Corporate Tax 2023

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Mexico: Trends and Developments
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MEXICO

Trends and Developments

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MLI – Relevant Issues to Consider in Mexico

Introduction

Globalisation has exacerbated the negative impact of loopholes on tax legislation and frictions among different countries’ tax systems. As a result, certain provisions of the current bilateral tax treaty system have facilitated base erosion and profit shifting (BEPS), making it crucial for most member countries of the G20 and the Organization for Economic Co-operation and Development (OECD) to address this situation.

Beyond the challenges faced by the current international tax treaty system, it would be highly burdensome and difficult, in the short term, to negotiate and update each one of the treaties of the current international tax treaty network, considering the vast number of bilateral treaties executed and in force (ie, more than 3,000).

Even where a change to the OECD Model Tax Convention is consensual, a substantial amount of time and resources would be required to include its provisions into each one of the bilateral tax treaties of the international tax system. Therefore, the current international tax treaty network is not well-synchronised with the OECD Model Tax Convention, and issues that arise over time cannot be addressed rapidly.

Without a mechanism to swiftly implement such provisions, changes to models only generate greater gaps between the provisions of the models and the content of current tax treaties. This clearly contradicts the political objective of strengthening the current international tax treaty system by putting an end to BEPS, partly by modifying the international bilateral tax treaty network; doing so is necessary not only to tackle BEPS, but also to ensure the sustainability of the consensual framework to eliminate double taxation.

Consequently, in line with the BEPS measures, and after an arduous consensus-building process, the implementation of an international instrument to enable countries to swiftly modify their bilateral tax treaties was concluded and adopted, which gave rise to the Multilateral Instrument (MLI), the object of this article’s analysis.

Background

Firstly, it is important to note that the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (which gave rise to the Multilateral Instrument) is one of the outcomes of the OECD/G20 Project to tackle Base Erosion and Profit Shifting (the “BEPS Project”) in order to address tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions where the taxpayer has little or no economic activity, resulting in little or no overall corporate tax being paid.

The BEPS Action Plan was developed by the OECD Committee on Fiscal Affairs (CFA) and endorsed by the G20 Leaders in September 2013. It identified 15 actions to address BEPS
in a comprehensive manner, and set out deadlines to implement those actions. Action 15 of the BEPS Action Plan provided for an analysis of the possible development of a multilateral instrument to implement tax treaty-related BEPS measures “to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties”.

The endorsement of the BEPS Action Plan by the leaders of the G20 showed unprecedented political support for adapting the current international tax system in order to face the challenges posed by globalisation. Tax treaties are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments; notably, the current network of bilateral tax treaties dates back to the 1920s and the first soft law Model Tax Convention developed by the League of Nations.

The OECD and the United Nations (UN) have subsequently enhanced and adopted model tax conventions based on that work. The contents of those model tax conventions are reflected in thousands of bilateral agreements among different jurisdictions.

For this reason, under Action 15 of the BEPS Action Plan, governments agreed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

Action 15 of the BEPS Action Plan provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and to amend bilateral tax treaties.

Based on this, interested countries developed an instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution. The goal of Action 15 was to streamline the implementation of the tax treaty-related BEPS measures. This is an innovative approach with no exact precedent in the tax world.

After several years of working meetings and negotiations between the OECD and authorities of the G20 countries, in November 2016 the Convention was concluded and the Multilateral Instrument was adopted. The first signing ceremony for the MLI was held on 7 June 2017 in Paris, and it entered into force on 1 July 2018.

Mexico’s entry into force and effects
On 12 October 2022, the Mexican Senate approved the MLI. Subsequently, the Decree approving the MLI, its reservations and notifications, was published in the Federal Official Gazette, on 22 November 2022.

According to Article 34, the MLI would enter into force in Mexico in two stages:

- on the first day of the month following the end of the three-month period starting from the date of deposit of the fifth instrument of ratification, acceptance or approval; or
- if there is ratification, acceptance or approval after such deposit, on the first day of the month following the end of the three-month period starting from the date of deposit of the instrument of ratification, acceptance or approval.
Consequently, if Mexico deposits its instrument during the first semester of 2023, the MLI would enter into force in 2023.

On the other hand, Article 35 of the MLI sets forth the provisions related to the entry into effect of the MLI in Mexico, which specifically refer to the time at which the provisions of the MLI will be applicable for the contracting jurisdictions. According to Mexico’s position, the MLI would enter into effect in Mexico on 1 January 2024.

General Considerations and Issues
With the entry into force and effects of the MLI, the rules of the international tax treaty system would be modified, since the Convention could perform any or all of the following:

• co-exist with current bilateral tax treaties and modify a limited number of provisions common to most existing bilateral treaties;
• add new provisions specifically designed to counter BEPS for those treaties that do not already have such provisions; and
• clarify the compatibility with tax treaties of other anti-BEPS measures developed in the course of the BEPS Project.

Derived from the above, potential conflicts could arise from the interaction between new MLI provisions and similar provisions included in current bilateral tax treaties that fully or partly cover the same subject matter. Therefore, it is necessary to analyse on a case-by-case basis the modifications that may affect the existing bilateral treaties as a result of the implementation of the MLI.

With this in mind, the following sections will analyse Mexico’s position in relation to the MLI and, from the authors’ point of view, the most common situations in which two jurisdictions may encounter conflicts when taxing under their domestic laws and under the application and interpretation of the international tax system, such as the rules for the prevention of treaty abuse (PPT or LOB rules, as defined below), dividend payments, and alienation of real estate shares.

Article 7 – Prevention of Treaty Abuse
Article 7 of the MLI provides in general terms two alternative rules to address situations of treaty abuse:

• the general anti-abuse rule based on the Principal Purposes of Transactions (PPT); and
• the Simplified Limitation on Benefits provision (LOB).

The PPT provision is considered the minimum standard general anti-abuse rule required for the contracting jurisdictions, according to the Explanatory Statement to the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting.

The Explanatory Statement was issued to provide clarification on how each provision of the MLI is intended to affect covered tax agreements, including descriptions and examples of the types of treaty provisions which are intended to be covered and the way that the MLI would modify such provisions.

The Explanatory Statement also states that “… a PPT is the only approach that can satisfy the minimum standard on its own, and is presented as the default option in paragraph 1…” (Article 7 of the MLI).

Additionally, the Explanatory Statement states that “… countries, at a minimum, should implement: i) a PPT only; ii) a PPT and either a simplified or detailed LOB provision; or iii) a detailed
LOB provision, supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties”.

Finally, the Explanatory Statement states that “… Parties are permitted… to supplement the PPT by choosing to apply a simplified LOB provision… Given that the detailed LOB provision requires substantial bilateral customisation, which would be challenging in the context of a multilateral instrument, the Convention does not include a detailed LOB provision…” Therefore, the simplified LOB is the provision included by the Convention.

In line with the above, being an optional provision, the simplified LOB works as a supplement to the PPT and could be applied only if all contracting jurisdictions affirmatively choose to apply it.

The PPT, under paragraph 1 of Article 7 of the MLI, provides that “… a benefit under the covered tax agreement shall not be granted… if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of transaction… unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the covered tax agreement”.

Accordingly, the simplified LOB provision under paragraphs 8 through 13 of Article 7 of the MLI establishes that a resident of a contracting state shall not be entitled to a benefit contained in a covered tax agreement, unless such resident meets certain conditions.

In general terms, the simplified LOB provision establishes objective criteria to ensure that a person is considered “qualified” to receive the benefits of a covered tax agreement; therefore, the following criteria of the simplified LOB provision shall be required for residents of a contracting state to be entitled to a covered tax agreement benefit.

- At a time when the benefit would be accorded or raised according to the covered tax agreement, a “qualified person” is:
  (a) an individual;
  (b) the contracting jurisdiction or a political subdivision, among others;
  (c) a company or other entity if the principal class of its shares is regularly traded on one or more recognised stock exchanges; or
  (d) a non-profit organisation, among others.
- Regardless of whether the resident is a “qualified person”, residents of a contracting state will be entitled to benefits under the covered tax agreements, if such residents are engaged in the “active conduct of a business”. This term shall not include the activities of:
  (a) operating as a holding company;
  (b) providing overall supervision or administration of a group of companies;
  (c) providing group financing (including cash pooling); and
  (d) making or managing investments (unless made by a bank, insurance company or registered securities dealer in the ordinary course of their business).
- If a resident of a contracting jurisdiction of a covered tax agreement derives income from a “business activity” by that resident in the other contracting jurisdiction or from a “connected person”, the “active conduct of a business” shall be satisfied with respect to such item only if the business activity carried on by the resident to which the item is related
is substantial in relation to the same activity or a complementary business activity carried on by the resident or such connected person in the other contracting jurisdiction. Whether a “business activity” is substantial shall be determined based on all the facts and circumstances.

- A resident of a contracting state that is not considered a “qualified person” shall be entitled to the benefits contained in the covered tax agreement only if, on at least half the days of any twelve-month period, persons that are equivalent beneficiaries own, directly or indirectly, at least 75% of the beneficial interests of the resident.

Once the above points have been analysed, it is important to emphasise the rules of interaction between the PPT and the simplified LOB provision under the MLI according to the Explanatory Statement, as follows.

- The parties can choose to apply the simplified LOB provision as a supplement to the PPT. The simplified LOB provision is an optional provision and applies with respect to a covered tax agreement only if all the contracting jurisdictions have chosen to apply it.
- If one party made the choice to apply the simplified LOB provision and the other did not, the simplified LOB provision would not apply, and by default the PPT rule would apply.
- Parties that choose to apply the PPT alone are allowed to agree that the simplified LOB provision would apply for the purposes of granting benefits in the case of covered tax agreements with parties that choose to apply the simplified LOB provision; therefore, the simplified LOB provision would apply asymmetrically with respect to a covered tax agreement. That is, parties that choose to apply the simplified LOB provision would apply the PPT and the simplified LOB provision in determining whether to grant the benefits under a tax treaty, while the other party (who does not choose to apply the simplified LOB provision) would apply the PPT alone in determining whether to grant treaty benefits.
- If a party opts to apply the PPT alone and does not expressly agree to the application of the simplified LOB provision (through a notification) the exceptions would not apply with respect to the covered tax agreement, and therefore the PPT alone would apply.

**Mexico’s position regarding the PPT and simplified LOB provisions**

Mexico opts to apply the simplified LOB provision. This means that such provision shall apply with respect to covered tax agreements where both contracting jurisdictions have chosen to apply it, except where some but not all the parties have chosen to apply the LOB provision.

For instance, in line with the above, in the specific case of Mexico and the Netherlands the following consequences would arise.

From the information available on the OECD’s website regarding the position of the Dutch MLI, it can be concluded that the Netherlands chooses to apply only the PPT; on the other hand, Mexico chooses to apply the simplified LOB provision. Therefore, the simplified LOB provision could be applied asymmetrically with respect to the tax agreement signed by Mexico and the Netherlands. That is, Mexico could apply the PPT and the simplified LOB provision.
while the Netherlands could only apply the PPT in determining whether to grant the treaty benefits, provided that such agreement was notified.

Mexico could not apply the simplified LOB provision to covered tax agreements that already have limitations with respect to such benefits contained therein; this reservation would be applicable for the treaties executed by Mexico with the United States, Panama, Colombia, China, Israel, among others, since each of these treaties already has an updated LOB provision (e.g., Article 17 of Mexico-United States Income and Capital Tax Treaty) and therefore would not be superseded by the MLI.

Mexico has chosen not to apply the PPT minimum standard provision to its covered tax agreements which already contain provisions that deny benefits (under the same treaty) where the principal purpose or one of the principal purposes of certain arrangements or transactions was to obtain those benefits. This would be applicable for the covered tax agreements executed with Spain, Argentina and the Philippines.

The PPT minimum standard provision would be applicable for listed agreements that may or may not have provisions regarding a PPT but are not too broad, and address treaty abuse in a manner consistent with the provisions of the MLI. Consequently, provisions on a covered tax agreement would be replaced by the PPT provision. Examples of listed agreements are Austria, Belgium, Brazil, Canada, France, Luxembourg, the Netherlands, Singapore, Switzerland and the United Kingdom, among others.

In other cases (i.e., where provisions contained in covered tax agreements are incompatible with PPT provisions), PPT provisions shall supersede the provisions of the covered tax agreement only to the extent that those provisions are incompatible with PPT provisions.

**Article 8 – Dividend Transfer Transactions**

In general terms, Article 8 of the MLI adds language to covered tax agreements to require a minimum shareholding period to be satisfied in order for a company to be entitled to a reduced rate or obtain an exemption on dividends from a subsidiary. This is in consideration of the following ownership conditions:

- that the beneficial owner is a resident of the other contracting jurisdiction and is the recipient of such dividend; and
- that the beneficial owner shall own a certain amount of the capital, shares, stock, voting power, voting rights or similar ownership interests in the company paying the dividends.

In other words, ownership conditions (beneficial owner and minimum capital requirements) must be met throughout a 365-day period to be entitled to such reduced rates or exemptions provided under covered tax agreements. The minimum shareholding period shall be applicable provided that both contracting jurisdictions made such a notification with respect to that provision.

Article 8 does not provide a minimum standard; therefore, contracting jurisdictions may opt out of the entire article. Additionally, contracting jurisdictions may opt out of the entire article to the extent that covered tax agreements already include provisions with respect to a minimum holding period, regardless of it being shorter or longer than 365 days.
Mexico’s position regarding dividend transfer transactions of the MLI
An example of the application of Article 8 of the MLI would be Mexico and Belgium opting in the same way with respect to the minimum shareholding period to be satisfied in order for a company to be entitled to a reduced rate or an exemption. Therefore, the minimum holding period would be applicable to Mexico and Belgium on dividend transactions, considering that both contracting jurisdictions made such election with respect to that provision.

On the other hand, considering that Article 8 is an optional provision and does not provide a minimum standard, from the information available on the OECD’s website regarding their position, the United Kingdom opted out of the entirety of Article 8 such that it should not apply to its covered tax agreements. Therefore, the minimum holding period requirement shall not be applicable between Mexico and the United Kingdom on dividend transactions.

Article 9 – Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property
In general terms, Article 9 of the MLI addresses situations in which assets are contributed to an entity shortly before the sale of shares or comparable interests (such as interests in a partnership or trust) in that entity with the aim of diluting the proportion of the value of the entity that is derived from immovable property.

Therefore, covered tax agreements affected by the MLI with respect to Article 9 could be modified by:

- introducing a testing period for determining whether the condition on the value threshold is met; and
- expanding the scope of interests covered to include interests comparable to shares, such as interests in a partnership or trust.

Mexico’s position regarding capital gains from alienation of shares or interests of entities deriving their value principally from immovable property consists of applying paragraph 4 of Article 9. Therefore, gains derived by a foreign resident from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in Mexico if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50% of their value directly or indirectly from immovable property (real estate property) situated in Mexico.

Due to the nature of Article 9, paragraph 4, the provisions of the covered tax agreement which regulate this kind of transaction would be replaced by the MLI rules. For example, regarding the Mexico and Spain tax agreement, Article 13(2) (as amended by Article IV(1) of the Protocol of the Convention) would be replaced by the provisions of Article 9 of the MLI.
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