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MEMORANDUM

Re: Rev. Rul 2004-75 — Income Received by Non-Resident Aliens under Life Insurance and Annuity Contracts Issued by a Foreign Branch of a U.S. Insurer Is U.S.-Sourced Income

From: Susan J. Hotine

Date: July 13, 2004

In recently released Rev. Rul. 2004-75, the IRS concluded that (1) income received by non-resident alien individuals (“policyholders”) under life insurance and annuity contracts issued by foreign branches of a U.S. life insurance company is U.S.-sourced income subject to the 30% tax and withholding of I.R.C. §§ 871(a) and 1441; and (2) income received by bona fide residents of Puerto Rico (also, “policyholders”) under life insurance and annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-sourced income that is subject to the tax imposed by I.R.C. § 1.

The facts of the ruling noted that branches offered a wide range of insurance products that were life insurance and annuities for U.S. tax purposes and that there were no income tax treaties between the foreign country and the U.S. The facts stated that the premiums are paid by the policyholder to a U.S. life insurance company, and that the company invests the premiums received with respect to its life insurance and annuity contracts in both domestic and foreign income-producing assets, such as stocks and bonds. The factual situation presented is that the policyholder owns an insurance or annuity product that has a cash value and either (a) withdraws an amount from the cash value of the life insurance or annuity contract that is includible in gross income, or (b) receives annuity payments under the annuity contract and some portion of those payments are includible in gross income. The ruling specifically says that it does not apply to amounts that are received under life insurance contracts by reason of the death of the insured and excludible from gross income under I.R.C. § 101.

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Not having the source (U.S. vs. foreign) designated specifically for income paid under life insurance or annuity contracts, the ruling concluded that such payments were analogous to interest, dividends and earnings on pension fund assets, which generally are sourced to the country of the obligor/payor/trust. Thus, income payments under life insurance and annuity contracts of a U.S. insurance company, even though the contracts are sold through a foreign branch, are U.S.-sourced income.

Some observations: Taxpayers have argued that the income paid under contracts sold through foreign branches should be foreign-sourced if the sale activities took place in the country of the foreign branch and the location (foreign or domestic) of the investments underlying the contracts are in foreign countries. By its silence on the facts, the IRS seems to have rejected these taxpayer arguments. At the same time, the facts of the ruling make a point that the contracts under which payments are being made meet the U.S. tax requirements for life insurance and annuity contracts. Accordingly, Rev. Rul. 2004-75 should not be read as affecting old rulings that concluded that income payments or accruals under “failed” annuities issued to non-resident alien individuals qualify as portfolio interest.