

Puerto Rico Retirement Plan Qualification Requirements and Trusts Modified

ATTORNEYS

- Carlos J. Villafañe-Real
- Lillian Toro-Mojica
- Yamarly I. González-Berríos
- Leyla González-Ibarría
- Angel S. Ruiz-Rodríguez
- Mayleen Santiago-Garcés

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An McV Employee Benefits Alert

February 10, 2017

On February 8, 2017, the Puerto Rico Governor signed into law Act No. 9-2017 (the “Act”), which is based on House Bill No. 3, dated January 2, 2017 (“HR-3”). As indicated in our Employee Benefits Alert of January 20, 2017, the Act is intended to amend certain provisions of the Trust Act of 2012, Act No. 219-2012 (the “Trust Act”), and the Puerto Rico Internal Revenue Code of 2011, as amended (“PR Code”), governing the treatment of retirement benefit plans, to halt the exodus from Puerto Rico of professionals, protect their economic future, and attract productive human talent to Puerto Rico.

As more fully discussed below, the Act amends the Trust Act to provide an enhanced protection of trust assets against creditor’s claims, incorporate the concept of “retirement plan trust” (a concept covered up to this point only by the PR Code), protect the surviving spouse of a retirement plan participant by recognizing him/her as the beneficiary of the plan’s death benefits, unless someone else is appointed pursuant to applicable Puerto Rico or Federal laws, and reduce the uncertainty and court intervention when there is a change in trustee. The Act also amends the PR Code in an effort to ease the establishment and operation of retirement plans in Puerto Rico, particularly those established by small employers and owner-employees. Such changes may have the unintended effect of requiring the amendment of existing retirement plans to comply with the new qualification requirements.

CHANGES ENACTED BY THE ACT

The changes made by the Act regarding retirement plans are the following:

The Trust Act:

- Adds a chapter on Retirement Plan Trusts that includes the definition of Retirement Plan Trust, Settlor, Owner-employee, Self-employed individual, Participants and Death Beneficiary.
- With respect to the beneficiary designation in a retirement plan, if the participant is married and dies, the beneficiary of the retirement plan death benefits will be the deceased participant’s spouse, unless the participant

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designates someone else (with the surviving spouse approval) in compliance with provisions of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).

However, if the trust of the plan is exempt from ERISA (as would be the case with retirement plans covering only owner-employees), and the plan participant and his/her spouse executed a pre-nuptial agreement providing for the complete separation of properties, the participant will not need the spouse’s consent to designate someone else as beneficiary.

- All the assets in a retirement plan trust will be exempt from the estate and inheritance provisions of the Puerto Rico Civil Code of 1939, as amended. Accordingly, the filing of court proceedings will not be necessary to distribute the plan assets to the beneficiary designated under the terms of the retirement plan.

The PR Code – Retirement Plans:

- The maximum deduction for employer contributions to defined contribution plans cannot exceed 25% of the compensation paid or accrued to all employees in the plan during the taxable year (the “25 Limitation”). The limitation initially proposed in HR-3 of the lesser of \$75,000 or 25% of the compensation paid or accrued to all employees in the plan was not adopted by the Puerto Rico Legislature. However, contributions to these plans (excluding rollovers) that do not exceed the limitations discussed in the paragraph below will be considered allowable deductions even if in excess of the 25% Limitation.
- The maximum limit to employer and employee contributions, excluding rollovers, to a defined contribution plan is the lesser of \$75,000 or 25% of “Net Income.” The new limitation does not allow for cost-of-living adjustments, and is not clear as to how the dollar limitation will be computed and whether the “Net Income” is that of the employee.

Contributions on behalf of low-wage workers may be impacted adversely by this new limitation. Under the former rules, the maximum limit was determined by the lesser of: i) 100% of the employee’s annual compensation; or ii) the dollar limitation under Section 415(c) of the United States Internal Revenue Code of 1986, as amended (“US Code”), as established annually by the U.S. Internal Revenue Service (“IRS”) after considering cost-of-living adjustments (for 2017, \$54,000).

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Furthermore, the new maximum limitation does not take into account the provisions of PR Code Section 1081.01(a)(12) that limit the “compensation” that can be used for purposes of determining benefits under a qualified retirement plan to the amount allowed under US Code Section 401(a)(17) (for 2017, \$270,000) (the “Compensation Limitation”). We expect to see guidance and further clarification from the Puerto Rico Treasury Department (“PR Treasury”) regarding this matter, since the Compensation Limitation will not allow participants reach this new maximum limitation.

- The definition of “Highly Compensated Employee” is modified to exclude officers of the participating employer and include any employee that for the prior taxable year received compensation from the employer in excess of \$150,000. This compensation limitation is fixed and no longer determined by reference to the dollar limitation under US Code Section 414(q)(1)(B), as determined annually by the IRS for cost-of-living adjustments (for 2017, \$120,000).
- Retirement Plans with a Cash or Deferred Arrangements (“CODA”) are now exempt from complying with the “Average Deferral Percentage Test” of PR Code Section 1081.01(d) (3), provided the retirement plan has fewer than 100 participants whose businesses generate less than \$10 million of annual gross income, and the employer provides to all eligible employees a benefit of no less than 3% of the compensation of each eligible employee.

The Act establishes a safe harbor rule in Puerto Rico for small businesses. Although the language of the Act establishing the requirements for the safe harbor rule is not clear, we understand that the \$10 million gross income limitation is for the employer that has established the retirement plan with a CODA.

Notwithstanding compliance with the new safe harbor rule of the Act, all retirement plans must continue to meet the coverage and participation requirements of PR Code Section 1081.01(a)(3) and the non-discrimination provisions of PR Code Section 1081.01(a)(4) as to benefits and contributions.

- In the case of owner-employees, the definition of earned income includes net gains (except capital gains) derived from the transfer of any interest in property. The plans of owner-employees, however, will remain subject to the additional qualification requirements of PR Code Sections 1081.01(e) and (f).

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NEXT STEPS AND POTENTIAL ISSUES

The Act departs from the previous PR Treasury's policy of conforming Puerto Rico retirement plan qualification requirements under the PR Code to those under the US Code, which may create administrative compliance issues.

In addition, the Act may have the unintended effect of placing on sponsors the burden of amending plan documents and modifying the administration and operation of retirement plans covering Puerto Rico employees.

The provisions by the Act are effective immediately and the required amendments to the plans as a consequence of the enactment of the Act are "qualification amendments" under current guidance issued by PR Treasury. Thus, plan sponsors will be required to adopt such amendments in 2017 to secure the qualified status of the plans under the provisions of the PR Code. We expect to see guidance and further clarification from PR Treasury regarding this matter.

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