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PENSION ANALYST
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Puerto Rico tax reform act includes retirement provisions

On December 10, 2018, the Governor of Puerto Rico signed into law Act No. 257-2018 (the Act), which includes revisions to the Puerto Rico Internal Revenue Code of 2011 (PR Code). The changes impact all qualified retirement plans covering Puerto Rico employees including those qualified under the PR Code (Puerto Rico-only plans) and plans also qualified under the United States Internal Revenue Code (dual-qualified plans).

Overview

The Act focuses on promoting economic development in Puerto Rico and introduces various changes that impact individuals and corporations including changes to tax withholding rates for lump sum distributions from retirement plans, the compensation limit for Highly Compensated Employees, and distributions following a Disaster Declared by the Governor of Puerto Rico.

Summary of changes

Lump sum distributions

A new tax withholding rate of 20% applies to lump sum distributions, which is an increase from the previous rate of 10%. A lump sum distribution is defined as a distribution of total benefits to a participant or beneficiary within the same taxable year due to the participant's separation from service or a plan termination. The new withholding rate applies to distributions made on or after December 10, 2018.

Highly compensated employees

A modified definition of Highly Compensated Employee (HCE) includes an annual HCE compensation threshold that aligns with the limit under the US Internal Revenue Code, effective January 1, 2018 ($125,000 for 2019 per PR Treasury Circular 18-21). This replaces the fixed $150,000 limit that previously applied under Puerto Rico Act No. 9-2017. Employees who own more than 5% of the voting shares or total value of all classes of shares of stock, and employees who own more than 5% of the capital or interest in the profits of an employer that is not a corporation are still considered owners and HCEs.

Disaster-related distributions

The Act incorporates certain disaster relief provisions contained in prior hurricane-related guidance, Administrative Determination 17-29, issued by the Puerto Rico Treasury. This includes the availability of special distributions for "eligible expenses" when a disaster is declared by the Governor of Puerto Rico.

"Eligible expenses" are defined as expenses that an individual incurs to correct losses or damages or extraordinary and unforeseen expenses to cover basic needs as a result of a declared disaster. The expenses may be incurred by the participant, his or her spouse, descendants, or ascendants.

Distributions must be made within the period specified in the guidance issued for each declared disaster.

The following special tax rules apply to these distributions:

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- The first $10,000 (aggregated across all retirement plans and individual retirement accounts) distributed is exempt from income tax and the Alternate Basic Tax (ABT) under the PR Code. Therefore, this amount would not be subject to Puerto Rico income tax withholding.
- Distributions in excess of the first $10,000 are subject to a flat 10% income tax rate with mandatory 10% withholding. If the 10% income tax is not withheld at the time of the distribution, the amount distributed is subject to the ordinary income tax rates, including the ABT, established by the PR Code.

An individual may make several distributions within the specified period, but total distributions taken from all eligible plans, cannot exceed $100,000. Distributions are deemed to come first from amounts that had not previously been taxed (e.g., pre-tax contributions) and then from amounts that had previously been subject to tax (e.g., after-tax contributions).

Next steps

Plan sponsors and their counsel should review the information in this publication to understand how it may apply to their plans and participants.

Additionally, plan sponsors may be required to adopt amendments in 2019 to maintain the qualified status of their plans under the PR Code. Qualification amendments must generally be filed with Hacienda by the plan sponsor on or before the due date of the employer's Puerto Rico income tax return for the year in which the amendment is adopted. For sponsors that use Prudential Retirement's document services, we will notify you when applicable amendments are available.

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