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THE U.S.-MEXICO TAX TREATY: ITS RELATION TO NAFTA AND ITS STATUS

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I. TAX TREATIES AND FREE TRADE

It is a great pleasure for a Washington tax lawyer to be here in Santa Fe this weekend. Santa Fe affords all of its well known advantages as one of the few places in the United States where one can really find a cultural crossroads. To a *tax lawyer*, however, this conference affords a different sort of cultural crossroad—the ability to mix with, and learn a little from, my trade lawyer brethren. Indeed, some of my trade lawyer brethren may be wondering why a tax lawyer is participating in a conference on the North American Free Trade Agreement ("NAFTA").[1] The answer to that question is, in fact, the subject of my talk.

NAFTA's chief goals, of course, are to stimulate cross-border trade and cross-border investment. It will do this in many ways, both with respect to tariffs and non-tariff barriers. Income taxes, however, for the most part are carved out of the most favored nation ("MFN") and national treatment protections provided under NAFTA. Tax issues are left, instead, to the provisions of bilateral income treaties.

Income taxes, of course, can have just as deleterious an effect on cross-border trade and cross-border investment as tariffs and other barriers. Bilateral tax treaties are designed to prevent this. The United States has long had a tax treaty with Canada.[2] For the last three years that treaty has been undergoing renegotiation, but no changes have been definitely agreed upon.[3] The United States does not yet have a tax treaty with Mexico. On September 18, 1992, however, U.S. Treasury Secretary Brady and Mexican Finance Minister Aspé signed the first U.S.-Mexico Tax Treaty.[4] This concluded lengthy negotiations over the course of the last three years. I was fortunate to have headed the U.S. delegation for much of that time.

Like most of the United States tax treaties, and like the evolving series of tax treaties that Mexico is entering into, the U.S.-Mexico Tax Treaty

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1. Oct. 7, 1992 draft, U.S.-Can.-Mex.

2. *See generally* THE NEW CANADA-UNITED STATES INCOME TAX TREATY (1984).

3. As of December 31, 1992.

4. 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, Sept. 18, 1982, U.S.-Mex., *reprinted in* TAX NOTES INT'L 39-22 (1992) [hereinafter U.S.-Mexico Tax Treaty].

is based on the 1977 Office of Economic Control and Development ("OECD") Model Income Tax Convention.[5] Before I highlight some of the specifics regarding the U.S.-Mexico Tax Treaty, let me put those specifics in context by describing generally what tax treaties do, i.e., how they reduce or eliminate income tax barriers to cross-border trade and investment.

One of the most important protections tax treaties are designed to provide is the prevention of discrimination against foreign nationals, individual or corporate, or against domestic entities whose capital is owned by foreign nationals. Most tax treaties provide for national treatment, although there are important qualifications conditioning the protection on a similarity of circumstances. Typically, then, a domestic subsidiary owned by a foreign corporation must be taxed on its profits in the same fashion as a domestic subsidiary of a domestic corporation. The same is true of an office or branch operations of a foreign corporation. Payments of periodic income, like dividends, interest, or royalties, may be treated differently, however, depending on whether they are paid to residents or non-residents. This is because countries typically tax residents on their worldwide income, allowing deductions for costs, but tax nonresidents earning periodic income only on their local income without deductions. This difference in fundamental tax circumstances justifies different treatment under most treaty nondiscrimination provisions. Restricting the operation of the different tax treatment for periodic income earned by nonresidents, therefore, is the subject of many other provisions of a tax treaty.

As the late Professor and former Treasury Assistant Secretary Stanley Surrey explained in congressional testimony back in 1961,[6] one such group of tax treaty provisions imposes limits on, or provides complete exemption from, tax for temporary, preliminary, or exploratory activities. Treaties do this by requiring the existence of a "permanent establishment" ("P.E.") before imposing tax on a foreign person's activities, and then by limiting the tax that may be imposed to tax on only that income directly attributable to that P.E. For example, a businessman from the United States who temporarily visits Mexico for the purpose of exploring business opportunities, or to consult with associates and employees in Mexico, is often in a difficult position from a tax standpoint. It is not simply that he may have to pay taxes in Mexico on his income during his stay in Mexico—typically the individual involved will be able to claim a credit against his U.S. tax for taxes paid to Mexico—but that the credit does not eliminate the annoyance and inconvenience of having to file a tax

5. *Office of Economic Control and Development Model Double Taxation Convention on Income and Capital* (1977), *reprinted in* C. VAN RAAD, MODEL INCOME TAX TREATIES: A COMPARATIVE PRESENTATION ON THE TEXTS OF THE MODEL DOUBLE TAXATION CONVENTIONS ON INCOME AND CAPITAL OF THE OFFICE OF THE ECONOMIC CONTROL AND DEVELOPMENT (1981) [hereinafter OECD].

6. *U.S.-Thai Tax Convention: Hearings Before the Subcomm. on Tax Conventions of the Senate Comm. on Foreign Relations*, Fed. Taxes (P-H), ¶ 84,132 (Aug. 11, 1963) (statement of Stanley S. Surrey, Assistant Secretary, U.S. Treasury).

return in Mexico, not to speak of the consequences of erroneous interpretations or inadvertent errors which compliance with unfamiliar laws may involve. This type of problem is generally eliminated in tax treaties by reciprocal exemption of residents of one country who visit the other for limited periods of time.

A similar problem afflicts a business enterprise itself, quite apart from its employees. A U.S. firm seeking to enter the Mexican market or a Mexican firm starting up a U.S. business may not only be confronted with the difficulties of complying with unfamiliar tax laws, but may also be confronted with a foreign tax burden that is not always relieved by the foreign tax credit provisions of their home country's tax law. The P.E. provision seeks to cope with such cases.[7] It describes certain types of activities which, when carried on in Mexico by a U.S. firm, or vice versa, are regarded as not constituting a P.E. within that country, and therefore any profits earned through such activity are not taxable in that country. Thus a U.S. firm may send salesmen to Mexico in an effort to penetrate the Mexican market without becoming subject to Mexican taxes, and vice versa. Other types of activities, some involving the maintenance of a definite place of business, may also be carried on without creating a P.E. These include such activities as the purchase of merchandise, the storage of merchandise, the conduct of advertising, and the use of commission agents.

A somewhat similar problem relates to the determination by Mexico of the amount of income earned therein by a branch or foreign office of a U.S. enterprise, or vice versa. It is not always clear that costs allowed as a deduction, in arriving at the taxable income of such a branch, include costs that are allocable to the activities of the branch, but that are incurred outside of Mexico. A tax treaty resolves this problem so that the tax imposed will be a tax on true net rather than gross profits.

The third broad subject area of tax treaties is the elimination of "double tax." Double tax occurs where both the United States and Mexico claim taxing rights over the same dollar or peso of income. The United States provides unilateral relief from many instances of double taxation by the provision of a foreign tax credit in our Internal Revenue Code.[8] Mexican income tax, if it is like U.S. income tax and is imposed on Mexican source income, will be credited against and will thus offset U.S. income tax on the same income. If the U.S. tax is higher than the foreign tax, the U.S. collects the remainder but no more. Mexico also has provisions providing unilateral relief from double tax.

There are, however, very complex rules regarding the application and limitation of the U.S. foreign tax credit, and they do not always mesh with other countries' rules. Treaties, therefore, provide coordination. First, they may confirm that a foreign country's tax qualifies under these rules.

7. U.S.-Mexico Tax Treaty, *supra* note 4.
8. *See* 26 U.S.C.A. §§ 901-08 (1992).

They also can resolve conflicts regarding the source of income and the size of the income tax base—that is, the foreign income against which deductions should be taken. For example, if the United States and Mexico utilize different methods for determining the amount of income allocable to each country from transactions between related enterprises, such as the appropriate transfer price when a parent corporation in one country sells goods or licenses know-how to a subsidiary in the other country, both countries may refuse to credit the other's tax on the disputed income. Tax treaties deal with these problems by providing mutually acceptable rules regarding the source of income and allocations of income, at least in general terms, and by providing a mutual agreement process for ironing out specific case disputes between the tax authorities of each country. This dispute resolution mechanism is a particularly important provision of tax treaties since it provides the potential for relief for taxpayers who are caught in the middle between two tax authorities. While most taxpayers are willing to pay tax to one government or another on an item of income, few are willing to pay tax to both. The dispute resolution mechanism provided by treaties, which is evolving into a more certain and reliable mechanism in newer treaties by the addition of an arbitration provision, is designed to get the taxpayer out of the middle.

Still another case where unilateral relief from double taxation is inadequate to deal with international tax problems is the relatively simple case where foreign tax rates are higher than U.S. taxes on the same income. In such cases, because the United States will not credit foreign taxes that exceed U.S. tax on the same income, an unused or "excess" tax credit is generated. Taxes on interest and royalty payments paid to nonresidents, for example, are taxed at rates (thirty percent in the United States and varying rates up to thirty-five percent in Mexico) that may be nearly confiscatory when you consider that they are imposed on the *gross* amount of the payment, without reduction for the costs of earning the interest or royalty income. Thirty percent, or even fifteen percent on the gross flows of interest income to a bank, will virtually always exceed the thirty-four percent corporate income tax on the net profit earned with respect to the loan on which the interest is paid since, of course, the bank must pay interest to its depositors and earns only a relatively small spread between the interest received versus the interest paid. Thirty percent of gross interest will sometimes exceed 100% of net profit on a loan. To solve this difficulty, tax treaties seek to arrive at mutually acceptable adjustments in the withholding tax rates on interest, royalties, and dividends paid by the residents of each country to residents in the other.

Finally, a tax treaty provides a relative degree of certainty regarding the tax rules that will apply to cross-border investment. While the U.S. Congress has become notorious in recent years for overriding certain relatively narrow aspects of our tax treaties when they wish to change policy quickly, these overrides are still relatively rare and reluctantly enacted. While I do not mean to oversell the point, treaties at least provide some modest level of stability in the tax that will apply to a

cross-border investment so that businessmen can plan with more certainty than if they are left entirely at the mercy of the United States and Mexico legislatures.

An additional unique benefit for U.S. business that may come from the U.S.-Mexico Tax Treaty is the precedent it sets for tax treaties between the United States and the countries of South and Central America. Despite relatively good coverage for the rest of the world—there are approximately forty U.S. tax treaties currently in force—the United States has no treaties with Latin America. Just as NAFTA may encourage a freer trade within the rest of the hemisphere, the U.S.-Mexico Tax Treaty with Mexico may encourage Latin American finance ministries to enter into similar treaties with the United States.

II. The U.S.-MEXICO TAX TREATY

Now let me turn to the specifics of the tax treaty between the United States and Mexico.

Negotiations began in March 1990, following the successful implementation of a Tax Information Exchange Agreement[9] between the Mexican federal tax authority, known as the Hacienda, and the U.S. Internal Revenue Service ("IRS") in late 1989. These were the first tax treaty negotiations for Mexico and progress was slow, chiefly because of the importance of the treaty to both sides; to Mexico because of the large income flows to the U.S. and corresponding potential revenue loss, and to the United States because of the precedent the treaty will set for the rest of Latin America and because of the fear that tax barriers could undo the investment achievements of NAFTA.

Shortly after the first round with the United States, Mexico commenced negotiations on tax treaties with Canada and several European Community countries. The Mexico-Canada Treaty[10] was signed in April 1991, and was a disappointment to the U.S. Treasury since, consistent with then-current Canadian Treaty policy—now undergoing some change—it set levels of taxation considered too high for partners in a free trade relationship.

In September 1991, however, a firm link between NAFTA and the tax treaty was established and progress was made. The final negotiation was held in early August and the treaty was signed September 18. It is now subject to the ratification procedures of both Mexico and the United States.

On the United States side, the ratification process commences with hearings before the Senate Foreign Relations Committee. Typically, the Senate desires to consider several tax treaties at the same time. A new treaty with Russia and probably a new treaty with the Netherlands will,

9. Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes (U.S. Dep't Treasury Nov. 9, 1989).

10. Convention Between the Government of Canada 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 (Can. Dep't Finance Apr. 8, 1991).

therefore, likely be considered at the same time as the U.S.-Mexico Tax Treaty. Once the Foreign Relations Committee approves the treaty it goes to the full Senate, which must approve it by a two-thirds vote. Documents of ratification may then be exchanged and the treaty enters into force. The U.S. House of Representatives, the body in which, under our Constitution, all revenue legislation must originate, has no say in the ratification. This is a source of friction that has led, in my opinion, to the tax treaty override problems of recent years. But that is another story.

The treaty has been sent to the Mexican Senate, where it will go before its Senate Foreign Relations Commission. That group will review the treaty and will make its recommendation to the full Senate.

Prospects in both the United States and Mexican Senate appear good. There are no apparent controversies, at least none that are notable. So, what is in this treaty? The U.S.-Mexico Tax Treaty contains many standard features and some relatively innovative ones. It provides for non-discrimination—national treatment—in very typical tax treaty terms.

The treaty provides typical thresholds for taxation and typical exemptions, but with a few notable twists. The threshold before a construction site or installation project may be taxed is six months, rather than the United States and OECD preferred twelve months. The Permanent Establishment Article,[11] which describes the level of activity of an enterprise before it can be subject to tax, also contains relatively unusual language that appears to confirm specifically that a typical *maquiladora* arrangement would constitute a P.E. of its owner and, therefore, be taxable by Mexico if Mexico wished. The treaty does not impose a tax on *maquilas*—it merely preserves Mexico's right to tax them if it wishes. But the insistence by Mexico on the inclusion of this language is most unusual, given that the standard OECD model language arguably would also permit the conclusion that a *maquila* could be a P.E. Perhaps this insistence is indicative of the Hacienda's continuing antipathy towards the tax treatment of maquilas and may portend a future effort to exact more reserves from the *maquilas*.

The treatment of international transportation is quite standard but, given the geographic proximity of Mexico to the United States, somewhat disappointing. The OECD and the recently withdrawn U.S. model tax treaties, like the U.S.-Mexico Treaty, provide that profits of an enterprise from the international operation of ships and airplanes will be taxed only in the country of residence of the enterprise.[12] This prevents an airline or shipping company from being taxed in every airport or port at which their planes or ships call. With contiguous countries, however, this concept logically also should apply to ground transportation—trucks and trains. Unfortunately, the U.S.-Mexico Treaty does not cover trucks or trains, so their revenue and costs on trips, and rentals of equipment across the border, must be allocated between Mexico and the United States. Inconsistent allocations, of course, are quite possible and the extra administrative burden is a certainty.

11. U.S.-Mexico Tax Treaty, *supra* note 4, art. 5(5).
12. OECD, *supra* note 5, art. 8.

The treatment of personal services income under the U.S.-Mexico Tax Treaty is the same as under the OECD model. If the services are rendered by an employee—so-called dependent services—the employee cannot be taxed in the source country—the country he is not a resident of but where the services are performed—provided: (1) he is paid by a nonresident employer; (2) his wages are not cross-charged to a P.E. in the same country; and (3) he is not present in the source country for more than 183 days per year. If the services are performed by an "independent agent" his income will not be taxed by the source country unless he operates from a "fixed base" in the source country—a concept similar to the P.E. concept for enterprises—or he is present in the source country for 183 days per year.

There are unusual provisions in the U.S.-Mexico Tax Treaty to deal with Mexico's asset tax—a sort of alternative minimum tax, imposed at two percent of gross assets, that Mexico imposes to the extent it exceeds regular Mexican income tax. As a property tax, the asset tax is not a creditable income tax under U.S. law. Because of this, the Mexican negotiators desired not to have the treaty apply to the asset tax. Because the asset tax would act as a substitute for treaty-relieved regular income tax, however, this would have completely undermined the P.E. and other protections afforded by the treaty. A compromise was reached. The treaty protocol provides that the asset tax will not be applied to U.S. residents that have no Mexican P.E., except on real property and on assets giving rise to royalties.[13] In those cases where the asset tax does apply, however, it will not be applied to substitute for regular tax relieved by treaty. Instead, it will only apply to the extent it would have created an excess liability above that owed by virtue of the regular tax *before* the treaty relief is computed. Thus, in a case where the asset tax is $120 and the regular tax $100, so that $20 in assets tax is owed, if the treaty cuts the regular tax from $100 to $50, the assets tax will not increase by $50 to soak up the treaty benefit but will remain at the original $20.

Some of the most contentious issues in the negotiation were the withholding rates on cross-border interest, dividends, and royalty payments. Because of the present imbalance of flows (most flow from Mexico to the U.S.), and the concomitant revenue implications for Mexico of rate reductions, these provisions were hard-fought. Under the treaty, royalty withholding tax will be reduced to ten percent, higher than desired by the United States, but a substantial reduction from the rates that apply under domestic law, up to thirty-five percent in Mexico.

The dividend withholding tax provisions break new ground for both countries. Portfolio dividends—dividends earned by small shareholders—may be taxed at a fifteen percent rate that, in five years, will step down to ten percent. Ten percent on portfolio dividends is unprecedented in the U.S. Treaty network; no other treaty provides a rate lower than fifteen percent. Direct dividends—dividends earned by parent companies

13. *Id.*

which own at least ten percent of a subsidiary—may be taxed at a maximum five percent. Mexico apparently wanted a zero rate—exemption—on direct dividends, presumably because dividends out of taxed corporate profits bear no Mexican withholding tax at present. The United States reportedly offered to go to zero only if Mexico would agree also to exempt certain *interest* from withholding, because the United States unilaterally exempts portfolio interest by statute. Each wanted zero from the other on the category it unilaterally exempted. This stand-off was apparently resolved by providing Mexico with MFN status—if the United States ever agrees to a rate lower than five percent on dividends, that lower rate will apply under the U.S.-Mexico Tax Treaty.

Interest withholding rates in the treaty are also unprecedented for both countries. Most notable is the 10% rate, declining to 4.9% after 5 years, for interest paid to banks. A 4.9% (or lower) rate for interest paid to U.S. banks is a substantial benefit because it allows the banks to put the interest income and the 4.9% tax in a foreign tax credit "basket" that is likely *not* to have excess, unusable credits. Interest withholding taxes at five percent or more must be placed in a separate "high withholding tax" basket that is virtually certain to have unusable, excess credits, so a five percent or higher rate cannot, as a practical matter, be credited against U.S. tax for virtually any U.S. bank. Getting the rate below five percent, therefore, was crucial.

The treaty is also unusual, also in a positive way, in providing reciprocal exemptions for charitable and educational organizations. A U.S. charity, for example, will be exempt from income tax in Mexico to the extent that (1) it is exempt in the United States or (2) it would be exempt in Mexico if it were organized there. More radically, the treaty allows the United States and Mexico to agree (and they do agree, in the protocol, with respect to most public charities) that their standards for charities that receive deductible contributions are identical enough that a Mexican can deduct against Mexican tax his contributions to a U.S. charity and vice versa. This special deduction will be restricted, however, to the amount of United States-source income for a Mexican contributor and Mexican-source income for a U.S. resident contributor.

Finally, a few words about dispute resolution. Typically, individual cases of unresolved double taxation must be submitted to the so-called "Competent Authority" process. The Competent Authority process, however, does not guarantee a resolution. If the IRS and the Hacienda cannot agree, they can simply walk away and leave the taxpayer subject to double tax. Given the United States' new and controversial proposals on intercompany transfer pricing of tangible goods and intangibles, the difficulties faced by the Competent Authorities may be large.

The treaty, like the U.S.-German Tax Treaty,[14] provides for the option, upon agreement by both the IRS and the Hacienda, as well as by the taxpayer, of binding arbitration. Unfortunately, because of IRS resistance, the arbitration option will not be available until after consultations between

14. Convention Between the United States and the Federal Republic of Germany for the Avoidance

Mexico and the United States, three years after the treaty enters into force.

In summary, the U.S.-Mexico Tax Treaty is a good deal for both sides because it is a good deal for cross-border investment. The disappointments are relatively modest, particularly in light of the far greater flows of taxable income from Mexico to the United States than from the United States into Mexico. Indeed, the treaty is better, from the perspective of business, than the tax treaty between the U.S. and Canada. In short, it is a crucial and ground-breaking complement to NAFTA.

of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Tax Treaties (CCH) ¶ 3249 (Aug. 29, 1989).

MEXICAN TAX LAWS

DIONISIO J. KAYE*

I. INTRODUCTION

Mexico is entering a new era of social progress and economic growth, at the heart of which is a comprehensive policy dedicated to the revitalization and modernization of the nation's economy. The new policy, which focuses on domestic economic stabilization and internationalization, began in 1986. The first step involved dramatic government financial changes through significant cuts in expenditures, reprivatization of government-owned businesses, renegotiation of public foreign debt, and deep tax law revisions which could broaden the tax base and improve the administration of the federal government's income systems.

These steps have produced positive results. Domestically, the new approach resulted in a reduction of eighty-two percent of the number of government owned or operated enterprises, and in a lowering of the annualized rate of inflation from 159% in December of 1987 to less than 20% in 1991. There has also been a significant reduction in the public foreign debt, which has contributed to the growth in Mexico's economy.

In the new tax scheme, corporations resident in Mexico, whether their capital stock is owned by nationals or by foreigners, are subject to several taxes and governmental fees, including income tax, value added tax, special taxes on production or service rendering, taxes on assets, taxes on payrolls, taxes on international trade, etc. Non-residents doing business in Mexico are taxed under the same scheme as residents or, in specific cases, are generally subject to income tax through a very simple withholding tax system.

II. THE LEGAL STRUCTURE OF TAXES IN MEXICO

Taxation in Mexico is an obligation imposed by the Mexican Constitution[1] on residents notwithstanding their source of income, and on non-residents having a source of income in Mexico. According to the Constitution, federal taxes and government fees must be established and regulated

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1. MEX. CONST. art. XXXI, § 9.

through specific laws issued only by the Federal Congress and, in case of local taxes or state or municipal government fees, by the state congress. Figure 1 shows the way the Constitution has structured the Mexican Legal Tax System:

Figure 1

Federal Common Law	
Specific Laws & Regulations	
Federal Fiscal Code	Internal Revenue Law
Article 31, Section IV, Article 73, Sections VII & I of the Constitution	

The Mexican Tax System originates in the Constitution, as do all Mexican legal areas. Section IV of Article 31 establishes the obligation of residents and non-residents to pay taxes. Sections VII and XIXX of Article 73 grant to the Mexican Congress the power to establish federal taxes. The Mexican Congress may only establish taxes through a specific tax law, the so-called Federal Internal Revenue Law ("IRL"). In order for IRL taxes to be collected by the government, each tax must be regulated by a specific tax law. For example, Mexican income tax law is established in section I of Article 1 of the IRL, and is regulated by the Mexican Income Tax Law ("ITL") and its Regulations. Mexico has fourteen specific federal taxes established in the IRL, each of which is regulated in a specific independent tax law.

The Federal Fiscal Code (the "Code") was promulgated by a decree of December 30, 1981, and has been in force since January 1, 1983. Its specific regulations were issued by the President of Mexico on February 28, 1984, and were put in force March 1, 1983. The Code comprises provisions for surcharges on delinquent payments, penalties, collection procedures, appeals, statutes of limitations, and other regulations applicable as complementary law to the fourteen specific federal taxes established by the IRL.

The Code includes a number of provisions considered of general application for all taxes. These include government fees such as those referring to geographical and economic zones considered as part of national territory; rules for sales on installments and for sales of property; fiscal year terms, obligations, and rules for keeping accounting records; procedures for guaranteeing payment of pending taxes in case of liquidation; basic conceptual definitions of taxable institutions; issuance of proper documentation to suppliers and clients; and authority of the Ministry of Finance to audit the accounting of taxpayers or to estimate income. As Mexico is part of the civil law system, each of the specific tax laws remits to other laws that do not form a part of the Mexican Legal Tax System directly, but rather regulate for other legal purposes.

This article focuses on the Mexican income tax through the withholding system provisions, which apply to non-residents having a source of income

in Mexico. Consequently, this article will not refer to any other law that could indirectly affect non-residents' economic interests in Mexico.

III. THE MEXICAN INCOME TAX LAW

The ITL became effective January 1, 1981, and has undergone very important changes with regard to taxation of non-residents, changes that were due both to the Tax Reform Acts of 1990-92 and to Mexico's internationalization. The ITL adopted the method, used by many countries to avoid double taxation problems, of imposing taxes on physical and juridical persons based on their residence. At present, Mexico is negotiating Bilateral Treaties Regarding Credit of Taxes to Avoid Double Taxation with sixteen countries. Up to date, Mexico has signed treaties with France, Canada, and the United States. None of these treaties has been ratified by the signatory countries' senate.

The modifications made to the ITL basically reinforce certain provisions existing since 1981. These modifications broaden the concept of permanent establishment and introduce the concept of fixed base, with the purposes of: (1) taxing income of alien residents derived from some of their activities in Mexico, notwithstanding the existence of a place of business or the place of payment for permanent establishment; (2) taxing all income derived from the rendering of independent services by non-profit organizations; and (3) considering as taxable income any financial savings obtained by non-residents carrying out certain activities in Mexico.

The concepts of residence and source of income, adopted by a great number of countries, have as a principal goal the establishment of a tax system that avoids double or multiple international taxation without opposing the right of a state to tax the economic or financial consequences of all acts and transactions carried out by non-residents. Nevertheless, the concepts of residence and source of income as a solution to avoid double or multiple international taxation are relative because of national sovereignty. Thus, nationals of a country whose source of income is located in another country, in addition to being taxed as residents by the laws of their own country on their gross income, are taxed in the country in which they have a source of income even though they are not residents. As a result, a double taxation is presented, especially if a non-resident's country of residence has not entered into international or bilateral tax credit agreements.

IV. PERSONS SUBJECT TO INCOME TAX

The ITL, through Article 1, adopts both the residence and source of income concepts when establishing that individuals and corporations are subject to income tax payment. Residents in Mexico are taxed on all their total income wherever its source is located. Residents abroad who have a permanent establishment in Mexico are taxed on the incomes conferred or attributable to such permanent establishment. Residents abroad are taxed only on their incomes derived from sources located in national territory when they do not have a permanent establishment in

Mexico or, when having it, the income is not conferred or attributable to such permanent establishment.

Section I of Article 1, which had its origin in Article 9 of the Code, defines both corporate and individual residents in national territory. A corporation is considered a resident when the primary management of the business is located in Mexico. This would be the equivalent to the concept of corporate residence that is derived from the Mexican General Law of Commercial Companies. In the case of individuals, residents are considered those individuals who obtain in Mexico taxable income for more than 183 calendar days, either consecutive or not, for a period of twelve months. Resident status is lost for fiscal purposes when the individual does not remain in Mexico for 183 calendar days and does not prove by means of his registration with the income tax registry of another country to have acquired residence for fiscal purposes in that country. Mexican residents must accrue and declare to the Ministry of Finance all of their income, notwithstanding its source, and must pay monthly income tax calculated by current statutes and regulations.

Section II of Article 1, which has its origin in Article 2 of the ITL, defines a permanent establishment as a place of business in the territory of Mexico where partial or total entrepreneurial activities are carried out. As of January 1, 1992, a permanent establishment is presumed to exist when a non-resident carries out certain acts in Mexico through an individual or juridical person (i.e. an agent), even though the non-resident does not have a place of business within national territory. Such acts include the following: (1) when the agent through whom the non-resident acts exercises powers of attorney to execute agreements on behalf of such non-residents; (2) when the agent supplies the goods or merchandise to be delivered on behalf of the non-resident; (3) when the agent assumes risks derived from the goods and/or services rendered to residents in national territory; (4) when the agent carries out its activities subject to detailed instructions from, or is under the general control of, the non-resident; (5) when the agent carries on activities that may be economically attributable to the non-resident; and (6) when the agent has a guaranteed remuneration independent of the result of the agent's activities.

Article 16 of the Code defines, for tax purposes, entrepreneurial activities which involve trade, manufacturing, agricultural, cattle-raising, or forestry operations carried out in Mexico by individuals or corporations.

With Mexico's recognition of the General Agreement on Tariffs and Trade ("GATT")[2], a great commercial opening has emerged in which Mexico not only has increased its non-oil exports, but has also increased its imports of goods for consumption, raw materials, parts, and components for industry. With regard to Mexican imports, non-resident en-

2. Apr. 10, 1947, 55 U.N.T.S. 194, *reprinted in* BASIC DOCUMENTS OF INTERNATIONAL ECONOMIC LAW 3 (Stephen Zamora & Ronald A. Brand eds., 1990).

terprises have traditionally exported to Mexico under the world-recognized concept of "sale in the international marketer." Most of these transactions are documented according to the International Commercial Terms ("INCOTERMS") of the International Chamber of Commerce, such as Free on Board or Ex-Works. They are documented not only for price purposes, but also for transfer of property titles, for assumption of risks, and not to avoid being involved in a permanent establishment. From a fiscal point of view, these transactions cause the foreign exporter to pay taxes in its country for the incomes derived from the sale, while the Mexican importer is subject to domestic import duties and other taxes at the time of importation.

There are also non-resident enterprises which export under different INCOTERMS than those mentioned above, and which make transfer of title of goods in the country of destination. Article 14 of the Code provides that in such cases a sale is carried out in Mexico when delivery of the goods is made there, or when the goods have not been delivered but are found in Mexican territory.

These cases must be carefully analyzed by non-resident enterprises. If the sale of goods is considered by Article 16 of the Code to be an entrepreneurial activity, it must be understood that the non-resident that delivers goods in Mexico, or keeps such goods in Mexico out of fiscal premises, is considered as doing business in Mexico and as having a permanent establishment with the obligation to pay the Mexican income tax as any resident in Mexico. In addition, the non-resident will be subject to other taxes derived from entrepreneurial activities. Finally, Article 3 of the ITL establishes that the existence of a permanent establishment will not be considered in several cases, including the case of simple storage or exhibition of the goods of a non-resident and the case of the site of business being for the purpose of developing activities of preparatory or auxiliary nature for the non-resident.

V. WITHHOLDING TAX SYSTEM

The permanent establishment and fixed base provisions cover taxation of non-residents doing business in Mexico through entrepreneurial activities or independent services, and for other activities or services. The current Title V of the ITL establishes the fiscal withholding regime for payments made by residents in Mexico to non-residents due to: (1) payments on cash, goods, or services from a source of income located in Mexico if the recipient has no permanent establishment in Mexico; (2) payments on cash, goods, or services from a source of income that has a permanent establishment in Mexico if said income is not attributable to that permanent establishment; or (3) payments made on behalf of non-residents for taxable acts or activities that benefit such non-resident, even if they prevent the non-resident from incurring an expense or if they are for financial savings.

As a consequence of the above, Title V of the ITL presents the following structure:

TYPE OF INCOME	SOURCE OF INCOME	RATE OF WITHHOLDING TAX
Wages and Salaries for Subordinated Services	When the subordinate work is rendered in Mexico (Arts. 145 and 146)	0% to 30% of the total income
Fees for Independent Services	When the independent work is rendered in Mexico (Arts. 147 and 147A)	0% to 30% of the total income
Lease of Real Estate or Personal Property	When the real estate or personal property is located in Mexico (Arts. 148 and 149)	21% of the total income or 5% in case of railroad wagons
Sale of Real Estate	When the real estate is located in Mexico (Art. 150)	20% of the total income or 30% of the profit
Sale of Shares and Other Instruments Representing Property	When the issuer of the shares is a Mexican resident (Art. 151)	20% of the total income or 30% of the profit
Exchange of Public Debt for Capital	When the debt is by a Mexican resident (Art. 151A)	20% of the total income or 30% of the profit
Dividends	When the corporation distributing them is a Mexican resident (Art. 152)	0% of the total income if derived from net profit account or 35% of total income if not derived from mentioned account
Remnants of Non-Profit Organizations	When the one distributing them is a Mexican resident (Art. 153)	35% of the total income
Interests	When the one paying them is a Mexican resident (Arts. 154 and 154A)	Tax exempt or 15%, 21%, and 35% of the total income depending on the lender qualifications
Financial Leasing	When the leased goods are used in Mexico (Art. 155)	15% of the total interest portion
Royalties	When the industrial or intellectual rights are used in Mexico (Art. 156)	15% or 35% of the total income on technical assistance or patents and trademarks, respectively
Construction, Erection Maintenance and Supervision Services	When services are carried out in Mexico for less than 183 calendar days in a 12 month period	30% of the total income or 35% on taxable profit
Prizes	When they are paid in Mexico	15% of the total income
Public Shows	When the performance is made in Mexico	30% of the total income

Based on the above, I will next begin a specific analysis of the tax regime for those activities carried out by non-residents that are regulated by Title V of the ITL.

A. *Wages and Salaries*

A special tax system is established with respect to salaries when the source of income is in Mexico and when the subordinated service is rendered in Mexico by non-residents. Article 78 of the ITL defines salaries for tax purposes as any and all payments derived from a labor relation, including the participation of the workers in corporate profits and any and all payments received as a consequence of the termination of the labor relation. Article 78 also defines salaries as fees paid to members of boards of directors, to examiners, and to individuals who render services preponderantly to a borrower in the borrowers' facilities.

Article 146 of the ITL exempts foreign individuals residing in another country from tax payment if their salaries are paid by individuals or corporations which reside abroad but which have permanent establishments in the country where the service is rendered. This provision is only valid for a period of six months in a twelve-month term due to the fact that after six months foreigners that render services in Mexico acquire residence for fiscal purposes and are thus subject to normal income tax requirements.

When the subordinated services are rendered by the non-resident for a period exceeding 183 calendar days in a twelve-month period, the ITL provides a tax exemption for salaries not exceeding in Mexican currency the equivalent to $10,250 (U.S.) per year. If the salary exceeds that amount but is not higher than the equivalent of $80,500 (U.S.), non-residents will be subject to a fifty percent income tax rate. Any other salary exceeding the equivalent of $80,5000 (U.S.) is subject to income tax at a rate of thirty percent of the total income, with no deductions allowed. According to Article 146 of the Law, this exemption is not applicable to foreigners that render services at their establishments in Mexico, even if such establishments are not considered by the ITL as permanent establishments.

B. *Fees*

With respect to fees, a special tax system is established for non-residents considering Mexico as a source of income and whose independent work is rendered in Mexico by non-residents. Article 84 of the ITL defines fees as any and all remunerations derived from independent personal services, with the understanding that the income obtained from the rendering of such services is obtained only by the individual rendering them. The ITL includes individuals acting as agents, credit institutions, insurance companies, securities and bond companies, promoters of securities, and custom brokers when they do not render subordinated personal services as defined above.

Articles 147 and 147A of the ITL presume that the services are rendered in Mexico unless the person rendering the services is able to evidence that they were totally or partially rendered in another country. In such a case, the person's taxable income will either be proportionally calculated based only upon the services rendered in Mexico, or will be tax exempt.

As with salaries, the ITL exempts from tax payments all persons rendering independent services in Mexico if the services are rendered for

no longer than 183 calendar days in a twelve-month period. When the service time exceeds 183 days in a twelve-month period, income derived from those services that does not exceed the amount of Mexican currency equivalent to $10,250 (U.S.) is tax exempt. When the amount of fees exceeds the equivalent of $10,250 (U.S.), but does not exceed the equivalent of $80,500 (U.S.), it is subject to an income tax rate of thirty percent of the total income, with no deductions allowed. According to Article 146 of the ITL, this exemption is not applicable to foreigners that render services at their establishments in Mexico, even if such establishments are not considered by the ITL to be permanent establishments.

C. Lease of Goods

With respect to income derived from lease of goods, the ITL considers the source of income to be located in Mexico when the real estate or personal property leased by the non-resident is located in Mexico. Under this concept, Article 89 of the ITL considers taxable income to be that derived from: (1) grants, at onerous title, of the temporary use or enjoyment of personal property or real estate; (2) yields from non-amortizable real estate participation certificates; and (3) the inflationary gain derived from debts related to the lease of goods. In these cases, non-residents are subject to income tax, to be withheld by the payer of the rents, at a rate of twenty-one percent of the total income, with no deductions allowed.

In case the non-resident is leasing railroad wagons, the applicable rate is five percent. In case the non-resident is leasing real estate located in Mexico for tourism purposes (including time-sharing), Article 148A provides that the applicable rate is thirty-five percent, with no deductions allowed.

D. Sale of Real Estate

With respect to income derived from the sale of real estate, the ITL considers the source of income to be in Mexico when the real estate is located in Mexico. Articles 14 of the Code and Article 95 of the ITL define as sale or alienation of real estate: (1) any transfer of ownership, even one in which the seller reserves the property of the alienated real estate; (2) adjudications, even when carried out in favor of the creditor; (3) non-cash contributions to the capital stock of a company or association; (4) transfers of ownership carried out by means of financial leases; (5) transfers of ownership carried out through trusts; (6) the transfer of title of tangible assets, or the right to acquire assets through alienation of credit instruments or the assignment of rights which represent them; and (7) expropriation of property made by the government.

The ITL establishes for the non-residents obtaining income derived from alienation of real estate, as a general rule, a withholding tax of twenty percent on the total income without any deduction allowed or, at the non-resident's option, a withholding tax of thirty percent on the

profit if the non-resident appoints in Mexico a fiscal representative who will calculate the profit on the transaction and declare it to the Ministry of Finance. In this last case, Article 160 of the ITL establishes that the fiscal representative of a non-resident must either be a resident in the country or a non-resident with a permanent establishment in Mexico. The fiscal representative must also keep all documents relative to the tax payments on behalf of the non-resident at the disposal of the Ministry of Finance for a certain number of years[3] commencing on the following day of the date on which the tax return paying the thirty percent on the profit is filed. If the documents supporting the transaction do not comply with the ITL requirements, non-resident tax representatives become jointly liable with the non-resident.

E. Sale of Shares and Other Securities Representing Personal Property

With respect to income derived from the sale of shares and other securities representing the ownership of goods, Article 151 of the ITL considers the source of income to be located in Mexico when the corporation issuing the shares or securities is a Mexican resident. For tax purposes, the concept of shares includes any and all documents representing a partner or associate contribution in the capital stock of a mercantile or civil corporation and/or association, notwithstanding the fact that the Mexican General Law of Commercial Companies uses the term share only for the so-called figure "Sociedad Anonima."

As in the sale of real estate, the ITL establishes a withholding tax of twenty percent of the total amount of the transaction, with no deductions allowed. The withholding tax must be effected by the acquirer if it is a resident in Mexico or a non-resident with a permanent establishment in Mexico. If the acquirer is a non-resident and does not have a permanent establishment in Mexico, then it shall pay the corresponding tax by means of a tax return which shall be filed at the authorized offices of the Ministry of Finance within the fifteen days following the receipt the income.

If the non-resident appoints a fiscal representative in Mexico who meets the requirements set out in the chapter of sale of real estate, such non-resident may choose to apply the rate of thirty percent only on the gain determined by a certified public accountant following the procedures of the ITL and its regulations. This option may only be exercised if the non-resident resides in a country where said income is subject to corporate income tax at a rate of thirty percent or more. Such countries are listed in a general resolution issued by the Ministry of Finance every year. For 1992, these countries were Austria, Belgium, Canada, Denmark, England, the Federal Republic of Germany, Finland, France, Greece, Italy, Japan, the Netherlands, New Zealand, Spain, Sweden, Switzerland, and the

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3. Six for 1992, seven for 1993, eight for 1994, nine for 1995 and ten for 1996.

United States. If the non-resident transmitting the shares exercises the above mentioned option, its fiscal representative shall pay the tax of thirty percent on the gain obtained by means of a tax return filed with the authorized office of the Ministry of Finance within fifteen days following the receipt of the income.

Finally, the ITL establishes a great number of rules which allow the Ministry of Finance to make appraisals if there is a free acquisition or if the difference between the price and an official appraisal exceeds ten percent. In the latter case, the total of the difference shall be considered as taxable income for the non-resident and the tax shall be twenty percent of such income, with no deduction allowed. The non-resident must pay this tax by means of a tax return filed at the authorized offices of the Ministry of Finance within the fifteen days following the official notice made by the tax authorities.

As of January 1, 1992, the Code provides that if the juridical person registers the transfer of shares without requesting from the buyer evidence of the tax payment derived from the transaction, such juridical person shall become jointly liable for the payment of the tax.

F. *Exchange of Public Debt for Capital*

On March 30, 1990, the Mexican government issued a Program for the Exchange of Public Debt for Capital (the "Program"), the purpose of which is to stimulate national and foreign investment in projects for the development of infrastructure and privatization of government enterprises. Under the Program, the Mexican government has been assigning rights to exchange public debt for capital for an amount that allows the Government to cancel $3,500,000,000 (U.S.) during the period ending on June 30, 1993. In this case, Article 151A of the ITL considers the source of income to be located in Mexico when the income obtained by the non-resident from exchanging public debt for capital derives from a debt of a resident in Mexico. The withholding tax shall be at a rate of twenty percent of the total amount of the transaction, with no deduction allowed, and such withholding shall be made by the resident in Mexico acquiring or paying the debt.

As with the sale of real estate or shares, non-residents having a fiscal representative in Mexico may choose to apply the rate of thirty percent to the gain obtained, deducting from their gross income the cost of acquisition of the credit. As required by the chapter on the sale of shares, tax payment must be made to the tax authorities during the fifteen days following the receipt of the income. Again, this option may only be exercised by non-residents of a country where said income is taxable through corporate income tax at a rate of thirty percent or higher.

G. *Dividends*

If a non-resident receives as income gains distributed by a juridical person, the source of income is considered to be in Mexico when the juridical person that distributes the gains resides in Mexico. Under the

dividend concept, Article 120 of the ITL considers taxable income to be any and all gains distributed by legal entities residing in Mexico in favor of their associates, partners, and/or shareholders. This is true even when the gains shall be distributed by means of an increase of partners' interests or delivery and when gains or profits are reinvested in the subscription and payment of such capital increase within the thirty days following its distribution. The ITL also considers a dividend to be any reimbursement per share in the case of liquidation or reduction of the capital stock of juridical persons, when the amount of capital to be reimbursed is updated. To determine the updated capital contribution of juridical persons, a so-called capital contribution account ("CCA") shall be kept in the accounting of the juridical person. The CCA shall record any capital contribution made by the members or shareholders, and any reduction thereof. The balance of the CCA shall be updated on the closing day of each fiscal year, using official inflation rates for the period commencing on the month in which the last update was effected until the closing month of the fiscal year. Consequently, updated capital per share shall be determined by dividing the balance of the CCA by the total shares of the juridical person on the date of reimbursement, including those contributions derived from the reinvestment of capitalization of profits.

The ITL also considers dividends to be any interest paid by capital contributions represented by the so-called Bearing Interest Shares contemplated in Article 123 of the General Law of Commercial Companies. Loans to partners which are not a consequence of the operation of the juridical person, loans the term of which are for more than one year, and loans the interest of which are not equal or higher to the rate fixed by the IRL, are also considered to be dividends. In addition, non-deductible expenditures which benefit partners or shareholders, non-declared income, and deductions of purchases not effected and duly registered or determined to be taxable profit by the fiscal authorities are treated as dividends for tax purposes.

A major innovation effective as of January 1, 1990, establishes that no tax shall be withheld if the dividends are paid out of the so-called net tax account (*cuenta fiscal neta*) referred to in Article 124 of the ITL. If the dividends are not distributed from said account, the tax shall be paid at the rate of thirty-five percent of the amount of the dividend by the juridical person declaring such dividend. As of January 1, 1992, the foreign remittances account (*cuenta de remesas al extranjero*) for payments made by a permanent establishment or a fixed base of a foreign legal entity to the head office is not considered a dividend if the remittance is paid from a remittance account existing in the accounting records of the establishment or base.

H. Remnants of Non-Profit Organizations

Article 153 of the ITL provides that when remnants of non-profit organizations ("NPO") are obtained by a non-resident through an NPO, the source of income is considered to be in Mexico when the remnants are paid by an NPO residing in Mexico.

Title III of the ITL regulates the tax regime for NPOs. It establishes that for income tax purposes, labor or employers' unions, chambers of commerce and industry, professional institutes or bars, mankind institutions, private schools, and artistic, scientific, political, and religious organizations, are not subject to income tax. With these organizations, the ITL considers their members to be subject to income tax when the organizations generate and distribute a remnant higher than three times the yearly minimum wage of Mexico City. If a non-resident is a member of such an organization and collects part of a remnant, he is subject to a withholding tax of thirty-five percent on his income, which must be withheld by the organization.

I. Interest

With regard to interest, Article 154 of the ITL considers the source of income to be in Mexico when the capital has been disposed of or invested in Mexico. Such disposal or investment is presumed when the payer of interest is a resident in Mexico or a non-resident having a permanent establishment in Mexico. The ITL also considers as interest any and all yields from credits, with or without guarantee or the right to participate in the profits. For tax purposes, commissions or payments made for the purpose of opening or guaranteeing credits, payments made to third parties with the object of granting a guarantee of a liability of any kind, and/or premiums derived from sales of foreign currency futures, are all considered to be interest.

Withholding income tax rates depend upon the qualifications of the lenders. Article 154A of the ITL establishes an income tax exemption when credits are granted to the federal government, or when interest derived from credits either is granted in a period of three or more years or is guaranteed by a non-resident development financial institution. A fifteen percent withholding tax is established for financial entities belonging to foreign countries and non-resident banks duly registered with the Ministry of Finance. A twenty-one percent withholding tax rate is established for financial institutions not registered with the Ministry of Finance. Twenty-one percent is also established for interest paid to non-resident suppliers of machinery and equipment, and for fixed assets of the borrower in general. Finally, a resident paying interest is obligated to withhold the tax and pay it to the Ministry of Finance.

J. Financial Leasing

With regard to income received by a non-resident from financial leasing, Article 155 of the ITL considers the source of income to be located in Mexico when the leased goods are used in the country. It is presumed by the ITL that the leased goods are used in the country when the user of the goods is a resident in Mexico or a non-resident with a permanent establishment in Mexico.

As of January 1, 1991, Article 15 of the Code requires the parties executing a financial leasing agreement to distinguish, in the text of the

agreement, the amounts corresponding to the value of the goods from the interest. The withholding tax, therefore, shall be calculated and paid by the lessee, applying the rate of twenty-one percent on the interest, with no deductions allowed.

K. Royalties

With regard to income derived from royalties, Article 156 of the ITL considers the source of income to be in Mexico when the industrial or intellectual property rights for which the royalties are paid are exercised in Mexico. Such rights are exercised in Mexico when the royalties are paid by a resident or by a non-resident with a permanent establishment in Mexico.

Income tax rates to be withheld on income derived from royalties depend upon the specific industrial or intellectual property rights exercised by the resident. A rate of fifteen percent is established for royalties derived from the exploitation of copyrights and/or industrial models, drawings, and formulas; the same rate applies to the amounts paid for technical assistance or transfer of technology. A rate of thirty-five percent is established when royalties are paid for advertising as well as for the exploitation of patents, trademarks, trade names, or symbols. When the contracts between the non-resident receiving the royalties and the resident in Mexico involve patents, trademarks, trade names, symbols, or technical assistance, the withholding tax shall be calculated at a rate of fifteen percent, to be withheld and paid by the licensee of such rights.

It must be taken into consideration that when an agreement between a non-resident and resident paying royalties causes the resident to pay salaries and to reimburse traveling or other expenses incurred by technicians traveling to Mexico, the resident must withhold income tax in the amounts previously discussed.

L. Construction, Erection, Maintenance, and Supervision Services

When construction, erection, maintenance, and supervision services are rendered in Mexico by a non-resident for a period exceeding more than 183 calendar days per year, Article 2 of the ITL provides for a permanent establishment of the non-resident. When the duration of these services is for less than the 183 days per year, the withholding tax rate will be thirty percent of the total income with no deduction allowed, the tax being withheld by the resident making the payments. As mentioned previously, if the non-resident appoints a fiscal representative in the country, it may choose to apply the rate of thirty-five percent on the gain or profit calculated with the procedures established in the ITL for residents in Mexico. Income derived from prizes or obtained by public show enterprises do not need a greater explanation than that given for the services mentioned above.

M. Conclusion

In conclusion, it is important to note that, except for salaries paid from abroad and for sale of shares made abroad, residents in Mexico

making payments to non-residents for the types of income discussed above must withhold the different rates of income tax to the recipients of such payments. For tax purposes, these recipients are considered the direct taxpayers.

As of January 1, 1992, officials of the Ministry of Finance have new guidelines to estimate a non-resident's taxable income, to calculate the value of the acts or activities performed in Mexico, and to determine any tax evasion. Readers of this article must take into consideration that resident withholders are jointly liable with the non-resident taxpayers for any and all amounts established in the different withholding rates. Readers must also consider that in the case of any resident in Mexico making payments abroad for the types of income discussed above, the evidence of the withholding and payment of the tax to the Ministry of Finance is a requisite to deduct such payments as an expense from their accruable income for income tax purposes.

Finally, it is important to note that, according to Article 144 of the ITL, when a resident who makes any payment of income tax herein explained on behalf of a non-resident, the payment is considered as income for the non-resident and causes the non-resident to be subject to income tax. In such a case, when a withholding tax is not paid on its due date, the withholder is obligated to pay an amount equivalent to that which it should have withheld on its due date.

COMMENTS ON THE U.S.-MEXICO TAX TREATY

SCOTT A. TAYLOR*

I have a few comments about the proposed U.S.-Mexico Tax Treaty ("Treaty"). The first is that, overall, in meeting the primary purpose of lowering the impediments to the free flow of capital, the Treaty is about as good as it could be. A criticism does not concern the Treaty itself, but rather the United States and its reliance on the double taxation of corporation and shareholders. Mexico does not have this double taxation. Because of the American double taxation, and because of the Treaty's withholding rate on dividends, I suppose Mexico will find it necessary to impose its own dividend withholding tax. Otherwise, Mexico will effectively lose the revenues to the United States because, with the credit mechanism, American shareholders owning stock pay the same amount of tax whether or not Mexico imposes a dividend tax. One of the likely effects of the Treaty, therefore, will be to cause Mexico to give up its complete integration of its corporate/shareholder income tax. It would be nice if the United States would follow the lead of Mexico, Canada, the United Kingdom, Germany, and other countries and have either partial or complete integration of its corporate/shareholder income tax.

Another criticism I have, and again it has to do with the structure of the American tax system, is that the Treaty really does not do very much to alleviate the incredible complexity that goes along with computing the foreign tax credit. I am not sure any treaty could, but in any case, that is a thicket with which American taxpayers have to deal.

Finally, I believe that the charity provision of the Treaty, Article 22, is both beneficial and innovative. My reading of the protocol is that it will be effective upon ratification and will allow organizations in Mexico, certified by governmental authorities in Mexico, to receive tax deductible donations from American taxpayers with Mexican sources of income. The same result would occur for Mexican citizens with American sources of income making donations to an American charity listed in section 509(a)(1) or (a)(2) of the Internal Revenue Code of 1986.

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DISCUSSION OF THE U.S.–MEXICO TAX TREATY

QUESTION: Under the North American Free Trade Agreement ("NAFTA"),[1] could the United States-Mexico Law Institute, which is a section 501(c)(3) not-for-profit corporation under the Internal Revenue Code of 1936, receive tax deductible contributions from our Mexican friends?

ANSWER, *Prof. Taylor*: Yes, if the Mexican donors have U.S. source income. If not, the donation would be governed by Mexican tax law, with which I am not familiar. Similarly, a U.S. donor with Mexican source income could deduct contributions to a Mexican charity pursuant to the same provisions of the U.S.-Mexico Tax Treaty.

QUESTION: At what levels are withholding tax rates for bank interest set under Mexico's tax treaty with Canada, and how will treatment of interest paid by Mexicans to American banks compare to that of interest paid to other countries?

ANSWER, *Mr. Morrison*: As an American tax lawyer I did not have much cause to look at the Mexico-Canada Treaty, but as a treaty negotiator I did. The rate was no lower than ten percent, and if I am not mistaken, the rate on interest was fifteen percent. At any rate, it does not go below ten percent.

QUESTION: How will the treatment of interest paid by Mexicans to American banks compare to that of interest paid by Mexicans to the banks of other countries?

ANSWER, *Lic. Kaye*: To be honest with you, it has not been resolved in the treaty, but Mexico did agree to review its rates of withholding tax to make them comparable with other countries of the world, maybe even tax exempt.

ANSWER, *Mr. Morrison*: At the moment, if there is not future Mexican legislation, in five years when the rate goes to 4.9% the withholding rate on interest paid to American banks will be far lower than the withholding rate on interest paid to banks in other jurisdictions. But as Licenciado Kaye said, the Mexicans are treating that question as a matter of domestic Mexican law.

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1. Oct. 7, 1992 draft, U.S.-Can.-Mex.