

# Compliance Advisory

March 2007



## Developments Affecting Plans with Puerto Rico Participants

Over the past year, developments have occurred that may affect plans qualified under the Puerto Rico Internal Revenue Code (“Puerto Rico-qualified plans”) or plans qualified under the United States Internal Revenue Code (“U.S.-qualified plans”) that have Puerto Rican participants. Plan sponsors with these types of plans should review this overview to determine the possible affect of these developments on plan administration.

### Repeal of Puerto Rico Trust Requirements

In 2004, the Puerto Rico legislature made a change to the Puerto Rico Tax Code to require U.S.-qualified plans with Puerto Rico participants to establish a separate Puerto Rico trust. Under this law, U.S.-qualified plans covering Puerto Rico employees that were established before September 22, 2004, had until September 22, 2007, to formally appoint a Puerto Rico paying agent and request a favorable determination letter from the Hacienda.

In January 2006, Puerto Rico Act No. 49 provided welcome relief for sponsors of U.S.-qualified plans that cover Puerto Rico employees by eliminating the Puerto Rico trust requirement.

### Favorable Tax Treatment

Beginning in 2006, if a plan has either a Puerto Rico trust, or a Puerto Rico trustee who is also the trust’s paying agent, lump sum distributions made to Puerto Rico employees are subject to a 12.5% income tax rate, rather than a 20% tax rate. For lump sum distributions made between January 30, 2006, and December 31, 2007, the lower tax rate is automatic. Beginning January 1, 2008, the lower rate applies only if at least 10% of the participant’s account (or 10% of all plan assets for defined benefit plans) have been invested in “property located in Puerto Rico” at the close of the plan year during which the distribution is made and during each of the two preceding plan years.

Puerto Rico Act No. 49 defines “property located in Puerto Rico” as:

- Puerto Rico real property;
- Puerto Rico government bonds;
- Stocks or bonds of Puerto Rico companies; or
- Stocks or bonds of foreign companies where, for the three-year period ending prior to the transaction, 80% of their gross income was from business in Puerto Rico.

Absent any guidance from Puerto Rico tax authorities, it appears that “property located in Puerto Rico” does not include common pooled investments (e.g., mutual funds, separate accounts and bank collective trusts) based in the United States.

Plan sponsors that have Puerto Rico employees eligible for this tax treatment should refer those employees to a tax advisor for information and guidance.

### Catch-up Contributions

In May 2006, the Puerto Rico legislature enacted a change in the law to permit Puerto Rico-qualified plans with cash-or-deferred arrangements (section 1165(e) plans) to offer catch-up contributions for Puerto Rico participants age 50 and older. Act No. 92 limits these catch-up contributions to \$500 for the 2006 tax year, and \$1,000 for 2007 and later tax years. (Since the limit is based on tax years, it appears that non-calendar year plans may need to track compliance with different contribution limits within the same plan year.) The Puerto Rico catch-up contributions, like United States catch-up contributions, are not subject to nondiscrimination testing, and may be eligible for matching contributions. Unlike U.S. catch-up contributions, these limits are not indexed for inflation, and apply to participants that reach age 50 by the end of the *plan* year, rather than *calendar* year.

This change in the Puerto Rico law raises questions regarding the “universal availability” requirement for catch-up contributions. Since 2002, some plan sponsors that adopted catch-up contribution provisions for their U.S.-qualified plans relied on IRS guidance that allowed plans to exclude Puerto Rico participants from making catch-up contributions. Following the change in the Puerto Rico law to allow catch-up contributions, it is not clear whether U.S.-qualified plans that allow catch-up contributions and have Puerto Rico participants are required to adopt the Puerto Rico catch-up contributions in order to satisfy the “universal availability” requirement. Plan sponsors with plans qualified under only the United States Internal Revenue Code will not be impacted by this catch-up contribution provision. However, the “universal availability” issue may affect:

- Plan sponsors with plans that are qualified under both the Puerto Rico Internal Revenue Code and the United States Internal Revenue Code (“dual-qualified plans”); or
- Plan sponsors with separate U.S.-qualified 401(k) plans and Puerto Rico-qualified section 1165(e) plans.

It is expected that the IRS will issue further guidance to address this and other issues regarding retirement plans with Puerto Rico participants.

*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 own legal counsel to the extent they deem appropriate.*

#### Compliance Advisory by Prudential Retirement

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