in others. The definition of HCEs includes officers, 5-percent shareholders, spouses or dependents of an HCE and individuals earning at least \$110,000. The compensation limit of \$110,000 does not contain a cost-of-living-adjustment. Note that dual-qualified plans apply the compensation limit under U.S. Code Section 414(q)(1)(b). Also, the PR Code does not contain a “top 20%” alternative definition as found in the US Code. The new Puerto Rico HCE definition applies to testing for 2011.
- Correction of Excess Contributions (PR Code Section 1081.01(d)(6))—If the plan sponsor does not correct excess contributions by the close of the following plan year a 10 percent tax will be levied on the plan sponsor.
- Limitations on Deferred Contributions (PR Code Section 1081.01(d)(7))—The limit on pre-tax contribution for 2011 continues to be \$10,000. For future years, the limits are increased to \$13,000 for 2012 and \$15,000 for 2013 and beyond. However, for dual-qualified plans the limit is the U.S. Code Section 402(g) limit.
- Limitations on Catch-Up Contributions (PR Code Section 1081.01(d)(7))—The limit on catch-up contributions for 2011 continues to be \$1,000. For 2012 and beyond, the limit is increased to \$1,500. Unlike regular deferred contributions, dual-qualified plans do not use the U.S. Code limits.

Next Steps for Plan Sponsors

Sponsors of both dual-qualified and Puerto Rico-only qualified retirement plans should begin working with advisors to update plan documents and administration for compliance with the new PR Code as soon as possible. Specifically, plans sponsors should consider the following steps:

- Update election forms, rollover forms and tax notices immediately to comply with the changes affecting plan distributions
- Prepare to amend plan documents to comply with the new PR Code
- Prepare to file the plan for a determination letter with the Puerto Rico Treasury Department (additional guidance is likely to be issued on the timing and process for submitting determination letter applications; the U.S. Internal Revenue Service is working with the Puerto Rico Treasury Department to establish a voluntary compliance program to correct plan errors and may also be advising on procedures for determination letter filings)
- Update summary plan descriptions and other employee communications describing plan changes

Finally, sponsors of both dual-qualified and Puerto Rico-only qualified plans should keep in mind potential restrictions on participation in U.S. group and master trusts following the end of the transition period announced in IRS Revenue Ruling 2011-1. For more information on Puerto Rico plan participation in U.S. group and master trusts, as well as the ability to transfer assets from dual-qualified plans to Puerto Rico-only plans until December 31, 2011, see [IRS Permits Puerto Rico-Qualified Plans to Participate in U.S. Group and Master Trusts for Transition Period, Extends Deadline for Puerto Rico Spin-Offs](#).

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