



New Puerto Rico tax code impacts retirement plans

On January 31, 2011, the Governor of Puerto Rico signed into law a new Puerto Rico Internal Revenue Code (the “2011 PRIRC”). The 2011 PRIRC contains provisions affecting Puerto Rico qualified plans. These new provisions also affect “dual-qualified” plans that are tax-qualified under both the United States Internal Revenue Code (“USIRC”) and the PRIRC. Some of the qualified plan changes became effective on January 1, 2011, and others are effective January 1, 2012. Although some of the provisions of the 2011 PRIRC bring these rules closer to the U.S. rules, differences between the two sets of rules continue to exist.

Changes effective January 1, 2011

Definition of Highly Compensated Employee (HCE)

The 2011 PRIRC contains a new definition of Highly Compensated Employee (HCE). This new definition includes:

- Officers;
- 5% owners;
- An employee who for the immediately preceding taxable year had compensation in excess of \$110,000; and
- Spouse or dependents of an HCE.

This new definition applies only to Puerto Rico qualified plans. Although this new definition appears to be similar to the U.S. definition, there are important differences. The 2011 PRIRC does not include the 20% top-paid option. In addition, the \$110,000 compensation threshold does not contain a cost-of-living adjustment. However, in the case of a dual-qualified plan, the U.S. Code threshold under section 414(q) applies instead of the static \$110,000 threshold.

Coverage testing rules

All retirement plans qualified in Puerto Rico must pass a minimum coverage test. A new provision has been added to the minimum coverage testing rules that provides relief for plans affected by mergers or acquisitions. Similar to the USIRC, this new provision exempts a plan from performing a minimum coverage test and deems it to pass the test for both the plan year in which a merger or acquisition occurs and the immediately following plan year, provided:

- The plan passed the minimum coverage test for the plan year immediately preceding the merger or acquisition; and
- The plan’s coverage did not significantly change except for the fact of the merger or acquisition.

Controlled group rules

Before January 1, 2011, the Puerto Rico rules did not require employer aggregation for testing purposes. However, the 2011 PRIRC introduces a new definition of controlled group that requires employees of all corporations and other entities that are members of a controlled group or an affiliated service group to be treated as employees of the same employer. As a result, all members of the controlled group must be aggregated for purposes of nondiscrimination testing.

ADP testing failures

The 2011 PRIRC imposes a 10% excise tax on any excess contributions under the Average Deferral Percentage (ADP) test that are not corrected by the due date for filing the plan sponsor’s Puerto Rico income tax for the tax year that ends with or includes the plan year during which the ADP was failed. For a plan with a calendar plan year, the 10% excise tax would apply if a failed ADP test is not corrected by the next July 15th. This new provision is similar to the USIRC but provides for a longer period of time to correct the ADP testing failure. The 2011 PRIRC still does not contain an equivalent to the USIRC Average Contribution Percentage (ACP) test.

Deduction limits and penalties on nondeductible contributions

The maximum limit on deductible contributions to defined contribution plans is increased under the 2011 PRIRC from 15% to 25% of total compensation for employees participating in the plan. If a plan sponsor makes contributions that exceed the deduction limits, the excess amount is subject to a new 10% excise tax, which continues to apply as long as the excess amounts remain in the plan.

Tax withholding on plan distributions

Previously, only lump sum distributions were subject to a 20% tax withholding requirement. The 2011 PRIRC expands the requirement to also apply to a series of distributions of a participant's entire plan benefit within a single calendar year following:

- The participant's separation from service for any reason (termination of employment, death or disability); or
- Plan termination.

However, if:

- A defined benefit plan invests 10% or more of its assets; or
- A participant in a defined contribution plan invests 10% or more of the value of his account balance in certain property situated in Puerto Rico, such as local government bonds, stock of local companies and mutual funds of local companies,

these payments will be taxed at a flat rate of 10% and will be subject to 10% withholding, rather than 20%.

In addition, effective January 1, 2011, other forms of distributions are generally subject to a mandatory 10% income tax withholding. This new withholding applies to partial distributions made before separation from service and in-service distributions, such as hardship withdrawals.

Rollovers

Previously, only lump sum distributions could be rolled over. However, the 2011 PRIRC allows any distributions paid to a participant as the result of separation of service to be rolled over to another Puerto Rico qualified plan, or to an individual retirement account or an individual retirement annuity (IRA) of a bank or other financial institution located in Puerto Rico. The new rollover rules apply to annuity payments and periodic installments. Tax-free rollovers still may not be made to a U.S. qualified plan or to a U.S. IRA.

Responsibility for income tax withholding

Previously, the individual who paid the benefits (i.e., trustee, local paying agent) was responsible for compliance with the income tax withholding rules. However, the 2011 PRIRC clarifies that the plan sponsor is jointly and severally liable for failure to comply with the withholding rules.

Changes effective January 1, 2012

New benefit and contribution limits

The maximum annual benefit under a defined benefit plan cannot exceed the lesser of:

- \$195,000; or
- 100% of the participant's average compensation for the three consecutive years of their highest compensation.

The maximum annual contribution under a defined contribution plan cannot exceed the lesser of:

- \$49,000; or
- 100% of the participant's compensation for the current plan year.

Unlike the USIRC, these dollar limits are not adjusted for cost-of-living increases.

New annual compensation limit

The 2011 PRIRC imposes a new annual limit on employee compensation used for benefit accruals, calculation of plan contributions, and nondiscrimination testing. This limit is \$245,000 and is not adjusted for cost-of-living increases. In the case of dual-qualified plans, the annual compensation limit is the amount stated in USIRC section 401(a)(17) which is \$245,000 for 2011, but does provide for cost-of-living adjustments.

New elective deferral limits

The 2011 PRIRC also made changes to elective deferral limits, including catch-up contribution limits as follows:

	Original limit	New Limit
2011	\$10,000	\$10,000
2012	\$10,000	\$13,000
2013 and later years	\$11,000	\$15,000

In addition, effective January 1, 2012, the catch-up contribution limit increases from \$1,000 to \$1,500.

However, these new limits are not adjusted for cost-of-living increases.

In addition, the 2011 PRIRC does not allow Roth contributions.

New determination letter requirement

Sponsors of plans that intend to be qualified under the 2011 PRIRC must request and obtain a determination letter with the Puerto Rico Department of the Treasury (Hacienda) regarding the qualified status of the plan. The deadline for filing the request is the filing deadline (including extensions) for the plan sponsor's Puerto Rico income tax return for the tax year in which the plan first began covering Puerto Rico participants. Corporations are required to file their income tax return on or before the 15th day of the fourth month following the close of their taxable year. A 90-day extension is available upon request.

Group trust issues

The IRS issued [Revenue Ruling 2011-1](#), which revised the rules for group trusts. The Ruling provides that until the IRS issues additional guidance, the assets attributable to a Puerto Rico plan may remain in a group trust provided:

- The Puerto Rico trust was participating in the group trust as of January 10, 2011; or
- The Puerto Rico trust holds assets that had been held by a U.S. qualified plan immediately prior to the transfer of those assets to the Puerto Rico trust under the transition relief provided by [Revenue Ruling 2008-40](#) and modified by [Revenue Ruling 2011-1](#).

In addition, the IRS provided a transition period to allow the spinoff of assets and liabilities from a U.S. qualified plan into a separate Puerto Rico qualified plan until December 31, 2011. Such spinoffs are intended to avoid tax compliance issues.

Next steps

Sponsors of dual-qualified plans and plans qualified solely under the 2011 PRIRC that wish to take advantage of the increased limits should review their plan documents and summary plan descriptions to determine if any amendments are needed. Plan sponsors should contact their document providers if amendments are required to their plan documents. Plan sponsors should also review their administrative procedures, forms and checklists to ensure limits are correct and being monitored appropriately. They should also take action to comply with the new tax and withholding requirements for plan distributions. Prudential has implemented the new tax and withholding requirements required under the 2011 PRIRC.

Finally, plan sponsors should consult with their legal counsel regarding the application process for requesting and obtaining a determination letter from Hacienda regarding the qualified status of their plan under the 2011 PRIRC.

This information is an overview of recent developments. It is not intended to be legal advice. Sponsors of plans with Puerto Rico participants should discuss these issues with their legal counsel to the extent they deem appropriate.

Compliance Advisory by Prudential Retirement

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