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Update on US Tax Issues for Puerto Rico Plans

Now that it is mid-2011, it is a good idea to review where things stand with your company's dual and Puerto Rico-only qualified plans and master/group trusts. Unfortunately, many of the key US tax issues remain in limbo due to the lack of further IRS guidance.

The Master/Group Trust Issue for Puerto Rico Only Plans

As you may recall, recent IRS Rev. Rul. 2011-1 updating the group trust guidance indicated that the Service anticipates issuing further guidance as to whether a 1022(i)(1) plan (a Puerto Rico-only qualified plan) may participate in a group trust on a permanent basis. So far, there have been no further developments. But because the same ruling provides that the transition relief of Rev. Rul. 2008-40 allowing transfers from qualified trusts to Puerto Rico trusts was extended only one year, through December 31, 2011, the practical deadline for deciding what to do for a master or group trust with both US and PR plans may be the end of 2011 unless this is further extended.

(Rev. Rul. 2011-1 provides that, until such further guidance is issued, the Service will not treat a group trust as failing to satisfy the requirements of the revenue ruling merely because the group trust includes the assets of a section 1022(i)(1) plan as long as the plan (1) was participating in the group trust as of January 10, 2011, or (2) holds assets that had been held by a qualified plan immediately prior to the transfer of those assets to the section 1022(i)(1) plan pursuant to the transition relief in Rev. Rul. 2008-40, as modified by Rev. Rul. 2011-1.)

Options for Puerto Rico Qualified Only Plans with Assets Combined with US Qualified Plan Assets

If you currently have both US qualified plans and 1022(i)(1) Puerto Rico-only qualified plan assets in the same master or group trust, your options currently appear to be:

1. Rely on the transition relief of Rev. Rul. 2011-1 allowing the Puerto Rico plan assets to remain in the master or group trust - at least until further guidance is issued - or go back to having the Puerto Rico plan dual qualified, so that use of a master or group trust will remain possible. Puerto Rico employees would be at a tax disadvantage under this scenario, by having to pay US tax withholding on distributions of trust earnings because those are US source income, but such a master or group trust would at least be tax-qualified.

Note: One major wrinkle with dual-qualified status is that the Puerto Rico Income Tax Code has been amended effective January 1, 2011 (though some changes are not effective until later dates) to make significant changes to the qualified plan rules in Puerto Rico (under old section 1165 of the 1994 Puerto Rico Internal Revenue Code, now found in section 1081.01). These changes generally bring the pension tax rules in Puerto Rico closer to those in the US, but the rules are still different in many respects. In addition, technical corrections to the new Puerto Rico Income Tax Code have yet to be adopted. Thus, keeping or obtaining dual qualified status may be complicated by bringing the Puerto Rico portion of the plan into compliance with the new law.

2. Move the Puerto Rico only-plan trust assets out of the group or master trust, and transfer them to a separate Puerto-Rico only trust by the end of 2011 (presumably domiciled in Puerto Rico - if domiciled in the US, the distributions from the trust would appear to still be subject to US tax withholding on the earnings portion). However, this can be complex and add considerable costs.

Options for Puerto Rico Dual Qualified Plans

If you currently have a dual qualified US and Puerto Rico plan (including a 1022(i)(2) plan, which is dual qualified but has a Puerto Rico only trust that has made an election to be treated as a US qualified trust even though not a US domiciled trust), your options are generally:

1. Do nothing. For dual qualified plans in a US domiciled trust, though, the earnings in the trust generally will be subject to US tax withholding when distributed to the Puerto Rico distributes. (Note that this appear to be true even if the trust held only assets of a Puerto Rico dual qualified plan. For a 1022(i)(2) plan with a separate trust which is domiciled in Puerto Rico - which would preclude participation by US qualified plans in such a trust - Treas. Reg. §1.401(a)-50(d) appears to provide that trust earnings will not be taxable on distribution to Puerto Rico participants.)

2. Create a Puerto Rico-only qualified 1022(i)(1) plan and spin the assets off to a separate Puerto Rico domiciled trust under Rev. Rul. 2011-1 prior to 2012, or spin the assets off to a separate Puerto Rico domiciled trust under an electing dual qualified 1022(i)(2) plan.

What About Waiting?

Of course, another option in all of these situations is to continue to wait, either until the IRS issues further guidance, which might or might not be before the end of 2011, or hoping that the IRS will change its position or that the matter is otherwise resolved favorably, such as by legislation (though that has not been proposed yet).

We would caution, though, that there does not seem any to be any movement on this issue so far. Consequently, there are risks with this approach - such as that the 2011 transfer deadline will come and go without guidance and that the IRS does not change its position. In that event, if the assets of a Puerto Rico plan remain in the US domiciled qualified trust, there will be US tax on the distribution of the earnings portion to Puerto Rico residents and no opportunity to avoid that by transferring the assets to a Puerto Rico trust other than a separate Puerto Rico trust under an electing, dual qualified 1022(i)(2) plan. But at least the US trust itself will not fail to be a tax exempt entity due to the transition relief of Rev. Rul. 2011-1 until further guidance is issued.

Contact Us

We would be happy to help you analyze the options and issues concerning your plans' situation regarding Puerto Rico participants. We also urge you to contact us if you are interested in participating (at a modest cost) in our ongoing efforts to persuade IRS and Treasury to promptly issue favorable permanent relief.