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

SCHEDULED FOR A HEARING

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the income tax treaty between the United States of America and Mexico ("the proposed protocol"). The proposed protocol was signed on November 26, 2002. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for March 5, 2003.

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains an article-by-article explanation of the proposed protocol. Part IV contains a discussion of issues relating to the proposed protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Mexico* (JCS–6–03), March 3, 2003.

I. SUMMARY

The principal purposes of the proposed protocol are to reduce or eliminate the double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed protocol also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. In the case of dividends, the proposed protocol contains provisions that would eliminate source-country tax on certain intercompany dividends in which certain ownership thresholds and other requirements are satisfied. In addition, the proposed protocol would provide a parallel exemption from the U.S. branch profits tax (Articles 2 and 3 of the proposed protocol).

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed protocol generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Articles 4 and 5 of the proposed protocol).

The United States and Mexico have an income tax treaty currently in force (signed September 18, 1992, together with a protocol of the same date and a second protocol signed September 8, 1994). The proposed protocol includes provisions similar to those of other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the proposed protocol contains certain substantive deviations from these treaties and models.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

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

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 generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30–percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30–percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of 1 or 4 percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30–percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30–percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In

addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are 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 property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the 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 foreign income taxes paid 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 liability on U.S.-source income. Therefore, the foreign tax credit provisions 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 basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

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 and its foreign tax credit limitation calculations for the year in which the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by 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. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in 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 agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. 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 addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both the countries. Treaties generally 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 permanent establishment or fixed base in that jurisdiction. Treaties also 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 (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30–percent withholding tax (or, in the case of some income, to eliminate it entirely) 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. The United States also 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. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out 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 that is not obtainable under its laws or in the normal course of its administration

or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the “IRS”), 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 countries is enhanced further under treaties by the inclusion of a “competent authority” mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

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 treaty country may discriminate against enterprises owned by residents of the other country.

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, treaties generally contain an “anti-treaty shopping” provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. EXPLANATION OF PROPOSED PROTOCOL

Article 1. General Scope

Article 1 of the proposed protocol restates Article 1 of the U.S.-Mexico treaty, with the exception of Paragraphs 3, 6, 7, and 8. Paragraph 3 relates to the interaction of the treaty with other agreements. As amended by the proposed protocol, Paragraph 3 provides two exceptions to the rule of Paragraph 2 that the treaty shall not restrict in any manner any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded by the laws of either Contracting State or by any other agreement between the Contracting States. Paragraphs 6, 7, and 8 relate to the countries' rights to tax certain former citizens and former long-term residents.

The treaty entered into force on December 28, 1993, before the entry into force of certain other agreements to which the Contracting States are parties (such as the General Agreement on Trade in Services ("GATS")). Consequently, the provisions of Paragraph 3 serve to clarify and update the rules for determining the interaction of the treaty with other agreements with respect to the scope of the treaty. With respect to taxation measures, the provisions of Paragraph 3 generally have the effect of resolving which agreement applies in favor of the treaty (not another agreement), except in cases in which the competent authorities agree that the treaty should not be applied.

Under the first provision of Paragraph 3, any question or dispute concerning the interpretation or application of the treaty, in particular whether a taxation measure is within the scope of the treaty, is to be determined or resolved only as provided by Article 26 of the treaty (Mutual Agreement Procedure). Article 26 authorizes 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 treaty. The Technical Explanation notes that as a result, dispute resolution procedures under other agreements do not apply in determining the interpretation or application of the treaty (including whether a taxation measure is within the scope of the treaty).

Under the second provision of Paragraph 3, no other agreement applies to a taxation measure unless the competent authorities agree that the measure is not within the scope of Article 25 of the treaty (Non-Discrimination). For this purpose, a measure is defined inclusively to mean a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action. Article 25 of the treaty provides a comprehensive nondiscrimination provision relating to all taxes of every kind imposed at the national, state, or local level. The Technical Explanation notes that, under the second provision of Paragraph 3 of the proposed protocol, if the nondiscrimination provisions of the treaty apply to a taxation measure,

then no national treatment or most-favored-nation ("MFN") obligations in another agreement of the Contracting States applies to that taxation measure. The Technical Explanation concludes that this provision, though it differs from the equivalent provision in the U.S. model treaty, has a similar effect. The provision does not explicitly provide that the General Agreement on Tariffs and Trade ("GATT") also is applicable to taxation measures that are within the scope of Article 25 of the treaty, but that article generally does not relate to the treatment of trade in goods. Thus, if the competent authorities agree that a taxation measure is not within the scope of Article 25, the provisions of GATT would apply to the measure, which is the same result as under the U.S. model.

Under paragraph 6 of the proposed protocol, the United States and Mexico reserve for a period of 10 years their right to tax former citizens and former long-term residents whose loss of citizenship or long-term resident status had, as one of its principal purposes, the avoidance of tax. Consequently, the saving clause of paragraph 4 applies to such individuals for a period of 10 years. This provision expands on the comparable provision of the current treaty, which applies only to former citizens, and not to former long-term residents. The term "long-term resident" is defined to include an individual (other than a citizen of either country) who is a lawful permanent resident of the country in 8 or more taxable years of the proceeding 15 taxable years. Paragraphs 7 and 8 of the proposed protocol set forth factors similar to those set forth in section 877 of the Code for use in determining whether one of the principal purposes of a change in status of a former citizen or long-term resident was the avoidance of tax.

Article 2. Dividends

Internal taxation rules

United States

The United States generally imposes a 30–percent tax on the gross amount of U.S.-source dividends 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 on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

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 earnings and profits. However, liquidating distributions 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).

Dividends paid by a U.S. corporation generally are U.S.-source income. Also treated as U.S.-source dividends for this purpose are portions of certain dividends paid by a foreign corporation that conducts a U.S. trade or business. The U.S. 30–percent withholding tax imposed on the U.S.-source portion of the dividends paid by a foreign corporation is referred to as the "second-level" withholding

tax. This second-level withholding tax is imposed only if a treaty prevents application of the statutory branch profits tax.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where 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 reduced rate of tax often applied by treaty to dividends paid to direct investors 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. 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. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30–percent withholding tax when paid to foreign owners.

A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30–percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

U.S. internal law also generally treats a regulated investment company ("RIC") as both a corporation and a conduit 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

Mexico currently does not impose a withholding tax on dividend payments to nonresidents.[2]

Proposed protocol limits on internal law

10–percent and 5–percent withholding rates

The proposed protocol generally limits dividend withholding tax in the country of source to 10 percent of the gross amount of the dividend. If the beneficial owner of the dividend is a company resi-

[2] Mexico adopted a dividend withholding tax in 1999, but then repealed it in 2001 (effective for dividends paid after 2001).

dent in the other State and directly owns shares representing at least 10 percent of the voting power of the company paying the dividend, then the withholding tax in the State of source is limited to 5 percent of the gross amount of the dividend. The Technical Explanation states that shares are considered voting shares if they provide the power to elect, appoint, or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation. The Technical Explanation states that the 5 and 10 percent rate benefits may be granted at the time of payment by means of reduced withholding at the source; and that it is also consistent with the protocol for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund, so long as such procedures are applied in a reasonable manner.

The Technical Explanation notes that the term "beneficial owner" is not defined in the treaty, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). According to the Technical Explanation, the beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source State. Thus, the Technical Explanation states that if a dividend is paid by a corporation that is a resident of one of the States (as determined under Article 4 (Residence)) is received by a nominee or agent that is a resident of the other State on behalf of a person that not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits.[3]

The Technical Explanation states that companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares. As a result, companies holding shares through such entities may be able to claim the benefits of the proposed protocol under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold. The Technical Explanation notes that whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

Zero rate of withholding on certain dividends

The proposed protocol provides a zero rate of withholding with respect to certain intercompany dividends where there is a sufficiently high (80 percent of voting power) level of ownership (often referred to as "direct dividends"). The proposed protocol also provides a zero rate of withholding with respect to dividends received by tax-exempt pension funds.

Direct dividends

The proposed protocol reduces the withholding tax rate to zero on certain dividends beneficially owned by a company that has owned

[3] The Technical Explanation states that these limitations are confirmed by paragraph 12 of the OECD Commentaries to Article 10. The Technical Explanation also refers to paragraph 24 of the Commentary to Article 1 of the OECD model.

directly 80 percent or more of the voting stock of the company paying the dividend for the 12–month period ending on the date the dividend is declared.

In the case of a dividend-receiving company that satisfies the Limitation on Benefits provision of the treaty only under paragraphs 1(c), 1(d)(iii), or 1(f) of Article 17, the proposed protocol imposes an additional requirement for qualification for the zero rate, that the dividend be received from a company with respect to which the dividend-receiving company owned, directly or indirectly, 80 percent of the voting stock prior to October 1, 1998.[4] The October 1, 1998, date is intended to prevent restructurings of corporate ownership in order to take advantage of the zero-rate provision in circumstances where the Limitation on Benefits provision does not provide sufficient protection against treaty shopping.

The proposed protocol also provides that, if the United States agrees in another tax treaty to a zero-rate dividends provision under conditions more beneficial than those of the proposed protocol, the United States and Mexico shall, at Mexico's request, consult with a view to incorporating a similar provision into the U.S.-Mexico treaty.

Tax exempt pension plans

The proposed protocol also allows the zero withholding rate for dividends beneficially owned by a trust, company, or other organization constituted and operated exclusively to provide benefits under a pension, retirement, or other employee benefit plan. In order to qualify for the zero rate, the trust, company, or other organization must be generally exempt from tax in the Contracting State of which it is a resident, and the dividends must not be derived from the carrying on of a business, directly or indirectly, by such trust, company, or organization. The Technical Explanation states that the exemption is parallel to an existing exemption from the withholding tax on interest available to pension funds under Article 11(4)(c).

Dividends paid by RICs and REITs

The proposed protocol generally denies the 5 percent and zero rates of withholding to dividends paid by a RIC or REIT.

In the case of a RIC, any such dividends are eligible for the zero rate paid to tax exempt pension, retirement, or other employee benefit plans. The 10 percent rate of withholding is allowed for any dividends paid by a RIC.

In the case of a REIT, the 10 percent rate of withholding or zero rate of withholding with respect to dividends paid to tax exempt pension, retirement, or other employee benefit plans is allowed for dividends paid by a REIT only if one of three additional conditions is met. First, the person beneficially entitled to the dividend is an individual holding an interest of not more than 10 percent in the REIT. Second, the dividend is paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the

[4] It is understood that this is the date on which the Treasury Department announced that it was negotiating a zero rate of withholding with the United Kingdom, the first instance in which the United States was negotiating a zero rate. A similar restriction referring to this date is contained in the proposed income tax treaty with the United Kingdom.

dividend is a person holding an interest of not more than 5 percent of any class of the REIT's stock. Third the person beneficially entitled to the dividend holds an interest in the REIT of not more than 10 percent and the REIT is "diversified" (i.e., the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property). For purposes of this diversification test, the Technical Explanation indicates that foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The Technical Explanation indicates that these restrictions in availability of the different rates are intended to prevent the use of RICs and REITs to gain unjustifiable source-country benefits for certain shareholders resident in Mexico. For example, a company resident in Mexico could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 10 percent on dividends on those shares. There is a concern that such a company could purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thus obtain a lower withholding rate on a similar portfolio held by the RIC if the 5 percent rate were allowed to RIC dividends, or if the zero rate were allowed for RIC dividends other than for dividends paid to pension plans.

Similarly, the Technical Explanation gives an example of a resident of Mexico directly holding real property and required to pay U.S. tax either at a 30–percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Dividends with respect to permanent establishment or fixed base

The proposed protocol provides that dividends paid with respect to holdings that form part of the business property of a permanent establishment or fixed base situated in the source country are taxed on a net basis, using the rules of taxation generally applicable to residents of the State in which the permanent establishment is located, as modified by the treaty. The Technical Explanation gives as an example dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers.

Definition of "dividends"

Dividends are defined under the proposed protocol as covering income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights that is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

The Technical Explanation states that this definition is intended to cover all arrangements that yield a return on an equity invest-

ment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future. The Technical Explanation gives as examples of covered situations a constructive dividend that results from a non-arm's length transaction between a corporation and a related party; amounts treated as dividends under U.S. law upon a sale or redemption of shares; distributions from publicly traded limited partnerships that are treated as corporations under U.S. law (but not from limited liability companies, under U.S. law); and payments denominated as interest but made by a thinly capitalized corporation such that the debt is recharacterized as equity under the laws of the source State.

The Technical Explanation states that under the existing treaty and protocol, each Contracting State may apply its statutory rules for distinguishing debt from equity or for preventing thin capitalization in defining dividends for purposes of this article. As under the existing Treaty, the Technical Explanation gives an example of the U.S. rules of Code section 163(f), denying a deduction for interest on certain obligations not in registered form.

Company resident of one State deriving profits or income from the other State

Under the proposed protocol, if a company that is a resident of one Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by a company which is not a resident of that State, except insofar as such dividends are paid to a resident of that other State or are attributable to a permanent establishment or fixed base situated in that State. The Technical Explanation states that in the case of the United States, this provision overrides the ability to impose taxes under section 871 and 882(a) on dividends paid by foreign corporations that have a U.S. source under section 861(a)(2)(B).

Relation to other Articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 24 (Relief from Double Taxation), as if the Treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 17 (Limitation on Benefits). Thus, if a resident of Mexico is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 17 in order to receive the benefits of the Article 10 (Dividends).

Paragraph (b) of Article 2 of the protocol replaces paragraph 8 of the treaty's existing protocol. The new paragraph provides that if the United States agrees in a tax treaty to a dividend exemption under conditions more beneficial than those in paragraph 3 (which grants a zero rate of withholding tax in certain circumstances), the Contracting States shall, at Mexico's request, consult each other with a view to concluding another protocol to incorporate a similar provision into paragraph 3 of Article 10 (Dividends).

Paragraph (c) of Article 2 of the proposed protocol is a technical correction to ensure that the provision of the treaty's existing protocol paragraph 9 will continue to refer to the definition of "dividends" which in the new Article 10 is found in paragraph 6.

Article 3. Branch Tax

Internal taxation rules

United States

U.S. persons are subject to U.S. tax on their worldwide income. Foreign taxes may be credited against U.S. tax on foreign-source income of the taxpayer. For purposes of computing the foreign tax credit, the taxpayer's income from U.S. sources and foreign sources must be determined.

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30–percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) that is not effectively connected with a U.S. trade or business. This 30–percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general sourcing rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30–percent withholding tax (sec. 861(a)(2)(B)). This rule is sometimes referred to as the "secondary withholding tax." The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the

U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation's "dividend equivalent amount," which generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (secs. 884(a) and (b)). In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business) (sec. 884(b)). The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)). If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders. Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

Mexico

Mexico does not impose a branch profits tax.

Proposed treaty limitations on internal law

Article 3 of the proposed protocol provides an exemption from the branch profits tax that parallels the provision of the proposed protocol providing a zero rate of withholding on dividends.[5]

The United States is allowed under the current treaty to impose the branch profits tax (at a rate of 5 percent) on the business profits of a Mexican corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and are either attributable to a permanent establishment in the United States, or subject to tax on a net basis in the United States on income subject to Article 6 (Income From Immovable Property (Real Property)) or paragraphs 1 or 4 of Article 13 (Capital Gains). The tax is imposed on the "dividend equivalent amount," as described above.

Under the proposed protocol, the branch profits tax will not be imposed by the United States in cases in which a zero rate of withholding on dividends would apply if the U.S. branch business had been conducted by the Mexican company through a separate U.S. subsidiary. Thus, the branch profits tax will not be imposed in the

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[5] This provision is similar to the provision relating to branch profits tax in the proposed U.S.-U.K. treaty. The October 1, 1998, date in the proposed protocol follows the date set forth in the proposed U.S.-U.K. treaty.

case of a company that, before October 1, 1998, had a permanent establishment in the United States, or in the case of income or gains subject to tax on a net basis in the United States from real property or from the disposition of interests in real property. In addition, the branch profits tax will not apply to a Mexican company that is considered a qualified person by reason of being a publicly-traded company, or that is entitled to benefits with respect to the dividend equivalent amount under the derivative benefits or competent-authority discretion rules under Article 17 (Limitation on Benefits).

Article 4. Capital Gains

Article 4 of the proposed protocol relates to the sourcing rule for capital gains. The provision removes a sentence relating to resourcing of capital gains from Article 13, paragraph 4 of the treaty (Capital Gains) that is not necessary, given the modification of the treaty's resourcing rule made by Article V of the proposed protocol (described below).

Article 5. Relief from Double Taxation

Internal taxation rules

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. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that 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.

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 only offsets U.S. tax on foreign-source income. The foreign tax credit 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. The limitation is computed separately for certain classifications of income (*e.g.,* passive income and financial services income) in order to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

Mexico

Mexican residents are allowed a credit against their Mexican income tax for foreign income taxes imposed on their foreign-source income. The credit is limited to the Mexican tax payable on the net

foreign-source income. To the extent that foreign taxes are not credited in a particular tax year, a taxpayer may not deduct such foreign taxes. Excess foreign tax credits, however, may be carried forward for a period of 10 years. Foreign tax credits may not be carried back.

Proposed treaty limitations on internal law

Article 5 of the proposed protocol revises the rule in the current treaty for resourcing income taxed in accordance with the treaty to relieve double taxation (paragraph 3 of Article 24, Relief from Double Taxation). The resourcing rule currently in the treaty provides generally that income derived by a resident of the United States that may be taxed in Mexico is deemed to be Mexico-source income; however, such income generally is subject to the source rules of U.S. domestic law that apply for purposes of limiting the foreign tax credit (except with respect to capital gains). Certain gains derived by a U.S. resident from rights in the capital of a company or person that is a resident of Mexico are deemed to be Mexico-source income, to the extent necessary to avoid double taxation (paragraph 4, Article 13 (Capital Gains)). Thus, in general, under the current resourcing rule of the treaty, income taxed in Mexico is subject to U.S. domestic foreign tax credit limitation sourcing rules (except for certain capital gains).

The proposed protocol generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes imposed by Mexico. The proposed protocol contains a resourcing rule for this purpose. This rule provides that an item of gross income (as defined under U.S. law) that is derived by a U.S. resident that is taxed by Mexico is deemed to be Mexico-source income. The proposed protocol eliminates the rule of the current treaty that such income is subject the source rules of U.S. domestic law that apply for purposes of limiting the foreign tax credit. The provision of the current treaty deeming certain capital gains as Mexico-source income is eliminated as unnecessary, as the general resourcing rule of the proposed protocol subsumes this provision.

The Technical Explanation states that in the case in which the treaty allows Mexico to tax an item of gross income (as defined under U.S. law) derived by a U.S. resident, the United States will treat that item of income as Mexico-source income for purposes of the U.S. foreign tax credit. The Technical Explanation further states that in such a case, however, section 904(g)(10) may apply for purposes of determining the U.S. foreign tax credit. Section 904(g)(10) generally provides that the foreign tax credit limitation applies separately to income resourced under a treaty. The Technical Explanation points out that, because the resourcing rule of the proposed protocol applies to gross income, not net income, U.S. expense allocation and apportionment rules continue to apply to income resourced under the rule of the proposed protocol.

Article 6. Entry into Force

The proposed protocol provides that the protocol is subject to ratification in accordance with the applicable constitutional and statutory requirements of each country. The proposed protocol requires each State to notify the other as soon as its requirements

for ratification have been fulfilled; the proposed protocol will enter into force upon the date of the later of the two notifications.

The proposed protocol provides explicit effective dates for each of the provisions of the proposed protocol. With respect to Article 2, the proposed protocol will be effective with respect to dividends paid or credited on or after the first day of the second month after the date on which the protocol enters into force. The Technical Explanation provides the following example to illustrate the operation of this rule: if the second notification of the fulfillment of the ratification requirements is received on April 25, then the provisions of Article 2 would take effect for dividends paid or credited on or after June 1. All other provisions of the proposed protocol will be effective for taxable periods beginning on or after the first day of January of the year following the year in which the proposed protocol enters into force.

The purpose of this bifurcated effective date is to permit the benefits of the withholding reductions with respect to dividends to be put into effect as soon as is administratively feasible. A similar bifurcated effective date (permitting reductions in withholding to occur sooner than other provisions of the treaty) is included in the proposed income tax treaty with the United Kingdom.

Article 7. Remaining in Force

The proposed protocol will remain in force as long as the underlying convention to which this proposed protocol is an amendment remains in force.

IV. ISSUES

A. Zero Rate of Withholding Tax on Dividends from 80–Percent-Owned Subsidiaries

In general

The proposed protocol would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (subparagraph 3(a) of Article 10 of the current treaty (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Currently, no U.S. treaty provides for a complete exemption from withholding tax under these circumstances, nor do the U.S. or OECD models. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, the United States has signed a proposed treaty with the United Kingdom and a proposed protocol with Australia that include zero-rate provisions similar to the one in the proposed protocol.

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on certain dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12–month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 of the current treaty (Dividends)). Under the current U.S.-Mexico treaty, these dividends may be taxed at a 5–percent rate.

Issues

In general

Given that the United States has never before agreed bilaterally to a zero rate of withholding tax on direct dividends, the Committee may wish to devote particular attention to the benefits and costs of taking this step. The Committee also may want to determine whether the inclusion of the zero-rate provision in the proposed protocol (as well as in the proposed treaty with the United Kingdom and the proposed protocol with Australia) signals a broader shift in U.S. treaty policy, and under what circumstances the United States may seek to include similar provisions in other treaties. Finally, the Committee may wish to be aware of the "most favored nation" provision relating to this subject in the current U.S.-

Mexico treaty, and the ramifications of this provision in light of the proposed treaty with the United Kingdom and proposed protocol with Australia.

Benefits and costs of adopting a zero rate with Mexico

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., 5 percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit,[6] withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Mexico, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is at least 80–percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since Mexico does not currently impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by Mexican companies, as opposed to direct investment in Mexico by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it.[7]

However, it should be noted that, although Mexican internal law currently does not impose a withholding tax on dividends paid to

[6] *See, e.g.,* Code sec. 904.

[7] In contrast, including a similar provision in a treaty with a country that does impose withholding tax on some or all direct dividends under its internal law (e.g., Australia) would provide more immediate and direct benefits to the United States as both an importer and an exporter of capital.

foreign persons, there is no guarantee that this will always be the case.[8] Thus, the inclusion of a zero-rate provision under the proposed protocol would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in Mexico, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc against increased foreign tax credit claims in the event that Mexico were to change its internal law in this regard.

Although the United States has never agreed bilaterally to a zero rate of withholding tax on direct dividends, many other countries have done so in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed protocol is unprecedented in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

General direction of U.S. tax treaty policy

Looking beyond the U.S.-Mexico treaty relationship, the Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed protocol (as well as in the proposed treaty with the United Kingdom and the proposed protocol with Australia) signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department: (1) intends to pursue similar provisions in other proposed treaties in the future; (2) proposes any particular criteria for determining the circumstances under which a zero-rate provision may be appropriate or inappropriate; (3) expects to seek terms and conditions similar to those of the proposed treaty in connection with any zero-rate provisions that it may negotiate in the future; and (4) intends to amend the U.S. model to reflect these developments.[9]

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[8] Indeed, Mexican law has changed recently in this regard—Mexico adopted a dividend withholding tax in 1999, but then repealed it in 2001 (effective for dividends paid after 2001).

[9] More broadly, since the U.S. model has not been updated since 1996, the Committee may wish to ask whether the Treasury Department intends to update the model to reflect all relevant developments that have occurred in the intervening years. A thoroughly updated model would provide a more meaningful and useful guide to current U.S. tax treaty policy and would thereby increase transparency and facilitate Congressional oversight in this important area. *See* Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code*

Continued

"Most favored nation" agreement

Under the current U.S.-Mexico income tax treaty, dividends beneficially owned by a company that owns at least 10 percent of the voting stock of the dividend-paying company are subject to a maximum withholding rate of 5 percent (paragraph 2(a) of Article 10 of the current treaty), which is the lowest rate of withholding tax on dividends currently available under U.S. treaties. Under Protocol 1 to that treaty, as modified by a formal understanding subject to which the treaty and protocol were ratified, the United States and Mexico have agreed, if the United States adopts a rate on dividends lower than 5 percent in a treaty with another country, "to promptly amend [the U.S.-Mexico treaty] to incorporate that lower rate."[10]

The adoption of a zero-rate provision in the U.S.-Australia or the U.S.-U.K. treaty relationship would trigger this obligation to amend the current treaty with Mexico. The proposed protocol with Mexico would amend that treaty to incorporate a zero-rate provision substantially identical to that of the proposed treaty with the United Kingdom, and substantially similar to that of the proposed protocol with Australia, and thus would seem to fulfill the U.S. obligation under the "most favored nation" agreement. Thus, if the Senate were to ratify the proposed protocol with Mexico along with either the proposed treaty with the United Kingdom or the proposed protocol with Australia (or both of them), no issues of interaction between the two treaty relationships would need to be confronted.

If, on the other hand, the Senate were to ratify either the proposed treaty with the United Kingdom or the proposed protocol with Australia, but not the proposed protocol with Mexico, then the possibility would arise that the United States eventually could be regarded as falling out of compliance with its obligations under the U.S.-Mexico treaty. This would raise difficult questions as to the exact nature of this obligation and whether and how the United States would come into compliance with it.

B. Visiting Teachers and Professors

The proposed protocol maintains the present treaty's treatment of visiting teachers and professors, in which an individual visiting in the host country to engage in teaching or research at an educational institution is subject to income tax in the host country on any remuneration received for his or her teaching or research. The treatment of the present treaty conforms to the U.S. model. While this is the position of the U.S. model, an exemption for visiting teachers and professors has been included in many bilateral tax treaties. Of the more than 50 bilateral income tax treaties in force, 30 include provisions exempting from host country taxation the income of a visiting individual engaged in teaching or research at an

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of 1986 (JCS–3–01), April 2001, Vol. II, at 445–47 (recommending that the Treasury Department revise U.S. model tax treaties once per Congress).

[10] This formal understanding was a response to an objection raised by the Committee to the original language of the treaty protocol, under which the "most-favored nation" provision would have been self-executing—i.e., immediately upon U.S. agreement to a lower rate with another treaty partner, the United States and Mexico would have begun applying that lower rate in their treaty.

educational institution, and an additional 10 treaties provide a more limited exemption from taxation in the host county for a visiting individual engaged in research. Although the proposed protocol with Australia would not include such a provision, the proposed treaty with the United Kingdom does include such a provision, and three of the most recently ratified income tax treaties did contain such a provision.[11] The Committee may wish to satisfy itself that the inclusion of such an exemption is not appropriate.

[11] The treaties with Italy, Slovenia, and Venezuela, each considered in 1999, contain provisions exempting the remuneration of visiting teachers and professors from host country income taxation. The treaties with Denmark, Estonia, Latvia, and Lithuania, also considered in 1999, did not contain such an exemption, but did contain a more limited exemption for visiting researchers.