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Puerto Rico Code Amended to Allow Tax Pre-Payment Window on Retirement Plan Account Balances

On July 1, 2014, Puerto Rico Governor, Alejandro Garcia Padilla, enacted into law the Tax System Adjustment Act ("Act 77-2014"), which, among other changes, amends the Puerto Rico Internal Revenue Code of 2011 to allow participants in both qualified and non-qualified retirement plans from July 1 to October 31, 2014 (the "Window Period") to pre-pay a 15% tax on all or part of the participant's accumulated and undistributed balance in the plan.¹ The participant's tax basis on his plan account would have to be increased by the amount for 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 pre-payment of the 15% tax) would be subject to taxation at the then applicable tax rates for plan distributions. Note that 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).

Based on its vague language, it would appear that Act 77-2014 would allow for an in-service plan distribution during the Window Period for the tax pre-payment. At this time, it is unclear as to whether a plan would be required to be amended to either provide for the pre-payment or to allow for an in-service distribution of the amount required to make the tax pre-payment (as opposed to an optional determination by the plan sponsor or administrator),² and what tax rate would apply to such in-service distributions. In addition, it is also unclear if and how the provisions of Act 77-2014 would be applicable with respect to defined benefit plans. Finally, we note that Act 77-2014 does not modify the tax withholding rules on plan distributions which currently require a 10% or 20% tax withholding depending on the type of distribution from a qualified plan and up to 33% withholding on distributions from a non-qualified plan.

Formal guidance addressing these and other ambiguities of Act 77-2014 is expected from the Puerto Rico Department of the Treasury in the near future. We will issue additional Briefs once such guidance is issued.

¹ 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%. Note that Act 77-2014 also provides for an 8% tax rate, but it appears that it is only applicable with respect to gains on capital assets and not with respect to accumulated and undistributed retirement plan balances.

² "Dual-qualified" plans (i.e., qualified both under the PR Code and the U.S. Code) 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.