Volume 23 | Number 3 Article 4

1-1-1992

Federal Income Tax Issues in the Organization, Financing, and Operation of Maquiladoras.

William R. Leighton

T. Richard Sealy III

FEDERAL INCOME TAX ISSUES IN THE ORGANIZATION, FINANCING, AND OPERATION OF MAQUILADORAS

WILLIAM R. LEIGHTON*
T. RICHARD SEALY III**

* B.B.A., J.D., University of Texas; L.L.M., New York University. Mr. Leighton is a Senior Attorney with the District Counsel for the Internal Revenue Service in Austin, Texas.

** B.B.A., J.D., University of Texas. Mr. Sealy is a trial attorney with the District Counsel for the Internal Revenue Service in Austin, Texas.

The views and opinions expressed in this article are solely those of the authors. They do not necessarily represent the positions or policies of the Internal Revenue Service, of the Office of Chief Counsel, or of the Austin District Counsel.

I. INTRODUCTION

Begun in 1966 in response to the United States' elimination of its Bracero Program,[1] Mexico's Maquiladora Program, created to encourage U.S. and other non-Mexican enterprises to establish manufacturing facilities in Mexico, has become that nation's most successful means of attracting foreign investment, and has spawned a domestic industry whose economic output is second only to that of Mexico's national oil industry.[2] In the decade of the 1980s, the maquiladora industry experienced explosive growth from six hundred and twenty plants in 1980 to more than two thousand currently which employ approximately five hundred thousand workers earning an average wage of five dollars per day plus a free lunch.[3]

Maquiladoras are also important to the United States' economy. U.S.-Mexico bilateral trade hit a record $59 billion in 1990, making Mexico the United States' third largest trading partner.[4] Total U.S. exports to Mexico tripled between 1986 and 1990 from $12.4 billion to $28.4 billion.[5] Maquiladoras account for a substantial share of this trade. The University of Texas estimates that U.S. sales to maquiladoras were worth approximately $8 billion in 1989. This estimate is corroborated by both the Bank of Mexico, which states that goods imported from all countries in 1988 for use in the maquiladora sector amounted to $7.8 billion, and by U.S. production-sharing statistics, which show that U.S.-origin value incorporated in maquiladora imports from Mexico during 1989 was worth $6 billion.[6] Mexico tends to "buy American"—the United States supplies seventy percent of

1. Matilde K. Stephenson, *Mexico's Maquiladora Program: Challenges and Prospects*, 22 ST. MARY'S L.J. 589, 590 (1991).

2. KPMG Peat Marwick, Maquiladora Industry Development Incentives (November 1, 1990) (unpublished manuscript on file with the *St. Mary's Law Journal*).

3. Internal Revenue Service, Maquiladora 9 (June 1989) (on file with the *St. Mary's Law Journal*); Matilde K. Stephenson, *Mexico's Maquiladora Program: Challenges and Prospects*, 22 ST. MARY'S L.J. 589, 590-91, 594-95 (1991).

4. U.S. DEP'T OF COMMERCE, NORTH AMERICAN FREE TRADE AGREEMENT: GENERATING JOBS FOR AMERICANS 3, 7, 8 (May 1991).

5. *Id.* at 5.

6. *Id.* at 49-50.

Mexico's imports.[7] The maquiladora trade dominates U.S. imports from Mexico, accounting for forty-four percent in 1989. Absent the agricultural, petrochemical, and steel sectors, to which foreign assembly provisions do not apply, maquiladora goods accounted for seventy-eight percent of total imports.[8] Also, 1989 U.S. imports from Mexico contained fifty-one percent U.S.-origin content compared with thirty-three percent for imports from Canada, and thirteen percent for the rest of the world.[9] Maquiladoras purchase the overwhelming majority of their components and supplies from U.S. sources.[10] In 1990, U.S. exports to Mexico were related to 538,000 U.S. jobs, half of them created in recent years.[11] Obviously, the United States has a direct economic interest in the continued viability of the maquiladora industry.

While no particular form of organization is required by Mexican law to qualify for maquiladora status,[12] the preferred form of operation seems to be the "Sociedad Anonimá de Capital Variable" (S.A. de C.V.), which is essentially the Mexican counterpart of a corporation in the United States.[13] Unless otherwise specifically stated, the maquiladora business scenarios in this article assume a United States parent corporation conducting a maquiladora operation through a wholly-owned S.A. de C.V. subsidiary, or a United States corporation and a Mexican S.A. de C.V. enjoying a brother-sister relationship.[14] This article principally considers various United States federal income

---

7. *Id.* at 50.

8. U.S. DEP'T OF COMMERCE, NORTH AMERICAN FREE TRADE AGREEMENT: GENERATING JOBS FOR AMERICANS 50 (May 1991).

9. *Id.* at 50-51.

10. *Id.* at 51, 53 n.3. One estimate is that maquila plants purchase ninety-seven percent of their production raw materials, supplies, and components from U.S. sources. Matilde K. Stephenson, *Mexico's Maquiladora Program: Challenges and Prospects*, 22 ST. MARY'S L.J. 589, 592 (1991).

11. U.S. DEP'T OF COMMERCE, NORTH AMERICAN FREE TRADE AGREEMENT: GENERATING JOBS FOR AMERICANS 50 (May 1991).

12. Angelo C. Falcone, *Mexico's In-Bond Manufacturing Program U.S. Tax Considerations After the 1986 Tax Act*, 65 TAXES 211, 212 (1987).

13. KPMG Peat Marwick, KPMG Peat Marwick Guide to Mexico's Maquila Program 27 (1989) (unpublished manuscript, on file with the *St. Mary's Law Journal*); Douglas Alexander, Legal Aspects of Foreign Investment in Mexico 5 (1988) (unpublished manuscript, on file with the *St. Mary's Law Journal*).

14. Maquiladoras also operate through "Shelter Plans." In a shelter arrangement, the U.S. corporation contracts with an independently (usually Mexican) owned maquiladora operation for the assembly or manufacturing labor. The U.S. corporation generally provides the production technology and equipment; the maquiladora operation provides the labor and fac-

tax issues in the formation, financing, and operation of maquiladoras. The first section discusses "debt/equity swaps," which have frequently been used to provide the initial funding for maquiladoras. The following sections then consider the income tax effect of the operations of maquiladoras, including transfer pricing, intercompany services, intercompany expenses, intercompany use of tangible and intangible assets, and intercompany receivables under I.R.C. § 482, the impact of I.R.C. § 1059A on correlative adjustments under I.R.C. § 482, and the "contiguous country" election of I.R.C. § 1504(d).

II. Debt/Equity Swaps

A. *General Background*

Due to economic conditions in Latin American and other developing countries, and the problems encountered in servicing their worldwide debt, the governments of such countries have been willing to enter into so-called "debt/equity swaps" with foreign businesses. Due to lack of creditworthiness, these developing nations' foreign public-sector debt can be purchased on the international market at substantial discounts from face value. A typical market purchase price would be sixty-five percent of face value, i.e., a market discount of thirty-five percent. In order to encourage foreign investment and to ease the debt burden, the governments of these countries will repurchase (retire) this debt with government funds for eighty-five to one hundred percent of face value. The funds used to repurchase the debt must, however, be invested in the debtor country, typically through corporations organized under the laws of the debtor country. Thus, United States parent corporations are able to obtain foreign debt on the international market for a cost of sixty-five percent of face value, plus a one to two percent commission to the investment banker (or other broker), and exchange it for foreign currency worth eighty-five to one hundred percent of the face value, which must be used for capital investment in the nation which issued the debt. A debt/equity swap permits an enterprise to acquire far more local currency (thus, buying power) than it could by simply purchasing currency at the prevailing market exchange rate.[15] Mexico, Chile, Argentina, Brazil, and the

---

tory space. This article does not consider arrangements of this type, although they present federal income tax considerations of their own.

15. *See* Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 143 (1988).

Philippines are among the nations with such programs.[16]

B. *Mexico's Debt/Equity Swap Program*

The government agencies responsible for conducting the Mexican debt/equity conversion program are the Secretaría de Hacienda y Crédito Público (Ministry of the Treasury and Public Credit or SHCP), and the Comisión Nacional de Inversiones Extranjeras (National Commission On Foreign Investments or CNIE).[17] Prior to the actual transaction, the U.S. parent corporation (investor) conducts extensive negotiations with these agencies concerning the intended use of the proceeds of the swap, i.e., the type of investment to be made in the Mexican economy.[18] There are no limitations on these transactions, although the Mexican government has established criteria to rank them according to their perceived benefit to the economy. For example, purchase of stock in public enterprises which the government is privatizing (e.g., Aeronaves de Mexico), projects which will export most of their production (or which will effect import substitution, i.e., will produce goods in Mexico which it is currently importing), projects involving the transfer to Mexico of advanced technology, and projects which will be situated away from Mexico City receive high-priority.[19] The basic aim of the program is to avoid the outflow of the peso proceeds of the swaps, so that proposals involving the purchase of machinery and equipment from abroad, the repayment of debt to foreign (i.e., non-Mexican) lenders, or increases in working capital not specifically related to a priority use are not considered.[20] The government also prefers to grant equity injections

---

16. *Id.* at 144 n.5, 153 n.34.

17. Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 164 (1988); Bufete Sepulveda, S.C., Memorandum on Capitalization of Credits of the United Mexican States 3 (October 1986) (on file with the *St. Mary's Law Journal*).

18. Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 164 (1988); Angulo, Calvo, Enriquez y Gonzalez, S.C., Mexican Public Foreign Debt-Equity Conversion Program 2, 4, 5 (undated memorandum, on file with the *St. Mary's Law Journal*); Bufete Sepulveda, S.C., Memorandum on Capitalization of Credits of the United Mexican States 6-8, 11-12 (October 1986) (on file with the *St. Mary's Law Journal*).

19. Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 159 n.51 (1988); Bufete Sepulveda, S.C., Memorandum on Capitalization of Credits of the United Mexican States 6-7 (October 1986) (on file with the *St. Mary's Law Journal*).

20. OPERATING MANUAL FOR THE CAPITALIZATION OF LIABILITIES AND REPLACE-

to enterprises which are already totally owned by non-Mexican interests.[21] After all, the program is designed to attract new foreign investment, rather than simply to reshuffle pre-existing domestic investment.

There are, however, specific limitations on the form which the new investment must take. Under section 5.11(a) of the New Restructuring Agreement of the Mexican Foreign Public Sector Debt of August 29, 1985,[22] the investment must take the form of "qualified capital stock." Section 5.11(b) of the agreement defines "qualified capital stock" as capital stock of any Mexican public sector entity or private sector company which is

(1) issued in registered, certificated form in the name of the foreign bank holding the Mexican foreign debt, or in the name of a person (in the case of this article, the U.S. parent company wishing to participate in the debt/equity substitution program) which the Bank designates and which is not a "Mexican entity" (any individual who is a resident of Mexico, and any non-individual entity with its principal place of business in Mexico);
(2) not transferable to any Mexican entity before January 1, 1998, and the certificate of which bears a legend to this effect;
(3) not by its terms subject to redemption on a basis more favorable to the bank or the designated person than the amortization of the debt for which it is issued in exchange (i.e., the stock cannot be redeemed prior to, or in amounts greater than, payments due under the Mexican foreign debt instrument for which the stock is issued in exchange);
(4) not entitled to guaranteed dividends payable irrespective of earnings and profits; and
(5) not convertible into any instrument or security other than qualified capital stock.

Once the CNIE and SHCP have approved the proposed investment and authorized the swap, the U.S. parent will purchase Mexican for-

---

MENT OF PUBLIC DEBT WITH INVESTMENT 20 (trans., Ritch, Rovzar y Heather, S.C., 1986) (on file with the *St. Mary's Law Journal*); Bufete Sepulveda, S.C., Memorandum on Capitalization of Credits of the United Mexican States 10 (October 1986) (on file with the *St. Mary's Law Journal*); Angulo, Calvo, Enriquez y Gonzalez, S. C., Mexican Public Foreign Debt-Equity Conversion Program 4 (undated memorandum, on file with the *St. Mary's Law Journal*).

21. OPERATING MANUAL FOR THE CAPITALIZATION OF LIABILITIES AND REPLACEMENT OF PUBLIC DEBT WITH INVESTMENT 4 (trans., Ritch, Rovzar y Heather, S.C., 1986) (on file with the *St. Mary's Law Journal*).

22. *Id.* exhibit A.

eign debt from a foreign bank for a deep discount, for example, sixty cents for each one dollar of face value. The debt will then be cancelled by the SHCP. The SHCP will then create and fund an account in the Mexican treasury (Tesoreria de la Federacion) for the Mexican subsidiary with an amount of pesos calculated by multiplying the face amount of the cancelled debt (always denominated in dollars) by the current pesos per dollar exchange rate, less a discount determined in advance by the government agencies, which varies inversely with the determined priority of the investment. For example, assume that the U.S. parent acquires one million dollars face amount of Mexican debt on the international market for six hundred thousand dollars, that the free-market rate of exchange on the date of funding is three thousand pesos/dollar, and that the priority discount is ten percent. The subsidiary's account will be credited with three billion pesos (one million dollars face amount of debt x three thousand pesos/dollar exchange rate), less a discount of three hundred million pesos (ten percent of the three billion pesos), for a total of two billion, seven hundred million pesos. The subsidiary will then issue qualified capital stock, with a par value equal to the peso proceeds, to the U.S. parent. Thus, in our example, for six hundred thousand dollars plus transaction costs, the U.S. parent acquires one hundred percent ownership of a Mexican subsidiary with a bank account worth nine hundred thousand dollars[23] which must be used for the authorized investment in Mexico.

C. *Revenue Ruling 87-124*

Revenue Ruling 87-124[24] sets forth the position of the Internal Revenue Service on debt/equity swaps. The ruling provides, in Situation 1, a typical debt/equity swap scenario. X is a U.S. bank which holds a dollar-denominated debt (the obligation) of foreign country FC, evidencing a loan of one hundred dollars which X made to FC's central bank. X's adjusted basis in the obligation is one hundred dollars. Y is a U.S. domestic corporation, and FX is a corporation organized under the laws of FC. FX engages in business in FC but not in the U.S. The local currency of FC is the LC. The free-market exchange rate on July 1, 1987 was ten LCs per dollar.

FC has a program under which a holder of FC's dollar-denomi-

23. These funds accrue interest at the treasury certificate (CETES) rate while in the account, being thereby protected from currency inflation.

24. Rev. Rul. 87-124, 1987-2 C.B. 205.

nated debt can negotiate with the central bank of FC to receive LCs if the holder agrees to invest the LCs in the stock of an FC corporation or otherwise use the LCs in FC in a manner approved in advance by the government of FC. The program controls the LCs by either remitting the LCs to, or crediting them to the account of, an FC corporation that issues capital stock to the holder, or by otherwise channeling the LCs to a designated use in FC. In the case of a stock investment, the stock cannot be sold or otherwise transferred to other FC entities. The amount of LCs which the central bank will give the holder in exchange for the debt varies according to how the LCs are used.

In accordance with a prearranged plan pursuant to the FC program, on July 1, 1987, Y purchased the obligation from X for sixty dollars, which was the fair market value of similar FC debt in the secondary international markets. X, on behalf of Y, delivered the obligation to the central bank, which credited the account of FX with nine hundred LCs. FX then issued all of its capital stock to Y.

According to ruling 87-124, under I.R.C. § 1001(a), X realizes a loss on the sale of the obligation to Y in the amount of the excess of its adjusted basis in the obligation (one hundred dollars) over the amount realized on the sale (sixty dollars). Y's adjusted basis in the obligation is sixty dollars. Y is considered to have received the nine hundred LCs from the central bank in exchange for the obligation, and then to have contributed the LCs to FX in exchange for the FX stock. Y realizes a gain on the exchange of the obligation for the nine hundred LCs to the extent that the fair market value of the nine hundred LCs exceeds sixty dollars, Y's adjusted basis in the Obligation. The fair market value of the nine hundred LCs is determined by taking into account all of the facts and circumstances of the exchange. The limitation on Y's use of the nine hundred LCs will generally reduce their fair market value below the free-market exchange rate of ninety dollars. Y's basis in the nine hundred LCs is sixty dollars plus the gain recognized on the exchange. The fair market value of the FX stock is presumed equal to that of the nine hundred LCs, and is Y's basis in the FX stock.

Situation 1 of the ruling is clearly patterned upon a program very similar to, if not identical with, the Mexican program. Thus, under the ruling, the U.S. parent, which in the Mexican program example purchased three billion pesos debt for six hundred thousand dollars, would realize a gain on the debt/equity swap equal to the excess of the fair market value of the two billion, seven hudred million pesos, as restricted by the Mexican government, over six hundred thousand dollars, which is the U.S. parent's adjusted basis in the Mexican debt exchanged for the pesos.

Many U.S. parent companies who utilize debt/equity swaps do not agree with Revenue Ruling 87-124's conclusion that they are not taxable events which result in realized and recognized gain. The following portions of the article consider the major arguments advanced against the ruling.

D. *The Step Transaction Doctrine*

Taxpayers have attacked the ruling under the "step transaction doctrine." This section of the article considers the doctrine, its application to debt/equity swaps, arguments which have been advanced under the doctrine against the ruling, and possible counterarguments.

1. Does the Doctrine Apply to Debt/Equity Swaps, Assuming That the Taxpayer Can Assert It?

The step transaction doctrine is a rule of substance over form[25] that "treats a series of formally separate 'steps' as a single transaction if such steps are focused toward a particular result."[26] The Tax Court has described the doctrine as follows:

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged.[27]

The existence of an overall plan does not require that the steps comprising it be disregarded. The step transaction doctrine combines a series of individually meaningless steps into a single transaction.[28]

---

25. *See generally* Gregory v. Helvering, 293 U.S. 465, 469 (1935).
26. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).
27. Smith v. Commissioner, 78 T.C. 350, 389 (1982).
28. Esmark, Inc. v. Commissioner, 90 T.C. 171, 195 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989).

Thus, the party seeking to invoke the doctrine[29] must show that the steps are individually meaningless or unnecessary, i.e., that they lack independent economic significance.[30]

It has been argued that, under this doctrine, the steps of a debt/equity swap should be collapsed into a contribution of capital by the U.S. parent to its Mexican subsidiary in exchange for its stock, thus escaping taxation under I.R.C. § 351. Under this scenario, the purchase of the Mexican debt, its transfer to the Mexican government, and the deposit of the pesos to a bank account for the subsidiary, would be disregarded.[31]

On the other hand, it can be argued that each step in a debt/equity swap has independent economic significance and is undertaken for valid business purposes. The investor (U.S. parent) purchases the Mexican foreign debt from an unrelated holder in the international market at a bargained-for, arm's length price. This transaction is, arguably, economically significant because the holder parts with foreign public-sector debt, with uncertain prospects for repayment, and receives money (dollars, a stable international currency) in exchange. The investor parts with that same money and receives the debt, thereby assuming the position of the original holder. The real economic positions of these parties have changed.

In the next step, the investor transfers the discounted debt to the Mexican government, and receives in exchange (through its subsidiary) money, this time in the form of pesos, an international currency with less stability than the dollar, but with a more certain value than the debt. The Mexican government is relieved of a portion of its debt burden, which includes future debt-service costs in the form of outflows of foreign exchange, as well as the time and effort which it might spend in future restructuring negotiations, in return for simply issuing more of its own currency, which carries no risk, except perhaps added inflationary pressures.[32]

---

29. It would appear somewhat oxymoronic for the taxpayer to rely on the doctrine and thereby argue that the form of his own transaction does not correspond to its substance. Whether the taxpayer can successfully do so is discussed in the next section.

30. *Esmark*, at 195, 198; Rev. Rul. 83-142, 1983-2 C.B. 68 (doctrine inapplicable where "each step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes").

31. *See* Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 160-71 (1988).

32. The annual rate of inflation in Mexico has fallen from 160 percent in 1987 to 30

In the last step, the currency is expended to create a facility which produces goods at a much lower cost than would be possible in the United States, benefitting the investor, and which expands Mexico's capital stock, creating jobs for its citizens and providing new technology to its industry.

Each "step" may thus constitute a legitimate business transaction with economic substance. Further, it may be suggested that all of them are necessary to accomplish the objectives of both the Mexican government and of the investor. The mere fact that, together, they form the "overall plan" of the debt/equity swap may not deprive them of their independent significance.

2. May the Taxpayer Successfully Assert the Doctrine?

Assuming that the taxpayer invokes the doctrine, thereby attacking the form in which he has voluntarily chosen to cast the transaction, the general rule is that

> while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.[33]

By contrast,

> the Government may not be required to acquiesce in the taxpayer's election of that form. . . . The Government may look at actualities and, upon determination that the form employed . . . is unreal or a sham, may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute.[34]

Thus, there may be some question as to whether a taxpayer may successfully invoke the step-transaction doctrine and contend that the substance of the transaction differs from the form in which he chose to place it.[35]

---

percent in 1990. U.S. DEP'T OF COMMERCE, NORTH AMERICAN FREE TRADE AGREEMENT: GENERATING JOBS FOR AMERICANS 5 (May 1991).

33. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974)(citations omitted).

34. Higgins v. Smith, 308 U.S. 473, 477 (1940).

35. *E.g.*, FNMA v. Commissioner, 90 T.C. 405, 417-21, 426-27 (1988), *aff'd on other grounds*, 896 F.2d 580 (D.C. Cir. 1990), *cert. denied*, __ U.S. __, 111 S.Ct. 1619, 113 L.Ed.2d 717 (1991). The taxpayer argued that transactions which in form were the origination of new mortgages and the payoff of old mortgages pursuant to resales of the mortgaged property, or to refinancings of the old mortgages, in substance constituted exchanges of the old for the new

E. *Presumed Equivalency In Value Argument*

Taxpayers have also argued that Revenue Ruling 87-124 is incorrect by asserting that, even if the debt/equity swap's steps are to be viewed separately, and that the Mexican debt is in fact exchanged for Mexican currency in a taxable event, the currency received should be presumed to be equivalent in value to the debt exchanged for it, allegedly because the currency is incapable of being valued.[36] On the other hand, there exists a ready international market for pesos; daily quotes are available for peso/dollar exchange rates. The restrictions on the use of the pesos must also be taken into account. However, it should also be remembered that the pesos are used for a purpose desired by the investor.

F. *Capital Contribution Under I.R.C. § 118*

The final argument against application of the ruling and taxation of the debt/equity swap which this article considers is that the excess of the value of the Mexican currency over the cost of the debt exchanged for it represents a contribution to the Mexican subsidiary's capital by the Mexican government, and is exempt from taxation under I.R.C. § 118.[37] That section provides that, "in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer."[38] The regulations under the section state that it applies to contributions to capital made by persons other than shareholders, and gives as an example the value of land or other property contributed to a corporation by a governmental unit "for the purpose of inducing the corporation to locate its business in a particular community," or to enable it to expand its facilities.[39]

Thus, the argument goes, the excess of the value of the pesos over the cost of the debt represents "property" "contributed" by the Mexican government to the subsidiary or the investor to induce them to build the facility in Mexico. A potential problem with this argument, however, is that the pesos are not an outright grant, but are paid in

---

mortgages, upon which gain or loss should be recognized. The court refused to allow the taxpayer to "attack the form of [the] transactions," and "recharacterize them by hindsight, and after it conceived that a tax advantage could be obtained." *Id.* at 426-27.

36. *See* Christopher Gottscho, Note, *Debt-Equity Swap Financing of Third World Investments—Will the I.R.S. Hinder U.S. Swappers?*, 8 VA. TAX REV. 143, 171-74, 173 n.122.

37. *See id.* at 174-76.

38. I.R.C. § 118(a).

39. Treas. Reg. § 1.118-1 (1956).

exchange for the cancellation of the debt, which benefits the government. The regulations provide that "the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered."[40] The Mexican government makes its payment of currency in exchange for the direct benefit of the repayment of a portion of its debt with its own currency, rather than foreign exchange, and the concomitant reduced future debt service costs and associated activities.[41]

The foregoing discussion involves issues relating to the formation and financing of maquiladoras. The remainder of the article addresses some tax aspects of a maquiladora's operations.

III. I.R.C. § 482 ALLOCATIONS INVOLVING MAQUILADORAS

A. *General Background*

As the maquiladora industry typically involves two or more closely related entities, there exists a great potential for the shifting of income and expenses between the related entities. As a result, many issues can arise in the maquiladora industry with respect to allocations under I.R.C. § 482. Section 482 provides that

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary [of the Treasury] may distribute, apportion, or allocate gross income, deductions, credits, or allowances be-

40. *Id.* For example, in *White, Inc. v. Commissioner*, 55 T.C. 729 (1971), *aff'd*, 458 F.2d 989 (3d Cir. 1972), *cert. denied*, 409 U.S. 876 (1972), the Tax Court held that a contribution made by the Ford Motor Company to induce a dealer to relocate was not a capital contribution within the meaning of I.R.C. § 118 because Ford made the payment in order to increase the sales of its product, and to enhance its image by having the dealership located in a better neighborhood and in a more attractive and better-equipped building. *See also* United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401, 413 (1973) (property "may not be compensation, such as direct payment for a specific, quantifiable service provided for the transferor by the transferee").

41. The above discussion assumes a contribution by a nonshareholder, i.e., the Mexican government. The argument could be made, however, that the contribution is in reality from the parent to the maquiladora, i.e., a shareholder contribution, which Treas. Reg. § 1.118-1 makes *per se* untaxable to the maquiladora, and I.R.C. § 351 makes untaxable to the parent. I.R.C. § 367 would apply, however, to an I.R.C. § 351 exchange in which a United States person transfers property to a foreign corporation, so that the foreign corporation would not be considered a corporation for purposes of determining the extent to which gain is recognized on the transfer. I.R.C. § 367 does provide a number of exceptions, however, which may apply in specific situations.

> tween or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The purpose of I.R.C. § 482 is to place a controlled taxpayer on a tax parity with an uncontrolled, unrelated taxpayer.[42] Moreover, an intent to evade tax is not a prerequisite to an I.R.C. § 482 allocation.[43]

A necessary concomitant of I.R.C. § 482's broad grant of authority to allocate the specified items is that any such allocation must be sustained absent a showing that the Internal Revenue Service has abused its discretion.[44]

The regulations promulgated pursuant to I.R.C. § 482 provide that if the secretary makes an adjustment to the income of one member of a group of controlled taxpayers, he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation.[45]

Section 482 issues may arise in the maquiladora context in several ways. The most common problems, which will be discussed below, are transfer pricing, intercompany services, payment of intercompany expenses, intercompany use of tangible assets, and transfer of intangibles. Although a discussion of transfer pricing is included, transfer pricing issues generally arise in the context of attempting to shift the income from an entity in a higher tax country to a related entity in a lower tax jurisdiction. Maquiladoras, however, typically involve Mexican corporations formed to provide labor intensive services at reduced cost to American parents. The Mexican maquiladoras are generally not profit centers, but are more in the nature of cost centers. Thus, most of the I.R.C. § 482 issues which will arise with respect to maquiladoras will involve the American entity incurring costs on behalf of its maquiladora.

---

42. Commissioner v. First Security Bank, 405 U.S. 394, 400 (1972); Treas. Reg. § 1.482-1(b)(1) (as amended in 1968).

43. Fitzgerald Motor Co. v. Commissioner, 508 F.2d 1096, 1102 (5th Cir. 1975), *aff'g* 60 T.C. 957 (1973).

44. Phillips Bros. Chem., Inc. v. Commissioner, 435 F.2d 53, 57 (2d Cir. 1970), *aff'g* 52 T.C. 240 (1969); Ach v. Commissioner, 42 T.C. 114, 125 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966).

45. Treas. Reg. § 1.482-1(d)(2) (as amended in 1968).

B. *Transfer Pricing*

Although it will not be common, transfer pricing issues could arise with respect to sales of products from the Mexican maquiladora to its related American entity. The regulations under I.R.C. § 482 provide that where one member of a group of related entities sells tangible property to another member of the group at other than an arm's length price, the Internal Revenue Service may make appropriate allocations between the buyer and the seller to reflect an arm's length price.[46] If this issue were to arise with respect to a maquiladora, it would involve a Mexican entity inflating the cost of items sold to the related American entity in an effort to increase the American entity's cost of goods sold, which in turn would reduce its net income. As stated above, most Mexican maquiladoras are cost centers rather than profit centers; thus, there is little attempt to shift income to the Mexican entity.

If a transfer pricing issue does arise, the required analysis focuses on a determination of the arm's length price.[47] The regulations prescribe three methods of determining an arm's length price and the standards for applying each method.[48] The three methods are the comparable uncontrolled price method, the resale price method, and the cost-plus method. The regulations further provide that the three methods should be used in the order stated; thus, resort to the second method should only be had if there are no comparable uncontrolled sales, and the third method should only be used if neither the first nor the second method is available.[49]

The comparable uncontrolled price method requires that the arm's length price of a controlled sale be equal to the price paid in comparable uncontrolled sales, subject to certain ascertainable adjustments for the "quality of the product, terms of sale, intangible property associated with the sale, time of the sale," and the market in which the sale takes place.[50] If such adjustments are not ascertainable, this method

46. Treas. Reg. § 1.482-2(e)(1)(i) (as amended in 1988). An arm's length price is defined as the price that an unrelated party would have paid under the same circumstances for the property involved in the sale. *Id.*

47. Given the limited applicability of transfer pricing issues to maquiladoras, the discussion of transfer pricing is limited to an overview of the regulations. A complete discussion of transfer pricing must, however, include a review and analysis of the relevant case law.

48. Treas. Reg. § 1.482-2(e)(i)(ii) (as amended in 1988).

49. *Id.*

50. Treas. Reg. § 1.482-2(e)(2)(ii) (as amended in 1988).

can not be used.[51] "Uncontrolled sales are sales in which the seller and the buyer are not members of the same controlled group," and include "(a) sales made by a member of the controlled group to an unrelated party, (b) sales made to a member of the controlled group by an unrelated party, and (c) sales made in which the parties are not related to each other."[52]

If the comparable uncontrolled price method is not appropriate, the resale price method must be considered. The theory behind the resale price method is to determine the buyer's (reseller's) gross profit percentage (markup) on resales of similar property purchased from an unrelated entity.[53] The resale price method is generally not appropriate if the buyer (reseller) has "added more than an insubstantial amount of value to the property by physically altering the property before resale."[54] Additionally, the following factors should be considered when determining whether similar purchases and resales are comparable

> (a) the type of property involved in the sale; (b) the functions performed by the buyer with respect to each product; (c) the effect on price of any intangible property utilized by the reseller in connection with the property resold; and (d) the geographic market in which the functions are performed by the buyer.[55]

Although maquiladoras almost always involve labor intensive work, including processing and assembling which, by their very nature, add more than an insubstantial value to the property, the resale price method could be appropriate if the maquiladora sells its products to its parent which resells them on the United States market without further processing, i.e., in effect acting merely as a distributor. The focus would be on the first uncontrolled sale outside of the controlled group. From this sales price would be subtracted an appropriate markup (determined from the parent's resales of products purchased from unrelated entities, or from information from other persons selling comparable products) to determine an appropriate transfer price between the maquiladora and the parent.

If neither the comparable uncontrolled price method nor the resale

51. *Id.*
52. *Id.*
53. Treas. Reg. § 1-482-2(e)(3)(i) (as amended in 1988).
54. Treas. Reg. § 1-482-2(e)(3)(ii)(c) (as amended in 1988).
55. Treas. Reg. § 1.482-2(e)(3)(vi) (as amended in 1988).

price method is available, however, the regulations direct the consideration of the use of the cost plus method. Under this method, "the arm's length price of a controlled sale of property shall be computed by adding to the cost of producing such property, an amount which is equal to such cost multiplied by the appropriate gross profit percentage, plus or minus the appropriate adjustments."[56] Thus, this method determines the appropriate gross profit percentage for the related party sales by determining the seller's cost of production and adding to such cost the gross profit percentage earned on similar sales to unrelated parties, or earned by other persons selling comparable products. The same types of factors considered in determining comparability of sales for the resale price method should be considered with respect to comparability of sales for the cost plus method.[57]

The regulations further provide that if none of the three methods outlined above are appropriate, then some other appropriate method, or variation of such methods, may be used.[58] Of course, no guidance with respect to other methods or variations of the above methods is provided.

Given the nature of the maquiladora industry, the Mexican company will probably be providing all of its products to its United States parent. Thus, the ability to rely on the comparable uncontrolled price method would depend upon whether the United States parent purchased comparable products from unrelated entities, or whether there were comparable sales involving totally unrelated entities. If the comparable uncontrolled price method is unavailable, then the resale price method may be used to determine the appropriate transfer price, if the parent sells the the product without further processing. Otherwise, the government would be forced to rely on the cost plus method.

C. *Intercompany Services*

As a general rule, "when one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge," or at less than an arm's length charge, the Internal Revenue Service may make appropriate allocations to reflect

56. Treas. Reg. § 1.482-2(e)(4)(i) (as amended in 1988).
57. Treas. Reg. § 1.482-2(e)(4)(iii) (as amended in 1988).
58. Treas. Reg. § 1.482-2(e)(1)(iii) (as amended in 1988).

an arm's length charge.[59] Given the close relationship between most American entities and their Mexican maquiladoras, and that most maquiladoras are operated as cost centers, it is very common for American companies to provide administrative and managerial services to their maquiladoras. In such situations, the Internal Revenue Service may attempt to allocate an arm's length charge for the services provided by the American company to its maquiladora.

The regulations provide that "an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances."[60] The regulations further provide that, "except in the case of services which are an integral part of the business activity of either" of the parties involved, "the arm's length charge is deemed to be the amount of the costs or deductions incurred with respect to such services, unless the taxpayer establishes a more appropriate charge."[61] Services are considered to be an "integral part of the business activity" if either the provider or the recipient "is engaged in the trade or business of rendering similar services to one or more unrelated parties,"[62] or if the provider "renders services to one or more related parties as one of its principal activities."[63] When the "amount of an arm's length charge for services is determined with reference to the costs or deductions incurred with respect to such services," all direct and indirect costs associated with such services must be taken into account.[64] If the taxpayer has "allocated and apportioned costs or deductions to reflect arm's length charges. . . in a consistent and reasonable manner which is in accord with sound accounting practices," such method will be allowed.[65]

Allocations for services may also be made with respect to services performed for the "joint benefit of the members of a group of controlled entities."[66] In such a case, the allocation should be made in

59. Treas. Reg. § 1.482-2(b)(1) (as amended in 1988).
60. Treas. Reg. § 1.482-2(b)(3) (as amended in 1988).
61. *Id.*
62. Treas. Reg. § 1.482-2(b)(7)(i) (as amended in 1988).
63. Treas. Reg. § 1.482-2(b)(7)(ii)(a) (as amended in 1988). The regulations provide further guidance with respect to determining whether services are an integral part of a business. *See* Treas. Reg. § 1.482-2(b)(7)(ii)—(iv) (as amended in 1988).
64. Treas. Reg. § 1.482-2(b)(4)(i) (as amended in 1988).
65. Treas. Reg. § 1.482-2(b)(6)(i) (as amended in 1988).
66. Treas. Reg. § 1.482-2(b)(2)(i) (as amended in 1988).

accordance with the "relative benefits intended from the services," without the aid of hindsight.[67] However, no allocation is to be made if the expected benefits to the other members of the group were so remote that "unrelated entities would not have charged for such services."[68] Furthermore, the regulations provide that an allocation will generally not be necessary if the service is merely a duplication of a service which the related party has independently performed or is performing for itself.[69]

The Internal Revenue Service may also disallow expenses for services paid by the United States parent which are for the direct benefit of the Mexican subsidiary under the general principles of I.R.C. § 162. For example, assume that a United States corporation pays the salary of a manager who is employed by, and spends all of his time providing management services to, the corporation's wholly owned Mexican maquiladora. It would be difficult to argue that incurring expenses for the benefit of another entity is either ordinary or necessary for the American company, as required for deductibility under section 162.[70] This issue will be addressed further below in the context of the I.R.C. § 1059A discussion.

D. *Payment of Intercompany Expenses*

Intercompany services are not the only expenses which may be incurred by the domestic entity on behalf of foreign related entities. Given the nature of the maquiladora industry and the assumptions relied upon herein, the domestic entity will control, for the most part, both the resources and the decision-making of its maquiladora. Inevitably, the domestic entity will incur and deduct traditional operating

67. *Id.*

68. *Id.*

69. Treas. Reg. § 1.482-2(b)(2)(ii) (as amended in 1988).

70. Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); *see also* Young & Rubicam, Inc. v. United States, 410 F.2d 1233 (Cl. Ct. 1969) (court disallowed under section 162 deductions by a United States parent for salaries paid to its employees for periods of time when they were detailed to foreign subsidiary corporations). It should be noted that there are no correlative adjustments with respect to expenses disallowed under I.R.C. § 162. An I.R.C. § 482 allocation may be necessary, however, when an individual who is employed and paid by the parent spends all or a substantial portion his time providing services to the maquiladora. In this situation, the service may not disallow the parent's deduction for the employee's compensation, but may allocate fee income to the parent, and a correlative deduction to the maquiladora, in the amount of the portion of the employee's compensation attributable to the performance of services for the latter.

expenses, such as professional services, insurance, travel, supplies, maintenance, and utilities, which benefit the Mexican company.

Expenses incurred by a domestic company on behalf of its maquiladora may be challenged by the Internal Revenue Service under either I.R.C. § 482 or § 162. As stated above, the theory behind section 482 is to determine what the income and expenses of members of controlled groups of taxpayers would have been had such members dealt with each other at arm's length. At arm's length, taxpayers simply do not pay the expenses of other taxpayers. Under section 482, the Internal Revenue Service could either allocate the deduction to the entity who benefited from it, or impute income to the entity who erroneously deducted it, with a corresponding allocation of the deduction to the other party.[71]

As stated with respect to intercompany services, the Internal Revenue Service may choose to disallow the deductions under I.R.C. § 162. Business expenses must be both ordinary and necessary to be deductible. The payment of someone else's debt is simply not an "ordinary" expense.[72]

E. *Intercompany Use of Tangible Assets*

Problems can arise with respect to the transfer of equipment and other tangible assets from the domestic entity to its controlled Mexican company. If the domestic company owns equipment and allows the Mexican company to use it either at less than fair market value or at no charge, the Internal Revenue Service may use section 482 to impute lease income to the domestic company at an arm's length rate.[73]

Additional problems can arise if domestic companies claim depreciation with respect to assets purchased by them, but used by their Mexican controlled corporations. I.R.C. § 167 allows a deduction for the reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or of property held for the production of income. In a maquiladora context, the first hurdle in establishing an entitlement to a depreciation deduction is proving that the assets are used in the American company's trade or business. If the assets are only being used by the Mexican subsidiary in its trade or business,

---

71. *See* Treas. Reg. § 1.482-1(d)(2) (as amended in 1968).
72. Welch v. Helvering, 290 U.S. 111, 114 (1933).
73. Treas. Reg. § 1.482-2(c) (as amended in 1988).

then there should be no depreciation deduction for the American company.

If it can be established that the assets are used in the American company's trade or business, but are still located abroad, the depreciation deduction may be limited by I.R.C. § 168(g). Section 168(g) provides, in pertinent part, that the depreciation deduction allowed by section 167 for property used predominantly outside the United States during the taxable year is subject to the alternative depreciation system set forth in section 168(g)(2), which would generally call for straight line depreciation over a twelve-year period.

F. *Intercompany Receivables*

The transfer and sale of goods and services between related entities often creates receivables between such related entities. The maquiladora industry is no exception. Any time there are receivables or loans between two or more related entities, issues can arise with respect to imputed interest on such receivables and loans. The section 482 regulations provide that where one member of a group of related entities "makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of the group and either charges no interest or charges interest at a rate which is" below an arm's length rate, the Internal Revenue Service may make appropriate allocations to reflect an arm's length rate of interest.[74] The regulations provide that the Internal Revenue Service may impute an appropriate rate of interest with respect to loans or advances of money, and with respect to "indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group."[75]

The regulations generally provide that interest should be imputed from the day after the indebtedness arises until the day it is satisfied.[76] However, with respect to intercompany trade receivables involving a foreign debtor, "interest is not required to be charged until the first day of the [fourth month] following the month in which the receivable

74. Treas. Reg. § 1.482-2(a)(1)(i) (as amended in 1988).

75. Treas. Reg. § 1.482-2(a)(1)(ii) (as amended in 1988). Indebtedness arising in the ordinary course of business from sales, leases or the rendition of services by or between members of the group are referred to as intercompany receivables.

76. Treas. Reg. § 1.482-2(a)(1)(iii)(A) (as amended in 1988).

arises."[77] The regulations also provide that if it is an industry practice to allow longer periods to run before charging interest on similar transactions, then such longer period will be allowed.[78] The regulations also provide a safe harbor rate between the "applicable federal rate" (determined under I.R.C. § 1274(d)) and 130% of the applicable federal rate.[79]

Thus, assuming there are no advances or other typical loans between the domestic entity and its related maquiladora, which are typically avoided in the maquiladora industry because of Mexican withholding requirements, imputed interest on intercompany trade receivables can be avoided by repaying such receivables in less than four months.

G. *Transfer of Intangibles*

The Tax Reform Act of 1986 amended I.R.C. § 482 by adding the following sentence, "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[80] Prior to the amendment of section 482, the Internal Revenue Service relied on the principles espoused in the section 482 regulations.[81]

The regulations provide that where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available by one member to another member of a controlled group of corporations for other than an arm's length consideration, the Internal Revenue Service may make necessary allocations to reflect an arm's length consideration.[82] The regulations generally provide that the standard to be applied in determining the amount of an arm's length consideration is the amount that would have been paid by an unrelated party for the same intangible property under the same cir-

77. Treas. Reg. § 1.482-2(a)(1)(iii)(C) (as amended in 1988).

78. Treas. Reg. § 1.482-2(a)(1)(iii)(D) (as amended in 1988).

79. Treas. Reg. § 1.1482-2(a)(2)(iii)(B) (as amended in 1988).

80. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231 (e)(1), 100 Stat. 2085, 2562-63 (codified at 26 U.S.C. § 482). Section 1231(g)(2)(B) provides that the amendments made by Act § 1231(e) apply to taxable years beginning after December 31, 1986, with respect to transfers after November 16, 1985 or licenses granted after that date.

81. Treas. Reg. § 1.482-2(d) (as amended in 1988).

82. Treas. Reg. § 1.482-2(d)(1)(i) (as amended in 1988).

cumstances.[83] If there is no comparable transaction involving an unrelated taxpayer, then the regulations provide specific factors to be considered in arriving at the amount of an arm's length consideration.[84]

The standard set forth in section 482 looks to the income to be derived from the transfer of the intangible as indicative of arm's length consideration. Prior case law focused on the amount that an unrelated buyer would have paid for the same rights in the intangible without sufficient consideration of all of the terms and conditions surrounding the transfer. Although there are no current regulations interpreting the amendment to section 482, the legislative history provides meaningful insight. The Ways and Means Committee report explaining the House version of the bill provides that one of the factors to be considered in determining the profit potential of the intangible transferred is the "extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible, or, instead, sells products produced with the intangible largely to related parties . . . and has a market essentially dependent on, or assured by, such related parties' marketing efforts."[85] Additionally, the committee report explains that the most important factor is the "profit or income stream generated by or associated with intangible property."[86] Another important change is that hindsight will now be an appropriate factor in the analysis.[87] In other words, the new law is intended to cause the parties to analyze the payments being made over time, requiring appropriate adjustments for changes in the income attributable to the intangible. The inquiry is no longer limited to the facts in existence at the time of the transfer.

Unfortunately, there are no current guidelines to comply with the amendment to section 482. Furthermore, given the large number of U.S. companies which have shifted their manufacturing and processing operations to Mexico and other foreign countries, and the degree to which technology plays a part in such manufacturing and processing, it is impossible to forecast the impact of this amendment to section 482. Congress clearly believed there was a problem in the way

---

83. Treas. Reg. § 1.482-2(d)(2)(ii) (as amended in 1988).

84. Treas. Reg. § 1.482-2(d)(2)(iii) (as amended in 1988).

85. H.R. Rep. No. 426, 99th Cong., 2d Sess., at 426 (1986).

86. *Id.*

87. *Id.* at 425.

the section 482 regulations handled the transfer of intangibles, and enacted the amendment to section 482 to tighten the rules. It will be left to the courts to provide the final analysis.

IV. Correlative Adjustments Under I.R.C. § 482 and I.R.C. § 1059A

A. *Correlative Adjustments*

As stated above, whenever the Internal Revenue Service makes a section 482 adjustment to the income of one member of a group of controlled taxpayers, it must also make appropriate correlative adjustments to any other members of the group related to the allocation.[88] The regulations provide that the correlative adjustment shall actually be made if the U.S. income tax liability of the other member(s) of the group would be affected for any pending taxable year. A pending taxable year is defined as "any taxable year with respect to which the U.S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of law."[89] Even "if a correlative adjustment is not actually made," it shall "be deemed to have been made for the purpose of determining" that member's "U.S. income tax liability in a later year, or for the purposes of determining the U.S. tax liability of any other person for any taxable year."[90]

The regulations also provide that the correlative adjustment is not to be made until there is some degree of finality with respect to the primary section 482 adjustment. Under the regulations, the correlative adjustment should not be made until the earliest of the following events involving the primary adjustment:

(a) the date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to the adjustment;
(b) acceptance of a Form 870-AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax And Acceptance of Overassessment);
(c) payment of the deficiency;
(d) stipulation in the Tax Court of the United States; or

88. Treas. Reg. § 1.482-1(d)(2) (as amended in 1968).
89. *Id.*
90. *Id.*

(e) final determination of tax liability by offer in compromise, closing agreement, or court action.[91]

B. *I.R.C. § 1059A*

Section 1059A was enacted as part of the Tax Reform Act of 1986 to limit an importer's basis in inventory to the value of the imported goods claimed for customs purposes.[92] Section 1059A provides that where property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of section 482), the amount of any costs taken into account in determining basis or inventory costs by the purchaser which are also taken into account in computing the customs value of such property, shall not exceed such customs value. "Customs value" is defined as the value taken into account for purposes of determining the amount of any duties imposed on the importation of property.[93] "Import" is defined as the entering or withdrawal from a warehouse for consumption, except as otherwise provided in the regulations.[94]

The regulations provide that section 1059A does not apply to items or portions of items which are not subject to duty.[95] Likewise, section 1059A is inapplicable if the customs duty on property is not based on value; thus, this section is inapplicable if the customs duty is based on volume or if there is a per item duty.[96] The regulations also make it clear that section 1059A has no application if the customs value is greater than the inventory cost; section 1059A is not a two way street.

The regulations recognize that there may be certain costs which are properly included in the cost of inventory which are not included in the customs value. These include costs for freight, insurance, expenses incurred after importation (such as construction, erection, assembly or technical assistance), and any other costs properly included in inventory cost under I.R.C. §§ 471 and 263A.[97]

The regulations expressly state that neither section 1059A nor the

---

91. *Id.*
92. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1248(c), 100 Stat. 2085, 2584.
93. I.R.C. § 1059A(b)(1) (codified at 26 U.S.C. § 1059A).
94. I.R.C. § 1059A(b)(2).
95. Treas. Reg. § 1.1059A-1(c)(1) (1989).
96. *Id.*
97. Treas. Reg. § 1.1059A-1(c)(2) (1989).

section 1059A regulations limit in any way the authority of the Internal Revenue Service to make adjustments to inventory costs under section 482 or any other section of the code.[98] A more difficult question, which is not specifically answered in the regulations, is whether the Internal Revenue Service can use section 1059A to limit the benefit of a correlative adjustment. For example, assume that, under section 482, the Internal Revenue Service allocates deductions for salaries which a parent corporation paid to an employee of its Mexican subsidiary from the parent to the subsidiary and, as a correlative adjustment, treats the subsidiary as having paid or incurred those salaries. The subsidiary, a maquiladora, operates on a cost plus basis, i.e., the amount which the parent pays the maquiladora for processing its widgets is equal to the maquiladora's total costs plus a certain percentage of those costs. Therefore, any excess costs which it would incur would normally be passed up to the parent corporation in the price the parent paid for the processing of widgets.

Without the limitations of section 1059A, the utilization of section 482 and the correlative adjustment should create a wash, and possibly a benefit, with respect to the domestic parent's U.S. tax liability, because any decrease in salaries expense will be offset, through the correlative adjustment and the cost-plus arrangement, by an increased cost the parent is paying its subsidiary for the widgets. Thus, salaries expense may decrease, but the cost of goods sold will increase, presumably by that amount plus the cost-plus arrangement. The question is whether section 1059A will limit the ability of the domestic parent to utilize the benefit of the correlative adjustment.

The section 1059A regulations provide that a taxpayer is bound by the finally determined customs value and by every final determination made by the United States Customs Service, including the determination of dutiable value.[99] The customs value is considered to be finally determined, and all United States Customs Service determinations are considered final, when liquidation of the entry becomes final.[100] Liquidation generally occurs ninety days after notice of liquidation to the importer, unless a protest is filed. If a protest is filed, the customs value is considered to be finally determined either when a decision by the Customs Service with respect to the protest is not contested or

98. Treas. Reg. § 1.1059A-1(c)(7) (1989).
99. Treas. Reg. § 1.1059A-1(d) (1989).
100. *Id.*

when a decision of the Court of International Trade becomes final.[101]

The Internal Revenue Service may argue that the finality of the customs value precludes adjustment of the inventory cost resulting from a section 482 correlative adjustment. By the time a correlative adjustment would be required, the customs value would likely be final, and the regulations under section 1059A are explicit that the finally determined customs value controls.

The taxpayer may counter-argue that with a maquiladora, where the Mexican corporation is passing along all of its costs to its domestic counterpart, no section 482 adjustment should be made in the first instance because there is no attempt to evade taxes and the adjustment is not needed to clearly reflect income. Although the statute appears to require either an attempt to evade taxes or the necessity for an adjustment to clearly reflect income, the regulations expressly do not.[102] The courts have followed the regulations.[103] Transactions involving related entities will be closely scrutinized, and the aim of section 482 is to prevent the shifting of net incomes of controlled taxpayers by placing them on a parity with uncontrolled taxpayers.

Questions may arise concerning the potential interplay between section 482 correlative adjustments and the section 1059A limitations with respect to deductions disallowed under I.R.C. § 162. As discussed above, expenses must be both ordinary and necessary to be deductible under I.R.C. § 162, and the service may successfully argue that it is not ordinary for one taxpayer to pay the expenses of another. Although no correlative adjustment is required with respect to deductions disallowed under I.R.C. § 162, the domestic parent may argue that it should be able to recharacterize the disallowed expenses as part of its cost of purchasing inventory from the maquiladora, or of having the maquiladora assemble or manufacture the inventory. Consequently, the parent would contend that its cost of goods sold should be increased by the amount of the disallowed deductions. The service might respond as follows:

(1) The expenses cannot be recharacterized as part of the parent's cost

101. *Id.*

102. Treas. Reg. § 1.482-1(c) (as amended in 1968).

103. *See, e.g.*, Fitzgerald Motor Co. v. Commissioner, 508 F.2d 1096, 1102 (5th Cir. 1975), *aff'g* 60 T.C. 957 (1973); Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234, 236 (2d Cir. 1935), *cert. denied*, 296 U.S. 645 (1935); Foster v. Commissioner, 80 T.C. 34, 138 (1983), *aff'd*, 756 F.2d 1430 (9th Cir. 1985).

of goods sold because they were not paid as such. They are at most contributions to the maquiladora's capital, which would at most increase the basis of its stock in the parent's hands; and

(2) Even if the expenses could be so recharacterized, I.R.C. § 1059A would prohibit the parent from taking them into account in calculating its cost of goods sold if they were not included in the declared dutiable value of the inventory imported from the maquiladora.

Thus, I.R.C. § 1059A may apply to an adjustment under I.R.C. § 162.

The potential conflict between I.R.C. §§ 482 and 1059A will be unavoidable, however, with respect to transfer pricing allocations or any imputations of income under section 482. Although the service will likely rely on I.R.C. § 1059A to limit the use of the correlative adjustment, the issue has yet to be decided by any court.

V. I.R.C. § 1504(D) ELECTION

Generally, a foreign corporation may not be included in an affiliated group of corporations for the purpose of filing a consolidated return.[104] However, a domestic corporation may elect to include a wholly owned subsidiary incorporated in a contiguous country (Mexico or Canada) in the consolidated return group if such wholly owned subsidiary is "maintained solely for the purpose of complying with the laws of such country as to title and operation of property."[105] Including a Mexican subsidiary in a consolidated return group could be beneficial if it would allow the affiliated group to offset its income by the Mexican subsidiary's start-up losses. The I.R.C. § 1503(d) limitation on dual consolidated losses must, however, be considered.[106]

Whether a Mexican subsidiary formed as part of the maquiladora industry is maintained solely for the purpose of complying with the

104. I.R.C. § 1504(b)(3).

105. I.R.C. § 1504(d).

106. I.R.C. § 1503(d). Internal Revenue Code section 1503(d) generally provides that, subject to certain exceptions, a dual consolidated loss of a domestic corporation (including a foreign corporation treated as a domestic corporation under section 1504(d)), incurred after 1986, cannot be allowed to reduce the taxable income of any other member of the consolidated group for that or any other taxable year. *Id.* A dual consolidated loss is a net operating loss of a domestic corporation incurred in a year in which the corporation is a dual resident corporation. *Id.* A domestic corporation is a dual resident corporation if the worldwide income of such corporation is subject to tax in a foreign country, or such corporation is subject to the income tax of a foreign country on a residence basis. *Id.*

laws of Mexico as to title and operation of property was considered by the Internal Revenue Service in General Counsel Memorandum 38,119 (October 1, 1979) and Private Letter Ruling 81-25-143 (March 27, 1981) which answered that question in the negative. General Counsel Memorandum 38,119 involved a U.S. corporation, Corp P, establishing a wholly-owned Mexican corporation, Corp S, to participate in the Mexican Border Industrialization Program under Mexican law and to hold title to real estate used for a processing plant in Mexico near the U.S. border. According to the memorandum, Corp S was established partly to comply with the laws of Mexico as to title of property and partly to receive the benefits as a maquiladora. The memorandum stated that the "maintained solely" requirement in section 1504(d) required the taxpayer to establish that foreign incorporation would not have been maintained "but for" the need to comply with the laws of Mexico or Canada as to title or operation of property. General Counsel Memorandum 38,119, relying on Revenue Ruling 71-523,[107] concluded that Corp S was not qualified to make a section 1504(d) election because it was formed partially to gain benefits under the Mexican Border Industrialization Program, and not solely for the purpose required by the statute.

Likewise, in Private Letter Ruling 81-25-143, the Internal Revenue Service determined that the Mexican subsidiary involved therein did not qualify for the section 1504(d) election because it was maintained partly for its status as a maquiladora. The private letter ruling also relied upon Revenue Ruling 71-523 which involved a Canadian corporation incorporated to apply for a grant under the Canadian Program for Advancement of Industrial Technology. Under Canadian law, the grant was only available to Canadian corporations. The revenue ruling concluded that since the Canadian corporation was not formed solely to comply with Canadian laws as to title and operation of property, the corporation was not eligible to make the section 1504(d) election.

Thus, the Internal Revenue Service has expressly taken the position that corporations formed to benefit from the maquiladora program are not eligible for the section 1504(d) election. Whether a Mexican maquiladora may avail itself of the section 1504 election has, however, been somewhat clouded. In *U.S. Padding Corp. v. Commis-*

107. Rev. Rul. 71-523, 1971-2 C.B. 326.

sioner,[108] the issue was whether a Canadian corporation, formed to facilitate the purchase by a U.S. corporation of the assets of a Canadian manufacturing concern, qualified for the section 1504(d) election. Although there was no law which required the formation of a Canadian corporation to purchase the assets, the U.S. company was advised that incorporation of the Canadian company was essential to avoid delaying agency recommendation for approval of the acquisition, and the government offered no evidence to challenge such fact. The United States Tax Court, relying on treasury regulations applicable to years prior to 1966 and the legislative history of section 1504(d), concluded that the term:

> laws of such country . . . include[s] not only explicit constitutional or statutory provisions and explicit rules and regulations prescribed by controlling authorities, but also any existing practice or policy of such foreign country which results in a domestic corporation finding it necessary to maintain its foreign business and properties as a foreign corporation in order to operate in that country.[109]

On appeal, the Commissioner of Internal Revenue conceded that existing practice or policy could be incorporated into the term "laws of such country." The Sixth Circuit, after noting that because of the government's concession of the legal issue, the issue on appeal was purely factual, affirmed the Tax Court's decision, holding that "there is ample evidence to show that 'but for' incorporation, Trans Canada would not have been allowed to operate in Canada."[110]

In a maquiladora case, however, the disposition of this issue would focus on the reasons for forming or acquiring the Mexican corporation. If the Mexican corporation was formed or acquired to qualify for the maquiladora and/or debt substitution programs, then the section 1504(d) election should fail because the Mexican corporation would not have been formed solely to comply with Mexican laws as to title and operation of property. The issue raised in *U.S. Padding Corp.* (i.e., whether an administrative practice or procedure can qualify as a "law") should be irrelevant to this determination.

VI. CONCLUSION

This article has provided a discussion of the tax issues associated

108. 88 T.C. 177 (1987), *aff'd*, 865 F.2d 750 (6th Cir. 1989).
109. *Id.* at 187-88.
110. *U.S. Padding Corp.*, 865 F.2d at 751.

with debt/equity swaps as well as many of the United States income tax issues associated with the operation of maquiladoras, including I.R.C. § 482 concerns involving transfer pricing, intercompany services, intercompany expenses, intercompany receivables, and the intercompany use of tangible and intangible assets, the impact of I.R.C. § 1059A on correlative adjustments under I.R.C. § 482, and the I.R.C. § 1504(d) contiguous country election. There are clearly other United States tax issues which could surface in the formation and operation of maquiladoras, which have not been addressed in this article.[111]

111. Issues under I.R.C. § 263A, referred to as the "uniform capitalization rules," could surface if a United States company claims depreciation with respect to equipment used by its maquiladora, or if a United States company pays expenses of its maquiladora which are either directly or indirectly associated with the manufacturing or processing of property for sale. I.R.C. § 263A generally requires the capitalization as a part of inventory of all direct and indirect costs incurred with respect to the manufacturing or production of products for sale or resale.

Finally, the operation of a maquiladora could trigger subpart F (I.R.C. §§ 951 through 964) issues. Subpart F was designed primarily to prevent United States taxpayers from using related entities in tax haven countries to defer or avoid United States income taxes. As Mexico is not a tax haven country and as most maquiladoras do not involve the attempt to shift income to the maquiladora, most of the subpart F issues should be avoided, although certain issues may arise with respect to debt/equity swaps. I.R.C. § 956, however, which creates deemed dividends to shareholders of controlled foreign corporations with respect to the increases in the foreign corporation's investment of its earnings in the United States, may be a trap for the unwary.