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## Puerto Rico Treasury Issues Guidance on Tax Prepayment Window on Retirement Plans

As we anticipated in our Groom Benefits Brief of July 16, 2014 (available [here](#)), the Puerto Rico Treasury Department (the “PR Treasury”) recently issued Administrative Determination No. 14-16 (“AD 14-16”).<sup>1</sup> AD 14-16 provides guidance on the many ambiguities of the provisions in the Tax System Adjustment Act (“Act 77-2014”) which amended the Puerto Rico Internal Revenue Code of 2011, as amended (the “PR Code”), to provide a window period for the pre-payment of Puerto Rico income taxes on account balances and accrued benefits under qualified and non-qualified retirement plans.

### In General

Act 77-2014 amended the PR Code to give Participants<sup>2</sup> in both qualified and non-qualified retirement plans a window – from July 1 to October 31 (the “Window Period”)<sup>3</sup> – to voluntarily pre-pay the Puerto Rico income taxes on a participant’s accumulated and undistributed balance in the plan (the “Prepayment”).<sup>4</sup> AD 14-16 clarifies that the Prepayment may be made on all or part of both the Participant’s account balance in the case of a defined contribution plan or the present value of the Participant’s accrued benefit in the case of a traditional defined benefit pension plan (both as of the date the Prepayment is made). The election to prepay may be made on a per plan basis in the case of participation in more than one plan.

### Applicable Tax Rate

AD 14-16 clarifies that an 8% tax rate is applicable for the Prepayment in the case of plans qualified under the PR Code, and a 15% tax rate is applicable for non-qualified plans. For purposes of the Prepayment, AD 14-16 provides that a qualified plan includes plans that

<sup>1</sup> AD 14-16 in Spanish is available [here](#).

<sup>2</sup> AD 14-16 defines Participants to include plan participants, beneficiaries and alternate payees.

<sup>3</sup> We have been informed that during the next session beginning later this month the Puerto Rico Legislative Assembly may be considering a technical amendments bill to Act 77-2014 that, among other things, would extend the Window Period for the Prepayment until December 31, 2014. We will issue a Brief if the extension is approved.

<sup>4</sup> The Prepayment applies to Puerto Rico Participants in either a Puerto Rico-only qualified plan or in a “dual-qualified plan” (i.e., qualified both under the PR Code and the U.S. Code), but only with respect to the Participants’ Puerto Rico income tax liability. The portion constituting earnings of a distribution to Puerto Rico Participants in a dual-qualified plan funded through a trust with a situs in the U.S. would remain subject to U.S. income taxes when applicable.

have been submitted with the PR Treasury for qualification under the PR Code as of the time the Prepayment is made.<sup>5</sup>

### **Prepayment of Tax – Plan Sponsor Options**

The Prepayment may be made with the Participant's own funds or with funds distributed from a plan, and cannot exceed the Participant's account balance or accrued benefit as of the date the Prepayment is made. However, a plan is not required to either keep track of the Prepayment or allow distributions from the plan for the Prepayment. That is, the plan sponsor has not only the discretion whether to allow distributions from a plan for the Prepayment, but also has discretion to whether maintain or not maintain record-keeping of the Prepayments.<sup>6</sup>

Note that allowing distributions from a plan for the Prepayment will most likely require a plan amendment. However, DA 14-16 provides that such amendment would not be considered a "qualification amendment" and, therefore, would not be required to be filed with the PR Treasury, and the PR Treasury would not be issuing any determinations with respect to such amendments.<sup>7</sup>

### **Prepayment by the Participant**

A Participant may make the Prepayment by completing three Forms SC 2911, Election for Prepayment of Special Tax on Accumulated Amounts in Employee's Trusts and Instructions (available [here](#)),<sup>8</sup> and filing: (i) the Forms SC 2911, (ii) a copy of a plan statement reflecting the account balance or accrued benefit as of a date within 30 days before the date of the Prepayment, and (iii) the moneys for the Prepayment (cash, certified/cashier's check, money order or debit/credit card) at a PR Treasury Collector's ("Colecturía"). The Participant would receive back from the PR Treasury two of the Forms SC 2911 stamp-received by the PR Treasury and reflecting the Prepayment. The Participant then has 30 days to provide the plan with one of the Forms SC 2911 so that the plan may maintain tracking of the Prepayment.<sup>9</sup>

A Participant would have to use money from his own funds for the Prepayment unless the plan allows for a distribution of the moneys to be used for the Prepayment.<sup>10</sup> In the latter case, the plan must issue a

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<sup>5</sup> Under the PR Code, lump-sum distributions from qualified retirement plans on account of separation from service or the termination of the plan are generally subject to tax at a special long-term capital gain rate, which at the present time is 20% for most qualified plans. Other distributions from qualified plans and distributions from non-qualified plans are subject to tax at the ordinary tax rates which range from 0% to 33%, although qualified plan distributions in the form of annuity or in installments are subject to the applicable tax only after exceeding an annual threshold amount (2014: \$11,000, and \$15,000, if the Participant is age 60 or older as of December 31, 2014).

<sup>6</sup> At the present time, it is unclear how a Participant in a plan that is not keeping track of the Prepayment would claim the benefit of the Prepayment.

<sup>7</sup> Dual-qualified plans generally may not be amended for such purposes since the pre-payment of Puerto Rico income taxes is not a distributable event under the U.S. Code.

<sup>8</sup> Form SC 2912, Election for Prepayment of Special Tax on Accumulated Amounts in Deferred Compensation Plans and Instructions (available [here](#)), must be used for the Prepayment on non-qualified plans.

<sup>9</sup> As mentioned above, a plan is not required to keep track of the Prepayments.

<sup>10</sup> As mentioned above, a plan is not required to provide for distributions for the Prepayment.

certified/cashier's check payable to the order of the Puerto Rico Treasury Department for the participant to complete the Prepayment process at the PR Treasury.

AD 14-16 provides that a plan is not required to issue a Form 480.7C in 2014 when the Participant makes the Prepayment with his own money unless there is another reportable distribution during the year. Consequently, AD 14-16 also provides that a distribution made for the Prepayment must be reported as an exempt distribution under PR Code Section 1023.21 in a Form 480.7C, Informative Statement – Retirement Plans and Annuities, for year 2014.

### **Prepayment by the Plan**

A plan provider, at the request of a Participant, may make the Prepayment.<sup>11</sup> In such case, on or before October 31, 2014, the participant must provide the provider with four completed Forms SC 2911. The provider must return one of the Forms SC 2911 to the Participant evidencing date of receipt of the forms. On or before the 15<sup>th</sup> day of the month following the end of the month in which the Forms were received by the provider, the provider must file at a Colecturía or at Office 421 of the PR Treasury Intendente Ramirez Building:<sup>12</sup> (i) the Forms SC 2911 received during the previous month, (ii) a copy of a plan statement reflecting the account balance or accrued benefit as of a date within 30 days before the date of the Prepayment, (iii) Form 480.9D, Payment Voucher of Special Tax on Distributions from Employee's Trust (sample available [here](#)),<sup>13</sup> and (iv) the total amount of the Prepayments.

The provider would receive back from the PR Treasury two of the Forms SC 2911 stamp-received by the PR Treasury and reflecting the Prepayment. The provider then has 30 days to provide the Participant with one of the Forms SC 2911. The provider keeps the other Form in its records to maintain evidence and tracking of the Prepayment.<sup>14</sup>

### **Tax Treatment of Prepayment**

AD 16-14 confirms that the participant's tax basis in his plan account would have to be increased by the amount by which the participant elected to pre-pay the tax so that upon a subsequent distribution only amounts for which the tax was not pre-paid (e.g., employer and employee contributions made, and earnings and accretions accumulated, after the Prepayment) would be subject to taxation at the then applicable tax rates for plan distributions. Consequently, the amount for which the tax is prepaid would not be recharacterized as an after-tax contribution. Therefore, such prepaid amounts would continue to be subject to applicable rules and limitations under the plan (e.g., vesting and distribution rules).

### **Distributions During Window Period**

A Participant who is receiving a lump-distribution during the Window Period may enjoy the special tax rate if the Participant makes the Prepayment and provides one of the Forms SC 2911 to the plan provider prior to receiving the distribution during the Window Period.

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<sup>11</sup> Note that a plan/plan provider is not required to make the Prepayments with the PR Treasury.

<sup>12</sup> The PR Treasury will not accept Prepayments sent by the USPS or carrier service (e.g., FedEx, UPS, and DHL).

<sup>13</sup> Form 480.9E, Payment Voucher of Special Tax on Distributions from Deferred Compensation Plans and Governmental Plans (sample available [here](#)), must be used for the Prepayment of non-qualified plans.

<sup>14</sup> The provider is required to forward Forms SC 2911 to any new plan provider.

It would also appear that if the Participant complies with the requirements listed above for Prepayment by the Plan prior to receiving a lump-sum distribution during the Window Period, the plan would withhold the Prepayment amount from the distribution and make the Prepayment at the PR Treasury, as described above. In such case, the Participant would receive the lump-sum distribution net of the Prepayment.

### **No Prepayment Tax Refund**

AD 16-14 provides that the Prepayment is irrevocable once made and that the Prepayment is non-refundable. For example, in case of a reduction in the value of the investments for which the tax was prepaid, AD 16-14 provides that the Participant would not be eligible to receive a refund of any “overpayment” resulting from a Prepayment at a higher value. Notwithstanding, a Participant may be able to claim a deduction for such loss, subject to certain limitations included in AD 16-14.

### **What Should a Plan Sponsor Do Now?**

Plan sponsors must first decide if the plan will keep track of the Prepayments. Before making such determination, a plan sponsor must first confirm that the plan or its provider would be able to maintain such tracking.<sup>15</sup> If in the affirmative, procedures must be established on how to comply with the requirements of AD 16-14 discussed above, and a determination must be made as to whether a plan amendment would be required. In addition, a notice about the Prepayment and the related PR Treasury and any operational plan rules should be provided to Participants.

Second, a plan sponsor must decide whether distributions would be allowed from the plan to make the Prepayment. Before making such determination, a plan sponsor must first confirm that the plan or its provider would be able to handle such distributions. If in the affirmative, procedures must be established on how to comply with the requirements of AD 16-14 discussed above, and a determination must be made as to whether a plan amendment would be required. In addition, a notice about the Prepayment, and the related PR Treasury and any operational plan rules (including instructions for distribution requests) should be provided to Participants.

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<sup>15</sup> Note that in 2006 the Puerto Rico Internal Revenue Code of 1994 was amended to also provide for the prepayment of taxes during a specified window period. Consequently, some plans and/or providers may already have procedures in place for keeping track of the Prepayments.