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EMPLOYEE BENEFITS NEWSLETTER

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NEW PUERTO RICO INTERNAL REVENUE CODE APPROVED

A new Puerto Rico Internal Revenue Code was signed into law as Act No. 1 of January 31, 2011 known as the "Puerto Rico Internal Revenue Code for a New Puerto Rico" (the "New Code"). The New Code amends and adds new provisions to former Section 1165 of the Puerto Rico Internal Revenue Code of 1994, as amended (the "1994 Code"), which governed the qualification of pension plans in Puerto Rico. Among the most significant changes brought by the New Code are the following:

1. *New Annual Compensation Limitation*

For taxable years commencing after January 1, 2012, a plan shall not be considered a qualified plan if the participant's annual compensation that can be taken into account for purposes of determining the contributions and benefits under the plan and the application of the discrimination testing and the limitations on benefits and contributions exceeds \$245,000. Notwithstanding the above, instead of the \$245,000 limit, in the case of dual qualified plans, the limit established under Section 401(a)(17) of the Internal Revenue Code of 1986, as amended, (the "US IRC") will apply.

2. *Maximum Limitations on Annual Benefits and Annual Contributions*

A new section was added governing limits on benefits and contributions, effective for taxable years commencing after January 1, 2012.

In the case of a defined benefit plan, the annual benefit, when expressed as a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and does not accept rollover contributions, cannot exceed the lesser of: \$195,000 or 100% of the average annual compensation for a period of no more than 3 consecutive years during which the compensation paid was the highest.

In the case of a defined contribution plan, the annual employer and employee contributions (excluding rollovers made from other qualified plans) cannot exceed the lesser of: \$49,000 or 100% of the participant's compensation during the calendar year or plan year, as selected by the employer.

3. *Taxation of Total Distributions*

Under the 1994 Code, only total distributions paid within a single taxable year due to separation from service qualified for the special tax of 20%. Under the New Code, total distributions made as a result of the plan's termination will also qualify for the 20% special income tax.

With respect to the requirements that must be met in order to qualify for the special tax rate of 10% on lump-sum distributions, under the New Code the manner in which the 10% Puerto Rico investment requirement is calculated is now based on the average daily balance of the investment of the trust during the plan year in which the distribution is made and each of the preceding two years.

4. *Rollover of Partial Distributions Allowed*

Under the 1994 Code only rollover of lump-sum distributions were allowed. The provisions of the New Code allow for rollover of partial distributions due to separation from service from PR qualified plans to other PR qualified plans and PR IRAs.

5. *New Withholding Requirement on Partial Distributions*

A new provision was added requiring a 10% withholding on any distribution to a plan participant, other than a lump-sum distribution or loans to participants, such as partial distributions due to separation from service and in-service withdrawals.

6. *Liability of Employer*

Under the New Code the employer sponsoring the plan is jointly liable with the withholding or paying agent for the amounts not withheld and for which the plan participant failed to pay the corresponding income tax.

7. *New Definition of Highly Compensated Employee*

Under the 1994 Code, the top one third of the eligible employees were considered highly compensated employees ("HCE"). The New Code defines HCE as an (i) officer, (ii) shareholder who owns more than 5% of the voting shares or

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the total value of all classes of shares of the employer, (iii) an employee who for the prior taxable year had compensation in excess of \$110,000, or (iv) the spouse or dependant of any HCE. In the case of a dual qualified plan, the compensation limit established under Section 414(q)(1)(B) of the US IRC will be applicable for purposes of the definition of HCE.

8. Imposition of Tax for Failure to make Corrections of Excess Contributions

Under the New Code failure to correct excess contributions no later than the last day to file the Puerto Rico income tax return of the employer that sponsors the plan for the taxable year of the employer in which the excess contributions were made, including any extensions granted, will result in the imposition of a tax equal to 10% of the excess contributions that were not corrected.

9. New Deferral Contribution Limits

The provisions of the New Code increased the deferral contribution limit amount to \$13,000 for taxable years commencing on January 1, 2012 and to \$15,000 for taxable years commencing on January 1, 2013.

In the case of federal employees, the deferred compensation limit applicable will be the one established under Section 402(g) of the US IRC.

Under the New Code the language establishing a combined limit between IRA contributions and contributions made to qualified plans was eliminated. Thus, the maximum deferral limit per employee for this year will be \$15,000.

10. New Catch-Up Contribution Limits

The provisions of the New Code increased the catch-up contribution limit amount to \$1,500 for taxable years commencing on January 1, 2012.

11. Mandatory Aggregation

For purposes of nondiscrimination and ADP testing, all the employees of all the corporations, partnerships and other persons that are members of a controlled group of corporations or to an affiliated group of services will be considered employees of the same employer.

12. Proof of Exemption

For taxable years commencing after January 1, 2012 any trust claiming to be exempt must request and obtain an administrative determination to such effect. Such request must be filed no later than the last day established for the filing of the income tax return of the employer maintaining the plan, including any extensions granted for the filing of the

return for the taxable year of the employer during which the plan commenced to extend participation to Puerto Rico residents.

As in the past, any amendments to existing qualified Puerto Rico plans should continue to be submitted to Treasury for an updated determination letter.

13. Filing of Informative Return

The New Code establishes that the Secretary of the Treasury may authorize, through regulations, circular letter, administrative determination or informative bulletin, the filing of a copy of Form 5500 instead of Form 480.70E.

14. Status of Regulations Under the 1994 Code

Regulations under the New Code are yet to be issued by Treasury. The Regulations under the 1994 Code will continue to be in effect with respect to the interpretation of identical provisions under the New Code until the new regulations are issued. The provisions of the New Code may be subject to new requirements and interpretation under the new regulations.



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