

**Puerto Rico Tax Reform Impacts Retirement Benefit and Employment Law Provisions**

On December 10, 2018, the Governor of Puerto Rico enacted Act 257-2018 (the “Act”), which includes several amendments to the Puerto Rico Internal Revenue Code of 2011, as amended (“PR Code”). The most significant changes regarding retirement benefit and employment are set forth below:

**I. Tax Qualified Retirement Plans (PR Code Section 1081.01)**

- The Act statutorily incorporates into the PR Code the provisions of Puerto Rico Treasury Department (“PR Treasury”) Administrative Determination 17-29 (“AD 17-29”) regarding special income taxation rules for “Declared Disaster Distributions” (as for example, distributions due to the passing of Hurricane María). As incorporated into the PR Code, Declared Disaster Distributions from retirement plans are considered excluded from taxable gross income up to the first \$10,000 and taxable at a preferential 10% PR income tax rate in excess of said amount and up to \$100,000, to be withheld at source during the eligible period that may be established by the PR Treasury.
- Lump-sum distributions (due to separation of employment or plan termination) of tax qualified retirement plans are reverted to a 20% withholding rate at source (10% in 2018, under Act 106-2017). Said distributions continue to be eligible for special capital gains-type tax treatment, except that participants may elect to treat such distributions as ordinary income.
- Lump-sum distributions from retirement plans that comply with the special “Puerto Rico investment rule” of PR Code Section 1081.01(b)(1) (regarding investment in Puerto Rico property) continue to enjoy the special reduced withholding and income tax rate of 10%.
- The definition of the term “Highly Compensated Employee” (“HCE”) was modified by the Act to eliminate the change brought by Act No. 9 of February 8, 2017 (“Act 9”), and therefore eliminate the fixed compensation limitation of \$150,000 per year to determine HCE, and to reinstate the tie-in dollar limit under Section 414(q)(1)(B) of the United States Internal Revenue Code of 1986, as amended (the “US Code”) (\$125,000 for 2019, as per PR Treasury Circular Letter 18-21). However, the Act retains the change to the definition of HCE under Act 9 that excluded “officers” of the participating Employer as HCE.
- The annual income tax exemption limit on installment/annuity payments per retirement plan is left unchanged at \$11,000 (\$15,000, if the individual is 60 years or older). The Act does clarify that this rule applies to payments made to surviving beneficiary(ies) of the participant after his/her death through a pension or life annuity or periodic payments made after the participant has terminated employment (apparently excluding “Alternate Payees”). However, periodic payments must now be made for a minimum of 5 years (previously, the minimum was 2 years, per PR Treasury regulations).

**II. IRAs (PR Code Section 1081.02)**

- The interest portion of Puerto Rico individual retirement account (“IRA”) distributions made after December 31, 2018, is subject to a 10% income tax rate (previously, 17%) if subject to withholding at source.

- The Act also statutorily incorporates Declared Disaster Distributions under AD 17-29 for PR IRAs. Therefore, any amounts paid or distributed from IRAs for Declared Disaster Distributions during the eligible period will be excluded from gross income up to the first \$10,000 that are paid or distributed from an IRA to cover eligible expenses. Any amount distributed in excess of \$10,000 (and up to \$100,000 as applicable) will be eligible for a preferential tax rate of 10% to be withheld at source.
- IRA trustees and insurance companies that administer IRA programs are now required to prepare reports regarding contributions and distributions of such IRAs for the PR Treasury and the applicable IRA holder no later than the last day of the second month after the month in which the contributions have been made or distributions have been received.

### **III. Employment Settlement Matters**

- Severance payments made up to the amount provided under Act No. 80-1976 as amended (i.e., unjust dismissal), continue to be treated as excluded from Puerto Rico gross income. However, employers in Puerto Rico will be required to report certain severance payments as "wages". Under Publication 18-03, the PR Treasury had recently stated that this is to be reported on Withholding Statement Form 499R-2/W-2PR, as opposed to Form 480.6D, as "exempt income".
- The Act increases the withholding tax rate from 7% to 10% for judicial and extrajudicial settlement payments made after December 31, 2018.
- The Act also increases the withholding on service payments to 10% (formerly 7%), which generally applies to separate payments made to claimants' attorneys. Likewise, the amount exempt from withholding at source is reduced from the first \$1,500 to \$500 (per year) for payments made after December 31, 2018.
- For tax years commencing after December 31, 2018, a deduction will not be allowed for settlement payments made on account of sexual harassment cases that include a non-disclosure agreement.
- Any compensation received for mental anguish in a court proceeding or extrajudicial transaction will be excluded from gross income.

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