

(H.B. 1548)

(No. 49)

(Approved January 30, 2006)

AN ACT

To eliminate clause (11) of subsection (a) and amend clauses (1) and (3) of subsection (b) of Section 1165 of Act No. 120 of October 31, 1994, as amended, known as the “Puerto Rico Internal Revenue Code of 1994,” in order to eliminate as part of the requirements for a retirement plan to be qualified under Section 1165, that the trust of the plan must be organized in Puerto Rico and that its trustee must be a resident of Puerto Rico; and to provide that in certain cases the total distributions of the trusts of the pension plans whose trustees are residents of Puerto Rico be considered as long term capital gains derived from the sale of property located in Puerto Rico.

STATEMENT OF MOTIVES

It is the public policy of the Commonwealth of Puerto Rico to foster savings and investments in our economy and to make available mechanisms to achieve this purpose. To those effects, pension plans have become one of the most attractive benefits that employers may offer their employees. In matters of taxation policy, they are one of the means through which the Government can modify the conduct of the taxpayers by encouraging savings and promoting the creation of capital markets.

The Legislature amended Section 1165 of the Puerto Rico Internal Revenue Code of 1994, the “Code”, through Act No. 404 of September 22, 2004, “Act No. 404,” in order to grant a reduction of from twenty (20)

percent to ten (10) percent in the tax rate applicable to lump sum distributions of the bonus plans in stock, pensions, shares in profits or annuities, when the (1) participant or beneficiary is fifty-five (55) years of age or older at the time of the distribution and (2) when an average of ten (10) percent of all contributions to the trust that may be attributed to participating residents of Puerto Rico have been invested “in property located in Puerto Rico” as said term is defined in Section 1014(e)(3) of the Code. Act No. 404 also amended Section 1165(a) of the Code in order to provide as part of the requirements to allow that a retirement plan be exempted under said Section, that the trust of the plan be organized in Puerto Rico and that its trustee be a resident of Puerto Rico.

This Legislature understands that one of the main purposes of Act No. 404 is to foster the investment in Puerto Rico of part of the funds deposited in retirement plans trusts which invest a very limited amount of their funds in Puerto Rico. We therefore believe that their scope must cover all retirement plan participants who invest in Puerto Rico at least ten (10) percent of their assets regardless of the age of said participant. On the other hand, this Legislature believes that to impose as a requirement that the trust be organized in Puerto Rico in order to enjoy the exemption under Section 1165(a) of the Code might limit the benefit opportunities for Puerto Rican employees under plans whose trusts have been created outside of Puerto Rico. It is important to mention that the Employee Retirement Income Security Act of 1974, as amended, better known as ERISA, grants a tax exemption on federal income to pension plans organized through local trusts and whose participants are residents of Puerto Rico.

To those ends, the Legislature of Puerto Rico deems it necessary to approve legislation to eliminate the requirement that indicates that the

retirement plans trusts have to be created or organized in Puerto Rico so that said plans may be exempt under Section 1165 of the Code and to provide that the tax rates herein provided are available to all participants in pension plans who meet the requirements imposed by this Act.

BE IT ENACTED BY THE LEGISLATURE OF PUERTO RICO:

Article 1.-Clause (11) of subsection (a) is hereby eliminated and clauses (1) and (3) of subsection (b) of Section 1165 of Act No. 120 of October 31, 1994, as amended, are hereby amended to read as follows:

“Section 1165.-Employee’s Trusts

(a) Exemption.-...

(1)...

(b) Taxation of Beneficiary.-

(1) In general.-The amount actually distributed or made available to any participant or beneficiary by any such trusts shall be taxable for such participant or beneficiary on the year in which it is so distributed or made available under Section 1022(b)(2), as if it were an annuity whose price or consideration are the amounts contributed by the participant, except for those amounts contributed by the participant on the basis of a cash or deferred contributions arrangement under subsection (e). If the total payable distributions with respect to any participant or beneficiary are paid to the participant or beneficiary within a single taxable year of the latter due to the participant’s separation from service, the amount of such distribution, in the amount which exceeds the amount contributed by the participant, which has already been paid by him shall be deemed as long-term capital gains subject to a rate of twenty (20) percent. The preceding notwithstanding, in the case of total distributions made after the effective

date of this Act by a trust which is part of a pension plan, participation in profits, bonuses as shares or the acquisition of shares for employees, if

(A) the trust is 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; and

(B) ten (10) percent of the total assets of the trust attributable to the participants who reside in Puerto Rico, calculated at the close of the year of the plan during which the distribution is made and during each of the two years of that precede the date of the distribution, have been invested in 'property located in Puerto Rico,' as said term is defined in Section 1014(e)(3), in registered investment companies organized under the laws of Puerto Rico and subject to taxation under Section 1361 of the Code or any other which through regulations or circular letter to the Secretary qualifies as property located in Puerto Rico, then the amount of such distribution in excess of the amount contributed by the participant that has been paid by the latter, shall be deemed as long-term capital gains subject to a rate of twelve point five (12.5) percent. Provided, however, that the investment requirement established in paragraph (B) of clause (1) of subsection (b) shall not apply to distributions made between the effective date of this Act and December 31, 2007. In the case of defined contribution plans whereby a separate account is maintained for each participant or beneficiary, the requirement for investing in 'property located in Puerto Rico' may be met in relation to the assets accredited to the account of the participant or beneficiary. The Secretary may, through regulations, circular letter or administrative determination, provide the manner in which the requirement of investing in Puerto Rico shall be met. For the purposes of this paragraph, the paying agent shall be responsible for complying with the

provisions of the Code applicable to the withholding agents, as well as with the obligations imposed by any other law of the Commonwealth of Puerto Rico. The administrator or the sponsor of the plan under which the trust is created shall be jointly and severally liable for noncompliance with the legal obligations of the withholding agent.

(2) Exception and Special Rule.-

(A) The provisions of clause (1) of this subsection shall not apply to an amount paid or distributed by a qualified trust to a participant or beneficiary if the total amount received (in money or any other type of property) is distributed to an individual retirement account or annuity under the provisions of Section 1169, to a nondeductible individual retirement account or to a retirement plan that qualifies under the provisions of the Section for the benefit of said participant or beneficiary not later than sixty (60) days after said payment or distribution has been received. In the case of a transfer to a nondeductible individual retirement account, the exception to which this paragraph refers shall only apply to those contributions described in Section 1169B(d)(5)(A). The preceding notwithstanding, contributions by transfers to nondeductible individual retirement accounts shall be subject to taxation as provided in Section 1169B(d)(5) and for the purposes of this paragraph it shall be considered that the requirements of the same have been met if a contribution is made to the nondeductible individual retirement account of an amount equal to the total amount received from the qualified trust by the participant or beneficiary minus the contribution provided in said Section 1169B(d)(5) that has been withheld as therein provided.

(B) If a total distribution as described in clause (1) of this subsection includes employer's shares, that portion of the total

distribution which consists of employer's shares shall be excluded from the total distribution for the purpose of calculating the tax provided in clause (1) of this subsection. To determine profits or losses in the future disposition of these shares, the base of the employer's shares distributed shall be zero, increased by the amount contributed by the participant that has already been paid by the latter and that has not been taken into consideration under the preceding clause (1) when determining the taxation of other trust distributions. The terms 'actions of the employer' and the 'controlled group' shall have the same meaning provided in clause (2) of subsection (h) of this Section. The withholding agent shall not have to make the withholding required by clause (3) of subsection (b) of this Section on that portion of the total distribution consisting of the employer's shares.

(3) Obligation to deduct and withhold.-Any person, in whichever capacity he/she may act, who makes total distributions payable with respect to any participant or beneficiary within a single tax year due to the separation from services of the participant, which under the provisions of clause (1) are deemed as long-term capital gains, shall deduct and withhold from said distributions an amount equal to twenty (20) percent of the amount of the same in excess of the amounts contributed by the participant to the plan that have already been paid by the latter. This deduction and withholding shall be of twelve point five (12.5) percent if the trust meets the requirements provided in paragraphs (A) and (B) of clause (1) of this subsection." The employer whose employees participate in the plan or the administrator of the plan shall certify to the person who makes the distributions of the trust that the requirement of investing in 'property located in Puerto Rico,' has been met. Once the certification issued by the employer, the person who makes the distributions of the trust shall not be

liable for the payment of taxes, interest, or penalties in case this requirement has not been met, but shall be liable for deducting and withholding the twelve point five (12.5) percent.

(4) ...”

Section 2.-This Act shall take effect immediately after its approval.

CERTIFICATION

I hereby certify to the Secretary of State that the following Act No.49 (HB. 1548) of the 3rd Session of the 15th Legislature of Puerto Rico:

AN ACT eliminate clause (11) of subsection (a) and amend clauses (1) and (3) of subsection (b) of Section 1165 of Act No. 120 of October 31, 1994, as amended, known as the “Puerto Rico Internal Revenue Code of 1994,” in order to eliminate as part of the requirements for a retirement plan to be qualified under Section 1165, that the trust of the plan must be organized in Puerto Rico and that its trustee must be a resident of Puerto Rico; and to provide that in certain cases the total distributions of the trusts of the pension plans whose trustees are residents of Puerto Rico be considered as long term capital gains derived from the sale of property located in Puerto Rico,

has been translated from Spanish to English and that the English version is correct.

In San Juan, Puerto Rico, today 14th of August of 2006.

Francisco J. Domenech
Director