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## Practical Considerations and Recommendations Regarding 2014 Prepayments of Puerto Rico Income Tax on Retirement Benefits



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Before addressing the technical and practical aspects of the prepayments of Puerto Rico (P.R.) income taxes on retirement plan benefits provided by Puerto Rico Act No. 77 of July 1, 2014 ("Act 77"), it is important to point out that retirement plans in operation in P.R., whether P.R.-only qualified plans or dual-qualified plans, are *NOT* legally required to allow their P.R. participants to make these prepayments. Plan sponsors have full discretion to decide whether or not to amend their plans to allow for prepayments. Given the various administrative complexities these prepayments may bring about, many of the U.S. and international companies doing business on the island, as well as large local employers, have decided not to allow for prepayments within their plans. That is a valid and reasonable plan sponsor decision. Companies interested in allowing their P.R. employees to prepay P.R. income taxes on their retirement plan benefits should first have a detailed conversation with the employee benefits advisors, recordkeepers, and TPAs servicing their plans to evaluate the impact these prepayments could have on the administration of their plans, such as the need for plan amendments, changes to recordkeeping systems, SDPs, and quarterly statements of accounts, and, but of course, related fees and expenses. Thus far, most of the companies the author has discussed this matter with are finding out that the potential costs of implementing these prepayments exceed their potential benefits, and thus are not going forward with them.

### 2014 P.R. Tax Prepayments in a Nutshell

At present, the Puerto Rico Department of the Treasury ("Hacienda") is working on issuing a Circular Letter (i.e., pretty much the local equivalent to an IRS Rev. Proc. or Notice) which will establish specific rules on the implementation of the P.R. tax prepayments on retirement benefits brought by Act 77. Hacienda's Circular Letter should be issued by the middle of August 2014. Taken together, Act 77 and the upcoming Circular Letter are likely to provide that a participant, beneficiary, or alternative payee under a QDRO (collectively, a "participant") who has an account balance or accrued benefits under a retirement plan qualified in P.R., whether DC or DB, may elect to prepay P.R. income taxes on all or a portion of his or her plan benefits at a flat rate of 8%; provided that the prepayment is completed or formally requested (more on this later) no later than Friday, October 31, 2014. Participants may also elect to prepay P.R. income taxes on their benefits under non-qualified retirement plans (e.g., deferred compensation arrangements) at a flat rate of 15%, but, judging by the experience with previous prepayments (e.g., the P.R. tax prepayment program that was in place back in 2006), prepayments on nonqualified plans should be very rare.

Participants will be allowed to prepay P.R. income taxes on all or just a portion of their retirement plan benefits, and they will not be required to cash-out or receive an immediate distribution of the amounts over the taxes they prepaid. For example, if a participant has \$100,000 in his or her account in a P.R.-only qualified 401(k) plan, he or she could elect to prepay P.R. income taxes on the entire \$100,000, for a prepayment of \$8,000, or just on \$50,000, for a prepayment of \$4,000. In either case, provided that the plan documents allows for it, the participant could elect to receive an immediate distribution of the portion of his or her account subject to the prepayment or keep that money invested within the plan.

Amounts over which P.R. income taxes have been prepaid will then be considered after-tax money, therefore not subject to P.R. taxation or the withholding of P.R. taxes at source upon distribution. Investment income earned on such amounts, however, will be considered pre-tax money subject to taxation and, depending on the method of payment, withholding upon distribution. Notice that, unlike Roth 401(k) contributions, future investment earnings remain subject to taxation.

There will be two ways for completing a prepayment: either directly by the participant or through the retirement plan. Under the first one, the participant would personally prepay the tax, out of his or her personal funds, at one of Hacienda's internal revenue collection offices (known by their Spanish name as "*colecturías*"), and will then provide evidence of payment – a stamped copy of Hacienda Form SC 2911<sup>1</sup> – to the trustee of the trust fund forming part of the plan or, if applicable, the recordkeeper or paying agent responsible for processing benefit payments to the P.R. participants in the plan (collectively, the "trustee"). Alternatively, the participant can request the trustee to complete the prepayment by using a portion of the benefits under plan account (e.g., moneys allocated to the participant's account). For that, the participant will need to provide the trustee a completed copy of Hacienda Form SC 2911. On or before the 15<sup>th</sup> day of the next following month, the trustee will (i) deposit the corresponding tax prepayment with Hacienda, and (i) file with Hacienda a copy of the Form SC 2911 completed by the participant. In either case, the trustee will have to make the necessary adjustments within the plan's recordkeeping system to flag as after-tax money the portion of the participant's account or accrued benefits, as applicable, over which P.R. taxes were already paid. If the prepayment is completed by the participant, he or she will have to pay the corresponding amount at a *colecturía* no later than October 31, 2014, and if it is completed by the trustee, the participant will have to formally request the trustee to complete the prepayment (i.e., deliver the executed Form SC 2911 to the trustee) by October 31, 2014, and the trustee will then have to deposit the corresponding amount with Hacienda no later than November 15, 2014.

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<sup>1</sup> Copies of Form SC 2911 and other forms related to the processing of the prepayments will be available at Hacienda's webpage, [www.hacienda.gobierno.pr](http://www.hacienda.gobierno.pr), under "*Planillas y Formularios*."

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Since, by definition, prepayments completed by the trustee involve the outlay of a portion of the participant's benefits, no later than February 28, 2015, the trustee will have to report such prepayment, using Hacienda Form 480.7C (i.e., the local version of IRS Form 1099-R), as a distribution of benefits to the participant. Unless the amount of the prepayment is attributable to the participant's after-tax contributions under the plan, it will be reported as a taxable distribution, but it will not be subject to a P.R. tax withholding.

### Good and Bad Candidates for Prepayments

Just as it happened back in 2006, the best candidates for taking advantage of the 2014 P.R. tax prepayments are local professionals and small business owners that sponsor a P.R.-only qualified profit sharing plan (i.e., a Keogh plan), whereas large U.S. international, and even local companies that sponsor corporate plans in P.R. are likely to take a pass on them.

In the case of a dual-qualified 401(k) plan (i.e., a regular U.S. 401(k) plan that covers both U.S. and P.R. participants), which have become quite popular since the P.R. tax code was substantially updated in 2011, prepayments completed by the trustee could very well result in a violation of the restriction on early distributions of elective deferrals of IRC §401(k)(2)(B),<sup>2</sup> and in the case of a DB pension plan, whether P.R.-only or dual-qualified, prepayments, regardless of who completes them, would require the plan to split the participant's accrued benefits between their pre-tax and after-tax components, something that most pension plans are not designed nor prepared to do. That leads P.R.-only qualified 401(k) plans as the only corporate plans for which prepayments could be legally and practically feasible, but even for these plans incorporating prepayments could require various changes to the plan terms and recordkeeping systems (e.g., for those 401(k) plans that do not currently provide for employee after-tax contributions).

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<sup>2</sup> The P.R. tax code also restricts early distributions of elective deferrals, but Act 77 expressly states that the adoption of the 2014 prepayments will not have an adverse impact on a plan's P.R. qualified status.

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### A Remaining Administrative Problem

So it is clear that a plan sponsor does not have to amend its retirement plan to allow for prepayments if it does not want to. But there is still one potential administrative challenge that needs to be considered. What to do if a P.R. participant in a retirement plan that was not amended to incorporate the 2014 P.R. tax prepayments (e.g., the plan is not set up for allowing employee after-tax contributions) simply goes a *colecturía*, prepays P.R. taxes on his or her plan benefits, and shows up at the trustee's doorstep with a stamped copy of Form SC 2911 demanding that the eventual distribution of his or her plan benefits be handled consistently with the prepayment? Would the trustee be legally required to abide by the participant's demand? In the author's opinion, the answer is "no." The trustee can continue to operate the plan "as is," treat the eventual payment of the participant's benefits as a taxable distribution, and it would be up to the participant to square things up with Hacienda through a claim for a tax refund. Having said that, this potential scenario definitely has the makings of an unnecessary and time consuming employee-relations problem. To avoid such problem, sponsors of retirement plans in operation in P.R. should make a decision as to whether or not to allow for prepayments, and communicate such decision to the active and inactive P.R. participants in their plans, as soon as administratively practicable.

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