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## Retirement Plans in Puerto Rico — 2016/2017 Developments

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### INTRODUCTION

This article describes the main changes made between the end of 2016 and the beginning of 2017 to the rules regarding the operation and qualification of retirement plans in Puerto Rico (P.R.). The three main changes are:

- (1) The new procedures the P.R. Department of the Treasury (Hacienda) adopted on December 15, 2016, for requesting favorable determination letters concerning a retirement plan's qualification under §1081.01(a) of the Puerto Rico Internal Revenue Code of 2011 (PRIRC).
- (2) The changes P.R. Act No. 9 of February 8, 2017 (Act No. 9-2017) made to the local retirement plan rules.
- (3) The issuance of an updated version of Hacienda Form 480.7C (i.e., the local version of IRS Form 1099-R).

For most plan sponsors, particularly multinational corporations operating on the Island and large and mid-size local companies, there are three practical impacts of these recent developments. First, plan spon-

sors may periodically need to resubmit their plans to Hacienda to obtain an updated favorable determination letter confirming that the plans, as amended, continue to be qualified under the PRIRC. Second, most, if not all, of the changes resulting from Act No. 9-2017 do not directly affect plan sponsors; therefore, it is likely that plan sponsors will not have to take any action. Third, plan sponsors should provide a notice to the P.R. participants in their retirement plans reminding them to notify the trustee of the trust fund forming part of the plan and/or the recordkeeper servicing the plan if they previously elected to prepay P.R. income taxes on their plan benefits, so that the trustee or recordkeeper, as applicable, can properly reflect such prepayments on the Forms 480.7C that are filed with Hacienda.

### NEW PROCEDURES ON PLAN FILINGS WITH HACIENDA

On December 15, 2016, Hacienda issued Circular Letter of Tax Policy No. 16-08 (CL 16-08),<sup>2</sup> setting out the process to be followed, and listing the documents and information to be included, for requesting and obtaining from Hacienda a favorable determination letter confirming that a retirement plan is duly qualified under PRIRC §1081.01(a) (these letters are commonly known by their name in Spanish as *cartas de cualificación*). Before discussing the details and practical aspects of CL 16-08, it's helpful to give a brief background of the local retirement plan qualification requirements.

Since at least 1994, to be locally qualified, all retirement plans that cover active participants who are bona fide residents of Puerto Rico (P.R. participants) need to obtain a favorable determination letter from Hacienda. Without it, a retirement plan with P.R. participants is considered nonqualified, which, technically, means that (1) participating employers cannot

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<sup>2</sup> A copy of CL 16-08 (in Spanish) may be found at: <http://www.hacienda.gobierno.pr/publicaciones/carta-circular-de-politica-contributiva-num-16-08>.

claim an immediate deduction on their P.R. income tax returns on account of their contributions to the trust fund or annuity contract forming part of the plan (collectively, the Trust), (2) P.R. participants cannot make employee contributions on a pre-tax basis, and (3) distributions of benefits to P.R. participants are not eligible for the very favorable tax treatment local tax laws afford on retirement income from qualified plans.<sup>3</sup> A Hacienda favorable determination letter is needed even if the plan is in good qualified status with the IRS (i.e., a U.S. plan that covers both U.S. and P.R. participants). Currently, these requirements are found in PRIRC §1081.01(a)(13), which expressly states that a favorable determination letter is a necessary prerequisite for local tax qualification.

Before 2011, there were no clear-cut rules as to the process to be followed and the documents to be included for obtaining a favorable determination letter. Instead, the process was pretty much set by prior practice and customs which, over time, became unwritten rules. Through experience and a good deal of trial and error, practitioners had to figure out the “dos” and “don’ts” of qualifying retirement plans with Hacienda. Needless to say, that was neither the most efficient nor pleasant way to deal with Hacienda.

Effective January 1, 2011, the PRIRC made substantial changes to the local retirement plan rules, now codified in PRIRC §1081.01, for qualification and income taxation as well as changes to PRIRC §1033.09 for the deduction of employer contributions. On December 16, 2011, Hacienda issued Circular Letter of Internal Revenue No. 11-10, which, among other things, provided clear rules on the process to be followed for adopting the January 1, 2011 changes (commonly known at the time as the New Plan Qualification Rules) and for requesting a favorable determination letter confirming that a plan, as amended or restated for adopting the New Plan Qualification Rules, was or remained duly qualified in Puerto Rico.

As per Hacienda’s Circular Letter of Internal Revenue No. 13-02 of May 28, 2013 (CL 13-02), all retirement plans in operation in Puerto Rico on or after January 1, 2011, were required to adopt the New Plan Qualification Rules and file with Hacienda a request for an initial determination letter as to their qualification under PRIRC §1081.01(a) no later than the due date, including extensions, for filing the plan sponsor’s 2013 P.R. income tax return. For most plans, the due date for adopting those rules and completing that filing was July 15, 2014. Thus, except for new plans established after July 15, 2014, and a few existing

plans that, for one reason or another, failed to comply with CL 13-02, chances are that most retirement plans currently in operation in Puerto Rico were filed with Hacienda between 2011 and 2014 to obtain a favorable determination letter as to their initial qualification under PRIRC §1081.01(a).

CL 13-02, however, did not specify the plan filing requirements, if any, that would be in effect after July 15, 2014. The question then became if/when future Hacienda filings would be needed for those plans that were filed between 2011 and 2014 or were established afterwards. Would the favorable determination letters issued in connection with those 2011-2014 filings be the last ones that a plan sponsor would ever need to obtain? CL 16-08 now provides the answers.

## Events Requiring Hacienda Filings

A plan sponsor needs to complete a plan filing with Hacienda under two circumstances: (1) when a new retirement plan is established in Puerto Rico (i.e., when a retirement plan begins to cover active participants who are residents of Puerto Rico); *or* (2) when an existing retirement plan (i.e., a retirement plan already in operation in Puerto Rico and for which a favorable determination letter under PRIRC §1081.01(a) has already been obtained) is amended or restated to adopt one or more amendments listed below, which CL 16-08 refers to as Qualification Amendments.<sup>4</sup> Therefore, if a retirement plan that, between January 1, 2011 and July 15, 2014, was amended to adopt the New Plan Qualification Rules and filed with Hacienda to obtain an initial favorable determination letter under PRIRC §1081.01(a), is subsequently amended to adopt a Qualification Amendment, a new favorable determination letter regarding that Qualification Amendment must be requested.

Hacienda officials considered, but decided not to follow, the recent elimination by the IRS of periodic plan qualification filings for individually designed plans.<sup>5</sup> In a nutshell, the local rule is that (1) new retirement plans always need to be filed with Hacienda to obtain an initial determination letter approving their qualification under PRIRC §1081.01(a), and (2) existing retirement plans need to be filed with Hacienda to obtain an updated determination letter confirming their continued qualification under PRIRC §1081.01(a) only if they are amended or restated to adopt a Qualification Amendment. As long as no Qualification Amendments are made to an existing retirement plan, a retirement plan’s existing favorable determination letter remains valid and no further Hacienda filings are due.

<sup>3</sup> For a comprehensive description of the local rules on income taxation of distributions from qualified plans, see Gonzalez, *New Rules on Puerto Rico Taxation of Retirement Income*, 41 Tax Mgmt. Comp. Plan. J. 87 (Apr. 5, 2013).

<sup>4</sup> CL 16-08, at ¶II.A.1.

<sup>5</sup> Rev. Proc. 2016-37, 2016-29 I.R.B. 136.

## Qualification Amendments

The following changes to an existing retirement plan are considered Qualification Amendments, and therefore require a new filing with Hacienda:<sup>6</sup>

1. Amendments incorporating future statutory changes to the plan qualification rules of PRIRC §1081.01(a) (i.e., new P.R. retirement plan laws enacted on or after January 1, 2017). As discussed below, this would include incorporating into a plan any of the changes to the local retirement plan rules made by Act No. 9-2017.
2. Changes to the eligibility or participation rules applicable to P.R. participants, such as a soft freeze barring new participants.
3. Changes to the formula for benefits accruals or the allocation of employer contributions applicable to P.R. participants, such as a hard freeze on future benefits.
4. Changes to the form or method for the payment of benefits to P.R. participants.
5. Adding, removing, or replacing participating employers that employ P.R. participants.
6. Changes to the rules on the application or correction of the local nondiscrimination tests, which are the minimum coverage test of PRIRC §1081.01(a)(3) (i.e., the local equivalent to the Internal Revenue Code of 1986, as amended (I.R.C.), §410(b)), the general non-discrimination requirement of PRIRC §1081.01(a)(4) (i.e., the local equivalent to I.R.C. §401(a)(4)), and the actual deferral percentage (ADP) test of PRIRC §1081.01(d)(3)(A) (i.e., the local equivalent to I.R.C. §401(k)(3)).
7. The award of prior service credits to P.R. participants for their years of service with another employer for purposes of initial plan participation, benefit accruals, or allocation of employer contributions.
8. The merger of the plan into another retirement plan.
9. The termination and liquidation of the plan.
10. The substitution or replacement of the trustee and, if different, the person or entity responsible for complying with the local income taxation rules on benefit payments to P.R. participants (e.g., reporting payments to Hacienda using local Form 480.7C). Depending on the relevant facts, this responsibility may belong to a third-party administrator or a paying agent.

11. Changes to the official name of the plan or the employer identification number assigned by the IRS (EIN) to the Trust.
12. Any other amendment which, through the issuance of regulations, a circular letter, or an administrative determination of general application, Hacienda subsequently designates as a Qualification Amendment.

Any other amendment to an existing retirement plan is not a Qualification Amendment, and does not prompt a new Hacienda plan filing. For example, CL 16-08 makes clear that the following changes are *not* Qualification Amendments:

1. Amendments incorporating future changes to the plan qualification rules of I.R.C. §401(a) and/or to the plan administration/fiduciary rules of the Employee Retirement Income Security Act of 1974, as amended (ERISA).
2. Changes to the internal rules on plan administration, such as the fees and expenses charged against participant accounts and other plan assets.
3. The substitution or replacement of the plan administrator or the custodian of the Trust (but not the trustee); provided that they are not the party responsible for complying with the local income taxation rules on benefit payments to P.R. participants.
4. Changes to the rules regarding the handling of benefit claims (e.g., ERISA §503).
5. Changes to the vesting schedule, even if it applies to P.R. participants.
6. Adding, removing, or modifying regular plan features, such as investment options, plan loans programs, and the types of employee contributions allowed under the plan.
7. Any changes that do not apply to P.R. participants.
8. Adding, removing, or replacing participating employers that do not employ P.R. participants.

It should be noted that CL 16-08 eliminated the long-standing practice that required a new plan filing whenever the official plan document of an existing plan was restated. Beginning in 2017, if a plan amendment or restatement does not include one or more Qualification Amendments, no Hacienda filing is needed.

Rather than having an individually designed plan document, many plans qualified only in Puerto Rico (commonly known as P.R.-only qualified plans) are

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<sup>6</sup> CL 16-08, at ¶II.A.2.

established or maintained through the adoption of a master plan & trust document or a prototype plan-only document (collectively, an M&P plan) sponsored by a P.R. financial institution or retirement plan services provider, such as a local bank, TPA, or law firm. In that case, it is necessary to identify the specific document(s) where Qualification Amendments were included. If Qualification Amendments were made solely within the M&P plan document, the sponsoring organization, not the employer that adopted that M&P plan, is responsible for completing the necessary Hacienda filings with respect to the M&P plan. On the other hand, if Qualification Amendments were made, totally or partially, through changes to the adoption agreement, the employer that adopted the M&P plan will need to complete a Hacienda filing with regard to its own retirement plan. For purposes of their P.R. qualification, U.S. retirement plans that cover both U.S. and P.R. participants (commonly known as dual-qualified plans) that are established or maintained through the adoption of a U.S. M&P plan are considered plans with an individually designed plan document. Therefore, regardless of the specific document(s) where Qualification Amendments are made, the employer that adopted the U.S. M&P plan will need to complete a Hacienda filing with regard to its own retirement plan.

## Filing Due Date

**New retirement plans** have to be filed with Hacienda to request an initial favorable determination letter under PRIRC §1081.01(a) by the due date, including extensions, for the filing of the P.R. income tax return of the plan sponsor or participating employer doing business in Puerto Rico, as applicable, for its tax year during which the plan was established or, if later, began to cover P.R. participants.<sup>7</sup> For example, if a calendar year plan that is sponsored by a corporation with a calendar tax year was established effective January 1, 2018, the filing would need to be completed by April 15, 2019, or, if the corporation requested an extension to file its 2018 P.R. income tax return, by July 15, 2019.<sup>8</sup>

**Existing retirement plans** have to be filed with Hacienda to request an updated favorable determination letter under PRIRC §1081.01(a) by the due date, in-

<sup>7</sup> CL 16-08, at ¶II.B.2.

<sup>8</sup> For corporations, the regular due date for filing the P.R. income tax return is the 15th day of the fourth month following the end of the tax year, but they may request a three-month automatic extension. PRIRC §1061.16(a) and §1061.16(b). For pass-through entities, such as partnerships and LLCs, the regular due date for filing the P.R. income tax return is the 15th day of the third month following the end of the tax year, but they may request a three-month automatic extension. PRIRC §1061.03(a) and §1061.03(c).

cluding extensions, for the filing of the P.R. income tax return of the plan sponsor or the participating employer doing business in Puerto Rico, as applicable, for its tax year during which the Qualification Amendment was *executed*, not when the Qualification Amendment became effective.<sup>9</sup> For example, if a plan with a calendar plan year and sponsored by a corporation with a calendar tax year is amended on June 30, 2018, to adopt a Qualification Amendment effective as of January 1, 2017, the filing would need to be completed by April 15, 2019, or, if the corporation requested an extension to file its 2018 P.R. income tax return, by July 15, 2019 (i.e., the filing due date is determined by the execution date, not the effective date). In addition, if the Qualification Amendment is adopted on December 1, 2018, to be effective as of January 1, 2019, the filing due date would be April 15 or July 15 of 2019, not 2020.

## Form of Filing

There is no local equivalent to IRS Form 5300. Instead, plan filings with Hacienda must include the following items:

- (1) A cover letter, which details the basic facts about the plan, the plan sponsor and/or participating employer doing business in Puerto Rico, and the P.R. participants in the plan;
- (2) A series of exhibits or attachments to the cover letter, which include copies of the required documents; and
- (3) A check for the payment of the applicable Hacienda filing fee.

The filing packet should include front and back cover pages and all pages should be permanently attached or bound (e.g., bound with a wire spine, rather than with rubber stamps or a metal clip).<sup>10</sup>

## Content of Filing

In the case of a new or existing retirement plan established or maintained through an *individually designed plan document*, the filing must include the following documents and information:<sup>11</sup>

1. Name, EIN, postal address, and telephone number of the plan sponsor and those participating employers that employ P.R. participants.
2. Plan name, plan year, and type of plan (e.g., defined benefit pension plan, defined contribution

<sup>9</sup> CL 16-08, at ¶II.B.1.

<sup>10</sup> CL 16-08, at ¶II.D.1.

<sup>11</sup> CL 16-08, at ¶II.C.1.

retirement plan, profit-sharing plan with or without a CODA, and stock bonus plan), the EIN for the Trust, and the ERISA PIN used for Form 5500 filings. If the Plan does not have a PIN because it is not subject to ERISA (e.g., a church plan), this should be specified in the cover letter.

3. Date on which the plan was established, or, in the case of a dual-qualified plan, date on which it began to cover P.R. participants (P.R. establishment date).
4. If the case of *new retirement plans*, executed copies of the official plan document and the Trust document in effect as of the P.R. establishment date, along with executed copies of subsequent Qualification Amendments.
5. In the case of *existing retirement plans*, executed copies of the Qualification Amendments. If the Qualification Amendments were incorporated through a restatement of the official plan document, the cover letter should include a listing, table, or chart identifying the pages, paragraphs, or sections of the official plan document in which the Qualification Amendments were incorporated. This listing, table, or chart is not needed if the Qualification Amendments were incorporated through a separate or stand-alone amendment (e.g., a P.R.-specific supplement or addendum to the official plan document). Unless the Qualification Amendments modified the Trust document (e.g., the trustee was replaced), it is not necessary to include a copy of the Trust document.
6. If the plan has been previously qualified with Hacienda (i.e., an existing retirement plan), a copy of the most recent Hacienda favorable determination letter. If the plan has not been previously qualified with Hacienda or if the plan was already filed with Hacienda, but Hacienda has not yet issued the corresponding favorable determination letter, this should be specified in the cover letter.
7. If the plan has been previously qualified with the IRS (i.e., a dual-qualified plan), a copy of the most recent IRS determination letter. If the plan has not been previously qualified with the IRS, or if the plan was already filed with the IRS, but the IRS has not yet issued the corresponding determination letter, this should be specified in the cover letter.
8. In the case of a new retirement plan, and when an existing retirement plan is being terminated, a copy of the document(s) establishing that the plan complies with the P.R. income tax rules on distributions to P.R. participants (e.g., distributions are timely reported to Hacienda using local Form 480.7C and, when applicable, are subject to P.R. income tax withholding at source). This requirement may be met by including a copy of the pages or sections of the plan document or Trust document that incorporate the relevant P.R. income tax rules, a copy of the agreement with the paying agent that handles distributions to P.R. participants, or even a letter or memo signed and dated by the plan sponsor or the paying agent confirming that the plan is in fact compliant with the local tax rules. Also, for the termination of an existing retirement plan, the cover letter should include a brief explanation of the business or commercial reasons for such termination (e.g., the plan sponsor ended its P.R. operations, filed for bankruptcy, or replaced its DB pension plan with a DC savings plan).
9. If the filing is completed by an authorized representative for the employer, such as an ERISA attorney, CPA, or employee benefits consultant, an executed copy of Hacienda Form AS 2754-A.<sup>12</sup> This form is not required if the filing is completed by a director, officer, or employee of the employer maintaining or participating in the plan.
10. A certified check, manager's check, or money order (but not a regular commercial check) for the payment of the applicable Hacienda filing fee. The filing fee is \$1,500 for either the initial qualification of a new retirement plan or when Qualification Amendments are made to an existing retirement plan through a restatement of its official plan document. If Qualification Amendments are made to an existing retirement plan through a separate or stand-alone amendment, the filing fee is only \$350. If the Qualification Amendment is the termination of an existing retirement plan, the filing fee is \$500. The check or money order should be made payable to: *Secretario de Hacienda*.
11. The number of P.R. participants in the plan, both active and inactive (e.g., retirees and terminated/vested) as of the beginning of the plan year during which the plan is filed with Hacienda, or, in the case of new retirement plan, as of the P.R. establishment date.
12. If the plan is under a Hacienda, IRS, or EBSA audit or investigation, a brief description of such

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<sup>12</sup> Form AS 2754-A, *Power and Declaration of Representation*, is the Puerto Rico equivalent to IRS Form 2848. A copy of Form AS 2754-A may be found at: <http://www.hacienda.gobierno.pr/documentos/poder-y-declaracion-de-representacion-power-and-declaration-representation> (readers should hit the tab entitled "Documento en inglés" to obtain a copy of the form in English).

audit or investigation and the contact information for the agent in charge of the case. If the plan is not under an audit or investigation, that should be specified in the cover letter.

13. A summary of the eligibility and participation requirements and the benefits/contributions formula applicable to P.R. participants. In lieu of having to provide details of the relevant rules, this requirement may be met simply by including within the cover letter a listing, table, or chart identifying the pages, paragraphs, or sections of the plan document in which these rules are included.
14. A description, schedule, or attachment showing that, with respect to its P.R. participants, the plan meets the minimum coverage test of PRIRC §1081.01(a)(3), and, if the plan has a cash-or-deferred arrangement (i.e., a 401(k) plan), the ADP test of PRIRC §1081.01(d)(3)(A) as of any day within the plan year during which the plan is filed with Hacienda or the last day of the immediately preceding plan year.

In the case of a new or existing retirement plan established or maintained through the *adoption of a P.R. M&P plan*, the filing must include the following documents and information:<sup>13</sup>

1. Name, EIN, postal address, and telephone number of the plan sponsor and those participating employers that employ P.R. participants.
2. Plan name, plan year, type of plan, the EIN for the Trust, and the ERISA PIN.
3. The P.R. establishment date.
4. In the case of *new retirement plans*, an executed copy of the adoption agreement in effect as of the P.R. establishment date and any subsequent Qualification Amendments thereto. If the plan has an individual trust fund, an executed copy of the Trust document is also needed.
5. In the case of *existing retirement plans*, an executed copy of the Adoption Agreement. The cover letter should include a listing, table, or chart identifying the pages, paragraphs, or sections of the Adoption Agreement in which the Qualification Amendments were incorporated.
6. If the plan has been previously qualified with Hacienda, a copy of the most recent Hacienda favorable determination letter. If the plan has not been previously qualified with Hacienda or if the plan

was already filed with Hacienda, but Hacienda has not yet issued the corresponding favorable determination letter, this should be specified in the cover letter.

7. If the plan has been previously qualified with the IRS, a copy of the most recent IRS determination letter. If the plan has not been previously qualified with the IRS, or if the plan was already filed with the IRS, but the IRS has not yet issued the corresponding determination letter, this should be specified in the cover letter.
8. In the case of a new retirement plan, and when an existing retirement plan is being terminated, a copy of the document(s) establishing that the plan complies with the P.R. income tax rules on distributions to P.R. participants. This requirement may be met by including a copy of the pages or sections of the plan document or Trust documents that incorporate the relevant P.R. income tax rules, a copy of the agreement with the paying agent that handles distributions to P.R. participants, or even a letter or memo signed and dated by the plan sponsor or the paying agent confirming that the plan is in fact compliant with the local tax rules. Also, for the termination of an existing retirement plan, the cover letter should include a brief explanation of the business or commercial reasons for such termination.
9. If the filing is completed by an authorized representative for the employer, such as an ERISA attorney, CPA, or employee benefits consultant, an executed copy of Hacienda Form AS 2754-A.<sup>14</sup> This form is not required if the filing is completed by a director, officer, or employee of the employer maintaining or participating in the plan.
10. A certified check, manager's check, or money order (but not a regular commercial check) for the payment of the applicable Hacienda filing fee. The filing fee is \$800 for the initial qualification of a new retirement plan established through the adoption of a P.R. master plan & trust document, \$1,000 for the initial qualification of a new retirement plan established through the adoption of a P.R. prototype plan-only document, and \$350 when Qualification Amendments are made to an existing retirement plan through an amendment of the adoption agreement. If the Qualification

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<sup>14</sup> Form AS 2754-A, *Power and Declaration of Representation*, is the Puerto Rico equivalent to IRS Form 2848. A copy of Form AS 2754-A may be found at: <http://www.hacienda.gobierno.pr/documentos/poder-y-declaracion-de-representacion-power-and-declaration-representation> (readers should hit the tab entitled "Documento en inglés" to obtain a copy of the form in English).

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<sup>13</sup> CL 16-08, at ¶III.C.2.

Amendment is the termination of an existing retirement plan, the filing fee is \$500. The check or money order should be made payable to: *Secretario de Hacienda*.

11. The number of P.R. participants in the plan, both active and inactive as of the beginning of the plan year during which the plan is filed with Hacienda, or, in the case of new retirement plan, as of the P.R. establishment date.
12. If the plan is under a Hacienda, IRS, or EBSA audit or investigation, a brief description of such audit or investigation and the contact information for the agent in charge of the case. If the plan is not under an audit or investigation, this should be specified in the cover letter.
13. A summary of the eligibility and participation requirements and benefits/contributions formula applicable to P.R. participants. In lieu of having to provide a detailed summary of the relevant rules, this requirement may be met by including within the cover letter a listing, table, or chart identifying the pages, paragraphs, or sections of the plan document in which these rules are incorporated.
14. A description, schedule, or attachment showing that, with respect to its P.R. participants, the plan meets the minimum coverage test of PRIRC §1081.01(a)(3), and, if the plan has a cash-or-deferred arrangement (i.e., a §401(k) plan), the ADP test of PRIRC §1081.01(d)(3)(A) as of any day within the plan year during which the plan is filed with Hacienda or the last day of the immediately preceding plan year.

## Filing Address

The filing should be submitted in person or mailed to the following addresses:<sup>15</sup>

### *Personal Filing*

P.R. Department of the Treasury  
Internal Revenue Area  
Office 620  
Superintendente Ramirez Building  
Paseo Covadonga #10  
San Juan, P.R.

### *Filing by Mail*

P.R. Department of the Treasury  
Internal Revenue Area  
Office 620  
P.O. Box 9024140  
San Juan, P.R. 00902-4140

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<sup>15</sup> CL 16-08, at ¶III.E.

The author recommends that plan filings be made in person by having someone, such as an employee working at the employer's P.R. offices or location or a local employee benefits advisor, physically deliver the documents at office No. 620 of Hacienda's main building in Old San Juan, rather than by mailing the documents to Hacienda's postal address. Personal filings have the advantage that the documents are promptly forwarded to the Hacienda's Pension Plan Office, which is located in office No. 624 of the same building, and allow the person completing the filing to immediately receive a stamped copy of the cover letter for the filing, which in practice is considered official and legally valid evidence that the plan was timely filed with Hacienda. Everything equal, filings by mail should be left as an alternative of last resource.

## CHANGES MADE BY ACT NO. 9-2017 TO LOCAL RETIREMENT PLAN RULES

### Introduction

From the onset, it should be noted that some of the provisions of Act No. 9-2017 dealing with qualified retirement plans were poorly planned, should not have been enacted into law, and most likely will need to be amended. Fortunately, in the author's opinion, most plan sponsors, particularly multinational corporations operating on the Island and large and mid-size local companies, are not required to amend their retirement plans on account of the changes brought by Act No. 9-2017, but may, if they so decide, adopt a few of those changes. Any such amendments would be considered a Qualification Amendment, and thus would require a Hacienda filing following the procedures described above.

To get a better understanding of the rationale behind Act No. 9-2017 and what it set out to accomplish, one should be aware that the P.R. retirement plan market is roughly divided in half between "corporate retirement plans" maintained by multinationals and large and mid-size local companies, and Keogh plans maintained by small local companies and self-employed individuals, such as small business owners, doctors, and other professionals.

Act No. 9-2017 was designed with Keogh plans in mind. Specifically, to help stem the problem that Puerto Rico is facing with the exit of business owners and professionals, such as doctors moving to the U.S., Act No. 9-2017 was intended to provide those individuals with enhanced tax benefits and legal protections with respect to their retirement and investment

vehicles. As noted above, these business owners usually sponsor Keogh plans. For reasons that are not entirely clear, however, rather than incorporating the enhanced tax benefits within the sections of the PRIRC specific to Keogh plans, the local legislature did so within the sections dealing with qualified retirement plans in general. Therefore, at least on paper, most of the changes brought by P.R. Act No. 9-2017 apply to both corporate retirement plans and Keogh plans. As described below, in practice the situation is different, and Act No. 9-2017 should have little effect on corporate retirement plans.

With that said, following is a description of the main provisions of Act No. 9-2017 dealing with qualified retirement plans.<sup>16</sup>

## Increased Tax Deduction

Increased tax deduction was perhaps the main purpose behind the enactment of Act No. 9-2017; allowing local business owners, entrepreneurs, and professionals (i.e., the population most likely to emigrate) to claim a higher deduction on their P.R. income tax return for their contributions to their qualified retirement plans. Previously, PRIRC §1033.09(a)(1)(C) (i.e., the local equivalent to I.R.C. §404(a)(3)(A)) allowed employers to currently deduct their contributions to a defined contribution plan up to a maximum of 25% of the compensation paid to all participants during the year to which the contribution relates. Section 12 of Act No. 9-2017 amended PRIRC §1033.09(a)(1)(C) to provide that, irrespective of the 25% of compensation limit, contributions allocated to a participant's account not in excess of the limit on annual additions of PRIRC §1081.01(a)(11)(B) (i.e., the local equivalent to I.R.C. §415(c)(1)), are fully deductible. In turn, Section 13 of Act No. 9-2017 attempted, but, as described below, failed, to increase the local limit on annual additions, from \$54,000 (for 2017) to \$75,000.

The idea behind these two changes was to allow business owners and professionals to deduct all contributions allocated to their plan accounts, up to a maximum of \$75,000, even if that amount exceeded 25% of their annual compensation. For example, a doctor with a 1-participant Keogh plan and \$200,000 in W-2 compensation would have been able to claim a deduction of up to \$75,000, not the \$50,000 previously allowed.

Because Section 12 of Act No. 9-2017 modified the income tax deduction provisions of the PRIRC, not the rules on retirement plan qualification, employers

<sup>16</sup> P.R. Act No. 9-2017 also made several changes to the local rules on private and commercial trust funds, but those are outside the scope of this article.

do not have to make any changes to their plan documents.

## Limit on Annual Additions

Previously, PRIRC §1081.01(a)(11)(B) provided that annual additions to a participant's account in a defined contribution plan could not exceed the lesser of: (1) the equivalent annual limit set forth by the IRS under I.R.C. §415(c)(1)(A) (i.e., \$54,000 for 2017), or (2) 100% of the participant's compensation for the year. That is, in its original form, PRIRC §1081.01(a)(11)(B) was pretty much a carbon copy of I.R.C. §415(c)(1).

According to its legislative history, Act No. 9-2017 was intended to increase the first tier of the limit on annual additions from the current \$54,000 to \$75,000. But, for unknown reasons, §13 of Act No. 9-2017 ended up modifying PRIRC §1081.01(a)(11)(B) to provide that, beginning in 2017, annual additions to a participant's account in a defined contribution plan may not exceed the lesser of: (1) \$75,000 (now a flat amount, not pegged to I.R.C. §415(c)(1)(A) or indexed for inflation), or (2) 25% of the participant's "Net Income" (which is an undefined term). This new reference to "25% of Net Income" was clearly an error and needs to be changed. In fact, Hacienda officials are already in talks with the local legislature to replace this limit with the old "100% of participant's compensation" limit.

Unless promptly corrected, the new limit on annual additions of PRIRC §1081.01(a)(11)(B) would single-handedly defeat the purpose behind Act No. 9-2017, because it would be mathematically impossible for a business owner or professional to claim a deduction on account of contributions to his/her 1-participant Keogh plan of \$75,000.<sup>17</sup> Moreover, assuming that a participant's "net income" is akin to his/her "compensation," which is something Act No. 9-2017 does not address, sponsors of Keogh plans whose net income is below \$216,000 are worse off under the new version of PRIRC §1081.01(a)(11)(B) than the previous one, because 25% of amounts below \$216,000 are less than \$54,000.

**Don't Change Your Plan:** In the author's opinion, given this legislative mess, companies should not modify their defined contribution plans, either in form or operation, to incorporate the changes Act No. 9-2017 made to the limit on annual additions to par-

<sup>17</sup> PRIRC §1081.01(a)(12) provides that, for purposes of, among others, the limit on annual additions of PRIRC §1081.01(a)(11)(B), a participant's compensation cannot exceed the equivalent annual compensation limit set forth by the IRS under I.R.C. §401(a)(17) (i.e., \$270,000 for 2017), and 25% of \$270,000 is only \$67,500.

ticipant accounts. Instead, unless and until Hacienda indicates otherwise, they should continue operating their plans in accordance with the previous version of PRIRC §1081.01(a)(11)(B), which, again, is similar to I.R.C. §415(c)(1). The author has been unofficially informed by Hacienda officials that plan sponsors can safely keep their plan provisions on annual additions “as is.”

Act No. 9-2017 did not make any changes to the limit on annual benefits payable under defined benefit pension plans of PRIRC §1081.01(a)(11)(A) (i.e., the local equivalent to, and essentially a carbon copy of, I.R.C. §415(b)(1)).

## Beneficiary Designations

Section 7 of Act No. 9-2017 amended P.R. Act No. 219-2012 of August 31, 2012 (P.R. Trust Act) to, among other things, provide that if a participant in a qualified retirement plan is married, his/her spouse will be considered the beneficiary entitled to receive benefits payable under the terms of the plan upon the participant’s death. If the spousal notice and consent provisions of ERISA §205(c)(2) are met, however, a married participant may designate someone other than his/her spouse as the beneficiary. This Section merely incorporates the relevant ERISA rules into the P.R. Trust Act, therefore it neither leads to any substantive changes nor seems to require any sort of plan amendment for its implementation.

## Probate Avoidance

Section 7 of Act No. 9-2017 also sets into P.R. law the rule that has been widely known since *Boggs v. Boggs*: distributions of benefits from retirement plans subject to ERISA are exempt from local inheritance and probate rules.<sup>18</sup> Instead, those distributions are governed by the relevant terms of the plan. Resulting action items for plan sponsors? None.

## ADP Test Safe Harbor

Section 14 of Act No. 9-2017 incorporated within PRIRC §1081.01(d)(3)(A) (i.e., the local ADP test) a local version of the safe harbor in I.R.C. §401(k)(12)(C), but it only applies to small/mid-size §401(k) plans sponsored by small/mid-size companies. Specifically, if a company with less than \$10 million in annual gross revenues sponsors a §401(k) plan with fewer than 100 participants, the ADP test will not apply to that §401(k) plan if all employees eligible for participation in the plan receive within their plan accounts an employer nonelective contribu-

tion in an amount equal to at least 3% of their compensation.

In the past, by way of private letter rulings, Hacienda had allowed sponsors of §401(k) plans to avoid the ADP test by following the safe harbors of I.R.C. §401(k)(12)(B) or §401(k)(12)(C). Act No. 9-2017 adopted a local version of the safe harbor in I.R.C. §401(k)(12)(C), but not of the one in I.R.C. §401(k)(12)(B). Also, many important aspects about the implementation and operation of this safe harbor remain unclear, such as whether the \$10 million limit in annual gross revenues refers to revenues from sources within Puerto Rico or worldwide revenues, whether the 100 participants limit refers to P.R. participants or total participants (United States and Puerto Rico), and whether the employer nonelective contributions need to be fully vested and/or subject to the same restrictions on distribution that apply to elective deferrals.

Pending the issuance of additional guidance on the subject, which is unlikely to happen right away, employers that want to take advantage of this new safe harbor on the ADP test should do so by following the equivalent provisions of I.R.C. §401(k)(12)(C). The incorporation of this safe harbor is not a requirement or condition for local qualification, and would be considered a Qualification Amendment requiring a Hacienda filing.

It is doubtful that many sponsors of §401(k) plans that are P.R.-only qualified will be implementing this safe harbor into their plans, because, unlike the I.R.C., the PRIRC still allows for the correction of a failed ADP test through bottoms-up QNECs. On the other hand, assuming the limits on annual gross revenues and plan participants are met, implementing this safe harbor could make sense for sponsors of §401(k) plans that are dual-qualified, because, through application of Reg. §1.401(k)-2(a)(6), bottoms-up QNCEs are not available for those plans. In fact, a dual-qualified 401(k) plan that already uses, with regard to its U.S. participants, the ADP testing safe harbor of §401(k)(12)(C), should implement and use, with regard to its P.R. participants, the new local ADP testing safe harbor.

## “HCE” Definition

Section 14 of Act No. 9-2017 also modified the definition of highly compensated employee (HCE) to be used for nondiscrimination testing purposes by increasing the HCE compensation threshold from \$120,000 (for 2017) to \$150,000, and removing a P.R.-specific rule added back in 2011 that automatically classified company executives and key officers as HCEs.

Previously, PRIRC §1081.01(d)(3)(E)(iii) defined HCEs to include those employees who were execu-

<sup>18</sup> *Boggs v. Boggs*, 520 U.S. 833 (1997).

tives, key officers, or 5% owners of the employer that sponsors the plan or a participating employer doing business in Puerto Rico, or who for the preceding year had compensation from the employer in excess of the equivalent compensation limit set forth by the IRS under I.R.C. §414(q)(1)(B)(i) (i.e., \$120,000 for 2017). Now, PRIRC §1081.01(d)(3)(E)(iii) defines HCEs as those employees who either own 5% or more of the employer that sponsors the plan or a participating employer doing business in Puerto Rico (intended to be similar to I.R.C. §414(q)(1)(A)), or who, for the preceding year, had compensation from the employer in excess than \$150,000 (now a flat amount, not pegged to I.R.C. §414(q)(1)(B)(i) or indexed for inflation).

**Plan Sponsors Can Continue to Use Old HCE Definition.** The author has been unofficially informed by Hacienda officials that plan sponsors can continue to use the previous HCE definition, but any changes thereto would be considered a Qualification Amendment requiring a filing with Hacienda. Hacienda officials are aware that most recordkeeping systems are designed based on the U.S. qualified plan rules, not the local ones, and making one-off exceptions or special rules solely for Puerto Rico could be costly and administratively challenging. Insofar as the previous HCE definition is broader than the new one, retaining it would not present the potential for discrimination in favor of HCEs. Accordingly, plan sponsors that would prefer to keep using the previous HCE definition can certainly do so. Alternatively, a plan sponsor may decide to make the HCE definition as close as possible to the one under I.R.C. §414(q) by removing the reference to key officials, but keeping the HCE compensation threshold set forth by the IRS, in which case the corresponding amendment would need to be filed with Hacienda.

## UPDATED FORM 480.7C

### Introduction

Form 480.7C, *Informative Return — Retirement Plans and Annuities*, is the local form used for reporting to Hacienda (1) payments of benefits and other taxable distributions to P.R. participants in a retirement plan qualified in Puerto Rico (e.g., lump-sum payments, monthly pensions, in-service withdrawals, and defaulted plan loans), and (2) the receipt by a retirement plan qualified in Puerto Rico of a rollover contribution or a direct transfer completed by a P.R. participant. In the case of payments and taxable distributions to P.R. participants, Form 480.7C is due February 28th of the year immediately following the year of payment or distribution, and in the case of rollovers and transfers by P.R. participants into the plan, Form

480.7C is due August 30th of the year immediately following the year of rollover or transfer. These due dates may not be extended.

Form 480.7C has to be filed electronically with Hacienda through an internet portal known as the *Colecturía Virtual*.<sup>19</sup> Also, a copy of the form has to be mailed or hand delivered to the corresponding P.R. participant. Failure to e-file Form 480.7C with Hacienda by the applicable due date carries a penalty of \$500/form, and failure to provide a copy of Form 480.7C to the P.R. participant by the applicable due date carries a penalty of \$100/form.

### Recent Changes

During October 2016, Hacienda issued a new version of Form 480.7C, together with revised instructions. The new version must be used for reporting distributions and rollovers/transfers completed during 2016 (i.e., those reported during 2017) and, most likely, during 2017 (i.e., those reported during 2018). Vis-à-vis the previous version of the form, the 2016 edition did not make major changes, but there is one worth noting. As per the Instructions, Hacienda is requesting plan service providers to report on Line 18 of the form, *Amounts Over Which a Prepayment Was Made*, the portion of reportable distributions over which the corresponding P.R. participant previously elected to prepay P.R. income taxes pursuant to the special tax prepayment opportunities in effect back in 2006 and 2014/2015, if any.<sup>20</sup>

Specifically, as a mean for accelerating tax collections, §1012D(b)(5) of the Puerto Rico Internal Revenue Code of 1994 (i.e., the previous local tax code, which was in effect until December 31, 2010) provided participants in retirement plans qualified in Puerto Rico with the opportunity to voluntarily elect to prepay P.R. income taxes on all or a portion of their plan benefits at discounted tax rates (e.g., a 5% tax rate). PRIRC §1023.21 and §1081.01(b)(9) implemented a similar prepayment window, which was in effect between July 1, 2014 and April 30, 2015. Amounts over which a participant prepaid P.R. income taxes became part of the participant's basis on his/her plan benefits (i.e., after-tax money). Upon completion of a payment of benefits to the participant, the after-tax portion of the payment needs to be reported on Line 18 of Form 480.7C.

<sup>19</sup> The internet address for the *Colecturía Virtual* is: <https://colecturiavirtual.hacienda.pr.gov/portal>.

<sup>20</sup> For a comprehensive description of the special tax prepayment opportunity in effect during 2014/2015, please see Carolos Gonzalez, *Practical Considerations and Recommendations Regarding 2014 Prepayments of Puerto Rico Income Tax on Retirement Benefits*, 33 Tax Mgmt. Wkly. Rep. 1044 (Aug. 4, 2014).

In practice, a problem with the administration of these prepayments is that oftentimes the service provider responsible for reporting distributions to Hacienda does not have complete information as to which participants elected to prepay taxes, if any, and thus cannot complete Line 18. Technically, participants who prepaid P.R. taxes on their retirement benefits were supposed to (1) provide a stamped copy of the prepayment election form (Hacienda Form SC 2911, *Election for Prepayment of Special Tax on Accumulated Amounts in Employee's Trust (Qualified Plans)*) to the trustee of Trust or, if so specified within the SPD or an SMM on the subject, to the recordkeeper servicing the plan, and (2) keep within their personal records another stamped copy of the election form. Not surprisingly, some participants failed to provide a

copy of the election form to the trustee or recordkeeper, as applicable.

In light of Hacienda's recent emphasis on the proper reporting of distributions, including amounts over which P.R. taxes were prepaid, some plan sponsors have decided to address the situation with missing information by sending a notice to all P.R. participants reminding them that, if they completed a prepayment, they need to send a stamped copy of the election form to the trustee or recordkeeper by the due date provided in the notice. Participants for which a Form SC 2911 has not been received by the relevant due date are deemed not to have completed a prepayment. Accordingly, in preparing Form 480.7C for reporting distributions to such participants, no information needs to be included on Line 18.