UNITED STATES TAX COURT
WASHINGTON, DC 20217
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EMILIO EXPRESS, INC., ET AL.,	)	
	)	
Petitioner(s),	)	
	)	
v.	)	Docket No. 14949-10, 14962-10.
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent	)	

ORDER

These are unusual deficiency cases that all parties agree can be decided through summary judgment. They arise from four different tax years, and all involve a common question of law -- did a decision in these cases by the Treasury Department's competent authority under the United States - Mexico tax treaty (Treaty)[1] necessarily relieve petitioners of any liability for U.S. income tax?

There are no similar cases that either party or the Court's own research could find.

[1] The formal citation is the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Mex.-U.S., Sept. 18, 1992, S. Treaty Doc. No. 103-7 (amended by Protocols, Sept. 8, 1994; Nov. 26, 2002).

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Background

A.

There are two cases in this consolidated group. The first was begun by Emilio Express for the tax year 2003. Emilio Express was incorporated that year by Emilio Torres Luque, a Mexican national who is also a permanent resident of the United States. He is the sole shareholder, and he views the corporation as his "alter ego." Torres (following the parties' lead, we will adhere to Mexican naming customs) is married to Gabriela Medina and they filed joint returns for the tax years 2003 through 2005. The Commissioner also audited those returns and determined that they owed a substantial deficiency for each year.

Emilio Express is a trucking corporation that specializes in moving cargo across the international border between Tijuana and southern California. It is authorized to move the cargo a fixed distance from the border, and its trucks generally return to Mexico empty. Torres incorporated Emilio Express in 2003 to hold at least part of what had been his sole proprietorship business; he also chose to make Emilio Express a C corporation for 2003. This was an unusual choice and Torres seems to have converted Emilio Express to an S corporation for the 2004 and 2005 tax years, before finally dissolving it in 2009.[2]

On its tax return for 2003, Emilio Express reported slightly more than $500,000 in gross receipts; $350,000 in deductions; and (quite unusually for an industry in which one might think there would be little inventory) more than $200,000 in a cost-of-goods-sold (COGS) adjustment.[3]

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[2] A C corporation is a corporation not taxed under subchapter S of the Internal Revenue Code. A C corporation's net income is taxed twice -- first at the corporate level, and again at the individual level when the shareholders receive distributions of profits in the form of dividends. An S corporation, on the other hand, is a corporation that meets the requirements of I.R.C. § 1361 and elects to be treated as an S corporation. An S corporation's income and losses, like a partnership's, flow through to its shareholders, who then pay income tax. *See* I.R.C. § 1366. This is beneficial from a tax perspective because it generally allows the corporation to avoid corporate-level tax. I.R.C. §§ 1362(a), 1363(a). By making Emilio Express a C corporation, Torres was essentially volunteering to pay an additional layer of tax.

[3] COGS is the costs of acquiring inventory, through either purchase or production. Treas. Reg. §§ 1.61-3(a), 1.162-1(a). It is technically an exclusion from gross income rather than a deduction but is "deducted from gross sales in computing gross income." Treas. Reg. § 1.162-1(a).

In 2003 both Torres and his wife had been green-card holders for more than a decade, though both of them retained their Mexican citizenship at least until 2010. They filed their U.S. income tax returns for all the years at issue from their home near San Diego. They sent their children to public school nearby in Chula Vista and spent more than half of each year in the United States.

The Torreses' returns were also a bit unusual. On their return for 2003, they reported $31,680 in "other income" comprised of income from Emilio Express and $26,000 in "gross foreign source income," which seems to have been mostly wages from some unspecified job in Mexico. After application of the foreign tax credit, they reported tax due of only $802.

On their return for 2004, they reported $20,000 as wage income from Emilio Express and $48,000 in net income on their Schedule C, also presumably from Emilio Express (income which they should have reported on a Schedule E if Emilio Express was an S corporation that year). This Schedule C income was also unusual in that it came from gross receipts not offset by any deductions or adjustments at all. The Torreses reported no Mexican income and claimed no foreign tax credit for this year.[4]

The Torreses switched preparers for their 2005 tax year, and their return for that year seems to lack the anomalies of the other returns. Emilio Express showed net income that flowed through to their joint return on a Schedule E. They reported no Mexican income or payments of Mexican income tax, however, and so claimed no foreign-tax credit.

The Commissioner chose to audit Emilio Express and the Torreses. The anomalies triggered a wider look and the Commissioner ended up undertaking a bank-deposit analysis that showed some unreported income. This led him to determine rather significant deficiencies:

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[4] Emilio Express's Form 1120S for 2004 featured no COGS adjustment but offset $593,000 in gross receipts with $597,000 in deductions -- most of which were for unspecified "outside services."

Taxpayer	Tax Year	Total Income	Deficiency
Emilio Express	2003	$279,000	$92,304
Torreses	2003	200,094	46,879
Torreses	2004	589,273	189,801
Torreses	2005	475,884	163,539

The Commissioner also tacked on 20% penalties under I.R.C. § 6662(a). Both Emilio Express and the Torreses responded to these determinations by filing timely petitions. In these petitions they did not challenge the amounts of these adjustments to income or the imposition of penalties. They instead alleged that both Emilio Express and Torres qualified for relief under the Treaty: Emilio Express because it lacked a "permanent establishment" in the United States, which it claimed meant that any of its business profits had to be taxed only by Mexico; and Torres because he fell within the definition of resident under the Treaty, and because as he said "Mexico is where my vital interests are, thus I am a resident of Mexico where I file income taxes."

At about the same time, Torres submitted amended U.S. returns to the Commissioner. These amended returns were consistent with the petitions in that Torres stated that he had very close to zero taxable income after he combined his income with that of Emilio Express (in effect ignoring the corporate form for all years at issue) and asserted that it was all exempt from U.S. income tax under the Treaty. The Commissioner refused to file these amended returns because in his view, they were inaccurate.

We started continuing the cases as soon as they were calendared, and then put them on hold while the Torreses sought to claim benefits under the Treaty. They and the Commissioner did this with a referral of the matter to the "competent authority" established under the Treaty. (This term might sound odd to those outside the international-tax cloister, but is simply an office within the Treasury Department that is enabled by the Treaty to communicate informally with its counterpart in the Mexican government to try to resolve disputes about taxes owed by the same taxpayer of these two sovereigns.)

That process began with a short letter between a deputy commissioner at the IRS and his Mexican counterpart at the Servicio de Administración Tributaria (SAT). Through much email and written correspondence between the IRS and the

SAT, these competent authorities pieced together the record that forms a substantial part of the supporting documentation for these crossmotions for summary judgment. Some of their conclusions are that neither Torres nor his wife owned real property in Mexico, but that Torres did own several trucks in Tijuana, including several registered in his own name that had active permits to make deliveries within 20 km of the international boundary.

The most important finding, however, is that there was no record that Emilio Express ever filed returns in Mexico, but that Torres did. His original Mexican returns showed the following (all amounts are in pesos):

Year	Total income	Deductions	Taxable income	Tax
2003	1,684,744	1,687,478	(2,734)	0
2004	4,744,066	4,744,771	(705)	0
2005	6,004,769	5,779,304	225,465	28,768

Then, at about the same time that Torres tried to file amended returns with the IRS, he did file amended returns with its Mexican counterpart. These showed substantially changed numbers (again, all amounts are in pesos):

Year	Total income	Deductions	Taxable income	Tax
2003	7,388,036	7,475,260	(87,224)	0
2004	11,259,489	11,380,653	(121,164)	0
2005	9,384,364	10,749,433	(1,365,069)	0

An agent of the IRS's competent authority wanted to know what the effect of these amended returns would be, and she wrote her Mexican counterpart to ask. He replied that "I can tell you that in terms of article 32, paragraph 4 of our Federal Fiscal Code, an amended income tax return has the effect to replace the normal income tax return, prevailing over the normal income tax return." Other correspondence confirmed that this meant the original payment of more than Mex$28,000 was now an asset to Torres, available as an offset or refund.

This led the competent authorities to wind up their consideration. With no Mexican tax liability for Torres or Emilio Express, the "U.S. Competent Authority

. . . concluded that the Taxpayers were not liable for taxes in Mexico during tax years 2003 through 2005. Therefore, the U.S. Competent Authority has determined that the Taxpayers were not subject to double taxation during tax years 2003, 2004, and 2005 and no relief is appropriate."

Both petitioners accepted this finding.

B.

Torres says this was a victory for him. He argues that he was a Mexican resident under the Treaty. He believes that this means that he owed tax only to Mexico, and as proof he cites the undisputed fact that Mexico accepted the amended Mexican returns that he submitted and that reflected this position. Mexico's acceptance of those returns, he adds, necessarily means that the competent authorities agreed with his position. That his reported Mexican income was entirely offset by Mexican deductions is good for him, but irrelevant to what he asserts is his exemption from U.S. tax liability under the Treaty.

The Commissioner disagrees. He argues that the purpose of the referral to the competent authorities was only to consider and decide if Torres and Emilio Express were subject to double taxation. Because there is no dispute that neither Torres nor Emilio Express owed any tax to Mexico, he asserts that their full income (as determined in the notices of deficiency) is subject to U.S. tax without adjustment.

The petitioners and the Commissioner moved for summary judgment.

Discussion

The Court will grant summary judgment if "there is no genuine dispute as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b). We'll look at both motions and measure them against this standard.

A.

We can look at petitioners' motions first. Under § 7701(a)(30) of the Code, both Torres and his corporation are "United States persons" -- Torres (and his wife) because they are green-card holders, *see* 26 C.F.R. § 301.7701(b)-1(b)(1), and Emilio Express because it is a domestic corporation, *see* I.R.C. § 7701(a)(30)©. There is no dispute about this.

Petitioners' argument therefore depends on their satisfaction of the different definition of "resident" under the Treaty. Here is the general definition:

> For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.

Treaty, *supra* note 1, art. 4, para. 1.

We agree with Torres that this general rule defines him and his wife as residents of both Mexico and the United States. The Commissioner does not disagree.

Torres then points us to the next paragraph in the Treaty:

> Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his residence shall be determined as follows:
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> a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);
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> b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
>
> c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

> d) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement.

Id. at art. 4, para. 2.

Torres argues that he has a permanent home available to him in both countries. He and his wife own their home near San Diego, and he swore in his declaration that he also has a home next door to his parents' house in Tijuana. In addition to his bare statement, he attached photos and utility bills to his declaration as proof. He also states that he was employed in the City of Tijuana's Sanitation Department, though the paystubs he attached to his declaration weren't from any of the years at issue. His wife also filed a declaration (with paystubs that *were* from one of the years at issue) that show she was employed by a school on the Mexican side of the border. (Though we note that none of her income seems to have made its way to any of the Torreses' U.S. returns.)

The Commissioner contests all of this. He points out that nothing in the Torreses' submissions undermines the status of Emilio Express as a U.S. resident under the Treaty[5] and cites the Torreses' extensive contacts with San Diego as proof that it is their "center of vital interests."

The question of the Torreses' residence is a factual one that is an essential premise of petitioners' motions. There is a genuine dispute about it, which means we must deny their motions.

B.

When we analyze the Commissioner's motions, we must assume that the Torreses are Mexican residents under the Treaty. The Torreses argue that this is enough for them to win. They do not agree with the competent authorities' focus on the question of double taxation. From their perspective, both authorities had both sets of original and amended returns in front of them, and neither disagreed

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[5] It is axiomatic that when a taxpayer chooses the corporate form, he adopts both the advantages and disadvantages that result from that choice. *See Moline Props. v. Commissioner*, 319 U.S. 436, 439 (1943). In other words, a taxpayer cannot simply ignore the corporate form when its recognition becomes inconvenient.

with the Mexican authority's decision to accept their Mexican amended returns as filed. Those returns were premised on their Mexican residence, and they argue this means that their total tax liability to both Mexico and the United States has to be determined under Mexican law using Mexican deductions. If their tax *liability* is zero under Mexican law, that doesn't mean that their total income was not *subject to tax* in Mexico.

Let us turn first to the language of the Treaty. What is its purpose -- is it to determine residence in ambiguous situations like this, or is it something else? The submittal letter from the Secretary of State to the President that accompanied the Treaty says that the Treaty's purpose is to "cooperate to resolve issues of potential double taxation and to exchange information relevant to implementing the Convention and the domestic laws imposing the taxes covered by the Convention." Letter of Submittal from Warren Christopher, Dep't of State, to the President of the U.S. (May 11, 1993), S. Treaty Doc. No. 103-7. Article 26 sets up the mutual agreement procedure that the parties in these cases used. *See* Treaty, *supra* note 1, art. 26. That Article states that the procedure is to be used when there is "taxation not in accordance with the provisions of this Convention." *Id.* at art. 26, para. 1.

There is nothing in the Treaty that creates exemptions from taxation for income based on residence as the Treaty defines it. What the Treaty does is embody an agreement between the two countries that each shall relieve residents of the other from double taxation on the same income through a system of tax credits. This is set out in Article 24, where both countries agree that "a Contracting State shall allow to a resident of that State . . . as a credit against the income tax of that State: a) the income tax paid to the other Contracting State by or on behalf of such resident or citizen . . ." *Id.* at art. 24, para 1, subpara. a.

This is why the conclusion of the competent authorities was that the Torreses' income was not subject to double taxation: There is nothing in the Treaty that prohibits either country from taxing the income of residents of the other. What is prohibited is not allowing tax credits to offset that burden.

The Torreses' argument is based on an that, if they qualify as residents of Mexico under the Treaty, all of their income can be taxed only by Mexico and not by the United States, even though they are green-card holders. The Court can sympathize with them a bit -- it certainly might seem that relief from double taxation could be more easily done by a treaty allocating to either Mexico or the United States the right to tax particular taxpayers on particular sorts of income. But that is not how the Treaty is set up -- it is set up instead to allow both countries to subject to their tax law the entire income of the same taxpayer as long as a system of credits is in place to prevent double taxation.

And, if the purpose of a tax treaty exercised any pull over the interpretation of its language, one must consider the advantages of such a credit system over an exemption system. Under an exemption system, two residents of the same country with the same amount of income could be subject to different effective rates of taxation -- a resident with low-taxed foreign income would be subject to less total tax than would a resident with purely domestic income. (And that would be the situation with the Torreses and their San Diego neighbors.) With a system of credits in place based on tax paid, there is no such advantage.

The Torreses are therefore, regardless of their status as residents of the United States or Mexico under the terms of the Treaty, subject to tax on all their income under the Code. If Mexico *had* made them pay tax on any of that income, they might have been able to successfully use the Treaty if the Code's own provisions on tax credits were inadequate. But there is no dispute that they owed no income tax to Mexico at all for any of the years in question. Neither did Emilio Express. Neither the Torreses nor Emilio Express challenged any other aspect of the Commissioner's determinations in the contested notices of deficiency. That means that it is

ORDERED that petitioners' motions for summary judgment are denied. It is also

ORDERED that respondent's motions for summary judgment are granted.

The Court will enter final decisions in both cases in accord with this order.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
January 30, 2019