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November 3, 2014 www.groom.com

If you have questions, please contact your regular Groom attorney or one of the attorneys listed below:

Juan Luis Alonso
jalonso@groom.com
(202) 861-6632

Elizabeth Thomas Dold
edold@groom.com
(202) 861-5406

David N. Levine
dlevine@groom.com
(202) 861-5436

Louis T. Mazawey
lmazawey@groom.com
(202) 861-6608

David W. Powell
dpowell@groom.com
(202) 861-6600

Puerto Rico Retirement Plans Tax Prepayment Window to be Extended / PR Treasury Issues Additional Guidance on Prepayment Window

As anticipated in our Brief of August 14, 2014 (available here), a technical corrections bill to the Puerto Rico Tax System Adjustment Act ("Act 77-2014") is expected to be enacted into law later this week.[1] Among other changes, such Act would extend until December 31, 2014, the current window period for the pre-payment of income taxes under the Puerto Rico Internal Revenue Code of 2011, as amended (the "PR Code"), on balances and benefits in qualified and non-qualified retirement plans (the "Prepayment Window"). In addition, the Puerto Rico Treasury Department (the "PR Treasury") recently issued Circular Letter of Tax Policy No. 14-02 ("CLTP 14-02") providing additional guidance on the Prepayment Window.[2]

Below we provide a summary of the applicable updated Prepayment Window provisions.

In General

Act 77-2014 amended the PR Code to give Participants[3] in both qualified and non-qualified retirement plans a limited period – originally from July 1 to October 31, and expected to be extended until December 31, 2014 (the "Window Period") – during which the Participant may voluntarily elect to pre-pay the Puerto Rico income taxes on a participant's accumulated and undistributed balance/benefit in the plan (the "Prepayment").[4] Subsequently, the PR Treasury issued Administrative Determination No. 14-16 ("AD 14-16")[5] and CLTP 14-02 to provide guidance on the Prepayment Window.

The Prepayment may be made on all or part of:

- 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 (calculation of present value must follow assumptions under US Code Section 417(e)(3)).

The election to prepay must be made on a per plan basis in the case of participation in more than one plan.

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[1] Puerto Rico Senate Bill No. 1189 ("PS 1189") was approved by the Puerto Rico Senate on the evening of October 23, 2014. In the next days, PS 1189 is expected to be approved by the Puerto Rico House of Representatives with minor amendments, if any, and it is expected to be enacted into law by Governor Alejandro Garcia Padilla shortly thereafter.
[2] CLTP 14-02 in Spanish is available here.
[3] The term Participant includes not only plan participants, but also beneficiaries and alternate payees.
[4] The Prepayment applies to 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.
[5] AD 14-16 in Spanish is available here.

Applicable Tax Rate

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, a qualified plan includes plans that have been submitted with the PR Treasury for qualification under the PR Code as of the time the Prepayment is made, even though the determination letter may have not been issued.[6]

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 the present value of the Participant's accrued benefit as of the date the Prepayment is made. Although a plan is not required to allow in-service distributions specifically for the Prepayment, to the extent eligible for such withdrawals under the terms of the plan, a Participant may take other in-service withdrawals (e.g., hardship and age 59 ½), and use the withdrawn money for the Prepayment.

Allowing in-service distributions from a plan specifically for the Prepayment will most likely require a plan amendment which should be adopted as soon as possible prior to allowing distributions from a plan for the Prepayment. However, such amendment would not be considered a "qualification amendment" by the PR Treasury and, therefore, it would not be required to be filed with the PR Treasury. Importantly, 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.

Originally, the position of the PR Treasury was not to require plans or providers to keep track of Prepayments. However, CLTP 14-02 changed that and now plans or plan providers are required to maintain tracking of the Prepayment. Notwithstanding, employers and plan sponsors are not required to notify Participants about the Prepayment Window.

Prepayment by the Participant

In order to make a Prepayment, a Participant must complete three Forms SC 2911, Election for Prepayment of Special Tax on Accumulated Amounts in Employee's Trusts and Instructions (available here),[7] and file them at a PR Treasury Collector's ("Colecturía") along with:

(i) a copy of a plan statement reflecting the account balance or the present value of the Participant's accrued benefit as of a date within 30 days before the date of the Prepayment, and

(ii) the Prepayment (only in cash, certified/cashier's check, money order or debit/credit card).

The Participant would receive back from the PR Treasury two of the Forms SC 2911 stamp-received by the PR Treasury 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.

[6] 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 (for 2014, the threshold is $11,000, or $15,000, if the Participant is age 60 or older as of December 31, 2014).

[7] 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.

A Participant would have to use money from his own funds for the Prepayment unless the Participant uses the money received from a plan's in-service distribution or the plan allows a distribution to be used for the Prepayment. As noted above, a plan is not required to provide for in-service distributions specifically for the Prepayment. In the latter case, the plan must issue a check payable to the order of the PR Treasury for the Participant to complete the Prepayment process at the PR Treasury.

A plan is not required to issue a Form 480.7C, Informative Statement – Retirement Plans and Annuities, in 2014 when the Participant makes the Prepayment with his own money unless there is another reportable event during the year (e.g., withdrawals, distributions, or rollovers).

Prepayment by the Plan

A plan provider may, but is not required to, handle the Prepayment with the PR Treasury. In such case, on or before December 31, 2014 (or such other earlier date established by the plan or provider), the Participant must furnish the provider the request for the in-service distribution for the Prepayment and four completed Forms SC 2911. The provider must return one of the Forms SC 2911 to the Participant evidencing date of receipt of the request and forms. On or before the 15th day of the month following the end of the month in which the forms are received by the provider, the provider must file at a Colecturía or at Office 421 of the PR Treasury Intendente Ramirez Building:[8]

(i) all Forms SC 2911 received during the previous month,

(ii) a copy of a plan statement reflecting the account balance or the present value of the Participant's accrued benefit as of a date within 30 days of the date of the Prepayment,

(iii) Form 480.9D, Payment Voucher of Special Tax on Distributions from Employee's Trust (sample available here),[9] and

(iv) A check for the total amount of the Prepayments for the previous month.

The provider would receive back from the PR Treasury two of the Forms SC 2911 for each Participant, stamp-received by the PR Treasury reflecting the Prepayments. The provider then has 30 days to forward to the Participants with one of the Forms SC 2911. The provider keeps the other Form SC 2911 in its records in order to maintain evidence and tracking of the Prepayment.[10]

Tax Treatment of Amount Distributed from Plan for Prepayment

A distribution made for the Prepayment (or any other in-service withdrawal money used for the Prepayment) is not subject to Puerto Rico income taxes and must be reported as an exempt distribution under PR Code Section 1023.21 in a Form 480.7C for year 2014.

Tax Treatment of Account Balance/Accrued Benefit for Which Tax was Prepaid

A participant's tax basis in his plan account is increased by the amount by which the participant elected to pre-pay the Puerto Rico income 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)

[8] The PR Treasury does not accept Prepayments sent by the USPS or carrier service (e.g., FedEx, UPS, and DHL).
[9] 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.
[10] The provider is required to forward Forms SC 2911 to any new plan provider.

would be subject to withholding and taxation at the then applicable tax rates for plan distributions. Consequently, the amount for which the tax is prepaid must not be recharacterized as an after-tax contribution. That is, account balances or accrued benefits for which the tax is prepaid 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-sum distribution during the Window Period may enjoy the special tax rate if the Participant provides the Forms SC 2911 to the plan provider, as described above, prior to receiving the distribution during the Window Period. In such case, the plan would withhold the Prepayment amount from the distribution and make the Prepayment at the PR Treasury following the procedures described above (i.e., tax withheld is not deposited with PR Treasury through the regular monthly deposit process). In such case, the Participant would receive the lump-sum distribution net of the Prepayment.

Refund of Prepayment Tax

A Participant may request a refund of any tax that was over-withheld during the Window Period in his 2014 Puerto Rico income tax return. The Participant must include a brief explanation of the over-withholding, along with Forms 480.7C and SC 2911 and a certification issued by the plan or provider regarding the date of the distribution. In addition, electronic filing will not be available in such cases.

The Prepayment is irrevocable once made and, except as provided in the prior paragraph, it is non-refundable. For example, in case of a reduction in the value of the investments for which the tax was prepaid, 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 14-16.

What Should a Plan Sponsor Do Now?

Before making any determination regarding the Prepayment Window, a plan sponsor must first confirm applicable procedures with the plan provider and determine how tracking of the Prepayment will be kept.

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 deposit, withholding and reporting requirements discussed above, and a plan amendment must be adopted.

Finally, a notice about the Prepayment, and the related PR Treasury and any operational plan rules (including instructions for distribution requests) may be prepared and provided to Participants.