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Recent Developments Affect Puerto Rico Retirement Plans

Employers with employees in Puerto Rico should be aware of some recent developments affecting benefits. Puerto Rico has enacted legislation that increases the pre-tax contribution limits to qualified savings plans under Section 1165(e) of the Puerto Rico Internal Revenue Code. Recent guidance provides that distributions from Puerto Rico profit sharing plans are not taxable in Puerto Rico upon company shutdowns. Also, the IRS issued a revenue ruling establishing that a transfer of assets from a U.S. qualified plan to a plan qualified only and exclusively under Section 1165 of the Puerto Rico Internal Revenue Code is a distribution to a participant whose account is included in the transfer, but the ruling is subject to important transition relief.

Background

Puerto Rico, a U.S. commonwealth, has its own tax code. Like the U.S. Internal Revenue Code (IRC), the Puerto Rico IRC provides favorable tax treatment with respect to employee pension plans that meet specified requirements. Section 1165(e) of the Puerto Rico IRC provides rules for cash or deferred savings plans that are somewhat similar to the rules governing Section 401(k) plans under the U.S. IRC.

Law Increases Annual Limits

On August 7, 2008, the Governor of Puerto Rico signed into law Act 186, which increases the pre-tax contribution limits for Section 1165(e) savings plans. Under prior law, pre-tax contributions were limited to the lesser of 10 percent of compensation or $8,000 per year. The new law removes immediately the 10 percent cap, so that the limit for 2008 plan years is $8,000 regardless of compensation. It also increased the annual limits for plan years beginning in 2009 and thereafter as follows:

Plan Year	Contribution Limit
2009 and 2010	$ 9,000
2011 and 2012	$ 10,000
2013 and beyond	$ 12,000

Beginning with 2007 plan years, employees who have attained or will attain age 50 by the end of the plan year and whose pre-tax contributions have reached the applicable limit for the year may also make a pre-tax catch-up contribution of up to $1,000.

BUCK COMMENT. *Employers that maintain "Puerto Rico-only" savings plans or that include their Puerto Rico employees in "dual-qualified" plans (i.e., plans that are intended to be qualified under both the U.S. and Puerto Rico IRC) and that wish to take advantage of these new limits should review their plan provisions and determine whether amendments are needed. Although Puerto Rico no longer imposes the 10 percent of compensation limit, plans may still choose to include it as a policy matter. If the new limits are adopted, other plan materials and communications will have to be revised.*

Administrative Determination Affects Puerto Rico Profit Sharing/Stock Bonus Plans

On October 31, 2008, the Puerto Rico Secretary of the Treasury issued Administrative Determination No. 08-13, which provides that the lump sum distribution of a participant's entire accrued benefit from a profit sharing or stock bonus plan that is qualified under the Puerto Rico IRC will not be treated as taxable income, if the participant's termination of employment was due to the total or partial shutdown of the company's operation in Puerto Rico. The participant's termination must meet certain of the "just cause" requirements of Law 80 (enacted on May 30, 1976), which include a company shutdown on account of technological or reorganizational changes or a reduction in force due to decreases in the volumes of production, sales, etc. In addition, the distribution must occur within 12 months of the participant's termination. This special tax treatment does not apply to any other types of qualified plans such as defined benefit plans, target benefit plans, or 1165(e)/401(k) plans.

IRS Revenue Ruling on Transfers to Puerto Rico Plans

On July 1, 2008, the IRS issued Revenue Ruling 2008-40, which addresses the tax treatment of a transfer of assets and liabilities from a U.S. qualified plan to a nonqualified foreign trust, and a transfer of assets and liabilities from a dual-qualified plan to a plan qualified only under Puerto Rico law. The ruling concludes that in both cases the transfer is generally treated as a taxable distribution to each participant whose benefits are included in the transfer, even though the participant does not receive any immediate payment from either plan.

The holding of Revenue Ruling 2008-40 with respect to a transfer from a dual-qualified plan to a plan qualified only in Puerto Rico is not consistent with previously issued private letter rulings. For that reason, and to allow plan sponsors a reasonable time to unwind their current arrangements without adverse tax consequences for participants, the ruling provides important transition relief. Transfers from a U.S.-only qualified plan or a dual-qualified plan to a plan qualified only under Puerto Rico law that are completed prior to January 1, 2011 will not be subject to the new ruling and will not be treated as taxable distributions to plan participants. Moreover, any amounts transferred before that date will be treated only as Puerto Rico source income, and not as U.S. source

income, when ultimately distributed to the participant. Thus, the distribution will be taxed only by Puerto Rico and the U.S.-based transferor plan will not retain any residual tax reporting obligations.

The transition guidance also addresses the application of the nondiscrimination requirements of the U.S. IRC to a dual-qualified plan that makes a transfer to a plan qualified only under Puerto Rico law prior to January 1, 2011. This guidance includes relief permitting these transfers to avoid some thorny coverage issues that might otherwise pose a danger of disqualification.

> ***BUCK COMMENT.*** *All employers that have included their Puerto Rico employees in their U.S.-based retirement plans and have attempted to comply with the requirements applicable to dual-qualified plans should carefully consider whether such arrangements will continue to serve the needs of the company and plan participants more effectively than the establishment of a separate plan qualified only under Puerto Rico law. The favorable tax treatment of pre-2011 transfers from a dual-qualified plan to a Puerto Rico-only plan provides a strong incentive for resolving these issues before the end of 2010.*

Conclusion

These latest developments from Puerto Rico and the IRS provide an impetus for affected sponsors to review their plans and make appropriate changes.

Buck's consultants in the U.S. and in Puerto Rico would be pleased to discuss your options and best course of action with you.