E–ALERT

McConnell Valdés LLC

December 24, 2014 www.mcvpr.com

EMPLOYEE BENEFITS ALERT

Act. No. 238 Extends Tax Prepayment of Accrued Value of Benefits on Retirement Plans and IRAs until January 31, 2015

As indicated in our August 11, 2014 McV Employee Benefits Alert, Act Number 77-2014 amended the Puerto Rico Internal Revenue Code of 2011 ("PR Code") to allow participants, during the election period running from July 1, 2014 to October 31, 2014 ("Prepayment Period"), to prepay, at a reduced tax rate, the income tax applicable upon the accrued value of their benefits in an employee retirement plan ("Special Tax"), whether or not qualified in Puerto Rico.

On December 22, 2014, the Governor of Puerto Rico signed House Bill 1189 into law, which became Act No. 238-2014 ("Act. 238"). Pursuant to Act 238, the Prepayment Period has been extended until **January 31, 2015** ("Extended Prepayment Period). Proper guidance from the Puerto Rico Treasury Department ("Treasury") is necessary to establish how participants and beneficiaries who received distributions from employee retirement plans from November 1, 2014 to December 22, 2014, may benefit from the Special Tax.

Furthermore, Act 238 amends Section 1023.21 of the PR Code to clarify the election procedure and income tax consequences of the prepayment of the Special Tax. Act 238 incorporates into the PR Code some prior guidance issued by Treasury through Administrative Determination Number 14-16 of August 6, 2014 ("AD 14-16") and Circular Letter of Tax Policy No. 14-02 of September 29, 2014 ("CL TP 14-02"), as follows:

- Participants or beneficiaries of retirement or deferred compensation plans may prepay the income tax applicable upon the accrued value of their plan benefits in such plans at a reduced rate of 8% for qualified retirement plans under Section 1081.01(a) of the PR Code and 15% for non-qualified retirement plans under Section 1081.01 (a) of the PR Code. To qualify for the Special Tax, non-qualified plans must have been adopted through a written agreement prior to November 1, 2014.

- After the prepayment of the Special Tax, the participant's basis in their plan benefits will increase by the value of the accrued benefits in the plan for which the Special Tax was prepaid. The base recovery shall be conducted in accordance with the rules established by the Secretary of the Treasury for qualified plans under Section 1081.01 of the PR Code. Plan sponsors of qualified retirement plans under Section 1081.01 must account for, and keep records of, the resulting participant's basis in their plan benefits.

- The Special Tax also applies to certain plan distributions made to participants or beneficiaries during the Prepayment Period and the Extended Prepayment Period. In the case of qualified retirement plans, the reduced tax rate of 8% applies to lump-sum distributions made on account of the participant's separation from service or termination of the plan. In the case of non-qualified retirement plans, all distributions are subject to the reduced tax rate of 15%. In any retirement plan distributions made during the Prepayment Period and the Extended Prepayment Period, the withholding agent will be required to make the applicable withholdings at the reduced tax rate (i.e., the Special Tax). Contrary to the provisions of CL TP 14-02, Act 238 does not amend the PR Code to provide that partial distributions from qualified retirement plans during the Prepayment Period and the Extended Prepayment Period are entitled to the reduced withholding tax rate of 8%.

- Subject to the provisions of the applicable plan, participants may request a partial distribution for the payment of the Special Tax. This distribution will be reported by the employer or administrator of the plan to the Secretary of the Treasury. The participant or beneficiary must include this amount in its income tax return as a non-taxable distribution. Employers who wish to amend their plans to allow participants to pay the Special Tax by using funds accumulated thereunder, must include language in such amendment as to the paying agent's obligation to issue the payment instrument (i.e., the manager's check, certified check, etc.) to the name of the Secretary of the Treasury. If the participant uses these funds for the payment of other obligations (including other taxes), the distribution will be treated as a taxable distribution subject to the tax rates applicable as of the date of the distribution.

Act. 238 amends Section 1023.23 of the PR Code to apply the Extended Prepayment Period to the prepayment of accrued and undistributed balances in individual retirement accounts ("IRA") at the reduced tax rate of 8%. In addition, the penalty on IRA distributions to participants that have not reached 60 years of age and who have elected to prepay the tax is reduced from 30% to 15% of the distributed amount.

Please refer to our previous McV Employee Benefits Alerts regarding the tax prepayment, issued on August 11, 2014 and October 1, 2014**.** Some of the rules described in prior guidance issued by Treasury may have been superseded by Act 238.

If you have any questions you may contact any of the attorneys of our Employee Benefits Practice Group listed below:

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