

Proposed Amendments to the Retirement Plan Provisions of the PR Internal Revenue Code of 2011 and Other Related Matters

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PRACTICE AREAS

- Employee Benefits

An McV Employee Benefits Alert

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On January 2, 2017, House Bill No. 3 (“HR 3”) was filed with the Puerto Rico Legislature 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. The purpose of HR 3 is to halt the exodus from Puerto Rico of human resources, protect their economic future, and attract productive human talent to Puerto Rico.

CHANGES PROPOSED BY HR 3

HR 3 amends the Trust Act to provide enhanced protection of trust assets, incorporate the concept of “retirement plan trust”, protect the surviving spouse of a retirement plan participant, and reduce uncertainty and litigation when there is a change in trustee. HR 3 also amends the PR Code to ease the establishment of retirement plans in Puerto Rico, particularly by small employers and owner-employees. The proposed changes affecting retirement plans are as follows:

I. The Trust Act:

- Adds a chapter on Retirement Plan Trusts that defines Retirement Plan Trust, Settlor, Owner-employee, Self-employed individual, Participants and Death Beneficiary. With respect to beneficiary designation, 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 designates someone else (with the surviving spouse approval) before a notary public. This change could be viewed as the enforcement of local restrictions on an area already governed by the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and, therefore, going against the preemption provisions of ERISA.

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In addition, assets in a retirement plan trust will be exempt from the PR Civil Code estate and inheritance provisions at the time of the transfer of title to the beneficiary if the beneficiary is the spouse. This is a positive change that should make retirement plans a more attractive savings vehicle in Puerto Rico.

II. The PR Code - Retirement Plans:

- The maximum deduction for employer contributions to defined contribution plans is modified and now is capped at the lesser of \$75,000 or 25% of compensation paid or accrued to all employees in the plan during the taxable year. This change appears to impose a maximum limitation of \$75,000 upon the deduction that could be claimed by an employer sponsoring a retirement plan with respect to the amounts contributed to such plan on behalf of all its employees, which is a new restriction not previously included in the PR Code.
- The maximum limit of employer and employee contributions, excluding rollovers, to a defined contribution plan is modified to exclude reference to US Code limitations, and to be the lesser of \$75,000, 25% of Net Income, or 100% of the participant's compensation paid during the natural or plan year. This change, although positive to some extent, should also include an increase in the amounts an individual can defer on a pre-tax basis under a 1081.01 (d) plan, which are amounts that have not been revised for inflation since the adoption of the PR Code in 2011, as regularly done under the counterpart provision of the US Code.
- The definition of Highly Compensated Employees is simplified to mean any employee that for the prior taxable year obtained compensation from the employer that exceeds the greater of the applicable limit under Section 414 (q) (1) (B) of the US Code or \$250,000. In the case of owner-employees, the definition of earned income includes net gains derived from the transfer of any interest in property. Also, the additional requirements for qualification of plans of owner-employees are eliminated.
- Coverage and Average Benefit Percentage Test requirements of the PR Code will not apply to retirement plans with less than 100 participants whose businesses generate less than 10 million annually in gross income, if the employer provides a benefit to all eligible employees of no less than 3% of the compensation of each eligible employee. This safe harbor as to the

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coverage and discrimination tests of Section 1081.01(a) (3) of the PR Code for small retirement plans is a positive alternative that will facilitate complying with the qualification requirements of the PR Code.

III. PR Code – Estate Tax:

- The value of property transferred by a Puerto Rico resident during his life to a Puerto Rico trust will be excluded from his gross estate at the time of his death if the trustee of such trust is not the decedent, even if the decedent is the beneficiary of the trust. (Art. 17 of HR 3 amending Sec. 2022.01 (b) of the PR Code).
- Stock issued by any domestic corporation or partnership will be property located in Puerto Rico regardless of whether the owner possesses more than 10% of the stock, and whether or not the entity complies with the 80% gross income test. (Art. 18 of HR 3 amending Sec. 2023.02(b) (2) of the PR Code).

OTHER ISSUES AS THE RESULT OF THE CHANGES PROPOSED BY HR 3

The enactment of some of the proposed changes to the PR Code would place upon the sponsors of Puerto Rico retirement plans the burden of an additional layer of qualification compliance, requiring further amendments to their plans, additional filings with the Puerto Rico Treasury Department (“PR Treasury”), and incurring additional costs. In addition, some of the proposed changes depart from PR Treasury’s prior public policy of conforming the retirement plan provisions of the PR Code to those of the US Code, which could have the unintended consequence of causing US employers to stop offering or terminating their United States retirement plans in Puerto Rico.

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