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For your information

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Recent Developments Affect Puerto Rico Retirement Plans

Employers with employees in Puerto Rico should be aware of three recent developments affecting Puerto Rico retirement plans. First, the Governor of Puerto Rico recently signed legislation making technical amendments to the retirement plan provisions in the Puerto Rico tax code enacted in January 2011. Second, Puerto Rico issued Circular Letter 11-10 which provides guidance for amending plans and obtaining plan qualification letters. Finally, the IRS issued Notice 2012-6 which further extends the transfer deadline for U.S. qualified plans to spin off their Puerto Rico participants into a second plan.

Background

Under the Puerto Rico Code there are two primary alternatives that an employer may use to offer retirement benefits under a Puerto Rico Qualified Plan (P.R. Qualified Plan) on a tax-advantaged basis to its Puerto Rico employees: either a P.R.-only qualified plan or a dual-qualified plan (a plan that typically covers both U.S. and P.R. employees).

P.R.-only qualified plans are generally subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA) but not to the plan qualification rules of the U.S. Internal Revenue Code (U.S. Code). Dual-qualified plans are subject to both ERISA and the plan qualification rules of the U.S. Code. Under each of these alternatives, the plan is subject to the plan qualification rules of the P.R. Code.

Technical Amendments to the 2011 P.R. Code

Recently, Governor Luis Fortuño signed Act 232-2011 into law, which made numerous technical amendments to the Puerto Rico tax code (2011 P.R. Code). The major provisions affecting retirement plans are the following.

Clarified Definition of Highly Compensated Employee (effective 1/1/2011)

The new legislation eliminates some of the remaining differences between the definitions used in the P.R. and U.S. Codes. The technical amendments drop the requirement to treat the spouses and dependents of highly compensated employees (HCEs) as being highly compensated, allows officers of non-participating employers to be ignored, and allows all plans (whether dual-qualified or P.R.-only

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qualified) to use the inflation-adjusted compensation limit under U.S. Code Section 414(q)(1)(B) for purposes of determining HCEs for coverage and nondiscrimination testing. The revised definition under the 2011 P.R. Code states that an HCE is any of the following:

- An officer of a participating employer
- A 5% owner of the employer, measured on the basis of voting stock or the total value of all classes of stock of a corporation (or, for unincorporated businesses, 5% of the capital or profits interest)
- An employee who receives compensation in the previous tax year above the U.S. Code Section 414(q)(1)(B) limit, as adjusted by the Internal Revenue Service (IRS) ($110,000 in 2010 for 2011 testing)

COMPLIANCE ALERT: Because there are still significant differences between the U.S. Code and P.R. Code with respect to the definition of an HCE, dual-qualified plans will have different definitions for HCEs. Specifically, Puerto Rico still includes the officers of participating employers and does not allow a top-20%-paid group election for purposes of limiting the number of employees who are considered HCEs.

Synchronized the U.S. and P.R. Code Limits (effective 1/1/2012)

The technical amendments equalized certain qualified plan limits applicable to Puerto Rico residents under both P.R.-only and dual-qualified plans:

- **Annual compensation limits**: The technical amendments established the annual compensation limit for Puerto Rico residents to be amounts determined under U.S. Code Section 401(a)(17) as adjusted by the IRS. The original law set the compensation limit for P.R.-only qualified plans at $245,000 without adjustment for changes in the cost of living.
- **Annual addition limits**: The annual addition limits for defined benefit and defined contribution plans were tied to U.S. Code Section 415(b) and Section 415(c), respectively. They were previously set to the 2011 levels but without adjustment for changes in the cost of living. The amendments also clarify that the annual benefit accrued as of December 31, 2011 under a defined benefit plan cannot be reduced for plans subject to the anti-cutback rule under Title I of ERISA.

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Increased Deduction Limit under a Pension Plan to Satisfy ERISA Minimum Funding (effective 1/1/2011)

Previously, it was not clear whether a P.R. Qualified Plan was permitted to deduct the contribution required to meet ERISA minimum funding standards even if it exceeded the combined defined benefit/defined contribution plan deduction limit specified under the 2011 P.R. Code (25% of compensation). The technical amendments clarified that such a contribution is in fact deductible.

INSIGHT

Although some practitioners may have already inferred that the higher contribution required under ERISA was deductible (as is the case under U.S. Code Section 404), this is welcome clarification especially given that non-deductible contributions will now be subject to a 10% penalty tax under the 2011 P.R. Code.

Clarified Aggregation of Controlled Group and Affiliated Service Group Rules (effective 1/1/2011)

The 2011 P.R. Code, as originally enacted, mandated the aggregation of all employers in the controlled group and affiliated service group for purposes of applying annual limits, nondiscrimination, and coverage testing (which was previously optional). The technical amendments clarified that only employers with P.R.-based employees need to be aggregated for purposes of meeting the qualification requirements under the 2011 P.R. Code.

COMPLIANCE ALERT: P.R. Qualified Plans must meet these new testing requirements. Dual-qualified plans will still require separate U.S. and P.R. coverage and nondiscrimination testing due to differences in testing methodology that remain, such as in the method of determining excludible employees under coverage testing, the criteria for identifying HCEs, the methodology employed under the Actual Deferral Percentage (ADP) test for cash or deferred arrangements (under U.S. Code Section 401(k) – including the correction methods available thereunder) and the fact that Puerto Rico still does not apply the Actual Contribution Percentage (ACP) test to U.S. Code Section 401(m) arrangements.

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Codified 10% Voluntary After-Tax Contribution Limit

The Puerto Rico tax regulations capped the cumulative amount of voluntary (i.e., unmatched) after-tax contributions that participants were permitted to make under a qualified plan over their careers at 10% of the cumulative compensation earned for all years since becoming a participant. This limit did not apply to mandatory after-tax employee contributions (e.g., contributions required as a condition of employment or required in order to receive employer-funded contributions or benefits under the plan).

Although the 2011 P.R. Code as originally enacted did not contain this special limit on voluntary after-tax contributions, the technical amendments codified what previously was a regulatory pronouncement.

COMPLIANCE ALERT: This clarifies the status of voluntary after-tax contributions under the 2011 P.R. Code. Dual-qualified plans will generally have to include after-tax contributions (and any matching contributions) in performing the ACP test, but P.R.-only qualified plans are still not subject to the ACP test.

Deferral Contribution Limit

The 2011 P.R. Code updated both the annual limit on employee deferral contributions and the catch-up contribution limits and made them applicable to both P.R.-only and dual-qualified plans. The technical amendments added a new wrinkle by linking the maximum annual deferral limit under U.S. Code Section 402(g) to dual-qualified plans while leaving the original limits in place for P.R-only qualified plans. However, a separate catch-up contribution limit applies to all Puerto Rico residents, whether or not the plan is dual qualified. The Puerto Rico catch-up limit is $1,000 for 2011 and $1,500 for 2012 and later years. Further, in exchange for a higher deferral limit, participants in dual-qualified plans who are bona fide residents of Puerto Rico are subject to a combined deferral limit that applies to both contributions made to a Puerto Rico IRA and amounts contributed to an employer-sponsored qualified plan.

Considering these changes, the new limits are as follows:

1. **Annual Deferral Contribution Limit (applicable to those who have not attained age 50 by the end of the calendar year and to participants in plans that do not provide for catch-up contributions)**

Calendar Year	P.R.-Only Qualified Plan	Dual-Qualified Plan
2011	$10,000	$16,500
2012	$13,000	$17,000
2013+	$15,000	Indexed to U.S. Code Section 402(g) limit

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2. **Age 50+ Contribution Limit (applicable only to participants attaining age 50 by the end of the calendar year who are in plans that permit catch-up contributions)**

Calendar Year	P.R.-Only Qualified Plan	Dual-Qualified Plan
2011	$11,000	$17,500*
2012	$14,500	$18,500*
2013+	$16,500	$1,500 above the U.S. Code Section 402(g) limit (as indexed)*

*Note: Federal government employees are permitted to make catch-up contributions in accordance with the higher limits contained in U.S. Code Section 414(v), currently $5,500 for 2012.

3. **Combined Deferral/IRA Limit Applicable to Dual-Qualified Plans**

For participants in an employer-sponsored dual-qualified plan, deferral contributions (excluding any catch-up contributions) and contributions to a Puerto Rico IRA cannot exceed the sum of the 2011 P.R. Code IRA limit and the 2011 P.R. Code annual deferral contribution limit for the employee (not including the P.R. Code IRA limit applicable to the employee's spouse). The Puerto Rico IRA contribution limit is generally $5,000 per year but is reduced to zero starting in the calendar year in which the individual attains age 75. In 2012, participants who have not attained age 75 by the end of the year can make up to $18,000 in combined contributions: $13,000 Puerto Rico retirement plan limit + $5,000 Puerto Rico IRA limit = $18,000. In 2013, participants who have not attained age 75 by the end of the year can make up to $20,000 in combined contributions: $15,000 Puerto Rico retirement plan limit + $5,000 Puerto Rico IRA limit = $20,000.

Defined Installment Payments for Annual Tax-Free Distributions (effective 1/1/2011)

The 2011 P.R. Code established an annual exemption from income for the first $11,000 ($15,000 for age 60 or older) of distributions paid due to separation from service in the form of an annuity or installments. The technical amendments define installments as either:

- Annual fixed payments in substantially equal amounts, or
- Required minimum distributions under U.S. Code Section 401(a)(9) (which applies only to dual-qualified plans).

Provided Higher Annual Threshold Levels for Withholding (effective 1/1/2011)

The 2011 P.R. Code provided that the 10% withholding applicable to non-lump-sum distributions was only required for amounts distributed above an annual threshold of $19,500 ($23,500 if age 60 or

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older). The technical amendments introduced higher exemption levels for years starting with 2012, as follows:

- $21,000 in 2012; $25,000 if age 60 or older as of 12/31/2012
- $23,500 in 2013; $27,500 if age 60 or older as of 12/31/2013
- $26,500 in 2014; $30,500 if age 60 or older as of 12/31/2014
- $31,000 in 2015; $35,000 if age 60 or older as of 12/31/2015.

Clarified Definition of Puerto Rico Property for Special 10% Tax and Withholding Rules (effective 1/1/2011)

The 2011 P.R. Code provided that a special 10% rate of tax and withholding applies to lump sum distributions paid from retirement plans that invest at least 10% of their assets attributable to Puerto Rico residents in Puerto Rico-located (P.R.-located) property. In a defined contribution plan that provides for participant-directed investments, the requirements for this special rate can also be satisfied by holding 10% of the assets in the individual account in P.R.-located property. Absent the availability of this special rate, a 20% Puerto Rico tax rate applies to lump sums. The technical amendments clarified that the investment requirement is calculated on the average daily balance over a three-year look-back period, and defined P.R.-located property as any of the following:

- Mutual fund companies registered in Puerto Rico
- Assets invested in fixed or variable annuities issued by domestic insurance companies or a foreign insurer deriving 80% of its gross income during the prior three years from Puerto Rico sources
- Deposits in interest-bearing accounts in commercial banks, cooperatives, or thrift associations based in Puerto Rico and authorized by the Puerto Rico or U.S. government
- Other property identified by the Puerto Rico Treasury by regulations or circular letter as property located in Puerto Rico.

COMPLIANCE ALERT: Although plan sponsors and fiduciaries of ERISA plans with bona fide Puerto Rico resident participants should consider the more favorable Puerto Rico tax rates associated with Puerto Rico investments that would become available if the investment-in-Puerto-Rico requirement is met, they must also ensure that any investment by their plan is made in a manner consistent with ERISA’s prudence and diversification requirements.

Clarified Direct Rollovers Amounts (effective 1/1/2011)

The 2011 P.R. Code allowed participants to roll over partial distributions after separation from service. It also permitted direct rollovers from P.R.-qualified plans to Puerto Rico nondeductible IRAs (the Puerto Rico equivalent of Roth IRAs in the U.S.), which results in the inclusion in income of the taxable amount rolled over. The technical amendments clarified that any percentage, up to 100%, of the partial distribution may be rolled over to another eligible retirement plan.

Clarified Plan Loan Rules (effective 1/1/2011)

The technical amendments added to the 2011 P.R. Code language to the effect that a plan loan will be treated as a distribution unless the loan, by its terms and in its operation, must be repaid:

- In installments that are substantially similar on at least a quarterly basis, and
- Within a period of not more than five years or, in the event that the loan is taken to finance the purchase of a principal residence for the participant, any longer term permissible for principal residence loans under the terms of the plan.

> COMPLIANCE ALERT: P.R. Qualified Plans will now have to ensure they comply with the loan provisions long applicable to U.S. qualified plans.

Updated Qualification Letter Filing Requirements

Plans that obtained, or filed for, a qualification (determination) letter from the Puerto Rico Treasury as of December 31, 2011, even if obtained under the 1994 P.R. Code, will be deemed in compliance with the requirement to obtain a qualification letter under the 2011 P.R. Code for the period prior to January 1, 2012 (when the guidance regarding the qualification process was issued).

The 2011 P.R. Code required that plans obtain a qualification letter no later than the sponsor's deadline (including any extension) to file its Puerto Rico income tax return for the first year the plan covers Puerto Rico residents. This deadline has now been extended to allow sponsors to apply for a qualification letter by the due date for filing the sponsor's income tax return for the first tax year beginning on or after January 1, 2012, if later.

Circular Letter 11-10

The Revenue Division of Puerto Rico's Department of the Treasury (known as Hacienda) issued Circular Letter 11-10 providing guidance on the procedures for amending plans and for obtaining plan qualification letters. Circular Letter 11-10 indicates that generally plans must adopt amendments necessary to comply with the 2011 P.R. Code by the last day of the first plan year beginning on or after January 1, 2012 (and that dual-qualified plans will have to amend their "Puerto Rico addendums" by this date).

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P.R. Qualified Plans that were amended for the 2011 P.R. Code must first be submitted to obtain a qualification letter with respect to the 2011 P.R. Code provisions by the due date for the employer's tax return for the first tax year of the employer beginning on or after January 1, 2012. New plans have until the due date for the employer's tax return for the tax year in which the plan was established or the due date of the employer's tax return for the tax year in which the plan began to cover Puerto Rico participants, if later. Unlike in the U.S., where obtaining a determination letter from the IRS is optional, a qualification letter in Puerto Rico is required to attain qualified status under the P.R. Code. Importantly, Circular Letter 11-10 still provides plan sponsors a one-time opportunity to obtain a retroactive qualification letter under the 2011 P.R. Code even if the plan operated before 2012 without obtaining a qualification letter under the 1994 P.R. Code.

INSIGHT

Puerto Rico evidently decided not to adopt the procedures instituted by the IRS in recent years (such as implementing a five-year or six-year remedial amendment cycle for plan amendments). Sponsors generally will have to amend their plans by the end of the 2012 plan year and file a determination letter request by their 2012 tax filing deadline.

It is still not known how the initial 2011 P.R. Code filing deadline will be applied to plans sponsored by tax-exempt organizations or to plans sponsored by related groups of employers (i.e., commonly controlled corporations or businesses or affiliated service groups) whose members file using different tax years.

Notice 2012-6

Owing to the difficulty of being subject to both the U.S. and the P.R. plan qualification rules, which sometimes conflict, many sponsors of U.S.-only qualified plans and dual-qualified plans transferred the assets of P.R. participants to stand-alone P.R.-only qualified plans. Before IRS Revenue Ruling 2008-40, several IRS Private Letter Rulings indicated that the transfer of benefits (assets and liabilities) from a U.S. qualified plan or dual-qualified plan to a P.R.-only qualified plan was considered a transfer between qualified plans and was not considered a taxable event.

However, in Revenue Ruling 2008-40 (See Our November 18, 2008 For Your Information), the IRS stated that if a U.S. qualified plan transfers a participant's benefits to a P.R.-only qualified plan, the transfer is considered a taxable event for the participant under the U.S. Code. In addition, the transfer itself could jeopardize the qualified status of the U.S. plan if the assets were not distributable under the terms of the plan at the time the transfer occurred. Revenue Ruling 2008-40 provided transition relief for transfers made before January 1, 2011. Revenue Ruling 2011-1 further extended this transition relief to transfers made before January 1, 2012.

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Notice 2012-6 extends the transfer deadline again to January 1, 2013 and also offers relief to certain group trusts (Revenue Ruling 81-100 group trusts) that continue to hold the assets of these P.R.-only qualified plans that receive a transfer of assets (as described above) from a U.S. qualified plan that participated in a group trust before January 10, 2011.

Conclusion

Although most U.S. plan sponsors will welcome the 2011 P.R. Code and technical amendments because they significantly reduce the differences between the qualification requirements in the P.R. Code and those of the U.S. Code, timely action will be required to avoid adverse tax consequences for Puerto Rico plan participants. Circular Letter 11-10 also provide guidance on qualification letters under the P.R. Code. Finally, Notice 2012-6 extends the transfer deadline to January 1, 2013. Plan sponsors with Puerto Rico participants must now begin planning for compliance with the 2011 P.R. Code and technical amendments and must be prepared to make the necessary amendments.

Buck Can Help

- Determine whether a dual-qualified or P.R.-only qualified plan is best for your workforce and whether a spin-off of your Puerto Rico population from a dual-qualified plan to a P.R.-only qualified plan by the December 31, 2012 deadline makes sense
- Update your plan document to ensure compliance with the requirements of the 2011 P.R. Code and technical corrections and prepare the plan for submission to Hacienda
- Review plan administration to determine if it is in compliance with the updated legislation
- Perform applicable coverage, nondiscrimination, and annual limits testing on your plan to determine compliance with the requirements under the P.R. Code (and under the U.S. Code if dual qualified) and determine any anticipated effects on funding and administration.
- Weigh the possible tax benefit to your Puerto Rico participants of investing in property located in Puerto Rico (or making such investments available in a participant-directed defined contribution plan) against the administrative and fiduciary concerns such investments can entail
- Prepare communications to the affected participants in Spanish and/or English.