

New Puerto Rico tax code requires big changes to retirement plans for Puerto Rico employees

By Marcia S. Wagner, Esq.

On January 31, 2011, the Commonwealth of Puerto Rico adopted a new Internal Revenue Code (the "2011 PR Code"), which substantially overhauls the tax qualification requirements for retirement plans that cover Puerto Rican employees. The qualified retirement plan provisions found in the 2011 PR Code (which, in general, are effective as of January 1, 2011) contain requirements that parallel the requirements found in Section 401(a) of the U.S. Internal Revenue Code (the "U.S. Code") governing qualified retirement plans. However, the 2011 PR Code made a number of changes to the requirements applicable to Puerto Rican qualified plans thereby creating significant differences between the U.S. Code and the 2011 PR Code. Employers sponsoring Puerto Rican plans or United States plans covering Puerto Rican employees should review their plans carefully to ensure compliance with these changes.

Significant changes: Some of the more notable changes include the following:

- *Benefit and contribution limits:* For taxable years beginning on or after January 1, 2012, new annual benefit and contribution limits are imposed on defined benefit and defined contribution plans. The Puerto Rican defined benefit plan limit for a participant's benefits has been increased to the lesser of \$195,000 or 100% of the participant's average annual compensation over a three consecutive calendar year period. The Puerto Rican defined contribution plan limit for a participant's annual contributions has been increased to the lesser of \$49,000 or 100% of the participant's compensation for the plan year. Unlike U.S. Code Section 415, the dollar limits are not adjusted for cost-of-living under the 2011 PR Code.
- *Compensation limits:* For taxable years beginning on or after January 1, 2012, a new annual compensation limit is imposed. Annual compensation exceeding \$245,000 cannot be considered when determining contributions or benefits, applying nondiscrimination tests, and limiting benefits and contributions. Unlike U.S. Code Section 401(a)(17), there is no cost-of-living adjustment provided under the 2011 PR Code. It should be noted that dual-qualified plans (i.e., retirement plans qualified under both the U.S. Code and Puerto Rico Internal Revenue Code) apply the limits found under U.S. Code Section 401(a)(17), which does include cost-of-living adjustments.
- *Adoption of controlled group rules:* For purposes of the qualified retirement plan provisions under the 2011 PR Code (including nondiscrimination testing), employees of all corporations, partnerships, or other entities that are members of a controlled group or an affiliated service group are now deemed to be employees of the same employer; this is similar to the related U.S. Code provisions.
- *Excess contribution correction:* A new 10% tax will be imposed on plan sponsors that do not correct excess contributions before the sponsor's deadline to file its income tax return (including extensions) with the Puerto Rico Treasury Department (the "PR Treasury").
- *Elective deferral limits:* The amounts of pretax contributions that can be made to a 401(k) plan are limited as follows: \$10,000 in 2011; \$13,000 in 2012; and, \$15,000 in 2013. However, the applicable limits imposed under U.S. Code Section 402(g) will apply to dual-qualified plans.
- *Catch-up contributions:* Under the 2011 PR Code, the catch-up contribution limit for 2011 will remain at \$1,000 but will increase to \$1,500 for 2012 and beyond.
- *Definition of Highly Compensated Employee ("HCE"):* The definition of HCEs in the 2011 PR Code is now similar to that found in U.S. Code Section 414(q) in that the HCE definition includes officers, 5% shareholders, spouses or dependents of an HCE, and individuals earning \$110,000 or more. However, the \$110,000 compensation limit does not contain a cost-of-living adjustment. Additionally, the 2011 PR Code does not contain the "top 20%" alternative definition found in the U.S. Code. This new HCE definition applies to nondiscrimination testing performed for the 2011 plan year.
- *Taxation and withholding of plan distributions:*
 - *Special 20% Tax Rate for Lump-Sum Distributions:* The 20% tax withholding and taxation rate that previously applied only to lump-sum distributions as a result of a separation of service now applies to lump-sum distributions due to a plan termination.
 - *Withholding Applicable to Other Distributions:* Distributions, other than lump-sum distributions or participant loans, are subject to a 10% withholding to any part of the distribution not previously subject to taxation.
 - *Sponsor's Withholding Obligation:* The employer sponsoring the plan is jointly responsible for the withholding agent's withholding and reporting obligations.
- *Rollovers:* Participants may now rollover partial or complete distributions or only the pretax portion (and not the after-tax portion) of a distribution into an individual retirement account, annuity, or Puerto Rican qualified retirement plan.
- *Determination letter:* For taxable years beginning on or after January 1, 2012, retirement plans intended to be qualified under the 2011 PR Code must request and obtain a favorable determination letter from the

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PR Treasury as to the qualified status of the plan. The request must be filed no later than the plan sponsor's deadline (including extensions) to file its income tax return with the PR Treasury for the year in which the plan began to cover residents of Puerto Rico.

It should be noted that the 2011 PR Code does not allow Roth contributions or pass through of dividends from employee stock ownership plans.

Action items: Employers with employees based in Puerto Rico must

carefully evaluate the impact of these significant changes to the requirements for qualified retirement plans resulting from the enactment of the 2011 PR Code. For example, these changes may impact an employer's decision to maintain a dual-qualified plan or a Puerto Rican plan. Furthermore, prompt action will be required by employers to comply with tax and withholding requirements for plan distributions from both dual-qualified retirement plans and Puerto Rican qualified plans. Additionally, employers with qualified plans covering Puerto Rican employees will need to take the following actions before December 31, 2011:

- Perform nondiscrimination testing using the new rules, and if necessary, modify the plan design;
- Amend their plans for the new law and submit them to the Puerto Rican Treasury Department for review;
- Update Summary Plan Descriptions; and
- Update forms used to administer the plans. ❖

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