[Florida Journal of International Law](https://scholarship.law.ufl.edu/fjil)

Volume 8 | Issue 1 Article 4

January 1993

The U.S.-Mexico Tax Treaty

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THE U.S.-MEXICO TAX TREATY

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I. INTRODUCTION

The first treaty between the United States and Mexico for the avoidance of double taxation (Treaty) entered into force on January 1, 1994.[1] The Treaty represents a significant milestone in the economic relations between the two countries, especially in light of the historic North American Free Trade Agreement (NAFTA). The Treaty complements NAFTA and will improve the investment climate in both countries, building on an already dynamic economic partnership between the United States and Mexico.

The purpose of this article is to analyze the Treaty in the context of model bilateral tax treaties and other recent U.S. tax treaties, with an emphasis on U.S. companies and individuals doing or contemplating doing business in Mexico. Part II provides an overview of the purpose and legal status of bilateral tax treaties. Part III discusses the scope of the Treaty and the requirements for its application. The Treaty's substantive income taxation rules are analyzed in part IV. Part IV also outlines special provisions, such as relief from double taxation, nondiscrimination, exchange of information, and the procedures for dispute resolution. Finally, part V provides a brief conclusion.

II. THE PURPOSE AND LEGAL STATUS OF INCOME TAX TREATIES

A. *Purpose and History of Income Tax Treaties*

Income tax treaties are entered into primarily to facilitate international trade and investment by eliminating tax barriers to the international exchange of goods and services and the international movement of capital and persons.[2] The most serious tax barrier that income tax treaties are designed to avoid is "double taxation."

International double taxation occurs when two or more countries impose

1. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Sept. 18, 1992, U.S.-Mex., S. Treaty Doc. No. 103-07, *reprinted in* 2 TAX TREATIES (CCH) ¶ 5903 [hereinafter U.S.-Mex. Tax Treaty and Protocol].

2. AMERICAN LAW INSTITUTE, 2 INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 1 (1992) [hereinafter ALI PROPOSALS].

comparable taxes on the same taxpayer with respect to the same income and for identical periods.[3] Double taxation most often arises when one country taxes on the basis of residence,[4] and another country taxes on the basis of source.[5] For example, if a U.S. resident receives investment income from Mexico, the United States will tax the income (because U.S. residents are subject to tax on their worldwide income). Mexico will also tax the income because it is from a Mexican source. This double taxation can have a chilling effect on international commerce. For this reason, it has long been customary for countries to adopt measures to alleviate double taxation.[6]

Double taxation may be alleviated unilaterally if one of the countries withdraws its tax claim. Established international practice dictates that the source country (the country in which the income arises, or is "sourced") is allowed the primary taxing right, while any relief from double taxation is provided by the residence country.[7] For example, the United States reduces double taxation by allowing residents to "credit" tax paid abroad against the amount of U.S. tax otherwise due.[8] By contrast, some nations use an "exemption system" whereby the residence country exempts income from its own tax when it is subject to tax in another country.[9] Unilateral measures, however, are an insufficient solution to international double taxation because they are not mutually consistent and often fail to address particular problems between the two countries. Consequently, nations attack the problem by entering into bilateral tax treaties.

When entering into a bilateral tax treaty, a country acts in two capacities.[10] First, it acts in its capacity as a residence country. Under the principle of residence, a country's jurisdiction to tax is based on the personal

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3. COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REPORT ON MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL ¶ 3 (1977) [hereinafter OECD 1977 REPORT].

4. Current international law allows taxation of foreign transactions when a sufficient connection exists between the taxpayer and the taxing state, such as through residence, habitual abode, citizenship, and situs of capital. KLAUS VOGEL, KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS 3 (1991); *see also* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW (1987) [hereinafter FOREIGN RELATIONS RESTATEMENT]; RUTSEL S.J. MARTHA, THE JURISDICTION TO TAX IN INTERNATIONAL LAW (1989).

5. VOGEL, *supra* note 4, at 2.

6. ALI PROPOSALS, *supra* note 2, at 5.

7. *Id.*

8. I.R.C. §§ 901-908 (1993). *See generally* ALI PROPOSALS, *supra* note 2, at 6. For a review of how the relevant U.S. provisions developed, see William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379 (1989).

9. *See* Model Double Taxation Convention on Income and on Capital (1977), art. 23A, *in* COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REPORT ON MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL 23 (1977) [hereinafter OECD MODEL].

10. ALI PROPOSALS, *supra* note 2, at 1.

status of the taxpayer, such as the domicile or residence (in the case of an individual), or place of incorporation or management (in the case of a corporation).[11] Second, a country acts in its capacity as a source country. In this capacity, the country's taxing jurisdiction is based on a geographic connection: tax is imposed on the income of nonresidents that arises in the taxing country.[12] A country has divergent interests when negotiating source-based taxation in a treaty.[13] It must balance its revenue interest with the need to maintain a hospitable environment for foreign investment.[14] Additionally, because treaties are reciprocal, each country must compromise in order to gain concessions from the treaty partner.

The resulting solution to these conflicting interests is invariably a treaty that reduces or eliminates source-based taxation. There is a remarkably broad consensus among the nations that the consequential loss in source-based tax revenue resulting from entering into a treaty is outweighed by the perceived benefit of promoting international commerce by creating a neutral tax environment.[15] Equally noteworthy is the striking similarity of tax treaties throughout the world.[16]

The current degree of uniformity in bilateral tax treaties is a result of work that the League of Nations began in 1921.[17] Building on the League of Nations' early work, the Organization for Economic Cooperation and Development (OECD) prepared a Model Taxation Convention that was published in 1963 and revised in 1977 and 1992 (OECD Model).[18] The vast majority of tax treaties between developed nations are modeled after the OECD Model.

Although the OECD Model effectively addressed the needs of developed nations, it failed to address the special needs of developing nations. Consequently, the United Nations published a model treaty in 1980 (U.N. Model), which was designed to serve the interests of developing nations.[19] The U.N. Model has gained considerable importance in negotiations be-

11. *See* AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS 6-7 (1987) [hereinafter ALI FEDERAL INCOME TAX PROJECT].

12. *Id.*

13. ALI PROPOSALS, *supra* note 2, at 2.

14. *Id.*

15. *Id.* at 2-3.

16. *Id.* at 3.

17. *See* Ke Chin Wang, *International Double Taxation of Income: Relief Through International Agreement, 1921-1945*, 59 HARV. L. REV. 73 (1945).

18. *See* OECD MODEL, *supra* note 9.

19. UNITED NATIONS DEP'T OF INT'L ECONOMICS & SOCIAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. MODEL]. The structure of this treaty corresponds to the OECD Model, but its content diverges in some important respects.

tween industrialized countries and developing countries.[20]

Most countries base their tax treaty negotiations on the OECD or the U.N. Model Treaty. The United States, however, developed its own model treaty (U.S. Model) to serve as the basis for U.S. treaty negotiations.[21] The U.S Model is based on the OECD Model, but differs especially in that unique provisions of the Internal Revenue Code (Code) are adopted in the U.S. Model. The purpose of including these provisions is to provide consistency between special U.S. policy concerns and the Code.[22] When entering into a treaty with developing countries, the U.S. typically draws from both the U.S. Model and the U.N. Model.

B. *Important Provisions of U.S. Tax Treaties*

Since most countries have unilateral rules to deal with the problem of double taxation, bilateral tax treaties generally operate to refine and adapt the two countries' unilateral double tax avoidance measures to address the specific tax relationship between the two treaty partners.[23] U.S. tax treaties use several techniques to accomplish this goal.

First, the source country cedes taxing jurisdiction in whole or in part to the residence country.[24] Second, the treaty attempts to clarify and modify the application of the U.S. foreign tax credit to insure that, to the extent possible, the provision achieves its objective of eliminating tax barriers to foreign investment by U.S. residents.[25] Additionally, the treaty partner usually obligates itself to grant some reasonable form of relief from double taxation on investment in the United States by its nationals, thus reducing any double tax barriers to their investment in the United States.[26] Third, a non-discrimination provision prohibits each country from burdening businesses owned or operated by residents of the other country with taxes that are different or more onerous than the taxes imposed on similar, domestically owned businesses.[27] Finally, U.S. tax treaties seek to coordinate

20. ALI FEDERAL INCOME TAX PROJECT, *supra* note 11, at 10.

21. The U.S. Treasury Department first published the U.S. Model in 1976. In 1977 the model was revised, and in 1981 a second revision was made, this time called a "draft." *See* U.S. Dep't of the Treasury, *Model Income Tax Treaty of 18 May 1976*, 31 BULL. INT'L FISCAL DOC. 313 (1977); U.S. Dep't of the Treasury, *Model Income Tax Treaty of 16 June 1981*, 36 BULL. INT'L FISCAL DOC. 15 (1982) [hereinafter U.S. MODEL].

22. *See* Robert J. Patrick Jr., *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 LAW & POL'Y INT'L BUS. 613 (1978).

23. PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 173 (Kluwer Series on International Taxation No. 10, 3d rev. ed. 1989).

24. *Id.* at 174.

25. *Id.*

26. *Id.*

27. *See* OECD MODEL, *supra* note 9, art. 24; U.S. MODEL, *supra* note 21, art. 24; U.N. MODEL, *supra* note 19, art. 24.

the administration of the tax laws of the two countries by including provisions for the exchange of information and procedures for consultation on disputes.[28]

The reciprocal reduction in source-based taxation in treaties based on the OECD or U.S. Model presumes that investment and capital flows between the two countries are roughly equal. However, in the case of developing countries, capital investment flow is primarily from the developed country to the developing country, and the resulting income flow is in the other direction.[29] Consequently, the interest of the developing country is principally as a source country.[30] In order to take into account the importance of source-based taxation for those countries, the United States often includes several provisions based on the U.N. Model in its treaties with developing countries. For example, one such provision allows higher permissible rates of source country withholding tax on investment income and royalties.[31] Another provision expands the definition of permanent establishment,[32] which generally alludes to a fixed place through which an enterprise engages in business in the other country, to permit broader source-based taxation of nonresident business activities.[33]

C. *The Legal Status of Tax Treaties*

Each individual treaty represents an independent source of law.[34] A tax treaty does not lead to the application of foreign law. Rather, the treaty avoids double taxation by limiting the content of domestic tax law, or by obliging one or both countries to allow a credit against their domestic tax for taxes paid in the other country.[35] Although these "rules of limitation" are closely related to the domestic tax laws of the treaty partners, the treaty rules are formulated separately from domestic tax law, and thus have an independent origin and legal foundation.[36]

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28. MCDANIEL & AULT, *supra* note 23, at 174.

29. ALI PROPOSALS, *supra* note 2, at 220.

30. *Id.*

31. For example, in the treaty with Egypt, royalties and interest are taxed at 12.5%, while such payments are exempt from source country tax in the U.S. Model. Convention for the Avoidance of Double Taxation and the Prevention of Income Tax Evasion, Aug. 24, 1980, U.S.-Egypt, *reprinted in* 1 TAX TREATIES (CCH) ¶ 2703, arts. 12-13. In the U.S.-India treaty, direct investment dividends are taxed at 15%, while portfolio dividends are taxed at 25%. Convention for the Avoidance of Double Taxation and the Prevention of Income Tax Evasion, Sept. 12, 1989, U.S.-India, *reprinted in* 2 TAX TREATIES (CCH) ¶ 4303, art. 10. The corresponding U.S. Model rates are 5% and 15%. U.S. MODEL, *supra* note 21, art. 10.

32. *See infra* notes 58-69 and accompanying text.

33. U.N. MODEL, *supra* note 19, art. 5.

34. MCDANIEL & AULT, *supra* note 23, at 173.

35. VOGEL, *supra* note 4, at 12.

36. Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW. 1, 14 (1986).

Under international law, a bilateral tax treaty comes into existence upon the declaration of consent by both contracting parties.[37] The United States Constitution vests the treaty-making power in the hands of the President, who must also obtain the advice and consent of the Senate.[38] In the United States, a treaty properly entered into is the supreme law of the land and has a legal status equal to a federal statute.[39]

D. *The U.S.-Mexico Treaty*

The U.S.-Mexico Treaty draws from the U.S. Model, the OECD Model, and, in recognition of Mexico's status as a developing country, the U.N. Model. The Treaty also reflects the unique relationship of the United States and Mexico as parties to NAFTA. The Treaty is an important complement to, but is separate from, NAFTA. In most cases, NAFTA leaves tax questions to be resolved by the bilateral tax treaties entered into by Canada, the United States, and Mexico.[40] Several articles in the Treaty have no precedent in the U.S. tax treaty network, and provide numerous opportunities for U.S. residents doing business in Mexico. Some commentators have suggested that the Treaty may indicate directions in which the U.S. Treasury is moving as it drafts a new U.S. Model and as it approaches other potential Latin American treaty partners.[41]

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37. Vienna Convention on the Law of Treaties, U.N. Doc. A/CONF. 39/27, May 23, 1969, art. 9(1), *reprinted in* 63 AM. J. INT'L L. 875 (1969) [hereinafter Vienna Convention]; FOREIGN RELATIONS RESTATEMENT, *supra* note 4, § 312(1).

38. U.S. CONST. art. II, § 2, cl. 2.

39. *Id.* art. VI, cl. 2. Where treaties and federal legislative provisions conflict, the latter in time prevails.

40. Generally, the provisions of NAFTA do not apply to taxation measures of the member countries. North American Free Trade Agreement, Dec. 8, 1992, U.S.-Mex.-Can., art. 2103(1), 32 I.L.M. 289 (1993) [hereinafter NAFTA]. However, numerous exceptions to this general principle are enumerated in article 2103. NAFTA article 2103(2) states that, as a general rule, the tax treaties will prevail to the extent of any inconsistency with NAFTA. Some exceptions to the primacy of a right under a tax treaty do exist. Article 301 (National Treatment) and such other provisions as are necessary to give effect to that article will apply to taxation measures to the same extent as does article 3 of the General Agreement on Tariffs and Trade (GATT). Article 314 (Export Taxes) and Article 604 (Export Taxes) apply to taxation measures. Article 1110 (Expropriation and Compensation) also applies to taxation measures, subject to certain procedural rules. For a detailed discussion of the interaction of the tax treaty and NAFTA, see SENATE COMM. ON FOREIGN RELATIONS, REPORT ON INCOME TAX CONVENTION WITH MEXICO (WITH PROTOCOL), S. REP. NO. 20, 103d Cong., 1st Sess. 32 (1993) [hereinafter SENATE REPORT].

41. Phillip D. Morrison, *U.S.-Mexico Income Tax Treaty Breaks New Ground — Implications for the New U.S. Model and for Latin America*, 5 TAX NOTES INT'L 825 (1992); *see also U.S.-Mexico Treaty Seen as Standard for Future Pacts with Third World Nations*, BNA INT'L FIN. DAILY, Nov. 13, 1992, at 8 (quoting statements by Joni L. Walser, an attorney advisor at the Treasury Department who helped negotiate and draft the U.S. Mexico Treaty, during a forum sponsored by the Council of the Americas on November 12, 1992). Note, however, that the NAFTA link and certain peculiarities in Mexico's tax system resulted in provisions in the Treaty that are unlikely to be reflected in a new U.S. model treaty. Morrison, *supra*, at 825-26. For example, the provisions dealing with the Mexican Asset Tax would be

The Treaty is composed of thirty articles as well as a protocol that adds explanatory material and extra rules. The Treaty can be analyzed in three parts: first, the scope and requirements for application of the treaty;[42] second, the substantive or "distributive" rules of taxation;[43] and, third, special provisions, including exempt organizations, relief from double taxation, non-discrimination articles, and administrative articles.[44]

III. SCOPE OF THE TREATY AND REQUIREMENTS FOR ITS APPLICATION

Taxpayers must be subject to the jurisdiction of the treaty before they are entitled to its benefits. This section explores the concept of jurisdiction by defining residence, permanent establishment, limitation on benefits, and taxes covered under the Treaty.

A. *Scope of the Treaty*

In order to determine whether the Treaty will apply in a given situation, both the *taxpayer* and the *tax* at issue must fall within the scope of the Treaty. As for the taxpayer, the Treaty applies to "residents" of Mexico or of the United States.[45] With regard to the tax, the Treaty generally applies to the United States federal income taxes that the Code imposes, excluding the accumulated earnings tax, the personal holding company tax, and social security taxes.[46] In Mexico, the Treaty applies to the Mexican Income Tax Law [*Ley Del Impuesto Sobre La Renta*].[47] Significantly, where the Treaty requires Mexico to exempt or reduce its tax on Mexican income of a U.S. resident, Mexico also agreed to provide relief from its Assets Tax.[48]

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irrelevant unless another country had a similar tax. *Id.* at 826 n.2. Likewise, the paragraph relating to maquiladoras that was added to the permanent establishment article will be irrelevant for most other countries. *Id.; see infra* text accompanying note 67.

42. *See* U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, arts. 1-5, 17. These articles cover the areas of general scope, taxes covered, general definitions, residence, permanent establishment, and limitation on benefits.

43. *See id.* arts. 6-23.

44. *Id.* art. 24 (Relief from Double Taxation).

45. *Id.* art. 1, para. 1. The terms "Mexico" and the "United States" include the areas of seabed and subsoil adjacent to their respective territorial seas in which they may exercise rights in accordance with domestic legislation and international law. *Id.*

46. *Id.* art. 2, paras. 1, 3(a). The excise tax imposed on insurance premiums paid to foreign insurers and the excise tax with respect to private foundations to the extent necessary to implement the provisions of paragraph 4 of article 22 (Exempt Organizations). *Id.* The Treaty shall, however, only apply to the excise taxes imposed on insurance premiums paid to foreign insurers to the extent that the risks covered by such premiums are not reinsured with a person not entitled to exemption from such taxes under this or any other convention which applies to these taxes. *Id.*

47. *Id.* art. 2, para. 3(b).

48. Asset Tax Law (*Ley Del Impuesto Al Activo*), *reprinted in* 1 MEXICO TAX, CUSTOM AND FOREIGN INVESTMENT LAWS (CCH) ¶ 15,009 [hereinafter Mexican Assets Tax]. The Mexican Asset Tax is a form of alternative minimum tax which is calculated on the value of a company's assets in Mexico and

B. *Definitions*

1. Residence

Aside from one exception discussed below, the Treaty only applies to persons who are residents of either the United States or Mexico.[49] In accordance with the U.N. and OECD Models, Article 4 (Residence) provides that "resident" means any "person"[50] who is subject to tax in either Mexico or the United States, under the laws of that country, because of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.[51] Although the United States, unlike any other developed country, asserts worldwide income taxing jurisdiction on the basis of citizenship, the Treaty follows the OECD Model, not the U.S. Model, by not including in the definition of "resident" U.S. taxpayers who have no connection to the United States other than citizenship.[52] The term "resident" does not include any person who is subject to tax in a contracting country with respect only to income from sources in that country.[53] Thus, for example, an individual resident of the United States will be covered by the Treaty since she is subject to U.S. tax because of her *residence*. By contrast, the Treaty will not cover a U.S. citizen who resides outside of Mexico or the United States.

If an individual could be considered a resident of both the United States and Mexico (dual residence), the Treaty's tie-breaker provisions apply. Dual residence can occur, for example, if a U.S. citizen or green card holder who

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which generally applies only to the extent that it exceeds any income tax paid to Mexico by the taxpayer.

49. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 1, para. 1. The exception is provided in the Treaty's article on limitation of benefits, which provides that the U.S. and Mexico will grant treaty benefits to certain entities, even if the typical residency requirements are not satisfied, provided the company is wholly owned by residents of any state that is a party to NAFTA. *Id.* art. 17; *see infra* notes 78-83 and accompanying text.

50. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 3, para. 1(a) & art. 4, para. 1. The article defines person as an individual, a company, a corporation, a trust, a partnership, an association, or any other body of persons. A partnership, estate or trust is considered a resident of the U.S. or Mexico only to the extent that the income it derives is subject to tax in that state as the income of a resident, either in the hands of the entity, or in the hands of the partners or beneficiaries. *Id.* para. 2(b). For example, if the share of U.S. beneficiaries in the income of a U.S. trust is only one-half, Mexico must reduce its withholding tax on only one-half of the Mexican source income paid to the trust. JOINT COMMITTEE ON TAXATION, 103D CONG., 1ST SESS., EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND MEXICO 46 (Comm. Print 1993) [hereinafter JOINT COMMITTEE EXPLANATION].

51. Although the U.S. Model and several U.S. tax treaties include citizenship in this definition, the Protocol provides that Mexico shall not consider a U.S. citizen or permanent resident (green card holder) to be a U.S. resident for treaty proposes unless that individual has a "substantial presence" in the U.S., or would be a resident of the U.S. and not of another country under the tie-breaker principles of article 4. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 4, para. 2(a).

52. *Id.* art. 4, para. 1.

53. *Id.*

has a "substantial presence" (as defined under Code section 7701(b)) in the United States also has a home in Mexico at which he spends 183 days or more during any calendar year.[54] If under U.S. and Mexican domestic law an individual is a resident of both contracting countries, the tie-breaker provisions provide that residence for Treaty purposes is determined by looking, in descending order of priority, to the country where the taxpayer has a permanent home, a center of vital interests, a habitual abode, or nationality status.[55]

In a sharp and significant departure from the OECD and U.S. Models, persons other than individuals (such as corporations, partnerships, trusts or estates) who are considered dual residents are not entitled to the benefits of the Treaty.[56] A corporation would be a dual resident, for example, if it were incorporated in the United States but had its principal place of management in Mexico.[57] Consequently, corporations and other entities which fail to plan for residence interpretations will be denied benefits under the Treaty.

2. Permanent Establishment

Mexico may only tax the business profits derived by a U.S. enterprise to the extent that the enterprise carries on business through a "permanent establishment" situated in Mexico.[58] The Treaty definition of a permanent establishment generally follows all three model treaties, but departs from the U.S. and OECD Models by providing for broader source-based taxation.[59]

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54. Those who establish a permanent home in Mexico are considered Mexican residents unless such persons are present in another country for more than 183 days in a calendar year. Federal Fiscal Code (*Código Fiscal De La Federación*), *reprinted in* 1 MEXICO TAX, CUSTOM AND FOREIGN INVESTMENT LAWS (CCH) ¶ 35,001, at ¶ 35,050, art. 9(I)(a), art. 9(II) [hereinafter CFF]; *see also* I.R.C. § 7701(b)(1)(A)(ii) ("substantial presence" means present in the U.S. for at least 183 days during a three-year period).

55. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 4, para. 2. Article 4, paragraph 2, establishes the legal consequences of Treaty entitlement by determining which contracting country may tax an individual on the principle of residence, and which may tax on the principle of source of income. VOGEL, *supra* note 4, at 169.

56. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 4, para. 3.

57. The Treaty does not define the term "resident;" therefore, one must look to the domestic laws of the contracting countries. *Id.* art. 3, para. 2; *see* CFF, *supra* note 54, ¶ 35,050, art. 9(I)(a) (Mexican residents include companies whose principal place of management is in Mexico); I.R.C. § 7701(b) (definition of a resident alien and nonresident alien).

58. The reciprocal rule applies to the U.S., but for clarity, this article analyzes the Treaty primarily from the perspective of U.S. persons doing business in Mexico.

59. The Mexican Income Tax Law employs a permanent establishment concept also based on the OECD Model. Income Tax Law (Ley Del Impuesto Sobre La Renta), 1 MEXICAN TAX, CUSTOMS AND FOREIGN INVESTMENT LAWS (CCH) ¶¶ 1001, 1005 [hereinafter Mexican Income Tax Law]. The definition in the Mexican Income Tax Law is so similar to that in the Treaty that Mexican interpretation under the Treaty may, in practice, be influenced by pre-Treaty domestic law concepts. John A. McLees, *Doing*

Under the Treaty, a "permanent establishment" means a fixed place of business through which the enterprise carries out its business.[60] A permanent establishment could consist of a place of management, a branch, an office, a factory, a workshop, a mine, or an oil well.[61] Certain preparatory activities, even if carried out in a fixed place of business, are expressly excluded from the permanent establishment definition. These activities include storing or displaying goods, maintaining a stock of goods for processing, purchasing goods, advertising, and other preparatory or auxiliary activities.[62] For example, a U.S. business that uses an office in Mexico only to advertise and promote its products would not have a permanent establishment so long as all of the orders and sales contracts were placed by the Mexican buyer directly to the U.S. home office.[63] The U.S. business could also avoid permanent establishment status if it maintained a warehouse in Mexico to store goods that would be delivered to Mexican buyers.

Certain activities will only constitute a permanent establishment if they are carried on in the country for longer than six months.[64] These activities include construction projects, drilling rigs or ships used for exploration of natural resources, or related supervisory activities.[65] This provision is based partly on the U.N. Model and is thus more expansive than the OECD and U.S. Models, which have a twelve-month period.

Certain agency relationships may also constitute a permanent establishment. As a general rule, using an independent agent to transact business in the other contracting country will not constitute a permanent establishment.[66] An agent for a particular enterprise will not be considered independent, however, if the transactions between the agent and the enterprise are not made at arms-length. Likewise, the agent will not be considered independent if, like an employee, the agent has a comprehensive obligation to obey instructions, rather than an obligation related merely to specific transactions.[67] Thus, for example, a U.S. corporation could hire a Mexican law

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Business in Mexico Under the U.S.-Mexico Income Tax Treaty: Initial Thoughts, 5 TAX NOTES INT'L 995, 996 (1992). But the Treaty defines the term "permanent establishment." Therefore, as a rule, domestic law may not be used when interpreting it for Treaty purposes. VOGEL, *supra* note 4, at 201.

60. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 5, para. 1.

61. *Id.* art. 5, para. 2.

62. *Id.* art. 5, para. 4.

63. However, the Treaty will allow Mexico to continue to look at all the facts and circumstances to determine whether an agent has "concluded" a contract on behalf of the U.S. company. Consequently, specific procedures, such as requiring the agent or customer to send the contract back to the U.S. company for acceptance, will not provide a safe harbor against the finding of a permanent establishment if it appears, under all the facts and circumstances, that the agent actually makes the decision. McLees, *supra* note 59, at 997.

64. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 5, para. 3.

65. *Id.*

66. *Id.* art. 5, para. 7.

67. VOGEL, *supra* note 4, at 257.

firm to act as its agent in Mexico without thereby creating a permanent establishment in Mexico because the Mexican law firm is an independent agent — it charges arms-length fees, acts in the ordinary course of business, and obeys instructions for specific transactions only.

Nonindependent agents may create a permanent establishment under three circumstances. First, a U.S. enterprise will be deemed to have a permanent establishment in Mexico if its agent has and habitually exercises the authority to contract on behalf of the U.S. parent company in Mexico.[68] Second, in a measure aimed at in-bond assembly plants (otherwise known as "maquiladora" operations), a permanent establishment will exist where an agent, even one without the authority to contract, habitually processes goods on behalf of, and using equipment furnished by, the U.S. enterprise.[69] For example, if a U.S. toy manufacturer maintains a dependent agent in Mexico to assemble toys, the dependent agent's processing operations will constitute a Mexican permanent establishment of the U.S. manufacturer. However, if the U.S. toy manufacturer uses an independent agent (i.e., a contract processor) to assemble its toys in Mexico, no permanent establishment will exist. Third, except in the case of reinsurance, a U.S. insurance company that collects insurance premiums through a representative in Mexico also will be deemed to have a permanent establishment.[70]

Article 5 (Permanent Establishment) of the Treaty significantly limits Mexican tax jurisdiction with respect to U.S. residents. The Mexican Income Tax Law, unlike the Internal Revenue Code, uses the permanent establishment concept. The Treaty definition of a permanent establishment, though, is narrower than the Mexican Income Tax Law's definition, thus providing fewer circumstances under which a U.S. company's representative in Mexico will be deemed a permanent establishment.[71] Perhaps more important, the Treaty will provide tax planners with greater certainty in deter-

68. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 5, para. 5(a).

69. *Id.* art. 5, para. 5(b). Mexico currently does not treat these operations as permanent establishments, even though it could under Mexican law. *See* Greer L. Phillips & John R. Washlick, *The New Income Tax Convention Between the United States of America and the United Mexican States*, 57 TAX NOTES 1447, 1448 (1992).

70. U.S.-Mex. Tax Treaty and Protocol, art. 5, para. 6. On this point, the U.S. Senate added the following: "That, while Mexico imposes no excise tax on insurance premiums paid to foreign insurers and has no immediate plans to do so, should Mexico enact such a tax in the future, Mexico will waive such tax on insurance premiums paid to insurers resident in the United States." SENATE REPORT, *supra* note 40, at 105.

71. For example, the Mexican Income Tax Law does not contain the distinction between dependent and independent agents found in the Treaty. Additionally, the Mexican Income Tax Law also lists factors not contained in the Treaty that will constitute a permanent establishment. Such factors include an agent's exercise of authority to conclude contracts, maintaining inventories of goods to be delivered on behalf of the foreign resident, acting under the detailed instructions of the foreign resident, receiving a salary or other guaranteed remuneration, assuming risks on behalf of the foreign resident, or engaging in activities that correspond to the foreign resident. Mexican Income Tax Law, *supra* note 59, art. 2(I).

mining whether a permanent establishment exists in a particular situation than was possible under Mexican domestic law. This is because extensive interpretive material exists for the Treaty definition,[72] whereas Mexico lacks precedential cases or other material to interpret its domestic law definition.

C. *Limitation on Benefits*

Article 17 (Limitation on Benefits) of the Treaty contains an unique and elaborate anti-treaty-shopping provision that is linked to NAFTA.[73] Anti-treaty-shopping rules are meant to prevent persons who are not residents of one of the contracting countries from artificially and unjustifiably creating conditions to satisfy the jurisdictional requirements of the treaty and thereby receive its benefits.[74]

The basic rules in Article 17 are taken from the U.S.-Germany income tax treaty and include specific tests under which a "person" may qualify for benefits. Those tests include: (1) a "Business Nexus" test which qualifies income that is "derived in connection with or is incidental to" the active conduct of a trade or business in the United States or Mexico;[75] (2) a "Publicly Traded" test which qualifies a company, or a wholly owned subsidiary thereof, whose principal class of shares is regularly and substantially traded on a recognized security exchange in Mexico or the United States;[76] (3) an "Ownership" test accompanied by a "Base Erosion" test, which requires that more than 50% of the beneficial interest in either a corporation or other person nominally resident in Mexico or the United States be directly or indirectly owned by residents of Mexico or the United States, and that less than 50% of the gross income of such corporation or other person is used to pay liabilities to persons not entitled to benefits under the Treaty;[77] (4) a "Non-Profit Organization" test which qualifies a tax-exempt, non-profit organization provided that more than half of the beneficiaries or

72. Examples are: Commentary to the OECD Model, *infra* note 105; the Treasury Department's TECHNICAL EXPLANATION, *infra* note 80; and numerous court decisions on the matter. *See generally* VOGEL, *supra* note 4, at 191-267.

73. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 17.

74. VOGEL, *supra* note 4, at 273.

75. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 17, para. 1(c). The term "trade or business" means, in the case of Mexico, activities carried on through a permanent establishment as defined in the Mexican Income Tax Law. *Id.* para. 15(a). The business of making or managing investments is excluded, unless these activities are banking or insurance activities carried on by a bank or insurance company. *Id.* A letter of understanding concluded in connection with the U.S.-Germany treaty contains several examples of qualifying fact patterns, giving some guidance to the limits of the Business Nexus rule. *Letter of Understanding*, 2 TAX TREATIES (CCH) ¶ 3252 (1990).

76. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 17, para. 1(d)(i), (ii).

77. *Id.* art. 17, para. 1(f).

members are entitled to Treaty benefits;[78] and (5) a "Facts and Circumstances" test under which a person who does not qualify under any of the other tests may demonstrate to the competent authority of the source country that such person should be granted Treaty benefits.[79]

The Treaty sets precedent by including two unique provisions that contemplate the trilateral relationship to be formed among Mexico, Canada, and the United States when NAFTA enters into force. The Treasury Department's Technical Explanation of the Treaty states that inclusion of the two novel provisions is justified on the grounds that one of the expected results of NAFTA is the encouragement of joint ventures among residents of the United States, Mexico and Canada.[80] Under the first provision, the Publicly Traded test described above is extended to wholly owned subsidiaries of companies that are publicly traded in any country that is a party to NAFTA,[81] so long as more than 50% of the subsidiary is owned by one or more publicly traded companies resident in Mexico or the United States.[82] For example, a Canadian public company owned 51% by a U.S. public company would qualify for Treaty benefits on income sourced in Mexico.

Under the second provision (known as a "limited derivative benefits provision"), benefits related to dividends, interest, and royalties are extended to certain entities owned by residents of NAFTA countries if detailed Ownership and Base Erosion tests are met.[83] Therefore, the fact that Cana-

78. *Id.* art. 17, para. 1(e).

79. *Id.* art. 17, para. 2. These tests may produce varied results. The Ownership/Base Erosion test, for example, could deny the benefits of the reduced Mexican withholding tax rates on royalties paid to a U.S. company that is controlled by individual residents of a third country. However, under the Business Nexus test, Treaty benefits are available to an entity that is a resident of the United States or Mexico, the Ownership/Base Erosion test notwithstanding, if it is engaged in the active conduct of a trade or business in its resident country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business.

80. U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE MEXICAN STATES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992, at 36 [hereinafter TECHNICAL EXPLANATION].

81. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 1, para. 1(d)(iii)(A).

82. *Id.* art. 17, para. 1(d)(iii)(B).

83. The Senate Report explains the test as follows:

> A person would qualify for benefits under Article 10 (Dividends), 11 (Interest), 11A (Branch Tax), or 12 (Royalties) if it satisfies the following four conditions. First, more than 30 percent of the beneficial interest (in the case of a company, more than 30 percent of the number of shares of each class of shares) in that person must be owned (directly or indirectly) by any combination if one or more individual residents of Mexico or the United States, certain publicly traded companies (as described under either of the proposed treaty's public company tests), the countries themselves, political subdivisions or local authorities of the countries, or tax-exempt organizations that qualify for treaty benefits. Second, more than 60 percent of the beneficial interest (in the case of a company, more than 60 percent of the number of shares of each class of shares) in that

dian residents hold interests in a U.S. or Mexican resident entity may not, in and of itself, disqualify the entity from Treaty benefits.[84] Treaty benefits under the limited derivative benefits provision will only be granted if those benefits are no more generous than the related benefits granted under the relevant Canadian income tax treaty.[85] Thus, for example, a Canadian resident would not be able to invest in the United States through a Mexican corporation for the purpose of obtaining withholding rates more favorable than those that could be obtained by investing through a Canadian corporation.

IV. SUBSTANTIVE RULES OF INCOME TAXATION

Articles 6 to 23 of the Treaty, excluding Article 17, contain classification and assignment rules meant to cover all items of income and capital taxed under domestic law. The rules avoid double taxation by limiting the content of the tax laws of both countries. In essence, the rules form a third body of law which operates as a "stencil" over domestic tax law.[86] The

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> person must be owned (directly or indirectly) by persons resident in a country that is a party to NAFTA. For purposes of the requirement, a resident of a NAFTA country would only be treated as owning a beneficial interest (or share) if its residence country has a comprehensive income tax treaty with the country from which the income is derived and if the particular profit or item of income in respect of which benefits under the proposed U.S.-Mexico treaty are claimed would be subject to a rate of tax under that other treaty that is no less favorable than the rate of tax applicable to that person under the relevant article of the proposed U.S.-Mexico treaty.
>
> The third requirement would be satisfied only if less than 70 percent of the gross income of the person is used (directly or indirectly) to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those listed as qualifying owners under the first requirement above.
>
> The fourth requirement would be satisfied only if less than 40 percent of the gross income of the person is used (directly or indirectly) to meet liabilities (including liabilities for interest or royalties) to a combination of persons other than (1) persons or entities listed as qualifying owners under the first requirement above and (2) other residents of NAFTA countries. The Committee understands that the definition of "gross income" contained in paragraph 15(c) of the proposed protocol is intended to apply for purposes of these base erosion tests. Paragraph 15(d) of the proposed protocol specifies that this provision of the proposed treaty would only take effect upon entry into force of NAFTA.

SENATE REPORT, *supra* note 40, at 82.

84. An entity that satisfies the extended Publicly Traded test will qualify for all benefits under the Treaty. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 17, para. 1(d)(iii)(A). An entity that satisfies the limited derivative benefits provisions will only qualify for benefits (i.e., reduced source country taxes) under the dividends, interest, branch tax, and royalty articles. *Id.* art. 17, para. 1(g).

85. *Id.* art. 17, para. 1(g)(iii).

86. Vogel, *supra* note 36, at 26. Under a treaty, a tax obligation exists only if, and to the extent that, in addition to the requirements of domestic law, the treaty requirements are also met. VOGEL, *supra* note 4, at 12. Like most U.S. tax treaties, this one contains a so-called "savings clause" which effectively allows the U.S. to continue taxing its citizens and residents as if the Treaty had not come into effect. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 1, para. 3; *see* MCDANIEL & AULT, *supra* note

following analysis of these rules is organized into four parts: income from activities; income from assets; income from capital gains and other income; and exempt organizations. The branch tax (Article 11A) will not be discussed because Mexico does not apply a branch profits tax.

A. *Income from Activities*

1. Business Profits

Unlike the U.S. Model, Article 7 (Business Profits) of the Treaty does not define the term "business profits." The Treaty does, however, specify the scope of "business profits" by providing that items of income covered elsewhere in the Treaty will not be governed by Article 7.[87] Thus, the term "business profits" does not include dividends (Article 10), interest (Article 11), royalties (Article 12), capital gains (Article 13), or income from real property (Article 6). In conformity with the U.S. Model, the Treaty provides that business profits of an enterprise of one contracting country are only taxable in the other contracting country to the extent they are attributable to a permanent establishment in the other country.[88] Importantly, however, the Treaty also contains a limited force of attraction principle taken from the U.N. Model, which allows a contracting country to tax not only profits attributable to a permanent establishment, but also profits from sales in the other country of goods of "the same or similar kind as those sold through the permanent establishment."[89] Such profits, however, may not be taxed by the host country if the enterprise demonstrates that the sales by the home office have been carried out for reasons other than to obtain a benefit under the Treaty.[90] There could be several non-tax business reasons for selling directly from the home office. For example, it may be more efficient for a

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23, at 176. As a result, even though a particular Treaty article may, by its terms, appear to assign exclusive taxing jurisdiction of a particular type of income to the source country, the savings clause operates to deny that benefit to a U.S. citizen or resident. *Id.* On the other hand, the Treaty provides that it may not operate to the detriment of the taxpayer. In general then, the benefits of a provision of the Internal Revenue Code, or the Mexican Income Tax Law, cannot be limited by a more restrictive Treaty provision. *Id.* For example, the Treaty authorizes a withholding tax on dividends, but generally dividends are exempt from tax in Mexico. In this situation, the Treaty will not operate to impose a tax. *See* U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 10.

87. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 7, para. 6.

88. The term "attributable to a permanent establishment" is determined by the "direct" method, which involves a transaction-by-transaction analysis, treating the permanent establishment as if it were an enterprise separate from its head office and other branches. *Id.* art. 7, para. 2; *see* ALI PROPOSALS, *supra* note 2, at 204. However, where the information available to the competent authority is insufficient to determine the profits attributable to the permanent establishment, the contracting country may apply its domestic law to determine the tax liability of a person, so long as the principles used are consistent with those in the Treaty. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, para. 4.

89. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 7, para. 1.

90. *Id.*

U.S. company based in San Diego and having a permanent establishment in Mexico City to sell goods to Tijuana directly from the San Diego home office, whereas it would be less efficient to do so with respect to sales to Mexico City.[91]

In determining business profits, the Treaty allows the deduction of expenses "incurred for the purpose of the [permanent establishment]."[92] This definition includes executive and general administrative expenses, whether or not these expenses are borne in the country where the permanent establishment is located.[93] For example, in the case of a U.S. company with a Mexican permanent establishment (a branch, for instance), the cost of administrative services performed in the U.S. home office but related to the Mexican permanent establishment may be deducted from the gross income of the Mexican permanent establishment. In accordance with the U.N. Model and the Mexican Income Tax Law, however, the Treaty allows no deductions for amounts paid to the head office as royalties or as interest on money lent to the permanent establishment, unless those amounts constitute a reimbursement by the permanent establishment of "actual expenses" incurred by the head office.[94] This last provision, along with the Treaty's reduced withholding rates on royalties and know-how payments,[95] intensifies the tax incentive to conduct business operations in Mexico through a subsidiary rather than a permanent establishment, and then to charge the subsidiary for services and know-how provided by the U.S. parent company.[96]

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91. TECHNICAL EXPLANATION, *supra* note 80, at 15.

92. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 7, para. 3. Such deductions may include a "reasonable allocation" of research and development expenses, interest, and other expenses incurred for the enterprise as a whole (or the part thereof which includes the permanent establishment), regardless of where incurred, but only to the extent that such expenses are not also deducted by the enterprise and are not reflected in other deductions for the cost of goods sold or, in the case of Mexico, of the value of the purchases. *Id.* para. 5.

93. *Id.*

94. *Id.* art. 7, para. 3. The pertinent provision provides:

> However, no such deduction shall be allowed in respect of such amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices by way of royalties, fees or other similar payments in return for the use of patents or other rights, by way of commission, for specific services performed or for management, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment.

Id.

The exception for bank interest was not intended to override U.S. Treasury regulations in the context of a U.S. permanent establishment of a Mexican bank. *See* TECHNICAL EXPLANANTION, *supra* note 80, at 16, 17.

95. *See infra* text accompanying notes 140-47.

96. It is important to note that the tax advantages of a subsidiary will be defeated if the subsidiary acts in such a way that it is deemed to be a permanent establishment of the parent company. McLees, *supra* note 59, at 998. For a discussion of tax and non-tax factors to consider in the choice of entity for

The operation of a subsidiary in Mexico will not by itself constitute a permanent establishment in Mexico. The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company resident in the other country.[97] Such relationships, thus, are not relevant; only the activities of the company being tested for permanent establishment status are relevant. Article 7 (Business Profits) of the Treaty will have a favorable impact on U.S. persons because it limits the scope of the Mexican Income Tax Law's taxation of a U.S. enterprise's business profits that arise in Mexico. Without the limitations of the Treaty, the Mexican Income Tax Law employs two broad forces of attraction principles. First, a permanent establishment is subject to tax on income from *all* sales by its central office in Mexico.[98] Second, a permanent establishment is taxed on a proportion of the parent company's worldwide income equal to the ratio

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Mexican operations, see Nicasio de Castillo & Manuel F. Solano, *Tax Planning Opportunities for U.S. Business in Mexico*, 21 TAX MGMT. INT'L J. 131, 133-35 (1992).

For U.S. foreign tax credit reasons (which are beyond the scope of this article), it is generally preferable for a U.S. taxpayer to minimize the foreign tax on its foreign source income. The following example highlights how Mexican tax can be reduced by operating in Mexico through a subsidiary as opposed to through a permanent establishment:

U.S. Corporation X (X-U.S.) owns and operates a chain of restaurants in Mexico through a branch office (a permanent establishment). X-U.S. is subject to Mexican income tax at a rate of 35% on the business profits attributable to its permanent establishment. Under the Treaty, except for reimbursements for actual expenses, X-U.S. cannot deduct royalties or know-how fees paid to the X-U.S. home office.

X-U.S.'s Mexican tax liability is:

Profits (gross income less general deductions)	100
Mexican tax rate on business profits	x35%
Mexican tax	35

Alternatively, X-U.S. owns and operates its restaurants in Mexico through a wholly owned Mexican subsidiary, X-Mexico. Because X-Mexico does not constitute a permanent establishment of X-U.S., it may deduct payments to X-U.S. for royalties and know-how. X-Mexico's Mexican tax liability is:

gross income less general deductions	100
less payments to X-U.S. for royalties and know-how	(80)
profits	20
Mexican tax rate on business profits	x35%
Mexican tax	7

X-U.S.'s Mexican tax liability is eight (eighty in royalty and know-how payments x the 10% withholding on royalties under the Treaty). By using a subsidiary instead of a branch, the Mexican tax liability for the group in this second example is 15 (eight attributable to X-U.S. and seven attributable to X-Mexico), compared to 35 in the first example.

97. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 5, para. 8.

98. *Id.* art. 7; Mexican Income Tax Law, *supra* note 59, art. 4.

of the amount of deductions taken by the Mexican permanent establishment to the amount of deductions for the enterprise worldwide.[99] As discussed above, the Treaty limits the first principle and eliminates the second, thus narrowing Mexico's jurisdiction to tax the business profits of U.S. enterprises.

2. Shipping and Air Transport

Article 8 (Shipping and Air Transport) provides that an enterprise's profits from the operation of ships and aircraft in international traffic will only be taxable in the enterprise's resident country.[100] Thus, for example, a U.S. cargo airline company that flies cargo from the United States to Mexico would only be subject to income tax in the United States. Profits from the operation of ships or aircraft in international traffic generally include profits derived from the rental of ships or aircraft used in international traffic.[101] Additionally, profits from the use, demurrage or rental of containers, including trailers, barges, and related equipment for the transport of containers, are likewise only taxable in the residence country.[102]

3. Personal Services

The Treaty narrows and makes more certain the situations under which Mexico may tax U.S. residents on their services performed in Mexico. Personal services are divided into two categories: "independent" personal services (self-employment services) and "dependent" personal services (employee services).

a. *Independent Personal Services*

Article 14 (Independent Personal Services) expressly includes scientific, literary, or artistic activities, educational or teaching activities, as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants.[103] Although Article 14 speaks only to income derived by

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99. Mexican Income Tax Law, *supra* note 59, art. 4.

100. *Id.* art. 8, para. 1. The operation of ships and aircraft in international traffic by an enterprise does not include transportation by any other means of transport provided directly by the enterprise or the provision of overnight accommodation. *Id.* art. 8, para. 2. Article 6 of the Protocol provides that if a U.S. resident derives profits that are exempt from Mexican income tax under article 8, then the assets used to produce such profits are exempt from the Mexican Assets Tax. *Id.* art. 8, para. 6.

101. *Id.* art. 8, para. 2. Such profits always include profits from the rental of ships and aircraft on a full-time or voyage basis. *Id.* They also include profits from the rental of ships or aircraft on a bareboat basis if the lessee operates such ships or aircraft in international traffic, and such rental profits are accessory to other international shipping and air transport profits. *Id.*

102. *Id.* art. 8, para. 3.

103. *Id.* art. 14, para. 2.

an individual, the Protocol extends Article 14 to cover income from personal services that a U.S. company performs through a fixed base in Mexico.[104]

The Treaty states that income from independent personal services may only be taxed in the resident country unless either of two exceptions applies. Under the first exception, the source country (where the services are performed) may tax income attributable to independent personal services if the service provider regularly makes use of a "fixed base" in the source country in the course of performing its activities.[105] Under the second exception, if an individual service provider is present in the source country for more than 183 days during a twelve-month period, it may be taxed on the income attributable to activities performed in the source country.[106] For example, a U.S. resident architect who maintains an office in Mexico, but is only present in Mexico for 120 days in a twelve-month period may be taxed in Mexico because her office constitutes a fixed base. If, however, the architect did not maintain an office, but instead provided services out of her hotel room and at various job sites, she would not be taxable in Mexico because there would be no fixed base, as long as she was present in Mexico for less than 183 days in the twelve-month period.

b. *Dependent Personal Services*

Income from dependent personal services includes salaries, wages, and other similar remuneration that employees receive.[107] From the perspective of a U.S. resident who is employed in Mexico, such income is only taxable in the United States, and not in Mexico, as long as all three of the following tests are met: First, the employee must be present in Mexico for 183 days or less in a twelve-month period.[108] Second, the employer that pays the employee's salary, wages or other similar remuneration must not be a resident of Mexico.[109] Last, a permanent establishment or fixed base that the employer maintains in Mexico must not bear the remuneration.[110]

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104. *Id.* art. 14, para. 1. In such a case, the company may compute the tax on the income from such services on a net basis as if it were attributable to a permanent establishment in Mexico. *Id.*

105. *Id.* art. 14, para. 1(a). The OECD Committee on Fiscal Affairs names as typical examples of a fixed base a physician's consulting room or the office of an architect or a lawyer. COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, COMMENTARY ON MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL art. 14, para. 4 (1977) [hereinafter OECD MODEL COMMENTARY]. The fixed base concept is similar and connected to the permanent establishment concept, and when interpreting the term, resort may also be had to the principles relating to the permanent establishment of business enterprises. VOGEL, *supra* note 4, at 767.

106. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 14, para. 1(b).

107. *Id.* art. 15, para. 1.

108. *Id.* art. 15, para. 2.

109. *Id.* art. 15, para. 2(a).

110. *Id.* art. 15, para. 2(c).

Thus, for example, a U.S. resident employee of a U.S. computer retailing company who works in Mexico for four months and is paid by the U.S. home office will not be taxed in Mexico on his salary. This is because he was in Mexico for less than 183 days during the year, and a U.S. resident company paid his salary. If, however, the U.S. computer company had a branch in Mexico that constituted a permanent establishment, and the employee's salary was an expense of the branch, the salary would be subject to Mexican taxation. Likewise, if the U.S. company had a wholly owned Mexican subsidiary that paid the employee's salary, the salary would be subject to Mexican tax because the Mexican subsidiary is a resident of Mexico.

c. *Special Types of Services*

Income flows from special types of services are treated separately under the Treaty as exceptions to the general rules of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services). These exceptions include income from directors fees, government services, annuities, alimony, and child support, as well as income that artists, athletes, and students receive.

In a departure from the OECD Model, directors fees will not be taxable in Mexico if a U.S. resident director of a Mexican company holds board meetings in the U.S.[111] Fees for board meetings held in Mexico or third countries, however, are taxable in Mexico. Thus, for example, a U.S. resident director of a Mexican subsidiary will be taxed in Mexico for fees related to board meetings held in the Cayman Islands or in Mexico, but not for fees related to meetings held in Ohio.

Entertainers and athletes are generally subject to taxation in the source country, unless the taxpayer receives less than three thousand dollars during a taxable year for his or her services, regardless of the existence of a fixed base or the number of days the taxpayer is present in the country.[112] This measure is meant, in part, to prevent highly paid entertainers and athletes who are residents in one country from using the Treaty to avoid tax on income earned in the other country.[113]

In accordance with the OECD Model, the Treaty seeks to foster educational and training exchanges between Mexico and the United States. Arti-

111. *Id.* art. 16.

112. *Id.* art. 18, para. 1. Source country taxation is prohibited when an entertainer or artist's visit is substantially supported by public funds or a political subdivision of the taxpayer's residence country. *Id.* art. 18, para. 3. For income earned by an entertainer or athlete but paid to another party, see *id.* art. 18, para. 2.

113. Phillips & Washlick, *supra* note 69, at 1453; *see* TECHNICAL EXPLANATION, *supra* note 80, at 38.

cle 21 (Students) prohibits host-country taxation of payments received by visiting students or business apprentices resident of the other country, provided these payments are from sources outside the host country.[114] For example, a U.S. law student who clerks at a Mexican law firm for a summer would not be taxed in Mexico if a U.S. sponsoring firm paid the student. The law student would be taxed by Mexico, however, if the Mexican firm paid her.

B. *Income from Certain Assets*

Like all model income tax conventions, the Treaty defines and limits the source country's ability to tax passive income from dividends, interest, royalties, real property, and capital gains. For dividends, interest, and royalties, unlike other types of income, the Treaty provides for "tax sharing." Tax sharing occurs when both the source country and the residence country are allowed to tax the income. Although both countries are allowed to tax the income, the Treaty limits the rate of tax imposed by the source country, and requires the recipient's residence country to give a credit for the tax levied by the source country.[115] By contrast, the Treaty allocates all other types of income to one country for "primary" taxation at the full rates allowed under its domestic law.[116]

1. Dividends

The source country withholding rate for dividends under the Treaty is unprecedented in U.S. bilateral tax treaty history. Instead of higher source-based withholding rates, the Treaty contains a withholding rate limit that is lower than the U.S. Model.[117] In the case of a U.S. resident, dividends received from a Mexican company are taxable in both the United States (subject to the foreign tax credit) and in Mexico. The Mexican tax is subject to two levels of limitation: 5% of the dividend, where the "beneficial own-

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114. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 21. Like the U.S. and OECD Models, the Treaty does not provide separate rules for teachers. The remuneration of teachers and researchers is taxable under either article 14 (Independent Personal Services) or article 15 (Dependent Personal Services), as appropriate.

115. *Id.* arts. 10, 11, 12, 24; *see* VOGEL, *supra* note 4, at 454.

116. While treaties between other countries may provide for exclusive taxation by one country for certain types of income, U.S. treaties, including the U.S.-Mexico Treaty, contain a "savings clause" which protects the right of the United States (and the treaty partner) to tax its residents or citizens as if the treaty had not come into effect. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 1, para. 3.

117. The U.S. Model allows the source country to withhold 15% of portfolio dividend income. U.S. MODEL, *supra* note 21, art. 10, para. 2(b). In contrast, the Treaty will eventually only permit a withholding rate of 10% on portfolio dividends. *See infra* notes 119-20 and accompanying text. While treaties with developing countries usually involve greater source-based withholding than does the U.S Model, Mexico negotiated for a zero withholding rate on dividends because, with its integrated corporate tax system, Mexico does not withhold tax on dividends anyway. Morrison, *supra* note 41, at 5.

er"[118] is a company that owns at least 10% of the voting stock of the company paying the dividend (direct dividends); and 10% of the dividend in all other cases (portfolio dividends).[119] Yet the 10% rate for portfolio dividends will not apply until five years after the dividends article has been in effect. Until that time, portfolio dividends may be taxed at the U.S. Model rate of 15%.[120] The dividends provision of the Treaty does not currently help most U.S. residents because Mexico has an integrated corporate tax system, and thus generally does not apply any withholding tax on dividends paid to nonresidents.[121]

2. Interest

The U.S. Model's zero withholding rate on interest can be explained by the fact that the Internal Revenue Code grants broad exemptions for interest paid to nonresidents.[122] Mexico, on the other hand, derives a significant portion of its revenue from withholding taxes on interest paid to nonresidents, which explains why it negotiated for high interest withholding rates under the Treaty.[123] The divergent goals of the Untied States and Mexico led to an interesting compromise, with Article 11 (Interest) representing one of the most unusual withholding tax provisions in any bilateral tax treaty.[124] Rather than providing for a zero or maximum source country withholding rate on all interest, the Article mirrors Mexican domestic law by setting different rates for different types of interest.

The Treaty provisions on interest are based on the Mexican Income Tax Law system of taxing interest, except that the Treaty imposes lower withholding rates.[125] Like Mexican domestic law, the Treaty creates a three-tier system. Under this system, the withholding rates on interest sourced in one country and paid to a resident of the other country are as follows: 4.9% of the interest on bank loans[126] and on bonds traded on a recognized secu-

118. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 10, para. 2(a).

119. *Id.* art. 10, para. 2. For a definition of "dividends" and its limitations, see *id.* art. 10, paras. 4-6 (stating, *inter alia*, that dividends are defined by domestic law of the contracting countries). Also, the Protocol contains a most-favored-nation provision under which the U.S., if it agrees to a lower dividend withholding rate with another country, will also apply the lower rate to Mexico. *Id.* para. 8.

120. *Id.* art. 10, para. 3.

121. An "integrated" corporate tax system imposes only one level of tax on income. The U.S. system, by contrast, imposes two levels of tax by taxing the corporation on income, and the shareholders on their dividends.

122. *See, e.g.*, I.R.C. § 871.

123. Morrison, *supra* note 41, at 827.

124. *Id.*

125. Mexico made a significant concession by agreeing to lower withholding rates because Mexico derives a significant (estimated to be 7%) portion of its revenue from withholding tax on interest remitted abroad. Kathleen Matthews, *U.S. IFA Branch Meeting Focuses on U.S.-Mexico Tax Treaty Negotiations and Proposed North America Free Trade Agreement*, 5 TAX NOTES INT'L 465 (1992).

126. "Banks" include investment banks, savings banks, and insurance companies. U.S.-Mex. Tax

rities market; 10% of the interest on loans not made by banks, if the interest is paid to a bank, or by the purchaser of machinery and equipment to the original seller of such machinery and equipment;[127] and 15% of the interest in all other cases.[128] A five year phase-in period, like that in the dividends provision, applies to the first two categories. Therefore, for five years from the date upon which the Treaty takes effect, 10% shall apply in place of 4.9%, and 15% will apply in place of 10%.[129]

The reduced tax rate will not apply if the recipient maintains a permanent establishment or fixed base in the source country, and the interest is attributable to that permanent establishment or fixed base. In such case, the interest is instead taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 14).[130] Thus, if the property generating the interest payment (i.e., a debt-claim) is properly an asset of the permanent establishment, that interest shall be treated as part of the gross income of the permanent establishment. Consequently, it will be subject to tax on a net basis as business profits under Article 7.

Article 11 (Interest) also contains sourcing rules. Interest will be deemed to arise in a contracting country when the payor is a resident or governmental entity of that country.[131] But, if the interest expense is borne by (i.e., for purposes of computing taxable income, deductible by) a permanent establishment or fixed base that the payor has in Mexico or the United States, the interest has its source in the country where the permanent establishment is situated, regardless of the residence of the payor.[132] For example, if a German resident who has a permanent establishment in Mexico borrows money from a U.S. resident for the Mexican permanent establishment, and the permanent establishment bears the interest, the interest will be sourced in Mexico.

Finally, certain types of interest are exempt from source country taxation under the Treaty. The Treaty exemptions are broader than those under the Mexican Income Tax Law[133] and include interest paid by or to a government entity, interest paid to an exempt pension trust or other retirement

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Treaty and Protocol, *supra* note 1, art. 11, para. 2(a). For U.S. foreign tax credit purposes, rates below 5% fall outside of the separate basket for high withholding tax interest, and instead may be treated by financial institutions as falling within the general financial services basket. I.R.C. § 904. This standard will benefit a financial institution's foreign tax credit position because a bank is very likely to have excess foreign tax credits in the high withholding tax basket that expire unused. Morrison, *supra* note 41, at 827.

127. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 11, para. 2(b); *Id.* para. 10.

128. *Id.* art. 11, para. 2(c).

129. *Id.* art. 11, para. 3.

130. *Id.* art. 11, para. 6.

131. *Id.* art. 11, para. 7.

132. *Id.* This rule is generally consistent with U.S. source rules under I.R.C. §§ 861-862, which provide that interest income is sourced in the country in which the payor is resident.

133. *See* Mexican Income Tax Law, *supra* note 59, art. 154(A).

benefits fund, and interest paid on a three-year or longer loan backed by the Export-Import Bank (EXIM), the Overseas Private Investment Corporation, or the equivalent Mexican entities.[134] For example, if Petroleos Mexicanos (PEMEX) obtains a loan from EXIM to develop oil fields, the interest payments that PEMEX remits to EXIM are exempt from Mexican taxation.

In summary, Article 11 (Interest) benefits U.S. lenders by reducing the Mexican withholding rates on interest paid abroad.[135] However, the Protocol provides that the domestic law of each country applies to the recharacterization of debt or equity.[136] Although Mexican domestic law does not have thin capitalization rules, it does contain extensive rules under which shareholder loans may be recharacterized as equity.[137] Therefore, tax planners considering reducing a U.S. resident's Mexican tax burden by holding debt rather than equity in a Mexican subsidiary must carefully analyze Mexican domestic law to avoid unanticipated results.[138]

3. Royalties

In recognition of Mexico's status as a developing country, Article 12 (Royalties) of the Treaty is based on the U.N. Model. While the OECD and U.S. Models provide for exclusive taxation by the residence country, the Treaty also allows the source country to tax royalties, up to a rate of

134. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 11, para. 4. The "equivalent" Mexican entities are the Banco Nacional de Comercio Exterior, S.N.C., and the Banco Nacional Financiera, S.N.C. *Id.* art. 11, para. 4(d).

135. For the rates applied by Mexico in the absence of the Treaty, see Mexican Income Tax Law, *supra* note 59, art. 154.

136. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, para. 9.

137. *See* Mexican Income Tax Law, *supra* note 59, art. 120, para 3.

138. In deciding whether to introduce related-party debt into the capital structure of a Mexican subsidiary, tax planners must also be aware that, for Mexican income tax purposes, the nominal interest expense of a Mexican company is reduced by the discharge of indebtedness resulting from inflation during the tax year. Mexican Income Tax Law, *supra* note 59, art. 7(B). For a discussion of this issue, see Castillo & Solano, *supra* note 96, at 137, 149 n.58.

10%.[139] Nonetheless, Article 12 represents a significant reduction in Mexican withholding rates on royalties sourced in Mexico and paid to U.S. residents — the Mexican Income Tax Law taxes such royalty payments at rates of 15%, 21%, and 35%.[140]

In general conformance with the U.S. Model, the Treaty defines "royalties" 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, tape or other means of reproduction for use in connection with television. The definition also includes the use of, or right to use, any patent, trademark, design, model, plan, process, secret formula, or other like right or property, as well as information concerning industrial, commercial, or scientific experience.[141]

In a significant departure from the U.S Model, royalties under the Treaty include payments of any kind received as consideration for the use of, or right to use, industrial, commercial, or scientific equipment not constituting real property.[142] These payments are often considered rents in other treaties, subject to the business profit rules which typically permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country. In such case, the tax is computed on a net basis.[143] By contrast, if such payments are not attributable to a permanent establishment situated in that country, the Treaty permits gross-basis source country taxation of these payments, at a rate not to exceed 10%.[144]

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139. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 12(2). The term "source" is defined in article 12, paragraph 6, as follows:

> Royalties shall be deemed to arise in a contracting country when the payor is that state itself, a political subdivision, a local authority or a resident of that state. (a) Where, however, the person paying the royalties, whether he is a resident of a contracting country or not, has in a contracting country a permanent establishment or a fixed base in connection with which the liability to pay royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in that State in which the permanent establishment or fixed base is situated; (b) Where subparagraph a) does not operate to deem royalties as arising in either contracting country and the royalties relate to the use of, or the right to use it, in one of the contracting countries, any property or right described in paragraph 3 [*see supra* note 121 and accompanying text], they shall be deemed to arise in that State.

Id. art. 12, para. 6.

140. Mexican Income Tax Law, *supra* note 59, art. 156.

141. The term "information concerning industrial, commercial or scientific experience" will be defined under paragraph 12 of the Commentary on Article 12 (Royalties) of the OECD Model, which distinguishes between "know-how" and pure "technical services." U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, para. 11; *see* OECD MODEL COMMENTARY, *supra* note 105, art. 12, para. 12.

142. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 12, para. 3.

143. SENATE REPORT, *supra* note 40, at 23.

144. *Id.* If the payments are attributable to a permanent establishment, article 7 (Business Profits) applies. Article 8 (Shipping and Air Transport) covers payments for the leasing of containers used in international transport and payments for certain leasing of ships and aircraft. TECHNICAL EXPLANATION, *supra* note 80, at 28; *see also* U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, arts. 7, 8.

Again, as in the case of dividends and interest, the reduced rate will not apply if the beneficial owner of the royalties (the licensor) maintains a permanent establishment or fixed base in the country where the royalties arise, and the property giving rise to the royalty forms part of the business property of the permanent establishment or fixed base.[145] In that event, Article 7 (Business Profits) or Article 14 (Independent Personal Services) applies, not Article 12 (Royalties).

Article 12 (Royalties) benefits U.S. companies doing business in Mexico by providing lower withholding rates as well as more certainty when determining what constitutes royalties. Companies resident in the United States also will benefit. The Treaty will lower the Mexican tax burden on their Mexican subsidiaries by defining "royalty" more broadly than does Mexican domestic law, and by limiting the withholding rate to 10%, a rate substantially lower than the Mexican domestic rates of 15% and 35%.[146]

4. Real Property

Under Article 6 (Income From Immovable Property), income from real property[147] may be taxed in the country in which the property is situated.[148] Although "real property" is defined by the domestic law of each country, the Treaty expressly includes fixtures and excludes ships, aircraft, and containers.[149] Article 6 applies regardless of whether the income is derived from the direct use, leasing, or any other use of the real property.[150]

Real property income is taxed irrespective of the existence of a permanent establishment or fixed base in the country where the real property is located.[151] However, in a significant departure from Mexican domestic law, U.S. residents may elect to compute income from real property situated in Mexico on a net basis, as opposed to a gross basis, as if such income were attributable to a permanent establishment in Mexico.[152] The Mexican Income Tax Law imposes a 21%, and, in some cases 35%, tax on gross

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145. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 12, para. 4.

146. Because Mexico subjects corporate profits to a 35% tax, a Mexican subsidiary of a U.S. enterprise will be subject to less Mexican tax if it treats greater amounts as royalties paid to its U.S. patent. The Treaty requires arms-length pricing for royalty payments between related entities. *Id.* art. 12, para. 5. In fact, the failure of a U.S. company to charge its Mexican subsidiary arms-length royalty rates may lead to increased U.S. tax liability under I.R.C. § 482.

147. The Treaty uses the term "immovable property," but the two terms are intended to be synonymous. TECHNICAL EXPLANATION, *supra* note 80, at 13. Income from real property includes income from agriculture and forestry. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 6, para. 1.

148. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 6, para. 1.

149. *Id.* art. 6, para. 2.

150. *Id.* art. 6, para. 3.

151. *Id.* art. 6, para. 4.

152. *Id.* art. 6, para. 5.

receipts received by a foreigner for the rental of real property located in Mexico, with no allowance for deductions.[153] Thus, the Treaty will provide significant advantages to U.S. residents who own real property in Mexico, such as time share units or vacation property, that they rent at times to other parties.

C. *Income from Capital Gains and Other Income*

1. Capital Gains

In general, the Treaty (like the OECD, U.N., and U.S. Models) permits the source country to tax gains in situations involving dispositions of either real property interests or personal property associated with either a permanent establishment or a fixed base. The Treaty, like other recent U.S. treaties, in certain cases also allows source country taxation of gains from the sale of stock or other rights in the capital of a company.[154]

Gains from the disposition, by a resident of one country, of real property (or, in the language of the Treaty, "immovable property") situated in the other country may be taxed in that other country.[155] Of interest to Mexican residents, the Treaty conforms with U.S. tax law requirements on the sale of real estate under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA),[156] by defining "immovable property" to include a U.S. real property interest.[157] In order to grant Mexico taxing rights equivalent to those relating to U.S. real property interests, the Treaty permits source country taxation of gains from the sale of interests in entities that own real property.[158] To do so, the Treaty expands the definition of real property.

Accordingly, in addition to real property, a U.S. resident may be subject to Mexican tax on the disposition of any of the following real property interests: (1) an interest in a partnership, trust, or estate to the extent that its assets consist of real estate situated in Mexico; (2) shares of a Mexican company whose assets consist of at least 50%, by value, of real property situated in Mexico; and (3) any other right that allows the use or enjoyment

153. Mexican Income Tax Law, *supra* note 59, art. 148. In the case of condominiums or lodgings for rental to third parties, that rate is 35% of gross receipts, with no deductions allowed. *Id.* art. 148(A).

154. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 13, para. 4.

155. *Id.* art. 13, para. 1.

156. Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, § 1121(1), 94 Stat. 2682 (1980) (codifying I.R.C. § 897) [hereinafter FIRPTA].

157. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, para. 12. Thus, the U.S. retains its right to impose the tax provided in I.R.C. § 897(c) (relating to gains derived by non-resident aliens or foreign corporations from the disposition of investments in U.S. real property interests). TECHNICAL EXPLANATION, *supra* note 80, at 30. The U.S. Congress expressly provided that FIRPTA should override tax treaty provisions that prohibited source country taxation of non-business capital gains. FIRPTA § 1125(c), 94 Stat. at 2690; *see also* I.R.C. § 7852(d).

158. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 13, para. 2(c).

of real property located in Mexico.[159]

In addition to real property, U.S. residents may be subject to Mexican tax on the disposition of personal property. First, gains from the sale of personal property attributable to a permanent establishment or fixed base in Mexico are subject to Mexican tax.[160] So, too, are gains from the sale of the entire permanent establishment or fixed base. Moreover, gains from the disposition of stock or other rights in the capital of a company resident in Mexico are taxable by Mexico if the U.S. resident owned at least 25% of such company within the prior twelve-month period.[161] Importantly, however, gains arising in connection with certain corporate restructurings or reorganizations will be exempt from tax.[162]

The Mexican Income Tax Law does not impose tax on gains derived from the sale of stock through an authorized Mexican stock exchange.[163] Generally, the sale of other stock by nonresidents is taxed at a rate of 20% on the gross proceeds, unless a variety of conditions are met. In that event, the tax may be imposed at a rate of 30% on the net gain from the sale.[164]

2. Other Income

Like all the models, the Treaty contains a catch-all provision intended to cover items of income not specifically covered in other articles. If a resident of one contracting country receives income that is not dealt with elsewhere in the Treaty,[165] and which has its source in the other country, the income may be taxed in the other country.[166] This provision differs from the U.S. and OECD Models, which give the exclusive right to tax "other income" to the residence country. Rather, this source-based residual provision is a shortened version of the U.N. Model and is the preferred alternative for countries, like Mexico, that are net capital and service importers.

159. *Id.* art. 12, para. 2.

160. *Id.* art. 13, para. 3.

161. *Id.* art. 13, para. 4. The right to tax is limited to the residence country in the case of gains derived from the alienation of ships, aircraft, and containers used in international traffic. *Id.* art. 13, para. 5.

162. *See* U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, para. 13.

163. Mexican Income Tax Law, *supra* note 59, art. 151.

164. *Id.*

165. Such items of income may include, *inter alia*, scholarships and awards for general artistic or academic achievements, contributions by foundations, gambling winnings, and lottery prizes. VOGEL, *supra* note 4, at 917.

166. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 23.

D. *Exempt Organizations*

Article 22 (Exempt Organizations) of the Treaty permits an entity that is exempt from tax in one country to be exempt from tax in the other country.[167] Also, residents of one country may, subject to limitations, receive a deduction for contributions to charitable organizations resident in the other country.[168] Although neither the U.S. nor OECD Models contain an article on exempt organizations, both the German and Canadian treaties contain a version of this new, interesting provision.

While Article 22 closely parallels similar provisions in the U.S.-Germany and U.S.-Canada treaties, the Protocol to the Treaty ensures that the U.S.-Mexico provision will have far greater practical effects than the equivalent provision in the German and Canadian treaties.[169] Under the Protocol, one country's certification of an organization's tax exempt status generally will exempt the organization in the other country.[170] By contrast, the German and Canadian treaties require a taxpayer to take affirmative steps to have an exempt organization in one country qualified by the competent authorities for exempt status in the other country.[171]

In the most significant and unusual detail of Article 22 (Exempt Organizations), a Mexican charity will be considered a public charity by the U.S. for purposes of grants by U.S. private foundations and public charities. Moreover, contributions by U.S. citizens to Mexican charities shall be deductible from their U.S. tax.[172] Likewise, contributions by a Mexican resident to a U.S. public charity will be deductible under Mexican law. However, contributions by U.S. citizens or residents to Mexican charities are subject to the charitable-contribution limitations of U.S. law as applied to the taxpayer's Mexican source income.[173] Parallel limitations apply to deduc-

167. *Id.* art. 22, para. 1.

168. *Id.* art. 22, para. 2.

169. Morrison, *supra* note 41, at 832.

170. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, para. 17. However, if the competent authority of the other contracting country decides that granting an exemption in a specific case is inappropriate, the exemption may be denied after consultation with the competent authority of the first contracting country. *Id.*

171. Income Tax Treaty Between Germany and the United States, Aug. 29, 1986, *reprinted in* 2 TAX TREATIES (CCH) ¶ 28,001, art. 21; Income Tax Treaty Between Canada and the United States, Sept. 26, 1980, *reprinted in* 1 TAX TREATIES (CCH) ¶ 21,001, art. 27.

172. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 22, para. 2; *id.* para. 17(b). A finding by the tax authorities of Mexico that an organization qualifies under article 70(B) of the Mexican Income Tax Law, or by the U.S. tax authorities that an organization qualifies under I.R.C. § 509(a)(1) or (2) (except for an organization described in § 170(b)(1)(A)(i)), shall be accepted by the other contracting country for purposes of extending to such organization the charitable deduction benefits provided in article 22, paragraphs 2 and 3, of the Treaty. *Id.*

173. TECHNICAL EXPLANATION, *supra* note 80, at 43. These limitations include the percentage and other limitations under Code section 170 and the overall limitation on itemized deductions under Code section 68. Thus, the amount of the deduction for a U.S. taxpayer's contributions to Mexican charities is

tions taken by a Mexican resident for contributions to U.S. charities.[174]

V. SPECIAL PROVISIONS

This section analyzes articles of the Treaty that do not specifically provide classification and assignment rules of income taxation. Like all U.S. tax treaties, the Treaty seeks to avoid double taxation and tax evasion through various coordinated tax measures, such as tax credits, nondiscrimination provisions, mutual agreement procedures, and exchange of information provisions.

A. *Relief From Double Taxation*

Article 24 (Relief from Double Taxation) of the Treaty requires each country to provide a credit (against its income tax) for income taxes paid to the other country. Because the United States already has a highly developed foreign tax credit system in its domestic law,[175] the function of the Treaty credit is, in addition to assuring that Mexico provides double tax relief for U.S. taxes, to modify the domestic law principles to fit any special aspects of the fiscal relations between the United States and Mexico.[176] Article 24 avoids double taxation by defining the taxes that are creditable,[177] and by clearly defining the source of income.[178] The United States must allow a U.S. resident or citizen a foreign tax credit for income taxes paid to Mexico.[179] Additionally, the United States must allow U.S. companies with at least 10% ownership in a Mexican company a deemed paid credit for Mexican income tax paid on the profits from which dividends are distributed. The same rules apply to Mexico in allowing credits to its residents, with one exception — Mexico is only obligated to extend foreign tax credits to its residents, regardless of their nationality, while the United States must extend the credits to both residents and citizens.[180]

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limited to the U.S. taxpayer's Mexican source income, as determined under the Treaty, and the general limitations under U.S. law (for example, the percentage limitations of Code section 170) are applied to this amount.

174. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 22, para. 3.

175. *See* I.R.C. §§ 901-906.

176. ALI PROPOSALS, *supra* note 2, at 232.

177. Mexican and U.S. income taxes are creditable. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 24, para. 1. The taxes referred to in article 2 (*see supra* notes 46-48 and accompanying text) are expressly treated as income taxes. *Id.*

178. Income derived by a resident of one country that may be taxed in the other country under the Treaty (other than solely by reason of citizenship) shall be deemed to arise in (be sourced in) that other country. *Id.* art. 24, para. 3. However, except for capital gains under article 13, any domestic statutory rules that apply for purposes of limiting the foreign tax credit take precedence over the Treaty source rules. *Id.*

179. *Id.* art. 24, para. 1.

180. *Id.*

B. *Non-Discrimination*

Article 25 (Non-Discrimination) contains the standard U.S. Model non-discrimination provision which obligates each country to tax the nationals of the other country in a manner that is neither different from, nor more burdensome than, the way in which it taxes its own nationals in the same circumstances.[181] Each country is also required to extend similar nondiscriminatory treatment to permanent establishments owned by residents of the other country and to domestic companies that are partly or wholly owned by residents of the other country.[182] Unlike other Treaty articles, Article 25 applies to all taxes that a contracting country or one of its political subdivisions imposes, not just income taxes specified in Article 2.[183]

Of particular interest to U.S. persons who own Mexican real estate, the Treaty expressly allows Mexico to deny deductions for presumed expenses, regardless of where incurred, to an individual resident of the U.S. who elects to be subject to tax in Mexico on a net basis with respect to income from real property.[184] Thus, for example, a U.S. resident who owns a vacation home in Mexico which he rents out occasionally may be denied deductions for expenses, such as property management, maintenance, or advertising, that are claimed but not sufficiently documented.

C. *Mutual Agreement Procedure*

The Treaty's article regarding a mutual agreement procedure is taken from the OECD Model, with the addition of an arbitration clause similar to the one in the U.S.-Germany treaty. In general, Article 26 (Mutual Agreement Procedure) authorizes the competent authorities of the contracting countries to settle, by mutual agreement, taxpayer disputes and difficulties regarding interpretation or application of the Treaty, without first having to go through diplomatic channels.[185] If the competent authorities cannot resolve a dispute, the taxpayer and the competent authorities may agree to submit the matter to arbitration.[186] The arbitration option will not be available, however, until the U.S. and Mexico exchange diplomatic notes on the matter.[187]

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181. *Id.* art. 25, para. 1. The U.S Model version is a slightly modified version of the OECD Model. U.S. MODEL, *supra* note 21, art. 24; OECD MODEL, *supra* note 9, art. 24. For a detailed discussion of the principals and ambiguities of treaty non-discrimination provisions, see ALI PROPOSALS, *supra* note 2, at 253-83; Sanford H. Goldberg & Peter A. Glicklich, *Treaty-based Nondiscrimination: Now You See It Now You Don't*, 1 FLA. TAX REV. 51 (1992).

182. U.S.-Mex. Tax Treaty and Protocol, *supra* note 1, art. 24, para. 2.

183. *Id.* art. 25, para. 6.

184. *Id.* art. 26, para. 3.

185. *Id.* art. 26, para. 2.

186. *Id.* art. 26, para. 5.

187. *Id.* Three years after the Treaty enters into force, the competent authorities shall consult to

D. *Exchange of Information*

Article 27 (Exchange of Information) incorporates by reference the 1989 Agreement Between Mexico and the United States for the Exchange of Information Agreement with Respect to Taxes.[188] The Agreement applies to numerous federal taxes in each country,[189] and is meant to better enable the countries to prevent fiscal evasion and fraud and to develop better information sources for tax matters.[190]

VI. CONCLUSION

The Treaty is a significant step in the evolving economic relationship between Mexico and the United States. The Treaty creates a more tax-neutral investing environment by partially harmonizing the two countries' tax laws. Consequently, both governments view it as a necessary complement to the NAFTA. Although the Treaty is generally based on the OECD and U.S. Models, it also recognizes Mexico's status as a developing country and thus includes provisions from the U.N. Model. Several articles in the Treaty have no precedent in the U.S. tax treaty network, and provide numerous opportunities for U.S. persons doing business in Mexico. By establishing clear rules of taxing jurisdiction, reducing the overall tax burden on investment income flowing between the two countries, relieving the double taxation, and providing for cooperation between the nations' tax authorities, the Treaty will improve the climate for bilateral investment and expand economic and cultural relations between the United States and Mexico.

determine whether it is appropriate to make the exchange of diplomatic notes. *Id.* para. 18.

188. *Id.* art. 27 (citing Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes, Signed November 9, 1989, *reprinted* in 1 TAX TREATIES (CCH) ¶ 263 (1993)).

189. For the U.S., the taxes covered are: (i) federal income taxes; (ii) federal taxes on employment income; (iii) federal taxes on transfers to avoid income tax; (iv) federal estate and gift taxes; and (v) federal excise taxes. *Id.* art. 2, para. 1. For Mexico, the taxes covered are: (i) federal income taxes; (ii) federal taxes on employment income; (iii) federal taxes on business assets; (iv) federal value-added taxes; and (v) federal excise taxes. *Id.*

190. *Id.* art. 1, para. 1.