Notes on the Answers
International Tax Treaties
Fall 2001
Prof. McIntyre

Question 1

(a) No protection under actual US/Mexico treaty. MCo's activities for the US companies cause them to have a PE because of Article 5(5)(b) (attached to exam). That provision provides, in relevant part as follows:

> 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State in respect of any activities which that person undertakes for the enterprise, if such person:
>
> b) has no such authority [to conclude contracts] but habitually processes in the first-mentioned State on behalf of the enterprise goods or merchandise maintained in that State by that enterprise, provided that such processing is carried on using assets furnished, directly or indirectly, by that enterprise or any associated enterprise.

(b) ACO, BCo, and CCo are taxable in Mexico on the income attributable to their PE. That means that they are taxable on the income they earn on account of the activities conducted on their behalf by MCo. In comparable circumstances, the US would use an apportionment formula to determine the allocation of the income derived from the manufacture and sale of the goods produced through MCo. Mexico probably would follow the OECD commentary and use an arm's length approach. In general, the three US companies would value the goods acquired from MCo at their fair market value and subtract their costs to give them the amount of their income attributable to their Mexico PE.

(c) The standard Article 5 in the OECD Model convention does not include anything like Art. 5(5)(b). As a result, the issue is more complicated. If MCo is viewed as manufacturing on behalf the three US companies, then the companies are manufacturing in Mexico through a fixed place of business and would have a PE. their contracts with MCo, however, almost certainly assert that MCo is manufacturing on its own behalf and selling to the three US companies. So I think it unlikely that there is a manufacturing PE under the OECD Model Convention. MCo does lease equipment from the three US companies, and that equipment would be a PE for the three US companies if it is used by them in carrying on a business in Mexico. But this line of inquiry gets us back to whether MCo is conducting a manufacturing business for the three US companies. If not, then the leased equipment would not be a PE.

Note: If there is no PE, US companies might be taxable by Mexico on a deemed leasing fee. The fee would be taxable under the expansive “Other Income” article of that treaty (Art. 23). That article states:

> Items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may be taxed in that other State.

I see no great purpose, however, in taxing the deemed lease payment because it presumably would be deductible by MCo, resulting in no net tax revenue for Mexico.

(d) Mex-Lex is unincorporated, so it is not itself a taxpayer. The taxpayer is Mr. W, the sole proprietor. It would seem that Mr. W would be taxable, if at all, under Article 14 of the US/Mexico treaty, not under Articles 5 and 7. Under Article 14, the issue is whether Mr. W has a fixed base. but I think the issues are really the same. The OECD has removed article 14 from its model, so that under the current OECD Model Convention, the issue would be decided under Articles 5 and 7.

In any event, I think that Mr. W clearly has a fixed base or PE in Mexico, due to the office in Monterrey. He may also have a fixed base or PE due to the employees he sends down to Mexico, but the facts are unclear. I do not believe that MCo is a PE of Mr. W because it does not act on his behalf.

(e) Mr. W is taxable on the income attributable to his PE in Mexico. I think it is arguable that the one percent royal is attributable at least in part to the Monterrey office. In that event, the royalty is business income attributable to a PE and not royalty income under Article 12. Mr. W should be taxable on the royalty attributable to the PE at the normal rates. Some of the work that led to the royalty payment probably was carried out in the United States. That portion of the income would not be attributable to the Monterrey PE. So I conclude that some but not all of the royalty is taxable by Mexico.

Note: If the royalty was being paid to the US companies, it would be seen as a royalty for use of their technology and would be taxable by Mexico under Article 12 unless it was attributable to a PE. Under Article 12, Mexico could not tax the royalty at a rate in excess of ten percent. Mr. W, however, has no patent or anything that he is making available to MCo. He is providing a service and is getting a contingent fee for doing so.

<u>Question 2</u>

(a) Miss S is resident of Country S under the Country S/Country Z treaty. The issue is decided under Art. 4(2) of the relevant treaty. She has no permanent home in either of the two countries. As a result, the permanent home location and the location of her vital interests are both irrelevant. See Art. 4(2)(a) and (b). She has an habitual abode in both States, so that test is not determinative. The next test is the country where she is a national (that is, a citizen). she is a citizen (national) of country S, so she is treated as a resident of Country S under the Country S/Country Z treaty.

Note: I believe that the center of her vital interests is Country S, due to amount of income earned there, her family ties there, and her citizenship there. I'm not sure whether citizenship counts for this purpose, but I believe it should count. Even if it does not count, I would find that Country S was the center of her vital interests. But note that this test comes into play only if the individual has a permanent home in both treaty countries.

(b) Under the Country B/Country S treaty, Miss S is a resident of Country B. She has a permanent home in County B, and that is the first tiebreaker under Art. 4(2)(a).

(c) <u>Country B</u>. Miss S is taxable by County B on her investment income of $20,000 derived from Country S. She has no treaty protection because there is no treaty between Country B and Country S. Country B will not give a credit for any taxes paid to Country S because there is no treaty. It will not give a credit for taxes paid to Country Z because it uses the exemption method for earned income.

<u>Country Z</u>. Country Z will tax Miss B on her income derived from Country Z to the extent permitted by treaty and not on any foreign income. The money Miss S gets from giving free-lance skiing instructions in Country Z is fully

taxable by Country Z under Article 14 (or Articles 5 and 7) because the hotel where she stays for several months is a fixed base (or PE), and the income is attributable to that fixed base (or PE). Country Z can tax the employment income (the income received from the hotel plus related tips) under Article 15 because the income arose from services provided in that country and the exception for fees paid by a foreign corporation and not deducted locally would not apply (almost certainly). Domestic law prevails, so the food and lodging is included in her income.

Country S. Country S will tax Miss S on her worldwide income. It will not tax the food and lodging either in Country S or country Z because its domestic rules prevail. It will give a credit for the source taxes paid to Country Z, but the credit is limited to the taxes paid on income derived from Country Z that is taxable in Country S. Thus no credit would be given for the Country Z taxes imposed on the food and lodging benefit. No credit would be given for the taxes imposed on the investment income by Country B, so there is double taxation with respect to this item of income. Note that Country S would not have given a credit even if it had a treaty with Country B. Indeed, under a treaty, Country B would be prohibited from taxing the investment income because it arose in Country S.

(d) Country S. If Miss S is a resident of Country Z, then Country S would tax only income arising in Country S under its treaty with Country Z. Under the treaty, it would be permitted to tax the income from giving skiing instructions as an employee and as an independent contractor under Articles 14 (Article 5) and 15, respectively (see discussion of comparable point in answer to subquestion (c) above). The food and lodging benefit would not be taxed under its local law. Country S also would be permitted to tax the dividend income arise therein, but the rate would be capped at 15 percent under Article 10. Country S would not give a credit for any foreign taxes.

Country B. Country B would not impose any taxes on Miss S. Because Miss S is a resident of Country Z under the Country B/Country Z treaty, Country B is precluded under the Other Income Article from taxing the income arising in Country S. As a result, there is no double tax on that income, as there was under the facts of subquestion (c), above.

Country Z. Country Z would tax Miss S on her worldwide income, including the income represented by the free meals and lodgings in Country S. It would give a credit for all of the taxes paid by Miss S to Country S because those taxes were assessed in accordance with the treaty.

Question 3

(a) (1) Taxable by Country Q under Article 16 of the OECD Model Convention, even though the services were performed outside Country Q.

(2) Not taxable by Country Q under the Other Income (Art. 21) article of the treaty.

(3) Not taxable by Country Q under the Other Income (Art. 21) article of the treaty.

(4) Taxable by Country Q at a maximum rate of 10 percent under the Interest (Art. 11) article of the treaty.

(b) Under the revised Other Income article, the gambling winnings in Item (2) are now taxable because their source is Country Q. No change for any other of the items. The consulting fees in Item (4) remain exempt in Country Q under the revised Other Income article because they arise outside of that country.

(c) The language is identical to the language in the UN Model Treaty. The same result is achieved in the US/Canada treaty, although the language is different. As noted in the answer to question 1, the US/Mexico treaty also allows the source country to tax other income.