Significant Index Number 0072.00-00

200711022

Department of the Treasury
Internal Revenue Service

DEC 21 2006

T: EP: RA: T: A2

A =
B =
Country C =
Date D1 =
Date D2 =
Date D3 =
Entity E =
Pension
Organization O =
Year Y1 =
Year Y2 =

Dear

This is in reply to your request for a ruling concerning the income tax treatment of certain annuity benefits receivable by you from a pension plan. We hereby revoke our previous letter to you dated October 12, 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. B became entitled to annuity payments of $ per year, payable monthly (also adjusted for cost of living) for such time as she survives you. You elected to have the pension fund transfer to an Individual Retirement Account one third 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 all of this time you were a citizen of the U.S. and a resident of Country C. Before you retired, you contributed $ to 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 U.S. tax purposes. Neither Organization O nor Entity E is a U.S. employer or entity. Based on the above facts and representations, you requested a ruling as to the correct income tax treatment of the annuity payments for U.S. income tax purposes.

ANALYSIS OF LAW

Generally, pension payments are includible 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, as defined in section 72(c).

Section 72(f) also provides that employer contributions to the pension plan are part of the investment in the contract if they would have been excludible from the employee's gross income had they been paid directly to the employee. However, this provision does not apply if the contributions were made for services rendered after 1962 and if the excludability from gross income would have been by reason of the section 911 foreign income exclusion. (See Rev. Rul. 71-436, 1971-2 C.B. 85) In your case the employer contributions were for service after 1962 and had they been paid directly to you they would have been includible in your gross income but for the application of section 911 of the Code. Therefore, these amounts are not part of your investment in the contract.

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

Therefore, your annuity benefits are entirely includible in gross income except for that portion of each payment which represents a return of your employee contributions. For a pension starting at Date D1 the exclusion amount is determined under the Simplified Method of section 72(d) of the Code, based on the ages of the retiree and survivor annuitant, and based on the total amount of the investment in the contract reduced by any investment amounts recovered before the annuity starting date. The excludible amount remains fixed in terms of U.S. currency, although this amount may vary with the exchange rate with Country C currency. The amount includible in income will also vary due to the receipt of cost of living adjustments, which are fully includible in income for U.S. purposes.

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) of the Code, 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 one third percent of the present value of the contract, the total present value of the contract would have been $. Your employee contributions of $ were your investment in the contract. The ratio of the investment in the contract to the account balance at that time was ___ percent. Therefore percent of the lump sum payment, or $ represented a return of your investment. After this, your remaining investment in the contract was $.

ANNUITY PAYMENTS

Under the Simplified Method of section 72(d) of the Code, the monthly exclusion amount is found by dividing your investment in the contract by a divisor based on the combined ages of A and B. Since the sum of these ages was at least and less than ____ the divisor is . Your remaining investment in the contract as reduced by the tax-free part of the lump sum payment was $ Therefore, your monthly exclusion amount is $ / or $. This amount is excludible from gross income for each annuity payment you receive, until the total amount so excluded equaled the remaining investment amount of $. After this amount has been excluded the annuity amounts will be fully includible in your gross income.

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 should attach a copy of this ruling to the initial tax returns in which you apply the exclusion determined above. We are enclosing a copy for your U.S. return and a copy for your Country C 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
Two copies of this ruling
Notice 437
Deleted Copy