[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND MEXICO

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ON OCTOBER 27, 1993

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

OCTOBER 26, 1993

U.S. GOVERNMENT PRINTING OFFICE

73-304 WASHINGTON : 1993 JCS-16-93

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041715-5

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States of America and the United Mexican States ("Mexico"). The proposed treaty and protocol were both signed on September 18, 1992. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on October 27, 1993.

The proposed treaty (as amended by the proposed protocol) is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model"), and the 1977 model income tax treaty of the Organization of Economic Cooperation and Development ("OECD model"). However, there are certain substantive deviations from those documents. Among other things, the proposed treaty includes a number of provisions to accommodate aspects of the Tax Reform Act of 1986.

Part I of the pamphlet summarizes the principal provisions of the proposed treaty and protocol. Part II presents a discussion of issues raised by the proposed treaty and protocol. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. income tax treaties in general. This is followed in part IV by a detailed, article-by-article explanation of the proposed treaty including, where appropriate, explanation of the provisions of the proposed protocol.[2]

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States Mexico* (JCS–16–93), October 26, 1993.

[2] For a copy of the proposed tax treaty and protocol, see Senate Treaty Doc. 103-7, May 20, 1993.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and Mexico are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country would tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other country would not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14, 15, and 18). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally could be taxed by both countries (Articles 10, 11, 12, and 13); generally, however, the rate of tax that the source country could impose on a resident of the other country on dividends, interest, and royalties would be limited by the proposed treaty (Articles 10, 11, and 12).

In situations where the country of source would retain the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally would provide for the relief from the potential double taxation by the country of residence allowing a tax credit for certain foreign taxes paid to the other country (Article 24).

The proposed treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country would retain the right to tax its citizens and residents as if the treaty had not come into effect (Article 1(3)). In addition, the proposed treaty contains the standard provision that it would not be applied to deny any taxpayer any benefits it would be entitled to under the domestic law of a country or under any other agreement between

the two countries (Article 1(2)); that is, the treaty would only be applied to the benefit of taxpayers.

Differences between proposed treaty and model treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model and OECD model treaties. Some of these differences are as follows:

(1) The saving clause of the U.S model provides that a country may tax its citizens as if the treaty were not in effect. For this purpose, it includes as a citizen a person who is a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of *income* tax, but only for a period of ten years following such loss. The proposed treaty contains a similar ten-year rule for ex-citizens, except that it would apply to any such person whose loss of citizenship had as one of its principal purposes the avoidance of tax. Thus, for example, the proposed treaty's saving clause would apply to a former citizen whose principal purposes for renouncing his or her citizenship included the avoidance of U.S. estate or gift tax.

(2) The U.S. model specifically permits the competent authorities to agree to a common meaning of any term that is not defined in the treaty. The proposed treaty does not contain such specific authority.[3] Under the proposed treaty, any undefined term would have the meaning which it has under the laws of the taxing country unless the context requires otherwise.

(3) For purposes of determining an individual's country of residence (and thus, his or her entitlement to treaty benefits), the U.S. model generally treats a citizen of one of the treaty countries as a resident of that country. The proposed treaty and protocol, by contrast, provides that Mexico would consider a U.S. citizen to be a U.S. resident for treaty purposes only if he or she has a substantial presence in the United States or would be a U.S. resident (and not a resident of any other country) under the proposed treaty's tie-breaker rules for determining residency. The proposed protocol contains a similar limitation, also not present in the U.S. model, for aliens admitted to the United States for permanent residence (i.e., "green card" holders).

(4) The proposed treaty explicitly provides that the governments of Mexico and the United States (including political subdivisions and local authorities) would be treated as residents of Mexico and the United States, respectively. Neither the U.S. model nor the OECD model contain specific residency rules for the governments of the countries that are parties to the treaty.

(5) The proposed treaty, unlike the U.S. model, does not treat a dual resident company (i.e., a company that is a resident of both treaty countries) as a resident of the country under whose laws it was created. Under the proposed treaty, a dual resident company would be treated as a resident of neither the United States nor Mexico for treaty purposes, and, hence, would be entitled to no treaty benefits. Nor would the recipient of a dividend such a com-

[3] The proposed treaty does provide that the competent authorities may consult together regarding cases not provided for in the treaty. It is not clear whether this language is intended to permit them to agree to a common meaning of an otherwise undefined term.

pany pays be entitled to treaty reduction of source country taxation of the dividend.

Similarly, whereas the U.S. model provides for competent authority determination (on the basis of mutual agreement) on the mode of application of the treaty to a person other than an individual or a company that is a dual resident, no such rule is found in the proposed treaty. As would be the case for a dual resident company, such a person would be treated as a resident of neither the United States nor Mexico under the proposed treaty.

(6) The proposed treaty's definition of a permanent establishment diverges in some respects from the definition contained in the U.S. model. For instance, under the proposed treaty, a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources (or related supervisory activity) that an enterprise of one country has in the other country would constitute a permanent establishment in that other country if it lasts more than six months. This six-month period is significantly shorter than the 12-month period provided for in the U.S. model.

In addition, some differences exist between the provisions of the U.S. model and those of the proposed treaty with respect to the determination of whether the activities in one of the countries (the "first country") of an agent (other than an independent agent as defined in the treaties) that is acting on behalf of an enterprise of the other country constitutes a permanent establishment. Both treaties provide that such an enterprise would be deemed to have a permanent establishment in the first country if the agent has and habitually exercises in that country an authority to conclude contracts in the name of the enterprise, unless the activities of the agent are limited to those activities specifically mentioned in the treaty as activities that would not give rise to a permanent establishment. The proposed treaty further provides that a permanent establishment would be deemed to exist in a case where the agent has no authority to conclude contracts in the name of the enterprise, but habitually processes in the first country on behalf of the enterprise goods or merchandise maintained there by that enterprise, provided that the processing is carried on using assets furnished (directly or indirectly) by that enterprise or a related person. In addition, the proposed treaty provides that an enterprise of one of the countries that is engaged in the insurance business would, except with respect to reinsurance activities, be deemed to have a permanent establishment in the other country if it collects premiums in the territory of that other country or insures risks situated therein through a representative other than an independent agent. The U.S. model treaty does not contain either of these latter two provisions.

With respect to the activities of independent agents, both the proposed treaty and the U.S. model provide that an enterprise of one country would not be deemed to have a permanent establishment in the other country merely because it carries on business in that other country through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. The proposed treaty, however, places an additional limitation on the oper-

ation of this rule that is not found in the U.S. model. Under the proposed treaty, this rule would not apply if in the persons' commercial or financial relations with the enterprise, conditions are made or imposed that differ from those generally agreed to by independent agents.

(7) The proposed protocol contains a special provision concerning the imposition of the assets tax by Mexico. A similar provision is not contained in the U.S. model because the United States does not impose a tax based on assets. Under the proposed protocol, the Mexican assets tax generally would not apply to a U.S. resident that, pursuant to Article 7 (Business Profits) of the proposed treaty, would not be taxable in Mexico on its business profits because it has no permanent establishment in Mexico. Notwithstanding this exception, the assets tax could be imposed on immovable property situated in Mexico and on certain tangible and intangible property specified in Article 12 (Royalties) that are furnished to Mexican residents.

Under Mexican law, the assets tax generally applies only to the extent that it exceeds any income tax paid to Mexico by the taxpayer. The proposed protocol contains a provision that would prevent the operation of the assets tax from negating certain income tax benefits granted under the proposed treaty.

(8) Unlike the U.S. model, the proposed treaty provides that a country could tax the business profits of an enterprise of the other country where those profits are attributable to a permanent establishment that the enterprise formerly had in the first country. This provision reflects the policy underlying Code section 864(c)(6) which was added by Congress in the Tax Reform Act of 1986 and permits the United States to tax certain deferred payments received by a foreign person without regard to whether the person is engaged in a U.S. trade or business in the taxable year of receipt of the payments.

Similarly, Article 13 (Capital Gains) of the proposed treaty clarifies that a country could tax the capital gains of a resident of the other country that are attributable either to a permanent establishment which that person has or had in the first country, or to a fixed base which is or was available to that person in the first country for the purpose of performing independent personal services. Addition of the words "or had" clarifies that, for purposes of the treaty rules stated above, any gain attributable to a permanent establishment (or fixed base) during its existence would be taxable in the country where the permanent establishment (or fixed base) is situated even if the gain is deferred until after the permanent establishment has ceased to exist. The Treasury Department has indicated that this language would accommodate the application of Code section 864(c)(7) to a resident of Mexico.

(9) The business profits article of the U.S. model treaty omits the force of attraction rules contained in the Code, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. The proposed treaty, on the other hand, contains a limited force of attraction rule under which a country (the "first country") could tax sales in that country by a resident of the other country of goods or merchandise of the

same or similar kind as the goods or merchandise that are sold by that person through its permanent establishment in the first country. Such profits would not be taxable by the first country, however, if the enterprise demonstrates that the sales have been carried out for reasons other than obtaining a treaty benefit. This rule is narrower in scope than the Code's force of attraction rules.

(10) Both the U.S. model and the proposed treaty provide that in determining the business profits of a permanent establishment, there would be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses wherever incurred, for the purposes of the enterprise as a whole (or part thereof which includes the permanent establishment). The proposed treaty (as amended by the proposed protocol), but not the U.S. model, specifies that this rule would apply only to the extent that the expenses have not been deducted by the enterprise and are not reflected in other deductions allowed to the permanent establishment, such as the deduction for the cost of goods sold or the value of purchases. In a further divergence from the U.S. model, the proposed treaty provides that no such deduction would be allowed in respect of such amounts, if any, paid (otherwise than toward reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents or other rights, by way of commission, for specific services performed or for management, or except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment.

(11) As is true of some other existing U.S. income tax treaties, the proposed treaty would not provide protection from source country taxation of income from bareboat (i.e., without crew) leases of ships and aircraft in international traffic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the model provides for exemption from tax in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic, but that leases ships or aircraft to others for use in international traffic. Under the proposed treaty, the exemption for shipping profits would not apply to profits from the rental on a bareboat basis of ships or aircraft unless those profits are accessory to international shipping income of the lessor.

(12) The proposed protocol specifies that if the law of one of the treaty countries calls for a payment to be characterized in whole or in part as a dividend or limits the deductibility of such payment because of thin capitalization rules or because the relevant debt instrument includes an equity interest, that country could treat such payment in accordance with such law. Thus, for example, the proposed treaty would foreclose any suggestion that the proposed treaty might preclude the United States from applying (or limit the application of) its so-called "earnings stripping" rules (sec. 163(j)) re-

lating to the deductibility of interest expense. No similar provision is contained in the U.S. model treaty.

(13) The proposed treaty and the U.S. model treaty differ in their respective treatment of rental income. Under the U.S. model, the term "business profits" includes income of a trade or business which is derived from the rental of tangible personal property and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting. Thus, such income could only be taxed by the source country if it were attributable to a permanent establishment situated therein. Under the proposed treaty, on the other hand, such income generally is treated as "royalties" and, accordingly, is subject to the rules of Article 12. Under Article 12, the source country would be permitted to tax royalties derived by a resident of the other country at a rate not in excess of 10 percent. Alternatively, royalties that are attributable to a permanent establishment located in the source country would be taxable on a net basis as business profits.

(14) The proposed protocol specifies that nothing in the business profits article of the proposed treaty would affect the application of any law of either the United States or Mexico relating to the determination of the tax liability of a person in any case where the information available to the competent authority of that country is inadequate to determine the profits to be attributed to a permanent establishment or in the cases covered by Article 23 of the Income Tax Law of Mexico, provided that, on the basis of the available information, the determination of the profits of the permanent establishment is consistent with the principles of the business profits article. A provision of this nature is not found in the U.S. model treaty.

(15) The associated enterprises article of the proposed treaty differs in two principal respects from that article of the U.S. model treaty. First, under the proposed treaty, either treaty country would be required to correlatively adjust any tax liability it previously imposed on an enterprise for profits reallocated to an associated enterprise by the other treaty country, if the first country agrees with the substance of the second country's adjustment. The corresponding U.S. model language is slightly different in that it does not condition the making of the correlative adjustment on the first country's *agreement* to the original adjustment made by the other country. Second, the proposed protocol provides that the rule requiring the country of residence to make a correlative adjustment would not apply in the case of fraud, gross negligence, or willful default.

(16) Under the proposed treaty, direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) would generally be taxable by the source country at a rate no greater than 5 percent. Portfolio investment dividends (i.e., those paid to companies owning less than a 10 percent voting share interest in the payor, or to noncorporate residents of the other country) would generally be taxable by the source country, after the treaty is fully

phased in, at a rate no greater than 10 percent.[4] (Different rules, discussed below, are provided for dividends from a regulated investment company or real estate investment trust.) The U.S. model prescribes maximum source country tax rates of 5 percent on direct investment dividends and 15 percent on other dividends.

The proposed protocol contains a unique "most-favored nation" clause relating to the taxation of dividends. Under that clause, if the United States agrees in a treaty with another country to impose a rate of tax on direct investment dividends that is lower than the 5-percent rate contained in the proposed treaty, then the United States and Mexico would apply that lower rate as if it were the rate specified by the proposed treaty.

(17) The proposed protocol would apply a withholding rate of 10 percent (15 percent during the transition period) on dividends if those dividends are paid by a U.S. regulated investment company (RIC) regardless of whether the RIC dividends are paid to a direct or portfolio investor. The proposed treaty would not provide for a reduction of U.S. withholding tax on dividends if those dividends are paid by a U.S. real estate investment trust (REIT), unless the dividend is beneficially owned by an individual Mexican resident holding a less than 10 percent interest in the REIT.

(18) The U.S. model treaty provides an exemption from source country taxation on interest. To the contrary, the proposed treaty provides that certain categories of interest derived by a resident of one country which arises from sources in the other country could be taxed by the other country, subject to maximum rates established in the treaty (ranging from 4.9 percent to 15 percent depending on the category in which the interest falls and when it is received).

(19) Under the proposed protocol, no reduction of U.S. withholding tax would be granted under the proposed treaty to a Mexican resident that is a holder of a residual interest in a U.S. real estate mortgage investment conduit (REMIC) with respect to any excess inclusion.[5] Moreover, if either country develops an entity that, although not identical to a REMIC, is substantially similar to a REMIC or an instrument that is substantially similar to a residual interest in a REMIC, the competent authorities of the two countries would be required to consult with each other to determine whether the above-described treatment applicable to REMICs would apply to such instrument or entity. The interest article of the U.S. model treaty does not contain a provision dealing with residual interests in REMICs or similar entities.

(20) Unlike the U.S. model treaty (which was drafted before enactment of the branch taxes in the United States), the proposed treaty expressly would permit the United States to impose the branch profits tax. The proposed treaty also would expressly prevent imposition of any other form of second-level withholding tax. The U.S. branch profits tax could be imposed at a rate not exceed-

[4] For a period of five years from the date on which the provisions of the dividends article takes effect, such dividends would be taxable by the source country at a rate of 15 percent.

[5] Similarly, upon notification of the U.S. competent authority by the Mexican competent authority that Mexico has authorized the marketing of securitized mortgages in a manner identical to a REMIC, no treaty reduction in Mexican withholding tax would apply to a U.S. resident that is a holder of an interest in such an entity with respect to income that is comparable to an excess inclusion.

ing 5 percent under the proposed treaty. In addition, the proposed treaty would expressly permit the United States to impose the branch-level interest tax at a rate not exceeding 10 percent (or in some cases, at a rate not exceeding 4.9 percent). The non-discrimination article of the proposed treaty makes clear that nothing in that article is to be construed as preventing either country from imposing its branch taxes.

(21) The U.S. model treaty provides that royalties derived and beneficially owned by a resident of one treaty country generally are taxable only in that country, even if they arise from sources in the other country (unless they are attributable to a permanent establishment located in that other country). The proposed treaty, on the other hand, would permit the source country to tax such royalties. In such a case, the tax so charged could not exceed 10 percent of the gross amount of the royalties.

(22) The proposed treaty provides a rule for determining where royalties are deemed to arise which is not found in the U.S. model treaty. This source rule would not apply for purposes of the rules of the proposed treaty dealing with relief from double taxation. Under this rule, a royalty would be deemed to arise in a treaty country when the payor is that country (or its political subdivision or local authority) or a resident (as defined in the treaty) of that country. If, however, the royalty expense is borne by (i.e., for purposes of computing taxable income, deductible by) a permanent establishment (or fixed base) that the payor has in Mexico or the United States, the royalty would have as its source the country in which the permanent establishment (or fixed base) is located, regardless of the residence of the payor. In addition, the proposed treaty provides that where the preceding rules would not operate to deem royalties as arising in either the United States or Mexico, and the royalties relate to the use of, or the right to use, in one of those countries, any property or right encompassed within the proposed treaty's definition of royalties, then the royalties would be deemed to arise in that country.

(23) Both the U.S. model treaty and the proposed treaty provide for source country taxation of capital gains from the disposition of real property regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty (as amended by the proposed protocol) would expand the U.S. model treaty definition of real property for these purposes to encompass "U.S. real property interests." This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980 which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

(24) The proposed treaty would permit a treaty country (the "first country") to impose its statutory tax on gains from the disposition, by a resident of the other country, of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the first country if the recipient of the gain, during the 12-month period preceding the disposition, had a direct or indirect participation of at least 25 percent in the capital of that company or other legal person. Such gains would be treated as arising in the first country to the extent necessary to avoid double taxation. The proposed protocol further provides that certain tax-free

reorganization rules would apply (similar to the reorganization rules under U.S. law) to transactions involving the stock of certain closely-held U.S. and Mexican companies, and, thus, no source country tax would be imposed with respect to such stock dispositions.

(25) In a manner similar to the U.S. model treaty, the proposed treaty provides that income derived by an individual who is a resident of one of the treaty countries from the performance of personal services in an independent capacity generally would not be taxable in the other treaty country unless the person has a fixed base in the other country which he or she regularly makes use of in performing his or her activities; in such a case, the other country would be permitted to tax the income from services performed within its territory which is attributable to the fixed base. Contrary to the U.S. model, however, the proposed treaty also would allow a treaty country to tax income attributable to independent personal services performed within its territory by a resident of the other country if he or she is present in the source country for a period or periods exceeding a total of 183 days within a 12-month period.

(26) The independent personal services article of the proposed treaty (as supplemented by the proposed protocol) also deviates from the U.S. model and from other U.S. tax treaties by extending the application of that article to income derived by a U.S. company from the furnishing of personal services through a fixed base in Mexico. In such a case, the company would be permitted to compute the tax on the income from such services on a net basis as if that income were attributable to a permanent establishment in Mexico. This rule is necessary because, under Mexican law, a personal service company is not considered to earn business profits, so such a company would be taxed by Mexico under Article 14 rather than under Article 7. Such treatment, however, would not result in a substantially different level of taxation since both articles would allow for taxation on a net-income basis.

(27) The dependent personal services article of the proposed treaty varies slightly from that article of the U.S. model. Under the U.S. model, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of employment exercised in the other country may be taxable by the other country if the recipient is present in the other country for a period or periods exceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied. The proposed treaty contains a similar rule, but provides that the measurement period for the 183-day test would not be limited to the taxable year; rather, the source country could tax the income if the individual is present there for a period or periods exceeding in the aggregate 183 days in a 12-month period.

(28) The U.S. model treaty prohibits source country tax on remuneration of a treaty country resident employed as a member of the regular complement of a ship or aircraft operating in international traffic. The proposed treaty contains no special rule for such employment income.

(29) The proposed treaty would allow directors' fees and similar payments derived by a treaty country resident for services performed outside of the residence country in his or her capacity as

a director or overseer of a company resident in the other country to be taxed in the other country. The U.S. model treaty, on the other hand, treats directors' fees as personal service income. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model positions.

(30) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar in many respects to the limitation on benefits articles contained in recent U.S. treaties[6] and in the branch tax provisions of the Code. The article of the proposed treaty, however, contains rules dealing with residents of certain third countries that are present in neither the U.S. model treaty nor in most other existing U.S. income tax treaties.[7] Under these rules, the proposed treaty would treat as non-disqualifying ownership certain proprietary interests held by residents of countries that are parties to the proposed North American Free Trade Agreement (NAFTA); those countries presently are the United States, Mexico, and Canada. The proposed protocol specifies that these rules would only take effect upon entry into force of NAFTA.

The proposed treaty also contains an alternative public company test which would treat certain ownership by residents of any country that is a party to NAFTA as qualifying ownership for all purposes of the proposed treaty. Under this alternative public company test, a company that is a resident of Mexico or the United States and that (1) is owned entirely (directly or indirectly) by publicly-traded companies that are residents of NAFTA countries, and (2) is more than 50-percent owned (directly or indirectly) by either publicly traded Mexican or U.S. companies would be entitled to the benefits of the treaty.

(31) Under the U.S. model treaty, a source country may tax income derived by an entertainer or athlete who earns more than $20,000 there during a taxable year, without regard to the existence of a fixed base or other contacts with the source country. The proposed treaty, on the other hand, provides for a much lower $3,000 annual income threshold. The proposed treaty, unlike the U.S. model, provides that the income of an entertainer or athlete that would be subject to this article of the treaty includes remuneration for any personal activities he or she performs in the other treaty country relating to that individual's reputation as an entertainer or athlete (e.g., remuneration derived from product endorsements). Also unlike the U.S. model, the entertainers and athletes article in the proposed treaty prohibits source country taxation of

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[6] See, e.g., the recently ratified income tax treaty between the United States and Germany.

[7] The proposed income tax treaty between the United States and the Netherlands does, however, contain similar rules, as does the current income tax treaty between the United States and Jamaica.

income derived on visits substantially supported by a government in the residence country.

(32) The U.S. model treaty provides that pensions (other than those relating to government service) and other similar remuneration derived and beneficially owned by a resident of a treaty country in consideration of past employment are taxable only in the residence country. The proposed treaty contains a similar provision, but would explicitly extend coverage to pensions and other similar remuneration in consideration of past employment by another individual resident of the same country as the person deriving and beneficially owning the income. Thus, for example, the treaty makes it clear that it would cover pension payments received by a person related to past employment of that person's spouse.

(33) The proposed treaty differs from the U.S. model treaty with respect to the tax treatment of alimony payments. Under the U.S. model, on the one hand, alimony is taxable only in the country where the recipient resides. Under the proposed treaty, on the other hand, alimony would be taxable only in the source country (i.e., the country of residence of the payor).

(34) The U.S. model, and many existing U.S. treaties,[8] permit only the source country to tax remuneration, including pension payments, paid to its *citizens* from the public funds of that country (or a political subdivision or local authority thereof) in respect of services rendered in the discharge of functions of a governmental nature. The proposed treaty, by contrast, provides that remuneration other than a pension, paid by the government of a treaty country to *an individual* in respect of services rendered to it generally would be taxable only by that country. Such remuneration, however, would be taxable only by the other treaty country if the services are rendered in that country by a resident individual who either is a national of that country or did not become a resident solely for the purpose of rendering the services.

With respect to government pension payments, the proposed treaty provides that such payments made to *an individual* in respect of services previously rendered to the payor treaty country generally would be taxable only by that country. This rule would not apply, however, if the individual recipient of the payments is a resident and national of the other country. In this case, the payments would be taxable only by the country of residence of the recipient.

(35) The proposed treaty contains an article dealing with tax-exempt organizations which is neither found in the U.S. model treaty nor in most other U.S. income tax treaties. In general, this article of the proposed treaty provides for reciprocal recognition of the status as tax-exempt of certain organizations that reside in either the United States or Mexico. In addition, this article would permit deductions for contributions made by a resident of one of the countries to a qualified charitable organization located in the other country. The provisions of this article would not be subject to the proposed treaty's saving clause; the United States would be required, therefore, to permit a deduction for contributions by its citi-

[8] See U.S. income tax treaties with Australia, Barbados, Belgium, China, Cyprus, Finland, France, Hungary, Iceland, Indonesia, India, Jamaica, Korea, New Zealand, the Philippines, and Sri Lanka, and pending treaties such as Denmark.

zens or residents to Mexican charitable organizations even though doing so would be contrary to domestic U.S. law.

Also under the proposed treaty, a religious, scientific, literary, educational or other charitable organization which is resident in Mexico and which has received substantially all of its support from persons other than U.S. citizens or residents would be exempt from the U.S. excise taxes imposed with respect to private foundations. In addition, qualified Mexican charities would be treated as public charities under U.S. law for purposes of grants by U.S. private foundations and public charities. Thus, such grants would not be considered "taxable expenditures" for purposes of the excise tax on taxable expenditures (Code sec. 4945).

(36) The proposed treaty contains an "other income" article which differs fundamentally from the "other income" article of the U.S. model treaty. Under the U.S. model, income not dealt with in another treaty article generally may be taxed only by the residence country. By contrast, the proposed treaty specifies that items of income of a resident of a treaty country which are not dealt with elsewhere in the treaty and which arise in the other treaty country would be taxable in the other country.

(37) The relief from double taxation article of the proposed treaty expressly provides that the taxes covered by that article include the Mexican profits tax which is imposed on certain distributions, but only to the extent that such tax is imposed on earnings and profits as calculated under the tax accounting rules of the treaty country in which the beneficial owner of the distribution resides.

(38) The relief from double taxation article of the proposed treaty contains a special rule for U.S. citizens who reside in Mexico. Under that rule, with respect to items of income derived by such a person which, pursuant to the proposed treaty, would be either exempt from U.S. tax or subject to a reduced rate of U.S. tax, Mexico would allow as a credit against its income tax, subject to Mexico's domestic foreign tax credit rules, only the tax paid (if any) that the United States would be permitted to impose under the proposed treaty (other than taxes that it could impose solely on the basis of the person's U.S. citizenship). For purposes of computing U.S. tax, the United States would allow as a credit against its income tax the income tax paid to Mexico after application of the credit described in the preceding sentence. The credit so allowed by the United States, however, could not reduce that portion of the U.S. tax that is creditable against Mexican tax under this special rule. For the exclusive purpose of relieving double taxation in the United States under these rules, the items of exempt or reduced rate income described above would be sourced in Mexico to the extent necessary to avoid double taxation of such income.

(39) The proposed treaty would require a case to be presented for competent authority review in sufficient time so that the competent authority of the other country is notified within four and a half years from the due date or the date of filing of the return at issue in that country, whichever is later. This contrasts with the absence of such a time limit under the U.S. model and with a three-year limit under the OECD model. The proposed treaty further provides that any agreement reached with respect to a competent authority case would have to be implemented within 10 years from the due

date or the date of filing of the return at issue in the other country, whichever is later, or a longer period if permitted by the domestic law of that other country. No such time limit applies under either the U.S. or OECD model treaties.

(40) The U.S. model treaty makes express provision for competent authorities to mutually agree on topics that may arise, such as (1) the attribution of income, deductions, credits, or allowances of an enterprise of a treaty country to its permanent establishment in the other treaty country, (2) the allocation of income, deductions, credits, or allowances between persons, (3) the characterization of particular items of income, (4) the application of source rules with respect to particular items of income, (5) the common meaning of a term, (6) increases in any specific amounts referred to in the treaty to reflect economic or monetary developments, (7) the application of procedural aspects of internal law, and (8) the elimination of double taxation in cases not provided for in the treaty. The proposed treaty merely provides that the competent authorities of Mexico and the United States could consult together regarding cases not provided for in the treaty. It does not contain the above-cited list of examples from the U.S. model.

(41) The proposed treaty (as supplemented by the proposed protocol) provides for a binding arbitration procedure which could be used to settle disagreements between the two countries regarding the interpretation or application of the treaty. The arbitration procedure is similar to the procedure agreed to in the recently ratified treaty between the United States and Germany. The procedure could only be invoked by the agreement of the taxpayers involved and the competent authorities of both countries. This provision of the proposed treaty would only become effective after a further exchange of diplomatic notes by the United States and Mexico.

(42) The exchange of information article of the proposed treaty is very similar to, but somewhat more detailed than, the corresponding article of the U.S. model treaty. The proposed treaty would incorporate the provisions of the existing bilateral Tax Information Exchange Agreement (TIEA) which was entered into by the United States and Mexico in 1989.

II. ISSUES

The proposed treaty, as amended by the proposed protocol, presents the following specific issues.

(1) Treaty-shopping—in general

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country would receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Mexico and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money, to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provision, however, differ either from an anti-treaty shopping provision proposed at the time that the U.S. model treaty was proposed, or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty shopping provision of the treaty would effectively forestall potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in one version proposed with the U.S. model treaty. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the company's country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country, as well as the governments of the two countries (including local authorities and political subdivisions thereof), and certain public companies and tax-exempt entities that are qualifying residents of either the United States or Mexico. Thus, this safe harbor

would be considerably easier to enter under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article differs from the comparable rule of some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that would allow denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test would not apply with respect to a business of making or managing investments, so benefits could be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty would give the competent authority of the country in which the income arises the ability to override this standard. The proposed treaty provides that in making such a determination, one factor the competent authority should take into account is whether the establishment, acquisition, and maintenance of the person and the conduct of its business did not have as one of its principal purposes the obtaining of treaty benefits.

The practical difference between the proposed treaty tests and the earlier tests would depend upon how they are interpreted and applied. The principal purpose test might be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it might be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., the principal purpose test would operate to deny benefits in potentially abusive situations more often).

It is believed that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible, and in exercising any latitude Treasury has to adjust the operation of the proposed treaty, it should satisfy itself that its rules as applied would adequately deter treaty shopping abuses. The proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Mexico since third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Mexican residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The base erosion test would provide protection from certain potential abuses of a Mexican conduit. Finally, Mexico imposes significant taxes of its own; these taxes may deter third-country investors from

seeking to use Mexican entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. Thus, the Committee may wish to satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses in the future.

(2) Treaty-shopping—treatment of residents of NAFTA countries

The anti-treaty shopping article of the proposed treaty contains two provisions not found in most existing U.S. income tax treaties. (Similar provisions are included, however, in the U.S. income tax treaty with Jamaica and in the proposed treaty between the United States and the Netherlands.) These provisions of the proposed treaty would extend benefits under the treaty to certain entities which satisfy either alternative ownership and base erosion tests or an alternative public company test. These alternative tests would consider as qualifying ownership of such an entity certain interests beneficially held by persons resident in a country that is a party to the proposed North American Free Trade Agreement ("NAFTA"). Thus, interests in a U.S. or Mexican resident entity that are held by residents of Canada may not, in and of themselves, disqualify the entity from treaty benefits.[9] These provisions would only take effect upon the entry into force of NAFTA.

The Treasury Department's technical explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation") states that inclusion of the alternative tests is justified on the grounds that one of the expected results of NAFTA is to encourage joint ventures among residents of the United States, Mexico, and Canada. In addition, under one of the alternative tests, benefits under the proposed treaty would be granted only if those benefits are no more generous than the related benefits granted under the relevant Canadian income tax treaty. Thus, for example, a Canadian resident would not be able to invest in the United States through a Mexican corporation for the purpose of obtaining rates of withholding tax more favorable than could be obtained by investing through a Canadian corporation.

The issue is whether and to what extent, in the context of bilateral income tax treaties, U.S. policy should encourage the grant of special recognition (and extension of treaty benefits) to investors from specified third countries who are entitled to benefits of a separate treaty. Furthermore, in light of the existence and anticipated continual negotiation of other multinational trade agreements (e.g., the General Agreement on Tariffs and Trade ("GATT") and agreements among member states of the European Community), the Committee may wish to consider whether extension of treaty benefits to Canadian residents on the justifiable grounds presented under the U.S.-Mexico treaty would be viewed as having precedential effect, and thus, might give rise to similar requests by

[9] An entity that satisfies the alternative public company test would qualify for all benefits under the proposed treaty. An entity that satisfies the alternative control and base erosion tests would only qualify for benefits (i.e., reduced source country taxes) under the dividends, interest, branch tax, and royalties articles.

other countries in future tax treaty negotiations with the United States.

A second issue involves whether the competent authorities of the treaty countries would adequately administer provisions of a treaty that take into consideration ownership interests held by certain non-treaty country residents. To illustrate, the proposed treaty provides numerous rules for determining whether a person is a resident of either the United States or Mexico. To the contrary, it does not specify rules for determining whether a person would be considered a resident of Canada. Thus, the proposed treaty does not appear to establish controls and guidelines to deal with persons who may claim Canadian residency in order to qualify for treaty benefits.

(3) Insurance excise tax

The proposed treaty covers the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a Mexican insurer or reinsurer with no permanent establishment in the United States could collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. The tax would be imposed, however, to the extent that the risk is reinsured by the Mexican insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause. It appears that the proposed treaty would permit Mexico to impose a similar excise tax and U.S. insurance companies whether or not the insured risks are reinsured with third parties. Moreover, the imposition of such a tax by Mexico would be specifically authorized, up to whatever rate is now imposed by the United States or Canada (whichever is higher), under Article 2103(4)(h) of the proposed North American Free Trade Agreement (NAFTA).

Although waiver of the excise tax appears in the 1981 U.S. model treaty, waivers of the excise tax have raised serious Congressional concerns. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if a substantial tax is not otherwise imposed (e.g., by the other treaty country) on the insurance income of the foreign insurer (or if the insured risk is reinsured with a company that is not subject to a substantial tax). Moreover, in such a case, waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda income tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the so-called "anti-conduit rule") has been followed

by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.[10]

The proposed treaty would waive imposition of the excise tax on premiums paid to residents of Mexico. Based on prior consultations with the Treasury Department, the staff understands that, unlike Bermuda and Barbados, Mexico imposes tax on the income of Mexican insurance companies at an effective rate that is substantial in relation to the U.S. tax on U.S. insurance companies. Unlike the U.K. waiver, moreover, the Mexican treaty waiver contains the standard anti-conduit language. Although it may be difficult to generalize about the precise tax burdens Mexican insurers bear relative to U.S. insurers, or the precise effects of imposing or waiving the excise tax on Mexican insurers' rates of economic return, it may be that there is reason to believe that failure to impose the tax on Mexican insurers would be consistent with the criteria the Committee has previously laid down for waiver of the tax.

(4) Arbitration of competent authority issues

In a step that has been taken only once previously in a U.S. income tax treaty (i.e., in the income tax treaty between the United States and Germany), the proposed treaty and proposed protocol would make provision for a binding arbitration procedure, if both competent authorities and the taxpayers involved agree, for the resolution of those disputes in the interpretation or application of the treaty that it is within the jurisdiction of the competent authorities to resolve. This provision would have effect only after diplomatic notes are exchanged between Mexico and the United States. Consultation between the two countries regarding whether such an exchange of notes should occur would take place after a period of three years after the proposed treaty has entered into force.

Generally, the jurisdiction of the competent authorities under the proposed treaty would be as broad as it is under any U.S. income tax treaties. Specifically, the competent authorities would be required to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They could also consult together regarding cases not provided for in the treaty.

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of review.[11] The competent authorities would not properly agree to be

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[10] See, e.g., P.L. 99-514, sec. 1244 (1986), which directed the Secretary of the Treasury (or his delegate) "to determine whether United States reinsurance corporations are placed at a significant competitive disadvantage with foreign reinsurance corporations by existing treaties between the United States and foreign countries." (The Treasury's report was submitted to Congress in March 1990.) Also see sec. 20132 of the Senate amendment to Title XIX of H.R. 776 (the Comprehensive National Energy Policy Act of 1992) and sec. 303 of H.R. 5270 (the Foreign Income Tax Rationalization and Simplification Act of 1992), which were not enacted into law.

[11] In discussing a clause permitting the competent authorities to eliminate double taxation in cases not provided for in the treaty, Representative Dan Rostenkowski, Chairman of the House Ways and Means Committee, submitted the following testimony in 1981 hearings before the Senate Foreign Relations Committee:

> Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance.

Continued

bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' decision-making power, there likely would be issues that one or the other competent authority would not agree to put in the hands of arbitrators. Consistent with these principles, the proposed protocol provides that the competent authorities would not accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

In approving ratification of the U.S.-Germany treaty, the Committee indicated a belief that the tax system potentially may have as much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes which otherwise may impede efficient administration of the tax laws. However, the Committee also believed that the appropriateness of such a clause in a future treaty depended strongly on the other party to the treaty, and the experience that the competent authorities would have under the provision in the German treaty. To date there have been no arbitrations of competent authority cases under the German treaty, and few tax arbitrations outside the context of that treaty.

(5) Developing country concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most significant of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for broader source-basis taxation. The proposed treaty's permanent establishment article, for example, would permit the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction or installation project (or supervisory activities related to such projects) would create a permanent establishment if it exists in a country for more than six months; under the U.S. model, a building site, etc., must last for at least one year. Thus, for example, under the proposed treaty, a U.S. enterprise's business profits that are attributable to a construction project in Mexico would be taxable by Mexico if the project lasts for more than six months. Similarly, under the proposed treaty, the use of a drilling rig or ship for the exploration or exploitation of natural resources (or related supervisory activities) in a country for more than six months would create a permanent establishment there; under the U.S. model, drilling rigs or ships must be present in a country for at least one year. It should be noted that many tax treaties between the United States and developing countries provide a permanent establishment threshold of six months for building sites and drilling rigs.

Tax Treaties: Hearings on Various Tax Treaties Before the Senate Committee on Foreign Relations, 97th Cong., 1st Sess. 58 (1981).

In addition, the proposed treaty contains two provisions, not present in either the U.S. or OECD model treaties, that specify certain activities of dependent agents which would give rise to a permanent establishment. The first provision would treat an insurance company resident in one of the countries as having a permanent establishment in the other country if it receives premiums or insures risks in that other country.[12] This rule would apply unless the risks are insured through a broker or independent agent operating in the ordinary course of its business. Thus, for example, if a U.S. insurance company insures, through an employee, risks located in Mexico, then the income generated from the insurance of those risks could be taxed by Mexico under the business profits article of the proposed treaty. A similar provision is contained in the United Nations model treaty.

Under the second provision, an enterprise of one treaty country would be treated as having a permanent establishment in the other country if its dependent agent habitually processes in the other country on behalf of the enterprise goods or merchandise maintained in that other country by the enterprise with the use of assets furnished by the enterprise or a related person. It is understood that the purpose of this provision is to allow Mexico, if it so chooses, to impose income and assets tax on so-called "maquiladora" (or "twin-plant" or assembly) operations.

Source basis taxation

Additional concessions to source basis taxation in the proposed treaty include maximum source country tax rates on interest that are higher than that provided in the U.S. model treaty; a maximum rate of source country tax on royalties that is higher than that provided in the U.S. model treaty; taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the proposed treaty; and broader source country taxation of personal services income (especially directors' fees) and income of artistes and athletes than that allowed by the U.S. model.

Taxation of business profits

Under the U.S. model and many other U.S. income tax treaties, a country may only tax the business profits of a resident of the other country to the extent those profits are attributable to a permanent establishment situated within the first country. The proposed treaty would expand the definition of business profits to include profits that are derived from sources within the country where a permanent establishment exists from sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment. This expanded definition is similar to the United Nations model treaty. It should be noted that although this rule provides for broader source basis taxation than does the rule contained in the U.S. model, it is less broad in some respects than the general "force of attraction" rule of Code section 864(c)(3).

Also following the United Nations model treaty is a rule in the proposed treaty that would limit certain deductions for expenses in-

[12] This rule does not apply to reinsurance activities, however.

curred on behalf of a permanent establishment by the enterprise's head office.

Certain equipment leasing

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties would include payments for the use of, or the right to use, industrial, commercial, or scientific equipment. These payments are often considered rentals in other treaties, subject to business profits rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country, and in such case, the tax is computed on a net basis. By contrast, the proposed treaty would permit gross-basis source country taxation of these payments, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment situated in that country.[13]

Issue presented

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Mexico. The practical effect of these developing country concessions could be greater Mexican taxation of future activities of U.S. firms in Mexico than would be the case under the rules of either the U.S. or OECD model treaties.

The issue is whether these developing country concessions represent appropriate U.S. treaty policy and, if so, whether Mexico is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries. A number of existing U.S. income tax treaties with developing countries already include similar concessions. Such concessions arguably are necessary in order to obtain treaties with developing countries. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

(6) Tax-exempt entities

Pursuant to the exempt organizations article of the proposed treaty, if the United States and Mexico agree that a provision of Mexican internal law provides standards for organizations authorized to receive deductible contributions that are essentially equivalent to the standards of U.S. law for public charities, then an organization which is determined by Mexican authorities to meet such standards would be treated, for purposes of grants by U.S. private foundations and public charities, as a public charity under U.S. law. In addition, contributions by a U.S. resident or citizen to such an organization would be treated as charitable contributions to a public charity under U.S. law. The proposed treaty, thus, would re-

[13] If the payments are attributable to such a permanent establishment, then the business profits article of the proposed treaty would apply.

quire that the United States grant a deduction for contributions made by U.S. persons to certain Mexican charities.[14]

According to the proposed protocol, the two countries have agreed that Article 70-B of the Mexican Income Tax Law and section 509(a)(1) and (2) (except as that section applies to churches) of the U.S. Internal Revenue Code, as interpreted by the governing regulations and administrative rulings of Mexico and the United States, respectively, as in effect on the date of signing of the proposed treaty, provide essentially equivalent standards for organizations within their coverage. Pursuant to this agreement, the rules detailed in the preceding paragraph would become operational at the time the treaty enters into effect. The proposed protocol further explains that the certification made by a treaty country of the status of its resident as an organization meeting the standards set out in the proposed treaty would be accepted by the other country for the purpose of allowing the organization to qualify for the above-described benefits. If the competent authority of the other country determines, however, that granting such benefits would be inappropriate with respect to a particular organization or type of organization, then such benefits could be denied after consultation with the other competent authority.

These rules are contrary to the U.S. model treaty and standard U.S. treaty policy. A provision requiring the granting of deductions for contributions to treaty country charities is found in only one currently effective U.S. income tax treaty—the treaty with Canada—and in one income tax treaty that is not yet in force—the treaty with Israel. The Senate report in 1981 on the Israel treaty and first protocol included the following "Committee comment":

> The Committee is concerned with granting deductions to U.S. persons by treaty in cases where the Congress has chosen not to do so under the Code. The Committee does not believe that the practice of allowing tax deductions to U.S. persons for contributions to charities in foreign countries should be expanded by the treaty process. The same objective can be accomplished through domestic law, and the Committee does not believe that treaties are a proper forum for providing the deduction. The Committee notes that the chairmen of both the Senate Committee on Finance and the House Committee on Ways and Means have expressed serious reservations about this provision. The Committee is, however, aware that a similar provision is contained in the Canadian treaty and that this provision was negotiated with that precedent in mind. Accordingly, because of the importance of this provision to Israel the Committee will not recommend a reservation. The Committee will, however, very seriously consider such a recommendation if in the future, a treaty with a similar provision is negotiated and transmitted to the Senate.[15]

Subsequent to the issuance of that report, the Senate reported a revision of the Canadian treaty which contained a restatement of

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[14] The proposed treaty contains a reciprocal rule that would require Mexico to grant deductions for contributions made by its residents to qualifying U.S. organizations.

[15] Exec. Rep. No. 97-29, 97th Cong., 1st Sess., 6 (1981).

the charitable deduction provision. The Senate report contained the following "Committee Comment":

> The proposed treaty also would permit U.S. persons a deduction for contributions to Canadian charities and Canadian persons a deduction for contributions to U.S. charities. The present treaty (like the treaty with Israel) contains a similar provision.
>
> The Committee recognizes that the special relationship between the United States and Canada may arguably warrant the treaty's expanded allowance of deductions for contributions to charities of the other country. . . . However, the Committee remains deeply concerned about the granting of deductions to U.S. persons by treaty where the Code does not otherwise grant the deductions. The Committee expressed this concern in 1981 in connection with its consideration of the proposed Canadian treaty (and the proposed Israeli and Jamaican treaties) at that time. In most cases, the objective of special treaty deduction provisions can be accomplished through domestic law. The Committee does not believe that treaties are a proper forum for providing deductions not otherwise permitted under domestic law.
>
> The Committee wishes to stress that the inclusion of special charitable . . . deduction rules in the proposed treaty should not be taken as precedent for future treaty negotiation. On the contrary, the Committee will, in the future, seriously consider recommending a reservation on any treaty provision that grants U.S. persons deductions not otherwise allowed under the Code.[16]

Given the Committee's view that treaties generally are not the proper forum for expanding the allowance of charitable contribution deductions beyond the provisions of the Internal Revenue Code, the Committee must decide whether the relationship between the United States and Mexico is special enough to warrant an exception to that general principle.

(7) Most-favored nation provision

As a result of Mexico's system of corporate tax integration (under which recipients of dividends paid by Mexican companies are exempt from Mexican tax, even if the recipients are not residents of Mexico), it is understood that in the negotiations of the proposed treaty, a complete exemption of source country tax on dividends was considered. Neither in this case nor in any previous case, however, has the United States agreed to cede to the other treaty country all taxing rights with respect to dividends paid by U.S. companies.

The proposed treaty specifies that dividends paid by a corporation resident in one of the treaty countries (the "source country") to a resident of the other country could be taxed by both countries. The amount of tax levied by the source country, however, generally could not exceed 5 percent in the case of dividends paid to a direct

[16] Exec. Rep. No. 98-22, 98th Cong., 2d Sess., 8-9 (1984).

investor (i.e., a company which owns at least 10 percent of the voting stock of the company paying the dividend). This rule is consistent with general U.S. treaty policy and follows the U.S. model treaty.

The proposed protocol contains a provision which states that if the United States agrees in a treaty with another country to impose a maximum rate of tax on direct investment dividends of less than 5 percent, then the proposed treaty would automatically incorporate that lower rate in lieu of the 5-percent rate. Similar "most-favored nation" provisions have been included in other U.S. tax treaties. For example, in the notes accompanying the income tax treaty between the United States and India, it was agreed that treaty would be promptly amended to incorporate a tax sparing provision if the United States subsequently amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.[17] Similarly, it is stated in the notes accompanying the U.S. income tax treaty with Tunisia that should the United States agree to include a tax sparing credit in an income tax treaty with another country, discussions with Tunisia would be reopened with a view to extending the same benefit to investment in Tunisia.

The most-favored nation provision contained in the proposed treaty is distinguishable from analogous provisions in other treaties in that the provisions in other treaties would give rise to amendments to the treaties which would then have to be resubmitted to the Senate for advice and consent with respect to those amendments. To the contrary, the provision of the Mexican treaty would be self-executing. The issue is whether the Senate is comfortable with the self-executing nature of this provision, or alternatively, should seek an understanding that any reduction in the source country tax rate on direct investment dividends resulting from the most-favored nation provision be subjected to the usual ratification procedures of both countries.

(8) Source country tax rate on interest received by banks and insurance companies

A premise of the foreign tax credit granted under U.S. law is that it should not reduce a taxpayer's U.S. tax on its U.S. source income; rather, it should only reduce U.S. tax on its foreign source income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned from domestic sources. Under present law, the foreign tax credit is subject to an overall limitation. That is, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which its foreign source income bears to its worldwide income for the taxable year. In addition, the foreign tax credit limitation is computed separately for various categories of income generally referred to as "separate limitation categories." That is, the total amount of the credit for foreign taxes *on income in*

[17] Although the proposed protocol provides U.S. persons a mechanism for reducing the Mexican assets tax in order to preserve for the U.S. enterprise the benefits of the reduced level of taxation provided for in the proposed treaty, this is not viewed as a tax sparing credit in the sense envisioned in the notes to the India treaty and treaties with certain other countries.

each category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income *in that category* bears to its worldwide taxable income for the taxable year.

A separate limitation generally is applied to a category of income for one of three reasons: the income's source (foreign or U.S.) can be manipulated; the income typically bears little or no foreign tax; or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate foreign tax credit limitation to a category of income is intended to prevent the use of high foreign taxes imposed on one category of income to reduce the U.S. tax on low-taxed income of another category.

The Tax Reform Act of 1986 (the "1986 Act") established a separate limitation category for "high withholding tax interest." High withholding tax interest generally is any interest subject to a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more.[18] The separate limitation for high withholding-tax interest was created in recognition of the fact that some foreign countries impose gross withholding taxes on interest earned by nonresident lenders that significantly exceed the general income taxes that would be imposed on the associated net interest income were it taxed on a net basis. In the case of U.S. lenders, these gross withholding taxes may often far exceed the pre-credit U.S. tax on the net interest income as well. Prior to establishment of this separate limitation, when a gross withholding tax equaled the pre-credit U.S. tax, the U.S. lender paid no U.S. tax on loan proceeds associated with interest subject to the withholding tax due to the foreign tax credit. Moreover, when a gross withholding tax exceeded the pre-credit U.S. tax, the U.S. lender was subject to a negative rate of U.S. tax on the foreign loan transaction to the extent that the lender used the excess foreign tax credits to reduce its U.S. tax liability on other income, derived either from the same foreign country or from other sources outside of the United States, that was subject to little or no foreign tax. Interest from domestic loans, by contrast, generally is subject to full U.S. tax. As a result of the foreign tax credit mechanism, the U.S. Treasury, in effect, bore the burden of those high levels of foreign tax on foreign loans.

Congress was concerned, moreover, that the available evidence suggested that the economic burden of high foreign gross withholding taxes on interest may have fallen largely on the foreign borrower rather than on the U.S. lender. To the extent that was the case, pre-1986 Act rules that allowed a full foreign tax credit for high foreign taxes on interest paid to U.S. lenders provided an incentive for some U.S. lenders to make foreign loans rather than domestic loans that would otherwise have been equally attractive, and to make otherwise uneconomical foreign loans. The higher the applicable foreign tax on interest was, the larger the U.S. lender's foreign tax available for credit was and, thus, the greater the incentive could be. Congress was particularly concerned that foreign countries seeking to attract U.S. capital might have been encouraged by the pre-1986 Act rules to increase rather than to decrease their gross withholding taxes on interest paid to U.S. persons. For

[18] Code sec. 904(d)(2)(B).

example, according to a January 1985 report in the *Wall Street Journal*, some U.S. bank lenders to Mexico responded negatively after the Mexican Government decided to exempt from a Mexican withholding tax on interest payments made by a Mexican state-owned food distributor to foreign banks.[19] The Mexican Government subsequently withdrew the exemption.[20]

In light of these factors, Congress believed that interest received by U.S. persons that bears significant foreign withholding tax on a gross basis should be subject to a separate foreign tax credit limitation; and subjected such interest that bears a gross-basis withholding tax of 5 percent or more to a separate limitation. Congress used the mechanism of a separate limitation, rather than directly disallowing foreign tax credits for gross interest taxes in excess of net U.S. tax, because some argued that such disallowance could have violated U.S. income tax treaties. Congress chose to apply the separate limitation to interest subject to a 5-percent or greater gross-basis tax, instead of interest taxed on a gross basis at a net rate greater than the net U.S. rate, in the interest of administrative simplicity. Thus, the 86 Act's approach may be theoretically inferior to the latter approach, but avoids the necessity of computing the net U.S. tax on particular interest payments to determine allowable foreign tax credits.[21]

There presently are no U.S. tax treaties which permit a treaty partner to levy a gross-basis withholding tax on interest paid to U.S. persons, but limit the rate of such tax to less than 5 percent.[22] Following a five-year transition period, the proposed treaty, by contrast, would limit source country tax to 4.9 percent of the gross amount of interest derived from (1) loans granted by banks (including investment and savings banks) and insurance companies, or (2) bonds or securities that are regularly and substantially traded on a recognized securities market.[23]

The issue is whether the above-documented concerns about cross-crediting of high foreign taxes on interest against U.S. tax on low-taxed income that led to enactment of the separate foreign tax credit limitation category for high withholding tax interest would be renewed as a result of the proposed treaty's incorporation of a 4.9 percent gross-basis source country withholding tax rate. The Technical Explanation suggests that the 4.9 percent rate was negotiated in order to *ensure* that the interest would not be treated as high withholding tax interest. Thus, it appears that the effect of this provision might be to maximize the rate of tax Mexico could charge on interest payments to qualifying U.S. persons, and also to

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[19] S.K. Witcher, "Foreign Banks Worry Mexican Ruling Could Mean Loss of Tax Credits at Home," *Wall Street Journal*, Jan. 25, 1985, p. 24.

[20] S. Frazier & S.K. Witcher, "Debt-Swap Plan is Proposed by Mexicans," *Wall Street Journal*, March 15, 1985, p. 29.

[21] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, pp. 864-865.

[22] Most U.S. treaties, consistent with U.S. treaty policy eliminate source country withholding tax on interest. Those treaties which permit such tax generally limit the rate of tax to 10 percent (see, e.g., the U.S. income tax treaties with Japan and Spain); however, in at least one case, a treaty has sanctioned a maximum rate of 5 percent (i.e., the U.S.-Switzerland income tax treaty).

[23] Under the proposed treaty, other categories of interest would be either exempt from source country tax, or subject to a maximum source country tax rate of 10 or 15 percent, depending on the circumstances.

maximize the creditability of those taxes by those persons under the U.S. foreign tax credit rules.

(9) Expenses deductible in computing business profits of a permanent establishment

The business profits article of the proposed treaty generally would permit the business profits of an enterprise of a treaty country to be taxed by the other treaty country only if the profits are attributable to a permanent establishment located in that other country. In such a case, the proposed treaty makes clear that in determining an enterprise's business profits, a deduction would be allowed for expenses which are incurred for the purpose of the permanent establishment.[24] The proposed treaty provides, however, that no such deduction would be allowed in respect of such amounts which are paid (other than as reimbursements of actual expenses) by the permanent establishment to the head office or any other office of the enterprise by way of royalties, fees, or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed. It further provides that, *except in the case of a banking enterprise*, no such deduction would be allowed for payments by a permanent establishment to its head office (or another office) by way of interest on moneys lent to the permanent establishment.

The proposed treaty's general rule for the treatment of interest expense is consistent with the rules of U.S. law for determining the deductible interest expense of a U.S. branch of a foreign corporation.[25] Those rules do not treat the U.S. branch and its home office (and other offices) as separate taxpayers. Rather, the amount of interest expense that is deductible by the U.S. branch is based on a formula under which a portion of the worldwide interest expense of the foreign corporation is apportioned to the U.S. branch.

The Technical Explanation makes clear that the banking exception to the general rule for determining deductible interest expense is not intended to override the interest allocation rules of internal U.S. law in the context of a U.S. permanent establishment of a Mexican resident corporation. An identical banking exception was included in the U.S.-India income tax treaty which came before the Committee in 1990. The Committee's report on that treaty stated that the Treasury interprets the banking exception as relating only to India's treatment of such payments, and that, for U.S. tax purposes, the provisions of U.S. internal law are to apply.[26] According to the Treasury Department, a similar interpretation is intended under the proposed treaty. That is, the purpose of the banking exception relates to the application of Mexican law, which generally does not permit a branch to deduct interest incurred by its home office or another branch.

Some commentators have argued, to the contrary, that the position explained in the Technical Explanation appears to be incon-

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[24] The proposed treaty makes specific reference to the allowance of deductions for executive and general administrative expenses so incurred, whether in the country where the permanent establishment is located or elsewhere.

[25] Treas. Reg. sec. 1.882-5.

[26] Sen. Sen. Exec. Rept. 101-25, 101st Cong., 2d Sess. 33 (1990).

sistent with the language of the proposed treaty.[27] In light of this, the Committee might want to consider whether providing support for the position of the Treasury Department by making specific reference in its report on the proposed treaty (as was done in the report on the India treaty) as to the application of the banking exception would be sufficient.

(10) Second-level withholding tax on dividends

Under current U.S. law, a foreign corporation engaged in the conduct of a trade or business in the United States would, in the absence of a treaty, be subject to a flat 30-percent branch profits tax on its "dividend equivalent amount." In a case where a treaty prevents imposition of the branch profits tax, the Internal Revenue Code imposes U.S. withholding tax on a portion of the dividends paid by the foreign corporation to a foreign person, if 25 percent or more of the corporation's gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such dividend is generally equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. This so-called second-level withholding tax is only imposed in the absence of a branch profits tax because both taxes accomplish a similar objective—namely, ensuring that, like the U.S. earnings of U.S. corporations, the U.S. earnings of foreign corporations are subject to both corporate and shareholder level U.S. tax.

The proposed treaty would expressly permit the United States to impose the branch profits tax on a Mexican corporation, and would forbid imposition by the United States of the second-level withholding tax on a dividend paid by a Mexican corporation to a Mexican resident. The proposed treaty also would forbid imposition of the second-level withholding tax on a dividend paid by a corporation that is resident in a third country to a Mexican resident.

The issue is whether this favorable treatment of dividends paid by non-Mexican corporations under the proposed Mexican treaty is appropriate. Corporations resident in many other countries with which the United States has income tax treaties currently are not subject to the branch profits tax. This is not the preferred U.S. treaty position, and the Treasury Department is in at least some cases negotiating to permit the imposition of the branch profits tax on residents of these countries. At present, however, many U.S. income tax treaties, as interpreted by the Treasury Department, do not permit imposition of the branch profits tax, except in treaty-shopping cases.

In light of the number of countries which have U.S. tax treaties protecting residents from the U.S. branch profits tax, and in light of the purposes of the second-level withholding tax, it would seem appropriate that a dividend paid by a corporation which is resident in neither Mexico nor the United States, to a resident of Mexico, be subject to possible U.S. withholding tax, if the corporation is not

[27] See, e.g., Greer L. Phillips and John R. Washlick, "The New Income Tax Convention Between the United States of America and the United Mexican States," *Tax Notes*, December 7, 1992, p. 1450.

subject to the U.S. branch profits tax due to a treaty. Yet under the proposed treaty, for example, a British company doing business in the United States can pay dividends to a Mexican resident who has no U.S. permanent establishment or fixed base without incurring U.S. branch profits tax (assuming there is no treaty shopping) or U.S. dividend withholding tax.

The proposed treaty can be said to be flawed insofar as it treats such a dividend no differently than it treats a dividend paid by a Mexican corporation, which is subject to the U.S. branch profits tax. The Committee may wish to express its views toward the proper method for relieving second-level withholding tax in the future. Given that a similar issue was raised by the Committee in its 1990 comments on the U.S. income tax treaty with Finland, the Committee may wish to inquire as to why language similar to the Finnish treaty provision was agreed to in the proposed Mexican treaty.

(11) Portfolio dividend withholding

The proposed treaty, like the pending treaty with Russia, would limit to 5 percent the source country tax on direct investment dividends, and generally would limit to 10 percent the source country tax on other dividends. By contrast, U.S. treaty policy, as reflected in the U.S. model treaty, generally has been to retain the right to impose full corporate tax on U.S. corporations, plus a tax of 15 percent on "portfolio" dividends. Aside from the U.S. income tax treaties with China and Romania, U.S. treaties in force allow the source country to withhold at least a 15-percent tax on a portfolio dividend paid to a resident of the other treaty country. U.S. treaty partners that have corporate tax systems at least partially integrated with individual-level taxes may either impose no withholding tax on dividends (by internal law or treaty), impose lower rates, or afford foreign portfolio investors with integration-related benefits for corporate taxes paid by the distributing corporation. In the case of Mexico, it generally exempts from tax dividends received from a Mexican company.[28]

The Committee may wish to consider whether the 10-percent limit on portfolio dividends would be appropriate as a matter of U.S. treaty policy generally, or whether it would be appropriate in this case even if not in the general case. It may be that portfolio investment in Mexican corporations by U.S. residents will, for the foreseeable future, be greater than portfolio investment by Mexican residents in U.S. corporations. On the other hand, foreign investors might seek to use the Mexican treaty to obtain U.S. tax reductions not available under any other treaty. If Mexican law were to make such treaty-shopping profitable, and the proposed treaty's limitation on benefits article sufficiently porous to allow treaty benefits in such a case, then the proposed treaty could have a detrimental influence on the other policy goals of the U.S. income tax treaty program.

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[28] The U.S. income tax treaties with China and Romania generally allow source country taxation of any dividend at a rate of no more than 10 percent.

(12) Associated enterprises and permanent establishments

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent enterprises. In addition, the proposed treaty requires each country to attribute to a permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty. A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise.

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[29] Some prefer a so-called "formulary apportionment," which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[30]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the non-discrimination rules embodied in Article 25.[31] Some, who advocate a change

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[29] See generally *The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing before the Senate Committee on Governmental Affairs,* 103d Cong., 1st Sess. (1993) (hereinafter, *Hearing Before the Senate Committee on Governmental Affairs).*

[30] See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 101st Cong., 2d Sess. 360-61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 102d Cong., 2d Sess. (1992).

[31] Compare *Hearing Before the Senate Committee on Governmental Affairs* at 26, 28. ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder) *with* a recent statement conveyed by foreign governments to the U.S. State Department that "[w]orldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State). See also *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and*

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in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

Means, 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States generally taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States generally taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and, in certain limited situations on foreign source income, that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income").

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level excess interest tax, which amounts to 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called "withholding taxes").

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on de-

posits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obligations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[32]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real estate.

The source of income received by nonresident alien individuals and foreign corporations is determined under rules contained in the Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient of a dividend to the extent of such U.S. source portion unless a treaty prevents application of the branch profits tax on the paying corporation.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the

[32] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons and the amount of interest paid on debt guaranteed by tax-exempt related persons.

income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions of the Code contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (i.e., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the residual U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided look-through rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction).

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if each country considers the same deduction allocable to income that it treats as foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in situations were a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation generally is accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each

of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base in that jurisdiction. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent withholding tax and agrees to reduce this tax (or in the case of some income, eliminate it entirely) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. Such a treaty provision generally is referred to as a so-called "saving clause." Double taxation also may arise, notwithstanding the existence of a treaty, because most countries will not exempt passive income from tax at the source.

Double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further enhanced under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individ-

ual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, the treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Mexico is presented below. This explanation includes a discussion of the provisions of the proposed protocol under the proposed treaty articles amended by it.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties.

The proposed treaty generally would apply to residents of the United States and to residents of Mexico, with specific exceptions designated in other articles (e.g., Article 25 (Non-Discrimination) and Article 27 (Exchange of Information)) and discussed below. This is consistent with other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. Residence is defined in Article 4.

The proposed treaty provides that it would not restrict any benefits (e.g., any exclusion, exemption, deduction, credit, or other allowance) accorded by internal law or by any other previously or subsequently concluded agreement between the United States and Mexico. Thus, the treaty would apply only where it benefits taxpayers.

As set forth in the Technical Explanation, the fact that the proposed treaty would only apply to a taxpayer's benefit does not mean that a taxpayer could inconsistently select among treaty and internal law provisions in order to minimize its overall tax burden. The Technical Explanation sets forth the following example. Assume a resident of Mexico has three separate businesses in the United States. One business is profitable, and constitutes a U.S. permanent establishment. The other two are trades or businesses that would earn effectively connected income as determined under the Internal Revenue Code, but do not constitute permanent establishments as determined under the proposed treaty; one trade or business is profitable and the other incurs a net loss. Under the Code, all three operations would be subject to U.S. income tax, in which case the losses from the unprofitable line of business could offset the taxable income from the other lines of business. On the other hand, only the income of the operation which gives rise to a permanent establishment would be taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer could not invoke the proposed treaty to exclude the profits of the profitable trade or business and invoke U.S. inter-

nal law to claim the loss of the unprofitable trade or business against the taxable income of the permanent establishment.[33]

Like all U.S. income tax treaties, the proposed treaty includes a "saving clause." Under this clause, with specific exceptions described below, the treaty would not affect the taxation by a country of its residents or its citizens. By reason of this saving clause for example, unless otherwise specifically provided in the proposed treaty, the United States would continue to tax its citizens who are residents of Mexico as if the treaty were not in force.[34] "Residents" for purposes of the treaty (and thus, for purposes of the saving clause) would include corporations and other entities as well as individuals (Article 4 (Residence)).

Under Section 877 of the Internal Revenue Code, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The proposed treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens under Code section 877. Even absent a specific provision, the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner.[35]

Exceptions to the saving clause are provided for certain benefits conferred by a treaty country, namely: the allowance of correlative adjustments to the income of enterprises of one country associated with other enterprises the profits of which were adjusted by the other country (Article 9, paragraph 2); the exemption from residence country tax of social security benefits paid by one country to a resident of the other country or to a citizen of the United States (Article 19, paragraph 1(b)); the exemption from residence country tax of certain alimony and child support payments (Article 19, paragraph 3); allowance of deductions for contributions paid by U.S. residents to certain charitable organizations located in Mexico (Article 22, paragraph 2); relief from double taxation by the provision of a foreign tax credit (Article 24); protection from discrimination (Article 25); and mutual agreement procedures (Article 26).

In addition, the saving clause would not apply to the following benefits conferred by one of the countries upon individuals who are neither citizens of that country nor acquire immigrant status in that country.[36] These benefits include (1) exemption from tax on compensation from government service in the other country (Article 20); exemption from tax on certain income received by students or business apprentices (Article 21); and certain fiscal privileges of diplomats referred to in the treaty (Article 28).

Article 2. Taxes Covered

The proposed treaty generally would apply to the income taxes of the United States and Mexico. For this purpose, all taxes im-

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[33] See Rev. Rul. 84-17, 1984-1 C.B. 10.

[34] Although this provision of the proposed treaty is drafted reciprocally, Mexico currently does not tax the income of its nonresident citizens or former citizens.

[35] Rev. Rul. 79-152, 1979-1 C.B. 237.

[36] For U.S. purposes, an individual has "immigrant status" in the United States if he or she has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., he or she holds a "green card").

posed on total income or any part of income, including tax on gains derived from the alienation of movable or immovable property would be regarded as taxes on income. The proposed treaty would not apply to payroll taxes and generally would not apply to property taxes; however, the proposed treaty and protocol would affect the imposition of Mexico's assets tax in some cases, as discussed in detail below. In addition, Article 25 (Non-Discrimination) would apply to all taxes imposed at all levels of government; thus, it would encompass state and local taxes. Also, the provisions of Article 27 (Exchange of Information) would apply to all Federal level taxes, including, for example, estate and gift and excise taxes, to the extent that such information is relevant to enforcement of the proposed treaty or of any covered tax as long as they are applied in a manner consistent with the proposed treaty.

United States

In general

In the case of the United States, the proposed treaty would apply to the Federal income taxes imposed by the Code, but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes.

Insurance excise tax

Under the Code the United States imposes an excise tax on certain insurance premiums received by a foreign insurer from insuring a U.S. risk or a U.S. person (Code secs. 4371-4374). Unless waived by treaty, the excise tax applies to those premiums which are exempt from U.S. net basis income tax.[37] This insurance excise tax would be covered by the proposed treaty, but only to the extent that the foreign insurer does not reinsure the risks in question with a person not entitled to relief from this tax under the proposed treaty or another U.S. treaty. (It appears that the proposed treaty would permit Mexico to impose a similar excise tax on U.S. insurance companies whether or not the insured risks are reinsured with third parties. Moreover, the imposition of such a tax by Mexico would be specifically authorized, up to whatever rate is now imposed by the United States or Canada (whichever is higher), under Article 2103(4)(h) of the proposed North American Free Trade Agreement (NAFTA).

More specifically, income of a Mexican insurer from the insurance of U.S. risks would not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption or to an exemption under another treaty). This waiver would apply even if that insurance income is not attributable to a U.S. permanent establishment maintained by the Mexican insurer and hence is not subject to U.S. net basis tax pursuant to the business profits article (Article 7) and other income article (Article 23). This treatment is similar to that provided in some other recent U.S. tax treaties, for example, the treaties with Finland, Germany, India, Italy, Spain, France, and Hungary. The

[37] Income from premiums earned by foreign persons may be exempt from U.S. net basis income tax either because the income is not effectively connected with the conduct of a trade or business in the United States, or because of a treaty waiver of the net basis tax.

excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model treaty.

Under the Code (in the absence of a contrary treaty provision), a foreign insurer is subject to U.S. income tax on income derived from the insurance of risks situated in the United States in situations where that insurance income is effectively connected with a U.S. trade or business. A foreign insurer insuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business and thus will not be subject to U.S. income tax if it has no U.S. office or dependent agent and operates in the United States solely through independent brokers.

In these situations, a foreign insurer is not subject to U.S. income tax, but the insurance excise tax is imposed (except as otherwise provided in a treaty) on the premiums paid for that insurance.[38] The excise tax may be viewed as serving the same function as the tax imposed on dividends, interest, and other types of passive income paid to foreign investors. In general, the excise tax applies to insurance covering risks wholly or partly within the United States where the insured is (1) a U.S. person or (2) a foreign person engaged in a trade or business in the United States. Under the Code, the excise tax generally applies to a premium on any such insurance unless the amount is effectively connected with the conduct of a trade or business in the United States and not exempt by treaty from the statutory net-basis tax.

The treatment of insurance income of foreign insurers is complicated somewhat in situations where, as is often the case, some portion of the risk is reinsured with other insurers in order to spread the risk. In situations where the foreign insurer is engaged in a U.S. trade or business and thus subject to the U.S. income tax, reinsurance premiums, whether paid to a U.S. or a foreign reinsurer, are allowed as deductions. Accordingly, the foreign insurer is taxable only on the income attributable to the portion of the risk it retains. However, while no excise tax generally is imposed on the insurance policy issued by the foreign insurer doing business in the United States, the one-percent excise tax on reinsurance is imposed if and when that insurer reinsures that U.S. risk with a foreign insurer not subject to U.S. net-basis income tax.

In exempting from the U.S. income tax and the insurance excise tax all insurance income which is not attributable to a permanent establishment in the United States, the proposed treaty would make two changes in the statutory rules governing the taxation of insurance income of Mexican insurers. First, any insurance income which is effectively connected with a U.S. trade or business but is not attributable to a U.S. permanent establishment would not be subject to U.S. income tax. Second, Mexican insurers not engaged in a U.S. trade or business would no longer be subject to the insurance excise tax. However, those Mexican insurers which continue to maintain a U.S. permanent establishment after the proposed treaty enters into force would remain subject to the U.S. income tax on their net U.S. insurance income attributable to the permanent establishment.

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[38] The excise tax currently is imposed at a rate of four percent of the premiums paid on casualty insurance and indemnity bonds, and one percent of the premiums paid on life, sickness, and accident insurance, annuity contracts, and reinsurance (Code secs. 4371-4374).

In addition, the insurance excise tax would continue to apply in situations where a Mexican insurer with a U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer, other than a resident of Mexico or another insurer entitled to exemption under a different tax treaty (such as the U.S.-France treaty). The tax liability could be imposed on the Mexican insurer which, for withholding purposes, is treated in the same manner as a U.S. resident person transferring the premium to the foreign reinsurer. The excise tax also would apply to such reinsurance even where the Mexican insurance company has a U.S. trade or business, but no U.S. permanent establishment, and thus would not be subject to U.S. *income* tax on the net income it derives on the portion of the risk it retains.

If the excise tax applies to premiums paid to the Mexican insurer in the absence of the treaty exemption, the tax would continue to apply to that insurer to the extent of reinsurance with a nonexempt person. For example, assume a Mexican company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a Danish insurance company (not currently entitled to exemption from the excise tax) and pays that Danish company a premium of $100. The four-percent excise tax on casualty insurance would apply to the premium paid to the Mexican insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured would be liable for an excise tax of $4, which is four percent of the portion of the U.S. risk covered by the premium paid to the Mexican insurer which was then reinsured with the Danish insurer. It would be the responsibility of the U.S. insured to determine to what extent, if any, the risk is to be reinsured with a nonexempt person. Under an administrative procedure currently in effect, the burden of this responsibility effectively could be shared with the Mexican insurer.[39]

Excise taxes on private foundations

The proposed treaty also would apply to the excise taxes with respect to private foundations to the extent necessary to implement the provisions of paragraph 4 of the article on exempt organizations (Article 22). Under that paragraph, a religious, scientific, literary, educational, or other charitable organization which is resident in Mexico and which receives substantially all of its support from persons other than U.S. citizens or residents would be exempt from the U.S. excise taxes imposed on private foundations.[40]

Mexico

In the case of Mexico, the proposed treaty would apply to the income tax imposed by the Income Tax Law. The assets tax imposed under internal Mexican law would not be a covered tax; however, the proposed protocol would limit application of that tax in certain

[39] See Rev. Proc. 87–13, 1987–1 C.B. 596; and Rev. Proc. 92–39, 1992–1, C.B. 860.

[40] Under present U.S. law, various excise taxes may be imposed on private foundations. These include taxes on net investment income, self-dealing, undistributed income, excess business holdings, investments which jeopardize the foundation's charitable purpose, certain "taxable" expenditures, and political expenditures. (See Code sec. 4940 et. seq.) Under Code section 4948, the United States imposes a 4-percent excise tax on the gross U.S. source investment income for the taxable year of every foreign organization which is a private foundation.

cases where there would be no Mexican income tax liability (or reduced liability) because of the proposed treaty (for example, where the business profits of a U.S. enterprise would be exempt from income tax in Mexico because the enterprise does not have a permanent establishment in Mexico). In such a case, the proposed protocol provides a mechanism for reducing the assets tax in order to prevent the that tax from offsetting (or "soaking up") the reduction in income taxation provided for in the proposed treaty.

Other rules

The proposed treaty also contains a rule generally found in U.S. income tax treaties which provides that the proposed treaty would apply to substantially similar taxes that either country may subsequently impose. The proposed treaty would obligate the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws that are relevant to the operation of the proposed treaty, and of official published materials that concern the application of the proposed treaty.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

The term "person" would include an individual or legal person, including a company, a corporation, a trust, a partnership, an association, an estate, and any other body of persons. Although this list is somewhat more expansive than the comparable provision of the U.S. model treaty, the Technical Explanation states that it is intended to have the same meaning. A "company" under the proposed treaty is any body corporate or any entity which is treated as a body corporate for tax purposes.[41]

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" would mean, respectively, an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State. The treaty does not define the term "enterprise." Although there is no explicit definition of the term "Contracting State" in the proposed treaty, it refers to the United States or Mexico according to the context in which it is used.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in the other treaty country. Accordingly, with respect to a Mexican enterprise, purely domestic transport in the United States is excluded.

The U.S. competent authority would be the Secretary of the Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

[41] For U.S. tax purposes, the principles of Code section 7701 are applicable in determining whether an entity is a body corporate.

The competent authority in Mexico would be the Ministry of Finance and Public Credit. In general, that function is delegated to the General Directorate of Revenue Policy and International Fiscal Affairs.

The term "United States" means the United States as defined in the Internal Revenue Code. The Code generally provides that, when used in a geographical sense, it means only the States and the District of Columbia. Thus, it does not include Puerto Rico, the U.S. Virgin Islands, Guam or any other U.S. possession or territory. Under Code section 638, where the term "United States" is used in a geographical sense, it also includes the continental shelf; that is, the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. The proposed protocol (paragraph 1) would treat the United States as including these areas. According to the Technical Explanation, it is understood by the parties to the proposed treaty that the continental shelf would be covered only to the extent that any U.S. taxation therein is in accordance with international law and U.S. tax law.

The term "Mexico" means Mexico as defined in the Federal Fiscal Code. When used geographically, therefore, it is understood that "Mexico" includes the states thereof and the Federal District, the territorial sea and, as provided in the proposed protocol (paragraph 1) the Mexican continental shelf. As is the case with respect to the definition of the United States, the Technical Explanation provides that it is understood that coverage under the proposed treaty of Mexico's continental shelf is limited to those areas with respect to which any Mexican taxation would be in accordance with international law and Mexican tax law.

Under the proposed treaty, a person would be considered a national if the person is an individual possessing the nationality of a treaty country, or is any legal person, association, or other entity deriving its status as such from the law in force in a treaty country. This term is particularly relevant to the provisions of Articles 20 (Government Service) and 25 (Non-Discrimination).

The proposed treaty also contains the standard provision that, unless the context otherwise requires, all terms not defined in the treaty would have the meaning which they have under the laws of the country applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation often is avoided by the treaty assigning one of the countries as the country of residence where, under the internal laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his or her worldwide income, while a nonresident alien is taxed only on his or her U.S. source income and on income that is effectively connected with a U.S. trade or

business. An individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a "green card" holder) also is a U.S. resident. The standards for determining residence provided in the Code alone do not determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States.)

A company is taxed on its worldwide income if it is a "domestic corporation." A domestic corporation is one that is created or organized in the United States or under the law of the United States or any State.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax therein by reason of its domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The term "resident of a Contracting State" does not include, however, any person that is liable to tax in that country in respect only of income from sources in that country.[42] The proposed protocol (paragraph 2) provides that Mexico would consider a U.S. citizen or a green card holder to be a U.S. resident only if the individual has a substantial presence in the United States (as described in Code section 7701(b)) or would be a resident of the United States and not of another country under the proposed treaty's residency tie-breaker rules described below.

This provision of the proposed treaty in some respects is based on the article on residence of the U.S. and OECD model treaties and is similar to the provisions found in other U.S. tax treaties. Under U.S. treaty policy, as expressed in the U.S. model, however, citizenship alone would establish residence; but the U.S. model result has been achieved in very few treaties.

Paragraph 2 of the proposed protocol further provides that it is understood by the United States and Mexico that a partnership, estate, or trust would be considered to be a resident of one of the countries only to the extent that the income it derives is subject to that country's tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.[43] For example, if the share of U.S. beneficiaries in the income of a U.S. trust is only one-half, Mexico would have to reduce its withholding tax on only one-half of the Mexican source income paid to the trust.

In addition, that paragraph of the proposed protocol treats as a resident of a treaty country the government of country itself, or a political subdivision or local authority thereof.

A set of "tie-breaker" rules is provided to determine residence in the case of an individual who, under the basic residence rules, would be considered to be a resident of both countries. Such a dual resident individual would be deemed to be a resident of the country in which he has a permanent home available to him. If this permanent home test is inconclusive because the individual has a perma-

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[42] According to the Technical Explanation, it is understood that the reference in the proposed treaty to persons "liable to tax" refers to those persons subject to the taxation laws applicable to residents. That reference is not intended to exclude tax-exempt organizations.

[43] Under U.S. law, a partnership is not a taxable entity. Rather, income earned by a partnership is taxable as income of its partners. Conversely, under Mexican law, most partnerships are taxable entities.

nent home in both countries, the individual's residence would be deemed to be the country with which his personal and economic relations are closer (i.e., his "center of vital interests"). If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he would be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he would be deemed to be a resident of the country of which he is a national (i.e., the country of which he is a citizen). In any other case (i.e., if the person is either a citizen of both countries or neither of them), the competent authorities of the countries would settle the question of residence by mutual agreement.

A person other than an individual that is a resident of both countries under the basic treaty definition would be considered a resident of neither treaty country for purposes of the proposed treaty. Under internal U.S. law, a corporation is considered a domestic corporation if it is created or organized in the United States or under the law of the United States or of any State. In addition, under certain circumstances, a corporation organized under the laws of Mexico may elect to be treated as a U.S. domestic corporation (Code sec. 1504(d)). Mexican law treats as a Mexican corporation any corporation that has its place of effective management in Mexico. Thus, the situation could arise where a company is organized under U.S. law or is subject to an election to be treated as such, and is effectively managed in Mexico. Such a company generally would be treated as a resident of neither the United States nor Mexico under the proposed treaty, and thus would be denied treaty benefits. Moreover, since such a company would be considered a resident of neither country for purposes of the proposed treaty, it is understood that payments (e.g., of dividends, interest, or royalties) made by such a company to a resident of either the United States or Mexico would not qualify for the reduced source-country withholding tax rates specified in the proposed treaty.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties will apply, or whether those items of income will be taxed as business profits. Taxation of business profits is discussed under Article 7 (Business Profits).

The concept of permanent establishment is also relevant to the application of Mexico's assets tax. Under the proposed treaty, as modified by paragraph 3 of the proposed protocol (discussed in detail below), the assets tax generally would not apply to the Mexican

assets of U.S. residents that do not maintain a permanent establishment.

In general, under the proposed treaty, a permanent establishment would be a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment would include a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It also would include any building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, or a related supervisory activity, if the site, project, or activity lasts for more than 6 months. The 6-month period for establishing a permanent establishment in connection with a site, project, or activity is significantly shorter than the 12-month period provided in the corresponding rule of the U.S. model treaty, but is similar to periods contained in U.S. treaties with some developing countries and in the U.N. model treaty.

The general rule is modified to provide that a fixed place of business that is used for any of a number of specified activities would not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise and the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. These activities include, as well, the maintenance of a fixed place of business solely for the purpose of advertising, the supply of information, scientific research activities, preparations relating to the placement of loans, or of similar activities that have a preparatory or auxiliary character.

The exclusion of an office used for the preparations relating to the placement of loans is not found in the U.S. model treaty. According to the Technical Explanation, the provision is intended to cover representative offices of U.S. banks located in Mexico. Under present Mexican law, U.S. banks are precluded from accepting deposits or otherwise conducting banking business in Mexico. However, they may use such offices to facilitate the placement of loans from the U.S. home office to borrowers in Mexico. In such cases, the proposed treaty would not treat the Mexican office as a permanent establishment; hence, the income would not be subject to tax by Mexico under Article 7 (Business Profits) of the proposed treaty. Rather, the interest earned by the U.S. banks would be subject to the provisions of Article 11 (Interest).[44]

Under the U.S. model treaty, the maintenance of a fixed place of business solely for any combination of the above-listed activities would not constitute a permanent establishment. Under the proposed treaty, a fixed place of business used solely for any combina-

[44] It should be noted that the proposed North American Free Trade Agreement (NAFTA) would permit U.S. banks to conduct banking operations in Mexico. If NAFTA becomes effective, it is possible that U.S. banks will establish branch operations in Mexico. These operations would most likely constitute permanent establishments and, as such, would be subject to the rules of the Business Profits article of the proposed treaty.

tion of these activities would not constitute a permanent establishment, provided that the overall activity of the fixed place of business is of a preparatory or auxiliary character.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, then the enterprise would be deemed to have a permanent establishment in the first country. Consistent with the model treaties, this rule would not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment.

The proposed treaty contains a similar rule that would deem an enterprise of one country to have a permanent establishment in the other country even if the agent has no authority to conclude contracts on behalf of the enterprise, but habitually processes in the other country on behalf of the enterprise goods or merchandise maintained in the other country by that enterprise, provided that the processing is carried on using assets furnished, directly or indirectly, by the enterprise or by an associated enterprise. This provision is not found in the U.S. model treaty. According to the Technical Explanation, this provision is meant to clarify that a dependent agent (whether or not a subsidiary of its principal) which processes the inventory of the principal using assets belonging to the principal (or a related enterprise), without itself having ownership of either the inventory or the assets used in the processing, would represent a permanent establishment of the principal. Because this provision is intended simply as a clarification, it is not intended to create a permanent establishment where one would not exist absent this provision.[45]

The agency rule would not apply if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business and if in the agent's commercial or financial relations with the enterprise, conditions are not made or imposed that differ from those generally agreed to by independent agents. In addition, the proposed treaty provides a special rule for determining whether an insurance enterprise of one country would have a permanent establishment in the other country.

Under the proposed treaty, an insurance enterprise of one country would, except with respect to reinsurance activities, be deemed to have a permanent establishment in the other country if it collects premiums in the territory of the other country or if it insures risks located within the other country's territory through a representative other than an independent agent. This provision is not contained in the U.S. model treaty, but has been incorporated in some U.S. treaties (e.g., Belgium and France). Presently, Mexico does not impose a tax on foreign insurers comparable to the U.S. insurance excise tax (see Code secs. 4371–4374). According to the Technical Explanation, the treaty negotiators anticipated that, if ratified, the North American Free Trade Agreement would allow U.S. insurers to insure risks in Mexico. In order to preserve a com-

[45] For example, the provision would not apply to the use of an independent contract manufacturer in Mexico by a U.S. enterprise to process inventory on its behalf. In such a case, the contract manufacturer would be subject to tax in Mexico, but its activities would not create a permanent establishment in Mexico of the U.S. enterprise.

petitive neutrality between U.S. and domestic insurers, Mexico sought to be permitted to tax the business profits of U.S. insurers operating within its borders. Thus, the proposed treaty specifies that a dependent agent who collects premiums or insures risks (other than through reinsurance) in Mexico on behalf of a U.S. insurer would be a permanent establishment of the U.S. insurer in Mexico.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Such relationships, thus, would not be relevant; only the activities of the company being tested would be relevant.

Article 6. Income from Immovable Property (Real Property)

This article covers income from "immovable" (or for U.S. purposes, real) property. The rules covering gains from the sale of immovable property are in Article 13 (Capital Gains).

Under the proposed treaty, income derived by a resident of one country from immovable property situated in the other country could be taxed in the country where the property is located. For this purpose, income from immovable property would include income from agriculture or forestry situated in the other country.

The term "immovable property" would have the meaning which it has under the law of the country in which the property in question is situated. For property situated in the United States, the term would mean "real property" as defined by U.S. law. The term in any case would include property accessory to immovable property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Thus, income from immovable property would include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). Ships, boats, aircraft, and containers would not be immovable property.

The source country could tax income derived from the direct use, letting, or use in any other form of immovable property. These rules which permit source country taxation also would apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

As is the case in the U.S. model treaty and certain other U.S. income tax treaties, the proposed treaty would provide residents of one country with an election to be taxed on a net basis by the other country on income from real property situated in that other country (i.e., as if the income were attributable to a permanent establishment).[46] An election, once made, would remain in effect for all sub-

[46] Under Mexican law, income from the leasing of real property is taxed on a net basis if earned by a Mexican resident corporation. Individuals who are residents of Mexico may elect under Mexican law to be taxed on hypothetical net income which is equal to 50 percent of gross real property rental income. Nonresidents are taxed in Mexico on gross real property rental in-

sequent taxable years unless the competent authority of the country in which the immovable property is situated agrees to its termination.

The proposed protocol (paragraph 3) provides that the 2-percent assets tax imposed under Mexican law generally would not apply to a U.S. resident that, pursuant to Article 7 (Business Profits) of the proposed treaty, would not be taxable in Mexico on its business profits because it has no permanent establishment in Mexico.[47] Notwithstanding this exception, the assets tax could be imposed on immovable property situated in Mexico and on certain tangible and intangible property specified in Article 12 (Royalties) that is furnished to Mexican residents. Under Mexican law, the assets tax generally applies only to the extent that it exceeds any income tax paid to Mexico by the taxpayer.[48] With respect to the assets tax on immovable property, the proposed protocol specifies that Mexico would grant a credit against such tax in an amount equal to the income tax that would be imposed under the Mexican Income Tax Law on gross income (if any) from such property even in cases where the U.S. person has made the election under the proposed treaty to be taxed on a net basis on such income. This enhanced credit would not apply if the U.S. person uses 50 percent or more of the gross income directly or indirectly to meet liabilities (including liabilities for interest) to persons who are not U.S. residents.[49] (In such a case, the assets tax would apply to the extent that it exceeds the net-basis tax actually paid by the U.S. person.) According to the Technical Explanation, this "base erosion" limitation is considered necessary to prevent Mexican residents that own immovable property located in Mexico from avoiding the assets tax by making a U.S. resident the nominal owner of the property, while retaining beneficial ownership in Mexico.

Article 7. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

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come at a flat rate of 21 percent. An election by a U.S. person under the treaty will permit that person to be taxed in Mexico in the same manner as a Mexican resident corporation (i.e., on a net-income basis based on actual expenses) on rental income earned from real property situated in Mexico.

[47] U.S. persons that have permanent establishments in Mexico are subject to Mexican income tax on the business profits from the permanent establishment and to the assets tax on the assets used in the enterprise.

[48] In this sense, the asset tax operates in a manner similar to the U.S. alternative minimum tax (AMT). That is, like the AMT, the asset tax applies only to the extent it exceeds the regular income tax paid by the taxpayer.

[49] A similar credit will be granted by Mexico against the assets tax on certain tangible and intangible property of a U.S. person. An explanation of that credit is provided in the discussion of Article 12 below.

The taxation of income as U.S. business income or not varies depending upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (thus, it is said to be taxed as if it were business income under a limited "force of attraction" rule).

In the case of foreign persons other than insurance companies, foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such persons, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as effectively connected with a U.S. trade or business without regard to the foregoing rules, so long as such income is attributable to its U.S. business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its worldwide operations and by the U.S. insurance industry.

Trading in stocks, securities, or commodities in the United States for one's own account generally does not constitute a trade or business in the United States, and accordingly, income from those activities is not taxed by the United States as business income. Thus, income from trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent, or trading by a foreign person physically present in the United States generally is not taxed as business income. This rule, however, generally does not apply to a dealer, or, in the case of trading in stocks or securities, to a corporation the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

The Code, as amended by the Tax Reform Act of 1986, provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition,

the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Business profits subject to host country tax

Under the proposed treaty, business profits of an enterprise of one of the countries would be taxable in the other country only to the extent that they are attributable to (1) a permanent establishment in the other country through which the enterprise carries on (or has carried on) business or (2) sales in the other country of goods or merchandise of the same or similar kind as the goods or merchandise sold through such a permanent establishment. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

Taxation by the source country of the second category of profits described above represents a limited force of attraction rule that is found in the U.N. model treaty, but is not present in either the U.S. or OECD model treaties.[50] The intent of the provision is to permit the source country to tax the income derived from sales within its borders by the home office of the enterprise of goods which are the same as or similar to goods sold there by the permanent establishment. Such profits could not be taxed by the host country if the enterprise demonstrates that the sales by the home office have been carried out for reasons other than obtaining a benefit under the proposed treaty. As an example of a situation where the exception might apply, the Technical Explanation posits a case where it may be more efficient for a U.S. company based in San Diego and having a permanent establishment in Mexico City to sell goods in Tijuana directly from the San Diego home office, whereas that may not be the case with respect to like goods sold in Mexico City.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Profits from U.S. source income other than U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains, are treated as effectively connected with the conduct of a trade or business in the United States, and taxed as such by the United States, without regard to whether they were derived from business activities or business assets. Under the proposed treaty, by contrast, some level of fixed place of business would have to be present and the business profits

[50] Similar provisions are contained in certain other U.S. treaties (e.g., Indonesia and India).

generally would have to be attributable to that fixed place of business (or subject to the limited force of attraction rule described above).

The proposed treaty clarifies that for purposes of the taxation of business profits (and for purposes of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 13 (Capital Gains)), any income attributable to a permanent establishment during its existence would be taxable in the country where the permanent establishment was situated even if the payments are deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above.

There would be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions. Amounts could be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

Treatment of expenses

In computing taxable business profits, deductions would be allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions would include expenses directly incurred by the permanent establishment as well as a reasonable allocation of expenses incurred by the home office, as long as the expenses were incurred on behalf of the company as a whole, or a part of it which includes the permanent establishment. Such allocable expenses would include a reasonable amount of executive and general administrative expenses, and, as specified in the proposed protocol (paragraph 5), research and development expenses, interest, and other expenses (e.g., charges for management, consultancy, or technical assistance) incurred in the taxable year, but only to the extent that such expenses have not been deducted by the enterprise and are not reflected in other deductions allowed to the permanent establishment (e.g., the deduction for cost of goods sold or of the value of purchases). Under this language, which differs in certain respects from the U.S. model, the staff understands that the United States would be free to use its expense allocation rules in determining the reasonable amount. Thus, for example, a Mexican company which has a branch office in the United States but which has its head office in Mexico would, in computing the U.S. tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in Mexico by the head office, allocated and apportioned in accordance with Treas. Reg. sec. 1.861-8, for purposes of operating the U.S. branch.

The proposed treaty provides (as does the U.N. model treaty and the commentary to the OECD model treaty) that no deductions would be allowable to the permanent establishment in respect of such amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices as royalties, fees, or other similar payments in return for the use of patents or other rights. In addition, no deduction in excess of actual reimburse-

ments would be allowable for payments by the permanent establishment to its home office (or other offices) as commissions for specific services performed or for management, or except in the case of a banking enterprise, for interest on moneys lent to the permanent establishment. According to the Technical Explanation, this rule reflects the premise that since the permanent establishment and the home office (and other offices) are parts of a single entity, there should be no profit element in such intracompany transactions.

The tax law of Mexico generally precludes a Mexican branch of a foreign corporation from deducting interest expense incurred by the home office or another branch, or interest expense on amounts that the home office lends to the branch; it may only deduct interest expense that it incurs to third-party lenders. The treaty would confirm that in the event that Mexico permits a U.S. bank to establish a branch in Mexico, that branch would be permitted to deduct interest initially incurred by its home office or another branch. The Technical Explanation states that Mexico could determine the appropriate level of a branch's interest deduction by taking into account actual transactions between the home office and the branch, or by using another appropriate method for approximating the branch's interest expense. The proposed treaty does not specify any particular method to be employed.

The Technical Explanation clarifies that reference above to an exception in the case of a banking enterprise is not intended to override the application of the U.S. interest allocation rules of Treas. Reg. sec. 1.882-5 to a U.S. permanent establishment of a Mexican corporation.[51] As indicated above, intracompany bank interest would be an exception to the proposed treaty's general preclusion of deductions for intracompany interest payments. Either country, under its respective internal laws, could, but is not required to, grant a deduction for interest paid on actual intracompany transactions. Rather than allowing deductions for such actual payments, the tax law of the United States determines the amount of deductible interest expense of a U.S. branch under the above-cited regulations.

The proposed protocol (paragraph 9) provides that where the internal law of one of the countries characterizes a payment in whole or in part as a dividend, or limits the deductibility of such payment because of thin capitalization rules or because the relevant debt instrument includes an equity interest, that country could treat the payment in accordance with such law. Thus, for example, the proposed treaty would not preclude the United States from disallowing the deduction of interest by a U.S. branch of a foreign corporation under the so-called "earnings-stripping" rules of Code section 163(j).[52]

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[51] Under this regulation, the deductible interest expense of a U.S. branch of a foreign corporation is computed as a portion of the worldwide interest expense of the corporation. The portion attributable to the U.S. branch is based on the corporation's U.S.-connected liabilities (i.e., an imputed portion of the overall liabilities of the corporation that are deemed necessary to fund the assets used by the corporation which generate effectively connected income) and an average rate of interest.

[52] See Prop. Treas. Reg. sec. 1.163(j)-8.

Other rules

Business profits would not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities would not be increased by a profit element in its purchasing activities.

The proposed treaty contains the language of the U.S. model and many existing treaties under which the business profits to be attributed to the permanent establishment would include only the profits (or losses) derived from the assets or activities of the permanent establishment. Moreover, the proposed treaty specifies that such attributable profits (or losses) would have to be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, would govern the treatment of those items of income. Thus, for example, dividends would be taxed under the provisions of Article 10 (Dividends), and not as business profits, except as provided in paragraph 5 of Article 10.

The proposed treaty, contrary to the U.S. model treaty, does not contain a definition of the term business profits. Under the U.S. model, the term "business profits" means income derived from any trade or business, including the rental of tangible personal property and the rental or licensing of cinematographic films or films or tapes used in radio or television broadcasting. Under the proposed treaty, the categories of rental income defined in the U.S. model's definition of business profits would be subject to the provisions of Article 12 (Royalties). Thus, for example, income earned by a U.S. person from the rental of tangible equipment in Mexico would be taxable by Mexico under Article 12, unless the income is attributable to a permanent establishment of the U.S. person in Mexico.

Paragraph 4 of the proposed protocol provides that nothing in Article 7 of the proposed treaty would affect the application of any law of either country that relates to the determination of the tax liability of a person in any case where the information available to the competent authority of the country is not sufficient to determine the profits to be attributed to the permanent establishment (or in cases covered by Article 23 of the Income Tax Law of Mexico), provided that, on the basis of the available information, the determination of the profits of the permanent establishment is consistent with the principles embodied in this article of the proposed treaty.[53]

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation or rental of ships and aircraft, and profits from the use or rental

[53] Article 23 of Mexico's Income Tax Law apportions the worldwide net income of international transportation companies on the basis of the ratio of Mexican to worldwide gross receipts.

of containers, trailers, barges, and related container transport equipment, in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in Article 13 (Capital Gains).

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.[54]

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") would be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. International traffic means any transport by ship or aircraft, except where the transport is solely between places in the other country (i.e., the treaty country other than the residence country of the enterprise) (Article 3(1)(d) (General Definitions)).

Profits derived from the rental of ships or aircraft on a full (time or voyage) basis (i.e., with crew) would be covered by the treaty exemption described in the preceding paragraph. Also covered would be profits from the rental of ships or aircraft on a bareboat basis (i.e., without crew) if they are operated in international traffic by the lessee and the rental profits are accessory to other profits from the operation of ships or aircraft in international traffic.

The term "operation of ships or aircraft in international traffic" by an enterprise would not include transportation by any other means of transport (e.g., transport by truck or rail) provided directly by the enterprise or the provision of overnight accommodation. Thus, profits from such operations would not constitute the type of accessory profits which would qualify for the exemption provided in the proposed treaty. Likewise, the exemption would not be extended to cross-border transport by truck or rail.[55]

The exemption would apply to income derived from the use, demurrage, or rental of containers, trailers for the inland transportation of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic. The U.S. model provides similar treatment for income derived from the maintenance of containers, trailers, barges, and related equipment, but does not cover income from the demurrage of such items. The staff understands that the substitution of the term "demurrage" for the term "maintenance" in the proposed treaty is not intended to provide a result different from the U.S. model. In addition, the shipping and air transport provisions would apply to profits from participation in a pool, joint business, or international operating agency, assuming that the other provisions of the treaty

[54] On August 7, 1989, the United States and Mexico exchanged notes concerning such a reciprocal exemption of international shipping and airline income. According to the Technical Explanation, the proposed treaty, once effective, would replace the 1989 agreement.

[55] Note that the U.S.-Canada income tax treaty provides an exemption for international transport by truck or rail. (See Article VIII, paras. 4 and 6.)

(e.g., Article 17 (Limitation on Benefits), or paragraph 2(b) of the proposed protocol, relating to treaty benefits for income of partnerships, trusts, and estates) would permit such application.

Under the proposed protocol (paragraph 6), U.S. persons that would qualify for the exemption from income taxation by Mexico under Article 8 also would be exempt from the Mexican assets tax with respect to the assets used to produce the exempt income.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Code which would recognize the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. In such a case, a country could allocate to such an enterprise the profits which it would have accrued, but for the conditions so imposed.

For purposes of the proposed treaty, an enterprise of one country would be related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises would also be related if the same persons participate directly or indirectly in their management, control, or capital.

Under the proposed treaty, either country could apply the rules of its national law that permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons, whether or not residents of one of the countries, in order to prevent evasion of taxes or clearly to reflect the income of any such persons. Thus, the proposed treaty makes clear that the United States would retain the right to apply its intercompany pricing rules (Code section 482, including, it is understood, the "commensurate with income" standard for pricing transfers of intangibles) and its rules relating to the allocation of deductions (Code sections 861, 862, and 863, and applicable regulations).

When a redetermination of tax liability has been properly made by one country, and the other country agrees to its propriety, the other country would make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. The language of this "correlative adjustment" clause differs from the corresponding U.S. model treaty language insofar as the correlative adjustment would only be required to the extent that the other country *agrees* with the original adjustment by the first country. In making that adjustment, due regard would be given to other provisions of the treaty (e.g., paragraph 2 of Article 26 (Mutual Agreement Procedure)) and the competent authorities of the two countries would consult with each other if necessary. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship would not apply in the case of such adjustments.

Paragraph 7 of the proposed protocol specifies that no correlative adjustment would be required to be made by a competent authority

if the misstatement of profits which gave rise to the original adjustment was the result of fraud, gross negligence, or willful default.

Article 10. Dividends

Internal dividend rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax, like a U.S. person, at the standard graduated rates, on a net basis. The United States imposes a branch profits tax on the deemed repatriation of U.S. earnings and profits of a U.S. branch of a foreign corporation (see detailed discussion below under Article 11A (Branch Tax)).

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders, either from accumulated earnings and profits or current year earnings and profits. Liquidating distributions, however, generally are treated as payments in exchange for stock, and thus are not subject to the 30-percent withholding tax described above (see discussion of capital gains in connection with Article 13, below). Moreover, amounts paid on debt obligations carrying the right to participate in profits typically are treated as interest under U.S. law, and as a result, such amounts may in some cases be exempt under the Code from U.S. withholding tax (see discussion of interest in connection with Article 11, below).

U.S. source dividends generally are dividends paid by a U.S. corporation. Also treated as U.S. source dividends for this purpose are portions of certain dividends paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such a dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to its total gross income. No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax. The tax imposed on dividends paid by a foreign corporation is often referred to as the "second-level" withholding tax.

Under proposed regulations, certain other payments that substitute for dividends in a securities lending transaction are treated as dividends for tax purposes.[56] These regulations cover cases where, for example, a foreign person owns dividend-paying stock in a U.S. corporation and "lends" the stock to a second person in exchange for a promise by the second person to make payments to

[56] INTL-106-89, 1992-1 C.B. 1196. The proposed regulations would amend sections 1.861-2, 1.861-3, 1.871-2, 1.871-7, 1.881-2, 1.894-1, and 1.1441-2 of the Treasury regulations.

the lender. The "borrower" collects the dividends paid with respect to the stock, and is required to make equivalent payments to the lender during the term of the "loan." This equivalent payment is referred to in the proposed regulations as a substitute dividend payment.

In general, corporations do not receive deductions for dividends paid under U.S. law. Thus, the withholding and branch taxes often represent imposition of a second level of tax on corporate taxable income. Treaty reductions of these taxes reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5-percent rate on dividends paid to direct investors which is found in many U.S. income tax treaties reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A real estate investment trust (REIT) is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met (Code sec. 857(b)). In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. Distributions of rental income, for example, are not themselves considered rental income. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are U.S. source and thus are subject to U.S. withholding tax of 30 percent when paid to foreign owners.

Like dividends, U.S. source rental income of foreign persons generally is subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on real property rental income generally is not reduced in U.S. income tax treaties.

The Code also generally treats regulated investment companies (RICs) as both corporations and conduits for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

Mexico

Mexican corporations generally are subject to corporate income tax at a 35-percent rate.[57] At present, under Mexico's integration system, no tax is imposed on dividends paid (to either residents or nonresidents) by Mexican corporations out of previously taxed net earnings. In cases where the corporate tax has been reduced by tax preferences, a 35-percent compensatory tax is imposed on the distributing corporation at the time of the distribution to recapture those preferences.

Treaty reduction of dividend taxes

Under the proposed treaty, each country could tax dividends paid by its resident companies, but the rate of tax would be limited by the treaty if the beneficial owner of the dividends is a resident of the other country.[58] Source country taxation generally would be limited to 5 percent of the gross amount of the dividend if the beneficial owner of the dividend is a company which holds directly at least 10 percent of the voting shares of the payor corporation. Subject to a transition rule, the tax generally would be limited to 10 percent of the gross amount of the dividends in other cases involving dividends paid to residents of the other country. Under the transition rule, for a period of five years from the date on which the provisions of Article 10 of the proposed treaty take effect, the withholding rate of 15 percent would be permitted.[59] The limitation of the tax at source to 10 percent on portfolio dividends would be more restrictive than most other existing U.S. income tax treaties and more restrictive than the U.S. model, which prescribes a maximum rate of 15 percent.

Pursuant to the proposed protocol (paragraph 8(a)), the prohibition on source country tax in excess of 5 percent on direct investment dividends would not apply to a dividend from a RIC or REIT. Thus, the proposed protocol would allow the United States to impose the portfolio dividend rate of tax (generally 10 percent, subject to the transition rule) on a U.S. source dividend paid by a RIC to a Mexican company owning 10 percent or more of the voting shares of the RIC. In addition, there would be no limitation under the proposed protocol on the tax that could be imposed by the United States on a dividend paid by a REIT to a Mexican resident, if the recipient is either an individual holding a 10 percent or greater interest in the REIT, or a company. Such a dividend would thus be taxable by the United States, assuming no change in present internal law, at the full 30-percent rate. The portfolio dividend rate would apply to REIT dividends paid to Mexican individuals who hold a less than 10-percent interest in the REIT.

Paragraph 8(b) of the proposed protocol contains a special provision which would reduce the 5-percent rate of withholding tax on direct investment dividends under the proposed treaty if the United States agrees in a treaty with another country to impose a lower

[57] The staff understands that there is a current proposal in Mexico to reduce the corporate income tax rate to 34 percent.

[58] The proposed treaty would not limit Mexico's ability to levy its 35-percent compensatory tax on Mexican corporations that distribute non-previously-taxed earnings.

[59] See the discussion of Article 29 (Entry Into Force) below for details on when the provisions of Article 10 will take effect.

rate on such dividends. If such an agreement were to ever come about, the applicable rate for purposes of the U.S.-Mexico treaty would be the rate agreed to for purposes of the other treaty. The staff understands that it is intended that such reduction would take effect at the same time as it takes effect in the U.S. treaty with the third country.

The limitations on source country taxation of dividends would not affect the corporate-level taxation of the profits out of which the dividends are paid.

Definition of dividends

The proposed treaty provides a definition of dividend that is similar to the definition in the U.S. model treaty and some U.S. treaties. The proposed treaty generally defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. The term also includes income from other corporate rights that is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares.

Special rules and exceptions

The proposed protocol (paragraph 9) provides that where the internal law of one of the countries characterizes a payment in whole or in part as a dividend, or limits the deductibility of such payment because of thin capitalization rules or because the relevant debt instrument includes an equity interest, that country could treat the payment in accordance with such law.

The proposed treaty's reduced rates of tax on dividends would not apply if the dividend recipient carries on (or has carried on) business through a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and dividends are attributable to the permanent establishment (or fixed base). Dividends attributable to a permanent establishment would be taxed as business profits (Article 7); dividends attributable to a fixed base would be taxed as income from the performance of independent personal services (Article 14).

The proposed treaty contains a general limitation on the taxation by a treaty country of income of a resident of the other treaty country from dividends paid by a corporation which is not a resident of that country (a so-called "second-level withholding tax"). Under this provision, Mexico could not impose any taxes on dividends paid by a non-Mexican corporation except where the dividends are paid to Mexican residents or are attributable to a permanent establishment or fixed base in Mexico. Similarly, the United States could not impose any tax on dividends paid by a non-U.S. corporation except where the dividends are paid to a resident of the United States or where the dividends are attributable to a permanent establishment or fixed base in the United States.

Article 11. Interest

Internal interest rules

United States

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent tax, collected by withholding, on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (a so-called "80/20 company"). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch-level excess interest tax, which is the tax it would have paid had a wholly-owned domestic subsidiary paid the foreign corporation the portion of the interest it deducted (under the rules of Treas. Reg. sec. 1.882-5) in computing its U.S. effectively connected income that is in excess of the interest actually paid by the U.S. trade or business (sec. 884(f)).

Portfolio interest generally is defined as any U.S. source interest that is not effectively connected with the conduct of a trade or business and (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution.[60]

Under a provision enacted in the Omnibus Budget Reconciliation Act of 1993, the portfolio interest exemption is inapplicable to certain contingent interest income. For this purpose, contingent interest generally includes interest determined by reference to any of the following attributes of the debtor or any related person: receipts, sales, or other cash flow; income or profits; or changes in the value of property. In addition, contingent interest generally includes interest determined by reference to changes in the value of, or yields on, certain actively traded property. In the case of an instrument on which a foreign holder earns both contingent and noncontingent interest, denial of the portfolio interest exemption applies only to the portion of the interest which is contingent interest.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (REMIC), the REMIC generally is treated for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on some portion of the REMIC's income (which, in turn, generally is interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor's "excess inclusion"—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unre-

[60] Certain additional exceptions to this general rule apply only in the case of a corporate recipient of interest. In such a case, the term portfolio interest generally excludes (1) interest received by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), and (2) interest received by a controlled foreign corporation from a related person.

lated business income tax under section 511, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor were otherwise eligible for such a rate reduction.

Mexico

Mexico generally imposes a 35-percent tax on interest derived in Mexico by nonresidents. This tax is collected by withholding. Exceptions to the general rate of tax apply as follows: interest paid to foreign governments or to foreign banks registered with the Ministry of Finance is subject to 15-percent tax; interest derived from publicly-offered securities also is subject to tax at a 15-percent rate; interest paid to foreign persons for loans used to purchase machinery, equipment, or inventory, or used for working capital in a business is subject to 21-percent tax if the lender is registered with the Ministry of Finance; and the interest portion of finance leases is taxable at a 21-percent rate. In addition, exemption from Mexican income tax is granted to nonresidents with respect to (1) loans to the Federal government; (2) fixed-rate loans with a duration of at least 3 years if made for export financing by registered financial entities; and (3) loans granted to certain government entities that are devoted to promoting foreign trade.

Treaty reduction of interest taxes

The proposed treaty provides that interest arising in one of the countries and paid to a resident of the other country generally could be taxed by both countries. This is contrary to the position of the U.S. model treaty which provides for an exemption from source country tax for interest earned by a resident of the other country.

The proposed treaty establishes maximum rates of source country tax that could be imposed on interest income. Subject to a transition rule, the proposed treaty provides that source country tax on interest could not exceed 4.9 percent of the gross amount of interest derived from the following: (1) loans granted by banks (including investment banks and savings banks) and insurance companies; and (2) bonds or securities that are regularly and substantially traded on a recognized securities exchange.[61] Under the transition rule, for a period of five years from the date the provisions of Article 11 of the proposed treaty take effect, source country tax on interest described above would be subject to a rate not in excess of 10 percent.[62]

For purposes of computing the foreign tax credit under U.S. law, the 4.9 percent rate of tax on such interest would cause the interest (and the related tax) to be excluded from the separate foreign tax credit limitation category for high withholding tax interest

[61] For this purpose, the proposed protocol (Paragraph 15(b)) defines a "recognized securities exchange" as including (1) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, (2) stock exchanges duly authorized under the terms of the Stock Market ("Mercado de Valores") Law of January 2, 1975, and (3) any other stock exchange agreed upon by the competent authorities of Mexico and the United States. (This definition is also relevant for purposes of Article 17 (Limitation on Benefits) of the proposed treaty.)

[62] See the discussion of Article 29 (Entry Into Force) below for details on when the provisions of Article 11 would take effect.

(which is defined as any interest that is subject to a foreign withholding tax at a rate of at least 5 percent (Code sec. 904(d)(2)(B)(i))). Thus, the income likely would be treated as either financial services income, general limitation income, or passive income, depending on the circumstances.

The proposed treaty further provides, again subject to a 5-year transition rule, that for the following interest, source country tax could not exceed 10 percent of the gross amount of the interest if from an instrument not described above: (1) interest paid by banks (including investment banks and savings banks); and (2) interest paid by the purchaser of machinery and equipment to a beneficial owner that is the seller of the machinery and equipment in connection with a sale on credit. In the case of such interest, the maximum rate of tax during the transition period would be 15 percent. The proposed protocol (paragraph 10(b)) clarifies that with respect to interest paid by the purchaser of machinery and equipment in connection with a sale on credit, the proposed treaty's 10-percent rate would apply only if the beneficial owner of the interest is the original seller of the machinery and equipment. If the original seller were to transfer the beneficial ownership of the interest, then the identity of the transferee would determine the rate of source country tax that may charged on the interest.

The proposed treaty provides for complete exemption from source country withholding tax in the case of certain categories of interest earned by residents of the other country. The exemption would apply if either the beneficial owner or the payor of the interest is the government of the United States or Mexico or a political subdivision or local authority thereof. In addition, interest would be exempt from source country tax if the beneficial owner is a trust, company, or other organization that is constituted and operated exclusively to administer or provide benefits under a plan (or plans) established to provide pension, retirement, or other employee benefits and its income generally is exempt from tax in its country of residence. The exemption also would apply for U.S. source interest which is paid in respect of a loan or credit with a duration of at least three years, if made, extended, guaranteed, or insured by the Banco Nacional de Comercio Exterior, S.N.C. or the Banco Nacional Financiera, S.N.C. Similarly, Mexican source interest would be exempt from Mexican tax if paid in respect of a loan or credit with a duration of at least three years, if made, extended, guaranteed, or insured by the Export-Import Bank or the Overseas Private Investment Corporation.

With respect to any interest not described in the preceding paragraphs that is earned by a resident of one of the countries from sources within the other country, the proposed treaty would limit the rate of source country tax to 15 percent. The proposed treaty further provides that in the case of any interest paid on back-to-back loans, the taxation of such interest would be in accordance with the domestic law of the country in which the interest arises.[63] Moreover, the proposed treaty's reductions of source country tax would apply only if the interest is beneficially owned by a resident

[63] See, e.g., P.L. 103-66, sec. 13238 (1993); Rev. Rul. 84-152, 1982-2 C.B. 381; Rev. Rul. 84-153, 1982-2 C.B. 383; Rev. Rul. 87-89, 1987-2 C.B. 195; and Tech. Adv. Mem. 9133004 (May 3, 1991).

of one of the countries. Accordingly, they do not apply if the recipient of the interest is a nominee for a nonresident.

According to paragraph 10(a) of the proposed protocol, no reduction of U.S. withholding tax would be granted under the proposed treaty to a Mexican resident that is a holder of a residual interest in a REMIC with respect to any excess inclusion. Similarly, upon notification of the U.S. competent authority by the Mexican competent authority that Mexico has authorized the marketing of securitized mortgages in a manner identical to a REMIC, no treaty reduction in Mexican withholding tax would apply to a U.S. resident that is a holder of an interest in such an entity with respect to income that is comparable to an excess inclusion. Moreover, if either country develops an entity that, although not identical to a REMIC, is substantially similar to a REMIC or an instrument that is substantially similar to a residual interest in a REMIC, the competent authorities of the two countries would be required to consult with each other to determine whether the above-described treatment applicable to REMICs would apply to such instrument or entity.

Definition of interest

The proposed treaty defines interest as income from debt claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The proposed treaty includes in the definition of interest any other income that is treated as income from money lent by the domestic law of the country in which the income arises. The proposed protocol (paragraph 9) provides, however, that where the internal law of one of the countries characterizes a payment in whole or in part as a dividend, or limits the deductibility of such payment because of thin capitalization rules or because the relevant debt instrument includes an equity interest, that country could treat the payment in accordance with such law.

Under the U.S. model treaty, penalty charges for late payment specifically are not considered interest. No such rule is included in the proposed treaty.

Special rules and exceptions

The treaty's reductions in source country tax on interest would not apply if the beneficial owner carries on (or has carried on) business in the source country through a permanent establishment located in that country or performs (or has performed) in that country independent personal services from a fixed base located there, and the interest is attributable to that permanent establishment or fixed base. In such an event, the interest would be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14). This rule would not, however, override the proposed treaty's exemptions from source country tax as described above. Thus, for example, no Mexican tax would be imposed on interest paid by the government of Mexico to a U.S. person, even if the interest were attributable to a permanent establishment of the U.S. person in Mexico.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying this article would be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest would be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Source rule for interest

The proposed treaty provides a source rule for interest. The staff understands that this rule would not, however, be relevant under Article 24 (Relief From Double Taxation) for foreign tax credit purposes. Interest would be treated as arising within a country if the payor is the government of that country, including its political subdivisions and local authorities, or a resident of that country.[64] If, however, the interest expense is borne by (i.e., for purposes of computing taxable income, allocable to) a permanent establishment (or fixed base) that the payor has in Mexico or the United States, the interest would have as its source the country in which the permanent establishment (or fixed base) is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Mexico and that French resident incurs indebtedness to a U.S. person, the interest on which is attributable to the Mexican permanent establishment, then the interest would be treated as having its source in Mexico.

Article 11A. Branch Tax

Internal branch tax rules

United States

A foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount." The dividend equivalent amount is the corporation's earnings and profits which are attributable to its income that is effectively connected (or treated as effectively connected) with its U.S. trade or business, decreased by the amount of such earnings that are reinvested in business assets located in the United States (or used to reduce liabilities of the U.S. business), and increased by any such previously reinvested earnings that are withdrawn from investment in the U.S. business.

Interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent (if paid to a foreign person), unless the income is exempt from tax under a specific Code provision. If a U.S. branch of a foreign corporation has allocated to it under regulation section 1.882-5 an interest deduction

[64] Generally, this is consistent with the source rules of U.S. law (Code secs. 861-862), which provide as a general rule that interest income has as its source the country in which the payor is resident.

in excess of the interest actually paid by the branch, such excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary from its foreign corporate parent. This excess interest is subject to 30-percent withholding tax absent a specific statutory exemption.

Mexico

Mexico imposes neither a branch profits tax nor a branch-level interest tax.

Proposed treaty provisions

Branch profits tax

The proposed treaty would expressly permit the United States to collect the branch profits tax from a Mexican company.[65] The United States would be allowed to impose the branch profits tax on a Mexican corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from immovable property or gains from the disposition of real property interests. However, the proposed treaty would permit at most a 5-percent branch profits tax rate, and, in cases where a foreign corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed treaty would completely eliminate the branch profits tax that the Code imposes on such corporation (unless the corporation earned income from real property as described above).

The branch profits tax could be imposed only on that portion of the profits of the foreign corporation that are effectively connected (or treated as such) with the conduct of a trade or business in the taxing country and which are either attributable to a permanent establishment situated there or represent the corporation's real property income and gains. Such amount would represent the "dividend equivalent amount" of those profits as that term is defined under the Code as it may be amended from time to time, without changing the general principle thereof.[66]

None of the restrictions on the operation of the U.S. internal law branch profit tax provisions would apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 17). As described in the discussion of Article 17 below, the limitation on benefits requirements of the proposed treaty are similar, but not identical, to the corresponding provisions of the branch tax provisions of the Code (sec. 884(e)).

Branch-level excess interest tax

Similarly, the proposed treaty would permit either country to impose a branch-level interest tax on a corporate resident of the other country. The proposed treaty, however, generally would limit the branch-level interest tax to 10 percent of the excess (if any) of (1) interest deductible in one or more taxable years in computing the

[65] It would also permit Mexico to reciprocally impose a branch profits tax on U.S. companies if one were to be enacted into Mexican law.

[66] Pursuant to the proposed protocol (paragraph 15(a)), in the case of Mexico, the term "trade or business" for this purpose means activities carried on through a permanent establishment as defined in the Income Tax Law of Mexico.

corporation's profits that are either attributable to a permanent establishment in the other country or to income or gain attributable to real property that is subject to net-basis tax, over (2) the interest paid by or from such permanent establishment or trade or business. After a period of five years from the date on which Article 11 takes effect, the maximum rate of branch-level interest tax would be reduced to 4.9 percent with respect to banks (including investment banks and saving banks) and insurance companies. All other taxpayers would continue to be subject to a 10-percent rate of tax.

Other rules

The proposed treaty explicitly states that nothing in the non-discrimination article (Article 25) is to be construed as preventing either of the countries from imposing a branch profits tax or a branch-level interest tax.

Paragraph 15(a) of the proposed protocol includes a clarification of the meaning of the term "trade or business" as employed for purposes of the branch tax article of the proposed treaty. According to the proposed protocol, that term means, in the case of Mexico, activities carried on through a permanent establishment as defined in the Income Tax Law of Mexico.

Article 12. Royalties

Internal royalty rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. U.S. source royalties include royalties for the use of or the right to use intangible property in the United States. Such royalties include motion picture royalties.

Mexico

Mexico imposes a 15-percent withholding tax on royalties for the use of models, plans, formulas, know-how, copyrights, artistic, literary and scientific works, and rights to use movie and television films and recordings derived by nonresidents. It also imposes a 15-percent tax on technical assistance fees. A 35-percent withholding tax is imposed on royalties for the use of patents, trade names, and trademarks.

Mexico generally imposes tax at a rate of 21 percent on equipment rentals.

Taxation of royalties under the proposed treaty

The proposed treaty provides that royalties derived and beneficially owned by a resident of a country generally could be taxed by that country. In addition, the proposed treaty would allow the country where the royalties arise (the "source country") to levy a tax of no more than 10 percent on royalties. Thus, the proposed treaty would permit the United States to impose a 10-percent tax on gross U.S. source royalties paid to Mexican residents, and would permit Mexico to impose a 10-percent tax on gross Mexican source royalties paid to U.S. residents. This provision of the proposed treaty is contrary to the corresponding provision of the U.S. model trea-

ty, which generally provides for complete exemption from source country taxation of royalties earned by residents of the other country.

Special rules and exceptions

The reduced rate would apply only if the royalty is beneficially owned by a resident of the other country; it would not apply if the recipient of the royalty is a nominee for a nonresident.

In addition, the reduced rate would not apply where the recipient is an enterprise that carries on (or has carried on) business through a permanent establishment in the source country, or an individual who performs (or has performed) personal services in an independent capacity through a fixed base in the source country, and the royalties are attributable to the permanent establishment or fixed base. In that event, the royalties would be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by holding that the amount of royalties for purposes of applying this article would be the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty, for whatever reason, would be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article 10 of the proposed treaty.

Definition of royalties

The term "royalties" as used in the proposed treaty would mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including motion picture films and works on film or tapes or other means of reproduction for use in connection with television broadcasting; or for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience.[67] This definition generally conforms to the definition included in the U.S. model treaty, except that the U.S. model specifically excludes from royalties any payments for the use of, or right to use, cinematographic films or tapes used for radio or television broadcasting.

Pursuant to paragraph 11 of the proposed protocol, it is understood that the term "information concerning industrial, commercial or scientific experience" would be defined in accordance with paragraph 12 of the Commentary on Article 12 (Royalties) of the 1977 Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital of the Organization for Economic Cooperation and Development (the "OECD Commentary"). The OECD Commentary on Article 12 states that in

[67] The Technical Explanation states that the term "copyright" as used in the proposed treaty is understood to include the use or right to use computer software programs and sound recordings.

classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, the OECD model treaty alludes to the concept of "know-how." One working definition of "know-how" is "all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique." In a contract for the use of know-how, one party agrees to impart to the other, so that it can use them for its own account, the first party's special knowledge and experience which remain secret from the public. The drafters of the OECD Commentary recognized that the grantor of the know-how is not required to play any part in the application of the know-how granted to the licensee, and that it does not guarantee the result thereof. This type of contract, thus, differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of its calling to execute work itself for the other party. Thus, according to the Commentary, payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties for the use of industrial, commercial, or scientific experience. Instead, such payments generally would be subject to the rules of the Articles on business profits or independent personal services, as appropriate.[68]

In a significant departure from the U.S. model treaty, the proposed treaty also would include as royalties payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial or scientific equipment not constituting immovable property (as defined in Article 6 of the proposed treaty).[69] Under the U.S. model treaty, such payments for the use of tangible personal property would not constitute royalties, but rather would be treated as rents, and if earned by an enterprise resident in one of the countries, would be taxable by the other country *only if* attributable to a permanent establishment of the enterprise located in that other country. Under the proposed treaty, by contrast, the source country could impose a 10-percent gross basis tax on such rental of tangible personal property if the rental income is not at-

[68] The OECD Commentary goes on to say that in business practice, contracts are sometimes entered into which cover both know-how and the provision of technical assistance (e.g., in a franchising contract, the franchisor may impart its knowledge and experience to the franchisee and, in addition, provide the franchisee with technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods). According to the Commentary, the appropriate approach in dealing with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided under the contract constitutes by far the principal purpose of the contract, and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.

[69] Payments for the leasing of containers used in international transport and payments for the rental of ships or aircraft used in international traffic on a full (time or voyage) basis or for the incidental leasing of ships and aircraft used in international transport on a bareboat basis are covered by the provisions of Article 8 (Shipping and Air Transport) of the proposed treaty.

tributable to a permanent establishment located within its territory.[70]

Under the proposed treaty, the term "royalties" also would include gains from the alienation of any right or property described above which are contingent on the productivity, use, or disposition of such right or property. As a result, such amounts would be taxable at source in accordance with Article 12 rather than being exempt from source country tax under the capital gains provisions of the proposed treaty (Article 13).

Source rule for royalties

The proposed treaty provides a source rule for royalties. The staff understands that this rule, however, would not be relevant under Article 24 (Relief From Double Taxation) for foreign tax credit purposes. Royalties would be deemed to arise within a country if the payor is the government of that country, including its political subdivisions and local authorities, or a resident of that country. If, however, the royalty expense is borne by (i.e., for purposes of computing taxable income, deductible by) a permanent establishment (or fixed base) that the payor has in Mexico or the United States, the royalty would have as its source the country in which the permanent establishment (or fixed base) is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Mexico and that French resident pays a royalty to a U.S. person which is attributable to the Mexican permanent establishment, then the royalty would be treated as having its source in Mexico. In addition, the proposed treaty provides that where the preceding rules would not operate to deem royalties as arising in either the United States or Mexico, and the royalties relate to the use of, or the right to use, in one of those countries, any property or right encompassed within the proposed treaty's definition of royalties, then the royalties would be deemed to arise in that country.

Special rule for imposition of Mexican assets tax

The proposed protocol (paragraph 3) provides that the 2-percent assets tax imposed under Mexican law generally would not apply to U.S. residents that, pursuant to Article 7 (Business Profits) of the proposed treaty, are not taxable in Mexico on their business profits because they have no permanent establishments in Mexico.[71] Notwithstanding this exception, the assets tax could be imposed on immovable property situated in Mexico and on the types of tangible and intangible property specified under the definition of royalties in this Article that are furnished to Mexican residents. Under Mexican law, the assets tax generally applies only to the extent that it exceeds any income tax paid to Mexico by the taxpayer.[72] With respect to the assets tax on tangible and intangible

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[70] If the rental income is attributable to such a permanent establishment, then the business profits article of the proposed treaty would apply.

[71] U.S. persons that have permanent establishments in Mexico would be subject to Mexican income tax on the business profits from the permanent establishment and to the assets tax on the assets used in the enterprise.

[72] In this sense, the assets tax operates in a manner similar to the U.S. alternative minimum tax (AMT). That is, like the AMT, the assets tax applies only to the extent it exceeds the regular income tax paid by the taxpayer.

property described in Article 12, the proposed protocol specifies that Mexico would grant a credit against such tax in an amount equal to the income tax that would have been imposed under the Mexican Income Tax Law on the royalties paid (i.e., at the rate of withholding tax provided under Mexican law instead of the 10-percent rate provided under the proposed treaty). According to the Technical Explanation, the credit granted by Mexico under this provision would be expected to eliminate any assets tax liability of the U.S. person.

Article 13. Capital Gains

Internal capital gains rules

United States

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

The Code generally provides for the nonrecognition of gain that is realized upon certain exchanges of property or stock in connection with contributions of property to corporations, liquidations of corporations, distributions of stock, and corporate reorganizations. Where a foreign corporation is involved in the transaction, however, these nonrecognition rules may in some cases be inapplicable. Recognition of gain may arise from treating a foreign corporation as not a corporation for purposes of the general nonrecognition rules (Code sec. 367(a) and (b)), or from an explicit rule requiring recognition of gain in a particular circumstance (e.g., sec. 367(d) and (e)).[73]

Under regulations, taxpayers are covered in certain circumstances by exceptions under section 367 to the nonrecognition rules are able to enter into agreements with the IRS under which nonrecognition treatment is preserved, or recognition of gain is deferred.

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[73] For example, the general rule under the Code treats a corporation that distributes property in complete liquidation as realizing gain or loss as if the property had been sold to the distributee (sec. 336(b)). If, however, a sufficient amount of the stock of the corporation is owned by another corporation, a nonrecognition rule applies: no gain or loss is recognized to the liquidating corporation. A provision in section 367, in turn, makes the nonrecognition provision inapplicable, except as provided in regulations, if the distributee is a foreign corporation (sec. 367(e)(2)). Even where the distributee is a foreign corporation resident in a treaty country, such treatment is not considered impermissibly discriminatory, because absence of tax to the subsidiary in this case represents a complete elimination of U.S. tax jurisdiction over any appreciation, while a similar absence in the case of a domestic distributee simply moves the untaxed appreciation into the hands of another U.S. taxpayer. *See* Notice 87-66, 1987-2 C.B. 376.

Mexico

Except for sales of stock of public companies through the Mexico Stock Exchange, Mexico generally taxes gain recognized by a nonresident alien or foreign corporation on the sale of stock in a Mexican corporation or on the sale of Mexican real property. Furthermore, Mexico taxes the sale by a nonresident of shares of a non-Mexican corporation if the majority of assets of the corporation consists of real property located in Mexico. As a general rule, tax on such gains is equal to 20 percent of the gross sales price; in some cases, however, nonresident persons may elect instead to pay tax at a rate of 30 percent on the net gain from the sale if the purchaser is given proper notification and the sale is made through a Mexican agent. Sales of capital assets not listed above by foreign persons generally are not taxed by Mexico.

Treatment of capital gains under the proposed treaty

Under the proposed treaty, gains derived by a resident of one treaty country from the disposition of immovable or real property situated in the other country could be taxed in the other country (i.e., the country where the immovable property is situated). Immovable property for the purposes of this article would include (1) immovable property as defined in article 6 (Income for Immovable Property (Real Property)) situated in the other country, (2) an interest in a partnership, trust, or estate, to the extent that its assets consist of immovable property situated in that other country, (3) shares or comparable interests in a company that is, or is treated as, a resident of that other country, the assets of which company consist or consisted at least 50 percent (by value) of immovable property situated in that other country, and (4) any other right that allows the use or enjoyment of immovable property situated in the other country. Under paragraph 12 of the proposed protocol, the term immovable property situated in the other country would include, when the United States is the other country, a "U.S. real property interest" as defined under Code section 897. The proposed treaty, thus, would allow the United States to tax transactions of Mexican residents taxable under FIRPTA.

Gains from the alienation of movable property which are attributable to a permanent establishment which an enterprise of one country has (or had) in the other country, gains from the alienation of movable property which are attributable to a fixed base which is (or was) available to a resident of one country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, could be taxed in that other country. The wording of this rule varies somewhat from the U.S. model treaty to clarify that any gain attributable to a permanent establishment (or fixed base) during its existence would be taxable in the country where the permanent establishment (or fixed base) is situated even if the gain is deferred until after the permanent establishment (or fixed base) has ceased to exist. Thus, the proposed treaty would give a taxing right to a country in which the other country's resident has *or had* a permanent establishment; the proposed treaty further would give a taxing right to a country in which a fixed base is *or was* available to

the other country's resident. As stated in the Technical Explanation, this language of the proposed treaty would permit the United States to impose tax under the rules of Code section 864(c)(7), as described above in connection with Article 7 (Business Profits).

The proposed treaty would expressly permit a country to tax gains derived by a resident of the other country from the disposition of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the first country if the recipient of the gain, during the 12-month period preceding the disposition, had a participation (directly or indirectly) of at least 25 percent in the capital of that company or other legal person. If this ownership threshold is not met, the source country would be precluded from taxing the disposition of such property by a resident of the other country (unless the property constituted an interest in immovable property as detailed above). Thus, Mexico would not be prevented from imposing its statutory tax on gains from the disposition of stock in a Mexican resident company by a resident of the United States that was a substantial shareholder in the Mexican company.

Under a special rule contained in the proposed protocol (paragraph 13), no tax under the preceding paragraph would apply in the case of a transfer of property between members of a group of companies that file a consolidated tax return, to the extent that the consideration received by the transferor corporation consists of participation or other rights in the capital of the transferee or of another company resident in the same country that owns (directly or indirectly) 80 percent or more of the voting rights and value of the transferee corporation as long as the following three conditions are satisfied. First, the transferor and transferee corporations must both reside in the United States or must both reside in Mexico. Second, before and immediately after the transfer, the transferor corporation or the transferee corporation must own (directly or indirectly) no less than 80 percent of the voting rights and value of the other, or a company resident in the same country must own (directly or indirectly) no less than 80 percent of the voting rights and value of the transferor and transferee corporations. Third, for purposes of determining gain on any subsequent disposition, either the initial cost of the asset for the transferee must be determined based on the cost it had for the transferor, increased by any cash or other property paid (i.e., carryover basis rules must apply), or the gain must be measured by another method that gives substantially the same result. Notwithstanding the foregoing rules, the proposed protocol mandates that if cash or property other than the participation or other rights is received, the amount of the gain (limited to the amount of cash or other property received), would be taxable by the source country.

To illustrate the application of the rule set forth in paragraph 13 of the proposed protocol, assume, for example, that a U.S. corporation owns all of the stock of a Mexican subsidiary corporation. Further assume that the U.S. corporation establishes a new, wholly-owned, U.S. subsidiary corporation (with which it files a U.S. consolidated income tax return). If, in capitalizing the new company, the U.S. parent transfers all of the stock of the Mexican corporation to the U.S. subsidiary in exchange solely for stock of the U.S.

subsidiary, no U.S. tax would be imposed (as a result of either section 351 or 368(b) of the Code), and the U.S. subsidiary would take as its basis in the stock of the Mexican company the basis that the U.S. parent had in such stock. Under the proposed protocol, Mexico also would not impose tax on this transaction even though it involved the disposition of stock of a Mexican company by a substantial nonresident shareholder.

Gains from the alienation of ships, aircraft, or containers (including trailers, barges, and related equipment for the transport of containers) used principally in international traffic, would be taxable only in that country. Gains described in Article 12 (Royalties) would be taxable only in accordance with the provisions of that Article.

Gains from the alienation of any property other than that discussed above would be taxable under the proposed treaty only in the country where the person disposing of the property is a resident.

Source rule for certain capital gains

With respect solely to the provisions of the proposed treaty (and the proposed protocol) relating to the taxation of gains from the alienation of stock, participation, or other rights in the capital of a company or other legal person, the proposed treaty provides that to the extent necessary to avoid double taxation, such gains would be deemed to arise in the country of residence of the company or other legal person whose ownership rights are so disposed of. Thus, the United States would treat gain taxed by Mexico under those provisions as foreign source income (if not already so treated under the Code; see section 865(f)) to the extent necessary to permit a credit for the Mexican tax, subject to the limitations of U.S. law (i.e., Code sec. 904). In such a case, if the Mexican tax on the gain does not exceed the U.S. tax on that gain, then the U.S. generally would be required to grant a full credit for the Mexican tax.

Article 14. Independent Personal Services

Internal rules regarding services income in general

United States

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can constitute a trade or business within the United States (Code sec. 864(b)).

Under the Code, the income of a nonresident alien individual from the performance of personal services in the United States is excluded from U.S. source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if certain criteria are met. The criteria are: (1) the individual is not in the United States for over 90 days during a taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of or under a contract with a foreign person not engaged in a trade or business in the United States, or they

are performed for a foreign office or place of business of a U.S. person.

Mexico

Mexico generally imposes a 30-percent tax on gross income of nonresidents derived from the performance of personal services within Mexico for Mexican residents or for the Mexican permanent establishment of a nonresident.

Treatment of independent personal services under the proposed treaty

The proposed treaty would limit the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) would be treated separately from income from the performance of dependent personal services.

Income from the performance of independent personal services in one country by a resident of the other country would be exempt from tax in the country where the services are performed (the source country) unless the individual performing the services crosses either of two thresholds in the first country. The individual could be taxed in the first country if he or she has a fixed base which he or she regularly makes use of in that country in the course of performing the services.[74] In that case, the source country would be permitted to tax only that portion of the individual's income which is attributable to the fixed base. In addition, if the individual is present in the first country for a period or periods exceeding 183 days within a 12-month period, the first country would be permitted to tax the income from the performance of independent personal services in that country during that period. This latter rule represents a departure from the U.S. model treaty, which would permit the source country to tax the income from independent personal services of a resident of the other country only if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing the activities.

The Technical Explanation specifies that under either the fixed base or 183-day test, it is understood by the parties to the proposed treaty that the taxation of income from independent personal services would be governed by the principles set forth in Article 7 (Business Profits); that is, the tax base would be net of expenses incurred in generating the income.

Paragraph 14 of the proposed protocol provides that the provisions of Article 14 would also apply to income derived by a U.S. corporation from the furnishing of personal services through a fixed base located in Mexico. In such a case, the corporation could compute the Mexican tax on the income from such services on a net basis as if the income were attributable to a Mexican permanent establishment. This rule is necessary because under Mexican law,

[74] According to the technical explanation, it is understood that for purposes of the proposed treaty, the concept of a fixed base is to be interpreted consistently with the concept of a permanent establishment.

a personal service company is not considered to earn business profits, so such a company would be taxed by Mexico under Article 14 rather than under Article 7.[75]

For purposes of this article, personal services include independent scientific, literary or artistic activities, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. According to the Technical Explanation, this Article would apply to personal services performed by an individual for his or her own account, whether or not as a sole proprietor, where he or she receives the income and bears the risk of loss arising from the services.

It is understood that no change to the model treaty language is necessary to conform the treatment of income derived from independent personal services with Code section 864(c)(6), under which, as described above, any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year. An analogous rule applies to income for a taxable year from independent personal services performed in another year in which a fixed base was available.[76]

Article 15. Dependent Personal Services

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the "source country") by a resident of the other country would be taxable by the source country unless three requirements are met: (1) the individual must be present in the source country for fewer than 184 days in a 12-month period; (2) his or her employer must not be a resident of the source country; and (3) the compensation must not be borne (i.e., deductible) by a permanent establishment or fixed base of the employer in the source country. This degree of limitation on source country taxation is similar to the U.S. and OECD model treaties. The principal difference between the proposed treaty and the U.S. model treaty is that under the model, the first criteria listed above is based on a fixed measurement period—that period being the taxable year concerned.

The U.S. model treaty provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in the employee's country of residence. The proposed treaty contains no such limitation on the source country. Hence, such persons would be subject to the general rules detailed above for the taxation of dependent services income.

This article is modified in some respects for directors' fees (Article 16), pensions, annuities, alimony, and child support (Article 19),

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[75] The United States would apply Article 7 (Business profits) to the service income earned by a Mexican company.

[76] If a treaty country resident receives income for independent activities rendered by that resident, and the activities were performed in the other treaty country in a year during which the resident was present in the second country for more than 183 days (or the resident maintained a fixed base in the second country), then that income is taxable by the second treaty country, regardless of whether payment for the activities was deferred to years in which the resident had no presence in the second country. (See, Rev. Rul. 86-145, 1986-2 C.B. 297.)

and government service income (Article 20). In this respect, the article is consistent with the corresponding article of the U.S. model treaty.

Article 16. Directors' Fees

Under the proposed treaty, directors' fees and similar payments derived by a resident of one country for services rendered outside of that country as a director or overseer of a company which is a resident of that other country would be taxable in that other country.[77]

The proposed treaty rule for directors' fees differs from that of the U.S. model treaty. The U.S. model generally treats directors' fees as personal service income. This treaty rule also differs from the OECD model treaty, which places no limits on the ability of the country of residence of the company to tax the fees of that company's directors. Under the proposed treaty, the country where the recipient resides would continue to have primary taxing jurisdiction over directors' fees except where the services are performed outside of that country.

Article 17. Limitation on Benefits

In general

The proposed treaty contains a provision intended to limit the benefits of the treaty to persons who are entitled to them generally by reason of their residence in the United States or Mexico.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Mexico as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as "treaty shopping" and refers to the situation where a person who is not a resident of either treaty country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the third-country resident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the treaty countries which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed anti-treaty shopping article provides that a person that is a resident of either Mexico or the United States and derives income from the other treaty country would be entitled to the bene-

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[77] According to the Technical Explanation, Mexican corporations may have persons who are not directors, but who look out for the shareholders' interests in an oversight capacity without engaging in day-to-day management functions. Inclusion of the term "overseer" in this article of the proposed treaty is intended to cover the income earned by persons providing such services.

fits of the treaty only if that person is an individual, unless it satisfies an active business test, an ownership/"base erosion" test, or either of two public company tests, or unless it is itself one of the treaty countries or a political subdivision or local authority thereof, or else is a not-for-profit, tax-exempt organization that also satisfies an ownership test. In addition, a special rule would grant benefits under Articles 10 (Dividends), 11 (Interest), 11A (Branch Tax), and 12 (Royalties) to persons who satisfy an ownership/base erosion test that factors in certain ownership by persons who are residents of any country that is a party to the proposed North American Free Trade Agreement ("NAFTA").

Active business test

Under the active business test, treaty benefits would be available under the proposed treaty to an entity that is a resident of the United States or Mexico, the ownership/base erosion and public company tests notwithstanding, if it is engaged in the active conduct of a trade or business in its residence country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business. However, this exception would not apply (and benefits could therefore be denied) to the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This active business test would replace a more general rule in some earlier U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

Paragraph 15(a) of the proposed protocol includes a clarification of the meaning of the term "trade or business" as employed for purposes of the limitation on benefits article of the proposed treaty. According to the proposed protocol, that term means, in the case of Mexico, activities carried on through a permanent establishment as defined in the Income Tax Law of Mexico.

Ownership/base erosion test

Under the ownership/base erosion payment test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity would have to be owned, directly or indirectly, by any combination of one or more individual residents of Mexico or the United States, certain publicly traded companies (as described in the discussion of the public company tests below), the countries themselves, political subdivisions or local authorities of the countries, or certain tax-exempt organizations (as described in the discussion of tax-exempt entities below). This rule could, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends and royalties paid to a Mexican company that is controlled by individual residents of a third country. This rule would not be as strict as that contained in one proposed U.S. model version of an anti-treaty shopping provision, which requires 75 percent ownership by residents of the person's country of residence, to preserve benefits.

In addition, the ownership/base erosion test would be met only if less than 50 percent of the gross income of the entity is used,

directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those named in the preceding paragraph. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. This provision is substantially similar to that in one proposed U.S. model version of an anti-treaty shopping provision. Paragraph 15(c) of the proposed protocol clarifies that for purposes of this base erosion rule, the term "gross income" means gross receipts, or where an enterprise is engaged in a business which includes the manufacture or production of goods, gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

Public company tests

Under the public company test, a company that is a resident of Mexico or the United States and that has substantial and regular trading in its principal class of stock on a recognized securities exchange would be entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes. Similarly, treaty benefits would be available to a company that is wholly owned (directly or indirectly) by a Mexican or U.S. company that satisfies the public company test just described.

According to the proposed protocol (paragraph 15(b)), the term "recognized securities exchange" would include the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; any stock exchange duly authorized under the terms of Mexico's Stock Market ("Mercado de Valores") Law of January 2, 1975; and any other stock exchange agreed upon by the competent authorities of the two countries.

The proposed treaty also contains an alternative public company test which would treat certain ownership by residents of any country that is a party to NAFTA (currently, the United States, Mexico, or Canada) as qualifying ownership. Under this alternative public company test, a company that is a resident of Mexico or the United States would be entitled to the benefits of the treaty if it (1) is owned entirely (directly or indirectly) by companies that are residents of NAFTA countries, and (2) is more than 50-percent owned (directly or indirectly) by Mexican or U.S. companies that satisfy the public company test described above. Pursuant to paragraph 15(d) of the proposed protocol, this alternative public company test would only take effect upon entry into force of NAFTA.

Tax-exempt entities

An entity also would be entitled to benefits under the proposed treaty if it is a not-for-profit organization that, by virtue of that status, generally is exempt from income taxation in its treaty coun-

try of residence, provided that more than half the beneficiaries, members, or participants, if any, in the organization would be entitled to the benefits of the treaty. The organizations covered by this rule would include, but would not be limited to, pension funds and private foundations.

Special rule for NAFTA country ownership

Under a provision neither found in the U.S. model nor in most other current U.S. income tax treaties, a person would qualify for benefits under Article 10 (Dividends), 11 (Interest), 11A (Branch Tax), or 12 (Royalties) if it satisfies the following four conditions. First, more than 30 percent of the beneficial interest (in the case of a company, more than 30 percent of the number of shares of each class of shares) in that person must be owned (directly or indirectly) by any combination of one or more individual residents of Mexico or the United States, certain publicly traded companies (as described under either of the proposed treaty's public company tests), the countries themselves, political subdivisions or local authorities of the countries, or tax-exempt organizations that qualify for treaty benefits.

Second, more than 60 percent of the beneficial interest (in the case of a company, more than 60 percent of the number of shares of each class of shares) in that person must be owned (directly or indirectly) by persons resident in a country that is a party to NAFTA. For purposes of this requirement, a resident of a NAFTA country would only be treated as owning a beneficial interest (or share) if its country of residence has a comprehensive income tax treaty with the country from which the income is derived and if the particular profit or item of income in respect of which benefits under the proposed U.S.-Mexico treaty are claimed would be subject to a rate of tax under that other treaty that is no less favorable than the rate of tax applicable to that person under the relevant article of the proposed U.S.-Mexico treaty.

The third requirement would be satisfied only if less than 70 percent of the gross income of the person is used (directly or indirectly) to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those listed as qualifying owners under the first requirement above.

The fourth requirement would be satisfied only if less than 40 percent of the gross income of the person is used (directly or indirectly) to meet liabilities (including liabilities for interest or royalties) to a combination of persons other than (1) persons or entities listed as qualifying owners under the first requirement above and (2) other residents of NAFTA countries.

The staff understands that the definition of "gross income" contained in paragraph 15(c) of the proposed protocol is intended to apply for purposes of these base erosion tests.

Paragraph 15(d) of the proposed protocol specifies that this provision of the proposed treaty would only take effect upon entry into force of NAFTA.

Competent authority determination

Finally, the proposed treaty provides a "safety-valve" for a person that has not established that it meets one of the other more objec-

tive tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person could be granted treaty benefits if the competent authority of the source country so determines. According to the proposed treaty, one of the factors the competent authorities should take into account in evaluating such a case is whether the establishment, acquisition, and maintenance of the person and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits.

This provision is similar to a portion of the qualified resident definition under the Code's branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule.

Article 18. Artistes and Athletes

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that would apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules would apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Except as detailed below relating to certain publicly-sponsored events, this article of the proposed treaty would permit one of the countries to tax an entertainer who is a resident of the other country on the income from his or her personal services as an entertainer in the first country during any year in which the amount of the remuneration derived by him or her from such activities, including reimbursed expenses, exceed $3,000 or its Mexican currency equivalent. Thus, if a Mexican entertainer maintains no fixed base in the United States and performs (as an independent contractor) for one day of a taxable year in the United States for total compensation of $2,000, the United States could not tax that income. If, however, that entertainer's total compensation were $4,000, the full amount (less appropriate deductions) would be subject to U.S. tax.

The proposed treaty specifies that if an entertainer or athlete who is a resident of one of the countries is not subject to tax in the other country under this article (for example, the person is a U.S. resident who earns less than $3,000 from performing in Mexico), the other country could nevertheless withhold tax on the entire amount of gross receipts derived by the athlete or entertainer during the taxable year. The tax so withheld would be refunded to the entertainer or athlete upon application at the end of the calendar year concerned. A country would be permitted to tentatively withhold tax under the proposed treaty in recognition of the fact that it may not be possible to determine the annual amount of re-

muneration received by an entertainer or athlete until the taxable year has ended.

The proposed protocol (paragraph 16) clarifies that for purposes of this Article, remuneration derived by an entertainer or athlete who is a resident of one of the countries would include remuneration for any personal activities performed in the other country relating to that person's reputation as an entertainer or athlete (such as compensation for services performed in personal endorsements of commercial products). The provisions of this Article would not apply, however, to auxiliary or supporting personnel (e.g., technicians), or to managers or coaches. Income from personal services performed by those persons would be subject to the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services) of the proposed treaty, as appropriate.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete, but to another person, that income would be taxable by the country in which the activities are exercised unless it is established that neither the entertainer or athlete nor persons related to him or her participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other income distributions. (This provision applies notwithstanding the business profits and personal service articles (Articles 7, 14, and 15).) This provision prevents highly paid performers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

The foregoing provisions are similar to provisions in the U.S. and OECD model treaty articles dealing with entertainers and athletes. The $3,000 threshold for source country taxation, however, is considerably lower than the corresponding $20,000 threshold in the U.S. model. In addition, the proposed treaty departs from the models in excluding from the article income derived from activities performed in a country by entertainers or athletes if the visit to that country is substantially supported, directly or indirectly, by public funds of the other country or a political subdivision or a local authority thereof. In that case, the income is taxable only in the entertainer's or athlete's residence country. According to the Technical Explanation, it is understood that the competent authorities could consult as to which visits satisfy this standard.

Article 19. Pensions, Annuities, Alimony, and Child Support

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment by that person (or by another individual, the recipient's spouse, for example, who is a resident of the same country) would be subject to tax only in the recipient's country of residence at the time the remuneration is received.[78] In

[78] This provision would apply to a pension whether paid periodically in installments or in a lump sum.

contrast, the proposed treaty provides that social security and other public pensions paid by one of the countries (the source country) to a resident of the other country or to a U.S. citizen would be taxable by the source country, but not by the country of residence. Consistent with the U.S. model treaty, this rule would be an exception to the proposed treaty's saving clause (Article 1, paragraph 3). Thus, a Mexican social security benefit would be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen.

The above rules would be subject to the provisions of Article 20 (Government Service). Thus, they would not apply, for example, in the case of pensions paid to a resident of one country attributable to services performed for government entities of the other, unless the resident of the first country is also a citizen of the first country.

The proposed treaty also provides that annuities would be taxed only in the country of residence of the person who beneficially owns and derives them. Annuities are defined under the proposed treaty as a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

The proposed treaty provides for the treatment of alimony and child support payments made by a resident of one of the countries to a resident of the other country. The proposed treaty is similar to the U.S. model to the extent that it provides that child support would be taxable only in the source country (i.e., the country of residence of the payor). However, it differs from the U.S. model with respect to the taxation of alimony payments. Under the proposed treaty, alimony payments also would be taxable only in the source country (i.e., the country of residence of the payor). By contrast, the U.S. model would permit only the country of residence of the person receiving alimony payments to tax such payments.

The term "alimony" as used in the proposed treaty means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. Child support payments are defined by the proposed treaty as periodic payments for the support of a minor child, made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support.

These treaty rules on alimony and child support would not be superseded by the saving clause.[79] Thus, under the proposed treaty, a U.S. citizen could not be taxed by the United States on alimony paid by a Mexican resident, despite the tax jurisdiction generally maintained by the United States over its citizens.

Article 20. Government Service

Under the proposed treaty, remuneration, other than a pension, paid by one of the countries (or a political subdivision or local authority thereof) to an individual in respect of services rendered to

[79] Under U.S. law, child support payments are not taxable to the recipient, and may not be deducted by the payor. Alimony payments, however, are taxable to the recipient, and are deductible by the payor.

Under Mexican law, neither alimony nor child support payments are taxable to the recipient or deductible by the payor.

that country (or subdivision or authority) generally would be taxable only by that country. Such remuneration would be taxable only in the other country, however, if the services are rendered in that other country by an individual who is a resident of that country and who (1) is also a national of that country, or (2) did not become a resident of that country solely for the purpose of rendering the services.

The proposed treaty further provides that any pension paid directly by, or out of funds created by, one of the countries (or a political subdivision or local authority thereof) to an individual in respect of services previously rendered to that country (or subdivision or authority) would be taxable only by that country. Such a pension would be taxable only by the other country, however, if the individual is a national and resident of that other country. This rule would not apply to social security benefits and other public pensions which are not paid in respect of services rendered to the paying government.[80]

The provisions described in the foregoing paragraphs would be exceptions to the proposed treaty's saving clause for individuals who are neither citizens nor permanent residents of the country where the services are performed. Thus, for example, payments by the government of Mexico to its employees at the Mexican Embassy in the United States would be exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by the Mexican government.

Similar to the U.S. and OECD model treaties, the proposed treaty provides that if a country or one of its political subdivisions or local authorities is carrying on commercial or industrial activities (as opposed to functions of a governmental nature), the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 18 (Artistes and Athletes), and 19 (Pensions, Annuities, Alimony, and Child Support) would apply to remuneration and pensions paid for services rendered in connection with the business. For example, under the proposed treaty, a Mexican government official stationed in the United States would not be subject to U.S. income tax. However, a resident of Mexico who works for a Mexican state-owned commercial bank in the United States would be taxable by the United States on his wages pursuant to the provisions of Article 15 of the proposed treaty.

The Technical Explanation states that it is understood by both countries that the provisions of Article 20 would apply only to remuneration and pensions in respect of services rendered in the discharge of functions of a governmental nature.

Article 21. Students

Under the proposed treaty, a student or business apprentice who is or was immediately before visiting the host country, a resident of the other country, would not be taxable in the host country on certain payments he or she receives. In order to qualify for the exemption from host country tax, the individual must be in the host

[80] Such amounts would be subject to the provisions of Article 19 (Pensions, Annuities, Alimony, and Child Support).

country solely for the purpose of his or her education or training.[81] In such case, payments received for the purpose of his or her maintenance, education, or training would be exempt if they arise from sources, or are remitted from, outside of the host country.[82]

This provision of the proposed treaty is excluded from the saving clause in the case of persons who are neither citizens nor lawful permanent residents of the host country. It closely resembles the corresponding provisions of the OECD and U.S. model treaties.

Article 22. Exempt Organizations

In general

This article of the proposed treaty would provide for reciprocal recognition of certain tax-exempt organizations that reside in either country and qualify for benefits under the treaty's limitation on benefits article (Article 17). In addition, this article would permit deductions for contributions made by a resident of one of the countries to a qualified charitable organization located in the other country. The provisions of this article would not be subject to the proposed treaty's saving clause; the United States would be required, therefore, to permit a deduction for contributions by its citizens or residents to Mexican charitable organizations even though the United States has not, under domestic law, recognized the Mexican organizations as public charities. In addition, the United States could not require so-called "expenditure responsibilities" of U.S. private foundations that make contributions to qualified Mexican charities.

Reciprocal tax exemption

The proposed treaty provides that an organization that is a resident of either the United States or Mexico which is operated exclusively for religious, scientific, literary, educational, or other charitable purposes would be exempt from income tax in the other country if it is also exempt from income tax in its country of residence. In such a case, the exemption granted by the other country would only be with respect to the items of income of such organization that would be exempt from tax under the domestic laws of that country if received by an organization that was created for religious, scientific, literary, educational, or other charitable purposes and was recognized as a tax-exempt entity by that country. Thus, for instance, this provision of the proposed treaty would not preclude the United States from taxing the income of a Mexican charitable organization that, if earned by a U.S. charitable organization, would have constituted unrelated business taxable income under the Internal Revenue Code.

Paragraph 17(a) of the proposed protocol states that for the purpose of allowing an organization that is a resident of one treaty country to be exempt from tax in the other country under this arti-

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[81] According to the Technical Explanation, use of the word "solely" in the proposed treaty is meant to describe persons participating in a full-time program of study or training. It is not intended, however, to exclude full-time students who, in accordance with their visas, are also employed in the host country.

[82] The exemption would not apply to amounts received as compensation for services rendered. Such amounts would be subject to the provisions of Article 14 (Independent Personal Services) or Article 15 (Dependent Personal Services), as the case may be.

cle of the proposed treaty, the other country would accept a certification made by the country of residence that the organization is operated exclusively for the purposes articulated in the treaty. If the competent authority of the other country, however, determines that granting an exemption would not be appropriate in a specific case or circumstance, the exemption could be denied after consultation with the competent authority of the country of residence.

Deduction for charitable contributions

The proposed treaty also provides that if the United States and Mexico agree that a provision of Mexican internal law provides standards for organizations authorized to receive deductible contributions which are essentially equivalent to the standards of U.S. law for public charities, then an organization determined by Mexican authorities to meet such standards would be treated as a public charity under U.S. law for purposes of grants by U.S. private foundations and public charities. Thus, such grants would not be considered "taxable expenditures" for purposes of the excise tax on taxable expenditures (Code sec. 4945).

In addition, contributions by a U.S. citizen or resident to an organization determined by Mexican authorities to meet such standards would be treated as charitable contributions to a public charity under U.S. law. Such contributions, therefore, generally would be deductible for U.S. income tax purposes. The proposed treaty provides, however, that such contributions would not be deductible in any taxable year to the extent that they exceed an amount determined by applying the limitations of U.S. law on the deductibility of charitable contributions to public charities (as those limitations may be amended from time to time without changing the general principle hereof) to the person's income for the taxable year from Mexican sources. According to the proposed treaty, this rule should not be interpreted to allow in any taxable year deductions for charitable contributions in excess of the amount allowed under the limitations of U.S. law.

Under a reciprocal rule, the proposed treaty provides that if the two countries agree that U.S. law provides standards for public charities that are essentially equivalent to the standards of Mexican law for organizations authorized to receive deductible contributions, then contributions by a resident of Mexico to an organization determined by the U.S. authorities to meet the standards for public charities would be treated as deductible under Mexican law. Such contributions, however, would not be deductible in any taxable year to the extent that they exceed an amount determined by applying the limitations of Mexican law on the deductibility of contributions to organizations authorized to receive deductible contributions (as those limitations may be amended from time to time without changing the general principle hereof) to the person's income for the taxable year from U.S. sources. According to the proposed treaty, this rule should not be interpreted to allow in any taxable year deductions for charitable contributions in excess of the amount allowed under the limitations of Mexican law.

According to the Technical Explanation, the U.S. law limitations that would remain applicable under the proposed treaty include, in particular, the percentage and other limitations under section 170

of the Code and the overall limitation on itemized deductions under section 68. According to the Technical Explanation, any amounts that would be treated as charitable contributions under the proposed treaty that are in excess of amounts deductible in a taxable year could be carried forward and deducted in a later year, subject to the same U.S. law limitations, if a carryforward of such amounts would be permitted under U.S. law.

In the case of an individual U.S. resident, Code section 170(b)(1) provides that the deduction for charitable contributions generally is allowed to the extent that the aggregate of such contributions does not exceed 50 percent of the individual's contribution base (i.e., adjusted gross income computed without regard to any carryback of a net operating loss) for the taxable year. Under the proposed treaty, contributions by such an individual to qualified Mexican charities would be deductible to the extent that the aggregate of such contributions does not exceed 50 percent of the taxpayer's contribution base (taking into account only income derived from sources within Mexico) for the taxable year.

The Technical Explanation makes clear that the overall limitation on itemized deductions of individuals under Code section 68 would be applicable to charitable contributions that would be deductible under the proposed treaty. Under Code section 68, in the case of an individual whose adjusted gross income exceeds the "applicable amount" (generally $100,000 (adjusted for inflation since 1990)), the amount of itemized deductions (including charitable contributions) otherwise allowable for the taxable year are reduced by the lesser of (1) 3 percent of the excess of the adjusted gross income over the applicable amount, or (2) 80 percent of the amount of the itemized deductions otherwise allowable for the taxable year.

The proposed protocol (paragraph 17(b)) reflects that the United States and Mexico agree that, except for churches or conventions or association of churches, Article 70–B of the Mexican Income Tax law and section 509(a)(1) and (2) of the Internal Revenue Code, as interpreted by the governing regulations and administrative rulings of Mexico and the United States, respectively, in effect on the date of signing of the proposed treaty, provide essentially equivalent standards for organizations within their coverage.[83] Therefore, a finding by the tax authorities of Mexico that an organization qualifies under Article 70–B, or by the U.S. tax authorities that an organization qualifies under section 509(a)(1) or (2) (except for a church or convention or association of churches) would be accepted by the other country for the purpose of extending to that organization the benefits detailed above. If the competent authority of the other country, however, determines that granting such benefits would not be appropriate with respect to a particular organization or type of organization, such benefits could be denied after consultation with the competent authority of the country of residence of the organization.

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[83] Although the provisions of the proposed treaty that permit deductions for cross-border charitable contributions would not themselves be self-executing, this paragraph of the proposed protocol would bring those provisions into effect immediately upon entry into force of the proposed treaty.

Exemption from excise taxes

Under the proposed treaty, a religious, scientific, literary, educational or other charitable organization which is resident in Mexico and which has received substantially all of its support from persons other than U.S. citizens or residents would be exempt from the U.S. excise taxes imposed with respect to private foundations.

Article 23. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Mexico. Contrary to the corresponding articles in the OECD and U.S. model treaties, this article of the proposed treaty would not forbid taxation of a treaty country resident's other income by the other treaty country.[84] On the contrary, it confirms that the treaty country of source would retain the right to tax the other income of a resident of the other treaty country.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of one of the countries and arise in the other country would be taxable by the other country. An item of income is considered to be "dealt with" in the proposed treaty if an item in the same income category is the subject of provisions of an article of the treaty, whether or not a treaty benefit would be granted to that item. Examples of categories of income that are not dealt with in the proposed treaty, and thus would be subject to the provisions of Article 23, are lottery winnings, punitive damages, and cancellation of indebtedness income.

Article 24. Relief from Double Taxation

In general

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Internal rules regarding the relief from double taxation

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income.

[84] The other income articles of the model treaties provide as a general rule that items of income of a resident of one of the countries, *wherever arising*, that are not otherwise dealt with in the treaties, would be taxable only by the country of residence. This general rule would not apply where the income is attributable to a permanent establishment or fixed base in the other country.

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income, subject to the separate limitation rules discussed below.

The limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). The 90 percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

An indirect or "deemed-paid" credit is also provided. A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid (or deemed paid) by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

Mexico

Like the United States, Mexico taxes its residents on their worldwide income. Subject to certain limitations, Mexico grants a credit against Mexican income tax for foreign taxes paid by the taxpayer on foreign source income.

An indirect or "deemed-paid" credit also is provided in Mexico. A Mexican corporation that owns at least 10 percent of the capital of a foreign corporation and receives a dividend from the foreign corporation is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. Earnings of a foreign subsidiary are not taxed by Mexico until distributed to the Mexican parent corporation.

Proposed treaty rules for the relief from double taxation

Credit for taxes paid to the other country

Part of the double tax problem is dealt with in other articles of the proposed treaty that would limit the right of a source country to tax income. Article 24 would provide further relief where both Mexico and the United States would otherwise still tax the same

item of income. This article would not be subject to the saving clause, so that the country of citizenship or residence would waive its overriding taxing jurisdiction to the extent that this article applies.

The proposed treaty generally would provide for relief from double taxation of a U.S. resident or citizen by the United States permitting a credit against its income tax for the income taxes paid to Mexico by or on behalf of that resident or citizen. Similarly, Mexico would grant to a Mexican resident a credit against its income tax for the income tax paid to the United States by such person. The credit mandated by the proposed treaty would be computed in accordance with the provisions of and subject to the limitations of the law of the country granting the credit (as those provisions and limitations may change from time to time without changing the "general principles hereof"). Thus, for example, the credit granted by the United States under the proposed treaty would be subject to the overall foreign tax credit limitation, the alternative minimum tax foreign tax credit limitation, and the limitations imposed on each separate foreign tax credit category. This provision is similar to that found in many U.S. income tax treaties.

The proposed treaty also would allow the U.S. deemed paid credit, subject to the "gross-up" rules of section 78 of the Code, to U.S. corporate shareholders of Mexican companies receiving dividends in any taxable year from those companies if the U.S. company owns 10 percent or more of the voting stock of the Mexican company. Similarly, the proposed treaty would allow the Mexican deemed paid credit to Mexican corporate shareholders of U.S. companies receiving dividends in any taxable year from those companies if the Mexican company owns 10 percent or more of the voting stock of the U.S. company.

The double taxation article provides that the following taxes would be considered income taxes and, thus, would be eligible for the foreign tax credit: the U.S. income taxes (excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), the excise taxes imposed by the United States on insurance premiums paid to foreign insurers and with respect to private foundations, the income tax imposed by the Mexican Income Tax Law, and any identical or substantially similar taxes which are imposed by either country after the date of signature of the proposed treaty in addition to, or in place of, existing taxes.

In addition, the proposed treaty specifies that creditable taxes would include any profits tax imposed on distributions, but only to the extent such tax is imposed on earnings and profits as calculated under the tax accounting rules of the country of residence of the beneficial owner of the distribution. This provision is intended to assure that the United States would grant a credit to a U.S. shareholder of a Mexican corporation which pays Mexico's tax on distributed profits. That tax is imposed by Mexico to ensure that full 35-percent tax has been paid at the corporate level on corporate earnings.[85] The tax is imposed on the distributing corporation, at the regular corporate tax rate of 35 percent, on the amount

[85] Under Mexico's integrated tax system, no tax is imposed on shareholders with respect to the receipt of dividend distributions from Mexican corporations.

of a distribution that exceeds the corporation's income that previously has been subject to tax. According to the Technical Explanation, the purpose of limiting the credit for this tax by the extent to which it is imposed on earnings and profits in the U.S. sense is to ensure that creditability would be consistent with the prevailing U.S. principle of only allowing credits for those foreign taxes which are imposed on net income.

Under the proposed treaty, where in accordance with a provision of the treaty a Mexican resident would be exempt from Mexican tax on certain income it derives, Mexico would use the exemption method, rather than the credit method, of avoiding double taxation. In such a case, Mexico would be permitted to take into account the person's entire income, including the exempted income, in computing the tax rate to apply to the taxable portion of that person's income.

Source rules

In this article, for purposes of implementing the proposed treaty's foreign tax credit, source rules are provided for determining from which of the countries an item of income would be deemed to have arisen. Under these rules, income derived by a resident of one of the countries that may be taxed in the other country in accordance with the proposed treaty (other than solely by reason of citizenship) would be treated as arising in that other country. Except as provided in Article 13 (Capital Gains), however, the preceding rule would not override the source rules of the domestic laws of countries that are applicable for purposes of limiting the foreign tax credit.[86]

Special rules for U.S. citizens who reside in Mexico

In the case of a U.S. citizen residing in Mexico, the proposed treaty provides that with respect to items of income derived by that person which would be either exempt from U.S. tax or subject to a reduced rate of U.S. tax, Mexico would allow as a credit against its income tax, subject to Mexico's domestic foreign tax credit rules, only the tax paid (if any) that the United States would be permitted to impose under the proposed treaty (other than taxes that it could impose solely on the basis of the person's U.S. citizenship). For purposes of computing U.S. tax, the United States would allow as a credit against its income tax the income tax paid to Mexico after application of the credit described in the preceding sentence. The credit so allowed by the United States, however, could not reduce that portion of the U.S. tax that is creditable against Mexican tax under this special rule. For the exclusive purpose of relieving double taxation in the United States under these rules, the items of exempt or reduced rate income described above would be treated as Mexican source income to the extent necessary to avoid double taxation of such income.

To illustrate this provision, assume that a U.S. citizen who resides in Mexico (and is treated as a Mexican resident under the proposed treaty's tie-breaker rules for determining residency) re-

[86] Under Article 13, capital gains would be treated as foreign source to the extent necessary to avoid double taxation.

ceives $1,000 of interest from a U.S. bank. Absent the proposed treaty's saving clause (which would allow the United States to tax the interest income as if the treaty were not in effect), the maximum amount of tax that could be imposed by the United States would be $100 (based on the 10-percent rate applicable after the treaty's five-year transition period). In computing the individual's Mexican income tax on the interest income, the proposed treaty would require Mexico to allow a credit against Mexican tax only for the amount of U.S. tax that the individual would have owed absent the saving clause (i.e., $100). Assuming the individual's marginal tax rate in Mexico is 40 percent, his pre-credit Mexican tax liability on the interest would be $400; and his after-credit liability would be $300.

In computing the individual's U.S. tax liability on the interest income, the proposed treaty would require the United States to grant a credit for the $300 of Mexican tax paid, subject to the limitation that the credit could not reduce the overall tax liability on that income below the $100 amount that Mexico credited against its tax.[87] Assuming the individual's U.S. marginal tax rate is 36 percent, his pre-credit tax liability on the interest income would be $360. Because the proposed treaty would limit the cumulative amount of credit so as to not reduce tax liability below $100, the amount of credit allowed under the treaty would be $260. Thus, the total amount of tax paid would be the combination of the two liabilities, or $400—of which $300 would be paid to Mexico and $100 to the United States.

Article 25. Non-discrimination

The proposed treaty contains a comprehensive non-discrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the non-discrimination article in the U.S. model treaty and to provisions that have been embodied in other recent U.S. income tax treaties. The non-discrimination article of the proposed treaty differs from the U.S. model in protecting all legal persons deriving their status as such from the United States, not only U.S. citizens. In this regard, the non-discrimination article of the proposed treaty more closely resembles that of the OECD model treaty.

In general, under the proposed treaty, one country could not discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. According to the Technical Explanation, this provision would apply whether or not the nationals in question are residents of the United States or Mexico. By the express terms of the proposed treaty, a U.S. national who is subject to tax in the United States on worldwide income and a Mexican national who is not taxed in the United States on the basis of worldwide income would not be deemed to be in the same circumstances.[88]

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[87] Solely for this purpose, the interest income is treated as foreign source income.

[88] This rule would apply reciprocally; i.e., a Mexican national who is taxable in Mexico on worldwide income and a U.S. national who is not taxable on worldwide income by Mexico would not be deemed to be in the same circumstances.

Under the proposed treaty, neither country could tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Consistent with the U.S. and OECD model treaties, however, a country would not be obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

The proposed treaty explicitly states that nothing in the non-discrimination article is to be construed as preventing either of the countries from imposing a branch profits tax or a branch-level interest tax.[89] Moreover, nothing in this article is to be construed as preventing Mexico from denying a deduction for presumed expenses (without regard to where such expenses are incurred) to an individual resident of the United States who elects to be subject to tax in Mexico on a net basis with respect to income from real property.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(8) (Interest), and 12(5) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. The staff understands that this provision is not intended to limit in any way the ability of the United States to deny deductions for interest expense under the so-called "earnings-stripping" rules of section 163(j) of the Code.

The rule of non-discrimination also would apply to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, would not be subjected in the first country to any taxation or any connected requirement which is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises. The Technical Explanation includes examples of Code provisions which are understood by the two countries not to violate this provision of the proposed treaty. Those examples cover rules that impose a tax on a liquidating distribution of a U.S. subsidiary of a Mexican company and rules preventing foreign persons from owning stock in Subchapter S corporations.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) would not apply to the non-discrimination article.

Article 26. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some differences therefrom, that would authorize

[89] See detailed discussion of proposed treaty rules regarding branch taxes under Article 11A above.

the competent authorities of the United States and Mexico to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty would not apply to this article, so that the application of this article might result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him to pay a tax not in accordance with the proposed treaty would be permitted to present his case to the competent authority of the country of which he is a resident or national. The competent authority would then make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority would endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty.

The rules of the preceding paragraph would apply only if the competent authority of the other country is notified of the case within four and a half years from the due date or the date of filing of the return in question (whichever is later) in the other country. If this requirement is met, the provision provides that, notwithstanding the statute of limitations, any agreement reached between the two competent authorities could be implemented within ten years from the due date or date of filing of the return in question (whichever is later), or a longer period if permitted by the domestic laws of the other country.

The four-and-a-half-year limitation on presentation of competent authority cases is not the preferred U.S. treaty position. On the other hand, the OECD model treaty includes a three-year limitation. According to the Technical Explanation, the four-and-a-half-year time limit was included in the proposed treaty in order to accommodate Mexico's five-year limit within which it may initiate an audit of a tax return.

The competent authorities of the countries would be mandated to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. They could also consult together regarding cases not provided for in the treaty.

The proposed treaty would authorize the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision would make clear that it would not be necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty.

The proposed treaty provides that if any difficulty or doubt arising as to the interpretation or application of the proposed treaty cannot be resolved by the competent authorities, the case could be submitted for arbitration if both competent authorities and the taxpayer or taxpayers so agree, and the taxpayer agrees in writing to be bound by the decision of the arbitration board. In such a case,

the decision of the arbitration board in a particular case would be binding on both treaty countries with respect to that case.

The proposed treaty provides that procedures for the arbitration process would be established by notes exchanged between the two countries through diplomatic channels. The arbitration provisions would not go into effect until after the countries have so agreed through the exchange of diplomatic notes. According to paragraph 18(a) of the proposed protocol, after a period of three years following the entry into force of the proposed treaty, the competent authorities of Mexico and the United States would consult in order to determine whether it would be appropriate to make the exchange of notes that would make effective the arbitration procedures.

The proposed protocol (paragraph 18(b)) further provides that if the competent authorities of the two countries agree to submit a disagreement regarding the interpretation or application of the proposed treaty to arbitration, the following seven procedures would apply:

First, the competent authorities could agree to invoke arbitration only after the other competent authority procedures spelled out in the treaty have been fully exhausted, and only if at least two years have lapsed since the case was originally submitted to one of the competent authorities. The competent authorities would not accede to arbitration with respect to matters concerning either the tax policy or the domestic tax law of either treaty country.

Second, the competent authorities would establish an arbitration board for each specific case that is taken to arbitration. Each board would have at least three members. Each competent authority would appoint the same number of members, and these members would agree on the appointment of the other member or members of the board. Further criteria for selecting the other member, or other members, of the arbitration board could be issued by the competent authorities. All board members and their staffs would be required to agree in writing to abide by, and be subject to, the applicable confidentiality and disclosure rules of both countries and of the proposed treaty.[90]

Third, the competent authorities could agree on, and instruct the arbitration board regarding, specific procedural rules (e.g., appointment of a chairman, procedures for reaching a decision, or establishment of time limits). Otherwise, the board would establish its own procedural rules which would be consistent with generally accepted principles of equity.

Fourth, taxpayers and their representatives would be given the opportunity to present their views on the case to the arbitration board.

Fifth, the arbitration board would decide each specific case on the basis of the proposed treaty, giving due consideration to the domestic laws of the treaty countries and the principles of international law. The board would provide the competent authorities with an explanation of its decision. The decision, although binding on both countries and the taxpayers with respect to the case at

[90] In cases where there are conflicting applicable confidentiality and disclosure standards, the proposed protocol specifies that the most restrictive condition would apply.

issue, would not have precedential effect. However, it is expected that the decisions ordinarily would be taken into account in subsequent competent authority cases involving the same taxpayer or taxpayers, the same issue or issues, and substantially similar facts. Decisions could also be taken into account in other cases where appropriate.

Sixth, each treaty country would be required to bear the costs of compensating its appointees, and half of the compensation of the appointees chosen by the arbitration board members. Each country would also be required to bear the cost of remuneration for its representation in the proceedings before the arbitration board. However, the arbitration board would be given authority to allocate costs differently, and each competent authority of a treaty country would be given the authority to require the taxpayer or taxpayers to agree to bear that country's share of the costs as a prerequisite for arbitration.

Seventh, the competent authorities of the two countries could agree to modify or supplement the procedures detailed above; however, they would continue to be bound by the general principles established in the proposed treaty and protocol.

Article 27. Exchange of Information and Administrative Assistance

In general

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the treaty. Notwithstanding the provisions of Article 2 (Taxes Covered), the proposed treaty's information exchange provisions would apply to all taxes imposed in either country at the Federal level.

The proposed treaty provides that the competent authorities would exchange information as provided in the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes that was signed on November 9, 1989 (the "Tax Information Exchange Agreement" or "TIEA"). Pursuant to paragraph 19 of the proposed protocol, if at some future point the Tax Information Exchange Agreement is terminated, the United States and Mexico would promptly endeavor to conclude a protocol to the proposed treaty to accomplish the purposes of this article.

The proposed treaty further provides that if the Tax Information Exchange Agreement is terminated, the two competent authorities would exchange such information as would be necessary to carry out the provisions of the proposed treaty or to administer and enforce the domestic laws of the two countries concerning taxes to which the proposed treaty would apply insofar as the taxation under those domestic laws would not be contrary to the proposed treaty. This exchange of information would not be restricted by Article 1 (General Scope). Therefore, third-country residents would be covered.

Any information exchanged under the proposed treaty would be treated as secret in the same manner as information obtained

under the domestic laws of the country receiving the information. The exchanged information could be disclosed only to persons or authorities (including courts and administrative bodies) involved in the determination, assessment, collection, or administration of, the recovery and collection of claims derived from, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the treaty would apply. Such persons or authorities could use the information for such purposes only. Persons involved in the administration of taxes include legislative bodies, such as, for example, the tax-writing committees of Congress and the U.S. General Accounting Office. Exchanged information could be disclosed in public court proceedings or in judicial decisions.

Explanation of the Tax Information Exchange Agreement

Article 1—Object and Scope

The objective of the TIEA is to facilitate the exchange of information between the United States and Mexico on the assessment and collection of taxes, with a view to better enable each country to prevent fiscal evasion and fraud, and to develop improved information sources for tax matters. Under the TIEA, the two countries are to cooperate with one another to carry out this objective. Such cooperation is to be exercised in conformity with, and subject to the limitations of, each country's respective national laws and regulations. Information is to be exchanged to fulfill the purpose of the TIEA without regard to whether the person to whom the information relates is, or whether the information is held by, a resident or national of the United States or Mexico.

Requests for assistance under the TIEA are to be executed except to the extent that execution of the request would require the requested country to exceed its legal authority or would otherwise be prohibited by the laws of that country, or when the information requested is not obtainable under such laws or in the normal course of the administration of either country, in which case the competent authorities of the two countries are to consult with each other to establish alternative lawful means for rendering assistance. Nor must a request for assistance be executed to the extent that (1) execution of the request would in the judgment of the requested country be contrary to its national security or public policy; (2) the supplying of requested information would disclose any trade, business, industrial, commercial, or professional secret or trade process; or (3) the request does not comply with the provisions of the TIEA.

A request for assistance also could be denied to the extent that the supplying of the requested information by the applicant country to administer or enforce a provision of its tax law (or any connected requirement) would discriminate against a national of the country receiving the request. A provision of tax law (or connected requirement) is considered discriminatory against such a person if it is more burdensome with respect to such person than with respect to a national of the country requesting assistance in the same circumstance. The TIEA explicitly states that for purposes of this rule, a national of the requesting country that is subject to tax on

worldwide income is not in the same circumstances as a national of the requested country that is not subject to such taxation. It further states that this provision is not to be construed to prevent the exchange of information with respect to the taxes imposed by the United States or Mexico on branch profits or branch-level interest or on the premium income of foreign insurers.

Article 2—Taxes Covered

In the case of the United States, the TIEA applies to the following taxes: Federal income taxes, Federal taxes on employment income, Federal taxes on transfers to avoid income tax, Federal estate and gift taxes, and Federal excise taxes. In the case of Mexico, it applies to: Federal income taxes, Federal taxes on employment income, Federal taxes on business assets, Federal value added taxes, and Federal excise taxes. The TIEA also applies to any identical or substantially similar taxes which are imposed after the date of signature of the TIEA in addition to or in place of the existing taxes. The competent authority of a country is responsible for notifying the other competent authority of changes in laws which may affect the obligations of that country pursuant to the TIEA.

The TIEA does not apply to the extent that an action or proceeding concerning covered taxes is barred by the statute of limitations of the country requesting assistance. Nor does the TIEA apply to taxes imposed by states, municipalities or other political subdivisions, or possessions of a country.

Article 3—Definitions

The TIEA provides definitions, as set forth below, for certain terms contained therein.

The U.S. competent authority is the Secretary of the Treasury or his delegate. The competent authority in Mexico is the Secretary of Finance and Public Credit.

Under the TIEA, a person is considered a U.S. national if the person is a citizen or any legal person, partnership, corporation, trust, estate, association, or other entity deriving its status as such from the laws in force in the United States. A national of Mexico is a Mexican citizen or any legal person, partnership, corporation, trust, estate, association, or other entity deriving its status as such from the laws in force in Mexico.

The term "person" includes an individual and any legal person, including a partnership, corporation, trust, estate, or association.

The term "tax" means any tax to which the TIEA applies.

The term "information" means any fact or statement, in whatever form, that may be relevant or material to tax administration and enforcement, including (but not limited to) testimony of an individual, and documents, records or other personal property of a person or of one of the countries.

For purposes of determining the geographical area within which jurisdiction to compel production of information may be exercised, the term "United States" means the United States of America. The term "Mexico," for this purpose, means the United Mexican States.

The TIEA also provides that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not explicitly defined have the mean-

ing which they have under the laws of the country applying the TIEA relating to the taxes covered by the TIEA.

Article 4—Exchange of Information

Under the TIEA, the competent authorities of the United States and Mexico are to exchange information to administer and enforce each country's domestic laws concerning covered taxes. Such information includes information to effect the determination, assessment, and collection of tax, the recovery and enforcement of tax claims, or the investigation or prosecution of tax crimes or crimes involving the contravention of tax administration. The competent authorities are to automatically transmit information to each other for this purpose, and are to determine the items of information to be exchanged and the procedures to be used.

A competent authority is to spontaneously transmit to the other competent authority information which has come to its attention and which is likely to be relevant to, and bear significantly on, accomplishment of the purposes of the TIEA. The competent authorities are to determine the information to be exchanged under the TIEA and take such measures and implement such procedures as are necessary to ensure that the information is forwarded to one another.

The competent authority of the country whose assistance is requested under the TIEA is to provide information upon such request. If the information available in its tax files is insufficient to enable compliance with the request, it is to take all relevant measures to provide the requesting country with the information requested. Under the TIEA, the requested country has the authority to: (1) examine any books, papers, records, or other tangible property which may be relevant or material to the inquiry; (2) question any person having knowledge or in possession, custody or control of information which may be relevant or material to the inquiry; (3) compel any person having knowledge or in possession, custody or control of information which may be relevant or material to the inquiry to appear at a stated time and place and testify under oath and produce books papers, records, or other tangible property; and (4) take such testimony of any individual under oath.

If the United States is requested to obtain the types of information covered by section 3402 of the Right of Financial Privacy Act of 1978 (12 USCA 3402), it is to obtain the requested information pursuant to that statute. If Mexico is requested to obtain the types of information covered by Article 93 of the Regulatory Law of Banking and Credit Public Service, it is to obtain the requested information pursuant to that provision. Laws or practices of the requested country do not prevent or otherwise affect the authority of the competent authority of the requested country to obtain and provide the types of information covered by the above-cited statutes.

Privileges under the laws of the country requesting assistance under the TIEA do not apply in the requested country in the execution of a request. Claims of privilege under the laws and practices of the requesting country are to be determined exclusively by the courts of that country, and claims of privilege under the laws and practices of the requested country are to be determined exclusively by the courts of that country.

If information is requested under the TIEA by one of the countries, the other country is to obtain the information requested in the same manner, and provide it in the same form, as if the tax of the requesting country were the tax of the requested country and were being imposed by it. However, if specifically requested by the competent authority of the requesting country, the other country is to: (1) specify the time and place for the taking of testimony or the production of books, papers, records, and other tangible property; (2) place the individual giving testimony or producing books, papers, records and other tangible property under oath; (3) permit the presence of individuals (who may be accompanied by their attorneys) designated by the competent authority of the country requesting assistance as being involved in or affected by execution of the request; (4) provide individuals described in (3) with an opportunity to question the individual giving testimony or producing books, papers, records and other tangible property through the executing authority (or if Mexico is the requesting country, directly); (5) secure original and unedited books, papers, and records, and other tangible property; (6) secure or produce true and correct copies of original and unedited books, papers, and records; (7) determine the authenticity of books, papers, records, and other tangible property produced; (8) examine the individual producing books, papers, records, and other tangible property regarding the purpose for which and the manner in which the item produced is or was maintained; (9) permit the competent authority of the requesting country to provide written questions through the executing authorities of the requested country to which the individual producing books, papers, records, and other tangible property is to respond regarding the item produced; (10) perform any other act not in violation of the laws or at variance with the administrative practice of the requested country; (11) certify either that procedures requested by the competent authority of the requesting country were followed or that the procedures requested could not be followed, with an explanation of the deviation and the reason therefor.

The provisions of the preceding paragraph are to be construed so as to impose on a country the obligation to use all legal means and its best efforts to execute a request. A country may, in its discretion, take measures to obtain and transmit to the other country information which, pursuant to the limitations of Article 1 of the TIEA, it has no obligation to transmit.

Any information received by a country is to be treated as secret in the same manner as information obtained under its domestic laws and is to be disclosed only to individuals or authorities (including judicial and administrative bodies) involved in the determination, assessment, collection, and administration of, the recovery and collection of claims derived from, the enforcement or prosecution in respect of, or the determination of appeals in respect of, the taxes which are the subject of the TIEA, or the oversight of the above. Such individuals or authorities are to use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

Article 5—Mutual Agreement Procedure

The competent authorities of Mexico and the United States are to agree to implement a program to carry out the purposes of the TIEA. This program may include, in addition to information exchanges specified in the TIEA, other measures to improve tax compliance, such as exchanges of technical know-how, development of new audit techniques (including simultaneous examinations and simultaneous criminal investigations in their respective jurisdictions and by their respective competent authorities), identification of new areas of non-compliance, and joint studies of non-compliance areas. They may communicate with each other directly for the purposes of reaching such an agreement.

The competent authorities are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the TIEA. In particular, they may agree to a common meaning of a term and may determine when costs are extraordinary for purposes of Article 6 of the TIEA.

Article 6—Costs

Unless the competent authorities of the two countries otherwise agree, ordinary costs incurred in providing assistance under the TIEA are to be borne by the country whose assistance is requested. Extraordinary costs incurred in such endeavors are to be borne by the country requesting assistance.

Article 28. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions would not affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the treaty would not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in the application of this article to host country residents who are neither citizens nor lawful permanent residents of that country. Thus, for example, U.S. diplomats who are considered Mexican residents may be protected from Mexican tax.

Article 29. Entry Into Force

Under the proposed treaty, each country would be required to notify the other when their respective constitutional and statutory requirements for the entry into force of the proposed treaty have been satisfied. The treaty would enter into force on the date of receipt of the later of such notifications.

With respect to taxes withheld at source (i.e., taxes imposed in accordance with Articles 10 (Dividends), 11 (Interest), and 12 (Royalties)), the proposed treaty would be effective for amounts paid or credited on or after the first day of the second month next following the date on which the proposed treaty enters into force if it enters into force prior to July 1 of that year. Otherwise, it would be effective with respect to these taxes on the first day of January of the year following the year in which the proposed treaty enters into force.

With respect to other income taxes, the treaty would be effective for taxable periods beginning on or after the first day of January

of the year following the year in which the proposed treaty enters into force.

The proposed treaty specifies that the existing agreement between the United States and Mexico for the avoidance of double taxation on income derived from the operation of ships or aircraft in international traffic that was concluded by exchange of notes on August 7, 1989 would terminate upon the entry into force of the proposed treaty. The provisions of that agreement, however, would continue in effect until the corresponding provisions of the proposed treaty take effect.

Article 30. Termination

The proposed treaty would continue in force indefinitely, but either country could terminate it by giving written notice through diplomatic channels at any time after the expiration of the 5-year period from the date of its entry into force. Termination of the proposed treaty could not occur earlier than six months following the date such written notice is given. A termination would be effective with respect to taxes imposed in accordance with the articles on dividends (Article 10), interest (Article 11), and royalties (Article 12), for amounts paid or credited on or after the first day of the second month next following the expiration of the notification period. In the case of other taxes, a termination would be effective for taxable periods beginning on or after the first day of January next following the expiration of the notification period.

Under the proposed protocol (paragraph 20), the competent authority of either of the United States or Mexico could make a determination that the law of the other Contracting State is or may be applied in a manner that eliminates or significantly limits a benefit provided by the proposed treaty. If such a determination is made, that competent authority would inform the competent authority of the other country in a timely manner and could request consultations with a view to restoring the balance of benefits of the proposed treaty. If so requested, the other country would be required to begin such consultations within three months of the date of such request. If the two countries are not able to agree on a modification to the treaty that would restore the balance of benefits, the affected country could terminate the treaty in the manner described above, notwithstanding the general limitation that no termination could occur during the first five years following entry into force. Alternatively, that country could take such other action regarding the proposed treaty as may be permitted under the general principles of international law.

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