

Retirement and Welfare Plans: Recent Trends and What to Expect

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Background

- On January 31, 2011, the Governor of Puerto Rico signed into law Act No. 1 of January 31, 2011 adopting the Internal Revenue Code for a New Puerto Rico to be effective as of January 1, 2011 (the “2011 PR Code”).
- Act No. 232 of December 10, 2011 introduced technical corrections to the Internal Revenue Code for a New Puerto Rico.
- On December 16, 2011, the Puerto Rico Treasury Department issued Circular Letter 11-10 to provide guidance on the procedure to obtain a favorable determination letter under the 2011 PR Code, including specific dates by which the amendments need to be adopted and plans submitted for qualification.

Changes Incorporated by the 2011 PR Code and the Technical Amendments

Limits on Annual Benefits and Contributions

- Effective for taxable years commencing on or after January 1, 2012

-Defined Benefit Plans

In the case of a defined benefit plan, the annual benefit, when expressed as a benefit payable annually in the form of a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and does not accept rollover contributions cannot exceed the lesser of: (i) the limit applicable under Section 415(b) of the US Code; or (ii) 100% of the average annual compensation for a period of no more than 3 consecutive years during which the compensation paid was the highest.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

-Defined Contribution Plans

In the case of a defined contribution plan, the 2011 PR Code was amended to provide that the annual employee and employer contributions (excluding rollovers made from other qualified plans) cannot exceed the lesser of: (i) the limit applicable during such taxable year under Section 415(c) of the US Code; or (ii) 100% of the participant's compensation during the calendar year or plan year, as selected by the employer.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Annual Compensation Limit

- The Technical Amendments amended the annual compensation limit under the 2011 PR Code to replace \$245,000 with reference to US IRC Section 401(a)(17).
- Annual Compensation limit is effective on January 1, 2012.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

New Definition of Highly Compensated Employee

- Act No. 232 amended the definition of highly compensated employee ("HCE") to include any employee that is: (i) an officer of the participating employer, (ii) owns more than five percent (5%) of the voting shares or the total value of all classes of shares of the participating employer, (iii) owns more than five percent (5%) of the capital or interest in the profits of the employer when such entity is not a corporation; or (iv) an employee who for the prior year received compensation in excess of the applicable limits for such year established under Section 414(q)(1)(B) of the US Code.
- The Technical Amendments made the new definition of HCE more similar to US IRC definition of HCE.
- The new definition is effective January 1, 2011.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Mandatory Aggregation Rules

- The 2011 PR Code requires that for purposes of coverage and discrimination testing employees of controlled group companies or affiliated service groups need to be aggregated.
- Technical Amendments clarified that the new aggregation rules are effective January 1, 2012 and the same will apply only with respect to participating employers with employees that are bona-fide residents of Puerto Rico.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Taxation of Total Distributions

- Under the 1994 Code, only total distributions paid within a single taxable year due to separation from service qualified for the special tax of 20%. Under the 2011 PR Code, total distributions made as a result of the plan's termination will also qualify for the 20% capital gain tax rate.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

New 10% Withholding Requirement

- 2011 PR Code requires a 10% withholding on all in-service taxable distributions and partial distributions and annuities due to a participant's separation from service
- Technical Amendments clarified that in the case of annuity or installments due to separation from service, the 10% tax withholding will only apply to the amounts in excess of:

Taxable YearAmounts not subject to Withholding

Participant less than 60 years of age
Participant 60 years of age or more

2011	\$19,500	\$23,500
2012	\$21,000	\$25,000
2013	\$23,500	\$27,500
2014	\$26,500	\$30,500
2015	\$31,000	\$35,000

- Technical Amendments clarified that the 10% withholding will not apply to partial distributions that are rollovered.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Calculation of 10% PR Investment Requirement For Purposes of the 10% Tax Withholding Rate on Lump-Sum Distributions

- Must be calculated based on the average balance of the investment of the trust during the plan year in which the distribution is made and each of the preceding two (2) years.
- Plan document must contain the PR investment rules to take advantage of the reduced 10% tax rate.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Catch-Up Contributions

The Technical Amendments amended the 2011 PR Code to allow federal government employees to make catch-up contributions up to the limits provided under Section 414(v) of the US IRC.

- In the case of employees that participate in 2 or more plans, such plans will be treated as one for purposes of determining the catch-up contribution limits.
- Limit is \$1,500 for year 2012.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Loans

- Plan must include language describing loan requirements.
- Technical Amendments provide that effective January 1, 2011 a loan that does **NOT** meet the following requirements will be treated as a taxable distribution subject to 10% withholding.
 - (i) The loan, by its terms and its operation, must be repaid, at least quarterly, by means of partial payments that are substantially similar; and
 - (ii) The loan, by its terms and its operation, must be repaid in a term not exceeding five (5) years. In the case of loans to finance the purchase of the participant's principal residence, the same must be repaid within the period of time provided in the plan.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Pre-Tax Contribution Limit

- 2011: \$10,000
2012: \$13,000
2013 and thereafter: \$15,000
- US Code limit 402(g) applies to dual qualified plans, but combined elective deferrals and IRA contributions may not exceed the combined PR deferral and IRA limits.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

After-Tax Contributions

- Plan must state after-tax contributions limitation: 10% of the aggregate compensation of the employee for all the years he/she was a participant.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Rollovers

- The Technical Amendments amended the 2011 PR Code to allow a participant to **elect** to rollover a portion of the total distribution or the total distribution received on account from separation from service.
- Effective January 1, 2011.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Responsibility of Employer

- Under the 2011 PR Code the employer sponsoring the plan is jointly liable with the withholding or paying agent for the amounts not withheld and for which the plan participant failed to pay the corresponding income tax.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Imposition of Tax for Failure to Make Corrections of Excess Contributions ("ADP Failure")

- Under the 2011 PR Code failure to correct excess contributions no later than the last day to file the Puerto Rico income tax return of the employer that sponsors the plan for the taxable year of the employer in which the excess contributions were made, including any extensions granted, will result in the imposition of a tax equal to 10% of the excess contributions that were not corrected.
- Require annual testing and corrections.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

Increased Deduction in Plan Contributions

- Profit Sharing Plans and Stock Bonus Plans:
 - Increased from 15% to 25% of compensation.
- Defined Benefit Plans:
 - The employer may include the amount contributed to meet the funding requirements of ERISA.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

- New Rule: 10% tax on the amount of non-deductible contributions that the employer makes to a qualified plan in P.R.
- Will apply even if the amount of the non-deductible contribution is not claimed as a deduction in the income tax return of the employer.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

- Circular Letter No. 11-10 provides detailed rules on the procedures related to the implementation of the new qualification requirements under the 2011 PR Code. The most important deadlines are the following:
 - Plan amendments must be adopted on or before the last day of the plan year beginning on or after January 1, 2012. For calendar year plans, this means December 31, 2012.
 - The amendments must be filed with PR Treasury on or before the last day on which the employer that maintains the plan is to file its Puerto Rico income tax return (including extensions) for the first year that begins on or after January 1, 2012. For calendar year employers, that means April 15, 2013 (July 15, 2013 with extension).

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

- Required tax qualification amendments include:
 - (i) HCE definition;
 - (ii) Limits on annual benefits contributions and compensation;
 - (iii) New controlled group rules; and
 - (iv) Tax free rollover.
- If a plan does not file a petition for a favorable determination letter under the 2011 PR Code, the plan will be deemed a non-qualified retirement plan under the 2011 PR Code.

Changes Incorporated by the 2011 PR Code and the Technical Amendments (Cont'd.)

- Establishes the rules to allow employers that have PR qualified plans that are subject to ERISA to comply with their obligation to file an annual informative return by filing Form 480.7(OE) or Form 5500 or 5500 SF.
- For taxable years commencing on or after January 1, 2011 those plans that are:
 - 1) Subject to Title I of ERISA, and
 - 2) have been submitted to qualification in PR under Section 1081.01(a) of the 2011 PR Code or Section 1165(a) of the 1994 PR Code.

will be able to comply with their obligation to file an annual informative return by filing Form 480.7(OE) or an exact copy of Form 5500 or 5500 SF. If elect to file Form 5500 or 5500 SF, the plan must complete page 1 of Form 480.7(OE) and attach a copy of Form 5500 or 5500 SF.

- Once the plan elects to file Form 5500 or 5500 SF, it must require authorization from PR Treasury to change.

What to Expect During 2012

- Increase in establishments of Puerto Rico only qualified plans.
 - Revenue Ruling 2008-40, as amended by Revenue Ruling 2011-1 and IRS Notice 2012-4.
- Continue freeze of defined benefit plans and more employers shifting to defined contribution plans (i.e. profit-sharing, cash or deferred arrangements).
 - Mercer survey shows pension plans pose a significant risk issue to employers ("Redefining Pension Risk Management in a Volatile Economy").

What to Expect During 2012

(Cont'd.)

- Some employers that have seen an improvement in their finances are re-establishing company matching contributions or employer contributions that were suspended due to a poor economy.
- Many employers considering termination of medical benefits to retirees in order to reduce costs.
 - Must evaluate employer liability.
- U.S. Supreme Court will determine constitutionality of Health Care Law.

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