Part I

Section 861, 862, 933—Income from sources within the United States

26 CFR 1.861: 26 CFR 1.862

Rev. Rul. 2004-75

ISSUES

(1) Whether income received by nonresident alien individuals under life insurance and annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source income that is subject to 30% tax and withholding under sections 871(a) and 1441.

(2) Whether income received by bona fide residents of Puerto Rico under life insurance and annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income that is subject to the tax imposed by section 1.

FACTS

A U.S. life insurance company conducts business in Country A and Puerto Rico through a separate branch in each jurisdiction. The branches sell a wide range of insurance products including, but not limited to, whole life, universal life, and variable life insurance and fixed and variable annuities to individuals living in Country A and Puerto Rico. These products are life insurance and annuity contracts under the Internal Revenue Code. See sections 72(s), 101(f), 817(h), and 7702. There is no income tax treaty in force between Country A and the United States.

Individuals in Country A and Puerto Rico pay premiums to the U.S. life insurance company in exchange for the benefits set forth in the relevant contracts. For example, under a life insurance contract, the life insurance company generally agrees, in exchange for premiums, to pay a certain amount to a beneficiary upon the death of the insured. Under an annuity contract, the life insurance company typically agrees, in exchange for premiums, to pay a certain amount each year to the owner of the contract beginning upon the owner’s retirement and ending upon the owner’s death. The life insurance company invests the premiums received with respect to its life insurance and annuity contracts in domestic and foreign income-producing assets, such as stocks and bonds.

The life insurance and annuity contracts issued by the U.S. life insurance company to individuals in Country A and Puerto Rico have cash values. The individuals in Country A and Puerto Rico withdraw amounts from the cash values of their life insurance and annuity contracts, and the amounts withdrawn are gross income under section 61 to the extent provided under section 72. The individuals in Country A and Puerto Rico also receive annuity payments under their annuity contracts that are gross income under section 61 to the extent provided under section 72.

This revenue ruling applies only to annuity payments and withdrawals of cash value that are gross income to the extent provided under section 72, and does not apply to amounts received under life insurance contracts by reason of the death of the insured that are excludible from gross income under section 101.

LAW

Section 861(a) specifies that certain items of income are U.S.-source income. Section 861(a)(1) generally provides that interest is U.S.-source income when paid by a U.S. obligor. Section 861(a)(2) generally provides that dividends are U.S.-source income when paid by a domestic corporation. Section 861(a) does not specify the source of income paid by a U.S. life insurance company under a life insurance or annuity contract.

When the source of an item of income is not specified by statute or by regulation, courts have determined the source of the item by comparison and analogy to classes of income specified within the statute. Bank of America v. United States, 680 F.2d 142, 147 (Ct. Cl. 1982); Howkins v. Commissioner, 49 T.C. 689 (1968). In 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), the Court of Federal Claims held that the earnings and accretions component of distributions made by an employee stock ownership plan ("ESOP") to foreign participants was U.S.-source income because the trust underlying the ESOP was a domestic trust. See also, Rev. Rul. 79-388, 1979-2 C.B. 270.

Section 871(a) generally provides that a tax of 30 percent is imposed on an amount received from U.S. sources by a nonresident alien individual as interest, dividends, rents, annuities, and other fixed or determinable annual or periodical gains, profits, and income ("FDAP income"), provided that the amount is not income that is effectively connected with the conduct of a U.S. trade or business ("ECI"). The 30-percent tax is imposed by section 871(a) only upon the amount that constitutes gross income. Treas. Reg. § 1.871-7(a)(2). Section 61(a) generally provides that annuities and income from life insurance and endowment contracts are included in gross income. Section 72 generally provides rules for determining the portion of certain amounts received under an annuity, endowment, or life insurance contract that is included in gross income.

FDAP income generally includes all U.S.-source income included in gross income under section 61, except for gain derived from the sale of property, or any other income that the Internal Revenue Service determines, in published guidance, is not FDAP income. Treas. Reg. §§ 1.871-7(b)(1), 1.1441-2(b)(1)(i), and 1.1441-2(b)(2). Moreover, section 871(a)(1) specifically includes amounts received as annuities as a type of FDAP income. In Barba v. United States, 2 Cl. Ct. 674 (1983), the court, in determining whether gambling winnings of nonresident alien individuals from U.S. sources were FDAP income, concluded that the words "fixed and determinable annual or periodical gains" should be interpreted broadly to include all classes of income, except income arising from the sale of property. See also, Commissioner v. Wodehouse, 337 U.S. 369 (1949).

Section 933(1) provides that in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof) is not included in gross income.

Treas. Reg. § 1.863-6 provides that the principles applied for determining income from sources within and without the United States shall generally be applied for purposes of determining income from sources within and without a possession of the United States.

Section 876 provides that in the case of an alien individual who is a bona fide resident of Puerto Rico, sections 871 through 879 do not apply and such individual is subject to the tax imposed by section 1.

ANALYSIS

Because section 861(a) does not include rules specifying the source of income received under a life insurance or annuity contract under section 72, the source of such income is determined by comparison and analogy to classes of income that are specified within the statute. Bank of America, 680 F.2d at 147; Howkins, 49 T.C. at 689. Income received under a life insurance or annuity contract under section 72 is an investment return on the cash value of the contract and is analogous to (1) interest on a debt obligation, (2) dividends on a stock, and (3) earnings and accretions on pension fund assets. Thus, the source of that income is determined in the same manner as the source of interest, dividends, and earnings and accretions on pension fund assets. Under sections 861(a)(1) and (2), interest or dividends are U.S. source when the obligor or corporation, respectively, is domestic. Earnings and accretions on pension fund assets are also U.S. source when the pension trust is domestic. Clayton, 33 Fed. Cl. 628. Accordingly, income received under a life insurance or annuity contract is U.S. source when the issuer of the contract is a domestic corporation.

Income received from a life insurance or annuity contract under section 72 is not gain derived from the sale of property or income that is excluded from FDAP income by the IRS in published guidance. Payments from annuity contracts are specifically listed as a type of FDAP income in section 871(a)(1)(A). Thus, income received from a life insurance or annuity contract under section 72, both annuity payments and withdrawals made from the cash value of the contract, is FDAP income. Accordingly, when such income is received by nonresident alien individuals, it generally is subject to 30% tax and withholding under sections 871(a) and 1441.

Payments made to bona fide residents of Puerto Rico with respect to life insurance and annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company are derived from sources within the United States under the principles described above. Because the payments are not derived from Puerto Rican sources, the payments are not excludible from gross income of the recipient under section 933.

Although the U.S.-source income of bona fide residents of Puerto Rico is subject to U.S. income tax, payments to such residents are not generally subject to tax and withholding under sections 871 and 1441. Bona fide residents of Puerto Rico who are citizens of the United States, as well as bona fide residents of Puerto Rico who are lawful permanent residents of the United States, are generally subject to the tax imposed by section 1. Moreover, under section 876, bona fide residents of Puerto Rico who are not citizens of the United States also are generally subject to the tax imposed by section 1.

HOLDINGS

(1) Income received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source FDAP income that is subject to 30% tax and withholding under sections 871(a) and 1441.

(2) Income received by bona fide residents of Puerto Rico under life insurance or annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income that is subject to the tax imposed by section 1.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory A. Spring of the Office of the Associate Chief Counsel (International). For further information regarding this revenue ruling, contact Mr. Spring at (202) 622-3870 (not a toll-free call).