#### PUERTO RICO QUALIFIED PLAN DISCRIMINATION TESTING AND REPORTING

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### WHAT IS THE PURPOSE OF DISCRIMINATION TESTING?

 Discrimination testing is meant to keep qualified plans from favoring the prohibited groups

3

#### WHO ARE THE PROHIBITED GROUPS?

- Highly Compensated Employees
- Shareholders
- Supervisors
- Partners
- Officers



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### WHO ARE HIGHLY COMPENSATED EMPLOYEES?

- 1. Five percent owner of employer's stock or capital at any time during current or preceding year, or
- Received annual compensation greater than U.S. Internal Revenue Code 414(q) limit during the preceding year:
  - \$120,000 for 2018
  - \$125,000 for 2019

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# WHO ARE NON-HIGHLY COMPENSATED EMPLOYEES (HCE)?

Anyone who does not meet the HCE definition

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# WHAT DISCRIMINATION TESTS ARE REQUIRED UNDER THE PUERTO RICO INTERNAL REVENUE CODE OF 2011?

ALL PLANS:

- Coverage Test
- General Test of contributions and benefits
- CASH OR DEFERRED ARRANGEMENTS:
  - ADP TEST

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692

# COVERAGE TEST

- A qualified plan must meet one of three tests:
  - Under the <u>percentage test</u>, the plan must cover at least 70% of all non-highly compensated employees
  - Under the <u>ratio test</u>, the percentage of non-highly compensated employees covered under the plan must be at least 70% of the percentage of highly compensated employees who are covered
  - Under the <u>average benefits test</u>:
    - The plan must benefit a reasonable classification of employees and not discriminate in favor of highly compensated employees; and
    - The average benefit for the non-highly compensated employees must be at least 70% of the average benefit provided to all highly compensated employees

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# COVERAGE TEST EXCLUSIONS

- Collectively bargained employees
- Non-resident aliens who do not receive Puerto Rico source income
- Employees who do not meet age and service requirements

# GENERAL TEST OF CONTRIBUTIONS AND BENEFITS

This test requires that contributions and benefits not discriminate in favor of partners, officers, shareholders, supervisors or HCEs

- Discrimination test for cash or deferred arrangements (401(k) type plans) actual deferral percentage test (ADP) of employees who are eligible to participate in the plan.
- First step, calculate actual deferral ratio (ADR) for all eligible employees:

Employee's annual elective deferrals

Employee's ADR = ----- x 100

Employee's total annual compensation

- Catch-up contributions are not included in employee elective deferrals and employee's total annual compensation taken into account cannot exceed annual compensation limit (\$280,000 for 2019)
- Second step, ADPs for nonhighly compensated employees (NHCEs) and highly compensated employees (HCEs) are averaged for each group by adding them together and dividing by number of employees in each group
- Third step, compare the average ADP of the groups:

Average ADP for HCEs may not be greater than:

•1.25 x average ADP of NHCEs or

•2 times the average ADP for NHCEs and 2% more than average ADP for NHCEs

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- Ratios are calculated to two decimal places (nearest 1/100<sup>th</sup> of a percent)
- Eligible participants who chose not to defer have ADRs of zero when calculating group averages
- In Puerto Rico, plans must use current year testing method, where current year HCE's ADP is measured against current year NHCE's ADP; may need mid-year test to estimate results

- What if the test fails?
- Two options:
  - 1. Raise NHCE averages to achieve passing results; or
  - 2. Distribute or recharacterize sufficient excess contributions to affected HCEs so that HCE averages are lowered to acceptable levels
- To raise NHCE averages plan makes qualified nonelective contributions (QNECs) for NHCEs that can be taken into consideration for ADP test purposes.
- QNECs must be 100% vested when made and subject to same withdrawal restrictions as elective deferrals

- To lower HCE average accomplished in two steps:
- First, total dollar amount of correction is calculated by lowering individual ADRs in turn, beginning with the HCE who deferred the highest percentage of compensation, until the HCE's ADP reaches the required level. The required level is either the one that allows passing the ADP test or the HCE's ADR is equal to the next highest HCE's ADR
- Second, total dollar amount of correction from Step 1 is apportioned among HCEs, beginning with the HCE who deferred the highest percentage of compensation and distributed to the HCE or recharacterized as after-tax contributions

- Recharacterization of excess contributions must be completed within 2 ½ months after close of plan year for which ADP test failed
- Corrective distributions of excess contributions (and earnings) must occur within 12 months after the close of the plan year in which the ADP failure occurred.

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### REPORTING

Puerto Rico qualified plans must complete and file:

- 1. FORM 5500 (plans subject to ERISA)
- 2. PR TREASURY FORM 6042



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### FORM 5500

- Required by ERISA
- Is due on the last day of 7<sup>th</sup> month after Plan Year closes
  - Calendar plan year, July 31<sup>st</sup>
- Filing Form 5558 on time, will extend the due date to 2 ½ months beyond the regular deadline
  - Calendar plan year, October 15<sup>th</sup>

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# WHAT IS THE PURPOSE OF FORM 5500?

- An important compliance, research, and disclosure tool for the Department of Labor (DOL)
- A disclosure document for plan participants and beneficiaries
- A source of information and data for use by other Federal agencies, Congress, and the private sector in assessing employee benefit, tax, and economic trends and policies
- Part of ERISA's overall reporting and disclosure framework, which is intended to assure that employee benefit plans are operated and managed in accordance with certain prescribed standards
- Ensure that participants and beneficiaries, as well as regulators are provided or have access to sufficient information to protect the rights and benefits of participants and beneficiaries under employee benefit plans.

### WHO HAS TO FILE FORM 5500 AND HOW IS IT FILED?

- The Plan Administrator is responsible for filing the Form 5500
- The Form 5500 must be filed using the DOL's EFAST2 system or other commercially available software

#### FORM 5500 SERIES

- Form 5500
- Form 5500-SF
- Form 5500-EZ

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#### FORM 5500 EZ

- Form 5500-EZ: One participant or a foreign plan
- No filing is required if plan assets are less than \$250K at the end of the plan year

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#### COMMON 5500 QUESTIONS AND MISTAKES

- Use of incorrect plan characteristic codes
- Not having a Fidelity Bond
- Not reporting late participant remittances

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# PLAN CHARACTERISTIC CODES

- Identify in more detail the type of plan and its features
- Common codes for Puerto Rico qualified 401(k) type plans:
  - 2E Profit Sharing Plan
  - 2F ERISA Section 404(c) plan
  - 2G Total participant directed account plan
  - 3C Plan not intended to be qualified under Section 401, 403 or 408
  - 2T Total participant directed account plan plan uses a QDIA

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692

# FIDELITY BONDS WHAT ARE THE BOND REQUIREMENTS?

- Bonds are required by law
- Bonds are also known as Fidelity Bonds; Dishonesty policy or Crime policy and the surety generally has recourse against fiduciaries
- ERISA Section 412 and related regulations require that fiduciaries and every person handling funds or other property of any plan ("plan officials") shall be bonded. Exceptions: Broker Dealers, Banks, Insurance companies and corporations, if they comply with similar bonding requirements
- The bond shall provide protection to indemnify the plan for loss caused directly by dishonest act including fraud by plan officials
- Plan Officials shall be bonded for at least 10% of the amount of funds handled by the person or group the preceding year; a minimum bond of \$1,000 per plan and a required maximum of \$500,000 (higher maximums may be purchased)
- Plans that hold employee securities shall bond plan officials for \$1,000,000

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# ARE THERE OTHER REQUIREMENTS?

- The form used by the Insurance Company shall be approved by the Secretary of the Department of Labor and must be approved by the Secretary of Treasury for Federal Bonds. See list of Treasury Listed companies at <u>www.fms.treas.gov</u>.
- Is the employer's existing commercial crime policy acceptable?
  - Yes, as long as the minimum requirements of Section 412 are met "ERISA rider"
  - Also, a fidelity or crime policy may insure more than one plan, but each plan shall be able to present a claim for the full amount allowed under Section 412
- Exempt from Bonding
  - Some plans may be exempt if there is sufficient evidence of the financial capacity of the plan
- Conflict of interest (only for the Bond)
  - It is unlawful to procure the bond from any surety or agent if the plan or any party in interest has control or significant financial interest in the surety or agent

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#### LATE PARTICIPATION REMITTANCES WHEN ARE PARTICIPANT CONTRIBUTIONS AND LOAN REPAYMENTS PAYBLE TO THE PLAN'S TRUST?

• An employer must deposit the participant contributions and loan repayments as soon as it is reasonably possible to segregate them from the company's assets,

#### BUT

- <u>NEVER</u> LATER than the 15<sup>th</sup> business day of the month following the pay day.
- Late remittances are reported on Schedule H, Part IV

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#### FORM 6042

- What is it?
- What do I need to do?

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#### FORM 6042

Form 6042 is a Puerto Rico Treasury Department Form that must be included with an Employer's Puerto Rico Income Tax Return if the Employer is claiming a deduction for contributions to a PR qualified plan

#### SAMPLE FORM 6042

Modelo SC 6042	Estado Libre Asociado de Puerto Rico DEPARTAMENTO DE HACIENDA		Núme	ero de Ser	ie
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PARTE II - CONTRIBUCION S	OBRE APORTACIONES NO DEDUCIBLES		(10	2	15
7. Aportaciones no deducibles p	ara el año corriente (Anote aquí la cantidad de la Parte I, línea 6	5)		)	Ö
<ul> <li>A) Aportaciones para años o B) Aportaciones devueltas al</li> </ul>	ciones no deducibles atribuibles a: ontributivos comenzados antes del 1 de enero de 2011 (Sección 10 contribuyente antes del último día para rendir la planilla de contribuci	ón sohre ingresos			c
(Sección 1033.09(a)(5)(D 9. Monto de aportaciones no ded	) del Código)ucibles sujetas a contribución (Línea 7 menos líneas 8A y 8B)			)	x 10%
10. Tasa contributiva 11. Contribución sobre aportac	iones no deducibles (Véanse instrucciones)			2	x 10%
	PITAL EN APORTACIONES DE PROPIEDAD				
complete la siguiente sección:	el año corriente fueron hechas total o parcialmente en propiedad que n				
12. Justo valor en el mercado de 13 Menos: Base ajustada de la	la propiedad aportada al momento de la aportación			2	0
13. Menos: Base ajustada de la propiedad al momento de la aportación		buyente. Véanse instru	icciones) (14	14)	
	OBRE APORTACIONES EXCESIVAS				
el plan no pasó la prueba de por	ortaciones en efectivo o diferidas y para el año del plan que terminó con o dur siento actual de diferimiento de la Sección 1081.01(d)(3) del Código, compl	lete la siguiente sección:	,		
<ol> <li>Total de aportaciones excesivas 16 Anortaciones excesivas corregi</li> </ol>	ras al plan bajo la prueba de por ciento actual de diferimiento das en o antes del último día para rendir la planilla de contribución s	obre ingresos		0	0
17. Aportaciones excesivas no o	prregidas a tiempo (Línea 15 menos línea 16)				x 10%
19. Contribución sobre aporta	ciones excesivas (Véanse instrucciones)			0	0
PARTE V - INFORMACION GE			. (10		
	an ción del plan más reciente emitida por el Departamento de Hacier		(01) Dia	_ Mes	_ Año
<ol> <li>Fecha de la carta de cualifica</li> <li>Fecha de la solicitud de cualifica</li> </ol>	ción del plan más reciente emitida por el Departamento de Hacier icación del plan / enmiendas más recientes radicadas con el Depa	nda artamento de Hacienda	(02) Dia	_ Mes Mes	Año Año
<ol> <li>Ultimo día del año del plan qui</li> </ol>	ue terminó con o durante el año contributivo del contribuvente		(04) Dia	Mes	Año
<ol> <li>Número de empleados del co</li> <li>Número de empleados del co</li> </ol>	ntribuyente al último día del año del plan ntribuyente elegibles a participar en el plan al último día del año (	del plan		)	
7 Número de narticinantes en e	l nlan al último dia del año del nlan:				
B) Participantes inactivos y Tatal da participantes ( ) Tatal da participantes ( ) Tatal da participantes ( )	etirados / separados recibiendo beneficios			) )	
<ol> <li>Compensación total pagada a</li> </ol>	etirados / separados recibiendo beneficios			)	0
	que trabajan por cuenta propia, anote el ingreso ganado por tale o a la industria o negocio que mantiene el plan				0

Período de Conservación: Diez (10) años

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### **QUESTIONS?**



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