

Employee Benefits

Notes¹

February 19, 2014

Schuster Aguiló LLC's (SA) Employee Benefits *Notes* is intended as a tool to keep employers abreast of the latest developments in the Employee Benefits area, and to provide tips and useful information for employers to maintain compliance with this ever-changing area of employment law. It is sponsored by SA's ERISA Litigation and Employee Benefits Practice Group ("ELEBPG").

The ELEBPG is engaged in the design, revision and qualification of employee benefits plans, as well as in the litigation of ERISA claims before Puerto Rico and federal courts. The ELEBPG applies its ERISA litigation experience to benefit plan design, in order to achieve, not only the required qualification before the appropriate government agencies, but also plan documents that will satisfy judicial scrutiny when faced with court claims by participants and beneficiaries. The ELEBPG also provides consulting services as well as seminars on selected employee benefits matters, such as ERISA employee benefits plans, COBRA and HIPAA issues.

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THE DEADLINE FOR ADOPTING AND SUBMITTING AMENDMENTS FOR COMPLIANCE WITH THE NEW PR CODE PROVISIONS FOR PLAN SPONSORS WITH A CALENDAR YEAR IS AROUND THE CORNER AND PLAN SPONSORS ARE URGED TO REACT SOON IN ORDER TO MAINTAIN THE QUALIFIED STATUS OF THEIR PR PLANS

As you are all aware, all retirement plans with Puerto Rico participants must be amended to incorporate the new qualification requirements under the Puerto Rico Internal Revenue Code of 2011 (the "New PR Code") and submitted for qualification with the Puerto Rico Department of the Treasury ("PR Treasury") in order to maintain their Puerto Rico qualified status

In general, pursuant to PR Treasury Circular Letter 11-10, the following provisions must be incorporated into the retirement plans for compliance with the New PR Code:

1. Definition of "highly compensated employee", as defined in New PR Code Section 1081.01(d) (3) (E) (iii).
2. Maximum annual benefit and contribution limitation, pursuant to New PR Code Section 1081.01(a) (11).
3. Maximum annual compensation limitation, pursuant to New PR Code Section 1081.01(a) (12).
4. Definition of "employer" for purposes of aggregation rules for nondiscrimination testing, pursuant to New PR Code Section 1081.01(a) (14).
5. Rollover distribution rules, pursuant to New PR Code Section 1081.01(b)(2)(A).

Also, if applicable:

1. Pre-Tax and catch-up annual limitations, pursuant to New PR Code Section 1081.01(d) (7).
2. After-tax maximum limitation, pursuant to New PR Code Section 1081.01(a)(15).
3. Deem distributions for default loan provisions, pursuant to New PR Code Section 1081.01(b) (3) (E).

As further discussed below, the deadline for adopting the aforementioned amendments and submitting the PR plans for qualification under the New PR Code for plan sponsors with a calendar year is around the corner and plan sponsors must take steps immediately to meet this upcoming deadline in order to avoid treating their retirement plans as non-qualified plans.

Deadline

Last year's deadline for adopting and submitting PR retirement plans for qualification under the New PR Code was extended pursuant to PR Treasury Circular Letter 13-02, and for plan sponsors with a calendar year, the deadline for both the adoption and the submission of the New PR Code amendments with the PR Treasury is **APRIL 15, 2014**. For plan sponsors with a fiscal year, the deadline is the same deadline to file the tax return for the taxable year that commenced on or after January 1, 2013.

A 3-month extension is allowed, subject to an additional \$150.00 filing fee, and only available if the Plan sponsor had previously requested an extension to file its corporate income tax return and includes such evidence with the qualification submission.

In addition, although after the aforementioned deadline the PR Treasury may still allow a retirement plan to be amended and submitted for qualification under the New PR Code if certain special circumstances apply, the procedure is not too clear, and the risks and consequences for not complying are very high.

Currently, there are no rumors of a further extension to be granted by the PR Treasury. Consequently, Plan sponsors who have not completed the qualification process of their PR plans are urged to react soon in order to avoid the adverse consequences discussed below for not complying on time.

Consequences of Not Complying with the Deadline

Retirement plans that do not comply with the deadline imposed by the PR Treasury will be considered as non-qualified plans, and therefore might have severe tax consequences for both the participating employers and employees. Some of the implications of maintaining a non-qualified plan in Puerto Rico are:

1. The employer may be denied a current deduction for plan contributions in its PR tax return until such amounts are included in the gross income of the employees.
2. Employees may be considered to be in constructive receipt of vested employer contributions, and therefore subject to an immediate tax liability on such amounts even if not distributed.
3. Plan distributions will be treated like any payment of wages. Consequently, lump sum distributions as a result of a separation from service for any reason or plan termination will not be eligible for the special capital gain treatment (20% tax rate) and will not be eligible for rollover. In addition, plan distributions in the form of periodic payments or annuities will not qualify for the annual gross income exclusion currently available to such distributions under a qualified plan (up to \$11,000 per year or \$15,000, if participant is 60 years or older on 12/31).

4. Employee pre-tax contributions pursuant to the plan will be treated as after-tax contributions in the year in which they are made.

Based on the foregoing, and in order to avoid the adverse tax consequences discussed above to both the participating employer(s) and the participating employees under a retirement plan, it is highly advisable to maintain the qualified status of a retirement plan under the New PR Code. Consequently, **SINCE FOR CALENDAR-YEAR PLAN SPONSORS THE DEADLINE IS SOON APPROACHING, WE URGE SUCH SPONSORS TO REACT SOON IN ORDER TO MEET THE DEADLINE.**

PUERTO RICO TREASURY NOTIFIES 2014 LIMITS ON RETIREMENT PLANS

The PR Code requires that, prior to the beginning of each taxable year, the Secretary of the Treasury notify the applicable limits under the US Code which are incorporated by reference into the PR Code limits (i.e., annual compensation, highly compensated, annual benefit/contribution limits), once the IRS has issued the applicable limits under the US Code.

On October 31, 2013, the IRS notified the applicable limits under the US Code for the taxable year beginning on or before January 1, 2014. Consequently, the PR Treasury has recently announced, through PR Treasury Circular Letter 14-01 issued on February 3, 2014, the applicable limits under the PR Code, including those limits applicable under the US Code.

The following are the applicable 2014 limits:

- Annual Benefit Limit applicable to defined benefit plans - \$210,000 (increased).
- Annual Contribution Limit applicable to defined contribution plans - \$52,000 (increased).
- Annual Compensation Limit - \$260,000 (increased).
- Compensation Limitation for HCE - \$115,000.
- Elective Deferrals Limit (applicable only to federal government employees or participants in a dual qualified plan) - \$ 17,500.¹

¹ The maximum elective deferral limitation for an employee who participates in a dual qualified plan, which also contributes to a deductible PR IRA, cannot exceed: (i) the maximum limitation on elective deferrals to participants in a PR only qualified plan, and (ii) the PR Code annual limit on contributions to a deductible IRA (i.e. \$20,000 for 2014 (\$15,000 for the maximum limitation on elective deferrals and \$5,000 for maximum limitation on a deductible PR IRA). If the employee contributes the US Code maximum (\$17,500), this means that the employee can only contribute \$2,500 to a PR IRA.

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- Elective Deferral Limit (applicable to participants in PR only qualified plans) - \$15,000.
- Catch-Up Contributions (applicable only to federal government employees)-\$5,500.
- Catch-Up Contributions (applicable to participants of PR qualified only plans and dual qualified plans) - \$1,500.
- After-Tax Contributions Limit - 10% of the aggregate compensation of the employees for all years in which they are participants in a retirement plan.

PBGC COVERAGE OF PR ONLY QUALIFIED PLANS IS AT STAKE

On April 19, 2013, the Pension Benefit Guaranty Corporation (the "PBGC") withdrew two opinion letters (Opinion Letters 77-172 and 85-19), addressing the issue of whether defined benefit plans qualified only in Puerto Rico are covered by Title IV of ERISA. Under such opinion letters, in general, the PBGC had stated that PR qualified defined benefit plans ("PR Plans") are covered by Title IV of ERISA if they had been determined by the IRS to be a US Code Section 401(a) qualified plan; or if such plan in practice had met the requirements of US Code Section 401(a) during the preceding five plan years. Accordingly, if a PR Plan had not received an IRS determination letter, the PR Plan was only subject to the termination insurance provisions of Title IV if such plan had in practice met the qualification requirements of US Code Section 401(a) during the preceding five plan years.

Notwithstanding the above, for more than 30 years, the fact is that although most PR only qualified plans have not in practice met the qualification requirements of the US Code, they have been paying PBGC insurance. Some of them due to the benefits of the insurance coverage vs. historical low cost insurance premiums and belief that PBGC would apply if the premiums were paid, and others since they were successor plans from a prior US Code qualified plans, they continued paying the insurance under the belief that transferred assets were tainted.

As a result of the uncertainty created by the PBGC by withdrawing the aforementioned opinions and due to the new

high costs of insurance premium, many PR only qualified plans are reconsidering if it is necessary to maintain the PBGC insurance and are recurring to withdraw such insurance coverage and request a refund of the premiums paid to the PBGC. It is expected that the PBGC will issue further guidance on this matter soon.

THE FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA) MAY IMPOSE NEW WITHHOLDING REQUIREMENTS TO PR ONLY QUALIFIED PLANS

FATCA is a federal legislation that will require imposing a 30% withholding on most interest and dividends ("fixed, determinable, annual, periodic" (FDAP) payments) paid by US payors to non-US retirement plan funds after June 30, 2014. Although PR only qualified plans are treated as deemed US Code qualified plans pursuant to ERISA Section 1022(i) (1) and therefore, such plans' investment earnings are generally exempt from federal taxes, it is unclear whether under the current FATCA regulations such PR only qualified plans will be treated as deemed US Code qualified plans and be exempted from the applicability of the withholding and reporting requirements under FATCA. Further guidance from the IRS on this matter is expected soon.

Should you have any questions on this subject, please contact Carlos J. Villafañe at cvillafane@salawpr.com or Ana Maria Bigas at abigas@salawpr.com

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