EXHIBIT B

QUALIFIED RETIREMENT PLAN ISSUES WITH EMPLOYEES IN PUERTO RICO

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1. **Employee Benefit Retirement Issues in Puerto Rico**. Over the years Congress has enacted various tax incentives to encourage corporations to invest in manufacturing and business operations in Puerto Rico. As a territory of the United States, Congress believes that infusion of capital into Puerto Rico will benefit the territory and ultimately the economy of Puerto Rico. Although most of the tax incentives have expired, legislation is currently being contemplated to advance new initiatives in Puerto Rico. Furthermore, many U.S. companies continue to maintain business operations and a presence in Puerto Rico to expand their businesses and for other economic reasons. The purpose of this series is to review various employee benefit and employment-related issues that U.S. employers should consider when maintaining or opening operations in Puerto Rico.

2. **Tax Overview**. Residents of Puerto Rico who do not have any U.S. income are not subject to U.S. federal income taxes. Such individuals are, however, subject to U.S. social security taxes, including both the social security and Medicare components totaling **7.45%** from an employee's wages. Employees are also subject to local Puerto Rican income taxes. Under these tax rules a Puerto Rican employee is the equivalent of an individual working in either New York or California, who is not subject to federal income taxes but is only subject to state and FICA taxes.

3. **Section 401(k) Plans**. The most popular form of retirement plan in the United States is the Section 401(k) Plan. When a U.S. employer opens operations in Puerto Rico it is not uncommon to initially transfer an individual from the United States to open the operations and to hire local employees. This action may occur as a separate legal entity or as a division of a U.S. company. When transferring employees from the United States most employers wish to maintain the same level of benefits for the individual, so they will not be adversely affected by accepting a transfer. Thus, it is common for U.S. individuals residing in Puerto Rico to continue to participate in a U.S. retirement plan. This action is permitted as long as the individual remains on a U.S. payroll and does not become a resident of Puerto Rico. Unfortunately, including Puerto Rican employees in a U.S. Section 401(k) Plan can be fraught with difficulties.

   Initially, it is important to note that under the Puerto Rican Code of 1994 (the "PR Code"), the U.S. rules in effect prior to the Tax Reform Act of 1986 continues to exist. Accordingly, Puerto Rican employees are only permitted to contribute up to the lesser of **10%** of their compensation or **$8,000** on an annual basis, rather than the current U.S.

level of **$15,500**. Furthermore, Puerto Rico did not implement Catch-Up Contributions until 2006. In 2006, Catch-Up Contributions could have been made for individuals who attain age **50** in the amount of **$500**, which was increased to **$1,000** dollars in 2007. By contrast, the U.S. Catch-Up Contributions for both 2006 and 2007 was **$5,000**. Most importantly, in performing the annual Section 401(k) nondiscrimination tests (i.e., the actual deferral percentage ("ADP") and actual contribution percentage ("ACP") tests), in lieu of the current **$100,000** threshold for determining highly compensated employees in 2007, Puerto Rico continues to treat the highest **1/3** group of employees as highly compensated. Thus, the remaining **2/3** of employees are treated as non-highly compensated employees for testing purposes.

To the extent that a U.S. employer includes Puerto Rican employees in a U.S. Section 401(k) Plan, the U.S. plan must contain language to ensure that the Puerto Rican rules are being satisfied in the U.S. The recordkeeper for the plan must also monitor that the Puerto Rican contribution limitations are not being exceeded. It is easy to imagine that a U.S. employer, with several hundred employees, might include **20** employees in Puerto Rico in a U.S. plan. This action is taken, since the employer does not wish to incur the time and expense in establishing a separate Puerto Rican 401(k) Plan. However, once the Puerto Rican employees are included in the U.S. plan, it is equally easy to anticipate that the Puerto Rican requirements will not be satisfied. In the event that the Puerto Rican limitations are exceeded, employees must receive a return of excess contributions in order to maintain the qualified status of the U.S. plan.

For the above reasons, before a U.S. employer includes Puerto Rican employees in a U.S. plan it is important to review the advantages and disadvantages of maintaining a separate Puerto Rican plan or including Puerto Rican employees in the U.S. plan. The primary advantage of establishing a Puerto Rican plan is the plan need only satisfy the PR Code under a plan approved by the Puerto Rican taxing authority, known as the Hacienda. However, the primary advantage of establishing a Puerto Rican plan is that Puerto Rican employees who participate in a Puerto Rican plan have favorable tax treatment when distributions are made from the plan. To the extent that a Puerto Rican employee participates in a U.S. plan, distributions are subject to a **20%** income tax on the full amount of the distribution. The employee also has U.S. source income, which must be considered for purposes of the employee's individual income tax return. By contrast, distributions from a Puerto Rican Section 401(k) Plan, which is known as a Section 1163(e) Plan, is only subject to tax at a rate equal to **12%**. In addition, Puerto Rico has enacted certain rules which provide additional tax incentives. For example, if an individual between the ages of **55** and **60** withdraws less than **$8,000** per year, the distribution is not subject to "any" Puerto Rican income taxes. These tax benefits were enacted in Puerto Rico in order to encourage individuals to leave their retirement assets in Puerto Rican plans, in order to encourage retirement savings, rather than taking lump sum distributions and spending retirement assets.

Based upon the significant disadvantage to Puerto Rican employees by having them contribute to a U.S. Section 401(k) Plan, this author posets that in virtually all situations it will be more economical and beneficial to a U.S. employer to establish a separate

Puerto Rican 1165(e) plan, rather than to have Puerto Rican employees participate in the U.S. plan. Given the fact that including of such employees in U.S. plans will most likely result in administrative errors occurring and corrective actions being required, the benefits of establishing a local plan will outweigh the additional costs for maintaining a separate program.

Additional issues for U.S. employers to consider are that Puerto Rican 1165(e) plans are subject to all provisions of ERISA. Accordingly, a Form 5500 is required for an 1165(e) plan, in addition to or in lieu of filing a Puerto Rican Form 480.70. Lastly, since the Hacienda does approve prototype plans, similar to U.S. prototype plans, the establishment of a Puerto Rican plan can be simplified if the proper resources and service providers are identified.

4. **Conclusion**. In conclusion, this author recommends that all U.S. employers with Puerto Rican operations immediately determine whether such employees participate in a U.S. plan or a separate Puerto Rican plan, and review the administrative issues identified in this article.

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