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QUALIFIED PLANS IN PUERTO RICO SUBJECT TO NEW RULES UNDER THE RECENTLY ENACTED NEW PUERTO RICO INTERNAL REVENUE CODE

By: César R. Rosario-Vega, Esq.

The recently enacted New Puerto Rico Internal Revenue Code, Act No. 1 of January 31, 2011 ("NPR-IRC") adopts new rules for qualified plans in Puerto Rico.

The NPR-IRC maintains the general framework for qualified plans in Puerto Rico, although the main statutory provision was renumbered as Section 1081.01 of the NPR-IRC (formerly Section 1165). Thus, qualified plans in Puerto Rico will continue to include, among other, pension plans, money purchase plans, profit sharing plans, stock bonus plans, cash or deferred arrangement plans or "CODA Plans" (also known as "1165(e)" or "401(k)" plans) and Keogh plans. It should also be noted that qualified plans in Puerto Rico covering "employees" are generally required to satisfy the rules for "defined benefit plans" or "defined contribution plans" under the U.S. federal law known as the Employee Retirement Income Security Act of 1974 ("ERISA"). Furthermore, some qualified plans in Puerto Rico may also be subject to the rules for qualified plans under the U.S. Internal Revenue Code of 1986 ("US Code").

The qualified plan provisions of the NPR-IRC are generally effective with respect to taxable years beginning after December 31, 2010. However, the NPR-IRC provides several exceptions in the case of certain new rules which are effective with respect to taxable years beginning on or after January 1, 2012. The interplay of the transition rules may be complicated in certain cases since the "plan year" of qualified plans in Puerto Rico may be different than the "taxable year" of employers and employees (i.e., the "taxable year" of individuals is generally the "calendar year"). Unless otherwise noted, the reference below to a specific year refers to a taxable year beginning on or after January 1 of such year.

In general, the application of the new rules will depend on the design of each plan. However, we summarize below the most important changes of the NPR-IRC.

A. SPECIFIC RULES FOR CASH OR DEFERRED ARRANGEMENT PLANS ("CODA PLANS")

1. Increase in Limitation of Deferred Contributions by Participants – The limitation of deferred contributions (i.e., pre-tax contributions by participants) will remain at $10,000 for 2011, but will increase to $13,000 for 2012 and $15,000 for 2013. In the case of employees of the U.S. federal government the limitations of the US Code will be applicable.

2. Increase in Catch-Up Contributions by Participants with at least 50 years of age – The "catch-up" contributions by participants with at least 50 years of age at the end of the plan year will remain at $1,000 for 2011, but will increase to $1,500 for 2012.

3. Increase in Maximum Contributions to CODA Plans and Individual Retirement Accounts ("IRA") – Participants in CODA Plans will be able to make the maximum contributions to CODA Plans and IRAs, but deferred contributions to CODA Plans will continue to be subject to the testing rules of the Actual Deferral Percentage test or "ADP Test". Previously, the aggregate contributions by participants to CODA Plans and IRAs were subject to a combined limitation up to the limitation of deferred contributions to CODA Plans. This change is effective for taxable years beginning after December 31, 2010.

4. New Definitions of Highly Compensated Employee ("HCE") and Non-Highly Compensated Employee ("NHCE") – The term HCE is limited to: (i) officers, (ii) certain 5% shareholders, (iii) employees that for the previous taxable year earned more than $110,000 in compensation (with certain coordination for qualified plans under the US Code), or (iv) the spouse or dependent of an individual described in (i), (ii) or (iii). In turn, the term NHCE includes any eligible employee who is not HCE. The new definitions will apply for the ADP Test of CODA Plans. Previously, the HCE included the top 1/3 of eligible employees and the NHCE included the lower 2/3 of eligible employees, based on compensation. This change is effective for taxable years beginning after December 31, 2010.

B. GENERAL RULES FOR QUALIFIED PLANS

1. Coverage Test and General Nondiscrimination Test – The new definitions of HCE and NHCE, as described above, will also apply for purposes of the coverage test and general nondiscrimination test of all qualified plans in Puerto Rico. This change is effective for taxable years beginning after December 31, 2010.

2. Repeal of Plan Design that allowed the Exclusion of Employees with FICA Wages – The NPR-IRC repeals the plan design that allowed the exclusion of employees the whole of whose remuneration constitutes wages under Section 3121(a)(1) of the US Code (for Social Security and Medicare taxes under the Federal Insurance Contributions Act - "FICA Tax"). Previously, qualified plans in Puerto Rico were allowed to exclude such employees under the applicable rules for the coverage test and general nondiscrimination test. This change is effective for taxable years beginning after December 31, 2010.

3. Increase in Employer Deduction for Contributions to Profit Sharing Plans and Stock Bonus Plans – The employer deduction for contributions to profit sharing plans and stock bonus plans is increased from 15% to 25% of compensation. This change is effective for taxable years beginning after December 31, 2010.

4. Increase in Employer Deduction for Contributions to Defined Benefit Plans – The employer deduction for contributions to defined benefit plans may include the amount contributed to meet the funding requirements of ERISA. This change is effective for taxable years beginning after December 31, 2010.

5. Controlled Groups and Affiliated Service Groups – The NPR-IRC adopts new rules for entities which are members of a "controlled group" or "affiliated service group" (as defined in the NPR-IRC). Under the new rules, all of the employees of all members of a "controlled group" or "affiliated service group" shall be considered to be employed by a single employer. This change is effective for taxable years beginning after December 31, 2010.

6. Acquisitions or Dispositions – The NPR-IRC includes special rules for coverage test in the case of certain acquisitions or dispositions if an entity becomes or ceases to be a member of a "controlled group" (as defined in the NPR-IRC). This change is effective for taxable years beginning after December 31, 2010.

7. Limitation on Annual Benefits for Defined Benefit Plans – In the case of defined benefit plans, the NPR-IRC generally adopts a limitation on annual benefits of the lesser of $195,000 or 100% of the participant's average compensation. For this purpose, all defined benefit plans of an employer shall be considered a single plan. This change is effective for taxable years beginning on or after January 1, 2012.

8. Limitation on Annual Contributions for Defined Contribution Plans – In the case of defined contribution plans, the NPR-IRC generally adopts a limitation on annual contributions (including the employer and employee contributions, and other additions, but excluding rollovers from other qualified plans in Puerto Rico) of the lesser of $49,000 or 100% of the participant's compensation. For this purpose, all of the defined contribution plans of an employer shall be considered a single plan. This change is effective for taxable years beginning on or after January 1, 2012.

9. Compensation Limit – The NPR-IRC adopts a limit on annual compensation of a participant of $245,000 for purposes of benefits, contributions and testing. However, for qualified plans under the NPR-IRC, that are also qualified under the US Code, the limit on annual compensation under the US Code will be applicable under the NPR-IRC. This change is effective for taxable years beginning on or after January 1, 2012.

C. NEW RULES FOR DISTRIBUTIONS AND TAXATION

1. Withholding Tax of 20% or 10% on Total Distributions for Separation from Service for Any Reason or Plan Termination without Separation from Service – The total benefits with respect to a participant, which are paid or made available to the participant or his or her beneficiary within a single taxable year of the latter, due to the participant's separation from service for any reason, or the plan termination (referred to as "total distributions" under the NPR-IRC), on the amount that exceeds contributions by the participant that have been taxed to the participant (i.e., after-tax voluntary contributions and those for which taxes have been prepaid), are considered "long-term capital gains" subject to Puerto Rico capital gains tax and Puerto Rico income tax withholding at the rates of 20% or 10% (i.e., 10% if certain investments in "property located in Puerto Rico" are met by the plan, or separate account in the plan). Previously, only the taxable amount of total distributions upon separation from service enjoyed this tax preferred treatment. The new rules for the Puerto Rico income tax withholding of 20%, or 10%, on total distributions should apply to payments made after the enactment of the NPR-IRC (i.e., January 31, 2011).

2. Withholding Tax of 10% on Other Distributions – Plan distributions (other than total distributions or participant loans) to participants or beneficiaries are generally subject to Puerto Rico income tax withholding of 10% on the amount that exceeds contributions by the participant that have been taxed to the participant (i.e., after-tax voluntary contributions and those for which taxes have been prepaid). For example, the taxable amount of partial distributions after separation from service, or in-service withdrawals, is generally subject to Puerto Rico income tax withholding of 10%. Previously, the taxable amount of such distributions, or withdrawals, was not subject to Puerto Rico income tax withholding. Furthermore, such taxable amount will continue to be treated as ordinary income. The new rules for the Puerto Rico income tax withholding of 10% on other distributions should apply to payments made after the enactment of the NPR-IRC (i.e., January 31, 2011).

3. Rollover of Taxable Amount of Total Distributions and Partial Distributions after Separation from Service – In general, for purposes of rollover to IRAs, Roth IRAs or other qualified plans in Puerto Rico, the NPR-IRC only requires the rollover of the taxable amount of total distributions and partial distributions after separation from service, subject to the new rules of the NPR-IRC. In essence, the NPR-IRC allows the rollover of total distributions and partial distributions after separation from service, if the amount received in excess of the amounts contributed by the participant which have been taxed to the participant, is contributed to IRAs, Roth IRAs or other qualified plans in Puerto Rico, no later than 60 days after having received the payment or distribution. Previously, participants were generally required to rollover the total amount received without any exclusion (except income tax withholding in the case of Roth IRAs). This change is effective for taxable years beginning after December 31, 2010.

4. Investment in Property Located in Puerto Rico – Under the NPR-IRC, the testing for "property located in Puerto Rico" is based on the average daily balance of the plan investments or account balance. In addition, in the case of transfer of plan assets from a transferor plan to a transferee plan, the testing for "property located in Puerto Rico" shall consider the period during which the plan assets were held by the transferor plan. This change is effective for taxable years beginning after December 31, 2010.

5. New Tax of 10% on Employer if Plan does not correct the ADP Test – The employer is subject to a new tax of 10% on the amount of "excess contributions" to CODA Plans whenever the plan does not correct the ADP Test as provided in the NPR-IRC. This change is effective for taxable years beginning after December 31, 2010.

6. New Tax of 10% on Employer for Non-Deductible Contributions – The employer is subject to a new tax of 10% on the amount of non-deductible contributions that it makes to a qualified plan in Puerto Rico. This new tax shall apply even if the amount of the non-deductible contributions is not claimed as a deduction in the income tax return of the employer. This change is effective for taxable years beginning after December 31, 2010.

D. <u>ADDITIONAL CONSIDERATIONS</u>

1. Joint and Several Liability of Employer and Withholding Agent – The NPR-IRC establishes that the employer shall be jointly and severally liable for the breach of the obligations imposed by the NPR-IRC on the withholding agent. This change is effective for taxable years beginning after December 31, 2010.

2. Statutory Requirement for Proof of Exemption – The NPR-IRC establishes a statutory requirement for proof of exemption. Specifically, the NPR-IRC provides that for taxable years beginning on or after January 1, 2012 any "trust" of a plan intended to be qualified plan under the NPR-IRC shall be required to request and obtain an administrative determination from the Secretary of the Treasury to that effect. In general, the request shall be filed no later than the due date to file the Puerto Rico income tax return of the employer (including any extension to file such return) for the taxable year during which the plan commenced to cover participants who are residents of Puerto Rico. Previously, the proof of exemption was required by regulation.

3. Annual Return – The NPR-IRC maintains the requirement to file an annual return for the "trust" of the qualified plan in Puerto Rico at the Puerto Rico Treasury Department, and includes a statutory provision acknowledging that the due date for the annual return is July 31, with an extension due on October 15, if the calendar year is used as taxable year (for other taxable years the annual return is due on the last day of the 7th month, with an extension due on the 15th day of the 3rd month following the initial due date). Previously, the due date was established by administrative guidance. On the other hand, the NPR-IRC establishes that, by regulations or administrative guidance, the Secretary of the Treasury may allow the filing of a copy of the annual return required under ERISA (i.e., Form 5500), instead of a separate annual return under the NPR-IRC (i.e., currently Form 480.70(OE)).

The adoption of the above described new rules for qualified plans in Puerto Rico will require the review and amendment of current plan documentation and procedures by employers and plan sponsors, plan fiduciaries and service providers, in order to comply with the provisions of the NPR-IRC.

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Should you have any questions with respect to the above, please contact César R. Rosario-Vega, Esq. at (787) 281-1820.

Westernbank World Plaza
268 Muñoz Rivera Ave. Suite 1400
San Juan, PR 00918

PO Box 70294
San Juan, PR 00936-8294

Telephone: (787) 756-9000 & (787) 474-0004
Fax: (787) 756-9010 & (787) 756-9023