Corporate Reorganizations and Treaty Relief from Double Taxation Within the NAFTA Block

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I. TAXATION OF CAPITAL GAINS IN THE NAFTA BLOCK: CRITICAL DISPARITIES IN TREATY RELIEF FOR CORPORATE REORGANIZATIONS IN THE FREE TRADE ZONE

Canada, Mexico and the United States entered into the North American Free Trade Agreement on December 17, 1992. The new tariff-free trade zone was intended to promote the expansion of trade and investment, and facilitate the provision of cross-border services. Almost concurrently, Mexico entered into bilateral tax treaties with both Canada and the United States. Amendments were also made to the Canada-United States Tax Treaty to accommodate NAFTA in the form of a third Protocol. The trilateral NAFTA agreement and the three bilateral tax treaties, although independent in operation, are clearly symbiotic partners in the NAFTA economic zone. However, notwithstanding clauses heralding most favoured nation status throughout the NAFTA agreement, this preferential policy has not been carried forward to the bilateral tax treaties. Furthermore, discrimination among the NAFTA partners in tax matters appears to have been not only anticipated but intended. In fact, NAFTA specifies that the bilateral tax treaties take precedence in all but a few very limited circumstances over the NAFTA agreement, and any obligation with respect to most favoured nation status regarding tax matters is expressly refuted in the NAFTA document.

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5. With few exceptions, NAFTA leaves tax questions to be resolved by the bilateral tax
Because most favoured nation status in tax matters is not required under NAFTA, the bilateral tax treaties between Canada and the United States, the United States and Mexico, and Mexico and Canada, contain critical differences, particularly with respect to the tax treatment of capital gains. As a consequence, the Mexican tax liability for a United States taxpayer who incurs a capital gain in Mexico, may be very different than that of a Canadian taxpayer in identical circumstances. Similarly, a Mexican taxpayer may have a totally different tax result depending on whether a capital gain was generated in Canada or the United States. These differences might not be important but for the fact that NAFTA, while encouraging the expansion of trade, also encourages the consolidation or reorganization of business enterprises originally structured to meet former trade restrictions. Many of these business restructurings will involve assets situated in neighbouring NAFTA countries. For example, a United States taxpayer may move United States branch assets located in Canada from a United States parent to a United States subsidiary or two Canadian corporations might consolidate at a time when one of the Canadian corporations owns shares in a Mexican real estate corporation. In both cases, tax liability will arise in the treaty country where the assets are situated and treaty relief will be sought by the nonresident taxpayer. In some cases, double taxation may result. Thus, NAFTA, while providing new opportunities, has also created new tax problems, and, in particular, the potential problem of double taxation whenever a corporate restructuring involves the transfer of ownership of business assets located in one tax jurisdiction between legal entities of another.6

This paper explores the problem of double taxation in corporate reorganizations and other similar transactions by the NAFTA signatories involving the...
transfer of assets situated within the NAFTA block. The article begins with a
discussion of the problem of double taxation. The paper then analyzes each of
the NAFTA countries' jurisdiction to tax and the general treaty provisions which
address the tax treatment of capital gains. It examines the relief from double
taxation granted under the Canada-U.S. Treaty, the Mexico-Canada Treaty, and
the United States-Mexico Treaty. Utilizing a series of examples, the authors
compare the relief provisions for corporate reorganizations in each of the three
countries and illustrate the critical differences in tax treatment. The paper also
discusses the Competent Authority function in the three NAFTA signatories and
the procedure, if any, for obtaining relief from double taxation. Addressing
cross-border reorganizations, the article concludes with suggestions and
recommendations to further coordinate the bilateral tax treaty measures between
the three NAFTA signatories.

II. THE PROBLEM OF DOUBLE TAXATION

Generally, the income tax base of Canada, Mexico and the United States
includes the worldwide income of the residents and citizens of each country.
Nonresident aliens, however, are taxed only on income that originates in the
particular country. Typically, the income of nonresidents who are employed or
carry on a business in the foreign country or the gains from the disposition of
certain assets, such as real property situated in the foreign country, are considered
"sourced" in that foreign country. Withholding taxes are also imposed upon the
gross receipts of certain foreign source income such as interest, dividend and
royalty income. Tax treaties are designed to avoid the double taxation of income
that might result when two or more countries seek to levy a tax on the same
income base. The removal of such tax barriers is considered necessary to
courage and facilitate international trade and investment. Tax treaties generally
eliminate double taxation by giving primacy to the source jurisdiction. Thus, the
resident jurisdiction either foregoes taxing income subject to taxation by the
country of source by exempting such income by crediting, within limits, the
foreign tax paid against the amount of tax that would be otherwise imposed by
the country of residence.

Tax treaties are therefore critical in adapting the general provisions of
domestic tax law to the particular problem of double taxation which arises
between treaty countries. For example, double taxation may result because two
countries consider the same person or entity to be a resident for tax purposes.
Double taxation might also occur when more than one country views certain
income as arising within its borders. With regard to taxable dispositions of

7. The jurisdiction to tax the income of a taxpayer may be based upon the personal status of
an individual taxpayer such as citizenship, residence or domicile, or place of incorporation or
management of a corporation taxpayer.
Taxation 1987 A.L.I.
property, the problem may even arise if there is foreign tax credit relief available but no concurrent taxable income. This is often the case with business or corporate restructurings which take place under the income tax system of one country while the affected assets are located in another country. The disposition may not result in a taxable event both domestically and in the foreign jurisdiction, or the taxable event may not occur in the same tax period. Consider our earlier example, a United States parent with a Canadian branch that transfers the Canadian branch assets to its United States subsidiary corporation in exchange for stock. Because this is a disposition of taxable Canadian property, this transaction is taxable in Canada. However, the transfer of the real property will be tax deferred in the United States pursuant to Internal Revenue Code section 351. As with most nonrecognition provisions, the appreciation is preserved in the basis of the real property and will not be recognized for United States tax purposes until the real property is ultimately disposed of by the subsidiary corporation. Double taxation generally occurs in these circumstances as a result of an immediate timing problem with respect to the use of the foreign tax credit because at the time of the exchange the transaction produces taxable Canadian income but no taxable United States income, and because the applicable foreign tax credit may expire before an actual disposition or other taxable event occurs in the United States. The potential for double taxation also exists in the second example involving the consolidation of two Canadian corporations when shares in a Mexican real estate corporation are held. The merger results in a disposition of the shares in the Mexican corporation which is a taxable event in Mexico, but will not be currently taxable in Canada pursuant to the Canadian Income Tax Act subsection 87(1). In both cases, the bilateral tax treaties between the affected NAFTA countries must be looked to for relief from double taxation. As will be demonstrated, whether tax liability will arise on the disposition of assets located in another bilateral treaty country and whether relief is available from the double taxation of the resulting gain will vary between the NAFTA countries.

10. See Canada-U.S. Treaty, supra note 4, art. XIII.
13. See I.R.C. § 904(a) (1998) (limiting the credit for foreign tax to the United States tax (before the credit) on income from foreign sources).
14. See I.R.C. § 904(c) (1998) (allowing foreign income taxes in excess of United States tax to be carried back two years and forward five years).
15. See, e.g., I.T.A., supra note 9, section 126, Interpretation Bulletin IT-270R2, supra note 9.
16. See Mexico-Canada Treaty, supra note 2, art. XIII(4)(a).
17. Id. The merger results in taxation in Mexico when the value of the shares of the subsidiary in which the Canadian corporation had a substantial interest is derived principally from real property located in Mexico. Id.
III. TAX TREATY PROVISIONS AFFECTING DOUBLE TAXATION OF CAPITAL GAINS

Under their domestic law, Canada, Mexico, and the United States.

18. Canada taxes its residents on their worldwide income. Persons who were not resident in Canada at any time in the year are taxable on Canadian source income if they were employed in Canada, carried on business in Canada, or have disposed of a "taxable Canadian property." Taxable Canadian property includes real estate situated in Canada, capital property used in carrying on a business in Canada, and shares of a private corporation resident in Canada. Taxable Canadian property also includes an interest in a partnership in which at least 50% of the fair market value of the assets consist of Canadian resource properties, timber resource properties, income interests in trusts, or any other taxable Canadian property. The amount included in a nonresident's taxable income from the disposition of taxable Canadian property is the excess of taxable capital gains over allowable capital losses, including gains and losses arising from "deemed dispositions." Deemed dispositions include, for example, the winding-up of a nonresident corporation which held taxable Canadian property. Proceeds of a disposition, whether actual or deemed, equal the fair market value in any nonarm's-length transaction. Part XIII of the I.T.A. generally provides for a withholding tax of 25% (subject to reductions under a particular tax treaty) of income of a "passive" nature from Canadian investments or properties. Typical payment so taxed are interest, rent, royalties, trust income, management fees and the like. See I.T.A., supra note 9, section 212.

19. Gains on the sale of stock issued by a Mexican corporation or capital interests in non-publicly traded stock companies are fully taxable to nonresident individuals and foreign corporations. An exemption does exist, however, for the sales of publicly and widely traded shares sold through the Mexican stock exchange. In addition, gains from the sales of land or buildings located in Mexico or trust rights to such real property are considered Mexican source income. Income from personal services rendered by nonresident individuals temporarily in Mexico directly to Mexican taxpayers are subject to a graduated withholding tax rate to the extent income exceeds an exempt amount. Mexican source income, such as salaries, rents, interest, capital gains, and royalties, are generally taxed to nonresident individuals and foreign corporations on a withholding basis applied to gross income without deductions. The withholding rate as well as when liability will arise for a capital gain realized in Mexico varies in the tax treaties entered into by Mexico with Canada and the United States.

20. A nonresident alien individual or foreign corporation carrying on a trade or business in the United States is taxed as a United States taxpayer on taxable income which is effectively connected with the conduct of a trade or business. Foreign persons are also subject to United States tax on some types of recurring investments including interest, dividends, rents and royalties sourced in the United States. These types of noneffectively connected income are subject to a flat 30% withholding tax on gross income. The bilateral tax treaties entered into by the United States often contain provisions reducing the 30% withholding rate to a lower percentage. Capital gains are generally exempt from the withholding tax. However, a nonresident alien who is physically present in the United States for 183 days or more during a taxable year is subject to a 30% tax on the excess of United States source gains on the sales and exchanges of capital assets over losses allocable to United States sources. Since 1986, foreign corporations engaged in business in the United States are subject to a 30% branch-profits tax and a branch level-interest tax in addition to the regular tax on income effectively connected with the conduct of a trade or business in the United States, whenever the branch profits are withdrawn from the United States.

The United States generally does not tax foreign persons for gains on the sale or exchange of United States real property unless the gains are effectively connected with the conduct of a trade or business within the United States. Concerned with the increasing foreign ownership of United States real property, however, Congress enacted I.R.C. section 897 in 1980. Under I.R.C. section 897, the gain
each claim a broad right to tax capital gains realized on the disposition of assets within their respective sovereign jurisdictions. The bilateral tax treaties entered into by these countries attempt to limit this broad right to tax gains to one of the two bilateral treaty signatories or, correspondingly, require that the other bilateral treaty signatory provide tax relief for foreign tax paid. Notwithstanding the attempt to eliminate double taxation of capital gains through bilateral treaties, double taxation remains a reality in many corporate reorganizations. Further, there are significant differences in the tax relief offered by each of the three treaty countries to alleviate the potential double tax.

A. Canada-United States Treaty

The current version of the Canada-U.S. Treaty was negotiated on the basis of the Organization for Economic Cooperation and Development Model Treaty. The Treaty was signed in 1980 and has been the subject of four subsequent protocols, the latest being signed in July of 1997. The Treaty

or loss of a foreign person on the disposition of a “United States real property interest” is treated as a gain or loss effectively connected with a trade or business carried on in the United States. A United States real property interest is defined to include a direct interest in real property situated in the United States and stock in a domestic corporation which is a “United States real property holding company.” A United States corporation is a United States real property holding corporation if at any time during the previous five years the fair market value of the corporation’s United States real property interests equals or exceeds 50% of the sum of the fair market value of the corporation’s total United States and foreign real property interests, plus any other assets used or held for use in a trade or business.


22. See supra note 4. The 1997 Protocol came into effect on December 16, 1997, and limits the capital gains that each country can tax. The 1997 Protocol is the result of a 1995 proposed amendment to the I.T.A. paragraph 115(1)(b) to tax nonresidents’ gain on shares of nonresident corporations, and interest in nonresident trusts, where most of the value of the shares or interest is attributable to Canadian real estate or resource property. Except where a tax treaty precludes such tax, the amendment would apply to increases that accrued (measured proportionally) after April 26, 1996. The 1997 Protocol, according to the Technical Notes, will limit the application of the proposed Canadian tax change in the cases of United States residents. Canada will agree not to tax United States residents’ gain on shares of corporations that are not resident in Canada. Similarly, the United States will agree that “United States real property interests” will not include shares of corporations that are not resident in the United States. The change applies as of April 26, 1995. Thus, Canadians who invest in United States real estate through Canadian companies will continue to pay Canadian tax, rather than any possible future United States tax, upon disposition of their shares. And United States investors in United States companies who hold real property in Canada will continue pay United States tax when they dispose of their shares. See Technical Explanation for the July 29, 1997 Protocol, released by the United States Treasury Department, Dec. 1997.
operates to limit and define when one contracting state may subject the residents of the other contracting state to taxation and, conversely, to define when and under what circumstances a contracting state will provide relief for foreign taxes paid to the other contracting state.

Article XIII of the Canada-U.S. Treaty, which addresses the taxation of capital gains, has largely adopted the OECD Model provisions with the addition of some unique embellishments discussed below. The result is that both Canada and the United States have limited their general right to tax capital gains on the disposition of property by a nonresident located within their respective jurisdictions to two defined sets of circumstances: first, where there is an alienation of real property, and, second, where there is an alienation of personal property forming part of a permanent establishment or a fixed base. Gains from the disposition of any other property may be taxed only in the contracting state of residence.

1. Real Property

Article XIII (1) provides that gains derived by a resident of a contracting state from the alienation of real property situated in the other contracting state may be taxed in that other contracting state. Article XII(3) defines "real property situated in the other contracting state." In the case of real property situated in the United States, the term "real property" includes a United States real property interest and real property as defined in Article VI of the Canada-U.S. Treaty. Article VI(2) defines real property to have the same meaning given under the tax laws of the United States, including options and similar rights, usufruct of real property, rights to explore for, or to exploit, mineral deposits, sources and other natural resources, and rights to amounts computed with reference to the amount or value of production from such resources.

In the case of real property situated in Canada, the term "real property situated in the other contracting state" again includes real property as defined in Article VI. Article XIII(3) further defines real property to include a share of the capital stock of a company where the value of the share is derived principally...
from real property situated in Canada, and an interest in a partnership, trust, or estate, the value of which is derived principally from real property situated in Canada.29

2. Personal Property

Gains from the alienation of personal property are taxable in the contracting state of source if the alienated property is or formed part of the business property of a permanent establishment30 which the nonresident has in the contracting state within the twelve month period preceding the date of alienation or pertaining to a fixed base31 which is available to the nonresident resident in the

29. Canada-U.S. Treaty, supra note 4, art. XIII(3)(b). The term “principally” means more than 50%. Taxation in Canada is thus preserved through several tiers of entities if the value of the company’s shares or the partnership, trust, or estate is ultimately dependent principally on real property situated in Canada. Technical Explanation of Can.-U.S. Treaty, supra note 25. See Rev. Rul. 84-128, 1984-2 C.B. 41.

30. The term “permanent establishment” is defined in Article V of the Canada-U.S. Treaty as meaning a fixed place of business through which the business of a resident of a contracting state is carried on in the other contracting state, including a place of management, a branch, an office, a factory, a workshop, a mine, an oil well, or quarry and a farm or plantation. In addition, a building site or construction or installation project that continues for more than twelve months will be considered a permanent establishment. Finally, the use of a drilling rig or ship in the other Contracting State for a period of more than three months in any twelve month period to explore for or exploit natural resources will fall within the definition. Canadian cases have followed United States jurisprudence in holding that to be a permanent establishment an office must be staffed and capable of carrying on the business of the taxpayer, and plants or other facilities must be equipped to carry on the taxpayer’s business activity. Canada-U.S. Treaty, supra note 4. See Richard G. Tremblay, Permanent Establishments in Canada, 2 J. Int’l Tax 305, 307 (1992).

Revenue Canada has adopted a broad view of what constitutes a site or installation project. In a recent ruling, Revenue Canada was asked to consider whether a United States corporation which sold and later installed computer software to an unrelated Canadian corporation would have a permanent establishment in Canada where employees of the United States corporation provided installation and maintenance services in Canada. Citing several authorities, Revenue Canada concluded that although testing computer software and setting up a data base was likely not an installation project, an installation project did not need to be related to a construction project. Technical Interpretation, Reorganization and Foreign Division, July 5,1994.

Revenue Canada has stated that a foreign corporation may have a permanent establishment in Canada and may be carrying on business in Canada if one of its employees provides expertise as a project manager for a job of the Canadian subsidiary. A permanent establishment may also exist where the Canadian subsidiary makes space available to a foreign corporation, for example to provide management to a subsidiary for a fee. See Window on Canadian Tax (CCH) at 1352.

31. The term “fixed base” is not defined in the Canada-U.S. Treaty. Revenue Canada has stated that a fixed base would include, for example, a physician’s consulting room, the office of an architect, or the office of a lawyer. A location where a United States resident is situated temporarily and performs independent personal services while in Canada may be considered a fixed base. However, Revenue Canada has taken the position that an individual will not be considered to have a fixed base if the period in Canada for performing the independent personal services is less than 61 days and the services in Canada are not perform on a recurring basis. Interpretative Bulletin IT-173R2(8) (as revised Jan 30, 1989).
contracting state for the purpose of performing independent personal services, or which was so available within the twelve month period preceding the date of alienation. These rules apply both to the alienation of individual assets which are attributable to the permanent establishment or fixed base as well as to the alienation of the permanent establishment or fixed base itself.\textsuperscript{33}

3. Other Gains

Subject to three limited exceptions,\textsuperscript{34} gains from the alienation of any property other than the real property and personal property described above are taxable only in the contracting state of which the alienator is a resident.\textsuperscript{35}

B. Mexico-Canada Treaty

The Convention between Canada and Mexico which entered into force on May 11, 1992,\textsuperscript{36} was the first bilateral tax treaty signed by Mexico. Like the Canada-U.S. Treaty, it is generally patterned on the OECD Model; however, in recognition of Mexico's status as a developing country,\textsuperscript{37} it also borrows from

\textsuperscript{32} Consideration of the application of the permanent establishment rules also requires an analysis of when a wholly owned subsidiary would be viewed as a permanent establishment of the United States parent corporation. Under the Treaty, a United States resident would not be deemed to have a permanent establishment in Canada merely because that resident carried on business in Canada through an agent of independent status. Revenue Canada has stated that “while it is possible for a wholly owned subsidiary to be an independent agent of its nonresident parent, there are no precise tests to determine whether a person is an independent agent of another person.” Revenue Canada Technical Interpretation 4112-2-5, June 14, 1993. Permanent establishment status for the subsidiary would result in tax liability for the United States parent on the basis of the parent's profit attributable to the permanent establishment. Quaere would it also result in liability under Article XIII when assets of the Canadian subsidiary are alienated?

\textsuperscript{33} Article XIII(3) of the Canada-U.S. Treaty provides an exception to the general rules and reserves the right of a contracting state to tax an individual who is a resident of the other contracting state on gains from the alienation of property if the individual was: (1) a resident of that contracting state for 120 months during any period of 20 years prior to the alienation of the property, (2) a resident of that contracting state during the ten years immediately prior to the alienation of the property, and (3) owned the property at the time of ceasing to be resident of the contracting state. Article XIII(6) of the Canada-U.S. Treaty applies to a Canadian resident who emigrates to the United States and, while a United States resident, sells a former principal residence situated in Canada. In determining the taxpayer's United States tax liability with respect to any gain from the alienation of the principal residence, the adjusted basis of the property will not be less than its fair market value at the time of emigration. Article XIII(9) is a transition rule for certain capital gains which are taxable by the contracting state of source under the current Canada-U.S. Treaty but were exempt under the predecessor Treaty. Canada-U.S. Treaty, supra note 4.

\textsuperscript{35} See Mexico-Canada Treaty, supra note 2.

\textsuperscript{37} In the case of developing countries, capital investment flows primarily from the developed...
the United Nations’ Model Treaty. The specific tax treatment of capital gains is contained in Article XIII.

I. Real Property

By virtue of Article XIII(1), a resident of one contracting state is taxable under the Mexico-Canada Treaty with respect to capital gains realized from the alienation of immovable property situated in the other contracting state. For this purpose, gains from the alienation of immovable property include gains derived by a resident of a contracting state from the alienation of shares, other than shares quoted on an approved stock exchange in the other state, forming part of a substantial interest in the capital stock of a company which is a resident of that other contracting state if the value of the shares is derived principally from immovable property situated in that other state, or a substantial interest in a partnership, trust or estate the value of which is derived principally from immovable property situated in that other state.

There is no definition of “substantial interest” or “principally” in the Mexico-Canada Treaty. Thus, the percentage of the stock in a company that must be owned by the nonresident and the percentage of the value of the corporate assets that must consist of real property before a gain on the disposition of corporate shares is taxable in Mexico is unclear. Under the Canada-U.S. Treaty, the word “principally” is generally conceded to mean more than 50%. In contrast, in the U.S.-Mexico Treaty, the word principally is replaced with the words “at least fifty per cent, by value, of immovable property.” This difference in this wording is unlikely to have any significant impact unless the country to the developing country with the resulting income benefitting the former. Therefore, the interest of the developing country in protecting and broadening source-based taxation must be protected. See U.S. Treasury Dep’t Technical Explanation of the Convention and Protocol 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, D.C. on September 18, 1992, reprinted in 3 Tax Treaties (CCH) ¶ 5943 [hereinafter Technical Explanation of U.S.-Mex. Treaty]. See Eric J. Smith, The U.S.-Mexico Tax Treaty, 8 Fla. J. Int'l L. 97, 102 (1993).

38. 1980 United Nations “Convention Between (State A) and (State B) for Avoidance of Double Taxation with Respect to Taxes on Income [and on Capital],” reprinted in U.N. Model Convention for Tax Treaties Between Developed and Developing Countries, 1980 [hereinafter U.N. Model].

39. For the purposes of this provision, the term “immovable property” includes the shares of a company referred to in Article XIII(4)(a) or an interest in a partnership, trust or estate referred to in Article XIII(4)(b) but does not include any property, other than rental property, in which the business of the company, partnership, trust or estate is carried on. See Mexico-Canada Treaty, supra note 2, art. XIII(4)(a).

40. See Mexico-Canada Treaty, supra note 2, art. XIII(4).

41. See supra note 29 (discussing the definition of “principally” for the purposes of the Canada-U.S. Treaty).

42. U.S.-Mexico Treaty, supra note 3, art. XIII(2)(c).
value of the Mexican real property held by the company is exactly 50%. What is far more likely to create major differences in the overall tax treatment of the NAFTA neighbors is the distinction between a “substantial interest” in a Mexican corporation that holds real property, which is required before a Canadian is liable for Mexican tax under the Mexico-Canada Treaty, and “any shares or comparable interest in such a corporation,” which, if held by a United States taxpayer, would result in automatic tax liability under the U.S.-Mexico Treaty when such shares of the Mexican corporation are disposed of.

2. Personal Property

Gains from the alienation of movable property forming part of the business property of a permanent establishment in the other contracting state or pertaining to a fixed base in the other contracting state for the purpose of performing independent personal services are also taxable in that state. As well, gains from the alienation of the entire permanent establishment (alone or with the whole enterprise carried on by such resident) or fixed base may be taxed in that other state.43

3. Other Property

Gains from the alienation of other property are taxable only in the contracting state in which the alienator is resident. Notwithstanding, a contracting state may levy, according to its law, tax on gains from the alienation of any property derived by an individual who is a resident of the other contracting state and has been a resident of the first-mentioned contracting state at any time during the six years immediately preceding the alienation of the property.44 This provision allows the country from which a taxpayer emigrated in the prior six years to continue to tax gains on property held by that taxpayer at the time of departure.

C. U.S.-Mexico Treaty

Following the negotiation of NAFTA by the United States, Mexico and Canada, the tax treaty between the United States and Mexico with a related protocol was signed on September 18, 1992.45 In 1995, an additional protocol came into force amending Article XXVII, thereby expanding the scope of coverage of the exchange of information provision to include all taxes imposed by the contracting states, including state and local taxes.46

43. Id. art. XIII(2).
44. Id. art. XIII(7).
46. See 1992 Protocol, supra note 3; U.S. Treasury Dep’t Technical Explanation of Protocol Amending the Convention Between the United States of America and Canada, Signed at Washington,
The U.S.-Mexico Treaty draws from the OECD Model and the United Nations Model. Although it follows the same general pattern as the Canada-U.S. and Mexico-Canada treaties, there are some significant differences.

Article XIII of the U.S.-Mexico Treaty limits a contracting state's ability to tax capital gains to the source country. Like the treaty with Canada, capital gains are taxable in the contracting state where the assets are situated in the case of either real property interests or personal property associated with either a permanent establishment or a fixed base. Unlike the treaty with Canada, however, the source country is also allowed to tax capital gains from the sale of stock or other rights in the capital of a resident company. As will be shown, the U.S.-Mexico Treaty thus provides little or no relief to United States taxpayers from the taxation in Mexico of capital gains income.

1. Real Property

Article XIII(1) of the U.S.-Mexico Treaty provides that gains derived by a resident of a contracting state from the alienation of “immovable property situated in the other contracting state” is taxed in that other state. As defined in paragraph 2 of Article VI, “immovable property” is real property in accordance with the laws of the contracting states. In any case, real property includes accessory property, livestock and equipment used in agriculture and forestry, and the right to receive payments in exchange for the right to extract natural resources. Article XIII(2) expands the definition of “immovable property situated in the other contracting state” to include an interest in a partnership, trust or estate to the extent that its assets consist of real property, the shares or comparable interests in a company or other legal person if at least 50%, by value, of the assets of that company consist of real property, and any other right that confers the use or enjoyment of real property. For example, the sale of time shares for the use of vacation property in a contracting state can produce gain taxable by that state. Paragraph 12 of the 1992 Protocol provides that the term “immovable property” situated in the other Contracting State includes a United States real property interest.


49. Id. art. XIII(3).
50. Id. art. VI(2).
52. 1992 Protocol, supra note 3, ¶ 12. See supra note 20 (providing the definition of “United States real property interest”).
2. Personal Property

Article XIII(3) provides that the gains from the alienation of personal property which are attributed to a permanent establishment or a fixed base for the purposes of performing independent personal services which a resident of a contracting state has, or had, in the other contracting state are taxed in that other state. Further, gains from the alienation of a permanent establishment or a fixed base may be taxed in that other state.

3. Stock

Unlike the Canada-U.S. and Mexico-Canada Treaties, Article XIII (4) of the U.S.-Mexico Treaty allows the other contracting state to tax gains derived by a resident of a contracting state from the alienation of stock, participation, or other rights in the capital of a company or other legal person which is a resident of the other contracting state. The gain is taxed only if the alienator had a participation, directly or indirectly, of at least 25% in the capital of the company or other legal person during the twelve-month period preceding the disposition. The gain will be deemed to arise in the other contracting state to the extent necessary to avoid double taxation. Mexico does not tax gain recognized on the sale of publicly traded stock sold through the Mexico Stock Exchange. Thus, Mexico taxes United States individuals and corporations on the gain from the alienation of stock of a closely held Mexican corporation, regardless of the place of sale, residence of the buyer and seller, or nature of the assets of the corporation. In contrast, the United States generally does not tax “non-effectively connected capital gain income” recognized by a nonresident individual or foreign corporation on the sale of stock in a United States corporation, other than United States real property holding companies. If the United States resident is not a substantial shareholder in a Mexican company, Article XIII(4) prevents Mexico from imposing a tax on gains from the disposition of stock in a Mexican company. However, if the United States taxpayer owns 25% or more of the stock of an unlisted Mexican corporation, the Treaty deems the gain from a disposition to be sourced in Mexico. Paragraph 13 of the 1992 Protocol creates an exception to Article XIII(4) in the case of the transfer of stock.
“between members of a group of companies that file a consolidated” return.57

4. Other Property

Article XIII(5) of the U.S.-Mexico Treaty provides that gains derived by an enterprise carried on by the resident of one of the contracting states from the alienation of ships, aircraft, and containers, including trailers, barges, and related equipment for the transport of containers, used principally in international traffic, is taxable only in that state. The use of the term “principally” in this context, clarifies that occasional use in domestic traffic does not cause the disposition to fall outside the scope of this provision.58 Article XIII(6) confirms that royalties are taxable only in accordance with the provisions of Article XII of the U.S.-Mexico Treaty.59 Finally, Article XIII(7) reserves the exclusive right to tax gains from the alienation of any other property to the alienator’s state of residence.60

D. The Treatment of Capital Gains under the Tax Treaties: A Comparison

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<th>Treaty Provisions</th>
<th>Canada-U.S.</th>
<th>U.S.-Mexico</th>
<th>Mexico-Canada</th>
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| Real Property              | U.S.: Gains from the alienation of real property or a U.S. real property interest61 | Gains from the alienation of real property, shares of a corporation, the value of the assets of which are at least 50% real property, or an interest in partnership, trust or estate | Gains from the alienation of real property, shares representing a substantial interest in an unlisted corporation or a partnership the value of the shares of which is de-
|                            | Canada: Gains from the alienation of real property or interest in the value of the substantial assets of which interest in an unlisted corporation or a partnership, the shares of which are at least 50% real property. | | |


58. U.S.-Mex. Treaty, supra note 3, art. XIII(5). This paragraph is intended to produce the same result as the corresponding language in the U.S Model. Technical Explanation of U.S.-Mex. Treaty, supra note 37.


60. Id. art XIII(7).

61. See supra note 20 (providing a definition of a “United States real property interest”).
<table>
<thead>
<tr>
<th></th>
<th>Personal Property</th>
<th>Stock</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>to extent the assets are real property</td>
<td>Gains from the alienation of personal property which is or forms part of the business property of a permanent establishment or fixed base for performing independent personal services (during 12 months prior to alienation)</td>
<td>Gains from the alienation of an unlisted Mexican corporation if the nonresident owns a capital interest of at least 25% (during 12 months prior to alienation)(^\text{62})</td>
<td></td>
</tr>
<tr>
<td>rived principally from real property</td>
<td>Gains from the alienation of personal property which is or forms part of the business property of a permanent establishment or fixed base for performing independent personal services (which alienator has or had in other state)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

As can be seen, United States taxpayers will be taxed in Mexico on the disposition of any stock or comparable interests held in a corporation resident in Mexico if the value of the assets of the corporation consist at least 50% of real

\(^{62}\) An exception exists in the case of the transfer of stock between members of a group of companies that file a consolidated return. 1992 Protocol, \textit{supra} note 3, ¶ 13.
property situated in Mexico. Further, United States taxpayers will be taxed in Mexico upon the alienation of non publicly-traded stock in a Mexican corporation in which their interest is 25% or more regardless of the type of assets held by the corporation unless the disposition is to a corporation which is part of a group filing consolidated returns.\textsuperscript{63} Identically placed Canadian taxpayers, however, will not be taxed on the disposition of shares of a Mexican corporation unless they hold a “substantial interest” in an unlisted Mexican corporation and the value of the shares is derived “principally” from real property.\textsuperscript{64} Thus, Canadian taxpayers can own substantial interests in closely held Mexican corporations without concern for double taxation, as long as the Mexican corporation’s assets do not consist principally of real property. In contrast, United States taxpayers will potentially face double taxation when any shares of a closely held corporation in which they hold a 25% interest or more are disposed of, regardless of the corporation’s underlying asset base. In addition, Canadian taxpayers who hold a substantial interest in an unlisted Mexican corporation the value of the shares of which is derived principally from real estate will also have the opportunity to purify the corporation and reduce the value of the real estate located in Mexico prior to the disposition of their shares, thereby, avoiding Mexican tax liability. United States taxpayers, in contrast, will remain liable for Mexican tax if the value of their shares, at any time, was derived at least 50% from real property located in Mexico.

There are also significant differences in the wording of the treaty provisions with respect to the disposition of moveable property consisting of or forming part of a permanent establishment or fixed base. These differences may prove significant when calculating the total tax liability on the movement of such branch assets to a subsidiary or other related corporation. Under the Canada-U.S. Treaty, liability in the host country will arise if the alienator “has or had” the property in any twelve-month period preceding the date of the alienation. In contrast, under the Mexico-Canada Treaty, liability will arise only if the alienator has the assets in such a capacity at the time of the alienation. Finally, under the U.S.-Mexico Treaty no reference is made to specific timing but rather more generally to the notion of whether the alienator “has or had” such property. Clearly, if the treaty conditions as to the holding of property are not met, no host country tax liability will result. These references to timing could thus prove significant in determining overall tax liability, assuming the gain is otherwise taxable under the country’s domestic law.

IV. CAPITAL GAINS, CORPORATE REORGANIZATIONS AND DOUBLE TAXATION

As previously discussed, tax liability in a source country may result in double taxation. Corporate reorganizations involving cross-border assets are

\textsuperscript{63} \textit{Id.}

\textsuperscript{64} Mexico-Canada Treaty, \textit{supra} note 2, art. XIII(4).
particularly vulnerable to this result. Such transactions often receive deferred tax treatment under domestic law, nevertheless, the transfer of ownership of an asset situated in the foreign jurisdiction will result in immediate taxation. Under domestic tax law, the corporation involved in the reorganization will take the asset with its tax deferred cost base and tax liability will not arise until the disposition of the asset. Because the gain realized at the time of acquisition by the corporation in its own jurisdiction is deferred, the foreign tax credit otherwise available when foreign tax is paid may be unavailable when the gain is ultimately recognized.  

Consider the following example: a United States resident transfers real property situated in Canada to a newly organized United States corporation in exchange for 100% of that corporation's stock. This transaction will be taxable under Canadian domestic law because the Canadian property is not being transferred to a taxable Canadian corporation and remains taxable in Canada because the Canada-U.S. Treaty preserves Canada's right to tax gains on dispositions by nonresidents of real property situated in Canada. However, this transfer is not taxable in the United States as the transaction meets the requirements of the nonrecognition provision I.R.C. section 351. Double taxation may result when the real property is ultimately disposed of by the United States corporation since the full gain will be taxable at that time in the United States. Double taxation could occur either as a result of an immediate timing problem with respect to the unused foreign tax credit, as there is no taxable U.S. income at the time of the transfer, or because the credit may expire before an actual disposition or other taxable event occurred in the United States. Double taxation may also occur because the transaction results in a foreign tax credit to the transferor corporation while the transferee corporation has taxable income as a result of the eventual disposition of the transferred assets. If a corporate reorganization does not result in an economic realization of proceeds at the time of transfer under United States tax law, but is, nonetheless, subject to Canadian tax, the potential for double taxation exists.

If the country's statutory provisions are met, the types of corporate reorganizations which are typically tax deferred in the NAFTA countries for domestic tax purposes are corporate mergers, divisions, stock-for-stock exchanges, certain liquidations, and, in Canada and the United States, transfers of property to a corporation in exchange for shares. The United States corporate reorganization provisions are a highly complex entanglement of statutory, administrative and judicial law. The Canadian corporate tax provisions often

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65. Foreign tax credit relief is generally time sensitive and may either expire, or, if usable in some form, may not provide matching relief for the foreign taxes that have been paid. I.R.C. § 904(e) (1998).
66. I.T.A. subsections 69(1) and 85(1).
67. Canada-U.S. Treaty, supra note 4, art. XIII(1), (3).
68. See Canada-U.S. Treaty, supra note 4, art. XIII(2) which deems a disposition at the time of transfer, notwithstanding that no disposition may occur under United States domestic law. See, e.g., I.R.C. § 351 (1998).
provide a similar result but are less involved while Mexico’s corporate tax provisions are just emerging. These different stages of complexity and development add significantly to the possibility of double taxation. Although a detailed discussion of the corporate reorganization provisions of each country is beyond the scope of this article, a summary of these provisions is presented below. Any corporate reorganization which is tax deferred domestically, and which involves a cross-border asset which the treaty country of locale may tax on disposition, may result in double taxation.

Summary of Tax Deferment Provisions: Corporate Reorganization Provisions in Canada, the United States and Mexico

<table>
<thead>
<tr>
<th>Transfers of Property to a Corporation</th>
<th>Canada</th>
<th>United States</th>
<th>Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, I.T.A. section 85: Elective transfer for property that includes shares; tax deferred rollover unless gain elected if consideration received exceeds tax cost; boot permitted</td>
<td>Yes, I.R.C. §§ 351,368(a)(1)(C): Tax deferred transfer of property in exchanged for stock; transferor(s) has 80% control immediately after exchange; boot results in recognized gain; C reorganizations require a transfer of “substantially all the assets” and the receipt of voting stock. I.R.C. § 368(a)(1)(D): nondivisive D reorganizations</td>
<td>No, Article 14 FFC:Disposition at fair market value even if transferor retains control over transferred asset</td>
<td></td>
</tr>
</tbody>
</table>

69. The Mexican provisions are of relatively recent vintage and were adopted in an effort to harmonize Mexico’s tax system with those of the United States and Canada. In broad terms the requirements imposed by the corporate nonrecognition provisions follow the principles of the United States Internal Revenue Code. See generally M. Gammie, The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement, 49 Tax L. Rev. 615, 627 (1994).
70. See generally Código Fiscal de la Federación (C.F.F.-Mexico) [hereinafter FFC].
| Corporate Divisions | Yes, I.T.A. section 55: Tax deferred division permitted if shares of corporation continue to be owned by shareholders of original corporation; corporate assets must be divided among shareholders | Yes, I.R.C. §§ 355, 368(a)(1)(D): Allows tax deferred spin offs, split offs, split ups; gain recognized to the extent boot received; distribution of 80% control necessary; cannot have a 50% shift in ownership within preceding five years; at least two active businesses must result. | Yes, Articles 14-A & 15A FFC: Allows tax deferred spin offs and split ups; 51% of original voting shareholders must be the same for two years prior and immediately after; transaction would qualify under I.R.C. § 355 |
| Stock-for-Stock Exchange | Yes, I.T.A. section 85.1: Exchange solely for shares; parties must be at arm’s length before and after exchange or I.T.A. section 85 must be used | Yes, I.R.C. § 368(a)(1)(B): exchange must be solely for voting stock; must meet 80% control test immediately after acquisition. I.R.C. § 368(a)(1)(E): tax deferred re- | No, Article 17 FFC: However, nonresident corporation can request a ruling from SHCP that transfer be at tax cost |

71. The shares may also be alienated to persons who have been owners of voting shares in the divided company at the time of the division provided those persons do not change their shareholding, as a percentage of the capital stock of the spin off, by more than 20% of what they had in the capital stock of the divided company at the time of the spin off.

72. The Ministry of Finance (Secretaria de Hacienda y Crédito Publico—SHCP).
| Merger | Yes, I.T.A. section 87: Includes vertical and horizontal amalgamations | Yes, I.R.C. § 368(a)(1)(A): Statutory merger or consolidation; stock for asset acquisition; continuity of interest and continuity of business enterprise doctrines must be met | Yes, Article 14A FFA: Includes vertical amalgamations; transaction would also qualify under I.R.C. §§ 386(a)(1)(C) or (D) |

V. TREATY RELIEF FROM DOUBLE TAXATION IN CORPORATE REORGANIZATIONS

The problem of double taxation in the course of corporate reorganizations is not new. It has been recognized by both Canada and the United States as significant in their cross-border arrangements and, consequently, provisions have been included in the Canada-U.S. Treaty allowing for tax relief when double taxation occurs. Some consideration has also been given to the problem of


Article XIV(8) of the U.S.-Netherlands Treaty contains a paragraph similar to that in the U.S.-Canada Treaty but imposes a more affirmative obligation on the Competent Authority of a contracting state to defer tax in circumstances in which it is deferred under the laws of the other state. This deferral is conditional on later collectibility of taxes. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18,
double taxation in corporate reorganizations in the tax treaties between Canada and Mexico\textsuperscript{75} and the United States and Mexico.\textsuperscript{76} These provisions are outlined below.

A. Canada-United States Treaty

1. Corporations

Article XIII(8) of the Canada-U.S. Treaty permits a taxpayer who acquires\textsuperscript{77} property in the course of a "corporate or other organization, reorganization, amalgamation, division or similar transaction\textsuperscript{78}" to request Competent Authority relief. For example, under the domestic law of the United States, a foreign corporation that qualifies as a "United States real property holding corporation" is taxed in some circumstances if it transfers its assets to a United States corporation in a reorganization. In such a case, only if the shareholders of such foreign corporation agree to reduce basis (if and only to the extent available) by "closing agreement" can the tax that otherwise would be imposed on such alienation be reasonably imposed or collected at a later time.\textsuperscript{79}

Article XIII(4) of the U.S.-Spain Treaty permits the source country to tax gains on stock dispositions if the taxpayer held at least 25% of the company's stock during the twelve months preceding the alienation of stock. Paragraph 10 of the 1990 Protocol provides that an alienation covered by Article XIII(4) does not include certain transfers between members of a group of companies that file consolidated returns. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Feb. 22, 1990, U.S.-Spain, art. XIII(4), 4 Tax Treaties (CCH) ¶ 8403.03. See Editorial Comment s. 67.12 Spain, Art. 13: "Taxation and Foreign Related Transactions" (MB)67-26.

75. Mexico-Canada Treaty, supra note 2, art. XIII(5).
77. The language of Article XIII(8) of the Canada-U.S. Treaty refers to the alienation of "property in the course of a corporate organization, reorganization, amalgamation, division or similar transaction." Canada-U.S. Treaty, supra note 4, art. XIII(8). The meaning of this expression, in the case of a United States resident seeking relief from the Canadian Competent Authority, must be found in Canadian domestic law. Id. art. III(2). Unfortunately, neither the complete phrase nor all of the individual words are defined for Canadian tax purposes. Generally, the words "winding-up, discontinuance and reorganization" refer to the corporation's business, not to the corporate entity itself. "Business" may be defined widely enough, or narrowly enough, to include almost any corporate activity; therefore, any change from one type of business to another may be construed as a "winding-up, discontinuance or reorganization" of a business. See Merritt v MNR [1940-41] C.T.C. 226, Exch Ct; Canada Tax Service—Stikeman Analysis, I.T.A. subsection 15(1) (Carswell).
78. The 1995 Protocol to the Canada-U.S. Treaty amended Article XIII(8). 1995 Protocol, supra note 4, art. VIII. The Treasury Department's Explanation of the 1995 Protocol states that the amendment to Article XIII(8) broadens the scope of Article XIII(8) of the Canada-U.S. Treaty to cover organizations, reorganizations, amalgamations, and similar transactions involving either corporations or other entities such as trusts and partnerships. It further states:

As in the case of transactions covered by the present Convention, the deferral allowed under this provision shall be for such time and under such other conditions as are stipulated between the person acquiring the property and the competent authority. The
Authority assistance to defer the profit, gain or income. If a resident of a contracting state alienates property in such a transaction and the profit, gain or income with respect to such alienation is not recognized for income tax purposes in the contracting state of residence, the Competent Authority of the other contracting state may agree to defer recognition of such profit, gain, or income. Article XIII(8) allows for potential relief to a nonresident only if deferral is available in the resident, but not the nonresident contracting state and if deferral would have been available to a resident of the nonresident contracting state. This provision becomes operative upon request of the Competent Authority of the nonresident contracting state by the nonresident taxpayer who acquires the property in the corporate transaction. Deferral lasts for such time and under such conditions as stipulated between the nonresident taxpayer and the Competent Authority. For example, relief from taxation may be granted until there is an actual disposition of the asset involved. The duration and conditions of the deferral, however, are completely at the discretion of the Competent Authority and will only be granted by the Competent Authority to the extent necessary to avoid double taxation.

The wording of Article XIII(8), in addition to providing relief in the course of a corporate reorganization, was expanded under the 1995 Protocol to include organizations of noncorporate entities such as partnerships and trusts. Because the 1995 Protocol and the Canada-U.S. Treaty do not address whether, or to what extent, a partnership, joint venture, or other unincorporated association of person, is considered a resident of Canada or of the United States, a close examination of Canadian and United States domestic tax agreement of the competent authority of the State of source is entirely discretionary and, when granted, will be granted only to the extent necessary to avoid double taxation.


81. Unless extraordinary circumstances exist, Article XIII(8) relief will be applied by the Competent Authority consistently within the taxable period with respect to transactions described in paragraph 8. Technical Explanation of the March 17, 1995 Protocol, supra note 78.
82. The language "in order to avoid double taxation" is used in the Canada-U.S. Treaty but not in Canada's Treaty with the Netherlands or Mexico. Although the scope of the Competent Authorities' discretion is not clear, it may be that the breath of these treaties is broader than that intended in the Canada-U.S. Treaty.
83. See 1995 Protocol, supra note 4, art. VIII.
provisions is required in order to determine when Treaty relief will be available.85

2. Nonrecognition and Timing Problems for Individuals

Individuals are also potentially subject to double taxation as a result of a corporate organization or reorganization. Two examples illustrate the double taxation problem. The first includes the transfer of assets which constitute a permanent establishment or fixed base in Canada by a United States resident individual to a United States corporation in exchange for stock constituting control of the corporation. The second example involves the receipt by a United States resident shareholder of new shares on the consolidation of two United States corporations, assuming the corporations hold Canadian real property the value of which exceeds 50% of the value of the corporation. In both situations, the United States resident would be immediately subject to Canadian tax while receiving tax deferred treatment in the United States.86 The Canada-U.S. Treaty provides an individual with the option of seeking relief from double taxation under Article XIII(7) or under Article XIII(8) under those circumstances.

According to the 1984 Technical Explanation to the Canada-U.S. Treaty, Article XIII(7) was intended “to coordinate United States and Canadian taxation of gains where an individual is subject to tax in both contracting states and one contracting state deems a taxable alienation of property by the person to have occurred, while the other defers but does not forgive taxation with respect to the gain. Under those circumstances, the individual can elect in his annual return for the year of the transaction to be liable to tax in the contracting state which is deferring recognition.”87 The individual will be liable to tax in the contracting state as though the property was sold and repurchased for an amount equal to its fair market value. However, because of the time value of money, Article XIII(8) relief which results in a deferral of tax often is preferable.

85. See also Commentary on Article I, paragraphs 2-6, Report of the OECD, Nov. 1997 (discussing the OECD’s recognition of the difficulties in applying the treaty provisions to partnerships and recommendation that such matters be resolved in bilateral negotiation).


87. Technical Explanation of Can.-U.S. Treaty, supra note 25. The examples in the Technical Explanation include (1) a gift by a United States citizen or resident individual which is taxable for Canadian income tax purposes and not for United States purposes and (2) a United States citizen who is deemed to recognize income for Canadian income tax purposes upon departure from Canada. See id.
B. Mexico-Canada Treaty

Although seemingly more limited in scope, the wording of Article XIII(5) of the Mexico-Canada Treaty is similar to that in Article XII(8) of the Canada-U.S. Treaty. Potential relief from double taxation in the course of a corporate reorganization is available when a resident of one of the contracting states alienates property "in the course of a corporate amalgamation or division or of a corporate reorganization involving an exchange of shares and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that state." When these conditions are met, and if requested by the person acquiring the property, the Competent Authority of the contracting state otherwise entitled to tax under the Treaty, may agree to defer the recognition of the profit, gain, or income. The agreement may include terms and conditions as deemed necessary by the Competent Authority to assure the eventual collection of tax by the contracting state.

It is not clear what was intended by the phrase "a corporate reorganization involving an exchange of shares" contained in Article XIII(5). With regards to Canada, this language appears to limit potential relief to transactions contemplated under I.T.A. section 85.1 in which shares are exchanged for shares. However, the provision may not be this restrictive and relief may be available where property other than shares is exchanged for shares in a transfer to which, for example, I.T.A. section 85 would apply. This broader interpretation appears to have been the intention of Canada. Thus, in substance, the provisions of both the Canada-U.S. Treaty and Mexico-Canada Treaty would be viewed by the Canadian Competent Authority as the same as long as there is a disposition of a property in Canada which subjects a nonresident to Canadian tax on a corporate organization, reorganization, amalgamation, division or other similar transaction. According to the Canadian Competent Authority, since these transactions or concepts are not defined terms in the Treaty, the generally accepted meaning is used. Therefore, the corporate transactions encompassed are the transactions described in the sections of the I.T.A. that allow a deferral of taxation.

However, if a Canadian is seeking relief as a result of tax liability arising in Mexico under the Mexico-Canada Treaty, it is the view of the Mexican Competent Authority on the scope of the provision that is critical. It was apparently the Mexican negotiating team that restricted the wording from that used in the Canada-U.S. Treaty. Thus, the change of wording may have been quite deliberate. Mexico does not provide a tax deferral similar to I.T.A. section 85 or I.R.C. section 351 to its own nationals on transfers of property to a

88. Mexico-Canada Treaty, supra note 2.
89. Conversations with representative of Legislative and Policy Division and Canadian Competent Authority. (Ottawa, Sept. 1997).
90. Id. See also Canada-U.S. Treaty, supra note 4, art. III(2).
91. See I.T.A. subsections 85(1), 85(2), 87(1), 87(9),88(1); I.T.A. sections 85.1, 86, & 51 (providing tax deferred treatment on certain corporate transactions).
corporation. A disposition is deemed to occur at fair market value. In consequence, it is unlikely that a Canadian would be given Mexican Competent Authority relief in these circumstances.

C. United States-Mexico Treaty

Relief from double taxation on a corporate reorganization under the Treaty between the United States and Mexico is dramatically different than the relief offered under both Canadian treaties. As will be demonstrated, this difference will benefit United States taxpayers in some cases, but most often it will leave United States taxpayers in a highly disadvantageous tax position relative to their Canadian or Mexican counterparts.

According to the terms of the U.S.-Mexico Treaty, instead of providing access to Competent Authority relief for double taxation in the course of a corporate reorganization, paragraph 13 of the 1992 Protocol limits the imposition by Mexico of source country tax on corporate reorganizations.92 As previously discussed, the U.S.-Mexico Treaty maintains Mexico's right to tax a United States resident on the gain from the sale of shares of a closely held corporation in which the United States alienator had a participation interest of at least 25% in the capital of the corporation during the twelve-month period preceding the disposition.93 Paragraph 13 of the 1992 Protocol provides an exception to taxation if the transfer of property is between members of a group of United States companies filing a consolidated return.94 No tax will result:

to the extent that the consideration received by the transferor consists of participation or other rights in the capital of the transferee or of another company resident in the same Contracting State that owns directly or indirectly 80% or more of the voting rights and the value of the transferee, if:

93. See supra text accompanying notes 56-58.
94. See I.R.C. §§ 1501-1504 (1998) (granting an affiliated group of corporations the privilege of filing consolidated returns). An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. I.R.C. § 1501 (1998). Generally, the election allows the affiliated group to be taxed as a single corporation. An "affiliated group of corporations" is defined to mean certain "includible corporations" connected through specified stock ownership requirements. I.R.C. § 1504(a) (1998). An "includible corporation" is any corporation except a tax exempt corporation, an insurance company, certain foreign corporations, a regulated investment company or an S corporation. I.R.C. § 1504(b) (1998). The stock ownership rule requires that the affiliated group of corporations consist of one or more chains of includible corporations connected through stock ownership with a common parent corporation, which is also an includible corporation, such that: (1) Stock with at least 80% of the voting power of all classes of stock and at least 80% of the value of each includible corporation must be owned directly by one or more of the other includible corporations; and (2) the common parent must also meet the 80% test with respect to at least one of the other includible corporations. I.R.C. § 1504(a) (1998).
(i) The transferor and transferee are companies resident in the same Contracting State;

(ii) before and immediately after the transfer, the transferor or the transferee owns, directly or indirectly, 80 percent or more of the voting rights and value of the other, or a company resident in the same Contracting State owns directly or indirectly (through companies resident in the same Contracting State) 80 percent or more of the voting rights and value of each of them . . . . 95

If cash or other property is received in the exchange in addition to participation or other rights in the capital of the transferee, gain may be taxed by the other contracting state limited to the amount of cash or other property received. For the purposes of determining gain on any subsequent disposition, the basis of the assets for the transferee is the same basis for the transferor, increased by any cash or property paid by the transferee. 96

This provision of the 1992 Protocol defers the tax on the gain from the transfer of shares, participation or other rights in the capital of a Mexican company or other legal entity until after the shares are transferred outside of the United States consolidated group. To illustrate, assume that a United States corporation owns all of the stock of a Mexican subsidiary corporation, and forms a new, wholly owned United States subsidiary for which it files a United States consolidated income tax return. In capitalizing the new corporation, the United States parent transfers all of the stock of the Mexican subsidiary to the new United States subsidiary in exchange solely for all of the voting stock of the United States subsidiary. This transaction would qualify for nonrecognition of United States tax under I.R.C. section 351. Under I.R.C. section 362(a), the transferee corporation receives the transferor's basis in the stock of the Mexican subsidiary, increased by any gain recognized by the transferor on the transaction. Under Paragraph 13 of the 1992 Protocol, Mexico cannot impose a tax on the transfer of the Mexican subsidiary's shares even though it involved the disposition of stock of a Mexican company by a substantial nonresident shareholder until the shares are ultimately disposed of by the transferee corporation. 97 Nevertheless, the relief from double taxation offered by Article XIII(4) of the U.S.-Mexico Treaty and paragraph 13 of the 1992 Protocol is extremely limited. Although paragraph 13 establishes standards for restricting tax on intercompany transfers for the purposes of the U.S.-Mexico Treaty, its language does not parallel the reorganizations described in I.R.C. section 368. Thus, the potential for double taxation will continue to exist in a wide range of circumstances.

96. Id.
Article XIII(4) further states that the gain will be deemed to arise in the other contracting state to the extent necessary to avoid double taxation. Thus, the gain from the alienation of stock, participation, or other rights in the capital of a Mexican company or other legal entity by a United States taxpayer will be deemed to be income sourced in Mexico. As a result, the United States will treat the gain taxed by Mexico under Article XIII(4) as foreign source income\(^9\) to the extent necessary to permit a foreign credit for the Mexican tax, subject to the limitations of United States law.\(^9\) If the Mexican tax on the gain does not exceed the United States tax, the United States will grant a foreign tax credit for the entire amount of the Mexican tax paid.\(^10\)

### D. Summary of Treaty Provisions: Potential Relief from Double Taxation

The following provides a summary of potential treaty relief from double taxation in the course of a corporate reorganization among the NAFTA signatories:

<table>
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<tr>
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<tbody>
<tr>
<td>Property is alienated in the course of a corporate reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that state. Request for relief is made by the person acquiring the property.</td>
<td>Property is alienated in the course of a corporate amalgamation or division or of a corporate reorganization involving an exchange of shares and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that state. Request for relief is made by the person acquiring the property.</td>
<td>No tax is payable on the disposition of unlisted shares in a corporation in which at least a 25% interest is held if the transfer is between a group of corporations that files a consolidated return and only to the extent the consideration received by the transferor constitutes shares. No request for relief is necessary.</td>
</tr>
</tbody>
</table>

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98. The gain from the sale of stock of a foreign affiliate may already be considered foreign source income. I.R.C. § 865(f) (1998).

99. See I.R.C. § 904(a) (1998) (limiting the credit amount to the "proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year").

100. Technical Explanation of U.S.-Mex. Treaty, supra note 37, at 76.
VI. EXAMPLES

As indicated, in a corporate reorganization involving assets located in another treaty country, significant differences in the relief or potential relief from double taxation are available under the tax treaties among the NAFTA countries. These differences have a major impact on the tax treatment of the treaty partners. The following examples illustrate some of the circumstances where double taxation may occur on a corporate reorganization. The examples are divided into transfers of real property under Article XIII(1) and transfers of assets of a permanent establishment or fixed base under Articles XIII(2) and (3). The examples begin with generic facts and then illustrate the potential tax result under each of the NAFTA treaties.

A. Article XIII(1) Liability: Transfers of Real Property

Example 1: A parent corporation resident in Country A transfers investment real property situated in Country B to a 90% owned subsidiary resident in Country A in exchange for subsidiary stock.

![Diagram of corporate reorganization involving assets located in another treaty country.](Image)

- **Parent**
  - Real property (Country B)
  - Sub stock

- **Sub**

- **Country A**
  1. United States
  2. Canada
  3. Mexico

- **Border**

- **Country B**
  1. Canada
  2. Mexico
  3. United States

Real Property
1. Canada-United States Treaty

If a United States parent transfers investment real property situated in Canada to a 90% owned United States subsidiary in exchange for subsidiary stock, the transaction is tax deferred under I.R.C. section 351. If the real property is owned by a Canadian resident and the transfer is to a taxable Canadian corporation, the transaction is also tax deferred under I.T.A. subsection 85(1). Nevertheless, the transfer of the real property is subject to Canadian tax under Article XIII(1) of the Treaty.

Result: Competent Authority relief is potentially available under Article XIII(8). The United States taxpayer may petition the Canadian Competent Authority for assistance.

2. Mexico-Canada Treaty

If a Canadian parent transfers investment real property situated in Mexico to a 90% owned Canadian subsidiary in exchange for subsidiary shares, the transaction qualifies as a rollover under I.T.A. subsection 85(1). However, the transfer is subject to Mexican tax under Article XIII(1) of the Treaty. Under Mexican domestic law such a transfer by a Mexican corporation is subject to tax in Mexico. If Mexico adopts Canada's position with respect to when relief is granted, that is, relief is provided only if it is available to Mexican residents in similar circumstances, then no relief will be granted under these circumstances. There is no equivalent to I.T.A. section 85 in Mexico's Fiscal Code.

Result: Competent Authority relief is probably not available to the Canadian transferor from the Mexican Competent Authority since the transaction would be taxable in Mexico if undertaken by a Mexican corporation. In consequence, double taxation may result.

3. United States-Mexico Treaty

If a United States parent transfers investment real property situated in Mexico to a 90% owned United States subsidiary in exchange for subsidiary stock, the transaction is tax deferred under I.R.C. section 351. Nevertheless, the transfer will be subject to Mexican tax under Article XIII(1) of the Treaty.

Result: No relief from double taxation will be granted. The United States corporation may consider seeking assistance from the U.S. Competent Authority. However, since Mexico has exercised its legitimate right to tax under the Treaty, it is unlikely that the U.S. Competent Authority will grant relief under these circumstances.
Example 2: A parent corporation resident in Country A owns all of the stock of a subsidiary also resident in Country A (Sub 1). Sub 1 owns all of the stock of a taxable corporation resident in Country B (Sub 2). The value of the shares of Sub 2 is derived principally from real property situated in Country B. Sub 1 is liquidated into its parent.

1. Canada-United States Treaty

A United States parent owns all of the stock of a United States subsidiary. The United States subsidiary owns all of the stock of a taxable Canadian corporation. The value of the shares of the taxable Canadian corporation is derived principally from real property situated in Canada. The United States subsidiary is liquidated into the United States parent. United States parent and United States subsidiary receive nonrecognition treatment under I.R.C. section 332 and section 337, respectively. Under Canadian law, I.T.A. subsection 88(1) also provides for nonrecognition on the winding up of a 90% owned subsidiary by a parent if both corporations are taxable Canadian corporations. The transaction would be subject to Canadian tax under Article XIII(1) of the Treaty.

Result: Relief from double taxation is potentially available under Article XIII(8). Assistance must be sought from the Canadian Competent Authority.
2. Mexico-Canada Treaty

A Canadian parent owns all of the stock of Canadian subsidiary. The Canadian subsidiary owns all of the stock of a Mexican corporation. The value of the shares of the Mexican corporation is derived principally from real property situated in Mexico. The Canadian subsidiary is liquidated into the Canadian parent. Under Canadian tax law, I.T.A. subsection 88(1) provides for nonrecognition on the transfer of assets on the winding up of a 90% owned subsidiary by a parent if both corporations are taxable Canadian corporations. The transaction would be subject to Mexican tax under Article XIII(1) of the Treaty.

Result: According to the wording of Article XIII(5), no Competent Authority relief will be granted if this is a corporate "liquidation." Nonetheless, relief may be available from the Canadian Competent Authority under the provisions of I.T.A. subsection 87(1) or 88(1). Canada takes a broad view of its role in providing relief where property is alienated "in the course of a corporate amalgamation or division or of a corporate reorganization involving an exchange of shares" and looks to the substance of the transaction. This transaction is not taxable in Mexico as a vertical amalgamation. Article 14A of the FFA provides for a tax deferred merger by absorption.

3. United States-Mexico Tax Treaty

A United States parent owns all of the stock of a United States subsidiary. The United States subsidiary owns all of the stock of a Mexican corporation. The value of the shares of the Mexican corporation is derived at least 50% from real property situated in Mexico. The subsidiary is liquidated into the United States parent. United States parent and United States subsidiary receive nonrecognition treatment under I.R.C. section 332 and section 337, respectively. The transaction would be subject to Mexican tax under Article XIII(1) of the Treaty.

Result: No treaty relief from potential double taxation is available. The United States taxpayer must seek assistance from the U.S. Competent Authority. Special relief is unlikely since Mexico is exercising its right to tax under the U.S.-Mexico Treaty.

Example 3: Corporation X resident in Country A owns investment real property situated in Country B. Unrelated Corporation Y is also resident in Country A. Corporation X and Corporation Y consolidate to form new Corporation Z resident in Country A.
1. Canada-United States Tax Treaty

United States Corporation X owns investment real property situated in Canada. United States Corporation X and unrelated United States Corporation Y consolidate to form United States Corporation Z. The consolidation constitutes a tax deferred reorganization under I.R.C. section 368(a)(1)(A). If the predecessor corporations are taxable Canadian corporations, the transaction qualifies as an amalgamation under I.T.A. subsection 87(1). Under XIII(1) of the Treaty, the transfer of the Canadian real property is subject to tax in Canada.

**Result:** Relief from double taxation is potentially available under Article XIII(8). Assistance may be sought from the Canadian Competent Authority.

2. Mexico-Canada Treaty

Canadian Corporation X owns investment real property situated in Mexico. Corporation X and unrelated Canadian Corporation Y consolidate to form Canadian Corporation Z. The transaction qualifies as a tax deferred amalgamation under I.T.A. subsection 87(1). If a Mexican corporation owned real property in Canada, the transfer would be tax deferred in Mexico under FFC 14A. Under XIII(1) of the Treaty, the transfer is subject to tax in Mexico.

**Result:** Relief from double taxation is potentially available under Article XIII(5) of the Treaty. Assistance may be sought from the Mexican Competent Authority.
3. United States-Mexico Treaty

United States Corporation X owns investment real property situated in Mexico. Corporation X and unrelated United States Corporation Y consolidate to form United States Corporation Z. The consolidation constitutes a tax deferred reorganization under I.R.C. section 368(a)(1)(A). Under XIII(1) of the Treaty, the transfer of the real property situated in Mexico would be subject to tax in Mexico.

Result: No treaty relief is available, therefore, double taxation is a potential.

Example 4: Corporation X resident in Country A holds only real property situated in Country B. Unrelated Corporation Y is also resident in Country A. The shareholders of Corporation X exchange all of their Corporation X stock solely for voting stock of Corporation Y. Immediately after the exchange, Corporation Y owns 100% of Corporation X.

1. Canada-United States Treaty

United States Corporation X holds only real property situated in Canada. The shareholders of United States Corporation X exchange all of their Corporation X stock solely for voting stock of United States Corporation Y. United States Corporation Y is a United States Corporation which owns 100% of United States Corporation X immediately after the exchange. The stock exchange qualifies as a tax deferred reorganization under I.R.C. section
368(a)(1)(B) and also receives tax deferred treatment in Canada under I.T.A. section 85.1. The transaction is subject to tax under Article XIII(1) of the Treaty.

Result: Relief from double taxation is potentially available under Article XIII(8). Assistance may be sought from the Canadian Competent Authority.

2. Mexico-Canada Treaty

Canadian Corporation X holds only real property situated in Mexico. The shareholders of Corporation X exchange all of their Corporation X stock solely for voting stock of Corporation Y. Corporation Y is a Mexican Corporation which owns 100% of Corporation X immediately after the exchange. The share exchange qualifies as a tax deferred reorganization under I.T.A. section 85.1. The transaction is subject to tax under Article XIII(1) of the Treaty.

Result: Relief from double taxation is potentially available under Article XIII(5) of the Treaty. Assistance must be sought from the Mexican Competent Authority. Although there is no automatic tax deferral on an exchange of shares by a Mexican corporation, a ruling may be sought from the Mexican Ministry of Finance that the transfer occur at tax cost.

3. United States-Mexico Treaty

United States Corporation X holds only real property situated in Mexico. The shareholders of United States Corporation X transfer all of their Corporation X stock solely for voting stock of United States Corporation Y. Corporation Y is a United States Corporation which owns 100% of Corporation X immediately after the exchange. The stock exchange qualifies as a tax deferred reorganization under I.R.C. section 368(a)(1)(B). The transaction is subject to tax under Article XIII(1) of the Treaty.

Result: No treaty relief is available, thus, potential double taxation. The United States taxpayer may wish to seek assistance from the U.S. Competent Authority.

B. Article XIII(2) or (3) Liability: Transfers of Personal Property Which is or Forms a Part of a Permanent Establishment or a Fixed Base

Example 5: Corporation X resident in Country A conducts business through a branch situated in Country B. Corporation X transfers the branch assets to newly organized Corporation Y resident in Country A in exchange for all of the Corporation Y stock.
1. Canada-United States Treaty

A United States Corporation conducts business through a Canadian branch. The United States Corporation transfers the branch assets to a newly organized United States Corporation Y in exchange for all of the corporation Y stock. I.R.C. section 351 provides for nonrecognition on the transfer of the branch assets. The transaction will receive rollover treatment if the newly formed corporation was a taxable Canadian corporation. Nevertheless, the transfer of the branch assets will be taxable in Canada under Article XIII(2) of the Treaty.

Result: Relief from double taxation is potentially available under Article XIII(8). Assistance may be sought from the Canadian Competent Authority.

2. Mexico-Canada Treaty

A Canadian corporation conducts business through a Mexican branch. The Canadian corporation transfers the branch assets to a newly organized Canadian Corporation Y in exchange for all of the Corporation Y shares. The transaction will receive rollover treatment in Canada if the newly formed corporation were a taxable Canadian corporation. Nevertheless, the transfer of the branch assets will be taxable in Mexico under Article XIII(2) of the Treaty.
Result: No Competent Authority relief will likely be granted under Article XIII(5) since this transaction is taxable to a Mexican transferor transferring assets to a Mexican corporation.

3. United States-Mexico Tax Treaty

A United States corporation conducts business through a Mexican branch. The United States corporation transfers the branch assets to a newly organized United States corporation Y in exchange for all of the corporation stock. I.R.C. section 351 provides for nonrecognition on the transfer of the branch assets. Nevertheless, the transfer of the branch assets will be taxable in Mexico under Article XIII(3) of the Treaty.

Result: No treaty relief will be granted. The United States taxpayer may seek assistance from the U.S. Competent Authority.

Example 6: Corporation X and Corporation Y are unrelated corporations resident in Country A and both carry on a oil and gas operations situated in country B through a branch. Corporation X and Corporation Y consolidate to form new Corporation Z resident in Country A.

1. Canada-United States Tax Treaty

Both United States Corporation X and United States Corporation Y carry on oil and gas operations in Canada through a branch. United States Corporation X and United States Corporation Y consolidate to form new United States
Corporation Z. The consolidation is tax deferred under I.R.C. section 368(a)(1)(A). If taxable Canadian corporations were involved, the transaction qualifies as an amalgamation under I.T.A. subsection 87(1). Nevertheless, the transfers of the branch assets will be subject to tax in Canada under Article XIII(2) of the Treaty. In this situation, both predecessor corporations would have to seek I.T.A. section 115.1 relief.

Result: Relief from double taxation is potentially available under Article XIII(8). Assistance may be sought from the Canadian Competent Authority.

2. Mexico-Canada Tax Treaty

Both Canadian Corporation X and Canadian Corporation Y carry on oil and gas operations in Mexico through a branch. Canadian Corporation X and Canadian Corporation Y consolidate to form new Canadian Corporation Z. If taxable Canadian corporations were involved, the transaction will qualify as an amalgamation under I.T.A. subsection 87(1). The transfers of the branch assets will be subject to tax in Mexico under Article XIII(2) of the Treaty. In this situation, both predecessor corporations will have to seek treaty relief.

Result: Competent Authority relief is available under Article XIII(5) of the Treaty. Assistance may be sought from the Mexican Competent Authority.

3. United States-Mexico Tax Treaty

Both United States Corporation X and United States Corporation Y carry on oil and gas operations in Mexico through a branch. United States Corporation X and United States Corporation Y consolidate to form new United States Corporation Z. The consolidation will be tax deferred under I.R.C. section 368(a)(1)(A). The transfers of the branch assets will be subject to tax in Mexico under Article XIII(3) of the Treaty.

Result: Relief from double taxation will not be granted.

D. Other Transactions

The above transactions illustrate some of the more common circumstances in which double taxation may occur in the course of a corporate reorganization. Additional situations exist in which tax liability may arise for one but not another NAFTA treaty partner. For example, the Canadian treaties with both the United States and Mexico allow for Competent Authority relief in the case of a corporate division; however, no such relief is provided in the U.S. Treaty with Mexico. United States taxpayers may also be taxable upon the disposition of shares in an unlisted Mexican corporation in which they hold a 25% or greater interest unless the transfer is to a United States corporation with which it files a consolidated return. There is no tax liability under these circumstances in the treaties between Canada and Mexico and Canada and the United States regardless of whether the transferor and transferee corporations file consolidated returns.
Finally, the Canada-U.S. Treaty envisions treaty relief if business reorganization involves entities other than corporations. Thus, there is the potential for treaty relief for partnerships, joint ventures and trusts involved in such reorganization. This extended relief is not available under either the Canadian or United States treaties with Mexico.

VII. COMPETENT AUTHORITY

Relief from double taxation under a tax treaty must be sought through the Competent Authority. All of the tax treaties signed among the NAFTA countries contain a provision establishing a Mutual Agreement Procedure. This procedure is the umbrella for a number of important aspects of taxpayer relief. For example, under the Mutual Agreement Procedure, if a taxpayer believes the actions of one or both of the contracting states will result in taxation not in accordance with the provisions of the treaty, the taxpayer may present the case in writing to the Competent Authority of the state in which the taxpayer is a resident or national. If relief appears to be justified and the contracting state of residency cannot arrive at a satisfactory solution, the Competent Authorities of both contracting states will attempt to resolve the case by mutual agreement. In addition to attempting to resolve disputes arising as to the interpretation or application of a provision in a tax treaty, the Competent Authorities of the contracting states may consult together regarding disputes not provided in the various Conventions.

101. Canada-U.S. Treaty, supra note 4, art. XXVI(1); Mexico-Canada Treaty, supra note 2, art. XXIV(1); U.S.-Mexico Treaty, supra note 3, art. XXVI(1).

102. Canada-U.S. Treaty, supra note 4, art. XXVI(2); Mexico-Canada Treaty, supra note 2, art. XXIV(2); U.S.-Mexico Treaty, supra note 3, art. XXVI(2). The Canada-U.S. Treaty provides further that the agreement reached will be implemented notwithstanding any time limitations in the domestic laws of the contracting states, provided that the Competent Authority of the contracting state of nonresidency receives notification of the existence of the case within six years from the end of the taxable year to which the case relates. Canada-U.S. Treaty, supra note 4, art. XXVI(2). The Mexico-Canada Treaty prohibits income adjustments by the other contracting state after five years from the end of the taxable period to which the income relates. See Mexico-Canada Treaty, supra note 2, art. XXIV(3). Under the Treaty between the United States and Mexico, the Competent Authority of the contracting state of nonresidency must be notified of the case within four and a half years from the due date or the date of filing of the return in the nonresidency state, whichever is later. Any agreement reached will be implemented within ten years from the due date or filing of the return, whichever is later, or longer if permitted by the domestic law of the nonresidency State. U.S.-Mexico Treaty, supra note 3, art. XXVI(2).

103. Article XXVI(3) of the Canada-U.S. Treaty expressly authorizes the Competent Authorities to agree on certain designated topics. The Treaty also states that the Canadian and U.S. Competent Authorities may consult one another regarding the elimination of double taxation in cases not provided for within the Convention. Canada-U.S. Treaty, supra note 4, art. XXVI(3). Article XXVI(3) of the U.S.-Mexico Treaty merely authorizes the Competent Authorities to consult together concerning cases not provided for in the Treaty. See U.S.-Mexico Treaty, supra note 3. Similarly, Article XXIV(4) of the Mexico-Canada Treaty provides for resolution by mutual agreement of any difficulties or doubts arising as
Treaty and the U.S.-Mexico Treaty also contain binding arbitration provisions if a dispute cannot be resolved. The availability of Competent Authority assistance is not limited to the situations stated in the treaty articles establishing the Mutual Agreement Procedures. Authority to grant relief may be specially provided in other provisions of a treaty. For example, Article XIII(8) of the Canada-U.S. Treaty permits taxpayers to request deferment of profit, gain or income with respect to property alienated in the course of a corporation or other organization, reorganization, amalgamation, division or similar transaction in order to avoid double taxation. Article XIII(5) of the Mexico-Canada Treaty permits a deferral with respect to gains on the alienation of shares on an amalgamation, reorganization or division. These provisions are disparate from the typical Mutual Agreement Procedure in that tax relief is sought from the Competent Authority of the nonresident, and not the resident, contracting state.

A. Canadian Competent Authority

The Canadian Competent Authority procedure and the potential for relief from double taxation is a concern to both United States and Mexican taxpayers holding Canadian assets. In the case of Canada, the term "Competent Authority" means the Minister of National Revenue or his representative. The general Mutual Agreement Procedure provisions of the Canada-U.S. Treaty and the Mexico-Canada Treaty provide a resident taxpayer the means of avoiding taxation that is contrary to the provisions of those treaties. In contrast, Article XIII(8) of the Canada-U.S. Treaty provides a nonresident the means of avoiding double taxation by allowing the nonresident taxpayer to request deferment of profit, gain or income properly taxed by the nonresident state under the Treaty, if a nonrecognition provision would have deferred taxation under the tax laws of the country of residence. In fact, the Canadian Competent Authority will not grant relief to a United States resident under Article XIII(8) without receiving written confirmation from the U.S. Competent Authority of nonrecognition under United States tax laws. Article XIII(5) of the Mexico-
Canada Treaty provides an opportunity for relief on a corporate amalgamation, division or reorganization involving an exchange of shares where profit, income or gain is not recognized in the State of residence but is taxable in the nonresident State. This is the case in an amalgamation, division or spinoff involving Mexican corporations which own Canadian assets that are taxable under the Mexico-Canada Treaty.111 As is the case with United States taxpayers, confirmation of non-taxability in Mexico must be provided to the Canadian Competent Authority before treaty relief will be provided.

Although the Canada-U.S. Treaty refers specifically to relief from double taxation, this language is not present in the wording of the Canadian Treaty with Mexico, leaving one to speculate whether relief is available in additional circumstances, for example, to preserve losses for later use. From discussions with the Canadian Competent Authority, however, it is unlikely that treaty relief under this provision, which is totally discretionary, would be made available other than to avoid double taxation and then only where it is clear that Canada’s right to tax the gain in future will not be compromised.

I.T.A. section 115.1112 implements the tax treaty’s relief provisions.113
The Competent Authority of Canada has granted I.T.A. section 115.1 relief under Article XIII(8) of the Canada-U.S. Treaty in only limited circumstances and to date has not provided relief under Article XIII(5) of the Mexico-Canada Treaty. Relief is most often granted for transactions which do not result in the economic realization of proceeds from the disposition. In addition, the transaction must potentially result in nonrecognition in Canada as well as the resident country of the taxpayer seeking Competent Authority relief. The transaction must otherwise satisfy the requirements of the Canadian provision allowing for the deferment of inclusion into income except for the problem of nonresidency. The transaction must not be prohibited for nonresidents under a provision of the Canadian tax law. Finally, the transaction cannot be contrary to the spirit of the Canadian I.T.A., nor can it be designed to evade Canadian tax liability.

Perhaps the factor that generates the most denials of relief by the Canadian Competent Authority is the concern that Canada may not be able to later identify, or enforce, a claim against the deferred gain. Other potential reasons for the denial of relief are as follows:

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114. Interpretation Bulletin IT-173R2 deals specifically with the Canadian tax treatment of gains derived in Canada from the alienation of property by residents of the United States. With regards to Article XIII(8), IT-173R2 states:

To achieve such a deferral, the person or partnership who acquires that property and the vendor must petition the Competent Authority in Canada to defer the taxation. If the Canadian Competent Authority accedes to the request, and agreement must be entered into between the Authority and the petitioners under which the deferral of taxation will be in effect for such time and under such other conditions as are stipulated in the agreement. Since the purpose of paragraph 8 of Article XIII of the 1980 Convention is to avoid double taxation, relief will only be granted to the extent necessary to avoid such double taxation. This provision is only applicable where alienation, in the circumstances stated, result in a net gain (i.e. gains exceed losses). Such an agreement may deal with (but is not restricted to) such matters as the vendor's proceeds of disposition and purchaser's cost of property in Canada (e.g., as capital property). Subsection 115.1(1) can apply to an agreement that concerns a completed or a proposed transaction.


1. The tax deferral is specifically prohibited for nonresidents. For example, the I.T.A. does not permit the rollover of real property to a corporation by a nonresident except in very limited circumstances. Specifically, tax deferral will result only if the nonresident uses the real property during the year in a business carried on in Canada.\textsuperscript{118} Thus, if a United States or Mexican taxpayer who was not carrying on business in Canada sought to transfer real property to a United States or Mexican corporation, I.T.A. paragraph 85(1.1)(a) would specifically prohibit the transfer on a tax deferred basis. In that case, relief will be denied.

2. The I.T.A. provides the nonresident the ability to defer recognition of gain or income on the transaction. For example, although the I.T.A. specifically prohibits the rollover of real property by nonresidents in most circumstances, an elective rollover is available to nonresidents who hold the property as capital property and who carry on business in Canada during the year. In this case, no relief will be granted.\textsuperscript{119}

3. I.T.A. section 115.1 relief will be granted only if the dispositions described in the case of Article XIII(8) of the Canada-U.S. Treaty or Article XIII(5) of the Mexico-Canada Treaty results in a net gain to the nonresident taxpayer and only to the extent required to avoid double taxation.\textsuperscript{120} In addition, I.T.A. section 115.1 relief must be applied consistently to all such dispositions that take place as part of a particular transaction within the taxable period.\textsuperscript{121} A taxpayer cannot, for example, realize losses and attempt to defer gains in the same transaction.\textsuperscript{122} In the case of the Canadian Competent Authority, net gain is computed for Canadian, not United States or Mexican, tax purposes. Thus, a nonresident taxpayer must experience a net gain under Canadian tax law from the property alienated within the taxable period and all such property transferred must be considered in the I.T.A. section 115.1 relief request. Revenue Canada has indicated that the nonresident taxpayer does not have to use carryover losses otherwise available in computing net gain.\textsuperscript{123}

4. Before I.T.A. section 115.1 relief is sought, a taxpayer must verify that nonrecognition is the tax result in the contracting state of resi-
and that recognition is the tax result in Canada, the nonresident state where the alienation of property occurred. If it is determined that deferment will result in both contracting states treaty relief is clearly unnecessary.

5. Relief under I.T.A. section 115.1 on the alienation of property in a transaction described in Article XIII(8) of the Canada-U.S. Treaty or Article XIII(5) of the Mexico-Canada Treaty is available to a nonresident only if the transaction would result in deferral to a resident of Canada in similar circumstances. I.T.A. section 115.1 relief is not intended to grant deferrals to nonresidents that would not otherwise be available to Canadian residents. This restriction on the availability of relief requires an understanding of when a deferral will or will not be available under Canadian tax law.

The Canadian Competent Authority may impose conditions in the agreement granting the deferment to assure the tracing of property. For example, the acquirer of the property may have to report for a period of years to the Canadian Competent Authority to guarantee continued ownership. If the ability of Canada to enforce its tax claim under the I.T.A. section 115.1 agreement is sufficiently uncertain, I.T.A. section 115.1 relief will not be granted. I.T.A. subsection 115.1(2) also places the acquirer in the same tax position as the original transferor with regards to the property as a condition to subsequent relief under I.T.A. section 115.1 on the later disposition of the assets.\footnote{125}

\section*{B. U.S. Competent Authority}

The "U.S. Competent Authority" is defined in the Canada-U.S. Treaty and the U.S.-Mexico Treaty as the Secretary of the Treasury or his delegate.\footnote{126} The Assistant Commissioner (International) acts as the U.S. Competent Authority in administering the operative provisions of tax treaties. In interpreting and applying the tax treaties, the Assistant Commissioner (International) acts only with the concurrence of the Associate Chief Counsel (International).\footnote{127}

\begin{footnotes}
\item[124] The U.S. Competent Authority will provide verification of nonrecognition treatment by the United States upon request of the Canadian Competent Authority. The United States taxpayer may request a private letter ruling to substantiate the claim of nonrecognition treatment. Even if not requested, the U.S. Competent Authority may require the United States taxpayer obtain a private letter ruling. Rev Proc. 98-21, \textit{supra} note 113, § 4.04.
\item[125] I.T.A. subsection 115.1(2) states as follows:
Where rights and obligations under an agreement described in subsection (1) have been transferred to another person with the concurrence of the Minister, that other person shall be deemed, for the purpose of subsection (1), to have entered into the agreement with the Minister.
\item[126] Canada-U.S. Treaty, \textit{supra} note 4, art. III(1)(g); U.S.-Mexico Treaty, \textit{supra} note 3, art. III(1)(e).
\item[127] Rev. Proc. 98-21, \textit{supra} note 113, § 2.03.
\end{footnotes}
U.S. Competent Authority assists taxpayers with respect to matters covered in the Mutual Agreement Procedure provisions of tax treaties in the manner specified by those provisions. These provisions generally permit taxpayers to request U.S. Competent Authority assistance when they consider the actions of the United States, a treaty partner, or both, will result in taxation that is contrary to the provisions of the treaties. U.S. Competent Authority assistance is also available with respect to issues specifically dealt with in other provisions of a tax treaty such as Article XIII(8) of the Canada-U.S. Treaty.\footnote{128}

The U.S. Competent Authority procedure is of interest to Canadian taxpayers seeking treaty relief from the proper taxation by the United States of capital gains arising in the course of a corporate restructuring. Article XIII(8) of the Canada-U.S. Treaty permits a Canadian resident to request the assistance of the U.S. Competent Authority to resolve cases involving the deferral of recognition of gain or income from the alienation of property in the course of a corporate reorganization or similar transaction in order to prevent double taxation.\footnote{129} If a Canadian resident believes that tax was improperly imposed on the transaction by the United States, however, assistance must be requested from the Canadian Competent Authority under the general Mutual Agreement Procedure.\footnote{130} Under the Mutual Agreement provisions, the U.S. Competent Authority is of interest to United States residents alleging an improper imposition of Canadian tax to a transaction involving taxable property situated in Canada.\footnote{131}

Article XXVI(1) of the U.S.-Mexico Treaty requires nonresident taxpayers to seek relief from the Competent Authority of the resident contracting state under the general Mutual Agreement Procedure.\footnote{132} As there is no special Competent Authority provision allowing specifically for relief from the potential double taxation of gains in corporate restructurings, similar to that available under the Canadian treaties, a United States taxpayer can only seek tax relief from the U.S. Competent Authority. It is doubtful that relief will be granted if double taxation results in a corporate transaction in which tax is being properly imposed by Mexico under terms of the U.S.-Mexico Treaty. Unfortunately, this is the case in many corporate reorganizations.

Revenue Procedure 96-13\footnote{133} provides the procedures for requesting assistance from the U.S. Competent Authority under the provisions of any tax treaty to which the United States is a party. If a request is accepted, the U.S. Competent Authority will consult with the appropriate foreign Competent Authority and attempt to reach a mutual agreement that is acceptable to all parties. Unless otherwise permitted under an applicable tax treaty.

\footnotesize{\textsuperscript{128} Canada-U.S. Treaty, supra note 4.}\n\textsuperscript{129} Id.\n\textsuperscript{130} Id. art. XXVI(1).\n\textsuperscript{131} Id.\n\textsuperscript{132} U.S.-Mexico Treaty, supra note 3, art. XXVI(1).\n\textsuperscript{133} Rev. Proc. 95-9, I.R.B. 1995-7, 1 (superseding Rev. Proc. 91-23, 1991-1 C.B. 534, and Rev. Proc. 91-26, 1991-1 C.B. 453).}
treaty, the U.S. Competent Authority only considers requests for assistance from United States taxpayers.\textsuperscript{134} Revenue Procedure 98-21\textsuperscript{135} outlines the procedures that must be followed by Canadian residents requesting assistance from the U.S. Competent Authority under Article XIII(8) of the Canada-U.S. Treaty and, in general, requires that all requests be in accordance with Revenue Procedure 96-13. Revenue Procedure 96-13 sets forth the procedures that must be followed by both United States and Canadian residents\textsuperscript{136} in requesting assistance from the U.S. Competent Authority.\textsuperscript{137} A small case procedure for requesting Competent Authority assistance is also established. The small claims procedure simplifies the form of the request and reduces the amount of information that initially must be submitted. The small case procedure is available if the total proposed adjustment involved in the matter is not greater than $100,000 for an individual and $200,000 for other taxpayers.\textsuperscript{138}

Upon receiving a request for assistance, the Competent Authority will notify the taxpayer whether the facts of a taxpayer's case provide a basis for assistance. The Competent Authority's denial of a taxpayer's request for assistance or dismissal of a matter previously accepted for consideration is not subject to administrative review.\textsuperscript{139} Revenue Procedure 96-13 states that the U.S. Competent Authority generally will deny requests for assistance or will cease providing assistance in the following cases:

1. The taxpayer is not entitled to the treaty benefit or safeguard in question or to the assistance requested.
2. The taxpayer is only willing to accept a Competent Authority agreement under conditions that are unreasonable or prejudicial to the interests of the United States Government.
3. The taxpayer rejected the Competent Authority resolution of the same or similar issue in a prior case.
4. The taxpayer does not agree that Competent Authority negotiations are a government-to-government activity that does not include the taxpayer's participation in the negotiation proceedings.
5. The taxpayer does not furnish upon request sufficient information to determine whether the treaty applies to the taxpayer's facts and circumstances.
6. The taxpayer was found to have acquiesced in a foreign initiated adjustment that involved significant legal or factual issues that otherwise would be properly handled through the Competent Authority process

\textsuperscript{135} Rev. Proc. 98-21, \textit{supra} note 113.
\textsuperscript{136} Id. § 5.01. A Canadian resident's request for assistance from the U.S. Competent Authority must contain a statement containing information detailed in Rev. Proc. 98-21. \textit{Id.} § 5.02
\textsuperscript{138} Id. § 5.
\textsuperscript{139} Id. § 12.04.
and then unilaterally made a corresponding correlative adjustment or claimed an increased foreign tax credit, without initially seeking U.S. Competent Authority assistance.

7. The taxpayer: a) fails to comply with this revenue procedure; b) fails to cooperate with the U.S. Competent Authority (including failing to provide sufficient facts and documentation to support its claim of double taxation or taxation contrary to the treaty); or c) fails to cooperate with the Internal Revenue Service during the examination of the periods in issue and such failure significantly impedes the ability of the U.S. Competent Authority to negotiate and conclude an agreement (e.g., the period of limitations for assessment in the foreign country has expired or significant factual development is required that cannot effectively be completed outside the examination process).

C. Mexican Competent Authority

Canadian taxpayers with assets subject to tax in Mexico in the course of a corporate amalgamation, division or reorganization involving Canadian corporations may seek assistance from double taxation of the Mexican Competent Authority. The "Mexican Competent Authority" is defined as the Ministry of Finance and Public Credit. The Mexico-Canada Treaty, signed in 1992, was the first comprehensive double taxation agreement entered into by Mexico. The Treaty also marked Mexico's first obligation to consider Competent Authority assistance in the course of a corporate restructuring. In response to NAFTA, Mexico introduced corporate reorganization provisions into its domestic tax law. It is not surprising, therefore, that there are no guidelines from Mexico on when Competent Authority relief will be granted. From discussions with the Canadian Competent Authority, it appears that the Mutual Agreement Procedure provision allowing for Competent Authority relief was added largely at the insistence of Canada. Given that the provision was initiated by Canada, perhaps Mexico will follow Canada's example and provide deferment in similar circumstances and under similar conditions. Thus, Mexico would provide treaty relief where tax deferment is otherwise available to a resident taxpayer under Mexican tax law. This would include amalgamations, spinoffs and certain liquidations, such as, vertical amalgamations between a parent and subsidiary or two subsidiary corporations. It is uncertain whether tax deferment will be

140. Id. § 12.02.
141. Mexico-Canada Treaty, supra note 2, art. XIII(5).
142. Mexico-Canada Treaty, supra note 2, art. III(1)(i)(ii); U.S.-Mexico Treaty, supra note 3, art. III(1)(i)(ii). There are, however, special divisions in the Ministry of Finance dealing with international taxation. One such Department is the General Direction for Revenue Policy and International Fiscal Affairs.
143. See Gammie, supra note 69, at 624.
available in Mexico on a transfer of assets to a corporation in exchange for shares. Although such a transaction results in a nonrecognition treatment for Canadian tax purposes, no equivalent nonrecognition provisions exists under Mexican law. If Mexico follows Canada's lead in not offering treaty relief if similar relief is not available to resident taxpayers, no treaty relief would be available under these circumstances.

The Treaty between the United States and Mexico does not grant the Competent Authority of nonresidence the authority to grant relief from double taxation resulting in corporate restructurings. Thus, United States taxpayers are limited to seeking assistance from the U.S. Competent Authority under the general Mutual Agreement Procedure.

VIII. PROBLEMS AND SOLUTIONS

Operating within the NAFTA block may result in double taxation in many corporate restructurings. The treaty solutions to this problem are piecemeal, haphazard and inconsistent. Perhaps, it is naive to expect that the elimination of tariff and nontariff barriers to the movement of goods, services and capital within the trading block would necessarily lead to a harmonized tax system. Nonetheless, it seems that the broad objective's of NAFTA and the interests of the NAFTA partners is best served if a nonresident taxpayer within the NAFTA block is not at a disadvantage relative to domestic taxpayers as the result of a corporate transaction. At a minimum, all foreign based corporations from a NAFTA country operating within another NAFTA country should be subject to the same tax treatment regardless of the country of residence. Thus, it should be possible to move assets among corporations resident in the NAFTA block without tax penalty. This could be accomplished either through the domestic tax systems or through the current bilateral tax treaties. It might also be accomplished through a separate multi-lateral treaty among the NAFTA partners, which, it has been suggested, "could address specific issues or include general provisions that would apply to all countries under the agreement."
IX. CONCLUSION

Double taxation of gains on a corporate reorganization is a reality within the NAFTA block. Unfortunately, substantial differences exist in the relief from double taxation available to the three NAFTA partners under the current bilateral tax treaties. This discrepancy in treaty relief will result in an uneven playing field for the NAFTA signatories. Any advantage or disadvantage in tax treatment will, in turn, influence which treaty partners can effectively invest and operate in a particular NAFTA country on an after tax basis.

The significance of taxation as a factor in investment has been well documented and will clearly affect investments within the NAFTA block. The differences in tax treatment are surprising given that Chapter 11 of NAFTA generally provides for nondiscrimination and most favoured nation treatment for cross-border investments. The United States and Canada were also very concerned about securing most favoured nation provisions in the Protocols to their respective tax treaties with Mexico in the area of withholding tax on dividends in the case of the United States and in withholding on interest or royalties in the case of Canada. Both countries clearly had most favoured nation status in mind when considering tax issues. It is, therefore, surprising that such great inconsistencies in tax treatment among the three NAFTA countries in an area as key to foreign investment as the taxation of corporate reorganizations was apparently ignored by the NAFTA governments. It should clearly not be ignored by investors or their advisors.

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148. For example, in a survey conducted by the Commission of the European Committee of Independent Experts on Company taxation on taxation in the European Union, enterprises in seventeen European countries were asked to identify to what extent they took account of differences in taxation. Forty-eight percent of respondents claimed that taxation is always or usually a major factor in the decision on the location of a production plant. See also Gammie, supra note 69.

149. NAFTA, supra note 1.

150. Article 5 of the 1995 Protocol contains a provision that states if the United States agrees to a withholding rate on direct investment dividends of less than 5% in a treaty with another nation, then such lower rate would automatically be deemed to have been incorporated into the treaty with Mexico instead of the 5% rate. 1995 Protocol, supra note 4.

151. Mexico-Canada Treaty, supra note 2, protocol. It provides that if Mexico agrees to give another OECD country a rate of withholding tax on interest or royalties that is lower than 15%, then the lower rate (but not lower than 10%) shall apply instead of the treaty rate. Id.