

## Proposed Amendments to the Cafeteria Plan Provisions of the Puerto Rico Internal Revenue Code of 2011

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### PRACTICE AREAS

- Employee Benefits

### An McV Employee Benefits Alert

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On January 9, 2017, Governor Ricardo Rossello's administration filed with the Puerto Rico Legislature Senate Bill No. 212 and House Bill No. 453 ("HR 453") to establish the Labor Transformation and Flexibility Act ("Ley de Transformación y Flexibilidad Laboral"). Among the many changes proposed by HR 453 there are included certain amendments to the provisions of Section 1032.06 of the Puerto Rico Internal Revenue Code of 2011, as amended ("2011 PR Code"), governing the treatment of cafeteria plans.

These proposed amendments are intended to reactivate in Puerto Rico cafeteria plans and make the adoption of these plans more attractive to Puerto Rico employers by expanding the list of "qualified benefits" that they may be provided to Puerto Rico employees. However, as more fully explained below, unless HR 453 is further amended to correct or eliminate certain deficiencies existing in Section 1032.06 of the 2011 PR Code, it will be very difficult to accomplish its intended goal.

### Background to Section 1032.06 of the 2011 PR Code

The cafeteria plan provisions were initially incorporated to Section 1022(l) of the Puerto Rico Internal Revenue Code of 1994, as amended, by Act 277 of September 14, 2004 ("Act 277-2004"). These provisions are now found in Section 1032.06 of the 2011 PR Code. The provision of Section 1032.06 basically follow Section 125 of the United States Internal Revenue Code of 1986, as amended ("US Code"), with certain minor differences, such as (i) the type of qualified benefits, (ii) limitations for not accepting health coverage (must prove that was covered by another plan), and (iii) the requirement to submit the plan to the PR Treasury for approval/qualification. In general, and subject to certain limitations, the type of qualified benefits were limited to health and accident benefits, dependent care, group life insurance benefits and any other benefits adopted by the PR Treasury pursuant to regulations.

Although the intention of the Puerto Rico legislature when enacting Act 277-2004 was to follow the principles of Section 125 of the US Code, and therefore allow the Puerto Rico participants to make pre-tax contributions to cafeteria plans (to acquire "qualified benefits"), shortly after the enactment of

## Proposed Amendments to the Cafeteria Plan Provisions of the Puerto Rico Internal Revenue Code of 2011

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Act 277-2004, PR Treasury issued Circular Letter No. 04-07, dated December 22, 2004, (“CL 04-07”) concluding that the act did not authorize employee pre-tax contributions for the purchase of “qualified benefits.” At the time, this position was seen by most tax practitioners as going against the purposes of Act 277-2004. In light of this, PR Treasury established a committee to work on the drafting of regulations and to discuss the possibility of reconsidering its position in CL 04-07; however, a final consensus was never reached, the regulations were never issued, the position of CL 04-07 was never changed, and PR Treasury ceased to approve cafeteria plans adopted in Puerto Rico. The main reason for the disagreement was not permitting participants to make pre-tax contributions to such plans and as further discussed below, the disparity in the FICA tax treatment of the employee contributions made by the Puerto Rico participants to Puerto Rico cafeteria plans.

Under the US Code, an employee participating in a Section 125 cafeteria plan is not subject to federal income taxes or FICA taxation in connection with the contributions made to such plans. This treatment, however, is limited exclusively to the employee’s elections made under cafeteria plans that qualify as such under Section 125 of the US Code. Since Puerto Rico cafeteria plans are only qualified under Section 1032.06 of the 2011 PR Code, not Section 125 of the US Code, Puerto Rico employees that make an election under such Puerto Rico cafeteria plan are treated as deriving “taxable wages” for FICA tax purposes, even though as a general rule the amounts contributed under the election would be to a plan that would qualify for an exclusion from wages if made directly by the employer. At the time of enactment of Act 277-2004 an attempt was made to amend the US Code to include Puerto Rico cafeteria plans within the FICA wages exclusion. These efforts, however, failed to produce the desired amendment.

### **Changes Proposed by HR 453**

HR 453 proposes to amend Section 1032.06(d)(3) of the 2011 PR Code to add to the list of “qualified benefits” the following additional benefits: (1) health and dental plans; (2) health savings accounts; (3) dependent care assistance programs; (4) long-term disability benefits; (5) accident insurance including accidental death and dismemberment; (6) adoption assistance; and (7) any other “qualified benefit” authorized under Section 125 of the US Code.

## Proposed Amendments to the Cafeteria Plan Provisions of the Puerto Rico Internal Revenue Code of 2011

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A quick revision of the above list, however, shows that some of these benefits are already included in Section 1032.06(d)(3). Benefits such as health coverage, accident coverage and dependent care assistance are already allowed by Section 1032.06(d)(3). In light of this fact, it is expected that HR 453 be amended to clarify this matter.

Finally, as indicated above, the purpose of these changes is to reactivate in Puerto Rico the adoption of cafeteria plans and to make such plans a more attractive vehicle for those employers wishing to offer their Puerto Rico employees flexible benefits. However, in our view, HR 453 will not succeed in accomplishing its intended goals unless it is amended to: (1) allow for employee's pre-tax contributions; and (2) provide for the adoption of regulations by PR Treasury for purposes of reactivating the qualification process. Furthermore, to make the cafeteria plans a viable instrument in Puerto Rico, it is very important to push for the adoption of amendments to the US Code to treat the employee's pre-tax contributions to Puerto Rico cafeteria plans as non-taxable wages for FICA tax purposes.

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