Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

Qualified Pension Plans for Puerto Rico Employees– The Perfect Storm Has Arrived

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Over the past few years, a number of law changes have impacted the coverage of Puerto Rico employees in U.S. tax-qualified pension plans. Today, these law changes come together to create the perfect storm—creating new challenges in finding the right retirement vehicle to provide tax-favored pension benefits to bona fide Puerto Rico employees. The elements of the "perfect storm" are described below:

- Rev. Proc. 2004-37,[1] which provides a safe-harbor method for determining the U.S.-sourced portion of a distribution under a defined benefit plan and reaffirms the need for all plans to track the U.S. and Puerto Rico portion of a plan distribution
- Rev. Rul. 2008-40[2] and Rev. Rul. 2011-1,[3] which provide for transition relief to avoid taxation for a spin-off of a U.S. qualified plan to a Puerto Rico qualified plan (including transition relief for participation in a 81-100 group trust)
- 2011 Puerto Rico Code, which provides an expanded set of tax qualification and related provisions for *bona fide* Puerto Rico employees.

The combination of these changes has led to a new appreciation for these complex rules, and the need for plan sponsors to act carefully to preserve the tax-favored treatment of their plans and appropriately account for Puerto Rico employees. Plans that fail to properly take into account these three provisions may inadvertently cause taxation to Puerto Rico employees, raise tax-qualification concerns, and in the United States, where there is an increased audit focus on international benefits, one should tread carefully through these waters.

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I. Rev. Proc. 2004-37

First, the IRS issued Rev. Proc. 2004-37, which provides guidance for determining which portion of the pension payments is taxable in the United States for Puerto Rico employees.

As background, a *bona fide* Puerto Rico resident is generally taxed in the United States on his or her worldwide income. However, a *bona fide* Puerto Rico resident is not taxed in the United States on its Puerto Rico sourced income pursuant to Code Sec. 933. For U.S. qualified plans, this means that the contributions attributable to service performed in Puerto Rico are Puerto Rico sourced, and the earnings attributable to assets held in a United States trust are treated as U.S.-sourced income. For a defined contribution plan, this involves tracking where services are performed, and treating the plan earnings as U.S.-sourced and subject to U.S. taxation. For a defined benefit plan, it is difficult to ascertain which contributions/earnings are attributable to a plan distribution. Therefore, Rev. Proc. 2004-37 provides a safe-harbor method to determine the portion of the distribution that is Puerto Rico–sourced and not subject to U.S. taxation.

The applicable steps to follow to make this determination are set forth below:

Step 1: Determine Total Contributions. Total Contributions = Present Value of Benefit x Table I factor (based on number of years from first date became a participant until ASD) x number of years from first date became a participant until ASD

The "Present Value of Benefit" is determined as follows, based on the form of payment that commences at the annuity starting date ("ASD"):

- Straight life annuity: amount payable annually x Table II factor (based on the payee's age at ASD)
- Lump-sum payment: amount of the lump-sum payment
- Other forms: actuarial present value of the pension, determined on the ASD based on a seven-percent rate of interest and the applicable mortality table.

Step 2: Allocate Total Contributions between Foreign and U.S. Source. The portion of each payment that is deemed to be attributable to contributions for services outside the U.S. = [Step 1 x (months of service credited under the plan that were performed outside the U.S./total month of service credited under the plan as of the ASD)]/ Present Value of Benefit

However, if the employee made after-tax contributions to the plan, the following formula applies: [(Step 1—total employee after-tax contributions) x (months of service credited under the plan that were performed outside the U.S./total month of service credited under the plan as of the ASD)]/ (Present Value of Benefit—total employee after-tax contributions)

Step 3: Determine Taxable Payment. Taxable Payment = (1 – Step 2) x (total payment—after-tax contributions allocated to such payment). This amount represents the earnings and any contributions attributable to U.S. services.

Step 4: For Puerto Rico residents, Step 3 is subject to the regular U.S. withholding rules, and reported on Form 1099-R. (In addition, Puerto Rico withholding may apply.) The remainder of the payment is Puerto Rico–sourced and exempt from U.S. taxation (and reporting) under Code Sec. 933(1); however, Puerto Rico reporting may be required.

For example, P (a *bona fide* Puerto Rico resident) worked 10 years in the United States and the remainder in Puerto Rico. He is retiring at age 65 after 30 years of service in the plan. His benefit is $2,500 a month (all employer funded), payable as a straight life annuity.

Step 1: [$2,500/month x 12 months x 10.06 (Table II factor)] x 0.0106 (Table I factor) x 30 = $95,972

Step 2: [$95,972 x ((20 years in Puerto Rico x 12 month)/(30 years x 12 months))] / [$2,500/ month x 12 months x 10.06] = $63,981/$301,800 = 21%

Step 3: Taxable Payment = (1 – 0.21) x $2,500 = $1,975

Step 4: Report $1,975 on Form 1099-R, subject to U.S. withholding rules (*e.g.,* voluntary wage withholding).

Conversely, if he worked entirely outside the United States, the following results:

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Step 1: $95,972 (same as above)

Step 2: ($95,972 x 100%)/ $301,800 = 32%

Step 3: (1 – 0.32) x $2,500 = $1,700 (U.S. earnings)

Step 4: Report $1,700 on Form 1099-R, subject to U.S. withholding rules (*e.g.,* voluntary wage withholding).

As these sourcing rules result in a portion of the U.S. pension payments being subject to U.S. taxation, even if all the services are performed in Puerto Rico, a number of plans were considering a spin-off to a separate Puerto Rico only qualified plan, which brings into play Rev. Rul. 2008-40 and Rev. Rul. 2011-1.

II. Rev. Rul. 2008-40 and Rev. Rul. 2011-1

Second, the IRS issued Rev. Rul. 2008-40 and Rev. Rul. 2011-1. Rev. Rul. 2008-40 held in part that a spin-off of *bona fide* Puerto Rico employees from a U.S. qualified plan to a Puerto Rico qualified plan results in a taxable distribution for the Puerto Rico employees. The ruling explained that the tax-free transfer provisions only apply to transfers between U.S. qualified plans. Importantly, the ruling provided transition relief through December 31, 2010 (which was extended through December 31, 2011, in Rev. Rul. 2011-1), to permit a tax-free transfer to the Puerto Rico plan and trust, and the benefits (and earnings) transferred were treated as entirely from Puerto Rico–sourced income. For example, this results in the earnings transferred no longer being taxable in the U.S. if paid to a *bona fide* Puerto Rico resident.

The typical approach was for the U.S. plan to receive a retroactive determination letter from the PR Treasury Department ("Hacienda"), and to transfer the funds pursuant to Rev. Rul. 2008-40 to a Puerto Rico plan and trust, and for the Puerto Rico trust to continue to participate in the 81-100 group trust or a master trust (which is similar to a 81-100 trust for related entities).

Unfortunately, a September 14, 2010, letter from IRS to Sen. Arlen Spector (R-PA) suggested that Puerto Rico plans may not pool their assets with domestic trusts, contra to a number of IRS letter rulings that reached the opposite conclusion. And in Rev. Rul. 2011-1, the IRS indicated that it is considering the correct approach and in the meantime provided transition relief—these Puerto Rico trusts can participate in group trusts if they were participating as of January 10, 2011, or resulted from a spin-off from a U.S. trust made in response to the transition relief in Rev. Rul. 2008-40. We are still waiting for a final decision from the IRS on this issue.

III. New Puerto Rico Code

Third, a new Puerto Rico Code (hereinafter, "PR §") was issued effective January 1, 2011, that includes a number of significant changes for tax-qualified plans that cover Puerto Rico employees (whether these employees are covered by a dual-qualified plan or a Puerto Rico only plan). These changes, while they do not mirror the Internal Revenue Code, certainly bring the Puerto Rico laws closer to the U.S. provisions. But importantly, as they are not identical, the provisions must be carefully reviewed and applied consistently for Puerto Rico workers and the plan documentation and participant communications and forms, in addition to actual Plan operations, must accurately reflect these new provisions. The key charges are briefly summarized below:

- **Minimum Coverage Test (Code Sec. 410(b)).** Effective January 1, 2011, new PR §1081.01(a)(3) expanded on the existing coverage testing provisions that were largely similar requirements, but in practice the test results could vary, as for example, the definition of "HCE" was different. The new provision largely retains the same rules, but adds (1) an M&A relief provision similar to Code Sec. 410(b)(6)(C), and (2) control group concept for testing all related entities as a single employer, which is similar to Code Sec. 414(b), (c).
- **Nondiscrimination Testing (Code Sec. 401(a)(4)).** Effective January 1, 2011, new PR §1081.01(a)(14) expanded on the existing nondiscrimination testing provisions, which technically were the same requirements as under the Internal Revenue Code, but had completely different testing mechanics (for example, the test was a facts-and-circumstances standard). The new provision largely retains the same rules, but adds a specific reference to excluding individuals excluded under the coverage test, and applies the controlled group concept (as indicated above).
- **ADP Testing (Code Sec. 401(k)).** Effective January 1, 2011, new PR §1081.01(d) changed the definition of HCE (see below), and added a 10-percent excise tax on excess contributions for ADP testing violations. This provision is similar to Code Sec. 4979.

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- **Highly Compensated Employee (Code Sec. 414(q)).** Effective January 1, 2011, new PR §1081.01(d) changed the definition of HCE. Previously, HCEs were employees in the top one-third of the compensation scale. The new provision generally defines an HCE as an officer, a five-percent shareholder, receiving compensation over $110,000 (or for a dual qualified plan, the clone of Code Sec. 414(q)(1)(B)), or a spouse or dependent of one of the above.
- **Benefit and Contribution Limits (Code Sec. 415).** Effective January 1, 2012, new PR §1081.01(a)(11) added a benefit and contribution limit similar to Code Sec. 415. For defined benefit plans, the benefits cannot exceed the lesser of $195,000 or 100-percent high three-year compensation. For defined contribution plans, the contributions cannot exceed the lesser of $49,000 or 100 percent of compensation.
- **Annual Limit on Elective Deferrals (Code Sec. 402(g)).** Effective January 1, 2012, new PR §1081.01(d)(7) increased the annual limit for elective deferrals. For 2012, the deferral limit is $13,000 ($14,500 for age 50 or older), and for 2013 forward the limit is $15,000 ($16,500 for age 50 or older). There is no longer an offset for contributions to a PR IRA. However, for federal governmental employees, the Code Sec. 402(g) limit applies.
- **Annual Compensation Limit (Code Sec. 401(a)(17)).** Effective January 1, 2012, new PR §1081.01(a)(12) added an annual compensation limit that mirrors Code Sec. 401(a)(17), but the $245,000 limit is not indexed for a Puerto Rico only plan.
- **Rollover Distributions (Code Sec. 401(a)(31)).** Effective January 1, 2011, new PR §1081.01(b)(2) added a partial rollover distribution after severance from service.
- **Deduction Limits (Code Sec. 404).** Effective January 1, 2011, new PR §1033.09 added a defined benefit limit that is tied to the minimum funding standards set forth under Section 302(A)(2)(A) and (C) of ERISA, and increased the 15-percent limit for defined contribution plans to 25 percent.
- **Withholding on Plan Distributions (Code Sec. 3405).** Effective January 1, 2011, new PR §1081.01(b)(2) added a 10-percent withholding provision on partial distributions and in-service distributions, and 20 percent (10 percent if hold at least 10 percent of Puerto Rico assets) withholding on plan termination. Also, the paying agent is jointly liable for the withholding obligations.
- **Annual Tax Exclusion for Pension Distributions.** Effective January 1, 2011, new PR §1031.02(a)(13), the annual tax exclusion for pension distributions is $11,000 ($15,000 for a participant age 60 or older). The exclusion applies solely to amounts received on account of severance from employment in the form of an annuity or periodic payments.
- **Other Internal Revenue Code Provisions Not Added.** Importantly, the Puerto Rico Code did not add rules similar to the Code's minimum participation requirements set forth in Code Sec. 410(a)(26), top-heavy provisions set forth in Code Sec. 416; ACP testing set forth in Code Sec. 401(m) (for match and after-tax contributions), minimum funding standards set forth in Code Sec. 412 (but similar rules apply through ERISA), and minimum required distributions set forth in Code Sec. 401(a)(9).
- **Determination Letter Filing.** Effective January 1, 2012, new PR §1081.01(a)(13) added that determination letters are required to be filed by the tax filing deadline (plus extensions) for the year the plan is established. For plans that have not yet filed for a determination letter with the Hacienda, it appears that the deadline for filing a retroactive determination letter is December 31, 2011.

Endnotes

[1] Rev. Proc. 2004-37, 2004-1 CB 1099.
[2] Rev. Rul. 2008-40, IRB 2008-30.
[3] Rev. Rul. 2011-1, IRB 2011-2, 251.

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