Effective Date: February 25, 1998

COORDINATED ISSUE
MAQUILADORA INDUSTRY
I.R.C. § 1504(d) ELECTION

Generally, a foreign corporation may not be included in an affiliated group of corporations for the purpose of filing a consolidated return. However, a domestic corporation may elect to include a wholly-owned subsidiary incorporated in a contiguous country (Mexico or Canada) in the consolidated return group if that subsidiary is maintained solely for the purpose of complying with the laws of the contiguous country as to title and operation of property. Including a Mexican subsidiary in a consolidated return group could be beneficial if it would allow the affiliated group to offset its income by the Mexican subsidiary's start-up costs or operating losses. The I.R.C. § 1503(d) limitation on dual consolidated losses must, however, be considered.

ISSUE

Whether a U.S. corporation that formed a Mexican subsidiary to benefit from the Maquiladora program may elect to include the Mexican subsidiary in the consolidated return group?

FACTS

A U.S. corporation (P) organized a wholly-owned subsidiary (F) under the laws of Mexico.

F requested and received approval to operate as a Maquiladora from the Director General of the foreign investment division of the Mexican Secretariat of Commerce (SECOFI).

With respect to a U.S. taxable year ending prior to October 31, 1996, under I.R.C. § 1504(d) P treated F as a domestic corporation for all purposes of the Code. P included F in its consolidated return group.

LAW

I.R.C. § 1501 provides that an affiliated group of corporations shall, subject to the provisions of Chapter 6 of the I.R.C., have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of

separate returns.

I.R.C. § 1504(d) provides that a domestic corporation may elect to include a wholly-owned subsidiary incorporated in a contiguous country (Mexico or Canada) in the consolidated return group if such wholly-owned subsidiary is maintained solely for the purpose of complying with the laws of such country as to title and operation of property.

Rev. Rul. 71-523, 1971-2 C.B. 326, involved a Canadian corporation incorporated to apply for a grant under the Canadian Program for Advancement of Industrial Technology. Under Canadian law, the grant was only available to Canadian corporations. The ruling concluded that since the Canadian corporation was not formed solely to comply with Canadian laws as to title and operation of property, the corporation was not eligible to make the section 1504(d) election.

In Kohler Co. and Subsidiaries v. U.S., 124 F3d 1451 (Fed. Cir. 1997), the Court affirmed the lower court's determination that the U.S. taxpayer was not required by Canadian law to incorporate in Canada to purchase a Canadian factory and carry on a Canadian manufacturing business. Rather, the taxpayer incorporated in Canada to speed up, rather than ensure, the Canadian authority's approval of that purchase. More importantly, the taxpayer incorporated in Canada in order to qualify for a Canadian grant.

DISCUSSION

Generally, a foreign corporation is not includible in an affiliated group of corporations for purposes of filing a consolidated return under I.R.C. § 1501. A domestic corporation may elect to include a wholly-owned subsidiary that is incorporated in Mexico or Canada in its return, if the subsidiary is ". . .maintained solely for the purpose of complying with the laws of such country as to title and operation of property. . ." I.R.C. § 1504(d).

Because F was formed in order to secure benefits under the Maquiladora program, F was not maintained solely for the purpose of complying with the laws of Mexico as to title and operation of property. Accordingly, F does not qualify for the benefits of section 1504(d).

Kohler, supra, supports the view that certain rights such as "economic benefits" conferred by Maquiladora status are not "property" for purposes of section 1504(d). In 1985, Kohler Co., a U.S. taxpayer, established Kohler, Ltd. (Limited), a Canadian corporation, to facilitate the purchase of a factory in Canada and qualify for a Canadian government grant. Years later, Kohler Co. amended its 1985 return to add Limited to

the U.S. consolidated group and to apply Limited's losses to reduce its tax liability from its otherwise profitable domestic operations. The taxpayer contended that section 1504(d) permitted inclusion of Limited in its consolidated group and that its prior exclusion of Limited was a mistake correctable through filing of an informal claim or amended return. The Court determined that the taxpayer was not required by Canadian law to incorporate in Canada to purchase the Canadian factory and carry on Limited's manufacturing business. Rather, the taxpayer incorporated in Canada to speed up, rather than ensure, the Canadian authority's approval of that purchase. More importantly, the taxpayer incorporated in Canada in order to qualify for the Canadian grant. The Court stated:

> The facts make it clear that Kohler Ltd's Canadian incorporation was not "solely for the purpose of complying with the laws of [Canada] as to title and operation of property." . . . Rather, Canadian incorporation was the result of a strategy decision on the part of Kohler Co. which determined that such incorporation would increase the likelihood of prompt FIRA approval. Incorporation was also necessary in order for Kohler Co.'s Canadian business venture to be eligible for the Cdn $4 million CIRB grant.

Thus, the Court identified the receipt of the grant as a right other than one involving "title and operation of property".

It is the Service's view that the relevant test for determining eligibility for the I.R.C. § 1504(d) election is as follows. This analysis is supported by the Federal Circuit's decision in Kohler, supra.

a. At least one asset held or benefit obtained must be both property under section 1504(d) and be required under Mexican law to be held or operated in a Mexican corporation; and

b. No asset held that is not "property" within the meaning of section 1504(d) may be required under Mexican law to be held or operated in a Mexican corporation.

P's election for F fails under condition (b) because the Maquiladora benefits obtained by F by virtue of Mexican incorporation are not property within the meaning of section 1504(d). Yet, in order to obtain those benefits, P must incorporate F under Mexican law, rather than operate F's activities as a Mexican branch of P. F's Maquiladora activity is an economic benefit not rising to the level of property. See Kohler, supra.

Thus, F is not eligible for an election by P under section 1504(d) because F was formed and maintained to benefit from the Maquiladora program.

RECOMMENDED POSITION

The analysis set forth above, and supported by Kohler, supra, is applicable to the section 1504(d) election made by P. F does not meet the "maintained solely" requirement of section 1504(d) and, therefore, P cannot make the section 1504(d) election for F. Without the election, P may not include F on its consolidated return.

No inference should be drawn from this paper regarding the qualification of a Maquiladora for benefits under section 1504(d) with respect to U.S. taxable years ending on or after October 31, 1996, which was the date of certain amendments to the Mexican Maquiladora Decree. In addition, examiners should document issues arising from the interaction of Mexican land ownership requirements and the requirements of section 1504(d).