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Puerto Rico Tax Code Amendment Offers Window to Pay Reduced Tax on Retirement Funds

The Governor of Puerto Rico has signed into law the *Tax System Adjustment Act*. By and large, the new law increases taxes across the board for individuals and corporations. However, it also provides a short window of time from July 1, 2014 to October 31, 2014 when reduced tax rates can be applied to participants and beneficiaries of Puerto Rico qualified plans, non-qualified plans and Individual Retirement Accounts (IRAs) who either take distributions or prepay taxes on future distributions.

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Background

Under Puerto Rico tax law, lump sum distributions received by a participant in a Puerto Rico qualified plan on account of separation from service are taxed at long-term capital gains rates (which is generally capped at 20%, although a maximum 10% capital gains rate applies to plans with a Puerto Rico resident trustee or paying agent if at least 10% of its assets are invested in Puerto Rico property). Other payments from qualified plans, all distributions from non-qualified plans, and distributions from Puerto Rico IRAs are generally taxed at the graduated tax rates applicable to ordinary income - though special rules can apply to IRA income.

Many Puerto Rico qualified profit sharing and stock bonus plans include a provision allowing distribution in the event of "financial hardship" and allow the Secretary of the Treasury of Puerto Rico to define any event it deems appropriate to qualify as a "financial hardship." Other than under "financial hardship" conditions, qualified plan in-service distributions prior to age 59½ (or normal retirement age in a pension plan) are generally not permitted except in very limited circumstances (including disability and plan termination). Most IRA withdrawals before age 60 are generally subject to a 10% excise tax, in addition to inclusion in gross income for income tax purposes.

In 2006, Puerto Rico tax law was amended to allow prepayment of income tax at a preferential rate of 5% for a limited period of time. See the section on Act 87 in our May 26, 2006 *For Your Information*.

Opportunity to Pay or Prepay Tax at 8% or 15%

During a window offered by the *Tax System Adjustment Act* ("the Act"), participants in Puerto Rico qualified or non-qualified plans as well as IRA holders or beneficiaries may elect to pay income tax at a preferential rate of 8% for what the Act calls "capital assets" or 15% for income taxed as ordinary income. The preferential rates are applicable to distributions, and individuals can also choose to prepay the tax on funds that remain in the retirement fund–even if a distribution from the fund is not available at the time of the prepayment.

The Act specifically states that 8% is the rate applicable to prepayments of IRA balances–other than for IRA contributions for 2014 or later years. It is not clear whether, for this purpose, IRA contributions for 2014 or later years would include rollovers made to Puerto Rico IRAs.

> Comment. If the prepaid amount remains in the retirement fund, the member is paying tax capped at an 8% or 15% rate on the prepaid balance now with the expectation of avoiding potentially higher tax rates in retirement.
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> It is expected that lump sums distributions taken from a qualified plan following separation from service during the "window" period will be treated as capital gains taxed at the 8% rate. It is far less certain whether the rate applicable to prepayments before separation from service from qualified plans will be 8% or 15%. If the terms of a Puerto Rico qualified plan currently offers a lump sum distribution to a participant (and Hacienda, the Puerto Rico taxing authority, does not preclude a 2014 rollover from receiving the preferential IRA 8% tax rate), one possible approach to avail oneself of the 8% rate for qualified plan funds would be to roll over a lump sum distribution to a Puerto Rico IRA and then take advantage of the 8% preferential tax rate on IRA prepayments noted above. However, until Hacienda issues further guidance, practitioners cannot be certain of the circumstances (if any) under which the 8% rate will be available–either for qualified plan distributions (if any) or prepayments made for 2014 IRA rollovers.

The 15% preferential tax rate would be applicable to annuity payments from qualified plans (in excess of applicable thresholds) and to non-qualified plan distributions that are subject to ordinary income tax rates.

Paying from Balances?

The Act provides that a Puerto Rico qualified plan may allow a participant to elect to prepay the tax using his or her Puerto Rico retirement plan balance, without disqualifying the plan or affecting the participant's right to continue contributing to the plan. Many plan sponsors would welcome guidance from Hacienda allowing in-service withdrawals to prepay tax to be treated as a "financial hardship" event, given that many Puerto Rican plans already include a provision allowing the Secretary of the Treasury of Puerto Rico to define such an event. Allowing plan sponsors to use existing plan provisions to issue in-service distributions to fund prepayments would ensure that more participants will be allowed to take advantage of the prepayment opportunity. However, unless such guidance is issued, Puerto Rico plans may need to be amended to permit special in-service distributions authorized by the Act to fund prepayments for participants not otherwise eligible to receive a distribution under the terms of the plan.

> Comment. Participants in dual-qualified plans (i.e., plans that are also qualified in the US) may not be able to take advantage of this rule to the extent that the participant has not incurred a distributable event for US qualified plan purposes and does not have access to funds outside the plan to pay the tax. If they wish to take advantage of this opportunity, participants in dual-qualified plans that offer loans may be able to use

them to help finance the prepayment of the tax (although a loan must be repaid on time to avoid being treated as a taxable distribution in later periods).

Subsequent Distributions

When an amount that was previously included in tax under the prepayment provisions is subsequently distributed, the excess over the amount taken into income under the Act (if any) would be includible in gross income at the time of distribution.

IRA holders or beneficiaries who prepay the tax to take advantage of the 8% tax rate, and then withdraw the prepaid amount prior to age 60 will be subject to a special 30% excise tax on the prepaid amount (even though it will not be subject to income tax again). In addition to the usual exceptions to the premature distribution tax that are available, a special exception is available for IRA withdrawals made during the pre-payment window period to the extent that the amount withdrawn does not exceed the 8% tax that is due on the prepayment.

In Closing

As the Puerto Rico economy continues to struggle and the corresponding tax obligations get larger, employers with Puerto Rican operations can help their employees with this brief opportunity to lower their tax bill. Plan amendments, if needed, along with fast and effective communication of the provisions of the Act and the options available to eligible participants will allow employers to generate significant goodwill at minimal cost.

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