

WHAT HAPPENS IN MEXICO . . . HAS TO BE REPORTED TO THE IRS! MEXICAN RESIDENTIAL TRUSTS AND THE REPORTING REQUIREMENTS UNDER IRC SECTION 6048

By Enrique Hernández-Pulido, Esq.
Procopio, Cory, Hargreaves & Savitch LLP

INTRODUCTION

In recent years, Mexico has gained a preference among U.S. investors looking for new investment opportunities in real estate. American baby boomers have found Mexico, especially its coastal regions; as a great alternative for a second and/or retirement home because of its welcoming atmosphere and relative affordability. These folks have been vacationing in Mexico for various years and have become comfortable with Mexico, its customs, language, people and most importantly, its legal system that requires foreigners who want to own residential properties within the Mexican coastal and border zones to do it through a *fideicomiso* or Mexican Residential Trust (MRT).

With the current availability of sophisticated professional resources such as U.S. title insurance and escrow services, specialized legal services both in Mexico and the U.S. large amount of information can be found in the Internet, specialized publications and seminars and conferences,¹ a typical American buyer of Mexican residential real estate through an MRT ends up; after some expense for such services and information, with a fairly good understanding and comfort level that his or her property is legally secure.

In the author's experience, however, sophisticated investors with sophisticated advisors in both sides of the border many times fail to identify that an MRT is in fact a "foreign trust" for U.S. tax purposes and in that regard, its creation and other actions related thereof are subject to the reporting requirements of the Internal Revenue Code's (IRC) Section 6048. The real shock comes when investors and advisors alike learn of the steep penalties that, under IRC Section 6677, might apply for failure to properly comply with the IRC Section 6048 foreign trust reporting requirements. Ironically, this may translate in exposing the subject real estate property to being taken away (in the form of assessed penalties) by the U.S. government rather than the Mexican government.

This article provides first a basic description on why and how IRC Section 6048 applies to an MRT and what are the potential penalties under IRC Section 6677 for failing to comply. Secondly, it describes a recent proposal that the author, in his capacity as Chair of the International Committee for the Tax Section of the California Bar, made to the Internal Revenue Service and the Treasury Department so that MRTs are either exempted from IRC Section 6048 or subject to a simplified reporting regime that would not expose owners of MRTs to the harsh penalties of IRC Section 6677.

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RESTRICTIONS UNDER MEXICAN LAW FOR DIRECT OWNERSHIP OF RESIDENTIAL REAL ESTATE

The Mexican Federal Constitution designates all land located within 100 kilometers (about 62 miles) from Mexico's international borders or 50 kilometers (about 31 miles) from its coastline as land, the ownership of which is restricted to Mexican citizens² (commonly designated as the "forbidden or restricted zone").³ Practically all of the Baja Peninsula is included within this restricted area. Also, all beach front properties of Mexico, whether they are in Cancun, Puerto Vallarta, Los Cabos, Mazatlan, or any other coastal region, cannot be owned directly by anyone, including a U.S. person, who is not a Mexican citizen.

¹ See "How Do You Say "FIRPTA" In Spanish? A Comparative International Tax Analysis For Foreign Investors Of U.S. & Mexican Real Estate" by Patrick W. Martin and Enrique Hernández-Pulido of Procopio, Cory, Hargreaves & Savitch LLP for a comprehensive discussion of legal and Mexico and U.S. tax issues related to investing in Mexican Real Estate.

² Mexican Federal Constitution Art. 27, § 1

³ Mexican Constitution, Art. 27 § 1

This restriction is regulated by the Mexican Foreign Investment Law.⁴ Currently, direct ownership of real state in the restricted zone is permitted to Mexican corporations⁵ without regard to the citizenship of its shareholders with the exception of residential property. Only Mexican citizens or Mexican corporations which bylaws forbid the ownership of their stocks by non-Mexican citizens, are allowed to directly own real property within the forbidden zone for residential purposes.⁶

However, foreign investment in real estate for residential purposes is very common in the forbidden zone, since the forbidden zone is often the most attractive to foreign investors. For a U.S. person, acquiring a property in the forbidden zone can only be accomplished by acquiring the property indirectly through a MRT, which requires a special permit from the Mexican Ministry of Foreign Affairs.⁷ As noted, a U.S. person who is also a Mexican citizen is not subject to the above restrictions since the Mexican Federal Constitution and the Mexican Foreign Investment Law will allow such person to own the Mexican real property in fee simple.

MRTS AS FOREIGN TRUSTS, THE APPLICABLE REPORTING REQUIREMENTS OF IRC SECTION 6048 AND THE RELATED PENALTIES OF IRC SECTION 6677

Mexican trusts (“*fideicomisos*”), including MRTs, are civil law institutions and are specifically regulated by Mexican commercial and banking statutes. However, “*fideicomisos*” resemble common law trusts and thus, are considered to be “foreign trusts” under IRC Sections 7701(30)(E)(i), (ii) and (31)(B).⁸ A MRT where a U.S. person is the named beneficiary, is a “Foreign Trust owned by a U.S. Person” as defined under Treas. Regs. Section 1.643(d)-1 (a).

Under IRC Section 6048(a)(3)(A)(i), the creation of a MRT by a U.S. person is a “reportable event.” Further, to the extent that the U.S. owner of the MRT transfers additional property or money to the MRT (e.g., by making improvements or repairs to the property), such transfer is also considered a “reportable event” under IRC Section 6048(a)(3)(A)(ii). These reportable events must be reported on Form 3520 as provided under Treas. Regs. Section 16.3-1(a). Properly identifying and reporting a “reportable event” may be a challenge by itself, since there may be constant and diverse contributions to the MRT that may fall within the definition as may be the case, for example of payments to homeowner’s associations and other recurrent expense payments which is unclear if they should be considered additional transfers of money to the MRT (to the extent they benefit the property held by it) or when a dwelling is erected on a lot that is held through a MRT. In such case would the “reportable event” be the completion of the construction? Or each monthly payment to the construction company?

In addition, a U.S. person who is the owner of a MRT (i.e., the “responsible party” under IRC Section 6048(a)(4)) is responsible, pursuant to IRC Section 6048(a)(4)(A), for making sure that “such trust makes a return for such year which sets forth a full and complete accounting of all trust activities and operations for the year, the name of the United States agent for such trust, and such other information as the Secretary may prescribe . . .” This annual reporting requirement is satisfied by filing Form 3520-A per Treas. Regs. Section 404.6048-1 with the IRS Philadelphia Service Center by the 15th day of the 3rd month after the end of the trust’s tax year (subject to extension). The information reported on Form 3520-A includes a full and complete accounting of all trust activities and operations for the year, the name of the U.S. agent for the trust, and such other information as the IRS may prescribe. The U.S. owner is responsible for ensuring that the trust complies with these requirements.

⁴ *Ley de Inversion Extranjera (LIE)*

⁵ *In order for a Mexican corporation to have foreign shareholders, its bylaws have to contain a disposition whereas the foreign shareholders renounce to seek the protection of their corresponding governments in case of controversy and forfeit any interest in favor of the Mexican government if they are to request such protection. This is commonly known as the Calvo clause. See Art. 2 VII of the LIE.*

⁶ *LIE Art. 10.*

⁷ *See LIE Art. 11, § I and II. It is noticeable that even though foreign investment issues are of the competence of the Mexican Ministry of Economy pursuant to the statute that governs the functions of the Federal Government (Ley Organica de la Administracion Publica Federal), this authority is still vested within the Ministry of Foreign Affairs.*

⁸ *A trust is a United States person and hence not a “foreign trust” pursuant to Section 7701(a)(30)(E) only if it satisfies both the “court test” and the “control test” as follows:*

*(a) A court within the United States is able to exercise primary supervision over the administration of the trust (court test); **and***

(b) One or more United States persons have the authority to control all substantial decisions of the trust (control test). See Treas. Reg. Section 301.7701-7(cc) and (d).

The MRT does not satisfy the court test and thus, would be considered a foreign trust.

Lastly, distributions made to the U.S. beneficiary of a MRT (e.g., because of the sale of the residential real estate held by the MRT and its subsequent termination) would also trigger a reporting requirement under IRC Section 6048(d). U.S. persons are also required to report these distributions by filing Form 3520.

Failure to timely⁹ and fully comply with any of the reporting requirements imposed by IRC Section 6048 subjects the “responsible person” to a penalty under IRC Section 6677. Failure to properly file Form 3520 carries a civil penalty of up to “35 percent of the gross reportable amount” and, if the failure continues beyond 90 days after the Service has provided notice of such failure, an additional penalty of \$10,000 applies for each 30-day period (or fraction thereof) during which the failure persists but limited to the gross reportable amount. Similarly, failure to file a complete and accurate Form 3520-A¹⁰ carries a civil penalty equal to 5% of the gross value of the portion of the trust’s assets treated as owned by the U.S. person.

If Forms 3520 or 3520-A are never filed, the IRS has an unlimited period of time within which civil penalties under IRC Section 6677 may be assessed since the 3-year statute of limitations shall not start to run until the relevant form is properly filed.¹¹ This is important to understand because some taxpayers wrongly assume that if they comply with the IRC Section 6048 obligations for the current year, then they are “off the hook” for past non-compliance.

Unfortunately, statutory relief is limited. IRC Section 6677(d) provides a reasonable cause exception to the imposition of penalties with respect to a failure to timely file Forms 3520 and 3520-A. However, there are neither regulations under IRC Section 6677 nor administrative guidance to flesh out the meaning of, or the circumstances that give rise to, reasonable cause. By analogy, other code provisions that contain reasonable cause exceptions to penalties typically consider, taking into account all pertinent facts and circumstances, whether a taxpayer acted in good faith and had a reasonable excuse for failing to comply (e.g., the taxpayer is not experienced or knowledgeable in foreign tax law and reasonably relied on the advice – or lack thereof – of a competent tax advisor).¹²

CURRENT CALIFORNIA STATE BAR TAX SECTION’S PROPOSAL TO EXEMPT MRTS FROM IRC SECTION 6048

As mentioned earlier, the author in his capacity as chair of the International Committee of the Tax Section of the California State Bar recently presented a paper to the IRS and the Treasury Department containing a proposal to either exempt MRTs from the application of IRC Section 6048 or establish a simplified reporting regime for MRTs that would prevent exposing U.S. owners of MRTs to the costly penalties of IRC Section 6677. Following is a basic description of such proposal.

It is important to keep in mind that IRC Section 6048 reporting requirements only apply to U.S. persons who hold title to Mexican real estate in a MRT simply because they are required to do so under Mexican law. By contrast, there is no specific reporting requirement under IRC Section 6048 or penalty exposure under IRC Section 6677 for U.S. persons who directly own Mexican residential property (e.g., U.S. persons who are Mexican citizens or U.S. persons who own property in Mexico outside the restricted zones).

This disparate and unfair treatment would be eliminated by simply excepting transactions involving MRTs from the reporting requirements of IRC Section 6048, which the Service has the statutory authority to do under IRC Section 6048(d)(4).

To the extent that a U.S. persons’ decision to form and maintain a MRT is based primarily on the fact that he or she is required by Mexican law to own the underlying residential property through the MRT, the reporting requirements under IRC Section 6048 are not justified as to MRTs. The use of a MRT is not a tax haven problem and generally does not entail an attempt by a U.S. person to veil his or her activities from the IRS. Typically, all the tax items associated with the MRT and underlying real estate are reported by the U.S. person on his or her Form 1040 return.

Because the information about the Mexican real estate is provided on Form 1040 and a MRT is not a tax avoidance device, the information requested by Form 3520 does not provide elements that would help the Service in enforcing U.S. tax laws. Consequently, the requirements to file Forms 3520 and 3520-A with respect to MRTs are nothing more than complex and

⁹ Section 6048(a)(1) requires that notice of “reportable events” be given within a 90-day period.

¹⁰ *Id.*

¹¹ Section 6501(c)(8); CCA 200024051.

¹² See, e.g., Section 6664(c)(1) and regulations thereunder (reasonable cause exception for accuracy-related penalty). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis taking into account all pertinent facts and circumstances; the most important factor is the extent of the taxpayer’s effort to assess the proper tax obligations. Treas. Reg. Section 1.6664-4(b). A taxpayer who honestly relies on the advice of a qualified advisor has made the requisite effort to assess his tax liability, even if the advice turns out to be incorrect or incomplete. *Stanford v. Comm’r*, No. 97-60531 (5th Cir., 1998).

time-consuming reporting requirements that are not only misunderstood by taxpayers, but also misunderstood by (and often unknown to) their U.S. tax advisors.

Importantly and as most Mexican and some U.S. practitioners know, in operational terms there is no difference between owning Mexican residential real estate directly or through a MRT. Mexican banks acting as trustees of MRTs will not open and hold bank or investment accounts under the MRT. All income derived from the MRT's underlying assets, be it rental income or capital gains from the disposition of the real estate within the MRT, is received directly by its beneficiary without going through or being accounted for by the trustee of the MRT. The beneficiary of a MRT may not maintain the proceeds from the sale or disposition of the underlying assets inside the MRT.

Moreover, Mexican banks acting as trustees of MRTs will not hold or accept other types of assets within such MRTs such as intangibles or other personal property. Importantly, under Mexican tax law, any income derived from the rent, lease, sale or conversion of the underlying real estate of a MRT is attributed directly to the owner/beneficiary the same way as in the case of a direct ownership of the underlying property. The trustee is never charged either directly or as a withholding agent with any tax liability derived from the MRT. In essence, an MRT is treated, for tax purposes, very much like the Illinois land trust that was the subject of Rev. Rul. 92-105, 1992-2 C.B. 204¹³, and a MRT should, for purposes of IRC Section 6048, be disregarded as a foreign trust. If the Service were to adopt a similar criteria to MRTs, then MRTs would be presumably not be subject to IRC Section 6048.

Alternatively, the Service, under the authority provided by IRC Section 6048(d)(4) and as it did in the case of non-abusive Qualified Canadian Pension Trusts,¹⁴ should not apply the IRC Section 6048 informational reporting requirements to U.S. persons with regard to MRTs, since the Service does not have a "substantial tax interest" in obtaining the information. In this regard, it has been proposed that the Service should consider implementing a simplified regime similar to what it did in the case of Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs), so that the harsh penalties under IRC Section 6677 are not applicable in the case of MRTs.

Exempting or simplifying the reporting requirements as to MRTs would have a direct benefit on reducing compliance costs both for taxpayers and the Service, would avoid discriminating between taxpayers in similar situations, would avoid undue burdens on private investment and will make sure that what happens in Mexico . . . , stays in Mexico¹⁵!

In almost every article or discussion about pre-immigration tax planning, inevitably some statement similar to the following is said: ". . . for a nonresident alien contemplating immigration to the United States, careful trust planning is required at least five years prior to the time of the immigration."¹⁶ Wow! Does this mean a non-resident alien who is contemplating moving to the U.S., on a temporary or permanent basis, that they must be aware of their future plans at least five years in advance! Must they make various transfers of assets, including completed gifts (if such are not costly in their home country) not knowing if they will indeed ever move or come to the U.S.?

Can it be true that anyone who might consider moving to the U.S. must be able to plan their financial affairs five years in advance to avoid harsh U.S. tax consequences and lose various levels of control over their assets? Is there a difference for income taxes versus transfer taxes (estate gift and GSTT)? Why is this "5 year" statement so frequently made by investment advisors and many tax practitioners?

To be sure, I.R.C. Section 679(a)(4) and the 2001 Treasury Regulation Section 1.679-5¹⁷ (Pre-Immigration Trusts) have caused much confusion.

¹³ In Rev. Rul. 92-105, 1992-2 C.B. 204, the IRS found that an Illinois land trust should be disregarded as a trust for tax purposes since the trustee's only responsibility was to hold and transfer title at the direction of the taxpayer, consequently no trust, as defined in section 301.7701-4(a), was not established.

¹⁴ The Service issued Notice 2003-75 through which it adopted a simplified reporting regime with respect to Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) based on its authority under Section 6001. The Service issued Form 8891 for purposes of the new simplified reporting regime for RRSPs and RRIFs. Form 8891 must be attached by U.S. beneficiaries or annuitants of RRSPs and RRIFs to their Form 1040 returns.

¹⁵ Of course, any taxable gains or income derived through a MRT owned by a US person will likely be taxable in Mexico and the US and a foreign tax credit will potentially be available for the US owner.

¹⁶ See William P. Streng, *U.S. International Estate Planning, Part II. U.S. Income Tax Planning for Lifetime Wealth Accumulation and Investment Chapter 5. Foreign Estates, Trusts, and Beneficiaries*, ¶ 5.06 FOREIGN TRUSTS AND U.S. GRANTOR TRUST RULES, ¶ 5.06[4][j] Strategies to Avoid Foreign Grantor Trust Treatment.

¹⁷ Treas. Reg. Section 1.679-5(a) provide in its entirety as follows:

If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under section 7701(b)(2)(A)) within 5 years after directly or indirectly transferring property to a foreign trust (the original transfer), the individual is treated as having transferred to the trust on the residency

HYPOTHETICAL - NON-RESIDENT FUNDING OF FOREIGN TRUST

To illustrate how the law works, let us use an example as follows: Mr. Juan Perez (“**Mr. Perez**”) is a Mexican citizen who is contemplating immigrating to and taking up residence in the United States (“**U.S.**”) during 2005 or 2006. He does not know if he wants to stay and live in the U.S. temporarily or permanently as he has family in Mexico, Canada, Spain and the United States. He has homes in more than one country and often times rents an apartment temporarily in one of the countries outside of Mexico. Mr. Perez currently owns a majority interest in several Mexican corporations, as well as other assets, all being situated outside the U.S. Mr. Perez wants to know whether as part any pre-immigration tax planning considerations he might be able to reduce his exposure to U.S. estate or gift taxes that would otherwise apply upon his death if he becomes a U.S. domicile. This is particularly important since under Mexican law there is currently no type of estate, inheritance or other “death” tax.

Mr. Perez has received conflicting advice that any assets (the “**Assets**”) transferred to a foreign trust (the “**Pre-Immigration Trust**”) prior to becoming a U.S. resident should not be subject to estate tax because the Pre-Immigration Trust? This Pre-Immigration Trust will be just such a trust referred to in the regulations -Section 1.679-5 (*Pre-Immigration Trusts*). Will Mr. Perez be treated as the owner of these Assets for U.S. transfer tax purposes (estate, gift and GSTT)?

APPLICATION OF U.S. RULES TO FOREIGN TRUST AND FOREIGN SETTLOR?

Before we discuss in any detail Section 679, we can ask the question whether the Internal Revenue Code and its provisions can even apply to a foreign trust, such as a Pre-Immigration Trust contemplated by the regulations. How can U.S. statutory law apply to a foreign trust with a foreign settlor even if there are no U.S. beneficiaries? What if the foreign trust is not subject to the jurisdiction of any United States court as contemplated by Treasury Regulation Section 301.7701-7(a)(1) and (c)? What if the foreign trust does not have a single U.S. person (let alone a U.S. trustee) with any “substantial decision” powers as identified in Treasury Regulation Section 301.7701-7(d)(1)(ii)?¹⁸

Hence, an initial question is whether U.S. tax laws can even govern the potential U.S. taxation to the trust or possible future U.S. beneficiaries or the settlor who may become a U.S. person but not necessarily a beneficiary? According to the IRS and U.S. federal courts, “United States tax concepts apply to determine the tax consequences of events [for U.S. Tax purposes] even if those events occur outside of the United States and even if those events result from activities conducted by foreign persons.”¹⁹ Moreover, U.S. tax principles control over foreign tax principles or characterization absent express congressional intent to the contrary.²⁰ Indeed, the IRS has taken the position that U.S. tax principles govern notwithstanding the existence of a conflict with foreign tax treatment or policies.²¹ Consequently, any future U.S. tax consequences associated with the Pre-Immigration Trust will be governed by U.S. tax laws (to the extent they are relevant in determining the U.S. tax consequences to its U.S. assets or any future U.S. beneficiaries), even though the trust will be formed outside the U.S. by a nonresident alien, under foreign law.

SECTION 679(A)(4) AND ITS APPLICATION TO PRE-IMMIGRATION TRUSTS

starting date an amount equal to the portion of the trust attributable to the property transferred by the individual in the original transfer.

¹⁸ A trust is a United States person and hence not a “foreign trust” pursuant to Section 7701(a)(30)(E) only if it satisfies both the “court test” and the (“control test”) as follows:

(i) A court within the United States is able to exercise primary supervision over the administration of the trust (court test); **and**

(ii) One or more United States persons have the authority to control all substantial decisions of the trust (control test). See Treas. Reg. Section 301.7701-7(cc) and (d).

Hence it is quite easy to have a foreign trust under this statutory rule, if a single “substantial decision” is held by anyone other than a United States person (e.g., non-resident alien, foreign corporation, etc.).

¹⁹ 2002 IRS CCA LEXIS 134, *citing*, U.S. v. Goodyear Tire and Rubber Co. 493 U.S. 132, 145 (1989), *reh'g denied*, 493 U.S. 1095 (1990); *Biddle v. Comm'r*, 302 U.S. 573, 578 (1938); Rev. Ruls. 73-254, 64-158. See *generally*, Mary F. Voce, *Basis of Foreign Property Subject to U.S. Taxation*, 49 Tax Law. 341 (Winter, 1996).

²⁰ *Goodyear Tire and Rubber Co.*, at 145.

²¹ 1998 FSA LEXIS 630; 1997 FSA LEXIS 208; 1993 FSA LEXIS 44.

What about Section 679(a)(4)²² which raises the concern that despite the transfer to the Pre-Immigration Trust, Mr. Perez will continue to be treated as the owner of the Assets for estate and transfer tax purposes?

Section 679(a)(4), in conjunction with Section 679(a)(1), provides that where a nonresident alien individual becomes a U.S. resident within five (5) years of transferring property to a foreign trust, the individual is treated at least for income tax purposes, as the owner of the property so transferred if the trust has one or more U.S. beneficiaries. This is consistent with the statute that provides that the portion transferred to the foreign trust by the non-resident alien, shall be treated “as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer.” See section 679(a)(4).

SUBTITLE A VERSUS SUBTITLE B

Does Section 679(a)(4) (an income tax provision) apply only for income tax purposes under Subtitle A, or can it also be construed as also applying to the estate, gift tax or generation skipping transfer provisions and calculations under Subtitle B (thus resulting in Mr. Perez’s ownership of the Assets for estate tax purposes which would give rise to adverse and unexpected estate tax consequences upon Mr. Perez’s death assuming he will eventually become a permanent domicile in the U.S.)?

The answer to this question is surprisingly straightforward. Based on the legislative history, with which the IRS is in accord, Section 679 only applies for purposes of income taxes. It has no relevance for purposes of the estate, gift tax or generation skipping transfer provisions and calculations under Subtitle B. Thus, it is indeed a myth that²³ transferring assets to a foreign trust prior to coming to the U.S. within five years, will necessarily cause the trust assets to be subject to U.S. estate taxes.

CONCLUSION

After an extensive review of the legislative history, policy reasons behind enactment of Section 679 (as amended by the 1996 Act) and applicable IRS rulings, the law is clear under Section 679 (and its deemed ownership rule) does not apply for purposes of the estate and gift tax provisions of Subtitle B of the Code.²⁴ Therefore, provided Mr. Perez retains no rights or powers in the Assets held by the Pre-Immigration Trust that would require the Assets to be included in his gross estate under Sections 2031 through 2044 of Subtitle B, the Assets will not be so included, irrespective of the deemed ownership rule and income tax consequences under Section 679.

Mr. Hernández is a partner with Procopio, Cory, Hargreaves & Savitch LLP. He is licensed in Mexico and California and represents multinational clients in international tax planning and the development of business transactions, worldwide investment and financing structures, and planning for worldwide income and estate and inheritance taxes. Mr. Hernández-Pulido received his Mexican law degree from Universidad Iberoamericana, in 1992. He obtained a joint L.L.M./ITP degree in international taxation and tax policy from Harvard Law School in 1995, earning a special certificate of merit for excellence in research and writing for his Master’s thesis titled “Alternatives for Taxing Financial Services through a VAT in Mexico.” He is also a graduate of the University of Texas at Austin’s McCombs School of Business and of the Instituto Tecnológico de Estudios Superiores de Monterrey obtaining two distinct MBA degrees from the respective institutions. Mr. Hernández-Pulido served for several years in senior positions in the Mexican government in the areas of tax, finance and administration. He is a frequent presenter and writer on international tax topics and before moving to San Diego, he was on the faculty at ITAM (Instituto Tecnológico Autónomo de México) University’s School of Law in Mexico City teaching advanced courses in tax law. Mr. Hernández-Pulido is the current chair of the International Committee of the Tax Section of the California State Bar. Reach him at 19.515.3240 or eh@procopio.com.

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²² All Section references are to the Internal Revenue Code of 1986 (the “Code”), as amended, and the Treasury Regulations promulgated thereunder unless otherwise provided.

²³ An NRA.

²⁴ For recent guidance on the IRS position to this effect, *see* [PLR 200338015](#).