PLAN DISTRIBUTIONS

New IRS Guidance on Withholding Tax Treatment of Cross Border Pension Distributions

Details on the guidance provided by Revenue Procedure 2004-37 on the tax withholding obligations of persons making payments from U.S. pension plans to foreign employees or to employees who have performed services both in the United States and abroad.

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On June 9, 2004, the Treasury Department and the Internal Revenue Service issued Revenue Procedure 2004-37, [2004-26 I.R.B. 1099] which provides guidance on the treatment of pension distributions made by a United States qualified plan to a nonresident alien individual. Revenue Procedure 2004-37 provides guidance in particular for determining the tax withholding obligations of those persons responsible for making payments from a United States defined benefit pension plan to a foreign person.

The revenue procedure provides detailed rules for determining the US-source portion of a pension distribution under a defined benefit pension plan in cases where the retiree has performed services both in the United States and abroad during his or her employment. For pension distributions that take the form of a lump-sum distribution or a straight life annuity, the revenue procedure sets forth an actuarial method for apportioning the distribution between deemed employer contributions and deemed earnings and for apportioning those deemed contributions between services performed in the United States and services performed outside the United States. For other forms of pension distribution, the revenue procedure provides guidance on appropriate assumptions that may be used to apportion a distribution between sources within the United States and sources outside the United States.

Purpose of Revenue Procedure 2004-37

Revenue Procedure 2004-37 provides a method for determining the source of a pension payment to a nonresident alien individual from a defined benefit pension plan where the trust forming part of the plan is a qualified trust created or organized in the United States. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 1]

Background

Section 871(a) of the Internal Revenue Code of 1986, as amended (the Code), imposes a tax of 30 percent on amounts received by nonresident alien individuals as interest (other than original issue discount (OID) as defined in Code Section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic 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. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 2]

Code Section 1441(a) provides for tax withholding, generally at a 30 percent rate, on certain income from sources within the United States paid to a nonresident alien individual. Code Section 1441(b) lists salaries, wages, annuities, compensation, remuneration, or other fixed or determinable annual or periodic gains, among other things, as items of income subject to the withholding of tax under Code Section 1441(a). [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 2]

Section 1.1441-4(b)(1)(ii) of the Income Tax Regulations provides generally that US-source payments to a nonresident alien individual from a Code Section 401(a) qualified trust are subject to withholding under Code Section 1441. [*But see* Code Section 871(f)(excluding from income certain amounts received from certain qualified plans) and Treas. Reg. § 1.1441-4(d)(excluding such amounts from withholding)) [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 2]

Code 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. Code Section 862(a)(3) provides that compensation for labor or personal services performed outside the United States, however, is treated as income from sources without the United States. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 2]

Employer contributions to an annuity or pension plan constitute compensation for labor or personal service. [*See* Rev. Rul. 56-82, 1956-1 C.B. 59] For purposes of determining the source of pension payments from a Code Section 401(a) qualified trust, 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 outside 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)] [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 2]

Employer contributions to a Code Section 401(a) defined benefit plan 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. [Rev. Proc. 2004-37, 2004-26 I.R.B 1099, § 2]

Scope

In general, 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 that participant are not known, then the method set forth in Section 4 of Revenue Procedure 2004-37 may be used to allocate the payment to sources within and outside the United States. The method set forth in that section is based on methods similar to those used for purposes of Income Tax Regulations Sections 1.403(b)-1(d)(4), 1.402(b)-1(a)(2), and 1.402(b)-1(b)(2)(ii) when contributions for the benefits of a particular participant are not known. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, c§ 3.01]

The method set forth in Section 4 of Revenue Procedure 2004-37 also may be used for purposes of allocating a payment from a trust under a qualified defined benefit pension plan to sources within and outside a possession of the United States. [*See* Income Tax Reg. § 1.863-6, providing that the principles applied for determining income from sources within and outside the United States are generally applied for purposes of determining income from sources within and outside a U.S. 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 of Revenue Procedure 2004-37 may be used to determine the portion of the payment derived from sources within Puerto Rico and therefore excludable from the recipient's gross income under Code Section 933(1). [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 3.02]

Allocation Method

The method set forth in Section 4 of Revenue Procedure 2004-37 that may be used to allocate the payment from a trust under a qualified defined benefit plan to sources within and outside the United States (or to sources within and outside a US possession) is described here:

1. *Determination of total contributions.* The total contribution 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:

   a. The present value of the individual's pension payable at the annuity starting date [determined Rev. Proc. 2004-37, § 4.02);
   b. The amount from Table 1 (the table follows) 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 annually, will accumulate to $1.00 at the annuity starting date); and
   c. The number of years from the first date the individual became a participant in the plan to the annuity starting date. [Rev. Proc. 2004-

37, 2004-26 I.R.B. 1099, §§ 4.01(i)-4.01(iii)]

2. *Present value of pension.* 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 (a) the amount payable annually, multiplied by (b) the value from Table 2 (the table follows), 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. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.02(a)]

If payment is made in the form of a single-sum payment of the total benefit owed 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. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.02(b)]

If payment is not made in the form of a straight life annuity or a single-sum payment, then the present value of the individual's pension is the actuarial present value of his or her pension, determined on the annuity starting date based on a 7 percent rate of interest and the mortality table in Revenue Ruling 2001-62, 2001-2 C.B. 632. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.02(c)]

Table 1. 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	Number of Years	Amount
1	$.0000	27	.0134
2	.4831	28	.0124
3	.3111	29	.0115
4	.2252	30	.0106
5	.1739	31	.0098
6	.1398	32	.0091
7	.1156	33	.0084
8	.0975	34	.0078
9	.0835	35	.0072
10	.0724	36	.0067
11	.0634	37	.0062
12	.0559	38	.0058
13	.0497	39	.0054
14	.0443	40	.0050
15	.0398	41	.0047
16	.0359	42	.0043
17	.0324	43	.0040
18	.0294	44	.0038
19	.0268	45	.0035
20	.0244	46	.0033
21	.0223	47	.0030
22	.0204	48	.0028
23	.0187	49	.0026
24	.0172	50	.0025
25	.0158		
26	.0146		

[Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.03, Table I]

Table 2. 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	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		

[Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.03, Table II]

Allocation of Payment to Sources Within and Outside the United States

Under the general rule set forth in Revenue Procedure 2004-37, 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 outside the United States, is equal to the quotient of (1) the product of (a) the total deemed contributions (as determined under Section 4.01 of the 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 outside the United States), divided by (2) the present value of the pension at the annuity starting date (as determined under Section 4.02 of the Revenue Procedure). The remainder of the payment, which represents the sum of the deemed contributions for services rendered within the United States plus earnings on all contributions, is treated as income from sources within the United States. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.04(a)]

Under the 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 that payment under Code Section 72. The portion of the remainder of each payment that is treated as income from sources outside the United States is equal to the quotient of (1) the product of (a) the excess of the total contributions (as determined under Section 4.01 of the 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 (2) the excess of the present value of the pension at the annuity starting date (as determined under Section 4.02 of the

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 outside the United States is treated as income from sources within the United States. [Rev. Proc. 2004-37, 2004-26 I.R.B. 1099, § 4.04(b)]

Examples

Revenue Procedure 2004-37 includes the following examples to illustrate how defined benefit plan payments will be allocated between US-source and non-US-source income.

> **Example 1, Retirement at Age 65.** P, a nonresident alien individual, is a citizen and resident of Country B. P will be age 65 on December 31, 2004. No income tax treaty is 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 Code Section 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.
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> 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 Code Section 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 the 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 percent reduction applies at age 55). Contributions under Plan A are not made on behalf of specific individual participants.
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> 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 Code Section 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.
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> *Application*: The total deemed contributions for the benefit of P under the method set forth in Section 4.01 of Revenue Procedure 2004-37 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) of the Revenue Procedure, computed as the product of $30,000 multiplied by 10.06, which is the applicable adjustment factor under Table II of Section 4.03 of the Revenue Procedure), 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 the Revenue Procedure, the portion of each payment that is treated as income from sources outside the United States is equal to the quotient of (1) the product of 240/360 multiplied by $95,972, divided by (2) $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 Code Section 1441(a).
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> **Example 2, Early Retirement.** The facts with respect to Plan A and Company X are the same as in Example 1. Q, a nonresident alien individual, is a citizen and resident of Country B and will be age 55 on December 31, 2004. No income tax treaty exists 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 Code Section 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.
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> 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 annui-

tant is age 55), and the actuarial present value of that benefit under Section 4.02(c) of Revenue Procedure 2004-37 is $288,019. Q has never made any after-tax contributions to Plan A, and Code Section 871(f), relating to an exclusion from gross income for amounts received from certain qualified pensions plans, does not apply to any amounts received by Q from Plan A.

Application: The total deemed contributions for the benefit of Q under the method set forth in Section 4.01 of Revenue Procedure 2004-37 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) of the Revenue Procedure), 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 the Revenue Procedure, the portion of each payment that is treated as income from sources outside the United States is equal to the quotient of (1) 160/240 multiplied by $140,553, divided by (2) $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 Code Section 1441(a).

Limitation on Issuance of Private Letter Rulings

The IRS 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 Code Section 401(a) if the proposed method (including the related assumptions) is inconsistent with Revenue Procedure 2004-37.

Conclusion

Revenue Procedure 2004-37 provides a relatively straightforward method for determining the US-source portion of a pension distribution from a qualified defined benefit plan for a participant who has performed services both in the United States and abroad. The revenue procedure thus enables payors of such distributions to calculate and remit the required income tax withholding on the US-source portion of each payment. ■