

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 1.861-4: Compensation for labor or personal services
(Also: Part I, Sections 861, 862, 871, 1441)

Rev. Proc. 2004-37

SECTION 1. PURPOSE

This revenue procedure provides a method for determining the source of a pension payment to a nonresident alien individual from a defined benefit plan where the trust forming part of the plan is a trust created or organized in the United States that constitutes a qualified trust under § 401(a) of the Internal Revenue Code.

SECTION 2. BACKGROUND

Section 871(a) imposes a tax of 30 percent on amounts received by nonresident alien individuals as interest (other than original issue discount as defined in § 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income to the extent the amount so received is from sources within the United States and is not effectively connected with the conduct of a trade or business within the United States.

Section 1441(a) provides for the withholding of tax, generally at a 30 percent rate, on certain income from sources within the United States paid to a nonresident alien individual. Section 1441(b) lists salaries, wages, annuities, compensations,

remunerations, or other fixed or determinable annual or periodical gains, among other things, as items of income subject to the withholding of tax under § 1441(a).

Section 1.1441-4(b)(1)(ii) of the Income Tax Regulations provides generally that U.S.-source payments to a nonresident alien individual from a trust described in § 401(a) are subject to withholding under § 1441. But see § 871(f) (excluding from income certain amounts received from certain qualified plans); § 1.1441-4(d) (excluding such amounts from withholding).

Section 861(a)(3) provides generally that compensation for labor or personal services performed in the United States is treated as income from sources within the United States. Section 862(a)(3) provides that compensation for labor or personal services performed outside the United States is treated as income from sources without the United States.

Employer contributions to an annuity or pension plan constitute compensation for labor or personal services. See, e.g., Rev. Rul. 56-82, 1956-1 C.B. 59. For purposes of determining the source of pension payments from a qualified trust under § 401(a), the portion of each payment that is attributable to employer contributions with respect to services rendered within the United States is treated as income from sources within the United States, the portion that is attributable to employer contributions with respect to services rendered outside the United States is treated as income from sources without the United States, and the portion that represents earnings and accretions to contributions of either the employer or the employee is treated as income from sources within the United States. Rev. Rul. 79-388, 1979-2 C.B. 270. See also, Clayton v. United States, 33 Fed. Cl. 628 (1995), aff'd without published opinion, 91 F.3d 170 (Fed. Cir. 1996), cert. denied, 519 U.S. 1040 (1996).

Employer contributions to a defined benefit plan qualified under § 401(a) covering more than one individual participant are not made for the benefit of specific participants, but are made based on aggregate liabilities to all participants. All funds held under the plan are available to provide benefits to any participant. Accordingly, it is not possible in such a case to allocate actual contributions to specific participants.

SECTION 3. SCOPE

.01 General application. If a trust under a qualified defined benefit plan makes a payment with respect to a participant who is a nonresident alien individual and the actual amounts of employer contributions made to the plan for the benefit of such participant are not known, the method set forth in section 4 of this revenue procedure may be used to allocate the payment to sources within and without the United States. The method set forth in section 4 is based on methods similar to those used for purposes of §§ 1.403(b)-1(d)(4), 1.402(b)-1(a)(2), and 1.402(b)-1(b)(2)(ii) of the Income

Tax Regulations when contributions for the benefit of a particular participant are not known.

.02 Application to a possession of the United States. The method set forth in section 4 of this revenue procedure also may be used for purposes of allocating a payment from a trust under a qualified defined benefit plan to sources within and without a possession of the United States. See § 1.863-6 (providing that the principles applied for determining income from sources within and without the United States are generally applied for purposes of determining income from sources within and without a possession). Thus, for example, in the case of a payment from a trust under a qualified defined benefit plan to a bona fide resident of Puerto Rico, the method set forth in section 4 may be used for purposes of determining what portion of the payment is derived from sources within Puerto Rico and therefore excludible from the recipient's gross income under § 933(1).

SECTION 4. METHOD

.01 Determination of total contributions. The amount of total contributions to a defined benefit plan for the benefit of a particular individual is deemed to be the product of the following three quantities multiplied by one another, each such quantity determined as of the annuity starting date—

(i) the present value of the individual's pension payable at the annuity starting date, determined under section 4.02;

(ii) the amount from Table I below based on the number of years from the first date the individual became a participant in the plan to the annuity starting date (representing the amount that, when contributed on an annual level basis, will accumulate to \$1.00 at the annuity starting date); and

(iii) the number of years from the first date the individual became a participant in the plan to the annuity starting date.

.02 Present value of pension. (a) If payment is made in the form of a straight life annuity commencing at the annuity starting date, then the present value of the individual's pension is the product of (i) the amount payable annually, multiplied by (ii) the value from Table II below, based on the individual's age at the annuity starting date, of an annuity of \$1.00 per annum payable in equal monthly installments during the life of the individual.

(b) If payment is made in the form of a single-sum payment of the total benefit due to the individual under the plan at the annuity starting date, then the present value of the individual's pension is equal to the amount of the single-sum payment.

(c) If payment is made in a form not identified in either of the two preceding paragraphs, then the present value of the individual's pension is the actuarial present value of the individual's pension, determined on the annuity starting date based on a 7% rate of interest and the mortality table in Rev. Rul. 2001-62, 2001-2 C.B. 632.

.03 Tables.

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 first date the individual became a participant in the plan to the annuity starting date

| Number of Years | Amount |
|-----------------|----------|
| 1 | \$1.0000 |
| 2 | 0.4831 |
| 3 | 0.3111 |
| 4 | 0.2252 |
| 5 | 0.1739 |
| 6 | 0.1398 |
| 7 | 0.1156 |
| 8 | 0.0975 |
| 9 | 0.0835 |
| 10 | 0.0724 |
| 11 | 0.0634 |
| 12 | 0.0559 |
| 13 | 0.0497 |
| 14 | 0.0443 |
| 15 | 0.0398 |
| 16 | 0.0359 |
| 17 | 0.0324 |
| 18 | 0.0294 |
| 19 | 0.0268 |
| 20 | 0.0244 |
| 21 | 0.0223 |
| 22 | 0.0204 |
| 23 | 0.0187 |
| 24 | 0.0172 |
| 25 | 0.0158 |
| 26 | 0.0146 |
| 27 | 0.0134 |
| 28 | 0.0124 |

| | |
|----|--------|
| 29 | 0.0115 |
| 30 | 0.0106 |
| 31 | 0.0098 |
| 32 | 0.0091 |
| 33 | 0.0084 |
| 34 | 0.0078 |
| 35 | 0.0072 |
| 36 | 0.0067 |
| 37 | 0.0062 |
| 38 | 0.0058 |
| 39 | 0.0054 |
| 40 | 0.0050 |
| 41 | 0.0047 |
| 42 | 0.0043 |
| 43 | 0.0040 |
| 44 | 0.0038 |
| 45 | 0.0035 |
| 46 | 0.0033 |
| 47 | 0.0030 |
| 48 | 0.0028 |
| 49 | 0.0026 |
| 50 | 0.0025 |

Table II.— The value of an annuity of \$1.00 per annum payable in equal monthly installments during the life of the individual, based on the individual's age at the annuity starting date.

| Age at Annuity Starting Date | Value |
|------------------------------|-------|
| 40 | 13.61 |
| 41 | 13.54 |
| 42 | 13.46 |
| 43 | 13.38 |
| 44 | 13.29 |
| 45 | 13.20 |
| 46 | 13.11 |
| 47 | 13.00 |
| 48 | 12.89 |
| 49 | 12.78 |
| 50 | 12.66 |

| | |
|----|-------|
| 51 | 12.53 |
| 52 | 12.40 |
| 53 | 12.25 |
| 54 | 12.11 |
| 55 | 11.95 |
| 56 | 11.79 |
| 57 | 11.62 |
| 58 | 11.45 |
| 59 | 11.26 |
| 60 | 11.08 |
| 61 | 10.88 |
| 62 | 10.68 |
| 63 | 10.48 |
| 64 | 10.27 |
| 65 | 10.06 |
| 66 | 9.84 |
| 67 | 9.62 |
| 68 | 9.40 |
| 69 | 9.17 |
| 70 | 8.93 |
| 71 | 8.69 |
| 72 | 8.44 |
| 73 | 8.18 |
| 74 | 7.92 |
| 75 | 7.65 |
| 76 | 7.38 |
| 77 | 7.10 |
| 78 | 6.83 |
| 79 | 6.55 |
| 80 | 6.28 |

.04 Allocation of payments to sources within and without the United States. (a) General rule. The portion of each payment that is deemed to be attributable to contributions for services rendered outside the United States, and thus treated as income from sources without the United States, is equal to the quotient of (i) the product of (A) the total deemed contributions (as determined under section 4.01 of this revenue procedure), multiplied by (B) a fraction, the numerator of which is the months of service credited under the plan that were rendered outside the United States 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 within and without the United States), divided by (ii) the present value of the pension at the annuity starting date (as determined under section 4.02 of this revenue procedure). The remainder of the

payment, which represents the sum of deemed contributions for services rendered within the United States plus earnings on all contributions, is treated as income from sources within the United States.

(b) Special rule for employee after-tax contributions. If the participant has made any employee after-tax contributions to the plan, then each payment is first reduced by the employee after-tax contributions allocable to such payment under § 72. The portion of the remainder of each payment that is treated as income from sources without the United States is equal to the quotient of (i) the product of (A) the excess of the total contributions (as determined under section 4.01 of this revenue procedure) over the total employee after-tax contributions to the plan, multiplied by (B) a fraction, the numerator of which is the number of months of service credited under the plan that were rendered outside the United States and the denominator of which is the total months of service credited under the plan at the annuity starting date, divided by (ii) the excess of the present value of the pension at the annuity starting date (as determined under section 4.02 of this revenue procedure) over the total employee after-tax contributions to the plan. The portion of each payment that is allocable neither to employee after-tax contributions nor to income from sources without the United States is treated as income from sources within the United States.

SECTION 5. EXAMPLES

.01 Retirement at age 65. (a) Facts. P, a nonresident alien individual, is a citizen and resident of Country B. P will be age 65 on December 31, 2004. There is no income tax treaty in force between the United States and Country B.

P has been an employee of Company X, a domestic corporation, since 1975 and is retiring on December 31, 2004. P worked in Company X's branch office in Country B from January 1, 1975 through December 31, 1984. On January 1, 1985, P was transferred to the United States to work at Company X's headquarters. While P worked in the United States, P was classified as a resident alien under § 7701(b)(1)(A)(ii). On January 1, 1995, P was transferred back to Company X's branch office in Country B, where P will have worked until retiring on December 31, 2004. In total, P will have worked 360 months for Company X, including 240 months worked in Country B and 120 months worked in the United States.

Throughout P's employment by Company X, P has been a participant in a defined benefit plan ("Plan A") maintained by Company X. The trust forming part of Plan A is a trust created or organized in the United States that constitutes a qualified trust under § 401(a). The normal form of retirement benefit under Plan A is a straight life annuity. The amount payable under the straight life annuity form is an annual benefit of 1 percent of highest-five years' pay multiplied by years of service credited under the plan, payable monthly for life commencing at normal retirement age (age 65) or at actual

retirement age, if later. Plan A provides for an actuarially reduced amount to be payable if the participant has a severance from employment before normal retirement age, but the reduction is smaller if the participant retires after age 55 with at least 20 years of service (for example, only a 16.67% reduction applies at age 55). Contributions under Plan A are not made on behalf of specific individual participants.

P is entitled to a monthly pension from Plan A beginning at age 65, the annual amount of which will be \$30,000 payable as a straight life annuity. P elects to receive payment of that pension in the form of a straight life annuity commencing immediately. P has never made any after-tax contributions to Plan A, and § 871(f), relating to an exclusion from gross income for certain amounts received from certain qualified pension plans, does not apply to any amounts received by P from Plan A.

(b) Application. The total deemed contributions for the benefit of P under the method set forth in section 4.01 of this revenue procedure equal \$95,972, which is the product of \$301,800 (the present value of P's pension benefit from Plan A under section 4.02(a), computed as the product of \$30,000 multiplied by 10.06, which is the applicable adjustment factor under Table II of section 4.03), multiplied by 0.0106 (the number from 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). Under section 4.04 of this revenue procedure, the portion of each payment that is treated as income from sources without the United States is equal to the quotient of (i) the product of 240/360 multiplied by \$95,972, divided by (ii) \$301,800, or 21 percent. The remaining 79 percent is treated as income from sources within the United States that is subject to withholding under § 1441(a).

.02 Early Retirement. (a) Facts. The facts with respect to Plan A and Company X are the same as in Example 5.01. Q, a nonresident alien individual, is a citizen and resident of Country B. Q will be age 55 on December 31, 2004. There is no income tax treaty in force between the United States and Country B.

Q has been an employee of Company X since 1985 and is retiring on December 31, 2004. Q worked in Company X's branch office in Country B from January 1, 1985 through December 31, 1994. On January 1, 1995, Q was transferred to the United States to work at Company X's headquarters. While Q worked in the United States, Q was classified as a resident alien under § 7701(b)(1)(A)(ii). On September 1, 2001, Q was transferred back to Company X's branch office in Country B, where Q will have worked until retiring on December 31, 2004. In total, Q will have worked 240 months for Company X, including 160 months worked in Country B and 80 months worked in the United States.

Throughout Q's employment by Company X, Q has been a participant in Plan A. Q is entitled to a monthly pension from Plan A beginning at age 55, the annual amount of

which will be \$25,000 payable as a straight life annuity. Q elects to receive an actuarially equivalent joint and contingent annuity option of \$23,000 annually with a 50 percent continuation percentage (and Q's designated contingent annuitant is age 55) and the actuarial present value of that benefit under section 4.02(c) is \$288,019. Q has never made any after-tax contributions to Plan A, and § 871(f), relating to an exclusion from gross income for amounts received from certain qualified pension plans, does not apply to any amounts received by Q from Plan A.

(b) Application. The total deemed contributions for the benefit of Q under the method set forth in section 4.01 of this revenue procedure equal \$140,553, which is the product of \$288,019 (the present value of Q's \$23,000 annual pension benefit from Plan A with a 50-percent continuation percentage, as determined under the assumptions in section 4.02(c)), multiplied by 0.0244 (the number from Table I that corresponds to the total number of years of accumulation for Q before the annuity starting date), multiplied by 20 (Q's total years of service credited under the plan). Under section 4.04 of this revenue procedure, the portion of each payment that is treated as income from sources without the United States is equal to the quotient of (i) 160/240 multiplied by \$140,553, divided by (ii) \$288,019, or 33 percent. The remaining 67 percent is treated as income from sources within the United States that is subject to withholding under § 1441(a).

SECTION 6. LIMITATION ON ISSUANCE OF PRIVATE LETTER RULINGS

.01 The Service will not issue a private letter ruling regarding a method for determining the source of a pension payment to a nonresident alien individual from a trust under a defined benefit plan that is qualified under § 401(a) if the proposed method (including the related assumptions) is inconsistent with sections 4.01, 4.02, and 4.03 of this revenue procedure.

.02 Revenue Procedure 2004-7, 2004-1 I.R.B. 237, is amplified by adding the following to section 3.01:

Section 861. Income from Sources Within the United States. A method for determining the source of a pension payment to a nonresident alien individual from a trust under a defined benefit plan that is qualified under § 401(a) if the proposed method is inconsistent with sections 4.01, 4.02, and 4.03 of Revenue Procedure 2004-37, 2004-26 I.R.B. __.

Section 862. Income from Sources Without the United States. A method for determining the source of a pension payment to a nonresident alien individual from a trust under a defined benefit plan that is qualified under § 401(a) if the proposed method is inconsistent with sections 4.01, 4.02, and 4.03 of Revenue Procedure 2004-37, 2004-26 I.R.B. ___.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Michelle S. Lyon of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue procedure generally, contact Ms. Lyon on (202) 622-3880 (not a toll-free call). For information regarding computations under the method set forth in section 4 of this revenue procedure, contact Diane S. Bloom at (202) 283-9888 (not a toll-free call).