Bloomberg Tax

Tax Management Memorandum™

How SECURE 2.0 Provisions Apply to Puerto Rico Retirement Plans

By Carlos Gonzalez
BenefitsPuertoRico.com

Puerto Rico benefits expert Carlos Gonzalez addresses which of the SECURE 2.0 Act's main changes to the US retirement plan rules must be made to Puerto Rico-only qualified plans or applied to the Puerto Rico participants in dual-qualified plans, and which are optional.

To understand how provisions of the SECURE 2.0 Act of 2022 (the ''Act'')—Division T of the Consolidated Appropriations Act, 2023—apply to retirement plans operating in Puerto Rico, one should keep in mind that such plans come in two flavors: dual-qualified plans and Puerto Rico-only qualified plans.

Dual-Qualified Plans

US-based retirement plans that cover both US and Puerto Rico participants are subject to the retirement plan qualification requirements of the US Internal Revenue Code of 1986, as amended (the ''Code''), the various fiduciary and operational requirements of the Employee Retirement Security Act of 1974, as amended (''ERISA''), and, solely with respect to their Puerto Rico participants, the retirement plan qualification requirements of the Puerto Rico Internal Revenue Code of 2011, as amended (the ''PRIRC'') (in Spanish). Puerto Rico residents must pay Puerto Rico income taxes on their entire taxable income from all sources, pursuant to PRIRC §1031.01(a), and, pursuant to Code §933(1), do not have to pay federal income taxes on their income from sources on the Island. A US company with operations in Puerto Rico may amend its US 401(k) plan to allow participation by eligible employees working in Puerto Rico.

Moreover, because the individual income tax responsibilities of bona fide residents of Puerto Rico are generally established by the PRIRC, not the Code, Puerto Rico participants in dual-qualified plans should be allowed to make employee contributions to their plan accounts only up to the limits set forth by the PRIRC, not the Code, and the types of employee and employer contributions allocated to their accounts should be those allowed under the PRIRC. For example, even though Code §414(v) allows 401(k) plan participants age 50 or over to contribute up to $7,500 through catch-up contributions ($10,000 for participants ages 62–64, effective 2024, pursuant to Act §109), Puerto Rico participants in a US 401(k) plan (*i.e.*, effectively, a dual-qualified plan) are subject to the much smaller $1,500 annual limit on catch-up contribution set forth in PRIRC §1081.01(d)(7)(C)(i). Likewise, since the PRIRC neither envisions nor provides for Roth contributions, such contributions should not be made for or in connection with Puerto Rico participants in dual-qualified plans. The rule of Act §603—requiring, in the case of participants whose annual compensation exceeds $145,000, that catch-up contributions be made on a Roth basis—should, therefore, not be extended to Puerto Rico participants in dual-qualified plans.

Allowing Puerto Rico participants to make catch-up contributions above the local limit or save on a Roth basis could easily result in an income tax assessment by the Puerto Rico Department of the Treasury (commonly known by its Spanish name, Departamento de Hacienda or simply ''Hacienda'') against the participants because a portion of their taxable wages (*i.e.*, the catch-up contributions above the smaller local limit) would end up being misreported in the local W-2 as a tax-deferred amount and/or a portion of their retirement plan payments (*i.e.*, the investment earnings on the Roth contributions) would be misreported in the local informative return on retirement plan distributions as tax-exempt income. In turn, that could lead to a series of employee complaints against the plan sponsor, plus, although unlikely, Hacienda could go after the plan sponsor for failing to withhold Puerto Rico income taxes on the taxable amounts misreported as non-taxable (*e.g.*, the under-withholding of local taxes on catch-up contributions in excess of the smaller local limit).

Consistent with ERISA §402(a)(1), which requires that retirement plans be established and operated in accordance with their written plan documents, dual-qualified plans must be amended or at least supplemented to allow the eligible Puerto Rico employees of the corresponding participating employer, usually the Puerto Rico subsidiary of the US plan sponsor, to participate in the plan and to incorporate with respect to such participants the retirement plan qualification and operational requirements of PRIRC (*e.g.*, the lower local limit on catch-up contributions and the unavailability of Roth contributions). In the author's experience, provided that such amendment or supplement complies with the PRIRC and applies only to Puerto Rico participants, the IRS does not object to US-qualified plans having slightly different rules for their Puerto Rico participants.

The Puerto Rico amendment or supplement to the US plan should then be filed with Hacienda to obtain an administrative determination, also known as a qualification letter, confirming the US plan, as amended, meets the retirement plan qualification rules of the PRIRC (*i.e.*, remains as a dual-qualified plan). Distributions to the Puerto Rico participants in a dual-qualified plan must be reported to the IRS using US tax form 1099-R and to Hacienda using local tax form 480.7C, and, depending on the form of payment, federal and/or Puerto Rico income taxes must be withheld at source and deposited with the IRS and/or Hacienda, as applicable.

All-in-all, there is nothing unusual, obscure, or inherently risky with the operation of dual-qualified plans, and many US and international companies doing business in Puerto Rico use such plans to offer retirement benefits to their local employees.

Puerto Rico-Only Qualified Plans

Retirement plans established or based in Puerto Rico, covering only the eligible Island employees of the participating employer (*e.g.*, the Puerto Rico branch or subsidiary of a US company) and funded through a trust fund located on the Island or an annuity contract issued by an insurance company licensed to operate there, are fully subject to the PRIRC and ERISA Title I—but, the Pension Benefits Guarantee Corporation has determined, not to ERISA Title IV. Technically, they are exempt from the retirement plan qualification requirements of the Code (see, *e.g.*, Code §7701(a)(9) and (10), which generally exclude Puerto Rico from the definitions of "United States" and "State" to be used for purposes of the Code, and Code §401(a), which requires that retirement plans qualified in the United States, thus subject to the Code, be funded through a US-based trust fund or annuity contract). In practice, however, that is not entirely the case. While the PRIRC is not identical to the Code, it is largely based thereon and many of the local retirement plan qualification rules are intended to operate exactly as their US counterpart. Since the Code and its enacting regulations and related administrative guidance are vastly more comprehensive, current, and detailed than the PRIRC and its regulations and Hacienda guidance, in interpreting those local rules that are based on US rules, plan sponsors and ERISA practitioners need to refer to the Code. As a result, the Act's changes to US qualification rules that have been incorporated within the PRIRC should be equally applicable to Puerto Rico-only qualified plans. For example, PRIRC §1081.01(d)(4)(A) is based on Code §401(k)(4)(A) (*i.e.*, except for matching contributions, employee benefits cannot be conditioned on a participant's deferral elections under a 401(k) plan). Effective 2023, Act §113 amended Code §401(k)(4)(A) to allow employers to offer certain de minimis financial incentives to encourage and facilitate employee participation in 401(k) plans. Even though on paper Act §113 does not amend PRIRC §1081.01(d)(4)(A), given that the local rule is intended to operate just its US counterpart, this new US rule can be safely and validly implemented in connection with Puerto Rico-only qualified plans.

For similar reasons (*i.e.*, the breadth and depth of US retirement plan rules), sponsors of Puerto Rico-only qualified plans and their ERISA advisors regularly refer to the Code and relevant IRS guidance for determining how to correct failures in the operation of such plans. Consequently, the changes to the US correction rules and procedures brought by Act §305 and §350 should also apply to the correction of similar failures of Puerto Rico-only qualified plans; provided that any reporting needed as part of the correction is done using the corresponding local tax return, not its US equivalent. For example, the new safe harbor for the correction of automatic contribution errors that Act §350 enacted within Code §414(cc) may safely be followed for correcting similar errors under a Puerto Rico-only qualified plan, but any corrective distributions would need to be reported using Hacienda Form 480.7C, not IRS Form 1099-R.

Then there is the practical aspect that most of the Puerto Rico-only qualified plans sponsored by US and international companies doing business on the Island, or their local subsidiaries, are designed and intended to be kept as similar as possible to the US plans that the US parent company or affiliate uses to provide retirement benefits to its eligible US employees (*i.e.*, the local subsidiary's Puerto Rico-only qualified plan is a mirror of the parent company's US qualified plan). Insofar as the US plan is subject to the Code and the Puerto Rico plan is supposed to mirror the US plan, some of the Act's changes to the Code will indirectly apply to the Puerto Rico plan. For example, technically the required minimum distribution (RMD) rules of Code §401(a)(9) do not apply to Puerto Rico-only qualified plans and the PRIRC does not have any such rules. To maintain employee benefits uniformity, how-

ISSN 0148-8295

ever, some US companies have included RMD rules within their Puerto Rico-only qualified plans, which is totally permissible. To avoid having different RMD rules in the two jurisdictions, Puerto Rico-only qualified plans with RMD provisions must be amended to increase the applicable age thresholds in accordance with Act §107. On the other hand, Act §107 has no bearing on Puerto Rico-only qualified plans without RMD rules, which is the general rule.

The current state of the recordkeeping industry presents another practical reason why Puerto Rico-only qualified plans might indirectly be subject to some of the Act's changes to the Code. Puerto Rico is not immune from the large-scale consolidation occurring in the recordkeeping industry. With each passing year, large US recordkeepers are getting a bigger share of the local retirement plan market, and to maximize efficiencies and quality control those recordkeepers prefer to use with regards to the Puerto Rico-only qualified plans that they service the same systems, forms, and policies that they already have in place in the United States. Consequently, the adjustments that US recordkeepers end up making to their systems and procedures in response to the Act are bound to impact how they administer Puerto Rico-only qualified plans. The same procedures that US recordkeepers establish in connection with, for example, the automatic enrollment provisions of Act §101 and the recovery of retirement plan overpayments provisions of Act §301 are also likely to be used for administering Puerto Rico-only qualified plans.

On the other hand, several of the Act's changes to the Code simply do not apply to Puerto Rico-only qualified plans. For example, just as the catch-up contribution provisions of Act §109 and §603 should not be applied to Puerto Rico participants in dual-qualified plans, they should not be incorporated into Puerto Rico-only qualified plans because, by default, all participants in such plans are residents of Puerto Rico whose individual income tax responsibilities are established by the PRIRC, not the Code. As noted above, Act §107's changes to Code §401(a)(9) do not apply to Puerto Rico-only qualified plans without RMDs. And since the PRIRC does not have a local equivalent to the top-heavy rules of Code §416, Puerto Rico-only qualified plans do not have to be amended for the special top-heavy testing provisions of Act §310.

Based on the foregoing, the following general observations can be made about the Act's impact on Puerto Rico plans:

- Except for church plans, the Act changes to Title I of ERISA apply to all Puerto Rico plans, whether dual-qualified or Puerto Rico-only qualified, exactly as they do in the United States.
- The Act changes to the Code apply to dual-qualified plans but Roth contributions and the increased limits on catch-up contributions should not be extended or made available to Puerto Rico participants.
- The Act changes to the Code generally do not apply to Puerto Rico-only qualified plans but might need to be followed in connection with (a) local retirement plan qualification rules that are based on, and intended to operate just as, the equivalent Code rules, and (b) US retirement plan qualification rules that for business or practical reasons an employer voluntarily incorporates into its Puerto Rico plan.

Additional Examples

The following Act changes apply to all Puerto Rico plans because they amended Title I of ERISA.

Act §125, which created new ERISA §203(c); Special Rule for Certain Part-Time Employees. Effective for plan years beginning after December 31, 2024, employers must allow long-term, part-time employees to participate in their pension plans that include a qualified cash or deferred arrangement (CODA) upon completion of either one year of service (with at least 1,000 hours of service) or two consecutive years of service (each with at least 500 hours of service). Since ERISA Title I applies in Puerto Rico exactly as it does in the United States, the author considers that this rule also applies to Puerto Rico-only qualified plans with a CODA. An employer's failure to allow its Puerto Rico long-term, part-time employees to participate in such a plan could certainly result in a federal lawsuit under ERISA §502(a).

Act §304, which amended ERISA §203(e)(1). Effective for distributions made after December 31, 2023, the threshold for involuntary cash-outs is increased from $5,000 to $7,000. Importantly, the automatic IRA rollover rules of Code §401(a)(31) do not apply to Puerto Rico-only qualified plans, and neither the PRIRC nor ERISA include a similar rule. Therefore, such plans, but not dual-qualified plans, may provide that all inactive accounts that, excluding rollover contributions and earning thereon, do not exceed $7,000, shall be automatically distributed in a lump sum to the corresponding participants upon their termination of employment without any funds having to be transferred to an IRA. Reducing the number of inactive accounts should lower the administration and recordkeeping fees payable by or in connection with the plan and, through application of the US Department of Labor's new rules on the participant-counting methodology to be used for annual reporting purposes (*i.e.*, only participants with an account balance are considered in determining whether a plan has more than 100 participants), maximizing involuntary cash-

ISSN 0148-8295

outs of inactive participants should help some plans be eligible for filing Form 5500-SF, thus avoid the need for a plan audit.

On the other hand, the following Act changes to the Code may, but not do not have to, be made to Puerto Rico-only qualified plans.

Act §101, which created new Code §414A; Requirements Related to Automatic Enrollment. Effective for plan years beginning after December 31, 2024, 401(k) plans must automatically enroll all eligible employees with an initial elective deferral of between 3% and 10% of covered compensation. While Code §414A is, technically, inapplicable in Puerto Rico, similar automatic enrollment provisions may be adopted within Puerto Rico-only qualified plans because, pursuant to ERISA §514(e), Hacienda cannot preclude the adoption of automatic contribution arrangements within plans in Puerto Rico. In fact, over the last five or six years Hacienda has approved the local qualification of dozens of plans with automatic contribution arrangements. Therefore, if, in the interest of maintaining the uniformity of its retirement benefits offerings in the United States and Puerto Rico, an employer desires to extend to its Puerto Rico-only qualified plan the automatic enrollment provisions of Code §414A, it may freely and validly do so.

Act §110, which created new Code §401(m)(4)(iii). Effective for plan years beginning after December 31, 2023, 401(k) plans may provide for employer matching contributions on a participant's qualified student loan payments (*i.e*., the repayment of indebtedness incurred solely for the payment of the employee's higher education expenses). Even though Code §401(m)(4) does not apply in Puerto Rico, the author considers that Hacienda would not object to Puerto Rico-only qualified plans adopting this feature, particularly because such feature would benefit local employees and have very little impact, if any, on Hacienda's revenue collections.

Hacienda Plan Filings

Pursuant to Circular Letter of Tax Policy No. 16-08 of December 29, 2016, Act-related amendments to plans in Puerto Rico must be filed with Hacienda if they modified plan rules applicable to Puerto Rico participants regarding any of the following areas:

- Eligibility for participation (*e.g.*, Act §101, *Expanding automatic enrollment in retirement plans*, and Act §125, *Improving coverage for part-time workers*).
- Formula or methodology for benefits accruals or allocation of contributions (*e.g*., Act §110, *Treatment of student loan payments as elective deferrals for purposes of matching contributions*, and Act §316, *Amendments to increase benefit accruals under plan for previous plan year allowed until employer tax return due date*).
- Form, methodology, or timing for benefit payments (*e.g.*, Act §107, *Increase in age for required beginning date for mandatory distributions*, Act §115, *Withdrawals for certain emergency expenses*, Act §201, *Remove required minimum distribution barriers of life annuities*, Act §304, *Updating dollar limit for mandatory distributions*, and Act §314, *Penalty-free withdrawal from retirement plans for individual case of domestic abuse*).

The corresponding amendment must be filed with Hacienda no later than the due date, including extensions, for the filing of the Puerto Rico income tax return of the plan sponsor or the Puerto Rico participating employer, as applicable, for its tax year during which the amendment was executed. Since Act-related amendments must be adopted by the end of the ''remedial amendment period'' ending on the last day of the first plan year beginning on or after January 1, 2025 (*i.e.*, December 31, 2025, for calendar year plans), this means that the Hacienda filings will need to be completed no later than Summer 2026.

Failure to complete such filing could result in the disallowance of the employer's Puerto Rico tax deduction for its contributions to the plan and/or the assessment of an income tax deficiency on Puerto Rico participants upon Hacienda's denial of the pre-tax status of their elective deferrals under the plan. On paper, Hacienda could also revoke the local tax-qualification of the plan, but in practice such drastic action is almost never implemented.

Author Information

Carlos Gonzalez is President of BenefitsPuertoRico.com, a law firm providing assistance on employee benefits and executive compensation matters to US and international companies with Puerto Rico operations and is the author of Tax Management Portfolio 324-2nd T.M., *International Pension Planning—Puerto Rico*.

ISSN 0148-8295