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# **Puerto Rico Qualified Retirement Plans Significantly Impacted by Puerto Rico Internal Revenue Code of 2011, as Amended: Puerto Rico Treasury Department Issues Guidance on Qualification Process**

*Juan Luis Alonso*

*In late January 2011, the Puerto Rico Internal Revenue Code of 2011 (also known as the Internal Revenue Code for a New Puerto Rico, and hereinafter referred to as the “2011 PR Code”) became law.<sup>1</sup> In December 2011, a technical amendments bill to the 2011 PR Code was also enacted into law.<sup>2</sup> The Puerto Rico qualified retirement plan provisions under the Puerto Rico Income Tax Act of 1954 (based on the US Internal Revenue Code of 1939) and the Puerto Rico Internal Revenue Code of 1994 (1994 PR Code) were amended throughout the years but never kept pace with the continuous changes in the United States. Intended as an overhaul of the Puerto Rico income tax system, the 2011 PR Code, as amended, also brings the provisions on Puerto Rico qualified retirement plans much closer to those under the US Internal Revenue Code of 1986, as amended.*

## **MAJOR CHANGES TO QUALIFIED RETIREMENT PLANS UNDER THE 2011 PR CODE**

### ***Renumbering of Sections***

The provisions related to qualified plans, formerly Sections 1023(n) and 1165 under the 1994 PR Code, are now Sections 1033.09 (limit

Juan Luis Alonso is of counsel at Groom Law Group. His practice includes counseling plan sponsors, financial institutions, and other service providers on compliance with the Puerto Rico Internal Revenue Code’s qualification and operational requirements and applicable provisions under ERISA affecting retirement plans in Puerto Rico. In addition, Mr. Alonso regularly advises clients on pending legislative and regulatory matters, and was actively involved with the Puerto Rico Tax Reform Committee and the Puerto Rico Treasury Department in the revision of the retirement plan provisions included in the Puerto Rico Internal Revenue Code of 2011, and related amendments and guidance. Prior to joining Groom Law Group, Mr. Alonso was Capital Member, Vice-Chair of the Tax Practice Group, and Leader of the Employee Benefits Practice Team at McConnell Valdes LLC.

on deductions for employer contributions) and 1081.01 (qualified retirement plans) in the 2011 PR Code. Therefore, former Puerto Rico 1165(e) plans (similar to 401(k) plans in the United States) are now 1081.01(d) plans.

### ***Qualification Requirement***

Prior to the enactment of the 2011 PR Code, the regulations promulgated under the 1994 PR Code (the 1994 PR Code regulations) required retirement plans intended to be qualified in Puerto Rico to request and obtain a favorable determination letter from the Puerto Rico Treasury Department (the PR Treasury) as to the plan's Puerto Rico tax qualified status. The 2011 PR Code now expressly provides the qualification requirement for taxable years beginning on or after January 1, 2012.<sup>3</sup> Note that this requirement is applicable for both plans covering exclusively employees in Puerto Rico (commonly referred to as Puerto Rico—only qualified plans) and US qualified plans that cover employees in both the United States and Puerto Rico (commonly referred to as dual qualified plans).

### ***Trust Situs***

Effective January 1, 2011, a trust funding a Puerto Rico tax qualified plan must be established pursuant to the laws of the Commonwealth of Puerto Rico or be a domestic trust, as defined by the US Internal Revenue Code of 1986, as amended (US Code).<sup>4</sup>

### ***Coverage Testing***

Effective January 1, 2011, the 2011 PR Code contains special rules for meeting the Average Benefit Percentage Test in the “transition period” after a merger or acquisition (similar to US Code Section 410(b)(6)(C)). The rule provides that if an entity becomes or ceases to be a member of a controlled group, the minimum coverage rules will be deemed met during the “transition period” (which begins on the date of the change and ends on the last day of the first plan year beginning after the date of the change) in connection with any plan covering employees of the entities that are part of the controlled group if:

- Immediately before the acquisition or disposition the minimum coverage requirements were met; and
- The plan's coverage does not significantly change during the transition period; or
- The plan meets the requirements set forth by the PR Treasury.<sup>5</sup>

### ***Aggregation Requirements***

Effective for plan years beginning on or after January 1, 2012, for purposes of the 2011 PR Code qualification requirements and nondiscrimination and coverage testing, 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 PR Code) or of an Affiliated Service Group (as defined in Section 1081.01(a)(14)(B) of the 2011 PR Code) shall be deemed employees of the same employer (similar to US Code Section 410(b)(6)(C)). This requirement is applicable only with respect to participating employers with employees in Puerto Rico.<sup>6</sup>

### ***Highly Compensated Employee***

Effective January 1, 2011, a highly compensated employee (HCE) under the 2011 PR Code is:

- An officer of a participating employer, as defined by the PR Treasury;
- A 5 percent owner; or
- An employee who for the preceding year received more compensation from the employer than the amount determined in US Code Section 414(q)(1)(B), as adjusted by the IRS (*e.g.*, \$115,000 for 2012).<sup>7</sup>

### ***Annual Benefit Limitation***

Effective for plan years beginning on or after January 1, 2012, the annual benefit accrued by a participant cannot exceed the lesser of the amount determined in US Code Section 415(b), as adjusted by the IRS (*e.g.*, \$200,000 for 2012) (calculated as a straight-life annuity without ancillary benefits under a noncontributory plan) or 100 percent of the participant's average compensation for the participant's three highest years of service. The annual benefit accrued as of December 31, 2011, cannot be reduced for plans subject to ERISA.<sup>8</sup>

### ***Annual Contribution Limitation***

Effective for plan years beginning on or after January 1, 2012, annual additions to a participant's account in a defined contribution plan (excluding rollovers) cannot exceed the lesser of the amount determined in US Code Section 415(c), as adjusted by the IRS (*e.g.*, \$50,000 for 2012) or 100 percent of the participant's compensation for the limitation year.<sup>9</sup>

### ***Annual Compensation Limitation***

Effective for plan years beginning on or after January 1, 2012, the annual compensation limitation is imposed equal to the amount determined in US Code Section 401(a)(17), as adjusted by the IRS (*e.g.*, \$250,000 for 2012). For the purpose of the calculation of benefits, the annual compensation limitation for plans subject to ERISA is not effective for plan years prior to 2012.<sup>10</sup>

### ***Limit on After-Tax Contributions***

Effective January 1, 2011, under the 2011 PR Code, after-tax contributions cannot exceed 10 percent of the employee's aggregate compensation during the time the employee is a participant in the plan.<sup>11</sup> This requirement existed before but was formerly only found in the 1994 PR Code regulations.

### ***Limit on Elective Pre-Tax Contributions***

- Puerto Rico—only qualified plan: 2012 = \$13,000; 2013 and years thereafter = \$15,000 (no indexing)<sup>12</sup>
- Dual-qualified plan: Same limit under US Code Section 402(g) (*e.g.*, 2012 = \$17,000).<sup>13</sup> However, the sum of the contributions made by a Puerto Rico participant to a dual-qualified retirement plan and to a Puerto Rico individual retirement account (IRA) cannot exceed the sum of the 2011 PR Code annual pre-tax contribution limit and the 2011 PR Code annual limit on contributions to an IRA (*e.g.*, 2012 = \$13,000 + \$5,000 = \$18,000; 2013 and years thereafter = \$15,000 + \$5,000 = \$20,000)<sup>14</sup>
- US federal thrift plan: Same limit under US Code Section 402(g) (*e.g.*, 2012 = \$17,000)<sup>15</sup>

### ***Limit on Catch-Up Contributions***

- Puerto Rico—only and dual-qualified plans: \$1,500 per year<sup>16</sup>
- US federal thrift plan: Same limit under US Code Section 414(v) (*e.g.*, 2012 = \$5,500)<sup>17</sup>

### ***Special 20 Percent Tax Rate for Lump-Sum Distributions***

Effective January 1, 2011, the special 20 percent tax withholding rate and maximum tax rate under the PR Code for distributions taxable in Puerto Rico, previously applicable only to lump-sum distributions on account of separation from service, are now also applicable

to lump-sum distributions due to plan termination (even if there is no separation of service at the time the plan is terminated).<sup>18</sup>

### ***Special 10 Percent Tax Rate for Lump-Sum Distributions That Meet Puerto Rico Property Investment Requirement***

Effective January 1, 2011, in the case of distributions that are subject to a 10 percent Puerto Rico tax withholding and tax rate because the plan (or the participant account) is invested at least 10 percent in Puerto Rico property, compliance with the investment requirement is to be calculated on the average balance, and the look-back period to determine if the three-year investment period is met, will consider years in which the participant's assets were invested in a transferor plan.

The 2011 PR Code now includes in definition of Puerto Rico located property:

- Plan assets invested in fixed or variable annuities issued by domestic insurance companies or by a foreign insurance company of which at least 80 percent of its gross income during the three prior calendar years was from Puerto Rico sources; and
- Deposits in interest bearing accounts in commercial banks, cooperatives, thrift associations authorized by the Puerto Rico or US governments.<sup>19</sup>

### ***Annual Tax Exemption on Distributions from Retirement Plans***

Effective January 1, 2011, the \$11,000 (\$15,000 for persons age 60 or older as of December 31) annual exemption from Puerto Rico income tax is only applicable to distributions from Puerto Rico qualified plans on account of separation from service in the form of an annuity or in installments.<sup>20</sup> For this purpose, distributions in installments means:

- Annual payments made during a fixed period of time of no less than five years in substantially equal amounts; or
- Required minimum distributions under US Code Section 401(a)(9).<sup>21</sup>

### ***10 Percent Withholding Applicable to Other Types of Distributions***

Effective January 1, 2011, the taxable portion of distributions other than lump-sum distributions are subject to a 10 percent tax

withholding. This withholding applies to in-service distributions (e.g., hardship withdrawals, 59½), annuities, and installments. However, in the case of distributions in the form of an annuity or in installments on account of separation from service or plan termination, the 10 percent tax withholding only applies to amounts in excess of the following amounts per calendar year:

- \$21,000 (\$25,000, if participant is age 60 or older as of December 31, 2012) in 2012;
- \$23,500 (\$27,500, if participant is age 60 or older as of December 31, 2013) in 2013;
- \$26,500 (\$30,500, if participant is age 60 or older as of December 31, 2014) in 2014; and
- \$31,000 (\$35,000, if participant is age 60 or older as of December 31, 2015, and years thereafter) in 2015, and years thereafter.<sup>22</sup>

### ***Rollovers***

Effective January 1, 2011, partial rollovers from a Puerto Rico qualified plan to another Puerto Rico qualified plan are now allowed.<sup>23</sup> The 2011 PR Code now expressly provides that direct rollovers are not subject to tax withholding.<sup>24</sup>

### ***Plan Sponsor's Withholding Obligation***

Effective January 1, 2011, the employer sponsoring a plan is jointly responsible with the plan's trustee for complying with withholding and reporting obligations under the 2011 PR Code.<sup>25</sup>

### ***Deductibility of Contributions***

Effective for plan years beginning on or after January 1, 2011, the limit on the deduction for Puerto Rico income tax purposes by a participating employer for contributions to Puerto Rico qualified profit sharing and stock bonus plans is increased from 15 percent to 25 percent of the paid or accrued compensation during the taxable year of all employees participating in the plan.<sup>26</sup>

The employer may take a deduction of the full amount required by ERISA Sections 302(a)(2)(A) and (C) to be contributed to the plan in order to maintain the plan's funded status.<sup>27</sup>

### ***10 Percent Tax on Nondeductible Contributions***

Effective for plan years beginning January 1, 2011, a 10 percent Puerto Rico tax is imposed on nondeductible contributions made by

the employer to a qualified plan unless nondeductible contributions are returned to the employer before the due date of the employer's income tax return (including extension). The 10 percent tax is payable by the employer regardless of whether nondeductible contributions are actually claimed as a deduction<sup>28</sup> (similar to US Code Section 4972).

### ***10 Percent Excise Tax on Excess Contributions***

Effective for plan years beginning January 1, 2011, a 10 percent excise tax on excess contributions is imposed if a plan does not correct excess contributions (resulting from failing 2011 PR Code ADP Test) on or before the plan sponsor's due date for filing its income tax return (including extension)<sup>29</sup> (similar to US Code Section 4979).

### ***Plan Loans Treated as Distributions***

Effective for plan years beginning January 1, 2011, a plan loan will be treated as a taxable distribution for Puerto Rico income tax purposes if by its terms, and in operation, the loan is not:

- Amortized with substantially level payments made not less frequently than quarterly; and
- Repaid within five years (or as provided in the plan document for loans for the purchase of the participant's principal residence)<sup>30</sup> (similar to US Code Section 72(p)).

### ***Filing of Form 5500 with PR Treasury Instead of Form 480.70 (OE)***

In PR Treasury Circular Letter No. 12-02 (CL 12-02),<sup>31</sup> effective for plan years beginning on or after January 1, 2011, the Puerto Rico Secretary of the Treasury allows retirement plans covered under Title I of ERISA and which have been previously filed for qualification under the 2011 PR Code or the 1994 PR Code to file with the PR Treasury a copy of the plan's US Department of Labor (DOL) Form 5500 instead of the local annual return Form 480.70(OE).<sup>32</sup> Plans that elect to file Form 5500 must complete the trust's information on the first page of Form 480.70(OE) and attach to it a true and exact copy of the Form 5500 filed by the plan with the US DOL. Once a trust files a Form 5500 with the PR Treasury, it must obtain prior approval from the PR Treasury to file a Form 480.70(OE) in a later year.

The due date for filing of Form 5500 with the PR Treasury is the last day of the seventh calendar month following the close of the plan year (*i.e.*, July 31 for a plan with a calendar plan year). A one-time extension of up to two-and-a-half months (*i.e.*, October 15 for a plan with a calendar plan year) is available. Notwithstanding the foregoing,

CL 12-02 provides that if the US DOL approves an additional extension to a plan to file Form 5500 for any given year, the due date to file Form 5500 with the PR Treasury for the trust funding such plan is automatically extended to such extended due date. A copy of the approved US DOL extension must be included when filing Form 5500 with the PR Treasury. This additional extension does not apply for the filing of Form 480.70(OE) with the PR Treasury.

Form 480.70(OE) or Form 5500 may be filed in person or by mail at the respective addresses provided in CL 12-02. Electronic filing for Form 480.70(OE) or Form 5500 with the PR Treasury is not yet available.

## **PLAN AMENDMENT AND QUALIFICATION UNDER 2011 PR CODE**

### ***Deadline to Amend Plans in Compliance with 2011 PR Code***

PR Treasury Circular Letter No. 11-10 (CL 11-10)<sup>35</sup> provides that on or before the end of the plan year beginning on or after January 1, 2012 (*i.e.*, on or before December 31, 2012, for a plan with a calendar plan year) retirement plans covering employees in Puerto Rico must be amended to comply with the qualification provisions of the 2011 PR Code, including those which became effective January 1, 2011. CL 11-10 includes a list of the 2011 PR Code qualification provisions that must be included in the plan document (or appendix/supplement to the plan) in order to obtain a qualification letter under the 2011 PR Code. While amendments are not required until 2012, operational compliance is required beginning January 1, 2011. A plan that has never received a qualification letter from the PR Treasury must also be amended in compliance with the 1994 PR Code for the applicable years.

### ***Updated Qualification Under 2011 PR Code***

A plan that is timely amended to comply with the 2011 PR Code must be filed for an updated qualification letter on or before the due date, including any extension, of the participating employer's 2012 Puerto Rico income tax return (*i.e.*, the 15th day of the fourth month after the close of the taxable year; the 15th day of the seventh month, if an automatic extension is timely requested; April 15, 2013, or July 15, 2013, with extension, for a calendar year taxpayer). Plans that were amended to comply with the new qualification requirements of the 2011 PR Code and were submitted for qualification with the PR Treasury prior to the issuance of CL 11-10 are not required to be filed again, until they are subsequently amended and/or restated, as described below.

### ***Subsequent Updated Qualification Under 2011 PR Code***

CL 11-10 includes guidance with respect to requests for updated qualification letters after a plan has obtained a qualification letter under the 2011 PR Code. That is, not all amendments will be required to be filed with the PR Treasury, as it was required in the qualification letters previously issued by the PR Treasury under the 1994 PR Code. A plan restatement or amendment must be filed for an updated qualification letter on or before the due date, including any extension, of the participating employer's Puerto Rico income tax return for the year in which the restatement or amendment is adopted (*i.e.*, the 15th day of the fourth month after the close of the taxable year; the 15th day of the seventh month, if an automatic extension is timely requested; for example, if a plan is restated on January 15, 2014, the plan must be submitted for an updated qualification letter on or before April 15, 2015, or July 15, 2015, with extension, if the employer is a calendar year taxpayer).

### ***Retroactive Qualification Under the 1994 PR Code and the 2011 PR Code***

CL 11-10 provides relief for plans that have never been filed for qualification with the PR Treasury or which qualification under the 1994 PR Code had not been updated. Such plans may obtain retroactive qualification under the 1994 PR Code, and updated qualification under the 2011 PR Code, through the regular qualification process (and without the need to enter into a closing agreement) if:

1. On or before the end of the plan year beginning on or after January 1, 2012 (*i.e.*, on or before December 31, 2012, for a plan with a calendar plan year), the plan is: (a) retroactively amended in compliance with the provisions under the 1994 PR Code, and/or (b) retroactively amended or restated in compliance with the provisions of the 2011 PR Code, as applicable; and
2. The plan is filed for qualification (including retroactive qualification under the 1994 PR Code) on or before the due date, including any extension, of the participating employer's 2012 Puerto Rico income tax return (*i.e.*, April 15, 2013, or July 15, 2013, with extension, for a calendar year taxpayer).

### ***Failure to Comply with Amendment and/or Filing Requirements***

Plans that are not amended in compliance with the 1994 PR Code provisions and/or timely amended in compliance with the 2011 PR

Code, and plans that are not timely filed for retroactive qualification under the 1994 PR Code, updated qualification letter under the 2011 PR Code, and/or updated qualification letters after obtaining a qualification letter under the 2011 PR Code, will be deemed nonqualified funded plans for Puerto Rico income tax purposes.

### ***Items to Be Included with Request for Puerto Rico Qualification***

CL 11-10 includes updated lists of the documents that are required to be included with the requests for Puerto Rico tax qualification filed on or after January 1, 2012, under the 1994 PR Code and the 2011 PR Code. Special rules apply for plans adopted under Puerto Rico master or prototype plans.

### **NOTES**

1. Puerto Rico Act No. 1-2011, enacted Jan. 31, 2011.
2. Puerto Rico Act No. 232-2011, enacted Dec.10, 2011.
3. 2011 PR Code § 1081.01(a).
4. 2011 PR Code § 1081.01(a).
5. 2011 PR Code § 1081.01(a)(3)(D).
6. 2011 PR Code § 1081.01(a)(14)(A).
7. 2011 PR Code § 1081.01(d)(3)(E)(iii).
8. 2011 PR Code § 1081.01(a)(11)(A).
9. 2011 PR Code § 1081.01(a)(11)(B).
10. 2011 PR Code § 1081.01(a)(12).
11. 2011 PR Code § 1081.01(a)(15).
12. 2011 PR Code § 1081.01(d)(7)(A)(i).
13. 2011 PR Code § 1081.01(d)(7)(A)(ii).
14. 2011 PR Code § 1081.01(d)(7)(A)(iii).
15. 2011 PR Code § 1081.01(d)(7)(A)(ii).
16. 2011 PR Code § 1081.01(d)(7)(C)(i).
17. 2011 PR Code § 1081.01(d)(7)(C)(v).
18. 2011 PR Code § 1081.01(b)(1)(A).
19. 2011 PR Code § 1081.01(b)(1)(B). *See also* PR Treas. Administrative Determination No. 08-15.
20. 2011 PR Code § 1031.02(a)(13).
21. 2011 PR Code § 1081.01(b)(3)(C).
22. 2011 PR Code § 1081.01(b)(3)(B).

23. 2011 PR Code § 1081.01(b)(2)(A).
24. 2011 PR Code § 1081.01(b)(3)(D).
25. 2011 PR Code § 1081.01(b)(10).
26. 2011 PR Code § 1033.09(a)(1)(C).
27. 2011 PR Code § 1033.09(a)(1)(A)(i)(IV).
28. 2011 PR Code § 1033.09(a)(5).
29. 2011 PR Code § 1081.01(d)(6)(D).
30. 2011 PR Code § 1081.01(b)(3)(E).
31. PR Treas. CL 12-02, issued on Feb. 13, 2012.
32. 2011 PR Code § 1061.10(a)(2).
33. PR Treas. CL 11-10, issued on Dec. 16, 2011.

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