

## **MEMORANDUM TO CLIENTS AND FRIENDS**

May 18, 2006

### **Retirement Plans Update - Part IV**

#### **As Expected, Governor Signs Into Law H.R. Bills 2596 and 919, Lowering Tax Rates on Lump-Sum Distributions, Allowing for Pre-Payment of Taxes and Incorporating Catch-up Contributions**

As we had anticipated last week in our memorandum to Clients and Friends (Tax 2006-04), the Governor of Puerto Rico signed into law House of Representatives Bills Nos. 919 and 2596 (now Act No. 92 of May 16, 2006 and Act No. 87 of May 13, 2006, respectively). These acts amend the Puerto Rico Internal Revenue Code of 1994, as amended (the "PR Code") to: (i) lower the tax rate for distributions from Puerto Rico individual retirement accounts ("IRAs") and lump-sum distributions from Puerto Rico qualified plans ("Plans") received during a six-month period; (ii) allow during the same time period the pre-payment of the applicable tax on accumulated and undistributed amounts in IRAs and Plans; and (iii) incorporate provisions for Catch-up Contributions.

#### **I. Act No. 87 of May 13, 2006 ("Act 87")**

##### **A. Retirement Plans**

Act 87 amends the PR Code to lower the tax rate applicable to lump-sum distributions on account of separation from service<sup>1</sup> received from May 16 to November 15, 2006 (the "Window

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<sup>1</sup> Based on the language of Act 87, it would appear that the 5% tax rate would be applicable not only to lump-sum distributions on account of separation of service, but also to all other types of distributions (e.g., hardship distributions, age over 59½ distributions, deemed distributions in loan defaults, and earnings component on distribution of after-tax contributions). Also, it seems that Act 87 would allow a participant, while in-service, to receive total or partial distributions from the participant's account since Act 87 provides that distributions received during the Window Period are deemed to be on account of separation from service. However, based on informal conversations with PR Treasury officials, it appears that: (i) the 5% tax rate is only applicable to lump-sum distributions on account of separation from service, and (ii) in-service distributions under Act 87 would only be allowed for the pre-payment of the 5% tax. Specific guidance from the PR Treasury is expected during the coming days.

Period”) to a 5% tax rate, without regards as to the location of the trust funding the Plan.<sup>2 & 3</sup> It is worth mentioning that Act 87 does not modify the 12.5% and 20% tax withholding rates applicable to lump-sum distributions on account of separation of service from Plans that are funded through a trust with a situs in Puerto Rico or the U.S., respectively.

In addition, Act 87 allows a participant to elect to pre-pay the 5% tax on all or part of his/her accumulated and undistributed balances under a Plan. Based on its vague language, it appears that Act 87 allows for the pre-payment of the 5% tax with assets from the participant’s account in a Plan. The amount distributed from the Plan for the pre-payment of the tax would be considered a distribution on account of separation from service and would not be subject to tax at the time of distribution. The participants’ tax basis on his/her Plan account would be increased by the amount for which the participant elected to pre-pay the tax (i.e., amount would be re-characterized as an after-tax contribution), so that upon subsequent distribution only the earnings and accretions accumulated after the pre-payment of the 5% tax would be subject to taxation at the then applicable tax rates for Plan distributions.

We understand that Plans that do not provide for after-tax contributions would have to be amended to allow for the re-characterization of amounts for which the participant elects to pre-pay the 5% tax. In addition, it is possible that Plans may have to be amended to allow for the distribution of the amount required to pre-pay the 5% tax.<sup>4</sup> It remains unclear if and how the provisions of Act 87 will apply to defined benefits plans.<sup>5</sup>

## **B. IRAs**

Act 87 amends the PR Code to lower the tax rate applicable to distributions from IRAs not to exceed \$50,000<sup>6</sup> per owner or beneficiary and received during the Window Period to a 5% tax rate in lieu of any other tax imposed by the PR Code. Said distribution will not be subject to the 10% penalty for withdrawals by individuals under 60 years of age and the 5% tax must be withheld by the

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<sup>2</sup> Act 49 of January 30, 2006 (“Act 49”), amended the PR Code to provide 12.5% or 20% tax rates for lump-sum distributions on account of separation from service depending on certain requirements, including the location of the trust that is funding the Plan. (See our Memorandum to Clients Tax 2006-03 for a description of the provisions of Act 49.)

<sup>3</sup> This is not applicable for “dual-qualified” Plans (i.e., qualified both under the PR Code and the U.S. Code) since the provisions of Act 87 do not constitute a distributable event under the U.S. Code.

<sup>4</sup> Dual-qualified Plans may not be amended for such purposes since the pre-payment of Puerto Rico taxes is not a distributable event under the U.S. Code.

<sup>5</sup> Further guidance with respect to the issues we have raised in this section is expected in the near future from the Puerto Rico Department of the Treasury or through technical amendments to Act 87.

<sup>6</sup> Act 87 incorporates an amendment by the Senate to increase the limitation to \$50,000 from the \$20,000 originally provided by H.R. 2596

financial institution. Any distribution in excess of the \$50,000 cap will be taxed at the applicable tax rates

Act 87 also allow, during the Window Period, the pre-payment at a 5% tax rate of all or part of the accumulated and undistributed amounts in the IRAs. In such cases, the taxpayer's tax basis in the IRA would be increased by the amount for which the 5% tax was prepaid, so that upon the subsequent distribution only the earnings and accretions accumulated after the pre-payment would be subject to taxation at the then applicable tax rate for distributions from IRAs.

**II. Act No. 92 of May 16, 2006 ("Act 92")**

Act 92 allows for additional annual pre-tax contributions to Plans by participants who have reached age 50 at the end of the calendar year ("Catch-up Contributions"). Catch-up Contributions would be limited to \$500 for calendar year 2006, and 1,000 per year for calendar years after 2006,<sup>7</sup> and may be matched by employer contributions. Further, Catch-up Contributions would have no impact on the actual deferral percentage ("ADP") test for the year in which they are made.

Puerto Rico-only qualified Plans and dual-qualified Plans must be amended to prospectively allow Catch-up Contributions for participants age 50 or older.

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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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<sup>7</sup> This a correction to H.R. 919 which provided a that the maximum catch-up contributions were \$500 for calendar year 2005 and \$1,000 for calendar year 2006 and thereafter.