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Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: September 15, 1995
June 21, 1995

Section 72 -- Annuities: Endowment and Life Insurance (Included v. Not Included in Gross Income)

72.00-00 Annuities: Endowment and Life Insurance (Included v. Not Included in Gross Income)

Section 871 -- Tax on Nonresident Alien Individuals

871.00-00 Tax on Nonresident Alien Individuals

871.02-00 Tax on Nonresident Aliens

871.02-12 Certain Annuities Received Under Qualified Plans

Section 894 -- Income Affected by Treaty

894.00-00 Income Affected by Treaty

894.07-00 Transportation and Shipping Income (See Also 872.03, 883.01, & 9114.08-00)

894.07-01 Income Exempt by Treaty

INTL-0366-93

U.S. Corp = ***

U.S. Plan = ***

FS = ***

Foreign Plan = ***

Plan Administrator = ***

Fund Manager = ***

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Country A = ***

Dear ***

This responds to your letter, dated April 5, 1993, requesting rulings concerning the taxation of distributions from a U.S. profit-sharing plan to participants who are nonresident alien individuals. Additional information was provided in letters dated March 1, August 3, October 12, and October 18, of 1994.

The rulings contained in this letter are based upon information and representations submitted by the U.S. Plan and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information and representations may be required upon examination.

Facts

U.S. Corp is a U.S. corporation that makes contributions on behalf of its employees to U.S. Plan, a trust forming part of a profit-sharing plan under section 401(a) and exempt under section 501(a). U.S. Corp's subsidiary corporation, FS, located in Country A, also made contributions to the U.S. Plan on behalf of its employees, all of whom have been at all times residents of Country A. In order that FS's contributions to the U.S. Plan would receive tax-deferred status in Country A, the U.S. Plan was registered in Country A. U.S. Corp represents that more than 90 percent of all the employees for whom contributions or benefits are provided under the plan are citizens or residents of the United States.

U.S. Corp also represents that FS's contributions to the U.S. Plan were solely for services performed by its employees outside the United States. Further, no tax deductions for these contributions have been taken in the United States by U.S. Corp or any affiliated company. U.S. Corp represents that a few of FS's employees made minimal employee contributions to the U.S. Plan.

On December 15, 1992, changes in Country A law came into effect regarding the tax-deferred status of defined contribution plans. U.S. Corp determined that to continue to register the U.S. Plan in Country A, amendments would have to be made to the U.S. Plan that might jeopardize its tax-deferred status in the United States. Therefore, U.S. Corp decided that it would not continue to register the U.S. Plan in Country A. Instead, U.S. Corp established Foreign Plan. FS's employees ceased to be active participants in the U.S. Plan on January 1, 1991.

To permit the Country A participants in the U.S. Plan to continue to accumulate earnings on their U.S. Plan account balances on a tax-deferred basis in Country A, U.S. Corp, FS, and the Plan Administrator propose the following. Country A participants will be permitted to elect to receive their entire account balances in the U.S. Plan in five quarterly distributions made over a period of more than one year. The participants may also elect to contribute these amounts to a "locked-in" Registered Retirement Savings Plan (RRSP). Country A participants who do not make this election will be subject to tax in Country A on the distributions.

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If a Country A participant elects to receive his account balance in installments, the Plan Administrator will invest the participant's account balance in the GIC Fixed Income Fund (GIC Fund). The GIC Fund is one of several investment alternatives available to participants of the U.S. Plan. The GIC Fund is managed by the Fund Manager, the trustee of the U.S. Plan, and invests primarily in contracts that provide a specified rate of return for a fixed period of time and a repayment of the principal at the end of the term.

The Plan Administrator will make the first distribution on the last day of the calendar quarter in which a participant makes the election to receive his or her account balance. The remainder of the participant's account balance will be distributed in four subsequent quarterly payments, totaling five payments in all. The election will become effective on the date of the first distribution, which is also the date that the balance of the participant's account will be invested in the GIC Fund. Even though a participant may make an election prior to the initial distribution, such election can be revoked by the participant until the date of the first distribution.

The amounts of the five quarterly payments will be computed at the outset of the distribution period based on a projected rate of return determined by the Fund Manager. The rate used in the computation will be one percentage point below the rate of return of the GIC Fund predicted by the Fund Manager for the distribution period. The initial distribution will equal one fifth of the balance of the participant's account. Each subsequent distribution will equal one fifth of the balance of the account, plus the interest earned during that quarter at the projected rate of return. The amount, if any, by which the GIC Fund provides a return in excess of the projected rate of return will be distributed in a sixth payment.

Analysis

Section 871(f) provides, in part, that gross income shall not include any amount received as an annuity from a qualified trust described in section 401(a) which is exempt from tax under section 501(a), if the following conditions are met:

- (1) all the personal services by reason of which the annuity is payable were performed outside the United States by an individual who, at the time of the performance of the personal services, was a nonresident alien individual; and
- (2) at the time the first amount is paid as an annuity by the trust, 90 percent or more of the employees for whom contributions or benefits are provided under the plan of which the trust is a part, are citizens or residents of the United States.

U.S. Corp represents that the U.S. Plan is a profit-sharing plan that is qualified under section 401(a) and that the income of the trust under the plan is exempt from tax under section 501. U.S. Corp also represents that all the personal services for which contributions to the U.S. Plan were made were performed outside the United States by nonresident alien individuals. Moreover, U.S. Corp represents that more than 90 percent of the participants in the U.S. Plan are citizens or residents of the United States. Therefore, if the distributions from the U.S. Plan qualify as an "amount received as an annuity", the entire amount of the distributions will be excluded from gross income under section 871(f). Section

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871(f) does not define the phrase "amount received as an annuity." Section 72 and the regulations thereunder, however, contain a definition of the phrase "amounts received as an annuity."

Section 72(a) generally provides that gross income includes "any amount received as an annuity" under a life insurance, endowment, or annuity contract unless such amounts are specifically excluded from gross income under other provisions of Chapter 1 of the Code. Section 1.72-2(b)(2) of the regulations provides that amounts subject to section 72 of the Code are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) They are received on or after the "annuity starting date" as that term is defined in section 1.72-4(b);

(ii) They are payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly weekly, or otherwise) over a period of more than one full year from the annuity starting date; and

(iii) Except as indicated in subparagraph (3), the total amounts payable are determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Section 1.72-4(b) of the regulations provides that the annuity starting date is generally the first day of the first period for which an amount is received as an annuity. The first day of the first period for which an amount is received as an annuity is the later of:

(i) The date upon which the obligations under the contract became fixed; or

(ii) The first day of the period (year, half-year, quarter, month or otherwise, depending on whether payments are to be made annually, semi-annually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

If a distribution is not received as an annuity after the annuity starting date, then (except as provided in section 72(e)(5)(E)), the distribution is included in gross income unless another provision of subtitle A of the Code (Income Taxes) applies. Section 72(e)(1) and (2). Section 1.72-2(b)(2) of the regulations provides that if an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, the payments determinable at the outset by means of computations involving the fixed interest rate may qualify as amounts received as an annuity. Any payments of amounts earned in excess of the fixed rate that are made after the period used to compute the annuity do not qualify as annuity payments.

The U.S. Plan will make quarterly payments with the first payment made on the last day of the quarter in which the Country A participant elects to receive distributions. The obligations of the U.S. Plan to the Country A participants therefore become fixed on the date a participant's election becomes effective, which is also the date of the first distribution. Therefore, the last day of the quarter in which a participant makes the election will be the "annuity starting date."

The remaining four payments will be made over the succeeding four quarters. The

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last payment will be made on the last day of the quarter ending one year and one day after the date the first payment is made, and thus one year and one day after the annuity starting date. Therefore, the payments are payable in periodic installments at regular intervals (quarterly) over a period of more than one full year from the annuity starting date.

The total amount of the payments will be the amount of the balance of the participant's account as of the annuity starting date plus the projected rate of return. The projected rate of return is a fixed interest amount determined as of the annuity starting date. Thus, the total amounts payable will be determinable at the annuity starting date from the terms of the contract and by the use of compound interest computations, in conjunction with the contracted terms and in accordance with sound actuarial theory. Because the five quarterly payments satisfy the three requirements of section 1.72-2(b)(2), they will be treated as "amounts received as an annuity" under section 72. The entire amount of these payments therefore will be excluded from gross income under section 871(f).

To the extent the actual earnings of a participant's account exceed the amount determined at the annuity starting date, the excess earnings will be distributed in a sixth payment after the last scheduled payment. This distribution, if necessary, will be an amount not received as an annuity because it will not have been determinable at the annuity starting date. Because the sixth payment will not be an amount received as an annuity, section 871(f) will not exclude the amount of the payment from gross income.

The distributions that do not qualify as an annuity are subject to tax at a rate of 30 percent under section 871(a) of the Code, unless an income tax treaty to which the United States is a party provides for a reduced rate of tax. Section 894(a). The tax is collected by withholding at source under section 1441(a).

Article 18 of the income tax treaty between the United States and Country A (the Treaty) provides that a pension payment made to a resident of Country A within the United States is subject to a U.S. tax not to exceed 15 percent of the gross amount. Article 18(3) defines a pension payment, in part, as any payment under a superannuation, pension, or retirement plan.

The United States attaches a condition of retirement to its meaning of the term "pension". Rev. Rul. 71-478, 1971-2 C.B. 490. Since no such condition attaches to the distribution of amounts from the U.S. Plan to the Country A participants, such amounts being distributed upon demand by the participants electing to receive the funds, we believe that the sixth payment (of the excess earnings) from the U.S. Plan does not constitute a pension payment, but rather qualifies as "other income" under Article 22 of the Treaty.

Article 22 of the Treaty provides that items of income of a resident of Country A, wherever arising, not dealt with in the other articles of the Treaty, are taxable only in Country A, except that if such income arises in the United States it may also be taxed in the United States. To the extent the income is distributed by a trust resident in the United States to a beneficiary resident in Country A, the tax imposed by the United States may not exceed 15 percent of the gross amount of the income.

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Section 1.1441-6(a) of the regulations provides that the 30 percent withholding tax under section 1441 will be reduced as provided by a treaty. Section 1.1441-6(c)(1) provides that to secure a reduced rate of withholding under a treaty on a payment of income other than coupon bond interest and dividends, the recipient must file Form 1001 (Ownership, Exemption, or Reduced Rate Certificate) with the withholding agent. Form 1001 must contain a statement that the owner of the income is entitled to a reduced rate of tax under the Treaty. Therefore, upon receipt of a properly completed Form 1001 from a Country A participant, the Plan Administrator may withhold at the reduced treaty rate of 15 percent on the sixth payment (of the excess earnings) to that participant.

Accordingly, based solely on the facts and representations submitted, it is held as follows:

(1) The amounts of each of the five quarterly distributions from the U.S. Plan to participants resident in Country A will be considered as "amounts received as an annuity" under section 72 and excluded from their U.S. gross income under section 871(f) of the Code.

(2) The Plan Administrator is not required to withhold tax on distributions that qualify as amounts received as an annuity excluded from gross income under section 871(f). Section 1441(c)(7).

(3) Any distribution of earnings in excess of the projected rate of return used to compute the annuity, which will be paid in the sixth payment, is subject to U.S. tax at the rate of 15 percent under Article 22 (Other Income) of the Treaty.

(4) Upon receipt of a properly completed Form 1001 from a Country A participant, the Plan Administrator may withhold at the reduced treaty rate of 15 percent on the sixth payment made to that participant. Section 1.1441-6(c).

In accordance with the Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any federal income tax return to which it is relevant.

This ruling is directed only to the taxpayer requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

No opinion is expressed as to the federal tax consequences of the distributions described above under any other provision of the Code.

Sincerely Yours,

Philip L. Garlett

Senior Technical Reviewer

Branch 6

Office of Associate Chief

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Counsel (International)

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

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