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New Rules on Puerto Rico Taxation of Retirement Income[1]

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INTRODUCTION

This article describes in full detail the new regulations under the Puerto Rico Internal Revenue Code of 2011, as amended (the PRIRC), that the Puerto Rico Department of the Treasury (Hacienda) issued on January 9, 2013, regarding the Puerto Rico income taxation of benefits and payments from qualified retirement plans covering Puerto Rico participants (the Regulations).[3] The Regulations, which became effective on February 8, 2013, are officially coded as Articles 1081.01(b)-1 through 1081.01(b)-5 of the PRIRC regulations, and replaced the equivalent regulations under the Puerto Rico Internal Revenue Code of 1994 (the PRIRC-1994), that Hacienda issued in September 1997.

By way of background, on January 31, 2011, the PRIRC replaced the PRIRC-1994 in its entirety, and the local rules on the taxation of retirement income, which were previously included in PRIRC-1994 §1165(b) and (c), are now included in PRIRC §1081.01(b) and (c). Among other things, the PRIRC modified the local tax rules by requiring the withholding of Puerto Rico income tax at source on certain forms of payment that were previously not subject to withholding, expanding the forms of payment that may qualify for tax-free rollovers to qualified plans and IRAs, and making the employers that sponsor and/or participate in the plans jointly and severally liable to Hacienda in the event of a failure, by either the employer or its agents, to comply with the local tax

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[3] A copy of the Regulations, in Spanish, may be found on the Puerto Rico Department of State's website at http://www.estado.gobierno.pr. The author assisted Hacienda with designing and drafting the Regulations.

rules on distributions to Puerto Rico participants. The Regulations reflect these and other post-1997 changes to the local tax rules that were not previously reflected in the 1997 regulations.

All-in-all, the Regulations do not represent a major change to the local tax rules on retirement income. They keep the basic, long-standing structure of different sets of rules for (1) lump sum distributions, (2) annuities and installments, and (3) other forms of payment (e.g., partial payments and in-service withdrawals). So, anyone who is already familiar with the administration of retirement plans in Puerto Rico should not be taken aback by the text of the Regulations. On the other hand, the Regulations provide plenty of new and useful guidance and clarification on many tax-related issues that for years have hindered the administration of qualified retirement plans in Puerto Rico. This article should, therefore, prove quite useful to those U.S. and international companies that sponsor retirement plans with Puerto Rico participants and to their employee benefits practitioners and service providers.

REMINDER: HACIENDA PLAN FILING REQUIREMENT

Although the local plan qualification rules are beyond the scope of this article, before entering into a discussion of the local tax rules on retirement income, it is important to remind readers that all retirement plans that, on or after January 1, 2011, have included among their active participants individuals who are residents of Puerto Rico must be filed with Hacienda to request an initial or updated determination letter regarding their Puerto Rico qualification no later than the later of (1) September 30, 2013, or (2) the due date, including extensions, for filing the plan sponsor's Puerto Rico corporate income tax return (or, if the plan sponsor is not engaged in trade or business in Puerto Rico, the Puerto Rico corporate income tax return of the participating employer with operations in Puerto Rico) for the first taxable year that commenced on or after January 1, 2012.[4] Plans with Puerto Rico participants that are not filed with Hacienda by such due date will be treated as nonqualified retirement plans. As a result, the employer contributions to the plan attributable to the Puerto Rico participants will not be deductible on a Puerto Rico corporate income tax return until the year in which the Puerto Rico participants are taxed on their plan benefits, and the Puerto Rico participants will be taxed on their plan benefits at the time of vesting and will not be eligible to the favorable tax treatment generally afforded to distributions from qualified plans, as described herein.[5]

Why this reminder? Because more times than not, the fact that a plan with Puerto Rico participants does not have a Hacienda determination letter is a symptom of a much bigger problem: the plan is also not complying with the Puerto Rico tax rules on distribution of benefits to Puerto Rico participants, such as reporting those distributions to Hacienda and/or withholding and depositing with Hacienda Puerto Rico income taxes on the distributions. As described at the end of this article, the potential financial exposure resulting from such violations of the local tax rules could be significant, and, as noted above, the PRIRC specifically provides that the plan sponsor and/or the participating employer operating in Puerto Rico are liable for such violations. In addition, one of the various items Hacienda officials are now looking for as part of their evaluation of plan filings is precisely whether or not the plan has in place written provisions assigning responsibility over compliance with the local tax rules.[6] So, before filing the plan with Hacienda, the plan sponsor and/or its employee benefits

[4] Hacienda Circular Letter No. 11-10 of Dec. 16, 2011, as modified by Circular Letter No. 12-08 of Nov. 28, 2012. Pursuant to PRIRC §1061.16(a), the regular due date for filing the Puerto Rico corporate income tax return, officially known as Hacienda Form 480.20, is the fifteenth day of the fourth month following the close of the taxable year (i.e., April 15 for calendar year taxpayers), but if the taxpayer requests an extension by filing Hacienda Model SC 2644, *Request for Extension of Time to File the Income Tax Return*, on or before the regular due date, the due date is extended until the fifteenth day of the seventh month following the close of the taxable year (i.e., July 15 for calendar year taxpayers). For example, a plan sponsored by an employer that uses a fiscal tax year ending on June 30 would have to be filed with Hacienda no later than the latest of (1) Sept. 30, 2013; (2) Oct. 15, 2013 (i.e., the regular tax filing due date for the first taxable year commenced on or after Jan. 1, 2012); or (3) if the employer timely requested an extension to file its 2012 Puerto Rico corporate income tax return, Jan. 15, 2014. Readers should be aware that obtaining a determination letter from Hacienda is a necessary condition for plan qualification in Puerto Rico. PRIRC §1081.01(a)(13)(A). A plan that does not have a valid Hacienda determination letter is simply not a qualified plan in Puerto Rico. Thus, any and all retirement plans that on or after Jan. 1, 2011, have had active Puerto Rico participants need to be filed with Hacienda following the rules set forth in Circular Letter No. 11-10.

[5] Section II.B.1.a of Circular Letter No. 11-10.

[6] Specifically, Section II.B.1.c.1.h of Circular Letter No. 11-10 provides that Hacienda plan qualification filings need to include a copy of the document(s) assigning or delegating to one or more persons the responsibility for complying with the provisions of PRIRC §1081.01(b) regarding the withholding of Puerto Rico income tax at source on distributions of benefits to Puerto Rico participants and beneficiaries and notifying such distributions both to the corresponding Puerto Rico participants and beneficiaries and Hacienda. If the official plan document and/or the trust document includes rules to such effect and such documents have been previously filed with Hacienda (e.g., as part of the plan's prior local qualification under the PRIRC-1994), it will only be necessary to include reference to the corresponding section, paragraph or page

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advisor should confirm that (1) the plan has some sort of written evidence that someone is responsible for complying with the Puerto Rico income tax rules on distributions to Puerto Rico participants; and (2) beginning February 8, 2013, the responsible party discharges its responsibility in accordance with the new rules set forth in the Regulations, as described in this article.

What could happen if an employer files its plan with Hacienda, but the filing does not include any written evidence that someone is responsible for complying with the local tax rules? Hacienda will most likely send the employer or its authorized representative a request for supplemental information giving the employer between 15 and 30 days to submit the necessary documents. If it turns out that the employer cannot come up with the documents, Hacienda will deny the employer's request for plan qualification, and the employer will have to begin the entire plan qualification process from scratch, including having to submit the missing documents on Puerto Rico tax compliance and paying the applicable filing fees for a second time. Depending on the relevant facts, the matter may also be referred to Hacienda's Internal Revenue Area for an investigation about the plan's prior compliance with the local tax rules, which may eventually result in an income tax assessment.

A final observation about this matter: sponsors of U.S. qualified plans with active participants from Puerto Rico should be leery about advisers that tell them (with ''tell'' being the key word here) not to worry about filing their plans with Hacienda or complying with the Puerto Rico tax rules on distributions to Puerto Rico participants. To the author's surprise, some employee benefits professionals are doing exactly that: telling their clients that if they do not complete any qualification or taxation-related filings with Hacienda, Hacienda is never going to find out about their plans, so they can safely and efficiently avoid the process of having to comply with the local plan qualification and tax rules. What they are not telling their clients is that (1) the PRIRC is clear in that if Hacienda finds out about the plans, the sponsor, not the advisor, will be directly liable to Hacienda; (2) the resulting tax penalties can be significant; and (3) since 2005, the IRS's Employee Plans Group has been actively helping Hacienda audit U.S. qualified plans with Puerto Rico participants, and Puerto Rico tax compliance is one of the issues under review. So, if an employee benefits professional tells an employer to forget about its plan's Puerto Rico legal compliance, the author's advice to the employer is to ask the advisor to put that in writing.

of the relevant plan or trust document. If such documents do not include any provisions regarding Puerto Rico taxation, the filing will need to include a copy of the document(s) assigning or delegating responsibility over Puerto Rico tax compliance to a specific party, such as a paying agent services agreement with a Puerto Rico or U.S. financial institution or a third-party administration (TPA) services agreement. In lieu of submitting a copy of the paying agent or TPA services agreement, the filing may include a copy of an official, signed and dated letter or memorandum to clients from the trustee, paying agent or TPA for the plan whereby that party confirms that it has assumed responsibility over Puerto Rico tax compliance on the distributions to the Puerto Rico participants and beneficiaries of the plan.

GENERAL PRINCIPLES

Payments Subject to Puerto Rico Tax Rules

In principle, the local tax rules on retirement income apply to (1) any payments that a qualified retirement plan, be it a retirement plan qualified only in Puerto Rico (commonly known as a ''P.R.-only qualified plan'') or a retirement plan qualified in both the U.S. and Puerto Rico (commonly known as a ''dual-qualified plan''), makes to a participant or beneficiary, including an alternate payee under a qualified domestic relations order (a QDRO), who at the time of payment is a resident of Puerto Rico; or (2) the Puerto Rico income portion, if any, of a payment that a qualified retirement plan makes to a participant or beneficiary who at the time of payment is not a resident of Puerto Rico.[7] For these purposes, a ''resident of Puerto Rico'' means an individual who, in accordance with Puerto Rico law, is domiciled in Puerto Rico, and any individual who has been living in Puerto Rico for at least 183 days during a year is presumed to be a resident of Puerto Rico for that year.[8]

Ordinarily, the determination of which participants and beneficiaries are residents of Puerto Rico is a non-issue. In the case of P.R.-only qualified plans, the vast majority, if not all, of the participants and beneficiaries are residents of Puerto Rico, whereas in the case of dual-qualified plans, seldom are there any practical problems with identifying the participants and beneficiaries who reside in Puerto Rico, mainly because their residence is already included in benefits, payroll and other employment records. A couple of residence-related inquiries that oftentimes arise, however, are what to do with payments to (1) participants who did not render services in Puerto Rico but retired in Puerto Rico, and (2) participants who rendered services in Puerto Rico but retired in the U.S.

[7] Article 1081.01(b)-5(a) of the Regulations.

[8] PRIRC §1010.01(a)(30).

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With over 4½ million Puerto Ricans living in the U.S.,[9] it is not unusual for a U.S. company that does not have operations in Puerto Rico to employ a Puerto Rican living in the U.S. to work on its U.S. operations, and for that employee to move to Puerto Rico following his retirement. The question then becomes whether distributions of benefits from the company's U.S. qualified plan to that former employee, who is now living in Puerto Rico, should be subject to the Puerto Rico tax rules. Although neither the PRIRC nor the Regulations address the issue, in the author's opinion, the answer is "*no*." Insofar as the U.S. qualified plan distributing the benefits was not and did not have to be qualified in Puerto Rico, because the plan sponsor never derived any Puerto Rico tax benefits in connection with the operation of the plan (e.g., the company never claimed a deduction on its Puerto Rico corporate income tax return on account of contributions to the plan), distributions to those participants and beneficiaries who at the time of payment are residents of Puerto Rico should not be subject to the Puerto Rico tax rules. Instead, those distributions should be subject to the regular U.S. tax rules (i.e., reported to the IRS on Form 1099-R and subject to the U.S. income tax withholding rules of Code §3405). It would be up to the participants or beneficiaries to report the distributions on their U.S. and Puerto Rico individual income tax return(s), as they and/or their professional tax advisor may deem applicable.

The logical next question is what to do with a distribution to a participant who always worked in Puerto Rico, participated in the company's retirement plan covering Puerto Rico participants, and, following his or her retirement, moved to the U.S.? As per the Regulations, the portion of those distributions that is income from sources within Puerto Rico should be subject to Puerto Rico taxation. If the facts are right, however, these distributions can be totally shielded from Puerto Rico taxation through application of the State Taxation of Pension Income Act of 1995 (the "Source Act").[10] The Source Act, which expressly applies to Puerto Rico,[11] precludes U.S. states and other U.S. jurisdictions from imposing any income tax on the retirement income of those individuals who, at the time of payment, are no longer their residents.[12] Unfortunately, the Source Act is not a one-size-fits-all answer to this question, as its application to a particular case depends on the underlying facts of the case (e.g., whether the payment of benefits under the plan is a form of "retirement income" and the person receiving the payment is "not a resident or domiciliary of" the U.S. state or jurisdiction trying to impose the tax at the time of payment). But, if a plan sponsor is running into issues with the administration of retirement plan distributions to U.S. residents who previously rendered services in Puerto Rico, the Source Act may, under some circumstances, be the hero that saves the day.

Taxable Event

If an employer makes contributions to a plan for the benefit of a Puerto Rico participant during a plan year at the end of which the plan is qualified in Puerto Rico, the participant will not have to include those contributions and the investment earnings thereon (collectively the "benefits") in gross income until the year in which the benefits are actually distributed to the participant. But, if the retirement plan is not qualified in Puerto Rico by the end of the plan year, the participant will have to include the benefits in gross income for the year in which he or she acquires vested rights to the benefits or the benefits are actually distributed to him/her, whichever happens first.[13] If a retirement plan is qualified in Puerto Rico by the end of the plan year during which the employer makes the contributions, but subsequently loses its qualification, the participant will have to include in gross income for the year of disqualification those benefits over which he or she has vested rights as of the effective date of the plan's disqualification.[14] On the other hand, if a retirement plan is not qualified in Puerto Rico by the end of the plan year during which the employer makes the contributions, but subsequently becomes qualified, the participant will not have to include in gross income for the year of qualification those benefits over which he or she did not have vested rights as of the effective date of the plan's qualification.[15]

What would happen if, for example, a U.S. retirement plan has been covering Puerto Rico participants since 2003, but it was not initially qualified with Hacienda until 2013? Would the plan be automatically treated as a nonqualified plan for those 10 years and the Puerto Rico participants assessed back taxes for the value of their vested benefits as of the end of each year? Not quite. The solution to this apparent problem is fairly straightforward. As part of its upcoming Hacienda plan filing referred to above, the employer can

[9] Table I, *The Hispanic Population: 2010*, U.S. Census Bureau (May 2011).

[10] 4 USC §114.

[11] 4 USC §114(b)(3).

[12] 4 USC §114(a).

[13] Articles 1081.01(b)-1(a)(1) and (2) of the Regulations. The local rules for determining when a participant has vested rights to his plan benefits are based on, and should be construed in accordance with, the equivalent U.S. rules in Treas. Regs. §1.451-2.

[14] Article 1081.01(b)-1(a)(4) of the Regulations.

[15] Article 1081.01(b)-1(a)(3) of the Regulations.

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request that the plan be retroactively qualified as of a date within 2003, in which case, the plan will be deemed qualified since 2003. A request for a retroactive qualification is generally not a major endeavor. The employer would have to provide Hacienda with pretty much the same documents and information that would apply to a request for initial qualification of a brand new plan, plus (1) a schedule demonstrating that the plan satisfied the local minimum coverage test during the year of retroactive qualification (in this example, 2003), and (2) an additional filing fee of usually $350.[16]

It should be noted, however, that the fact that a plan is retroactively qualified with Hacienda does not mean that the employer does not have a potential Puerto Rico tax exposure if distributions previously made to the Puerto Rico participants were not timely reported to Hacienda and/or Puerto Rico taxes were not withheld from such distributions and deposited with Hacienda. Just as in the U.S., a failure to comply with the U.S. tax rules on retirement income cannot be corrected through an IRS determination or opinion letter or even a Voluntary Compliance Program compliance statement, a Hacienda determination letter provides no relief from Puerto Rico under-reporting and under-withholding violations. As explained at the end of this article, the best way to effectively remove any such potential tax exposure is for the employer to enter into a closing agreement with Hacienda.

Taxable Amount

The taxable or exempt character of the distribution of benefits from a qualified plan is determined exclusively by the participant's basis in the benefits, if any. If the participant has a basis in his or her benefits, the portion of the distribution attributable to the basis is tax-exempt and the remainder of the distribution is taxable income. If the participant does not have any basis in his/her benefits or has already recovered his/her basis, the entire distribution is taxable income.[17] The participant's basis in his/her benefits refers to the portion of the benefits attributable to (1) employee after-tax contributions; (2) other contributions to the plan that were previously taxed to the participant, such as a deemed distribution on a defaulted plan loan; or (3) those benefits over which the participant already paid Puerto Rico income taxes under a Hacienda voluntary tax prepayment program that was in effect in 2006.[18] The investment earnings that the plan may subsequently generate on funds attributable to the participant's basis are not included as part of the basis. Also, the taxable or exempt character of the investment earnings generated by the plan has no impact on the participant's basis in his/her benefits. For example, if a participant elects to invest his/her plan account in Puerto Rico government bonds, the interest income paid by such bonds, which is generally exempt from the payment of both U.S. and Puerto Rico income taxes, is not included as part of the participant's basis.[19]

As a general rule, the participant's basis is recovered by applying the "3% recovery method" provided under PRIRC §1031.01(b)(11)(A)(ii) for recovering a payee's cost or basis in payments from commercial annuities.[20] Under the 3% recovery method, during each taxable year, the participant will exclude from gross income an amount equal to the excess of (1) the amount distributed during the year, over (2) 3% of the participant's basis in the benefits as of the beginning of the year. This excess represents the tax-exempt recovery of the basis for the year. The process is repeated year after year, until the total amount excluded equals the participant's basis in the benefits. Thereafter, the entire amount received becomes taxable income. It should be noted that the 3% recovery method is substantially different and usually provides for a much faster tax-free recovery of basis than the simplified method which applies to annuity payments to participants in U.S. qualified plans under Code §72(d). In principle, this difference could present a problem for those U.S. recordkeepers and TPAs that service dual-qualified plans and, as part of those services, prepare both IRS Form 1099-R and its local equivalent, Hacienda Form 480.7C, to report distributions to the plan's Puerto Rico participants. Absent a way out, these recordkeepers and TPAs would have to follow the 3% recovery method, not the simplified method, for identifying the nontaxable amount, if any, of payments to Puerto Rico participants. Fortunately, the Regulations provide a handy way out of this potential problem. If the official plan document, trust document or other document forming part of the plan, or, in the case of a distribution to the participant's alternate payee under a QDRO, the QDRO document, already establishes a specific order for the recovery of the participant's basis in the benefits, that is the order that should be followed for Puerto Rico income tax purposes, including reporting the payment in Form 480.7C.[21]

Example: A participant has $30,000 in his plan account, of which $6,000 is attributable to employee after-tax contributions. The par-

[16] Paragraphs II.B.1.c.1.j and p of Circular Letter No. 11-10.

[17] Article 1081.01(b)-1(c)(1)(i) of the Regulations.

[18] Article 1081.01(b)-1(c)(2)(i) of the Regulations.

[19] Article 1081.01(b)-1(c)(1)(iv) of the Regulations.

[20] Article 1081.01(b)-1(c)(3) of the Regulations.

[21] Article 1081.01(b)-1(c)(3) of the Regulations.

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ticipant receives a $5,000 in-service withdrawal from his after-tax account, of which, according to plan records, $4,500 is attributable to his after-tax contributions and $500 to investment earnings thereon. The recovery of the participant's basis is based by the order set forth by the plan. Therefore, $4,500 is considered a tax-exempt recovery of basis, and the remaining $500 is a taxable payment.[22]

Example: A participant has $30,000 in his plan account, of which $6,000 is attributable to employee after-tax contributions. Following the participant's divorce, the plan administrator receives a QDRO requiring a $10,000 payment to the participant's ex-spouse, including the $6,000 in after-tax contributions, on account of division of marital property. Assuming that the QDRO is not in conflict with the terms of the plan, the $10,000 payment to the ex-spouse will include the $6,000 of after-tax contributions.[23]

Moreover, the Regulations state that, unless the plan or trust documents provide otherwise, if a participant who has a basis in his/her benefits makes a partial direct rollover to another qualified plan or an individual retirement account or annuity (IRA), the amount rolled over is deemed to consist first of the taxable portion of the benefits and then of the participant's basis in the benefits.[24]

Example: A participant has $30,000 in his plan account, of which $6,000 is attributable to employee after-tax contributions. Following his separation from service and during the same year, the participant receives a single distribution of $15,000 and directly transfers the remaining $15,000 to an IRA. Unless the plan or trust documents provide otherwise, the $6,000 attributable to employee after-tax contributions is included in the $15,000 distribution to the participant, not the $15,000 rollover to the IRA.

In addition to the technical differences between the PRIRC's 3% recovery method and the Code's simplified method, which can be easily addressed by including proper language in the plan documents, another potentially complicating factor in the determination of the taxable and nontaxable portions of distributions to Puerto Rico participants in a retirement plan, either a P.R.-only qualified plan or a dual-qualified plan, has to do with the 2006 Hacienda voluntary tax prepayment program referred to above. In summary, during 2006, Hacienda opened a limited window of opportunity for Puerto Rico taxpayers to prepay the Puerto Rico income taxes on their retirement income at a preferential rate of only 5%, even if they did not actually receive such income during 2006.[25] For example, a participant with a $30,000 plan account could have taken advantage of that break by paying $1,500 to Hacienda during 2006. The $30,000, but not the subsequent investment earnings thereon, would then become part of the participant's basis in his or her benefits and would be tax-exempt at the time of payment, either in 2006 or some other later year. Participants who took advantage of this opportunity were supposed to furnish evidence of the prepayment to the trustee or paying agent for the plan, so that they could process and report the distributions accordingly. In practice, a problem with these prepayments has been that, oftentimes, the trustee or paying agent for the plan is not the same party that serves as the recordkeeper for the plan. If the participant provided evidence of prepayment to the trustee, but the trustee did not forward that evidence to the recordkeeper, and the trustee processes distributions based on the information that it receives from the recordkeeper, it is likely that the distribution will be treated as totally taxable, which would create a potential tax problem for the participant. To avoid this, the trustee/paying agent and recordkeeper should establish a process for tracking those participants who took advantage of the 2006 tax prepayments and the amount to be treated as a tax-free recovery of basis at the time of distribution.

In-Kind Distributions

If a distribution is made by means other than cash or a cash equivalent, such as a check, the amount to be included in the participant's gross income is the fair market value of the property at the time of distribution. For these purposes, a property's fair market value is the price at which a willing seller would sell the property to a willing buyer, where neither is required or under any compulsion to sell or buy, and both have reasonable knowledge of the facts relevant to the transaction.[26] If a participant's benefits are distributed through a lump sum payment which includes shares of employer stock, however, the portion of payment attributable to the fair market value of the employer stock is not subject to income taxation at the time of payment, and the participant's basis on the

[22] Article 1081.01(b)-1(c)(3)(ii) of the Regulations.
[23] Article 1081.01(b)-1(c)(3)(iii) of the Regulations.
[24] Article 1081.01(b)-2(f)(1)(iv)(B) of the Regulations.
[25] PRIRC-1994 §1165(b)(9).
[26] Article 1081.01(b)-1(d)(1)(i) of the Regulations.

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stock to be used for calculating the capital gain upon the subsequent sale or disposition of the stock will be zero.[27]

A problem Hacienda has historically faced with the supervision of retirement plans sponsored by small, local employers (i.e., Keogh plans) is the prevalence of employers using plan property without paying adequate consideration to the plan. For example, a doctor would use the assets of his Keogh plan to buy an office building from which the doctor would then operate his medical practice, but the doctor would pay no rent to the plan, nor treat the transaction as a taxable distribution of benefits. Because many of the local Keogh plans are not covered by ERISA, as they do not benefit common law employees, and the PRIRC currently does not have an equivalent to Code §4975, some local professionals have been frequently using that same approach for financing their business operations. In an attempt to put an end to or at least reduce the incidence of that practice, the Regulations now specifically provide that if a qualified plan sells property belonging to the plan to a participant, the transaction will be considered a taxable distribution of benefits to the participant for the excess of the fair market value of the property at the time of the sale over the amount the participant paid the plan for buying the property. Likewise, if a qualified plan leases to a participant or allows a participant to use property belonging to the plan, the transaction will be considered a taxable distribution of benefits to the participant for the excess of the lease payments the plan would receive from a third party on account of a similar lease or use of the property over the amount the participant paid the plan for using the property.[28]

Annuity Contracts and Life Insurance Policies

Distribution of Contract

If a qualified plan distributes to a participant an annuity contract with a cash surrender value, the participant will not be taxed on the cash surrender value of the annuity at the time of distribution but, rather, will be taxed on the payments received under the annuity as and when they are actually made.[29] On the other hand, if a qualified plan distributes to a participant a life insurance policy, retirement income contract or other contract providing life insurance protection, the participant will be taxed on the fair market value of the contract at the time of distribution.[30] In either case, whether it is a distribution of an annuity contract or a life insurance policy, the resulting taxable distribution(s) to the participant will be subject to the local tax rules on retirement income.[31] For example, if in connection with the termination and liquidation of a U.S. defined benefit pension plan that covers Puerto Rico participants (i.e., a dual-qualified plan), the plan purchases and transfers to participants annuity contracts issued by a U.S. insurance company, the subsequent payments the U.S. insurance company makes under the annuity contracts to the Puerto Rico participants would have to be reported to Hacienda and, depending on the form and amount of the payments, may also be subject to Puerto Rico withholding at source. If for some reason, the U.S. insurance company solely reports the payments to the IRS using Form 1099-R and, if applicable, withholds U.S. taxes at source, but does not comply with the local tax rules, the plan sponsor and/or its Puerto Rico subsidiary would be potentially liable to Hacienda for the resulting Puerto Rico under-reporting and under-withholding violations.[32] Sponsors of dual-qualified plans that provide for the possibility of distributions of annuity contracts or life insurance policies are, therefore, advised to contact the insurance company offering those investments to evaluate how the distributions to the Puerto Rico participants in the plan will comply with the local tax rules. If the U.S. insurance company does not have procedures for complying with the local tax rules, it may be necessary to engage a separate paying agent to handle that matter.

Life Insurance Protection

If a qualified plan acquires a life insurance policy, retirement income contract or other contact providing life insurance protection, the portion of the premiums attributable to the cost of the life insurance protection that is paid for with employer contributions, employee pre-tax contributions and/or investment earnings thereon, is considered current taxable income to the participant, but not the portion of the premiums that increases the cash value or reserve of the policy.[33] For any taxable year, the life insurance protection pro-

[27] Article 1081.01(b)-1(d)(1)(ii) of the Regulations.

[28] Article 1081.01(b)-1(d)(1)(iii) of the Regulations.

[29] Article 1081.01(b)-1(d)(2)(i) of the Regulations. This rule is based on, and should be construed in accordance with, the equivalent U.S. rule in Treas. Regs. §1.402(a)-1(a)(1)(iii).

[30] Article 1081.01(b)-1(d)(2)(i)(B) of the Regulations. This rule in based on, and should be construed in accordance with, the equivalent U.S. rule in Treas. Regs. §1.402(a)-1(a)(2). Moreover, Article 1081.01(b)-1(2)(i)(D) of the Regulations expressly adopts as valid in Puerto Rico the rules set forth by the IRS for determining the fair market value of life insurance policies (e.g., Rev. Proc. 2005-25, 2005-17 I.R.B. 962).

[31] Articles 1081.01(b)-1(d)(2)(i)(A) and (B) of the Regulations.

[32] PRIRC §1081.01(b)(10).

[33] Article 1081.01(b)-1(d)(2)(iii) of the Regulations. This rule is based on, and should be construed in accordance with, the equivalent U.S. rule in Treas. Regs. §1.72-16(b).

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vided under the policy is the excess, if any, of (1) the amount that would be paid to the beneficiaries upon the participant's death, over (2) the cash value or reserve of the policy at the end of the taxable year. The cost of such life insurance protection (i.e., the taxable income) is determined by applying the premium rates on $1,000 of one-year term life insurance protection used by the insurance company that issued the policy to the plan or the similar rates set by either Hacienda or the IRS for the valuation of imputed income on term life insurance protection, whichever results in the smallest amount of taxable income to the participant.[34] The participant's taxable income on account of the cost of his or her life insurance protection must be reported to both the corresponding participant and Hacienda using Form 480.7C, but it is not subject to any Puerto Rico income tax withholding at source. A participant does not have taxable income on account of life insurance protection if (1) the plan paid the insurance premiums solely out of employee after-tax contributions, or (2) the plan itself is the beneficiary under the policy, unless the plan documents or some other contractual provisions between the plan and the participant require the plan to pay the insurance proceeds to some other person(s) designated by the participant.[35]

Life Insurance Benefits

Upon the participant's death, the excess of the amount paid to the beneficiaries over cash value or reserve of the policy at the time of payment is a tax-exempt payment of life insurance benefits, but the portion of the payment attributable to the cash value or reserve of the policy is considered a taxable distribution of benefits from a qualified plan and is subject to the regular tax rules on retirement income. If, however, the cost of the life insurance protection under the policy was not duly reported as taxable income to the participant, the entire amount paid to the beneficiaries is considered a taxable distribution of benefits from a qualified plan subject to the local tax rules.[36]

Distributions to Beneficiaries

As a general rule, distributions to beneficiaries, including alternate payees under a QDRO, are subject to the same local tax rules that apply to distributions to participants, but they are taxable income to the beneficiary, not the underlying participant.[37] The trustee or paying agent for the plan should, therefore, process distributions to a beneficiary just as it would if the same sort of distributions were made instead to the underlying participant, but it should prepare the corresponding Hacienda Form 480.7C in the beneficiary's name, not the participant's name. Along similar lines, the beneficiary must include the distributions in his gross income to the same extent as the underlying participant would have been required to do so if the same distributions were made to the participant. There is an exception to this general rule in the case of distributions to an alternate payee under a QDRO, be it the participant's spouse, ex-spouse or dependent, on account of the payment of child support for the participant's minor children (i.e., children under the age of 21). Even though those distributions are made to the alternate payee, they must be reported as taxable income to the participant. All other distributions to beneficiaries and alternate payees must be reported as taxable income to the person receiving the payment. In order for the aforementioned exception to apply, the QDRO must expressly designate the payment to the alternate payee as one made on account of the participant's child support obligations for his or her minor children.[38]

The local tax rules make no distinctions between spousal and non-spousal beneficiaries. They are subject to exactly the same set of rules, including rollover rights. For example, if a participant's beneficiary is his same-sex domestic partner, upon the participant's death, that beneficiary can certainly complete a tax-free rollover of his plan benefits to another qualified plan or IRA. Also, insofar as the PRIRC does not have an equivalent to Code §401(a)(9), the date by which payments to participants and/or beneficiaries must commence is determined by the relevant terms of the plan, not local law. However, by definition, dual-qualified plans are subject to Code §401(a)(9), and their Puerto Rico participants and beneficiaries must receive required minimum distributions just like any other participant or beneficiary.

TAXATION OF LUMP SUM DISTRIBUTIONS

The Puerto Rico rules on the taxation of retirement income can be split into three groups: taxation of lump sum distributions, taxation of annuities and installments, and taxation of other forms of payment. This structure is somewhat similar, yet not identical, to the equivalent U.S. rules on the taxation of eligible

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[34] Articles 1081.01(b)-1(d)(2)(iii)(C) and (D) of the Regulations. Note that the local rule provides for using the lowest of the insurance company rate, the Hacienda rate, or the IRS rate.

[35] Article 1081.01(b)-1(d)(2)(iv) of the Regulations.

[36] Article 1081.01(b)-1(d)(2)(v) of the Regulations. This rule is based on, and should be construed in accordance with, the equivalent U.S. rule in Treas. Regs. §1.72-16(c)(1).

[37] Article 1081.01(b)-1(b) of the Regulations.

[38] *Id.*

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rollover distributions, periodic payments, and nonperiodic payments. However, the PRIRC includes several tax breaks on retirement income that do not exist in the Code, and for the most part, the local tax rules are better for participants than the U.S. tax rules. The most common form of payment is lump sum distributions.

Definition of Lump Sum Distribution

For purposes of the local tax rules on retirement income, a ''lump sum distribution'' means the distribution or payment of all the benefits payable under a qualified retirement plan with respect to a participant, beneficiary or alternate payee under a QDRO, provided that the distribution is made (1) within a single taxable year of the person receiving the payment (i.e., generally, within a single calendar year), and (2) following or on account of the participant's separation from service with the plan sponsor or participating employer, including other members of the plan sponsor's controlled group, the termination of the plan, or in compliance with the terms of a QDRO.[39] Lump sum distributions may be completed through various payments occurring during a single year, but it is not necessary for lump sum distributions to be made during the same year in which the participant separates from service, the plan is terminated, or the plan administrator approves the QDRO. Furthermore, if a participant receives an in-service withdrawal or has a deemed distribution *before his separation from service*, those payments are not taken into account in determining if a payment made on or after his separation from service is a lump sum distribution.[40] For example, if on December 1, 2013, a participant with a $30,000 plan account receives a $5,000 in-service withdrawal, and on February 1, 2014, he receives the remaining $25,000 in a single payment following this separation from service, the $25,000 payment is considered a lump sum distribution. The same result would apply if, prior to his separation from service, the participant had a deemed distribution on account of a defaulted plan loan.[41] Defaulted plan loans *following separation from service*, however, are taken into account for purposes of identifying lump sum distributions. For example, if on February 1, 2013, a participant with a $30,000 plan account separates from service and shortly thereafter he defaults on a $5,000 outstanding loan, but the participant does not receive the remaining $25,000 until June 30, 2014, both the 2013 deemed distribution of $5,000 and the 2014 actual distribution of $25,000 are considered partial payments subject to the rules on ''other forms of payments'' described below, not the rules on lump sum distributions. Because the timing of defaulted loans may have an impact on whether a particular payment is a lump sum distribution or a partial payment, the Regulations include the following rules for determining the effective date of deemed distributions. As a general rule, an outstanding loan is deemed defaulted as of the due date set by the relevant loan documents for the first periodic payment the participant fails to pay on time. If the relevant loan documents provide for a cure period, however, the loan is deemed defaulted as of the last day of the cure period. But, if the participant receives the remainder of his or her plan account before the end of the cure period established under the plan, the loan is deemed defaulted as of the date of the distribution.[42]

A lump sum distribution may be made to a beneficiary or an alternate payee, and their respective rights to receive such distribution are separate and independent from the payments to the underlying participant and/or other beneficiaries or alternative payees. For example, if a participant with a $30,000 plan account dies, and following his death, $10,000 is transferred to the account of beneficiary A and the remaining $20,000 is transferred to the account of beneficiary B, beneficiary A may receive his $10,000 in a lump sum distribution, irrespective of how and when beneficiary B receives his $20,000. Similarly, if following the terms of a QDRO, the plan administrator transfers $10,000 of the participant's $30,000 plan account to a separate account established for the alternate payee's benefit, the alternate payee may receive his $10,000 through a lump sum distribution irrespective of how and when the participant receives the remaining $20,000.[43]

Tax Withholding

The taxable portion of a lump sum distribution (i.e., the entire amount distributed minus (1) the participant's basis in the benefits, and (2) the fair market value at the time of distribution of shares of employer stock included in the distribution) is subject to a mandatory 20% Puerto Rico income tax withholding at source.[44] In lieu of this 20% withholding rate, there is a preferential 10% withholding rate if (1) the plan is funded through a trust fund located in Puerto Rico or uses a Puerto Rico paying agent for processing distributions to Puerto Rico participants, and (2) the plan

[39] Article 1081.01(b)-2(a)(1) of the Regulations.

[40] Article 1081.01(b)-2(b)(1) of the Regulations.

[41] Article 1081.01(b)-2(b)(2)(ii) of the Regulations.

[42] Article 1081.01(b)-2(c) of the Regulations. This rule is based on, and should be construed in accordance with, the equivalent U.S. rule in Treas. Regs. §1.72(p)-1, Q&A-10.

[43] Article 1081.01(b)-2(a)(2) of the Regulations.

[44] Article 1081.01(b)-5(d)(1) of the Regulations.

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invests 10% or more of its assets (or, in the case of a defined contribution plan, the participant invests 10% or more of the value of his plan account) in certain property located in Puerto Rico, such as Puerto Rico government bonds, units from mutual funds organized in Puerto Rico, savings accounts and CDs from local banks, and certain annuity contracts issued by local insurance companies.[45]

If a lump sum distribution consists of both an actual distribution of liquid assets and a deemed distribution of the outstanding balance of a defaulted loan, the defaulted loan will be taken into account in determining the amount to be withheld, but the withholding will only be made out of the liquid assets. For example, if a participant receives a $30,000 lump sum distribution that includes an actual distribution of $25,000 and a deemed distribution of $5,000, the trustee or paying agent must withhold 20% of $30,000 ($6,000) out of the $25,000, for a net payment of $19,000.[46]

Tax Rate

The taxable portion of a lump sum distribution is considered a long-term capital gain (i.e., it can be offset by a long-term capital loss), and the participant must pay Puerto Rico income taxes on such portion at the lowest of (1) a flat 20% rate; (2) if the plan (or the participant) invested 10% or more of its assets (his plan account) in Puerto Rico property, a flat 10% rate; or (3) the participant's ordinary income tax rate for the year of distribution.[47] For 2013, the ordinary income tax rates are:[48]

Taxable income for the year	Ordinary income tax rate
$0 – $9,000	0%
$9,001 – $25,000	7% on the excess over $9,000
$25,001 – $41,500	$1,120 + 14% on excess over $25,000
$41,501 – $61,500	$3,430 + 25% on excess over $41,500
$61,501+	$8,430 + 33% on excess over $61,500

Rollovers

Lump sum distributions, and only lump sum distributions, are eligible for tax-free rollovers to either another retirement plan qualified in Puerto Rico or an IRA in Puerto Rico. A participant may roll over all or just a portion of the lump sum distribution. For example, a participant with a $30,000 plan account may decide to receive the entire $30,000, receive $15,000 and roll $15,000 over to an IRA, or roll the entire $30,000 to an IRA. The participant must include in his gross income the portion of the distribution he receives, but not the portion he rolls over.[49] However, the participant may not elect to roll over a portion of his plan benefits and leave the remainder invested in the plan, as that would convert the payout of his benefits into a series of partial payments, which are not eligible for tax-free rollover treatment.

A participant may complete either a direct rollover or in indirect rollover. In a direct rollover, the participant instructs the plan administrator or trustee of the transferor plan to transfer the corresponding portion of his or her plan benefits to the trustee of the transferee plan or IRA. A direct rollover may be completed through an electronic transfer of funds, the mailing of a check, or any other similar banking procedures. The check for the rollover may even be handed to the participant, provided that it is made payable to the order of the trustee of the transferee plan or IRA. Amounts transferred to another qualified plan or IRA through a direct rollover are not subject to Puerto Rico income

[45] Article 1081.01(b)-5(d)(2) of the Regulations.
[46] Article 1081.01(b)-5(d)(4) of the Regulations.
[47] Article 1081.01(b)-2(e)(1) of the Regulations.
[48] PRIRC §1021.01(a)(1)(3).

[49] Article 1081.01(b)-2(f)(1)(i) of the Regulations.

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tax withholding at the source.[50] On the other hand, in an indirect rollover, the participant receives a lump sum distribution of his or her plan benefits, which is subject to Puerto Rico income tax withholding at the source and deposits all or part of the amount received with the trustee of the other plan or IRA within 60 days of the date of distribution. On his or her Puerto Rico individual income tax return, the participant will have to claim a refund for the income tax withheld on the portion of the lump sum distribution he/she subsequently rolled over to the other plan or IRA.[51] If a lump sum distribution is completed through several payments all within the same year, the 60-day period for completing an indirect rollover applies separately for each of the payments.[52]

A qualified plan may impose reasonable rules, restrictions and administrative requirements for either completing rollovers to other qualified plans and IRAs or receiving rollover contributions from other qualified plans, such as imposing minimum amount requirements, not accepting rollover contributions of property or after-tax amounts, and requiring the participant to complete administrative forms and provide information the plan administrator may deem necessary or appropriate for processing the rollover.[53] In order for a qualified plan to accept a direct or indirect rollover contribution, the plan administrator or trustee of the plan that receives the contribution first has to obtain reasonable evidence that the plan from which the money is being transferred or contributed is duly qualified in Puerto Rico. This evidence may include a copy of that plan's most recent Hacienda determination letter, written or oral confirmation from that plan sponsor, administrator or trustee, and written or oral confirmation from the officers of Hacienda's Pension Plan Office.[54] The plan that receives the rollover contribution can safely rely on the accuracy and correctness of any such written or oral confirmations and is not required to confirm that in fact the other plan is qualified in Puerto Rico.[55]

Even though the Regulations adopted locally many of the U.S. rollover rules of Code §402(c), rollovers remain one of the thorniest issues with the operation of dual-qualified plans. Ordinarily, a transfer of assets that would be considered a tax-free rollover for Puerto Rico income tax purposes would not be considered a tax-free rollover for U.S. income tax purposes, and vice-versa. As noted above, in order to be tax-free in Puerto Rico, a rollover must be from a retirement plan qualified in Puerto Rico to either another retirement plan qualified in Puerto Rico or an IRA in Puerto Rico.[56] On the other hand, in order to be tax-free in the U.S., a rollover must be from a retirement plan qualified in the U.S. to, among others, another retirement plan qualified in the U.S. or an IRA in the U.S.[57] If, for example, a Puerto Rico participant in a dual-qualified plan were to transfer his or her retirement benefits to either a U.S. qualified plan that is not also qualified in Puerto Rico or an IRA in the U.S., the transfer would be a tax-free rollover in the U.S. Accordingly, it would defer U.S. taxation of the portion of the transferred amount that is considered income from U.S. sources, but it would not be a tax-free rollover in Puerto Rico. Thus, it would not defer Puerto Rico taxation of the entire transferred amount. Conversely, if the same Puerto Rico participant were to transfer his or her retirement benefits to either a Puerto Rico-only qualified plan or an IRA in Puerto Rico, the transfer would be a tax-free rollover in Puerto Rico, and therefore, it would defer Puerto Rico taxation of the entire transferred amount, but it would not be a tax-free rollover in the U.S. Thus, it would not defer U.S. taxation of the portion of the transferred amount that is considered income from U.S. sources. If the plan administrator or trustee of the transferor plan inadvertently treats any such transfers as a tax-free rollover in both jurisdictions, it would be incurring an under-reporting and under-withholding violation in one jurisdiction or the other. In the case of the Puerto Rico participants in a dual-qualified plan, the vehicle that would work for completing a rollover that is tax-free in both the U.S. and Puerto Rico would be another dual-qualified plan, as IRAs are generally not an option.

Inadvertent violations of the U.S. and/or Puerto Rico rules on tax-free rollovers are far more common than one would guess, and their correction is neither easy nor inexpensive. Basically, it involves preparing amended informative returns, trying to recover from the participant the U.S. or Puerto Rico taxes that should have been withheld on the rollover, and depositing into the plan and/or paying directly to the IRS or Hacienda the amount not recovered from the partici-

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[50] Articles 1081.01(b)-2(f)(2)(i)(A) through (D) of the Regulations.

[51] Article 1081.01(b)-2(f)(2)(ii) of the Regulations.

[52] Article 1081.01(b)-2(f)(2)(ii)(D) of the Regulations.

[53] Article 1081.01(b)-2(f)(1)(iv) of the Regulations. It should be noted that IRA-to-plan rollovers are not allowed in Puerto Rico.

[54] The telephone number for Hacienda's Pension Plan Office is 787-724-1495.

[55] Article 1081.01(b)-2(f)(i)(vi) of the Regulations.

[56] PRIRC §1081.01(b)(2)(A). Pursuant to PRIRC §1081.02(a) and (b), the individual retirement accounts that may be used for completing tax-free rollovers in Puerto Rico must be created or organized in Puerto Rico, and the individual retirement annuities that may be used for such purposes must be issued by an insurance company authorized to do business in Puerto Rico.

[57] *See* Code §402(c)(8)(B).

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pant, plus the interest and penalties that may apply on the under-withholding. In addition, this is a U.S. income tax violation that cannot be self-corrected through EPCRS.[58] To avoid or at least reduce the likelihood of this sort of inadvertent violation, many administrators of dual-qualified plans provide Puerto Rico participants with some basic information about the interplay between the U.S. and Puerto Rico tax rules on retirement income, including the ''catch-22'' on rollovers that applies to them. Once the Puerto Rico participants are made aware that entirely tax-free rollovers are generally not an option for them, they simply do not request rollovers. Would an easier solution to this potential issue be to amend the plan to preclude Puerto Rico participants from electing rollovers? Generally not, as that may be construed as a violation of Code §401(a)(31), which could jeopardize the plan's U.S. qualification.

TAXATION OF ANNUITIES AND INSTALLMENTS

Clearly, the two forms of payment that receive the most favorable tax treatment under the PRIRC are annuities and installments, as these are the only forms of payment eligible for a $11,000/$15,000 annual income tax exclusion, and a substantial annual exemption from income tax withholding. Not surprisingly, many plan sponsors of §401(k) plans in Puerto Rico have recently amended their plans to add installments as an additional form of payment.

Definition of Annuities and Installments

The Regulations define ''installments'' as the distribution or payment of all the benefits payable under a qualified retirement plan with respect to a participant, beneficiary or alternate payee under a QDRO, provided that (1) the payments begin following or on account of the participant's separation from service with the plan sponsor or participating employer, including other members of the plan sponsor's controlled group, the termination of the plan, or in compliance with the terms of a QDRO; (2) the payments are substantially similar in amount, and are made at regular intervals, such as yearly, monthly, weekly, or any other interval determined under the terms of the plan, over a period of at least two years beginning from the date of the first payment; and (3) except as noted below, the frequency and amount of the payments is determined and cannot be changed once the first payment has been made.[59] ''Annuities'' are defined exactly as installments, except that while installments are paid over a fixed period of time of at least two years, annuities are paid over the lifetime or life expectancy of the participant and/or his or her beneficiary (i.e., a regular pension).[60] Required minimum distributions under Code §401(a)(9) to the Puerto Rico participants in a dual-qualified plan are always considered annuities or installments, as applicable.[61]

Although the general rule is that the frequency and amount of both annuities and installments must be determined and cannot be changed once the payments have started, that rule does not preclude variations in either frequency or amount resulting from cost-of-living allowances, Social Security supplements, Social Security offsets, the investment earnings allocated to the participant's account, and other variation criteria established under the terms of the plan and/or the relevant benefits formula, provided that such variation criteria do not remain subject to the payee's control or discretion once the first payment has been made.[62] Following are some of the examples in the Regulations regarding this exception to the general rule.[63]

> *Example:* The participant has $30,000 in his plan account, and following his termination of employment, begins receiving his benefits through 30 periodic payments of $1,000 each. The plan provides for an automatic cash-out payment once the participant's account reaches $5,000. Even though the participant will end up receiving 25 payments of $1,000 and one payment of $5,000, because the variation in the amount of the payments was established under the terms of the plan and was not subject to the participant's discretion, all the payments are considered installments.

> *Example:* The participant has $30,000 in his plan account, and following his termination of employment, he instructs the plan administrator to pay him $10,000 during 2013, but at that time does not provide any instructions for the payment of the remaining $20,000. During 2014, the participant instructs the plan administrator to pay him the remaining $20,000 through a $10,000 payment in 2014 and a $10,000 payment in 2015. Because the amount and frequency of the payments was not determined as of the date of the first

[58] Rev. Proc. 2013-12, 2013-4 I.R.B. 313, §6.09.

[59] Article 1081.01(b)-3(a)(1) of the Regulations.

[60] Article 1081.01(b)-3(a)(2) of the Regulations.

[61] Article 1081.01(b)-3(a)(3) of the Regulations.

[62] Article 1081.01(b)-3(a)(4) of the Regulations.

[63] Article 1081.01(b)-3(a)(5) of the Regulations.

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payment in 2013, the payments are not installments but, rather, are periodic payments subject to the rules on other forms of payment described further below in this article.

Example: The participant elects to receive his benefits through a 50% qualified joint and survivor annuity that will provide him with a monthly pension of $1,000 and his surviving spouse with a monthly pension of $500. Because the variation in the amount of the payments results from the benefits formula, all of the payments are annuities.

Example: The participant has $30,000 in his plan account, and following his termination of employment, instructs the plan administrator to pay him five annual payments of $6,000 each. After the end of the second year, once the participant has already received $12,000, he changes his mind and instructs the plan administrator to pay him the remaining $18,000 in a single payment. The final payment of $18,000 will not be an installment, but rather a partial payment. That final partial payment of $18,000, however, will not have an impact on the first two payments of $6,000, which will remain classified as installments.[64]

Note that this example illustrates a major exception to the general rule mentioned above that the frequency and amount of all the payments must be set by the date the first payment was made, and any subsequent changes to either the frequency or amount of the payments resulting from the participant's discretion or control renders the payments partial payments rather than installments. This exception came about from comments some industry players submitted when the Regulations were first proposed. Because, as detailed below, most annuities and installments are eligible for an annual income exclusion and are generally exempted from the withholding of Puerto Rico income taxes at source, whereas partial payments do not receive the benefit of an annual income exclusion and are always subject to a 10% Puerto Rico tax withholding, trustees and paying agents servicing retirement plans in Puerto Rico were concerned about the actions they and/or the participants would have to take if subsequent changes to the benefits payout could have a retroactive impact on prior year distributions. Would the party responsible for processing distributions be required to withhold from current or future payments the 10% income tax that was not previously withheld on the prior year installments now reclassified as partial payments? Would they have to prepare and file with Hacienda an amended Form 480.7C to reclassify the prior year installments as partial payments? And would the participants be required to prepare an amended Puerto Rico individual income tax return to report the prior year payments as partial payments rather than installments, thus not eligible for the annual income exclusion on annuities and installments? To avoid the potential tax and compliance complications that could very well take place if payments initially classified as installments were required to be retroactively reclassified as partial payments, Hacienda decided to incorporate this exception. Therefore, if a chain of payments initially classified as installments is broken because of a subsequent change in the frequency and/or amount of the payments resulting from the participant's control or discretion, the payments impacted by the change will become partial payments, but the previous payments will continue to be classified as installments. There is no need for the plan administrator to prepare amended Forms 480.7C or for the participant to prepare an amended Puerto Rico income tax return with regard to the previous payments.

Tax Withholding

If the taxable portion of the annuity or installments (i.e., the entire amount distributed during the year minus the participant's basis in the payments) paid during the year exceeds the limits included in the following table, the excess over such limits is subject to 10% Puerto Rico income tax withholding. If the taxable portion of the annuity or installment payments for the year do not exceed such limits, no income tax withholding applies.[65]

	Amount of Annuity or Installments Not Subject to 10% Puerto Rico Income Tax Withholding	
Calendar Year	**If at year's end the participant is not age 60**	**If at year's end the participant is age 60 or older**
2013	$23,500	$27,500
2014	$26,500	$30,500
2015 & later	$31,000	$35,000

Insofar as the average account balance in U.S. §401(k) plans is worth around 60,000,[66] and, in the author's opinion, the average account balance of Puerto Rico participants in §401(k) plans, both P.R.-

[64] Article 1081.01(b)-3(a)(5)(vi) of the Regulations.

[65] Article 1081.01(b)-5(e) of the Regulations.

[66] EBRI Issue Brief No. 366, Dec. 2011.

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only qualified plans and dual-qualified plans, is less than that, the vast majority of annuities and installments paid to Puerto Rico participants should not be subject to any Puerto Rico income tax withholding at source.

Annual Income Exclusion

From a participant's standpoint, the best aspect about annuities and installments is the annual income exclusion provided in PRIRC §1031.02(a)(13). Only annuities and installments are eligible for an annual Puerto Rico income exclusion of $11,000, if by the end of the year of payment the participant has not yet reached age 60, or $15,000, if by the end of the year of payment the participant is age 60 or older. This is an annual (not a once in a lifetime) income exclusion.

> *Example:* If a participant receives his plan benefits in the form of an annuity providing for monthly payments of $900 (i.e., $10,800/year), his entire benefits will be exempt from the payment of Puerto Rico income taxes, regardless of his age. Moreover, as the annual benefits do not exceed the thresholds on the 10% withholding described above, they will not be subject to any income tax withholding either.

> *Example:* If a participant is age 55 and receives his plan benefits in the form of an annuity providing for monthly payments of $1,200 (i.e., $14,400/year), the first $11,000 that he receives each year before he reaches age 60 will be exempt from the payment of Puerto Rico income taxes, and the remaining $3,400 will be subject to the payment of Puerto Rico income taxes at his ordinary income tax rate for the year of distribution. Beginning in the year in which the participant reaches age 60, the annual income exclusion will increase to $15,000, and thus, the entire plan benefits will be exempt from the payment of income taxes. Again, because the annual annuity payments do not exceed the limits on the 10% withholding described above, they will not be subject to any income tax withholding.

Tax Rate

If the taxable portion of the annuity and installments exceeds the $11,000/$15,000 annual income exclusion, the excess will be subject to the participant's ordinary income tax rate for the year of distribution.[67]

Rollovers

For Puerto Rico income tax purposes, neither annuities nor installments are eligible for a tax-free rollover, direct or indirect, to another qualified plan or IRA.[68] Even installments completed over a period not exceeding 10 years, which would be eligible for a tax-free rollover in the U.S., are not eligible for a tax-free rollover in Puerto Rico.

TAXATION OF OTHER FORMS OF PAYMENT

Although annuities and installments receive the best tax treatment under local law, the other forms of payment described in this section receive just the opposite. They are not eligible for flat tax rates, tax-free rollovers, or annual income exclusions, and since 2011, they are subject to a 10% income tax withholding from the first dollar. Nevertheless, participant appetite for these other forms of payment, particularly in-service withdrawals, remains as strong as ever.

Definition of Other Forms of Payment

''Other forms of payment'' are simply any sort of taxable payment or distribution of benefits from a qualified plan other than lump sum distributions, annuities and installments. This includes partial payments following a participant's separation from service that are not installments, in-service withdrawals, corrective distributions of elective deferrals and elective contributions, and deemed distributions resulting from defaulted loans or the sale or lease of plan property to a participant at a discount.[69]

> *Example:* The participant has $30,000 in his plan account. Following his separation from service, he instructs the plan administrator to pay him $10,000 during 2013 and $20,000 during 2014. Because the two payments are not substantially similar in amount, they are not considered installments. Instead, they are considered partial payments subject to the local tax rules on other forms of payment.

> *Example:* At the time of his separation from service, the participant has $30,000 in his plan account, of which $5,000 is attributable to an outstanding plan loan. The participant

[67] Article 1081.01(b)-3(b)(1) of the Regulations.

[68] Article 1081.01(b)-3(c) of the Regulations.

[69] Article 1081.01(b)-4(a) of the Regulations.

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does not repay the loan, which is treated as a deemed distribution of $5,000 for that year. The participant does not elect to receive the distribution of his remaining $25,000 until two years later. Both the $5,000 deemed distribution and the actual distribution of $25,000 are considered partial payments. Had the deemed distribution of $5,000 and the actual distribution of $25,000 taken place during the same year, they would both be considered lump sum distributions.

Example: The participant has $30,000 in his plan account. On February 1, 2013, while still actively employed, he receives a hardship withdrawal of $5,000. On November 1, 2013, following his separation from service, he receives his remaining $25,000 in a single payment. The in-service withdrawal of $5,000 is subject to the local tax rules on other forms of payment, whereas the subsequent payment of $25,000 is subject to the rules on lump sum distributions.[70]

Tax Withholding

The taxable portion of these other forms of payment (i.e., the entire amount distributed less the portion attributable to the participant's basis) is subject to 10% Puerto Rico income tax withholding at the source.[71] Unlike annuities and installments, for which a certain amount is excluded from tax withholding, the 10% withholding on these other forms of payment starts from the first taxable dollar. In the case of deemed distributions, such as defaulted loans, the 10% withholding is to be withheld from the liquid assets, if any, paid to the participant during the same year of the deemed distribution, but no withholding applies if no liquid assets were paid to the participant during that year.[72]

Example: At the time of his separation from service, the participant has $30,000 in his plan account, including an outstanding plan loan of $5,000. The participant does not repay the loan, and the plan administrator reports the loan as a deemed distribution of $5,000. The participant does not receive his remaining $25,000 during the same year. Therefore, once the remaining $25,000 is paid, it will be subject to the tax rules on other forms of payment, not the rules on lump sum distributions. Because no liquid assets were paid during the year in which the deemed distribution took place, no Puerto Rico income tax withholding must be made during that year. Once the remaining $25,000 is distributed, the 10% withholding will only apply on the taxable portion of that payment, without taking into account the previous deemed distribution of $5,000 resulting from the defaulted loan. Had the participant received his remaining $25,000 during the same year of the defaulted loan, the actual distribution of $25,000 along with the deemed distribution of $5,000 would be considered a single lump sum distribution of $30,000, which would have been subject to 20% Puerto Rico income tax withholding (i.e., $6,000) to be withheld from the $25,000, for an actual distribution of $19,000.

Tax Rate

The taxable portion of these other forms of payment is subject to the participant's ordinary income tax rate for the year of distribution.[73]

Rollovers and Annual Income Exclusion

Other forms of payment are not eligible for either tax-free rollovers to other qualified retirement plans or IRAs, or the $11,000/$15,000 annual income exclusion on annuities and installments.[74]

ADMINISTRATION OF PUERTO RICO TAX REPORTING AND WITHHOLDING

Tax Reporting

Distributions to the Puerto Rico participants in P.R.-only qualified plans and dual-qualified plans must be reported to the corresponding participant and to Hacienda using Form 480.7C, the local equivalent to IRS Form 1099-R. Form 480.7C is generally due February 28 of the year following the year of distribution.[75] In the case of a rollover contribution to a qualified plan, however, the due date for reporting the receipt of the contribution using Form 480.7C is August 30 of the year following the year of the rollover. Accordingly, the trustee or paying agent of the transferor plan completing a direct rollover to another plan

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[70] Article 1081.01(b)-4(a)(1) of the Regulations.

[71] Article 1081.01(b)-5(f) of the Regulations.

[72] Article 1081.01(b)-5(f)(1)(A) of the Regulations.

[73] Article 1081.01(b)-4(b) of the Regulations.

[74] Article 1081.01(b)-4(c) of the Regulations.

[75] PRIRC §1063.13.

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or IRA must prepare a Form 480.7C to report the rollover distribution by February 28 of the next year, but the trustee or paying agent of the plan receiving a direct or indirect rollover contribution must prepare a Form 480.7C to report the rollover contribution by August 30 of the next year.[76]

Even though the instructions to Form 480.7C seem to indicate that Hacienda's copy of the form may be mailed to Hacienda's postal address in San Juan, Puerto Rico, the actual requirements are more complicated. Instead, the filing of Hacienda's copy of Form 480.7C must be completed as follows: (1) if the trustee or paying agent for the plan is only required to send Hacienda one or two forms for the same year, the forms should be mailed to Hacienda's postal address; (2) if the trustee or paying agent for the plan is required to send Hacienda between three and 249 forms for the same year, the forms must be filed electronically using Hacienda's W2 and Informative Returns Program, which is a software application found on Hacienda's website; and (3) if the trustee or paying agent for the plan is required to send Hacienda 250 or more forms for the same year, which in practice is very rare, the forms must be filed using an electronic transfer of data that requires coordination with Hacienda or certain authorized software providers.[77] Although the mechanics of filing Form 480.7C with Hacienda using either the W2 and Informative Returns Program or an electronic transfer are beyond the scope of this article, the filing process is generally very simple and inexpensive. For example, the current rate for the service of preparing and filing Form 480.7C with both participants and Hacienda is around \$10-\$15 per form. So, a plan that has to prepare 50 forms per year could expect total annual expenses of about \$500-\$600.

In contrast, the penalties for failing to prepare and deliver Form 480.7C by its applicable due date are \$100 per form for the failure to send a copy to the corresponding participant,[78] plus \$500 per form for the failure to send a copy to Hacienda.[79] A plan sponsor that determines that its plan has failed to report on Form 480.7C the distributions to Puerto Rico participants should consider engaging a paying agent to prepare and file the proper returns as soon as administratively practicable. Alternatively, if the plan also failed to withhold and deposit with Hacienda Puerto Rico income taxes on the distributions to the Puerto Rico participants, the plan sponsor should consider correcting both the under-reporting and under-withholding failures by entering into a closing agreement with Hacienda, which is basically a written, legally binding contract between the plan sponsor and Hacienda whereby the plan sponsor agrees to pay Hacienda a certain amount, usually much less than the potential tax exposure, and Hacienda agrees to provide administrative relief to the plan sponsor and the plan from the related tax exposure.[80]

Tax Withholding

The trustee or paying agent for the plan must deposit with Hacienda the Puerto Rico income taxes withheld on the distributions to the Puerto Rico participants by the fifteenth day of the month immediately following the month of distribution.[81] The tax may be deposited at any of the many Hacienda collection offices throughout the Island (known by their Spanish name as ''colecturías''), using Hacienda Form 480.9D, *Payment Voucher of Special Tax on Distributions from Employee's Trusts*. The plan sponsor may engage a local paying agent to deposit with Hacienda the local taxes withheld on the distributions to the Puerto Rico participants, and the current rate for those services is around \$20–\$30 per deposit. Unfortunately, Hacienda's online collection system (known by its Spanish name as the ''colecturía virtual'') is not currently set up for accepting these type of deposits, so the process must be handled through checks.

If, upon audit or investigation, Hacienda detects that a qualified plan has failed to withhold the applicable local taxes on distributions to its Puerto Rico participants, the plan sponsor and/or the Puerto Rico participating employer(s) in the plan could be facing a Puerto Rico income tax penalty equal to the entire amount that should have been, but was not withheld,[82] plus an interest charge of 10% per annum,[83] and a penalty charge of up to 24%.[84] Also, Hacienda's long-standing position is that insofar as the distributions were never reported to Hacienda using Form 480.7C, all the prior years affected by these under-withholdings remain open for an income tax assessment. For example, if during the last 10 years, a plan paid \$1,000,000 through lump sum distributions to its Puerto Rico participants, the plan sponsor could face a potential tax exposure of \$300,000–\$400,000. A plan sponsor that determines that its plan has failed to withhold local taxes on distributions to Puerto Rico participants should consider correcting the situation through a closing agreement with Hacienda.

[76] Article 1081.01(b)-2(f)(1)(vii) of the Regulations and Instructions to Form 480.7C.

[77] Hacienda Circular Letter No. 11-08 of Sept. 21, 2011.

[78] PRIRC §6041.04.

[79] PRIRC §6041.11(b)(1).

[80] PRIRC §6051.07.

[81] PRIRC §1081.01(b)(4).

[82] PRIRC §1081.01(b)(3) and (10).

[83] PRIRC §6030.01.

[84] PRIRC §1081.01(b)(8).

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CONCLUSION

Sponsors of qualified retirement plans covering Puerto Rico participants should contact the trustee or paying agent for the plan to confirm that distributions to the Puerto Rico participants in the plan are handled in accordance with the new rules set forth by the Regulations. Complying with these new rules should prove to be fairly simple and inexpensive, and should not require significant changes to either the plan terms or its administrative procedures. Also, the rules open some planning opportunities for lowering the local income taxes Puerto Rico participants must pay on their retirement income. On the other hand, sponsors that fail to comply with these rules could be assuming a substantial Puerto Rico tax exposure.

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