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Recommended Citation
https://scholar.smu.edu/lbra/vol1/iss1/4

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The New US-Mexico Income Tax Treaty: Overview and Analysis

J.D. Dell* and Geoffrey R. Polma**

Overwhelming media coverage and public attention focused on the debate over, and passage of, the North American Free Trade Agreement (the NAFTA). Little attention was accorded the almost concurrent ratification and adoption of the United States' first income tax treaty with Mexico. Although operating generally independently of the NAFTA, the income tax treaty is a critical complement to the NAFTA and a necessary component to achieving many of the mutual economic benefits that businesses in Mexico and the United States hope for under the NAFTA. Of further significance from a conceptual standpoint, although more forward-looking and far-reaching, the U.S.-Mexico income tax treaty could well become a model for tax treaties between the U.S. and other Latin American countries, and, more generally, between the U.S. and other developing nations.1 Finally, for U.S. businesses simply wanting to do business in Mexico, the finalization of the U.S.-Mexico income tax treaty provides significant and welcome benefits, by eliminating the risk of inconsistent and/or double taxation and thereby providing much needed certainty in income tax treatment with respect to cross-border business activities between the two countries.

The U.S. and Mexico signed the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income2 (the Treaty), with accompanying Protocol3 (the Protocol), on September 18, 1992. On November 20, 1993, the United States Senate ratified the Treaty, with an understanding and reservation attached.4 During the last week of December, 1993, the U.S. government exchanged instruments of ratification with the Mexican government, making the Treaty effective as of January 1, 1994. Prior to the ratification of the Treaty, the U.S. and Mexico had never had an income tax treaty in place.

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3. Id. (hereinafter Protocol).

In broadest terms, the Treaty, like all income tax treaties, is aimed both at avoiding double taxation and avoiding evasion or avoidance of the tax laws of either the U.S. or Mexico. The countries hope and believe that accomplishing these goals, in turn, will facilitate direct and portfolio investment between the U.S. and Mexico. Some of the more important specific functions of the Treaty are to (1) coordinate source-of-payment principles, (2) reduce withholding tax rates, and (3) standardize the creditability of each country’s taxes against the taxes imposed by the other country. The remainder of this article will provide an article-by-article overview of the operation of the Treaty, followed, in an Appendix, by a general summary of the Mexican tax laws.

I. The U.S.-Mexico Income Tax Treaty

A. Article 1: General Scope

The Treaty generally applies to “persons” who are residents of either or both the United States or Mexico (the Contracting States).5 “Persons” are defined as individuals or legal persons, and the term “legal persons” includes both a body corporate and an entity, such as U.S. partnership or a Mexican joint venture, that functions as flow-through entity for tax purposes.6

The Treaty provides a standard “savings clause” under which each country may tax its own citizens or “residents” (as determined under Article 4) as if the Treaty had not gone into effect.7 Consequently, and subject to specific exceptions such as the reciprocal foreign tax credit provision of the Treaty, each Article of the Treaty should not be read as providing benefits with respect to either U.S. taxation of its residents or citizens or Mexican taxation of its residents (since Mexico does not tax on the basis of citizenship).8

The Treaty may not increase the tax burden of residents of either country as compared to what the tax burden would be under each country’s respective domestic tax provisions without regard to the Treaty or any other agreement between the countries.9 Thus, the Treaty only applies where it would benefit taxpayers. Although the Treaty can only operate to benefit taxpayers, a taxpayer may not inconsistently select among provisions of the Treaty and domestic tax laws to minimize a tax burden. As an example of such impermissible manipulation, the U.S. Treasury cites a situation in which a Mexican resident has three businesses in the U.S., only one of which is a permanent establishment under the Treaty, but the other two of which are subject to income taxation under U.S. domestic tax laws.

5. Treaty art. 1(1).
6. Treaty art. 3.
7. Treaty art. 1(3).
law. The permanent establishment and one of the other two businesses generate taxable income; the remaining business generates a loss. The taxpayer cannot treat the loss-generating business as subject to U.S. income tax (to offset the income of the permanent establishment) while also claiming that the income-generating business is exempt from U.S. income taxation under the Treaty.\(^\text{10}\)

**B. ARTICLE 2: TAXES COVERED BY THE TREATY**

The Treaty applies to taxes on income, including both taxes on total income and taxes on a part of income (e.g., gains from real property sales).\(^\text{11}\) The Treaty generally does not apply to payroll taxes, including U.S. social security taxes, or to property taxes, among others.\(^\text{12}\)

One tax which is thereby excluded from coverage by the Treaty is the Mexican assets tax, which is treated as a property tax rather than an “income tax” under the Treaty. However, paragraph 3 of the Protocol clarifies that the Mexican assets tax will apply to a U.S. resident only if (i) the U.S. resident has a permanent establishment in Mexico,\(^\text{13}\) (ii) the U.S. resident owns real property in Mexico, or (iii) the U.S. citizen leases or permits a resident of Mexico to use property for which a “royalty” (as defined in Article 12) is paid. In the case of the latter two categories, however, the assets tax must be reduced by (i) Mexican income tax that would be imposed on the sale of the real property, irrespective of whether the U.S. resident elects to be taxed on a net income basis, and (ii) Mexican income tax that would be imposed on rents or royalties paid to the U.S. resident for use of property (i.e., rates of up to 35%), even if such amounts are actually subject only to the 10% withholding tax rate provided for by Article 12.

This clarification in the Protocol has particular relevance for the formation and operation of maquiladoras to minimize the impact of the Mexican assets tax. A central consideration in this regard is whether the maquiladora is a permanent establishment of a U.S. business. Whether a maquiladora constitutes a permanent establishment will depend upon whether the maquiladora is a “dependent agent” or an “independent agent” with regard to the U.S. participant.\(^\text{14}\) If the maquiladora is a dependent agent, the maquiladora should own its production equipment in order that the Mexican assets tax imposed on the maquiladora can be converted into a creditable (for U.S. purposes) Mexican income tax liability as a result of the fees paid by the U.S. participant to the maquiladora. If the maquiladora is an independent agent, the U.S. resident should furnish the equipment and charge rent sufficient to generate a deemed Mexican income tax liability that would offset

\(^{10}\) See Technical Explanation, at 1612.

\(^{11}\) Treaty art. 2(l)-(2).


\(^{13}\) Article 5 of the Treaty defines a “permanent establishment”. See Treaty, art. 5.

\(^{14}\) The rules under the Treaty for making this determination are described *infra* at notes 37 to 42 and accompanying text.

any assets tax liability.\textsuperscript{15}

The Treaty prohibits the imposition of the U.S. domestic excise tax that otherwise would apply to insurance premiums paid to Mexican residents that are not attributable to a permanent establishment in the U.S. The U.S. excise tax can, however, be imposed on amounts attributable to risks reinsured by a person not covered by the Treaty or another, similar U.S. income tax treaty provision.\textsuperscript{16} As a result of this rule and other Treaty provisions, (i) insurance income of a Mexican resident that is effectively connected with a U.S. trade or business but is not attributable to a permanent establishment in the U.S. is not subject to U.S. income tax; (ii) Mexican insurers not engaged in a U.S. trade or business will not be subject to the insurance excise tax; and (iii) Mexican insurers with a permanent establishment in the U.S. will be subject to U.S. income tax.\textsuperscript{17} Under these rules, the Treaty arguably provides Mexican insurers who operate free of tax in the U.S. a competitive advantage against their U.S. counterparts, who will be subject to U.S. tax. The U.S. concluded, however, that this concern was groundless: no overall tax differential will exist because Mexican insurers will be subject to substantial Mexican income tax on any income that escapes U.S. taxation under the Treaty.\textsuperscript{18}

Mexico does not currently impose an excise tax on U.S. insurers, and thus the Treaty provision exempting Mexican insurers from the U.S. excise tax is not phrased reciprocally. To allay fears that the Mexican government will take advantage of this situation in the future, the Senate Understanding attached to the Senate’s ratification of the Treaty provides “[t]hat, while Mexico imposes no excise tax on insurance premiums paid to foreigners and has no immediate plans to do so, should Mexico enact such a tax in the future, Mexico will waive such tax on insurance premiums paid to insurers resident in the United States.”\textsuperscript{19}

C. ARTICLE 3: GENERAL DEFINITIONS

The Treaty contains standard definitions of such terms as “person” (individual or legal person), “company” (any body corporate or entity treated as a body corporate for tax purposes) and “competent authority” (the Secretary of the Treasury or his authorized representative in the U.S. and the Ministry of Finance and Public Credit in Mexico).\textsuperscript{20} Certain

\textsuperscript{16} Treaty art. 2(3)(a).
\textsuperscript{17} See Senate Report, at 41-42.
\textsuperscript{18} Id. at 20; see also Hearings Before the Committee on Foreign Relations of the United States Senate on Bilateral Tax Treaties with: The Russian Federation, Barbados, the Kingdom of the Netherlands, United Mexican States, State of Israel, the Czech Republic, the Slovak Republic, Netherlands Protocol, 103rd Cong., 1st Sess. (1993) (hereinafter Senate Hearings) statement of Samuel Y. Sessions, Deputy Assistant Secretary (Tax Policy), Department of the Treasury (hereinafter Sessions Statement) (discussing the waiver of tax on Mexican insurers or reinsurers who do not have a permanent establishment but who insure U.S. risks or persons).
\textsuperscript{20} Treaty art. 3.
terms that embody key concepts, such as "resident" or "permanent establishment," are defined elsewhere in the Treaty. The Treaty departs from the U.S. Model Treaty by granting to undefined words the meaning such words would have under the laws of the taxing country, unless context requires otherwise. The U.S. Model Treaty directs the competent authorities of the participating countries to agree to the meaning of undefined terms.

D. Article 4: Residence

The determination of a taxpayer's country of residence is important because (i) the Treaty only applies to residents of the U.S. or Mexico, (ii) the Treaty often addresses double taxation issues by specifying certain tax treatment based upon a taxpayer's country of residence, and (iii) a taxpayer may be a resident of both countries under their domestic income tax laws.

A person is considered a resident of the U.S. or Mexico if the person is subject to tax in such country by reason of domicile, residence, place of management, place of incorporation, or any criterion of a similar nature. However, "resident" does not include persons subject only to tax on income sourced in the U.S. or Mexico. Moreover, under the Protocol, Mexico does not consider U.S. citizenship or "green card" status alone sufficient to establish U.S. residency; instead, such persons must also have a "substantial presence" in the U.S. or must be a resident of the U.S. and not another country under the Treaty's tie-breaker rules.

If an individual would be a resident both of the U.S. and of Mexico under the general rule, then (i) the individual is deemed a resident of the country in which he has a permanent home; or if he has permanent homes in both countries, he is deemed a resident of the country in which his personal and economic relations are closer (the individual's center of vital interests); (ii) if the center of vital interests cannot be determined, or if he has no permanent home in either country, then he is deemed a resident of the country in which he has a habitual abode; (iii) if he has a habitual abode in both countries or neither country, then he is deemed a resident of the country of his nationality; or (iv) in any other case, the competent authorities of the country will settle the question.

The tie-breaker rules are available only for individuals. Thus, if a company is a resident of both countries under the general rule, e.g., a U.S. corporation effectively managed in Mexico, then the company is considered a resident of neither country. This result renders any of the benefits of the Treaty, such as reduced withholding tax rates, unavailable to a dual

22. See Joint Committee on Taxation Staff, Explanation of Proposed Income Tax Treaty and Protocol with Mexico 3 (October 27, 1993) (hereinafter Joint Committee Explanation).
23. Treaty art. 4(1).
24. Id.
27. See Technical Explanation at 1614 ("[I]t was decided to exclude such persons from treaty coverage and to rely on the companies themselves not to get into the situation of dual residence").
In order to avoid this pitfall, entities need to carefully plan to ensure that they will be treated as residents of either the U.S. or Mexico but not both in order to avoid this pitfall.

**E. ARTICLE 5: PERMANENT ESTABLISHMENT**

An enterprise that is a resident of either Mexico or the U.S. is not taxable upon its business profits in the other country (i.e., its net income as opposed to gross receipts, asset value, etc.) unless those profits are "attributable to" a "permanent establishment" in the other country. As a corollary, when particular items of dividends, interest, or royalties are attributable to a permanent establishment, such items are taxable as business profits (under Article 7), rather than being subject to the maximum withholding tax rates permitted by the Treaty.

In general, a "permanent establishment" is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." The term specifically includes a place of management; a branch; an office; a factory; a workshop; or a place of extraction of natural resources. The term also includes certain construction sites and natural resource exploration sites lasting more than six months. The U.S. Model Treaty does not grant permanent establishment status to this latter category unless the construction or exploration project lasts more than a year; however, many developing country treaties contain a six month period to provide broader source-based taxation on what is one of the primary foreign activities in such countries.

The Treaty also provides that a nonresident may carry out certain designated activities without creating a permanent establishment: The use or maintenance of installations for storage or exhibition of goods; the use or maintenance of facilities for storage or exhibition of goods to be processed by another; the use of a place of business to buy goods or obtain information; the use of a facility to carry on preliminary or auxiliary activities such as advertising, research, or preparation for the arrangement of loans; and the physical deposit of goods in a general deposit warehouse.

The exclusion for activities in preparation for the arrangement of loans is significant for U.S. banks, whose operations in Mexico are limited, by Mexican law, to arranging for loans to be made by the home office of U.S. resident banks. This provision ensures that the interest attributable to loans procured by Mexican branches of U.S. banks is subject to the reduced

28. Treaty art. 7(1).
29. E.g., Treaty arts. 10(5), 11(6), and 12(4).
30. Treaty art. 5(1).
31. Treaty art. 5(2).
32. Treaty art. 5(3).
33. See Joint Committee Explanation at 20.
34. Treaty art. 5(4).
35. The phrasing of the exception for preliminary activities, however, makes clear that the use of a facility to perform multiple otherwise preparatory or auxiliary activities could give rise to a permanent establishment. See B. Cass & R. Andersen, *U.S.-Mexico Treaty Combines Developed and Developing Country Models*, 3 J. Int'l Tax'n 197, 198 (1992) (hereinafter Cass & Andersen).
withholding rate for interest under Article 11, rather than treated as business profits of a permanent establishment of the bank, which would be subject to Mexican income tax.  

The Treaty provides that a nonresident enterprise will not be considered to have a permanent establishment as a result of the actions of an "independent agent" who acts in the ordinary course of business pursuant to an arm's-length relationship.  The Treaty does not prohibit an agent that acts solely or nearly exclusively for an enterprise from being treated as "independent"; however, exclusivity is a factor to be considered in making the dependent/independent determination.

A nonresident will be considered to have a permanent establishment as the result of the actions of a "dependent agent" who either (i) "has and habitually exercises" contracting authority (other than with regard to the specific activities deemed by Article 5(4) not to constitute a permanent establishment), or who (ii) "habitually processes" goods or merchandise maintained by the nonresident, using assets furnished by the nonresident.  The dependent agent rule will supersede the broader Mexican tax law rules, described in the Appendix, for determining when a Mexican agent gives rise to a permanent establishment.

The "processing" aspect of the dependent agent rule, aimed at the maquiladora industry, clarifies that a dependent agent of a principal that processes inventory of the principal using assets of the principal or a related enterprise (without itself owning the inventory or assets used in the processing) will constitute a permanent establishment of the principal.  Mexican law currently permits the imposition of Mexican income tax on such enterprises, but, as a matter of administrative grace, Mexico has not attempted to tax them.

Contract manufacturing through an independent agent, however, will not create a permanent establishment.  Although Mexico does not currently permit foreign insurers to operate in Mexico, it anticipates opening those markets in the foreseeable future.  Thus, the Treaty provides that a nonresident insurance company will be considered to have a permanent establishment if it collects premiums or insures risks through a dependent agent.  Reinsurance, however, is specifically excluded from this insurance-related permanent establishment rule.

37. Treaty art. 5(7).
39. Treaty art. 5(5).
42. See Technical Explanation at 1615.
43. Treaty art. 5(6).
The Treaty permits a Contracting State in which immoveable property is located to tax income derived from such property, including agricultural income, lease income, and amounts realized on the sale of the property. Income from the use of immoveable property to perform independent personal services also is subject to tax under Article 6.

"Immoveable property" generally is defined by the domestic law of the Contracting State in which the property is situated; however, the Treaty also specifies that the term includes accessories to immoveable property, livestock and equipment used in agriculture and forestry, and rights to variable or fixed payments for working or the right to work mineral deposits and other natural resources. The Treaty excludes ships, boats, aircraft, and containers from the definition of "immoveable property.

Article 6(5) provides that a nonresident may elect to compute tax on income from real property on a net basis as if such income were attributable to a permanent establishment. The election is binding for future years, unless the competent authority of the Contracting State consents to a revocation. Irrespective of the Treaty, Mexican residents are able to elect to have income attributable to U.S. real property taxed on a net basis under United States income tax law; consequently, this provision primarily will benefit U.S. residents without permanent establishments in Mexico by allowing them to elect between the Mexican withholding tax rate of 21% or taxation on a net basis.

Article 7 of the Treaty prescribes the circumstances under which a Contracting State may tax the "business profits" of a nonresident (as opposed to imposing withholding tax on foreign-source income of a nonresident). Although the term "business profits" is not defined in the Treaty, the Treaty does provide that where "business profits" include items specifically addressed by other provisions of the Treaty (e.g., interest or capital gains), such other provisions will override the general rules for calculating "business profits." Certain Treaty provisions, however, exclude income attributable to permanent establishments from

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44. Treaty art. 6(1) and (3).
45. Treaty art. 6(4).
46. Treaty art. 6(2).
47. See I.R.C. §§ 871(d) and 882(d).
49. Treaty art. 7(1). The timing requirements for the application of the Treaty's business profits provisions appear to be in accord with U.S. tax law. The Code treats income of a nonresident in one taxable year that is attributable to a transaction in another taxable year as "effectively connected with the conduct of a U.S. trade or business" if the income would have been so treated if taken into account in that other taxable year. I.R.C. § 864(c)(6). A common example of such income is deferred payments attributable to services rendered in a prior year. The Treaty permits this treatment by providing that a Contracting State can tax business profits attributable to a permanent establishment where a nonresident enterprise "carries or has carried on" business through a permanent establishment in such Contracting State.
50. Treaty art. 7(6).
51. Treaty arts. 10(5) and 12(4).
their scope. For example, the Articles concerning dividends and royalties provide, respectively, that dividend and royalty income attributable to a permanent establishment is subject to the business profits rule rather than the royalty or dividend rule.\textsuperscript{51}

A Contracting State can only tax the "business profits" of a nonresident if the nonresident carries on business through a permanent establishment in the taxing country.\textsuperscript{52} Even then, the taxing country can tax only so much of the business profits of the nonresident as (i) are "attributable to" the permanent establishment itself or, (ii) under a "force of attraction rule," are attributable to sales of goods in a Contracting State of a like kind as those that are sold through the permanent establishment.\textsuperscript{53} The force of attraction rule does not apply, however, if a nonresident can establish that such sales were carried out for legitimate business purposes—for example, it may be economically more efficient for a San Diego-based firm with a Mexico City permanent establishment to sell and ship goods to Tijuana directly from the home base, rather than from Mexico City.\textsuperscript{54}

The attribution of business profits to a permanent establishment is limited by Article 7(2), which provides that the business profits attributed to a home base are those which the permanent establishment might be expected to make if it were a distinct and independent enterprise. Moreover, a Contracting State cannot attribute business profits based solely on the purchase of goods by a permanent establishment, which means that a Contracting State cannot assign a profit element and increase taxable income based on a permanent establishment's activities as purchasing agent for its parent.\textsuperscript{55}

In determining business profits, a nonresident is allowed deductions for expenses incurred for the purposes of the permanent establishment, including executive and general administrative expenses, irrespective of where such expenses are incurred.\textsuperscript{56} The Protocol further specifies that such deductions shall include a reasonable allocation of administrative, research and development, interest, and other expenses incurred by the enterprise as a whole, to the extent such expenses have not already been deducted by the enterprise and have not been reflected in other offsets to income allowed to the permanent establishment.\textsuperscript{57}

The Treaty limits this rule somewhat, however, by providing that a permanent establishment may only deduct amounts paid in reimbursement of actual expenses (rather than the entire amount of payments) to a home office for "royalties, fees or other similar pay-

\begin{itemize}
\item \textsuperscript{52} Treaty art. 7(1)(a). This rule will prove particularly beneficial to U.S. engineering and architectural design firms performing services with respect to projects in Mexico. In the past, the U.S. has sourced design fees based on the location of performance of the service (e.g., a U.S. office) while Mexico typically has sourced the fees based upon the service benefit location (e.g., a construction project in Mexico). The Treaty should eliminate this potential double taxation. See del Castillo, Solano & Podrasky, supra note 41 at 130.
\item \textsuperscript{53} Treaty art. 7(1)(a) and (b). This provision is a departure from standard U.S. treaty policy and represents a recognition of Mexico's developing country status. See Cass & Andersen at 198.
\item \textsuperscript{54} See Technical Explanation at 1617; see also McLees, Initial Thoughts, at 997 (noting that the Treaty's "force of attraction rule" is narrower than the otherwise applicable Mexican rules).
\item \textsuperscript{55} Treaty art. 7(4); Senate Report at 55-56.
\item \textsuperscript{56} Treaty art. 7(3).
\item \textsuperscript{57} Protocol para. 5.
\item \textsuperscript{58} Treaty art. 7(3).
\end{itemize}
ments 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 banking enterprise, by way of interest on moneys lent to the permanent establishment. This limitation, which will reduce the possibility of transfer pricing abuses, is based on the rationale that a permanent establishment and a home office are part of the same entity, and, therefore, there is no need for a profit element in transactions between them.

Article 7(3) of the Treaty excepts banks from the generally applicable deduction limit on "interest on moneys lent to the permanent establishment," which can be read to authorize a permanent establishment of a bank to deduct interest on interbranch loans. This rule would be inconsistent with U.S. taxation, which generally disregards loans between a U.S. permanent establishment and a home office or another branch. The U.S. position, however, is that the interbranch bank loan provision is intended only to supersede Mexican law, which does not permit a branch to deduct any interest incurred by its home office or another branch, but is not intended to affect U.S. law, under which a branch bank is granted an interest deduction based on a formula apportionment of world-wide interest expense of the bank.

Finally, although it is clear that a U.S. permanent establishment in Mexico can deduct its expenses, it is unclear whether Mexico will attempt to subject such deductions to the usual Mexican tax law requirement that an expense must be essential to a business before it can be deducted.

H. ARTICLE 8: SHIPPING AND AIR TRANSPORT

The Treaty provides an exemption from income taxation by a Contracting State of a nonresident's income from the operation or rental of ships and aircraft in international traffic, or from the use or rental in international traffic of containers, trailers, barges, and related container transport traffic. This exemption explicitly extends to (i) income from the rental of ships or aircraft on a full-time or full-voyage basis or (ii) income from the rental of ships or aircraft on a bareboat basis if the lessee operates such ships or aircraft in international traffic and the rental income is accessory to other income from the operation by the lessee of ships or aircraft in international traffic. However, the exemption does not

59. See Technical Explanation at 1617. The limitation on a permanent establishment's deduction of fees paid to a home office may, in some instances, encourage the formation of Mexican marketing and sales subsidiaries by U.S. companies. A Mexican subsidiary can buy products from the U.S. parent at a standard wholesale price, remit market-value payments for royalties and marketing fees (deductible by the subsidiary and subject to the Treaty's reduced rates of withholdings), and pay Mexican income tax of 34%. See Levey, Gordon & Sanders at 368-69.

60. See Phillips & Washlick at 21; J. Croker, Possible Inconsistency Between U.S-Mexico Treaty and Section 1.882-5 Regulations, Tax Notes Int'l, Nov. 9, 1992, at 993.

61. See Joint Committee Explanation at 28-29.

62. See McLees, Initial Thoughts at 996.

63. Treaty art. 8(1).

64. Treaty art. 8(2). This provision could be read to permit the taxation of the portion of an international passenger line's income attributable to overnight accommodation, which is probably an unintended result. See Cass & Andersen at 200.
apply to income either from transport by means other than ships or aircraft or from the provision of overnight accommodation. The exemption applies even if the nonresident has a permanent establishment through which it conducts its shipping or air transport business. The Protocol specifies that U.S. residents qualifying for this exemption also will be exempt from the Mexican tax on assets with regard to assets used to produce the exempt income. Container leasing activity (including trailers, barges, and related equipment) is taxable only in the Contracting State in which the enterprise is organized.

I. ARTICLE 9: ASSOCIATED ENTERPRISES

If related persons who are residents of a Contracting State participate in transactions that are not arm's-length, the Treaty grants authority to the Contracting State to adjust the income and tax liability of the persons to reflect the economic reality of the transactions. In particular, a Contracting State is permitted to adjust the income or loss of a resident to reflect income that would have been taken into account had "associated enterprises" utilized arm's-length terms for their commercial or financial relations. An "associated enterprise" is very broadly defined, i.e., it includes instances "[w]here: (a) an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or (b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State."

Either Contracting State can utilize principles of its domestic law that permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related parties. Thus, the U.S. will be able to apply its intercompany pricing rules under section 482 of the Code and its rules relating to the allocation of deductions under sections 861-863 of the Code. Mexico will apply its domestic authority to determine a taxpayer's income presumptively where one taxpayer in a transaction "possesses an
interest in the business of another.” Although Mexico historically has not pursued transfer-pricing abuses with any success, the Mexican tax authority — commonly known as “the Hacienda” — has implemented significant new transfer-pricing initiatives in response to the increased trade attributable to the NAFTA and the Treaty.

When a Contracting State adjusts the taxable income of a resident based on transactions with an “associated enterprise,” the other Contracting State, if it agrees with the adjustment, will make a corresponding adjustment in the income of the associated enterprise. The Protocol specifies that a correlative adjustment is not available where the associated enterprise’s misstatement of income was the result of fraud, gross negligence, or willful default. A failure by one Contracting State to agree to the adjustment would be resolved through the competent authority process of Article 26.

J. ARTICLE 10: DIVIDENDS

The Mexican tax system is an “integrated” tax system in that Mexico does not impose withholding or income tax on dividends distributed by Mexican resident companies to residents or nonresidents. Consequently, although the Treaty’s dividend provisions are phrased reciprocally, the provisions will mainly affect U.S. taxation of dividends paid to Mexican residents. The Treaty permits a Contracting State to impose a withholding tax on dividends paid by resident companies, but imposes maximum withholding rates on the dividends paid to residents of the other Contracting State. “Dividends” are defined as income from shares or other rights (not being debt-claims), participations in profits, and income from other corporate rights that is subject to the same tax treatment as income from shares under the laws of the Contracting State of which the company making the distribution is resident. If a dividend is paid to a resident of the other Contracting State owning at least ten percent of the payor (a direct-investment dividend), the maximum withholding rate is 5% of the gross dividend payment. If the recipient owns less than 10%, the maximum rate is 15% for the first five years that the Treaty is in force, after which the maximum rate is 10%. Paragraph 8(b) of the Protocol provides a “most favored nation” clause, rarely found in U.S. income tax treaties, whereby the Treaty will incorporate any lower maximum rate for direct investment dividends to which the U.S. agrees in a treaty with another country. The Protocol also

76. Treaty art. 9(2).
77. Protocol para. 7.
78. See Phillips & Washlick, at 28.
79. Treaty art. 10(1) and (2).
80. Treaty art. 10(4).
81. Treaty art. 10(2)(a). As described infra at text accompanying notes 217 to 218, Mexico imposes a substantial tax on a Mexican entity’s distributions in excess of a previously taxed earnings account. Because this tax is imposed on the distributor rather than recipient of distributions, the Treaty’s limitation on dividend withholding rates will not prevent the imposition of this tax on the Mexican subsidiary of a U.S. parent. See del Castillo, Solano & Podrasky at 134.
82. Treaty art. 10(2)(b) and (3).
84. Protocol para. 8(b).
modifies the application of the maximum withholding rates for distributions by U.S.
Regulated Investment Companies (RICs) or Real Estate Investment Trusts (REITs) by
including distributions from these vehicles in the 10/15% withholding rate category, unless,
in the case of the REIT, the dividend recipient owns ten percent or more of the REIT, in
which case the domestic-law 30% withholding tax rate applies.\textsuperscript{84}

If a nonresident dividend recipient carries on business through a permanent estab-
lishment or a fixed base in the other country, then dividends attributable to such activity
are taxed under the Treaty rules concerning business profits and income from personal
services rather than being subject to the withholding tax rules of Article 10.\textsuperscript{85}

The Treaty prohibits a Contracting State from taxing dividends (i) paid from a non-
resident and (ii) paid to a resident of the other Contracting State unless (iii) the dividends
are attributable to a permanent establishment or fixed base in the taxing Contracting
State.\textsuperscript{86} This rule prevents the imposition of "second-level withholding taxes."\textsuperscript{87} Generally,
a second-level withholding tax is necessary in the absence of a "branch profits tax,"
explained \textit{infra}. Because the Treaty expressly permits the imposition of a branch profits
tax, the prohibition of a second-level withholding tax generally will not open the door to
tax avoidance. A potential problem exists, however, with respect to dividends paid by com-
panies who are not residents of either Mexico or the U.S. As drafted, the Treaty exempts
any dividends paid to residents of the U.S. or Mexico by companies who are residents of
neither the U.S. or Mexico. Because the U.S. has a number of treaties that preclude the
imposition of branch taxes, such companies could be in a position of being exempt from
both second-level withholding taxes and branch taxes. In other words, the Treaty could
have a collateral effect of granting an advantage to a non-U.S. or non-Mexico company
that is not available to a U.S. or Mexico company.\textsuperscript{88}

\textbf{K. Article 11: Interest}

The Treaty permits a Contracting State to tax interest income received by its residents
from nonresidents without restriction, but imposes limitations on the maximum with-
holding rate at which each Contracting State can tax interest income paid to a resident of
the other Contracting State.\textsuperscript{89} "Interest" for these purposes includes income from debt-
claims of every kind, irrespective of whether the debt is secured or carries a right of partic-
ipation in profits.\textsuperscript{90} The Treaty's interest provision was "one of the most contentious issues
in the negotiations" producing the Treaty, since the rate-setting process necessarily reflect-
ed "an inherent tension in balancing Mexico's concerns about revenue loss with the inter-
est of attracting U.S. lenders, and the U.S. interest in making the U.S. lenders competitive
in Mexico while advancing its preference for exemption of interest at source."\textsuperscript{91} The treat-
ment of interest under the Treaty reflects a reversal of interests between the U.S. and

\begin{itemize}
  \item \textsuperscript{85} Treaty art. 10(5).
  \item \textsuperscript{86} Treaty art. 10(6).
  \item \textsuperscript{87} See \textit{generally} Senate Report at 59 and 62 (explaining "second-level withholding tax").
  \item \textsuperscript{88} See \textit{generally} Joint Committee Explanation at 30.
  \item \textsuperscript{89} Treaty art. 11(1) and (2).
  \item \textsuperscript{90} Treaty art. 11(5).
  \item \textsuperscript{91} Senate Hearings (Sessions Statement).
\end{itemize}
Mexico as compared to the dividend provisions of Article 10. In the case of dividends, the U.S. wanted a relatively high withholding tax rate in order to protect its double taxation of corporate profits, while Mexico’s integrated system caused Mexico to advocate a position of no withholding tax on dividends. With regard to interest, the U.S., given its relatively broad portfolio interest exclusion, did not desire any withholding tax on interest. Mexico, on the other hand, had an incentive to negotiate for a high withholding rate because it derived a significant amount of revenue from its domestic-law rates of 15%, 21%, or 35% in effect at the time the Treaty was signed. Thus, the Treaty’s relatively low maximum rates for withholding taxes on interest represented a significant concession by Mexico, presumably conceded in hopes of encouraging U.S. financial institutions to make loans to persons and businesses in Mexico.

Under the Treaty, source country withholding tax on interest cannot exceed 4.9% (10% for a five-year transitional period) of the gross interest from (i) loans by banks (including investment banks and savings banks) and insurance companies, and (ii) bonds or securities that are regularly and substantially traded on a recognized exchange. The 4.9% maximum rate was selected because it is less than the 5% rate at which interest and related tax become includible in a separate U.S. foreign tax credit limitation category for “high withholding tax interest.” Tax withheld at rates below 5% is included in the much broader foreign tax credit basket for either financial services income or passive income.

Source country tax on interest cannot exceed 10% of (1) the gross interest paid by banks (including investment banks and savings banks), and (2) the gross interest paid on seller financing of machinery and equipment. A 15% rate applies for a five-year transitional period. All other interest payments are subject to a maximum tax rate of 15%, with no transitional rule.

The Treaty completely exempts from source country withholding tax any interest payments (i) if either the beneficial owner or the payor is a Contracting State, a political subdivision of a Contracting State, or a local authority of a Contracting State (a Governmental Entity), (ii) the beneficial owner of the interest is an employee benefit plan the income of which is exempt from tax under the laws of the Contracting State in which it is a resident, or (iii) the interest is in respect of certain loans by governmental import-export banks.

The Treaty’s interest provisions are modified by paragraph 9 of the Protocol, which preserves each Contracting State’s right to recharacterize debt as equity pursuant to such

92. Phillips & Washlick at 31-32.
93. See Phillips & Washlick at 32.
94. Treaty art. 11(2)(a) and (3)(a).
95. See Senate Report at 64.
96. See Technical Explanation at 1620.
97. Treaty art. 11(2)(b).
98. Treaty art. 11(3)(b).
100. Treaty art. 11(4).
101. Treaty art. 11(1) and (2).
country's own law. Moreover, the Treaty provisions do not apply to back-to-back loans or to interest paid to a resident of a Contracting State acting as a nominee for a third person who is not a resident of either Contracting State.101 Finally, if a nonresident recipient of interest has carried on a business through a permanent establishment or a fixed base in the taxing country, then interest attributable to such activity is taxed under the Treaty rules addressing business profits and income from personal services rather than under the interest withholding tax provisions of Article 11.102

I. ARTICLE 11A: BRANCH TAX

The U.S. imposes a 30% branch profits tax on the “dividend equivalent amount” of a foreign corporation engaged in a trade or business in the U.S., where the “dividend equivalent amount” is roughly equal to the taxable income of the branch, less income tax paid by the branch and less amounts retained in U.S. operations.103 The U.S also imposes a “branch-level interest tax” by withholding at a 30% rate on allocations of interest deductions to a U.S. branch in excess of interest actually paid.104 Mexico has neither a branch profits tax nor a branch-level interest tax. Article 11A of the Treaty, though phrased reciprocally, is intended to preserve the United States' ability to impose its branch profits tax and branch-level interest tax, albeit at lower rates and subject to certain additional restrictions.

The Treaty generally permits the U.S. to impose a branch tax at a maximum rate of 5% of business profits that are effectively connected with a U.S. trade or business and either attributable to a permanent establishment in the U.S. or attributable to income and gains on U.S. real property.105 This definition precludes the imposition of a branch profits tax on a Mexican corporation that conducts a trade or business in the U.S. but does not have permanent establishment in the U.S.

The U.S. will be permitted to impose its branch-level tax on interest at a rate of 10%, which rate is further limited after five years to 4.9% for investment and savings banks and insurance companies.106 The excess interest on which such tax may be imposed is limited to the excess of (i) the interest deductible in computing either profits attributable to a permanent establishment, capital gains, or real property that is taxed on a net basis over (ii) the interest paid by or from such permanent establishment or trade or business.107

M. ARTICLE 12: ROYALTIES

A Contracting State may impose withholding tax at a maximum rate of 10% on royalties paid to residents of the other Contracting State.108 The Treaty defines a “royalty” as a payment for the use of, or 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, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial,

102. Treaty art. 11(6).
103. See generally I.R.C. § 884.
104. See generally I.R.C. § 881.
105. Treaty art. 11A(2)(a).
106. Treaty art. 11A(2)(b).
107. Treaty art. 11A(2)(b).
108. Treaty art. 12(1).
commercial, or scientific experience as well as for the use of or the right to use industrial, commercial, or scientific equipment not constituting immovable property.”

The Treaty's reduction of withholding tax rates imposed on payments for various types of technical assistance will increase the impetus for a U.S. company to form a Mexican subsidiary to which it can sell such technical assistance. Indeed, in defining “information concerning industrial, commercial, or scientific experience,” the Protocol incorporates standards that recognize payments under contracts for “know-how” as payments for royalties, to the extent such payments are for the know-how itself rather than technical services necessary for its implementation.

The Treaty includes a specific sourcing rule for royalties, which provides that (i) royalties are deemed to arise in a country in which the payor is a resident or a Governmental Entity, but (ii) royalties borne by a permanent establishment or fixed base are deemed to arise in the country in which the fixed base or permanent establishment is located, and (iii) in any situation in which these rules do not source a royalty to a Contracting Country, any royalties for the use of, or right to use, property in either country will be sourced to such country.

In some situations, a U.S. resident who provides a royalty-producing intangible asset to a Mexican resident may suffer unfairly from the interaction of the Mexican assets tax, the Mexican income tax, and the U.S. income tax. The Mexican assets tax, by its terms, applies to tangible and intangible property furnished to Mexicans and for which the U.S. owner receives a royalty. However, if a U.S. owner of such property does not have a permanent establishment in Mexico, the U.S. owner might be subject to the assets tax but not Mexican income tax — the Mexican income tax can only be applied to a U.S. resident's business profits attributable to a permanent establishment, while the assets tax can be applied to assets furnished to a Mexican resident under circumstances that do not give rise to a permanent establishment. Under these circumstances, the U.S. owner would not receive a U.S. foreign tax credit for the Mexican assets tax, even though the tax is intended to serve as an alternative minimum income tax. Consequently, the Protocol specifies that Mexico will grant a credit against the Mexican assets tax for royalty-producing assets.

109. Treaty art. 12(3). The characterization of equipment leasing payments as royalties is a significant departure from standard U.S. treaty policy, which generally treats these payments as rents from personal property. See Senate Report at 72.
110. See McLees, Initial Thoughts, at 998.
111. Article 11 of the Protocol specifies that the phrase “information concerning industrial, commercial or scientific experience” is equivalent to a “transfer of know-how” as defined in paragraph 12 of the commentary to paragraph 12 of the Model Double Taxation Convention on Income and Capital promulgated by the Organization for Economic Co-Operation and Development, reprinted at 1 Tax Treaties (W.G.L.) 1017 (hereinafter OECD Model). The OECD model limits “know-how” to transfers of special knowledge and experience that is not publicly known. See del Castillo, Solano & Podrasky at 136.
112. Protocol para. 11.
113. Treaty art. 12(6).
114. See supra notes 13 to 15 and accompanying text.
115. See Treaty art. 7(1).
in an amount equal to the tax that would have been imposed on the royalties, calculated by applying the withholding rate specified in the Mexican Income Tax Law without regard to the Treaty (i.e., 15% or 35%).\textsuperscript{117}

If a nonresident royalty recipient has carried on business through a permanent establishment or a fixed base in the taxing country, then royalties attributable to such activity are taxed under the Treaty rules addressing business profits and income from personal services.\textsuperscript{118} The Treaty also grants authority to recharacterize the amount of royalty payments where a "special relationship" leads to other than an arm's-length amount of royalties.

\section*{N. ARTICLE 13: CAPITAL GAINS}

Article 13 of the Treaty specifies all of the circumstances under which a Contracting State is permitted to tax the capital gains of a nonresident. The provision permits the taxation without restriction of four types of property, subject to the nondiscrimination rules of Article 25.

A Contracting State may tax a nonresident's gain derived from the alienation of "immoveable property" located in such Contracting State.\textsuperscript{119} For these purposes, "immoveable property" includes real property; interests in a partnership, trust, or estate to the extent its assets consist of real property; an interest in a company treated as a legal resident of the Contracting State if at least 50% of the value of the assets of the company consist of real property; and "any other right that allows the use or enjoyment of immoveable property."\textsuperscript{120}

A Contracting State also is permitted to tax the gain derived from the disposition of personal property that was part of the assets of a permanent establishment or fixed base of a nonresident, even if realization of the gain is deferred until after the nonresident no longer has a permanent establishment or fixed base.\textsuperscript{121} However, Article 13(3) appears to prohibit the U.S. taxation under section 864(c)(7) of the Code of gain realized on the sale of an asset no longer used in a U.S. trade or business but sold within ten years of the cessation of use, since the asset's removal from the U.S. trade or business prior to sale would cause the gain on the sale to be not attributable to any past or present U.S. permanent establishment.\textsuperscript{122}

A Contracting State may tax a nonresident's gain from the sale of stock or other rights in a resident company, if the nonresident had at least a 25% interest in the capital of the resident company at any time during the twelve months preceding the sale.\textsuperscript{123} The Protocol clarifies that this tax may not be imposed with regard to sales of stock between members of an affiliated group of corporations, subject to certain conditions.\textsuperscript{124} This provision represents a compromise between the U.S., which does not tax nonresident sales of

\begin{itemize}
\item \textsuperscript{117} Protocol para. 3; see McLees, \textit{Initial Thoughts}, at 1002.
\item \textsuperscript{118} Treaty art. 11(6).
\item \textsuperscript{119} Treaty art. 13(1).
\item \textsuperscript{120} Treaty art. 13(2).
\item \textsuperscript{121} Treaty art. 13(3).
\item \textsuperscript{122} Phillips & Washlick at 40.
\item \textsuperscript{123} Treaty art. 13(4).
\item \textsuperscript{124} Protocol para. 13.
\end{itemize}
stock in U.S. corporations (other than U.S. real property holding corporations), and Mexico, which taxes either 20% of the gross proceeds of the sale by a nonresident or, if the nonresident has appointed a qualified representative in Mexico and certain other conditions are satisfied, 30% of the net gain.  

Gains described under the Treaty's royalty provisions, including royalties from the alienation of intangible property, must be taxed in accordance with Article 12.  

Consistent with Article 9 of the Treaty, gain derived from the alienation of ships, aircraft, and containers used primarily in international traffic only can be taxed in the Contracting State of the seller's residence. Finally, gain derived from the alienation of any other property not described in Article 13 of the Treaty is taxable only in the seller's state of residence.  

O. ARTICLE 14: INDEPENDENT PERSONAL SERVICES

A Contracting State may tax the income from personal services of a nonresident individual acting as an independent contractor (and not as an employee or "dependent agent") only if (i) the individual has a fixed base in the Contracting State that he uses regularly in performing the services, in which case the Contracting State may tax income attributable to such fixed base, or (ii) the individual is present in the Contracting State for a total of more than 183 days in a twelve month period, in which case the Contracting State may tax the income from personal services performed in the Contracting State during that period. "Personal services" for these purposes "includes especially scientific, literary, or artistic activities, educational or training activities, as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants." The Technical Explanation states that the U.S. and Mexico both understand the independent personal services provision to require taxation of personal service income in accordance with the "business profits" rule of Article 7. Thus, for example, such income should only be taxable net of expenses.  

P. ARTICLE 15: DEPENDENT PERSONAL SERVICES

A Contracting State may tax employment income derived by a nonresident to the extent the employee services are performed in the Contracting State unless (i) the employee is present in the Contracting State less than 183 days during a twelve month period; (ii) the wages are paid by, or on behalf of, an employer that is a nonresident of the Contracting State; or (iii) the wages are paid by an employer that is a resident of the Contracting State, and the services are performed in a different state of residence. Further, this rule is necessary to permit a U.S. corporation to report personal service income on a net basis, since Mexican tax law does not treat a personal services company as earning business profits. Protocol para. 14; Senate Report at 77-78.

125. Phillips & Washlick at 41. The U.S.'s agreement to this provision may presage the enactment of such a tax by the U.S. See Cass & Andersen at 200.  
126. Treaty art. 13(6).  
127. Treaty art. 13(5).  
128. Treaty art. 13(7).  
129. Treaty art. 14(1).  
130. Treaty art. 14(2).  
131. The Protocol also explains that Article 14 applies to income derived from a U.S. corporation providing personal services in Mexico through a fixed base. This rule is necessary to permit a U.S. corporation to report personal service income on a net basis, since Mexican tax law does not treat a personal services company as earning business profits. Protocol para. 14; Senate Report at 77-78.
State; and (iii) the wages are not "borne by" a permanent establishment or fixed base of the non-resident employer in the Contracting State. The latter two conditions are intended to ensure that a Contracting State does not allow an employer a deduction for compensation that is exempt from tax in such Contracting State. The provisions of Article 16 (Director's Fees), Article 19 (Pensions, Annuities, Alimony, and Child Support), and Article 20 (Government Service) override the general rule of Article 15.

Q. ARTICLE 16: DIRECTOR'S FEES

A Contracting State may tax directors' fees received by a nonresident for actions as a director or overseer of a resident company only if such services are performed outside the other Contracting State. "Overseer" refers to a non-manager shareholder advocate, such as are found in some Mexican companies. Thus, for example, Mexico can tax a U.S. resident for directors' fees received with regard to a directorship of a Mexican company only if such services are performed in some country other than the U.S. This rule ensures that the U.S. resident director will have foreign-source income against which to credit the Mexican income tax.

R. ARTICLE 17: LIMITATIONS ON BENEFITS

The Treaty contains detailed rules intended to limit its benefits to persons entitled to such benefits by reason of their residence in a Contracting State. The rules are specifically intended to eliminate "treaty shopping" whereby, for example, a third-country resident could establish an entity in a Contracting State and utilize the provisions of the Treaty to repatriate funds under favorable terms. To eliminate this potential abuse, the full benefits of the Treaty are available to only a specified class of persons, limited Treaty benefits are provided to an additional class of persons, and a facts and circumstances test provides discretion to make the Treaty provisions available to others.

Under Article 17(1) of the Treaty, the full benefits of the Treaty are available to any individual who is a resident of either Contracting State, to any Governmental Entity, and to any entity satisfying one of four tests: the "active business test," the "ownership/base erosion test," the "publicly-traded company test," or the "derivative benefit test" for NAFTA country residents.

Treaty benefits are available to an entity that is a resident of a Contracting State if it is engaged in the active conduct of a trade or business in its country of residence and the income derived from the other country is connected with or incidental to such trade or business. In the case of Mexico, "active trade or business" includes activities carried on through a permanent establishment as defined under Mexican tax law. The active trade...

132. Treaty arts. 15(1) and (2).
133. See Technical Explanation at 1623.
134. Treaty art. 15(1).
135. Treaty art. 16.
136. See Treaty art. 17(1)(a).
137. See Treaty art. 17(1)(b).
138. Treaty art. 17(1)(c).
139. Protocol para. 15(a).
or business rule does not apply to the business of making or managing investments, other than banking or insurance activities carried on by a bank or insurance company.

To qualify for the benefits of the Treaty under the ownership/base erosion test, a company must satisfy two requirements. First, the “ownership test” specifies that more than 50% of the beneficial interest in the company (including more than 50% of each class of stock) must be owned, directly or indirectly, by individual residents of the Contracting States, “publicly-traded companies” as described below, Governmental Entities, or certain “tax-exempt entities” as described below. Second, the “base erosion rule” requires that less than 50% of the gross income of the company be used, directly or indirectly, to meet liabilities (including interest and royalties) to persons other than those named with regard to the ownership test.

A company that is a resident of a Contracting State and the principal class of stock of which is traded on a recognized securities exchange, or a wholly owned subsidiary of such a publicly-traded company, will be entitled to the benefits of the Treaty. A “recognized securities exchange” includes the NASDAQ system, national securities exchanges under the Securities Exchange Act of 1934, stock exchanges authorized under the terms of Mexico’s Stock Market Law of January 2, 1975 (Mercado de Valores), and any other exchange designated by the competent authorities of the Contracting States.

The Treaty contains a special provision that modifies the benefit limitation requirements “to take into account the economic flows anticipated in the proposed free trade area.” Thus, a company that is resident of a Contracting State qualifies for full benefits under the Treaty if (i) it is owned entirely by companies that are residents of NAFTA countries (i.e., Mexico, the U.S., or Canada) and (ii) it is more than 50% owned by a Contracting State resident company that satisfies the general publicly-traded company definition.

The benefits of the Treaty also apply to a not-for-profit entity that is exempt from income tax in its Contracting State of residence, provided more than half of the members or beneficiaries of the entity are entitled to the benefits of the Treaty.

An entity that fails all of the foregoing tests for complete Treaty coverage nevertheless can qualify for the benefits of the Treaty described in Article 10 (Dividends), Article 11 (Interest), Article 11A (Branch Profits Tax), and Article 12 (Royalties) if it satisfies four conditions. First, more than 30% of the beneficial interest in the entity must be owned, directly or indirectly, by any combination of Contracting State individual residents, publicly-traded companies as described above, Governmental Entities, or tax-exempt entities as described above. Second, more than 60% of the beneficial interest in the entity must be owned, directly or indirectly, by persons resident in a NAFTA signatory country, as long as

140. The U.S. Model Treaty requires 75% ownership under its ownership test.
141. See Treaty art. 17(1)(d).
142. See Treaty art. 17(1)(f).
143. Treaty art. 17(1)(d).
144. Protocol para. 15(b).
145. Senate Hearings (Sessions Statement). See generally Cass & Andersen at 201-202 (discussing the breadth of the Treaty’s limitation of benefits principles).
146. Treaty art. 17(1)(d)(iii).
147. Treaty art. 17(1)(e).
148. See Treaty art. 17(1)(g).
149. Treaty art. 17(1)(g)(i).
such country has an income tax treaty with the country from which the income is derived and such treaty imposes no less favorable a rate on the item of income in question than does the Treaty.\textsuperscript{150} Third, no more than 70% of the gross income of the entity can be used, directly or indirectly, to meet liabilities (including interest and royalties) to persons other than persons constituting qualified owners under the first requirement.\textsuperscript{151} Finally, no more than 40% of the gross income of the entity may be used, directly or indirectly, to meet liabilities (including interest and royalties) to persons other than persons constituting qualified owners under the first requirement above and other residents of NAFTA countries.\textsuperscript{152}

The competent authority of a Contracting State in which income arises also may grant Treaty benefits to persons who cannot meet the above tests but who can demonstrate that they should be granted such benefits.\textsuperscript{153} The legislative history explains that "[t]his discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended treaty benefits."\textsuperscript{154}

S. \textbf{Article 18: Artistes [sic] and Athletes}

A Contracting State may without restriction tax remuneration of a nonresident athlete or performing artist or entertainer for personal services performed in such Contracting State.\textsuperscript{155} The provision extends to remuneration for personal services, such as endorsements, that are related to the entertainer or athlete's reputation.\textsuperscript{156} Moreover, the provision explicitly authorizes a tentative withholding of tax from all gross receipts of the entertainer or athlete subject to the filing of a refund claim in the event of over-withholding, and the rule applies to an entity to which income from the performance of an athlete or artist accrues unless the athlete or artist does not participate, indirectly or directly, in the profits of such entity.\textsuperscript{157} The Article does not apply to athletes and artists with gross foreign-source remuneration of $3,000 or less (the U.S. Model Treaty calls for $20,000), nor does it apply to athletes or artists whose visits are substantially supported by public funds of a Governmental Entity of their country of residence.\textsuperscript{158}

T. \textbf{Article 19: Pensions, Annuities, Alimony, and Child Support}

Article 19 of the Treaty provides three basic rules. First, private pensions and annuities in consideration of past employment can be taxed only by the country of residence of the recipient.\textsuperscript{159} Second, social security benefits or other public pensions paid by a govern-
ment of one Contracting State to a resident of the other Contracting State may be taxed only by the Contracting State paying the pensions. Because this rule prevents a Contracting State's taxation of its own residents, it is an exception to the general savings clause of Article 1(3). Finally, alimony and child support payments may only be taxed by the country of residence of the payor. This rule also is an exception to the savings clause.

**U. ARTICLE 20: GOVERNMENT SERVICE**

Article 20 provides three rules governing compensation paid by a Governmental Entity. First, employment compensation paid by a Governmental Entity, other than a pension, generally is exempt from taxation by the other Contracting State. However, such compensation is taxable by the non-payor Contracting State if (i) the services are rendered in such Contracting State and (ii) the individual is a resident of such Contracting State who either is a national of the Contracting State or did not become a resident solely to render the services. Second, pensions paid by a Governmental Entity in respect of past services generally are taxable only by the payor Contracting State. However, pensions are taxable only by the other Contracting State if the recipient is both a resident and a national of such Contracting State. Finally, the special rules of Article 20 do not apply to compensation paid by a Governmental Entity in respect of commercial or industrial activity, as opposed to governmental functions. For example, a Mexican resident who works for a Mexican state-owned commercial bank in the U.S. would be taxable by the U.S. on wage income under Article 15 (rather than exempt from U.S. taxation under Article 20(1)).

**V. ARTICLE 21: STUDENTS**

A Contracting State cannot tax payments for maintenance, training, or education that (i) are from sources outside its borders and (ii) are to a student or apprentice in such Contracting State for the purposes of education or training if (iii) such student is, or was in the immediate past, a resident of the other Contracting State. The Treaty does not address the treatment of nonresident teachers and researchers, which is an unusual omission for a modern tax treaty.

**W. ARTICLE 22: EXEMPT ORGANIZATIONS**

Article 22 of the Treaty provides for reciprocal recognition of tax-exempt organizations, both in terms of providing an exemption from tax on income and providing for the
deductibility of contributions. This provision, which is likely to prove very important in increasing the flow of charitable donations from the U.S. to Mexico, is found in very few treaties. The inclusion of this provision in the Treaty is largely attributable to the substantial cross-border flow of charitable contributions between the countries, the substantial coordination of the countries’ taxing authorities, and the similarity of the countries’ definitional standards for exempt organizations (Mexico, in fact, adopted the U.S. standards). The provision is an exception to the savings clause of Article 1 because, in certain respects, it supersedes each Contracting State’s laws regarding the taxation of its residents.

Each Contracting State will exempt from taxation items of income of an organization that is a resident in the other Contracting State if such organization (i) is operated exclusively for religious, scientific, literary, educational, or other charitable purposes, (ii) is exempt from tax in its country of residence, and (iii) the item of income in question would be exempt from tax if received by a tax-exempt resident organization of such Contracting State (e.g., an item of income to a Mexican charitable organization would not be an item of unrelated business taxable income under U.S. domestic tax law). Paragraph 17(a) of the Protocol provides that the competent authority of each Contracting State generally will accept the certification of the competent authority of the other Contracting State that an organization qualifies under this provision for exemption, which makes the provision self-executing.

If the U.S. and Mexico agree that provisions of Mexican law creating standards for determining organizations eligible to receive deductible contributions are equivalent to U.S. law requirements for “public charities,” then an organization determined by Mexican authorities to meet such standards will be treated as a public charity under U.S. law for purposes of contributions by U.S. private foundations and public charities. Thus, for example, a U.S. private foundation will not have to exercise “expenditure responsibility” within the meaning of section 4945 of the Internal Revenue Code with regard to a grant to such Mexican organization.

In general, contributions by a U.S. citizen or resident to a Mexican organization meeting Mexican law “public charity” standards referenced in the preceding paragraph will be treated as charitable contributions to a public charity under U.S. law, which generally will cause such contributions to be deductible for U.S. income tax purposes. Such contributions, however, will not be deductible to the extent they exceed U.S. limits on the deductibility of charitable contributions to public charities as applied to the U.S. resident’s income from Mexican sources. U.S. limitations on deductibility include the percentage and other limitations under section 170 of the Code and the overall limits on itemized contributions.

170. See Senate Hearings (Sessions Statement); Taxleads, BNA Daily Report for Executives, Dec. 21, 1992, at 245.
171. Treaty art. 22(1).
172. See I.R.C. § 509(a) (defining public charities, i.e., organizations described in section 501(c)(3) of the Code that are not classified as “private foundations”).
173. See Treaty art. 22(2)(a).
174. Treaty art. 22(2)(b).
175. Treaty art. 22(2).
deductions under section 68 of the Code. Reciprocal provisions apply to contributions from Mexican residents to U.S. public charities if the Contracting States agree that U.S. standards for designating public charities are equivalent to Mexican standards for determining organizations eligible to receive deductible contributions.

Paragraph 17(b) of the Protocol incorporates a significant agreement that, except for churches or conventions of churches, ITA Article 70-B and sections 509(a)(1) and (a)(2) of the Code, as interpreted by administrative regulations and rulings and as in effect on the date of the signing of the Treaty, provide equivalent standards for organizations within their coverage. Thus, existing determinations by the competent authorities of each country as to public charity status became binding on the other country when the Treaty went into effect.

Chapter 42 of the Internal Revenue Code imposes a host of excise taxes on “private foundations,” which are a subset of organizations exempt from tax under section 501(c)(3) of the Code. The Treaty provides that charitable organizations that are resident in Mexico and that received substantially all their support from non-U.S. sources are not subject to the U.S. excise taxes on private foundations.

X. ARTICLE 23: OTHER INCOME

A Contracting State retains the right to tax any income of a nonresident arising in such country and not otherwise addressed by the Treaty. Examples of such income include lottery winnings, punitive damages, and cancellation of indebtedness income. This type of source-based residual provision is beneficial to Mexico since Mexico is a net importer of capital and services.

Y. ARTICLE 24: RELIEF FROM DOUBLE TAXATION

Article 24 attempts to safeguard one of the Treaty’s primary functions: prevention of double taxation of income. The Contracting States generally have agreed to allow residents (and, in the case of the U.S., citizens) a credit against income tax for income taxes paid to the other Contracting State. The credit extends to “indirect income taxes,” i.e., a Contracting State must allow a credit for income taxes paid by a subsidiary to the other Contracting State on profits distributed to a resident owner of at least 10% of its voting stock. “Income taxes” for this purpose also includes a “profits tax imposed on distributions,” such as the Mexican company-level tax on distributions from untaxed earnings, but

176. See Senate Report at 89.
177. See Treaty art. 22(3).
178. The Treaty does not address a Contracting State’s right to tax income of a resident of the other Contracting State that arises in a third country but is taxable under the Contracting State’s laws. See Cass & Andersen at 200.
179. See Senate Report at 90.
180. Phillips & Washlick at 60.
182. Treaty art. 24(1)(b).
only to the extent the tax is imposed on a distributee's "earnings and profits," as calculated under the law of the recipient. 183

The Treaty permits each Contracting State to apply domestic law limitations on credits for income taxes paid to the other Contracting State. 184 The U.S., therefore, can impose the limitations of section 904 of the Code on credits for Mexican taxes, and Mexico can impose its overall limitation on credits for U.S. income taxes. 185

Generally, income that may be taxed in a Contracting State under the Treaty must be sourced to that Contracting State. 186 This rule is inapplicable, however, to any divergent domestic law sourcing rules that apply for purposes of limiting the foreign tax credit. 187 Capital gains are excepted from the application of domestic sourcing rules, although the capital gains rule of Article 13(4) provides its own sourcing rules to prevent double taxation. 188

If a U.S. citizen who is a resident of Mexico earns income that would be subject to reduced or no tax under the Treaty if such Mexican resident were not a U.S. citizen, then Mexico may limit the credit for U.S. taxes to the amount permitted under the Treaty. However, the U.S. is required to provide a credit for any Mexican tax attributable to the disallowance of such credit and to re-source the item of income, as necessary, to avoid double taxation. 189

If the Treaty provides an exemption for income of a Mexican resident, Mexico agrees to use an exemption rather than a credit to avoid double taxation; however, Mexico is allowed to take into account the resident's entire income, including that which is exempt, in computing the tax rate to apply to the taxable portion of the income. 190

Z. ARTICLE 25: NON-DISCRIMINATION

The Treaty imposes nondiscrimination requirements applicable to "all taxes of every kind imposed at the national, state, or local level," generally preventing either Contracting State from discriminating by imposing other or more burdensome taxes (or related requirements) on nationals of the other country than it would impose on its own national under like circumstances. 191 For these purposes, persons who are and who are not, respectively, taxed on their world-wide income by a Contracting State are not considered in like circumstances.

Neither Contracting State may tax a permanent establishment of an enterprise of the other country less favorably than it would tax a domestic enterprise carrying on the same

183. Treaty art. 24(1); see Technical Explanation at 1628 (explaining that the "earnings and profits" limitation is to ensure that the creditable tax is a tax on income pursuant to U.S. tax principles).
184. Treaty art. 24(1).
185. See Phillips & Washlick at 62.
186. Treaty art. 24(3).
187. See Phillips & Washlick at 63-64 (noting that all domestic sourcing rules apply to limit the foreign tax credit, and thus speculating that only domestic sourcing rules applicable primarily or solely for such purposes should supersede the Treaty rules).
188. Treaty art. 24(3).
189. Treaty art. 24(4); see Technical Explanation at 1628 (providing example).
190. Treaty art. 24(2); Senate Report at 93.
191. Senate Report at 94.
activities, although this nondiscrimination requirement does not require a country to grant a resident of the other country any tax benefits based on civil status or family responsibilities.\textsuperscript{192} Each Contracting State also must grant to its residents a right to deduct payments to a nonresident for interest, royalties, and other disbursements (including allocable administrative, research and development, and similar expenses) to the same extent as if such amounts had been paid to a resident.\textsuperscript{193} These nondiscrimination rules, however, do not prevent either country from imposing a branch profits tax or branch-level interest tax, nor do the rules prevent Mexico from denying a deduction for presumed expenses to a U.S. resident electing to be taxed on a net basis on income from real property.\textsuperscript{194}

A Contracting State cannot discriminately tax an enterprise the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of the other Contracting State. This rule does not prohibit the U.S. from taxing the liquidating distributions of a U.S. subsidiary of a Mexican parent or restricting the use of small business corporations to U.S. citizens and certain U.S. residents.\textsuperscript{195}

\textbf{AA. ARTICLE 26: MUTUAL AGREEMENT PROCEDURE}

The Treaty provides relatively detailed procedures for attempting to resolve disputes with regard to the application and interpretation of the Treaty. These procedures, which may be invoked by a resident of a Contracting State, provide for resolution of issues through mutual agreement or through binding arbitration.\textsuperscript{196}

\textbf{AB. ARTICLE 27: EXCHANGE OF INFORMATION}

The Treaty incorporates by reference the Information Exchange Agreement discussed below and provides a bare-bones substitute provision to apply in the event of a termination of the Information Exchange Agreement.\textsuperscript{197}

\textbf{AC. ARTICLE 28: DIPLOMATIC AGENTS AND CONSULAR OFFICES}

Article 28 preserves for diplomatic agents or consular officials any fiscal privileges that may exist under international law or special agreements.

\textsuperscript{192} Treaty art. 25(2).
\textsuperscript{193} Treaty art. 25(4).
\textsuperscript{194} Treaty art. 25(3).
\textsuperscript{195} Treaty art. 25(5).
\textsuperscript{196} See Senate Hearings (Sessions Statement)(noting that the binding arbitration provision, which is based on the U.S-Germany income tax treaty, represents a fairly new and practical alternative to the traditional competent authority mechanism for resolving disputes). The availability of mutual agreement procedures may prove particularly valuable to U.S. companies that are targeted under Mexico's new transfer-pricing initiatives. See del Castillo, Solano & Podrasky at 126; supra text accompanying notes 67 to 77.
\textsuperscript{197} On September 12, 1994, the U.S. and Mexico signed a Protocol modifying Article 27 of the Treaty to cause it to conform to amendments to the Information Exchange Agreement. See infra note 202.
AD. Article 29: Entry into Force

The United States and Mexico exchanged instruments of ratification with regard to the Treaty in the last week of December, 1993. Consequently, under Article 29, the Treaty entered into force on January 1, 1994. The Treaty terminated and superseded the existing Convention Between the United States of America and the United Mexican States for the Avoidance of the Double Taxation of Income Derived from the Operation of Ships or Aircraft in International Traffic.198

AE. Article 30: Termination

The Treaty will remain in force until terminated by one of the Contracting States.199 Either Contracting State may terminate the Treaty at any time after five years from the date on which it enters into force, provided such Contracting State gives at least six months notice of termination.200 Because of Mexican fears that the U.S. legislature would enact laws inconsistent with Treaty provisions, the Protocol permits unilateral termination prior to the five year minimum period if one Contracting State applies its law in a fashion that eliminates or significantly limits a benefit of the Treaty and the Contracting States cannot resolve the problem through diplomatic channels.201

II. Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes

On November 9, 1992, the U.S. and Mexico signed the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes (the Information Exchange Agreement), which went into effect on January 18, 1990. The Information Exchange Agreement binds the U.S. and Mexico to exchange tax information helpful for the administration and enforcement of their respective tax laws.202 In Barquero v. United States,203 the United States Court of Appeals for the Fifth Circuit found that the Information Exchange Agreement was the "law of the land" and was not unconstitutional. Consequently, the Internal Revenue Service could utilize its administrative summons power to obtain information requested by Mexico under the Information Exchange Agreement.

198. See Treaty art. 29(3).
199. Treaty art. 30(1).
200. Id.
202. See generally Senate Report at 99 (providing a detailed discussion of the provisions and operation of the Information Exchange Agreement). On September 8, 1994, the U.S. and Mexico signed a Protocol that modified the Information Exchange Agreement (i) to cause it to apply to taxes imposed by states or other political subdivisions of the U.S. or Mexico and (ii) to require the U.S. and Mexico to apply their respective taxpayer privacy laws to information obtained under the Information Exchange Agreement.
203. 18 F.3d 1311 (5th Cir. 1994).
Appendix: Summary of the Mexican Tax Law

The Treaty was negotiated based upon, and in part supplants, existing U.S. and Mexican tax laws with respect to the matters covered in the Treaty. Consequently, a basic understanding of the tax law of Mexico is necessary to understand the Treaty's effects and significance.

A. Mexican Income Taxes

Mexico imposes an income tax on (i) resident companies, (ii) resident individuals, and (iii) "permanent establishments" of nonresident companies.

1. Taxation of Mexican Entities

Mexico imposes an income tax at a flat rate of 34% on the worldwide income of companies that are residents of Mexico.204 An entity is considered to be "resident" in Mexico if the entity's business is principally administered in Mexico.205 Under Mexican law, an entity's principal administration is located where the directors or administrators exercise management and control; however, a rebuttable presumption exists that legal entities established under Mexican law are resident in Mexico.206

With one limited "conduit" exception, the Mexican organizational forms, even those corresponding to partnerships under U.S. law, are separately taxable entities.207 The Mexican tax law's taxation of all businesses on an entity-by-entity basis eliminates the importance often attached to entity characterization under United States tax law (e.g., partnership vs. corporation classification). Moreover, the Mexican tax law's entity-based tax system encourages the use of the corporate form to the exclusion of other forms, because, unlike in the United States, no tax advantage offsets the disadvantages, such as unlimited liability or limited transferability of interests, that may attend the use of other forms.208

204. See ITA arts. 1 and 10.
205. ITA art. 1; Codiga Fiscal de la Federacion, arts. 9 and 15 (hereinafter Federal Fiscal Code, or FFC).
207. See generally Ley General de Sociedades Mercantiles (the General Law of Mercantile Societies).
208. There are six basic Mexican organizational forms. First, The Sociedad Anonima, or corporation, is a separate legal entity in which shareholders' liability is limited to their investment of capital in the corporations. Most foreign investors select this organizational form. Second, the Sociedad Anonima de Capital Variable, or corporation with variable capital, is identical to an ordinary Mexican corporation except that it does not have to amend its Articles of Incorporation or secure certain governmental approvals to change its capital structure. Third, the Sociedad de Responsabilidad Limitada, or limited liability company, rarely used by foreign investors, limits investors' liability to capital investment but restricts the transferability of investors' interests. Fourth, the Sociedad en Nombre Colectivo, or partnership, rarely used by either Mexicans or foreigners, is similar to a general partnership in the U.S. — each partner is jointly and severally liable for the partnership's debts. This entity and the limited partnership described below are used most frequently when foreign and domestic investors want to create a Mexican entity that will be taxed on a flow-through basis by another taxing jurisdiction. Fifth, the Sociedad en Comandita, or
Mexican tax law applies several computational principles that are not found (or are found only in modified form) in U.S. tax law to determine net taxable income. Among other requirements, Mexico requires that business expenses must be strictly indispensable to the conduct of a business activity before such expenses will be deductible. The doctrine of indispensability became an added legal requirement in 1974 as a reaction to a widespread practice of deducting as business expenses items of conspicuous personal consumption. Consequently, although the doctrine narrowed the deductibility of business expenses compared to prior Mexican law, the standard may not be a great deal more restrictive than the "ordinary and necessary" requirement of section 162 of the Code.

Unlike the U.S., Mexican tax law does not subject inventories to special treatment; rather, all purchases of raw materials and inventories and costs of production are treated as deductible expenses when incurred. On the other hand, Mexico recently enacted provisions setting forth specific rules governing the taxation of financial derivative products, such as foreign currency futures and transactions in commodities traded on futures markets.

Mexican taxpayers must compute an inflationary loss by multiplying financial assets by increases in a price index. The inflationary loss reduces the amount of recognized interest or foreign exchange income or, if in excess of such income, creates a deductible loss.

Note 208, continued
Limited Partnership, like limited partnerships in the U.S., has one or more general partners with joint and several liability and limited partners whose liability is limited to their investment. There are two subcategories of limited partnerships: the Sociedad en Comandita Simple, in which all investors hold partnership interests (limited or general), and the Sociedad en Comandita por Acciones, in which all partners' interests are represented by shares and limited partners' shares (but not general partners' shares) are freely alienable. Once again, these entities are rarely used. Finally, the Asociacion en Participacion, or joint venture contract, is not a legal entity per se, but rather a recognized contractual arrangement that permits an association of two or more parties for a specific project. This entity is treated as a conduit for Mexican tax purposes, though under certain circumstances, one joint venturer may be liable for unpaid Mexican federal income tax liability of another. See ITA art. 8. Unlike the United States, Mexico does not require that allocations of income and loss from a joint venture must have substantial economic effect, which permits the use of a joint venture to shift and allocate income to meet the participant's tax needs. See Castillo, Reyes, & Solano, Tax Planning Opportunities for U.S. Business in Mexico, 21 Tax Mgmt. Int'l. J. 131, 135 (1993).

209. ITA art. 24, para. 1.
210. See Foreign Tax Law Association, Inc., 3 Tax Laws of the World: Mexico 28 (rev. ed. Sept. 1993)(noting, for example, that expenses for business entertainment, subscriptions to newspapers, and advertising are deductible under the "strictly necessary" standard; "country homes" and "an indeterminate number of high-priced automobiles" are not).
211. See 972 Tax Mgmt. (BNA) 313, Tax Management Foreign Income Portfolios: Business Operations in Mexico (Apr. 6, 1992).
212. Generally, debt derivatives give rise to accruable or deductible interest, while capital derivatives are taxed analogously to capital gains. See ITA arts. 7-D, 18-A, & 135. It is unclear whether the Treaty's capital gains provisions will apply to capital derivatives. See L.M. Perez de Acha, Mexico Amends Tax Legislation to Reflect Increased Global Trade, NAFTA, 8 Tax Notes Int'l 623, 624 (1994).
213. See ITA arts. 7-A to 7-B.
Taxpayers are required to compute inflationary gains by periodically multiplying the balance of their liabilities by increases in a price index. The taxpayers must subtract this inflationary gain from otherwise deductible accrued interest expenses and foreign exchange losses, deducting the net expenses or including the excess of any inflationary gain in income.

A Mexican taxpayer may elect either to deduct the cost of a new fixed asset on a straight-line basis or to deduct a designated percentage of the cost of the asset in the year the asset is placed in service.\(^{214}\) The amount of the one-time deduction is calculated to approximate the present value of the otherwise available straight-line depreciation deductions.\(^{215}\) Net operating losses may be carried forward five years (adjusted for inflation) but may not be carried back.\(^{216}\)

Distributions by a Mexican company, including corporate dividends or partnership distributions, are exempt from further tax, i.e., such distributions do not constitute taxable income to the recipient.\(^{217}\) However, to prevent the use of this rule as a means of excluding net income from tax entirely, a Mexican business entity is subject to a 34% tax on the gross amount of any distributions in excess of the company's after-tax earnings account (cuenta de utilidad fiscal neta, or CUFIN), which is similar to the earnings and profits of a corporation under U.S. tax law.\(^{218}\)

Mexico grants a foreign tax credit for income tax paid in foreign countries on foreign-source income subject to Mexican income tax.\(^{219}\) In addition, a Mexican resident is granted a credit, in proportion to dividends or distributions from a nonresident, for foreign taxes paid by a nonresident entity in which it owns a capital interest of at least 10%.\(^{220}\)

A group of entities may elect to be taxed on a consolidated basis if they secure prior authorization from the Ministry of Finance and Public Credit. The controlling entity must be a resident of Mexico and no more than 50% of its voting interests may be held by companies that are resident in countries with which Mexico does not have a broad treaty for the exchange of tax information.\(^{221}\)

214. Some Mexican straight-line depreciation periods are relatively rapid. Trucks, trailers, automobiles, and buses are depreciable over four years, and pollution control equipment is depreciable over two years. ITA arts. 44 para. VI & X and 138 para. III.

215. See ITA arts. 41 and 51.

216. ITA art. 55.

217. ITA art. 10-A.

218. See ITA art. 120. Because the cost of acquiring inventory is deductible for Mexican income tax purposes, a company's CUFIN account may be low in relation to GAAP income or U.S. taxable income in the company's early years.

219. Under the most recent amendments to the Mexican Tax Code, entities and individuals may claim a credit equal to 34% of foreign-source taxable income, where such income is calculated in accordance with the income tax laws of Mexico rather than those of the foreign country. See L.M. Perez de Acha, supra note 212.

220. ITA art. 6.

221. See generally ITA art. 57; Labrador & Browne at 9.
A final point, particularly important from a transaction-planning standpoint, is that Mexico, unlike the U.S., requires taxpayers to recognize gain on the contribution of assets to a controlled entity. Consequently, a Mexican company contributing assets to a joint venture formed with a U.S. company could be forced to recognize gain. To avoid this result, the U.S. company, which would not be subject to the Mexican gain-recognition requirement, should contribute capital in exchange for an ownership interest in the existing Mexican entity. The feasibility of this structure, however, may be limited if the Mexican company is subject to potential liabilities or carries unwanted assets. In that event, a further alternative might be to cause the Mexican company to contribute capital and personnel to a Mexican joint venture to which the Mexican company leases the desired assets. The economics of this arrangement, however, may prove different from the other alternatives.

2. Taxation of Mexican Resident Individuals
Mexico imposes an income tax at graduated rates of up to 35% on the worldwide income of individuals who are residents of Mexico. "Resident" is presumed to include all Mexican nationals, subject to proof to the contrary. The income tax also includes foreign nationals who maintain a home in Mexico, unless they are resident in another country for more than 183 days and can prove tax residence in that other country. Although individuals are subject to many of the same rules as business entities in computing taxable income, a number of principles apply specifically to individuals. For example, individuals compute capital gains and losses subject to special rules, individuals need not recognize gain on the sale of their principal residence, individuals are granted deductions for certain personal expenses, and individuals' financial derivatives transactions are subject to special rules.

3. Taxation of Permanent Establishments of Foreign Entities
Mexico also imposes an income tax on net income attributable to a permanent establishment of a foreign company. A "permanent establishment" is broadly defined as "any place of business in which business activities are carried out partially or totally" in Mexico, including branches, offices, agencies, factories, workshops, installations, mines, or quarries. Permanent establishments also include a "fixed base," defined as any place in Mexico at which independent self-employment services of a scientific, literary, artistic,

222. See I.R.C. § 351. Mexican law also provides that transfers of assets pursuant to mergers or spin-offs are subject to the general tax law provisions governing dispositions of assets. See ITA art. 5A.
223. FFC art. 74.
224. See generally ITA tit. IV (concerning taxation of individuals); see also ITA art. 122 (exempting dividends received by individuals from income).
225. Subject to limited exceptions, however, Mexico imposes withholding tax at the source on a gross basis on Mexican-source income that is not attributable to a permanent establishment. See infra note 239 and accompanying text.
226. ITA arts. 1 and 2.
educational, pedagogical or professional nature are rendered.\textsuperscript{227} The presence of a joint venture (as defined by Mexican law) in Mexico will result in a permanent establishment for each nonresident participant if any joint venturer carries on activities that, if carried on by a nonresident, would give rise to a permanent establishment.\textsuperscript{228}

A nonresident company, even without any place of business in Mexico, can have a permanent establishment as a result of activities carried out by third-party individuals or entities. Under Mexican law, a variety of specifically enumerated acts by a third-party representative on behalf of a nonresident will lead to a permanent establishment.\textsuperscript{229} The rationale for treating these third-party activities as creating a permanent establishment is that, according to the theory of representation, the nonresident is executing juridical acts in Mexico through an agent, and therefore is developing economic activity in Mexico.\textsuperscript{230}

On the other hand, acts by independent agents for arm's-length consideration generally will not give rise to a permanent establishment.\textsuperscript{231} Moreover, a nonresident may carry out certain designated activities without creating a permanent establishment: the use or maintenance of installations for storage or exhibition of goods; the use or maintenance of facilities for storage or exhibition of goods to be processed by another; the use of a place of business to buy goods or obtain information; the use of a facility to carry on preliminary or auxiliary activities such as advertising, research, or preparation for the arrangement of loans; and the physical deposit of goods in a general deposit warehouse.\textsuperscript{232}

The three categories of income considered "attributable to" a permanent establishment are income resulting from the business activities of the permanent establishment; a portion of the Mexican-source income of any foreign operations of a nonresident company (e.g., a home base) equal to the proportion that the Mexican permanent establishment shared in the expenses associated with the creation of such income; and income from any sales of personal or real property in Mexico by a nonresident corporation having a permanent establishment in Mexico, irrespective of whether such sales are through the permanent establishment or through the nonresident company's other operations.\textsuperscript{233}

\textsuperscript{227} ITA art. 2.  
\textsuperscript{228} ITA art. 2.  
\textsuperscript{229} ITA art. 2 specifies that a permanent establishment arises when a third-party representative (i) has power to execute contracts on behalf of the nonresident; (ii) maintains inventories in Mexico to fill orders for the nonresident; (iii) assumes risks on account of the nonresident; (iv) acts pursuant to detailed instructions or under the general control of the nonresident; (v) engages in activities in Mexico that belong economically to the nonresident and with respect to which the third person has no power to act in an independent manner; and (vi) receives compensation that is guaranteed regardless of results.  
\textsuperscript{230} See E. Nicolau, \textit{Mexican Taxes on Foreign Investment and Trade}, 12 Hous. J. of Int'l L. 265, 268-71 (1990). Historically, the Hacienda did not try to interpret strictly the broad Mexican law definition of a permanent establishment. For U.S. residents, the issue may be moot since the Treaty has superseded the Mexican law definition. See K. Matthews, \textit{Conference Focuses on Recent Mexican Tax Developments}, Tax Notes Int'l, July 26, 1993, at 231, 232-33.  
\textsuperscript{231} ITA art. 2; see L. Perez de Acha, supra note 217, at 623.  
\textsuperscript{232} ITA art. 3.  
\textsuperscript{233} See ITA art. 4.
attributable to a Mexican permanent establishment generally is taxed at a rate of 34% under the same computational provisions applicable to the income of a resident company subject to certain qualifications. A Mexican permanent establishment may deduct all expenses incurred outside Mexico relating to the permanent establishment’s business activities in Mexico, including an appropriate allocation of home office expenses for the Mexican operations. A Mexican resident taxpayer, however, cannot deduct expenses incurred abroad and allocated to the Mexican resident taxpayer by a company that is not subject to Mexican income tax.

A permanent establishment also faces a potential tax on the repatriation of earnings. Permanent establishments in Mexico must maintain "remittance accounts," calculated as the permanent establishment’s unremitted net after-tax earnings account increased by remittances from related foreign offices and decreased by remittances to related foreign offices. A permanent establishment must pay a tax equal to 34% of the gross amount by which remittances to related foreign offices exceed the balance of this account, multiplied by 1.515. This tax ensures that amounts earned in Mexico and distributed to related foreign offices are subjected to Mexican income tax.

B. MEXICAN WITHHOLDING TAXES

Many nonresident companies conduct economic activities in Mexico yet lack sufficient contacts to establish a permanent establishment that brings them within the Mexican income tax regime. Most Mexican-source income that is paid to nonresidents but that is not attributable to a permanent establishment is subject to a withholding tax at the source, which must be collected and remitted by the Mexican payor to the Mexican tax authorities.

Dividends paid out of earnings that have been subjected to Mexican income tax are not subject to a withholding tax; however, dividends paid out of earnings that have not been subjected to a Mexican income tax are subject to a withholding tax of 35%. Most loans from a Mexican company to a foreign shareholder are treated as dividends.

Interest income is sourced to Mexico if it is paid with respect to a debt the principal of which is used to fund activities within Mexico. The law creates a rebuttable presumption that the principal of a loan is used in Mexico if the debtor is a Mexican resident or a permanent establishment in Mexico. Through December 31, 1995, the temporary withholding tax rates are (i) 4.9% on interest paid to foreign banks and certain financial insti-

234. See ITA art. 1
235. ITA art. 23. Note, however, that claiming deductions for such allocations will increase the portion of the home office’s Mexican-source income attributed to the permanent establishment.
236. ITA art. 25, para. XIX.
237. See ITA art. 152.
238. See Labrador & Browne at 8.
239. ITA tit. V.
240. ITA art. 152.
241. ITA art. 120 para. IV.
242. ITA art. 154.
tutions; (ii) 10% on interest paid by Mexican financial institutions to foreign creditors and on interest on acquisition indebtedness with regard to machinery and equipment that become part of a Mexican purchaser's fixed assets; and (iii) 35% on other interest. A flat withholding rate of 4.9% applies to interest payments to foreign banks and certain financial institutions.

Royalties and technical assistance payments are sourced to Mexico if the intangible asset for which payment is made is used in Mexico. The law creates a rebuttable presumption that intangible asset payments from a resident company or permanent establishment are for intangible assets used in Mexico. The withholding tax rate is 15% for technical assistance fees and royalties for the use of models, plans, formulas, know-how, copyrights, artistic, literary, and scientific works, and movie, television, and radio rights. The rate is 35% for royalties for the use of patents, trademarks, trade names, and publicity.

Fees from construction activities are subject to a 30% withholding tax. Nonresident companies are not considered to have a permanent establishment as a result of participation in a construction project in Mexico that lasts less than 183 days (and thus their fees are subject to the 30% withholding tax). Such nonresident companies, however, may elect to be treated as having a permanent establishment as a result of their construction activities, resulting in taxation on a net income basis. Mexican law allows companies engaged in construction that are taxed on a net basis to deduct construction-related expenses wherever incurred.

Most rental income from personal property is subject to a withholding tax rate of 21%, while rental income from real property is subject to a withholding tax of 35%. For sales of real estate, a nonresident may elect to pay either a withholding tax of 20% on the gross proceeds of the sale or a tax equal to 30% of the net gain from the sale.

Income from any sale of the stock of a Mexican corporation is considered Mexican source, even if, for example, the sale occurs between nonresidents. A nonresident seller is afforded an election between a withholding tax of 20% on the gross proceeds of the sale or a tax equal to 30% of the net gain.

Nonresident individuals are also subject to withholding taxes in Mexico on income derived from Mexican sources, and generally are subject to the same rates and calculation principles that apply to nonresident companies. Salaries and other compensation for services performed in Mexico are (i) exempt from withholding tax up to $11,250 per year, (ii)...

243. ITA art. 154; see L.M. Perez de Acha, supra note 219, at 625. 244. This low rate is intended to encourage U.S. banks to make loans to Mexican borrowers. See J. McLees, Mexico To Implement Interest Withholding Tax Reduction and Other Tax Changes, Tax Notes International, October 25, 1993, at 1015-16 (hereinafter McLees). 245. ITA art. 156. 246. Id. 247. See ITA art. 156. 248. ITA art. 157. 249. See ITA art. 157. 250. ITA arts. 148 and 149. 251. ITA art. 150. 252. ITA art. 151.
are subject to a withholding tax of 15% for amounts between $11,250 and $90,000 per year, and (iii) are subject to a 30% withholding tax for amounts in excess of $90,000. For these purposes, directors' and administrators' fees paid by a Mexican company are considered derived from Mexican sources irrespective of the place of performance of the services.

C. OTHER MEXICAN TAXES

1. Tax on Assets

Mexico imposes an annual asset tax, which is intended to approximate a company's minimum appropriate income tax and which can be offset by income taxes actually paid. The tax is calculated as 2% of the gross value of (i) the business assets of resident business enterprises; (ii) assets attributable to permanent establishments of nonresident business enterprises; (iii) assets owned by nonresidents that are used by Mexican resident taxpayers; and (iv) inventories maintained by nonresidents in Mexico that are to be transformed (i.e., processed) for the Mexican market by a taxpayer who is subject to the tax on assets. Financial institutions and certain other limited classes of taxpayers are exempt from this tax. Companies must file an annual return within three months of the end of their fiscal year; individuals must file an annual return between February and April of the fiscal year following the close of their own.

The tax on business assets is imposed on most assets used in a trade or business in Mexico, including financial assets, deferred charges and expenses, inventory, machinery and equipment, buildings, and land. As indicated above, the tax is imposed on the assets' gross value and a taxpayer's liabilities do not decrease the tax base for imposition of the tax.

Mexican income tax payments are creditable against the tax on assets. Moreover, if a taxpayer's Mexican income tax for a year exceeds the tax on business assets, the taxpayer can carry the excess back for up to ten years and receive a refund for prior payments of the tax on business assets (i.e., prior years' asset taxes that were not offset by prior years' income tax liability).

253. ITA art. 145.
254. Because the tax on business assets is not an "income tax," the U.S. does not grant a foreign tax credit to U.S. residents for the tax. See Rev. Rul. 91-45, 1991-2 C.B. 336 (holding that the tax on assets is not a creditable foreign income tax, and reasoning that the interaction of the Mexican federal income tax and the tax on assets as a minimum income tax backstop does not affect the creditability of the Mexican income tax for U.S. income tax purposes).
255. See Ley del Impuesto al Activo de las Empresas, art. 1 (hereinafter Tax on Assets Act, or TAA).
256. TAA art. 6.
257. See TAA art. 7 (also requiring monthly payments of estimated liability); see also Labrador & Browne at 9 (for 1990 and subsequent years, all taxpayers must report federal taxes on a calendar year basis).
258. TAA art. 2.
259. TAA art. 5.
260. TAA art. 9.
Because the tax on business assets is intended to operate as a minimum tax, it includes several provisions aimed at protecting taxpayers and preventing the tax on assets from over-estimating a taxpayer's appropriate income tax liability. For example, the tax on assets contains a reduction corresponding to the Mexican income tax law's expensing of machinery and equipment. Further, a taxpayer is exempt from the asset tax during its pre-operational period and its first three years of operations. The Mexican government has announced plans to extend the carryback period to ten years for crediting income taxes in excess of the asset tax and to liberalize taxpayers' ability to average their income tax liability over several years for purposes of the credit against the asset tax.

2. Value Added Tax
Mexico imposes a value-added tax (the VAT) at a rate of 10% on most sales of goods and services. The VAT is imposed on products at each stage of production, from sale of raw materials to sale for ultimate consumption. Generally, the VAT is added to the sale price of a product at each stage of production. Consequently, taxpayers add the VAT to the sales price of their products and collect it from their customers, but also must pay VAT to their suppliers. In practice, a company remits to the Mexican government the amount by which the VAT collected during a period exceeds the amount of VAT paid; thus, the VAT is imposed on the incremental value added at each stage of production, and collected from the ultimate consumer.

The VAT is imposed on sales of property, sales of services, leasing of property, and importation of goods and services. The application of the VAT to imports is in addition to, rather than in lieu of or as an offset against, any applicable import duties. Certain specified transactions are exempt from the VAT, including sales of land or residential buildings, sales of securities, interest charges, leases of residential property, and temporary imports for processing and export.

A number of transactions, including exports and most agricultural goods and services, are subject to the VAT but at a rate of 0%. Imposing a zero rate, as opposed to exempting the products from the tax, enables a producer of such goods to receive a credit...
for the VAT paid with respect to production inputs. To the extent the VAT paid on production inputs exceeds the VAT collected on production output, a taxpayer may claim a refund or a VAT credit carryforward.

3. Social Security

The Mexican Social Security system creates statutory obligations for most employers with regard to occupational risks, which are discharged through the payment of social security premiums by the employer and the withholding of amounts from workers' compensation. The primary benefits provided to workers by the Social Security system are medical benefits (including hospitalization), limited unemployment compensation for illness and maternity leaves, disability and old-age pensions, and maintenance of day care facilities for working mothers. Both employers and employees (through wage withholding) must remit social security premiums calculated as a percentage of an employee's wage base, subject to maximum contribution amounts. The requisite percentage of the employee's wage base subject to social security tax varies depending upon a number of factors, including the level of occupational risk attendant to an employer's business. The total premiums can be quite substantial — in 1994, some employers' contributions could be as much as 25% of an employee's wage base. Employees' contributions are much less, totalling somewhat less than 6% of the wage base.

4. Compulsory Profit Sharing

Although not a tax per se, Mexico requires most employers to distribute a portion of annual profits to employees. All individuals, companies, or economic units with employees—even many tax-exempt organizations — are required to distribute annually to their employees an amount equal to 10% of pre-tax taxable income as computed for Mexican federal income tax principles (subject to certain modifications). The profit sharing law contains a limited class of exemptions, including an exemption for newly-established businesses.

271. Id.
272. See generally Ley Federal del Trabajo art. 117 (the Mexican Federal Labor Law).