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B. U.S. Income Taxation

1. General Rule

a. Code §933 Exclusion

Individuals born in P.R. are U.S. citizens. [574] Thus, they are, in principle, subject to U.S. taxation on their worldwide income, including distributions from retirement plans. [575] Resident aliens who are bona fide residents of P.R. during the entire taxable year also are subject to U.S. taxation on their worldwide income. [576]

However, Code §933 provides important exclusions from U.S. income taxation in the case of the income from sources within P.R. received by current and even former bona fide residents of P.R. Pursuant to Code §933(1), income from sources within P.R. is exempt from the payment of U.S. income tax if received by an individual who is a bona fide resident of P.R. for the entire taxable year, whether or not the individual is a U.S. citizen. Under Code §933(2), in the case of a U.S. citizen (but not a resident alien) who has been a bona fide resident of P.R. for a period of at least two years before the date on which he or she changes residence from P.R., the income derived from sources within P.R. that is attributable to the period of P.R. residence is exempt from the payment of U.S. income taxes. The exemption under Code §933(2) only applies if the P.R. source income is received during the taxable year of the change of residence (i.e., P.R. source income received after the end of the year in which the payee moved out of P.R. is subject to the payment of U.S. income taxes). [577] Amounts received for services performed in P.R. as an employee of the U.S. government or its agencies are not exempt under Code §933(1) or (2) and, thus, are always subject to the payment of U.S. income taxes.

Following the principles of Code §933(1), participants or beneficiaries who are bona fide residents of P.R. during the entire taxable in which the distribution takes place are not required to pay any U.S. income taxes on the portion of their retirement benefits that is income from sources within P.R., but they must pay U.S. income taxes on the portion, if any, which is U.S. source income. This exemption applies whether the payee is a U.S. citizen or a resident alien. Under Code §933(2), a similar exemption from U.S. taxation applies to those participants and beneficiaries who are U.S. citizens, were bona fide residents of P.R. for two years before the date of distribution, and receive the distribution of their plan benefits during the year in which they move out of P.R. As detailed below, the determination of the P.R. and U.S. source portions of distributions from retirement plans in P.R. requires splitting the distribution between its employer and employee contributions component and its investment earnings component.

b. Code Definition of Bona Fide Resident of Puerto Rico

Historically, the determination of whether an individual was a bona fide resident of a U.S. possession, including P.R., turned on the facts and circumstances of the case, particularly the individual's intentions with respect to the length and nature of his stay in

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the possession. Effective for taxable years beginning after October 22, 2004, the American Jobs Creation Act of 2004 [578] changed the bona fide residence rule for individuals with income from a U.S. possession by enacting Code §937.

Pursuant to Code §937(a), an individual is considered a bona fide resident of P.R. only if he or she satisfies the following three conditions:

(1) The individual is physically present in P.R. for at least 183 days during the taxable year (the physical presence test);

(2) The individual does not have a tax home outside P.R. during the taxable year (the tax home test); and

(3) The individual does not have a closer connection to the U.S. or a foreign country than to P.R. (the closer connection test).

The IRS issued final regulations under Code §937 in January 2006. [579] The IRS modified and redesignated certain provisions of these final regulations in November 2006. [579.1]

(1) **Physical Presence Test**

A U.S. citizen or resident alien satisfies the physical presence test under Code §937(a) for a taxable year if the person:

(1) was present in P.R. for at least 183 days during the taxable year; [580]

(2) was present in P.R. for at least 549 days during the three-year period consisting of the taxable year and the two immediately preceding taxable years, provided that the individual was also present in P.R. for at least 60 days during each taxable year of the period; [580.1]

(3) was present in the U.S. for no more than 90 days during the taxable year; [581]

(4) during the taxable year had earned income in the U.S. not exceeding the amount specified in Code §861(a)(3)(B) ($3,000) and was present for more days in P.R. than in the U.S.; [582] or

(5) had no significant connection to the U.S. during the taxable year. [583]

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For these purposes, an individual is considered to be present in P.R. on:

(1) any day that the individual is physically present in P.R. at any time during the day;

(2) any day that an individual is outside of P.R. to receive, or to accompany on a full-time basis, a parent, spouse or child (as defined in Code §152(f)(1)) who is receiving qualifying medical treatment; and

(3) any day that an individual is outside P.R. because the individual leaves or is unable to return to P.R. during any (a) 14-day period within which a major disaster occurs in P.R. for which a Federal Emergency Management Agency Notice of a Presidential declaration of a major disaster is issued in the Federal Register, or (b) period for which a mandatory evacuation order is in effect for the geographic area in P.R. in which the individual's place of abode is located. [584]

An individual is considered to be present in the U.S. on any day that the individual is physically present in the U.S. at any time during the day. However, the following days will not count as days of presence in the U.S.:

(1) any day that an individual is temporarily present in the U.S. under circumstances described in (2) or (3) above;

(2) any day that an individual is in transit between two points outside the U.S. (as described in Treas. Regs. §301.7701(b)-3(d)) and is physically present in the U.S. for fewer than 24 hours;

(3) any day that an individual is temporarily present in the U.S. as a professional athlete to compete in a charitable sports event (as described in Treas. Regs. §301.7701(b)-3(b)(5));

(4) any day that an individual is temporarily present in the U.S. as a student (as defined in Code §152(f)(2)); and

(5) in the case of an individual who is an elected representative of P.R., or who serves full time as an elected or appointed official or employee of the government of P.R. (or any political subdivision thereof), any day spent serving P.R. in that role. [585]

If, during a single day, the individual is present in both the U.S. and P.R., that day is considered a day of presence in P.R. [586]

Example: H, a U.S. citizen engaged in a profession that requires frequent travel, spends 195 days of each of the years 2005 and 2006 in P.R. In 2007, H spends 160 days in P.R. H satisfies the presence test with respect to P.R. for taxable year 2007. Assuming that, in 2007, H does not have a tax home outside of P.R. and does not have a closer connection to the

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U.S. or a foreign country, then regardless of whether H was a bona fide resident of P.R. in 2005 and 2006, H is a bona fide resident of P.R. for taxable year 2007. [586.1]

The term “significant connection to the U.S.” means:

(1) a permanent home in the U.S.;

(2) current registration to vote in any political subdivision of the U.S.; or

(3) a spouse (but not a spouse from whom the individual is legally separated under a decree of divorce or separate maintenance) or child (as defined in Code §152(f)(1)) under the age of 18 whose principal place of abode is in the U.S., other than (a) a child who is in the U.S. because the child is living with a custodial parent under a custodial decree or multiple support agreement, or (b) a child who is in the U.S. as a student (as defined in Code §152(f)(2)). [587]

Example: W, a U.S. citizen, lives for part of the taxable year in a condominium, which she owns, located in P.R. W also owns a house in the U.S. where she lives for 120 days every year to be near her grown children and grandchildren. W is retired, and her income consists solely of pension payments, dividends, interest and Social Security benefits. For 2006, W is only present in P.R. for a total of 175 days because of a 70-day vacation to Europe and Asia. Thus, for taxable year 2006, W is not present in P.R. for at least 183 days, is present in the U.S. for more than 90 days, and has a significant connection to the U.S. by reason of her permanent home. However, W still satisfies the presence test with respect to P.R. because she has no earned income in the U.S. and is present for more days in P.R. than in the U.S. [588]

(2) **Tax Home Test**

An individual satisfies the tax home test under Code §937(a) with respect to P.R. for a taxable year if the individual did not have a tax home outside P.R. during any part of the taxable year. For these purposes, an individual's “tax home” is considered to be located at the individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of the business or because the individual is not engaged in carrying on any trade or business, then the individual's tax home is the individual's regular place of abode “in a real and substantial sense.” [589] Any days spent in the U.S. as a full-time student or as an elected representative or official of the government of P.R. are disregarded in determining whether an individual has a tax home outside P.R. [590]

Example: P, a U.S. citizen, is a permanent employee of a hotel in P.R. but works only during the tourist season. For the remainder of each year, P lives with her husband and children in the U.S. Virgin Islands (“U.S.V.I.”), where she has no outside employment. Most of P's personal belongings, including her car, are located in the U.S.V.I. P is registered to vote in, and has a driver's license issued by, the U.S.V.I. P does her banking in the U.S.V.I. and routinely lists her U.S.V.I. address on forms and documents. P satisfies the physical presence test with respect to both P.R. and the U.S.V.I. because, among other reasons, she does not spend more than 90 days in the U.S. during the taxable year. P satisfies the tax home test only with respect to P.R. because her regular place of business is in P.R. [591]

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(3) **Closer Connection Test**

An individual satisfies the closer connection test under Code §937(a) for a taxable year if the individual did not have a closer connection to the U.S. or a foreign country than to P.R. during any part of the taxable year. [592] For these purposes, an individual's connections to P.R. are compared to the aggregate of the individual's connections with the U.S. and foreign countries. [593] Thus, an individual's closer connection to a U.S. possession does not preclude him or her from having a closer connection to P.R. In determining whether an individual has maintained a closer connection to the U.S./foreign country than to P.R., the facts and circumstances to be considered include, but are not limited to, the following: [594]

(1) the location of the individual's permanent home; [595]

(2) the location of the individual's family; [596]

(3) the location of personal belongings, such as automobile, furniture, clothing and jewelry owned by the individual and his or her family; [597]

(4) the location of social, political, cultural or religious organizations with which the individual has a current relationship; [598]

(5) the location where the individual conducts his or her routine personal banking activities; [599]

(6) the location where the individual conducts business activities (other than those that constitute the individual's tax home); [600]

(7) the location or jurisdiction in which the individual holds a driver's license; [601]

(8) the location or jurisdiction where the individual votes; [602] and

(9) the country of residence the individual designates on forms and documents. [603]

Thus, in the previous example, because P does not have a closer connection to the U.S. or a foreign country (for these purposes the U.S.V.I. is not considered as either the U.S. or a foreign country), she satisfies the closer connection test with respect to both P.R. and the U.S.V.I. Therefore, P is a bona fide resident of P.R. [604]

Example: Z, a U.S. citizen, relocates to P.R. to start an investment consulting and venture capital business. Z's wife and two teen-aged children remain in State C in the U.S. to allow the children to complete high school. Z travels back to the U.S. regularly to see his wife and children, to engage in business activities and to take vacations. He has an apartment available for his full-time use in P.R., but he remains a joint-owner of the residence in State C where his wife and children reside. Z and his family have automobiles and personal belongings such as furniture, clothing and jewelry located at both residences. Although Z is a member of the P.R. Chamber of Commerce, Z also belongs to and has current relationships with social, political, cultural and religious organizations in State C. Z receives mail in State C, including brokerage statements, credit card bills and bank advices. Z conducts his personal banking activities in State C, holds a State C driver's license, and is registered to vote in State C. Z is not a bona fide resident of P.R. because he has closer connection to the U.S. than to P.R. [605]

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(4) **Change in Residence**

For the taxable year in which an individual changes his or her residence by moving to P.R., the individual satisfies the tax home and closer connection tests if:

(1) for each of the three taxable years immediately preceding the taxable year of the change of residence, the individual is not a bona fide resident of P.R;

(2) for each of the last 183 days of the taxable year of the change of residence, the individual does not have a tax home outside P.R. or a closer connection to the U.S. or a foreign country than to P.R.; and

(3) for each of the three taxable years immediately following the taxable year of the change of residence, the individual is a bona fide resident of P.R. [606]

Example: D, a U.S. citizen, files returns on a calendar year basis. From January 2003 through May 2006, D resides in State R. In June 2006, D moves to P.R., purchases a house, and accepts a permanent position with a local employer. D's principal place of business from July 1 through December 31, 2006 is in P.R., and during that period (which totals at least 183 days), D does not have a closer connection to the U.S. or a foreign country than to P.R. For the remainder of 2006, and throughout years 2007 through 2009, D continues to live and work in P.R. and maintains a closer connection to P.R. than to the U.S. or any foreign country. D satisfies the tax home and closer connection tests for 2006. Accordingly, assuming that D also satisfies the presence test under the regulations, D is a bona fide resident of P.R. for all of taxable year 2006. [607]

Under the regulations, the rule that applies when an individual moves away from P.R. is different than the rule applicable to individuals moving away from other U.S. possessions. [608] Under this rule, notwithstanding such an individual's failure to satisfy the presence, tax home or closer connection test for the taxable year, the individual is a bona fide resident of P.R. for that part of the taxable year preceding the date on which the individual ceases to have a tax home in P.R. if the individual:

(1) is a citizen of the U.S.;

(2) is a bona fide resident of P.R. for a period of at least two taxable years immediately preceding the taxable year;

(3) ceases to be a bona fide resident of P.R. during the taxable year;

(4) ceases to have a tax home in P.R. during the taxable year; and

(5) has a closer connection to P.R. than to the U.S. or a foreign country throughout the part of the taxable year preceding the date on which the individual ceases to have a tax home in P.R.

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Example: R, a U.S. citizen who files returns on a calendar year basis, satisfies the presence, tax home and closer connection tests under the regulations for years 2006 and 2007. From January through April 2008, R continues to reside and maintain his principal place of business in and closer connection to P.R. On May 5, 2008, R moves and changes his principal place of business (tax home) to State N and later that year establishes a closer connection to the U.S. than to P.R. R does not satisfy the presence test for 2008 with respect to P.R. Moreover, because R had a tax home outside of P.R. and establishes a closer connection to the U.S. in 2008, R does not satisfy the tax home or closer connection tests for 2008. However, because R was a bona fide resident of P.R. for at least two taxable years before his change of residence to State N in 2008, he is a bona fide resident of P.R. from Jan. 1 through May 4, 2008. [609]

2. Sourcing of Distributions

a. Contributions Portion

There are no specific Code provisions establishing the source of income resulting from retirement plan distributions, but over the years, the following rules have been developed. Employer and employee contributions to a retirement plan are considered a form of compensation for services rendered. [610] Accordingly, the portion of a distribution attributable to employer/employee contributions to the plan is sourced based on the place where the employee rendered the services with respect to which the contributions were made. [611] If the services were rendered exclusively in P.R., that portion would be considered P.R. source income and, as mentioned above, would not be subject to U.S. income taxes if received: (1) by a participant or beneficiary who is a bona fide resident of P.R. during the entire year in which the distribution takes place; or (2) during the taxable year of the change of residence from P.R. to the U.S., a U.S. possession, or a foreign country, by a participant who is a U.S. citizen and was a bona fide resident of P.R. for two years before the date of distribution. If the services are rendered partly in P.R. and partly in the U.S., it is necessary to allocate the source of the contributions between the two jurisdictions based on their respective portions of the total services rendered (e.g., by the ratio of days worked in each jurisdiction to the total number of days worked during the year to which the contributions relate). [612]

b. Investment Earnings Portion

(1) Trust Funded Plans

In the case of a plan funded through a trust fund, the source of the investment earnings portion of a distribution is determined by the situs or location of the trust. [613] If a trust is located in P.R., the investment income is from sources within P.R. Likewise, the use of a U.S. trust results in the investment income being from sources within the U.S.

Before January 1, 1997, the determination of whether a trust was located in the U.S. was made using a facts-and-circumstances analysis based on factors such as location of the assets, nationality of the trustee and beneficiaries, location of the administrative activities, and jurisdiction under whose laws the trust was created. [614]

Effective for taxable years beginning on or after January 1, 1997, such determination must be made following the trust residency rules enacted as part of the Small Business Job Protection Act of 1996. [615] These rules provide that a trust is a U.S. person if:

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(1) a court within the U.S. is able to exercise primary supervision over the administration of the trust (referred to as the "court test"); [616] and

(2) one or more U.S. persons have authority to control all substantial decisions of the trust (referred to as the "control test"). [617]

If either of these two tests is not met, the trust is a foreign person, and its income is generally not from sources within the U.S. [618]

For purposes of the court test, the term "U.S." is used in a geographical sense to include only the States and the District of Columbia. Accordingly, a court within a territory or possession of the U.S. (e.g., P.R.) is not a court within the U.S. [619] The term "able to exercise" means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust; [620] the term "primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust; [621] and the term "administration" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records, filing tax returns, managing and investing the assets of the trust, defending the trust from suits from creditors, and determining the amount and timing of distributions. [622]

Since it would be difficult to identify which court could have primary supervision over the administration of a trust absent an actual lawsuit involving the trust, the trust residency regulations provide a safe harbor for meeting the court test. Under this safe harbor, a trust satisfies the court test if: (1) the trust instrument does not direct that the trust be administered outside the U.S.; [623] (2) the trust in fact is administered exclusively in the U.S.; [624] and (3) the trust is not subject to an automatic migration provision (i.e., a provision in the trust instrument pursuant to which a U.S. court's attempt to assert jurisdiction or otherwise supervise the administration of the trust would cause the trust to migrate from the U.S., so that no U.S. court would have jurisdiction over the trust.) [625]

The substantial decisions of the trust over which U.S. persons must have control in order for the trust to satisfy the control test include, but are not limited to: whether and when to make distributions; the amount of any distributions; the selection of beneficiaries; the termination of the trust; the removal, addition and replacement of the trustee; the appointment of a successor trustee; and the hiring and firing of an investment manager. [626] For these purposes, a "U.S. person" includes a U.S. citizen or resident alien, a U.S. corporation or partnership, a U.S. estate, and a U.S. trust. [627]

Applying the foregoing rules to a trust forming part of a P.R.-only qualified plan, the IRS found that if the trustee is a resident of P.R. and the trust agreement grants the trustee ultimate responsibility for the administration of the trust, primary supervision over the administration of the trust rests with the courts in P.R., and no court within the U.S. would have primary supervision over the administration of the court. Thus, the trust was classified as a P.R. trust, and its investment income was from sources within P.R. [628]

(2) **Annuity Funded Plans**

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The IRS has held that because Code §861(a) does not include rules specifying the source of income received under a life insurance or annuity contract under Code §72, the source of such income is determined by comparison and analogy to the sourcing rules for interest, dividends, and earnings and accretions on pension funds assets. Basically, these items of income are U.S. (or foreign) income when the obligor, corporation, or trust, respectively, is a U.S. (or foreign) person. Accordingly, income received under a life insurance or annuity contract is U.S. (or P.R.) source income when the issuer of the contract is a U.S. (or P.R.) insurance company. Payments to bona fide residents of P.R. with respect to life insurance and annuity contracts issued by a P.R. branch of a U.S. life insurance company are U.S. source income, and thus, they are not excludible from gross income under Code §933. [629]

3. **Implementation of Sourcing Rule to Defined Benefit Plans**

While implementation of the general sourcing rule mentioned above does not present major problems with regard to distributions from defined contribution plans, the same cannot be said with regard to distributions from defined benefit plans. In defined contribution plans, a separate recordkeeping account within the trust is created for each participant, and the amount of a participant's benefits is determined by the balance of his account. At any given point in time, it is possible for a plan sponsor, trustee or paying agent to identify the portion of a participant's account attributable to employer/employee contributions (which is sourced based on the location where the participant rendered the services leading to the contributions) and the portion attributable to investment earnings (which is sourced based on the location of the trust), thus making implementation of the general sourcing rule administratively feasible.

In the case of defined benefit plans, it is extremely difficult, if not impossible, to split benefit distributions into their employer/employee contributions and investment earnings components. Participants in such plans do not have separate accounts within the trust, but rather, a right to receive in the future a specific amount established under the plan's benefits formula. No matter how well or poor the trust's investment performance, participants will end up receiving the same benefit amount. Furthermore, employer contributions to defined benefit plans are not made for the benefit of specific participants but are made based on the aggregate funding liabilities with respect to all participants (i.e., to the plan as a whole), and all plan assets are available to provide benefits to any given participant. Accordingly, in these plans, it is not possible to allocate actual contributions to specific participants or to segregate distributions between contributions and earnings.

To address this situation, in Rev. Proc. 2004-37, [630] the IRS provided a method that plan sponsors, trustees and paying agents may use for determining the U.S. and P.R. source of pension payments to P.R. participants and beneficiaries in dual-qualified plans funded through a U.S. trust (i.e., when P.R. employees are allowed to participate in the employer's U.S. qualified pension plan). [631] Although use of this method is technically optional, the IRS has indicated that it will not issue private letter rulings regarding any sourcing method that is inconsistent with this revenue procedure. [632] In practice, this means that, except for those plan sponsors, if any, willing to assume the risk of adverse tax consequences for using another method, the IRS-sanctioned method is likely to become the only one used for these purposes.

Under the IRS method, the amount of total contributions to a defined benefit plan for the benefit of a given P.R. participant is deemed to be the product of the following three items multiplied by one another, each determined as of the annuity stating date: [633]

(1) the present value of the participant's pension payable at the annuity starting date;

(2) the amount in Table I below based on the number of years from the first date of plan participation to the annuity starting date (representing the amount that, when contributed on an annual basis, will accumulate to $1.00 at the annuity starting date); and

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(3) the number of years from the first date of plan participation to the annuity starting date.

The method for calculating the present value of a participant's pension varies depending on the form of payment, as follows. [634] If the pension is paid in a straight life annuity commencing at the annuity starting date, the present value is the product of: (a) the amount payable annually, multiplied by (b) the value from Table II below, based on the participant's age at the annuity starting date, of an annuity of $1.00 per annum payable in equal monthly installments during the participant's life. If the pension is paid in a lump-sum payment of the total benefits as of the annuity starting date, the present value is the amount of the payment. If the pension is paid in any other form, the present value is the actuarial present value of the pension, determined based on a 7% interest rate and the mortality table in Rev. Rul. 2001-62. [635]

The portion of each payment that is deemed to be attributable to contributions for services rendered in P.R., thus treated as P.R. source income, is equal to the quotient of: (1) the product of (a) the total deemed contributions for the participant's benefit (as determined above), multiplied by (b) a fraction, the numerator of which is the months of service credited under the plan rendered in P.R., and the denominator of which is the total months of service credited under the plan as of the annuity starting date (i.e., prorated based on months of service rendered in P.R.); divided by (2) the present value of the participant's pension at the annuity starting date (as determined above). The remainder of the pension, which represents the sum of deemed contributions for services rendered within the U.S. plus earnings on all contributions, is treated as U.S. source income. [636] Certain special rules apply if the participant has made after-tax contributions to the plan. [637]

Table I — Amount that, when contributed on an annual level basis, will accumulate to $1.00 at the annuity starting date, based on the total number of years from the date the participant began participation to the annuity starting date. [638]

Number of Years	Amount	Number of Years	Amount
1	$1.0000	26	0.0146
2	0.4831	27	0.0134
3	0.3111	28	0.0124
4	0.2252	29	0.0115
5	0.1739	30	0.0106
6	0.1398	31	0.0098
7	0.1156	32	0.0091
8	0.0975	33	0.0084
9	0.0835	34	0.0078
10	0.0724	35	0.0072
11	0.0634	36	0.0067
12	0.0559	37	0.0062
13	0.0497	38	0.0058
14	0.0443	39	0.0054
15	0.0398	40	0.0050
16	0.0359	41	0.0047
17	0.0324	42	0.0043
18	0.0294	43	0.0040
19	0.0268	44	0.0038
20	0.0244	45	0.0035

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21	0.0223	46	0.0033
22	0.0204	47	0.0030
23	0.0187	48	0.0028
24	0.0172	49	0.0026
25	0.0158	50	0.0025

Table II — Value of an annuity of $1.00 per annum payable in equal monthly installments during the life of the participant, based on the participant's age at the annuity starting date. [639]

Age at Annuity Starting Date	Value	Age at Annuity Starting Date	Value
40	$13.61	61	10.88
41	13.54	62	10.68
42	13.46	63	10.48
43	13.38	64	10.27
44	13.29	65	10.06
45	13.20	66	9.84
46	13.11	67	9.62
47	13.00	68	9.40
48	12.89	69	9.17
49	12.78	70	8.93
50	12.66	71	8.69
51	12.53	72	8.44
52	12.40	73	8.18
53	12.25	74	7.92
54	12.11	75	7.65
55	11.95	76	7.38
56	11.79	77	7.10
57	11.62	78	6.83
58	11.45	79	6.55
59	11.26	80	6.28
60	11.08		

Example: P, a U.S. citizen and bona fide resident of P.R., has been an employee of Company X, a U.S. corporation, since 1975 and is retiring on Dec. 31, 2004. P worked in Company's X branch office in P.R. from Jan. 1, 1975 through Dec. 31, 1984. On Jan. 1, 1985, P was transferred to the U.S. to work at Company's X headquarters. On Jan. 1, 1995, P was transferred back to the P.R. branch, where he will work until retirement. In total, P will have worked 360 months for Company X: 240 in P.R. and 120 in the U.S. Throughout his employment with Company X, P has been a participant in Company X's U.S. pension plan, a dual-qualified plan funded with a U.S. trust. The normal form of retirement benefits under the plan is a straight life annuity payable monthly beginning at normal retirement (age 65). P is entitled to a monthly pension from the plan beginning at age 65, the annual amount of which is $30,000. The total deemed contributions for the benefit of P equal $95,972, which is the product of $301,800 (the present value of P's pension benefits, computed as the product of $30,000 multiplied by 10.06, which is the applicable adjustment factor in Table II), multiplied by 0.0106 (the number in Table I that corresponds to the total number of years of accumulation for P before the annuity starting date), multiplied by 30 (P's total years of service credited under the plan). The portion of each monthly payment that is treated as income from sources within P.R. is equal to the quotient of (a) the product of 240/360 multiplied by $95,972, divided by (b) $301,800, or 21%. The remaining 79% of each pension payment is treated as income from sources within the U.S. [640]

The sourcing method in Rev. Rul. 2004-37, which technically, relates to distributions from dual-qualified plans funded through a U.S.

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trust, is not likely to be needed with regard to distributions from P.R.-only qualified pension plans. As previously noted, P.R.-only qualified plans must be funded with a P.R. trust, and plan participation must be limited to residents of P.R. [641] If, as in the above Example, a participant in a P.R.-only qualified plan were to perform a full third of his creditable service in the U.S., that individual would not be a resident of P.R., and the P.R. trust would risk losing its exemption from U.S. taxation on its investment earnings. Thus, in practice, most if not all participants in a P.R.-only qualified plan are likely to render all or substantially all their creditable services in P.R., removing the need for sourcing allocation. In those exceptional cases in which some participants in a P.R.-only qualified pension plan have rendered a material share of their creditable service in the U.S., the IRS sourcing method may be used for determining the U.S. and P.R. source portions of these participants' benefits, which would be accomplished by performing the same calculations but replacing all references to U.S. with references to P.R. and vice versa. This reversal of roles would be needed because, as the plan is funded with a P.R. trust, the investment income portion, which under the IRS method is sourced to the U.S., would have to be sourced to P.R.

4. Withholding of U.S. Taxes on Distributions from Dual-Qualified Plans

Pursuant to Code §3405(c), eligible rollover distributions from U.S. qualified plans are subject to mandatory 20% U.S. income tax withholding. An "eligible rollover distribution" is basically any taxable distribution other than a series of equal periodic payments for the life or life expectancy of the participant, the joint lives or life expectancies of the participant and his beneficiary, or for a period of 10 years or more. [642] Most distributions other than annuities and periodic installments constitute eligible rollover distributions.

However, the mandatory 20% withholding requirement does not apply to the portion of an eligible rollover distribution which it is reasonable to believe is not includible in U.S. gross income. [643] This exception plays a significant role in determining if eligible rollover distributions to P.R. participants in dual-qualified plans are subject to mandatory 20% withholding. If the P.R. participants rendered their services in P.R. and are bona fide residents of P.R at the time of distribution, the portion of an eligible rollover distribution attributable to employer and employee contributions is P.R. source income exempt from the payment of U.S. income taxes under Code §933(1), and is thereby also exempt from mandatory 20% U.S. tax withholding. [644] On the other hand, the portion of an eligible rollover distribution from a dual-qualified plan funded through a U.S. trust attributable to investment income earned by the trust is U.S. source income subject to U.S. taxation and mandatory 20% U.S. tax withholding. Therefore, in the case of distributions from dual-qualified plans to participants or beneficiaries who are bona fide residents of P.R., the mandatory 20% U.S. tax withholding requirement will generally apply only to the investment income portion of eligible rollover distributions (not to the entire distribution), provided that the plan is funded through a U.S. trust. If the plan is funded through a trust in P.R. (i.e., an ERISA *§ 1022(i)(2)* dual-qualified plan), distributions to these P.R. participants or beneficiaries are not subject to 20% U.S. income tax withholding.

Because P.R.-only qualified plans are by definition not qualified in the U.S., their distributions are not subject to mandatory 20% U.S. income tax withholding.

5. U.S. Taxation on Sale of Employer Stock by Puerto Rico Participants

The factor that determines if a P.R. participant must pay U.S. income taxes on the gain realized from the sale of employer stock previously received as a distribution from a qualified plan is the participant's place of residence at the time of the sale, not whether the plan that distributed the stock is qualified in the U.S. If the participant is a bona fide resident of P.R. at the time of the sale, the gain is P.R. source income exempt from U.S. taxation, whereas if the participant is a resident of the U.S., the gain is subject to U.S. taxation. [645] Special rules may apply if the participant is a temporary resident of P.R. or a resident of a foreign country. The plan's P.R. and/or U.S. qualified status has no impact on these rules.

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-Footnotes-

[574] See 8 USC §1402.

[575] Code §§1 and 61(a).

[576] Code §876(a); Treas. Regs. §1.1-1(b).

[577] Rev. Rul. 68-7, 1968-1 C.B. 345.

[578] P.L. 108-357, §809.

[579] T.D. *9248*, 71 Fed. Reg. 4996 (1/31/06). Treas. Regs. §1.937-1 is generally effective for taxable years ending after Jan. 31, 2006. Taxpayers also may choose to apply the regulation in its entirety to all taxable years ending after Oct. 22, 2004, for which the statute of limitations under Code §6511 is open. Treas. Regs. §§1.937-1(i)

[579.1] T.D. *9297*, 71 Fed. Reg. 66232 (11/14/06). The revised regulation is subject to the same effective date rules of Treas. Regs. §§1.937-1(i) as noted above.

[580] Treas. Regs. §1.937-1(c)(1)(i).

[580.1] Treas. Regs. §1.937-1(c)(1)(ii).

[581] Treas. Regs. §1.937-1(c)(1)(iii).

[582] Treas. Regs. §1.937-1(c)(1)(iv). The term “earned income” means wages, salaries, professional fees and other amounts received as compensation for personal services actually rendered, including the fair market value of all remuneration paid in any medium other than cash. Treas. Regs. §1.911-3(b)(1).

[583] Treas. Regs. §1.937-1(c)(1)(v).

[584] Treas. Regs. §1.937-1(c)(3)(i). See Treas. Regs. §1.937-1(c)(4) for the definition of qualifying medical treatment.

[585] Treas. Regs. §1.937-1(c)(3)(ii).

[586] Treas. Regs. §1.937-1(c)(3)(iii)(A).

[586.1] Treas. Regs. §1.937-1(g), Ex. 1.

[587] Treas. Regs. §1.937-1(c)(5)(i). Generally, “permanent home” has the same meaning as in Treas. Regs. §301.7701(b)-2(d)(2). However, if an individual or the individual's spouse owns property and rents it to another person at any time during the taxable year, and even if the rental property may constitute a permanent home under that provision, it is not a permanent home under the significant connection element of the presence test under the regulations unless the taxpayer uses any portion of it as a residence during the taxable year under the principles of Code §280A(d). In applying Code §280A(d) for this purpose, an individual is treated as using the rental property for personal purposes on any day determined under the principles of Code §280A(d)(2) or on any day that the rental property (or any portion of it) is not rented to another person at fair rental for the entire day. The rental property is not used for personal purposes on

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any day on which the principal purpose of the use of the rental property is to perform repair or maintenance work on the property. Whether the principal purpose of the use of the rental property is to perform repair or maintenance work is determined in light of all the facts and circumstances including, but not limited to, the following: the amount of time devoted to repair and maintenance work, the frequency of the use for repair and maintenance purposes during a taxable year, and the presence and activities of companions. Treas. Regs. §1.937-1(c)(5)(ii).

588 Treas. Regs. §1.937-1(g), Ex. 2.

589 Treas. Regs. §1.937-1(d)(1).

590 Treas. Regs. §1.937-1(d)(3).

591 Treas. Regs. §1.937-1(g), Ex. 6.

592 Treas. Regs. §1.937-1(e)(1).

593 Treas. Regs. §1.937-1(e)(1)(ii).

594 Treas. Regs. §1.937-1(e)(1)(i).

595 Treas. Regs. §301.7701(b)-2(d)(1)(i).

596 Treas. Regs. §301.7701(b)-2(d)(1)(ii).

597 Treas. Regs. §301.7701(b)-2(d)(1)(iii).

598 Treas. Regs. §301.7701(b)-2(d)(1)(iv).

599 Treas. Regs. §301.7701(b)-2(d)(1)(v).

600 Treas. Regs. §301.7701(b)-2(d)(1)(vi).

601 Treas. Regs. §301.7701(b)-2(d)(1)(vii).

602 Treas. Regs. §301.7701(b)-2(d)(1)(viii).

603 Treas. Regs. §301.7701(b)-2(d)(1)(ix).

604 Treas. Regs. §1.937-1(g), Ex. 6.

605 Treas. Regs. §1.937-1(g), Ex. 7.

606 Treas. Regs. §1.937-1(f)(1).

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Treas. Regs. §1.937-1(g), Ex. 8.

608 Treas. Regs. §§1.937-1(f)(2)(ii) and 1.933-1(b).

609 Treas. Regs. §1.937-1(g), Ex. 10. See Code §933(2) and Treas. Regs. §1.933-1(b) for rules on attribution of income.

610 Rev. Rul. 56-82, 1956-1 C.B. 59.

611 Rev. Rul. 79-388, 1979-2 C.B. 270; and Rev. Rul. 79-389, 1979-2 C.B. 281. Treas. Regs. *§1.937-2T(e)(1)* expressly preserved the existing treatment of income from personal services rendered in the U.S. or a U.S. possession (e.g., P.R.). Thus, this income sourcing rule remains in effect.

612 Cf. Treas. Regs. §1.401(a)-50(d).

613 Rev. Rul. 79-388, 1979-2 C.B. 270; FSA 200215019. This sourcing rule does not appear to have been suspended or modified by the special rules under Code §937 and its regulations for certain types of income items earned after Dec. 31, 2004.

614 Rev. Rul. 60-181, 1960-1 C.B. 257, citing Jones Trust v. Comr., 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943).

615 Treas. Regs. §301.7701-7.

616 Treas. Regs. §301.7701-7(a)(1)(i).

617 Treas. Regs. §301.7701-7(a)(1)(ii).

618 Treas. Regs. §301.7701-7(a)(3); Code §7701(a)(31)(B).

619 Treas. Regs. §301.7701-7(c)(3)(ii); Code §7701(d).

620 Treas. Regs. §301.7701-7(c)(3)(iii).

621 Treas. Regs. §301.7701-7(c)(3)(iv).

622 Treas. Regs. §301.7701-7(c)(3)(v).

623 Treas. Regs. §301.7701-7(c)(1)(i).

624 Treas. Regs. §301.7701-7(c)(1)(ii).

625 Treas. Regs. §301.7701-7(c)(1)(iii) and (c)(4)(ii).

626 Treas. Regs. §301.7701-7(d)(1)(ii).

627 Treas. Regs. §301.7701-7(d)(1)(i); Code §7701(a)(30).

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628 FSA 200215019.

629 Rev. Rul. 2004-75, *2004-31 I.R.B. 109*, amplified by Rev. Rul. 2004-97, *2004-39 I.R.B. 516*. CCA 200646001 involved a U.S. insurance company (T) that operates in a branch form in an unidentified country (X) which sells life and annuity policies to residents of X. The Country X policyholders receive payments from T, in the form of annuity payments, as withdrawals of the accumulation value of an annuity policy, or as withdrawals from the cash value of a life insurance policy. T sought a private letter ruling to the effect that its payments to the Country X policyholders were not subject to the 30% withholding tax under Code §§871(a) and 1441, or the 15% withholding rate under the Pensions and Annuities Article of the U.S.-Country X income tax treaty. The IRS tentatively denied the ruling, citing Rev. Rul. 2004-75, in which the IRS concluded that distributions to nonresident aliens from life and annuity contracts issued by a U.S. insurer are subject to the Code §871(a) tax on fixed or determinable income. After receiving this adverse response, T withdrew its ruling request. In CCA 200646001, the IRS Branch that reviewed the letter ruling request notified the IRS Small Business/Self-Employed program manager of the withdrawal, citing §7.07(2) of Rev. Proc. 2006-1, *2006-1 I.R.B. 1*. The Branch representative pointed out that, unlike Rev. Rul. 2004-75, this case involved an applicable treaty, but the Pensions and Annuities Article of the treaty did not provide source rules for such payments. Accordingly, the IRS Branch representative concluded that Rev. Rul. 2004-75 would source the payments to the United States, thus subjecting them to 30% tax under Code §871(a) and withholding under Code §1441. The representative further noted that the Pensions and Annuities Article of the treaty would reduce the tax rate and withholding to 15% on the periodic annuity payments but that the other types of payments, subject to the Other Income Article of the treaty, would not be eligible for a reduced tax rate.

630 *2004-26 I.R.B. 1099*.

631 Rev. Proc. 2004-37, §3.02 (noting that, in the case of payments from a U.S. qualified pension plan to a bona fide resident of P.R., this sourcing method may be used for determining what portion of the payment is derived from sources within P.R. and therefore excludible from the recipient's U.S. gross income under Code §933).

632 Rev. Proc. 2004-37, §6.01.

633 Rev. Proc. 2004-37, §4.01.

634 Rev. Proc. 2004-37, §4.02.

635 2001-2 C.B. 632.

636 Rev. Proc. 2004-37, §4.04(a).

637 Rev. Proc. 2004-37, §4.04(b).

638 Rev. Proc. 2004-37, §4.03, Table I.

639 Rev. Proc. 2004-37, §4.03, Table II.

640 Rev. Proc. 2004-37, §5.01.

641 See IX, B, above.

642 Code §§402(c)(4) and 3405(c)(3).

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643 Code §3405(e)(1)(B)(ii).

644 See XI, B, 1, above.

645 Code §865(g)(2); Notice 89-40, 1989-1 C.B. 681. See also IRS Pub. 1321, Special Instructions for Bona Fide Residents of Puerto Rico Who Must File a U.S. Individual Income Tax Return (Form 1040 or 1040A). Basically, the applicable rule is as follows: pursuant to Code §865(a), the source of income from the sale of personal property, such as shares of stock, is determined by the seller's residence at the time of sale. Code §865(g)(2), however, provides that gains on the sale of personal property by a U.S. citizen or resident alien who, at the time of sale, is a resident of a foreign country are still considered U.S. source income, unless the person must pay a foreign income tax on the gain of at least 10%. For these purposes P.R. is considered a foreign country. Thus, absent an exception to this rule, gains from the sale of personal property by a U.S. citizen or resident alien who is a bona fide resident of P.R. would be P.R. source income (i.e., potentially eligible for the U.S. income tax exclusion in Code §933) only if the person had to pay a P.R. income tax on the gain of 10% or more. In Notice 89-40, the IRS announced its determination to waive the 10% foreign tax requirement for sales of personal property by U.S. citizens and resident aliens who are bona fide residents of P.R. for the entire taxable year in which the sale takes place. This waiver does not apply to sales by U.S. citizens or resident aliens who are only temporary residents of P.R. Similarly, Code §865(g)(3) provides that the 10% foreign income tax requirement does not apply with regard to sales of stock of P.R. companies (i.e., corporations actively engaged in trade or business in P.R. that derive more than 50% of their gross income from their business operations in P.R.) by U.S. citizens or resident aliens who are residents of P.R. during the entire year.

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