Puerto Rico 401(k) Plans: Do You Know the Rules that Apply?

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Background on Puerto Rico’s Interactions with the USA

- US Territory since 1898 (Spanish-American War)
- Persons legally born in Puerto Rico **ARE** U.S. citizens (since 1917)
- Puerto Rico has its own tax code (currently the PR Internal Revenue Code of 2011, as amended, or the “**PR Code**”) modeled after the U.S. Internal Revenue Code of 1939
- Bona-fide individual residents of PR are exempt from Federal income taxation on PR-source income (U.S. Code Section 933)
- However, bona-fide PR residents are subject to same FICA tax rules as U.S. resident individuals (U.S. Code Section 3121(e))
- ERISA generally applies to PR benefit plans, subject to certain limited exceptions (e.g., Title IV Coverage for PR D/B plans that are not intended to be U.S. tax qualified plans)
Who Maintains Retirement Plans in Puerto Rico?

• **Existing employers:** PR affiliates of US/multinationals that offer retirement plan benefits to their employees and wish to maintain similar retirement plan offerings to its workforce across geographies.

• **Existing employers:** local PR employers who wish to offer retirement benefits to their workforce.

• **New employers:** US/multinationals expanding operations in Puerto Rico.

• **M&A employers:** corporate acquisitions with operations in Puerto Rico.
Alternatives for Providing Retirement Plan Benefits to PR Workforce

- Extend U.S. retirement plan coverage to participants in PR (i.e., Dual Qualified Plan)
- Establish separate PR stand-alone plan (PR-Only Qualified Plan)
Dual Qualified Plans: How Do You Do That?

• Amend U.S.-qualified plan for compliance with PR Code requirements for PR-tax qualification of retirement plans (PR Code Section 1081.01, PR equivalent to U.S. Code Section 401)

• Amendments should **only** apply to PR residents and/or persons who provide services “primarily within Puerto Rico” (to prevent impacting U.S. participants by reason of PR amendments, and therefore U.S.-tax qualification)

• U.S.-qualified plans can maintain current structure (i.e., same U.S. trust, recordkeeping, and investments), but should determine if separate PR tax reporting and withholding is required

• In many instances a PR-paying agent is hired to assist in such tax reporting and withholdings
PR-Only Qualified Plans: Steps

• **Step 1:** Establish stand-alone PR plan covering only PR resident individuals and/or persons providing services primarily within Puerto Rico

• **Step 2:** Establish PR trust for PR plan

• **Step 3:** Coordinate with custodian (can be same US plan custodian) to receive assets and execute investments

• **Step 4:** Establish tax withholding and reporting (may be same trustee, custodian, or third-party)
Types of PR-Only Qualified Plans

A. Individually designed plans

B. Master/Prototype Adoption Agreement Plans
   - Master Plan Adoption: Adopts with Master Plan and Master Trust
   - Prototype Plan Adoption: Adopts a Prototype Plan but has its own stand-alone trust document
## Pros and Cons of Dual Qualified Plans

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>One Plan</td>
<td>Dual Taxation IRS/PR Treasury (source)</td>
</tr>
<tr>
<td>One 5500</td>
<td>Additional PR withholding/reporting</td>
</tr>
<tr>
<td>One Trust</td>
<td>Some U.S. Plan providers will not want to handle PR accounts</td>
</tr>
<tr>
<td>One SPD</td>
<td>Correction of errors requires <strong>both</strong> U.S. and PR Compliance</td>
</tr>
<tr>
<td>Easy to handle “expats” to PR</td>
<td>Issues with rollovers</td>
</tr>
<tr>
<td>Same 401k limits ($18k for 2017)</td>
<td>Coverage/ADP testing complexities</td>
</tr>
</tbody>
</table>
### Pros and Cons of Puerto Rico-Only Qualified Plans

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>No impact on U.S. Plan by PR Plan operation</td>
<td>2 Plans (U.S. Plan and PR Plan)</td>
</tr>
<tr>
<td>Easier to administer corrections (PR only)</td>
<td>2 Trust</td>
</tr>
<tr>
<td>Simpler taxation to participants (PR only)</td>
<td>2 SPDs</td>
</tr>
<tr>
<td>NO ACP testing (for 401k plans)</td>
<td>Difficult to handle “expats” to PR</td>
</tr>
<tr>
<td></td>
<td>Lower 401k limits ($15k vs $18k in 2017)</td>
</tr>
<tr>
<td></td>
<td>No rollovers to U.S. Plans/U.S. IRAs</td>
</tr>
</tbody>
</table>
Income Source Rules to Consider

• Revenue Ruling 79-388 (Source Rules)
• Revenue Ruling 2008-40 (Transfer Rules)
• Revenue Procedure 2004-37 (source allocation of D/B pension payments to participants)
## Income Source Rules to Consider (Continued)

<table>
<thead>
<tr>
<th></th>
<th>If Plan has a U.S. Trust</th>
<th>If Plan has a PR Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions</td>
<td>PR Source</td>
<td>PR Source</td>
</tr>
<tr>
<td>Earnings/Accretions</td>
<td>U.S. Source</td>
<td>PR Source</td>
</tr>
</tbody>
</table>

*Assumes all service by PR Participants is performed in Puerto Rico. Special contribution services rules apply if not.

**PR residents are worldwide taxable in PR and take credit for taxes paid in other jurisdictions*
ERISA Section 1022(i)

“Certain Puerto Rican Pension, etc., Plans to Be Exempt From Tax under Section 501(A):

1. General Rule. Effective for taxable years beginning after December 31, 1973, for purposes of section 501(a) of the Internal Revenue Code of 1954 (relating to exemption from tax), any trust forming part of a pension, profit sharing, or stock bonus plan all of the participants of which are residents of the Commonwealth of Puerto Rico shall be treated as an organization described in section 401(a) of such Code if such trust:

   A. Forms part of a pension, profit sharing, or stock bonus plan, and

   B. Is exempt from income tax under the laws of the Commonwealth of Puerto Rico.
2. Election to have provision of, and amendments made by, title II of this act apply:
   
   A. If the administrator of a pension, profit sharing, or stock bonus plan which is created or organized in Puerto Rico elects, at such time and in such manner as the Secretary of the Treasury may require, to have the provisions of this paragraph apply, for plan years beginning after the date of election, any trust forming a part of such plan shall be treated as a trust created or organized in the United States for purposes of section 401(a) of the Internal Revenue Code of 1954.
   
   B. An election under subparagraph (a), once made, is irrevocable.
ERISA Section 1022(i)(1)

- Allows for exemption from federal income taxation of earnings and accretions of PR trusts related to Puerto Rico only tax qualified retirement plans during the participants’ accumulation period by treating such plans as a plan qualified under US Code Section 401(a) (for purposes of US Code Section 501(a))
ERISA Section 1022(i)(1) (Continued)

• Requirements:
  – PR qualified plan
  – Covering **ONLY** PR residents or persons providing services primarily within PR
ERISA Section 1022(i)(2)

• Allows for special kind of dual-qualified plan with a PR trust
• Such plan and its enabling trust will be treated as a US tax-qualified retirement plan under Section 401(a) of the US Code
• Generally used for (i) PR employers expanding operations in the USA; (ii) US employers that want a separate PR plan but that can allow for transfers of employees and their benefits between the PR and US plans; and/or (iii) for US employers that have PR participants whose account balance are intended to be segregated from the US plan’s tax-qualified trust

<table>
<thead>
<tr>
<th>Matter</th>
<th>U.S. Code</th>
<th>PR Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Coverage</td>
<td>410(b)</td>
<td>1081.01(c)(3)</td>
</tr>
<tr>
<td>Non-Discrimination</td>
<td>401(a)(4)</td>
<td>1081.01(a)(4)</td>
</tr>
<tr>
<td>Cash or Deferred Arrangement</td>
<td>401(k)</td>
<td>1081.01(d)</td>
</tr>
<tr>
<td>Catch-Up Contributions</td>
<td>414(v)</td>
<td>1081.01(d)(7)(c)</td>
</tr>
<tr>
<td>ADP Testing</td>
<td>401(k)(3)</td>
<td>1080.01(d)(3)</td>
</tr>
<tr>
<td>Benefit/Contribution Limits</td>
<td>415(b)/415(c)</td>
<td>1081.01(a)(11)(A) and (B)</td>
</tr>
<tr>
<td>Compensation Limits</td>
<td>401(a)(17)</td>
<td>1081.01(a)(12)</td>
</tr>
</tbody>
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<tr>
<th>Matter</th>
<th>U.S. Code</th>
<th>PR Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Participation</td>
<td>410(a)(2)</td>
<td>N/A</td>
</tr>
<tr>
<td>Top-Heavy Provisions</td>
<td>416</td>
<td>N/A</td>
</tr>
<tr>
<td>MRDs</td>
<td>401(a)(9)</td>
<td>N/A</td>
</tr>
<tr>
<td>CODA Limits</td>
<td>$18k (adjusted)</td>
<td>$15k (static for PR-Q only)*</td>
</tr>
<tr>
<td>Catch-Up Contributions</td>
<td>$5k (adjusted)</td>
<td>$1,500 (static)</td>
</tr>
<tr>
<td>ACP Testing</td>
<td>401(m)</td>
<td>N/A</td>
</tr>
<tr>
<td>HCEs</td>
<td>414(q)</td>
<td>(No top-paid group Rule)</td>
</tr>
</tbody>
</table>

*Dual qualified plan are allowed the same U.S. Code CODA limits (with IRA interaction)*
## Special Taxation and Withholding Rules in Puerto Rico

<table>
<thead>
<tr>
<th>Type of Distribution</th>
<th>Taxation</th>
<th>Withholding</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lump Sum</strong></td>
<td>General Rule: 20% (*)</td>
<td>10% of taxable amount (**)</td>
</tr>
<tr>
<td></td>
<td>Exception: 10% if plan meets certain PR investment rule (or ordinary income at the taxpayer’s election)) (*)</td>
<td>10% of taxable amount</td>
</tr>
<tr>
<td><strong>Installment/Annuity</strong></td>
<td>Ordinary income with $11k (under age 60) or $15k (age 60+) annual exemption</td>
<td>10% in excess of $31k (under age 60) or $35k (age 60+) annually</td>
</tr>
<tr>
<td><strong>Other Payments</strong></td>
<td>Ordinary income</td>
<td>10% of taxable amount</td>
</tr>
</tbody>
</table>

(*) Subject to PR AMT rules.  
(**) For distributions made on/after 1/1/18.
Special Tax Reporting Rules for PR Qualified Plan Distributions (Dual or PR-only)

- Tax reporting of taxable distributions to participants in PR Treasury Form 480.7C (local equivalent to IRS Form 1099-R)
- 480.7C due on/before February 28 of the year following year of distribution
- Electronic filing of Form 480.7C with PR Treasury on/before that same date
Tax Reporting Rules for PR Qualified Plans and Trusts (Both Dual and PR-only)

• Plan qualification (filing with PR Treasury a/k/a Hacienda):
  a) Upon plan establishment (on or before the due date for the employer to file income tax return)
  b) Upon adoption of a “qualification amendment”
  c) Upon merger or consolidation of two or more qualified plans
  d) Upon plan termination

• Rules for Plan qualification submission to Hacienda currently set forth in PR Treasury Circular Letter 16-08
Tax Qualification Rules for Puerto Rico Tax-Qualified Plans: What Constitutes a “Qualification Amendment?”

• Future statutory amendments under PR Code Section 1081.01
• Changes in eligibility rules (e.g., participation freezes, etc.)
• Changes in formulas to determine participant benefits (e.g., allocation formulas)
• Changes in the form or method for payment of benefits (installments, partial payments, etc.)
• Add, remove, or substitute participating employers (excluding renaming with same EIN)
• Changes in rules to correct coverage, discrimination, or ADP testing
Tax Qualification Rules for Puerto Rico Tax-Qualified Plans: What Constitutes a “Qualification Amendment?” (Continued)

• Changes in rules to grant service credit with predecessor employer or to calculate benefits or contributions
• Benefit freezes or cessation of future benefits
• Plan consolidations, mergers, or terminations
• Substitution of plan sponsor, administrator, or paying agent for PR participants
• Changes in plan name or plan trust EIN
• Substitution of master/prototype plan sponsor
• Others, as the PR Treasury may determine pursuant to regulations or guidance
Annual PR Qualified Plan Reporting Requirements

• Annual Form 5500 reporting requirements, same as for US-based retirement plans
• Annual Form SC 6042 (for years beginning in 2015 and thereafter) or Form 480.70(OE) (for prior years)
• See PR Treasury Circular Letters 16-05 (establishing the Form SC 6042 requirement) and 12-02 (that allowed simplified filing under Form 480.70(OE) through use of copy of Form 5500 for years beginning in 2011 until 2015)
Recent PR Code Amendments to Be Considered

- Act 9-2017 (February 2017)
Most Important Changes Brought by Acts 9 and 106

• **Change in HCE definition:** changed reference to annual amount under U.S. Code Section 414(q)(1)(B) to static $150K

• **PR Safe-Harbor Rule for ADP Testing:**  
  • IF (i) employer has under $10 million in annual gross income; (ii) plan covers less than 100 participants; and (iii) employer provides a benefit to all eligible employees of at least three percent of compensation, **THEN**, ADP Testing will be deemed passed for such year
Most Important Changes Brought by Acts 9 and 106 (Continued)

• **PR Coverage compliance for Dual Qualified Plans if U.S. Code Coverage is complied with:** For dual qualified plans with US trusts (i.e., non- ERISA 1022(i)(2) dual qualified plans) if the plan complies with the U.S. Code coverage testing (U.S. Code Section 410(b)) then the plan will be deemed to comply with PR Coverage testing (PR Code 1081.01(a)(3))

• **Change in tax withholding for lump sum distributions (effective 1/1/18):** reduced from 20 percent of taxable amount to ten percent of taxable amount. However, tax rates remain the same (20 percent ordinary tax rates, at the election of taxpayer).
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