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U.S. Taxation of U.S. Persons Doing Business or Investing in Mexico: An Overview.

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U.S. TAXATION OF U.S. PERSONS DOING BUSINESS OR INVESTING IN MEXICO: AN OVERVIEW

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I. Introduction

U.S. persons[1] who plan to do business in Mexico or invest in a new or existing Mexican business venture are faced with a myriad of U.S. federal income tax issues.[2] U.S. counsel advising U.S. persons regarding the ownership structure for a contemplated business or investment in Mexico should have a basic understanding of the U.S. system of international taxation. Although a working knowledge of Mexico's tax system is also helpful, Mexican counsel can provide the Mexican tax implications of doing business or investing in Mexico.

A review of the U.S. system of international taxation should begin with a consideration of the general pattern of federal income taxation of income earned abroad by U.S. persons. U.S. citizens, resident aliens, and U.S. corporations are subject to federal income taxation on their worldwide income.[3] To avoid double taxation of income earned abroad by U.S. persons, the United States allows,

1. For U.S. federal income tax purposes, a "U.S. person" means a U.S. citizen or resident, a domestic partnership, a domestic corporation, or a U.S. estate or trust. I.R.C. § 7701(a)(30) (1988). A "domestic corporation" is a corporation organized in the United States or under the laws of the United States or of any state, and a "foreign corporation" is a corporation which is not a domestic corporation. I.R.C. § 7701(a)(4)-(5) (1988); Treas. Reg. § 301.7701-5 (1967). A "domestic partnership" is a partnership organized in the United States or under the laws of the United States or of any state, and a "foreign partnership" is a partnership which is not a domestic partnership. I.R.C. § 7701(a)(4)-(5) (1988).

2. Unless otherwise noted, all references to federal income tax hereinafter designate the U.S. system.

3. I.R.C. § 1 (1988 & Supp. V 1993); I.R.C. § 11 (1988). In contrast, nonresident aliens and foreign corporations are generally subject to U.S. income taxation on U.S.-source investment and business income, as well as certain limited amounts of foreign-source income "effectively connected" with a U.S. business. I.R.C. §§ 2(d), 11(d), 871, 881, 882 (1988). For a summary of the U.S. system of taxation for U.S. persons doing business abroad and foreign persons doing business in the United States, see U.S. Treas. Dep't, Report to the Congress on the Sales Source Rules 3–4 (1993), *reprinted in* Daily Tax Rep., Jan. 19, 1993, [hereinafter Treasury Source Study] at L-1 (discussing sources of income); *see also* U.S. Treas. Dep't, International Tax Reform: An Interim Re-

subject to certain limitations, a tax credit for income taxes paid to foreign countries on foreign-source income.[4] The United States also allows certain U.S. corporate shareholders in foreign corporations to claim a credit, known as the indirect or deemed-paid credit, usually in the year the foreign corporation pays a dividend for foreign income taxes paid by the foreign corporation.[5]

The general pattern of federal income taxation gives rise to a host of issues that an attorney should consider when developing the structure for a business or investment in Mexico, including:

1. How is income "sourced" for federal income tax purposes?
2. Can a U.S. person obtain federal income tax benefits by using a foreign sales corporation when selling products to Mexican buyers?
3. Does the United States allow a tax credit for income taxes paid in Mexico and, if so, is the credit subject to any limitations?
4. If a U.S. person does business or invests in Mexico through a Mexican entity, how is the entity treated for federal income tax purposes?
5. If a U.S. corporation forms a Mexican corporation to do business in Mexico, can the U.S. corporation include the Mexican corporation in a consolidated federal income tax return?
6. What are the federal income tax consequences arising from a transfer of property by a U.S. person to a Mexican entity?
7. Can a U.S. shareholder in a foreign corporation defer U.S. taxation of foreign corporate earnings until the earnings are distributed?
8. What federal income tax issues arise from the valuation of goods for U.S. customs purposes and from the sale of goods between related parties?
9. Are U.S. citizens and resident aliens who are working in Mexico allowed to exclude certain foreign earned income for federal income tax purposes?

PORT 7-39 (1993), *reprinted in* DAILY TAX REP., Jan. 22, 1993, at L-1 (providing overview of federal income taxation of U.S. persons doing business abroad).

4. I.R.C. § 901 (1988 & Supp. V 1993); TREASURY SOURCE STUDY, *supra* note 3, at 3.

5. I.R.C. § 902 (1988); TREASURY SOURCE STUDY, *supra* note 3, at 4–5.

II. Sources of Income for U.S. Federal Income Tax Purposes

The source of a U.S. person's income for federal income tax purposes is an important consideration when determining federal income tax liability. For example, the United States allows a foreign tax credit for foreign income taxes paid, but the amount of the credit is limited to the precredit federal income tax that would be due on the taxpayer's foreign-source income.[6] Thus, in general, as a taxpayer's foreign-source income increases, the taxpayer's foreign tax credit limitation amount should correspondingly increase. As another example, the United States allows some of its citizens and residents who work abroad to exclude certain foreign source earned income from gross income for federal income tax purposes.[7] Since this exclusion applies only to foreign-source income, the source of income represents an important factor for U.S. persons working outside of the United States.

A. *Statutory Framework*

The Internal Revenue Code[8] generally divides income into two categories: (1) domestic-source income—income from sources within the United States; or (2) foreign-source income—income from sources outside the United States.[9] Sections 861 through 865 of the Code set forth the rules for determining whether the source of income is domestic or foreign for federal income tax purposes.[10] Section 861(a) lists specific types of gross income that are treated as income from sources within the United States, while Section

6. I.R.C. §§ 901(a), 904(a) (1988).

7. I.R.C. § 911 (1988).

8. All references herein to the "Internal Revenue Code" or to the "Code" refer to the Internal Revenue Code of 1986, as set forth in Title 26 of the United States Code, 1988 and Supplement V 1993. Unless otherwise noted, all "Section" references herein are to the Internal Revenue Code.

9. *See* I.R.C. §§ 861-65 (1988 & Supp. V 1993); Intel Corp. v. Commissioner, 100 T.C. 616, 621–22 (1993) (discussing statutory framework and legislative history underlying source rules). *See generally* 3 Boris I. Bittker & Lawrence Loken, Federal Income Taxation of Income, Estates and Gifts ¶ 70.1, at 70-1 to 70-3 (2d ed. 1991) (providing overview of source rules).

10. *Intel Corp.*, 100 T.C. at 621.

862(a) lists specific types of gross income considered income from sources outside the United States.[11]

Section 863 provides source rules for those items of gross income, expenses, losses, and deductions not listed in Sections 861(a) and 862(a).[12] Section 863(a) requires that items not enumerated in Sections 861(a) and 862(a) "be allocated or apportioned to sources within or without the United States."[13] This treatment is mandatory for determining the source of all items governed by Section 863.[14] Section 863, however, does not prescribe the specific sourcing rules for nonenumerated items. Instead, Section 863 gives the Secretary of the Treasury the authority to promulgate regulations encompassing such sourcing rules.[15]

Section 863(b) describes certain transactions that create "income partly [from] within and partly [from] without the United States."[16] The types of transactions described within Section 863(b) include income from the sale of inventory property produced by the taxpayer within the United States and sold outside the United States, or produced outside the United States and sold within the United States.[17] For taxable income arising from these types of transactions, Section 863(b) allows a portion of such taxable income to be sourced domestically as determined by "processes or formulas of general apportionment prescribed by the Secretary."[18] The remainder is deemed foreign-source income.[19]

Section 864 provides certain definitions and special rules for purposes of Sections 861 through 865.[20] Section 865 provides special sourcing rules for income from the sale of certain personal property.[21]

11. The specific types of income listed within Sections 861(a) and 862(a) include interest, dividends, compensation for personal services, rentals and royalties, income from sales of real property, and income from sales of inventory property. I.R.C. §§ 861(a), 862(a) (1988 & Supp. V 1993); *Intel Corp.*, 100 T.C. at 621–22.

12. *Intel Corp.*, 100 T.C. at 622.

13. I.R.C. § 863(a) (1988).

14. *Intel Corp.*, 100 T.C. at 623.

15. *Id.* at 623.

16. I.R.C. § 863(b) (Supp. V 1993).

17. I.R.C. § 863(b)(2) (Supp. V 1993).

18. *Id.*

19. *Id.*; *Intel Corp.*, 100 T.C. at 623.

20. I.R.C. § 864 (1988 & Supp. V 1993).

21. I.R.C. § 865 (1988 & Supp. V 1993).

B. *Sources of Specific Types of Income*

The most common types of income that require a determination of source include interest, dividends, personal services income, rents and royalties, income from real estate sales, income from sales of noninventory personal property, and income from sales of inventory.

1. Interest

Interest accrued on an obligation of a noncorporate U.S. resident or domestic corporation is generally considered interest from a domestic source.[22] However, an exception applies to interest accrued on an obligation of a resident alien or domestic corporation if such individual or corporation meets the 80 percent foreign business requirement of Section 861(c).[23] A resident alien or corporation generally meets the 80 percent foreign business requirement if, for the three prior tax years, at least 80 percent of the resident alien or domestic corporation's gross income was from a foreign source and was attributable to the active conduct of a trade or business in a foreign country.[24] If the obligee is a related person,[25] a special look-through rule applies, under which the source of the interest is generally based upon the source of income earned by the obligor.[26] Interest not derived from a domestic source is deemed foreign-source interest.[27]

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22. I.R.C. § 861(a)(1) (1988 & Supp. V 1993). The Treasury Regulations expand the scope of the type of obligors that are subject to this sourcing rule. Treasury Regulation § 1.861-2(a) provides that gross income from the United States includes interest from a "resident of the United States . . . ." Treas. Reg. § 1.861-2(a) (as amended in 1989). The term "resident of the United States," as used in this regulation, includes (1) an individual who at the time of payment of the interest is a resident of the United States, (2) a domestic corporation, (3) a domestic partnership which at any time during its tax year is engaged in a U.S. trade or business, or (4) a foreign corporation or foreign partnership which at any time during its tax year is engaged in a U.S. trade or business. *Id.*

23. I.R.C. § 861(a)(1)(A) (Supp. V 1993).

24. I.R.C. § 861(c)(1) (1988).

25. "Related person" is defined as an individual or business entity which controls or is controlled by the foreign corporation. I.R.C. § 954(d)(3) (1988).

26. I.R.C. § 861(c)(2) (1988) (limiting gross income percentages for related persons).

27. I.R.C. § 862(a)(1) (1988 & Supp. V 1993).

2. Dividends

The Code treats dividends distributed by a domestic corporation, and under certain circumstances, by a foreign corporation, as dividends from a domestic source.[28] A portion of the dividends paid by a foreign corporation is considered domestic-source income if more than 25 percent of a foreign corporation's gross income for the preceding three tax years was effectively connected with the conduct of a U.S. trade or business.[29] Dividends not arising from domestic sources are classified as foreign-source income.[30]

3. Personal Service Income

Income from personal services performed in the United States is from domestic sources unless (1) the services were performed by a nonresident alien who was not in the United States for more than ninety days during the tax year, (2) the service income does not exceed $3,000, and (3) the income is for services performed as an employee of, or a person under contract with, (a) a nonresident alien, foreign partnership, or corporation not engaged in a U.S. business, or (b) a U.S. citizen, U.S. resident, or domestic partnership or corporation if such services are for a foreign office.[31]

Income from personal services performed outside the United States is from a foreign source.[32] If the performance of services occurs both within and outside the United States, the allocation of services income is generally made on a time basis unless a more appropriate method of allocation exists.[33]

4. Rents and Royalties

Rents are from domestic sources if the rents are derived from the rental of real or tangible personal property situated in the United States.[34] Royalties are from domestic sources if the royalties are derived from the use of intangible property (for example,

28. I.R.C. § 861(a)(2) (1988 & Supp. V 1993).
29. I.R.C. § 861(a)(2)(B) (1988).
30. I.R.C. § 862(a)(2) (1988).
31. I.R.C. § 861(a)(3) (1988).
32. I.R.C. § 862(a)(3) (1988).
33. Treas. Reg. § 1.861-4(b)(1) (as amended by T.D. 7378, 1975-2 C.B. 272).
34. I.R.C. § 861(a)(4) (1988).

copyrights, patents, secret processes, or formulas) in the United States.[35]

Rents derived from the rental of real or tangible personal property situated outside the United States are from foreign sources.[36] Royalties are from foreign sources if the royalties are from the use of intangible property outside the United States.[37]

5. Real Estate Sales

Gain from the sale of real property located in the United States is considered domestic-source gain.[38] Gain from the sale of real property located outside the United States is considered foreign-source gain.[39]

6. Sales of Noninventory Personal Property

Section 865 provides rules for sourcing income from sales of personal property other than inventory property.[40] Income realized by a U.S. resident[41] from the sale (wherever effected) of noninventory personal property is generally treated as domestic-source income,[42] whereas income realized by a nonresident[43] is generally sourced outside the United States.[44] Section 865 provides special

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35. *Id.*

36. I.R.C. § 862(a)(4) (1988).

37. *Id. But cf.* I.R.C. § 367(d)(2)(C) (1988) (noting that deemed royalty income arising from certain transfers of intangibles by U.S. person to foreign corporation is treated as U.S.-source income).

38. I.R.C. § 861(a)(5) (1988).

39. I.R.C. § 862(a)(5) (1988).

40. *See* I.R.C. § 865 (1988 & Supp. V 1993). "Inventory property" refers to stock in trade or other property of a kind which would be included in the inventory of a taxpayer if on hand at the close of the tax year, or property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business. I.R.C. §§ 865(i)(1), 1221(1) (1988).

41. For purposes of § 865, a "U.S. resident" generally means (1) a U.S. citizen or a resident alien who does not have a tax home, as defined in § 911(d)(3), in a foreign country, (2) a nonresident alien who has a tax home in the United States, and (3) any corporation, trust, or estate that is a U.S. person. I.R.C. § 865(g)(1)(A) (1988).

42. I.R.C. §§ 865(a)(1), (b) (1988 & Supp. V 1993); *see also* I.R.C. § 865(c) (1988 & Supp. V 1993) (providing exception for depreciable personal property); I.R.C. § 865(d) (1988) (creating exception for intangibles).

43. For purposes of § 865, the term "nonresident" refers to a person other than a U.S. resident as defined in § 865(g)(1)(A). I.R.C. § 865(g)(1)(B) (1988). A U.S. citizen or resident alien will not be treated as a nonresident with respect to a sale of noninventory personal property unless an income tax of at least 10% of the gain on the sale is paid to a foreign country. I.R.C. § 865(g)(2) (1988).

44. I.R.C. § 865(a)(2) (1988); *see also* I.R.C. § 865(c)-(d) (1988 & Supp. V 1993).

rules for gain from the sale of depreciable personal property[45] and for income from the sale of intangibles.[46]

7. Sales of Inventory

The source of income derived from the sale of inventory property is generally determined by the place where all right, title, and interest in the inventory passes to the purchaser.[47] This general rule of sourcing income, often referred to as the "title-passage" rule, does not apply in cases where the apportionment rule of Section 863(b) applies. The apportionment rule will apply in cases in which (1) inventory is produced within and sold outside the United States,[48] (2) inventory is produced outside and sold within the United States,[49] or (3) inventory is purchased within a U.S. possession and sold within the United States.[50]

a. Title-Passage Rule

Under the title-passage rule, if a seller purchases (as opposed to produces) inventory within the United States and later resells the inventory within the United States, any income derived from the sale will be domestic-source income.[51] If, on the other hand, a seller purchases inventory within the United States and later resells the inventory outside the United States, any income from the sale will generally be foreign-source income.[52]

Under the title-passage rule, a sale of property is generally "consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the

45. *See* I.R.C. § 865(c) (Supp. V 1993).

46. I.R.C. at § 865(d) (Supp. V 1993).

47. I.R.C. § 861(a)(6), 862(a)(6), 865(b) (1988 & Supp. V 1993).

48. I.R.C. § 863(b)(2) (Supp. V 1993).

49. *Id.*

50. I.R.C. § 863(b)(3) (Supp. V 1993).

51. I.R.C. § 865(b) (1988); I.R.C. § 861(a)(6) (Supp. V 1993); Treas. Reg. § 1.861-7(c) (1960).

52. I.R.C. §§ 865(b), (e) (1988 & Supp. V 1993); I.R.C. § 862(a)(6) (Supp. V 1993). For nonresidents, as defined in I.R.C. § 865(g)(1)(B) (1988), if title to an inventory item passes outside the United States, then gain from the sale will be U.S.-source income if the gain is attributable to a U.S. office or U.S. fixed place of business of the seller. I.R.C. §§ 862(a)(6), 865(b), 865(e)(2)(A) (1988 & Supp. V 1993). This exception does not apply, however, if the inventory is sold for use, disposition, or consumption outside the United States and a foreign office or other fixed place of business materially participated in the sale. I.R.C. § 865(e)(2)(B) (1988).

buyer."[53] When the seller retains bare legal title, the "sale is deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss."[54]

An understanding of commercial law principles is essential in determining the place where title passes under the title passage test. Under conflict-of-law rules, foreign law may determine title passage in a cross-border sale.[55] If U.S. law applies, however, reference should be made to the Uniform Commercial Code (UCC)[56] as well as to common law regarding passage of title in the commercial context.[57]

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53. Treas. Reg. § 1.861-7(c) (1960); *see also* Kates Holding Co. v. Commissioner, 79 T.C. 700, 706 (1982) (stating that "the country in which personal property is sold is the place where rights, title, and interest pass from seller to buyer, or under certain circumstances, where beneficial ownership and risk of loss pass from seller to buyer"); Liggett Group, Inc. v. Commissioner, 58 T.C.M. (CCH) 1167, 1172 (1990) (finding that "[t]he regulations thus adopt a practical test of locating the point of a sale . . . the seller's retention of bare legal title will not affect the determination that a sale has taken place, so long as the buyer has assumed the beneficial ownership and risk of loss").

54. Treas. Reg. § 1.861-7(c) (1960).

55. TREASURY SOURCE STUDY, *supra* note 3, at 7.

56. State law generally determines the passage of rights and interests between parties, while federal law determines the effect of these rights and interests on income taxation. *Kates Holding Co.*, 79 T.C. at 707.

57. The United States is a party to the United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, 19 I.L.M. 671 [hereinafter Sales Convention], which entered into force for the United States on January 1, 1988. As of July 23, 1991, 26 countries, including Mexico, were signatories to the Sales Convention. Steven J. Stein, *Sales Contracts and the Impact of the U.N. Convention on the International Sale of Goods on U.S. Businesses*, *in* INTERNATIONAL COMMERCIAL AGREEMENTS, at 259 (PLI Com. Law & Practice Course Handbook Series No. 592, 1991).

Generally, the Sales Convention applies to contracts for the sale of goods between parties whose places of business are located in countries that are parties to the Sales Convention. *See* Sales Convention art. 1(1); TREASURY SOURCE STUDY, *supra* note 3, at 8. Under Article 6 of the Sales Convention, the parties to a sales contract may exclude the application of the Sales Convention by express contract language in the sales agreement. Sales Convention, *supra*, art. 6. Although the Sales Convention does not provide rules for determining title passage, Articles 66 through 70 of the Sales Convention contain rules regarding the time when the risk of loss passes in a sale transaction. *See* Sales Convention, *supra*, arts. 66–70.

The Internal Revenue Service (IRS) has suggested that the Sales Convention is a fairly significant development in the area of U.S. commercial law. The IRS has indicated that, in cases where the Sales Convention applies, the Sales Convention rather than state UCC law "is likely to be important in future international title passage issues." *Liggett Group*, 58 T.C.M. 1167 (1990), *action on decision*, 1991-03 (Feb. 11, 1991). For a further analysis of the impact of the Sales Convention on source of income, see Caroline A. Krass, Note, *A Guide to the Source of Income Rules for the Sale and Purchase of Inventory Property*, 45 TAX LAW. 857 (1992).

The UCC allows parties to a sale to determine the time and place of title passage. Absent an agreement, title passes upon performance of delivery.[58] Parties to a sales transaction may indicate their intent with respect to title passage on contractual documents such as order forms, invoices, and bills of lading.[59] Often, parties use shorthand terms such as "F.O.B.," "F.A.S.," "C.I.F.," and "Ex-Ship."[60] These terms often control how the income is sourced.

b. Apportionment Rules Under Section 863(b)

The source of income from the sale of inventory produced or manufactured in the United States and sold outside of the United States, or produced or manufactured outside the United States and sold within the United States, is determined under Section 863(b) and the regulations thereunder.[61] Such income is apportioned between U.S. and foreign sources using three examples prescribed in the Treasury Regulations.[62] These examples illustrate three methods of apportionment: (1) the "independent factory price" (IFP) method; (2) the "50-50" method; and (3) the "taxpayer's books" method. The examples, "instead of being merely illustrative," provide "operating rules" in applicable cases.[63]

Example 1 of Treasury Regulation Section 1.863-3(b)(2) sets forth the IFP method.[64] The IFP method treats the portion of taxable income attributable to production activity as arising in the country where the property is produced and the portion attributa-

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58. *See* U.C.C. §§ 2-401(1)–(2) (1991); TREASURY SOURCE STUDY, *supra* note 3, at 7.

59. U.C.C. § 2–401 (1991).

60. *See id.* §§ 2-319, 2-320 (setting out these terms for use in business transaction context).

61. *See* I.R.C. § 863(b) (Supp. V 1993); TREASURY SOURCE STUDY, *supra* note 3, at 7; *see also* Hunt v. Commissioner, 90 T.C. 1289, 1301-02 (1988) (concluding that "[i]n situations where income is generated from sales of personal property acquired by production or other processing, section 863(b)(2) generally sources the income partly to the place of production and partly to the place of sale").

62. Treas. Reg. § 1.863-3(b)(2), example 1 (1957); Temp. Treas. Reg. § 1.863-3T(b)(2), example 2 (1988); Treas. Reg. § 1.863-3(b)(2), example 3 (1957); *see* Intel Corp. v. Commissioner, 100 T.C. 616, 626–27 (1993) (explaining applicability of examples 1 and 2); Phillips Petroleum Co. v. Commissioner, 97 T.C. 30, 36-38 (1991) [hereinafter *Phillips I*] (discussing how examples 1 and 2 apply to circumstances of case); *see also* Rev. Rul. 88-73, 1988-2 C.B. 173.

63. Phillips Petroleum Co. v. Commissioner, 101 T.C. 78, 94 n.13 (1993) [hereinafter *Phillips II*].

64. Treas. Reg. § 1.863–3(b)(2), example 1 (1960).

ble to sales activity as arising in the country where the property is sold.[65] Under the IFP method, the portion of taxable income attributable to production activity is determined by reference to the price at which the property is sold to independent distributors[66] or other selling concerns. Once a taxpayer determines the portion of taxable income attributable to the production activity, the balance of taxable income from the sale is attributed to sales activity and presumed to arise outside the country of production.[67]

The United States Tax Court has held that, "as a matter of law, when all the factual prerequisites to the application of example (1) are present, that example's method of apportionment must be used."[68] The Internal Revenue Service (IRS) has taken the position that taxpayers must use the IFP method in any case in which an IFP exists, regardless of whether the sale was consummated through a distributing branch or department of the producer located in a different country from that in which production of goods occurred.[69] The Tax Court, however, recently rejected the IRS's position and held that taxpayers are required to use the IFP method only if an IFP exists with respect to the goods sold and if the sale is made through a selling or distributing branch or department located in a different country from where the factory is located or production of the goods occurred.[70]

Example 2, outlined in Temporary Treasury Regulation Section 1.863-3T(b)(2), illustrates the 50-50 method, which should be used whenever the IFP method does not apply.[71] The 50-50 method determines the source of 50 percent of the income based on the location of the taxpayer's property held or used in the production or sale of the inventory and the source of the other 50 percent based on the title-passage rule.[72]

65. TREASURY SOURCE STUDY, *supra* note 3, at 8.

66. The Tax Court recently stated that a "distributor" does not change the product it acquires; rather, it merely acts as a middleman in the sale of the property to the retailer or, in certain circumstances, to the ultimate consumer. *Phillips II*, 101 T.C. at 100.

67. *Id.*

68. *Phillips I*, 97 T.C. at 38; *see also* I.R.S. Notice 89-10, 1989-1 C.B. 631 (supplementing example 1 by setting forth circumstances in which IFP is considered to exist).

69. Rev. Rul. 88-73, 1988-2 C.B. 173-74.

70. *Intel Corp.*, 100 T.C. at 630.

71. Temp. Treas. Reg. § 1.863-3T(b)(2), example 2 (1960).

72. *Id.*; TREASURY SOURCE STUDY, *supra* note 3, at 8. For a discussion of the operation of example 2, see generally *Phillips II*, 101 T.C. at 104–105.

Example 3 of Treasury Regulation Section 1.863-3(b)(2) provides for a third method of apportionment by allowing the source of income to be determined by the method regularly employed in the taxpayer's books.[73] This method may be used only with the consent of the district director of the IRS.[74]

III. USE OF A FOREIGN SALES CORPORATION TO OBTAIN U.S. FEDERAL INCOME TAX BENEFITS ON FOREIGN SALES

U.S. exporters can obtain federal income tax benefits on foreign sales by using a foreign sales corporation (FSC) to assist in the sale. The Code permits U.S. exporters to create FSCs,[75] which are special foreign corporations whose export income is partially exempt from federal income taxes.[76] A U.S. person can create a FSC as a "regular" FSC or a "small" FSC.

A. *Regular FSC*

1. Organizational Requirements

To qualify as a regular FSC, a corporation must satisfy eight organizational requirements. Importantly, the corporation must elect FSC status.[77] The Code requires that the corporation be organized under the laws of a U.S. possession other than Puerto Rico or of a foreign country that has entered into an exchange-of-information

73. Treas. Reg. § 1.863-3(b)(2), example 3 (1960).

74. *Id.*

75. *See* I.R.C. §§ 921-927 (1988 & Supp. V 1993).

76. U.S. TREAS. DEP'T, THE OPERATION AND EFFECT OF THE FOREIGN SALES CORPORATION LEGISLATION 1 (1993), *reprinted in* DAILY TAX REP., Jan. 19, 1993, at L-32, [hereinafter TREASURY FSC STUDY]. As an alternative to a foreign sales corporation, an exporter should consider the use of an interest-charge domestic international sales corporation (DISC) in international sales. Under the interest-charge DISC rules, a U.S. corporation pays a small interest charge to the IRS on savings attributable to tax deferral. *See* I.R.C. §§ 991-997 (1988 & Supp. V 1993); 2 RUFUS RHOADES & MARSHALL J. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 4A.01[1][a]-[b] (1993).

77. I.R.C. § 922(a)(2) (1988). A corporation that selects treatment as a FSC (or small FSC) for its first tax year must make its election within 90 days after the beginning of that tax year. A corporation electing in any tax year other than its first tax year must make its election during the 90-day period immediately preceding the first day of that tax year. Corporations make such elections on Form 8279. I.R.C § 927(f)(1) (1988); Temp. Treas. Reg. § 1.921-1T(b) (as amended in 1994). The election to regular FSC status remains effective for subsequent years until revoked or terminated by failure to qualify as a FSC for five consecutive years. I.R.C. § 927(f)(3)(B) (1988).

agreement with the United States.[78] The corporation must have no more than twenty-five shareholders at any time during the tax year[79] and have no preferred stock outstanding during the tax year.[80] Additionally, the corporation must maintain a foreign office in a U.S. possession or a foreign country that has entered into an exchange-of-information agreement with the United States and must maintain certain books and records at its office located abroad.[81] The Code further requires that the corporation, at all times during the tax year, have a board of directors which includes at least one individual who is not a resident of the United States.[82] Membership in any controlled group of corporations that includes a domestic international sales corporation (DISC), interest-charge DISC, or a small FSC bars the corporation from regular FSC status.[83] The FSC must have the same taxable year as the taxable year of the shareholder with the highest percentage of voting stock.[84]

2. Contractual Arrangement Between U.S. Parent and FSC

A FSC may be operated as a "commission" FSC or as a "buy-sell" FSC. In a commission FSC arrangement, the FSC earns a commission on export sales effected by the U.S. parent corporation (or other related party).[85] Title to the exported property flows directly from the U.S. parent to the foreign buyer.[86] In a buy-sell

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78. I.R.C. §§ 922(a)(1)(A), 927(e)(3) (1988). The IRS periodically issues notices and news releases listing the foreign countries certified for FSC purposes. As of November 1992, the following countries met the FSC location requirements: Australia, Austria, Barbados, Belgium, Bermuda, Canada, Costa Rica, Cyprus, Denmark, Dominica, Dominican Republic, Egypt, Finland, France, Germany, Grenada, Honduras, Iceland, Ireland, Jamaica, Korea, Malta, Marshall Islands, Mexico, Morocco, the Netherlands, New Zealand, Norway, Pakistan, Philippines, St. Lucia, Sweden, and Trinidad and Tobago. Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands qualified as U.S. possessions. TREASURY FSC STUDY, *supra* note 76, at 6 n.13.

79. I.R.C. § 922(a)(1)(B) (1988).

80. I.R.C. § 922(a)(1)(C) (1988).

81. I.R.C. § 922(a)(1)(D) (1988).

82. I.R.C. § 922(a)(1)(E) (1988).

83. I.R.C. § 922(a)(1)(F) (1988); Temp. Treas. Reg. § 1.921-2(b) (1987).

84. I.R.C. § 441(h)(1) (1988). If two or more shareholders have the highest percentage of voting power, the FSC's taxable year is the taxable year of any such shareholders. I.R.C. § 441(h)(2) (1988).

85. TREASURY FSC STUDY, *supra* note 76, at 3.

86. F. Jan Carnevale & Robert S. Giusti, *FSC Regulations: Qualifying Transactions, Foreign Presence, Foreign Management and Foreign Economic Process Requirements*, 16 TAX MGMT. INT'L J. 175, 176 (1987).

FSC arrangement, title to the export property passes from the U.S. parent to the FSC and then to the foreign buyer.[87] According to the United States Department of the Treasury, most FSCs are commission FSCs.[88]

3. Type of FSC Income Eligible for U.S. Tax Benefits

The "foreign trade income" (FTI) of a FSC represents the only type of income earned by the FSC eligible for U.S. tax benefits.[89] A buy-sell FSC earns FTI by purchasing export property from a related supplier and reselling it.[90] In contrast, a commission FSC earns FTI in the form of a commission by assisting the related supplier in the sale of export property.[91]

The FTI equals the gross income attributable to foreign trading gross receipts (FTGRs).[92] For a buy-sell FSC, FTGRs are the foreign trading gross receipts of the FSC as reduced by cost of goods sold.[93] FTGRs of a commission FSC are the commissions received by the FSC.[94] FTGRs generally include gross receipts from the sale of export property by the FSC, or by any seller for whom the FSC acts as a commission agent.[95] Additionally, FTGRs include gross receipts from the performance of certain services by the FSC that are related and subsidiary to the disposition of export property by the FSC or with respect to which the FSC acts as a commission agent.[96]

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87. *See* I.R.C. § 924(a) (1988); Temp. Treas. Reg. § 1.924(a)-1T(b) (1987); TREASURY FSC STUDY, *supra* note 76, at 3. *See generally* F. Jan Carnevale & Robert S. Giusti, *FSC Regulations: Qualifying Transactions, Foreign Presence, Foreign Management and Foreign Economic Processes Requirements*, 16 TAX MGMT. INT'L J. 175 (1987); F. Jan Carnevale, *Foreign Sales Corporations: An Analysis of New Regulations on Intercompany Pricing and Related Matters*, 16 TAX MGMT. INT'L J. 255 (1987).

88. TREASURY FSC STUDY, *supra* note 76, at 3.

89. Temp. Treas. Reg. § 1.923-IT(a) (1987).

90. *Id.*; TREASURY FSC STUDY, *supra* note 76, at 3.

91. Temp. Treas. Reg. § 1.923-1T(a) (1987); TREASURY FSC STUDY, *supra* note 76, at 3.

92. Temp. Treas. Reg. § 1.923-1T(a) (1987); Treas. Reg. § 1.921-2(e) (1987).

93. Temp. Treas. Reg. § 1.923-1T(a) (1987); TREASURY FSC STUDY, *supra* note 76, at 8.

94. Temp. Treas. Reg. § 1.923-1T(a) (1987); TREASURY FSC STUDY, *supra* note 76, at 8–9.

95. Temp. Treas. Reg. § 1.924(a)-1T(b) (1987).

96. *Id.* § 1.924(a)-1T(d).

Under the Code's FSC rules, "export property" is property that: (1) is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) is held primarily for sale, lease, or rental, in the ordinary course of a trade or business, to a FSC or any other person for direct use, consumption, or disposition outside the United States; (3) has a fair market value no more than 50 percent of which is attributable to articles imported into the United States; and (4) is not sold, leased, or rented by a FSC, or with a FSC as commission agent, to another FSC that is a member of the same controlled group as the FSC.[97] Categories of property expressly excluded from this definition of export property are patents, inventions, models, designs, formulas, or processes (whether or not patented), goodwill, trademark, trade brands, and certain other intellectual and intangible property.[98] Although some copyrights, such as copyrights on books or computer software, do not constitute export property, a copyrighted article, such as a book or standardized mass-marketed computer software, is export property if it is not accompanied by a right to reproduce for external use and if it otherwise satisfies the definition of export property. The software may be on any medium, including magnetic tape, punched cards, disks, semiconductor chips, or circuit boards.[99]

4. Foreign Management and Foreign Economic Processes Requirements

To be treated as having FTGRs for a tax year, a FSC must satisfy a "foreign management" requirement and a "foreign economic processes" requirement. Under the foreign management requirement, the FSC must conduct all board of directors and shareholders' meetings outside the United States.[100] Furthermore, the principal bank account of the FSC must be maintained at all times during the tax year in a foreign country which is a party to an exchange-of-information agreement with the United States.[101] The FSC must also disburse dividends, legal and accounting fees, and

97. I.R.C. § 927(a)(1) (1988); Temp. Treas. Reg. § 1.927(a)-1T(a)(4) (1987).

98. Temp. Treas. Reg. § 1.927(a)-1T(f)(3) (1987).

99. *Id.*; *see also* Priv. Ltr. Rul. 92-10-015 (Dec. 6, 1991) (ruling that certain discs imprinted with computer software qualify as export property).

100. I.R.C. § 924(c)(1) (1988).

101. I.R.C. § 924(c)(2) (1988).

salaries of officers and board of directors from bank accounts maintained outside the United States.[102]

Under the foreign economic processes requirement, certain economic processes with respect to sales transactions must occur outside the United States.[103] The two principal categories of economic processes are sales activities and foreign direct cost activities. A FSC's sales activities are performed outside the United States with respect to a transaction if the FSC has participated outside the United States in the solicitation, negotiation, or making of the contract relating to such transaction.[104]

The foreign direct cost activities of a FSC are performed outside the United States if 50 percent or more of the total direct costs (the five direct cost activities enumerated in Section 924(e)) incurred by the FSC are attributable to activities performed outside of the United States, or if 85 percent or more of the total direct costs incurred by the FSC (in two of the five categories of direct cost activities) are attributable to activities performed outside of the United States.[105] The five direct cost activities are: (1) advertising and sales promotion; (2) processing customer orders and arranging for delivery of export property; (3) transportation of the property to the customer; (4) determining and transmitting the final invoice or statement of account and receiving payment; and (5) assumption of credit risk.[106]

5. Pricing Rules

A portion of a FSC's FTI is treated as foreign-source income not effectively connected with the conduct of a U.S. trade or business and is therefore excluded from the FSC's gross income for federal income tax purposes.[107] The exact amount excluded from gross income depends upon the transfer pricing used between the U.S. parent and the FSC.[108] The Code provides two principal methods, administrative pricing rules and arm's-length transfer pricing rules,

102. I.R.C. § 924(c)(3) (1988).
103. I.R.C. § 924(d) (1988).
104. I.R.C. § 924(d)(1)(A) (1988); Treas. Reg. § 1.924(d)-1(c) (1987).
105. I.R.C. § 924(d) (1988).
106. I.R.C. §§ 924(d)(3)(A), 924(e) (1988).
107. I.R.C. § 921(a) (1988).
108. TREASURY FSC STUDY, *supra* note 76, at 9.

for use in determining the taxable income of the U.S. parent and the FSC.[109]

Under the administrative pricing rules, the FSC may share a percentage of the profit on the sale with its related supplier.[110] Alternatively, the FSC may take a percentage of gross receipts as its share of combined income.[111] Under the first alternative, 23 percent of the combined taxable income is allocated to the FSC and 77 percent of combined taxable income is allocated to the U.S. parent or other related supplier.[112] Under the second administrative pricing rule, the FSC's share of combined taxable income is 1.83 percent of gross receipts. However, this amount may not exceed twice the amount calculated under the combined taxable income method.[113]

Once taxable income is allocated between the FSC and the related supplier under the administrative pricing rules, sixteen twenty-thirds (fifteen twenty-thirds in the case of corporate shareholders)[114] of the combined taxable income allocated to the FSC is not subject to U.S. corporate taxation.[115] The portion that is subject to federal income taxation is seven twenty-thirds (eight twenty-thirds in the case of corporate shareholders) of combined taxable income.[116]

As an alternative to the administrative pricing rules, a FSC, subject to certain limitations, may charge its U.S. parent an arm's-length transfer price. If the FSC uses an arm's-length transfer price, 32 percent (30 percent in the case of corporate shareholders)[117] of the FSC's FTI is not subject to U.S. corporate taxation.[118]

6. Treatment of Distributions to U.S. Parent

A U.S. corporation may claim a 100 percent dividends-received deduction for dividends received from a FSC that are distributed

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109. *See* I.R.C. § 925(a) (1988).
110. I.R.C. § 925(a)(2) (1988).
111. I.R.C. § 925(a)(1) (1988).
112. I.R.C. § 925(a)(2) (1988).
113. I.R.C. § 925(a)(1) (1988).
114. I.R.C. § 291(a)(4) (1988).
115. I.R.C. § 923(a)(3) (1988).
116. *Id.*
117. I.R.C. § 291(a)(4) (1988).
118. I.R.C. § 923(a)(2) (1988).

out of earnings and profits attributable to exempt foreign trade income.[119] A 100 percent dividends-received deduction is also allowed for distributions of nonexempt foreign trade income, as determined under the administrative pricing rules, and for effectively connected foreign trade income, as determined using arm's-length transfer prices.[120]

B. *Small FSCs*

As an alternative to a regular FSC, a small exporter may consider using a small FSC. A small FSC must meet the eight organizational requirements necessary for a regular FSC, elect small FSC status on IRS Form 8279, and avoid membership in a controlled group of corporations that includes a regular FSC.[121] The foreign management and foreign economic process requirements applicable to a regular FSC do not apply to a small FSC, but a small FSC is limited to $5 million in FTGRs for purposes of the exempt foreign trade income computation.[122] Any foreign trading gross receipts of a small FSC for the tax year that exceed $5 million are not considered in determining the exempt foreign trade income of the corporation.[123] If the foreign trading gross receipts of a small FSC exceed the $5 million limitation, the corporation can select those receipts coming within the $5 million limitation.[124]

IV. ALLOWANCE OF FOREIGN TAX CREDIT IN THE UNITED STATES

A. *Direct Foreign Tax Credit*

Whether a foreign tax credit is allowed in the United States for taxes paid in Mexico represents an important issue for U.S. persons subject to tax in Mexico.

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119. I.R.C. § 245(c) (1988).

120. I.R.C. §§ 245(c)(1)-(2), 927(d)(6) (1988); TREASURY FSC STUDY, *supra* note 76, at 10.

121. I.R.C. § 922(b) (1988).

122. I.R.C. § 924(b)(2)(A) (1988).

123. I.R.C. § 924(b)(2)(B)(i) (1988).

124. I.R.C. § 924(b)(2)(B)(ii) (1988).

1. Section 901 Credit

Section 901 of the Code allows U.S. taxpayers[125] to claim foreign income taxes paid or accrued as a credit against federal income taxes due.[126] To qualify for the foreign tax credit, a tax paid must constitute (1) an income tax, a war profits tax, or an excess profits tax or (2) a tax in lieu of a tax on income, war profits, or excess profits.[127] A foreign levy is a "tax" if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. A foreign levy is not a tax to the extent a person receives a specific economic benefit in exchange for payment of the levy.[128]

For a foreign levy to be considered an "income" tax, two elements must be met. First, the levy must constitute a tax. Additionally, the "predominant character of that tax" must be "that of an income tax in the U.S. sense."[129] To satisfy the predominant character requirement, the tax must be likely to reach net gain in the normal circumstances in which it applies, and liability for the tax cannot depend on the availability of a credit for the tax against income tax liability to another country.[130]

The United States-Mexico Income Tax Treaty (U.S.-Mexico Treaty),[131] which is generally effective for tax years beginning on or after January 1, 1994, addresses the issue of whether the Mexican

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125. The United States allows a foreign tax credit for (1) U.S. citizens and domestic corporations, (2) residents of the United States or Puerto Rico, (3) nonresident alien individuals and foreign corporations under certain circumstances, and (4) individual partners or individual beneficiaries of an estate that are described in the foregoing categories. I.R.C. § 901(b) (1988); *see also* I.R.C. § 1373(a) (1988) (treating S corporation as partnership and its shareholders as partners).

126. I.R.C. § 901 (1988 & Supp. V 1993). In lieu of claiming a foreign tax credit for foreign income taxes paid or accrued, a U.S. taxpayer may elect to claim a deduction for the taxes. *Id.* at § 275(a) (1988 & Supp. V 1993).

127. I.R.C. §§ 901(a)-(b), 903 (1988).

128. Treas. Reg. § 1.901-2(a)(2)(i) (1983).

129. *Id.* § 1.901-2(a)(1).

130. *Id.* § 1.901-2(a)(3); *see also id.* § 1.901-2(b)(1) (providing circumstances under which foreign tax is likely to reach net gain).

131. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes, Sept. 18, 1992, U.S.-Mex., S. Treaty Doc. No. 7, 103d Cong., 1st Sess. (1993), *reprinted in* 92 TNT 191-7, TAX NOTES TODAY, Sept. 21, 1992, *available in* LEXIS, Taxana Library, TNT File [hereinafter U.S.-Mexico Treaty].

income tax is a creditable tax.[132] Before the U.S.-Mexico Treaty took effect, the Mexican income tax was generally regarded as a creditable tax for U.S. federal income tax purposes. Article 24 of the U.S.-Mexico Treaty confirms this understanding by providing that the United States allows a foreign tax credit for income taxes paid to Mexico by or on behalf of U.S. persons.[133] The U.S. foreign tax credit allowed by the U.S.-Mexico Treaty is computed in accordance with the provisions and limitations of U.S. tax law.[134]

According to the IRS, the Mexican assets tax does not qualify as a creditable income tax for purposes of Section 901 because the tax is not likely to reach net gain under normal circumstances.[135] The U.S.-Mexico Treaty does not change this conclusion.[136]

2. Section 903 Credit

In addition to the permissible credit under Section 901, Section 903 allows a foreign tax credit for a tax paid in lieu of a tax on income, war profits, or excess profits that is otherwise generally

132. Article 29 of the U.S.-Mexico Treaty, provides that the United States and Mexico will notify each other after satisfying their respective constitutional and statutory requirements for the activation of the Treaty. U.S.-Mexico Treaty, *supra* note 131, art. 29, para. 1. On the date of receipt of the last notification, the Treaty would enter into force. On December 28, 1993, the United States and Mexico exchanged diplomatic notes (presumably containing the required notices under Article 29), and on December 29, 1993, the Treasury Department announced that the Treaty had become effective. *U.S. Treasury Dept. News Release*, 93 TNT 264-18, TAX NOTES TODAY, Dec. 30, 1993, *available in* LEXIS, Taxana Library, TNT file. For a comprehensive discussion of the U.S.-Mexico Treaty from the perspective of two U.S. attorneys who advised the Mexican government regarding negotiation of the treaty, see Greer L. Phillips & John R. Washlick, *The New Income Tax Convention Between the United States of America and the United Mexican States,* 92 TNT 234, TAX NOTES TODAY, Nov. 23, 1992, *available in* LEXIS, Taxana Library, TNT file.

133. U.S.-Mexico Treaty, *supra* note 131, at art. 24(i).

134. JOINT COMM. ON TAX'N, EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND MEXICO, 103d Cong., 1st Sess. 92 (1993), *reprinted in* DAILY TAX REP., Oct. 28, 1993, at L-1 [hereinafter JOINT COMMITTEE EXPLANATION]. Thus, for example, the credit granted by the United States is subject to the overall foreign tax credit limitation, the alternative minimum foreign tax credit limitation, and the limitations imposed on each separate foreign tax credit category. *Id.* For additional legislative history underlying the U.S.-Mexico Treaty, see SENATE FOREIGN NATIONS COMM., REPORT ON THE 1992 U.S.-MEXICO INCOME TAX TREATY AND PROTOCOL, S. EXEC. REP. NO. 20, 103d Cong., 1st Sess. (1993), *reprinted in* 93 TNI 228-7, TAX NOTES INT'L, Nov. 29, 1993, *available in* LEXIS, Taxana Library, TXNINT file.

135. Rev. Rul. 91-45, 1991-2 C.B. 336, 337.

136. *See* U.S.-Mexico Treaty, *supra* note 131, art. 24, paras. 1, 3(b).

imposed by a foreign country.[137] A foreign levy constitutes a tax in lieu of an income tax if the levy is a tax and if the tax is imposed in substitution for, and not in addition to, an income tax.[138]

As interpreted by the IRS, the Mexican assets tax does not qualify as an in-lieu-of tax for purposes of Section 903.[139] The U.S.-Mexico Treaty does not alter this conclusion.[140]

3. Section 904 Limitation on Foreign Tax Credit

If the U.S. taxpayer elects to claim a credit for foreign income taxes paid or accrued to a foreign country, the amount of credit allowed is limited to the amount of U.S. income tax potentially owed on the foreign-source income absent the credit.[141] Section 904 contains a limitation which ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The Section 904 limitation is computed for the tax year as follows:

$$\text{Pre-credit U.S. tax} \times \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}^{142}}$$

If the foreign income tax exceeds the limitation amount, the taxpayer can carry the excess credits back two years and forward five years. The taxpayer may claim the credits against income taxes in those years, subject to the limitation in the carryback or carryover year.[143]

Generally, the foreign tax credit limitation is computed on a worldwide consolidated basis. This limitation, however, is calculated separately for certain "baskets" of income in order to prevent the crediting of foreign taxes on traditionally high-taxed foreign-source income against the residual U.S. tax on traditionally low-taxed foreign-source income.[144]

A taxpayer is required to compute a separate foreign tax credit limitation for each of the following eight baskets of income re-

137. I.R.C. § 903 (1988).
138. Treas. Reg. §§ 1.903-1(a), 1.903-1(b)(1) (1983).
139. Rev. Rul. 91-45, 1991-2 C.B. 336, 337–38.
140. U.S.-Mexico Treaty, *supra* note 131, at art. 24.
141. *See* I.R.C. § 904(a) (1988).
142. *Id.*
143. *See* I.R.C. § 904(c) (1988); TREASURY SOURCE STUDY, *supra* note 3, at 5.
144. *See generally* JOINT COMMITTEE EXPLANATION, *supra* note 134, at 35.

ceived or accrued in a tax year: (1) passive income;[145] (2) high withholding tax interest;[146] (3) financial services income;[147] (4) shipping income;[148] (5) certain DISC dividends;[149] (6) taxable income attributable to foreign trade income within the meaning of Section 923(b);[150] (7) certain FSC distributions;[151] and (8) dividends from each Section 902 noncontrolled corporation.[152] All other income falls into the general limitation income basket, which also requires a separate application of the foreign tax credit limita-

145. I.R.C. § 904(d)(1)(A) (1988). "Passive income" generally includes dividends, interest, certain rents and royalties, annuities, and gains from certain property transactions. I.R.C. § 904(d)(2)(A)(i) (1988); Treas. Reg. § 1.904-4(b) (as amended in 1992). Passive income does not include any income described in the other separate limitation baskets, certain export financing interest, any high-taxed income, any foreign oil and gas extraction income, or active business rents and royalties from unrelated persons. I.R.C. § 904(d)(2)(A)(iii) (Supp. V 1993); Treas. Reg. § 1.904-4(b)(1) (as amended in 1992); *see also* I.R.C. § 904(d)(2)(B) (1988) (defining "high-taxed income"); I.R.C. § 904(d)(2)(G) (1988) (defining "export financing interest").

146. I.R.C. § 904(d)(1)(B) (1988). "High withholding tax interest" basically means any interest, except export financing interest, that is subject to a foreign gross withholding or gross-basis tax of at least five percent. I.R.C. § 904(d)(2)(B) (1988). An interest that is not a high withholding tax interest because it is export financing interest is usually general limitation income. However, if such interest is received by a financial services entity, it is financial services income. I.R.C. § 904(d)(2)(C)(i)(III) (1988).

147. I.R.C. § 904(d)(1)(C) (1988). "Financial services income" generally includes any income except high withholding tax interest and certain dividends and interest which is (1) derived in the active conduct of a banking, financing or similar business, (2) passive income, or (3) export financing interest which is subject to a foreign gross-withholding or gross-basis tax of at least five percent. I.R.C. § 904(d)(2)(C) (1988).

148. I.R.C. § 904(d)(1)(D) (1988). "Shipping income" generally includes income derived in connection with the use, hiring, or leasing of any aircraft or vessel in foreign commerce. It also includes income from the sale or other disposition of these aircraft or vessels. Shipping income that is both shipping and financial services income is treated as financial services income. I.R.C. §§ 904(d)(2)(D), 954(f) (1988 & Supp. V 1993).

149. I.R.C. § 904(d)(1)(F) (1988). "DISC dividends" consist of dividends from an interest-charge DISC or former DISC to the extent they are attributable to qualified export receipts. *Id.*

150. I.R.C. § 904(d)(1)(G) (1988).

151. I.R.C. § 904(d)(1)(H) (1988 & Supp. V 1993). "FSC distributions" include distributions out of earnings and profits attributable to foreign trade income. *Id.*

152. I.R.C. § 904(d)(1)(E) (1988). If a noncontrolled § 902 corporation pays dividends eligible for the indirect foreign tax credit, a separate basket applies to the dividends received. *Id.* A noncontrolled § 902 corporation includes any foreign corporation with respect to which a taxpayer owns between 10 and 50% of the voting stock. I.R.C. § 904(d)(2)(E)(i) (1988). Under this limitation, foreign taxes associated with that dividend income may offset U.S. tax only on dividend income from that corporation. I.R.C. § 904(d)(2)(E) (1988); Treas. Reg. § 1.904-4(g) (as amended in 1992).

tion.[153] Thus, the potential exists for the Section 904(a) limitation formula to be applied separately to nine different baskets of income.

For foreign tax credit limitation purposes, if a taxpayer realizes a foreign loss when figuring taxable income in a separate basket, and the taxpayer has income in one or more of the separate baskets, the taxpayer must first reduce the income in other baskets by the foreign loss before offsetting domestic-source income.[154] Foreign losses must be allocated among separate baskets in the same proportion as each basket's income bears to total foreign income.[155] When a separate basket loss was allocated to income from any other basket and the loss basket has income for a subsequent year, the income in subsequent years is recharacterized as income from the other basket in proportion to the prior reductions for allocable losses.[156]

Taxpayers with losses in separate baskets and no taxable income in any basket, or with losses remaining after allocating foreign losses to other separate baskets, suffer an "overall foreign loss."[157] If a taxpayer has an overall foreign loss for a tax year, the taxpayer's foreign-source income in later years is treated as domestic-source income to the extent of the lesser of the amount of the overall foreign loss for the prior year or 50 percent (or such larger percent as the taxpayer may choose) of the taxpayer's foreign source taxable income.[158] The balance is suspended and carried forward.[159]

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153. I.R.C. § 904(d)(1)(I) (Supp. V 1993); Treas. Reg. § 1.904-4(a) (as amended in 1992).

154. I.R.C. § 904(f)(5)(A) (1988).

155. I.R.C. § 904(f)(5)(B) (1988).

156. I.R.C. § 904(f)(5)(C) (1988).

157. I.R.C. § 904(f)(2) (1988); *see also* 2 RUFUS RHOADES & MARSHALL J. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 5.04[4][a] (1993) (explaining operation of overall foreign loss rule).

158. I.R.C. § 904(f)(1) (1988).

159. *Cf.* Treas. Reg. § 1.904(f)-1(b) (1987); *id.* § 1.904(f)-2(a). Although the cited regulations do not reflect the changes enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, the principles in these regulations should apply as well to the post-1986 Act law. *See* 2 RUFUS RHOADES & MARSHALL J. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 5.04[4][a] (1993).

B. *Indirect Foreign Tax Credit*

1. Section 902

Under Section 902 of the Code, domestic corporations are generally entitled to claim a foreign tax credit for taxes paid (and, in certain circumstances, taxes deemed paid) by certain first-, second-, and third-tier foreign corporations in which the domestic corporation possesses an ownership interest.[160] Foreign taxes deemed paid under Section 902 are treated under Section 901 in the same manner as foreign income taxes paid directly by the domestic corporation and face the same limitations.[161]

A domestic corporation is allowed to claim an indirect foreign tax credit for foreign income taxes paid (and, in certain circumstances, taxes deemed paid) by a first-tier foreign corporation if (1) the domestic corporation receives a dividend from the foreign corporation and (2) the domestic corporation owns 10 percent or more of the voting stock of the foreign corporation at the time it receives the dividend.[162] If a domestic corporation meets these threshold requirements, the domestic corporation is deemed to have paid the amount of post-1986 foreign income taxes paid or deemed paid by the foreign corporation as determined under the following formula:

$$\frac{\text{Dividend received by the U.S. shareholder}}{\text{Post-1986 undistributed earnings of foreign corporation}} \times \begin{array}{c}\text{Post-1986 foreign}\\ \text{income taxes paid}\\ \text{and deemed paid by}\\ \text{first-tier}\\ \text{foreign corporation}\end{array} = \begin{array}{c}\text{Amount of first-tier}\\ \text{foreign corporations'}\\ \text{foreign income taxes}\\ \text{deemed paid by}\\ \text{domestic}\\ \text{corporation}^{163}\end{array}$$

For purposes of computing the amount of the indirect foreign tax credit, "dividends" are defined pursuant to Section 316 of the Code.[164] The term "post-1986 undistributed earnings" means cur-

160. I.R.C. § 902 (1988).

161. I.R.C. § 901(a) (1988).

162. I.R.C. § 902(a) (1988).

163. *Id.*

164. Under § 316, distributions by a corporation to its shareholders are deemed to be taken first from current earnings and profits, then from accumulated earnings and profits. Treas. Reg. § 1.902-1(a)(6) (as amended in 1979).

rent earnings and profits[165] unreduced by current-year distributions plus post-1986 accumulated earnings and profits.[166] The term "post-1986 foreign income taxes" means the sum of: (1) the foreign income taxes for the tax year of the foreign corporation in which the dividend is distributed and (2) the foreign income taxes for prior tax years beginning after 1986, to the extent such foreign taxes were not deemed-paid with respect to dividends distributed by the foreign corporation in prior tax years.[167] If a domestic corporation acquired 10 percent or more of the voting stock of a foreign corporation after December 31, 1986, the post-1986 undistributed earnings and the post-1986 foreign income taxes of the foreign corporation are determined by considering the period beginning with the tax year of acquisition.[168]

The U.S.-Mexico Treaty confirms that the United States will allow a deemed-paid credit to U.S. corporate shareholders receiving dividends from Mexican companies if the U.S. corporate shareholder owns 10 percent or more of the voting stock of the Mexican company.[169] The U.S.-Mexico Treaty and Treasury Department Technical Explanation accompanying the Treaty also clarify the extent to which a credit is allowed for the tax imposed by Mexico on certain corporate distributions. Mexico imposes a tax on corporate distributions of profit to the extent that the distribution is taken from corporate earnings which were not subject to Mexican corporate taxation. The tax is imposed on the corporation at the regular corporate rate.[170] Article 24(1) of the Treaty provides that, for purposes of the U.S. foreign tax credit, Mexico's tax on distributed profits is considered an income tax only to the extent that it is imposed on previously untaxed earnings and profits as calculated

165. The earnings and profits of the foreign corporation should be computed under the special rules of §§ 964 and 986 of the Code and the Regulations thereunder. I.R.C. § 902(c)(1) (1988).

166. I.R.C. § 902(c)(1) (1988); *see also* I.R.C. § 902(c)(6) (1988) (providing special rules for dividends paid from earnings and profits accumulated in years prior to 1987).

167. I.R.C. § 902(c)(2) (1988).

168. I.R.C. § 902(c)(3) (1988).

169. U.S.-Mexico Treaty, *supra* note 131, art. 24, para. 1(b).

170. U.S. TREAS. DEP'T, TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992, 93 TNT 224-19, TAX NOTES TODAY, at 44, Oct. 27, 1993, *available in* LEXIS, Taxana Library, TNT file [hereinafter TREASURY DEPARTMENT EXPLANATION].

under U.S. tax accounting rules.[171] The Treasury Department Technical Explanation confirms that Mexico's tax on distributed profits is creditable as an indirect or deemed-paid tax under the principles of Section 902 since the tax is imposed on the corporation rather than the shareholder.[172]

2. Section 78 Gross-Up Requirement

Under Section 78 of the Code, a domestic corporation that claims an indirect foreign tax credit for deemed-paid taxes must include the amount of the credit in gross income.[173] This rule is known as the "gross-up requirement."

V. Classification of a Foreign Entity for Purposes of U.S. Federal Income Taxation

Classifying a Mexican entity as a corporation or partnership for federal income tax purposes constitutes an important consideration for a U.S. investor in the entity. Such classification determines whether losses flow through to the investor, whether a U.S. person will be entitled to a direct or indirect foreign tax credit for foreign income taxes paid or accrued, and whether the Code's anti-deferral rules pertinent to U.S. shareholders in foreign corporations will apply to a U.S. person. The Code prescribes certain categories within which various organizations fall for purposes of federal income taxation, including associations, which are taxable as corporations, and partnerships.[174]

For federal income tax purposes, a corporation has the following major characteristics: (1) associates; (2) an objective to transact business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.[175] The presence or absence of the fore-

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171. U.S.-Mexico Treaty, *supra* note 131, art. 24, para. 1; Treasury Department Explanation, *supra* note 170, at 44. The Explanation states that, by agreeing to credit the tax only to the extent it is imposed on earnings and profits as calculated for U.S. purposes, the United States is seeking to ensure that creditability is consistent with prevailing U.S. principles, which only permit credits for those foreign taxes that reach net income. Treasury Department Explanation, *supra* note 170, at 44.

172. Treasury Department Explanation, *supra* note 170, at 44.

173. I.R.C. § 78 (1988).

174. Treas. Reg. § 301.7701-1(b) (as amended in 1977).

175. *Id.* § 301.7701-2(a)(1) (as amended in 1993).

going corporate characteristics determines the classification of an organization.[176] Since associates and a profit objective represent common factors in both corporations and partnerships, these characteristics are not material in distinguishing between the two.[177] Accordingly, the determination of whether an organization possessing these two characteristics should be treated for tax purposes as a partnership or a corporation depends on the existence of centralized management, continuity of life, free transferability of interests, and limited liability.[178]

To classify an unincorporated organization, whether foreign or domestic, as a corporation for U.S. federal income tax purposes, the organization must possess more corporate characteristics than noncorporate characteristics.[179] In the case of a foreign unincorporated entity, the local law of the foreign jurisdiction must be applied in determining the legal relationships of the members of the organization among themselves, the organization's relationship with the public at large, and the members' interest in the assets of the organization.[180]

In Revenue Ruling 88-8,[181] the IRS addressed the classification of foreign entities for federal income tax purposes. The IRS determined that an entity organized under foreign laws is classified for federal tax purposes solely on the basis of the classifying characteristics used in the United States. Additionally, a foreign entity is not classified as a corporation under Revenue Ruling 88-8 unless such entity has more corporate than noncorporate characteristics.[182] The applicable foreign statute and the entity's organization agreements must be examined to determine the entity's classifica-

176. *Id.*

177. *Id.* § 301.7701-2(a)(2).

178. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1993).

179. *Id.* § 301.7701-2(a)(3); *see also* Rev. Rul. 73-254, 1973-1 C.B. 613 (dictating standards to determine classification of unincorporated business organization).

180. Treas. Reg. § 301.7701-1(c) (as amended in 1977); Rev. Rul. 73-254, 1973-1 C.B. 613.

181. 1988-1 C.B. 403.

182. *See* Rev. Rul. 88-8, 1988-1 C.B. 403 (concluding that United Kingdom unlimited liability company was partnership for U.S. federal income tax purposes); *see also* Gen. Couns. Mem. 39,693 (Jan. 22, 1988) (agreeing that "any entity organized under foreign law will be classified as a corporation for federal tax purposes only if the standards set forth in Treas. Reg. 301.7701-2 so indicate").

tion for U.S. federal income tax purposes.[183] Thus, the same standards apply for the classification of foreign entities and unincorporated domestic entities.[184]

Since its conclusion in Revenue Ruling 88-8 that all foreign entities are regarded as "unincorporated organizations" for classification purposes under Section 301.7701-2(a)(3), the IRS has considered the classification of several foreign entities for federal income tax purposes.[185] Importantly, however, the current position of the IRS with respect to the classification of Mexican entities for federal income tax purposes remains unknown.[186]

183. Rev. Rul. 88-8, 1988-1 C.B. 403, 404.

184. Rev. Rul. 93-4, 1993-1 C.B. 225; *see* Barbara C. Spudis & Michael J. Wilczynski, *Entity Clarification Update: Revenue Ruling 93-4*, 71 TAXES 164, 164–69 (1993) (determining that new ruling will facilitate classification of wholly owned foreign limited liability companies as partnerships for U.S. tax purposes).

185. *See, e.g.*, Rev. Rul. 93-4, 1993-1 C.B. 225 (classifying entity formed under German law with limited liability, centralization of management, and free transferability of interests as corporation); Priv. Ltr. Rul. 93-25-043 (Mar. 29, 1993) (holding that limited liability partnership formed under unidentified foreign law was partnership); Priv. Ltr. Rul. 92-52-033 (Sept. 30, 1992) (concluding that *societe en nom collectif* was partnership); Priv. Ltr. Rul. 92-37-021 (June 12, 1992) (ruling that *societe en commandite par action*, which was formed under French law, was partnership); Priv. Ltr. Rul. 90-02-056 (Oct. 18, 1989) (finding that United Kingdom company, limited by shares, was partnership); Priv. Ltr. Rul. 90-01-018 (Oct. 6, 1989) (determining that company, which lacked free transferability of interest and continuity of life, was partnership). Notwithstanding the number of rulings issued, the IRS's policy on entity classification states that, absent unique and compelling reasons, the IRS will not ordinarily rule on "[w]hether what is generally known as a foreign corporation will be classified as a partnership for United States tax purposes, if the taxpayer requests classification as a partnership." Rev. Proc. 94-3, 1994-1 I.R.B. 79; *see also* Rev. Proc. 94-7, 1994-1 I.R.B. 174 (delineating areas under jurisdiction of Associate Chief Counsel (International) in which letter rulings will not ordinarily be issued); Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX. L. REV. 165, 165–67 (1991) (discussing tax planning opportunities and pitfalls in classification of foreign entities); David R. Ryder et al., *Beneficial Uses of Foreign Entities and Structures in Tax Planning for the U.S. Multinational Company*, 70 TAXES 1021, 1026–28 (1992) (reviewing process by which foreign entities are classified for U.S. tax purposes).

186. Three U.S. tax practitioners have suggested that the articles of incorporation of a Mexican corporation may be drafted so that the company is treated as a partnership for federal income tax purposes. *See* Nicasio de Castillo et al., *Tax Planning for U.S. Business in Mexico*, 21 TAX MGMT. INT'L J. 131, 134 (1992). The IRS, however, has not issued any guidance with respect to this issue.

VI. Section 1504(d): Consolidating a Mexican Corporation with U.S. Parent

When investing in Mexico, a U.S. person should determine whether a wholly owned Mexican subsidiary may be included in the U.S. parent's consolidated federal income tax return.[187] Inclusion is allowed under certain limited circumstances. The inclusion of a Mexican subsidiary in a U.S. consolidated return is particularly important in new ventures in which losses are anticipated for the first three to four years. If the Mexican subsidiary can be consolidated with the parent, the losses from the Mexican subsidiary can be used, with certain limitations, to offset the parent's income for federal income tax purposes.

Foreign corporations generally do not qualify as includable corporations for purposes of filing consolidated returns.[188] Under limited circumstances, however, a corporation organized under the laws of Mexico or Canada may qualify.[189] Under Section 1504(d), corporations of contiguous countries that are subsidiaries of domestic parent corporations may, upon election by the parent, be treated as domestic corporations if certain conditions are met. When such an election is made, the contiguous-country corporation which meets the requirements of Section 1504(d) is treated as a domestic corporation for all federal income tax purposes.[190]

To be eligible to make an election under Section 1504(d), a domestic corporation must meet a stock ownership requirement and a foreign law requirement. The stock ownership requirement is met if 100 percent of the capital stock (exclusive of directors' qualifying shares) of the contiguous-country corporation is owned or controlled by the domestic corporation.[191] The foreign law requirement is met if the contiguous-country corporation is maintained

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187. *See* I.R.C. § 1504(d) (1988) (treating corporation organized under foreign country's laws as domestic corporation).

188. I.R.C. § 1504(b)(3) (1988).

189. I.R.C. § 1504(d) (1988).

190. *Id.*; *see also* Treas. Reg. § 7.367(b)-1(a) (as amended in 1986) (providing election to treat qualifying corporation as domestic corporation under § 1504(d) when transfer of property is made pursuant to exchange described in § 367(b)); *id.* § 1.1503-2(c)(1) (1992) (defining domestic corporation); Priv. Ltr. Rul. 93-23-021 (Mar. 12, 1993) (explaining that foreign corporation subject to § 1504(d) election is subject to loss limitation rules of § 1503).

191. I.R.C. § 1504(d) (1988).

solely to comply with the laws of a country contiguous to the United States with respect to title or operation of property.[192] The contiguous-country corporation need not have been formed to comply with foreign law so long as it is maintained solely for that purpose during the time for which the election is effective.[193]

In the IRS's view, foreign laws include the laws of Canada and Mexico and any province, state, or other political subdivision thereof. The term "laws" means "[c]onstitution[s], treat[ies], statutory provisions, and judicial or administrative interpretations of such provisions . . . ."[194] An administrative interpretation is limited to a published, generally applicable agency position requiring incorporation, or in the absence of such a position, a written determination by the agency explaining that the specific taxpayer's application to do business as a branch has been rejected.[195]

Contrary to the IRS's interpretation of the term "laws" under Section 1504(d), the United States Tax Court held in *U.S. Padding Corp. v. Commissioner*[196] that the term "laws of such country" in Section 1504(d) includes not only "explicit constitutional or statutory provisions and explicit rules and regulations prescribed by controlling authorities," but additionally "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."[197] In affirming the Tax Court's *U.S. Padding Corp.* decision, the United States Court of Appeals for the Sixth Circuit stated: "The Commissioner's interpretation would require that, in the absence of an absolute written requirement of incorporation, the only way to determine whether incorporation is required is to apply and allow one's application to be rejected. We decline to insist upon proof the acquisition of which requires such risk."[198]

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192. *Id.*

193. U.S. Padding Corp. v. Commissioner, 88 T.C. 177, 181 n.8 (1987), *aff'd*, 865 F.2d 750 (6th Cir. 1989); *cf.* Priv. Ltr. Rul. 93-23-021 (Mar. 12, 1993) (analyzing domestic corporation that owns all shares of Canadian corporations).

194. Priv. Ltr. Rul. 93-23-021 (Mar. 12, 1993).

195. *Id.*

196. 88 T.C. 177 (1987).

197. *U.S. Padding Corp.*, 88 T.C. at 187–88; *accord* Proctor & Gamble Co. v. Commissioner, 95 T.C. 323, 337 (1990) (reiterating that "laws" include any foreign country's existing practice or policy), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

198. U.S. Padding Corp. v. Commissioner, 865 F.2d 750, 754 (6th Cir. 1989).

U.S. investors who wish to consolidate a Mexican corporation with a U.S. corporation for federal income tax purposes should know that the IRS has taken a fairly restrictive view of the types of activities that will enable a contiguous-country corporation to qualify under Section 1504(d).[199] In a recent private letter ruling, the IRS stated that "[t]he activities of a corporation for which a Section 1504(d) election is made are strictly limited (except for certain incidental activities) to those relating to title and operation of property that are specifically required by foreign law to be performed only by a corporation formed in that foreign country."[200]

VII. Transfers of Property by a U.S. Person to a Mexican Entity

Organizing a new venture in Mexico requires knowledge of the U.S. tax laws applicable to transfers of property, including intangibles, to foreign entities.[201] Absent a careful consideration and application of these rules, which are generally set forth in Sections 1491 through 1494 and in Section 367 of the Code, a U.S. person may face harsh tax consequences regarding transfers of tangible and intangible property to a foreign entity.

A. *Section 1491*

Section 1491 generally imposes a 35 percent excise tax on the transfer of appreciated property by U.S. persons to (1) a foreign corporation as paid-in surplus or as a contribution to capital, (2) a foreign estate or trust, or (3) a foreign partnership.[202] The amount

199. *See, e.g.*, Rev. Rul. 71-523, 1971-2 C.B. 326 (holding that wholly owned Canadian subsidiary formed by domestic corporation to obtain grant from Canadian government is ineligible for § 1504(d) treatment); Rev. Rul. 70-379, 1970-2 C.B. 179 (permitting domestic corporation to make § 1504(d) election with respect to Mexican subsidiary formed to comply with then-existing restrictions on foreign ownership of land); Priv. Ltr. Rul. 81-25-143 (Mar. 27, 1981) (denying § 1504(d) treatment for Mexican corporation maintained to comply with Mexican law on ownership of land and to obtain "maquila" status because it was not maintained solely for purpose of complying with foreign law).

200. Priv. Ltr. Rul. 93-23-021 (Mar. 12, 1993).

201. *See* I.R.C. §§ 1491, 367 (1988 & Supp. V 1993). *See generally* Allen R. Friedman, *U.S. Tax Considerations in Choosing an Entity to Hold Foreign Business Operations*, 45 Tax Law. 15, 16 (1991) (examining common U.S. tax issues that arise when choosing entity to hold foreign business operations).

202. I.R.C. § 1491 (1988); *cf.* Rev. Rul. 87-61, 1987-2 C.B. 219 (exempting transfer of appreciated property to foreign trust from excise tax where transferor was considered owner of trust under § 671).

of the excise tax under Section 1491 is equal to 35 percent of the excess of the fair market value of the property transferred over the sum of the adjusted basis of the transferred property in the hands of the transferor and the amount of gain recognized by the transferor at the time of the transfer.[203]

Section 1492 provides four exceptions to the general rule of Section 1491. The first exception applies to transfers of property to certain tax-exempt organizations.[204] Another exception involves transfers for which the transferor has elected to treat the transfer to the foreign person as a taxable exchange under Section 1057.[205] The third exception applies to transfers described within Section 367.[206] The final exception applies to transfers in which, prior to the transfer, the taxpayer elects principles similar to the those of Section 367.[207]

B. *Section 367*

Section 367(a) generally provides that a foreign corporation will not be considered a corporation for purposes of applying the corporate organization, reorganization, and liquidation rules to a U.S. person's transfer of property to a foreign corporation.[208] Thus, transfers of property to foreign corporations described in Section 367(a) will generally be treated as taxable exchanges. Section 367(a)(1) denies nonrecognition treatment, however, only with re-

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203. I.R.C. § 1491 (1988); *see also* Treas. Reg. § 1.1494-1(a) (1955) (specifying requirement for persons making transfer described in § 1491).

204. *See* I.R.C. § 1492(1) (1988) (exempting organizations that are also excluded from tax provisions in subchapter F).

205. I.R.C. § 1492(3) (1988). Section 1057 provides that, in lieu of paying the excise tax under § 1491, a taxpayer may elect to treat a transfer within § 1491 as a sale or exchange and to recognize gain in an amount equal to the fair market value less the adjusted basis of the property transferred. I.R.C. § 1057 (1988); Temp. Treas. Reg. § 301.9100-12T(b)(2) (as amended in 1992). An election under § 1057 must be made no later than the date (including extensions) for filing the taxpayer's federal income tax return. Temp. Treas. Reg. § 301.9100-12T(b)(2) (as amended in 1992); *see also id.* § 301.9100-12T(d) (describing procedure for making election).

206. I.R.C. § 1492(2)(A) (1988).

207. I.R.C. § 1492(2)(B) (1988); Priv. Ltr. Rul. 91-22-074 (Mar. 6, 1991); Priv. Ltr. Rul. 91-03-033 (Oct. 23, 1990); *see also* Janie R. Hayden & Harvey Mogenson, *Tax-Free Transfers to Foreign Partnerships and the IRS' Ruling Policy on Hybrid Foreign Entities*, 20 TAX MGMT. INT'L J. 503, 503–13 (1991) (analyzing Private Letter Rulings 91-03-033 and 91-22-074).

208. I.R.C. § 367(a)(1) (1988 & Supp. V 1993).

spect to transfers of items of property on which gain is realized. The amount of gain recognized because of Section 367(a)(1) is not affected by the transfer of items of property on which loss is realized but not recognized.[209] Thus, under Section 367(a), a taxpayer cannot "net" gains and losses realized on a unitary transfer of property to a foreign corporation. No loss can be recognized through the operation of Section 367.[210]

If a U.S. person is required to recognize gain under Section 367(a)(1) upon a transfer of property to a foreign corporation, the character and source of the gain are determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation. In addition, adjustments to earnings and profits, basis, and other affected items must be made according to otherwise applicable rules, taking into account the gain recognized because of Section 367(a)(1).[211]

The general rule of Section 367(a) does not apply to certain transfers of stock or securities of a foreign corporation[212] or to property transfers to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of the United States.[213] However, the latter exception does not apply to any inventory, installment obligations, accounts receivable, foreign currency or other property denominated in foreign currency, intangible property, or certain property of which the transferor is a lessor at the time of the transfer.[214]

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209. Temp. Treas. Reg. § 1.367(a)-1T(b)(1) (1986).

210. *Id.* § 1.367(a)-1T(b)(3)(ii).

211. *Id.* § 1.367(a)-1T(b)(4).

212. I.R.C. § 367(a)(2) (1988 & Supp. V 1993); *see* Temp. Treas. Reg. § 1.367(a)-3T (1986) (explaining rules providing for treatment of transfers of stock or securities to foreign corporations); I.R.S. Notice 87-85, 1987-2 C.B. 395 (providing rules governing outbound transfers of stock and securities under § 367(a)); Prop. Treas. Reg. § 1.367(a)-3, 56 Fed. Reg. 41992 (1991) (giving rules for treatment of transfers of stock or securities to foreign corporation); *see also* Quincy Cotton, *New Rules for Foreign Transfers Simplify Some Aspects, Complicate Others*, 76 J. TAX'N 24, 24–31 (1992) (analyzing § 1.367(a)-3); Charles I. Kingson, *The New Theory and Practice of Section 367*, 69 TAXES 1008, 1008–16 (1991) (discussing conceptual underpinnings and results under proposed regulation § 1.367(a)-3).

213. I.R.C. § 367(a)(3)(A) (1988 & Supp. V 1993); *see* Temp. Treas. Reg. § 1.367(a)-2T (1986) (providing rules for transfers of property for use in active conduct of trade or business).

214. I.R.C. § 367(a)(3)(B) (1988 & Supp. V 1993); *see also* Temp. Treas. Reg. § 1.367(a)-5T (1986) (listing property subject to § 367(a)(1) regardless of use in trade or business).

Section 367(d) applies to transfers of intangibles by a U.S. person to a foreign corporation. Under Section 367(d), if intangible property is transferred by a U.S. person to a foreign corporation in an exchange described in Section 351 or Section 361, the transferor will be deemed to have sold the property in exchange for annual payments contingent on the productivity or use of such property and received the annual payments over the useful life of the intangible property.[215] The amounts deemed to be received under Section 367(d) must be commensurate with the income attributable to the intangible.[216] In addition, amounts deemed received are characterized as ordinary income from domestic sources.[217]

VIII. Antideferral Mechanisms in the Internal Revenue Code for U.S. Persons Owning Stock in a Foreign Corporation

Generally, income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. shareholders.[218] The Code, however, imposes several exceptions on this ability to defer foreign corporate earnings until repatriation. These exceptions include the controlled foreign corporation rules,[219] the foreign personal holding company rules,[220] passive foreign investment company rules,[221] the personal holding company rules,[222] and the accumulated earnings tax rules.[223] These separate antideferral mechanisms in the Code are subject to certain "coordination" rules to ensure that a U.S. shareholder of a foreign corporation is not taxed twice on the same item of income. The potential application of the Code's an-

215. I.R.C. § 367(d) (1988).

216. I.R.C. § 367(d)(2)(A) (1988).

217. I.R.C. § 367(d)(2)(C) (1988). For an excellent discussion of the special U.S. tax problems relating to transfers of intangible property outside of the United States, see D. Kevin Dolan, *Special Issues in Structuring International Joint Ventures*, 22 Tax Mgmt. Int'l J. 51, 54–60 (1993).

218. H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 633 (1993).

219. I.R.C. §§ 951-964 (1988 & Supp. V 1993).

220. I.R.C. §§ 551-558 (1988 & Supp. V 1993).

221. I.R.C. §§ 1291-1297 (1988 & Supp. V 1993).

222. I.R.C. §§ 541-547 (1988 & Supp. V 1993).

223. I.R.C. §§ 531-537 (1988 & Supp. V 1993).

tideferral mechanisms should be considered when structuring a U.S. person's business or investment in Mexico.

A. *Controlled Foreign Corporation Rules*

A foreign corporation is a "controlled foreign corporation" (CFC) if more than 50 percent of the total combined voting power of all classes of voting stock or of the total value of the stock of the corporation is owned by "U.S. shareholders" on any day during the tax year.[224] A U.S. shareholder is a U.S. person who owns 10 percent or more of the total combined voting power of all classes of voting stock of the corporation.[225] In determining whether a foreign corporation is a CFC and whether a U.S. person is a U.S. shareholder, the complex ownership attribution rules of Sections 958(a) and 958(b) apply.

If a foreign corporation is a CFC for an uninterrupted period of thirty days or more during the tax year, every U.S. shareholder of the CFC is generally required to include in gross income his pro rata share of certain categories of income earned by the CFC, even though the income is undistributed.[226] Three different provisions of the CFC rules trigger such inclusions of undistributed CFC earnings.[227] One such provision requires the U.S. shareholder to include his pro rata share of the CFC's "subpart F income" earned during the year.[228] Another provision mandates that the U.S. shareholder include his pro rata share of the CFC's earnings that are invested in certain U.S. property for the year.[229] Under the third provision, enacted by the Budget Reconciliation Act of 1993,[230] a U.S. shareholder must include his pro rata share of the

224. I.R.C. § 957(a) (1988); *see also* Treas. Reg. § 1.957-1(b)(1) (1963) (explaining how to determine "combined voting power"); *id.* § 1.957-1(b)(2) (noting that "[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained"); *id.* § 1.957-1T(a)–(c) (1988) (providing examples of foreign corporations classified as CFCs).

225. I.R.C.§ 951(b) (1988); *see also* Treas. Reg. § 1.951-1(g)(2) (1965) (defining "combined voting power" of U.S. shareholders).

226. I.R.C. § 951(a) (1988 & Supp. V 1993).

227. *See* H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 633, 637 (1993).

228. I.R.C. § 951(a)(1)(A)(i) (1988).

229. I.R.C. § 951(a)(1)(B) (1988 & Supp. V 1993).

230. Budget Reconciliation Act, Pub. L. No. 103-66, § 13231(b), 1993 U.S.C.C.A.N. (107 Stat.) 496.

CFC's earnings invested in certain excess passive assets.[231] If one of these provisions is triggered, the income is includable for the U.S. shareholder's tax year within which the tax year of the CFC ends.[232]

1. Subpart F Income, CFC Earnings Invested in U.S. Property, and CFC Earnings Invested in Excess Passive Assets

a. Subpart F Income

U.S. shareholders of a CFC must include a pro rata share of the CFC's subpart F income.[233] Subpart F income is the sum of five categories of a CFC's earnings: (1) insurance income;[234] (2) foreign base company income;[235] (3) international boycott-related income;[236] (4) the sum of any illegal payments paid by the CFC to an official of a foreign government;[237] and (5) income derived from certain foreign countries whose governments support terrorism, do not maintain diplomatic relations with the United States, or are not

231. I.R.C. § 951(a)(1)(C) (Supp. V 1993).

232. I.R.C. § 951(a)(1) (1988 & Supp. V 1993); *see also* I.R.C. § 898 (Supp. V 1993) (requiring taxable year of certain controlled foreign corporations to conform, for U.S. tax purposes, to tax year of each "majority U.S. shareholder"); Kerry L. Plutte & Marjorie Rollinson, *Proposed Regulations Issued Under Section 898*, 22 TAX MGMT. INT'L J. 243, 244 (1993) (providing guidelines on how to determine year in which income is taxed).

233. I.R.C. § 951(a)(1)(A)(i) (1988).

234. The term "insurance income" is defined in § 953(a) and generally applies to foreign corporations that issue (or reinsure) certain insurance or annuity contracts. I.R.C. § 953(a) (1988).

235. The term "foreign base company income," as defined by § 954(a), consists of the following: (1) certain types of passive income, referred to as "foreign personal holding company income;" (2) certain types of sales income, referred to as "foreign based company sales income;" (3) certain types of services income, referred to as "foreign base company services income;" (4) certain types of oil-related income, referred to as "foreign base company oil related income;" and (5) certain types of shipping income, referred to as "foreign base company shipping income." I.R.C. § 954(a) (1988). Income (other than foreign base company oil related income) that would otherwise be foreign base company income is excluded from the foreign base company income category if it is subject to an effective foreign tax rate greater than 90% of the maximum U.S. statutory rate. I.R.C. § 954(b)(4) (1988). For an extensive analysis of the Treasury Regulations underlying § 954, see Clifford E. Muller et al., *The New Subpart F Regulations: A Detailed Analysis*, 17 TAX MGMT. INT'L J. 515, 515–67 (1988).

236. This category generally applies to foreign corporations with operations in countries carrying out an international boycott and foreign corporations participating in or cooperating with the international boycott. I.R.C. 952(a)(3) (1988).

237. I.R.C. § 952(a)(4) (1988).

recognized by the United States.[238] The subpart F income of a CFC for a tax year is limited to the current earnings and profits of the CFC for that year.[239]

b. CFC Investment in U.S. Property

If a CFC invests in certain U.S. property,[240] U.S. shareholders in the CFC are required to include any excess of the U.S. shareholder's pro rata share of the CFC's earnings invested in U.S. property for the year over that portion of the CFC's earnings that was previously included in the U.S. shareholder's income as a result of the foreign corporation's investment in U.S. property.[241] The amount includable is generally limited to the U.S. shareholder's pro rata share of the current earnings and profits, as reduced by current-year distributions, and the accumulated earnings and profits of the CFC, as reduced by certain earnings previously subject to U.S. tax.[242]

c. CFC Earnings Invested in Excess Passive Assets

Section 951(a)(1)(C), enacted in 1993,[243] generally requires that a U.S. shareholder of a CFC include in gross income the amount determined under Section 956A. This amount is equal to the excess, if any, of the U.S. shareholder's pro rata share of the CFC's "excess passive assets"[244] over that portion of the CFC's earnings

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238. *See* Rev. Rul. 92-63, 1992-2 C.B. 195, *as corrected by* Rev. Rul. 92-63A, 1992-2 C.B. 197 (listing countries affected by this ruling).

239. I.R.C. § 952(c)(1)(A) (1988).

240. The term "U.S. property" defined in § 956, includes certain tangible property located in the United States, certain stocks and obligations of a domestic corporation, and certain rights in intangible property. I.R.C. § 956(c) (Supp. V 1993).

241. I.R.C. § 951(a)(1)(B) (Supp. V 1993). The CFC's earnings invested in U.S. property for the year is computed by taking the average of U.S. property held by the CFC as of the close of each quarter of the year. I.R.C. § 956 (a)(i) (Supp. V 1993).

242. I.R.C. § 956 (1988 & Supp. V 1993).

243. Section 951(a)(1)(C) is effective for foreign corporation tax years beginning after September 30, 1993, and for tax years of U.S. shareholders in which such tax years end. Budget Reconciliation Act, Pub. L. No. 103-66 § 13231(e), 1993 U.S.C.C.A.N. (107 Stat.) 497.

244. A "passive asset" encompasses any asset held by the CFC that produces passive income (for example, interest and dividends) or is held for the production of passive income. I.R.C. § 956A(c)(2)(A) (Supp. V 1993). A passive asset does not include any "U.S. property" as defined in § 956. I.R.C. § 956A(c)(2)(B) (Supp. V 1993).

"Excess passive assets" are defined as the excess, if any, for the tax year of the average amount of passive assets held by the CFC as of the close of each quarter of its taxable year that was previously included in the U.S. shareholder's income as a result of excess passive assets.[245] The amount includable is generally limited to the U.S. shareholder's pro rata share of current earnings and profits, as reduced by current-year distributions, and earnings and profits accumulated in tax years beginning after September 30, 1993, as reduced by certain earnings previously subject to U.S. tax.[246]

2. Taxation of Actual Distributions from a CFC

If all or a portion of the earnings and profits of a foreign corporation have been included in the gross income of a U.S. shareholder as subpart F income, earnings invested in U.S. property, or as earnings invested in excess passive assets, the amounts previously included are not again included in the gross income of the U.S. shareholder upon distribution.[247]

3. Adjustments to Stock Basis

The amount a shareholder is required to include in his gross income as his pro rata share of subpart F income, earnings invested in U.S. property, or earnings invested in excess passive assets increases the basis of a U.S. shareholder's stock in a CFC.[248] If a U.S. shareholder receives a corporate distribution from a CFC, the shareholder is required to reduce his basis in the stock of the CFC to the extent that the distribution is attributable to CFC earnings previously taxed as subpart F income, earnings invested in U.S. property, or earnings invested in excess passive assets.[249] To the extent that the amount of this reduction exceeds the shareholder's adjusted basis in his stock, the amount is treated as capital gain.[250]

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over 25% of the average amount of total assets held by the CFC as of the close of each quarter of its tax year. I.R.C. § 956A(c)(1) (Supp. V 1993). For purposes of computing earnings and profits, an asset is measured by its adjusted basis. *Id.*

245. I.R.C. §§ 951(a)(1)(C), 956A(a) (Supp. V 1993).

246. I.R.C. § 956A(a)–(b) (Supp. V 1993). For a further analysis of § 956A, see David M. Benson & William F. Leary, *New Section 956A: Deferral Takes Another Hit*, 22 TAX MGMT. INT'L J. 528, 528–33 (1993).

247. I.R.C. § 959(a) (Supp. V 1993).

248. I.R.C. § 961(a) (1988).

249. I.R.C. § 961(b)(1) (1988).

250. I.R.C. § 961(b)(2) (1988).

4. Foreign Tax Credit for Amounts Included Under Section 951(a)(1)

Section 960 provides rules for determining the foreign income taxes deemed paid by a domestic corporation required to include in its gross income the amounts of subpart F income, earnings invested in U.S. property, or earnings invested in excess passive assets.[251]

B. *Foreign Personal Holding Company Rules*

A "foreign personal holding company" (FPHC) is any foreign corporation that meets a "stock ownership" test and a "gross income" test.[252] The stock ownership test is satisfied if more than 50 percent of the corporation's total voting stock or the total value of the corporation's stock is owned by five or fewer U.S. citizens or residents.[253] For purposes of determining whether a foreign corporation meets the stock ownership test, all stock actually or constructively owned[254] by U.S. citizens and residents is counted.[255]

The gross income test is met if at least 60 percent of the foreign corporation's gross income for the tax year is "foreign personal holding company income" (FPHCI).[256] After the first tax year for which a foreign corporation is a FPHC, the minimum percentage of FPHCI drops to 50 percent.[257] The FPHCI of a foreign corporation generally means that portion of gross income consisting of dividends, interest, royalties, and certain other types of income listed in Section 553(a).[258]

If a foreign corporation is a FPHC for the tax year, the "U.S. shareholders" of the FPHC[259] are required to include in their gross

251. I.R.C. § 960 (1988 & Supp. V 1993).

252. I.R.C. § 552(a) (1988).

253. I.R.C. § 552(a)(2) (1988).

254. Section 554 provides the method for determining actual or constructive ownership of stock. I.R.C. § 554 (1988).

255. *See* I.R.C. § 554 (1988) (outlining rules for determining constructive ownership).

256. I.R.C. § 552(a)(1) (1988); *see also* I.R.C. § 555(a) (1988) (defining "gross income").

257. I.R.C. § 552(a)(1) (1988).

258. I.R.C. § 553(a) (1988).

259. The "U.S. shareholders" of a FPHC include citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts other than foreign estates or trusts. I.R.C. § 551(a) (1988).

income, for the tax year in which the tax year of the FPHC ends,[260] the "undistributed foreign personal holding company income" (UFPHCI) of the FPHC.[261] UFPHCI equals the taxable income of the FPHC, as adjusted under Section 556(b), minus the dividends-paid deduction defined in Section 561.[262]

C. *Passive Foreign Investment Company Rules*

If any foreign corporation is a "passive foreign investment company" (PFIC), U.S. shareholders in the PFIC may be subject to one of two other sets of operating rules that eliminate or reduce the benefits of deferral. A PFIC is any foreign corporation which meets a "passive income" test or a "passive asset" test.[263] The passive income test is met if 75 percent or more of the gross income of the corporation for the tax year is passive income, which generally consists of dividends, interest, royalties, rents, and certain other types of income described in Section 1296(b).[264]

The passive asset test is met if the average percentage of "passive assets" held by the corporation during the tax year is at least 50 percent.[265] A passive asset is any asset that produces passive income or is held for the production of income.[266] For tax years beginning after September 30, 1993,[267] a controlled foreign corporation, or any other foreign corporation if such corporation so elects, is required to apply the passive asset test using the adjusted bases of the foreign corporation's assets in lieu of their value.[268]

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260. *See* I.R.C. § 898 (Supp. V 1993) (dictating that taxable year of certain foreign personal holding companies must conform to tax year of each "majority U.S. shareholder for U.S. tax purposes").

261. I.R.C. §§ 551(a)-(b) (1988).

262. I.R.C. § 556(a) (1988).

263. *See* I.R.C. § 1296(a) (1988 & Supp. V 1993) (providing two-prong test for PFIC qualification); I.R.S. Notice 88-22, 1988-1 C.B. 489, *modified by* I.R.S. Notice 89-81, 1989-2 C.B. 399 (giving guidance for applying passive income test and passive asset test).

264. I.R.C. §§ 1296(b), 1296(d)(1) (1988 & Supp. V 1993).

265. I.R.C. § 1296(a)(2) (1988).

266. *Id.*

267. Budget Reconciliation Act, Pub. L. No. 103-66, § 13231(e), 1993 U.S.C.C.A.N. (107 Stat.) 497.

268. *See* I.R.C. § 1296(a) (1988 & Supp. V 1993) (including any foreign corporation in definition of PFIC).

Certain U.S. shareholders in a PFIC are required to pay federal income tax plus an interest charge based on the value of tax deferral at the time the shareholder receives certain "excess distributions"[269] from the PFIC or disposes of his stock in the PFIC and recognizes a gain.[270] If a U.S. person receives an excess distribution from a PFIC, gain recognized on receipt of the excess distribution is considered earned pro rata over the period in which the shareholder held the investment.[271] Under this rule, U.S. tax due in the year of receipt of an excess distribution is the sum of (1) U.S. tax computed using the highest tax rate for the investor, without regard to other income or expenses the investor may have, on gain attributed to prior years, (2) interest imposed on the deferred tax, and (3) U.S. tax on the gain attributed to the year of receipt and to years in which the foreign corporation was not a PFIC.[272]

If a U.S. person disposes of stock in a PFIC, then any gain recognized will be subject to the rules of excess distribution in the same manner as if the gain were an excess distribution.[273]

A U.S. person owning PFIC stock may elect to include in current gross income its share of the PFIC's total earnings. Every U.S. person owning stock in a PFIC that is a "qualified electing fund" (QEF) is required to include in current gross income its pro rata share of certain categories of the PFIC's earnings.[274] A PFIC becomes a QEF if a U.S. shareholder elects to treat the PFIC as such, and the PFIC issues an annual information statement to the electing U.S. shareholder.[275] A PFIC election binds only the electing

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269. An "excess" distribution means any current-year distribution representing a ratable portion of the total distributions during the year that are in excess of 125% of the average amount of distributions during the three years preceding the year of distribution, or if shorter, the portion of the taxpayer's holding period before the tax year. I.R.C. § 1291(b)(1)-(2) (1988). The shareholder will have zero total excess distributions on any stock for the year that the taxpayer's holding period in that stock begins. I.R.C. § 1291(b)(2)(B) (1988).

270. I.R.C. § 1291(a) (1988). On April 1, 1992, the IRS issued proposed income tax regulations concerning the taxation of shareholders of certain PFICs. Prop. Treas. Reg. § 1.1291-1, 57 Fed. Reg. 11033 (1992). *See generally* Wayne E. Smith & James N. Calvin, *Regs. Affecting Passive Foreign Investment Companies Ensure Acceleration of Income*, 77 J. TAX'N 242 (1992).

271. I.R.C. § 1291(a) (1988).

272. I.R.C. §§ 1291(a)(1), 1291(c) (1988).

273. I.R.C. § 1291(a)(2) (1988).

274. I.R.C. § 1293(a) (1988).

275. I.R.C. § 1295(a)(1) (1988).

shareholder and results in current taxation on the current earnings of the PFIC attributable to the electing shareholder.[276] Each U.S. shareholder of the PFIC who wishes to be taxed currently on the earnings must make a QEF election.[277] A shareholder who makes the election is required to include as income its pro rata share of ordinary income for the PFIC's tax year, and net capital gain, which may be treated as capital gain income but may not exceed earnings and profits, for the PFIC's tax year.[278]

D. *Personal Holding Company Rules*

A foreign corporation may incur personal holding company tax on its domestic-source income.[279] However, a foreign corporation, other than one with income realized from certain personal service contracts, is not subject to the personal holding company tax if all the stock is owned by nonresident aliens, foreign trusts, foreign partnerships, or foreign corporations during the latter half of the tax year.[280]

E. *Accumulated Earnings Tax Rules*

The accumulated earnings tax applies to a foreign corporation with domestic-source income if any of its shareholders are (1) subject to U.S. federal income tax on the corporation's distributions due to status as U.S. citizens or residents, (2) nonresident aliens subject to federal income tax under Section 871, or (3) foreign corporations with a beneficial interest owned directly or indirectly by a U.S. citizen or resident or by a nonresident alien subject to U.S. tax under Section 871.[281]

The accumulated earnings tax is generally imposed on the accumulated taxable income of a corporation.[282] To calculate the accumulated taxable income of a foreign corporation that files a return,

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276. I.R.S. Notice 88-125, 1988-2 C.B. 535.

277. I.R.C. § 1295(a)(1) (1988); *see* I.R.S. Notice 88-125, 1988-2 C.B. 536 (providing instructions for making election).

278. I.R.C. § 1293(a)(1) (1988); *see also* I.R.C. § 1294 (1988) (explaining shareholder-level election to defer payment of tax on amounts included in income for which no current distributions are received).

279. Treas. Reg. § 1.541-1(b) (1960).

280. I.R.C. § 542(c)(7) (1988).

281. Treas. Reg. § 1.532-1(c) (1959).

282. I.R.C. § 531 (Supp. V 1993).

the sum of the dividends-paid deduction and the accumulated earnings credit must be subtracted, with certain adjustments, from the corporation's taxable income from U.S. sources.[283] If the corporation fails to file a return, the accumulated taxable income is the gross income from domestic sources without allowance for any deductions.[284]

F. *Coordination of Antideferral Provisions*

The Code provides certain coordination rules to prevent a single item of income from being taxed twice under the various antideferral mechanisms discussed above. For instance, if an amount is included in the income of a U.S. person as subpart F income, it is not includable income under the FPHC rules[285] or under the passive foreign investment company (PFIC) rules.[286] If an amount is included in the income of a U.S. person under the FPHC rules, it is not included in income under the PFIC rules.[287] Moreover, a foreign corporation classified as a FPHC is not subject to the personal holding company rules[288] and the accumulated earnings tax.[289] If a foreign corporation is classified as a PFIC, it is not subject to the personal holding company rules[290] or the accumulated earnings tax.[291] Finally, the accumulated earnings tax does not apply to foreign corporations classified as personal holding companies.[292]

IX. International Transfer Pricing of Goods and Services

U.S. persons who buy from and sell products to related entities in Mexico should also be aware of certain rules in the Code concerning the valuation of goods for customs purposes[293] and the

283. I.R.C. § 535(b) (1988); Treas. Reg. § 1.535-1(b) (1960).
284. I.R.C. § 535(b) (1988); Treas. Reg. § 1.535-1(b) (1960).
285. I.R.C. § 951(d) (1988).
286. I.R.C. § 951(f) (1988).
287. I.R.C. § 551(g) (1988).
288. I.R.C. § 542(c)(5) (1988).
289. I.R.C. § 532(b)(2) (1988).
290. I.R.C. § 542(c)(10) (1988).
291. I.R.C. § 532(b)(4) (1988).
292. I.R.C. § 532(b)(1) (1988).
293. I.R.C. § 1059A(b) (1988).

pricing of goods that are purchased and sold between related parties.[294]

A. *Section 482*

Section 482, which governs transfer pricing, allows the IRS to apportion items of income and expense between commonly controlled entities to prevent tax evasion or to clearly reflect income.[295]

In determining the true taxable income of a controlled taxpayer, the IRS applies the "arm's-length" standard. Under the arm's-length standard, the IRS examines whether the results of the transaction are consistent with the results that would have been obtained if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.[296] Sections 1.482-2 through 1.482-5 of the Treasury Regulations establish the methods used by the IRS to determine whether a particular transaction meets the arm's-length standard. U.S. taxpayers engaging in intercompany transactions, including sales of tangible personal property, should understand the methods used by the IRS to test whether a transaction between related parties is at "arms length."

B. *Section 1059A*

Under Section 1059A, a U.S. taxpayer that imports property into the United States in a transaction from a person related to the taxpayer, within the meaning of Section 482, may not claim, for purposes of computing the basis or inventory cost of the property, a greater cost than the amount of the cost considered for customs valuation.[297] If an item is not subject to any customs duty or is subject to a free rate of duty, the item is exempt from Section 1059A.[298]

294. *See* I.R.C. § 482 (1988) (explaining related party tax consequences).

295. I.R.C. § 482 (1988). On July 1, 1994, the IRS issued final regulations relating to intercompany transfer pricing under § 482 of the Code. The final regulations are generally effective for taxable years beginning after October 6, 1994. Treas. Reg. § 1.482-1(j)(1) (1994).

296. Treas. Reg. § 1.482-1(b)(1) (1994).

297. I.R.C. § 1059A(a) (1988).

298. Treas. Reg. § 1.1059A-1(c)(1) (1989); *see also* Tech. Adv. Mem. 93-01-002 (July 10, 1992) (discussing applicability of § 1059A to Mexican maquila operation). For a discussion of the application of §§ 482 and 1059A to a maquiladora operation in Mexico, see

X. Section 911 Exclusion of Foreign Earned Income

A U.S. employer who intends to transfer U.S. employees to a business operation in Mexico should be aware that the U.S. employees may be eligible to exclude a portion of their foreign earned income from federal income taxation. Under Section 911, a U.S. person can exclude from gross income for federal income tax purposes up to $70,000 of foreign earned income, and in addition, an amount for certain housing expenses incurred by or on behalf of the employee.[299]

To qualify for the benefits of Section 911, an individual must meet a "physical presence" test or a "bona fide foreign residence" test.[300] The physical presence test is met if the individual (1) is a U.S. citizen or resident,[301] (2) has been physically present in a foreign country or countries for at least 330 full days during any period of twelve consecutive months,[302] and (3) has a "tax home" in a foreign country throughout the 330 full days of physical presence.[303] An individual meets the requirements of the bona fide foreign residence test if (1) he is a U.S. citizen,[304] (2) he has been a bona fide resident of a foreign country for an uninterrupted period which includes a full calendar year,[305] and (3) his tax home is in a foreign country throughout the period of bona fide foreign residence.[306]

The amount of foreign earned income that an individual may exclude is limited to the lesser of (1) an individual's foreign earned income for the year, as reduced by the employer-provided housing

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William R. Leighton & T. Richard Sealy III, *Federal Income Tax Issues in the Organization, Financing, and Operation of Maquiladoras*, 23 St. Mary's L.J. 721, 733–48 (1992).

299. I.R.C. § 911 (1988).

300. I.R.C. § 911(d)(1) (1988).

301. Treas. Reg. § 1.911-2(a)(2)(ii) (1985).

302. *Id.*

303. Treas. Reg. § 1.911-2(a)(1) (1985). Under Treasury Regulation § 1.911-2(b), an individual's tax home is considered to be located at his regular or principal place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in a real and substantial sense. Treas. Reg. 1.911-2(b) (1985).

304. Treas. Reg. § 1.911-2(a)(2)(i) (1985).

305. *Id.*

306. *Id.* § 1.911-2(a)(1).

cost amount which the individual elects to claim as an exclusion for the year, or (2) $70,000 multiplied by the following fraction:[307]

$$\frac{\text{Number of qualifying days during the tax year}}{\text{Number of days in the tax year}}$$

The number of "qualifying days" consists of the days within the tax year during which the individual met either the bona fide foreign residence test or the physical presence test.[308]

In addition to the $70,000 exclusion for foreign earned income under Section 911, in some circumstances, an employee may be allowed to exclude a "housing cost amount" from gross income for federal income tax purposes. The housing cost amount is an amount equal to the reasonable expenses paid or incurred by or on behalf of an employee attributable to housing in a foreign country for the individual and any spouse or dependents who reside with the employee, less the housing base amount.[309] Examples of eligible housing expenses include rent, the fair rental value of housing provided in kind by an employer, utilities other than telephone charges, real and personal property insurance, rental of furniture and accessories, household repairs, and residential parking.[310]

The housing base amount is computed by multiplying 16 percent of the salary, computed on a daily basis, of a grade GS-14 (step 1) employee of the U.S. Government,[311] by the number of days in the relevant tax year for which the taxpayer qualified either under the bona fide foreign residence test or the physical presence test.[312]

The exclusion for the housing cost amount is limited to the lesser of the employee's housing cost amount attributable to "employer-provided amounts" or the individual's foreign earned income for the year.[313] Employer-provided amounts generally include any amount paid or incurred on behalf of the employee by the employer that is foreign source earned income includable in the em-

307. I.R.C. § 911(b)(2) (1988); Treas. Reg. § 1.911-3(d) (1985).

308. Treas. Reg. § 1.911-3(d)(3) (1985).

309. *Id.* § 1.911-4(a).

310. *Id.* § 1.911-4(b).

311. For 1993 this salary was $54,607, so the annual amount was $8,737 and the daily figure was $23.94. I.R.S. Publication 54 (Nov. 20, 1993).

312. Treas. Reg. § 1.911-4(c) (1985).

313. *Id.* § 1.911-4(d)(1). If a housing expense is not an employer-provided amount, the individual may, in lieu of an exclusion, take a deduction for the housing cost amount. *Id.* § 1.911-4(d).

ployee's gross income for the year. Examples of employer-provided amounts include any salary paid by the employer to the employee, and any reimbursement paid by the employer to the employee for housing expenses.[314]

XI. Conclusion

This Article provides an overview of some of the principal U.S. federal income tax issues that a U.S. person should consider when developing the structure for a business or investment in Mexico. In addition to the general pattern of federal income taxation of income earned abroad, U.S. persons should consider the sources of income to be derived from a Mexican business or investment, the federal income tax benefits associated with a foreign sales corporation, the availability of a foreign tax credit in the United States for Mexican income taxes paid or accrued, the classification of Mexican entities for federal income tax purposes, and whether a U.S. corporation can include a Mexican corporation in its consolidated U.S. federal income tax return.

U.S. persons should also consider the federal income tax consequences arising from a transfer of property to a Mexican entity, the antideferral mechanisms in the Code applicable to foreign corporations, the federal income tax issues arising from the valuation of goods for customs purposes and the pricing of goods purchased and sold between related parties. U.S. employers who are transferring U.S. employees to a Mexican operation should also note that the employees may be allowed to exclude a portion of their foreign earned income for federal income tax purposes.

314. Treas. Reg. § 1.911-4(d)(2) (1985).