

MEMORANDUM TO CLIENTS AND FRIENDS

January 31, 2006

Retirement Plans Update

I. Pre-tax Contributions Limitation for 2006

The limitation for pre-tax contributions to qualified retirement plans with a cash or deferred arrangement under Section 1165(e) of the Puerto Rico Internal Revenue Code of 1994, as amended (the "PR Code"), has not changed for calendar year 2006. The limitation remains at the **lesser of 10% of compensation or \$8,000, reduced by contributions made by the participant to a Puerto Rico individual retirement account ("IRA")**.

Although several bills have been introduced to increase the annual pre-tax contribution limitation, as of today, none has been approved. It is worth mentioning that among the changes included in the Governor of Puerto Rico's proposal to change the Puerto Rico tax system is an increase of the annual pre-tax contribution limitation to the lesser of 10% of compensation or \$10,000, reduced by contributions made by the participant to an IRA or to an Educational Contribution Account ("ECA"). For more information about the Governor's proposal as it relates to retirement plans, see Section IV below.

II. Withholding and Taxation of Plan Distributions Received in 2006

Act No. 40 of August 1, 2005 ("Act 40"), amended the PR Code to establish a single long-term capital gains tax rate of 12.5% for individuals effective January 1, 2006. In doing so, Act 40 not only eliminated the general long-term capital gain rate of 20%, which would otherwise apply in year 2006 for lump-sum distributions received on account of separation from service ("lump-sum distributions") by most participants or beneficiaries, but also eliminated the special long-term capital gains tax rate of 10% for gains on the sale of "property located in Puerto Rico," which otherwise may have applied for lump-sum distributions received by participants or beneficiaries age 55 or older and whose plans complied with certain requirements related to the investment of plan assets in property located in Puerto Rico. Consequently, all qualified plan distribution received on or after January 1, 2006 are currently taxable at a 12.5% rate.

Notwithstanding the foregoing, it is important to note that the 20% withholding tax rate applicable to lump-sum distributions remains unchanged. Accordingly, even though a lump-sum distribution received in year 2006 may be taxed at a 12.5% rate, the trustee and the plan administrator are required to withhold a 20% tax on such distributions. The participant or beneficiary will be required to request a refund of any tax overpayment in his/her income tax return.

III. Changes in the US Code

IRS CIRCULAR 230 DISCLOSURE: TO ENSURE COMPLIANCE WITH REQUIREMENTS IMPOSED BY THE INTERNAL REVENUE SERVICE, WE INFORM YOU THAT ANY TAX ADVICE CONTAINED IN THIS COMMUNICATION (INCLUDING ANY ATTACHMENTS) WAS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE OR (II) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR MATTER ADDRESSED HEREIN.

A. Qualified Roth Contribution Program

Plans qualified under Section 401(k) of the U.S. Internal Revenue Code of 1994, as amended (the “US Code”), may include a “qualified Roth contribution program” that will allow an employee to elect to be currently taxed on all or part of the employee contributions to these plans (*i.e.*, an after-tax contribution), instead of excluding such contributions from the employee's gross income (*i.e.*, a pre-tax contribution). Under such plan, the employee will be able to exclude from gross income later distributions (that would otherwise be included in his/her gross income) from these plans if certain requirements are met.

B. Catch-up Contributions

The limitation for “catch-up contributions” under the US Code increased for 2006. Catch-up contributions are pre-tax contributions in excess of the applicable annual limits that plans may allow for participants aged 50 and over.

C. Automatic Rollovers to Individual Retirement Accounts

US Code Regulations now require that a plan qualified under US Code 401(a) must include automatic rollover provisions of nonforfeitable accrued benefit of \$5,000 or less, but more than \$1,000, to an eligible U.S. individual retirement account.

D. Application of US Code Provisions to Puerto Rico Plans

Since the PR Code has not been amended to include provisions for qualified Roth contribution programs, catch-up contributions¹ and automatic rollovers to individual retirement accounts, they may not be included in a Puerto Rico qualified plan. Plans that are qualified under both US Code Section 401(a) and PR Code Section 1165(a) (*i.e.*, “dual-qualified plans”) which include said provisions must be amended to expressly exclude Puerto Rico participants from their application.

IV. Proposed 1.A.357(a) Plans

As mentioned above, the Governor of Puerto Rico recently unveiled the “Puerto Rico Internal Revenue Code of 2006” (the “2006 Code”) which, if approved by the Puerto Rico Legislative Assembly (**a big if in current times**) would bring major changes to the Puerto Rico tax system. During the following weeks, we will be issuing Memoranda to Clients and Friends in which we will discuss significant proposed changes to the Puerto Rico tax system such as: reduction in income tax rates and related elimination or limitation of certain deductions and special tax rates (including the elimination of long-term capital gains tax rates); elimination of the general excise tax; and introduction of a sales tax, among others. (See our Memorandum to Clients and Friends 2006-01 for a description of the proposed sales tax.)

The following table summarizes the changes that Section 1.A.357 of 2006 Code would make for qualified retirement plans in Puerto Rico, which changes would be effective two year after the bill is enacted into law.

Provision	PR Code	2006 Code
Compliance with Employee Retirement Income Security Act (“ERISA”)	As a requirement for qualification, a plan must comply with ERISA.	As a requirement for qualification, a plan must comply with ERISA. In addition, the 2006 Code provides that ERISA prevails over the 2006 Code in case of conflict between the laws. <i>Generally, will not require changes to plan documents.</i>

¹ Although a bill (P.C. 919) amending the PR Code to introduce catchup contributions in Puerto Rico was approved in October 2005, the bill was returned by the Governor at the request of the Puerto Rico Legislative Assembly. At this time, it is uncertain whether the bill will be enacted into law.

Provision	PR Code	2006 Code
<p>Requirement of a Puerto Rico Trust or Puerto Rico Trustee</p>	<p>Trusts funding Puerto Rico qualified plans must be established in Puerto Rico (“PR Trust”) and the trustee must be a resident of Puerto Rico (“PR Trustee”).</p> <p>Compliance with such requirements may be waived by Secretary of the Treasury for: (1) trusts established in the United States (“US Trust”) that appoint a financial institution regulated by the Puerto Rico Commissioner of Financial Institutions as Paying Agent in Puerto Rico; or (2) US Trust with a PR Trustee acting as the Paying Agent for the trust.</p> <p>Applicable for plans established on or after September 22, 2004. Plans established before said date must be in compliance with the requirements after September 22, 2007.</p>	<p>Trusts funding Puerto Rico qualified plans must have a trustee who is a resident of Puerto Rico (“PR Trustee”) acting as the Paying Agent for the trust.</p> <p><i>For plans funded through a US Trust, change would require: (1) amending the US Trust agreements in order to include a co-trustee arrangement; and (2) the execution of Deed of Co-trustee following provisions of Puerto Rico Notarial Law.</i></p>
<p>Taxation of lump-sum distributions</p>	<p>20% withholding on lump-sum distributions.</p> <p>Taxed at long-term capital gains tax rates (currently 12.5%).</p>	<p>20% withholding on lump-sum distributions remains unchanged.</p> <p>Taxed at ordinary tax rates.</p> <p><i>Benefit of special tax rate is lost. Need to confirm applicability of \$15,000 annual exclusion.</i></p> <p><i>Discussion of tax consequences in summary plan description (“SPD”) may be required to be modified.</i></p>

Provision	PR Code	2006 Code
<p>Taxation of distributions other than lump-sum distributions</p>	<p>No withholding on distribution.</p> <p>Taxed at ordinary tax rates after annual exclusion of \$8,000 per pension (\$12,000 per pension for participants and beneficiaries age 60 or older).</p>	<p>No withholding on distribution.</p> <p>Taxed at ordinary tax rates after annual exclusion of \$15,000 for single taxpayers and married taxpayers who file separately (\$30,000 for married taxpayers filing jointly). Phase-out of \$15,000 / \$30,000 annual exclusion for taxpayers with adjusted gross income (“AGI”), including pension income, in excess of \$15,000 and \$30,000, respectively. Exclusion is completely phased-out when AGI reaches \$25,000 (single or married filing separately) or \$50,000 (married filing jointly).</p> <p><i>Discussion of tax consequences of plan distribution in SPD may be required to be modified.</i></p>
<p>Limitation on Pre-tax Contributions</p>	<p>10% of compensation, not to exceed \$8,000. The \$8,000 annual limitation is reduced by contributions made by the participant to IRA.</p>	<p>10% of compensation, not to exceed \$10,000. Both the 10% and the \$10,000 annual limitation are reduced by contributions made by the participant to IRA and ECAs.</p> <p><i>Depending on the current language used for the limitation in the plan document, plans may be required to be amended to comply with the new limitation. Even though annual limitation is increased to \$10,000, the aggregate annual exclusion from gross income may actually be reduced for certain taxpayers (e.g., deduction of ECAs is currently not limited).</i></p>

Provision	PR Code	2006 Code
<p>Definition of Highly Compensated Employees (“HCE”)</p>	<p>HCE is any participant who, determined on the basis of compensation for each plan year, has greater compensations than two-thirds of all other participants. (i.e., Old U.S. Code 1/3 - 2/3 rule.)</p>	<p>HCE is any employee who: (1) was a five percent owner at any time during the current year or the preceding year; or (2) for the preceding year, received compensation from the employer in excess of \$50,000, (as periodically adjusted for cost-of-living increases by the Secretary), and, if the employer elects, was in the “top-paid group” of employees for the preceding year. An employee is considered to be in the “top-paid group” of employees for any year if the employee is in the group consisting of the top 20% of employees ranked on the basis of compensation paid during the year.</p> <p><i>Depending on the current definition in the plan document, plans may be required to be amended to comply with this definition. It is expected that the amendment should result in less plans failing the ADP Test under the PR Code.</i></p>
<p>Definition of Year of Service</p>	<p>None</p>	<p>A 12-month period during which an employee completes at least 1,000 hours of service.</p> <p><i>Most plans already provide this definition since it is similar to the definition under ERISA.</i></p>

Provision	PR Code	2006 Code
<p>Minimum Participation Requirement</p>	<p>None</p>	<p>Plan cannot require, as a condition of plan participation, that an employee complete a period of service extending beyond the later of: (1) the date the employee reaches age 21; or (2) the day the employee completes one “year of service.”</p> <p>Plan cannot exclude from participation (on the basis of age) employees who have attained a specified age.</p> <p>Plan must provide that an employee who has satisfied the minimum age and service requirements and who is otherwise entitled to participate in the plan, be admitted into the plan no later than the earlier of the following dates: (1) the first day of the first plan year beginning after the date the age and service requirements were satisfied; or (2) the date six months after the date on which the age and service requirements were first satisfied.</p> <p><i>Most plans already provide these rules since they are similar to the requirements under ERISA, except for plans that provide that a participant's right to his accrued benefit is 100% vested after not more than two years of service which may require that an employee be at least 21 years old or complete at least two years of service, whichever is later, to participate. Such plans may require an amendment to comply with the proposed rules.</i></p>

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<p>Minimum Vesting Schedules</p>	<p>None</p>	<p>Plan must provide for full vesting on the attainment of normal retirement age.</p> <p>Accrued benefit derived from employee contributions made to the plan must be nonforfeitable.</p> <p>Participants must acquire a nonforfeitable right on all employer contributions either: (1) to 100% of employer matching contributions on completion of three years of service; or (2) in accordance with the following schedule:</p> <table data-bbox="954 982 1398 1241"> <thead> <tr> <th><u>Years of Service</u></th> <th><u>Nonforfeitable Percentage</u></th> </tr> </thead> <tbody> <tr> <td>2</td> <td>20%</td> </tr> <tr> <td>3</td> <td>40%</td> </tr> <tr> <td>4</td> <td>60%</td> </tr> <tr> <td>5</td> <td>80%</td> </tr> <tr> <td>6</td> <td>100%</td> </tr> </tbody> </table> <p>(Vesting rules would be effective for contributions made after June 30, 2006.)</p> <p><i>2006 Code would provide faster vesting than ERISA for employer contributions other than matching contributions. Depending on current vesting provisions, a plan may be required to be amended to comply with these rules.</i></p>	<u>Years of Service</u>	<u>Nonforfeitable Percentage</u>	2	20%	3	40%	4	60%	5	80%	6	100%
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Definition of Compensation	Amount taken into account under the plan in calculating the elective contribution that may be made on behalf of the employee. (PR Code Regulations)	<p>Compensation received from the employer during the year, including any pre-tax contributions made to a Puerto Rico qualified plan.</p> <p><i>Depending on the current language used for the definition of compensation in the plan document, plans may be required to be amended to comply with the new definition.</i></p>
Participant's Rights Upon Merger or Consolidation	None	<p>Plan must provide that if the plan merges or consolidates with another plan, participants will be entitled to termination benefits after the merger or consolidation at least equal to the pre-merger or pre-consolidation termination benefits.</p> <p><i>Most plans already provide these rules since they are similar to the requirements under ERISA.</i></p>

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If you have any questions or comments, or wish additional information regarding these matters, please contact any of the attorneys listed below, members of our Employee Benefits Practice Group:

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