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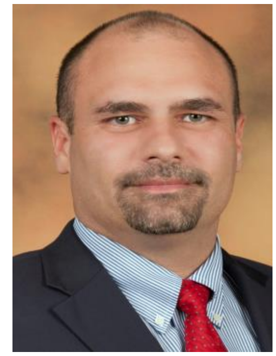

FEDERAL TAX TREATMENT OF POSSESSION SOURCE INCOME

Many US residents generate income related to a myriad of activities from U.S. possessions, which include Puerto Rico, American Samoa, the U.S. Virgin Islands, Northern Marina Islands and Guam. One of the basic questions in these situations is where will that income be taxed; this is essentially what the tax laws refers to as income sourcing rules. In its simplest form, the source of the income is the place where the income becomes available to a person. However, there are very specific rules that address income sourcing for tax purposes. In the case of income generated from U.S. possessions, taxpayers must separately identify income effectively connected with the conduct of a trade or business within the possessions. There are, however, certain specific matters that taxpayers must consider when filing their tax returns. Some specific rules are as follows:

TYPE OF INCOME	GENERAL SOURCING RULE
Salaries, wages and other compensation for labor	Where the labor or service was performed
Pensions	*Return of contributions made:* In the possession in which the services that earned the pension were provided. *Investment earnings*: Where the trust is located
Interest income	Taxpayer’s residence
Dividend income	Where the corporation was created or organized
Rents	Location of property

Given that these are general rules, there are many exceptions. For instance, if a taxpayer is a member of the Armed Forces, or a his/her civilian spouse, and a bona fide resident of a possession, the income will be taxed in the possession even if the services are rendered elsewhere in the U.S. On the other hand, if a person is an employee that works part of the time in a possession and part of the time elsewhere in the U.S., then compensation (other than fringe benefits) is sourced based on a time basis. In other words, if the employee spent 70% of his/her working days in the U.S. and 30% in a possession, then income is sourced 70-30. Some fringe benefits, such as housing, education, transportation, moving expenses and other are sources based on geography.

In the Pensions arena, it is important to note that if a person earned his/her pension from a possession and, once retired, continues to reside in the possession, the return of principal will be sourced to the possession yet the investment earnings, if the pension trust is in the U.S., will be U.S. source income. We will address some other exceptions and special rules in a separate article.