Tax Management
Compensation Planning Journal

Highlights of Recent Changes to Rules on Qualified Retirement Plans in Puerto Rico*

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Ask the Author: May 25, 12:30–2 pm ET

Carlos Gonzalez, author of the BNA Tax & Accounting Portfolio, *International Pension Planning — Puerto Rico*, and this month's featured *CPJ* article, will take your questions on the best strategies to confront the new P.R. tax code, which includes a substantial overhaul of the qualification rules for pension plans covering P.R. employees.

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INTRODUCTION

This article describes the various changes enacted on January 31, 2011, to the Puerto Rico tax rules on the establishment, qualification and operation of retirement plans in Puerto Rico. The new rules generally became effective January 1, 2011, and apply to all qualified retirement plans that cover employees working on the Island, even those plans that are also qualified in the United States. The new rules will require plan sponsors to amend or restate their plans and file them with the Puerto Rico Department of the Treasury (''Hacienda'') for the issuance of an updated determination letter. Also, the local nondiscrimination testing requirements and the rules on the Puerto Rico income taxation of retirement benefits have been modified. Every sponsor of a qualified retirement plan that covers employees who are residents of Puerto Rico will most likely have to take some action to ensure compliance with the new rules. As most of the new rules are modeled after the current United States tax qualification requirements, employers and practitioners familiar with the relevant U.S. rules should encounter no problems in understanding and applying the new Puerto Rico rules.

This article's author happens to be the Puerto Rico benefits and compensation practitioner that Hacienda used for evaluating, designing and drafting the new rules. Therefore, this article addresses not only the text of the new rules, but also the intent behind the rules and some alternatives and considerations for complying with them. For more information on the operation of retirement plans in Puerto Rico, readers may refer to the BNA portfolio on retirement plans in Puerto Rico: 324 T.M., *International Pension Planning — Puerto Rico*.

BACKGROUND AND PRELIMINARY OBSERVATIONS

The local tax rules on qualified retirement plans on the Island were first enacted as §§165 and 23(p) of the Puerto Rico Income Tax Act of 1954 (the ''PRITA''), and were largely modeled after §§165 and 23(p) of

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ISSN 0747-8607

the U.S. Internal Revenue Code of 1939. On October 31, 1994, the PRITA was replaced by the Puerto Rico Internal Revenue Code of 1994 (the ''PRIRC-94''), and the retirement plan rules were enacted as PRIRC-94 §§1165 and 1023(n). For the most part, the PRIRC-94 did not make substantial changes to the retirement plan rules previously found in the PRITA. So, with a few noticeable exemptions, such as the incorporation of cash-or-deferred arrangements during the late 1980s, the local regulation of retirement plans had remained pretty much the same since the 1950s.

On January 31, 2011, the PRIRC-94 was replaced by the Puerto Rico Internal Revenue Code of 2010 (the ''PRIRC''), and the retirement plan rules are now enacted as PRIRC §§1081.01 and 1033.09. Specifically, PRIRC §1081.01 is the successor to PRIRC-94 §1165 and, among other things, sets the requirements that retirement plans need to meet in order to be tax qualified in Puerto Rico. PRIRC §1033.09 is the successor to PRIRC-94 §1023(n) and governs the deduction on the Puerto Rico income tax return of contributions to qualified and nonqualified retirement plans in Puerto Rico. For ease of reference, the following is a comparison of the main PRIRC-94 and PRIRC sections governing the operation of retirement plans in Puerto Rico:

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Rule	PRIRC-94	PRIRC
General plan qualification requirements	1165(a)	1081.01(a)
Qualification rules specific to CODA/401(k) plans	1165(e)	1081.01(d)
Income taxation of qualified retirement plan benefits	1165(b)	1081.01(b)
Employer deduction of contributions to qualified plans	1023(n)	1033.09
Annual income exclusion of certain retirement benefits	1022(b)(24)	1031.02(a)(13)
Informative return on distributions (i.e., local Form 480.7C)	1152(a)	1063.01(a)
Penalties for failure to provide informative return on distributions	6063/6071(a)	6041.04/6041.11
Trust annual informative return (i.e., local Form 480.70(OE))	1054(f)	1061.10

The PRIRC was intended to be a major overhaul of the Puerto Rico tax rules. It makes substantial changes to the local rules on individual and corporate income taxation, forms of doing business in Puerto Rico, and sales and use taxes, among others. Modifying or updating the local rules on retirement plans, however, was not one of the main objectives behind the PRIRC's enactment. Instead, when it comes to retirement plans, the only two aspects that, for the most part, the PRIRC is intended to address are limiting tax evasion and abusive tax practices and facilitating the operation of retirement plans on the Island.

One of the first issues considered during the process of developing the new retirement plan rules was precisely the need and reason for the changes. The local rules could have been modified for a host of reasons, such as increasing or reducing tax incentives on retirement plans, extending favorable tax treatment to benefits and fringes currently offered in the United States but not in Puerto Rico, or even exempting retirement plans that are qualified in the U.S. from the Puerto Rico plan qualification requirements. Ultimately, Hacienda officials determined that, in order to maximize the chances that the new rules would be approved, the changes should be focused on the issues of tax evasion and plan administration. They felt, and the author considers that rightly so, that if the changes to the local retirement plan rules were too broad, complex or ambitious, they could have generated substantial concerns among, and/or opposition by, employers, plan participants, the local retirement plan community and other interest groups, which could have derailed the opportunity for making at least some changes to the rules.

It should be noted that previous efforts to make major changes to the local retirement plan rules generally went nowhere precisely due to lobbying against the changes by parties potentially affected by them. Knowing that, Hacienda officials decided to keep things simple and focus their efforts on limiting tax evasion and facilitating plan administration. Therefore, the simple response to a fairly common complaint among U.S. companies and benefits practitioners that the new rules did not go far enough in eliminating the differences between the U.S. and Puerto Rico qualified plan rules is that elimination of those differences was not a main purpose behind the enactment of the new rules. The day when retirement plans already qualified in the U.S. can be freely operated in Puerto Rico without having to worry about complying with the Puerto Rico plan qualification requirements has not yet arrived. In any event, the PRIRC did eliminate some of the U.S./Puerto Rico discrepancies, which should make life significantly easier for U.S. and international companies operating on the Island.

As noted above, the new rules are essentially modeled after the relevant plan qualification rules of the U.S. Internal Revenue Code of 1986 (the ''Code''). An obvious reason for that approach was to take advantage of tried and tested measures the United States Government has previously implemented for dealing with the problems of tax evasion and discriminatory benefits in the area of retirement plans. Some of the problems that the PRIRC is now addressing in Puerto Rico had also existed in the U.S., and legislation was previously enacted to resolve them. So, rather than reinventing the wheel, Hacienda officials decided to take advantage of some of the solutions already in the Code. A potential benefit of incorporating existing Code rules rather than creating a new and different set of Puerto Rico-specific rules for regulating the operation of retirement plans in Puerto Rico is that plan sponsors, benefits practitioners and even Hacienda officials can generally apply the guidance U.S. tax authorities have issued on the Code rules for interpreting the equivalent PRIRC provisions. Also, many of the companies operating in Puerto Rico and offering retirement benefits to their local employees are based in the U.S. The more familiar those companies are with the local retirement plan rules, the easier and less expensive it will be for them to operate their retirement programs in Puerto Rico.

Before moving into a detailed description of the new PRIRC rules on retirement plans, it is convenient to quickly recap the two basic approaches a U.S. or international company with operations on the Island may use for offering retirement benefits to its Puerto Rico employees: namely, dual-qualified plan or a Puerto Rico-only qualified plan. As its name implies, a dual-qualified plan is a plan that is qualified in both the U.S. and Puerto Rico. Basically, a company simply includes its Puerto Rico employees as another group of active participants in its existing retirement plans qualified in the U.S. In that case, the plans will have to be qualified both in the U.S. and Puerto Rico, and in operation will have to comply with the Code rules with respect to all of its participants, including the Puerto Rico participants, plus the PRIRC rules solely with respect to its Puerto Rico participants. The PRIRC rules would not apply to the U.S. participants.

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As an alternative, rather than including its Puerto Rico employees in its U.S. plans, a company may provide retirement benefits to its Puerto Rico employees through the use of a Puerto Rico-only qualified plan, which is a plan qualified only in Puerto Rico, only covering Puerto Rico participants, and only subject to the plan qualification requirements of the PRIRC. These types of plans are also known as ''ERISA §1022(i)(1) plans,'' for the section of the Employee Retirement Income Security Act of 1974 that gives them tax-exempt status in the United States.

Whether a company operates a dual-qualified plan or a Puerto Rico-only qualified plan, the recent changes to the local tax rules are likely to have an impact on the plan's operation, and the plan sponsor and/or plan administrator may need to take action to ensure that the plan remains qualified in Puerto Rico.

EFFECTIVE DATE

The new rules are generally effective for tax years beginning after December 31, 2010 (i.e., January 1, 2011, for calendar plan years).[2] There are a handful of rules, however, that are effective on or after January 1, 2012, such as the new limits on annual benefits, contributions and compensation, which are addressed below. Initially, some practitioners requested Hacienda to grant some transition relief by postponing until 2012 some of the changes effective in 2011. To date, Hacienda has refrained from doing so, and all of the 2011 changes are already in effect.

The practical implication of these effective dates is that most plan sponsors will have to revise and, to the extent necessary, amend their plans during 2011 and 2012, and they will have to file their amended plans with Hacienda for the issuance of an updated determination letter during 2012 and 2013.

GENERAL PLAN QUALIFICATION REQUIREMENTS

Nondiscrimination Testing

The basic framework of the nondiscrimination tests applicable to qualified retirement plans in Puerto Rico was not changed. All retirement plans qualified in Puerto Rico must pass the minimum coverage test of PRIRC §1081.01(a)(3) (the ''Minimum Coverage Test''), which is very similar to the test in Code §410(b), as well as the general nondiscrimination test on benefits and contributions of PRIRC §1081.01(a)(4) (the ''General Nondiscrimination Test''), which is modeled after the test in Code §401(a)(4), but is based on the relevant facts and circumstances, rather than on objective or numerical criteria like the United States counterpart. In lieu of the General Nondiscrimination Test, plans with a cash-or-deferred arrangement (''CODA'') allowing participants to make elective deferrals on a pre-tax basis (i.e., a 401(k) plan) has to pass the actual deferral percentage test of PRIRC §1081.01(d)(3) (the ''ADP Test''), which is equivalent to the test in Code §401(k)(3).

The PRIRC still does not have a local equivalent to several of the nondiscrimination tests included in the Code, such as the top-heavy requirements of Code §416, the actual contribution percentage test of Code §401(m)(2) (the ''ACP Test''), and the minimum participation requirements of Code §401(a)(26).

The main changes to the local nondiscrimination testing requirements are the new definitions of highly compensated employee (''HCE'') and non-highly compensated employee (''NHCE''), the addition of employer aggregation requirements for performing the nondiscrimination tests, the imposition of a 10% excise tax on the late correction of a failed ADP Test, the removal of certain deemed nondiscriminatory classifications, and the addition of temporary relief for the Minimum Coverage Test following certain corporate transactions.

New HCE/NHCE Definitions

Without a doubt, the main differences that previously existed between the U.S. and Puerto Rico nondiscrimination testing requirements, and a constant source of problems for the administration of dual-qualified plans, were the definitions of HCE and HNCE. Under the PRIRC-94, HCEs were those non-excludible employees who received from the employer a higher compensation than two-thirds of all non-excludible employees (i.e., non-excludible employees in the top third of the employer's compensation scale).[3] All other non-excludible employees were NHCEs.

HCEs are now defined as any non-excludible employee who is: (1) an officer of the employer; (2) a shareholder owning more than five percent of the employer's voting stock or the total value of all the classes of the employer's stock; (3) an employee who, for the immediately preceding taxable year had compensation from the employer in excess of $110,000 or, in the case of a dual-qualified plan, compensation in excess of the limit in Code §414(q)(1)(B); or (4) the spouse or a tax dependent of an individual in any of the three previous classifications.[4] All other non-excludible employees are NHCEs. Although the HCE/NHCE definitions are included as part of the ADP Test rules, they are supposed to be applied when performing all of the discrimination tests under the PRIRC. This change became effective January 1, 2011.

The new HCE definition is generally based on, and is intended to be interpreted in accordance with, the relevant U.S. definition in Code §414(q). A remaining difference is that the Puerto Rico definition does not include the alternative 20% top-paid group definition in Code §414(q)(3). In any event, the new HCE/NHCE definitions should facilitate the operation of dual-qualified plans on the Island, as it will no longer

[2] PRIRC §6100.04(a)(1)(A).

[3] PRIRC-94 §1165(e)(3)(E)(iii).

[4] PRIRC §1081.01(d)(3)(E)(iii).

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be necessary to run both the U.S. nondiscrimination tests with regard to all plan participants using the HCE/NHCE definitions of the Code and the Puerto Rico nondiscrimination tests with regard to those participants who are residents of Puerto Rico using the old one-third, two-thirds HCE/NHCE definitions of the PRIRC-94. Now, with some basic planning and the right plan terms, a single set of tests should be all that is required, which should lower the cost of plan administration.

Employer Aggregation Requirements

Before January 31, 2011, the Puerto Rico tax rules did not include a real employer aggregation requirement. Only plans benefitting owner-employers (i.e., Keogh plans) were required to be aggregated, and that aggregation only applied with respect to plans sponsored by employers that were unincorporated businesses, special partnerships or corporations of individuals.[5] Plans sponsored by employers organized as other forms of doing business, such as regular or C corporations, professional services corporations, and limited liability corporations, did not have to be aggregated.[6] The net result was a field day for discriminatory plans. An employer that wanted to set up a qualified retirement plan solely for the benefit of its HCEs only had to organize two or more of the business entities that did not have to be aggregated, cover its HCEs in one entity and its NHCEs in the others, and establish a retirement plan that only provided for participation by the employees of the entity with the HCEs. Amazingly, under PRIRC-94, that was perfectly valid and, not surprisingly, was a very common tax planning strategy. Those days are now gone. Effective January 1, 2011, all members of a controlled group of corporations or partnerships and/or an affiliated service group must be aggregated and treated as the same employer when performing the local nondiscrimination tests.[7] The local employer aggregation requirements are modeled after, and are intended to be interpreted in accordance with, the equivalent requirements in Code §414(b), (c) and (m).

This change is not likely to have a major impact on the operation of qualified retirement plans by United States and international companies operating in Puerto Rico, as those entities seldom took advantage of the loopholes in PRIRC-94 to establish discriminatory plans solely for the benefit of their HCEs. But, for many small and mid-size local employers, this will require a complete reassessment of, and the implementation of major changes to, their Puerto Rico qualified plans. Going forward, they will either have to provide some retirement benefits to their NHCEs or significantly curtail or even eliminate the retirement benefits of their HCEs, at least as far as qualified retirement plans are concerned.

10% Excise Tax on Late Correction of ADP Test

The local ADP Test was not changed. Plans that include a CODA must still be tested each year to confirm that the HCEs' ADP does not exceed the greater of: (1) 125% of the NHCEs' ADP, or (2) the smaller of two times the NHCEs' ADP or the NHCEs' ADP plus two percent. If a plan fails the ADP Test, the plan sponsor must implement proper corrective measures, which include completing a corrective distribution of excess contributions to the HCEs, recharacterizing the excess contributions as after-tax contributions, making qualified non-elective contributions or qualified matching contributions to the NHCEs, or a combination of these corrective measures. Under the PRIRC-94, if a failed ADP test was not corrected by the end of the plan year immediately following the plan year being tested (i.e., in the case of calendar plan years, by the following December 31), the plan was supposed to be disqualified. Hacienda's problem with that approach was that plan disqualification is seldom a feasible alternative, as it would have serious adverse tax consequences on plan participants who do not have any control over the administration of the plan. The net result was that Hacienda did not have real means for enforcing compliance with the ADP Test, and knowing that, some plan sponsors simply did not bother to perform and/or correct the ADP Test.

Effective January 1, 2011, PRIRC §1081.01(d)(6)(D) imposes on plan sponsors a 10% excise tax on the balance of excess contributions that are not corrected by the due date (including extensions) for filing the plan sponsor's Puerto Rico income tax return for the tax year that ends with or includes the plan year during which the ADP Test was failed. For a plan sponsor with a calendar tax year that operates a plan with a calendar plan year, the 10% excise tax would apply if a failed ADP Test is not corrected by the following July 15. This new Puerto Rico excise tax is essentially modeled after the 10% U.S. excise tax on excess contributions in Code §4979, but the local rule provides for a longer period for implementing the correction (up to 7½ months in Puerto Rico versus 2½ months in the U.S.), and because the PRIRC does not incorporate the ACP Test, there is no excise tax on excess aggregate contributions.

It should be noted that the purpose behind the incorporation of this excise tax was not to generate additional revenues to Hacienda, but to create an incentive for plan sponsors to comply with the local ADP Test requirements. This 10% excise tax could end up affecting U.S. and international companies that include their Puerto Rico employees in their U.S. qualified 401(k) plans (i.e., operate dual-qualified plans) but are not aware that, as a result, their plans must comply with the relevant PRIRC nondiscrimination testing requirements.

Elimination of Certain Deemed Nondiscriminatory Classifications

PRIRC-94 §1165(a)(5) included language to the effect that a plan that excluded from participation those company employees whose entire compensation was wages for purposes of Code §3121(a) (i.e., FICA wages) was not deemed discriminatory for purposes of the Minimum Coverage Test or the General Nondiscrimination Test. As a result, a plan that only cov-

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[5] PRIRC-94 §1165(g)(1).

[6] Articles 1165-3(a)(1) and 1165-8(h)(2) of the regulations under the PRIRC-94.

[7] PRIRC §1081.01(a)(14)(1).

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ered employees whose compensation was totally or partially exempt from FICA taxation was deemed nondiscriminatory. The employees who received some items of compensation that were exempt from FICA taxation included, among others, stockholders receiving dividends, as well as partners receiving distributions of partnership income. Not surprisingly, some local benefits practitioners were relying on this language to establish and market qualified retirement plans that only benefitted company owners. This language was removed from the successor provision to PRIRC-94 §1165(a)(5), PRIRC §1081.01(a)(5). Plans that only benefit company owners will now have to be tested for nondiscrimination just like any other qualified plan (e.g., through plan aggregation with another plan benefitting employees other than owners).

Temporary Relief from Minimum Coverage Test Upon Corporate Transactions

Of all of the changes recently made to the Puerto Rico qualified plan rules, this is the only one that admittedly was a pet project of this article's author: the incorporation of a local version of the temporary testing relief in Code §410(b)(6)(C). Over the years, the author has assisted many U.S. and international companies with the benefits and compensation aspects of corporate acquisitions and dispositions (''M&As'') involving, among others, Puerto Rico operations. A relatively minor yet recurring problem with those M&As resulted from the fact that the PRIRC-94 did not include a rule giving plan sponsors relief from having to perform the Minimum Coverage Test for a limited period of time following the M&A. Thus, while in the U.S., all of the time and effort could be devoted to integrating the various benefit programs of the companies involved in the M&A, in Puerto Rico, company officials and their service providers had to set aside some time for performing and complying with the local Minimum Coverage Test. At times, that required obtaining information that was not readily available, such as compensation data for classifying employees as HCEs or NHCEs. This would happen, for example, when the benefits officials of the seller were no longer with the company and when the third-party administrator (TPA) for the seller's Puerto Rico plans refused to provide the necessary information until an officer from the buyer provided written assurances that the buyer would cover the TPA's invoices for gathering and providing the requested information. In sum, this was an unnecessary distraction from the already complex and time-consuming benefits integration process.

To address that situation, PRIRC §1081.01(a)(3)(D) now provides that upon an M&A, the Minimum Coverage Test does not have to be performed and is deemed satisfied for the plan year of the M&A and the immediately following plan year, provided that (1) the plan passed the Minimum Coverage Test for the plan year immediately preceding the M&A, and (2) the plan's coverage did not significantly change except for the fact of the M&A. This rule is modeled after and is intended to be interpreted in accordance with the equivalent U.S. rule in Code §410(b)(6)(C).

Limits on Benefits, Contributions, and Compensation

Limits on Annual Benefits and Contributions

Effective January 1, 2012, PRIRC §1081.01(a)(11) incorporates a local version of the annual limits on benefits and contributions in Code §415(b) and (c). Thus, the maximum annual benefit under a defined benefit pension plan, when expressed as a single life annuity with no ancillary benefits beginning at normal retirement age, cannot exceed the lesser of $195,000 or 100% of the participant's average compensation for the three consecutive years with the highest compensation, and the maximum annual contributions (including both employer and employee money but excluding rollover contributions) under a defined contribution plan cannot exceed the lesser of $49,000 or 100% of the participant's compensation for the current plan year. For purposes of determining compliance with these limits, all plans maintained by the plan sponsor and its affiliates forming part of the same controlled or affiliated service group must be aggregated.

Limit on Annual Compensation

Similarly, PRIRC §1801.01(a)(12) incorporates a local version of the annual limit on employee compensation in Code §401(a)(17), pursuant to which the maximum compensation that can be used for benefit accruals, the calculation of employer and employee contributions to the plan, and nondiscrimination testing is limited to $245,000 or, in the case of dual-qualified plans, the relevant amount under Code §401(a)(17). This change is also effective January 1, 2012.

A concern voiced by some U.S. benefits practitioners is that the local limits do not seem to include a cost-of-living adjustment like their U.S. counterparts. Thus, over the years, this could lead to an unfortunate situation in which the Puerto Rico limits would be lower than the U.S. limits which, in the case of dual-qualified plans, would require a separate set of plan rules and/or administrative provisions solely for the Puerto Rico participants. That was certainly not the intention behind the implementation of these limits, as they are supposed to evolve in tandem with the relevant U.S. limits. Most likely, this is an issue that Hacienda will soon address through the issuance of regulations or an administrative determination.

It should be noted that these limits were not enacted with U.S. and international companies in mind. Instead, they were added to address a fairly common practice among small and mid-size local companies sponsoring Keogh plans of providing very large retirement benefits solely to company owners. The absence under the PRIRC-94 of any limits on benefits, contributions and compensation, coupled with the absence of employer aggregation requirements, was essentially allowing company owners to use qualified plans for setting up personal brokerage accounts on a tax-deferred basis, without having to provide any retirement benefits to their employees. There were, however, a few U.S. and international companies tak-

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ing advantage of the absence of local limits on benefits, contributions and compensation for providing executive compensation to their Puerto Rico officers through their qualified retirement plans. For example, without a local equivalent to Code §§415(b) and 401(a)(17), there was really no need to operate a supplemental executive retirement program (SERP) in Puerto Rico. The new local limits may require those companies to reassess and perhaps redesign their compensation programs for their Puerto Rico officials.

Limits on Employee Contributions

Employee Pre-Tax Contributions

The local annual limits on employee elective deferrals or pre-tax contributions to CODA plans (i.e., 401(k) plans) were increased as follows:[8]

Calendar Year	PRIRC-94	PRIRC
2011	$10,000	$10,000
2012	$10,000	$13,000
2013+	$12,000	$15,000

These local limits are not scheduled to be indexed for inflation, so chances are that the $15,000 limit that will begin to apply in 2013 will be in effect for years to come.

Another noticeable change was that the old offset for IRA contributions was eliminated. Under PRIRC-94 §1165(e)(7), the maximum amount that a participant could contribute on a pre-tax basis to a 401(k) plan was reduced dollar-for-dollar for the amounts the participant contributed to an IRA. For example, if the limit on pre-tax contributions to a 401(k) plan for a given calendar year was $10,000 and a participant already contributed $3,000 to an IRA for that year, the participant would only be able to contribute $7,000 to the 401(k) plan on a pre-tax basis. Now, the contributions to an IRA do not reduce the pre-tax contributions that a participant can make to a 401(k) plan.

Catch-up Contributions

The local catch-up contribution limits were also increased as follows:

Calendar Year	PRIRC-94	PRIRC
2011	$1,000	$1,000
2012+	$1,000	$1,500

PUERTO RICO INCOME TAXATION OF RETIREMENT BENEFITS

The PRIRC retained the basic structure on the Puerto Rico income taxation of qualified plan benefits. There is still one set of rules for lump-sum distributions and another for distributions other than lump-sums (e.g., annuities, periodic installments and in-service withdrawals). However, there were changes to the definition of a lump-sum distribution, the rules on tax-free rollovers, and the withholding at source of Puerto Rico income taxes on retirement benefits.

Taxation of Lump-Sum Distributions

The basic rule on the Puerto Rico income taxation of lump-sum distributions was not changed; they are taxed at a flat rate of 20% and are subject to a mandatory 20% income tax withholding at source. The definition of lump-sum distributions was expanded to include one or a series of distributions of a participant's entire plan benefits within a single calendar year following either the participant's separation from service for any reason (e.g., termination of employment, death or disability) or the termination of the plan.[9] Previously, distributions upon plan termination did not qualify as lump-sum distributions and were subject to the rules for distributions other than lump-sums.

Another change was to a special rule on the taxation of lump-sum distributions from plans that are funded through a trust fund located in Puerto Rico and invest a portion of their assets in Puerto Rico property. Basically, if a defined benefit pension plan invests 10% or more of its assets (or in the case of a defined contribution plan, a participant invests 10% or more of the value of his or her plan account) in certain property located in Puerto Rico (such as local government bonds, stock of local public companies) and mutual funds of local investment companies, lump-sum distributions are taxed at a flat 10% rate and are subject to a 10% Puerto Rico income tax withholding at source, rather than the 20% that would otherwise apply.

Under the PRIRC-94, compliance with this 10% investment requirement was measured at the time of distribution plus at the end of each of the two plan years immediately preceding the year of distribution. For example, in the case of a lump-sum distribution from a calendar year plan that was made on June 30, 2010, the 10% tax rate would have applied if 10% or more of the plan assets or plan account, as applicable, were invested in Puerto Rico property on June 30, 2010, December 31, 2009, and December 31, 2008. So, by investing a portion of its plan assets in Puerto Rico property during only three days in a two-plus-year period, a participant could have cut his Puerto Rico income tax liability in half. And of course, that is exactly what some savvy participants were doing; they were moving a portion of their plan money into Puerto Rico property on December 30 and moving it out of Puerto Rico property on January 1, and by doing so, they were taking advantage of the 10% tax rate. That was clearly defeating the initial intention behind the creation of this special 10% tax rate, which was to create a tax incentive for keeping a portion of the assets of local retirement plans invested in the local economy. To address that situation, compliance

[8] PRIRC §1081.01(d)(7)(A).

[9] PRIRC §1081.01(b)(1).

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with the 10% investment requirement is now measured based on the average daily balance of the plan assets or the participant's plan account for the year of distribution and the immediately preceding two plan years.[10] To qualify for the 10% tax rate, a participant now must keep its Puerto Rico investment in place for at least two years, rather than the three days that previously applied.

The special rule on the taxation of lump-sum distributions that include company stock was not changed. Specifically, the portion of a lump-sum distribution consisting of employer stock of a publicly traded company is totally exempt from the payment of Puerto Rico income taxes at the time of distribution.[11] The idea is that the participant will have no basis on the employer stock received from the plan, and he or she would have to pay a capital gains tax on the entire amount received upon the subsequent disposition of the stock. For this special rule to apply, it is not necessary that the retirement plan be funded through a Puerto Rico trust. Many of the U.S. and international companies that offer a company stock fund as an investment alternative under their retirement plans covering Puerto Rico employees are not aware of this rule and do not disclose it in their summary plan descriptions for Puerto Rico participants, which limits the chances that such participants can take advantage of this potential tax break.

Taxation of Distributions Other Than Lump-Sums

Under the PRIRC-94, distributions other than lump sums were taxed as ordinary income and were not subject to an income tax withholding at source. Under the PRIRC, such distributions remain 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, beginning January 31, 2011, are generally subject to a mandatory 10% Puerto Rico income tax withholding at source.[12] In the case of annuities and periodic installments paid after a participant's separation from service, the 10% withholding only applies to the excess of (1) the first $19,500 that a participant receives each calendar year if by the end of the year the participant is not yet age 60, or (2) the first $23,500 that a participant receives each year if by the end of the year the participant is age 60 or older.[13] In-service withdrawals, on the other hand, are fully subject to the 10% withholding.

Responsibility for Noncompliance with Income Tax Withholding Rules

Under the PRIRC-94, the ultimate responsibility for the failure to comply with the local rules on the withholding at source of Puerto Rico income taxes on qualified plans distributions (e.g., the 20% withholding on lump-sum payments) was on "the person paying the benefits," which was a somewhat vague term that could lead to confusion as to that person's identity. Depending on the circumstances, that term could be reasonably construed as referring to the trustee, the local paying agent or even the plan administrator. PRIRC §1081.01(b)(10) addresses that uncertainty by providing that the plan sponsor is jointly and severally liable for any such failures. This change became effective January 1, 2011. In the case of dual-qualified plans, where the trustee is usually a U.S. financial institution with no operations in or connections with Puerto Rico and there is no local paying agent, the plan sponsor should make sure that local income taxes are being withheld from the distributions to Puerto Rico participants (e.g., by engaging a local paying agent to process and/or report the distributions to Puerto Rico participants). Otherwise, in the event of a noncompliance situation, the plan sponsor would be the one potentially liable to Hacienda.

Tax-Free Rollovers

The local tax-free rollovers rules were modified to allow for partial rollovers. Previously, only lump-sum distributions could be rolled over. Now, any distributions made following a participant's separation from service, whether in the form of an annuity or periodic installments, can be rolled over on a tax-free basis to either another retirement plan qualified in Puerto Rico or to an individual retirement account or individual retirement annuity from a bank or other financial institution operating in Puerto Rico. Also, the after-tax portion of a distribution does not need to be included as part of the rollover.[14] The purpose behind this change was to end the situation existing under the PRIRC-94 whereby participants were oftentimes required to choose between either rolling over all of their retirement money, including after-tax contributions, or receiving all of their money at once, which resulted in most participants choosing a lump-sum distribution right after their termination of employment and running out of their retirement money a few years thereafter.

Annual Income Exclusion on Retirement Benefits

The PRIRC retained the existing annual income exclusion on annuities and periodic installments paid after a participant's termination of employment. Specifically, if a participant receives his or her plan benefits in the form of an annuity or periodic installments after termination of employment, the first $11,000 that the participant receives each year (if by the end of the year the participant has not yet reached age 60), or the first $15,000 that the participant receives each year (if

[10] PRIRC §1081.01(b)(1)(B).

[11] PRIRC §1081.01(b)(2)(B).

[12] PRIRC §1081.01(b)(3)(B).

[13] Hacienda Administrative Determination No. 11-02 (Mar. 1, 2011).

[14] PRIRC §1081.01(b)(2)(A).

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by the end of the year the participant is age 60 or older), is exempt from the payment of Puerto Rico income taxes.[15] For example, if a participant elects to receive his or her pension plan benefits in the form of an annuity providing for monthly payments of $1,250 (i.e., $15,000/year), the first $11,000 that the participant receives from the plan each year before he/she reaches age 60 will be exempt from the payment of Puerto Rico income taxes, and the remaining $4,000 may be subject to the payment of Puerto Rico income taxes at the ordinary income tax rates. Beginning in the year in which the participant reaches age 60, the annual income exclusion will increase to $15,000, and thus, the entire pension will be exempt from the payment of Puerto Rico income taxes.

Information Returns on Retirement Plan Distributions

Distributions from qualified retirement plans to Puerto Rico participants must be reported, both to the participant and Hacienda, by providing to the participant and filing with Hacienda a copy of local Form 480.7C (i.e., the local equivalent to IRS Form 1099-R) on or before February 28 of the year following the year of distribution. The penalty for the failure to comply with this reporting requirement is (1) $100 per form for the failure to provide a copy to the participant, and (2) $500 per form for the failure to file a copy with Hacienda.[16]

DEDUCTION OF PLAN CONTRIBUTIONS

The local rules on the income tax deduction of contributions to qualified retirement plans were modified to: (1) include a 10% excise tax on nondeductible contributions, and (2) increase from 15% to 25% of participant compensation the deduction limit on contributions to profit-sharing and stock bonus plans.

10% Tax on Nondeductible Contributions

As previously noted, due to the various limitations and loopholes in the PRIRC-94, over the years, many local business owners have been able to use qualified retirement plans as tax-exempt personal brokerage accounts. One of the loopholes allowing for tax abuse was the complete absence of limits on nondeductible contributions. The abusive practice would work as follows. A business owner sponsoring a Keogh plan would only be entitled to claim a $25,000 deduction for contributions to the plan for the current tax year. Nevertheless, the business owner would contribute $100,000 to the plan. He would deduct $25,000 in the current tax year and carry forward the remaining $75,000 to be deducted in future years. In the meantime, the money was invested within the trust forming part of the plan, which is a tax-exempt vehicle. The net result is that the business owner did not have to pay Puerto Rico or U.S. income taxes on its investment income.[17]

To help put an end to this practice, effective January 1, 2011, PRIRC §1033.09(a)(5) incorporated in Puerto Rico a 10% excise tax on nondeductible contributions similar to the one in Code §4972. The tax is assessed on the plan sponsor and applies whether or not the sponsor claims the nondeductible contributions as a tax deduction on its local income tax return. The tax will continue to apply for as long as the nondeductible contributions remain in the plan. Thus, in the illustration above, for the year in which the nondeductible contributions were made, the business owner would be liable for a $7,500 excise tax. Assuming that the deduction for the following year is also $25,000, the excise tax for that year would be 10% of the remaining $50,000, i.e., $5,000. The idea behind the 10% excise tax is to render the practice of making nondeductible contributions to a plan to benefit from the plan's tax-exempt status cost-prohibitive.

The 10% excise tax does not apply if the nondeductible contributions are returned to the employer on or before the due date, including extensions, for filing of the employer's Puerto Rico income tax return for the tax year in which the nondeductible contributions were made. For calendar year taxpayers, that would give them until the following July 15 to remove nondeductible contributions from the plan without having to pay the 10% excise tax. Another change made to the local tax rules to avoid the inadvertent application of this excise tax was to allow for the current deduction on the Puerto Rico income tax return of contributions to defined benefit pensions required by the minimum funding requirements of ERISA §302.[18] Therefore, any contributions that a plan sponsor is required to make to a defined benefit pension pursuant to ERISA §302 plan are immediately deductible and would not be subject to the 10% excise tax.

Contributions to Profit-Sharing and Stock Bonus Plans

Just like in the U.S., the local limit on the deduction of contributions to a profit-sharing plan or stock bonus plan qualified in Puerto Rico was raised from 15% to 25% of the aggregate compensation for the current tax year of all employees participating in the plan.[19] This change should eliminate the need to operate both a money purchase pension plan and a profit-sharing plan in order to be able to reach the 25% of compensation deduction, which resulted in

[15] PRIRC §1031.02(a)(13).

[16] PRIRC §§6041.04 and 6041.11.

[17] Pursuant to ERISA §1022(i)(1), a trust forming part of a Puerto Rico qualified retirement plan is treated as a U.S. qualified trust for purposes of Code §501(a). Therefore, the income the trust generates from its investments in the U.S. is exempt from the payment of U.S. income taxes.

[18] PRIRC §1033.09(a)(1)(A)(i)(IV).

[19] PRIRC §1033.09(a)(1)(C).

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unnecessary expenses and administrative work. It is expected that, over the next few years, many small and mid-size local companies will be replacing their money purchase pension plans with profit-sharing pension plans.

PLAN QUALIFICATION WITH HACIENDA

Unlike in the U.S., where plan qualification with the IRS is technically optional, in Puerto Rico, plan qualification with Hacienda is mandatory. Each and every retirement plan that covers one or more Puerto Rico active participants is required to be filed with Hacienda for the issuance of a determination letter regarding the plan's compliance with the qualification requirements of the PRIRC. In the past, the practical problem with that requirement was that the PRIRC-94 was not clear on when the plan sponsor was supposed to file the plan with Hacienda. As a result, many companies, both local and foreign, completed these filings many years after the plan began covering Puerto Rico participants. In the meantime, the employer and its Puerto Rico employees were enjoying the tax benefits of having a qualified retirement plan in Puerto Rico, but Hacienda did not even know that the plan existed. To address this situation, effective January 1, 2012, PRIRC §1081.01(a)(13) requires that plans be filed with Hacienda no later than the due date, including extensions, for filing the plan sponsor's Puerto Rico income tax return for the tax year in which the plan first began covering Puerto Rico participants. Failure to complete the filing by such due date may result in the disallowance of deductions for contributions to the plan.

In addition to setting a due date for the initial filing of qualified plans with Hacienda, PRIRC §1081.01(a)(13) provides that the Hacienda determination letters will only remain in effect for the period of time that Hacienda may set through the regulations under the PRIRC or other administrative guidance. The purpose of this provision is to set the stage for the implementation of a periodic or staggered plan qualification filing process similar to the one the IRS has instituted in the U.S. Thus, going forward, in order to remain qualified in Puerto Rico, retirement plans will have to be filed with Hacienda every certain number of years. In all likelihood, the author will be assisting Hacienda to put in place the relevant filing requirements before the end of 2011.

PUERTO RICO ANNUAL INFORMATION RETURN

To date, all retirement plans qualified in Puerto Rico are required to file local Form 480.70(OE) with Hacienda on or before the last day of the seventh month following the end of each plan year. This filing due date may be extended by an additional 2½ months (i.e., until October 15 in the case of calendar plan years). Form 480.70(OE) is an information return that more or less is supposed to be a local equivalent to IRS Form 5500. Unlike Form 5500, however, in this author's opinion, Form 480.70(OE) is totally useless. It does not serve any useful purpose in the administration of qualified retirement plans in Puerto Rico, and Hacienda does nothing with it. When Hacienda officials need basic financial information about a Puerto Rico qualified plan, they look at the plan's Forms 5500, not at its Forms 470.70(OE). Why are Puerto Rico qualified plans required to file this form? Fortunately, PRIRC §1061.10(a)(b) grants Hacienda the authority for plans to meet the local annual informative return requirement by filing with Hacienda a copy of their Form 5500 by the regular Form 5500 filing due dates in lieu of having to prepare and file Form 480.70(OE). It is expected that Hacienda will be issuing an administrative determination to such effect before the end of 2011, but any such determination most likely will be effective for plan years beginning on or after January 1, 2012. So, for 2010 and 2011, plan sponsors will have no choice other than to prepare and file Form 480.70(OE).

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