

## Puerto Rico Tax Reform Changes Employee Benefit Provisions

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### PRACTICE AREAS

- Employee Benefits

### **An McV Employee Benefits Alert**

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Act No. 257 of December 10, 2018 (the “Act”) amended the Puerto Rico Internal Revenue Code of 2011, as amended (“PR Code”), to simplify our tax system, stimulate economic growth, and promote voluntary compliance with tax laws. Although the Financial Oversight and Management Board for Puerto Rico has expressed reservations with respect to certain portions of the Act, in general, it became effective on December 10, 2018.

Our December 10, 2018 Tax Alert describes the most important aspects of the Act affecting individuals, corporations and partnerships. This Alert provides a general description of the most important aspects of the Act in the Employee Benefits Area:

#### **Gross Income Exclusions**

- Any compensation received in a court proceeding or extrajudicial transaction for mental distress is now excludable from taxable gross income irrespective of whether or not it results from a physical damage.
- Puerto Rico Treasury Department’s (“PR Treasury”) Administrative Determination No. 17-21 of October 4, 2017, which provided an income tax exclusion for qualified disaster relief payments in connection with Hurricane María, is incorporated into the PR Code to exclude from taxable gross income “qualified disaster relief payments” received by an individual, whether Puerto Rico resident or non-resident, following a disaster declaration issued by the Governor of Puerto Rico and within the time period established by the Secretary of PR Treasury.
- PR Treasury’s Administrative Determination No. 17-29 of November 15, 2017 (“AD 17-29”), which provided for Hurricane María tax relief provisions, is incorporated into the PR Code to exclude from taxable income certain distributions from Puerto Rico qualified plans or individual retirement accounts following a disaster declaration issued by the Governor of Puerto Rico. The Secretary of PR Treasury must notify via an official publication (i.e., regulation, administrative determination, circular letter or informative bulletin) the amount to be excluded from gross income and the window period for these distributions.

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### **Gross Income Exemptions**

Amounts received from pensions granted or to be granted by the systems or retirement funds subsidized by the Government of Puerto Rico, from annuities or pensions granted by the Government of the United States of America, and by the instrumentalities or political subdivisions of both governments, and from pension, retirement or annuity plans qualified under PR Code Section 1081.01 granted by private sector employers continue to enjoy the annual exemption per retirement plan of up to \$11,000 (\$15,000, if the individual is 60 years old or older). This annual pension exemption was not increased or limited on a per taxpayer basis as the draft of House Bill No. 1544 (now the Act) originally provided. After December 31, 2018, the annual pension exemption is available solely to:

- Payments made to a participant, or to his/her beneficiary after his/her death, through a pension or life annuity or periodic payments made after the participant has terminated employment (previously, the annual pension exemption was limited to annuities or periodic payments made to the participant after his separation from employment).
- Periodic payments made for at least 5 years in similar amounts or minimum required distributions under the United States Internal Revenue Code of 1986, as amended (“US Code”) (previously, periodic payments had to be made for a minimum of 2 years).

### **Cafeteria Plans**

- Cafeteria Plan provisions under the PR Code Section 1032.06 are repealed. The Act recognizes that these provisions were not operational due to the lack of regulations for qualification of cafeteria plans with PR Treasury and the tax disallowance of employee pre-tax contributions made to such plans. However, the Act did not amend the PR Code provisions that exclude from taxable gross income amounts paid or accumulated under a cafeteria plan.

### **Health Savings Account**

- Effective January 1, 2109, no deduction is allowed for contributions made to a Health Savings Account.

### **Statutory Severance Payments**

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- Although statutory severance payments made under Act No. 80 of May 30, 1976, as amended, continue to be excluded from taxable gross income, they are treated as “wages” for withholding tax purposes on and after January 1, 2019. This new treatment follows the recently adopted modification made to the 2018 Form 499R-2/W-2PR, “Withholding Statement,” to require that severance payments be reported as tax-exempt wages rather than payments of excluded income on Form 480.6D, “Informative Return- Exempt and Excluded Income and Exempt Income Subject to Alternative Basic Tax.” Please refer to our November 7, 2018 Employee Benefits Alert for more details.

### **Harassment Indemnification Payment under Non-disclosure Agreements**

- For taxable years commencing after December 31, 2018, no tax deduction will be allowed for an indemnification payment made in connection with harassment claims, including legal fees, if such payment is conditioned to the execution of a non-disclosure agreement. Indemnification payments and related attorney’s fees resulting from a harassment case will be deductible if the payments are not subject to a nondisclosure agreement. The PR Code does not define, however, the term “harassment.” The denial of deduction for settlements subject to a nondisclosure agreement paid in connection with sexual harassment follows equivalent federal income tax provisions adopted under the 2018 Tax Cuts and Jobs Act. More about this on our January 4, 2019 Labor & Employment Law Tidbit.

### **Judicial and Extrajudicial Settlement Payments**

- After December 31, 2018, the withholding tax rate on taxable judicial or extrajudicial settlement payments is increased from 7% to 10%, and the tax withheld must be deposited with PR Treasury by the 15<sup>th</sup> day of the month following the month in which the tax was withheld (deposit of taxes withheld is no longer based on the deposit schedule for wage withholding). Settlement payments of taxable income made to Non-Puerto Rico residents, whether individuals or entities, will be subject to the withholding tax rates applicable to foreign persons.

### **Attorney’s Fees**

- Attorney’s fees continue to be taxable, but those paid directly to the attorney resulting from a judicial or extrajudicial claim are reportable for income tax purposes solely to the attorney. As a general rule, after December 31, 2018,

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the withholding tax rate on attorneys' fees (legal services rendered in Puerto Rico) is increased from 7% to 10%, and the withholding tax exemption for the first \$1,500 paid during the calendar is reduced to \$500.

### **Puerto Rico Retirement Plan Qualification Requirements**

- The Act incorporates into the PR Code certain provisions under AD 17-29 and PR Treasury's Administrative Determination No. 18-02 of January 17, 2018, regarding eligible distributions made from Puerto Rico qualified retirement plans and individual retirement accounts or annuities to Puerto Rico resident individuals affected by Hurricane María. These provisions will now apply to "Declared Disasters," as such term is now defined under the PR Code.
- The withholding tax rate of 10% applicable to all lump-sum distributions from qualified retirement plans made after December 31, 2017, as adopted by Act No. 106 of August 23, 2017, was eliminated by the Act. Lump-sum distributions due to separation of employment or termination of a retirement plan (except amounts contributed by the participant as after-tax contributions) continue to be treated as ordinary income (not as a capital gain), but will be subject to a special withholding tax rate of 20%. Lump sum distributions from retirement plans funded through a Puerto Rico trust (or through a non-PR trust with a Puerto Rico resident agent) and that comply with the requirement of investing in Puerto Rico property, continue to enjoy the special reduced withholding and income tax rate of 10%.
- The Act also modified the definition of the term "Highly Compensated Employee" ("HCE"), as adopted by Act No. 9 of February 8, 2017 ("Act 9-2017"). The compensation limitation used in the definition of HCE is no longer fixed at \$150,000 per year. The Internal Revenue Service's ("IRS") annual compensation limit under US Code Section 414(q)(1)(B) is reinstated into the PR Code. The new definition of HCE is as follows:
  - a shareholder owning over 5% of the voting shares or total value of all classes of stock of the employer or owning over 5% of the capital or interest in the profits of the employer, if such employer is not a corporation, as defined in the PR Code and its regulations; or
  - any employee who for the preceding plan year received compensation from the employer over the compensation limitation under US Code Section 414(q)(1)(B), as adjusted annually by IRS for cost of living (i.e., \$125,000 for 2019).

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The change adopted by Act 9-2017 to exclude “officers” from the definition of HCE is still in effect.

### **Puerto Rico Individual Retirement Accounts**

- After December 31, 2018, the portion of a distribution from a Puerto Rico individual retirement account attributable to interest income is now subject to an income tax rate of 10% (previously, the rate was 17%).

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