



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

January 7, 2002

Number: **200215019**  
Release Date: 4/12/2002  
CC:INTL:01  
FSA-N-146403-01  
UILC: 933.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

INTERNATIONAL EXAMINER

FROM: M. Grace Fleeman  
Assistant to the Branch Chief CC:INTL:01

SUBJECT: Application of Section 933 to Distributions from a Puerto  
Rican Pension Plan

This Chief Counsel Advice responds to your memorandum dated September 4, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer  
Spouse  
The Plan

State A  
Amount 1  
Amount 2  
Amount 3  
Date 1  
Month 1  
Year 1  
Year 2

## ISSUE

Whether section 933 prohibits the United States from taxing a lump-sum distribution from a Puerto Rican pension plan to a citizen and resident of the United States who was a bona fide resident of Puerto Rico for a period of at least two years before his change of residence from Puerto Rico.<sup>1</sup>

## CONCLUSION

Based on the information provided, it appears the United States may not tax the portion of the lump-sum distribution that is attributable to the taxpayer's period of Puerto Rican residence.

## FACTS

Taxpayer and Spouse (collectively "the Taxpayers") are citizens of the United States. For more than two years prior to Date 1, they were residents of Puerto Rico.<sup>2</sup> Taxpayers were self-employed.

In Year 1, the Taxpayers established the Plan. The only participants in the Plan were the Taxpayers. The preamble of the Trust Agreement for the trust forming part of the Plan (the "Trust") provides that the Taxpayers are the settlors of the Trust and names the Taxpayer as the trustee. Article IX of the Trust Agreement provides that the validity and effect of the Trust Agreement and the rights and obligations of all parties thereto and/or all other persons affected thereby shall be construed in accordance with the laws of the Commonwealth of Puerto Rico, except where superceded by the laws of the United States.

The Trust was exempt from taxation in Puerto Rico under section 1165(a) of the Puerto Rico Internal Revenue Code. For purposes of section 501(a), the Trust was treated as an organization described in section 401(a) and was exempt from U.S. income tax on its investments even though it was not created or organized in the United States. ERISA §1022(i)(1); Treas. Reg. §1.501(a)-1(e). No election was made under section 1022(i)(2) of ERISA to have the provisions of Title II of ERISA apply.

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<sup>1</sup>Except where otherwise indicated, all references to "section" are to sections of the United States Internal Revenue Code, as amended ("Code" or "I.R.C.").

<sup>2</sup>We assume for purposes of this memorandum that Taxpayer and Spouse were "bona fide residents" of Puerto Rico for purposes of section 933. See Treas. Reg. §1.933-1(a).

The Taxpayers made contributions to the Plan in Year 1 and in each subsequent year until Year 2. We understand that all of the services to which the contributions were related were performed in Puerto Rico.<sup>3</sup>

On Date 1, a date within Year 2, the Taxpayers became residents of State A. In Month 1, Year 2, the Taxpayers received a lump-sum distribution of Amount 1 from Plan. Amount 2 was attributable to contributions made to the Plan and the remainder, Amount 3, represented earnings and accretions. The Taxpayers took the position for purposes of their Year 2 federal income tax return for the period they were residents of State A that their lump-sum distribution was excludible from their gross income pursuant to section 933 (quoted below).

### LAW AND ANALYSIS

Section 61 defines gross income as all income from whatever source derived. Because section 61 does not distinguish between domestic and foreign source income, U.S. citizens and residents are generally taxable on their worldwide income subject to any applicable exclusion expressly granted by the Code.

Income derived from United States possessions may, under certain circumstances, be excluded from gross income. Section 933 provides the following rules for income from sources within Puerto Rico:

The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) RESIDENT OF PUERTO RICO FOR ENTIRE TAXABLE YEAR.—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), but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction under section 151, relating to personal exemptions), or any credit, properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

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<sup>3</sup>This is a critical fact that should be confirmed. If some of the services were performed outside Puerto Rico, you should contact us for further advice.

(2) TAXABLE YEAR OF CHANGE OF RESIDENCE FROM PUERTO RICO.—In the case of an individual citizen of the United States who has been a bona fide resident of Puerto Rico for a period of at least 2 years before the date on which he changes his residence from Puerto Rico, income derived from sources therein (except amounts received for services performed as an employee of the United States or any agency thereof) which is attributable to that part of such period of Puerto Rican residence before such date, but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction for personal exemptions under section 151), or any credit, properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

The Taxpayers, as citizens of the United States who changed their residence from Puerto Rico after having been bona fide residents of Puerto Rico for a period of at least two years immediately preceding the date of such change in residence, are eligible for the section 933(2) exclusion for income derived from sources within Puerto Rico for the period of Puerto Rican residence prior to that date. In order to determine the portion of the lump-sum distribution that is excludible from the Taxpayers' gross income, it is, therefore, necessary to determine the portion that constitutes Puerto Rican source income attributable to the period the Taxpayers were residents of Puerto Rico.

Treasury Regulation §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.

Sections 861 through 864 contain rules for sourcing income for services performed within and without the United States, but those sections contain no specific provision regarding the source of income from pensions.

Section 861(a)(3) provides that compensation for labor or personal services performed within the United States shall be treated as income from sources within the United States, and section 862(a)(3) provides that compensation for labor or personal services performed without the United States shall be treated as income from sources without the United States. Income from services performed partly within and partly without the United States is treated as derived partly from sources within and partly from sources without the United States. I.R.C. §863(b).

Rev. Rul. 79-388, 1979-2 C.B. 270, describes the rules for determining the source of distributions from a private employer's qualified pension plan that is located in the United States and pays benefits to a retired nonresident alien individual who earned the right to the payments by performing services both within and without the United States. The ruling provides that such pension distributions must be allocated

between U.S. and foreign source income as follows: (i) the portion of each distribution attributable to employer contributions with respect to services performed within the United States is income from U.S. sources; (ii) the portion of each distribution attributable to employer contributions with respect to services performed without the United States is income from foreign sources; and (iii) the portion of each distribution attributable to earnings on or accretions to employer contributions is income from U.S. sources. See also G.C.M. 38007 (July 10, 1979).

In Rev. Rul. 79-389, 1979-2 C.B. 281, the Service held for purposes of the section 904 limitation that the same allocation method applies to a United States citizen receiving pension distributions in respect of services performed partly within and partly without the United States.

Treas. Reg. §1.401(a)-50(d) provides a special source rule for distributions to participants and beneficiaries residing outside the United States from a Puerto Rican trust that has made an election under section 1022(i)(2) of ERISA to be treated as a trust created or organized in the United States for purposes of section 401(a). The source of the portion of the distribution representing employer contributions is where the services giving rise to the contributions were performed. Treas. Reg. §1.401(a)-50(d). The remaining portion, which represents earnings and accretions, is treated as income from sources without the United States. Id. A memorandum prepared at the time this regulation was being proposed stated that the determination of the source of distributions from an electing Puerto Rican plan corresponds to the determination of the source of distributions from a U.S. plan as described in G.C.M. 38007, Rev. Rul. 79-388, and Rev. Rul. 79-389. Memorandum from Jerome D. Sebastian, Acting Chief Counsel, by Jonathan P. Marget, Acting Director Employee Plans and Exempt Organizations Division, to Honorable Roscoe L. Egger, Jr., Commissioner of Internal Revenue (May 7, 1981), available in LEXIS (1981 TM LEXIS 50). The memorandum explained that the source of the earnings and accretions “should be that of the situs of the trust, and the situs of a trust under an electing plan is Puerto Rico.” Id.

Prior to the enactment of the Small Business Job Protection Act of 1996, the determination of whether a trust was foreign or domestic depended on whether the trust was more comparable to a resident or nonresident alien individual. It was necessary to consider and weigh various factors such as the location of the assets, the country under whose laws the trust was created, the residence of the fiduciary, the nationality of the settlor, the nationality of the beneficiaries, and the location of the administration of the trust. See Rev. Rul. 60-181, 1960-1 C.B. 257, citing B.W. Jones Trust v. Commissioner, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4<sup>th</sup> Cir. 1943). Under the prior rules, the Trust in this case was classified as a foreign trust.

For tax years beginning after December 31, 1996 (or at the election of the trustee of a trust for tax years ending after August 20, 1996), section 7701(a)(30) provides that the term “United States person” means (A) a citizen or resident of the United States, (B) a domestic partnership, (C) a domestic corporation, (D) any estate

(other than a foreign estate, within the meaning of section 7701(a)(31)), and (E) any trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more United States persons have the authority to control all substantial decisions of the trust. Section 7701(a)(31)(B) provides that the term “foreign trust” means any trust other than a trust described in section 7701(a)(30)(E). Section 7701(a)(9) provides that the term “United States” when used in a geographical sense includes only the States and the District of Columbia.

Under the terms of the Trust Agreement, the trustee is granted various powers over the Trust and has the ultimate responsibility for its administration. Prior to the Taxpayers’ change of residence to State A, Taxpayer as the trustee and as a Puerto Rican resident administered the Trust in Puerto Rico. Accordingly, primary supervision over the administration of the Trust was with a court located in Puerto Rico and no court within the United States within the meaning of section 7701(a)(30)(E) would have exercised primary supervision over the administration of the Trust. See Hanson v. Denckla, 357 U.S. 235 (1958). Accordingly, prior to Taxpayers’ change of residence, the Trust failed the court test and was classified as a foreign trust for tax years beginning after December 31, 1996.

Based on the rules described above, the portion of the Taxpayers’ lump-sum distribution that is attributable to contributions to the Plan constitutes income from sources within Puerto Rico because all the services to which the contributions relate were performed in Puerto Rico. The portion of the lump-sum distribution that is attributable to earnings and accretions prior to Taxpayers’ change of residence also constitutes income from sources within Puerto Rico. Accordingly, the only portion of the lump-sum distribution that may be taxed by the United States is earnings and accretions attributable to the period after the Taxpayers’ change of residence from Puerto Rico.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand the Taxpayers have taken the position that their lump-sum distribution is exempt from tax in Puerto Rico pursuant to 4 U.S.C. §114, which provides that “[n]o State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).” 4 U.S.C. §114(a). For this purpose, the term “State” is defined to include the possessions of the United States. 4 U.S.C. §114(b)(3). However, the term “retirement income” is limited to income from one of nine specified types of plans, including, *inter alia*, a qualified trust under section 401(a) that is exempt under section 501(a) from taxation. 4 U.S.C. §114(b)(1). Because Plan is treated as an organization described in section 401(a) only for purposes of section 501(a), we question whether distributions from the Plan would qualify as “retirement income” for purposes of 4 U.S.C. §114. It is possible the Taxpayers’

lump-sum distribution may be taxable in Puerto Rico. We suggest you consider contacting the Puerto Rican tax authorities pursuant to the Tax Coordination Agreement Between the United States of America and the Commonwealth of Puerto Rico. To do so, you must complete Form 8796, Request for Return/Information, and send it to your Disclosure Officer. The Disclosure Officer will forward the completed Form 8796 to Steve Flesner, U.S. Possession Program Manager, and Steve Flesner will send it to the Puerto Rican tax authorities. If you have any questions with respect to this procedure, you may contact Mr. Flesner directly at (202) 874-1331.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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