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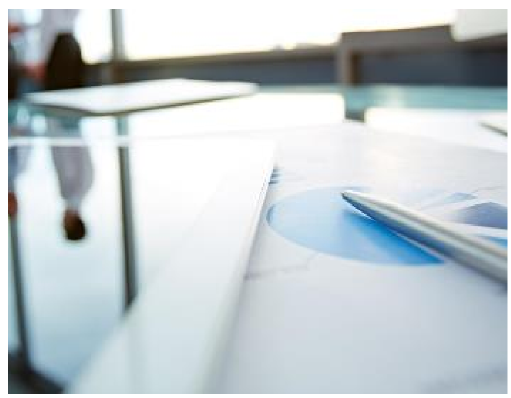
Puerto Rico Enacts Changes to Rules for Qualified Plans and Trusts

Act No. 9-2017 amends some of the qualification requirements for retirement plans under Puerto Rico's 2011 Internal Revenue Code and certain provisions of the Puerto Rico Trust Act of 2012. The changes are effective immediately and may trigger the need for plan amendments.

Background

In 2011, Puerto Rico enacted major tax reform and replaced the Puerto Rico Internal Revenue Code of 1994 with the "Internal Revenue Code for a New Puerto Rico" (2011 PR Code). In addition to its stated goal of putting "more money in the pocketbooks" of its residents, the 2011 PR Code's retirement plan provisions mimicked those of the US Internal Revenue Code (US Code) in several areas – alleviating some compliance problems for "dual qualified" plans that were designed to meet the qualification requirements in both the US and Puerto Rico.

Before the US issued Revenue Ruling 2008-40 in 2008, sponsors of dual qualified plans that were unable to meet certain US Code qualification requirements were able to resolve certain troublesome compliance problems (caused by differences between the US and PR Code retirement plan qualification requirements) by spinning off their Puerto Rico participants to a plan that only met Puerto Rico's qualification requirements without the spin-off being considered a disqualifying event and a taxable distribution under the US Code. However, the relief provided under Revenue Ruling 2008-40 permitting such spin-offs under the US Code finally expired on December 31, 2012 (after two previous extensions). (See our *For Your Information* dated January 29, 2013.)



Legal requirements for qualified retirement plan trusts were enacted as part of the 2011 PR Code. The requirements for trusts under the Puerto Rico Civil Code were modernized in 2012 under Act 219-2012, but did not specifically address retirement plan trusts.

2017 Legislation Aims to Retain Professionals

In the face of increasing levels of emigration of professionals out of Puerto Rico, on February 8, 2017, the governor of Puerto Rico signed Act No. 9-2017. This legislation is intended to encourage professionals to stay in Puerto Rico by amending Puerto Rico's "Trusts Law" and the Internal Revenue Code to provide better and broader asset protection, address statutory conflicts, protect surviving spouses, and create an opening for more private employers to offer retirement plans.

Changes to Annual Additions Limit for Defined Contribution Plans

Act. No. 9-2017 modifies the existing limits on annual additions to a defined contribution plan under the 2011 PR Code (which previously was the same as the Section 415 limit under the US Code: the lesser of 100% of compensation or $54,000). The new limit is the lesser of 25% of "net income" or $75,000.

> **Comment.** As under the US Code, the 2011 PR Code currently limits the amount of "compensation" that can be considered in determining contributions or benefits ($270,000 for 2017). "Net income" is not defined in Act. No. 9-2017, so it is not known whether it will be defined the same as "compensation" (and limited to $270,000), or whether it will be defined in some other fashion.
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> For example, under the US Code before 1998, pretax deferrals under cash or deferred arrangements and cafeteria plans were excluded from the definition of "compensation" for purposes of determining the Section 415 limits. This had the effect of limiting the annual additions to 25% of the taxable portion of employee compensation. Also, since 25% of the current limit of $270,000 is only $67,500 (lower than the new $75,000 annual addition limit), it is not clear how the new limit will operate until the compensation limit rises above $300,000 in later years due to inflation.
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> It appears that the new limit will serve to constrain (rather than increase) the annual additions limits for dual-qualified defined contribution plans, which will need to be amended to limit allocations to the lesser of the 2011 PR Code limit or the US Code limit to ensure continued qualification under both the US and PR Codes.

New Definition of Highly Compensated Employee

As was the case before Act No. 9-2017 was enacted, the new definition of "highly compensated employee" (HCE) includes 5% owners of the employer and employees who earned more than a specified dollar threshold in the prior year. However, the value of the dollar threshold has changed from the threshold specified under the US Code (currently $120,000, adjusted for inflation each year) to a flat $150,000 without adjustment for inflation. Additionally, under the new definition the "officer" category is eliminated.

> **Comment.** Additional guidance would be welcome on whether the change will first be effective next year (so that a participant earning more than $150,000 in 2017 will become an HCE in 2018) or whether it will be effective this year, so that a participant who earned more than $150,000 in 2016 would already be considered an HCE in 2017.

New Nondiscrimination Safe Harbor Available for Cash or Deferred Arrangements of Small Employers

Under the 2011 PR Code, unlike the US Code, there was no nondiscrimination "safe harbor" design available to sponsors of cash or deferred arrangements that would enable the local equivalent of Section 401(k) plans to be exempted from actual deferral percentage (ADP) testing. Act. No. 9-2017 establishes a new nondiscrimination safe harbor for cash or deferred arrangements in Puerto Rico qualified retirement plans with fewer than 100 participants that are sponsored by businesses that generate less than $10 million in annual gross income.

To meet the new safe harbor rule and avoid ADP testing, the plan sponsor must make a nonelective contribution for all eligible employees equal to at least 3% of compensation. This is similar to the 3% nonelective contribution safe harbor available under the US Code (except that the availability of the safe harbor under the US Code is not limited to plans with fewer than 100 participants and plan sponsors with under $10 million in gross income).

The new law leaves plan sponsors with the following unanswered questions about the new safe harbor:

- When determining whether gross income exceeds the $10 million threshold, which companies should be included? In a controlled group of corporations, will the gross income of all affiliates be counted, just those operating in Puerto Rico, or just those who employ participants?
- Unlike the US Code, the PR Code does not explicitly require the safe harbor contributions to be 100% immediately vested, restrict them from being withdrawn in-service before age 59 1/2, or require annual "safe harbor contribution notices" to be provided to all eligible employees as a condition for meeting the safe harbor. Therefore, it appears that these requirements will not apply in Puerto Rico. It would be useful for Hacienda to confirm this.
- What definition(s) of compensation can be used to determine the safe harbor non-elective contribution?
- In determining whether the 100 participant threshold has been exceeded, when must the number of participants be determined? Will the number of participants be determined as of a snapshot date before the beginning of the plan year? Can the Form 5500 counts for the prior year be used for ERISA plans? A snapshot date before the beginning of the plan year would allow for the plan sponsor to determine its eligibility for the safe harbor and provide some time to communicate the safe harbor to participants before the start of the plan year.
- Over which period should the employer's gross income be determined? For example, if the plan year and the employer's tax year are both the calendar year, can the employer use the 2016 gross income figure in determining whether the safe harbor is available for the 2018 plan year, or must the 2017 gross income figure be used? If the 2017 gross income must be used, the plan sponsor may not know if the safe harbor applies until after the start of the 2018 plan year. If several employers participate in the plan and each has a different taxable year, which year would be used to measure gross income?

Comment. The PR Code still does not provide for a match-based nondiscrimination safe harbor formula.

Trust Law Amended to Cover Retirement Plan Trusts

Act. No. 9-2017 adds a new chapter to the trusts section of the Puerto Rico Civil Code for retirement plan trusts. It clarifies that qualified retirement plan trusts are not subject to the Civil Code trust provisions on successions and inheritance, and that retirement plan trusts are instead governed by the terms of the trust instrument.

The law also requires spousal consent for married participants to designate non-spouse beneficiaries – even if the plan is not subject to ERISA requirements. It clarifies that spousal consent can be waived under the terms of a pre-nuptial agreement for plans that are not subject to ERISA (such as governmental plans, church plans that did not elect to be covered by ERISA, and plans that cover only the owners of unincorporated businesses and their spouses).

> **Comment.** Guidance would be welcome on whether a plan exempt from ERISA's spousal consent requirements *must* accept a spousal waiver by pre-nuptial agreement or whether such a plan is merely *permitted* to do so. There is also uncertainty about whether a plan not subject to ERISA's spousal consent requirements that voluntarily incorporates them by reference into the plan document would be allowed to accept spousal waivers by pre-nuptial agreement.

Effective Date

The new law is effective immediately.

In Closing

Act. No. 9-2017 marks a reversal of the trend of the Puerto Rico Internal Revenue Code converging toward the rules provided in the US Code on retirement plan qualification rules. The changes to the PR Code described above will require amendments to plan documents and administrative procedures for Puerto Rico qualified plans (including dual qualified plans) and especially defined contribution plans. As noted in our February 16, 2017 *For Your Information*, these changes will trigger the need to obtain an updated determination letter from Hacienda. As described above, we are hopeful that Hacienda will provide guidance clarifying how to apply the new rules.

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