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United States-Mexico Income Tax Treaty: Relief from Double Taxation, The

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The United States-Mexico Income Tax Treaty: Relief from Double Taxation

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I. INTRODUCTION

On September 18, 1992, the United States and Mexico signed the first bilateral tax treaty between the two nations.[1] On November 20, 1993, the United States Senate officially ratified the treaty known as the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Treaty).[2] After both governments formally exchanged the necessary instruments for ratification, the Treaty became effective on January 1, 1994.[3] Given the complexity surrounding the taxation of international income, the Treaty represents an effort by both countries to reduce the incidences of double taxation.[4]

Countries have the option to act on their own to reduce the domestic taxation of international income; however, such actions generally fail to achieve an efficient solution.[5] For example, the United States has three main tools, exclusive of a treaty, to eradicate the double taxation of international income: (1) a tax exemption;[6] (2) a foreign income tax credit;[7] and (3) a tax deduction.[8] The Treaty strives to coordinate these measures, as well as to achieve the added objectives

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1. Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., S. DOC. NO. 7, 103d Cong., 1st Sess. (1993), *reprinted in* 93 TAX NOTES INT'L 131-15, July 9, 1993, *available in* LEXIS, Taxana Library, Tni File [hereinafter Treaty].

2. *Id.*; *see* S. Foreign Rel. Comm. Rep. on the U.S.-Mex. Income Tax Treaty and Protocol, S. EXEC. REP. NO. 20, 103d Cong., 1st Sess. (1993), *reprinted in* 93 TAX NOTES INT'L 288-87, Nov. 29, 1993, *available in* LEXIS, Taxana Library, Tni File (providing legislative insight into the purpose and goal of the Treaty).

3. Treaty, *supra* note 1, art. 29, para. 2(b); *see First U.S. Mexico Income Tax Treaty to Take Effect in 1994*, TAX NOTES INT'L, Jan. 3, 1994, *available in* LEXIS, Taxana Library, Tni File (stating that the Treaty will take effect January 1, 1994).

4. Letter from Warren Christopher, Secretary of the United States, Dept. of State, to William J. Clinton, President of the United States, 93 TAX NOTES INT'L 131-15 (May 11, 1993); *see id.* (examining Secretary Christopher's opinion that the Treaty will reduce the incidences of double taxation between the United States and Mexico).

5. *See generally* Yoseph Edrey & Adrienne Jeffrey, *Taxation of International Activity: Over Relief from Double Taxation Under the U.S. System*, 9 INT'L TAX & BUS. LAW. 101 (1991) (supporting the position that the U.S. system of providing a tax credit, deduction, and exemption is inefficient in equitably reducing double taxation, in that it affords too much tax relief).

6. *See infra* notes 95-113 and accompanying text (examining the United States tax exemption).

7. *See infra* notes 114-142 and accompanying text (discussing the foreign income tax credit).

8. *See infra* notes 143-157 and accompanying text (applying the United States tax deduction for foreign taxes paid).

of promoting communication, reducing the incidences of tax evasion, easing administration of the tax laws between the two countries, and promoting bilateral investment.[9]

This comment provides an overview of various U.S. taxation relief methods for remedying double taxation of international income. Part II examines the textual language of many of the major Treaty provisions.[10] Part III reviews the current independent U.S. relief methods from double taxation.[11] Part IV discusses the interplay between the Treaty and NAFTA.[12] Part V concludes that the Treaty will be a more efficient eliminator of double taxation of international income than the current unilateral U.S. relief provisions.[13]

II. TREATY PROVISIONS

A. *General Scope of the Treaty Provisions*

The terms and conditions contained within the Treaty apply to all persons who are residents[14] of either or both of the Contracting States.[15] The Treaty defines "person" as any individual or legal person, including a company, corporation, trust, partnership, association, estate, or any other body of persons.[16] Similarly, the Treaty defines "company" as any corporate body or any other entity which is treated as a corporate body for the purposes of taxation.[17] The term "United States" means the United States as defined in the U.S. Internal Revenue

9. *See* Marc M. Levey, Patrick R. Gordon & Gary D. Sanders, *Planning for New and Existing Operations Under the U.S.-Mexico Income Tax Treaty*, 80 J. TAX'N 368 (June 1994) (stating the benefits through the substantial promotion of commerce between the two nations via the easing of tariffs and clarification of the accompanying international taxation issues); Linda B. Burke, *Tax Executives Institute Advocates Prompt Ratification of Seven Treaties and Protocols*, TAX NOTES INT'L, Jan. 30, 1995, *available* in LEXIS, Taxana Library, Tni File (stating that the Institute believes the principal function of income tax treaties is to facilitate international trade and investment between the member nations by removing tax barriers to the free exchange of capital, goods, and services).

10. *See infra* notes 14-94 and accompanying text.

11. *See infra* notes 95-159 and accompanying text.

12. North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 298 (1993) [hereinafter NAFTA]; *see id.* art. 2103(2) (stating that in the event of an inconsistency between NAFTA and the Treaty, the Treaty will prevail); *infra* notes 160-182 and accompanying text.

13. *See infra* notes 183-204 and accompanying text.

14. *See* Treaty, *supra* note 1, art. 4 (defining "residency" for the purposes of the Treaty).

15. *Id.* art. 1. (providing that Contracting States refers to the United States or the United Mexican States, or both).

16. *Id.* art. 3, para. 1(a).

17. *Id.* para. 1(b).

Code (I.R.C.),[18] and the term "Mexico" means Mexico as defined in the Mexican Federal Fiscal Code.[19] The Treaty applies to the income taxes imposed by each of the Contracting States.[20]

B. Residency Under the Treaty

Article 4 of the Treaty addresses the issue of residency,[21] and leaves the basic construction of the term "resident" to the laws of the Contracting States.[22] For persons deemed residents of both the United States and Mexico, as provided for under the applicable tax laws, the Treaty provides an in-depth balancing of factors to resolve the residency issue for the taxpayer.[23] Under Article 4, a person other than an individual,[24] despite being a resident of both Contracting States, is not to be deemed a resident, for tax purposes, of either the United States or Mexico, and thus, not subject to the provisions of the Treaty.[25]

If an individual is a resident of both of the Contracting States, then for purposes of taxation, the taxpayer will be considered a resident of the State in

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18. *Id.* para. 1(f); *see* I.R.C. § 7701(a) (1988) (defining United States to mean "only the States and the District of Columbia").

19. Treaty, *supra* note 1, para. 1(g).

20. *Id.* art. 2, para. 1; *see id.* para. (3)(a) (stating that the Treaty governs federal income taxes imposed by the U.S. I.R.C. (excluding the accumulated earnings tax, personal holding company tax, and social security taxes), excise taxes imposed on insurance premiums paid to foreign insurers, and excise taxes with respect to private foundations to the extent necessary to implement the provisions of Article. 22, paragraph 4 (Exempt Organizations)). The Treaty shall, however, apply to excise taxes imposed on insurance premiums paid to foreign insurers, but only to the extent the risks covered by such premiums are not reinsured with a person not entitled to exemption from such taxes under any applicable treaty which applies to those taxes. *Id.*; *see id.* para. (3)(b) (stating the Treaty encompasses income taxes imposed by the Mexican Income Tax Law); *id.* para. (4) (stating that the Treaty applies to subsequently enacted, substantially similar taxes imposed after the date of the Treaty). The Treaty also provides that the competent authorities shall notify each other of any significant changes made to the their respective tax laws, and of any officially published materials concerning the application of the Treaty, including any explanations, regulations, rulings, or relevant judicial decisions. *Id.* This Treaty shall not apply to any state taxes which may be imposed by virtue of their own taxing jurisdiction. *Id.*; *see infra* note 30 and accompanying text (defining "competent authority").

21. *Id.* art. 4.

22. *See id.* para. 1 (stating that "resident of a Contracting State" includes any person who is liable, under the laws of that State, to be taxed in that State by reason of one's domicile, residence, place of management, place of incorporation, or any other similar criteria); I.R.C. § 7701(b) (1988) (providing that for the purpose of determining U.S. residency, one is deemed to be a resident if that individual: (1) has been admitted lawfully to the United States ("green card"); (2) makes a first year election to be treated as a resident (the individual must be present in the United States for thirty one consecutive days and at least 75% of the days in the year that begins with the first thirty-one consecutive days); or (3) satisfies the "substantial presence" test which requires the individual to have been present in the United States for a minimum of thirty-one days during the current year, and at least 183 days for the three year period ending with the current year).

23. Treaty, *supra* note 1, art. 4, para. 2.

24. Since "person" includes individuals as well as corporations, partnerships, and associations, an individual is not a corporation, partnership, nor association; *see id.* art. 3, para. 1(a) (defining person); *supra* note 16 and accompanying text (defining person).

25. *Id.* art. 4, para. 3.

which the taxpayer has a permanent home available.[26] If the taxpayer has a permanent home in both of the Contracting States, then the taxpayer will be deemed to be a resident of the State with stronger economic and personal ties.[27] If for some reason the State in which the taxpayer has their center of vital interests cannot be determined, or if the taxpayer does not have a permanent home available in either State, then the taxpayer will be classified a resident of that State in which the taxpayer has an habitual abode.[28] If the individual has a habitual abode in both, or neither, of the Contracting States, then the taxpayer will be treated as a resident of the State in which the individual is seen as a national.[29] If for some reason the individual's residency status cannot be determined by the tests provided for above, the competent authorities[30] of the Contracting States shall settle the issue by mutual agreement.[31]

C. Prevention of "Treaty Shopping" and the Limitation of Benefits

Article 17 focuses on the prevention of "treaty shopping." The prevention of treaty shopping involves restricting Treaty benefits to eligible individuals and preventing third parties from gaining Treaty benefits if their establishing residency in a Contracting State is for the principal purpose of obtaining such benefits.[32] If a person fails to come within the Treaty's provisions for determining Treaty benefits, that person may attempt to demonstrate to the competent authority of the State in which the income has been earned that the taxpayer should be granted the benefits of the Treaty.[33] The competent authority will then consider a number of factors in deciding whether the income falls within the Treaty's protection.[34] The competent authority will consider "[w]hether the establishment, acquisition, and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention."[35] If it is found that the party's principal purpose is to secure Treaty benefits, then the competent authority shall deny all benefits to that party.

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26. *Id.* para. (2)(a).

27. *See id.* para. (2)(b) (suggesting that a test such as the center of vital interests test examines where the taxpayer maintains his closest economic and societal ties).

28. *Id.*

29. *Id.* para. (2)(c); *see id.* art. 3, para. (1)(h)(i)-(ii) (defining "national" as any individual possessing the nationality of a Contracting State, and any legal person, association, or other entity which derives its status as such from the law in force in a Contracting State).

30. *See id.* art. 3, para. (1)(e)(i)-(ii) (defining the "competent authority" of the United States as the Secretary of the Treasury, or an authorized representative of the Secretary). The "competent authority" of Mexico shall mean the Minister of Finance and Public Credit. *Id.*

31. *Id.* art. 4, para. (2)(d).

32. *See id.* art. 17 (addressing who may take advantage of Treaty benefits).

33. *Id.* para. 2.

34. *Id.*

35. *Id.*

In addition to the residency requirement,[36] the Treaty requires each person to meet an additional limiting test in order to obtain Treaty benefits.[37] The limiting

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36. *See supra* notes 21-31 and accompanying text (examining the Treaty's residency requirement).

37. *See id.* art. 17, paras. 1(a)-(g). A person is eligible for Treaty benefits if that person is a resident of either Contracting State, and that person is:

(a) an individual;
(b) a Contracting State, political subdivision, or local authority thereof;
(c) engaged in an active trade or business in one of the Contracting States, and the income derived from the other Contracting State is derived in connection with, or incidental to, that trade or business;
(d) either:
(i) a company "in whose principal class of shares there is a substantial and regular trading on a recognized 'securities exchange' located in either of the Contracting States;"
(ii) a company which is wholly owned, directly or indirectly, by residents of the Contracting State in whose principal class of shares is substantially and regularly traded on a recognized securities exchange located in either the United States, or Mexico; or
(iii) a company which is:
(A) wholly owned, directly or indirectly, by residents of any country which is a party to the North American Free Trade Agreement (NAFTA), in whose principal class of shares there is regular and substantial trading on a recognized securities exchange; and
(B) more than 50% owned, directly or indirectly, by residents of either Contracting State in whose principal class of shares there is substantial and regular trading on a recognized securities exchange located in that State;
(e) a non-profit organization, which by virtue of its status, is exempt from income taxation in the Contracting State of which it is a resident, so long as more than half of the beneficiaries, members, if any, of such organization are entitled, under Article 17, to the benefits of this Treaty;
(f) a person satisfying both of the following:
(i) more than 50% of the beneficial interest in that person is owned, directly or indirectly, by persons entitled to Treaty benefits by virtue of (a), (b), (d), or (e) above; and
(ii) less than 50% of gross income of such persons is used directly or indirectly to satisfy liabilities owed to persons who are not entitled to the benefits of the Treaty under (a), (b), (d), or (e); or
(g) a person who is claiming benefits under the Treaty pertaining to Dividends (Art. 10), Interests (Art. 11), Branch Tax (Art. 11A), or Royalties (Art. 12) and meets the following:
(i) more than 30% of the stock is owned by United States or Mexican residents who are entitled to Treaty benefits via (a), (b), (d), or (e) above;
(ii) more than 60% of such stock is owned by persons who are residents of a country which is a party to NAFTA;
(iii) less than 70% of its gross income is used, directly or indirectly, to satisfy liabilities to persons who are not entitled to Treaty provisions under (a), (b), (d), and (e); and
(iv) less than 40% of gross income of such person is used to meet liabilities to persons that are neither entitled to Treaty benefits under (a), (b), (d), and (e), nor is that person a resident of a state which is a party to NAFTA.

Id.; *see* Protocol for Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 93 TAX NOTES INT'L 131-15, para. 15(b)(i)-(iii) [hereinafter Protocol] (providing that the term "recognized securities exchange" is understood to mean the NASDAQ system, any stock exchange which is registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934, any stock exchange which has been authorized under the terms of the Stock Market (*Mercado de Valores*) Law of January 2, 1975, or any other stock exchange which is agreed upon by the competent authorities of the United States and Mexico); Treaty, *supra* note 1, art. 17, para. g(ii); *see id.* art. 17, para. g(1) providing:

test examines such issues as whether the person is an individual taxpayer, a corporation, or a subdivision of one of the Contracting States.[38]

Article 17 effectively limits Treaty benefits to eligible taxpayers and consequently encourages countries to enter into bilateral taxation treaties.[39] Additionally, some authors argue that tax treaties promote international trade and generally add to the economic well-being of all nations involved.[40]

D. Relief from Double Taxation

Article 24 authorizes the United States to credit U.S. residents and citizens for income taxes paid to the Mexican government.[41] Additionally, the Treaty requires Mexico to credit Mexican residents for income taxes paid to the United States.[42] The Treaty provides a foreign income tax credit to companies owning at least ten percent of the voting stock of a non-resident company, for taxes paid by the non-resident company on the income which provided the source of the dividends.[43]

In the case of a U.S. citizen who is also a resident of Mexico, the Mexican government shall allow a credit against the Mexican tax,[44] only for those taxes which the United States may impose under the provisions of this Treaty.[45] Other taxes may be imposed solely by reason of citizenship.[46]

E. Business Profits

The Treaty provides that the business profits of an enterprise of either Contracting State shall be taxable only in the member state in which the business is

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> A resident of a state which is a party to NAFTA shall only be considered as owning a beneficial interest (or share) under (g)(ii) if that particular state has a comprehensive income tax treaty with the Contracting State in which the income is derived, and if the particular dividend, profit, or income subject to the branch tax, interest, or royalty payment, with respect to the benefits under which are claimed this Treaty, would be subject to a rate of tax under the other treaty which is no less favorable than the rate of tax imposed under Articles 10 (Dividends), 11 (Interest), 11A (Branch Tax), or 12 (Royalties) of this Treaty.

Id.

38. Treaty, *supra* note 1, art. 17, paras. 1(a)-(g).
39. *See generally* Zack B. Mason, *Implications of the Income Tax Treaty Between the United States and Mexico*, 25 ST. MARY'S L.J. 1213 (1994) (stressing the benefits for Treaty participants).
40. *See id.* at 1213 (addressing the benefits provided via the Treaty for party participants such as lower tax rates and relief from double taxation).
41. Treaty, *supra* note 1, art. 24, para. 1(a).
42. *Id.*
43. *Id.* para. 1(b).
44. *See id.* para. 4(a) (stating that the exemption is subject to the provisions of the Mexican tax law regarding credit for foreign tax).
45. *Id.*
46. *Id.*

a resident.[47] However, the other Contracting State may tax business profits on a representative proportional basis[48] if the enterprise carries on, or has carried on, business in the other Contracting State through a permanent establishment.[49]

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47. *Id.* art. 7, para. 1.

48. *See id.* paras. (1)(a)-(b) (stating that the amount of tax liability shall be based on the: (1) amount of income which is attributable to the permanent establishment, or (2) the amount of sales in the other State of goods or merchandise of the same or similar kind as the goods or merchandise sold through that permanent establishment).

49. *Id.*; *see id.* art. 5. "Permanent establishment" is defined as:

1) a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2) The term "permanent establishment" includes specifically:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3) The term "permanent establishment" shall also include a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, or supervisory activity in connection therewith, but only if such building site, construction or activity lasts more than six months.

4) Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of advertising, supplying information, scientific research, or for the preparations relating to the placement of loans, or for similar activities which have a preparatory or auxiliary character, for the enterprise;

f) the maintenance of a fixed place business solely for any combination of the activities mentioned in subparagraphs a) to e), provided that the total activity of the combination is of preparatory or auxiliary character.

5) Notwithstanding the provisions of paragraphs 1 and 2, where a person, other than an agent of an independent status to whom paragraph 7 applies, is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State in respect of any activities which that person undertakes for the enterprise, if such person:

a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

b) has no such authority but habitually processes in the first-mentioned State on behalf of the enterprise goods or merchandise maintained in the State by that enterprise, provided that such processing is carried on using assets furnished, directly or indirectly, by that enterprise or any associated enterprise.

6) Notwithstanding the foregoing provisions of this Article, an insurance enterprise of a Contracting

However, profits derived from sales in the other State, of goods or merchandise, which are similar in kind to the goods or merchandise sold through the permanent establishment, shall not be taxable in the other State if the enterprise can demonstrate that such sales have a legitimate business purpose and have not been pursued solely for obtaining benefits under this Treaty.[50]

Subject to the provisions of Article 7, paragraph 3, when an enterprise of a Contracting State carries on, or has carried on, business in the other Contracting State through a permanent establishment, each of the Contracting States shall attribute those business profits to the permanent establishment.[51] The business profits attributable to the permanent establishment shall include only those profits or losses derived from the assets or activities of the permanent establishment.[52] However, business profits from the acquisition of goods or merchandise for use by the parent enterprise shall not be attributable to that permanent establishment.[53] Additionally, where business profits include items which are specifically addressed under other Articles of this Treaty, the provisions of those Articles are controlling with respect to those items.[54]

State shall, except in regard to reinsurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a representative other than an agent of an independent status to whom paragraph 7 applies.

7) An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on a business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business and that in their commercial or financial relations with the enterprise conditions are not made or imposed that differ from those generally agreed to by independent agents.

8) The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Id. See generally Roy D. Hershberger & Michael A. Siegel, *PE or No PE—That is the Question*, TAX NOTES INT'L, Dec. 27, 1994, *available in* LEXIS, Taxana Library, Tni File (examining the puzzling issue of what constitutes a permanent establishment).

50. Treaty, *supra* note 1, art. 7, para. 1.

51. *Id.* para. 2; *see id.* para. 3 (stating that in determining the profits of a business enterprise, the Treaty permits the deduction of expenses incurred by the permanent establishment, including any executive and general administrative expenses). No deductions will be allowed for any amounts paid, other than toward the reimbursement of actual expenses, by the permanent establishment to the head office of the enterprise. *Id.* Additionally, no deduction is allowed for any amount paid, by the enterprise to its other offices in the form of royalties, fees or other similar payments in return for the use of patents or other rights, by way of commission, for the specific services performed or for management, or except in the case of a banking enterprise through interest on monies lent to the permanent establishment. *Id.*

52. *Id.* para. 5. These amounts shall be determined by the same method year by year, absent a sufficient reason to do otherwise. *Id.*

53. *Id.* para. 4.

54. *Id.* para. 6.

F. Dividend Income

Dividends[55] paid by a resident company to a resident of the other Contracting State may be taxed by the other State.[56] However, the disbursing company's Contracting State may also tax the disbursement of these dividends.[57] If the owner of the dividend is a resident of a Contracting State of which the company is not a resident, and that owner owns at least ten percent of the voting stock of the company issuing the dividend, the amount of tax charged shall not exceed five percent of the gross amount of the dividend.[58] If the owner of the dividend does not meet this description, then the amount of tax imposed shall not exceed ten percent of the total amount of the dividend.[59] However, five years from the date of the Treaty this rate of ten percent will be increased to fifteen percent.[60] Absent these Treaty provisions, dividend income would be subject to a tax rate of thirty percent.[61]

The provisions of Article 10, paragraphs 1, 2, and 3, will not apply if the beneficial owner of the dividend: (1) is a resident of a Contracting State; (2) carries on, or has carried on, business in the other State through a permanent establishment; or (3) performs or has performed independent personal services from a fixed base located in the State of which the company issuing the dividend happens to be a resident, and those dividends are attributable to the permanent establishment or fixed base.[62] In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) apply.[63]

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55. *See id.* art. 10, para. 4, defining "dividends" as:

> [I]ncome generated from shares or other rights, other than debt-claims, participating in profits, as well as income from other corporate rights which is subject to the same taxation treatment as income from other shares by the laws of that State in which the company making the distribution is a resident.

Id.

56. *Id.* para. 1.
57. *Id.* para. 2.
58. *Id.* para. 2(a); *see* Protocol, *supra* note 37, art. 8, stating that:

> In the case of the United States, subparagraph (a) of paragraph 2 shall not apply to dividends paid by a U.S. Regulated Investment Company or a Real Estate Investment Trust. Subparagraph (b) of paragraph 2 and paragraph 3 shall apply in the case of dividends paid by a Regulated Investment Company. In the case of dividends paid by a Real Estate Investment Trust, subparagraph (b) of paragraph 2 and paragraph 3 shall apply if the beneficial owner of the dividends is an individual holding a less than 10% interest in the real estate investment trust; otherwise the rate of withholding applicable under domestic law shall apply.
>
> If the United States agrees in a treaty with another country to impose a lower rate on dividends than the rate specified in subparagraph (a) of paragraph 2, both Contracting States shall apply that lower rate instead of the rate specified in subparagraph (a) of that paragraph.

Id.

59. Treaty, *supra* note 1, art. 10, para. 2(b).
60. *Id.* para. 3.
61. I.R.C. §§ 871(a), 881 (1988).
62. Treaty, *supra* note 1, art. 10, para. 5.
63. *Id.*

When a company which is a resident of one Contracting State derives profits or income from the other Contracting State, that other State shall not tax dividends paid by a non-resident company.[64] However, the other Contracting State may impose taxes if the dividends are paid to a state resident, or dividends are attributable to a permanent or fixed base located within that State.[65]

G. Tax Treatment of Royalties

The Treaty provides that royalties[66] arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.[67] However, those royalties may also be taxed in the Contracting State in which they arise, according to the laws of that State.[68] But, if the payee is a resident of the other Contracting State, then the tax imposed shall not exceed ten percent of the gross amount of the royalty.[69]

The provisions of Article 12, paragraphs 1 and 2, do not apply if the owner of the royalty is a resident of a Contracting State and either carries on, or has carried on, business through a permanent establishment, or has engaged in the performance of independent personal services from a fixed base in the nonresident state, in which the royalties arise, and the royalties are attributable to that permanent establishment or fixed base.[70] In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) apply.[71]

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64. *Id.* para. 6.
65. *Id.*
66. *Id.* art. 12, para. 3. "Royalties" are defined as:

> Payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including motion picture films and works on film or tapes or other means of reproduction for use in connection with television, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience as well as for the use of or the right to use industrial, commercial or scientific equipment not construing immovable property referred to in Article 6. The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition thereof.

Id.

67. *Id.* para. 1.
68. *Id.* para. 2.
69. *Id.*
70. *Id.* para. 4.
71. *Id.*; *see supra* notes 47-54 and accompanying text (discussing Article 7's treatment of Business Profits); *see infra* notes 82-86 and accompanying text (examining Article 14's treatment of Independent Personal Services).

H. Tax Treatment of Capital Gains

Gains derived by a resident of a Contracting State from the sale of immovable property[72] situated in the other State may be taxed in accordance with the laws of that State.[73] Gains derived from the sale of personal property attributable to a permanent establishment which an enterprise of one Contracting State has or had in the other State may be taxed in that State where the permanent establishment is situated.[74] Similarly, gains derived from a fixed base located in a Contracting State which is or was available to a resident of the other Contracting State for the purpose of performing personal services may be taxed in that State where the personal services were performed.[75] Additionally, gains from the sale of the permanent establishment or fixed base may be taxed in that other State.[76]

In addition to gains taxable under Article 13, paragraph 3, gains earned by a resident of one Contracting State from the alienation of stock in a company which is a resident of the other State, may be taxed in that other State if the taxpayer, during the twelve month period preceding the sale, had an ownership of at least twenty-five percent in the capital of that company.[77] These gains will be deemed

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72. *See* Treaty, *supra* note 1, art. 6, para. 2. "Immovable property" is defined as:

> [t]he interpretation which it has under the law of the Contracting State where the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats, aircraft, and containers shall not be regarded as immovable property.

Id. See also id. art. 13, para. 2.

> For the purposes of Article 13, "immovable property situated in the other Contracting State" includes:
> (a) immovable property referred to in Article 6 (Income from Immovable Property (Real Property)) which is situated in that other Contracting State,
> (b) an interest in a partnership, trust, or estate to the extent that its assets consist of immovable property situated in that other State,
> (c) shares or comparable interests in a company or other legal person that is, or is treated as, a resident of that other Contracting State, the assets of which company consist or consisted of immovable property situated in that other Contracting State, and
> (d) any other right that allows the use or enjoyment of immovable property situated in that other Contracting State.

Id.; Protocol, *supra* note 37, art. 12 (providing that the term "immovable property situated in the other Contracting State," includes a U.S. real property interest when the United States is that other Contracting State); I.R.C. § 897(c) (1988) (defining "real property interest").

73. Treaty, *supra* note 1, art. 13, para. 1.

74. *Id.* para. 3.

75. *Id.*

76. *Id.*

77. *Id.* para. 4 (stating that in addition to stock, Article 13 includes other rights in the capital of a company or other legal person which is a resident of the other State).

to have arisen in the other State to the extent necessary to avoid double taxation.[78] Thus, the Contracting State of which the taxpayer is a resident will not tax the gains in order to prevent the multiple taxation of the same income.

Those gains derived from an enterprise of a Contracting State from the sale of ships, aircraft, and containers used principally for international traffic shall be taxable only in that State.[79] Gains detailed under Article 12 (Royalties) will be taxable only according to the provisions of that Article.[80] Gains from the sale of property other than property referred to in Article 13, will be taxable only in the State in which the alienator is deemed to be a resident.[81]

I. Independent Personal Services

Income derived by an individual who is a resident of one Contracting State from the performance of personal services[82] is taxable only in the State of residency unless the resident has a fixed base in the other Contracting State, which the taxpayer regularly uses in the course of performing his or her duties.[83] In such a case, the other State may tax the service income attributable to the fixed base located in that other State.[84] Alternatively, if the resident is present in the

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78. *Id.*; *see* Protocol, *supra* note 37, art. 13. Which states that for the purposes of Article 13, paragraph 4:

> [N]o tax shall apply in the case of a transfer of property between members of a group of companies that file a consolidated tax return, to the extent that the consideration received by the transferor consists of participation or other rights in the capital of the transferee or of another company resident in the same Contracting State that owns directly or indirectly 80 percent or more of the voting rights and value of the transferee, if:
> (i) the transferor and transferee are companies resident in the same Contracting State;
> (ii) before and immediately after the transfer, the transferor or the transferee owns, directly or indirectly, 80 percent or more of the voting rights and value of the other, or a company resident in the same Contracting State owns directly or indirectly (through companies resident in the same Contracting State) 80 percent or more of the voting rights and value of each of them; and
> (iii) for the purpose of determining gain on any subsequent disposition,
> A) the initial cost of the asset for the transferee is determined based on the cost it had for the transferor, increased by any cash or other property paid, or
> B) the gain is measured by another method that gives substantially the same result.
> Notwithstanding the foregoing, if cash or property other than such participation or other rights is received, the amount of the gain (limited to the amount of cash or other property received), may be taxed by the other Contracting State.

Id.

79. Treaty, *supra* note 1, art. 13, para. 5.

80. *Id.* para. 6; *see supra* notes 66-71 and accompanying text (examining the tax treatment of Royalties).

81. Treaty, *supra* note 1, art. 13, para. 7.

82. *Id.* art. 14, para. 2 (defining "personal services" to include independent scientific or artistic activities, educational or teaching activities, as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants).

83. *Id.* para. 1(a).

84. *Id.*

other Contracting State for a period of at least 183 days within a twelve month period,[85] the other State may impose a tax upon that income attributable to activities performed within the other State.[86]

J. Exchange of Information

The competent authorities of the United States and Mexico will exchange information between the two nations to effectively remedy the problems of double taxation and fiscal evasion with respect to taxes on income.[87] Specifically, the two governments shall exchange information as provided in the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes.[88]

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85. *Id.* para. 1(b).

86. *Id. See generally* Protocol, *supra* note 37, art. 14 (stating that Article 14 shall apply to income derived by a company which is a resident of the United States from the furnishing of personal services through a fixed base in Mexico in accordance with subparagraph (a) of paragraph 1). In that case, the company may determine the tax on the income from such services on a net basis as if that income were attributable to a permanent establishment in Mexico. *Id.*

87. *See* Treaty, *supra* note 1, art. 27, para. 1 (stating that the two governments shall exchange information as provided in the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes signed on November 9, 1989); Protocol, *supra* note 37, art. 19 (providing that if the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes is terminated, the Contracting States shall promptly draft a protocol to this Treaty in order to accomplish the purpose of exchanging information between the two nations); *Greater Taxpayer Disclosure Seen Improving Competent Authority Process*, Int'l Fin. Daily (BNA), Dec. 15, 1992, *available in* LEXIS, Bna Library, Bnaibf File (stating that the Treaty will improve the competent authority process by requiring greater taxpayer involvement which will aid in the disclosure of the taxpayer's pertinent tax information); John Turro, *U.S. Signs Treaty Protocol with Mexico*, TAX NOTES INT'L, Sept. 12, 1994, *available in* LEXIS, Taxana Library, Tni File (hailing the protocol as enhancing the current tax information exchange arrangement between the two countries); *Summaries of Today's Important Tax Items*, TAX NOTES INT'L, Sept. 19, 1994, *available in* LEXIS, Taxana Library, Tni File (stating that the protocol extends the exchange of tax information to the state and local level); John Turro, *U.S. and Mexico Sign Two Protocols to Extend Tax Information to State and Local Level*, TAX NOTES INT'L, Sept. 19, 1994, *available in* LEXIS, Taxana Library, Tni File (stating that the expanded scope of information exchange to state and local levels is the "by-product" of NAFTA and the need to share additional tax information); *Tax Eagles Soar Across the Rio Grande: Tax Enforcement Cooperation Increases Between Mexico and the United States*, MEX. TRADE & L. REP., Nov. 1, 1994, *available in* LEXIS, Legnew Library, Mtlr File (stating that tax enforcement cooperation between the United States and Mexico is important from macroeconomic, development, criminal justice, and tax equity perspectives); *see also RRA '93 Changes Sourcing Allocation Percentages for Research and Experimental Expenditures*, 4 J. INT'L TAX'N 477, 478 (Oct. 1993), *available in* LEXIS, Taxria Library, Jitax File (discussing the Exchange of Information Agreement used before the Treaty took effect).

88. *See generally* Richard E. Andersen, *U.S.-Mexico Tax Information Exchange Agreement*, 1 J. INT'L TAX'N. 126 (July/Aug. 1990) (discussing the benefits of the tax information exchange agreement).

K. Treaty Termination

The Treaty remains in effect until either the United States or Mexico chooses to terminate the specified provisions after January 1, 1999,[89] provided that the terminating party provides at least six months notice through the proper diplomatic channels.[90]

L. Summary

The Treaty marks a new era for international trade and investment between the United States and Mexico. Specifically, business profits are taxable in the foreign country, generally, only to the extent that they are attributable to the location of the permanent establishment there, and even then they are taxable only on a net basis after a deduction for all appropriate business expenses.[91] Additionally, the Treaty contains provisions limiting the maximum rates of tax applicable to payments of royalties and dividends.[92] U.S. officials believe these provisions will promote U.S. investment in Mexico because the Treaty provides certainty as to the tax consequences of contemplated investment and generally acts to substantially reduce the tax costs of investing in Mexico.[93] Furthermore, the Treaty provides protocol standards to promote effective communication and problem resolution with respect to double taxation of international income.[94]

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89. *See* Treaty, *supra* note 1, art. 30, para. 1 (stating that either party may move to terminate the Treaty at any time after five years from the date on which the Treaty entered into force).

90. *Id.*; *see* Protocol, *supra* note 37, art. 20 (stating that with respect to termination, when the competent authority of one of the Contracting States considers that the law of the other State is or may be applied in a manner that eliminates or significantly limits a benefit provided by the Treaty, that State shall inform the other State in a timely manner and may request consultations with a view to restoring the balance of benefits of the Treaty). If it is requested, the other State shall begin such consultations within three months of the date of such request. *Id.* If the Contracting States are unable to agree on the way in which the Treaty should be modified to restore the balance of benefits, the affected State may terminate the Treaty according to the procedures of paragraph 1, notwithstanding the 5 year period referred to in that paragraph, or take such other action regarding this Treaty as may be permitted under the general principles of international law. *Id.*

91. Letter from Warren Christopher, *supra* note 4; *see supra* notes 47-54 and accompanying text (examining the tax treatment of business profits).

92. *See supra* notes 55-71 and accompanying text (discussing the tax treatment of dividends and royalties).

93. Letter from Warren Christopher, *supra* note 4. *See generally* Levey, et. al., *supra* note 9 (stressing the overall positive nature of the Treaty for promoting U.S. investment in Mexico); *U.S., Mexico Treaty Seen as Standard for Future Pacts with Third World Nations*, Int'l Fin. Daily (BNA), Nov. 13, 1992, *available in* LEXIS, Bna Library, Bnaibf File (stating that the Treaty is seen as the standard for future tax treaties between the United States and Third World nations).

94. *Id.*; *see* Treaty, *supra* note 1, arts. 26-27 (expounding procedures for the exchange of information); *IRS Revises Procedures For Simultaneous Examinations*, 5 J. INT'L TAX'N 46 (Jan. 1994), *available in* LEXIS, Taxria Library, Jitax File (stating that the IRS has announced new Manual guidelines for simultaneous examinations conducted between the United States and a country with which it has a tax treaty (or Tax Information Exchange Agreement (TIEA))); M. Timberlake and John Turro, *In This Issue of Tax Notes International: September 19, 1994*, TAX NOTES INT'L, Sept. 19, 1994, *available in* LEXIS, Taxana Library,

III. INDEPENDENT U.S. RELIEF MEASURES FROM DOUBLE TAXATION

The United States employs a number of other means to minimize the impact of double taxation of income. These methods are: (a) a tax exemption on foreign source income; (b) a foreign income tax credit; and (c) a deduction for foreign taxes paid. Each of these mechanisms is examined more fully below.

A. *Tax Exemption on Foreign Source Income*

The tax exemption on foreign source income involves the exemption of all income not produced within that country.[95] The tax exemption promotes foreign investment of capital without taxing the economic gains of foreign earned income in the taxpayer's country of residence.[96]

The United States Internal Revenue Code (I.R.C.) provides a tax exemption for certain income earned outside of the country, and for the taxpayer's housing costs.[97] This provision is only applicable to taxpayers who are taxed by the United States due to some sort of personal connection (citizenship or residence), and who are also taxed by the foreign country due to a territorial connection (the source of the income).[98] Since Section 911 is an elective provision, a taxpayer may choose not to exercise the option if a greater benefit would be realized from having more income taxed by the United States.[99] However, if the taxpayer opts to exercise the

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Tni File (discussing the extension of information exchange between the United States and Mexico); *U.S., Mexico Sign Agreements to Ease Exchange of Tax Information*, 11 INT'L TRADE REP. 1393 (Sept. 14, 1993), *available in* LEXIS, Bna Library, Intrad File (stating that the protocol will facilitate the exchange of tax information between the two countries); *supra* notes 87-88 and accompanying text (discussing the exchange of tax information between the United States and Mexico to the state and local level).

95. *See* Edrey & Jeffrey, *supra* note 5, at 105 (stating that if a country exempts all income that is not produced within that country from taxation, the problem will be largely eliminated).

96. *See id.* (proclaiming the virtues of the tax exemption); *see id.* n.14 (describing tax neutrality, removing the tax consequences of investment, as being a frequent goal of tax policy makers). In general, tax neutrality calls for a tax system that has as little impact as possible upon the allocation of resources within the economy. *Id.* Thus, when tax neutrality is obtained, the government is able to raise revenue with a minimum distortion upon the economic decisions of taxpayers. *Id.*

97. I.R.C. § 911 (1988); *see id.* (providing that a qualified individual may choose to exclude from one's taxable income an amount which is equal to the taxpayer's "foreign earned income" as defined in § 911(b)); *id.* § 911(b)(2) (stating that the amount of foreign earned income which may be excluded is limited to $70,000 per year); *id.* § 911(b)(1) (defining "foreign earned income" as that income which is received from sources within a foreign country attributable to personal services provided by the taxpayer); *id.* § 911(c) (providing a broad interpretation of housing costs, excluding only those expenses which are extravagant or lavish); *id.* § 911(d)(1) (defining a "qualified individual" as one whose tax home is in a foreign country for a period which includes a full taxable year, or a citizen of the United States who has been present in a foreign country for a period of 330 days or more in a period of 12 consecutive months); Treas. Reg. § 1.911-2(b) (1985) (defining "tax home" as the location of the taxpayer's principal or regular place of business, or if the taxpayer does not have a regular place of business, his tax home will be deemed to be his regular place of abode).

98. Edrey & Jeffrey, *supra* note 5, at 113.

99. *See id.* (stating that a taxpayer would not choose to exercise the foreign tax exemption when the foreign country taxes at a higher rate than the United States).

tax exemption, the taxpayer loses any right to claim a tax credit or tax deduction for those foreign taxes paid with respect to that exempted income.[100]

The following hypothetical is based upon a model developed by Professors Yoseph Edrey and Adrienne Jeffrey:[101]

> Consider a United States tax rate of thirty percent and a U.S. taxpayer with earned income of 100 in Country A, which has a tax rate of fifty percent. The taxpayer meets the requirements of Section 911 and thus, he may choose whether to invoke the exemption and exclude this income from U.S. taxation. The taxpayer has additional income of 100 from Country B which imposes a tax rate of ten percent. As to the income generated in Country B, the taxpayer does not meet the requirements of Section 911; thus, this income will be included in the taxpayer's U.S. taxable income. If the taxpayer employs Section 911, with respect to income earned in Country A, the taxpayer will be accountable for U.S. tax on this income. The taxpayer's U.S. tax associated with that 100 will be thirty since the U.S. taxes at thirty percent, but the taxpayer will be allowed a foreign tax credit of ten (equal to the amount of tax paid to Country B).[102] The result of electing the Section 911 exemption will be a final U.S. tax payment of twenty.[103]

However, given these facts, the taxpayer will realize a greater tax benefit by not opting to apply Section 911 because in this situation a credit provides greater tax relief. Consider the following example in which the taxpayer opts not to exercise Section 911.

> Given the same facts of the preceding example, the taxpayer's U.S. taxable income will be 200 (100 from Country A and 100 from Country B). Thus, the corresponding U.S. tax liability will be sixty.[104] However,

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100. I.R.C. § 911(d)(6) (1988); *see id.* (stating that this limitation is to prevent the taxpayer from receiving a double exemption).

101. Edrey & Jeffrey, *supra* note 5, at 113.

102. The U.S. tax of 30 is assessed on the 100 of income produced in Country B since the taxpayer is not eligible to exclude this income via § 911. However, the corresponding tax credit of 10 is provided to relieve the taxpayer from paying 10 in tax to Country B, given that Country B taxes at a rate of 10%. *See infra* notes 114-142 and accompanying text (examining the foreign tax credit).

103. *See* Edrey & Jeffrey, *supra* note 5, at 114 (deriving the 20 tax liability as incurring the U.S. tax of 30 and applying the amount of the foreign income tax credit from Country B income of 10); *id.* at 114 n.39 (stating that although the taxpayer will incur a tax liability of 50 in Country A, no credit will be allowed for this payment since it is foreign tax paid with regard to income that is exempt from U.S. taxation via § 911).

104. The tax liability of 60 is calculated given the U.S. tax rate of 30%. Thus, the 200 of foreign earned income multiplied by the U.S. tax rate equals a tax of 60.

the domestic tax limitation is also increased to sixty.[105] The taxpayer will be allowed a foreign tax credit in an equal amount, and will pay no taxes to the United States. Thus, through not exercising the Section 911 election the taxpayer has reduced his U.S. tax by twenty.[106]

The taxpayer may elect to forego Section 911, even if his only foreign source income is potentially exempted income, thus creating a foreign tax credit (at no cost to the taxpayer).[107] This credit may be carried to be used in either previous or subsequent years.[108] However, the taxpayer will generally want to exercise the Section 911 election if the foreign country taxes at a lower rate than the United States.[109]

Section 911 is a poorly tailored solution to the problem of double taxation. This view is expounded by Professors Edrey and Jeffrey, who maintain that Section 911 is an inefficient remedy because it grants an overly generous amount of relief.[110] The tax exemption is not limited to the minimum amount of relief necessary to avoid double taxation.[111] Rather it affords an exemption greater than necessary to accomplish the stated goal of avoiding double taxation because the equilibrium level of tax relief would be an amount equal to the difference of the U.S. tax and foreign taxes paid.[112] The current system grants relief in excess of the equilibrium, and thus fails to be economically efficient.[113]

B. Foreign Tax Credit

Although the tax exemption is an available option, the foreign tax credit is the primary device used by the United States to mitigate the effects of double taxation.[114] As with the exemption, the credit is an elective option which applies

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105. *See* Edrey & Jeffrey, *supra* note 5, at 114 n.40 (stating that this is determined by multiplying his foreign source income of 200 by his marginal tax rate of 30%).

106. If the taxpayer had exercised the § 911 election, then the taxpayer would have incurred taxes of 20. However, since the foreign income tax credit grants a more favorable amount of relief, the taxpayer actually incurs no U.S. tax lability with respect to that income; *see infra* notes 114-142 and accompanying text (examining the foreign income tax credit).

107. Edrey & Jeffrey, *supra* note 5, at 114.

108. I.R.C. § 904(c) (1988).

109. *See* Edrey & Jeffrey, *supra* note 5, at 114.

110. *See generally id.*

111. *Id.* at 114; *see id.* n.42 (stating that in such situations, the United States loses more revenue than is necessary to eliminate double taxation since the United States can impose a tax equal to the difference between the U.S. tentative tax and the foreign taxes paid without subjecting the taxpayer to double taxation).

112. *See generally id.* (criticizing the current U.S. relief system as being overly generous).

113. *Id.* at 130.

114. I.R.C. §§ 901-08 (1988); *see* Edrey & Jeffrey, *supra* note 5, at 114 (stating that the foreign tax credit is the most widely used device to combat double taxation). In addition to a direct credit for those taxes paid directly by the taxpayer, an indirect credit also allows corporate parents to credit those foreign income taxes paid by a subsidiary when the subsidiary pays dividends to the parent. *Id.* The provisions for the indirect credit

to income taxes or taxes paid in lieu of income taxes.[115]

The credit is limited to the lesser of the U.S. tax on foreign source income (the "domestic tax limitation") or the foreign taxes paid or accrued (the "foreign tax limitation").[116] Foreign taxes which do not qualify for the credit, because they exceed the domestic tax limitation, may be carried back two years or forward five years to offset other tax liabilities.[117]

The domestic tax limitation, the amount of U.S. tax on foreign source income, limits the amount of the tax credit to those situations where the foreign country taxes income earned within that country.[118] The following hypothetical which demonstrates the impact of the foreign tax credit is based upon a model developed by Professors Edrey and Jeffrey:[119]

> Assume a U.S. corporation that operates in both the United States and in Country A. Both countries tax at a rate of twenty percent. Furthermore, assume that the corporation is involved in two lines of business. One of these businesses (B1) produces income of 100 that, according to U.S. law, is sourced within Country A but is not taxed by Country A.[120] The other business (B2) produces income of 100 that, according to U.S. law, is sourced within the United States, but according to the law of Country A the income is also sourced within Country A and subject to tax therein. The corporation pays Country A twenty in tax, and its tentative tax (U.S. (B1) and Country A (B2)) is forty. The domestic tax limitation is twenty since the corporation has foreign-source income of 100 (produced by B1) and the U.S. tax rate upon that income is twenty percent.[121] Therefore, the United States will allow a foreign tax credit of twenty with respect to the income generated by B1.[122]
>
> This result is overly generous since the corporation's income derived from B1 has not been subject to double taxation. Given that the income produced by B1 is generated from economic activities within Country A, if that income had been taxed by both the United States and Country A

are outlined in I.R.C. § 902. *Id.* at 114 n. 43. *See generally* J. ISENBERGH, INTERNATIONAL TAXATION 472-81 (1990) (examining the foreign income tax credit); E. OWENS, THE FOREIGN TAX CREDIT (1961) (explaining the foreign income tax credit).

115. I.R.C. §§ 901(b), 903 (1988).

116. *Id.* §§ 901(b), 904; *see* Edrey & Jeffrey, *supra* note 5, at 115 (stating that this limitation reduces the relief of the credit to alleviate only double taxation, and does not provide overly generous relief).

117. I.R.C. § 904(c) (1988).

118. Edrey & Jeffrey, *supra* note 5, at 117.

119. *Id.*

120. The United States taxes the income from B1, despite being sourced in Country A, since this is a U.S. taxpayer.

121. *See supra* note 118 and accompanying text (defining "domestic tax limitation" as the amount of U.S. tax on foreign source income).

122. *See* I.R.C. §§ 901-08 (1988) (comprising the foreign tax credit).

> it would have been proper for the United States to grant tax relief. However, that income was taxed only once (by the United States).
>
> However, the income produced by the economic activity of B2 may or may not warrant tax relief. Given that the income produced by B2 is sourced within the United States according to U.S. law, and within Country A according to that country's law, neither country has a superior jurisdictional claim to tax the income. Despite this, the United States grants full relief from double taxation.

This hypothetical demonstrates the inefficiency of the current U.S. tax relief system, and further supports the premise that the Treaty, through its clarity and guidance, will increase the efficiency of alleviating double taxation.[123] The current system grants too much tax relief, in that there is no economic reason: (1) to provide a credit for the taxes paid with respect to the activity of B1 since that income was only taxed once by the United States; or (2) to grant a credit for foreign taxes paid with respect to the income of B2, because the United States has an equally strong claim to tax the income as does Country A.

Professors Edrey and Jeffrey examine the problem which arises when a taxpayer has personal connections with both the United States (citizenship) and Country A (residence), and has income sourced in Country A.[124]

> Consider the case of a U.S. citizen who resides 200 days in Country A and operates a business in Country B. Due to the taxpayer's personal connections with both the United States (citizenship) and Country A (residence), both of these countries have jurisdiction to tax. Under current U.S. law, the taxpayer would be allowed a credit for those taxes paid to Country A on the income sourced in Country B.[125] Thus, the United States relinquishes the right to tax the taxpayer to Country A, even though Country A does not maintain a closer relationship to the taxpayer or the taxpayer's income than does the United States.

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123. *See supra* notes 55-65 and accompanying text (examining the Treaty's taxation of dividend income).

124. Edrey & Jeffrey, *supra* note 5, at 117; *see id.* (recognizing that both countries have jurisdiction to tax this income); *id.* n.57 (stating that no similar problem occurs if the income is sourced within the United States). In that event, the domestic tax limitation is zero and no foreign tax credit will be allowed. *Id.* Nor is there any problem if the income is sourced within Country A. *Id.* In that event, Country A is the host country and the foreign tax credit is properly allowed. *Id.*

125. I.R.C. §§ 901-08 (1988); *see* Edrey & Jeffrey, *supra* note 5, at 117 n.58 (stating that this credit would be allowable subject to the domestic tax limitation). *Id.* If Country B imposes a tax equal to or greater than the U.S. tax rate, no credit would be allowed in the current year for the taxes paid to Country A; nevertheless, a usable tax credit would be created that could be carried forward or back. *Id.*

In examining the taxation of income sourced within the United States, generally there is not a need for the United States to issue a tax credit to a foreign taxpayer with income earned within the United States. If double taxation does occur it is usually left to the foreign country to alleviate the excess taxation.[126] Furthermore, a foreign taxpayer engaged in a trade or business located in the United States is subject to tax on all income which is effectively-connected[127] with that trade or business.[128] The I.R.C. does not grant a tax credit if the effectively-connected income is earned within the United States, and the foreign country imposes a tax on this income based upon a personal (i.e. residency) rather than a territorial connection.[129]

Despite the legislative intent to tax the foreign income of U.S. taxpayers when that income is sourced outside the United States,[130] the text of I.R.C. Section 906(b) does not meet this end.[131] Rather, Section 906(b) only forbids the credit in those instances where the income is sourced within the United States and the foreign country taxes that income due to a personal, rather than a territorial, connection.[132] Professors Edrey and Jeffrey have developed the following

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126. Edrey & Jeffrey, *supra* note 5, at 118.

127. *See* I.R.C. § 864(c)(4)(B) (1988).

> Foreign source income which is effectively-connected includes:
> (1) rents or royalties from intangible property derived in the active conduct of the U.S. trade or business; (2) dividends or interest from stock or securities that is either derived from the active conduct of a banking, financing, or similar business, or is received by a corporation that is involved principally in the trading of stocks and securities on its own account; and (3) income from the sale or exchange of inventory if such sale is through the United States office, unless the inventory is sold for use outside the United States and a foreign office materially participated in the sale.

Id.

128. *Id.* §§ 871(b), 882.

129. *Id.* § 906(b); *see id.* § 906(b)(1) which states that:

> For purposes of subsection (a) . . . in determining the amount of any tax paid or accrued to any foreign country or possession there shall not be taken into account any amount of tax to the extent the tax so paid or accrued is imposed with respect to income from sources within the United States which would not be taxed by such foreign country or possession but for the fact that:
>
> (A) in the case of a nonresident alien individual, such individual is a citizen or resident of such foreign country or possession, or
>
> (B) in the case of a foreign corporation, such corporation was created or organized under the law of such foreign country or possession or is domiciled for tax purposes in such country or possession.

Id.; Edrey & Jeffrey, *supra* note 5, at 118 (discussing § 906(b)(1)).

130. *See* S. Rep. No. 1707, 89th Cong., 2d Sess. 44, *reprinted in* 1966 U.S. CODE CONG. & ADMIN. NEWS 4446, 4490 (explaining that § 906 was added "[t]o allow a foreign tax credit to nonresident aliens and foreign corporations with respect to foreign source income which is subject to tax in the United States because it is effectively-connected with the conduct of a trade or business in the United States").

131. *See* Edrey & Jeffrey, *supra* note 5, at 119 (arguing that the I.R.C. only forbids the credit in those instances when the income is sourced within the United States and subject to tax by a foreign country due to a personal connection).

132. I.R.C. § 906(b)(1) (1988).

example to demonstrate what occurs when a foreign country, due to a territorial connection, may tax income sourced within the United States.[133]

> Assume a foreign taxpayer operates a business (B1) in Country A with a branch (B2) located within the United States that produces taxable income of 200.[134] Assume that each country has essentially the same income tax system, but Country A uses the "force of attraction" concept[135] to determine territorial connections with a taxpayer's income. Country A taxes the income from B2 not due to a personal connection (citizenship), but because of a territorial (residence) connection. Section 906(b) provides for a foreign tax credit under these circumstances.[136] Therefore, the general rule of Section 906(a) which allows a credit for foreign taxes paid on effectively-connected income would apply.[137] Assuming that both Country A and the United States tax at a rate of twenty percent, the total foreign tax (twenty) and the U.S. tentative tax (twenty) on B1's income yields a total tax of forty. No U.S. tax payment is made since the foreign tax is credited against the equal U.S. tentative tax via I.R.C. Section 906(a). Thus, the United States has in effect relinquished priority to tax the income sourced within the United States to Country A, despite the fact that Country A lacks a closer territorial connection to the income, as defined by the U.S. system. The United States maintains a territorial connection to the income produced by B2 since it is generated within the United States. The United States' failure to tax violates the accepted international principle that the host country is entitled to the first tax bite.

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133. Edrey & Jeffrey, *supra* note 5, at 119.

134. The income generated by B2 is considered "effectively-connected" given that it is a branch office of the main corporation (B1).

135. *See* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, INTERNATIONAL TAX GLOSSARY 188 (1988) (explaining the "force of attraction" theory as when a taxpayer maintains a permanent establishment in a country, that country will assert jurisdiction to tax all income derived from the home office from sources and property within that country, rather than only taxing income derived by and property attached to the permanent establishment); Edrey & Jeffrey, *supra* note 5, at 119 n.67 (discussing the "force of attraction" theory).

136. *See* I.R.C. § 906(b) (1988) (providing guidelines for the implementation of the credit); *see supra* note 132 and accompanying text (discussing § 906(b)).

137. *Id.* § 906(a).

> A nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year shall be allowed a credit under § 901 for the amount of any income, war profits, and excess profits, taxes, aid or accrued during the taxable year (or deemed, under section 902, paid or accrued during the taxable year) to any foreign country or possession of the United States with respect to income effectively connected with the conduct of a trade or business within the United States.

Id. See also supra note 127 (defining "effectively-connected").

To briefly review, the United States imposes taxation based upon a personal connection; however, a credit is permitted when the income is generated outside of the country.[138] Additionally, the foreign tax limitation reduces the amount of the credit to those foreign taxes which have actually accrued or been paid,[139] while the domestic tax limitation is used to restrict the credit only when the United States is imposing tax on foreign source income.[140]

The current system has its critics. Professors Edrey and Jeffrey maintain that the present system is overly generous because it allows nonresident aliens to credit foreign taxes assessed upon effectively-connected income, as long as the foreign country asserts jurisdiction through a territorial connection, even though the income is sourced within the United States.[141] It is important to note that in those instances when foreign taxes are not creditable, the deduction for certain tax payments, as provided in I.R.C. Section 164(a)(3), becomes attractive to the taxpayer.[142] However, this additional U.S. remedy increases the possibility that the taxpayer will be entitled to relief from double taxation in both the United States and the foreign country, thus perpetuating the inefficiency of the current system.

C. Tax Deductions for Taxes Paid

The United States employs a third device which may be used to alleviate the effects of double taxation: a tax deduction for foreign tax payments.[143] If the taxpayer chooses to forego a tax credit, the taxpayer may deduct the amount of foreign taxes paid from his taxable income.[144] Some authors argue that when a tax credit is an available option, it is preferable to a deduction.[145] However, the taxpayer may prefer to take the deduction as opposed to the credit when the taxpayer incurs a higher taxable income in the foreign country because it would reduce the taxpayer's tax liability by a greater factor than would the credit.[146] The following

138. Edrey & Jeffrey, *supra* note 5, at 119.

139. *Id.*

140. *Id.*

141. *Id.* at 120; *see supra* note 127 (describing "effectively-connected" income).

142. I.R.C. § 164(a)(3) (1988) (allowing credit for taxes paid to state, local, and foreign entities).

143. *Id.*

144. *Id.*; *see id.* §§ 901-08 (comprising the foreign tax credit); *see also supra* notes 114-142 and accompanying text (discussing the implementation of the credit).

145. *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION 2-3 (1988) (stating that a credit differs substantially from a deduction, in that a credit reduces one's tax liability by the amount of the credit). Thus, the tax benefit is not dependent upon the taxpayer's marginal rate, but rather there is a dollar for dollar reduction. *Id.* In contrast, a deduction, which is subtracted from taxable income, reduces the amount of tax due by the marginal tax rate. *Id.* For example, if the taxpayer's marginal rate is 30%, a dollar deduction would reduce his tax liability by only 30 cents. *Id.*; Edrey & Jeffrey, *supra* note 5, at 120 n.70 (addressing the distinction between a deduction and a credit).

146. Edrey & Jeffrey, *supra* note 5, at 120-21.

hypothetical which illustrates this distinction is based upon a model developed by Professors Edrey and Jeffrey.[147]

> Consider a U.S. taxpayer who has income of 100 stemming from business activities in the United States, and is subject to tax at a rate of thirty percent. In addition, the taxpayer has gross income of fifty in Country A. Under the current U.S. system the taxpayer is allowed deductions of forty for business, travel, lodging, and miscellaneous expenses relating to the foreign income, which results in taxable foreign source income of ten.[148] The amount of U.S. tax payable on the foreign source income (and thus, the domestic tax limitation) equals three.[149] However, Country A's tax system only allows expenses of ten to be deducted, thus Country A's taxable income is forty. Since the maximum amount of the foreign tax credit is thirty,[150] the taxpayer will not be able to credit the entire amount of foreign taxes paid if the tax rate in Country A exceeds seven and one-half percent.[151] In such a case, the taxpayer will consider the option of waiving the foreign tax credit and deducting the entire amount of foreign taxes paid.[152] If the tax rate in Country A exceeds twenty-five percent, the taxpayer will realize a greater tax benefit in the current year by deducting the foreign tax payment.[153]

The taxpayer also has the choice of deducting the foreign tax payments when the tax credit is not an available option (either due to the income being sourced within the United States or because the taxpayer is not a U.S. resident or citizen).[154]

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147. *Id.* at 121.

148. *See* I.R.C. § 162 (1988) (allowing for deductions of expenses connected with a trade or business); *id.* § 164 (allowing deduction of taxes paid to state, local, and foreign governments); *id.* § 212 (allowing deduction of expenses connected with the production of income).

149. The U.S. tax of three is determined by the taxpayer's marginal rate of 30% multiplied by the taxable income of 10 on the foreign source income.

150. This amount is determined by multiplying the U.S. tax rate of 30% by the business income of 100. *See supra* note 116 and accompanying text (discussing the U.S. tax credit limitation).

151. A tax rate of 7.5% yields a tax of 30 when applied to taxable income of 400. Thus, in the present example the taxpayer would not earn a credit of 30 because the taxpayer's taxable income is less than 400. *See* Edrey & Jeffrey, *supra* note 5, at 121 (stating the taxpayer would not be able to credit the entire amount of foreign taxes paid if the tax rate in Country A exceeds 7.5%).

152. *See* Treas. Reg. § 1.901-1(c) (1987) (stating that a taxpayer cannot choose to deduct a portion of the foreign taxes paid and claim a credit for the remainder). Moreover, if a foreign credit is claimed in one year and part of the credit is carried forward, this carried-over credit shall never be deducted. *Id.*

153. If the foreign tax rate is 25%, the value of the deduction for foreign taxes paid, as determined by multiplying the foreign taxes paid by the U.S. tax rate of 30%, will equal 30, the maximum foreign tax credit allowable.

154. I.R.C. § 164(a)(3) (1988); *see* Edrey & Jeffrey, *supra* note 5, at 121 (stating that in this situation, the taxpayer is denied the foreign tax credit to insure that the United States gets the first tax bite when entitled). Allowing the deduction of the foreign income undermines this objective. *Id.*

However, Professors Edrey and Jeffrey fear that the current implementation of the tax deduction allows an excessive amount of tax relief.[155] In allowing the deduction when the United States is the host country, this greatly increases the chance that the taxpayer will be able to enjoy a double tax remedy.[156] Hence, if the deduction is examined exclusively as a means for remedying double taxation, it should not be allowed in those cases when the United States is the host country because it allows an overly generous remedy, and thus is not economically efficient.[157]

D. Summary

The current U.S. system of relief is economically inefficient for achieving the stated purpose of eliminating double taxation. The U.S. system of granting a tax exemption, credit, or deduction often provides an amount of relief which exceeds any potential double taxation. The present system grants the taxpayer an overly generous remedy for the problems associated with the double taxation of international income.[158] The Treaty, through its clarity and specific provisions, represents an attempt to efficiently remedy the problem of double taxation.[159]

IV. TREATY INTERPLAY WITH NAFTA

The signing of the Treaty on September 18, 1992, followed negotiations of the North American Free Trade Agreement (NAFTA)[160] between the United States, Canada, and Mexico.[161] NAFTA seeks to reduce trade barriers to goods and services, strengthen the protection of intellectual property rights, and eliminate investment barriers in North America.[162] Since NAFTA generally does not address taxation measures, the U.S. Treasury Department hails the Treaty as

155. Edrey & Jeffrey, *supra* note 5, at 121.

156. *See id.* (stating that since the foreign country will likely offer relief from double taxation, as it is the home country, this will allow the taxpayer to enjoy double relief).

157. *Id.*

158. *See supra* notes 95-157 and accompanying text (examining the current U.S. system of a tax exemption, credit, and deduction).

159. *See* Letter from Warren Christopher, *supra* note 4 and accompanying text (discussing the benefit of the Treaty's clarity and certainty as to possible tax consequences of international investment); *see also supra* notes 14-94 and accompanying text (discussing provisions of the Treaty).

160. *See* NAFTA, *supra* note 12 (addressing NAFTA).

161. *See* Treaty, *supra* note 1 (explaining that the Treaty was signed on September 18, 1992); NAFTA, *supra* note 12.

162. Alan S. Lederman & Bobbi E. Hirsh, *U.S.-Mexico Tax Treaty Complements NAFTA*, 79 J. TAX'N 100 (Aug. 1993). *See generally Mexico: Land of Opportunity?*, MEX. TRADE & L. REP., July 1, 1993, *available in* LEXIS, Legnew Library, Mtlr File (stating that NAFTA will further intensify trade between Mexico and the United States).

a significant complement to NAFTA.[163] The Treaty establishes clear guidelines for the taxing jurisdictions, reduces the overall tax on investment income flowing between the two countries, and grants relief from double taxation.[164] Despite the interplay between the Treaty and NAFTA, neither is based upon the other, but rather they are wholly independent documents.[165] In the event of inconsistencies between NAFTA and the Treaty, the Treaty will preempt all other provisions.[166] However, given the similarity of the underlying goals of the Treaty and NAFTA, many U.S. companies will have the incentive to venture into international trade for the first time. Consequently, legal practitioners and businesses need to be aware of the tax consequences of setting up operations in Mexico.[167] While the Treaty provides clear standards through certainty which is thought to ease the decision to invest internationally, the nuances of the Treaty may present taxpayers with adverse results if they fail to carefully plan their transactions and operations.[168] The following presents a few examples of the differences between NAFTA and the Treaty with respect to particular provisions of each.

A. Treaty Beneficiaries

NAFTA generally applies to nationals[169] or enterprises of a party to NAFTA.[170] Article 17 of the Treaty limits its benefits to income derived from Mexico by residents of the United States, or income derived from the United States by residents of Mexico (other than U.S. citizens).[171] Article 4 of the Treaty equates resident with an individual subject to tax on a worldwide basis.[172] How-

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163. *See* Lederman & Hirsh, *supra* note 162, at 100 n.2 (citing a U.S. Treasury Department news release dated September 18, 1992); *NAFTA Leaves Tax Issues to Separate Pacts; Treasury to State Mexico Tax Pact Status*, Int'l Fin. Daily (BNA), Aug. 14, 1992, *available in* LEXIS, Bna Library, Bnaibf File (stating that NAFTA leaves taxation issues to be addressed by the double taxation treaties of the member nations).

164. *Id.*; *see* David G. Roberts, *A Summary of the NAFTA Tax Treaties*, TAX NOTES INT'L, Nov. 28, 1994, *available* in LEXIS, Taxana Library, Tni File (providing a comprehensive summary of the different tax treaties entered into by the NAFTA member nations).

165. Lederman & Hirsh, *supra* note 162, at 106.

166. NAFTA, *supra* note 12, art. 2103(2).

167. Levey, et. al., *supra* note 9, at 368.

168. *Id.* at 371; *see* Roger Royse, *Doing Business in Mexico Means a New Set of Rules*, BUS. J., June 20, 1994, *available in* LEXIS, News Library, Curnws File (concluding that the decision to establish operations in Mexico carries weighty consequences that should not be entered into lightly, and urging consultation with Mexican counsel before entering into operations).

169. *See* NAFTA, *supra* note 12, art. 201, ch. 2 (defining "national" as including a natural person who is a citizen or permanent resident of a party and an entity, whether it be a corporation, partnership, or other entity, organized under the law of a party).

170. *Id.*

171. Treaty, *supra* note 1, art. 17.

172. *Id.* art. 4; Lederman & Hirsh, *supra* note 162, at 106 (supporting this analysis); *see ABA Tax Section's Treaty Committee Members Urge Treasury to Clarify Aspects of U.S.-Mexico Treaty*, TAX NOTES INT'L, Mar. 4, 1994, Taxana Library, Tni File (examining the limitation of Treaty benefits).

ever, Mexico does not tax the worldwide income of its nonresident citizens.[173] Thus, Mexican citizens who live outside Mexico will not be entitled to Treaty benefits; however, there are mitigating provisions to lessen the impact for these taxpayers.[174]

B. Limitation of Benefits

Articles 1113(2), 1211(2), and 1401(2) of NAFTA generally permit member nations to deny NAFTA benefits to the enterprises of another party if investors of a non-NAFTA country control the enterprise, and the enterprise lacks substantial business activities in the NAFTA country of organization or, in the case of services, any NAFTA country.[175]

The Treaty, like NAFTA, does not deny benefits with respect to income derived by an entity from an active trade or business conducted in a Treaty country.[176] Article 17 of the Treaty provides that a company residing in the United States or Mexico and engaged in the active conduct of a trade or business, including a banking or insurance business, is entitled to Treaty benefits with respect to all income derived from, or incidental to, that trade or business.[177]

C. Termination

Article 2205 of NAFTA states that a party may withdraw from the agreement on six months notice.[178] However, the Treaty remains in effect until either the United States or Mexico chooses to terminate the specified provisions after January 1, 1999[179] with proper notice.[180]

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173. Lederman & Hirsh, *supra* note 162, at 106.

174. Protocol, *supra* note 37, art. 2; *see* Lederman & Hirsh, *supra* note 162, at 106 (stating that in an attempt to provide approximate parity, Article 2 of the Protocol provides that Mexico will not treat a U.S. citizen or a green card holder as a U.S. resident for Treaty purposes unless that individual has a substantial presence in the United States, or would be a resident of the United States based upon the tie breaker comparison of enumerated personal contacts).

175. NAFTA, *supra* note 12, arts. 1113(2), 1211(2), 1401(2); *see* Lederman & Hirsh, *supra* note 162, at 106 (describing the limitation of NAFTA benefits).

176. Treaty, *supra* note 1, art. 17; *see* Lederman & Hirsh, *supra* note 162, at 106 (comparing the limitation of benefits under NAFTA with the Treaty's limitation provisions).

177. Lederman & Hirsh, *supra* note 162, at 106.

178. NAFTA, *supra* note 12, art. 2205.

179. *See* Treaty, *supra* note 1, art. 30, para. 1 (stating that either party may move to terminate the Treaty at any time after five years from the date on which the Treaty entered into force).

180. *Id.; see* Protocol, *supra* note 37, art. 20.

With respect to termination:

> [W]hen the competent authority of one of the Contracting States considers that the law of the other State is or may be applied in a manner that eliminates or significantly limits a benefit provided by the Convention, that State shall inform the other Contracting State in a timely manner and may request consultations with a view to restoring the balance of benefits of the Convention. If so requested, the other State shall begin such consultations within three months of the date of such

Although the Treaty and NAFTA are not dependent upon one another, each operates to promote international commerce between the United States and Mexico.[181] With the reduction of double taxation as addressed by the Treaty and the phasing out of barriers with regard to trade in goods, services, and investment, as addressed by NAFTA, each agreement complements one another in promoting the free trade spirit between the two nations.[182]

V. CONCLUSION

U.S. treaty negotiators have formulated a Treaty, which is generally consistent with historic U.S. treaty policies, yet takes into account both the intricacies of Mexican tax law and the overall free trade spirit of NAFTA.[183] The Treaty will likely make income tax consequences a neutral factor when a U.S. taxpayer is deciding whether to invest in the United States or Mexico.[184] The Treaty will act as a model for future U.S. treaties with less-developed countries, particularly those Central American, South American, and Caribbean countries which may join NAFTA under the guise of the proposed Enterprise for the

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request.

> If the Contracting States are unable to agree on the way in which the Treaty should be modified to restore the balance of benefits, the affected State may terminate the Convention in accordance to the procedures of paragraph one, notwithstanding the five year period referred to in that paragraph, or take such other action regarding this Convention as may be permitted under the general principles of international law.

Id. See id. (stating that the party wishing to terminate the Treaty must provide at least six months notice through the proper diplomatic channels).

181. *See* Barry M. Cass & Richard E. Andersen, *U.S.-Mexico Treaty Combines Developed and Developing Country Models*, 3 J. INT'L TAX'N 197, 201 (Nov./Dec. 1992), *available in* LEXIS, Taxria Library, Jitax File (stating that the Treaty and NAFTA operate together to blur the borders between the United States and Mexico with respect to lowering barriers to investment between the two countries); 11 INT'L TRADE REP. 37 (Jan. 5, 1994), *available in* LEXIS, Bna Library, Intrad File (stating that some joint ventures involving investors of the United States and Mexico will now, as a result of NAFTA, be able to take advantage of treaty benefits). *See generally Legal Considerations for Mexican Business in the United States*, MEX. TRADE & L. REP., Aug. 1, 1992, *available in* LEXIS, Legnew Library, Mtlr File (addressing the special concerns of Mexican businesses).

182. *See generally* Treaty, *supra* note 1 (providing for a positive environment for foreign investment); NAFTA, *supra* note 12 (removing trade barriers to facilitate foreign trade).

183. Lederman & Hirsh, *supra* note 162, at 107; *see supra* notes 160-182 and accompanying text (examining the interaction of the Treaty with NAFTA). *See generally Opportunities for U.S. Business in Mexico*, MEX. TRADE & L. REP., Dec. 1, 1993, *available in* LEXIS, Legnew Library, Mtlr File (stating that for U.S. investors the increased ownership percentages allowed by NAFTA have further enhanced investment opportunities in Mexico); *Tax Planning for Mexican Companies Doing Business in the United States*, MEX. TRADE & L. REP., Sept. 1, 1992, *available in* LEXIS, Legnew Library, Mtlr File (providing a general overview of the tax system faced by Mexican companies investing in the United States).

184. Lederman & Hirsh, *supra* note 162, at 107; *see id.* (stating that given the elimination of possible double taxation via the Treaty, businesses and investors will not hesitate to invest abroad for fear that their income will be the subject of possible multiple taxation in both countries).

Americas Initiative.[185] Specifically, the Treaty is seen as providing the model for future tax conventions given that it guarantees tax fairness and provides investors with a strong sense of security when deciding whether to invest in Mexico.[186]

In addition to the Treaty, the United States has a variety of other mechanisms to avoid the double taxation of income. However, these methods often overcompensate for any possible multiple taxation.[187] One method of analyzing the effectiveness of these mechanisms is to determine whether they adhere to the principle that the host country is entitled to the first tax bite.[188] To the extent that these mechanisms do not adhere to this principle, and to the extent that these provisions overlap, the devices are not necessary to eliminate or alleviate double taxation.[189] The tax exemption is criticized for providing greater tax relief than necessary to eliminate double taxation;[190] it applies even though the foreign country may tax the income either at a rate lower than the United States or not at all.[191] Additionally, the foreign tax credit is overly generous because it allows foreign taxpayers to claim a credit for taxes paid to foreign countries on effectively connected income even though that income is sourced within the United States.[192] Similarly, when examining the foreign tax deduction, it is clear that it conflicts with the objectives of the foreign tax credit.[193] Even though the United States follows the first tax bite principle by disallowing a foreign tax credit when income is sourced within the United States, I.R.C. Section 164 grants partial double taxation relief in allowing a deduction of the foreign tax payments.[194] This increases the possibility that the taxpayer will be entitled to relief from double taxation in both countries.[195] The Treaty's specific provisions, may more efficiently eliminate double taxation than the current, overly generous

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185. *Id.*; *see* NAFTA, *supra* note 12, art. 2204(1) (providing for the inclusion of new parties, pursuant to terms which are to be negotiated); *U.S., Mexico Treaty Seen as Standard for Future Pacts With Third World Nations*, Daily Tax Rep. (BNA), Nov. 13, 1992, *available in* LEXIS, Bna Library, Bnadtr File (stating that the Treaty is seen as the standard for future tax treaties between the United States and Third World nations).

186. *U.S., Mexico Treaty Seen as Standard for Future Pacts With Third World Nations*, *supra* note 185.

187. *See supra* notes 95-159 and accompanying text (detailing the current U.S. relief provisions).

188. Edrey & Jeffrey, *supra* note 5, at 128-29.

189. *Id.*

190. *Id.* at 129.

191. *Id.*; *see supra* notes 95-113 and accompanying text (examining the tax exemption).

192. *Id.*; *see supra* notes 114-142 and accompanying text (discussing the foreign income tax credit). *See generally* Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 (1987) (discussing the concept of "effectively-connected" income).

193. Edrey & Jeffrey, *supra* note 5, at 130; *see supra* notes 143-157 and accompanying text (examining the foreign tax deduction).

194. *See* I.R.C. § 164 (1988) (providing the general rules applicable to taxation); *see also supra* note 142 and accompanying text (describing the § 164 relief provision).

195. Edrey & Jeffrey, *supra* note 5, at 130; *see* Robert G. Nath, *Foreign Records Come to the Fore*, TAX PRAC. & CONTROVERSIES, Oct. 1994, *available in* LEXIS, Taxana Library, Tpcmag File (stating that the IRS is taking a stronger hand in monitoring and discovering the details of international tax transactions presumably to reduce the instances of granting more than an equitable amount of tax relief).

United States system of a tax exemption, tax credit, and tax deduction.[196] As an example of the Treaty's pro-international investment focus, the Treaty provides for the taxation of dividends at more favorable terms than the same taxpayer would incur without the advent of the Treaty provisions.[197] Similar advantageous treatment is afforded to business profits,[198] royalties,[199] and capital gains.[200] Additionally, the Treaty's provisions for the exchange of tax information between the United States and Mexico will increase the efficiency of relief through the communication of adequate and pertinent information.[201]

Investors and service providers will be among the biggest winners under the terms of the Treaty.[202] Both of these groups, whether located in Mexico or in the United States, will generally pay less tax on cross-border transactions than they would have paid without the benefit of the Treaty.[203] This easing of tax liability promotes international investment, and hence, is consistent with the underlying free-trade principles of NAFTA.[204] Thus, the Treaty marks a new era in international trade and investment, the boundaries of which remain undefined.

Christian A. Ameri

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196. *See generally* Edrey & Jeffrey, *supra* note 5 (criticizing the current U.S. system of relief).

197. Treaty, *supra* note 1, art. 10, paras. (1)-(6); *see supra* note 61 and accompanying text (explaining that absent the Treaty provisions, the taxpayer would be subject to a tax rate of 30% on that dividend income, while under the Treaty the same taxpayer incurs a rate of only 15%).

198. *See supra* notes 47-54 and accompanying text (detailing the Treaty's taxation of Business Profits).

199. *See supra* notes 66-71 and accompanying text (examining the Treaty's provisions concerning the taxation of Royalties).

200. *See supra* notes 72-81 and accompanying text (discussing the Treaty's taxation of Capital Gains).

201. *See supra* notes 87-88 and accompanying text (examining Treaty provisions for the exchange of tax information between the governments).

202. Mason, *supra* note 39, at 1233. *See generally* Paul Dacher, *New U.S.-Mexico Tax Treaty Will Benefit Business on Both Sides of the Border*, 114 BUS. AM. 19, Jan. 11, 1993, *available in* LEXIS, News Library, Mags File (highlighting the expected benefits for international trade and investment between the two nations).

203. Mason, *supra* note 39, at 1233.

204. *See Summaries of Today's Important Tax Items*, TAX NOTES INT'L, June 24, 1994, *available in* LEXIS, Taxana Library, Tni File (stating that Mexico continues to enhance its treaty network with the expectation of integrating the Mexican economy into the developed world); *Mexico, U.S. Initial Pact Covering Income Taxes*, WALL ST. J., Aug. 14, 1992, at C8 (stating that the Treaty is an important complement to NAFTA).