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COMMENTARY

RECENT MEXICAN TAX DEVELOPMENTS: NONBINDING CRITERIA, TAX DIRECTIVES, AND TAX TREATIES SIGNED BY MEXICO WITH KUWAIT AND COLOMBIA

In May, the Mexican Tax Administration Service (the "SAT") issued an amendment to Annex 3 of the Mexican Administrative Tax Resolutions for 2013, which provides certain nonbinding criteria for taxpayers.

According to the Mexican Federal Tax Code,[1] in order to ensure that the SAT properly exercises its powers, the SAT is required to provide free assistance to taxpayers by annually publishing rulings and general provisions and grouping them together to ensure that they will be understood more easily by taxpayers through the Administrative Tax Resolutions.

Moreover, Annex 3 of the Mexican Administrative Tax Resolutions sets forth examples in which the SAT demonstrates how the applicable law was improperly applied by taxpayers.

The most important recently published nonbinding criteria are the following:

INCOME TAX WITHHOLDING IN CONNECTION WITH STOCK SALES THROUGH THE MEXICAN STOCK EXCHANGE/GRUPO MODELO CASE

Article 109, Section XXVI of the Income Tax Law (the "ITL") provides that individuals and foreign tax residents who sell shares of companies traded on the Mexican Stock Exchange Market are not subject to tax on such sales, unless a person or group of persons sells (i) more than 10 percent of the capital stock of a listed company or (ii) "control" of such company. If the sale is not exempt from tax, financial intermediaries are required to withhold 5 percent of the sales proceeds. In preparing their annual tax returns, Mexican tax residents are required to calculate capital gain by applying a progressive tariff (with a maximum tax rate of 30 percent) and crediting the 5 percent withholding tax.

The SAT considered the application of this rule in connection with a stock sale by the former shareholders of Grupo Modelo, S.A.B. de C.V. ("Grupo Modelo"), who thought they did not sell control of Grupo Modelo and, therefore, believed they were not subject to tax on such sale.

However, based on the above-described rules,[2] the SAT has advised financial intermediaries to withhold 5 percent of the sales proceeds of each selling Grupo Modelo shareholder in connection with the Public Offer of Sale conducted by Anheuser-Busch México Holding, S. de R.L. de C.V. Specifically, the SAT concluded that the individual shareholders of Grupo Modelo did not qualify for the ITL's tax exemption on their stock sale because the SAT treated such individuals as a group that had control over Grupo Modelo.

The SAT also noted that if a financial intermediary acted in a manner contrary to standard financial practices, such intermediary could be sanctioned by the applicable Mexican financial authorities.

Finally, the SAT asked individual shareholders of Grupo Modelo to file a reimbursement request with the SAT if any such shareholder believed that he or she should not have been subject to the 5 percent withholding tax.

This is the first time that the SAT has created a nonbinding criteria directed to a specific taxpayer or group of taxpayers.

NONDEDUCTIBILITY OF CERTAIN PAYMENTS BETWEEN RELATED PARTIES PURSUANT TO DISTRIBUTION AGREEMENTS

The Mexican Flat Tax Law (the "FTL") provides that royalty payments made to a related party are not deductible in calculating such tax. The SAT has advised taxpayers not to deduct (for FTL purposes) copyright-related payments between related parties pursuant to distribution agreements because such copyrights are not subject to the FTL.[3]

A royalty payment is considered appropriate because the SAT considers that, through a distribution agreement, a portion of the economic rights of a copyright is transferred to the general public.[4]

Notwithstanding the SAT's position, it is important to note that (i) the Mexican Federal Tax Code contains a definition for royalties that is limited to payments of any kind for the temporary use or enjoyment of certain property[5]; and (ii) the Commentaries to Article 12 of the Model Tax Convention on Income and on Capital issued by the Organisation for Economic Development and Cooperation (of which Mexico is a member) expressly provide that payments made solely for obtaining exclusive distribution of rights of a product do not constitute royalties because such payments are not made in consideration for the use of, or the right to use, an element of property.[6]

Accordingly, in order to determine whether a copyright-related payment to a related party pursuant to a distribution agreement is deductible for FTL purposes, the specifics of the transaction must be disclosed to the SAT in order to prove that no royalty payments are triggered.

TAX DIRECTIVES

In April, the SAT issued its tax directives for the first quarter of 2013. Mexican tax directives are important because they (i) constitute binding criteria to be followed by the SAT's officers and (ii) create rights for taxpayers when such directives are published in the Federal Official Gazette, according to the Mexican Federal Tax Code.[7]

The most important recently published directives are the following:

Permanent Establishment. The SAT's officers must interpret the meaning of a "permanent establishment" as it is defined in the ITL; that is, a permanent establishment is "a place of business in which business activities are partially or totally conducted or personal services are rendered." Accordingly, the disposition by a taxpayer of branches, agencies, offices, factories, workshops, installations, facilities, mines, quarries, and all other places of exportation, extraction, or exploitation of natural resources would not be considered a permanent establishment to the extent they are not used in connection with the performance of business activities.

In addition, in interpreting the meaning of a "permanent establishment," the SAT must consider if business activities are conducted (in whole or in part) or if personal services are rendered through such a facility because simply disposing of such a facility does not constitute a permanent establishment in Mexico.

Deemed Transactions Between Related Parties. In auditing taxpayers in the transfer pricing context, Article 213 of the ITL permits the SAT to deem the existence of certain transactions for tax purposes when examining transactions between related parties resident for tax purposes outside of Mexico.

In disregarding the limited scope of Article 213 of the ITL, the SAT set forth an interpretative directive that permits its officers to deem the existence of certain transactions when auditing taxpayers not only for transactions between related parties resident for tax purposes outside of Mexico, but also for transactions between related parties in the transfer pricing context. Thus, this directive permits the SAT to deem the existence of certain transactions between related Mexican taxpayers in the transfer pricing context, notwithstanding the fact that the ITL does not provide the SAT with such authority for pure domestic transactions.

Derivative Transactions Involving Multiple "Maturity Periods." With respect to individuals who obtain income from derivative transactions involving multiple "maturity periods" (in other words, when derivative transactions have multiple payment dates depending on the amount of the underlying asset), SAT officers must consider the corresponding tax due as of the end of each "maturity period" and calculate such tax based on the amount effectively received.

Derivative Transactions Taxed Under the FTL. The SAT requires its officers to treat derivative transactions as taxable to the extent their underlying components are taxed under the FTL, irrespective of whether the underlying component of the derivative transaction is a product, an interest rate or any other variable, whether the asset is subject to commerce, or whether the transaction will be liquidated in cash or in kind.

Accordingly, in order to determine whether certain derivative transactions are subject to the FTL, it will now be necessary to determine whether the alienation of the underlying component would be taxed for FTL purposes.

DERIVATIVE TRANSACTIONS CARRIED ON OUTSIDE THE NORMAL COURSE OF BUSINESS

The SAT requires its officers to conclude that individuals are not obliged to pay flat tax on their derivative operations carried on outside the normal course of business, disregarding the fact that such operations might be taxed under the FTL, according to the earlier-discussed directive.

The SAT's interpretation of any tax provision in the nonbinding criteria and directives is not binding on the taxpayer; however, such interpretation does provide the taxpayer with insight into how the SAT will proceed with respect to a particular matter.

Because neither the nonbinding criteria nor the tax directives give rise to obligations for taxpayers, their interpretation by the SAT cannot be challenged by a taxpayer until the SAT has applied such criteria or directives to such taxpayer.

NEW TAX TREATIES: MEXICO-KUWAIT AND MEXICO-COLOMBIA

In May 2013 and July 2013, respectively, the tax treaties signed by Mexico and Kuwait and by Mexico and Colombia were published in the Mexican Official Gazette. With these tax treaties, Mexico will have in force tax treaties with 56 countries. Both tax treaties become effective on January 1, 2014.

When negotiating tax treaties, including the ones with Kuwait and Colombia, Mexico takes into account the OECD Model Tax Convention on Income and on Capital and certain provisions in the UN Model Tax Convention.[8] The withholding rates and special features under both new tax treaties are as follows:

MEXICO-KUWAIT TAX TREATY

- **Dividends:** No withholding tax is imposed on dividends.
- **Interest:** No withholding tax is imposed if the beneficial owner of a debt instrument is the government, a political subdivision thereof, a governmental bank or export bank, or if those entities pay the interest. However, a 4.9 percent withholding rate applies if the beneficial owner is a "banking institution"; otherwise, a 10 percent withholding rate applies. In addition, Mexican tax law imposes a 4.9 percent withholding tax for interest payments to registered foreign banks and financial institutions.
- **Royalties:** Royalties are subject to a 10 percent withholding rate.

MEXICO-COLOMBIA TAX TREATY

- **Dividends:** No withholding tax generally is imposed on dividends. According to the Protocol to the tax treaty, however, if the Colombian legal entity paying the dividend does not pay corporate income tax for the profits distributed through the dividend, the Colombian entity must withhold at a 33 percent rate.
- **Interest:** As with the Mexico–Kuwait tax treaty, no withholding tax is imposed if the beneficial owner of a debt instrument is the government, a political subdivision thereof, a governmental bank or export bank, or if those entities pay the interest. A 5 percent withholding rate applies if the beneficial owner is a "banking institution"; otherwise, a 10 percent withholding rate applies. As noted above, Mexican tax law imposes a 4.9 percent withholding tax for interest payments to registered foreign banks and financial institutions.
- **Royalties:** Royalties are subject to a 10 percent withholding rate. Moreover, the tax treaty broadens the concept of "royalties" to include payments for know-how, technical assistance, and consulting services. The tax treaty also broadens the concept of "royalties" to include payments for the transfer of intellectual property rights when the price is fixed on the future profits obtained by the acquirer of such intellectual property. In addition, the tax treaty provides a "most favored nation" clause. This means that if Colombia signs a tax treaty with another country and the definition of royalties is narrowed in such other treaty or the royalty withholding rate is reduced (or eliminated), the definition of royalties under the Mexico–Colombia tax treaty will be narrowed to comport with the definition in such other tax treaty, or the royalty withholding rate in the Mexico–Colombia tax treaty will be reduced (or eliminated) to comport with such other tax treaty.
- **Capital Gain:** Source taxation applies if, during a 12-month period prior to the sale of shares, a seller owns at least 20 percent of the capital of the legal entity whose shares are being sold. Under the treaty, source taxation of 20 percent applies to such capital gain. For example, if a Mexican tax resident sells shares of a Colombian legal entity (or vice versa, that is, a Colombian tax resident sells shares of a Mexican entity), no withholding applies if the seller's ownership of such entity during the 12-month period prior to the sale is less than 20 percent. If the seller's ownership of such entity during such 12-month period is 20 percent or more, source taxation at a 20 percent rate applies to the capital gain (as opposed to the gross proceeds) from the sale of such shares. According to ITL, foreign tax residents obligated to pay income tax on the capital gain must name a legal representative in Mexico who will be jointly and severally liable for the taxes of the foreign tax resident and who will calculate and pay such tax. Failure to name a legal representative allows the buyer of the shares to withhold the tax by applying the ITL's 25 percent tax rate on the gross proceeds; the seller may request a refund of the difference between the gross amount withheld and the actual tax due.

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LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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ENDNOTES

1 Article 33, Mexican Federal Tax Code.

2 Nonbinding criterion No. 28/ISR.

3 Nonbinding criterion No. 06/IETU.

4 Indeed, according to Article 27, section IV, of the Mexican copyright law, titleholders of the economic portion of a copyright are entitled to either authorize or prohibit the distribution of the copyright.

5 Among others, patents; certificates of invention or improvement; trademarks, trade names; copyrights of literary, artistic, or scientific works, including motion pictures and recordings for radio or television, as well as of drawings or models, blueprints, formulas; procedures; industrial, commercial, or scientific equipment, and amounts paid for technology transfers or information regarding industrial, commercial, or scientific experiences; or other similar rights or property.

6 Further, the OECD Commentaries (in addressing software) provide that in most software distribution transactions, distributors are paying only for the acquisition of the copyright and not for the right to exploit any right in the software copyrights.

7 Article 33, sec. III, Mexican Federal Tax Code.

8 The provisions in the UN Model Tax Convention that Mexico takes into account are: Article 5 (period for converting a construction site into a permanent establishment), Article 14 (independent personal services), and Article 23 (other income taxed in the source country).