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Puerto Rico Treasury Issues Guidance on Window to Pay Reduced Tax on Retirement Funds

Hacienda has clarified that from July 1 to October 31, 2014, the preferential 8% tax rate will apply to prepayments of tax on account balances and lump sum distributions from Puerto Rico qualified plans. During that window, the 15% preferential rate will apply to those from non-qualified plans and to plans that were previously considered qualified but have not applied for a qualification letter under the Puerto Rico Internal Revenue Code of 2011 by the required deadline. Administrative details have also been clarified.

Background

The Tax System Adjustment Act was enacted on July 1, 2014 and offers participants and beneficiaries in qualified and non-qualified retirement plans a window of time in which to prepay tax on their benefits at preferential rates of either 8% or 15%. However, as we noted in our July 24, 2014 *For Your Information*, the law was ambiguous about which distributions or prepayments were eligible for these preferential rates, and the associated administrative details.

Sponsors of Puerto Rico qualified plans were required to submit their plans for a qualification letter under the Puerto Rico Internal Revenue Code of 2011 by the due date of the tax return for the employer's 2013 taxable year, with a three-month extension available for sponsors paying an additional fee. (For sponsors with the calendar year as their taxable year, the filing was due April 15, 2014, or July 15, 2014 with extension.) A late filer correction program was also established. Please see our June 26, 2013 *For Your Information* for further details.

Administrative Determination #14-16

On August 6, 2014, Hacienda issued Administrative Determination #14-16 to provide guidance for plan participants (which for this purpose includes beneficiaries and QDRO alternate payees), sponsoring employers, and plan service providers about the distributions and prepayments eligible for the 8% and 15% preferential rates during the window period.

Participant Benefit Values

Participants can voluntarily elect to pay tax on all or part of their defined contribution plan balances or the present value of their accrued benefit under a defined benefit plan. If the participant has benefits under more than one plan, the election must be made separately for each plan, and tax cannot be prepaid on amounts in excess of the account balance or accrued benefit at the time that the prepayment is made.

> **Comment:** Guidance was not provided about how to determine the present value of accrued benefits under a traditional defined benefit plan for this purpose. However, as participants retiring with a lump sum during the window period would most likely have their lump sums computed using applicable ERISA rules, we assume that active participants can have the lump sum value of their deferred accrued benefits computed in similar fashion.

If a participant makes multiple prepayments for a single plan during the window period, the participant's prepayments on any date cannot exceed the participant's total account balance or accrued benefit as of that date, less the sum of any previous prepayments — including prepayments under previous windows.

Which Tax Rate to Use

The 8% preferential rate is available for distributions or prepayments from qualified plans during the window period; the 15% rate applies to nonqualified plans. For this purpose, plans that have not submitted their qualification letter requests to Hacienda under the Puerto Rico Internal Revenue Code of 2011 are not considered qualified, so the 15% preferential rate (not the 8% rate) would be used. A participant need not be separated from service with the employer maintaining the qualified plan to take advantage of the 8% rate.

These reduced rates are also applicable for amounts distributed during the window as a result of a distributable event such as separation from service, plan termination, or retirement (as long as the tax is paid at the time of distribution).

> **Comment:** Even though the Tax System Adjustment Act stated that income taxed as "ordinary income" (which includes periodic payments not subject to capital gains treatment) could prepay at the 15% rate, the guidance is silent on this issue.

Source of Payment

Prepayments may be made with the participant's own funds or participants may use their retirement plan balance, if available for distribution. Plans are not required to offer distributions to participants during the window period to facilitate prepayment, and such distributions may only be made if permitted in accordance with the terms of the plan. If the participant does not already have a distribution available under the terms of a qualified plan, the plan can be amended to allow for such distributions without the plan sponsor having to submit the amendment to Hacienda for a qualification ruling.

> **Comment.** Note that dual-qualified plans may not be amended to permit these distributions because prepayment of Puerto Rico income taxes is not a distributable event under the US Internal Revenue Code. However, distributions may be available from a dual-qualified plan from select accounts for certain other

reasons such as attainment of age 59½, completion of five years of participation, or two-year aging of employer contributions.

Method of Payment

Participants can prepay tax on their qualified plan benefit by submitting form SC 2911, or can prepay tax on their nonqualified plan benefit by submitting form SC 2912. The forms must be completed and filed with Hacienda in triplicate and submitted with proof of the plan account balance or the present value of accrued benefit prepared as of a date within the 30-day period prior to the date when the prepayment is made. Acceptable proof can include a participant statement, a benefit calculation, a plan service provider certification, or other administrative document. The participant will receive back two copies of the form from the Puerto Rico Treasury Department stamped to reflect the prepayment. Within 30 days, the participant would provide the plan with one of the copies so that the plan could maintain a record of the prepayment.

Comment. A plan is not required to keep track of prepayments. It is unclear, then, how a plan sponsor that does not maintain such records would take into account the prepayment made from a participant's private funds when reporting the taxable amount of a distribution to the participant at a later date. Presumably, the sponsor would report the entire amount of the distribution as a taxable amount and the participants would obtain a credit when filing their tax return.

If payments are to be made by a plan fiduciary, the participant must complete the applicable forms in quadruplicate and submit them to the plan fiduciary no later than October 31, 2014. The plan fiduciary then returns a stamped and/or signed copy to the participant (thereby acknowledging receipt of the forms by the fiduciary) and then submits the prepayment and three copies of the form to the Puerto Rico Treasury on or before the 15th of the month following the date of receipt of the form from the participant. The plan will receive back two copies of the form from Treasury and must provide one of the copies within 30 days to the participant.

Comment. In this situation, the plan will need to keep careful records to avoid duplicate payment of benefits at a later date and to correctly report the subsequent taxable distribution.

Once a prepayment has been made, it is irrevocable and a refund may not be made even if the value of the participant's account balance or lump sum value decreases by the date of distribution. Accrued amounts for which tax has been prepaid will be exempt from future taxation; however, earnings on those amounts will be taxed.

In Closing

In the past, these opportunities for lower taxation of account balances and lump sums out of Puerto Rico qualified and non-qualified plans have been extremely popular. As indicated in our July 24, 2014 *For Your Information*, given the current high tax environment in Puerto Rico, with further tax increases to come, plan sponsors have a great opportunity to generate significant goodwill at a relatively low cost. Furthermore, to avoid situations where employees find out, after the fact, that they may have missed a rare opportunity for considerable tax reduction, plan sponsors should be sure to notify participants of this prepayment opportunity and the related prepayment process.

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