



Puerto Rico law modifies retirement plan rules

On February 8, 2017, the Governor of Puerto Rico signed into law Act No. 9-2017, which includes revisions to the Puerto Rico Trust Act of 2012 (Act No. 219-2012) and Puerto Rico Internal Revenue Code of 2011. The changes apply to all qualified retirement plans covering Puerto Rico employees including those qualified under the Puerto Rico Code (Puerto Rico-only plans) and plans also qualified under the United States Internal Revenue Code (dual-qualified plans). Many of the changes apply to defined contribution plans, but some of the changes (such as those described in the [“Retirement Plan Trust”](#) section below) also pertain to defined benefit plans.

While the provisions of the Act are effective immediately, further guidance is needed from the Puerto Rico Treasury Department (Hacienda) to address some of the changes.

Overview

The recent changes to the Puerto Rico Trust Act and Internal Revenue Code are focused on the economic security and future of professionals in Puerto Rico. By providing broader, more flexible options and reducing administrative burdens, the Puerto Rico government hopes to encourage small businesses to offer retirement plans and increase participation in existing retirement plans.

The new law includes adjusted contribution and employer deduction limits, a revised definition of highly compensated employee, and a new safe harbor rule. Clarification on beneficiary designations and trusts is also provided.

Historically, the Puerto Rico Internal Revenue Code (PR Code) provisions have been consistent with those of the United States Internal Revenue Code (US IRC). However, the changes with Act No. 9 have created disparities between the rules under the PR and US Codes. As a result, plan sponsors of dual-qualified plans need to understand the differences and apply them accordingly. Additionally, sponsors of Puerto Rico-only plans must be aware of the new rules as they administer those plans.

Summary of changes

Contribution limit for defined contribution plans

The new annual contribution limit for employee and employer contributions is the lesser of \$75,000 or 25% of “net income.” Previously, the limit under the PR Code was tied to and consistent with the US limit of the lesser of the annual contribution limit for the year (\$54,000 for 2017) or 100% of the participant’s compensation. In addition, the new limit amount under the PR Code is no longer indexed to allow for cost-of-living adjustments.

Employer deductions for retirement plan contributions

The maximum deduction for employer contributions to a defined contribution plan remains at 25% of the aggregate paid or accrued compensation to all employees in the plan within the applicable tax year. However, contributions that exceed the 25% limit are deductible, so long as the new individual annual limits as described above are not exceeded.

Highly compensated employees

The definition of highly compensated employee (HCE) was revised to increase the annual compensation threshold to \$150,000 during the prior tax year. The new threshold is no longer aligned with the US threshold or subject to cost-of-living adjustments. In addition, officers are no longer automatically considered HCEs. Finally, it expands the definition of owner to include not only employees who own more than 5% of the voting shares or total value of all classes of shares of stock, but also employees who own more than 5% of the capital or interest in the profits of an employer that is not a corporation.

ADP safe harbor rule

A safe harbor rule for small businesses with a cash or deferred arrangement (CODA) now exempts eligible plans from average deferral percentage (ADP) testing, if the employer's businesses:

- Have fewer than 100 participants in a defined contribution plan;
- Generate less than \$10 million in annual gross income; and
- Provide a non-elective contribution to all eligible employees of at least 3% of their compensation.

While applying the safe harbor rule, retirement plans still must comply with coverage, participation, and non-discrimination requirements of the PR Code.

Retirement plan trusts

The new law also provides the following clarifications regarding beneficiary designations and trusts:

- For married participants, the spouse must be the designated beneficiary, unless the spouse provides written consent for another individual to be named the beneficiary and ERISA requirements are met. If the plan is exempt from ERISA, a prenuptial agreement that provides for complete economic separation exempts the participant from obtaining spousal consent to name a beneficiary other than the spouse; and
- All assets in a qualified retirement plan trust are now exempt from the estate and inheritance provisions of the Puerto Rico Civil Code. Therefore, retirement plan assets may be distributed according to the terms of the plan without the need for any court proceedings. This includes retirement plan trusts established by self-employed individuals.

Open items

The following items remain outstanding and require further guidance or clarification from Hacienda:

- Definition of "Net Income" as it relates to the new annual contribution limit;
- Calculation for the new annual contribution limit and how it will be measured;
- Determination of HCE status for 2017 testing;
- Application of nondiscrimination rules to the new HCE definition; and
- When determining eligibility for the new safe harbor:
 - Definitions of "business" and "gross income;" and
 - Time frame for verifying the number of plan participants.

We will provide updates on these items once additional details are made available by Hacienda.

Next steps

The provisions of Act No. 9 require plan amendments that appear to be considered “qualification amendments.” Plan sponsors may be required to adopt the amendments in 2017 to maintain the qualified status of their plans under the PR Code. For sponsors that use Prudential Retirement’s document services, we will notify you when applicable amendments are available.

In addition, to obtain Puerto Rico qualification, updated determination letters will be required by Hacienda.

Qualification amendments must generally be filed with Hacienda on or before the due date of the employer's Puerto Rico income tax return for the year in which the amendment is adopted. Hacienda is expected to release additional information related to the deadlines and requirements for plan amendments and determination letter requests.

Plan sponsors with Puerto Rico-only or dual-qualified retirement plans should carefully read the information contained in this publication and review the impacts with the plan’s legal counsel. Dual-qualified plans should pay special attention to the new discrepancies between the United States and Puerto Rico rules. Hopefully Hacienda guidance will provide needed clarifications in the near future.

Compliance Advisory by Prudential Retirement

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