taxnotes® international

Volume 82, Number 13 ■ June 27, 2016

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Reprinted from *Tax Notes Int'l*, June 27, 2016, p. 1285

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SPECIAL REPORT

Eligibility for Treaty Benefits Under The Mexico-U.S. Income Tax Treaty

by Jason Connery, Ron Dabrowski, and Jennifer Blasdel-Marinescu

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The information in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG.

In this article, the authors provide flowcharts to assist practitioners in determining whether companies are eligible for benefits under the limitation on benefits provision in the Mexico-U.S. income tax treaty.

To benefit from income tax treaties, companies must satisfy eligibility requirements. This article includes decision-making flowcharts to assist taxpayers and tax practitioners in navigating the eligibility requirements of the Mexico-U.S. income tax treaty and its accompanying protocols (collectively referred to as the treaty) as applied to Mexican companies. Particular attention is paid to the eligibility requirements for the 0 percent withholding tax rate on dividends.[1]

Income tax treaties can exempt business income from source-country income taxes and eliminate or reduce domestic withholding taxes on payments between residents of countries that are income tax treaty partners. To benefit from a U.S. income tax treaty, companies generally must be resident in a treaty partner country and must satisfy at least one of the tests under the applicable limitation on benefits provision.

The flowcharts in this article are focused on the eligibility of Mexican companies to claim treaty benefits under the treaty's LOB article (article 17) on income that would otherwise be subject to U.S. federal income taxation. The article does not address the treaty benefit eligibility of entities that are partnerships or are otherwise transparent for U.S. or Mexican tax purposes. The article is based on the treaty, its accompanying protocols, and U.S. Treasury technical explanations.

The article also addresses the eligibility of Mexican companies for the 0 percent withholding tax rate on dividends under article 10.3 and the LOB provision of the treaty.

Although the flowcharts in this article provide a comprehensive review of applicable provisions under the treaty, taxpayers and their tax advisers should carefully evaluate each individual case and determine

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[1]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, signed on September 18, 1992; and accompanying protocols signed on September 18, 1992, September 8, 1994, and November 26, 2002.

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whether the requirements of the treaty are met based on all facts and circumstances.

This article is the 15th in a series of articles[2] that provide flowcharts to assist taxpayers and tax practitioners in determining companies' eligibility for tax treaty benefits under the LOB provisions of specific U.S. income tax treaties and, when applicable, determining eligibility for a 0 percent withholding tax rate on cross-border intercompany dividend payments to the company. ◆

(Flowcharts start on next page.)

[2]See Jason Connery, Ron Dabrowski, and Jennifer Blasdel-Marinescu, ''Eligibility for Treaty Benefits Under the Denmark-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, June 29, 2015, p. 1219; Connery and Blasdel-Marinescu, ''Eligibility for Treaty Benefits Under the Belgium-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Feb. 10, 2014, p. 563; Connery and Blasdel-Marinescu, ''Eligibility for Treaty Benefits Under the Ireland-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, June 17, 2013, p. 1223; Connery, Douglas Poms, and Blasdel-Marinescu, ''Eligibility for Treaty Benefits Under the Sweden-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, July 23, 2012, p. 359; Connery, Poms, and Blasdel-Marinescu, ''Eligibility for Treaty Benefits Under the Australia-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Dec. 12, 2011, p. 843; Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the Switzerland-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, May 9, 2011, p. 505; Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the Japan-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Sept. 6, 2010, p. 789; Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the 2009 Protocol to the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Apr. 12, 2010, p. 149; John Venuti, Connery, Poms, and Blasdel, ''Eligibility for Treaty Benefits Under the Netherlands-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Nov. 23, 2009, p. 601; Venuti, Connery, Poms, and Alexey Manasuev, ''Eligibility for Treaty Benefits Under the Canada-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, June 15, 2009, p. 967; Venuti, Dabrowski, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under U.K.-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Mar. 23, 2009, p. 1095; Venuti, Connery, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under the Luxembourg-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, July 21, 2008, p. 285; Venuti, Dabrowski, Poms, and Manasuev, ''Eligibility for Treaty Benefits Under the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Feb. 11, 2008, p. 523; and Venuti and Manasuev, ''Eligibility for Zero Withholding on Dividends in the New Germany-U.S. Protocol,'' *Tax Notes Int'l*, Jan. 14, 2008, p. 181.

(Footnote continued in next column.)

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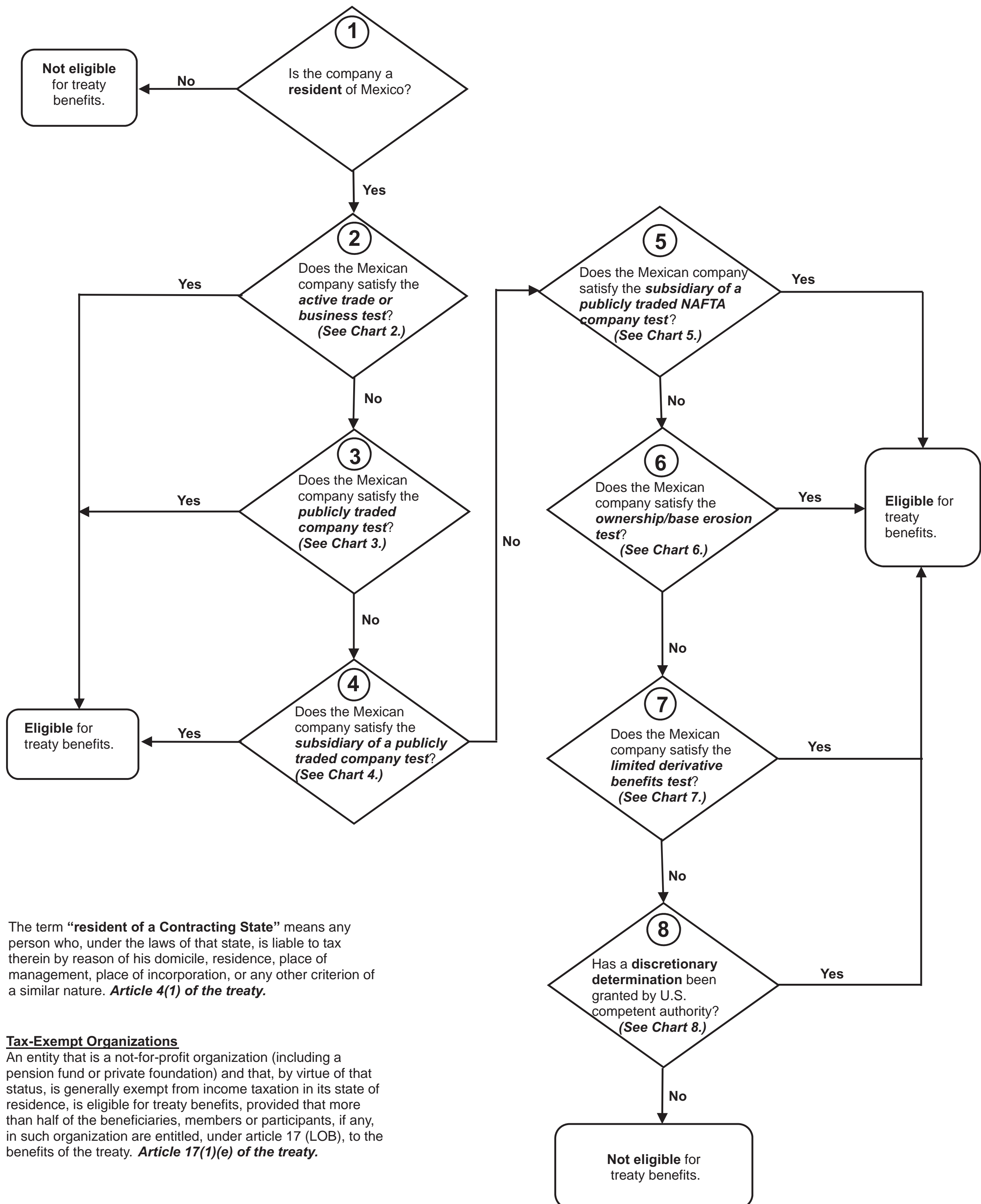

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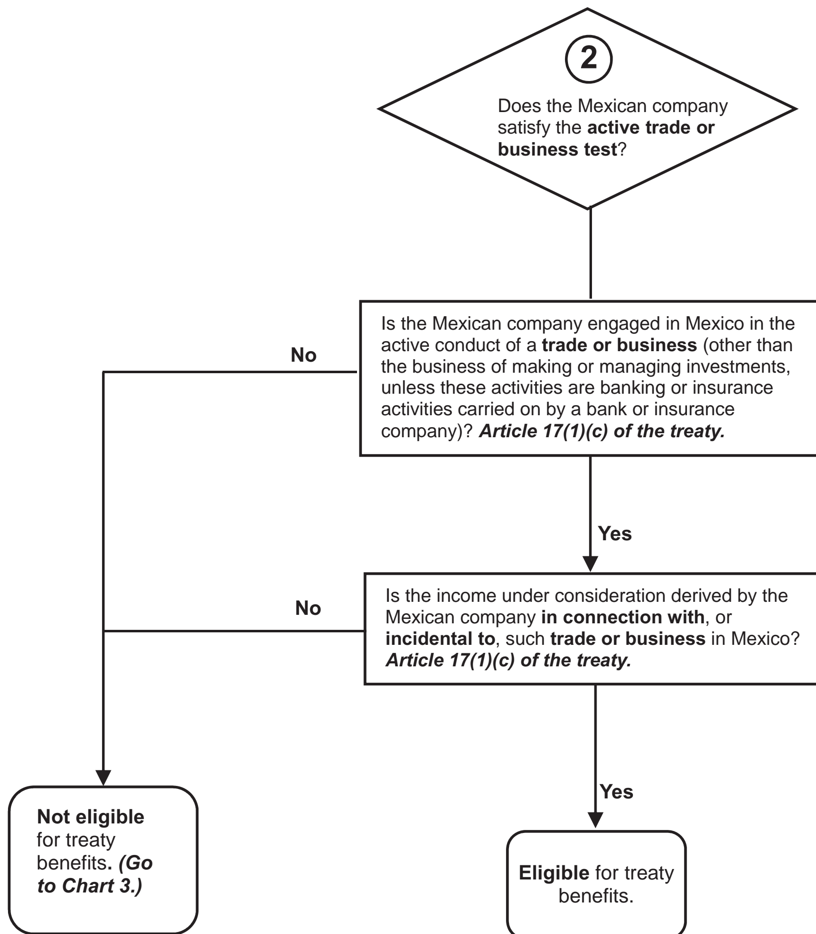
Chart 2. Active Trade or Business Test Under Article 17(1)(c) (LOB) of the Mexico-U.S. Tax Treaty

(Only applies if an item of income is derived in connection with or incidental to an active trade or business in Mexico)



The terms "**trade or business**," "**in connection with**," and "**incidental to**" are not defined in the treaty.

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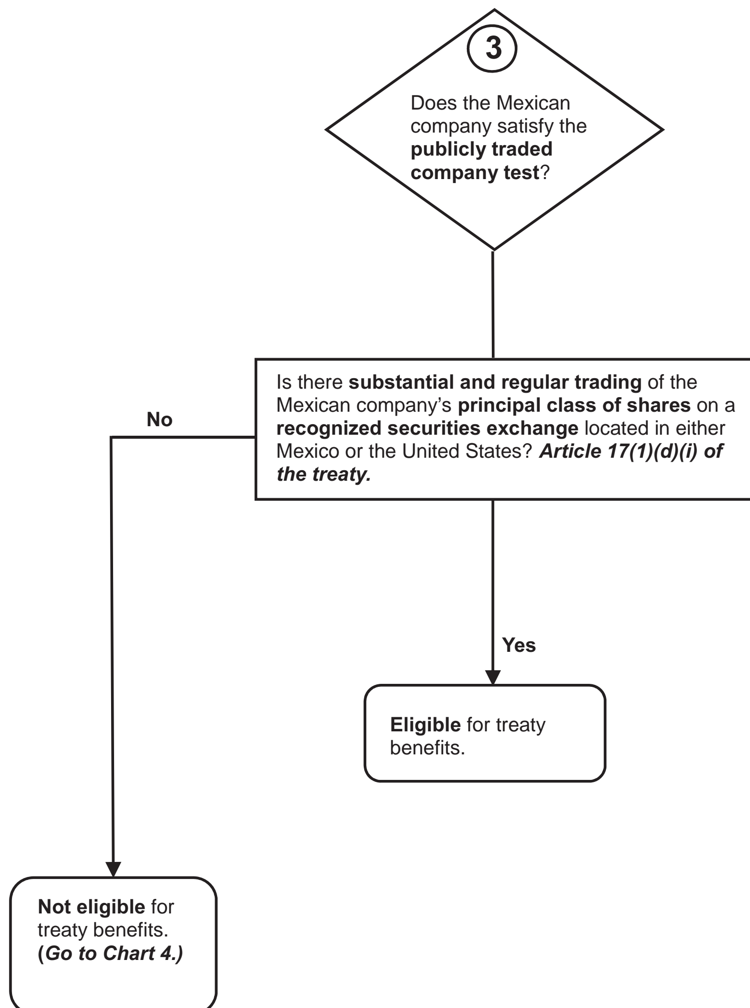
Chart 3. Publicly Traded Company Test Under Article 17(1)(d)(i) (LOB) of the Mexico-U.S. Tax Treaty



"Recognized securities exchange" means:

1) the NASDAQ System owned by the National Association of Securities Dealers, Inc., and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;
2) stock exchanges duly authorized under the terms of the Stock Market ("Mercado de Valores") Law of January 2, 1975; and
3) any other stock exchange agreed upon by the competent authorities of the contracting states.

Paragraph 15(b) of the protocol to the treaty.

The terms "**substantial and regular trading**" and "**principal class of shares**" are not defined in the treaty.

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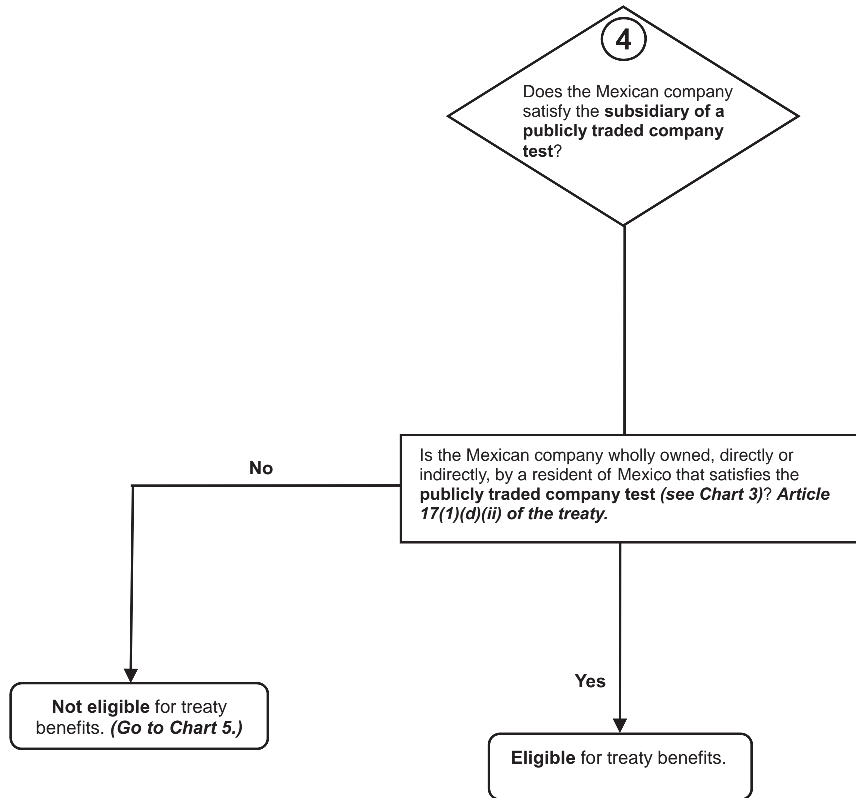
Chart 4. Subsidiary of a Publicly Traded Company Test Under Article 17(1)(d)(ii) (LOB) of the Mexico-U.S. Tax Treaty



Example

A Mexican company not publicly traded but wholly owned by a holding company that is a resident of Mexico whose shares are publicly traded on a recognized exchange in the United States or Mexico (i.e., it satisfies the **publicly traded company test** (***see Chart 3***)) will qualify under the **subsidiary of a publicly traded company test. *U.S. Treasury technical explanation to the treaty.***

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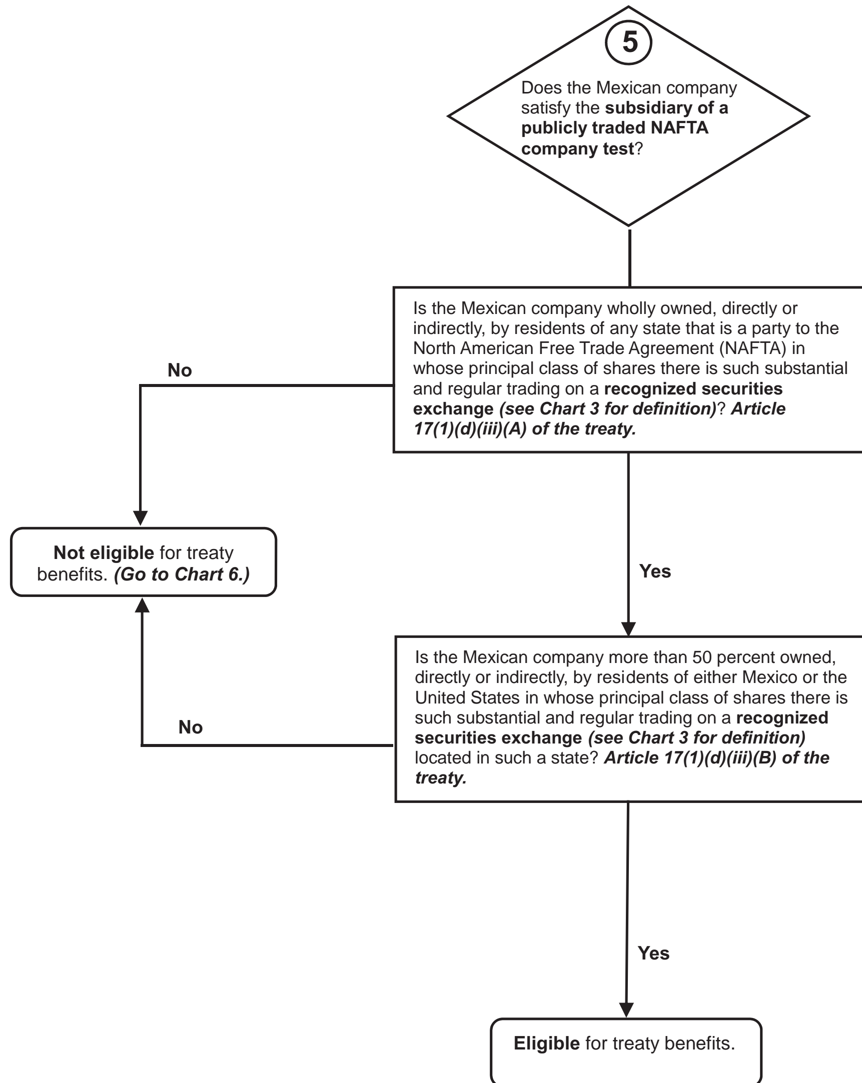
Chart 5. Subsidiary of a Publicly Traded NAFTA Company Test Under Article 17(1)(d)(iii) (LOB) of the Mexico-U.S. Tax Treaty



Example

A Mexican company will qualify if it is owned 51 percent by publicly traded U.S. and/or Mexican companies and 49 percent by a publicly traded Canadian company. ***U.S. Treasury technical explanation to the treaty.***

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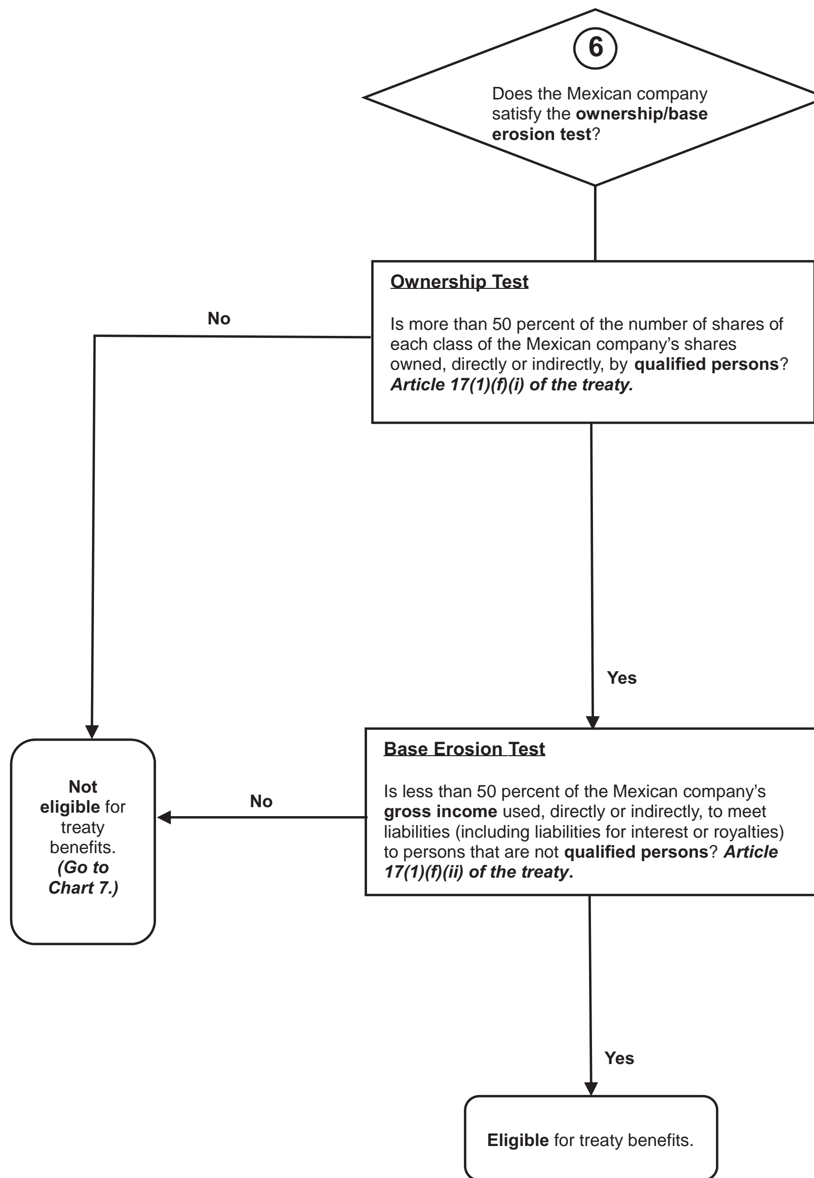
Chart 6. Ownership/Base Erosion Test Under Article 17(1)(f) (LOB) of the Mexico-U.S. Tax Treaty



"Qualified persons" means:

1) individuals resident in Mexico or the United States ***(article 17(1)(a) of the treaty)***;

2) Mexico, the United States, or a political subdivision or local authority of Mexico or the United States ***(article 17(1)(b) of the treaty)***;

3) Mexican or U.S. resident companies that satisfy the **publicly traded company test** ***(see Chart 3),*** the **subsidiary of a publicly traded company test** ***(see Chart 4),*** and/or the **subsidiary of a publicly traded NAFTA company test** ***(see Chart 5)***; and/or

4) certain Mexican or U.S. not-for-profit organizations ***(see Chart 1) (article 17(1)(e) of the treaty)***.

The term "**gross income**" means gross receipts, or where an enterprise is engaged in a business that includes the manufacture or production of goods, gross receipts reduced by the direct costs of labor, and materials attributable to such manufacture or production and paid or payable out of such receipts. ***Paragraph 15(c) of the protocol to the treaty.***

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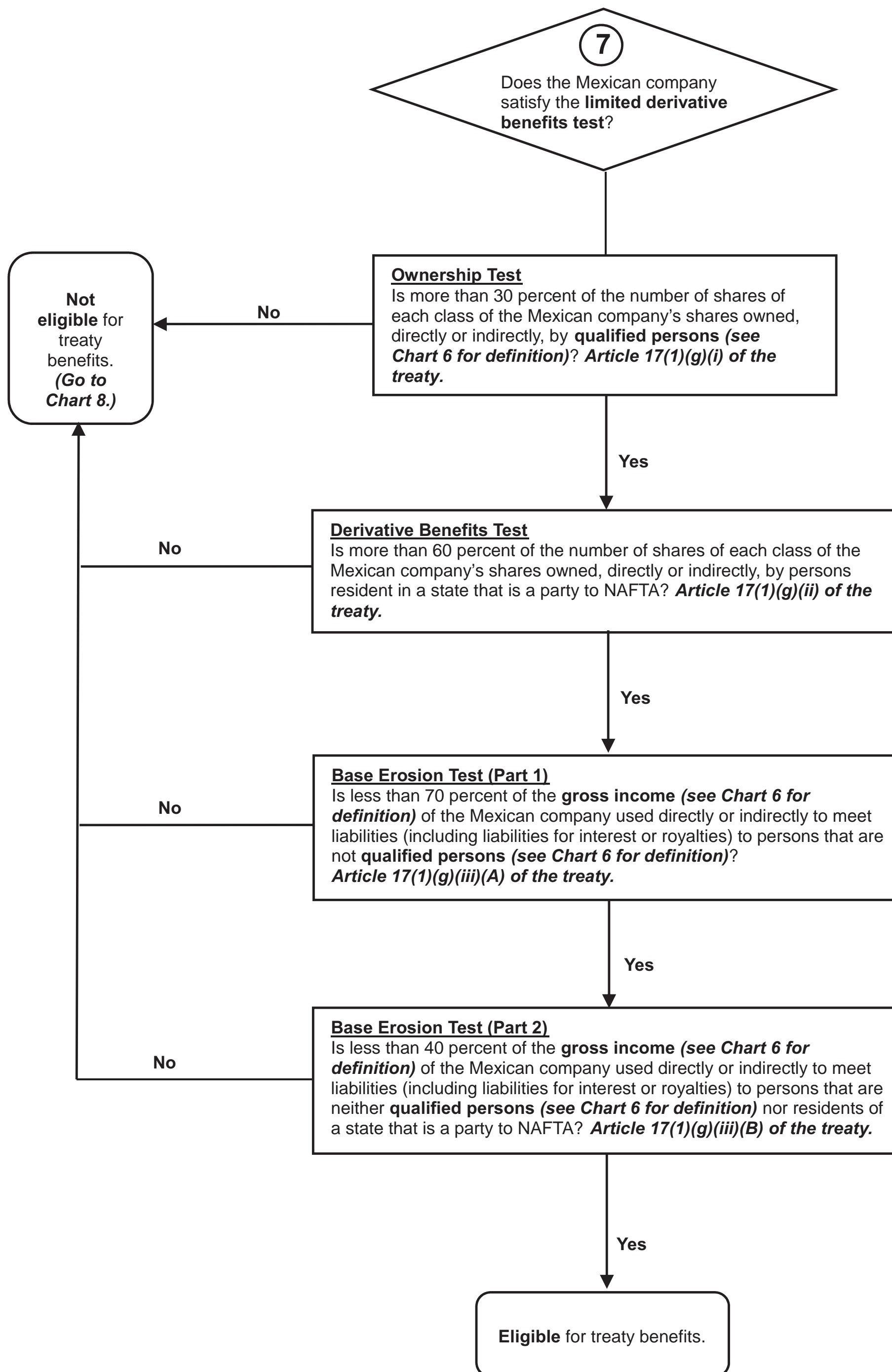
Chart 7. Limited Derivative Benefits Test Under Article 17(1)(g) (LOB) of the Mexico-U.S. Tax Treaty

(Only applies to dividends, interest, branch tax, and royalties)



A resident of a state that is a party to NAFTA shall only be considered as owning a share under the **limited derivative benefits test** that state has a comprehensive income tax convention with the contracting state from which the income is derived (in this case, the United States) and if the particular dividend, profit, or income subject to the branch tax, interest, or royalty payment, in respect of which benefits under this treaty are claimed, would be subject to a rate of tax under that convention that is no less favorable than the rate of tax applicable to such resident under articles 10 (dividends), 11 (interest), 11A (branch tax), or 12 (royalties) of this treaty. ***Article 17(1)(g) of the treaty.***

Ownership by residents of a NAFTA state other than the United States and Mexico (currently Canada) will be taken into account only if the resident of the NAFTA state qualifies for the benefits of the treaty between its state of residence and the source state (in this case, the United States) under its terms (e.g., its LOB article). ***U.S. Treasury technical explanation to the treaty.***

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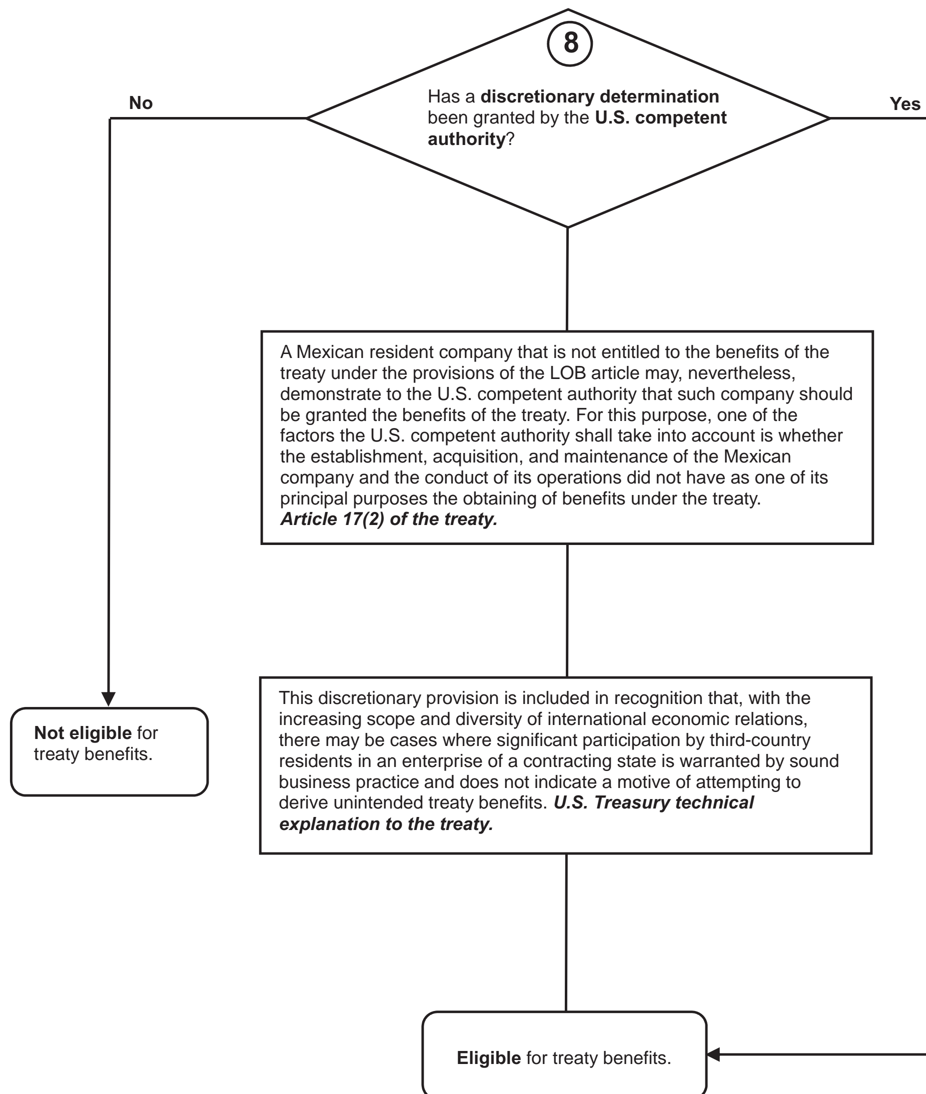
Chart 8. Discretionary Determination by U.S. Competent Authority Under Article 17(2) (LOB) of the Mexico-U.S. Tax Treaty



The **"U.S. competent authority"** is the secretary of the Treasury or his authorized representative. ***Article 3(1)(e)(ii) of the treaty.***

Requesting competent authority assistance – A taxpayer may request the assistance of the **U.S. competent authority** under Rev. Proc. 2015-40. The **U.S. competent authority** may determine in its own discretion that the taxpayer qualifies for certain benefits under the LOB article of the treaty.

There is a US $32,500 user fee for requesting a **discretionary determination** under the LOB provision for requests filed prior to September 30, 2016. The user fee increases to US $37,000 for requests filed on or after September 30, 2016. If a request is submitted for more than one entity, a separate user fee is charged for each entity. Rev. Proc. 2015-40, section 14.02.

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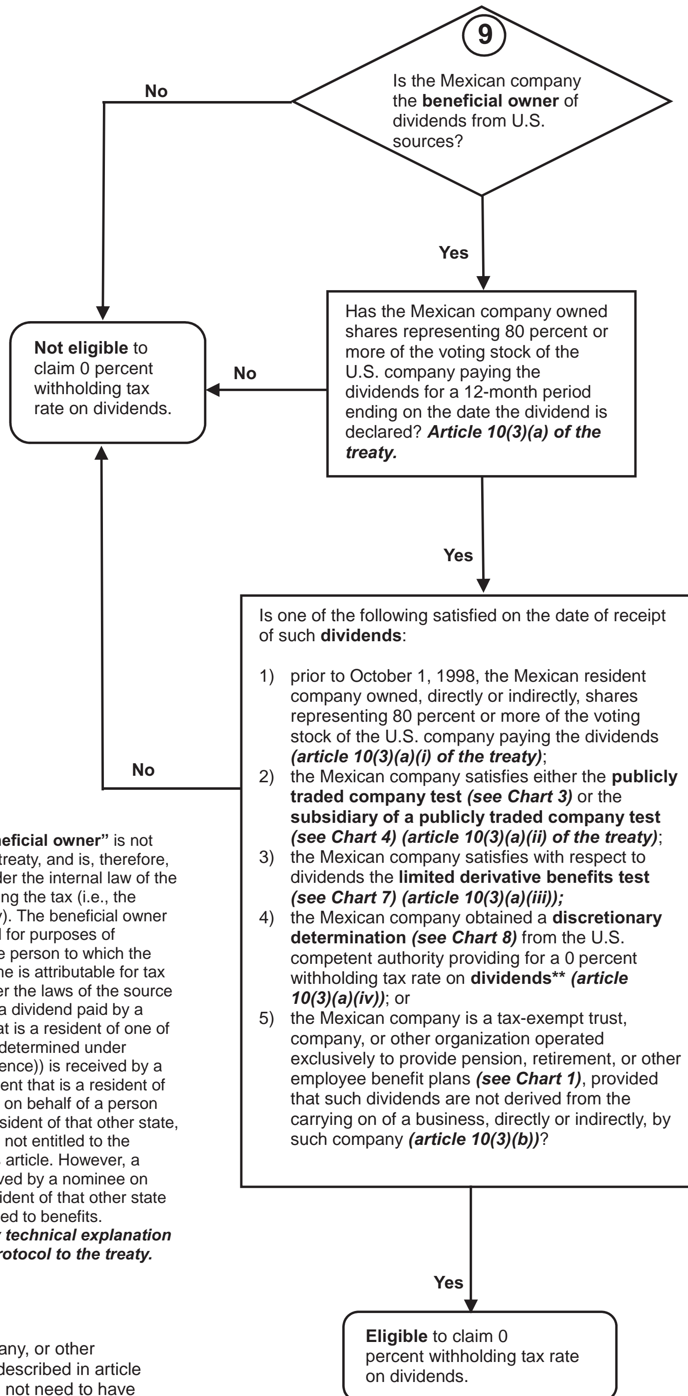
Chart 9. Eligibility for 0 Percent Withholding Tax Rate on Dividends Under Article 10(3) of the Mexico-U.S. Tax Treaty



The term **"beneficial owner"** is not defined in the treaty, and is, therefore, defined as under the internal law of the country imposing the tax (i.e., the source country). The beneficial owner of the dividend for purposes of article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source state. Thus, if a dividend paid by a corporation that is a resident of one of the states (as determined under article 4 (residence)) is received by a nominee or agent that is a resident of the other state on behalf of a person that is not a resident of that other state, the dividend is not entitled to the benefits of this article. However, a dividend received by a nominee on behalf of a resident of that other state would be entitled to benefits. ***U.S. Treasury technical explanation to the 2002 protocol to the treaty.***

A trust, company, or other organization described in article 10(3)(b) does not need to have owned shares representing 80 percent or more of the voting stock of the U.S. company paying the dividends for a 12-month period ending on the date the dividend is declared to qualify for a 0 percent withholding rate on dividends.

"Dividends" means income from shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights that is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident (in this case, the United States). ***Article 10(4) of the treaty.***

The term **"dividends"** is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source (in this case, the United States), as well as arrangements that might be developed in the future. ***U.S. Treasury technical explanation to the 2002 protocol to the treaty.*** **"Dividends"** includes income from shares, or other corporate rights that are not treated as debt under the law of the source state, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the state of source. Thus, a constructive dividend that results from a non-arm's-length transaction between a corporation and a related party is a dividend. ***U.S. Treasury technical explanation to the 2002 protocol to the treaty.***

In the case of the United States, the term **"dividend"** includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. *See, e.g.,* Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of subsidiary's and sister's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of article 10. However, a distribution by a limited liability company is not characterized by the United States as a dividend and, therefore, is not a dividend for purposes of article 10, provided the limited liability company is not taxable as a corporation under U.S. law. ***U.S. Treasury technical explanation to the 2002 protocol to the treaty.***

A payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source state. Paragraph 9 of the treaty's first protocol clarifies this by providing that each contracting state may apply its statutory rules for distinguishing debt and equity or for preventing thin capitalization in defining dividends for purposes of this article. In the case of the United States, these rules include Internal Revenue Code section 163(j). ***U.S. Treasury technical explanation to the 2002 protocol to the treaty.***

The treaty provides that the competent authorities of the contracting states shall consult each other with a view to develop a commonly agreed application of when to grant a discretionary determination providing for a 0 percent withholding rate on dividends. If a common application is agreed upon, the competent authorities shall publish regulations or other public guidance. ***U.S. Treasury technical explanation to the 2002 protocol to the treaty.*

Dividends received by a taxable Mexican company from U.S. real estate investment trusts and U.S. regulated investment companies are not eligible for a 0 percent withholding tax rate. ***Article 10(4) of the treaty.***

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