Qualified Plans in Puerto Rico

By Elizabeth A. LaCombe

In this article, Elizabeth A. LaCombe discusses some practical issues that a U.S. employer should consider before offering retirement benefits to employees who reside in Puerto Rico.

For multinational companies, the prospect of offering a qualified defined contribution plan to employees of a subsidiary operating in a foreign country is daunting, as it raises a plethora of issues. For starters, if the plan complies with local law, will it also satisfy Section 401(a) of the Internal Revenue Code (the IRC)? Will a separate foreign plan and trust be needed? If so, who will handle the administration of the foreign plan? Can participants in the foreign plan invest in a U.S. qualified trust? What if the other "country" is actually a possession of the United States?

In this article, I explore some of the practical issues that a U.S. employer may want to consider before offering retirement benefits to its employees who reside in Puerto Rico. Specifically, I will discuss some of the provisions that a plan needs to contain in order to be treated as "tax exempt" under the laws of Puerto Rico, and we will contrast those provisions to those set forth under the IRC. Finally, we will briefly discuss the various ways in which a U.S. employer may provide retirement benefits to its Puerto Rico employees.

What Are the Qualification Requirements Under Puerto Rico Law, and How Do They Fare Against the U.S. Requirements?

Until 1994, the income tax code of Puerto Rico was based upon the Internal Revenue Code of 1954. In general, the rules with which Puerto Rico plans were required to comply in order to be treated as tax exempt were relatively simpler rules than those reflected under the IRC. In 1994, the Puerto Rico Income Tax Code (the Laws of Puerto Rico Annotated or L.P.R.A.) was restructured through the Tax Reform Enabling Act of 1994. Although sections of the L.P.R.A. relating to qualified retirement plans were modified, it is still generally easier for a plan to satisfy the requirements associated with qualification under the laws of Puerto Rico, than those set forth in Section 401(a) of the IRC.

Similarities and Differences Between IRC Section 401(a) and L.P.R.A. Section 1165(a)

L.P.R.A. Section 1165(a) is the analog to IRC Section 401(a), as both provisions set forth the basic requirements that a plan needs to satisfy in order to be treated as "qualified." L.P.R.A. Section 1165(a) also contains provisions relating to plans that are sponsored by owner-employees, ESOPs, the taxation of benefits received from a qualified plan, and plan reporting and withholding requirements. In other words, unlike IRC Section 401(a), L.P.R.A. Section 1165(a) contains all of

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the tax provisions relating to qualified plans. In that regard, L.P.R.A. Section 1165(a) is all inclusive.

Qualified plans under Puerto Rico law must satisfy an exclusive benefit rule that is identical to the exclusive benefit rule set forth in IRC Section 401(a). Like IRC Section 401(a), L.P.R.A. Section 1165(a) also requires plans to satisfy minimum participation and coverage requirements and pass nondiscrimination testing. In addition, qualified Puerto Rico plans must satisfy the qualification rules on at least one day of each quarter. Similar to its U.S. counterpart, Section 1165(a) sets forth additional rules that apply to cash or deferred arrangements. Unlike some U.S. plans that qualify under IRC Section 401(a), though, qualified plans under L.P.R.A. Section 1165(a) must comply with ERISA.

Although the rules pertaining to plan qualification under IRC Section 401(a) are more complex than those under the laws of Puerto Rico, compliance with such rules does not guarantee qualification under Puerto Rico law. For example, L.P.R.A. Section 1165(a)(4) is the analog to IRC Section 401(a)(4). Under Section 1165(a)(4) a, trust will be exempt from tax if "contributions or benefits provided under the plan do not discriminate in favor of employees who are partners, officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees." Highly compensated employees include "any employee who is more highly compensated than two-thirds of all eligible employees, taking into account only compensation which is considered in applying this clause" [L.P.R.A. § 1165(e)(iii)]. Note that this definition of HCE also applies to the coverage test, the average benefit percentage test, the average deferral percentage test, as well as to the determination of excess contributions.

Compare IRC Section 401(a)(4), which provides that a trust will be qualified if "the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of Section 414(q))." The Code excludes from consideration those employees who are part of a collective bargaining agreement, as well as those employees who are nonresident aliens that receive no earned income from sources with the U.S. As explained below, residents of Puerto Rico are not considered nonresident aliens for these purposes.

Highly compensated employees (HCEs) under the IRC include "any employee who—(A) was a 5-percent owner at any time during the year or the preceding year, or (B) for the preceding year— (i) had compensation from the employer in excess of $80,000 [adjusted for inflation], and (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year" [IRC Sec. 414(q)(1)].

On the other hand, Puerto Rico laws retain the old one-thirds/two-thirds rule for determining who is a HCE. This means that the HCE group is different under Puerto Rican law than it is under the U.S. rules.

For example, assume an employer was a 100-percent-owner of a small business that employed five other employees, none of whom earned more than $75,000. Under IRC Section 414(q), there would only be one HCE (e.g., the owner), whereas under Puerto Rico law the HCEs are the top 1/3-paid employee group. Depending upon how much the five employees earn, one of them could be an HCE. In other words, if the compensation for the five employees was not uniform, and one of the employees earned more than the others, that employee would be an HCE under the plan.

Getting Past the Differences: What Options Are Available to U.S. Employers with Puerto Rico Employees?

Option 1: One Trust, One Plan

A U.S. employer may include its employees that reside in Puerto Rico in its U.S. qualified plan. In other words, it is possible for a U.S. employer to provide retirement benefits to its Puerto Rico employees through a U.S. qualified retirement plan that is a "dual qualified" plan.

It is important to note that, unlike IRC Section 401(a), L.P.R.A. Section 1165 is generally silent as to where the trust that funds the plan needs to be created. This provision is "generally silent" because there are some tax breaks available to recipients of total distributions from qualified plans that are created in Puerto Rico, or have a trustee who is resident of Puerto Rico [L.P.R.A. Sec. 1166 (b)(1)].

IRC Section 401(a) provides that "[a] *trust created or organized in the United States* and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—" if certain provisions are satisfied. Whereas L.P.R.A. Section 1165(a) provides that "[a] trust which is part of an employer's plan … shall not be taxable under this subchapter" if certain requirements are met. Accordingly, an employer that wants to provide retirement benefits to its Puerto Rico employees may use a trust created or organized in the United States.

Plan Administration

From an administration perspective, if a U.S. employer includes employees who are residents of Puerto Rico in its qualified plan, will such employees be treated as nonresident aliens and, thus, carved out from certain U.S. qualified plan testing provisions? In short, the answer is no.

As background, there are a number of U.S. qualified plan testing provisions that explicitly exclude employees who are nonresident aliens and receive no earned income from sources within the U.S. For example, such employees are specifically excluded from the nondiscrimination testing provisions under IRC Section 401(a)(4) and from coverage testing under IRC Section 410(b)(3)(C). Having said that, employees who are residents of Puerto Rico are not treated as nonresident aliens for IRC purposes [IRC Sections 871 and 876(a)]. Accordingly, such employees would not be excluded from the testing provisions that carve out employees who are nonresident aliens who receive no earned income from sources within the U.S.

Taxation of Puerto Rico Employees

First, consider how employees residing in Puerto Rico will be taxed for federal income tax purposes on contributions to and distributions from the dual qualified U.S. plan. With regard to contributions, if the plan qualifies under IRC Section 401(a), the Puerto Rico employees will be taxed in the same manner as the U.S. employees who also participate in the plan. That is, such employees will not be subject to federal income tax on contributions to the plan.

Residents of Puerto Rico generally pay income tax to the Puerto Rico version of the Internal Revenue Service, called the Hacienda, and do not pay any income tax to the IRS on any income from sources within Puerto Rico. Residents of Puerto Rico are subject to U.S. tax, however, on income from sources within the U.S. Income from sources within the U.S., for this purpose, includes earnings on contributions to the plan, as well as distributions therefrom.

For purposes of determining the source of pension payments from a qualified trust under IRC Section 401(a), the portion of each payment that is attributable to employer contributions with respect to services rendered within the United States is treated as income from sources within the United States, and the portion that is attributable to employer contributions with respect to services rendered outside the United States is treated as income from sources without the United States [Treas. Reg. § 1.401(a)-50(d). For rules regarding the treatment of earnings and accretions with respect to contributions of either the employer or the employee, see Rev. Rul. 79-388, 1979-2 C.B. 270, and Rev. Proc. 2004-37, 2004-1 C.B. 1099].

Accordingly, distributions from a dual qualified plan to residents of Puerto Rico will be subject to tax under the laws of Puerto Rico, and will also be subject to tax on the U.S. source portion of the payment. Although certain amounts received from a dual qualified plan may be subject to double taxation, residents of Puerto Rico may claim an income tax credit under Puerto Rico law for such taxes paid to the U.S. [L.P.R.A. § 8431].

Based upon the foregoing, it is clear that an employer that wants to provide retirement benefits for its Puerto Rico employees may do so through a dual qualified plan. It would be prudent for a plan sponsor that wants to sponsor a dual qualified plan to conduct a review of the terms of its plan with counsel to see what changes, if any, may need to be made in order for the plan to comply with L.P.R.A Section 1165(a).

If, after that review and analysis has been completed, no changes need to be made, it would be wise for counsel to seek a determination from the Puerto Rico Department of Treasury, or Hacienda, that the plan satisfies L.P.R.A. Section 1165(a). If changes are needed, counsel may need to draft an individually designed plan that satisfies both the requirements of IRC Section 401(a) and L.P.R.A. Section 1165(a), and then secure determination letters from both the IRS and the Hacienda. Since it is not critical that the plan trust be established or created in Puerto Rico, it may be a U.S. trust. The employer may consider having more than one trustee for the trust. That is, for the reasons stated below, a trustee in the U.S. and a trustee that is a resident of Puerto Rico.

Option Two: Two Trusts, Two Plans

An employer could create two trusts, one for its U.S. employees that will fund a plan that qualifies under IRC Section 401(a), and a separate trust for its Puerto Rico employees that funds a plan which satisfies L.P.R.A. Section 1165(a).

Situs of Puerto Rico Trust

It is assumed that a U.S. employer will create a U.S. trust to fund a plan that will qualify under IRC Section 401(a). But, what about the situs of the trust that will fund the benefits provided under the L.P.R.A. Section 1165(a) plan? Before creating the second trust, the employer should carefully weigh the pros and cons of creating a trust in the U.S. versus creating it in Puerto Rico.

Although not required under Puerto Rico law, there are some local tax advantages to establishing or creating the trust in Puerto Rico. For example, a total distribution from a trust that is "either … organized under the laws of the Commonwealth of Puerto Rico or has a trustee resident of Puerto Rico and uses said trustee as paying agent" is subject to favorable long term capital gains treatment if at least 10% of the assets of the trust are invested in a registered investment company that is organized under the laws of Puerto Rico, or property that is determined by the Secretary to be located in Puerto Rico. Accordingly, it would be prudent for a U.S. employer that wants to sponsor a separate L.P.R.A. Section 1165(a) plan to consider setting up a trust in Puerto Rico, or naming a trustee that is a resident of Puerto Rico.

Administration

If the employer decides to sponsor one plan for its U.S. employees and a second plan for its Puerto Rico employees, will the plans need to be aggregated for certain testing purposes? In short, the answer is no, because, absent an IRS determination letter to the contrary, the L.P.R.A. Section 1165(a) plan does not satisfy the requirements set forth in IRC Section 401(a). In essence, from the standpoint of the IRS, the employer would be maintaining two separate plans for two different groups of employees—a qualified plan for its U.S. employees and a nonqualified plan for its employees who reside in Puerto Rico.

As compared with the single plan approach discussed in Option One above, plan administration appears to be more cumbersome and costly under the Option Two approach, because the employer would bear higher ongoing administrative costs associated with maintaining two separate plans. Notwithstanding the additional cost, setting up a separate trust to fund the L.P.R.A Section 1165(a) plan ensures that the qualified status of the trust that funds the IRC Section 401(a) plan will not be jeopardized due to the Puerto Rico employee participation or the different administrative rules required by the L.P.R.A.

Income from Sources Within the U.S.

If the employer wants to offer participants under both plans the ability to invest in U.S. mutual funds, would its employees in Puerto Rico be subject to tax on the investment income as income from sources within the U.S.? The answer to this question depends upon whether the employer has made an ERISA 1022(i)(2) election with regard to the Puerto Rico plan.

Section 1022(i)(2)(A) of ERISA provides:

> If the administrator of a pension, profit-sharing or stock bonus plan which is created or organized in Puerto Rico elects … to have the provisions of this paragraph apply, for plan years beginning after the date of election, any trust forming part of such plan shall be treated as a trust created or organized in the United States for purpose of Section 401(a).

"The practical effect of section 1022(i) is to exempt these trusts from U.S. income tax on income from their U.S. investments" [Treas. Reg. § 1.501(a)-1(e)]. Plans created or organized in Puerto Rico whose administrators have made the election referred to in Section 1022(i)(2) of ERISA are treated as trusts created or organized in the United States for purposes of § 401(a) [Treas. Reg. § 1.401(a)-50].

In other words, if:

1. the trust is created or organized in Puerto Rico,
2. all of the participants are residents of the Commonwealth of Puerto Rico, and
3. an ERISA Section 1022(i)(2) election is made,

such trust will be treated as a tax exempt trust for purposes of IRC Section 501(a).

With respect to the second requirement reflected above, the regulations indicate that "residents of Puerto Rico" means bona fide residents of Puerto Rico, and persons who perform labor or services primarily in the Commonwealth of Puerto Rico, regardless of residence for other purposes [Treas. Reg. § 1.501(a)-1(e)].

If the employer does not make an ERISA Section 1022(i)(2) election with respect to the trust, the trust will not be treated as tax-exempt under IRC Section 501(a). In other words, if any of the participants in the Puerto Rico plan invest in U.S. mutual funds, such investment income may be subject to U.S. taxation as income from sources within the U.S. Although such investment income may be subject to U.S. income taxation, it is important to note that residents of Puerto Rico may be able to claim an income tax credit under Puerto Rico law for such taxes paid to the U.S. [L.P.R.A. § 8431].

Transferring Assets from IRC Section 401(a) Plans to L.P.R.A. Section 1165(a) Plans

Suppose a U.S. employer maintains a plan that qualifies under IRC Section 401(a) and L.P.R.A. Section 1165(a) for its U.S. and Puerto Rico employees, respectively, "Plan A," and then sets up an L.P.R.A. Section 1165(a) for only its employees that reside in Puerto Rico, "Plan B." Plan A is funded by a U.S. trust and Plan B is funded by a Puerto Rico trust. The employer amends both trusts to provide for the assets and liabilities held in the Plan A trust on behalf of bona fide residents of Puerto Rico who perform all of their services within Puerto Rico, to be transferred from the Plan A trust to the Plan B trust. How will the transfer of the assets and liabilities from Plan A to Plan B be treated for federal income tax purposes? This was precisely the issue addressed by the IRS through Revenue Ruling 2008-40 [2008-2 C.B. 16].

In Revenue Ruling 2008-40, the IRS ruled on whether the transfer of assets and liabilities from: (1) a qualified IRC Section 401(a) plan to a L.P.R.A. Section 1165(a) plan was a distribution; and (2) a qualified IRC Section 401(a) plan that also satisfies L.P.R.A Section 1165(a) to a L.P.R.A. Section 1165(a) plan that had made an ERISA Section 1022(i)(1) election was a distribution.

The IRS determined that, based upon the facts and circumstances, the transfer from an IRC Section 401(a) plan to an L.P.R.A. Section 1165(a) plan was an impermissible distribution that could result in plan disqualification, because the latter plan was not "qualified" under IRC Section 401(a).

Furthermore, the transfer under the second scenario was also an impermissible distribution, even though the plan had made a ERISA Section 1022(i)(1) election. The IRS noted that if, in the second scenario, the transfer had been from an IRC Section 401(a) plan to an L.P.R.A. Section 1165(a) plan that had made an election under ERISA Section 1022(i)(2), the transfer would not have been treated as a distribution because the Puerto Rico plan would be treated as a "qualified plan" for purposes of Section 401(a).

The IRS considered whether either plan could roll over amounts to a "foreign" plan on the basis that IRC Section 402(g) allows rollovers to plans that, but for the fact that the trusts were not created in the United States, otherwise satisfy IRC Section 401(a). The IRS dismissed this argument noting that neither Puerto Rico plan would qualify under this provision because, even ignoring where the trust was created or organized, neither plan satisfied the requirements set forth in IRC Section 401(a). In other words, both Puerto Rico plans were nonqualified deferred compensation plans for U.S. income tax purposes.

Transition Relief Under Revenue Ruling 2008-40

In Revenue Ruling 2008-40, the IRS offers some relief to sponsors of plans that are not dual qualified, that wish to transfer assets and liabilities from IRC Section 401(a) plans to "nonqualified" foreign plans.

Specifically, relief is extended to:

1. Those employers that have excluded employees that are also residents of Puerto Rico from their plans under IRC Section 410(b) for years beginning prior to January 1, 2011, if certain conditions are met;
2. Transfers made to Puerto Rico plans that have made an ERISA Section 1022(i)(1) election, provided the requirements of IRC Section 414(l) are otherwise met. In other words, such transfers will not cause the transferor plan to fail to satisfy IRC Section 401(a) for transfers made prior to January 1, 2011;
3. Transfers are made prior to January 1, 2011, from a qualified plan to a Puerto Rico plan that has made an ERISA Section 1022(i)(1) election, under IRC Section 933. In other words, such amounts transferred will be treated as income from sources within Puerto Rico for U.S. tax purposes.

Plan sponsors should bear in mind that, if they want to make changes involving plan transfers, this transition relief under Rev. Rul. 2008-40 for transfers to ERISA Section 1022(i)(1) transferee plans (qualified in Puerto Rico only) from U.S. qualified plans, ends on December 31, 2010. Therefore, there is a limited time during which the plan sponsor can change from a dual qualified plan to separate plans for the U.S. and Puerto Rico employees and spin-off the Puerto Rico portion of the U.S. plan to the Puerto Rico plan.

ERISA Section 1022(i)(1) vs. ERISA Section 1022(i)(2): Which Election Should a Plan Sponsor Make?

If a U.S. employer is not concerned whether the trust that is providing benefits to its employees who reside in Puerto Rico satisfies Section 401(a), and is, therefore, exempt from tax under Section 501(a), the employer may consider making an ERISA Section 1022(i)(1) election. To qualify for this election, the trust must be part of a pension, profit sharing, or stock bonus plan that is exempt from income tax under the laws of the Commonwealth of Puerto Rico. The practical effect of an ERISA Section 1022(i)(1) election is to exclude trust income earned in the U.S. from U.S. income taxation.

If, on the other hand, an employer wants the plan to cover both U.S. and Puerto Rico employees, the employer may consider making an ERISA Section 1022(i)(2) election. ERISA Section 1022(i)(2)(A) provides that if "the administrator of a pension, profit sharing or stock bonus plan which is created or organized in Puerto Rico elects … any trust forming part of such plan shall be treated as a trust created or organized in the United States for purposes of Section 401(a)." In other words, the sponsor of a Puerto Rico plan can make this irrevocable election for the plan to comply with all of the provisions set forth in Section 401(a), except for the trust situs requirement.

A plan administrator may make an ERISA Section 1022(i)(2) election in one of two ways:

1. Register the election with the Director's Representative at the IRS' office in Puerto Rico, or
2. File it as part of an application for a determination letter from the IRS. [*See* Treas. Reg. § 1.401(a)-50.]

Conclusion

A U.S. employer that is thinking of offering a retirement plan to its employees who reside in Puerto Rico should carefully weigh the pros and cons associated with offering benefits under a dual qualified plan, as opposed to a plan that qualifies under L.P.R.A. Section 1165(a). The employer will also need to consider whether it wants to set up the trust that funds the benefits to its residents of Puerto Rico in the U.S. or Puerto Rico. In weighing the benefits associated with each alternative, the employer also needs to take into account ongoing administrative and compliance costs, as well as the tax implications to its Puerto Rico employees. Finally, it would behoove an employer to discuss all of these options with U.S. tax counsel, as well as local tax counsel for Puerto Rico, before making a final decision. ■