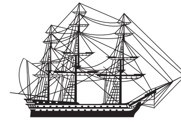

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Regulatory Brief: New Puerto Rico tax code

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On January 31, 2011, the governor of Puerto Rico signed Act No. 1 of 2011 into law, creating the Internal Revenue Code for a New Puerto Rico (New Puerto Rico Code). The New Puerto Rico Code entirely replaced and renumbered the old Puerto Rico Internal Revenue Code of 1994 (1994 Puerto Rico Code). As a result, Section 1165 of the 1994 Puerto Rico Code relating to employee benefit pension plans was renumbered as Section 1081.01 of the New Puerto Rico Code.

To leverage the U.S. retirement experience, the New Puerto Rico Code is modeled after, but not the same as, the U.S. Internal Revenue Code (U.S. Code) in regard to certain retirement plan provisions. Previously issued regulations can still be relied upon if they have not been changed by the New Puerto Rico Code until new regulations are issued by the Puerto Rico Department of the Treasury (Hacienda).

While an overhaul of the retirement plan provisions was not the main objective of the revised code, there are several revisions plan sponsors need to consider. The majority of the changes took effect January 1, 2011. In most cases, the changes apply to all Puerto Rico participants in solely qualified Puerto Rico plans and dual-qualified Puerto Rico plans. In some cases for dual-qualified plans, the U.S. Code provisions apply. Both solely qualified and dual-qualified plans are also subject to the Employee Retirement Income Security Act of 1974 (ERISA). For further information on solely qualified and dual-qualified Puerto Rico plans, please see Regulatory Brief 2008-05.

Changes in pre-tax deferral, annual additions, and compensation limits

Contributions to a Puerto Rico IRA no longer will reduce a participant's pre-tax annual contribution limit to a retirement plan. Therefore, in 2011 a participant may contribute $10,000 (plus catch-up, if applicable) to their retirement plan regardless of any Puerto Rico IRA contributions.

Effective January 1, 2012, pre-tax annual contribution limits will increase to $13,000 for 2012 and $15,000 for 2013 and years thereafter. Similarly, catch-up contributions will increase to $1,500 for 2012 and years thereafter. These limits are not indexed for inflation and will remain in effect unless changed through legislation. Please note that the elective deferral limits under Section 402(g) of the U.S. Code will apply to federal employees residing in Puerto Rico but do not extend to nongovernmental employees in dual-qualified plans.

The New Puerto Rico Code provides for a limit on annual additions. Effective January 1, 2012, these annual additions for a defined contribution (DC) plan are limited to the lesser of 1) $49,000 or 2) 100% of the participant's compensation for the subject year. All DC plans for a single employer must be aggregated to determine the annual additions to a participant's account. Similarly, all defined benefit (DB) plans for a single employer must be aggregated to determine the annual limit on benefits.

For a DB plan, the annual benefit (based on a straight life annuity with no ancillary benefits) is the lesser of 1) $195,000 or 2) 100% of the participant's average compensation for the three consecutive years with the highest compensation.

Starting in 2012, solely qualified Puerto Rico plans will have a maximum compensation limit of $245,000 for testing and accrual purposes. This limit is not currently adjusted for inflation. For dual-qualified plans, the U.S. Code limits under Section 401(a)(17) apply.

Highly compensated employees: Aggregation and testing

Under the 1994 Puerto Rico Code, the top one-third of the highest-paid eligible employees were considered highly compensated employees (HCEs). Effective January 1, 2011, the definition of an HCE changed to more closely mirror U.S. Code Section 414(q). An HCE is any employee who 1) is an officer, 2) is a five percent owner of the voting stock or the total value of all classes of stock, 3) received compensation in excess of $110,000 from the employer in the preceding tax year (or in excess of the limit in U.S. Code section 414(q)(1)(B) for dual-qualified plans), or 4) is the spouse or dependent of anyone meeting qualifications 1 through 3.

Before 2011, members of a controlled group or affiliated service group did not have to be aggregated except in limited cases. Under the New Puerto Rico Code, all members of a controlled group or affiliated service group must be treated as one employer for testing purposes.

The actual deferral percentage (ADP) testing rules remain unchanged. However, to provide an incentive for employers to correct excess contributions from the plan, the Hacienda has elected to impose a 10% excise tax on the employer if a failed ADP test in not corrected by the due date, including extensions, of the employer's Puerto Rico tax return. This change was effective January 1, 2011.

Client planning note: Dual-qualified plans must pass both the U.S. and the Puerto Rico ADP tests beginning in 2011 to avoid any excise tax. The deadline to correct excess contributions is different under the New Puerto Rico Code. Plan sponsors generally have 7½ months after year-end versus 2½ months after year-end under the U.S. Code.

The New Puerto Rico Code also provides some welcome relief to coverage testing in the event of a merger or acquisition and is modeled after U.S. Code Section 410(b)(6)(C). Plans that pass the minimum coverage test for the year immediately preceding the merger or acquisition year, and whose coverage did not significantly change except for the merger or acquisition, will not have to perform additional testing.

New taxation and rollover rules on distributions

Lump-sum distributions under the Puerto Rico Code are taxed differently than other types of distributions such as annuities, installments, and in-service withdrawals. The definition of a lump-sum distribution was changed under the New Puerto Rico Code to include one or a series of distributions within one calendar year whereby a participant receives their entire plan balance because they have separated from service or the plan has been terminated. Before 2011, plan terminations were not considered lump-sum distributions. Lump-sum distributions are taxed at a 20% flat rate and are subject to 20% withholding except for certain exemptions, including one for company stock.

Client planning note: Plan sponsors with company stock in their Puerto Rico plan should review any tax withholding disclosures. They may also want to confirm the withholding and reporting of transactions involving company stock with their trustee or paying agent.

Distributions received in a form other than a lump sum are now subject to 10% withholding but remain taxed as ordinary income. A terminated participant may exclude the first $11,000 of benefits received in the form of an annuity or periodic installment from their taxes. If the participant is age 60 by year-end, they may exclude up to $15,000. For 2011, participants are exempt from the 10% withholding on the first $19,500 if they are younger than age 60 or $23,500 if they are age 60 by year-end, paid in the form of annuities or periodic installment payments after separation from service. It is important to note that the amounts subject to withholding differ from the amount that can be excluded from tax, which could mean participants would owe tax on the difference. The withholding rules are effective for distributions made after January 31, 2011.

Under the 1994 Puerto Rico Code, participants were required to choose between receiving a lump sum or rolling over their entire distribution, including after-tax contributions, into another Puerto Rico qualified plan or a Puerto Rico IRA. As a result, many participants chose to receive a lump sum, which may not preserve the assets for retirement. Under the New Puerto Rico Code, any total or partial distribution received after a separation from service can be rolled over to another Puerto Rico qualified plan or to a Puerto Rico IRA. The entire taxable amount of any distribution must be rolled over. After-tax contributions that form the cost basis may be taken as a cash distribution.

The New Puerto Rico Code also clarifies that responsibility for tax withholding falls with the plan sponsor. Plan sponsors are now jointly and severally liable for any failure to comply with the Puerto Rico withholding rules.

Client planning note: Plan sponsors should ensure that taxes are being withheld and submitted for all distributions to Puerto Rico participants, whether from a solely qualified or dual-qualified Puerto Rico plan. Vanguard has a paying agent service available to assist plan sponsors with Puerto Rico participant disbursements from dual-qualified plans. Tax withholding and reporting for solely qualified Puerto Rico plans is prepared by the plan trustee.

Administration and compliance

Determination letter filing

While the Hacienda has always required plans to receive a determination letter, the 1994 Puerto Rico Code did not contain a specific deadline. Beginning with plan years on or after January 1, 2012, the New Puerto Rico Code requires plan sponsors to file for a determination letter by the tax-filing deadline (including extensions) for the employer.

Client planning note: Plan sponsors must amend their plan documents and must file with the Hacienda by the deadline to file a Puerto Rico income tax return (including extensions for the tax year in which the plan was effective) to obtain a determination letter. For existing plans that have never filed for a determination letter, this filing should be completed by December 31, 2011. Unlike the U.S. determination letter filing, plan qualification with the Hacienda is mandatory. Similar to the U.S. determination letter cycle filing program, obtaining an updated determination letter will become a periodic requirement.

Contribution deductions

The New Puerto Rico Code raised the employer deduction limit from 15% to 25% of the compensation paid or accrued for the current tax year to all employees participating in the plan. In many cases, this change will provide an opportunity for plan sponsors to streamline administration by merging existing money purchase pension plans into profit-sharing plans, because the deduction limits for both plan types will be the same.

Annual information return

Puerto Rico plans must continue to file Form 480.70(OE). The Hacienda may issue an administrative determination to allow plans to file a Form 5500 in lieu of the Form 480.70(OE). If this occurs, it will most likely not be effective until plan years beginning or after January 1, 2012.

There have been many changes to the regulations and most, if not all, plan sponsors will need to make at least some changes to their plans as a result of the New Puerto Rico Code. Plan sponsors should consult with their Puerto Rico counsel about the changes, and review existing citations and references in their plan documents and other plan materials.

Client planning note: Next steps

- Amend plan document and update Summary Plan Description by December 31, 2011.
- File plan document with Hacienda by December 31, 2011, for existing plans.
- Update applicable forms, notices, and all other relevant communications to comply with the new changes affecting plan distributions.

Contact your Vanguard representative if you have questions or need further detail about any of the changes included in the New Puerto Rico Code.

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