

Department of the Treasury  
Internal Revenue Service

200840056

DEC 21 2006

T:EP:RA:A2

A =  
B =  
Country C =  
Date D1 =  
Date D2 =  
Date D3 =  
Entity E =  
Pension Plan and Fund F =  
Organization O =  
Plan R =  
Year Y1 =  
Year Y2 =

Dear

This is in reply to your request for a ruling concerning the income tax treatment of annuity benefits receivable by you from Pension Plan and Fund F. We hereby revoke our previous letter to you dated October 13, 2006. This ruling letter replaces it completely.

According to the information submitted, you became eligible for pension annuity benefits for life commencing on Date D1, in the amount of \$ per year, payable monthly, and adjusted annually for cost of living. If B survives you, she will be entitled to annuity payments of \$ per year (also adjusted for cost of living). You also elected to have the pension fund transfer to Plan R in Country C 20% of the present value of your contract, or \$ , on Date D1. Your annuity benefit was reduced to reflect this distribution from your account. You were born Date D2. B was born Date D3.

From Year Y1 through Year Y2 you performed services for the Entity E, an agency of Organization O. During this time you were a citizen and resident of Country C. Before you retired, you contributed \$ to the Pension Fund

F. These employee contributions were includible in your gross income. Over the same period your employer contributed twice that amount to the fund on your account. These employer contributions were not includible in your income for the tax purposes of Country C. Neither Organization O nor Entity E is a U.S. employer or entity. At no time did you perform your services for your employer as a U.S. resident, or within the U.S. However, the Pension Fund F payments to you arise in the United States. Based on the above facts and representations, you requested a ruling as to the correct income tax treatment of the annuity payments as if you were a U.S. resident.

## I. INTERNATIONAL CONSIDERATIONS

Under the United States – Country C Income Tax Treaty (the Treaty), Article \_\_\_\_\_, Country C may tax its residents on pensions arising in the U.S. only to the extent such payments would be included in U.S. gross income if they had been received by a resident of the U.S. Generally, pension payments are included in gross income under section 72 of the Internal Revenue Code of 1986 (the Code), but subsection 72(b) excludes from income that portion of each payment which represents a return of the investment in the contract. The employee's own contributions which were includible in his gross income at the time contributed usually constitute his investment in the contract.

Under section 862(a)(3) of the Code, compensation for services performed outside of the U.S. is foreign source income. Employer contributions to a pension plan in respect of personal service performed outside the U.S. is treated as foreign source income. U.S. residents are subject to U.S. tax on their worldwide income, including foreign source income, under section 61 of the Code. In addition, U.S. residents are taxed on the earnings and accretions component of a distribution from a pension plan, whether the plan's trust is a domestic trust or a foreign trust.

## II. RULES APPLICABLE TO PAYMENTS UNDER ANNUITY CONTRACT

Although your annuity is finally made available to you in Country C currency, the payments arise within the U.S. and the amounts payable are first determined in U.S. currency. The following considerations treat the pension as an annuity of U.S. dollars. The amounts excludible for each year with respect to Article \_\_\_\_\_ of the Treaty by reason of U.S. exclusion from income will be the amounts determined under the exclusion rule using U.S. currency. This excludible amount remains fixed in U.S. currency, even though the gross amount received may change because of cost of living adjustments or because of changes in exchange rates. It is up to you to convert this U.S. exclusion amount to Country C values each year at the exchange rates in effect at those times.

Section 72(b) of the Code provides that gross income does not include that portion of each payment which represents a return of your investment in the

contract. For any annuity starting at Date D1 the General Rule of section 72(b) would be applicable for determining the excludible amount. However, Notice 88-118 (1988-2 C.B. 450) allowed retirees to elect to apply the simplified rule contained therein rather than the General Rule for determining the excludible amount. You have elected to use the simplified rule. The computation under this rule requires first determining the investment in the contract as of the annuity starting date.

### III. LUMP SUM PAYMENT RETURN OF INVESTMENT

Section 72(e) of the Code provides for the treatment of payments received under an annuity contract but received not as an annuity, such as lump sum distributions. Section 72(e)(2) distinguishes different treatments for a lump sum paid before or after the start of an annuity. In this case, the lump sum was paid on the same day as the annuity starting date. However, the election to receive the lump sum was made before the annuity starting date, and the annuity rate, from the first day of the annuity obligation, reflected the reduced account balance resulting from the payment of the lump sum. Section 72(d)(1)(D) provides that if a lump sum is paid from a qualified plan in connection with the commencement of an annuity, it is to be treated as being paid before the annuity starting date, even if the actual date of its transfer is not before the annuity starting date. For these purposes, your lump sum payment is treated as paid before the start of the annuity.

Under section 72(e)(8), if a lump sum payment is paid under a qualified plan before the start of the annuity, that portion of the lump sum payment is excludible from income which bears to the whole payment the same ratio as the investment in the contract bears to the account balance. With a defined benefit plan an account balance is often not available, but we will accept the present value of your contract as representative of the account balance. Since your lump sum payment was 20 percent of the present value of the contract, the total present value of the contract would have been \$ . Your employee contributions of \$ would be your investment in the contract. The ratio of the investment in the contract to the account balance would be 12.5 percent. Therefore 12.5 percent of the lump sum payment, or \$ , would have represented a return of your investment. After this, your remaining investment in the contract would be \$

### IV. ANNUITY PAYMENTS

Under the simplified Safe Harbor Rule of Notice 88-118, the monthly exclusion amount is found by dividing your investment in the contract by a divisor based on your age. Since your age at the annuity starting date was at least age 61 and below age 66, the divisor is 240. Considering your situation as if you were a U.S. resident, your contributions to the plan, reduced by the tax-free part of the lump sum payment, would constitute the remaining investment in the contract.

Therefore, your monthly exclusion amount would be \$ / 240 or \$ . This amount would be excludible from gross income for each annuity payment received under the contract, until the total amount so excluded equaled the remaining investment amount of \$ . This amount would be the exempt amount applicable under paragraph 1 of Article of the Treaty.

This ruling is limited to the issues expressly stated herein. We are expressing no opinion as to the taxability or non-taxability of any payments for a nonresident alien.

You may need to attach a copy of this ruling to the initial tax return in which you apply the above exclusion rule. We are enclosing a copy for your Country C tax return.

If you have any question concerning this matter, please contact \*\*\* (I.D. \*\*\* ) at \*\*\* (not a toll-free number). Or you may contact \*\*\*\* (I.D. \*\*\*\*), \*\*\*\*, at \*\*\*\* (also not a toll free number).

Sincerely,

**(signed) Donna M. Prestia**

Donna M. Prestia  
Manager, Actuarial Group 2  
Rulings & Agreements Technical

Enclosures

Copy of this ruling  
Notice 437  
Deleted Copy