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Mexico´s options under the Multilateral Instrument

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As a member of the Organization for Economic Co-operation and Development ("OECD") Mexico[1] has been actively involved in the design and development of the Base Erosion and Profit Shifting (BEPS) Project and began implementing many of the recommended actions in 2014, even before the final BEPS reports were finalized in 2015. The execution and implementation of the multi-lateral instrument on treaty related BEPS measures ("MLI") is one of the next steps in the process of the overall BEPS project. The first signing ceremony to be held in Paris on June 7, 2017 is around the corner. The time has come for the signature of the MLI and the entire world is awaiting the elections that each country, including Mexico, will make regarding new treaty rules in connection with hybrid mismatches, treaty abuse, permanent establishment and dispute resolutions.

Below we take a look at some of the options and decisions Mexico must make with respect to this instrument and the possible impact on cross border transactions with Mexico.

Implementation of BEPS in Mexico

Effective in 2014, Mexico enacted legislation which addressed certain of the BEPS action items including anti-hybrid rules (Action 2), as well as a form of mandatory disclosure requirement for tax payers ("Form 76") that seems to be based on BEPS Action 12. Legislative changes continued with the introduction, in 2016, of the obligation for (large) taxpayers to present the country-by-country report, master file and local file (Action 13).

As Mexican income tax rules refer to the OECD Transfer Pricing (TP) Guidelines as a source of interpretation of Mexican TP rules[2], Mexico has, in effect, adopted the new OECD Transfer Pricing Guidelines (Action 8-10).

Finally, the country started including some of the treaty related BEPS measures in its bilateral tax treaties; for instance, the new Spain-Mexico tax treaty, although not yet into force, includes a Principal Purpose Test (PPT) rule and a savings clause, based on BEPS Action 6.[3]

All of this activity is strong evidence of Mexico´s early commitment towards BEPS, which seems prudent for a country that is vulnerable for base erosion and profit shifting, being a (net) importer of capital. As a result, Mexico is pretty much aligned with what many other OECD countries are doing to date, but more advanced than other Latin American countries.

Speed bumps

Is it expected that Mexico will be implementing additional BEPS recommendations, including through the MLI? The answer is probably yes, but subject to certain limitations.

For instance, there is a commitment among Mexico's main political parties to not raise taxes until 2018 ("stability pact"). In this respect, we understand that the Mexican government has been analyzing the possible introduction of an interest deduction limitation rule based on a percentage of EBITDA (Action 4). However, as a result of the stability pact this is not likely to occur under the current administration.

It also appears that the Mexican government is evaluating legislative measures to more efficiently tax the digital economy, inspired by recent legislative initiatives in India, UK, Australia and Turkey (under Action 1). Considering the complexity of this matter which involves not only tax matters, but also technology as well as the potential involvement of the financial sector, among others, this will probably not be a swift process.

Furthermore, there may be limitations from a tax technical point of view for the implementation of certain BEPS actions. The principle of legality that is embedded in the Mexican Constitution may limit the implementation and application of some of the BEPS recommendations that look for the prevalence of **substance over form** of transactions. This tension between the principle of legality and certain BEPS actions can be seen in several aspects of the new OECD TP Guidelines[4], the expansion of the PE concept (Action 7) and particularly the inclusion of the PPT rule as anti-abuse measure in tax treaties.

In this regard, even though the PPT rule establishes an autonomous anti-abuse measure in tax treaties, it is difficult to imagine its application in Mexico, considering the lack of a PPT rule (or general anti-abuse rule or "GAAR") in Mexican *domestic* tax legislation. Tax treaties are an integral part of Mexico´s tax system and, although treaties are concluded between countries, they grant rights to individual taxpayers. The denial of treaty entitlement to a taxpayer should be based on rules that are in compliance with the constitutional rights of taxpayers, including the principle of legality.

For instance, under the application of the PPT, the tax authorities may be able to deny the existence of a transaction (or even the existence of a legal entity in the specific case of treaty shopping), which represent powers that Mexican tax authorities do not have under domestic tax legislation, and the execution of such powers (under the PPT treaty rule) may be in violation with the Constitution. It is also difficult to imagine the denial of treaty benefits in Mexico based on a subjective element such as the "intention" or "motive" of a taxpayer or transaction, specifically considering the lack of guidance regarding when one principal purpose is more important than another, and when a purpose is "principal" versus secondary or auxiliary.

Moreover, the PPT rule proposed under Action 6 (Article 7, paragraph 1 of the MLI) seems to differentiate the burden of proof for the tax authorities for the application of the PPT ("reasonable to conclude") vis-à-vis the burden of proof that the tax payer has ("to establish") when arguing on the contrary (i.e., that the transaction is in line with the object and purpose of the corresponding treaty). This seems to be contrary to the rules laid down in the Mexican Federal Tax Code.

The principle of legality also imposes requirements on the form of drafting legislation. For instance, the aforementioned mandatory disclosure requirement ("Form 76") was introduced in Mexican tax law in a generic manner, thereby almost fully delegating the actual design of the disclosure rules to the Mexican tax authorities. The Mexican Supreme Court recently declared this way of legislative technique to be in violation with the Constitution, as the law itself should include the principles and guidance to a certain level of detail, before delegating regulatory powers to the executive (tax authorities).[5]

Despite these political, technical and practical limitations, it is expected that the Mexican government will implement some or most of the treaty related BEPS measures through the MLI.

Hybrids (Action 2)

In line with the objectives of article 4 of the MLI, Mexico has, for many years, included in its tax treaties the "tie breaker" rule for dual resident companies, which requires a mutual agreement between competent authorities in order to resolve dual residence (rather than to give preference to the effective place of management as contemplated in the current OECD Model Convention).

The proposed application of the methods for the avoidance of double taxation in article 5 of the MLI are probably not that relevant in a Mexican context, considering that Mexico applies a credit mechanism for the avoidance of double taxation.

Permanent establishment (Action 7)

Mexico will likely be interested in implementing the expanded PE concept in its tax treaties (articles 12 and 13 of the MLI). However, a similar expansion of the domestic law PE definition is probably required in order for the treaty changes to be effective. That is, it is questionable whether the current domestic law PE definition (although broader than the current OECD Model treaty definition) is broad enough to be able to capture the expanded concepts designed in Action 7.

For instance, the domestic law definition of dependent agent currently refers to a person who habitually concludes contracts "in the name of or on behalf of" the non-resident enterprise.[6] Nevertheless, it is not clear whether this already broad concept ("on behalf of") would be sufficient to establish source taxation for all of the situations covered by article 12 of the MLI (*commissionaire* arrangements and similar strategies). The same can be said about the independent agent PE concept in Mexican income tax law, which does not exist in tax treaties.

In addition, one of the current domestic law exceptions for preparatory and auxiliary activities applies only to the maintenance of a place of business/stock of inventory for the sole purpose of "display or storage", excluding the word "delivery" from the exception. This exclusion of the word "delivery" seems to be based on the suggestion made under the UN Model Convention.[7] This more limited PE exception may potentially capture some of the situations targeted by Action 7 (see article 13 of the MLI), but likely not all of them.

In summary, despite the broad domestic law PE definitions, it is unclear whether these are broad enough to match the expanded PE concepts under the MLI and, therefore, Mexican government should analyze whether it needs to reform the income tax law for this purpose. This is likely not going to happen during the current presidential term.

Dispute resolution and mandatory arbitration (Action 14)

As mentioned above, several of the BEPS actions will imply the introduction of a substance-over-form type approach and quite subjective elements in treaty application and transfer pricing. This will result in increased controversy between taxpayers and governments.

In this respect, it is in the highest interest of Mexico to maintain and improve its competitive position to attract foreign investment, and therefore, provide legal certainty to investors in the form of solid dispute resolution mechanisms.

Mexico has included the Mutual Agreement Procedure (“MAP”) in all of its bilateral tax treaties, and corresponding domestic legislation, to a limited extent, and is expected to comply with the minimum standards and best practices established in BEPS Action 14.

The Mexican government, however, has historically not agreed to mandatory arbitration as part of resolving tax treaty disputes. The tax treaties with the Netherlands and Switzerland contain an OECD Model Convention type arbitration clause, however, these clauses are not yet in effect as they are part of a most favored nation mechanism.

Nevertheless, considering the uncertainty in the economic and political relationship with its main trading partner, the United States, perhaps the time has come for Mexico to reconsider its position on this point.

Treaty abuse (Action 6)

Tax treaties have historically been used and abused by taxpayers in order to facilitate the erosion of the Mexican tax base. In recent years, Mexico has negotiated the inclusion of various types of anti-avoidance measures in its tax treaties. These provisions include different types of limitation on benefits (LOB) provisions, subject-to-tax requirements, the exclusion of special tax regimes from treaty application, anti-conduit rules and a PPT that was recently included in the amendments to the treaty with Spain.

The implementation of the Action 6 minimum standard, however, will provide Mexico with more focused anti-abuse measures. The MLI includes the following (main) options for implementing the Action 6 minimum standard:

-Option 1: A PPT alone (Article 7, paragraph 1 of the MLI)

-Option 2: A combination of a PPT and a simplified LOB (Article 7, paragraph 8) of the MLI)

-Option 3: A combination of a detailed LOB and an anti-conduit rule, based on bilateral negotiations (Article 7, paragraph 15 subparagraph a of the MLI)

As a general rule, the MLI provides the PPT (Option 1) as the default position to combat treaty abuse. In principle, the opt in and opt out rules provide for the simplified LOB as a supplement to the PPT (Option 2) as optional and applies only if both Contracting Jurisdictions have chosen it.

These treaty abuse rules are intended to be adopted symmetrically by the parties to a covered tax treaty. However, in case of a mismatch of elections (one Jurisdiction chooses Option 1 and the other Option 2), the MLI provides for the following:

- Both jurisdictions opt-out of MLI and bilaterally negotiate a detailed LOB and anti-conduit rule (Option 3 above).
- The jurisdiction that prefers the PPT alone (Option 1) also agrees to apply the simplified LOB in

a symmetrical manner (Article 7, paragraph 7, subparagraph a) of the MLI).
- The jurisdiction that prefers the PPT alone (Option 1) agrees that the other jurisdiction will apply the PPT and simplified LOB (Option 2), resulting in an asymmetrical match (Article 7, paragraph 7, subparagraph b of the MLI).

LOB versus PPT

The above described opt-in and opt-out mechanism in case of an "Option 1 versus Option 2 mismatch" may be quite relevant in the context of several of Mexico´s bilateral treaties (specifically with some of Mexico´s European treaty partners).

On the one hand, Mexico has already included some form of a LOB provision in more than ten of its bilateral tax treaties, which to a certain extent demonstrates Mexico´s preference for this type of antiabuse rule. Moreover, as described above, the application of a treaty PPT rule in Mexico without the existence of a domestic GAAR seems to be difficult in practice and may give rise to constitutional concerns (rule of law and principle of legality). On the other hand, European jurisdictions generally prefer a PPT rule as this is pretty much in line with the antiabuse provision in the European tax directives, and domestic GAARs in most European countries. Additionally, an LOB clause may in certain cases potentially violate the basic freedoms of the European Union (e.g. free movement of goods, services, people and capital).

It remains to be seen how this potential Option 1 versus Option 2 mismatch between Mexico and other countries may be resolved. Would European -and other- jurisdictions agree with the asymmetrical match, whereby Mexico would be able to apply a combined PPT and LOB measure? Or would Mexico agree to a (symmetrical) PPT only approach to combat treaty abuse? Another option provided for in Article 17, paragraph a of the MLI is to accept the application of the PPT alone, as an interim measure, if Mexico intends to adopt a limitation on benefits provision (where possible), in addition or in replacement of the PPT alone.

Finally, with respect to the U.S.A., it is important to note that the Mexico-US tax treaty already provides for an LOB provision, however, it is a fairly old version (1997). Technically, it seems that the treaty does not fully comply with the Action 6 minimum standard (simplified LOB with PPT or LOB with *anti-conduit* rule), however, it is not clear whether both countries are interested in modernizing the LOB provision and/or renegotiating the treaty. Moreover, it is not clear whether the U.S.A. will be signing the MLI at this stage.

[[1]] Mexico is member of the OECD since 18 May 1994.

[[2]] Article 179, last paragraph, of the Mexican Income Tax Law establishes the following: "For purposes of the interpretation of the rules of this Chapter, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, approved by the Council of the Organisation for Economic Co-operation and Development in 1995, or those that supersede them, are applicable to the extent that such guidelines are consistent with the provision of this law and double tax treaties entered into by Mexico".

[[3]] In December 2015, Mexico and Spain signed a Protocol amending their double tax treaty, which includes a PPT rule with the same wording set forth in the MLI (Article XVII of the Protocol). This Protocol has been approved by the Mexican Senate and is likely going to be ratified by Spain during 2017. Therefore, it is likely that the Protocol will be ratified by both parties during 2017 (and will enter into force before the MLI).

[[4]] The new (2016) OECD Transfer Pricing Guidelines establish a substance over form approach without precedents, favoring the actual conduct of parties and the risk control function over contractual terms whereby risks, functions and (intangible) assets are allocated between related parties. It is highly questionable whether this is consistent with Mexican income tax law (as required by aforementioned article 179, last paragraph). In this regard, under Mexican tax law, legal forms determine the tax treatment applicable to transactions or arrangements and there are no rules (except for some special cases) allowing tax authorities to re-characterize transactions based on a substance over form approach.

[[5]] See Supreme Court, Decision on Constitutional Protection Act, AR 624/2016

[[6]] Article 2, paragraph 2 of the Mexican Income Tax Law

[[7]] In this regard, Commentaries on the UN Model Convention read (ad Article 5) as follows: "20. As noted above, the United Nations Model Convention, in contrast to the OECD Model Convention, does not refer to delivery" in subparagraphs (a) or (b). The question whether the use of facilities for the "delivery of goods" should give rise to a permanent establishment has been debated extensively. A 1997 study revealed that almost 75 per cent of the tax treaties of developing countries included the "delivery of goods" in the list of exceptions in subparagraphs (a) and (b) of paragraph 4. Nevertheless, some countries regard the omission of the expression in the United Nations Model Convention as an important point of departure from the OECD Model Convention, believing that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country".

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