

February 9, 2011 [www.mcvpr.com](http://www.mcvpr.com)**TAX ALERT*****RETIREMENT PLANS SIGNIFICANTLY IMPACTED  
BY THE 2011 PUERTO RICO INTERNAL REVENUE CODE***

Act No. 1 of January 31, 2011 establishes a new Puerto Rico Internal Revenue Code ("2011 Code") and repeals the Puerto Rico Internal Revenue Code of 1994, as amended ("1994 Code") almost in its entirety. Section 1081.01 of the 2011 Code (former Section 1165) contains new rules governing retirement plans intended to be qualified in Puerto Rico, many of which track similar provisions in the U.S. Internal Revenue Code of 1986, as amended ("US Code").

Section 1081.01 is generally effective January 1, 2011, although some provisions will be effective for taxable years beginning on or after January 1, 2012. Among the most significant changes are the following:

- **Qualification Requirements – Section 1081.01(a) (former Section 1165(a)):**
  - ABP Test – Special Rule – The 2011 Code contains special rules for meeting the Average Benefit Percentage Test in the case of mergers and acquisitions which are similar to those in US Code Section 410(b)(6)(C).
  - Annual Benefit and Contribution Limits (415 Limitations) – For taxable years beginning on or after January 1, 2012, new annual benefit and contribution limits are imposed for defined contribution and defined benefit plans. Although this new provision is similar to US Code Sections 415(b) and (c), the 2011 Code does not provide for cost of living adjustments.
  - Annual Compensation Limits – For taxable years beginning on or after January 1, 2012, a new annual compensation limit is imposed. Although this new provision is similar to US Code Section 401(a)(17), the 2011 Code does not provide for cost of living adjustments, except for plans that are qualified under the 2011 Code and the US Code ("Dual Qualified Plans"), in which case the plan must comply with US Code limits.
  - Determination Letters – For taxable years beginning on or after January 1, 2012, retirement plans intended to be qualified under the 2011 Code must request and obtain a favorable determination letter as to the qualified status of the plan. The request must be filed no later than the plan sponsor's deadline (including any extension) to file its income tax return with the Puerto Rico Treasury Department ("PR Treasury") for the year in which the plan began to cover Puerto Rico residents.

- Controlled Group / Affiliated Group Provisions – For purposes of the qualification requirements of Section 1081.01(a) and the cash or deferred provisions of Section 1081.01(d) (including non-discrimination provisions), the employees of all corporations, partnerships or other entities that are members of a Controlled Group (as defined in Section 1010.04 of the 2011 Code) or of an Affiliated Service Group (as defined in Section 1081.01(a)(14)(B)) shall be deemed employees of the same employer.
  
- **Taxation of Plan Distributions – Section 1081.01(b) (former Section 1165(b)):**
  - Special 20% Tax Rate for Lump-Sum Distributions – The special 20% tax withholding and taxation rate previously applicable only to lump-sum distributions on account of separation from service is now also applicable to lump-sum distributions due to a plan termination.
  - Special 10% Tax Rate for Lump-Sum Distributions that Meet the Puerto Rico Property Investment Requirement – In the case of distributions that are subject to a 10% withholding and tax rate because the plan or account of the participant is invested at least 10% in Puerto Rico property, compliance with the investment requirement is now to be calculated on the average daily balance, and the look-back period to determine if the 3-year investment period is met will consider years in which the participant's assets were invested in a transferor plan.
  - Withholdings Applicable to Other Distributions – Distributions other than lump-sum distributions or participant loans are subject to a 10% withholding to any part of the distribution not previously subject to taxation.
  - Sponsor's Withholding Obligation – The employer sponsoring the plan is jointly responsible for the paying or withholding agent's withholding and reporting obligations.
  
- **Cash or Deferred Arrangements (“CODA”) – Section 1081.01(d) (former Section 1165(e)):**
  - Highly Compensated Employee – Section 1081.01(d) contains a new definition of a Highly Compensated Employee, closely following its US Code counterpart. Dual Qualified CODA plans will, however, follow the compensation limits of US Code Section 414(q)(1)(B).
  - 10% Tax for Failure to Correct Excess Contributions – A 10% tax will be imposed on the employer if a plan does not correct excess contributions prior to the plan sponsor's deadline to file its income tax return with the PR Treasury, including any extension of time granted for the filing of the return.
  - Elective Deferrals Limits – The amount of pre-tax contributions to a CODA plan are capped at \$10,000 for the year 2011; \$13,000 for the year 2012 and \$15,000 for the years 2013 and beyond. The applicable elective deferral limit under the US Code will apply to Dual-Qualified Plans.
  - Catch-up Contributions – The amount of “catch-up” contributions for the year 2011 will remain at \$1,000, but will increase to \$1,500 for the years 2012 and thereafter.

- **Deductibility of Contributions – Section 1033.09 (former Section 1023(n)):**
  - Defined Contribution Plans – Contributions to profit sharing and stock bonus plans can be deducted up to 25% (increased from 15%) of the paid or accrued compensation of all employees participating in the plan.
  - Defined Benefit Plans – The employer may take a deduction of the full amount required by the Employee Retirement Income Security Act of 1974 (ERISA) to be contributed to the plan in order to maintain the plan's funded status.
  - 10% Tax for Non-Deductible Contributions – A 10% tax will be imposed on non-deductible contributions made by the employer to a qualified plan.

Regulations issued by the PR Treasury under Sections 1023(n) and 1165 of the 1994 Code will continue to govern the interpretation of identical provisions in Sections 1081.01 and 1033.09 of the 2011 Code, until new regulations are issued.

Plan Sponsors should revise the plan documents and summary plan descriptions for retirement plans offered to PR employees to ensure compliance with 2011 Code provisions.

For updates on this matter, you may contact the following attorneys, members of our [Employee Benefits Practice Team](#):

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