

MEMORANDUM TO CLIENTS AND FRIENDS

February 13, 2006

Retirement Plans Update - Part II
New Act Amends (Again!) PR Code Section 1165

Although the Puerto Rico Legislative Assembly is currently evaluating the Governor of Puerto Rico's proposed Tax Reform,¹ on January 30, 2006, the Governor signed into law House Bill No. 1548 (now Act No. 49 of January 30, 2006, and hereinafter, "Act 49"), which once again amends Section 1165 of the Puerto Rico Internal Revenue Code of 1994, as amended ("PR Code"), that is, the provisions regulating qualified retirement plans in Puerto Rico.

I. Elimination of Requirements of a Puerto Rico Trust and a Puerto Rico Trustee

Act No. 404 of September 22, 2004 ("Act 404") amended the PR Code to require that trusts funding Puerto Rico qualified retirement plans be established pursuant to the laws of Puerto Rico ("PR Trust") and that the trustee of such trust be a resident of Puerto Rico ("PR Trustee"). For such purposes, a PR Trustee is a trustee that is a Puerto Rico corporation or a foreign corporation engaged in trade or business in Puerto Rico. However, Act 49 expressly eliminates such requirement. Consequently, plans that are qualified under PR Code Section 1165 may be funded through a PR Trust or a trust with a situs in the U.S. ("US Trust"), and the trustee of such trust may be a resident of Puerto Rico or the U.S.²

II. Changes in Income and Withholding Tax Rates On Certain Lump-Sum Distributions**A. New General Income Tax Rate of 20% on Lump-Sum Distributions**

Act No. 40 of August 1, 2005 ("Act 40"), amended the PR Code to establish a single long-term capital gains tax rate for individuals, resulting in a tax rate of 12.5% for qualified plans lump-sum distributions on account of separation from service ("lump-sum

¹ See our Memoranda to Clients and Friends 2006-01 and 2006-02 for a discussion of the proposed Tax Reform. In Memorandum 2006-02, we discuss the proposed changes to retirement plans provisions of the PR Code.

² Although it eliminates the requirement of a PR Trust and a PR Trustee, Act 49 provides a lower tax rate on certain distributions from PR Trusts and certain US Trusts. See Section II.B below.

distributions”) received after December 31, 2005. However, Act 49 amends the PR Code once again to establish a general rule for the taxation of lump-sum distributions. Effective January 30, 2006, lump-sum distributions will be taxed at a special rate of 20%, unless the distribution qualifies for a 12.5% tax rate, as described below.

B. Special 12.5% Income Tax Rate on Certain Lump-Sum Distributions

Act 49 provides a 12.5% tax rate on lump-sum distributions if the following requirements are met:

1. The trust funding the plan is a PR Trust, or the plan is funded through a US Trust that has a trustee who is a resident of Puerto Rico acting as the paying agent (“PR Trustee/Agent”)³ for the trust; and
2. During the plan year of the distribution and the two prior years, an average of not less than 10% of the plan assets have been invested in either: (i) “property located in Puerto Rico”, as defined in PR Code 1014(e)(3); (ii) stock or participations in Puerto Rico registered investment companies; or (iii) any other property classified as “property located in Puerto Rico” by the Secretary of the Treasury in a regulation or circular letter (“Investment Requirement”).⁴ In the case of plans with participant-directed accounts, a participant may comply with the Investment Requirement only with respect to his/her individual account. The Secretary may prescribe how to meet the Investment Requirement by regulation, circular letter or administrative determination. **The Investment Requirement is not applicable for distributions received on or before December 31, 2007.**

³ Although Act 49 does not define who could be a PR Trustee/Agent, it would be reasonable to conclude that the PR Treasury will follow the definition used in Act 404 (i.e., a financial institution regulated by the Puerto Rico Commissioner of Financial Institutions).

⁴ Note that PR Code Section 1014(e)(3) was deleted by Act 40. Accordingly, the meaning of “property located in Puerto Rico” it is currently unclear for purposes of the special 12.5% rate. Under former PR Code Section 1014(e)(3), the term “property located in Puerto Rico” included: (a) real property located in Puerto Rico; (b) stock and participations in a Puerto Rico corporation or partnership; (c) stock and participations in foreign corporations and partnerships operating in Puerto Rico, if certain conditions are met; (d) bonds, notes or other debt obligations issued by: (i) the Commonwealth of Puerto Rico; (ii) the municipalities of the Commonwealth of Puerto Rico; or (iii) the authorities or public corporations of the Commonwealth of Puerto Rico and its municipalities; (e) bonds, notes or other debt obligations of an individual resident of Puerto Rico, of a Puerto Rico corporation or partnership, or collateralized with real property located in Puerto Rico; and (f) bonds, notes or other debt obligations of foreign corporations and partnerships operating in Puerto Rico, if certain conditions are met. As of the date of this memorandum, the Puerto Rico Treasury Department has not issued any guidelines on this matter.

C. Withholding Tax Rates on Lump-Sum Distributions

Although Act 49 maintains the general 20% withholding rate on lump-sum distributions, it also provides for a special 12.5% withholding rate for distributions from a PR Trust (or from a US Trust with a PR Trustee/Agent) that has complied with the Investment Requirement described in Section II.B above.⁵ In order for the lower withholding rate to apply, the employer or the plan administrator must certify to the payor that the plan complied with the Investment Requirement. Once the payor receives the certification, it will be responsible for the withholding of the 12.5%, but the payor will not be responsible for the payment of any tax, interest and penalties in case the plan did not comply with the Investment Requirement.

D. Summary of Income and Withholding Rates for Lump-Sum Distributions

Based on the foregoing:

1. From January 30, 2006 to December 31, 2007, all lump-sum distributions paid out of a PR Trust (or a US Trust with a PR Trustee/Agent) will be subject to the special 12.5% income and withholding tax rates.
2. Effective January 1, 2008, lump-sum distributions paid out of a PR Trust (or a US Trust with a PR Trustee/Agent) will be subject to the special 12.5% income and withholding tax rates only if the employer or the plan administrator has certified to the payor that the plan complied with the Investment Requirement.
3. Effective January 1, 2008, lump-sum distributions paid out of a PR Trust (or a US Trust with a PR Trustee/Agent) will be subject to the general 20% income and withholding tax rates if the plan has not complied with the Investment Requirement.
4. Effective January 30, 2006, lump-sum distributions paid out of a US Trust with no PR Trustee/Agent will be subject to the general 20% income and withholding tax rates.

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⁵ Note that, as mentioned above, the Investment Requirement is not applicable for distributions received on or before December 31, 2007.

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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