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Source of Income Rules and Treaty Relief from Double Taxation within the NAFTA Trading Bloc

Michael S. Schadewald*

Tracy A. Kaye**

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I. INTRODUCTION

The level of trade and investment among the NAFTA countries is significant and growing. As cross-border activity continues to grow, the NAFTA countries will experience greater pressure to harmonize their respective tax systems. A principal objective of the NAFTA accords is to promote economic neutrality by eliminating barriers to cross-border trade of goods and services. Because source of income is a primary determinant of which country is entitled to tax the income arising from a particular cross-border activity, the source of income rules of the NAFTA countries must be consistent if the goal of economic neutrality is to be fully achieved. The problem with inconsistent source rules is that they can lead to double taxation and, in turn, to differential tax burdens on a multinational business enterprise's domestic versus foreign profits. Such differences can distort the operating and investment decisions of businesses, leading to a misallocation of resources among the countries involved, and a resulting loss in overall economic welfare. The purpose of this article is to compare the source of income rules of the United States to those of Canada and Mexico in order to identify any inconsistencies that can result in double taxation.¹ Thus, two basic comparisons are made, the U.S. versus Mexico and the U.S. versus Canada.

Inconsistencies in the source of income rules employed by Canada, Mexico, and the United States can be found in the rules governing gains from the sale of stocks and other securities, gains from the sale of inventory, and interest expense. For example, in the U.S. gains from the sale of stocks and securities are sourced according to the residence of the seller; however, in Mexico the residence of the entity that issued the securities determines the source of such income. While the

1. Factors other than source of income rules, such as differences in the definition of taxable income and different systems for taxing corporations and their shareholders, can also lead to distortions. Nevertheless, the scope of this article is limited to the effects of inconsistencies among sources of income rules.

Canada-U.S. Treaty and the U.S.-Mexico Treaty generally resolve these inconsistencies, these treaties do not resolve the source rule inconsistencies with respect to inventory sales and interest expense.

The source of gains from the sale of inventory is based primarily on the title passage rule for U.S. tax purposes, but in Canada and Mexico the source is determined by the location of the actual underlying economic activity. As a U.S. tax incentive for stimulating export sales, the title passage rule does not create a double taxation problem for a U.S. exporter. However, it does create the possibility that a portion of a U.S. exporter's profits will escape taxation altogether. In contrast, the U.S. interest expense allocation rules have the potential for creating international double taxation. These rules require a U.S. parent corporation to apportion interest expense against its foreign source income based on the ratio of foreign assets to total assets, even though the U.S. parent corporation's foreign subsidiaries may not deduct interest expense costs in computing their foreign taxable income. Because NAFTA indicates that the U.S. views trade with Canada and Mexico as more integral to its economic future than trade with other foreign countries, U.S. policy should favor harmonization of the inconsistent source rules in the areas of inventory sales and interest expense allocations.

Further, a consequence of NAFTA is an increase in the commuting of individual employees across national borders as well as more frequent transfers between domestic and foreign affiliates of multinational corporations. Thus, the tax treatment of compensation packages, such as stock options and contributions to foreign pension plans, is of great importance as the mobility of the workforce continues to grow. At present, the difference in the source rules applicable to the income attributable to the exercise of a stock option can lead to double taxation. Also, as Canada and Mexico do not respect the salary reduction portion of a U.S. section 401(k) plan, there is likely to be a mismatch of the inclusion of earnings in Canadian or Mexican gross income and the foreign tax credits attributable to the U.S. tax on subsequent distributions from such plans.

In general, the source of income rules of the three NAFTA countries are similar, and to the extent differences exist, the applicable tax treaties for the most part resolve the inconsistencies so as to prevent double taxation. However, problems remain with respect to the compensation and benefits packages of expatriates and cross-border employees, inventory sales and interest payments, as well as the tax consequences of corporate reorganizations within the NAFTA bloc. These issues should be addressed during the modification and renegotiation of the bilateral treaties. The United States should also consider the negotiation of a multilateral treaty between Canada, Mexico, and the United States.²

2. Victor Thuronyi of the Fiscal Affairs Department of the International Monetary Fund pointed out at an International Tax Policy Conference that continued reliance on bilateral negotiations could eventually produce nearly 11,000 treaties between 150 countries. See Thomas Field, *International Tax Policy Conference in New York Focuses on 'Flawed Miracle,'* 21 Tax Notes Int'l 2341 (2000).

II. OVERVIEW OF THE INCOME TAX SYSTEMS OF THE NAFTA COUNTRIES

In the international trade arena, the current trend is toward the formation of regional trading blocs. For example, by 1998, the World Trade Organization, (replacing the General Agreement on Tariffs and Trade (GATT) in 1995), had been notified of almost 180 regional trade arrangements (a third of which had been registered since 1990)³ and reported that there were ninety-one regional trade areas.⁴ On December 17, 1992, Canada, Mexico and the United States agreed to the terms of the North American Free Trade Agreement (NAFTA)⁵ in order to create a trade area in which goods and services are exchanged free of tariffs and other trade restrictions. Article 102 of NAFTA states that the objectives of the Agreement include the elimination of barriers to cross-border trade, the promotion of fair competition in the NAFTA area, and the increase in investment opportunities within the NAFTA countries. With limited exceptions, NAFTA does not address the subject of taxation,⁶ except to specify that tax issues will generally be governed by the applicable income tax treaties in effect between the NAFTA countries. However, almost concurrently with the signing of NAFTA, Mexico entered into bilateral tax treaties with both Canada⁷ and the United States.⁸ Canada and the United States have had a bilateral tax treaty in place since 1942.⁹

The level of trade and investment among the NAFTA countries is significant and growing. U.S. merchandise trade with Mexico has increased 141 percent since 1993, reaching \$197 billion in 1999.¹⁰ At the end of 1996, U.S. direct investment totaled \$91.6 billion in Canada (11.5 percent of the total U.S. direct investment abroad) and \$18.7 billion in Mexico.¹¹ In 1996, the gross product of majority-

3. See Guy de Jonquieres, *Survey-World Trade System*, Fin. Times (London), May 18, 1998, at 4.

4. See Sheel Kohl, *Regional Threat to WTO Role*, S. China Morning Post, May 20, 1998, at 4.

5. North American Free Trade Agreement, Dec. 17, 1992, 107 Stat. 2057, 32 I.L.M. 289 (1993). NAFTA entered into force on January 1, 1994 [hereinafter NAFTA].

6. See NAFTA, *supra* note 5, at art. 2103(1). There are certain exceptions relating to nondiscrimination, however. See NAFTA, *supra* note 5, at art. 2103(4).

7. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 8, 1991, Can.-Mex., Ch. 3, 1992 S.C. 127 (Can.).

8. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Sept. 18, 1992, U.S.-Mex., S. Treaty Doc. No. 103-07 [hereinafter U.S.-Mexico Treaty].

9. The 1942 treaty, which was replaced in 1980, was entitled "Convention and Protocol between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the case of Income Taxes" and was signed in Washington, D.C. on March 4, 1942. See 56 Stat. 1399, 124 U.N.T.S. 27 (1).

10. Treasury Deputy Secretary Stuart E. Eizenstat, Challenges for the New Administration in the Global Economy, Remarks at the James A. Baker III Institute for Public Policy (Nov. 17, 2000) (available at www.treas.gov/press/releases/ps1036.html).

11. Sylvia E. Bargas, *Direct Investment Positions for 1996: Country and Industry Detail*, 77 *Surv. of Current Bus.* 34 (1997). The dollar amounts reported represent historical cost figures, not current market values. U.S. direct investment is defined as the ownership or control, directly or indirectly, by one U.S. resident of 10 percent or more of the voting securities of an incorporated foreign business enterprise or the equivalent interest in an unincorporated business enterprise.

owned foreign affiliates of non-bank U.S. multinational companies accounted for 8.9 percent of the gross domestic product of Canada and 3.1 percent of the gross domestic product of Mexico.¹² Likewise, inbound investment from Canada and Mexico is also significant. At the end of 1996, Canadian direct investment in the United States totaled \$53.8 billion (9.9 percent of the total foreign direct investment in the United States) and Mexican direct investment in the United States totaled \$1.1 billion.¹³ With this growing cross-border investment comes an increase in the volume of cross-border movement of human capital, namely commuters between the U.S. and Canada or Mexico and transferred employees of multinational firms.¹⁴ As cross-border activity continues to grow, the NAFTA countries will experience greater pressure to harmonize their respective tax systems.

The concept of eliminating tax barriers to cross-border trade is referred to as "economic neutrality." Neutrality is an issue with respect to the location of production facilities ("capital export neutrality") as well as competition between domestic and foreign business interests within a given jurisdiction ("capital import neutrality"). Capital export neutrality exists if the tax burden on a company's foreign operations is no lower than the burden on its domestic operations, and thus there is no tax incentive for domestic corporations to export capital. Capital import neutrality exists if domestic and foreign companies competing within the same jurisdiction all face the same total tax rate, and thus there is no tax disincentive for companies to do business in foreign markets. Unfortunately for policy makers, these two forms of neutrality can be at odds with one another. For example, subjecting a resident company's worldwide profits to home country taxation enhances capital export neutrality with respect to new investments in low-tax foreign jurisdictions, but at the same time diminishes capital import neutrality with respect to doing business in those same low-tax foreign jurisdictions.¹⁵

Each of the NAFTA countries employs a set of jurisdictional rules based on the principle of source-based taxation of nonresident business enterprises and residence-based taxation of resident business enterprises. For example, each NAFTA country taxes nonresident corporations on any income derived from sources within the country's borders (subject to treaty restrictions) but does not attempt to tax nonresident corporations on income derived from sources outside the

12. Raymond J. Mataloni, Jr., *U.S. Multinational Companies: Operations in 1996*, 78 *Surv. of Current Bus.* 47 (1998) (Table 13).

13. See Bargas, *supra* note 11.

14. See generally Ruth Ben-Israel, *Social Security in the Year 2000: Potentialities and Problems*, 16 *Comp. Lab. L.* 139, 155 (1995).

15. For a discussion of these issues, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, reprinted in *BNA Daily Tax Report*, S-1, S-78-79 (June 4, 1991). In contrast to the economic neutrality view, some policy makers believe that tax systems should be used to enhance the competitiveness of domestic businesses. A prime example was the foreign sales corporation provisions in U.S. tax law. See I.R.C. §§ 921-927 (CCH 1999) (prior to its repeal by the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000) and U.S. Treasury Department, *The Operation and Effect of the Foreign Sales Corporation Legislation* (1993).

country's borders. In contrast, each NAFTA country taxes resident corporations on their worldwide income but allows them to claim a credit for any foreign taxes paid on their foreign source income in order to prevent double taxation. Generally, the amount of creditable foreign income taxes is limited to the amount of home country tax otherwise due on a corporation's foreign source income. As a consequence, resident corporations deriving income from a low-tax foreign jurisdiction pay not only the host country tax but also any home country tax in excess of the lower host country tax. On the other hand, resident corporations deriving income from high-tax foreign jurisdictions pay only the host country tax because the credit for host country taxes is large enough to completely offset the pre-credit home country tax on the foreign profits.¹⁶

To achieve these jurisdictional objectives as well as promote economic neutrality, the NAFTA countries must employ consistent rules for determining the source of income. For example, if a U.S. corporation with operations in Mexico derives an item of income that is classified as Mexican source for Mexican tax purposes but is classified as U.S. source income for U.S. tax purposes, the income is subject to tax in both countries with no offsetting foreign tax credit relief. Indeed, double taxation is contrary to the economic neutrality policy objectives of the NAFTA countries. Specifically, it violates the capital import neutrality principle in that companies operating outside their home jurisdiction will face a higher rate of tax than their domestic competitors. These disparate tax burdens on a company's domestic versus foreign profits can distort investment decisions, thus resulting in the misallocation of resources among the countries involved as well as a loss in overall economic welfare.¹⁷

A. Canada

1. Types of Business Organizations

The principal forms of business entities in Canada include the following:

- (i) corporation;
- (ii) limited partnership;
- (iii) sole proprietorship; and
- (iv) trust

16. For a more thorough discussion of the difference between residence-based and source-based taxation, see Hugh J. Ault, *Comparative Income Taxation: A Structural Analysis* 345 (1997).

17. For a more thorough discussion of the role of taxation in furthering the goals of NAFTA, see Roger H. Gordon & Eduardo Ley, *Implications of Existing Tax Policy For Cross-border Activity Between The United States And Mexico After NAFTA*, 47 *Nat'l Tax J.* 435 (1994); see also Michael J. McIntyre, *The Design of Tax Rules for the North American Free Trade Alliance*, 49 *Tax L. Rev.* 769 (1994); see also Commission of The European Communities, *Report on The Committee of Independent Experts on Company Taxation* 19 (1992).

In Canada, most substantial business operations are carried on using incorporated business entities.¹⁸ Corporate law is a matter of both federal and provincial jurisdiction. The treatment of a corporation under Canadian tax law is dependent upon whether the corporation is classified as a public corporation or a private corporation, the type of income the corporation earns, and the type of distribution the corporation makes to the shareholders.¹⁹

A resident corporation is taxed on all of its taxable income earned from sources inside and outside Canada. A nonresident corporation is taxed on its taxable income derived from sources in Canada if it has carried on business in Canada or if it has disposed of taxable Canadian property.²⁰ Neither the equity nor the consolidated method of accounting is to be used in determining any amount under the Canadian Income Tax Act.²¹ All corporations must compute their income and tax payable and file their returns on a non-consolidated basis.²² However, administratively and legislatively, informal consolidation has been acknowledged.²³

Generally, Canadian tax law considers the legal characteristics of taxpayers as they exist formally and computes and taxes their income accordingly.²⁴ A corporation or company is a per se corporation under U.S. "check-the-box" regulations unless formed under a federal or provincial law which provides that the liability of all of the members of such corporation or company will be unlimited.²⁵ The Nova Scotia Unlimited Liability Company is the only such entity available in Canada.²⁶ A Nova Scotia Unlimited Liability Company is a hybrid entity that may be treated as a partnership for U.S. purposes and a corporation for Canadian purposes.²⁷ It has

18. See Robert Couzin et al., 955 *Tax Management Portfolios, Foreign Income: Business Operations in Canada-Regulation and Choice of Entity A-10* (Tax Management Inc., 2d ed. 1996).

19. *Id.*

20. See Income Tax Act, R.S.C., (5th supp.) ch. 1, § 2 (3) (1985) (Can.) [hereinafter I.T.A.]; Taxable Canadian property is defined by § 115(1)(b).

21. See I.T.A. § 248(24) (1985).

22. See CCH Canadian Master Tax Guide ¶15,389, (55th ed. 2000). This provision was put into effect on December 17, 1991. Prior to that date, however, it was arguable that certain amounts, such as the contributed surplus or retained earnings of a corporation, were to be calculated on a consolidated basis. See *id.*

23. See Ault, *supra* note 16, at 345.

24. See Ronald C. Maiorano, Tax Aspects of Structuring U.S. Operations, Presented at Canadian/U.S. International Tax Planning and Compliance Conference, 10 (Oct. 7, 1997) (on file with the author).

25. As of January 1, 1997, the U.S. "check-the-box" regulations took effect which enable a U.S. taxpayer to affirmatively elect to adopt or change the classification of an entity as a corporation or partnership for U.S. tax purposes. See 26 C.F.R. §301.7701-2(b)(8) (as amended in 1996).

26. See Harry F. Uhrig, Canadian Tax Aspects of U.S. Controlled Corporations with Canadian Operations, Presented at the Canadian/U.S. International Tax Planning and Compliance Conference (Oct. 6-7, 1997) [hereinafter Uhrig] (on file with the author).

27. See Robert Kopstein & Leonard Glass, *Canadian Inbound Investment with Limited Liability Companies—A Trap for the Unwary*, 17 *Tax Notes Int'l* 1289, 1293 (1998) [hereinafter Kopstein & Glass]. See also Treas. Reg. § 301.7701-2 (as amended in 1996). A hybrid entity for the purposes of this section, "is a flow-through entity for U.S. purposes while being considered a corporate entity for Canadian purposes." Uhrig, *supra* note 26.

become an increasingly common entity choice since the "check-the-box" entity rules were enacted in the United States.²⁸

The U.S. Subchapter S corporation ("S corporation") provides another hybrid entity that could be used to do business in Canada. Because the election of S corporation status is limited to corporations with no more than seventy-five shareholders, all of whom must be U.S. residents, this alternative is not generally available.²⁹ An S corporation is, in fact, a corporation for U.S. domestic law purposes.³⁰ But for U.S. tax purposes, the corporation is treated as a flow-through entity, whose shareholders pay tax on the corporation's income. An S corporation which operates only in Canada would allow the shareholders to have liability protection because Subchapter S corporations are treated as corporations for Canadian tax purposes.³¹ Although limited in application, this hybrid entity provides for desirable results in that it is treated as a U.S. flow-through mechanism and limits Canadian tax to the corporate level.³²

Turning to the partnership as a business entity in Canada, it must be noted that Canadian partnership law is subject to provincial jurisdiction. In fact, partnerships doing business in more than one province are required to comply with the laws of, and may be required to register in, each province.³³ The computation of income is made at the partnership level on an accrual basis. Tax is assessed against the individual partners on their shares of the partnership profits.³⁴ No such specific legislation exists for joint ventures, and parties entering into a joint venture must specify that "they do not intend to be associated in partnership."³⁵

The sole proprietorship entity model, usually an unincorporated business of a single individual under a registered trade name, is free from most government regulations that apply to business corporations. However, certain registration rules must be complied with in the jurisdiction in which the business is to be carried on.³⁶

28. Other hybrid entities that may be used to do business in Canada include the U.S. limited liability company (LLC) and the partnership. Although, considered a partnership for U.S. purposes and a corporation for Canadian purposes, it may be undesirable to use a U.S. LLC to carry on business in Canada. See Kopstein & Glass, *supra* note 27, at 1289. Revenue Canada takes the position that a U.S. LLC is not a "resident of the United States" for purposes of the Canada-U.S. Tax Treaty because the LLC is not a "person that under the laws of that state is liable to tax therein." I.T.A. Interpretation Bulletin IT-343R, *Meaning of the Term Corporation* (Sept. 26, 1977). The partnership is a hybrid entity in that it is considered a partnership for Canadian purposes and a corporate entity for U.S. purposes. Using this entity to do business in Canada may be unwise since it results in the exact opposite tax treatment sought after. Each of the partners would be subject to Canadian tax on their proportionate share of the Canadian profits for Canadian purposes, while these taxes would be taxed at the corporate level for U.S. purposes. See Uhrig, *supra* note 26.

29. See Kopstein & Glass, *supra* note 27, at 1292.

30. *Id.*

31. The corporate tax paid to Canada is allowed as a foreign tax credit against the U.S. shareholder's U.S. tax liability. See I.T.A. § 126 (1985) and I.R.C. § 902 (CCH 1999).

32. See Uhrig, *supra* note 26.

33. See Couzin, *supra* note 18, at A-10.

34. See I.T.A. § 96(1) (1985).

35. See Couzin, *supra* note 18, at A-10.

36. *Id.*

The business trust, as it is known in the United States, is a rare business entity in Canada. Consequently, the law of trusts is generally undeveloped, and no statutes specifically provide for the creation or operation of such trusts. However, there exists no legislation that would prevent a trust from carrying on business, and the income tax laws expressly address the possibility. For example, trusts in the forms of mutual funds, real estate investment trusts, equipment trusts, and pension trusts have all served as financial media in Canada.³⁷

2. Federal Income Tax

Canada taxes the worldwide income of every person (individual, trust, or corporation) who is a resident of Canada at any time during the year as well as certain Canadian source income earned by nonresidents.³⁸ Therefore, the issue of residence is key to tax liability in Canada as opposed to nationality or citizenship.³⁹ The corporate income tax in Canada, before the ten percent provincial abatement, is thirty-eight percent.⁴⁰

3. Subnational Income Taxes

All of the Canadian provinces and territories impose an income tax on corporations ranging from five percent to seventeen percent.⁴¹ In each case, the provincial tax rate should be considered in light of the ten percent abatement.⁴²

Corporate income, like individual income, is allocated among the provinces on a relatively uniform basis that reflects salaries paid and gross revenue received. Generally a corporation is subject to provincial tax on the basis of a permanent establishment test.⁴³

In all provinces except Quebec, Ontario, and Alberta, the federal government collects the provincial corporate tax, imposing the tax as a fixed percentage of taxable income. Quebec, Ontario, and Alberta collect their own corporate taxes; however, the substantive rules in these three provinces generally parallel federal legislation.⁴⁴

37. See Couzin, *supra* note 18, at A-55-6.

38. See I.T.A. § 3 (1985); Canada's tax system for individuals is based on a progressive rate structure so that the rate of tax increases with the level of income. Thus, higher income earners not only pay more tax than lower income earners, they also pay at a higher rate. See Vern Krishna, *The Fundamentals of Canadian Income Tax* 1304 (5th ed. 1995).

39. See Couzin, *supra* note 18, at A-28. See generally Edwin G. Kroft, *Jurisdiction to Tax: An Update*, Tax Planning for Canada-US International Transactions 1993 Corp. Mgmt. Tax Conf., 1:1 (examining the "facts and circumstances" analysis to determine Canadian residency) [hereinafter Kroft].

40. See I.T.A. § 123(1) (1985), amended by Bill C-139; S.C. 1988, ch. 55, § 101 (1988).

41. See CCH Canadian Master Tax Guide, *supra* note 22, at ¶460.

42. See Ault, *supra* note 16, at 26-7.

43. See Couzin, *supra* note 18, at A-27.

44. *Id.*, at A-28.

4. Foreign Tax Relief for Resident Corporations

Under Canadian law, a corporation is subject to tax on its worldwide income under the Income Tax Act if it is a resident of Canada.⁴⁵ There is no definition of "residence" or "resident" in the Income Tax Act. The determination of corporate residence is essentially a question of fact.⁴⁶ Tests for corporate residency are based mainly on English tax jurisprudence, which has generally been followed by Canadian courts.⁴⁷ Pursuant to these common law tests of residency, a corporation is generally resident where its central management and control is situated.⁴⁸ However, the law deems that companies incorporated under Canadian law after April 26, 1965 are residents of Canada.⁴⁹

To avoid double taxation on income earned from foreign sources, a resident taxpayer may claim a credit against Canadian tax for income or profits taxes paid to a foreign government.⁵⁰ A tax credit is available only in respect of obligatory taxes paid to a foreign government. Discretionary foreign taxes levied by a foreign government which would not have been imposed if the taxpayer were not entitled to a Canadian foreign tax credit are not eligible for a tax credit in Canada.⁵¹

The credit for foreign business income tax is for the benefit of Canadian resident taxpayers that have branch operations in foreign countries. The tax credit for business income taxes must be calculated separately for each country in which the taxpayer carries on business and foreign tax credit is available on a country by country basis.⁵² The foreign tax credit is also limited to an amount equal to the Canadian tax otherwise payable multiplied by the corporation's foreign source business income divided by income from all sources.⁵³ A "grossed-up" deduction

45. See I.T.A. § 2(1) (1985). Under the Canada-U.S. Tax Convention, a corporation created or organized under the laws of any of the United States is not subject to taxation by Canada with respect to its industrial and commercial profits except the profits applicable to a permanent establishment in Canada, regardless of whether the corporation is resident in Canada. See Income Tax Treaty, Mar. 29, 1984, U.S.-Can., Art. VII, T.I.A.S. No. 11087, in 1 CCH Tax Treaties ¶ 1901, at 21,003 (1998).

46. See Kroft, *supra* note 39, at 1:20-24.

47. However, three decisions of the Tax Appeal Board have held that central management and control is located where the legal control of the corporation is found and not where it is de facto managed and controlled. See Kroft, *supra* note 39, at 1:25. See also *Sinifero v. MNR*, 68 D.T.C. 522 (TAB); *Bedford Overseas Freighters v. MNR*, 68 D.T.C. 529 (TAB), 70 D.T.C. 6072 (Ex. Ct.); and *Zehnder & Co. v. MNR*, 68 D.T.C. 529 (TAB), 70 D.T.C. 6064 (Ex. Ct.).

48. See *DeBeers Consolidated Mines v. Howe*, [1906] C.A. 445.

49. See I.T.A. § 250(4)(a) (1985).

50. See I.T.A. § 126 (1985). Alternatively, a foreign tax deduction is available. The deduction is computed separately with respect to non-business income tax paid to a foreign government and business-income tax paid to such a government. See I.T.A. § 126(7) (1985).

51. See I.T.A. § 126(4) (1985). This rule discourages foreign governments from levying taxes upon Canadian residents in their country because of the expectation that the taxpayers will receive a rebate for the tax under Canadian tax law. See *Krishna, supra* note 38, at 639.

52. See I.T.A. § 126(6) (1985). "In addition, there is a 'basket' limitation for nonbusiness income which is also applied on a per-county basis." Ault, *supra* note 16, at 390.

53. See *Krishna, supra* note 38, at 642. The same limitation must be applied for non-business income. *Id.* at 641. Business income taxes paid to a foreign jurisdiction may exceed the amount that the taxpayer can claim as a credit against Canadian taxes. Any excess may be carried forward as an

is also available for taxes paid by foreign corporations if a Canadian corporation holds at least a ten percent share—either directly or indirectly—in the foreign corporation.⁵⁴

5. *Taxation of Nonresident Corporations*

Generally, in Canada two distinct taxes are imposed upon Canadian source income earned by nonresidents. First, ordinary income tax is payable on business or employment income and certain net capital gains.⁵⁵ Such tax under Part I of the Income Tax Act is applied to that nonresident corporation's "taxable income earned in Canada."⁵⁶ Second, a special nonresident tax applies to Canadian source property income.⁵⁷ This tax is levied as a final withholding tax at a rate of twenty-five percent on amounts paid by Canadian residents to nonresidents.

Nonresident corporations that do not have a permanent establishment or fixed base in Canada or that receive income not attributable to any such establishment or base, are also subject to Canadian withholding tax on many other types of income (primarily investment income) derived from sources within Canada. The Act establishes procedures for collecting tax from nonresident persons on the proposed or actual disposition of particular types of taxable Canadian properties.⁵⁸ The applicable withholding rate is subject to any applicable treaty reductions.⁵⁹

The Income Tax Act requires the Minister to issue a certificate in prescribed form where, prior to the disposition of taxable Canadian property, the vendor has paid on account of tax, thirty-three and one-third percent of the excess of the estimated proceeds of disposition over the adjusted cost basis of the property to him or has provided acceptable security to the Minister.⁶⁰ A similar rule is provided in Subsection 116(4) where, after the disposition, the nonresident vendor has paid on account of tax, thirty-three and one-third percent of the excess of the nonresident's

unused foreign tax credit for seven years or carried back for three years. See I.T.A. §§ 126(2)(a), 126(7) (1985). The foreign tax credit in respect of the current year must be claimed before any unused credits from other years. See I.T.A. § 126(2.3) (1985).

54. See Ault, *supra* note 16, at 384. There is also an exemption for dividends paid out of active business income from countries with a tax treaty with Canada. *Id.*

55. See I.T.A. §§ 115(a), 2(3) (1985).

56. Section 115(1)(a) provides that "taxable income earned in Canada" of a nonresident corporation shall include the following sources of income: income from duties of offices and employment performed by the nonresident in Canada; income from business carried on by the nonresident in Canada; taxable capital gains; certain income derived from the disposition of resource properties; certain recaptured capital cost allowances; taxable amounts arising from the disposition of interest income in a trust resident in Canada; certain amounts received as proceeds of disposition of a right to share in income of a partnership; certain remuneration, not otherwise taxable, received directly or indirectly from a Canadian resident, certain research grants, scholarships, etc.; and certain amounts arising from a disposition of an interest in Canadian life insurance policy. See I.T.A. § 3 (1985).

57. See I.T.A. § 2(3) (1985).

58. See I.T.A. § 116 (1985).

59. See CCH Canadian Master Tax Guide, *supra* note 22, at ¶520 (Rates of Withholding Tax under Income Tax Agreements signed by Canada).

60. See I.T.A. § 116(2) (1985).

proceeds over his adjusted cost base.⁶¹ This payment is intended to approximate the combined federal and provincial tax payable on capital gains at the highest marginal tax rates.

6. Computation of Taxable Income

A taxpayer is required to calculate income from each source separately and total the various amounts to compute "income" for tax purposes.⁶² The three main sources of income for Canadian tax purposes include business, property, and office or employment income, each of which is to be treated as a separate source of income and calculated in accordance with rules from various parts of the Income Tax Act.⁶³

The basic rate of corporate tax is thirty-eight percent with a surtax equal to five percent of federal income tax payable.⁶⁴ A corporation is allowed as an abatement a deduction equal to ten percent of its taxable income earned in the year with respect to provincial tax paid. Special deductions from tax payable, available to certain corporate taxpayers, include the small business deduction and the manufacturing and processing deduction.⁶⁵ Only a Canadian-controlled private corporation⁶⁶ may claim the small business deduction which is limited to sixteen percent of the least of its active business income or its Canadian source income with an overall limit of \$200,000 (Canadian) for the active business year.⁶⁷

The Income Tax Act also allows for a deduction of seven percent from the tax otherwise payable by a corporation for a taxation year with respect to certain types of profits.⁶⁸ When determining whether corporate profits qualify as Canadian manufacturing and processing profits, it should be noted that certain activities are expressly excluded.⁶⁹

61. See I.T.A. § 116(4) (1985). Where a certificate has been issued prior to the disposition and the cost to the purchaser of the property exceeds the certificate limit, the purchaser is required to pay on account of the tax the lesser of 15 percent of the cost of the property to him or 25 percent of the amount by which the cost of the property to him exceeds the certificate limit. See I.T.A. § 116(5)(a)(ii)(B) (1985).

62. See I.T.A. Interpretation Bulletin IT-134R, *Capital Gains and Losses on Dispositions of Business Property by an Individual* (Nov. 24, 1975).

63. See I.T.A. § 3 (1985).

64. See I.T.A. § 123(1) (1985). This surtax will be eliminated over the next five years.

65. See I.T.A. § 125 (1985).

66. I.T.A. § 125(7) (1985) defines a "Canadian-controlled private corporation" as a private corporation that is a Canadian corporation other than a corporation controlled by one or more nonresident persons or by one or more public corporations; or a corporation, that would, if each share of the capital stock of the corporation that is owned by a nonresident person or public corporation were owned by a particular person, be controlled by the particular person or a class of the shares of the capital stock which is listed on a prescribed stock exchange.

67. I.T.A. §§ 125(2) and 125(3) (1985) define a corporation's "business limit" for a taxation year as \$200,000 (Canadian) so as to restrict the deductions to "small" businesses. See also I.T.A. § 125(1) (1985) and Krishna, *supra* note 38, at 774-75.

68. See I.T.A. § 125.1 (1985).

69. I.T.A. § 125.1(3) (1985) excludes from the definition of "manufacturing and processing":

7. Corporations and Their Shareholders

Canada has developed an integrated system for taxing private corporations and their shareholders.⁷⁰ The policy objective behind this system is to ensure that individuals pay the same amount of tax on investment income, regardless of whether it is earned personally or indirectly through a corporation. For capital gains, this objective is implemented through the combined structure of a refundable dividend tax and the capital dividend account. The capital dividend account represents the non-taxable portion of capital gains and certain other non-taxable receipts.⁷¹

The integration of capital gains earned by a private corporation works as follows: first, a private corporation is taxed at full corporate rates on three-fourths of its capital gains,⁷² the remaining nontaxable portion of its capital gains accumulates in a special surplus account called the capital dividend account.⁷³ An amount paid to an individual out of the corporation's capital dividend account is not included in the individual's income and does not reduce the adjusted cost basis of the shares on which the dividend is paid.⁷⁴ A capital dividend is one that is paid out of a private corporation's capital dividend account and for which the corporation has made the necessary election.⁷⁵

A percentage of its net taxable gain goes into a special corporation refund account, and upon payment of a taxable dividend, the corporation generally receives a refund of one-third of the amount of the dividend.⁷⁶ The amount paid by the corporation as a taxable dividend to an individual is grossed up by one-fourth, and the individual can claim a dividend credit equal to the amount of the gross-up.⁷⁷

For the purpose of computing a resident shareholder's income, the shareholder benefit provisions apply whether or not the corporation is resident in Canada or carries on business in Canada.⁷⁸ Therefore, a Canadian resident who has received a loan from or has become indebted to a nonresident corporation may be liable for tax unless the loan qualifies as an "exempt loan."⁷⁹

A loan by a resident corporation to a nonresident shareholder is also subject to the shareholder benefit provisions.⁸⁰ The amount of the benefit that would have been included in income if the borrower were a resident and subject to the

farming, fishing, logging, construction, resource operations, producing industrial minerals, producing electrical energy for sale and processing gas as part of the business of selling or distributing gas.

70. See Couzin, *supra* note 18, at A-60-1. A partial integration system exists for all other corporations.

71. See Krishna, *supra* note 38, at 832.

72. See *id.*; see also I.T.A. § 123 (1985).

73. See Couzin, *supra* note 18, at A-60-1.

74. See Krishna, *supra* note 38, at 832; see also I.T.A. §§ 83(2)(b), 53(2)(a)(i) (1985).

75. See I.T.A. § 83(2) (1985).

76. See Krishna, *supra* note 38, at 832; see also I.T.A. §§ 129(3)(a)(1), (4) (1985).

77. See Krishna, *supra* note 38, at 832; see also I.T.A. §§ 82(1)(b), 121 (1985).

78. See I.T.A. § 15(7) (1985).

79. See I.T.A. § 15(2) (1985); Exceptions are provided for in §§ 15(2.1)-15(2.7) (1985).

80. See Krishna, *supra* note 38, at 857.

provisions of Section 15 of the Income Tax Act is deemed to have been paid to the nonresident shareholder as a dividend from a corporation resident in Canada and is subject to withholding tax.⁸¹

8. Special Rules for Taxation of Resource Income

The exploitation of natural resources and the income from such activity are both important in the Canadian economic system. Due to the scale and significance of the industry, special rules apply to the taxation of resource income.⁸² Taxpayers may claim capital cost allowances for classified types of depreciable property used in the exploitation of natural resources.⁸³

Incentives for the exploration and development of new sources of petroleum products or minerals have been adopted to offset the capital-intensive nature of the natural resource sector. The Canadian system of allowances in regards to exploration and development expenses establishes three accounts or "pools" of expenditures, namely "Canadian exploration expense"(CEE), "Canadian development expense"(CDE), and "Canadian Oil and Gas Property Expense" (COGPE).⁸⁴ The Income Tax Act explicitly sets forth the respective deductions allowed for corporations involved in the natural resource industry.⁸⁵

B. Mexico

1. Types of Business Organizations

The principal forms of business entities in Mexico include the following:

- (i) Sociedad Anonima ("S.A.") (corporation);
- (ii) Sociedad Anonimas de Capital Variable ("S.A. de C.V.") (corporation with variable capital);
- (iii) Sociedad de Responsabilidad Limitada ("S. de R.L.") (limited liability company);
- (iv) Sociedad en Nombre Colectivo ("S. en N.C.") (partnership); and
- (v) Sociedad en Comandita ("S. en C.") (limited liability partnership)

Multinational corporations typically operate in Mexico through a S.A. which is established as a local subsidiary.⁸⁶ A S.A. is considered a per se corporation under the U.S. "check-the-box" regulations, but the S. de R.L. is not,⁸⁷ and,

81. See I.T.A. § 214(3)(a) (1985).

82. See Couzin, *supra* note 18, at A-68.

83. See *id.*

84. *Id.*, at A-69.

85. See I.T.A. § 66 (1985).

86. See Castillo, et al., 972 Tax Management, Foreign Income: Business Operations in Mexico A-8 (Tax Management Inc. 2d ed. 1997).

87. Treas. Reg. § 301.7701-2(b)(8) (1999).

therefore, U.S. investors can elect to treat a S. de R.L. as a branch or partnership for U.S. tax purposes.⁸⁸

If certain conditions are met, Mexican holding companies may elect to file consolidated income tax returns with their fifty percent or more owned Mexican subsidiaries.⁸⁹ The group's consolidated taxable income equals the full amount of the holding company's income or loss, plus the taxable income or loss of each controlled company adjusted for the holding company's proportionate ownership interest.⁹⁰

2. Federal Income Tax, Assets Tax, and Profit Sharing Tax

For income tax purposes, Mexico recognizes only two types of taxpayers, corporations and individuals. Therefore, all business entities, not just corporations, are subject to the corporate income tax.⁹¹ Foreign-owned corporations are generally taxed in the same manner as Mexican corporations. At present, the corporate income tax rate in Mexico is thirty-five percent.⁹²

Mexico also imposes a 1.8 percent tax on the assets of resident corporations as well as nonresident corporations that have a permanent establishment in Mexico. This assets tax operates as a minimum income tax. Income tax may be credited against the tax on assets, and, therefore, the assets tax is due only if the current year's assets tax exceeds the current year's income tax.⁹³ The assets tax base is equal to the total value of the taxpayer's business assets, minus any debts to Mexican companies subject to this tax.⁹⁴

In addition to the corporate income tax and assets tax, Mexican employers are required to distribute ten percent of the company's annual profit to their workers. For this purpose, profit is defined as a hybrid between book profits before taxes and taxable income. Because of its mandatory nature, the profit sharing tax effectively functions as an additional tax on corporate profits.⁹⁵

88. Treas. Reg. § 301.7701-3 (1999).

89. *Ley del Impuesto Sobre la Renta* (Income Tax Law) [hereinafter L.I.S.R.] articles 57-A, 57-C and 57-D (Mex.).

90. L.I.S.R. art. 57-E.

91. L.I.S.R. art. 1.

92. L.I.S.R. art. 10.

93. Taxpayers may also credit against their current year's assets tax liability any income tax paid during the prior three years in excess of the assets tax due for those years. CCH Mexican Tax Guide, ¶4000, at 3001 (Jaime Gonzalez-Bendixsen, ed. 1999). For U.S. tax purposes, however, the Mexican assets tax is not considered an income tax in the U.S. sense. Therefore, a U.S. company can not claim a foreign tax credit on its U.S. tax return for any Mexican assets tax that it incurs. Rev. Rul. 91-45, 1991-2 CB 336.

94. The reduction in the assets tax base for debts to other Mexican companies prevents double counting of assets (i.e., by the loan on the lender's books and the assets purchased with the funds on the borrower's books). A company is not subject to the assets tax during its first few years of operations. *Ley del Impuesto al Activo de las Empresas* (L.I.A.) art. 2.

95. See Castillo, *supra* note 86, at A-64 (Profit Sharing).

3. Subnational Income Taxes

There are no local income taxes imposed on corporate income. Corporations are subject only to federal income taxes.⁹⁶

4. Foreign Tax Relief for Resident Corporations

Corporations that are organized under the laws of Mexico and foreign entities that have their seat of management in Mexico are presumed to reside in Mexico, and such resident corporations are taxed on their worldwide income.⁹⁷ To prevent double taxation, a resident corporation is allowed a credit against its Mexican income tax for any foreign income taxes paid on foreign source income. The foreign tax credit is limited to the amount of Mexican tax attributable to its net foreign source income.⁹⁸

A Mexican corporation may also claim a credit for the foreign income taxes paid by a foreign subsidiary provided the Mexican corporation holds directly at least a ten percent interest in the stock share of the foreign subsidiary. The Mexican parent corporation can claim this deemed paid foreign tax credit when it receives a dividend distribution from a qualifying subsidiary. The credit is based on the amount of foreign income tax paid by that foreign subsidiary as well as the ratio of the dividend received to the subsidiary's undistributed earnings. A taxpayer claiming this credit must recognize as income, in addition to the dividend received, the amount of foreign income tax associated with that dividend.⁹⁹ If various requirements are met, it is also possible for a Mexican parent corporation to claim a credit for foreign taxes paid by indirectly owned (second-tier) foreign subsidiaries.¹⁰⁰

5. Taxation of Nonresident Corporations

Nonresident corporations are subject to two taxes. First, Mexico taxes the net amount of income (after deducting allowable expenses) attributable to any permanent establishment that a nonresident corporation maintains in Mexico. The applicable rate for this tax scheme is thirty-five percent.¹⁰¹ Second, a permanent establishment or fixed base is taxed (thirty-five percent rate) on any profit remittances to the foreign corporation's home office that are not made out of the CUFIN¹⁰² account of the permanent establishment.¹⁰³

96. Mexico is a federal republic comprised of 31 States and the Federal District. In addition to federal taxes (corporate income tax, asset tax, profit sharing and value added tax), the principal state taxes are the payroll tax and the tax on the possession or usage of vehicles. Typical municipal taxes include land transfer tax and real estate tax. CCH Mexican Tax Guide, *supra* note 93, ¶79, at 502 (Federal Taxes).

97. L.I.S.R. art. 15.

98. L.I.S.R. art. 6.

99. *Id.*

100. *Id.*

101. L.I.S.R. art. 4.

102. For a discussion of Cuenta de Utilidad Fiscal Neta see *infra* Part I.B.7.

103. CCH Mexican Tax Guide, *supra* note 93, ¶3560, at 2537.

Nonresident corporations that do not have a permanent establishment in Mexico are subject to a tax on any nonbusiness income derived from sources within Mexico. This tax is applied to the gross amount of such income and is collected by withholding at the source.¹⁰⁴ The applicable withholding tax rate varies with the type of income (dividends, interest, royalties, etc.) and is subject to any applicable treaty reductions.¹⁰⁵ Mexico's withholding regime extends to a nonresident corporation's sale or disposition of real property in Mexico as well as stock of Mexican companies (an exemption applies to publicly-traded stock). In such cases, the purchaser must generally withhold twenty percent of the gross proceeds paid to the nonresident corporation. However, if the nonresident has a legal representative in Mexico and certain other requirements are met, the seller may elect to pay a tax of thirty percent on the net profit from the sale, in which case no withholding is required.¹⁰⁶

6. *Computation of Taxable Income*

Mexican tax law treats gains and losses on the sale or disposition of capital assets as ordinary income and taxes them at the regular corporate rates. However, as discussed below, when computing the gain or loss on real property, fixed assets, or stock, the asset's inflation-adjusted acquisition cost is subtracted from the proceeds from the disposition.

Depreciation of tangible and intangible fixed assets is computed on a straight-line basis using annual percentages prescribed by law. The following are the maximum annual depreciation rates for certain types of assets: buildings (five percent), furniture and office equipment (ten percent), motor vehicles (twenty-five percent), and computers (thirty percent).¹⁰⁷ Net operating losses may be carried forward ten years. Mexico does not allow loss carrybacks.¹⁰⁸ There are no formal debt-to-equity requirements in Mexico.

Mexico requires affiliated companies, such as a U.S. parent corporation and its Mexican subsidiary, to account for intercompany transactions based on an "arm's length" standard price estimation, that is, using prices that they would have used if they had been dealing with unrelated parties in comparable transactions.¹⁰⁹ Acceptable methods for determining an arm's length transfer price include the comparable uncontrolled price, resale price, cost-plus, profit-split, residual profit-split, and transactional profit margin methods.¹¹⁰

A distinctive feature of Mexican income tax law is that Mexico does not require accrual basis inventory accounting for tax purposes, and, therefore,

104. See Castillo, *supra* note 86, at A-56 (Income Not Attributable to a Permanent Establishment).

105. CCH Mexican Tax Guide, *supra* note 93, ¶10,000, at 7011-12 (Treaty Withholding Rates).

106. L.I.S.R. arts. 150, 151.

107. CCH Mexican Tax Guide, *supra* note 93, ¶51, at 437-440 (Standard and Intermediate Depreciation Rates).

108. L.I.S.R. art. 55.

109. L.I.S.R. art. 64-A.

110. L.I.S.R. art. 65.

taxpayers are not required to annually compute ending-inventory and cost-of-goods-sold amounts. In other words, an immediate deduction is allowed for the cost of any finished goods purchased, or in the case of a manufacturer, the cost of raw materials, component parts, and semi-finished goods. Other cost elements, such as labor and overhead, also may be deducted when incurred.¹¹¹ Under this somewhat novel approach to accounting for inventories, cost of goods sold is recognized in the year the costs are incurred as opposed to deferring the deductions to the year in which the related inventory is sold.

Another distinctive feature of Mexican income tax law is its rather comprehensive system for adjusting the income tax base to discount the effects of inflation. Inflation erodes the value of monetary assets, such as cash in bank and accounts receivable. Mexican tax law allows taxpayers to recognize these losses currently by making a downward adjustment in their interest income (usually at monthly intervals) for the inflationary loss realized with respect to the taxpayer's monetary assets. Likewise, a taxpayer's interest expense is reduced for an inflationary component based on the taxpayer's monetary liabilities, such as accounts payable. This adjustment reflects the fact that inflation reduces the future costs associated with amortizing such liabilities. Thus, the use of debt to capitalize a Mexican corporation can result in the creation of taxable income.¹¹² With respect to fixed assets, annual depreciation and amortization deductions for tangible and intangible fixed assets (which are computed on the basis of an asset's historical cost) are adjusted for inflation using the national consumer price index. Likewise, when computing the gain or loss on the disposition of an asset, the asset's inflation-adjusted acquisition cost (i.e., its historical cost adjusted for the cumulative rate of inflation between the asset's acquisition and sale dates) is subtracted from the proceeds from the disposition.¹¹³

Special rules apply to the computation of a taxpayer's basis in stock, which is adjusted according to a complicated formula that accounts not only for inflation but also the underlying earnings and dividend distributions of the issuing company. These adjustments are designed to make the taxation of capital gains consistent with Mexico's integrated system for taxing corporations and their shareholders.¹¹⁴ Finally, the amount of a tax loss carryforward, which can be carried forward ten

111. L.I.S.R. art. 22.

112. See Castillo, *supra* note 86, at A-36 (Interest and Inflation Adjustments). For example, assume ABC Corporation has interest income for the current year of 14,000 pesos and accounts receivable outstanding during the year of 100,000 pesos. If inflation is 12 percent, ABC realizes a 12,000 peso monetary loss with respect to the receivable's underlying value and that loss is included in the computation of ABC's net taxable income for the year. Therefore, ABC's net taxable interest income for the year is 2,000 pesos (14,000 peso interest income less 12,000 peso inflationary loss). As another example, assume XYZ Corporation has a debt of 100,000 pesos outstanding during the entire taxable year. The note bears interest at a nine percent rate, resulting in 9,000 pesos of interest expense for the year. If inflation is 15 percent, XYZ also realizes a 15,000 peso monetary gain with respect to the real value of that debt. Therefore, XYZ's recognizes net interest expense with respect to its outstanding debt is a 6,000 pesos gain (15,000 peso inflationary gain less 11,000 peso interest expense).

113. L.I.S.R. art. 41.

114. L.I.S.R. art. 19; see *infra* discussion at Part I.B.7.

years, is adjusted for inflation through the use of the national consumer price index.¹¹⁵

7. Corporations and Their Shareholders

Mexico has developed a semi-integrated system for taxing corporations and their shareholders under which corporate profits are generally taxed only once with the tax being imposed in the year such profits are earned. Integration is achieved by exempting dividends received by shareholders from income taxation. Therefore, dividends received by a resident shareholder (individual or corporation) from a Mexican corporation are tax-exempt as long as the distributed earnings were already subjected to the corporate income tax. Historically, the shareholder-level exemption also applied to nonresident shareholders, and thus, there was no Mexican withholding tax on dividends paid to nonresident shareholders. Effective January 1, 1999, however, dividends paid to nonresident shareholders are subject to withholding tax at an effective rate of 7.7 percent.¹¹⁶

In order to implement this shareholder exemption system, corporations must keep track of their previously taxed income in an "accumulated taxable earnings" or "CUFIN" (*cuenta de utilidad fiscal neta*) account. This account consists of the corporation's cumulative annual net taxable income (i.e., taxable income, reduced by the sum of income tax payments, nondeductible employee profit sharing payments and any other nondeductible expenses, increased by dividends received from other entities, and decreased by dividend distributions). The balance of this account is restated, using the national consumer price index, as of the time of the dividend. Dividends paid out of a CUFIN account are not taxed. Conversely, dividends that do not originate in a CUFIN account are taxable to the payer corporation (not the shareholder).¹¹⁷

C. United States

1. Types of Business Organizations

The principal forms of business entities in the United States include the following:

- (i) Subchapter C corporation;
- (ii) Subchapter S corporation;
- (iii) partnership;
- (iv) limited liability company; and
- (v) sole proprietorship.¹¹⁸

115. L.I.S.R. art. 55.

116. L.I.S.R. art. 152. Dividends paid to residents of a tax haven jurisdiction are subject to withholding tax at the rate of forty percent.

117. See Castillo, *supra* note 86, at A-26 (Corporate Taxation and Dividends).

118. See William P. Streng, *Choice of Entity*, 700 Tax Management Portfolios A-2 (Sandra C. Degler et al. eds., 1993); see also, e.g., Stephen A. Lind et al., *Fundamentals of Business Enterprise*

Treasury Regulations ("check-the-box" regulations) now determine the classification of most newly formed business entities for federal income tax purposes.¹¹⁹ The "check-the-box" regulations only apply to entities that are treated as maintaining a separate existence from their owners as a matter of federal income tax law.¹²⁰ Certain business entities—such as those organized under federal or state law that refers to the entity as "incorporated," "corporation," "body corporate," or "body politic"—are automatically classified as corporations for federal income tax purposes.¹²¹ Most noncorporate business entities with at least two members are classified as partnerships unless they elect to be classified as a corporation.¹²² A noncorporate business entity that has a single owner is disregarded as an entity separate from its owner unless the owner elects to be classified as a corporation.¹²³

Subchapter C corporations ("C corporations") are business entities which are incorporated under state law and considered as separate and distinct entities from their shareholder owners.¹²⁴ For federal income tax purposes, C corporations are subject to double taxation in that the corporation is taxed on its taxable income, and the shareholders are also taxed when the after-tax earnings are distributed.¹²⁵

In general, every corporation must report its tax liability separately.¹²⁶ However, an affiliated group of corporations may elect to report its tax liability on a single, consolidated return.¹²⁷ Once the election is made, the corporations must

Taxation: Cases and Materials 2 (1997); Laura E. Cunningham & Noel B. Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships* 8 (1996).

119. See generally Treas. Reg. §§ 301.7701-1 to -3 (as amended in 1996, 1998).

120. See Treas. Reg. § 301.7701-1(a)(1) (as amended in 1996).

121. See Treas. Reg. § 301.7701-2(b)(1) (as amended in 1996).

122. See Treas. Reg. §§ 301.7701-2(c)(1) (as amended in 1996), 301.7701-3(a), 301.7701-3(b)(1)(i) (as amended in 1998).

123. See Treas. Reg. §§ 301.7701-2(c)(2) (as amended in 1996), 301.7701-3(a), 301.7701-3(b)(1)(ii) (as amended in 1998).

124. See Streng, *supra* note 118, at A-7; see also, e.g., Lind et al., *supra* note 118, at 3, 4; Ault, *supra* note 16, at 289; I.R.C. § 1361(a)(2) (CCH 1999) (C corporations are corporations which do not qualify for and do not elect S corporation status); I.R.C. § 7701(a)(3) (CCH 1999) (corporations include associations, joint-stock companies, and insurance companies). But see Treas. Reg. § 301.7701-2(b)(1)-(7) (as amended in 1996) (the label of "corporation" should not per se control its status for federal tax purposes).

125. See I.R.C. §§ 61(a), 301(c)(1) (CCH 1999); see also, e.g., Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 1.03, at 1-7 (6th ed. 1998); Howard E. Abrams & Richard L. Doernberg, *Federal Corporate Taxation* ¶ 1.01, at 1 (4th ed. 1998); Ault, *supra* note 16, at 143.

126. See I.R.C. § 6012(a)(2) (CCH 1999); see also Treas. Reg. § 1.6012-2(a) (as amended in 1982).

127. See I.R.C. § 1501 (CCH 1999). An affiliated group is one or more chains of includible corporations connected through stock ownership with a common parent provided that: (1) the common parent directly owns stock having at least 80 percent of the total voting power and total value of the stock in at least one of the includible corporations; and (2) at least 80 percent of the total voting power and total value of the stock in each of the includible corporations (except the common parent) is directly owned by one or more of the other includible corporations, see I.R.C. § 1504(a) (CCH 1999). An includible corporation is any corporation barring the eight specific exceptions listed in the Code, see I.R.C. § 1504(b) (CCH 1999).

continue to file on a consolidated basis unless the Commissioner of the Internal Revenue Service consents to a termination or the common parent corporation no longer exists.¹²⁸ Although an S corporation may have C corporation and S corporation subsidiaries, it is not allowed to join in the filing of a consolidated return with its C corporation affiliates.¹²⁹

The consolidated taxable income of a consolidated group is subject to federal income tax.¹³⁰ In order to determine the consolidated taxable income, the separate taxable income (or loss) of each group member is determined separately (subject to special rules that take into account intercompany transactions and distributions, accounting methods, and other items of income and deductions).¹³¹ These separate taxable incomes are then aggregated along with each member's capital gains and losses, charitable contributions, Section 1231 transactions, and net operating losses.¹³² The gross consolidated tax liability is then calculated in accordance with the applicable statutory provisions and Treasury Regulations.¹³³ Finally, any available tax credits are allowed against the gross consolidated tax liability.¹³⁴

For federal income tax purposes, S corporations are subject to Subchapter S of the Internal Revenue Code ("IRC"), allowing for the avoidance of a corporate level tax in most transactions.¹³⁵ The eligibility requirements to qualify for S corporation status generally are as follows: (1) no more than seventy-five shareholders; (2) the shareholders must be individuals; (3) the shareholders cannot be nonresident aliens; and (4) the corporation cannot issue more than one class of stock.¹³⁶

Pursuant to Subchapter K of the IRC,¹³⁷ partnerships serve as tax conduits in that income, deductions, losses, and other tax liability items flow through the entity directly to the partners who must individually report the income attributable to the partnership.¹³⁸ The most common forms of partnerships include general partnerships ("GP"), limited liability partnerships ("LLP"), and to a lesser extent, publicly traded partnerships ("PTP").¹³⁹

128. See Treas. Reg. §§ 1.1502-75(a)(2), (c)(1), (d)(1) (as amended in 1994).

129. See I.R.C. § 1504(b)(8) (CCH 1999).

130. See generally Treas. Reg. § 1.1502-2 (as amended in 1996). An affiliated group of corporations that affirmatively elects to file a consolidated return is referred to as a consolidated group, see Treas. Reg. §§ 1.1502-1(a), (h) (as amended in 1996).

131. See generally Treas. Reg. §§ 1.1502-11 (as amended in 1996), 1.1502-12 (as amended in 1996).

132. See generally Treas. Reg. § 1.502-11 (as amended in 1996).

133. See, e.g., I.R.C. §§ 11, 541, 531, 594, 802, 831, 1201, and 1333 (CCH 1999); see generally Treas. Reg. § 1.1502-2 (as amended in 1996).

134. See, e.g., I.R.C. §§ 27, 41 (CCH 1999).

135. See generally I.R.C. §§ 1361-1379 (CCH 1999).

136. See I.R.C. § 1361(b)(1) (CCH 1999).

137. See generally I.R.C. §§ 701-761 (CCH 1999).

138. See I.R.C. §§ 701, 702 (CCH 1999); see also, e.g., Bittker & Eustice, *supra* note 125, ¶ 1.07, at 1-27; Ault, *supra* note 16, at 356-57; Cunningham & Cunningham, *supra* note 118, at 1.

139. See Streng, *supra* note 118, at A-2. Partners in a GP are vulnerable to unlimited liability

Perhaps the most favored business entity of late is the limited liability company ("LLC").¹⁴⁰ An LLC may elect to be taxed either as a partnership under Subchapter K of the IRC or as a corporation under Subchapter C or, if applicable, Subchapter S of the IRC.¹⁴¹ In many cases, the LLC chooses to be taxed as a partnership.¹⁴² The members of an LLC are subject to limited liability under the state law where the LLC formed barring certain exceptions.¹⁴³

Finally, a sole proprietorship is a business conducted by an individual without the organization of a separate legal entity.¹⁴⁴ Because a sole proprietorship is not recognized as a business entity, it is not taxed as a separate entity for federal tax purposes.¹⁴⁵

2. Federal Income Tax

For the most part, individuals and C corporations are subject to progressive taxation achieved through a schedule of increasing marginal rates.¹⁴⁶ In general, shareholders of corporations, partners of partnerships, members of limited liability companies, and owners of sole proprietorships are taxed at the individual level.¹⁴⁷

C corporations and some publicly traded partnerships are taxed at the entity level.¹⁴⁸ At present, the maximum rate on a corporation's taxable income is thirty-five percent.¹⁴⁹ The corporate tax rate structure is complex due to the phase out of lower bracket rates at higher income levels.¹⁵⁰

under the state law where the partnership formed. See Cunningham & Cunningham, *supra* note 118, at 7; see also Streng, *supra* note 118, at A-24. An LLP must have at least one general partner who is subject to unlimited liability. See Cunningham & Cunningham, *supra* note 118, at 4; see also Streng, *supra* note 118, at A-25. A PTP is any partnership whose interests are traded on an established securities market, or readily tradable on a secondary market or its substantial equivalent. See I.R.C. § 7704(b) (CCH 1999); see also Streng, *supra* note 118, at A-5. In some instances, certain PTP's may be subject to Subchapter C of the Code. See generally I.R.C. § 7704 (CCH 1999).

140. See generally Cunningham & Cunningham, *supra* note 118, at 8-9; see also, e.g., Bittker & Eustice, *supra* note 125, ¶ 2.05, at 2-29; Streng, *supra* note 118, at A-6; Lind et al., *supra* note 118, at 3.

141. See Treas. Regs. §§ 301.7701-2(c)(1) (as amended in 1996), 301.7701-3(a), 301.7701-3(b)(1)(i) (as amended in 1998).

142. See Cunningham & Cunningham, *supra* note 118, at 5; see also, e.g., Bittker & Eustice, *supra* note 125, ¶ 1.08, at 1-37; Streng, *supra* note 118, at A-6.

143. See Rev. Proc. 95-10, 1995-1 I.R.B. 20; see also, e.g., Streng, *supra* note 118, at A-24; Cunningham & Cunningham, *supra* note 118, at 7.

144. See Streng, *supra* note 118, at A-3; see also Lind et al., *supra* note 118, at 2.

145. See Treas. Reg. § 301.7701-2(a) (as amended in 1996); see also, e.g., Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945); Streng, *supra* note 118, at A-3.

146. See, e.g., I.R.C. §§ 1, 11 (CCH 1999).

147. See generally Streng, *supra* note 118, at A-38(11) to A-39. For calendar year 2000, the maximum rate on an individual's ordinary taxable income was 39.6 percent with a preferential capital gains rate for net long-term capital gains. See generally I.R.C. § 1 (CCH 2000).

148. See I.R.C. § 11(a) (CCH 1999).

149. See I.R.C. § 11(b) (CCH 1999).

150. The graduated rate structure is phased out at higher income levels by a five percent surtax on

Limited liability companies, S corporations, and most partnerships are classified as "eligible" business entities¹⁵¹ and, therefore, may elect to be taxed as a C corporation or as a partnership by election or default under the "check-the-box" regulations.¹⁵² One important note is that qualified personal service corporations are subject to a thirty-five percent flat tax rate on all their taxable income.¹⁵³

Corporations may be subject to the alternative minimum tax (AMT). The corporate AMT is imposed only to the extent that it exceeds a corporation's regular tax liability.¹⁵⁴ In general, the tax equals twenty percent of the amount by which a corporation's alternative minimum taxable income exceeds a specified exemption amount.¹⁵⁵

3. Subnational (State) Income Taxes

Forty-five states and the District of Columbia have adopted their own corporate income tax laws.¹⁵⁶ However, a state's taxing authority may be limited by Congress¹⁵⁷ or the U.S. Constitution.¹⁵⁸ Thus, a state may levy a corporate income tax only on the income (or a portion thereof) that has a sufficient nexus with the taxing state.¹⁵⁹ For a state to impose income tax generated in interstate commerce, there are two requirements: (1) a "minimal connection" between the taxing state and the interstate activities generating the tax and (2) a rational relationship between the income taxed and the activities conducted within the state.¹⁶⁰ A state may tax

taxable income between \$100,000 and \$335,000 and a three percent surtax on taxable income between \$15,000,000 and \$18,333,333, respectively. *See id.*; *see also* Ault, *supra* note 16, at 286.

151. *See* Treas. Reg. § 301.7701-3(a) (as amended in 1998).

152. *See* Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 1998).

153. *See* I.R.C. § 11(b)(2) (CCH 1999). In general, qualified personal service corporations are corporations "substantially all of the activities of which involve the performance of services" and substantially all of the stock (by value) is held directly or indirectly by employees, former employees, the estate of an employee or former employee, and "any other person who acquired such stock by reason of the death" of an employee or former employee. *See* I.R.C. § 448(d)(2) (CCH 1999).

154. *See* I.R.C. § 55(a) (CCH 1999).

155. Alternative minimum taxable income (AMTI) is the corporation's taxable income with certain adjustments under the Code. *See* I.R.C. § 55(b)(2) (CCH 1999). *See e.g.*, I.R.C. §§ 56-59 (CCH 1999); *see generally* I.R.C. §§ 55(b), (d)(2) (CCH 1999).

156. *See* Richard D. Pomp & Oliver Oldman, 3 *State and Local Taxation* 10-1 (3d ed. 1998); *see also* Jerome R. Hellerstein & Walter Hellerstein, *State and Local Taxation: Cases and Materials* 15 (6th ed. 1997).

157. *See* Public Law 86-272 which prevents states from taxing corporations when the corporation's only nexus with the state is personal property sales solicitations conducted in the state. 73 Stat. 555-56 (codified as amended at 15 U.S.C. §§ 381-384 (1976)). *See generally* Tracy A. Kaye, *Show Me the Money: Congressional Limitations on State Tax Sovereignty*, 35 *Harv. J. on Legis.* 149, 165 (1998); *see* Pomp & Oldman, *supra* note 156, at 10-34, -35.

158. *See* *Quill Corp. v. North Dakota*, 504 U.S. 298, 305, 112 S. Ct. 1904, 1909 (1992) (stating that "the [Due Process and Commerce] Clauses pose distinct limits on the taxing powers of the States").

159. *See* Pomp & Oldman, *supra* note 156, at 10-7; *see also* *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45, 74 S. Ct. 535, 539 (1954) (stating that "due process requires some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax.").

160. *See* *Exxon Corp. v. Wisconsin Dept. Of Revenue*, 447 U.S. 207, 219, 100 S. Ct. 2109, 2118

only income that is fairly attributable to a corporation's income-producing activities within the state.¹⁶¹

The states have developed three general approaches for determining a corporation's taxable income: separate accounting, formulary apportionment, and specific allocation.¹⁶² Separate accounting calculates taxable income by isolating the portion of the business that the corporation carries on within the taxing state as a distinct and independent entity.¹⁶³ Formulary apportionment utilizes a formula to determine a corporation's taxable income with respect to the states in which it has business activities.¹⁶⁴ Specific allocation assigns particular types of income to specific states by applying rules not based upon formulary apportionment.¹⁶⁵

4. Foreign Tax Relief for Resident Corporations

A domestic corporation is one that is created or organized under the laws of the United States or one of the states.¹⁶⁶ All domestic corporations are U.S. resident corporations, and a foreign corporation is treated like a U.S. resident corporation if it is engaged in a trade or business within the United States.¹⁶⁷ In general, U.S. resident corporations are taxed on all of their worldwide income, regardless of geographic origin.¹⁶⁸ Qualified taxpayers may elect to take a credit for foreign income taxes paid or deemed paid in lieu of a deduction of the foreign taxes.¹⁶⁹ The credit may not exceed the pre-credit U.S. tax on income from foreign sources.¹⁷⁰ In effect, a taxpayer's overall tax liability on foreign source income equals the higher of either the pre-credit U.S. tax on the income or the foreign tax.¹⁷¹ One important note is that the credit limitations must be determined separately with respect to nine categories (or baskets) of income.¹⁷²

(1980); *see also* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436-37, 100 S. Ct. 1223, 1231 (1980).

161. *See* Container Corp. Of America v. Franchise Tax Bd., 463 U.S. 159, 103 S. Ct. 2933 (1983) (a state may not tax income earned outside its borders when imposing an income tax); *see also* ASARCO v. Idaho State Tax Comm'n, 458 U.S. 307, 315, 102 S. Ct. 3103, 3108 (1982) (stating "a State may not tax value earned outside its borders").

162. *See* Pomp & Oldman, *supra* note 156, at 10-8.

163. *See id.*; *see also* Hellerstein & Hellerstein, *supra* note 156, at 410-11, 445-48.

164. *See* Pomp & Oldman, *supra* note 156, at 10-12; *see also* Hellerstein & Hellerstein, *supra* note 156, at 408-09.

165. *See* Pomp & Oldman, *supra* note 156, at 10-29; *see also* Hellerstein & Hellerstein, *supra* note 156, at 417-18.

166. *See* I.R.C. § 7701(a)(4) (CCH 1999).

167. *See* Treas. Reg. § 301.7701-5 (1967).

168. *See* Boris I. Bittker & Lawrence Lokken, Fundamentals of International Taxation: U.S. Taxation of Foreign Income and Foreign Taxpayers ¶ 65.1.2, at 65-3 (1998); *see also* Charles H. Gustafson et al., Taxation of International Transactions: Materials, Text and Problems ¶ 1155, at 28 (1997).

169. *See* I.R.C. §§ 164(a), 901(a) (CCH 1999).

170. *See* I.R.C. § 904(a) (CCH 1999).

171. *See* Bittker & Lokken, *supra* note 168, ¶ 69.5.1, at 69-45; *see also* Gustafson et al., *supra* note 168, ¶ 5010, at 226.

172. *See* I.R.C. § 904(d) (CCH 1999).

A U.S. resident corporation is deemed to have paid foreign income taxes actually paid by a nonresident corporation from which it receives dividend payments if the U.S. resident corporation owns at least ten percent of the nonresident corporation's voting stock.¹⁷³ A U.S. resident corporation is also deemed to have paid foreign income taxes actually paid by lower-tier nonresident corporations under certain circumstances.¹⁷⁴

A nonresident corporation receiving a dividend payment from another nonresident corporation is deemed to have paid portions of the foreign income taxes of the payer corporation if both corporations are part of a qualified group and the recipient owns at least ten percent of the payer's voting stock.¹⁷⁵ For a nonresident corporation below the third tier, indirect credit is only permitted for foreign income taxes for periods when the corporation was a controlled foreign corporation (CFC).¹⁷⁶ The amount deemed paid is calculated by prorating the nonresident corporation's foreign income taxes among its earnings and profits and attributing to the U.S. resident corporation the proportional amount allocated to the earnings it received as dividend payments.¹⁷⁷

5. Taxation of Nonresident Corporations

A corporation is considered a nonresident corporation if it is created or organized under the laws of a foreign country or a territory of the United States.¹⁷⁸ In general, nonresident corporations are taxed under one of two schemes. If a nonresident corporation conducts a trade or business within the United States, a U.S. tax is imposed on all taxable income that is effectively connected with that trade or business.¹⁷⁹ For all other income, gain, and loss from sources within the United States, a nonresident corporation is subject to a thirty percent flat-tax.¹⁸⁰

For federal income tax purposes, a nonresident corporation is considered a U.S. resident corporation if it is engaged in a trade or business within the United States.¹⁸¹ Therefore, it is subject to the graduated rates under the IRC on taxable income effectively connected with a U.S. trade or business.¹⁸² In addition, it is

173. See generally I.R.C. § 902(a) (CCH 1999).

174. See I.R.C. § 902(b). See also Bittker & Lokken, *supra* note 168, ¶ 69.8.5, at 69-126; see also Gustafson et al., *supra* note 168, ¶ 5135, at 259.

175. See I.R.C. §§ 902(b)(1), (2) (CCH 1999).

176. See *id.* A controlled foreign corporation is a foreign corporation in which at least 50 percent of the stock, by vote or value, is owned by U.S. persons who own more than 10 percent of the voting stock. See I.R.C. §§ 957(a), 951(b) (CCH 1999); see also Treas. Reg. §§ 1.957-1(a), (b) (as amended in 1996).

177. See Bittker & Lokken, *supra* note 168, ¶ 69.8.1, at 69-99; see for example Gustafson et al., *supra* note 168, ¶ 5135, at 259-62.

178. See I.R.C. §§ 7701(a)(4), (5) (CCH 1999).

179. See I.R.C. § 882(a) (CCH 1999).

180. See I.R.C. § 881(a) (CCH 1999). See *infra* note 191 and accompanying text.

181. See Treas. Reg. § 301.7701-5 (as amended in 1967).

182. See I.R.C. § 882(a)(1) (CCH 1999); see generally I.R.C. § 11 (CCH 1999).

entitled to offset the income with certain expenses, deductions, and credits.¹⁸³ The foreign tax credit is only allowed against the effectively connected income tax for the years in which the taxpayer carried on a trade or business within the U.S.¹⁸⁴

The thirty percent flat-tax is a withholding tax that is deducted and withheld at the source of income.¹⁸⁵ The tax is applicable to fixed or determinable annual or periodic ("FDAP") income such as interest, dividends, rents, and royalties.¹⁸⁶ The gross income subject to tax is the pretax amount of the income.¹⁸⁷ The amount withheld is allowed as a credit against the tax liability of the beneficial owner.¹⁸⁸

Different rules may apply if a nonresident corporation is a resident of one of the countries with which the U.S. has an income tax treaty. A corporation is a resident of a treaty country if it is taxed as a domestic corporation under the laws of the treaty country.¹⁸⁹ Typically, business profits of a resident of the treaty partner may be taxed by the United States only if the taxpayer has a permanent establishment in the United States and the profits are attributable to the permanent establishment.¹⁹⁰ A U.S. tax may be imposed at the statutory rates on any business profits that are attributable to the permanent establishment.¹⁹¹ In certain cases, the permanent establishment rules may not apply to all types of income.¹⁹² In general, treaties also reduce the thirty percent withholding tax for some types of income, in some cases to as low as zero withholding.¹⁹³

Capital gain from the sale or exchange of real property of the nonresident corporation is deemed to be income effectively connected with a U.S. trade or business, even if it was a passive investment to the nonresident corporation.¹⁹⁴ In contrast, capital gains of nonresident corporations from the disposition of all other capital assets (except inventory property) are not subject to tax unless the gains are effectively connected with a U.S. trade or business.¹⁹⁵

183. See I.R.C. § 882(c) (CCH 1999).

184. See I.R.C. §§ 882(c)(3), 906(a) (CCH 1999).

185. See I.R.C. § 1442(a) (CCH 1999).

186. See I.R.C. § 881(a)(1) (CCH 1999).

187. See I.R.C. § 1462 (CCH 1999).

188. See Treas. Reg. § 1.1462-1(a) (as amended in 1997).

189. See United States, Model Income Tax Convention, art. 4(1) (Treas. Dep't 1996) [hereinafter U.S. Model Treaty]. See also Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital [hereinafter OECD Model Treaty], art. 4(1) (1997).

190. Bittker & Lokken, *supra* note 168, ¶ 66.3.9, at 66-126; see also Gustafson et al., *supra* note 168, ¶ 1265, at 51-52.

191. See U.S. Model Treaty, *supra* note 189, at art. 7(1); see also OECD Model Treaty, *supra* note 189, at art. 7(1).

192. See e.g. U.S. Model Treaty, *supra* note 189, at arts. 6, 8, and 18; see also OECD Model Treaty, *supra* note 189, at arts. 6, 8, and 18.

193. See Bittker & Lokken, *supra* note 168, ¶ 66.1.2, at 66-6; see also Gustafson et al., *supra* note 168, ¶ 1265, at 52.

194. See I.R.C. § 897(a)(1) (CCH 1999).

195. See I.R.C. §§ 864(c)(2), 871(a)(2), 881 (CCH 1999).

6. Computation of Taxable Income

The computation of the taxable income of C corporations (and other business entities taxed pursuant to Subchapter C) begins with the calculation of gross income.¹⁹⁶ Certain items of income may require special treatment in the calculation of gross income.¹⁹⁷ Other items may be entirely excluded from the calculation of gross income.¹⁹⁸ Note, however, that "gross income derived from a manufacturing or merchandise business" means "gross receipts" or "total sales, less the cost of goods sold."¹⁹⁹

The next step is to calculate the taxable income by subtracting deductions allowable under the IRC.²⁰⁰ C corporations may deduct the ordinary expenses connected with the pursuit of profit.²⁰¹ Corporate shareholders may deduct seventy to one hundred percent of the dividends they receive from other corporations.²⁰²

Tangible property is depreciated under the accelerated cost recovery system (ACRS) of the IRC.²⁰³ The applicable depreciation method and recovery period is subject to the character or classification of the tangible property.²⁰⁴ Intangible property is amortized ratably over a fifteen year period.²⁰⁵ In general, net operating losses may be carried back to two taxable years preceding the loss year and may be carried forward twenty subsequent years.²⁰⁶

In certain instances, it is important to distinguish capital gain and loss from ordinary gain and loss. For C corporations, capital losses are allowed only against capital gains and not ordinary income.²⁰⁷ Furthermore, corporations may carry back unused net capital losses for three years and carry forward net capital losses for only five years.²⁰⁸

The federal income tax may be offset with any available tax credits. The most significant tax credits for corporations are the research and expenditure credit and the foreign tax credit.²⁰⁹ Other tax credits for corporations include the work opportunity tax credit and the rehabilitation and energy tax credit.²¹⁰

196. Gross income includes (but is not limited to) "income from whatever source derived, including . . . (1) Compensation for services; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; . . . (9) Annuities; . . . (11) Pensions," and income from partnerships, trusts, and estates. I.R.C. § 61(a) (CCH 1999).

197. See, e.g., I.R.C. §§ 71-85 (CCH 1999).

198. See, e.g., I.R.C. §§ 101-138 (CCH 1999).

199. See Treas. Reg. § 1.61-3(a) (as amended in 1992).

200. See I.R.C. § 63(a) (CCH 1999).

201. See I.R.C. § 162 (CCH 1999).

202. See I.R.C. § 243 (CCH 1999).

203. See I.R.C. § 168 (CCH 1999).

204. See I.R.C. §§ 168(b), (c), (e) (CCH 1999).

205. See I.R.C. § 197(a) (CCH 1999).

206. See I.R.C. § 172(b) (CCH 1999).

207. See I.R.C. § 1211(a) (CCH 1999).

208. See I.R.C. § 1212(a) (CCH 1999).

209. See generally I.R.C. §§ 41, 27 (CCH 1999).

210. See generally I.R.C. §§ 51, 46-48 (CCH 1999).

C corporations are generally required to use the accrual method of accounting when the accounting of inventory is necessary.²¹¹ Inventory valuation must conform as closely as possible to the best accounting practice in the trade or business, and it must clearly reflect income.²¹² Although greater weight is to be given to consistency in practice than to any particular accounting method of inventory, no method of accounting is acceptable unless it clearly reflects income.²¹³ Inventory includes all goods, raw materials, and supplies acquired for sale or that will become part of merchandise intended for sale.²¹⁴

7. Corporations and Their Shareholders

C corporations (and other business entities subject to Subchapter C) are taxed on their income earned at the entity level.²¹⁵ Individual shareholders are also taxed on the income received in the form of dividend distributions from C corporations.²¹⁶ Dividend distributions are those distributions (or a portion thereof) out of the earnings and profits of the corporation.²¹⁷ Because corporate taxable income is taxed at the entity level and at the shareholder level (when distributed), C corporation profit is taxed twice, hence the term "double taxation."²¹⁸

Not every corporate distribution to its shareholders is subject to ordinary income taxation.²¹⁹ Only that portion of the distribution that is considered a dividend shall be included in gross income.²²⁰ However, corporate shareholders may be entitled to a dividends received deduction (DRD), a deduction of seventy

211. See Treas. Reg. § 1.446-1(c)(2) (as amended in 1997); see also, e.g., J. Martin Burke & Michael K. Friel, *Taxation of Individual Income* 613 (5th ed. 1998); Paul R. McDaniel, et al., *Federal Income Taxation: Cases and Materials* 1045 (4th ed. 1998). The taxpayer must maintain inventories in every case in which the production, purchase, or sale of merchandise is a material income producing factor. See Treas. Reg. § 1.471-1 (1958).

212. See I.R.C. § 471(a) (CCH 1999); see also, e.g., Treas. Reg. § 1.471-2(a) (as amended in 1973); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532, 99 S. Ct. 773, 781 (1979) (stating that "[as] the Regulations point out, § 471 obviously establishes two distinct tests to which an inventory must conform.").

213. See Treas. Reg. § 1.471-2(b) (as amended in 1973); see also, e.g., Treas. Reg. § 1.446-1(a)(2) (as amended in 1997); *Thor Power*, 439 U.S. at 540, 99 S. Ct. at 785 (stating that "the Code and Regulations give the Commissioner broad discretion to set aside the taxpayer's method if, 'in [his] opinion,' it does not reflect income clearly.").

214. See Treas. Reg. § 1.471-1 (1958); see also William A. Klein & Joseph Bankman, *Federal Income Taxation* 629-30 (11th ed. 1997).

215. See *supra* note 125 and accompanying text.

216. See *id.*

217. See I.R.C. § 316(a) (CCH 1999). Although not specifically defining earnings and profits, the Code and the Treasury Regulations outline the effects of certain transactions on earnings and profits. See generally I.R.C. § 312 (CCH 1999); see also Treas. Reg. § 1.312 (1955).

218. See *supra* note 125 and accompanying text.

219. A corporation may make nonliquidating distributions to its shareholders in the forms of cash, other property, or the corporation's own stocks. See Bittker & Eustice, *supra* note 125, ¶ 8.04, at 8-30; see also, e.g., Abrams & Doernberg, *supra* note 125, ¶ 4.01, at 77; Lind et al., *supra* note 118, at 438.

220. See I.R.C. § 301(c)(1) (CCH 1999).

to one hundred percent of the dividends they receive from other corporations.²²¹

In general, the same accounting method used to determine a corporation's taxable income is employed in determining its earnings and profits.²²² Those distributions that are not dividends are treated as a return of the shareholder's investment in the corporation, thereby reducing the tax basis of the shareholder's stock in the corporation.²²³ Any further distributions in excess of that basis are treated as capital gain from the sale or exchange of the stock.²²⁴

III. SOURCE OF INCOME RULES

A. Canada

Canadian residents and corporations are taxed on worldwide income from whatever source derived.²²⁵ Subsection 2(1) of the Canadian Income Tax Act ("ITA") imposes a tax on the taxable income of anyone who is a resident in Canada at any time in a taxable year. In order to prevent double taxation, the ITA provides a foreign tax credit. Because the Canadian corporation's credit for foreign taxes is generally equal to the lesser of the foreign income taxes paid or the Canadian income taxes otherwise payable on foreign income, it is important to determine whether the income is from a foreign source and whether any expenses are deductible in whole or in part against such foreign income.²²⁶

The source rules play an important role in the taxation of nonresidents because nonresidents are generally only taxable on Canadian source income.²²⁷ Subsection 2(3) requires nonresidents to pay income taxes if at any time during the year or previous year the person was employed in Canada, carried on a business in Canada, or disposed of taxable Canadian property.²²⁸

Essentially, nonresidents are subject to a two part tax scheme. First, nonresidents carrying on business in Canada are taxed on that net income under Part I of the ITA.²²⁹ Nonresidents may generally claim deductions in the same manner

221. See I.R.C. § 243 (CCH 1999).

222. See Treas. Reg. § 1.312-6(a) (1955).

223. See I.R.C. § 301(c)(2) (CCH 1999).

224. See I.R.C. § 301(c)(3) (CCH 1999).

225. See I.T.A. § 3(a) (1985).

226. See I.T.A. § 126(2) (1985). The corporation must determine separately the foreign tax credit for business income and nonbusiness income for each country. See I.T.A. § 126(6) (1985).

227. See generally Jinyan Li, *Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 1*, 47 Canadian Tax Journal 1077 (1999) and *Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 2*, 47 Canadian Tax Journal 1411 (1999).

228. See I.T.A. § 2(3) (1985). Taxable Canadian property includes real estate situated in Canada, capital property used in carrying on a business in Canada, shares of a private corporation resident in Canada, and shares of a nonresident corporation owning principally Canadian real property. See I.T.A. § 115 (1985).

229. Because there is no statutory definition of what constitutes carrying on business in Canada, the issue is factual. The extensive case law indicates that the test most commonly used is the place where the contracts are entered into and where essential business activities are performed. See Brian Arnold, *Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia,*

as Canadian residents.²³⁰ Second, nonresidents are levied a withholding tax of twenty-five percent (subject to reductions under a particular treaty) under Part XIII of the ITA on any amounts such as interest, rent, royalties, trust income, and management fees, paid or credited by a Canadian resident.²³¹ This tax is applied to the gross amount of the relevant income without any deduction for related expenses.²³²

1. Interest Income

Unlike the Internal Revenue Code, the ITA does not contain rules on how to determine the source of non-business income.²³³ However, because Canada imposes a withholding tax on interest paid or credited by a resident of Canada to a nonresident,²³⁴ the specification of payments subject to the Canadian withholding tax makes source rules unnecessary.²³⁵ These withholding rules also provide support for the general proposition that interest income is Canadian source income if the payer is a domestic Canadian corporation or a Canadian resident, and is foreign source income if the payer is a foreign corporation or a nonresident residing in a foreign country in which the lender has no permanent establishment.²³⁶

2. Dividend Income

Canada imposes a withholding tax on dividends (including deemed dividends) paid or credited by a resident of Canada to a nonresident.²³⁷ Thus, dividends are Canadian source income if the payer is a domestic corporation, and foreign source income if the payer is a foreign corporation.²³⁸

3. Personal Services Income

Compensation for personal services (salaries, wages, fees, and commissions) performed in Canada is Canadian source income, while compensation for personal

New Zealand, the United Kingdom, and the United States 55 (1991). Nonresidents are also deemed to be carrying on business in Canada in the following situations: the nonresident, through an agent or employee, solicits orders or offers anything for sale in Canada in the year; or the nonresident produces, processes, manufactures, packages, constructs, or improves anything in whole or in part in Canada. See I.T.A. § 253 (1985).

230. See I.T.A. Interpretation Bulletin IT-420R3, *Non-Residents—Income Earned in Canada* (Mar. 30, 1992).

231. See I.T.A. § 212 (1985).

232. See Michael I. Atlas, *Canadian Taxation of Non-Residents* 11 (1995).

233. See CCH Canadian Tax Guide, *supra* note 22, at ¶ 18,253.

234. See I.T.A. § 212(1)(b) (1985).

235. See Arnold, *supra* note 229, at 52.

236. See I.T.A. § 212(1)(b) (1985). See also CCH Canadian Tax Guide, *supra* note 22, at ¶ 18,251. Under certain circumstances, non-resident persons are also required to withhold. See I.T.A. § 212(13.2) (1985).

237. See I.T.A. § 212(2) (1985).

238. See I.T.A. § 212(2) (1985).

services performed abroad is foreign source income.²³⁹ Apportionment is required for services that are rendered partly in a foreign country.²⁴⁰ A former resident of Canada is taxed on the entire employment income received from a Canadian payer except on amounts received for employment outside of Canada that are taxable by a foreign jurisdiction.²⁴¹ The lack of specific statutory rules may cause difficulty in determining employment income in Canada.²⁴²

Stock option benefits are taxable as employment income when shares are acquired for less than their fair market value.²⁴³ Nonresidents receiving stock options from employment in Canada are still taxable in Canada even if they exercise these options after giving up their Canadian residence.²⁴⁴ Canada sources such income according to the place of employment rather than the place where the stock option is exercised.²⁴⁵ Because a basic premise of Canadian tax law is that employment income is generally taxed when received, issues also arise when Canadian residents receive amounts that do not relate to services rendered in Canada.²⁴⁶

4. Rental and Royalty Income

Rental and royalty income is Canadian source income if the property is located or used in Canada. On the other hand, this is considered foreign source income if the property is located or used abroad.²⁴⁷ If the place of use of personal property is both within and without Canada, the taxpayer must apportion the rental income between Canadian and foreign sources.

5. Gains from the Disposition of Real Property

A gain on the sale, exchange, or any other disposition of "taxable Canadian property" is Canadian source income whereas a gain on the sale or exchange of real property located abroad is foreign source income.²⁴⁸ The concept of taxable

239. See I.T.A. §§ 2(3)(a), 115(1)(a)(i) (1985).

240. See Gilles Gagné, *Canada*, LXVb Cahiers De Droit Fiscal International 298 (1980).

241. See I.T.A. §§ 115(2)(c),(d),(e) (1985). See also Ault, *supra* note 16, at 443.

242. See Arnold, *supra* note 229, at 54. "For example, should a portion of a non-resident's annual salary attributable to his employment in Canada be based on the number of days during which he was physically present in Canada, or just the number of days during which he was performing the duties of employment in Canada?" *Id.* at 28.

243. See I.T.A. § 7(1) (1985). See also Krishna, *supra* note 38, at 210-11.

244. See I.T.A. § 7(4) (1985). See also Krishna, *supra* note 38, at 1232.

245. *Id.*

246. See Anne Montgomery & Gary Nachshen, *Canada*, LXXXVb Cahiers De Droit Fiscal International 316, 320 (2000).

247. See I.T.A. § 212(1)(d) (1985). Payments by a Canadian resident to a nonresident for the use in Canada of any property, invention, patent, trademark, etc. are subject to a 25 percent nonresident withholding tax, unless reduced by treaty. *Id.* In effect, this tax functions as a source rule. See Ault, *supra* note 16, at 447.

248. See I.T.A. § 2(3)(c) (1985). Taxable Canadian property also includes many types of property in addition to real property, e.g., shares of private corporations, certain shares of public corporations,

Canadian property establishes the sort of property for which nonresident gains are considered to be Canadian source.²⁴⁹ Taxable Canadian property includes any interest in or option with respect to real property situated in Canada.²⁵⁰

6. *Income from the Disposition of Inventory*

Inventory held for sale in the ordinary course of a business has its source where the business is carried on.²⁵¹ The meaning of "carrying on business" is generally determined under the common law.²⁵²

7. *Gains from the Disposition of Stocks, Bonds, and Other Securities*

As a general rule, gains from the sale of marketable securities are sourced in the country in which the exchange on which the shares are traded or where the contract of sale is made.²⁵³ The gain on the sale of "taxable Canadian property" is taxable in Canada regardless of the source.²⁵⁴ Taxable Canadian property includes, inter alia, shares of a Canadian private corporation and shares of a public corporation, if the nonresident holds or recently held at least twenty-five percent of the shares alone or together with related persons.²⁵⁵ The amount of income from a disposition of taxable Canadian property is the taxable portion of the gain (currently three-fourths) netted out against the relevant portion of capital losses realized by the nonresident.²⁵⁶

8. *Source Rules for Deductions*

A Canadian resident corporation's foreign tax credit may not exceed an amount equal to the Canadian tax otherwise payable, multiplied by the taxable income attributable to foreign source income, divided by income from all sources, as determined under Canadian tax law.²⁵⁷ The ITA requires a breakdown of income by territorial source, computed by deducting direct expenses incurred in carrying on the business and apportioning those indirect or overhead-type expenses that are

and certain shares of nonresident corporations.

249. See House of Commons, *Taxable Canadian Property*, Third Report of the Standing Committee on Finance 5 (Sept. 1996).

250. See *id.*, at 9.

251. See Gagne, *supra* note 240, at 294.

252. For an excellent discussion of the meaning of "carrying on business in Canada" and "carrying on business outside of Canada" under caselaw, section 253, and Canada's tax treaties, see Jinyan Li, *Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 1*, *supra* note 227, at 1094-1102.

253. See *id.* at 1122-24.

254. See I.T.A. § 2(3)(c) (1985).

255. See I.T.A. § 115 (1) (b) (1985).

256. See Arnold, *supra* note 229, at 57.

257. See *supra* note 51 and accompanying text for an explanation of the per-country limitation and the basket limitation for nonbusiness income that is also applied on a per-country basis.

incurred for multiple businesses or other sources of income.²⁵⁸ No methods of apportionment are provided for deductions in the statute.²⁵⁹

Interpretation Bulletin IT-270R²⁶⁰ states that an allocation of deductions, including overhead, should be made on the basis of the factual relationship between a particular deduction and the gross income arising in a particular country. If tracing is impossible, expenses may be allocated according to a reasonable formula based on asset values or gross income.²⁶¹ In general, Revenue Canada requires interest to be allocated to a particular territorial source using direct tracing where possible.²⁶² Furthermore, an allocation of expenses to territorial sources of gross income for financial statement purposes is normally accepted for purposes of computing the foreign tax credit, provided that the basic rules of section 4 are satisfied.²⁶³ The source rules in IT-270R are also applicable to the determination of income of nonresidents earned in Canada.²⁶⁴

B. Mexico

For corporations that reside in Mexico, the Mexican source of income rules play a significant role in the computation of the Mexican foreign tax credit, which is limited to the amount of Mexican tax attributable to net foreign source income.²⁶⁵ Source of income rules play an even more prominent role in the taxation of a nonresident. Nonresident corporations with a permanent establishment in Mexico are taxed only on income attributable to that permanent establishment,²⁶⁶ while nonresident corporations that do not have a permanent establishment are subject to Mexican tax on any other types of income derived from Mexican sources.²⁶⁷

1. Interest Income

Interest income is from a Mexican source when the capital is placed or invested in Mexico or when the payer of the interest is a Mexican resident or a nonresident with a permanent establishment in Mexico.²⁶⁸

258. See I.T.A. § 4(1)(b) (1985).

259. See generally, Bruce M. McLean, *Sourcing of Business Income*, in *Current Developments in Measuring Business Income for Tax Purposes*, 9:1-37 (Toronto: Canadian Tax Foundation, 1987).

260. See I.T.A. Interpretation Bulletin IT-270R, *Foreign Tax Credit* (as revised July 9, 1984).

261. See Ault, *supra* note 16, at 393.

262. Stephen Ruby & John Stacey, *Canada*, LXXIXa *Cahiers De Droit Fiscal International*, 133 (1994).

263. See I.T.A. Interpretation Bulletin IT-270R, *Foreign Tax Credit*, *supra* note 260, at ¶ 39. "Once a basis for allocation has been established, future allocations are expected to be made on a consistent basis."

264. See I.T.A. Interpretation Bulletin IT-270R2, *Non-Residents—Income Earned in Canada*, ¶ 8 (as revised Mar. 14, 1985).

265. L.I.S.R. art. 6.

266. L.I.S.R. art. 4.

267. See Castillo, *supra* note 86, at A-56 (Income Not Attributable to a Permanent Establishment).

268. L.I.S.R. art. 154.

2. Dividend Income

Dividends and other profit distributions by corporations are considered to be of a Mexican source when the distributing entity resides in Mexico.²⁶⁹

3. Personal Services Income

Income from either dependent or independent personal services is from a Mexican source when the services are rendered in Mexico.²⁷⁰

4. Rental and Royalty Income

Income derived from the rental of real property is deemed to be from a Mexican source if the property is located in Mexico.²⁷¹ Income from the rental of tangible personal property is deemed to be from a Mexican source if the property is used in Mexico for industrial, commercial, agricultural, stock breeding, or fishing activities.²⁷² Likewise, income from financial leases is of a Mexican source when the corresponding property is used in Mexico or when the leasing payments are deducted by a permanent establishment in Mexico.²⁷³

Income from royalties or "technical assistance" is from a Mexican source when the property or right giving rise to the payment is used in Mexico.²⁷⁴ If the payer is a Mexican resident or a nonresident with a permanent establishment in Mexico, it is assumed that the intangible asset is being used in Mexico. This presumption can be rebutted if the taxpayer can prove that the intangible assets are used outside Mexico.²⁷⁵

5. Gains from the Disposition of Real Property

Income from the sale or other disposition of real property is from a Mexican source if the property is located in Mexico.²⁷⁶

269. L.I.S.R. art. 152. Corporations that are organized under the laws of Mexico and foreign entities that have their seat of management in Mexico are presumed to be residents of Mexico. L.I.S.R. art. 15.

270. L.I.S.R. arts. 145, 147. Likewise, artists and athletes performing at public events or carrying on artistic or sporting activities earn Mexican source income when the public event or the artistic or sporting activity is performed in Mexico. L.I.S.R. art. 158.

271. L.I.S.R. art. 148.

272. L.I.S.R. art. 149. Income derived from property intended for other activities is Mexican source if the property is physically delivered in Mexico.

273. L.I.S.R. art. 167. The term financial leases includes leases of tangible goods that provide for occasional payments for the property plus fees, interest, and any other charge.

274. "Technical assistance" is defined as "the rendering of independent personal services by which the provider agrees to supply knowledge that is not capable of being patented and that does not imply the transmission of confidential information regarding industrial, commercial or scientific experience, requiring the receiver to intervene in the application of such knowledge." *Codigo Fiscal de la Federaci3n* art. 15B [hereinafter C.F.F.].

275. L.I.S.R. art. 156.

276. L.I.S.R. art. 150.

6. *Income from the Disposition of Inventory*

The source of income from the disposition of inventory is determined under the principle that income is considered attributable to a fixed place of business if it is the result of the activities of that place of business.²⁷⁷ Therefore, the gross profit realized by a distributor from an inventory sale is attributed to the location of the distribution facility or sales office. Likewise, the gross profit realized by a manufacturer from an inventory sale is attributed to the location of the underlying manufacturing facility.

7. *Gains from the Disposition of Stocks, Bonds, and Other Securities*

Income from the sale or other disposition of shares or other negotiable instruments that represent the ownership of goods is of a Mexican source if either the issuing entity resides in Mexico or at least fifty percent of the accounting value of the shares or securities is derived from real property located in Mexico.²⁷⁸

8. *Other Source of Income Rules*

Special source of income rules apply to income derived from (i) the exchange of public debt for stock and income derived from capital-related financial derivatives;²⁷⁹ (ii) services related to construction projects;²⁸⁰ (iii) prizes and awards from a lottery, raffle, drawing, betting game, or contest;²⁸¹ and (iv) residents of tax havens when acting as commissioners, brokers, agents, distributors, consignees, and, in general, intermediaries.²⁸²

9. *Source Rules for Deductions*

In computing the amount of "net" foreign source income for purposes of the foreign tax credit limitation, deductions attributable entirely to the foreign source income must be taken in their entirety; deductions attributable exclusively to Mexican source income are not to be taken; and deductions attributable both to foreign source and to Mexican source income must be taken ratably, based on the proportion of foreign source income to overall income of the taxpayer during the year.²⁸³ Similar principles apply when computing the amount of a nonresident corporation's income attributable to a permanent establishment, i.e., expenses allowed as a deduction shall include a reasonable allocation of research and

277. L.I.S.R. art. 4.

278. L.I.S.R. art. 151. However, no tax is payable on income from the sale of shares or other securities representing the ownership of goods when the transaction is made through an authorized stock exchange or broad-based market in Mexico.

279. L.I.S.R. arts. 151-A, 151-B.

280. L.I.S.R. art. 156.

281. L.I.S.R. art. 157.

282. L.I.S.R. art. 159-A.

283. See Castillo, *supra* note 86, at A-74 (Foreign Tax Credit).

development expense, interest, and other expenses incurred for purposes of the enterprise as a whole.²⁸⁴

C. United States

In the United States, source of income rules for resident corporations have a significant effect on the computation of the foreign tax credit limitation. The U.S. foreign tax credit limitation equals the portion of the pre-credit U.S. tax that is attributable to foreign source income.²⁸⁵ However, the source rules play a more prominent role in the taxation of nonresident corporations because they effectively define the boundaries of U.S. taxation. The U.S. taxes the gross amount of a nonresident corporation's U.S. source nonbusiness income at a flat rate of thirty percent.²⁸⁶ It also taxes nonresident corporations at graduated rates on the net amount of income effectively connected with the conduct of a U.S. trade or business.²⁸⁷

1. Interest Income

Interest income is deemed to be U.S. source income if the payer of the interest is a domestic corporation or a U.S. resident, whereas it is foreign source income if the payer of the interest is a foreign corporation or a nonresident.²⁸⁸ Interest paid by the United States government or any agency or instrumentality thereof (not including U.S. territories), interest paid by one of the fifty states or any political subdivisions thereof, and interest paid by the District of Columbia are all considered to be from a U.S. source.²⁸⁹ Exceptions apply to a number of special situations, including: (i) interest paid by a domestic corporation that derived eighty percent or more of its gross income from the active conduct of a foreign business during the past three taxable years;²⁹⁰ (ii) interest paid on deposits in a foreign branch of a domestic corporation or domestic partnership engaged in the commercial banking business;²⁹¹ (iii) interest paid by a foreign corporation in which at least a fifty percent share interest is held by U.S. persons, and then only to the extent the interest payment is attributable to income that the foreign corporation derived from U.S. sources;²⁹² and (iv) interest paid by a U.S. branch of a foreign corporation.²⁹³

284. L.I.S.R. art. 23; U.S.-Mex. Treaty, *supra* note 8, at art. 7, ¶ 3; and Protocol to U.S.-Mex. Tax Treaty, *supra* note 8, at Item 5.

285. I.R.C. § 904(a) (CCH 1999).

286. I.R.C. § 881(a) (CCH 1999).

287. I.R.C. § 882(a) (CCH 1999).

288. I.R.C. §§ 861(a)(1), 862(a)(1) (CCH 1999).

289. Treas. Reg. § 1.861-2(a)(1) (2000).

290. I.R.C. §§ 861(a)(1)(A), 861(c)(1) (CCH 1999).

291. I.R.C. § 861(a)(1)(B)(i) (CCH 1999).

292. I.R.C. § 904(g)(3) (CCH 1999).

293. I.R.C. § 884(f)(1)(A) (CCH 1999).

2. Dividend Income

Dividends are U.S. source income if the payer is a domestic corporation. They are foreign source income if the payer is a foreign corporation.²⁹⁴ Exceptions apply to a number of special situations, including (i) dividends paid by a foreign corporation if, during the preceding three taxable years, twenty-five percent or more of its gross income was effectively connected with the conduct of a U.S. trade or business;²⁹⁵ (ii) dividends paid by a foreign corporation that is at least fifty percent owned by U.S. persons to the extent the dividend payment is attributable to income that the foreign corporation derived from U.S. sources;²⁹⁶ (iii) dividends paid by a foreign corporation where the payee claims a dividends-received deduction;²⁹⁷ and (iv) dividends paid by a domestic corporation that has made a possessions credit election.²⁹⁸

3. Personal Services Income

Compensation for personal services (salaries, wages, fees, and commissions) performed in the United States is U.S. source income, whereas compensation for personal services performed abroad is foreign source income.²⁹⁹ The exercise of nonqualified stock options also gives rise to personal services income. If the taxpayer performed services both within and without the United States during the period beginning on the grant date and ending on the exercise date, the resulting compensation must be allocated between U.S. and foreign source income based on the relative number of months worked in the United States and abroad from the grant date to the exercise date.³⁰⁰

4. Rental and Royalty Income

Rental and royalty income is U.S. source income if the property is located or used in the United States, but is foreign source income if the property is located or

294. I.R.C. §§ 861(a)(2), 862(a)(2) (CCH 1999).

295. I.R.C. § 861(a)(2)(B) (CCH 1999). If a foreign corporation meets the 25 percent test, the U.S. source portion equals the amount of the dividend times the ratio of gross income that was effectively connected with a U.S. trade or business during the three-year test period to the foreign corporation's total gross income for that period. One effect of this rule is to make foreign shareholders of such foreign corporations liable for U.S. withholding taxes on the U.S. source portion of the dividends. U.S. withholding taxes are not due, however, if the foreign corporation is distributing earnings and profits from a taxable year in which it paid a branch profits tax. I.R.C. § 884(e)(3) (CCH 1999).

296. I.R.C. § 904(g)(4) (CCH 1999).

297. I.R.C. § 245(a)(9) (CCH 1999).

298. I.R.C. § 861(a)(2)(A) (CCH 1999).

299. I.R.C. §§ 861(a)(3), 862(a)(3) (CCH 1999). A de minimis rule applies to income of a nonresident alien that is attributable to U.S. services. I.R.C. § 861(a)(3) (CCH 1999).

300. Treas. Reg. § 1.911-3(e)(4) (2000).

used abroad.³⁰¹ A related rule concerns gains from the disposition of an "intangible," defined as "any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property."³⁰²

5. Gains from the Disposition of Real Property

A gain on the sale or exchange of a U.S. real property interest is U.S. source income, whereas a gain on the sale or exchange of real property located abroad is foreign source income.³⁰³ A U.S. real property interest includes land, buildings, other inherently permanent structures, mines, wells, and other natural deposits, growing crops and timber, and personal property associated with the use of real property (such as mining and farming equipment) located within the United States or the U.S. Virgin Islands.³⁰⁴

6. Income from the Disposition of Inventory

Gross income from the sale of inventory that the taxpayer purchased for resale is U.S. source income if title passes within the United States, whereas it is foreign source income if title passes abroad.³⁰⁵ Income from the sale of inventory produced in the United States and sold abroad (or vice-versa) is generally allocated between U.S. and foreign source income using the "fifty-fifty" method.³⁰⁶ Under the fifty-fifty method, a U.S. manufacturer apportions fifty percent of the gross profit from export sales based on a sales factor, and the other fifty percent based on a property factor.³⁰⁷ The sales factor equals the ratio of the gross amount of export sales that are classified as foreign (using the title passage rule)³⁰⁸ to the gross amount of all export sales.³⁰⁹ The property factor equals the ratio of the average adjusted basis

301. I.R.C. §§ 861(a)(4), 862(a)(4) (CCH 1999). Special source rules apply to rental income from railroad rolling stock, vessels, aircraft, or shipping containers. See I.R.C. §§ 861(e), 863(c) (CCH 1999) respectively.

302. I.R.C. § 865(d)(2) (CCH 1999). The portion of the gain which is attributable to prior amortization deductions is treated as having the same source as the related deductions. I.R.C. § 865(d)(4)(A). Any gain attributable to appreciation in the value of the intangible is sourced using the residence-of-seller rule, assuming the intangible is sold for a price that is not contingent on its productivity, use, or disposition. I.R.C. § 865(d)(1)(A) (CCH 1999). If the intangible is sold for a price that is contingent on its productivity, use, or disposition, then the appreciation portion of the gain is sourced as if it were a royalty payment. I.R.C. § 865(d)(1)(B) (CCH 1999).

303. I.R.C. §§ 861(a)(5), 862(a)(5) (CCH 1999).

304. I.R.C. § 897(c) (CCH 1999), Treas. Reg. § 1.897-1(b) (2000).

305. Treas. Reg. § 1.861-7(c) (2000). This is known as the title passage rule. An exception applies to sales made by a foreign resident through a U.S. office. I.R.C. §§ 865(e)(2)-(3) (CCH 1999). Inventory includes personal property (and not real property) that is held by the taxpayer primarily for sale to customers in the ordinary course of business. I.R.C. §§ 865(i)(1), 1221(a) (CCH 1999).

306. Treas. Reg. § 1.863-3(b)(1) (2000). U.S. exporters of natural resources must apply a special export terminal rule. Treas. Reg. § 1.863-1(b) (2000).

307. Treas. Reg. §§ 1.863-3(b)(1), (c) (2000).

308. The title passage rules sources based on the place where title passes.

309. Treas. Reg. § 1.863-3(c)(2) (2000).

of the taxpayer's production assets located abroad to the average adjusted basis of the taxpayer's production assets everywhere.³¹⁰

7. *Gains from the Disposition of Stocks, Bonds, and Other Securities*

As a general rule, a gain on the sale of stocks, bonds, and other securities is U.S. source income if the taxpayer is a U.S. resident,³¹¹ whereas it is foreign source income if the taxpayer is not a U.S. resident.³¹² Special rules apply to U.S. residents who maintain an office in a foreign country and to nonresidents who maintain an office in the United States.³¹³ There are also special rules concerning gains on the sale of stock of an eighty percent or more owned foreign affiliate³¹⁴ as well as gains on the sale of shares of corporation that was a U.S. real property holding corporation at any time during the five year period preceding the disposition.³¹⁵

8. *Other Source of Income Rules*

The source of gains and losses from foreign currency transactions is determined by reference to the residence of the taxpayer or the qualified business unit of the taxpayer, e.g., a foreign branch or subsidiary on whose books the underlying asset, liability, or item of income or expense is properly reflected.³¹⁶

The source of insurance income is generally the locale of the insured risk. Therefore, premiums for insuring property located in the United States would be treated as U.S. source income. The same would be true of the premiums paid for a liability arising out of an activity located in the United States or for premiums paid in connection with the lives or health of residents of the United States.³¹⁷ Any other type of underwriting income is treated as derived from a foreign source.³¹⁸

310. Treas. Reg. § 1.863-3(c)(1) (2000).

311. Defined for this purpose as a domestic corporation, "a United States citizen or a resident alien" who "does not have a tax home in a foreign country" and "a nonresident alien" who "has a tax home in the United States." I.R.C. § 865 (g)(1) (CCH 1999).

312. I.R.C. §§ 865(a), (g)(1) (CCH 1999).

313. I.R.C. §§ 865(e)(1), (e)(2) (CCH 1999).

314. If certain requirements are met, a U.S. resident can treat a gain on sale of stock of a foreign affiliate as foreign source income. I.R.C. § 865(f) (CCH 1999).

315. I.R.C. § 897(c) (CCH 1999); Treas. Reg. § 1.897-1(b) (2000). A U.S. real property holding corporation is any corporation that holds U.S. real property with a market value equal to fifty percent or more of the market value of all the corporation's real property (U.S. and foreign) plus any other property used in a trade or business. I.R.C. § 897 (c)(2) (CCH 1999).

316. I.R.C. § 988(a)(3)(A) (CCH 1999). For purposes of this source rule, a U.S. resident is "any corporation, partnership, trust, or estate which is a United States person," as well as any individual who has a tax home in the United States. I.R.C. §§ 988(a)(3)(B)(i)(I), (II) (CCH 1999). A foreign resident is any corporation, partnership, trust, or estate that is a foreign person, as well as any individual who has a tax home in a foreign country. I.R.C. §§ 988(a)(3)(B)(i)(I), (III) (CCH 1999).

317. I.R.C. § 861(a)(7)(A) (CCH 1999). Under an exception, U.S. source insurance income also includes income from insuring risks located outside the United States if, as a result of an arrangement, another corporation receives a substantially equal amount of premiums for insuring risks located within the United States. I.R.C. § 861(a)(7)(B) (CCH 1999).

318. I.R.C. § 862(a)(7) (CCH 1999).

A U.S. person treats fifty percent of international communications income as U.S. source income and the other fifty percent as foreign source income.³¹⁹ In contrast, a foreign person generally treats all international communications income as foreign source income unless that person "maintains an office or other fixed place of business in the United States." In that case, "any international communications income attributable to such office or other fixed place of business" is treated as U.S. source income.³²⁰

Income from space and ocean activities is treated as U.S. source if derived by a U.S. person, whereas it is treated as foreign source income if derived by a foreign person.³²¹ Income from transportation that both begins and ends in the United States is treated as U.S. source income.³²² If the transportation begins in the United States and ends abroad, or begins abroad and ends in the United States, then fifty percent of the resulting income is treated as U.S. source income and the other fifty percent is treated as foreign source income.³²³

9. Source Rules for Deductions

In computing the "net" taxable income from a U.S. or a foreign source, a taxpayer can deduct expenses and losses directly related to either U.S. or foreign source gross income; they may also deduct a ratable portion of expenses and losses that are not definitely related to any specific item of gross income.³²⁴ Specialized apportionment rules apply to interest expenditures. The expenditures

319. I.R.C. § 863(e)(1)(A) (CCH 1999).

320. I.R.C. § 863(e)(1)(B) (CCH 1999). "[I]nternational communications income' includes all income derived from the transmission of communications or data from the United States to any foreign country, or from any foreign country to the United States." I.R.C. § 863(e)(2) (CCH 1999). Examples include transmitting telephone calls or other data, images, or sounds by satellite or underwater cable. I.R.C. § 863(e)(1)(A) (CCH 1999).

321. I.R.C. § 863(d)(1) (CCH 1999). "The term 'space or ocean activity' means any activity conducted in space, and any activity conducted on or under water not within the jurisdiction of a foreign country. . . or the United States. Such term includes any activity conducted in Antarctica." I.R.C. § 863(d)(2)(A) (CCH 1999). Examples include fishing and mining activities undertaken on the high seas. "[S]pace or ocean activity' shall not include any activity giving rise to transportation income, . . . international communications income, and any activity with respect to mines, oil and gas wells, or other natural deposits" in a continental shelf area. I.R.C. § 863(d)(2)(B) (CCH 1999).

322. I.R.C. § 863(c)(1) (CCH 1999).

323. I.R.C. § 863(c)(2)(A) (CCH 1999). "Transportation income" includes income derived from the use or lease of a vessel or aircraft (including any container used in connection with a vessel or aircraft), or from "the performance of services directly related to the use of a vessel or aircraft." I.R.C. § 863(c)(3) (CCH 1999). Transportation income does not include income derived from transporting passengers or property between the United States and a foreign country by truck, rail, or bus, which is sourced under different rules (see Treas. Reg. § 1.863-4 (2000)).

324. I.R.C. §§ 861(b), 862(b) (CCH 1999). The apportionment of deductions between U.S. and foreign source gross income is accomplished by using an apportionment base that reflects, to a reasonably close extent, the factual relationship between the deduction and the gross income. Treas. Reg. § 1.861-8(a)(2) (2000). Examples of potential apportionment bases include gross income, gross receipts or sales, units sold, cost of goods sold, profit contributions, expenses incurred, assets used, salaries paid, space utilized, and time spent. Temp. Treas. Reg. § 1.861-8T(c)(1) (2000).

are allocated to all of the taxpayer's gross income³²⁵ and then apportioned between U.S. and foreign source income using the relative value of U.S. and foreign assets as an apportionment base.³²⁶ Specialized allocation and apportionment rules also apply to research and development expenditures,³²⁷ losses from the disposition of property,³²⁸ legal and accounting expenses,³²⁹ state income taxes,³³⁰ net operating losses,³³¹ stewardship expenses,³³² standard deductions,³³³ certain personal expenses,³³⁴ and personal exemptions.³³⁵

IV. COMPARATIVE ANALYSIS OF SOURCE OF INCOME RULES

A wide variety of factors can lead to double taxation or under taxation of income derived from international trade. Examples of such factors include differences not only in source of income rules but also different definitions of taxable income or different systems for taxing corporations and their shareholders. For example, inflation gains and losses are included in Mexican taxable income but are not included in Canadian or U.S. taxable income. Another example of the differing rules of taxation between the NAFTA countries is the treatment of corporations and their shareholders. The United States employs a classical system whereby corporate earnings are taxed at both the corporate and the shareholder level. On the other hand, Mexico employs an integrated system whereby dividends paid by Mexican corporations are excluded from the income of shareholders. Canada employs a partial integration system whereby shareholders receive credit for a portion of the corporate tax paid. Though these differences are important, the scope of this article is limited to the effects of inconsistencies among the source of income rules of the NAFTA countries. Because Professors Brown and Manolakas have already identified those corporate reorganizations in the NAFTA bloc that result in the double taxation of gains,³³⁶ this article will also not address that issue.

The critical issue regarding any inconsistency in source rules is whether it hinders the ability of the NAFTA countries to achieve their objectives with respect

325. Temp. Treas. Reg. § 1.861-9T(a) (2000).

326. I.R.C. § 864(e)(2) (CCH 1999). For this purpose, an asset is characterized as U.S. or foreign based upon whether the asset produces U.S. or foreign source income. Temp. Treas. Reg. § 1.861-9T(g)(3) (2000). "A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value." Temp. Treas. Reg. § 1.861-9T(g)(1)(ii) (2000).

327. I.R.C. § 864(f) (CCH 1999) and Treas. Reg. § 1.861-8(e)(3) (2000).

328. Treas. Reg. § 1.861-8(e)(7) (2000).

329. Treas. Reg. § 1.861-8(e)(5) (2000).

330. Treas. Reg. § 1.861-8(e)(6) (2000).

331. Treas. Reg. § 1.861-8(e)(8) (2000).

332. Treas. Reg. § 1.861-8(e)(4) (2000).

333. I.R.C. §§ 861(b), 862(b) (CCH 1999).

334. Treas. Reg. § 1.861-8(e)(9) (2000).

335. Treas. Reg. § 1.861-8(e)(11) (2000).

336. See generally Catherine Brown & Christine Manolakas, *Corporate Reorganizations and Treaty Relief from Double Taxation Within the NAFTA Bloc*, 59 La. L. Rev. 253 (1998) (positing that substantial differences exist in the relief from double taxation of gains arising from corporate reorganizations within the NAFTA bloc under the current bilateral tax treaties).

to the taxation of income derived from cross-border trade. Article 102 of NAFTA states that one of the principal objectives of the Agreement is the elimination of barriers to cross-border trade. In the tax policy arena this is referred to as economic neutrality. Neutrality is an issue with respect to the location of production facilities ("capital export neutrality") as well as with respect to competition between domestic and foreign companies within a given jurisdiction ("capital import neutrality"). These two forms of neutrality can be at odds with one another.

All three NAFTA countries tax resident companies on their worldwide income but allow them to claim a limited credit for any foreign taxes paid on their foreign source income. Under a credit system, a resident company's foreign profits are taxed one time at the higher of the host country rate or the home country rate. More specifically, resident companies deriving income from a low-tax foreign jurisdiction pay not only the host country tax but also any home country tax in excess of the lower host country tax. On the other hand, resident companies deriving income from high-tax foreign jurisdictions pay only the host country tax because the credit for host country taxes is large enough to completely offset the pre-credit home country tax on the foreign profits. Subjecting a resident company's worldwide profits to home country taxation enhances capital export neutrality but may place those companies at a competitive disadvantage in low-tax foreign jurisdictions.³³⁷ In contrast to the worldwide taxation of resident companies, each NAFTA country taxes nonresident companies only on income derived from sources within the country's borders, subject to treaty restrictions. Therefore, each NAFTA country attempts to tax the full amount of any income derived from sources within its borders regardless of whether that income is earned by resident or nonresident companies.

To avoid both double taxation and under taxation of income from cross-border trade, the NAFTA countries must employ consistent rules for sourcing the income of business enterprises. Two basic types of source rule inconsistencies are possible. The first type occurs when an item of income is considered to be from a domestic source for domestic tax purposes but is considered to be from a foreign source for foreign tax purposes. This would occur if, for example, Mexico considers an item of income to be from a Mexican source while the United States treats the same item as of a U.S. source. In this scenario, the income in question would be taxed by both countries, and, assuming the taxpayer was not in an excess foreign tax credit limitation position, there would be no offsetting foreign tax credit relief. The net result is double taxation.

337. For a discussion of these issues, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (U.S. Gov't Printing Office, May 30, 1991). In contrast to the economic neutrality view, some policy makers believe that tax systems should be used to enhance the competitiveness of domestic businesses. Examples of such provisions in U.S. tax law include the foreign sales corporation provisions. See I.R.C. §§ 921-927 (CCH 1999) (prior to its repeal by the Foreign Sales Corporation Repeal and Extraterritorial Income Exclusion Act of 2000) and U.S. Treasury Department, *The Operation and Effect of the Foreign Sales Corporation Legislation* (1993). Another example is the title passage rule for sourcing inventory sales. See Treas. Reg. § 1.861-7(c) (CCH 2000) and U.S. Treasury Department, *Report to the Congress on the Sales Source Rules* (1993).

The second type of source rule inconsistency occurs when an item of income is considered foreign source income for domestic tax purposes but domestic source income for foreign tax purposes. This would occur if, for example, Mexico considers an item of income to be from sources outside Mexico while the United States considers the same item to be from sources outside the United States. In this scenario, only the taxpayer's home country would tax the income in question. In addition, if the taxpayer is in an excess foreign tax credit position, the source treatment of the income may allow the taxpayer to claim additional foreign tax credits despite the lack of any accompanying new foreign taxes, and the income in question would effectively escape taxation by either country. The net result would be under taxation.

Both types of source rule inconsistencies lead to tax consequences that run counter to the economic neutrality policy objectives of the NAFTA countries. In particular, double taxation violates the capital import neutrality principle in that companies operating outside their home jurisdiction will face a higher rate of tax than their domestic competitors. These differential tax burdens on a company's domestic versus foreign profits can distort a taxpayer's business and investment decisions, leading to the misallocation of resources among the countries involved, thus, resulting in a loss of overall economic welfare. Likewise, under taxation violates the capital export neutrality principle. It allows a company to enjoy a lower rate of tax on its foreign profits than that applied to its domestic profits, thus resulting in distortions of the taxpayer's business and investment decisions.

A. *Canada and the United States*

1. *Canada-United States Income Tax Treaty*

Concluded in 1942, the Canada-United States Income Tax Treaty was Canada's first comprehensive treaty for the elimination of double taxation of income.³³⁸ A new treaty was negotiated in 1980,³³⁹ and after amendment of the original text by two protocols,³⁴⁰ instruments of ratification were finally exchanged. The new Treaty entered into force on August 16, 1984.³⁴¹ A third protocol amended the

338. See *supra* note 9.

339. See Income Tax Treaty, Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980, Can.-U.S., 1 CCH Tax Treaties, *supra* note 45, ¶1903, at 12,007 [hereinafter Canada-U.S. Income Tax Treaty].

340. Protocol Amending 1980 Income Tax Treaty, Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, June 14, 1983, Can.-U.S., 1 CCH Tax Treaties, *supra* note 45, ¶ 1939, at 21,030 [hereinafter 1983 Protocol]. Second Protocol Amending 1980 Income Tax Treaty, Second Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983, March 28, 1984, Can.-U.S., 1 CCH Tax Treaties, *supra* note 45, ¶ 1942, at 21,039 [hereinafter 1984 Protocol].

341. See Vern Krishna, Canadian International Taxation, 10-18 (1995); Canada-U.S. Income Tax Treaty, Convention Between the United States of America and Canada with Respect to Taxes on Income

Canada-U.S. Convention in 1995.³⁴² A fourth protocol, further amending the Canada-U.S. Convention, was signed on July 29, 1997 and entered into force on December 16, 1997.³⁴³ The treaty provisions directly related to determining the source of income or relief from double taxation are discussed below.

Under Article XI(6) ("Interest"), interest income is deemed to arise from a source within a country if the payer is the country itself, a political subdivision of the country, a local authority within the country, a resident of that country, or a nonresident who maintains a permanent establishment within the country and the interest is paid by that permanent establishment. An exception to this residence-of-payer rule applies, however, to interest paid by a resident who maintains a permanent establishment or a fixed base outside the country where the interest liability was incurred in connection with that permanent establishment or fixed base.³⁴⁴

Under Article XII(6) ("Royalties"), royalty income is deemed to arise from a source within a country if the payer is the country itself, a political subdivision, local authority, or resident of that state.³⁴⁵ An exception to this residence-of-payer rule applies, however, to royalties paid by a resident who maintains a permanent establishment or a fixed base outside the country where the liability to pay the royalties was incurred in connection with that permanent establishment or fixed base.³⁴⁶ The obligation to pay royalties must also be borne by that permanent establishment or fixed base.³⁴⁷

Royalties are deemed to arise in the U.S. if they are paid for the use of, or the right to use, intangible property or tangible personal property in the U.S. and are borne by a permanent establishment or fixed base other than the U.S. or Canada,

and on Capital, Aug. 16, 1984, Can.-U.S., 1 CCH Tax Treaties, *supra* note 45, ¶ 1901, at 21,005.

342. Revised Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as Amended by the Protocols Signed on June 14, 1983, and March 28, 1984, March 17, 1995, Can.-U.S., 1 CCH Tax Treaties, *supra* note 45, ¶ 1946, at 21,045 [hereinafter 1995 Protocol]. The Protocol was originally signed on August 31, 1994, and a revised version was signed on March 17, 1995. See Krishna, *supra* note 341, at 10-18.

343. See Fourth Protocol Amending 1980 Income Tax Treaty, Fourth Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as amended by the Protocols Signed on June 14, 1983, March 28, 1984, and March 17, 1995, July 27, 1997, Can.-U.S., 1 CCH Tax Treaties, *supra* note 45, ¶ 1949A, at 21,061 [hereinafter 1997 Protocol]. The United States and Canada began a consultation on modifications to the Canada-U.S. tax treaty beginning on October 20, 1998 in Washington. Discussions included possible reductions in withholding tax rates and changes in the treaty's rules on limitation on benefits. See U.S. Department of Treasury, *Treasury Announces Canada-U.S. Consultation on Income Tax Treaty*, 98 Tax Notes Int'l 193-22 (Oct. 12, 1998).

344. Thus, Canadian tax will not be imposed on interest paid by a Canadian resident to a U.S. resident if the indebtedness is incurred in connection with, and the interest is borne by, a permanent establishment of the company situated in a third state. "Borne by" means "allowable as a deduction in computing taxable income." Vern Krishna, *Technical Explanation CANIT 97-1*, in Canadian Internal Taxation, 22-58 (1997).

345. See Canada-U.S. Income Tax Treaty, *supra* note 339, art. XII(6)(a).

346. See *id.*

347. See *id.*

even if they are paid by a Canadian resident.³⁴⁸ Royalties are deemed to arise in Canada if they are paid by a nonresident of Canada but are borne by a permanent establishment or fixed base in Canada where the liability to pay the royalty was incurred in connection with that permanent establishment or fixed base.³⁴⁹ This gives Canada the right to tax U.S. residents on royalty payments received from other nonresidents.³⁵⁰

The "place of use" exception applies only when royalties are neither paid by a resident of one of the contracting states nor borne by a permanent establishment or fixed base in either state.³⁵¹ Thus, "if a Canadian resident were to grant franchise rights to a resident of Chile for use in the United States, the royalty paid by the Chilean resident to the Canadian resident for those rights would be U.S. source income. . . ."³⁵²

Under Article XXIV(3) ("Relief From Double Taxation"), where a resident of one country derives income that may be taxed in the other country under the Treaty (other than solely by reason of citizenship), the income is deemed to arise in that other country for purposes of the foreign tax credit provisions of the Treaty. However, except as provided in Article XIII, any statutory source rules that limit foreign tax credits take precedence over the treaty source rules.³⁵³ Under Article XIII(5) ("Capital Gains"), gains derived from the alienation of property by a former resident of that State are deemed to arise in the state in which the alienator is a resident.³⁵⁴

2. Interest Income

Under Canadian tax principles, withholding tax liability applies to any interest that is paid or credited or deemed to be paid or credited under Part I of the ITA by a resident of Canada to a nonresident.³⁵⁵ Thus, this residence-of-payer rule can be viewed as a general source rule.³⁵⁶ For U.S. tax purposes, interest is classified as U.S. source income if (a) the debtor is a domestic corporation or U.S. resident, (b) the interest is borne by a U.S. branch of a foreign corporation, or (c) the debtor is a foreign corporation that is at least fifty percent owned by U.S. persons and at least ten percent of its income is derived from U.S. sources. Interest is classified as foreign source if (a) the debtor is a foreign corporation or nonresident, (b) the

348. See Canada-U.S. Income Tax Treaty, *supra* note 339, art. XII(6)(b).

349. See Canada-U.S. Income Tax Treaty, *supra* note 339, art. XII(6)(a).

350. See Atlas, *supra* note 232, ¶ 8.12(e), at 194.

351. See Krishna, *Technical Explanation CANIT 97-1*, *supra* note 344, at 22-139 (1997).

352. See *id.* at 22-140.

353. Thus, for example, it would appear that the source rules of §§ 904(f) and (g) would take precedence over the Treaty for this purpose, but the general source rules of §§ 861, 862, 863, and 865 would not.

354. See Technical Explanation for the July 29, 1997 Protocol, released by the United States Treasury Department, Dec. 1997. 1 CCH Tax Treaties, *supra* note 45, ¶1950A, at 21,089-4 and 5.

355. See I.T.A. § 212(1) (1985).

356. Li, *Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 1*, *supra* note 227, at 1104-07.

debtor is a domestic corporation that regularly derives eighty percent or more of its gross income from the active conduct of a foreign business, or (c) the interest is paid on deposits made with a foreign branch of a domestic corporation engaged in the commercial banking business.

Two basic themes underlie these source rules, a relatively straight-forward residence-of-debtor principle and a more complex set of look-through rules that override the residence principle in certain circumstances. If the look-through rules do not apply, the source characterization of interest should be consistent across the two countries as long as they employ similar definitions of residence. The look-through rules generally apply only when a resident of one country has a branch operation in the other country that rises to the level of a permanent establishment. Inconsistent source treatment can arise in such situations. For example, if the U.S. branch of a Canadian corporation pays interest to a U.S. resident, the interest would be classified as Canadian source for Canadian tax purposes (under the residence-of-debtor principle) but U.S. source for U.S. tax purposes (under the exception for U.S. branches). This is because interest payments made by the U.S. branch are treated as if paid by a domestic corporation, where a foreign corporation is engaged in a U.S. trade of business through its U.S. branch.³⁵⁷

The Canada-U.S. Treaty resolves this inconsistency. Under Article XI(6), when the payer of interest has a permanent establishment within a country and that interest is borne by such permanent establishment, such interest is deemed to arise from sources within that country regardless of the payer's residence. Thus, in the scenario above, interest paid to a U.S. resident by a U.S. branch of a Canadian corporation would be classified as U.S. source interest income and therefore would not be subject to Canadian withholding taxes. Likewise, interest paid to a U.S. resident by a company resident in Canada would not be subject to Canadian withholding taxes if the indebtedness is incurred in connection with, and the interest is borne by, a permanent establishment of the company situated in a third state.³⁵⁸ In sum, the differences in statutory source rules for interest income should not create a double taxation problem because the Treaty resolves the inconsistency.

3. Dividend Income

Both the U.S. and Canada establish the source of dividends based on the residence of the payer as determined by the country of incorporation. However, U.S. law contains a number of exceptions to the residence-of-payer rule, all of which involve the application of a look-through principle that recharacterizes dividends paid by a foreign corporation as U.S. source income. As a result, a dividend paid by a Canadian corporation could be classified as U.S. source income for U.S. purposes but Canadian source for Canadian purposes, raising the specter of double taxation of the dividends. Double taxation could result if the U.S. source characterization of the dividend causes the U.S. recipient of the dividend to be

357. I.R.C. § 884(f) (CCH 1999).

358. See Krishna, *Technical Explanation CANIT 97-1*, *supra* note 344, at 22-58 (1997).

denied the foreign tax credits needed to mitigate double taxation. For example, dividends paid by a foreign corporation are nevertheless classified as U.S. source income if, during the preceding three taxable years, twenty-five percent or more of its gross income was effectively connected with the conduct of a U.S. trade or business.³⁵⁹ This look-through rule can, in theory, lead to inconsistent source treatment and double taxation. For example, if a Canadian corporation with a U.S. branch pays a dividend to a U.S. resident, the dividend would be classified as Canadian source income for Canadian tax purposes (under the residence-of-payer rule) but could be classified as U.S. source for U.S. tax purposes (under the twenty-five percent exception). However, the Canada-U.S. Treaty resolves this inconsistency. Under Article XXIV(3) income derived by a resident of one country that may be taxed in the other country under the Treaty is deemed to arise in that other country for purposes of the foreign tax credit provisions of the Treaty. Therefore, for purposes of the U.S. payee's foreign tax credit limitation, the dividend would be classified as foreign source income, making it possible for the U.S. payee to obtain foreign tax relief with respect to the Canadian withholding taxes.

4. Rental and Royalty Income

For both U.S. and Canadian tax purposes, the source of rental income derived from tangible personal and real property is determined by where the underlying property is located or used. Likewise, to determine the source of royalty income derived from intangible property, both U.S. and Canadian tax schemes look to where the intangible is actually used or where the licensee is legally entitled to use the intangible. However, Canadian law also treats as Canadian source income any royalty payment for the use of an intangible outside of Canada by either a Canadian resident or a nonresident with a permanent establishment in Canada. This can result in inconsistent source treatment. For example, if a Canadian resident pays a royalty to a U.S. resident for the use of an intangible located in the United States, the royalty would be classified as Canadian source for Canadian tax purposes (under its residence-of-payer rule) but U.S. source income for U.S. tax purposes (under the place-of-use principle).

The Canada-U.S. Treaty resolves this inconsistency. Under Article XII(6), royalty income is deemed to arise from sources within a country if the payer is a resident of that state or if the payer is a nonresident who maintains a permanent establishment situated within the country and the liability to pay the royalties was incurred in connection with that permanent establishment and the royalties are borne by that permanent establishment. Thus, going back to the earlier example, a royalty paid by a Canadian resident for the use of an intangible in the United States would be classified as Canadian source royalty income under the Canada-U.S. Treaty. As a consequence, the royalty would be subject to Canadian withholding taxes (at a ten percent rate). Under Article XXIV(3), income derived

359. I.R.C. § 861(a)(2)(B) (CCH 1999).

by a resident of one country that may be taxed in the other country under the Treaty is deemed to arise in that other country for purposes of the foreign tax credit provisions of the Treaty. Therefore, for purposes of the U.S. payee's foreign tax credit limitation, the royalty would be classified as foreign source income, making it possible for the U.S. payee to obtain foreign tax relief with respect to the Canadian withholding taxes.

5. Gains from the Disposition of Real Property

The exemption for capital gains provided in the Canada-U.S. Treaty does not apply to gains derived from real property or shares of a Canadian corporation that owns real property.³⁶⁰ For both U.S. and Canadian tax purposes, however, the source of income from the disposition of real property is determined by the location of the underlying property. As a consequence, there should be no source inconsistencies with respect to income from the disposition of real property.

The taxable Canadian property rules have been extended to include shares of a nonresident corporation owning principally Canadian real property.³⁶¹ The U.S. does not tax a Canadian resident on the sale of stock of a foreign corporation, regardless of the composition of its assets. The potential source inconsistency for U.S. residents selling shares of real property holding companies that are not resident in Canada has been eliminated by the Fourth Protocol.³⁶² Amendments to Article XIII(3) limit each state's right to tax the gains of a resident of the other state from stock sales to those situations where the real property holding company is a resident in that state.³⁶³

6. Personal Services Income

Both the U.S. and Canada establish the source of income derived from personal services based upon where the underlying services were performed. However, the lack of specific statutory rules may cause difficulty in determining employment income in Canada. This can result in inconsistent source treatment and creates the possibility of double taxation when the service income is not considered foreign source income for purposes of computing the U.S. service provider's foreign tax credit limitation.

Various provisions of the Canada-U.S. Treaty may operate to prevent double taxation in such instances. For example, under Article VII the business profits of a U.S. enterprise may only be taxed in Canada to the extent they are attributable to

360. See Canada-U.S. Income Tax Treaty Article XIII(1), *supra* note 339.

361. See I.T.A. § 115(1)(b) (1985). See also Jack Bernstein, *Nonresident Investment in Canadian Real Estate*, 16 Tax Notes Int'l 201, 206 (1998).

362. See Technical Explanation for the July 29, 1997 Protocol, released by the United States Treasury Department, Dec. 1997. 1 CCH Tax Treaties, *supra* note 45, ¶1956A, at 21,209.

363. See Canada-U.S. Income Tax Treaty, *supra* note 339, Article XIII(3). See also Technical Explanation for the July 29, 1997 Protocol, released by the United States Treasury Department, Dec. 1997. 1 CCH Tax Treaties, *supra* note 45, ¶1956A, at 21,209.

the business operations of a permanent establishment in Canada. Management fees and support services may be treated as business profits eligible for this exemption.³⁶⁴ Therefore, the Treaty should restrict Canada's ability to tax the business profits of a U.S. company to those instances where the income is attributable to a permanent establishment unless the income falls under one of the other provisions of the Treaty that authorizes Canada to tax income not attributable to a permanent establishment (e.g., the withholding taxes on royalties).³⁶⁵

Article XIV extends similar protections to U.S. individuals providing independent personal services in Canada, such as accountants, architects, artists, attorneys, educators, engineers, physicians, or scientists. Under Article XIV, such services are insulated from Canadian taxation unless the U.S. resident has a fixed base in Canada that he or she regularly uses in the course of performing such services. A U.S. resident employed in Canada can avoid Canadian tax if the remuneration does not exceed \$10,000 or if the U.S. resident is present in Canada for a period of 183 or less days within a twelve month period and the remuneration is borne by a nonresident employer.³⁶⁶

The Treaty does not, however, address the tax treatment of compensation in the form of stock options.³⁶⁷ For example, both Canada and the U.S. impose a tax on nonqualified stock options on the date of exercise based on the difference between the price the employee pays for the stock and the higher market price of the stock on the exercise date.³⁶⁸ Canada, however, establishes the source of this income based on where the employee was employed when the stock option was granted,³⁶⁹ whereas U.S. tax law looks to future services. The position of the IRS is that, generally, this income's source should be determined on the basis of the allocation of U.S. and foreign workdays starting at the date of grant and ending on the date of exercise.³⁷⁰ Thus, a U.S. citizen who exercises a stock option (granted while employed in the U.S.) while on foreign assignment in Canada, will derive mostly foreign source income for U.S. tax purposes but U.S. source income for

364. See Jack Bernstein & Marcel Guilbault, *Canada*, LXXXIIA Cahiers De Droit Fiscal International 280 (1997).

365. Article VII of the Third Protocol modifies Article XII (Royalties) of the Convention by expanding the classes of royalties exempt from withholding of tax at source to include royalties paid for the use of, or the right to use information concerning industrial, commercial, or scientific experience, other than payments in connection with rental or franchise agreements. This may include royalties paid for the use of, or the right to use, "know-how," designs, models, plans, secret formulas, or processes. See Technical Explanation for the July 29, 1997 Protocol, released by the United States Treasury Department, Dec. 1997. 1 CCH Tax Treaties, *supra* note 45, ¶1951, at 21,089-21,091.

366. See Canada-U.S. Income Tax Treaty, *supra* note 339, Art. XV(2).

367. The issue of employee stock options is being looked at in the course of the current treaty "discussions" with the United States. See Brian Arnold, *Canadian Branch of IFA Discusses Canadian Tax Treaties*, 20 TNI 2809, 2813 (2000).

368. Treas. Reg. § 1.83-3(a)(2)(2000) and I.T.A. § 7 (1985). See generally, Thomas St. G. Bissell & Alfred Giadinia, *International Aspects of U.S. Retirement Plans, Deferred Compensation and Equity-Based Compensation Plans: An Overview*, 25 Tax Mgmt. Int'l 274 (1996).

369. See Krishna, *supra* note 344, at 1232. See also Revenue Canada, Technical Explanation 912281 (Nov. 26, 1992).

370. Treas. Reg. § 1.911-3(e)(4) (2000). See also Rev. Rul. 69-118, 1969-1 C.B. 135.

Canadian tax purposes. Excess foreign tax credits may be used by the U.S. citizen to reduce U.S. tax on the foreign source portion. However, there is a risk of double taxation if a Canadian or an American taxpayer exercises a nonqualified option (granted while employed in Canada) while a resident of the U.S.³⁷¹ Although the state of residence is required to provide a foreign tax credit, the U.S. will consider the source of this income as U.S. source. This will reduce the taxpayer's foreign tax credit limitation.

Another problem occurs with respect to section 401(k) plans—a very popular form of pension plan used in the U.S. For U.S. tax purposes, the U.S. citizen will not be taxed on contributions made to such a plan even if working abroad on temporary assignment. However, Canada treats contributions to these plans differently. Salary reductions are included in the employee's income as compensation because an employee is only allowed a deduction for contributions to a registered pension plan.³⁷² As Canada does not recognize the section 401(k) plan, the employee is taxed on this salary reduction amount in Canada.³⁷³ In *Brilla v. Her Majesty the Queen*,³⁷⁴ the Tax Court of Canada held that a Canadian resident could be taxed on his U.S. salary amount calculated before his contribution to his section 401(k) plan. Therefore, he was currently taxed in Canada but would not be taxed on the same amounts in the U.S. until he started receiving distributions. The Canada-U.S. Treaty does not specifically address either of these issues.

7. Income from the Disposition of Inventory

In Canada, income from the sale of inventory is attributed to the location of the underlying business activity, such as a manufacturing, distribution, or sales facility.³⁷⁵ In the U.S., the "title passage" rule is used to determine the source of a distributor's gross profit from the sale of inventory;³⁷⁶ manufacturers, on the other hand, must use the fifty-fifty method. This method looks to both title passage and the physical location of production assets. Therefore, the principal difference between the U.S. and Canadian source rules is the prominent role of title passage in U.S. law. The U.S. title passage rule is somewhat unique in international tax law; it exists primarily as a tax incentive to stimulate export sales of U.S. manufactured goods.³⁷⁷ In fact, the title passage rule can lead to inconsistent source results.

371. See Revenue Canada, Technical Explanation 912281 (Nov. 26, 1992) (Because the stock options arose with respect to the individual's employment in Canada, Article XV(1) of the Canada-U.S. Income Tax Convention would not deny Canada or the U.S. the right to tax the income arising on the exercise of the option.)

372. See I.T.A. §§ 6(1)(a), 8(1)(m) (1985).

373. See I.T.A. § 248 (1985) for the definition of "registered plan."

374. See *Raymond Brilla v. Her Majesty the Queen*, 97-1194(IT) C.T.C. (1998). See also *Bussey v. Her Majesty the Queen*, 96-1639 (IT) C.T.C. (1998).

375. See *Gagne*, *supra* note 240, at 294.

376. See I.R.C. §§ 861(a)(6), 862(a)(6) (CCH 1999). See also *Treas. Reg. § 1.861-7(c)* (2000). An exception applies to sales made by a foreign resident through a U.S. office. See also *I.R.C. §§ 865(e)(2), (3)* (CCH 1999).

377. U.S. Treasury Department, Report to the Congress on the Sales Source Rules (1993).

However, this inconsistency does not create double taxation for the U.S. exporter. Instead it potentially results in a portion of the U.S. exporter's profits not being taxed in either country. Nonresidents of Canada are taxable on U.S. export income only when it can be allocated to a permanent establishment in Canada as defined by Article V of the Canada-U.S. Treaty.

The title passage rule and the fifty-fifty method utilized by the U.S. do not create double taxation concerns for Canadian-based distributors and manufacturers that export their goods to U.S. customers. These companies are subject to U.S. taxation only if they have a permanent establishment in the U.S. In addition, those importers that do have a permanent establishment in the U.S. are subject to U.S. tax only on the income attributable to that permanent establishment, computed as if that permanent establishment were a distinct and independent enterprise.³⁷⁸ This method of computing U.S. source taxable income is consistent with the Canadian approach to computing foreign source income for purposes of limiting the foreign tax credit.

8. *Gains from the Disposition of Stocks, Bonds, and Other Securities*

For Canadian tax purposes, income from the sale or other disposition of taxable Canadian property is of a Canadian source. Taxable Canadian property includes shares of Canadian private corporations and shares of public corporations if the nonresident holds or recently held at least twenty-five percent of the shares alone or together with related persons. For U.S. tax purposes, income from the disposition of stocks, bonds, and other securities is generally U.S. source income if (a) the seller is a U.S. resident or (b) the sale involves shares of a corporation that was a U.S. real property holding corporation at any time during the five year period preceding the disposition. These divergent rules can create source inconsistencies. For example, if a U.S. resident sells shares of a Canadian company that meets the definition of taxable Canadian property, the gain would be classified as Canadian source for Canadian tax purposes but U.S. source for U.S. tax purposes (under the residence-of-seller principle). This inconsistency creates the potential for double taxation because Canada imposes a tax upon gains realized by nonresidents on the sale of certain Canadian companies. The U.S. seller, however, may be denied an offsetting credit for such tax because of its domestic source characterization for U.S. tax purposes.

The Canada-U.S. Treaty resolves this inconsistency. Subject to three limited exceptions,³⁷⁹ Article XIII(4) exempts gains realized by U.S. residents from Canadian taxation. Gains from the alienation of any property—other than real property and personal property that is part of the business property of a permanent establishment—is taxable only by the country of residence.³⁸⁰

378. See Canada-U.S. Income Tax Treaty, *supra* note 339, Art. VII.

379. Article XIII(5) of the Canada-U.S. Income Tax Treaty, *supra* note 339, reserves the right of a contracting state to tax certain former residents. Article XIII(6) applies to Canadian residents who emigrate to the U.S. and sell their former principal residence in Canada. Article XIII(9) is a transition rule for certain capital gains.

380. See Canada-U.S. Income Tax Treaty, *supra* note 339, Art. XIII(4).

9. Interest Expense

For Canadian tax purposes, a Canadian subsidiary of a U.S. parent corporation can only deduct interest expense incurred by the subsidiary. Interest expense incurred by the subsidiary's U.S. parent corporation is not deductible against the subsidiary's Canadian taxable income. Nevertheless, when the U.S. parent corporation computes its foreign tax credit limitation, it must apportion interest expense against its foreign source income based on the relative value of its foreign assets,³⁸¹ including the value of the parent corporation's investment in its Canadian subsidiary.³⁸² Therefore, whereas the U.S. parent corporation's investment in the Canadian subsidiary reduces the parent's foreign tax credit limitation by increasing the amount of interest expense apportioned to foreign source income, there is no complementary reduction in the Canadian income tax base. This inconsistency can result in double taxation because the interest expense deductions reduce the U.S. parent corporation's foreign tax credit limitation but not its foreign income tax costs.

B. Mexico and the United States

1. U.S.-Mexico Income Tax Treaty

As with tax treaties in general, the principle purpose of the U.S.-Mexico Treaty is to prevent double taxation by providing a variety of tax reductions and exemptions for income from cross-border trade and investment. The Treaty provisions directly related to determining the source of income and those offering relief from double taxation are discussed below.

Under Article XI(7) ("Interest"), interest income is deemed to arise from sources within a country if the payer is the country itself, a political subdivision of the country, local authority within the country, a resident of that country, or a nonresident who maintains a permanent establishment within the country and the interest is borne by that permanent establishment.

Under Article XII(6) ("Royalties"), royalty income is deemed to arise from sources within a country if the payer is the country itself, a political subdivision of the country local authority within the country, a resident of that country, or a nonresident who maintains a permanent establishment within the country and the obligation to pay the royalty is borne by that permanent establishment.

Under Article XXIV(3) ("Relief From Double Taxation"), income derived by a resident of one country that may be taxed in the other country under the Treaty (other than solely by reason of citizenship) is deemed to arise in that other country for purposes of the foreign tax credit provisions of the Treaty. However, except as provided in Article XII, any statutory source rules that limit foreign tax

381. I.R.C. § 864(e)(2) (CCH 1999).

382. I.R.C. § 864(e)(4) (CCH 1999). Temp. Treas. Reg. §§1.861-9T, 11T-13T (2000) provide additional guidance regarding the allocation and apportionment of interest expense.

credits take precedence over the treaty source rules.³⁸³ Under Article XIII(4) ("Capital Gains"), if a U.S. resident is subject to Mexican tax on a gain from the sale of shares of a twenty-five percent or more owned Mexican corporation, then the U.S. resident can treat the gain as foreign source income for U.S. foreign tax credit purposes.

Other key provisions of the U.S.-Mexico Treaty for corporations doing business in the U.S. and Mexico include Article V ("Permanent Establishment"); Article IX ("Associated Enterprises"); Article X ("Dividends") which provides a five percent withholding rate for dividends received by controlling shareholders; Article XI ("Interest") which provides a withholding rate of between 4.9 and fifteen percent for interest; Article XIA ("Branch Tax") which provides a maximum branch profits tax rate of five percent; Article XII ("Royalties") which provides a ten percent withholding rate for royalties; and Article XVII ("Limitation on Benefits").

2. *Interest Income*

For Mexican tax purposes, interest is classified as Mexican source income if (a) the debtor is a Mexican resident, (b) the debtor is a nonresident but has a permanent establishment in Mexico, or (c) the debtor is a nonresident but the borrowed capital is invested in Mexico. Any interest that does not meet one of these tests is from a source outside Mexico. For U.S. tax purposes, interest is classified as U.S. source income if (a) the debtor is a domestic corporation or U.S. resident, (b) the debtor is a nonresident but the interest is borne by a permanent establishment in the United States, or (c) the debtor is a foreign corporation in which U.S. persons hold at least a fifty percent share interest in the corporation and at least ten percent of the foreign corporation's income is derived from U.S. sources. Interest is classified as foreign source if (a) the debtor is a foreign corporation or nonresident, (b) the debtor is a domestic corporation that regularly derives eighty percent or more of its gross income from the active conduct of a foreign business, or (c) the interest is paid on deposits made with a foreign branch of a domestic corporation engaged in the commercial banking business.

Two basic themes underlie these source rules: a relatively straightforward residence-of-debtor principle and a much more complex set of look-through rules that override the residence principle in certain circumstances. If the look-through rules do not apply, the source characterization of interest is generally consistent across the two countries as long as they employ similar definitions of residence. The look-through rules generally apply only when a resident of one country has a branch operation in the other country that rises to the level of a permanent establishment. Inconsistent source treatment can arise in such situations. For example, if the U.S. branch of a Mexican corporation pays interest to a U.S. resident, the interest would be classified as Mexican source income for Mexican tax purposes under the residence-of-debtor principle, but for U.S. tax purposes it would

383. Thus, for example, it would appear that the source rules of Sections 904(f) and (g) would take precedence over the Treaty for this purpose, but the general source rules of Sections 861, 862, 863, and 865 would not.

be classified as U.S. source income under the exception for U.S. branches. In a similar vein, if the Mexican branch of a U.S. corporation pays interest to a Mexican resident, the interest would be classified as U.S. source for U.S. tax purposes under the residence-of-debtor rule, but for Mexican tax purposes it would be classified as Mexican source income under the exception for permanent establishments.

The U.S.-Mexico Treaty generally resolves this inconsistency. Under Article XI(7), when the payer of interest has a permanent establishment within a country and that interest is borne by such permanent establishment, such interest is deemed to arise from a source within that country regardless of the payer's residence.³⁸⁴ Thus, in the first scenario, interest paid to a U.S. resident by a U.S. branch of a Mexican corporation would be classified as U.S. source interest for Mexican tax purposes under Article XI of the Treaty and, therefore, would not be subject to Mexican withholding taxes. Likewise, interest paid to a Mexican resident by a Mexican branch of a U.S. corporation would be classified as Mexican source interest for U.S. tax purposes under Article XI of the Treaty and, therefore, would not be subject to U.S. withholding taxes. In both cases, treaty relief prevents double taxation.

3. Dividend Income

Under both U.S. and Mexican tax principles, the source of dividends is based upon the residence of the payer as determined by the country of incorporation. Therefore, the source characterization of dividends should generally be consistent across the U.S. and Mexico. Perhaps the greatest departure from this residence-of-payer rule is the exception found in U.S. law, which provides that dividends paid by a foreign corporation are nevertheless classified as U.S. source income if, during the preceding three taxable years, twenty-five percent or more of its gross income was effectively connected with the conduct of a U.S. trade or business.³⁸⁵ This look-through rule can, in theory, lead to inconsistent source treatment. For example, if the U.S. branch of a Mexican corporation pays a dividend to a U.S. resident, the dividend would be classified as Mexican source income for Mexican tax purposes under the residence-of-payer rule, but the dividend could also be classified as U.S. source income for U.S. tax purposes under the twenty-five percent exception. Fortunately, the U.S.-Mexico Treaty resolves this inconsistency. Under Article XXIV(3), income derived by a resident of one country that may be taxed in the other country under the Treaty is deemed to arise in that other country for purposes of the foreign tax credit provisions of the Treaty. Therefore, for purposes of the U.S. payee's foreign tax credit limitation, the dividend would be classified as foreign source income, making it possible for the U.S. payee to obtain foreign tax relief with respect to the Mexican withholding taxes.

384. Another effect of Article XI(7) is to protect U.S. residents from Mexican taxation when they receive interest paid by a debtor who is not a resident of Mexico but has invested the borrowed capital in Mexico as prescribed by Mexican statute. *Reprinted in 3 CCH Tax Treaties, supra* note 45, ¶5903.12(7), at 35,813.

385. I.R.C. § 861(a)(2)(B) (CCH 1999).

4. *Rental and Royalty Income*

For both U.S. and Mexican tax purposes, the source of rental income derived from tangible personal and real property is determined by where the underlying property is located or used. Likewise, both U.S. and Mexican tax law look to where an intangible is used, or where the licensee is legally entitled to use the intangible, in determining the source of royalty income.

5. *Gains from the Disposition of Real Property*

For both U.S. and Mexican tax purposes, the source of rental income from the disposition of real property is determined by the location of the underlying property.

6. *Personal Services Income and Technical Assistance*

For both U.S. and Mexican tax purposes, income from personal services is sourced according to where the underlying service is performed. However, Mexico has a special rule applicable to fees for "technical assistance."³⁸⁶ The source of technical assistance is determined in the same manner in which Mexico determines the source of royalties. Thus, fees for technical services are deemed to be from a Mexican source when the consumer of the service is in Mexico and when the fees are paid by a resident of Mexico or by a nonresident with a permanent establishment in Mexico.³⁸⁷ The Mexican treatment of technical assistance can result in inconsistent source treatment. For example, if a Mexican resident pays a fee to a U.S. engineering or architectural firm for design work performed in the United States, the fee is classified as Mexican source income for Mexican tax purposes under its residence-of-payer rule, whereas it is considered to be U.S. source income for U.S. tax purposes under the place-of-work principle. This creates the possibility of double taxation because (a) for Mexican tax purposes, the technical assistance would be subject to a ten percent Mexican withholding tax applicable to both royalties and technical assistance fees (Article XII of the U.S.-Mexico Treaty) and (b) the U.S. service provider would potentially be denied foreign tax credit relief for the withholding tax since the fee is not considered foreign source income for purposes of computing the U.S. foreign tax credit limitation.

However, various provisions of the Mexico-U.S. Treaty operate to prevent double taxation in such instances. First, under Article VII, the "business profits" of a U.S. enterprise may be taxed in Mexico only to the extent they are attributable to the

386. "Technical assistance" is defined as "the rendering of independent personal services by which the provider agrees to supply knowledge that is not capable of being patented and that does not imply the transmission of confidential information regarding industrial, commercial or scientific experience, requiring the receiver to intervene in the application of such knowledge." C.F.F. art. 15B.

387. L.I.S.R. art. 156.

business operations of a permanent establishment in Mexico.³⁸⁸ Therefore, the Treaty prevents Mexico from taxing the fee income of a U.S. service provider with no fixed base in Mexico unless the income falls within one of the other provisions of the Treaty that authorize Mexico to tax income not attributable to a permanent establishment, such as royalty income. Contracts for the provision of services in which a party undertakes work and utilizes the customary skills of his profession or trade in order to execute such work for another party do not constitute royalty income. Therefore, fees paid by a Mexican customer to a U.S. engineering or architectural firm performing design work in the U. S. would generally be protected from Mexican taxation by Article VII. Second, under Article XXIV, income derived by a resident of one country that may be taxed in the other country under the Treaty (other than solely by reason of citizenship) is deemed to arise in that other country for purposes of the foreign tax credit provisions of the Treaty. Thus, even if Mexico does impose a ten percent withholding tax on technical assistance fees, by virtue of Article XXIV, the U.S. service provider should be able to obtain foreign tax credit relief.

Two other issues with respect to income from personal services are: (a) income from the exercise of stock options and (b) contributions to section 401(k) plans. For U.S. tax purposes, the source of income from the exercise of nonqualified stock options is based on the location at which an employee provides services from the grant date to the exercise date. On the other hand, in Mexico there is no clear-cut rule for determining the source of income from the exercise of stock options. As for section 401(k) plans, for U.S. tax purposes a U.S. citizen is not taxed on salary contributed to a section 401(k) plan, even if working abroad on temporary assignment. However, Mexico treats these contributions differently. Salary reductions are included in the employee's income as compensation, but the employee is allowed a deduction for contributions to a registered pension plan.³⁸⁹ Because Mexico does not recognize the section 401(k) plan, the employee is taxed on this salary reduction amount in Mexico. The U.S.-Mexico Treaty does not specifically address either of these issues.

7. Income from the Disposition of Inventory

For U.S. tax purposes, the title passage rule is used to determine the source of a distributor's gross profit from the sale of inventory. Manufacturers, however, must use the fifty-fifty method. This method looks to both title passage and the physical location of production assets. For Mexican tax purposes, income from the sale of inventory is attributed to the location of the underlying business activity, such as a manufacturing, distribution, or sales facility. Therefore, as is the case with Canada,

388. Article XIV extends similar protections to U.S. individuals providing independent personal services in Mexico, such as accountants, architects, artists, attorneys, educators, engineers, physicians, or scientists. Under Article XIV, such services are insulated from Mexican taxation unless the U.S. resident has a fixed base in Mexico that the taxpayer regularly uses in the course of performing such services, or the U.S. resident is present in Mexico for a period of 183 or more days within a 12 month period.

389. L. Pereira & D. Dungan, *Tax Aspects of U.S. Executives Working in Mexico*, Proceedings of the Council for International Tax Education Mexico Taxation Update, San Antonio, Tx. (Sep. 22-23, 1997).

the principal difference between the U.S. and Mexican source rules is the prominent role of title passage in U.S. law.

As mentioned earlier, the use of the title passage rule is somewhat unique in international tax law. It exists primarily as a tax incentive to stimulate export sales of U.S. manufactured goods.³⁹⁰ Therefore, it should come as no surprise that the title passage rule can lead to source inconsistencies. The U.S. title passage rule does not create a double taxation problem for a U.S. exporter in the U.S.-Mexico relationship. In fact, it creates the possibility that a portion of a U.S. exporter's profits will not be taxed in either country. For example, if a U.S.-based distributor derives income from export sales to Mexican customers and the distributor does not have a permanent establishment in Mexico, the sales will produce no Mexican source income for Mexican tax purposes. However, for U.S. tax purposes, the entire amount of gross profit from these sales is classified as foreign source income if the distributor passes title to the goods in Mexico. If the U.S. distributor has excess credits in its general limitation basket due to foreign taxes paid in other jurisdictions, the additional foreign source income will allow the distributor to claim additional foreign tax credits even though the Mexican export profits did not generate any additional foreign taxes. In effect, the total tax rate on the Mexican export profits (pre-credit U.S. tax on the export profits less the increase in foreign tax credit) would be less than the benchmark U.S. corporate tax rate of thirty-five percent. A similar result is obtained by a U.S. manufacturer that makes export sales to Mexican customers.³⁹¹

The title passage rule and the fifty-fifty method, however, do not create double taxation issues for Mexican-based distributors and manufacturers that export their goods to U.S. customers. These companies are subject to U.S. taxation only if they have a permanent establishment in the U.S. In addition, those Mexican importers that do have a permanent establishment are subject to U.S. tax only on the income attributable to that permanent establishment. This tax would be computed as if that permanent establishment was a distinct and independent enterprise (Article VII of the U.S.-Mexico Treaty). This method of computing U.S. source taxable income is consistent with the Mexican approach to computing foreign source income for purposes of limiting the foreign tax credit.

8. Gains from the Disposition of Stocks, Bonds, and Other Securities

For Mexican tax purposes, income from the sale or other disposition of shares or other negotiable instruments that represent the ownership of goods is classified as Mexican source income if the issuing entity resides in Mexico.³⁹² For U.S. tax purposes, income from the disposition of stocks, bonds, and other securities is

390. U.S. Dept. of the Treasury, Report to the Congress on the Sales Source Rules (1993).

391. As with the distributor, if the manufacturer does not have a permanent establishment in Mexico, the sales produce no Mexican source income for Mexican tax purposes. However, for U.S. tax purposes, if the manufacturer passes title to the goods abroad, the fifty-fifty method allows the manufacturer to classify half of the export gross profit as foreign source income. If the manufacturer has excess credits in its general limitation basket, the total tax rate on the Mexican export profits would again be less than 35 percent.

392. Income from the sale or other disposition of shares or other negotiable instruments is also classified as Mexican source income if at least 50 percent of the accounting value of said shares or securities is derived from real property located in Mexico.

generally classified as U.S. source income if the seller is a U.S. resident.³⁹³ These divergent rules can create source inconsistencies. In particular, if a U.S. resident sells shares of a Mexican company, the gain would be classified as Mexican source income for Mexican tax purposes under the residence-of-issuing-entity principle but U.S. source income for U.S. tax purposes under the residence-of-seller principle. This inconsistency creates the potential for double taxation because Mexico taxes gains realized by nonresidents on the sale of Mexican companies (an exemption applies to publicly-traded stock) and the U.S. seller may be denied foreign tax credit relief due to its U.S. source characterization for U.S. tax purposes.³⁹⁴

The U.S.-Mexico treaty resolves this inconsistency. Article XIII exempts gains realized by U.S. residents from Mexican taxation if they own less than a twenty-five percent share interest in the Mexican company whose shares are being sold. Therefore, double taxation is not an issue with respect to sales by U.S. shareholders with less than a twenty-five percent ownership interest. Article XIII also provides that if Mexico imposes a tax upon the gain of a U.S. resident on the sale of shares of a twenty-five percent or more owned Mexican corporation, the taxpayer can treat the gain as derived from a foreign source for U.S. foreign tax credit purposes, enabling the U.S. resident to obtain foreign tax relief.³⁹⁵

9. Interest Expense

For Mexican tax purposes, a Mexican subsidiary of a U.S. parent corporation can only deduct interest expense incurred by the subsidiary. An interest expense incurred by a subsidiary's U.S. parent corporation cannot be deducted from the subsidiary's Mexican taxable income. Nevertheless, when a U.S. parent corporation computes its foreign tax credit limitation, it must apportion its interest expenditures against its foreign source income based on the relative value of its foreign assets,³⁹⁶ including the value of the parent corporation's investment in its Mexican subsidiary.³⁹⁷ Therefore, whereas a U.S. parent corporation's investment in a Mexican subsidiary reduces the parent's foreign tax credit limitation by increasing the amount of interest expense apportioned to foreign source income, there is no complementary reduction in the Mexican income tax base. This

393. Income from the sale of shares is also classified as U.S. source income if the sale involves shares of a corporation that was U.S. real property holding corporation at any time during the five-year period preceding the disposition.

394. In a similar vein, if a Mexican resident sells shares of a U.S. company, the gain would be classified as U.S. source for Mexican tax purposes (under the residence-of-issuing-entity principle) but Mexican source for U.S. tax purposes (under the residence-of-seller principle). This inconsistency creates the potential for neither country taxing the gain since the source characterization of the gain may allow the Mexican resident to claim additional foreign tax credits despite the fact that the United States does not tax capital gains realized by foreign persons.

395. In addition, U.S. law provides a special source rule whereby a U.S. parent corporation can treat gains on sale of stock of eighty percent or more owned foreign affiliates as foreign source income. I.R.C. § 865(f) (CCH 1999).

396. I.R.C. § 864(e)(2) (CCH 1999).

397. I.R.C. § 864(e)(4) (CCH 1999). Temp. Treas. Reg. §1.861-9T, -11T-13T (2000) provide additional guidance regarding the allocation and apportionment of interest expense.

inconsistency can result in double taxation because the interest expense deductions are reducing the U.S. parent corporation's foreign tax credit limitation but not its foreign income tax costs.

V. SUMMARY AND CONCLUSIONS

The level of trade and investment among the NAFTA countries is significant and growing. As cross-border activity continues to grow, the NAFTA countries will experience greater pressure to harmonize their respective tax systems. A principal objective of the NAFTA accords is to promote economic neutrality by eliminating barriers to cross-border trade of goods and services. Because source of income is a primary determinant of which country is entitled to tax the income arising from a particular cross-border activity, the source of income rules of the NAFTA countries must be consistent if the goal of economic neutrality is to be fully achieved. The problem with inconsistent source rules is that they can lead to double taxation and, in turn, differential tax burdens on a multinational business enterprise's domestic versus foreign profits. Such differences can distort the operating and investment decisions of businesses and lead to a misallocation of resources among the countries involved. Ultimately this will cause a loss in economic welfare. The purpose of this article was to compare the source of income rules of the United States to those of Canada and Mexico in order to identify any inconsistencies that might result in double taxation. Thus, two basic comparisons were made, the U.S. versus Mexico and the U.S. versus Canada.

Table 1 summarizes the general rules for determining the source of income for each of the NAFTA countries. As Table 1 indicates, the source of income rules employed by Canada, Mexico, and the United States are, by and large, quite similar. The principal inconsistencies are found in the rules for determining the source of income from the sale of inventory and the source rules relating to gains from the sale of stocks and securities. Under U.S. taxation principles, the source of gains from the sale of inventory is based primarily on the location at which title passes, whereas under Canadian and Mexican tax principles the source of gains from the sale of inventory is based on the location at which the actual underlying business is conducted. Similarly, under U.S. law the source of gains from the sale of stocks and securities is based on the residence of the seller, whereas under Canadian and Mexican tax law the source of gains from the sale of stocks and securities is primarily based on the residence of the entity that issued the securities. However, as discussed in Part IV of this article, the Canada-U.S. Treaty and the U.S.-Mexico Treaty generally prevent these source rule differences from causing double taxation.

As an incentive for stimulating export sales, the title passage rule allows U.S. manufacturers and distributors to generate additional foreign source income for purposes of computing the U.S. foreign tax credit, regardless of whether the underlying export profits actually attract any foreign income taxes. In its fiscal 2000 budget, the Clinton administration proposed a substantial revision of the rules

for determining the source of the income from export sales of inventory.³⁹⁸ Under this proposal, which was also part of the Clinton administration's 1998 and 1999 budget proposals, the source of income from the production and sale of goods would be based on "actual economic activity." The Clinton administration believed that the current rules "generally produce more foreign source income for United States tax purposes than is subject to foreign tax" and that the source rules should characterize as foreign source income only that income arising from actual economic activity conducted abroad. As discussed earlier, it is well-accepted that the U.S. rules for determining the source of income from inventory sales have the practical effect of permitting exporters to create foreign source income that is typically subject to little or no foreign tax. This allows exporters to claim additional foreign tax credits for otherwise noncreditable foreign income taxes imposed on foreign operations located in high-tax foreign jurisdictions. Therefore, the Clinton administration's proposal may be viewed as an attempt to raise revenues by eliminating a corporate tax preference.³⁹⁹

Another difference between U.S., Canadian, and Mexican source of income rules is that the U.S. requires a U.S. multinational corporation to apportion interest expense deductions based on the ratio of foreign assets to total assets, even though the interest paid by a U.S. parent corporation does not reduce the Canadian or Mexican taxable income of a Canadian or Mexican subsidiary. In many cases, this rule reduces the amount of a U.S. parent corporation's foreign source income below the amount actually taxed by a foreign jurisdiction. In other words, the amount of interest expense apportioned against the U.S. parent corporation's foreign source income exceeds the amount of interest expense deductions allowed in computing taxable income for foreign tax purposes. This inconsistent treatment of interest expense deductions can result in double taxation.⁴⁰⁰

Further, a consequence of NAFTA is increased commuting between the United States and Canada or Mexico as well as more frequent transfers between domestic and foreign affiliates of multinational corporations. The tax treatment of employee compensation packages, such as stock options and contributions to foreign pension plans, is of great importance as the mobility of the workforce continues to grow. Employees transferred across borders often wish to continue to participate in benefit packages and the pension plans of their home country during their absence abroad so that there is no loss of rights or benefits. As discussed in Part IV of this article, the difference in the source rules for the income from the exercise of a stock option can lead to double taxation. Also, as Canada and Mexico do not respect the salary reduction portion of a U.S. section 401(k) plan, there is likely to be a mismatch of

398. Exec. Off. of the President, Budget of the U.S. Government: Analytical Perspectives, 47-92 (2000).

399. In 1998, the administration estimated that the proposed changes to the inventory source rules would raise \$6.5 billion over five years, 78 Tax Notes 1078 (Mar. 2, 1998).

400. The Taxpayer Refund and Relief Act of 1999, passed by Congress on August 5, 1999 and vetoed by President Clinton on September 23, 1999, included an amendment that would have permitted U.S. corporations to take into account the interest expense of foreign affiliates when apportioning their own interest expense. See generally, Bret Wells, *Interest Allocation: A Regime Desperately in Need of Sound Policy*, 53 Tax Lawyer 859 (2000).

the inclusion of earnings in Canadian or Mexican gross income and the foreign tax credits attributable to the U.S. tax on subsequent distributions from such plans.

Just as the Fourth Protocol to the Canada-U.S. treaty addressed the income tax treatment of cross-border payment of social security payments,⁴⁰¹ the current negotiations should include the coordination of private benefit programs. The 1992 OECD Model Tax Convention recognizes the increased significance of the international movement of workers and recommends changes to the provisions governing the taxation of employment income.⁴⁰² For example, a protocol to the Canada-U.S. Treaty or U.S.-Mexico Treaty might contain a provision stating that contributions to a tax-advantaged pension plan established in the U. S. on account of employment in Canada or Mexico will be recognized by Canada or Mexico and be deductible from the individual's income to the same extent as if made to a tax-advantaged plan in Canada or Mexico.⁴⁰³

In general, the source of income rules of the three NAFTA countries are similar, and to the extent differences exist, the applicable tax treaties for the most part resolve the inconsistencies so as to prevent double taxation. However, problems remain with respect to the compensation and benefits packages of expatriates and cross-border employees, inventory sales, and interest expense as well as the tax consequences of corporate reorganizations within the NAFTA bloc. These issues should be addressed during the modification and renegotiation of the bilateral treaties. The United States should also consider the negotiation of a multilateral treaty between Canada, Mexico, and the United States.

401. See Fourth Protocol Amending the 1980 Income Tax Treaty, Jul. 29, 1997, reprinted in 1 CCH Tax Treaties, *supra* note 45, ¶ 1949A.2(2), at 21,061; U.S.- Can., art. 2.2, CCH Tax Treaties, *supra* note 45, ¶ 1949A, at 21,061. See generally, Cynthia Blum, *Should the Government that Pays Social Security Benefits Across Borders Also Tax Such Benefits?*, 18 Va. Tax Rev. 621 (1999).

402. See Richard E. Andersen, *New OECD Model Updates Employment, Self-Employment Provisions*, 4 J. Int'l Tax'n 94 (1993).

403. See OECD Model Treaty, *supra* note 189, at Commentary on Article 18(11). Article 18(6) of the 1996 U.S. Model Income Tax Convention contains such language. See U.S. Model Treaty, *supra* note 189, at Article 18(6).

TABLE 1: SOURCE OF INCOME RULES, BY COUNTRY

Type of Income	Canada	Mexico	United States
Interest	Residence of payer	Residence of payer, or where capital is invested	Residence of payer
Dividend	Residence of payer	Residence of payer	Residence of payer
Personal Services	Where services are performed	Where services are performed	Where services are performed.
Rents and Royalties	Where property is located or used	Where property is located or used	Where property is located or used
Gains from Sale of Real Property	Where realty is located	Where realty is located	Where realty is located
Income from Sale of Inventory	Where business is conducted	Where business is conducted	Where title passes (distributors), or where sales and property are located (manufacturer)
Income from Sale of Stocks and Securities	Residence of issuing entity	Residence of issuing entity	Residence of seller

