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Final Rules on Qualified Retirement Plans in Puerto Rico[1]

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INTRODUCTION

This article describes the final rules governing the establishment, qualification, and operation of retirement plans in Puerto Rico (sometimes abbreviated "P.R.") set forth by the Puerto Rico Internal Revenue Code of 2011, as amended (the PRIRC), and is a follow-up to a previous article the author published on the subject.[3] The reason why this second article is needed and, hopefully, readers will find useful, when another article on the same subject was published barely a year ago, is that the PRIRC was amended on December 10, 2011, to, among other things, incorporate several changes to the local retirement plan rules. Those December 2011 changes to the PRIRC, commonly known among the Puerto Rico tax and benefits community as the "technical amendments to the PRIRC," together with some subsequent administrative pronouncements by the Puerto Rico Department of the Treasury ("Hacienda"), effectively address most of the questions and concerns U.S. benefits practitioners had raised following the PRIRC's enactment on January 31, 2011, about the ongoing operation of retirement plans in Puerto Rico, the process for qualifying such plans with Hacienda, and the Puerto Rico taxation of retirement income.

This article supplements, but does not replace, the previous article. Therefore, readers should read the previous article before reading this one, as this article does not generally address those aspects of the local retirement plan rules that were not modified by the technical amendments to the PRIRC or Hacienda's subsequent administrative guidance. Also, for ease of reference this article is organized following the same order as the previous article.

Before discussing the details and practical aspects of the final rules, it is worth noting the following. If history is any indication, the final rules are here to stay for a long while and are not likely to be substantially changed for years to come. As noted in the previous article, before the PRIRC became effective in 2011, the local rules on retirement plans had remained pretty much the same since the 1950s. CODAs/401(k) plans were incorporated in the late 1980s, and the limit on pre-tax contributions was raised every now and then, but otherwise, the retirement plan rules in effect in 2010 were for the most part the same as those in effect in 1954. As someone who was personally involved with the creation of the final rules, the author can say with a reasonable degree of certainty that the chances Hacienda will soon embark on the complex and time-consuming process of evaluating and modifying those rules are fairly remote. The PRIRC not only changed the local rules on retirement plans, but the entire set of local tax rules; income tax, sales and use, excise taxes, forms of doing business, administra-

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[3] "Highlights of Recent Changes to Rules on Qualified Retirement Plans in Puerto Rico," 39 *Tax Mgmt. Compensation Plan. J.* 91 (May 6, 2011) (the "previous article").

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tive provisions, etc. So, Hacienda officials will have plenty of things to keep them busy for a while. U.S. benefits practitioners can, therefore, rest assured that the time they spend becoming familiar with the final rules will not go to waste any time soon.

With the final rules set and not likely to change in the near future, does that mean that an employer facing an employee benefits-related issue in Puerto Rico not addressed by the PRIRC, such as the implementation of a retirement plan feature not currently available in Puerto Rico or the process to be followed for correcting a particular plan qualification failure for which the PRIRC provides not guidance, is completely out of luck? Not quite, as there is always the possibility of obtaining Hacienda's administrative approval for new plan features, corrective measures, and favorable tax treatment on new or different employee benefits, among others, via a private letter ruling or a closing agreement (i.e., the local equivalent to a VCP compliance statement under EPCRS). Although obtaining a PLR or a closing agreement is bound to cost more and take more time than just reading and following the black letter of the PRIRC, it is worth noting that this option may still be available.

Hacienda is currently working on drafting and issuing the regulations under the PRIRC and other administrative guidance construing and implementing the final rules (collectively referred to as the ''Regulations''). The Regulations will be issued gradually as they are finalized, and the entire process is scheduled to be completed this year.

In the interest of full disclosure, it should be noted that the author, who assisted Hacienda with the drafting of the final rules, is also assisting Hacienda with the drafting of the Regulations. For example, the author drafted Hacienda Circular Letter No. 11-10 (December 16, 2011), which sets new rules for obtaining Hacienda's determination letters on plan qualifications. Those rules are addressed at the end of this article.

Other matters likely to be covered by the Regulations include providing some numerical or objective standards for meeting the general nondiscrimination test on benefits and contributions of PRIRC §1081.01(a)(4) (i.e., the local equivalent to §401(a)(4)) of the U.S. Internal Revenue Code (Code), most likely along the lines of Treas. Regs. §1.401(a)(4)-1; imposing restrictions on the use of bottoms-up QNECs for the correction a failed ADP test, similar to those of Treas. Regs. §1.401(k)-2(a)(6); incorporating the Code's methodology for calculating, allocating, and correcting excess contributions to CODA/401(k) plans; and creating a set of rules and procedures for the self-correction and administrative approval of certain corrections of plan qualification failures under the PRIRC, along the lines of, albeit not as comprehensive as, EPCRS.

EFFECTIVE DATE

The PRIRC rules were effective for tax years beginning after January 1, 2010 (i.e., January 1, 2011, for calendar plan years), except for the following rules which were effective for tax years beginning after January 1, 2011 (i.e., January 1, 2012, for calendar plan years): (1) the limits on annual benefits and contributions of PRIRC §1081.01(a)(11); (2) the limit on annual compensation of PRIRC §1081.01(a)(12); (3) the requirement of PRIRC §1081.01(a)(13) that all retirement plans with Puerto Rico participants be timely amended and filed with Hacienda for the issuance of a new or updated determination letter concerning their local qualification; and (4) the employer aggregation requirements of PRIRC §1081.01(a)(14). Thus, by now all of the PRIRC rules are in effect.

GENERAL PLAN QUALIFICATION REQUIREMENTS

Nondiscrimination Testing

The technical amendments did not add, remove or replace any of the basic nondiscrimination tests applicable to retirement plans in Puerto Rico; namely, the minimum coverage test of PRIRC §1081.01(a)(3), the general nondiscrimination test of PRIRC §1081.01(a)(4), and the ADP test of PRIRC §1081.01(d)(3). As noted above, the Regulations are likely to add some objective elements to the general nondiscrimination test, which is currently entirely subjective. Any such objective elements are likely to be similar to the equivalent elements of Code §401(a)(4), so they should not have an adverse impact on the retirement plans of U.S. and international companies operating on the Island, but could impact the retirement plans of some small local employers, such as Keogh plans of sole proprietors.

The PRIRC still does not have a local equivalent to the minimum participation test of Code §401(a)(26), the top-heavy requirements of Code §416, and the ACP test of Code §401(m)(2). Nevertheless, it is perfectly valid to include those U.S. qualification requirements on a retirement plan qualified in Puerto Rico. In fact, by definition, dual-qualified plans have to incorporate and comply with those U.S. rules.

A common question raised by U.S. benefits practitioners is whether the ADP test safe harbors of Code §401(k)(12) apply in Puerto Rico. They do not, as there is no PRIRC equivalent to Code §401(k)(12). Absent a Hacienda PLR providing otherwise, all plans qualified in Puerto Rico that include a CODA must pass the local ADP test, which is essentially identical to the ADP test in Code §401(k)(3).

New HCE/NHCE Definitions

The technical amendments modified the PRIRC to remove from the definition of highly compensated employee (HCE) those employees who are spouses or dependents of other HCEs. PRIRC §1081.01(d)(3)(E)(iii) now defines HCEs as those non-excludible employees who are: (1) officers of the employer; (2) 5% or more owners of the employer, measured on the basis of voting stock or the total value of all classes of stock of a corporation (or, for incorporated businesses, 5% of the capital or profits

ISSN 0747-8607

interest); or (3) employees who for the immediately preceding taxable year received compensation from the employer in excess of the limit in Code §414(q)(1)(B), as periodically adjusted by the IRS (e.g., $115,000 for 2012). All other non-excludible employees are non-highly compensated employees (NHCEs). The same HCE/NHCE definitions apply to Puerto Rico-only qualified plans and dual-qualified plans. Spouses and dependents of other HCEs were removed from the HCE definition to address concerns raised by some employers and their third-party administrators (TPAs) to the effect that keeping such classification of HCEs would require them to incur in additional time and expenses for obtaining information about the family relationships and tax connections among company employees.

In its final form, the local HCE definition is essentially identical to the equivalent definition of Code §414(q)(1), except for two aspects. First, the PRIRC does not incorporate the 20% top-paid group limitation of Code §414(q)(3), and, second, under the PRIRC, company officers are automatically classified as HCEs. This rule treating officers as HCEs is a reflection of the fact that the average income of Puerto Rico employees is significantly lower than the average income of U.S. employees. The author has been informally told by some Hacienda officers that about seven percent of all Puerto Rico taxpayers report in their local tax returns wages or net earnings from self-employment in excess of $100,000. Thus, by using an HCE definition that would only cover company owners and employees making more than $115,000 (i.e., a mirror of the U.S. definition), the vast majority of retirement plans in Puerto Rico would be automatically exempt from the PRIRC's nondiscrimination tests, as they would only benefit NHCEs. The concern was that many small and mid-size local companies would take advantage of such a rule to replace their current qualified plans that benefit a cross-section of all company employees with other plans, also qualified, that only benefit executives. As long as those executives are not the business owners and have compensation below the Code §414(q) threshold, which, as noted above, is usually the case, that approach would be perfectly valid, resulting in qualified retirement plans solely for the benefit of executives. To reduce the chances of such executive-only qualified plans, the ''officers'' prong of the local HCE definition was kept.

So, who is an officer for these purposes? Although the final answer to this question will have to wait until the Regulations are issued, the author has suggested that Hacienda adopt a definition of officer based on the equivalent definition the IRS adopted for Code §409A purposes.[4] The term ''officer'' would therefore be defined more or less as follows:

> The term ''officer'' shall mean the employer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the employer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the employer. Officers of the employer's parent(s) or subsidiaries shall be deemed officers of the employer if they perform such policy-making functions for the employer. In addition, when the employer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. When the employer is a trust, officers or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust. This definition applies without regard to whether the employer has any class of securities registered under the securities rules of Puerto Rico or the United States. In the case of an employer who is not a corporation, this definition shall be applied by analogy.

Such a definition should be broad enough to prevent many small and mid-size local companies from setting up executive-only qualified plans, but it should not have a significant impact on the average U.S. or international company operating in Puerto Rico, as those companies generally do not have many, if any, officers in their P.R. operations. Pending the enactment of the Regulations, the author recommends that plan sponsors follow a good faith interpretation of the definition above.

In light of the new HCE definition, which is substantially narrower than the previous top one-third HCE definition of §1165(e)(3)(E)(iii) of the Puerto Rico Internal Revenue Code of 1994 (the ''PRIRC-94''), some companies are assessing whether their Puerto Rico retirement plans still need to be tested for discrimination. As a general rule, in performing the local nondiscrimination tests, an employer only needs to take into account those non-excludible employees who are residents of Puerto Rico.[5] If certain conditions are met, an employer may include some U.S. non-excludible employees in performing the local tests, but it is not required to do so. Thus, if none of the employer's Puerto Rico employees are HCEs, the plan would automatically be nondiscriminatory, and the local tests would not have to be performed. With the current market rate for completing the local nondiscrimination test at around $30 per each Puerto Rico employee (not Puerto Rico participant or even Puerto Rico non-excludible employee, but Puerto Rico em-

[4] *See* Notice 2008-113, 2008-51 I.R.B. 1305, §III.G. (referencing 17 CFR §240.16a-1(f)).

[5] Article 1165-3(a)(1) of the regulations under the PRIRC-94, which is not likely to be modified by the Regulations.

ISSN 0747-8607

ployee), a company with 100 Puerto Rico employees none of whom is an HCE would save around $3,000 each year, plus some time and effort, by doing away with the local tests. These potential savings on plan administration were not possible prior to 2011, as under the PRIRC-94 all employers always had some HCEs (one-third of their non-excludible Puerto Rico employees). Even companies that only have one or two HCEs in Puerto Rico may be able to realize such savings by imposing plan limitations on the retirement benefits of the HCEs, such as a cap on elective deferrals, and equalizing them through nonqualified retirement arrangements or bonuses.

Employer Aggregation Requirements

The technical amendments made some minor changes to PRIRC §1081.01(a)(14)(A) to: (1) make clear that the local employer aggregation requirements apply both to incorporated and to unincorporated entities; and (2) exclude from aggregation those members of the controlled group that do not have employees in Puerto Rico. For example, if companies A, B and C are members of the same controlled group of corporations, but only company A has employees in Puerto Rico, companies B and C are not considered ''employers'' and may be disregarded for Puerto Rico nondiscrimination testing purposes. As noted in the previous article, these requirements are modeled after, and intended to operate like, Code §414(b), (c) and (m), and should not have a material impact, if any, on the retirement plans of U.S. and international companies.

10% Excise Tax on Late Correction of ADP Test

The technical amendments did not make any changes to this rule. As noted above, given the new HCE definition, some companies are finding out that, beginning with the 2011 plan year, their Puerto Rico retirement plans automatically pass the local ADP test, and thus, this tax would not apply to them.

Elimination of Certain Deemed Nondiscriminatory Classification

The technical amendments did not make any changes to this rule.

Temporary Relief from Minimum Coverage Test upon Corporate Transactions

The technical amendments did not make any changes to this rule.

Limits on Benefits, Contributions, and Compensation

One of the main concerns among U.S. benefits practitioners about the initial text of the new rules was that although the PRIRC incorporated the limits on annual benefits and contributions of Code §§415(b) and (c), and the limit on annual compensation of Code §401(a)(17), it did not seem to incorporate the periodic cost-of-living adjustments that go with such limits in the U.S. For example, in its original form, PRIRC §1081.01(a)(11)(B) (i.e., the local equivalent to Code §415(c)), provided for an annual limit on contributions equal to the lesser of 100% of the participant's compensation or $49,000. That is, instead of adopting the periodically-adjusted dollar limit that applies in the U.S., the PRIRC adopted the specific dollar amount that was in effect in the U.S. for 2011. The concern was that, as the dollar limits under the Code are subsequently adjusted, the local limits would remain frozen in their 2011 form, eventually leading to disparities between the two. In turn, that would slowly but steadily bring back the administrative challenges that used to apply to the operation of dual-qualified plans (i.e., having to comply with two different sets of laws). As noted in the previous article, that was not the intention behind the local implementation of the U.S. dollar limits. The idea was that the local dollar limits would operate exactly like their U.S. counterparts. Apparently, somewhere during the PRIRC's review and approval process, the references to the relevant Code sections were replaced with the specific dollar amounts that were in effect at the time. The technical amendments corrected this situation by replacing those dollar amounts with references to the relevant Code sections. As a result, the periodic adjustments to the U.S. dollar limits will be equally applicable to the local dollar limits.

In addition, to address some concerns among U.S. actuaries about possible anti-cutback violations if the new local limits were applied retroactively, PRIRC §1081.01(a)(11)(A) (i.e., the local version of Code §415(b)) and 1081.01(a)(12) (i.e., the local version of Code §401(a)(17)) were amended to specify that the new local limits cannot reduce or otherwise adversely affect a participant's accrued benefits as of December 31, 2011. The author considers that the reference to December 31, 2011, was merely an inadvertent error on the local legislature's part, as it does not contemplate fiscal plan years, and the correct rule should cover accrued benefits as of the end of the last plan year beginning before January 1, 2012.

Limits on Employee Contributions

Employee Pre-Tax Contributions

In an interesting development, and one with which the author was not involved, the technical amendments split the local limits on pre-tax contributions to CODA/401(k) plans in two: one set of limits applicable to Puerto Rico-only qualified plans and another one applicable to dual-qualified plans. Pursuant to PRIRC §1081.01(d)(7)(A)(i), participants in Puerto Rico-only qualified plans — which pursuant to ERISA §1022(i)(1) are always Puerto Rico residents — are subject to the limits described in the previous article (e.g., $13,000 for 2012), which, as noted, are unlikely to go up anytime soon. On the other hand, pursuant to PRIRC §1081.01(d)(7)(A)(ii), the Puerto Rico participants in a dual-qualified plan are now subject to the Code §402(g) limits, as periodically adjusted by the IRS (e.g., $17,000 for 2012).

One of the main reasons for the addition of this new higher limit on dual-qualified plans was to facili-

ISSN 0747-8607

tate the administration of dual-qualified 401(k) plans of those companies with a relatively large Puerto Rico workforce. For example, if a company with 100 employees in the U.S. and 200 employees in Puerto Rico covers both groups under the same 401(k) plan (i.e., the plan is dual-qualified), and 50% of the U.S. employees are HCEs for purposes of Code §414(q), whereas none of the Puerto Rico employees are HCEs for those purposes, subjecting the Puerto Rico employees to a smaller pre-tax contributions limit reduces the plan's chances of passing the U.S. ADP test, which statutorily must include both groups of employees. The thought was that by allowing the Puerto Rico employees to contribute up to the Code §402(g) limit, some of them, such as the members of the local management team, will max out their pre-tax contributions, increasing the NHCE group's ADR. In practice, however, this change should not have much of an impact on a 401(k) plan's U.S. ADP test, as it is doubtful that many Puerto Rico participants will increase their pre-tax contributions up to the §402(g) limits. In any event, for the vast majority of U.S. and international companies operating in Puerto Rico, this was and remains a non-issue because their Puerto Rico employees are only a small percentage of their workforce and their impact in the U.S. ADP test should be minimal.

But there is a bit more to this story. The previous article mentioned that the PRIRC did away with the old IRA offset on pre-tax contributions (i.e., a participant's contributions to an IRA used to reduce, dollar-for-dollar, the maximum amount of his or her pre-tax contributions to a CODA plan). PRIRC §1081.01(d)(7)(A)(iii) brought back a new version of the IRA offset that only applies to dual-qualified plans. Specifically, if during the same tax year, a Puerto Rico participant in a dual-qualified plan makes both pre-tax contributions to the plan and contributions to a Puerto Rico IRA for himself or herself, as opposed to contributions to an IRA for his or her spouse, the combined limit on such contributions cannot exceed the following limits:

Calendar Year	Combined CODA & IRA contributions limit
2011	$15,000
2012	$18,000
2013+	$20,000

The author believes that the IRA offset always was, and now once again is, a local tax requirement that only applies to the participant as a taxpayer, not to the plan. That is, it is up to the participant in his or her Puerto Rico income tax return, and not to the plan sponsor in the plan records, to make sure that his or her total pre-tax contributions to the plan and contributions the IRA do not exceed the applicable limit. As far as the plan sponsor is concerned, as long as the pre-tax contributions to the plan do not exceed the Code §402(g) limits, the plan should not have an operational failure. Nevertheless, in the interest of minimizing possible employee relations issues, this is the sort of information that some sponsors of dual-qualified plans disclose to the Puerto Rico participants in the plan through a notice, SMM, or memorandum on the basic U.S. and P.R. income tax treatment of retirement income, so those participants are not caught off-guard during tax filing season.

It is worth noting that although the changes to the local pre-tax contribution limits became effective in 2011, this does not mean that all CODA plans qualified in Puerto Rico had to incorporate such higher limits beginning in 2011. Plan sponsors have full discretion to decide if and when to increase the limits of their respective plans. Retaining the previous lower limits is not a breach of the local plan qualification rules.

Catch-up Contributions

The limits on catch-up contributions remain exactly as they are described in the previous article. Although the Code §402(g) limits now apply to dual-qualified plans, the Code §414(v) limits do not. Puerto Rico participants in both Puerto Rico-only qualified plans and dual-qualified plans are subject to the limits set forth in PRIRC §1081.01(d)(7)(C)(i) (e.g., $1,500 for 2012). Sponsors of dual-qualified plans should, therefore, confirm with their recordkeepers or TPAs that the Code §414(v) limits are not inadvertently extended to the Puerto Rico participants together with the Code §402(g) limits, as that would lead to an operational failure that may require an administrative correction with Hacienda.

After-Tax Contributions

The technical amendments added a new PRIRC §1081.01(a)(15), which provides that a participant's voluntary after-tax contributions to a qualified plan cannot exceed 10% of his or her aggregate compensation for all of his or her years of participation. This is not a flat 10% annual limit but, rather, a rolling 10% limit that depends on the participant's after-tax contributions and compensation for all years of participation in the plan. This same limit has been in place since 1997, but it was included in the regulations to the PRIRC-94, rather than the PRIRC-94 itself. To address the incidence of excessive voluntary after-tax contributions among local Keogh plans (i.e., to shelter investment earnings from current income taxation), it was decided to set the limit within the PRIRC. As noted above, the PRIRC does not have an ACP test, so, absent this sort of limit, owner-employees, which by definition are HCEs, would be able to load up their Keogh plans with after-tax contributions. This limit does not apply to mandatory employee after-tax contributions, such as contributions required as a condition of employment. Dual-qualified plans, but not Puerto Rico-only qualified plans, also have to take into account after-tax contributions by Puerto Rico participants in performing the ACP test of Code §401(m)(2).

Trust Fund Location

PRIRC §1081.01(a) now provides that, as a condition for qualification in Puerto Rico, a retirement plan

ISSN 0747-8607

covering Puerto Rico participants, be it a Puerto Rico-only qualified plan or a dual-qualified plan, must be funded through either (1) a trust fund organized under the laws of Puerto Rico (i.e., a Puerto Rico trust), or (2) a trust fund considered a U.S. person under Code §7701(a)(30)(E) (i.e., a U.S. trust). Accordingly, a retirement plan qualified in Puerto Rico cannot be funded through a trust fund established in a jurisdiction other than the U.S. or Puerto Rico (i.e., a foreign trust). In practice, this is also a non-issue, as all Puerto Rico-only qualified plans use a Puerto Rico trust and, except for a handful of Puerto Rico-based plans that have made an election for U.S. qualification pursuant to ERISA §1022(i)(2)/Treas. Regs. §1.401(a)-50, all dual-qualified plans use a U.S. trust.

In his 20-plus years of dealing with retirement benefits in Puerto Rico, the author has never come across a retirement plan qualified in Puerto Rico funded through a foreign trust. So why was this language added to the PRIRC? The answer has to do with the ongoing saga of the participation by Puerto Rico-only qualified plans in certain group trusts that are tax-exempt in the U.S. pursuant to Rev. Rul. 81-100,[6] commonly known as ''81-100 group trusts.''[7] Apparently, some IRS officers were concerned that if Puerto Rico-only qualified plans could be funded through foreign trusts and are allowed to participate in 81-100 group trusts, that could lead to some 81-100 group trusts holding the assets of a foreign trust, which could present a host of U.S. and international tax complications. The introductory paragraph of PRIRC §1081.01(a) effectively puts an end to that concern by clearly stating that all plans qualified in Puerto Rico need to use either a U.S. trust or a Puerto Rico trust.

PUERTO RICO INCOME TAXATION OF RETIREMENT BENEFITS

As a result of certain changes brought about by the technical amendments to the PRIRC, the local rules on the taxation of retirement income may now be split in three groups: taxation of lump-sum distributions, taxation of annuities and installments, and taxation of other forms of payment. This structure is somewhat similar to the equivalent U.S. rules on the taxation of eligible rollover distributions, periodic payments, and nonperiodic payments. As explained below, however, the Puerto Rico tax rules on retirement income, particularly those on annuities and installments, are for the most part better for participants than the U.S. tax rules.

Taxation of Lump-Sum Distributions

Basic Rule

The basic rule remains the same: lump-sum distributions are generally subject to 20% Puerto Rico income tax withholding at source, and are also taxed at a flat rate of 20%. Because the amount withheld is also the amount ultimately due to Hacienda, there is no need for participants to pay estimated taxes on account of their retirement income.

Special Rule on Investments in Puerto Rico Property

The technical amendments made a few changes to the special rule providing for 10% withholding and flat rate tax on lump-sum distributions from plans that are funded through a Puerto Rico trust or use a Puerto Rico paying agent for processing distributions to the Puerto Rico participants and invest 10% or more of the plan assets attributable to those participants (or in the case of a defined contribution plan, the participant invests 10% or more of the value of his or her account) in Puerto Rico property. PRIRC §1081.01(b)(1)(B) was amended to expand definition of the term ''Puerto Rico property'' to include investments in: (1) investment companies organized under the laws of Puerto Rico (i.e., mutual fund companies registered in Puerto Rico); (2) fixed or variable annuities issued by either a Puerto Rico insurance company or a non-Puerto Rico insurance company that, for the three-year period immediately preceding the date of distribution, earned more than 80% of its gross income from sources within Puerto Rico (e.g., the Puerto Rico subsidiary of a U.S. insurance company); (3) deposits in interest-bearing accounts, such as savings accounts and certificates of deposit, issued by commercial banks, mutualist banks, cooperative financial institutions, and savings and loans/thrift associations licensed by the U.S. or Puerto Rico governments, or any other banking organization based in Puerto Rico (e.g., a Puerto Rico bank or the Puerto Rico branch of a U.S. bank); and (4) any other property Hacienda may formally designate in the Regulations as Puerto Rico property.

If it seems that this new definition resulted from lobbying with the local legislature by some Puerto Rico banks and insurance companies interested in getting a piece of the Puerto Rico plan assets businesses, it is because that was precisely the case. In any event, some sponsors of retirement plans qualified in Puerto Rico, mainly Puerto Rico-only qualified plans, are already considering adding interest-bearing accounts from Puerto Rico financial institutions as investment alternatives under their plans, so as to allow participants to take advantage of the potentially lower tax rate. Dual-qualified plans may also take advantage of this special rule, but in order to do so, they need to engage a Puerto Rico paying agent. As with any other decision involving the addition of investment funds, plan sponsors are advised to evaluate whether including Puerto Rico property in the plan's investments would be a prudent decision under ERISA §404.

Tax-Free Rollovers

The technical amendments changed the local rollover rules to preclude rollovers of distributions other than lump sums, but allow for partial rollovers in the case of lump sums. The pre-2011 rollover rules were

[6] 1981-1 C.B. 326.

[7] In Notice 2012-6 2012-3 I.R.B. 293, the IRS announced that it continues to review, and requested comments on, whether Puerto Rico-only qualified plans are eligible to pool their assets with those of U.S. qualified retirement plans and IRAs in an 81-100 group trust.

ISSN 0747-8607

rather restrictive, as only lump-sum distributions could be rolled over and the rollover had to include the entire amount distributed, including after-tax contributions. Partial rollovers were not allowed. In its original form, PRIRC §1081.01(b)(2)(A) was just the opposite. Any total or partial distributions following a participant's separation from service, such as lump sums, annuities and installments, were eligible for a rollover. That broad rollover rule was intended to eliminate the previous ''Catch 22'' situation in which a participant who kept a single dollar of his or her plan benefits was automatically precluded from completing a rollover. Some plan sponsors, however, noted that their recordkeeping and tax reporting systems were not suited for handling the multitude of partial rollovers that could result from the new rule. To address that concern, PRIRC §1081.01(b)(2)(A) was modified to limit rollovers to all or part of a lump-sum distribution following the participant's termination of employment. Distributions other than lump sums are no longer eligible for a rollover.

For example, a participant with a $50,000 plan account who elects to receive the entire $50,000 may directly receive $30,000 and roll $20,000 over to another plan or IRA, or may roll over the entire $50,000 to another plan or IRA. If the rollover is completed through a direct or trust-to-trust transfer of assets, the amount rolled over is not subject to the 20% income tax withholding at source on lump-sum distributions (10% if the special rule on investments in Puerto Rico property is met). Participants and their beneficiaries, whether or not surviving spouses, may complete a total or partial rollover of a lump-sum distribution.

As under the pre-2011 rules, the only valid transferees for a rollover that would defer the Puerto Rico taxation of retirement income are retirement plans qualified in Puerto Rico and IRAs issued by financial institutions based in Puerto Rico. Thus, the potential problem with rollovers from dual-qualified plans, where, for example, a rollover to a U.S. IRA would defer U.S. income taxation but not P.R. income taxation and a rollover to a P.R. IRA would defer P.R. income taxation but not U.S. income taxation, still remains. In light of this situation, some sponsors of dual-qualified plans have modified their plans to provide that the Puerto Rico participants in the plan can only complete a rollover to another dual-qualified plan, to avoid exposing the sponsor to the U.S. or P.R. under-reporting and under-withholding violations that could result if the sponsor treats a direct rollover by a Puerto Rico participant to a vehicle other than another dual-qualified plan as tax-free both in the U.S. and in Puerto Rico. Again, this is the sort of information frequently disclosed in a tax-related memo/SMM to Puerto Rico participants in dual-qualified plans.

Taxation of Annuities and Installments

Basic Rule

The technical amendments kept the basic rule that distributions in the form of annuities or installments following the participant's termination of employment are taxed as ordinary income (i.e., at a rate between 7% and 33%, depending on the participant's taxable income for the year of distribution), but incorporated into the text of PRIRC §1081.01(d)(3)(B) the rule Hacienda previously set in Administrative Determination No. 11-02 (March 1, 2011) exempting a portion of such payments from the 10% Puerto Rico income tax withholding at source that went into effect on January 31, 2011. As a result, the following amounts distributed to a participant or beneficiary in the form of an annuity or installments following the participant's termination of employment are exempt from the 10% withholding:

Tax Year of Distribution	Amount Exempt from 10% Withholding	
	If at year-end the participant/ beneficiary has not yet reached age 60	If at year-end the participant/ beneficiary is age 60 or older
2011	$19,500	$23,500
2012	$21,000	$25,000
2013	$23,500	$27,500
2014	$26,500	$30,500
2015+	$31,000	$35,000

The portion of annuities or installments in excess of the exempt amount, if any, is subject to 10% Puerto Rico income tax withholding at source. For these purposes, the term ''installments'' is simply defined as: (1) payments of substantially-equal amounts completed over a fixed period, and (2) in the case of dual-qualified plans, required minimum distributions under Code §401(a)(9).[8] Time and again, Hacienda officials and the author have warned the local legislature against adopting such a broad definition of installments, as basically any two payments following termination of employment can be easily structured to fit that definition, and thus, escape the 10% income tax withholding. Time and again, however, the local legislature rebuffed Hacienda and the author and refused to narrow or impose conditions on the definition of installments. Thus, this broad definition is not an inadvertent error but, rather, the clear intent of the local legislature.

Annual Income Exclusion of Retirement Benefits

The main problem or opportunity, depending on how one sees it, with the broad definition of ''installments'' described above is not that it allows for many distributions to escape the 10% withholding at source, but that it allows for many distributions to escape Puerto Rico income taxation altogether. Pursuant to PRIRC §1031.02(a)(13), if a Puerto Rico participant in a retirement plan qualified in Puerto Rico, be it a Puerto Rico-only qualified plan or a dual-qualified plan, receives his or her benefits in the form of an annuity or installments following termination of employment, the first $11,000 the participant receives

[8] PRIRC §§1081.01(b)(3)(C) and 1031.02(a)(13)(D).

ISSN 0747-8607

each year (if by the end of the year the participant has not yet reached age 60), or the first $15,000 the participant receives each year (if by the end of the year the participant is age 60 or older) is exempt from the payment of Puerto Rico income taxes. As practically any two payments following termination of employment can, with a little planning and the right plan terms, be structured as installments, participants can easily take advantage of the annual income exclusion to avoid paying any Puerto Rico income taxes on their retirement income.

A few illustrations should help make the point. For example, if a participant age 60 receives a $30,000 lump-sum distribution following termination of employment, he or she will end up paying $6,000 in taxes to Hacienda, but if the same participant receives $30,000 through a $15,000 payment on December 31 and another $15,000 payment on January 1, both payments would be eligible for the $15,000 annual income exclusion, and thus, the $30,000 would be completely tax-free. Moreover, as there is no minimum age requirement for the annual income exclusion, a participant who separates from service at age 35 with a $20,000 plan account can also escape Puerto Rico income taxation by receiving his or her benefits in two annual payments of $10,000 each. In light of this tax planning opportunity, some sponsors are amending their plans covering Puerto Rico employees to add installments as a form of payment.

As noted above, annuities and installments are not eligible for tax-free rollovers.

Taxation of Other Forms of Payment

Payments other than lump-sum distributions, annuities and installments, such as in-service withdrawals, defaulted loans, and periodic payments following termination of employment that are not of substantially-equal amounts, are taxed as ordinary income (i.e., at a rate between 7% and 33%, depending on the participant's taxable income for the year of distribution) and are subject to 10% Puerto Rico income tax at source from the first dollar (to the extent that cash is actually paid). Also, they are not eligible for a rollover of the $11,000/$15,000 annual income exclusion.

To put an end to, or at least reduce the incidence of, an abusive practice followed by some sponsors of Keogh plans regarding plan loans, new PRIRC §1081.01(b)(3)(E) was created, incorporating the loan repayment requirements of Code §72(p)(2)(B) and (C). Basically, taking advantage of the fact that neither the PRIRC-94 nor the DOL regulations under ERISA §408 have a local equivalent to those Code sections, some owner-employees were receiving tax-free loans from their Keogh plans that provided for extremely long repayment periods (e.g., a 30-year repayment period on a non-residential loan). PRIRC §1081.01(b)(3)(E) now requires that participant loans be repaid through substantially-equal installments on at least a quarterly basis and within a period not greater than five years or, in the case of loans taken to finance the purchase of the participant's primary residence, any longer period permissible for primary residence loans under the terms of the plan or the loan documents. This rule is intended to operate exactly like Code §72(p)(2)(B) and (C).

DEDUCTION OF PLAN CONTRIBUTIONS

10% Tax on Nondeductible Contributions

PRIRC §1033.09(a)(5) was amended to exempt from the 10% tax on nondeductible contributions (i.e., the local equivalent to Code §4972): (1) contributions carried forward from a tax year that commenced before January 1, 2011; and (2) contributions attributable to employee after-tax contributions up to the rolling 10% of compensation limit set forth in PRIRC §1081.01(a)(15), as described above.

Contributions to Profit-Sharing and Stock Bonus Plans

The technical amendments did not make any changes to this rule.

Contributions to Defined Benefit Pension Plans

PRIRC §1033.09(a)(1)(A)(i)(IV) was amended to clarify that contributions to a defined benefit pension plan required to meet the minimum funding requirements of ERISA §302 are fully deductible and are not subject to the otherwise applicable combined defined benefit/defined contribution plan deduction limit of 25% of compensation. Minimum required contributions are, therefore, exempt from the 10% tax on nondeductible contributions described above.

PLAN QUALIFICATION WITH HACIENDA

Basic Rules

Pursuant to PRIRC §1081.01(a)(13), all retirement plans intended to be qualified in Puerto Rico, whether Puerto Rico-only qualified or dual-qualified, must obtain a determination letter from Hacienda, commonly known as a qualification letter, regarding their qualification under PRIRC §1081.01(a). Hacienda Circular Letter No. 11-10 (December 16, 2011) establishes the process that, beginning January 1, 2012, plan sponsors and their authorized representatives need to follow for requesting such letters.

The first thing that should be noted about the new plan qualification process, because it initially led to some confusion among employers and benefits practitioners, is that retirement plans qualified in Puerto Rico were *not* legally required to be formally amended to incorporate the new PRIRC rules and

ISSN 0747-8607

filed with Hacienda to request a new or updated determination letter during 2011. Instead, plans will have be amended to incorporate the new PRIRC rules by the end of the first plan year commencing on or after January 1, 2012 (i.e., by December 31, 2012, for calendar plan years), and the amended plans will have to be filed with Hacienda to request a new or updated determination letter concerning their local qualification by the due date, including extensions, for filing the employer's Puerto Rico income tax return for the 2012 tax year (i.e., by April 15, 2013, for calendar year taxpayers, or, if a request for extension is duly filed with Hacienda, by July 15, 2013). Therefore, plan sponsors that have not yet amended their plans or filed them with Hacienda on account of the new PRIRC rules have not breached any local plan qualification requirements.

Plan Amendments for Incorporating New PRIRC Rules

Due Date for Completing Amendments

All retirement plans that, on or after January 1, 2011, have provided benefits or contributions to active participants who are residents of Puerto Rico need to be amended to incorporate the new PRIRC rules no later than the last day of the first plan year that commenced on or after January 1, 2012 (i.e., by December 31, 2012, for calendar plan years). In the case of those new PRIRC rules over which the plan sponsor has discretion about the implementation date, such as the adoption of the higher limits on employee pre-tax contributions, the amendment formally incorporating such rules into the plan will have to be adopted by the last day of the plan year in which the change became effective, or, if later, the last day of the first plan year that commenced on or after January 1, 2012. For example, if a plan with a calendar plan year adopted the higher pre-tax contribution limits during 2011, the relevant amendment will have to be adopted by December 31, 2012.

Content and Form of Amendments

Puerto Rico-only qualified plans will have to be amended to incorporate the following new PRIRC rules:

(1) the HCE definition of PRIRC §1081.01(d)(3)(E)(iii);

(2) the limits on annual benefits or contributions, as applicable, of PRIRC §1081.01(a)(11);

(3) the limit on annual compensation of PRIRC §1081.01(a)(12);

(4) the employer aggregation rules of PRIRC §1081.01(a)(14);

(5) the tax-free rollover rules on distributions to Puerto Rico participants of PRIRC §1081.01(b)(2)(A).

Because dual-qualified plans already include the dollar limits of Code §§415(b) and (c) and 401(a)(17), and the employer aggregation rules of Code §414(b), (c) and (m), the only required amendments would be the new HCE definition and the local tax-free rollover rules, and any such amendments would be applicable solely to the Puerto Rico participants in the plan.

Also, depending on the relevant circumstances, some plans, whether P.R.-only qualified or dual-qualified, may need to be amended to adopt the following new PRIRC rules:

(1) the higher employee pre-tax contributions and catch-up contributions limits of PRIRC §1081.01(d)(7);

(2) the limit on voluntary employee after-tax contributions of PRIRC §1081.01(a)(15);

(3) the restrictions on participant loan repayments of PRIRC §1081.01(b)(3)(E);

(4) the special rule on investments in Puerto Rico property of PRIRC §1081.01(b)(1)(B).

Circular Letter No. 11-10 does not establish a required procedure for the adoption of these amendments. A plan sponsor may follow any procedures for adopting amendments established under the terms of the plan or its regular policies for approving corporate or business decisions, such as the approval of resolutions by the board of directors or the administrative committee. Also, the new PRIRC rules may be adopted through a plan restatement, a formal plan amendment, or a supplement or addendum to the plan that only applies to the Puerto Rico participants in the plan. It is acceptable to adopt the new PRIRC rules by including reference to the relevant PRIRC sections.

Filing Amended Plans with Hacienda

Due Date for Completing Filing

The amended plans will have to be filed with Hacienda to request a new or updated determination regarding their qualification under PRIRC §1081.01(a) by the due date, including extensions, for filing the employer's Puerto Rico income tax return for the 2012 tax year (i.e., by April 15, 2013, for calendar year taxpayers, or, if a request for extension is duly filed, by July 15, 2013). Plans established or that begin to cover Puerto Rico participants after January 1, 2012, will have to be filed with Hacienda by the due date, including extensions, for filing the employer's Puerto Rico income tax return for the taxable year in which the plan was established or began to cover Puerto Rico participants, as applicable.

Notwithstanding the foregoing, those plans that were amended to incorporate the new PRIRC rules and filed with Hacienda during 2011 are deemed to have already meet the Hacienda filing requirements and will not have to be filed again by the April 15/July 15, 2013, due dates.

Documents and Information to Be Filed

For plans established and maintained through an individually-designed plan document (e.g., many Pu-

ISSN 0747-8607

erto Rico-only qualified plans and basically all dual-qualified plans), the filing has to include the following documents and information:

(1) name, EIN, postal address and telephone number for the plan sponsor and the participating employers that have employees in Puerto Rico;

(2) plan name, plan year, type of plan (e.g., defined benefit pension plan, money purchase plan, profit-sharing plan with or without a CODA, and stock bonus plan), and PIN;

(3) date on which the plan was established or began to cover Puerto Rico participants;

(4) copy of the restated plan document or plan amendment/Puerto Rico supplement incorporating the new PRIRC requirements. If the plan has been previously qualified with Hacienda and the new PRIRC rules are adopted through a plan amendment or Puerto Rico supplement, it will not be necessary to include a copy of the plan document, but if the new PRIRC rules are adopted through a plan restatement or the plan has not been previously qualified with Hacienda, it will be necessary to include a copy of the plan document. If the new PRIRC rules are incorporated through a plan restatement, it will also be necessary to include reference to the relevant plan sections including the new rules.

(5) If those cases in which a copy of the plan document is needed (e.g., the new PRIRC rules are adopted through a plan restatement or the plan has not been previously qualified with Hacienda), it will also be necessary to include a copy of the trust agreement or insurance contract used for funding the plan.

(6) if the plan has been previously qualified with Hacienda, a copy of the most recent Hacienda determination letter.

(7) if the plan has been previously qualified with the IRS, a copy of the most recent IRS determination letter.

(8) copy(ies) of the document(s) establishing that the plan is complying with the Puerto Rico income tax rules on distributions to Puerto Rico participants. This requirement may be met by including reference to the sections of the plan document or trust document that incorporate the relevant Puerto Rico income tax rules, a copy of an agreement with the paying agent handling distributions to Puerto Rico participants, or a letter or memo signed and dated by such paying agent whereby it confirms that the plan is in fact compliant.

(9) if the filing is completed by an authorized representative for the employer, a completed copy of Hacienda Form AS 2754-A, *Power and Declaration of Representation*. This requirement does not apply if the filing is completed by an employee of the employer maintaining or participating in the plan.

(10) a check for the payment of the filing fees set forth in Hacienda Regulation No. 6103 (February 25, 2000). Usually, the Hacienda filing fees are $1,500 if either the new PRIRC rules are adopted through a plan restatement or the plan has not been previously qualified with Hacienda, or $350 if both the plan has been previously qualified with Hacienda and the new PRIRC rules are adopted through a plan amendment or a Puerto Rico supplement. Additional filing fees may apply if the employer requests that the Hacienda determination letter be retroactively effective as of a plan year before 2011. The PRIRC did not increase the applicable filing fees.

(11) if the plan sponsor is a member of a controlled group, a description of those members of the group that have employees in Puerto Rico, including their names and EINs, the ownership interest or relationship between the members, and whether their Puerto Rico employees are covered by the plan.

(12) the number of Puerto Rico participants in the plan as of the beginning of the plan year during which the plan is filed with Hacienda;

(13) if the plan is under an audit or investigation by the IRS or U.S. Department of Labor (i.e., the Employee Benefits Security Administration (EBSA)), a description of such audit or investigation;

(14) a summary of the eligibility requirements and benefits/contributions formula applicable to the Puerto Rico participants in the plan (which may be provided by reference to the relevant sections of the plan document);

(15) a description or schedule evidencing that the plan meets the minimum coverage test of Code PRIRC §1081.01(a)(3).

For plans established and maintained through the adoption of a pre-qualified master and prototype plan from a Puerto Rico financial institution or TPA (e.g., some Puerto Rico-only qualified plans), where that financial institution or TPA adopts the new PRIRC rules through an amendment to its own master plan document and no changes are made to the individual adoption agreements of the participating employers, the filing only has to include the following documents and information:

(1) name, EIN, postal address and telephone number for the plan sponsor and the participating employers that have employees in Puerto Rico;

ISSN 0747-8607

(2) plan name, plan year, type of plan, and PIN;

(3) copy of the most recent Hacienda determination letter;

(4) copy(ies) of the document(s) establishing that the plan is complying with the Puerto Rico income tax rules on distributions to Puerto Rico participants;

(5) if the filing is completed by an authorized representative for the employer, a completed copy of Hacienda Form AS 2754-A, *Power and Declaration of Representation*. This requirement does not apply if the filing is completed by an employee of the employer or the financial institution or TPA that sponsors the master and prototype plan.

(6) a $350 check for the payment of the Hacienda filing fees;

(7) if the plan sponsor is a member of a controlled group, a description of those members of the group that have employees in Puerto Rico, including their names and EINs, the ownership interest between the members, and whether their Puerto Rico employees are covered by the plan;

(8) the number of Puerto Rico participants in the plan as of the beginning of the plan year during which the plan is filed with Hacienda;

(9) if the plan is under an IRS or EBSA audit or investigation, a description of such audit or investigation.

Additional documents and information will have to be included if the new PRIRC rules are adopted through an amendment to the adoption agreement or if the plan has not been previously qualified with Hacienda.

Consequences of Failing to Amend or File Plans

Retirement plans with Puerto Rico participants that are not amended and filed with Hacienda within the due dates described above will be considered retirement plans not qualified in Puerto Rico. As a result, the trust fund or annuity contract forming part of the plan will not be tax-exempt in Puerto Rico, contributions to the plan will not be immediately deductible on the employer's Puerto Rico income tax return, and Puerto Rico participants will be immediately taxed on the value of their vested benefits under the plan.

PUERTO RICO ANNUAL INFORMATION RETURN

Hacienda Circular Letter No. 12-2 has essentially eliminated the requirement of preparing and filing with Hacienda local Form 480.70(OE), *Informative Return of Income Tax Exempt Organizations* (or the Spanish version thereof, local Form 480.7(OE)). Beginning with the 2011 plan year, in lieu of having to file these forms, the sponsors of those retirement plans qualified in Puerto Rico that are subject to Title I of ERISA (i.e., all of the U.S. and international companies operating on the Island) will only have to mail to Hacienda a simple copy of the Form 5500 (or, in the case of a small plan, Form 5500-SF) filed with EBSA, together with the top part of the first page of Form 480.70(OE) detailing the plan name, the plan sponsor's address and telephone number, the EIN of the trust forming part of the plan, and the date the plan began to cover Puerto Rico participants. That is, the top part of the first page of Form 480.70(OE) is intended to serve as a cover or transmittal letter for the copy of the Form 5500. It is not necessary to complete and send to Hacienda any other portions or pages of Form 480.70(OE), nor for the plan sponsor to sign and date that form.

The due dates for mailing a copy of the Form 5500 to Hacienda are the same as due dates for filing the Form 5500 with EBSA (i.e., usually July 31, or, if a filing extension of timely requested, October 15). In order to take advantage of the October 15 extended filing due date, however, the plan sponsor or its representative will have to file local Model SC 2644, *Request for Extension to File the Income Tax Return*, with Hacienda on or before the July 31 regular filing due date. That is, in addition to filing Form 5558 with EBSA, the plan sponsor or its representative will also have to file Model SC 2644 with Hacienda. The author recommends that, if a filing extension has been requested, copies of the relevant Form 5558 and Model SC 2644 should be attached to the copies of the Form 5500 being sent to Hacienda.

The copies of Form 5500 may be hand-delivered at Hacienda's main building in San Juan, Puerto Rico, or mailed, preferably via USPS certified mail, to: Puerto Rico Department of the Treasury, P.O. Box 9024140, San Juan, PR 00902-4140. Form 480.70(OE) and Model SC 2644 may be found at Hacienda's website: *www.hacienda.gobierno.pr.*

The alternative of mailing a copy of Form 5500 to Hacienda rather than filing Form 480.70(OE) is optional. A plan sponsor may decide to continue preparing and filing Form 480.70(OE) rather than mailing a copy of Form 5500. Because the plans eligible for this alternative filing are already required to file Form 5500, continuing with the filing of Form 480.70(OE) would be a waste of time and money. Therefore, in all likelihood, plan sponsors will just do away with the filing of Form 480.70(OE). Plan sponsors should consider contacting the recordkeepers or TPAs servicing their retirement plans qualified in Puerto Rico to confirm that, beginning with the 2011 plan year, the full Form 480.70(OE) is no longer prepared and they should not be invoiced for that work.

ISSN 0747-8607