



MEMORANDUM TO CLIENTS AND FRIENDS

May 31, 2006

Retirement Plans Update - Part VI

H.R. 2710 Would Amend Act 87 to Change Window Period for Special Lower Tax Rate on Plan and IRA Distributions and Pre-Payment of Taxes and to Clarify Other Provisions

As we had anticipated in our Memorandum to Clients and Friends (Tax 2006-05), House of Representatives Bill 2710 ("H.R. 2710") was filed last week to amend Act 87 of May 13, 2006 ("Act 87"), which was enacted to: (i) lower the tax rate for lump-sum distributions from Puerto Rico qualified plans ("Plans") and distributions from Puerto Rico individual retirement accounts ("IRAs"), received during a six-month period; and, (ii) allow during the same time period the pre-payment of the applicable tax on accumulated and undistributed amounts in Plans and IRAs.¹

A. Retirement Plans

H.R. 2710 would amend Act 87 to change the "Window Period" for the special tax rate applicable to lump-sum distributions on account of separation from service² from a Plan received from June 1 to November 30, 2006,³ without regards as to the location of the trust funding the Plan.⁴ In addition, H.R. 2710 would provide that distributions on account of separation from service received during the Window Period would be subject to a 5% tax withholding instead of the 12.5% or 20% tax withholding generally applicable under Section 1165(b)(3) of the Puerto Rico Internal Revenue Code of 1994, as amended (the "PR Code").

¹ H.R. 2710 also intends to amend Act 41 of August 1, 2005, and Act 89 of May 13, 2006, concerning the Additional Contribution for Corporations and Partnerships. A discussion of these proposed amendments is out of the scope of this memorandum.

² Under Act 87, it was reasonable to conclude that the 5% special tax rate would also be applicable 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). H.R. 2710 clarifies that the 5% tax rate is only applicable to lump-sum distributions on account of separation of service received during the Window Period

³ Originally under Act 87, the Window Period was from May 16 to November 15, 2006.

⁴ 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.)



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. Pursuant to H.R. 2710, the participant must complete a form to be made available by the Puerto Rico Treasury Department (the “PR Treasury”) and pay the amount of the tax pre-payment in any PR Treasury Collector’s Office. We understand it is the PR Treasury’s position that H.R. 2710 would not provide for the pre-payment of the 5% tax with assets from the participant’s account in a Plan.⁵ The participants’s tax basis on his/her Plan account would be increased by the amount for which the participant elected to pre-pay the tax, 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 may have to be amended to allow for the re-characterization of amounts for which the participant elects to pre-pay the 5% tax in order to easily account for the pre-payment of the tax at the time of distribution.

B. IRAs

Act 87 amended the PR Code to lower the tax rate applicable to distributions from IRAs not to exceed \$50,000 per owner or beneficiary⁶ and received during the Window Period⁷ 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 financial institution sponsoring the IRA.⁸ Any distribution in excess of the \$50,000 cap will be taxed at the applicable tax rates and will be subject to the 10% penalty for withdrawals by individuals under 60 years of age.

Act 87 also allows, 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. To do so, the participant must complete a form to be made available by the PR Treasury and pay the amount of the tax pre-payment in any PR Treasury Collector’s Office. 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

⁵ In the days following the date this memorandum was issued, the PR Treasury will be issuing regulations that should provide additional guidance on the application of Act 87 and H.R. 2710.

⁶ H.R. 2710 clarifies that in the case of married persons, the \$50,000 limit would apply separately to each spouse.

⁷ As mentioned above, the Window Period would be changed by H.R. 2710 to June 1 to November 30, 2006.

⁸ On or before the tenth day of the month following the date of distribution, the financial institution must deposit the tax withheld with the PR Treasury Collector’s Office.



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. Notwithstanding, H.R. 2710 specifically provides that distributions of amounts for which the tax has been pre-paid would be subject to the 10% penalty if distributed to individuals under 60 years of age.

It is important to note that the provisions of H.R. 2710 may be modified before its approval by the Puerto Rico Legislative Assembly and the Governor. As always, we will keep you informed about any developments in the retirement plans practice.

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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:

Juan Luis Alonso	787-250-5655	jla@mcvpr.com
Roberto L. Cabañas	787-250-5611	rlc@mcvpr.com
José M. Falcón	787-250-2603	jmf@mcvpr.com
Yamary González	787-250-5687	yg@mcvpr.com
Xenia Vélez Silva	787-250-2620	xv@mcvpr.com

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