

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND  
PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA  
AND THE GOVERNMENT OF THE UNITED MEXICAN STATES  
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF  
FISCAL EVASION WITH RESPECT TO TAXES ON INCOME,  
SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992

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INTRODUCTION

This is a technical explanation of the Convention and Protocol between the United States and Mexico signed on September 18, 1992 ("the Convention"). The Convention is based on the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 ("the OECD Model"), the Model Double Taxation Convention published by the United Nations in 1980 (the "U.N. Model") and recent income tax treaty negotiations of both countries.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

The explanations of each Article include explanations of any Protocol provisions relating to that Article.

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## ARTICLE 1

### General Scope

Paragraph 1 provides that the Convention applies to residents of the United States or Mexico, and in some cases may apply to residents of third States. Article 4 defines residents of the United States and Mexico for the purposes of the Convention. Examples of cases where the Convention may affect residents of third States include the Articles on non-discrimination (Article 25) and the exchange of information (Article 27).

Paragraph 2 is the same as the corresponding provision in the U.S. Model. The Convention may not increase the tax burden of residents of either country compared to what it would be under the respective domestic law provisions or under any other agreement between the two States. Thus, for example, a right to tax given by the Convention cannot be exercised unless domestic law also provides for such a tax; and this Convention will not restrict the benefits provided by another U.S.- Mexico agreement, whether concluded previously or subsequently. This does not mean, however, that a taxpayer may pick and choose among Internal Revenue Code (hereinafter "Code") and Convention provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of Mexico has three separate businesses in the United States. One is a profitable permanent establishment. The other two are trades or businesses that would earn income taxable in the United States under the Code but that do not meet the permanent establishment threshold tests of the Convention; one of these is profitable, and the other incurs a loss. Under the Convention the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code all three would be taxable. The loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B.10.) If the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States which is not effectively connected with any of his business activities in the United States.

Paragraph 3 contains the traditional "saving" clause, which provides that each country may tax in accordance with its domestic law, without regard to the Convention, its residents, citizens, and former citizens whose loss of citizenship had tax avoidance as one of its principal purposes. Although the paragraph is drafted reciprocally, Mexico does not now tax the income on the basis of citizenship. The taxation of former citizens is limited to a period of ten years, as provided in section 877 of the Code. "Residence", for the purpose of the saving clause, is determined under Article 4 (Residence). Thus, for example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, e.g., a "green card" holder, and is also a resident of Mexico under Mexican law, and the tie-breaker rules of paragraph 2 of Article 4 determine that he is a resident of Mexico, he will be entitled to U.S. benefits under the Convention.

As a consequence of the saving clause, each Article should be read as not providing benefits with respect to the U.S. taxation of U.S. citizens (wherever resident) or residents or with respect to Mexico's taxation of Mexican citizens or residents. However, paragraph 4 provides certain exceptions to the saving clause. Under subparagraph (a), for example, U.S. residents and citizens are entitled to certain U.S. benefits provided under the Convention. Those benefits are: the correlative adjustments authorized by paragraph 2 of Article 9; the exemption of social security benefits paid by the other State and of child support and alimony paid by residents of the other State, that are provided in paragraphs 1(b) and 3 of Article 19; the deductibility of certain contributions to Mexican charities and the relief from expenditure responsibilities provided in Article 22; the guarantee of a foreign tax credit provided in Article 24; the non-discrimination protection of Article 25; and the competent authority procedures of Article 26. Mexican residents are entitled to the benefits provided by Mexico under the same Articles (and Mexican citizens or former citizens would be entitled to the same benefits, if relevant).

Under subparagraph (b) certain additional benefits are available to U.S. residents who are neither U.S. citizens nor "green card" holders; these are the U.S. benefits extended to employees of the Mexican Government under Article 20, to visiting students, under Article 21, and to members of diplomatic and consular missions under Article 28. This subparagraph also applies reciprocally.

## ARTICLE 2

### Taxes Covered by the Convention

This Article identifies the taxes to which the Convention applies. Paragraphs 1 and 2 are based on the OECD model and explain that the Convention applies to taxes on income; this covers taxes on total income or any part of income and includes tax on gains derived from the alienation of property. The Convention does not apply to payroll taxes. Nor does it apply to property taxes; however, the Convention does affect the imposition of Mexico's asset tax in some instances, as explained in the Protocol.

In the case of the United States, the existing taxes to which the Convention applies are the Federal income taxes imposed by the Internal Revenue Code, but not including the accumulated earnings tax or personal holding company tax (which are considered penalty taxes)

or social security contributions. It also applies to certain excise taxes. The excise taxes with respect to private foundations are covered to the extent necessary to implement paragraph 4 of Article 22 (Exempt Organizations). The Convention also applies to the Federal excise taxes imposed on insurance premiums paid to foreign insurers, in the case of Mexican insurers, but only to the extent that the Mexican insurer does not reinsure those risks with a person not exempt from such taxes. As we have discussed in prior consultations with the staff of this Committee and of the tax-writing Committees, our review of Mexico's taxation of the income of Mexican insurance companies indicated that it results in a burden that is substantial in relation to the U.S. tax on U.S. insurance companies. It is, therefore, appropriate to waive the insurance excise tax in the case of Mexico, as in the recent Conventions ratified with Germany, Spain, Finland, India, and other countries. In addition, Article 25 (Non-Discrimination) applies to all taxes imposed at all levels of government. The exchange of information provisions of Article 27 apply to all Federal level taxes, e.g. including estate and gift and excise taxes, to the extent that such information is relevant to enforcement of the Convention or of any covered tax as long as the tax in question is applied in a manner consistent with the Convention.

In the case of Mexico, the Convention applies to the income tax imposed by the Income Tax Law, amplified in the case of Articles 25 (Non-Discrimination) and 27 (Exchange of Information) to include all taxes and all national level taxes, respectively. The assets tax is not a covered tax. However, the Protocol limits application of the assets tax in certain cases where there would be no Mexican income tax liability because of the Convention (e.g., where there is no permanent establishment), and it preserves the benefits of the Convention in cases where the tax does apply. Thus, Point 3 of the Protocol generally limits application of the assets tax to cases where a U.S. resident either

- (i) has a permanent establishment in Mexico under Article 5,
- (ii) has real property in Mexico, or
- (iii) leases or otherwise permits a resident of Mexico to use property for which a "royalty" (as defined in Article 12) is paid.

Point 6 of the Protocol also makes clear that the assets tax may not be applied to property used to produce profits that are exempt from Mexican income tax under Article 8 (Shipping and Air Transport).

Under paragraph 4, the Convention will apply to any taxes which are substantially similar to those enumerated in paragraph 3, and which are imposed in addition to, or in place of, the existing taxes after September 18, 1992, the date of signature of the Convention. Paragraph 4 also provides that the U.S. and Mexican competent authorities will notify each other of significant changes in their taxation laws that are relevant to the operation of the Convention, and of official published materials that concern the application of the Convention.

### ARTICLE 3 General Definitions

Paragraph 1 defines a number of basic terms used in the Convention. Certain others are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Residence). The term "permanent establishment" is defined in

Article 5 (Permanent Establishment). The terms "dividends", "interest" and "royalties" are defined in Articles 10, 11 and 12, which deal with the taxation of those classes of income, respectively.

Subparagraph (a) defines the term "person" to include an individual or legal person. The latter includes a company, a corporation, a trust, a partnership, an association, an estate and any other body of persons. Any "person" may be a "resident" of a Contracting State for purposes of Article 4 and thus entitled to the benefits of the Convention. This list is somewhat more expansive than the definition in the U.S. Model, but it is intended to have the same meaning.

The term "company" is defined in subparagraph (b) as any entity treated as a body corporate for tax purposes. For U.S. tax purposes, the rules of reg. § 301.7701-2 generally will be applied to determine whether an entity is a body corporate.

An "enterprise of a Contracting State" is defined, as in the U.S. and OECD Models, to mean an enterprise carried on by a resident of Mexico or the United States, as appropriate. (Although there is no explicit definition of the term "Contracting State", it refers to Mexico or the United States according to the context.)

Subparagraph (d) defines the term "international traffic". The term means any transport by a ship or aircraft except when such transport is solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that the transport of goods or passengers solely between Miami and New York by a Mexican carrier (if it were permitted) would not be treated as international traffic, and the resulting income would not be exempt from U.S. tax under Article 8. It would be treated as business profits under Article 7 and would, therefore, be taxable in the United States if attributable to a U.S. permanent establishment. If, however, goods or passengers are carried by a Mexican plane from Mexico City to Miami and then to New York the trip would be international transport for those that continued to New York as well as for those that disembarked in Miami.

The "competent authority" is the Government official charged with administering the provisions of the Convention and with attempting to resolve any differences or difficulties which may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his authorized representative. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, re-delegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International). In Mexico, the competent authority resides in the Ministry of Finance and Public Credit. In general, that function is delegated to the General Directorate of Revenue Policy and International Fiscal Affairs.

The terms "United States" and "Mexico" are defined in subparagraphs 1(f) and (g), respectively. The term "United States" means the United States as defined in the Code (section 7701 (a)(9)). Accordingly, the term does not include Puerto Rico, the U.S. Virgin Islands, Guam or any other U.S. possession or territory. It includes the fifty states, the District of Columbia, and the territorial sea. When used geographically, the "United States" also includes the continental

shelf. (See Point 1 of the Protocol.) It is understood that the continental shelf is covered only to the extent that any U.S. taxation therein is in accordance with international law and U.S. tax law. Currently, U.S. tax law applies on the continental shelf only with respect to the exploration for and exploitation of mineral resources under section 638 of the Code.

The term "Mexico" means Mexico as defined in the Federal Fiscal Code. When used geographically, "Mexico" includes the states thereof and the Federal District, the territorial sea and the continental shelf. As in the case of the United States, it is understood that any Mexican taxation on its continental shelf must be in accordance with international law and Mexican tax law.

The term "national" is defined in subparagraph (h) to include both individuals and legal persons. This term is relevant, in particular, to Articles 20 (Government Service), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure).

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning which it has under the law of the Contracting State whose tax is being applied, unless the context requires a different interpretation.

#### ARTICLE 4 Residence

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. Determination of residence is important because, as noted in the explanation to Article 1 (General Scope), as a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is used for all purposes of the Convention, including the saving clause of paragraph 3 of Article 1 (General Scope), but it is used only for purposes of the Convention.

The determination of residence for purposes of the Convention looks first to domestic law criteria. A person subject to tax as a resident or domestic entity under the law of one of the Contracting States is a resident of that State. If that person is not a resident of the other Contracting State for tax purposes under its domestic law criteria, he or it need look no further. If such a person is a dual resident, paragraph 2 provides a series of tests for assigning a single residence to an individual. Dual resident companies are not considered to be residents of either country for treaty purposes (paragraph 3).

It is understood that the reference in paragraph 1 to persons "liable to tax" refers to those subject to the taxation laws applicable to residents, and is not meant to exclude tax-exempt organizations. Article 22 (Exempt Organizations) provides some special rules with respect to tax-exempt organizations that are residents of one of the Contracting States and entitled to the benefits of the Convention under Article 17 (Limitation on Benefits).

A person that is liable to tax in a Contracting State only in respect of income from sources within that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Mexican Embassy official in the United States, who may

be subject to U.S. tax on U.S. source investment income but not on his non-U.S. income, would not be considered a resident of the United States for purposes of the Convention. (In most cases such an individual also would not be a U.S. resident under the Code.)

Even though a United States citizen, wherever resident, is liable to tax in the United States on worldwide income, U.S. citizenship alone does not automatically render the person a resident of the United States for purposes of the Convention. Thus, Mexico is not required to provide benefits of the Convention to a U.S. citizen resident in a third country. Point 2 of the Protocol explains that a U.S. citizen or an individual who is a U.S. resident by virtue of holding a "green" card for immigration purposes will be considered a resident of the United States for purposes of Mexican tax benefits only if the individual has a substantial presence in the United States as defined in Code section 7701(b) or if his permanent home, personal and economic relations, or habitual abode are in the United States and not in another country. The reference to "another" country means a third country; a U.S. citizen or green card holder who is also, under paragraph 1 of this Article, a resident of Mexico, will have his residence for treaty purposes determined under paragraph 2, which includes, in subparagraph (c), citizenship as one of the tie-breakers. A U.S. citizen who is determined under paragraph 2 to be a resident of Mexico would continue to be subject to U.S. taxation under the saving clause of paragraph 3 of Article 1 (General Scope), but a green card holder determined under paragraph 2 to be a Mexican resident would not be subject to the saving clause.

Point 2 of the Protocol also explains that a partnership, estate or trust will be treated as a resident of a Contracting State only to the extent that the income derived by the partnership, estate, or trust is taxed as the income of a resident, whether in the hands of the person deriving the income or in the hands of its partners or beneficiaries. Under U.S. law, a partnership is never, and an estate or trust is often not, a taxable entity. Thus, for treaty purposes, the question of whether income received by a partnership is received by a U.S. resident will be determined by the residence of its partners (looking through any partnerships which are themselves partners) rather than by the residence of the partnership itself. In Mexico, most partnerships are taxable entities. The treatment under the Convention of income received by a trust or estate will be determined by the residence of the person subject to tax or, such income, which may be the grantor, the beneficiaries, or the estate or trust itself, depending on the particular circumstances. This rule regarding the residence of partnerships, estate or trusts is applied to determine the extent to which that person is entitled to treaty benefits with respect to income which it receives from the other Contracting State.

Finally, Point 2 of the Protocol clarifies that the two Contracting States and their political subdivisions are to be treated as residents of those States for purposes of treaty benefits.

If, under the laws of the two Contracting States, and thus under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules is provided in paragraph 2 to determine a single State of residence for that individual. These rules come from the OECD Model. The first test is where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closer, i.e., the location of his "center of vital interests". If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be

treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of his Contracting State of nationality. In any other case, the competent authorities are instructed to resolve his residence by mutual agreement. This could be the case, for example, where the individual is not a national of either Contracting State.

The tie-breaker rules of paragraph 2 apply only to individuals. Paragraph 3 provides that, where a person other than an individual is a dual resident under paragraph 1, such person will not be treated as a resident of either State for purposes of the Convention. Under U.S. law, a corporation that is created or organized under the laws of the United States or a state or the District of Columbia is liable to U.S. tax by reason of that incorporation and therefore is a resident of the United States under paragraph 1. A corporation that has its place of effective management in Mexico is liable to Mexican tax by reason of that activity and therefore is a resident of Mexico under paragraph 1. Thus, if a corporation organized under U.S. law had its place of effective management in Mexico, it would be a resident of both countries under their respective domestic laws. One possibility considered for resolving dual residency in such cases was to permit the competent authorities to determine a single residence in such cases. However, it was considered unlikely that either competent authority would concede to the other on this Point. Thus, it was decided to exclude such persons from treaty coverage and to rely on the companies themselves not to get into the situation of dual residence.

## ARTICLE 5 Permanent Establishment

This Article defines the term "permanent establishment", which is relevant to several articles of the Convention. The existence of a current or former permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for that State to tax the business profits of a resident of the other Contracting State. Articles 10, 11 and 12 (dealing with dividends, interest, and royalties, respectively) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State; if the income is or was attributable to a permanent establishment, Article 7 applies, and if the income is or was attributable to a fixed base, the principles of Article 7 apply. The term "permanent establishment" is also relevant to the application of the Mexican assets tax. As provided in Point 3 of the Protocol, the assets tax in general may only be applied to the assets of, a U.S. resident if that resident has a Mexican permanent establishment.

This Article is similar in most respects to the corresponding Articles of the U.S. and OECD Models, but includes some departures from those Models.

Paragraph 1 provides the basic definition of the term "permanent establishment". As used in the Convention, the term means a fixed place of business through which a resident of one Contracting State carries on business activities in the other Contracting State.

Paragraph 2 contains a list of examples of fixed places of business that constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, and



a mine, well, quarry or other place of extraction of natural resources. The use of singular nouns in this illustrative list is not meant to imply that each such place necessarily represents a separate permanent establishment. In the case of mines or wells, for example, several such places of business could constitute a single permanent establishment if the project is a whole commercially and geographically. (See the following discussion under construction sites and drilling operations.)

Paragraph 3 adds that a building or construction site or installation project, or an installation or drilling rig or ship used to explore for or exploit natural resources also constitutes a permanent establishment, but only if it lasts more than 6-months. This is a shorter period than the 12 months provided for in the U.S. and OECD Models. This paragraph follows instead the UN Model. The 6-month test has been accepted in some other U.S. tax treaties, e.g., with Spain and Tunisia, and has been reduced further in the treaties with Indonesia and India.

The furnishing of supervisory activities at such a site or installation may also constitute a permanent establishment and is taken into account in measuring the 6-month period. The addition of the reference to supervisory services is not considered a substantive difference from the U.S. or OECD Models. The commentary to paragraph 3 of Article 5 of the OECD Model, which constitutes the generally accepted international interpretation of the language in that paragraph, points out that activities of planning and supervision are taken into account, as is time spent by subcontractors at the site or project, in determining whether the general contractor has a permanent establishment. Supervisory services that do not themselves last for more than 6-months may nonetheless be an interrelated part of a construction, installation, building, or drilling project; in that case, the period of time during which supervisory services were carried on will be added to the time during which the construction, installation, building, or drilling is carried on for purposes of meeting the 6-month test.

The 6-month period applies separately to each site or project. The period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A site should not be regarded as ceasing to exist when work is temporarily discontinued. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project. For example, the construction of a housing development would be considered a single project even though each house may be constructed for a different purchaser. If the 6-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day. Drilling rigs, both onshore and offshore, are covered by the construction site rule, and must, therefore, be present in a Contracting State for 6-months to constitute a permanent establishment. The drilling of several wells within the same geographic area and as part of the same commercial operation will be considered a single permanent establishment.

Paragraph 4 contains exceptions to the general rule of paragraph 1. The paragraph lists a number of activities which may be carried on through a fixed place of business, but that, nevertheless, will not give rise to a permanent establishment. Using facilities or maintaining a supply of goods or merchandise solely to store, display, or deliver goods or merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. Similarly, maintaining a supply of goods or merchandise solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the enterprise owning the

goods or merchandise. (See, however, the discussion below about paragraph 5 and its treatment of certain dependent agents that process goods on behalf of an enterprise using assets furnished by the enterprise.) The maintenance of a fixed place of business solely for purchasing goods or collecting information for the enterprise, or for carrying out any other activity of a preparatory or auxiliary character for the enterprise, such as advertising, supplying information, conducting scientific research, or placing loans will not constitute a permanent establishment of the enterprise. A combination of such activities will not constitute a permanent establishment, provided that the aggregate activity is of a preparatory or auxiliary character for the enterprise.

The exclusion of an office used for preparations relating to the placement of loans is not in the U.S. or OECD Models. It refers to representative offices in Mexico of U.S. banks, which generally are not allowed under current Mexican banking law to accept deposits or otherwise conduct a banking business in Mexico. In such cases, loans from the U.S. home office to Mexican borrowers will not be attributable to a permanent establishment in Mexico, and the interest paid will be subject to Mexican tax in accordance with Article 11 (Interest). It is expected that U.S. banks may be able to establish branches in Mexico that will be permanent establishments taxable in accordance with Article 7 (Business Profits).

Paragraphs 5, 6 and 7 specify when the use of an agent will constitute a permanent establishment. Under subparagraph (a) of paragraph 5, a dependent agent of an enterprise will be deemed to be a permanent establishment of the enterprise if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 4 which would not constitute a permanent establishment if carried on directly by the enterprise through a fixed place of business, the agent will not be a permanent establishment of the enterprise. Under subparagraph (b) of paragraph 5, a dependent agent who does not have the authority to conclude contracts in the name of the enterprise will nevertheless be a permanent establishment of the enterprise if the agent habitually processes on behalf of the enterprise goods or merchandise owned by the enterprise using assets furnished, directly or indirectly, by the enterprise or an associated enterprise. This subparagraph is meant to clarify that a dependent agent that processes inventory of its principal using assets of the principal (or a related enterprise) without itself having ownership of either the inventory or the assets used in the processing, represents a permanent establishment of the principal. This is the case whether or not the dependent agent is a subsidiary of the U.S. enterprise. Because such an agent represents a permanent establishment, the income and assets attributable to its activity are subject to income and assets tax in Mexico. As mentioned above, this subparagraph is intended simply as a clarification. It is not meant to create a permanent establishment where one would not exist without this language. It does not apply to the use of an independent agent, such as a contract manufacturer. In such a case the contract manufacturer would be subject to tax by Mexico, but the person on whose behalf the processing is undertaken would not have a permanent establishment, and pursuant to Point 3 of the Protocol, Mexico's assets tax would not apply to the assets of such person.

Paragraph 6 inserts a special rule for insurance companies, similar to the rule found in the U.S. treaties with Belgium and France. Mexico does not have a tax comparable to the U.S. insurance excise tax. Although foreign insurers are not now permitted to operate in Mexico, Mexico anticipates a greater opening of its financial sector in this regard. The Mexican delegation wished to clarify the rules that will apply when U.S. insurers are permitted to insure

risks in Mexico by specifying in the Convention that a dependent agent who collects premiums or insures risks in Mexico on behalf of a U.S. insurer is a permanent establishment of the U.S. insurer in Mexico. There is an exception for reinsurance. This rule applies reciprocally. Thus, although the United States (by covering it in Article 2 (Taxes Covered)) agrees not to apply the insurance excise tax to Mexican companies that do not reinsure with persons subject to those taxes, if the Mexican company maintains a dependent agent in the United States who collects premiums or insures risks on its behalf, the United States may impose its net income tax. Consistently with the rule of paragraph 2 of Article 1 (General Scope) that prevents the imposition of tax by the Convention, the tax so imposed could not exceed the tax that would apply under U.S. law.

Under paragraph 7, an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as such and if their relationship is at arm's length; both conditions must be satisfied.

Paragraph 8 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination of whether or not a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether or not a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

## ARTICLE 6

### Income from Immovable Property (Real Property)

Paragraph 1 provides the standard income tax treaty rule that income derived from real property (here referred to as immovable property, as in the OECD Model and Mexican usage) may be taxed in the Contracting State where the property is located. This includes income from agriculture or forestry. Since paragraph 5 of this Article permits net basis taxation, it should have the same result in principle as Article 7 (Business Profits) in the case of an agricultural or forestry enterprise that makes the election to be taxed on a net basis.

Paragraph 2 defines real property in accordance with the laws of the Contracting States, but provides that it includes, in any case, immovable property as described in the OECD Model, which includes references to accessory property, livestock and equipment used in agriculture and forestry, and rights to receive payments in exchange for the right to extract natural resources. Boats, ships, aircraft and containers are not immovable property.

Paragraph 3 clarifies that the Article covers income from the use of real property, without regard to the form of exploitation, and paragraph 4 clarifies that it also covers immovable property used in a business or for performing independent personal services;

Paragraph 5 provides that the taxpayer (whether an individual or a legal entity) may make a binding election to be taxed on a net basis. The election is based on the 1981 U.S. model provision. However, it does not require the consent of both competent authorities to terminate the election; only the agreement of the competent authority of the State in which the property is located is required. Under Mexican law, income from the leasing of real property is taxed on a net basis when derived by resident corporations. Resident individuals may elect to be taxed on a presumed net income equal to 50 percent of the gross income. Nonresidents are taxed at 21 percent of the gross amount. When the Mexican corporate tax rate was 42 percent, this represented a 50 percent presumed expense allowance. At a rate of 35 percent, it amounts to a 40 percent deduction for expenses. And if the Mexican rate is reduced to 34 percent, as has been proposed, the 21 percent tax on gross income will reflect presumed expenses of 38 percent. This paragraph will permit U.S. residents to be taxed on a net basis, like Mexican corporations. If they so elect, they must be able to document expenses, and must forego the presumed expense deduction.

Point 3 of the Protocol provides that, in applying its asset tax to immovable property, Mexico shall allow a credit for the gross income tax which would have applied under its statutory rules (21 percent at the time the treaty was signed), even if the U.S. owner elects to pay tax on the net income. This credit is available only if less than 50 percent of the U.S. owner's gross income from the property is used, directly or indirectly, to meet liabilities to persons who are not United States residents; otherwise Mexican (or third country) owners of Mexican immovable property could avoid the asset tax by making the U.S. resident the nominal owner of the property, while remaining beneficial ownership in Mexico (or in the third country).

## ARTICLE 7 Profits Business

This Article provides the rules for the taxation by a Contracting State of the business profits of a resident of the other Contracting State. The general rule is found in paragraph 1, that business profits of a resident of one Contracting State may not be taxed by the other Contracting State unless the resident carries on or has carried on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated in the latter State. Where that condition is met, the State in which the permanent establishment is situated may tax the business profits attributable to the assets or activity of that permanent establishment. That State may also tax the business profits derived from the sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment. The latter rule, which comes from the U.N. Model, amounts to a partial "force of attraction", by attributing to the permanent establishment home office sales of the same or similar goods as those sold through the permanent establishment, even if, under paragraph 5 of this Article, the assets and activities of the permanent establishment were not involved in the sale. This limited "force of attraction" rule is frequently requested by developing countries to prevent avoidance of their tax at source. It has been agreed to in some other U.S. income tax treaties, such as those with India and Indonesia, although it is not in the U.S. Model and does not represent the preferred U.S. policy. In this Convention it is subject to the significant qualification that the limited force of attraction will not apply if the enterprise demonstrates that the sales were not made from the home office to avoid the tax on profits attributable to a permanent establishment.

For example, it may be more efficient for a U.S. company based in San Diego and having a permanent establishment in Mexico City to sell goods to Tijuana directly from San Diego, whereas that may not be the case with respect to sales to Mexico City.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it would be expected to make if it were an independent entity, engaged in the same or similar activities under the same or similar conditions. Profits so attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were made. This rule incorporates the rule of section 864(c)(6) of the Internal Revenue Code with respect to deferred payments. If the income was attributable to the assets or activities of a permanent establishment when earned, it is taxable by the State where the permanent establishment was located, even if receipt of the income is deferred until the permanent establishment has ceased to exist.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, certain items of foreign source income described in section 864(c)(4)(B) or (C) of the Code may be attributed to a U.S. permanent establishment of a Mexican resident and subject to tax in the United States. The concept of "attributable to" in the Convention is narrower than the concept of "effectively connected" in section 864(c) of the Code. The limited "force of attraction" rule in Code section 864(c)(3), therefore, is not applicable under the Convention to the extent that it is broader than the rule of subparagraph (b) of paragraph 1 of this Article.

Paragraph 3 provides that the tax base must be reduced by deductions for expenses incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses incurred by the home office, as long as the expenses were incurred on behalf of the company as a whole, or a part of it which includes the permanent establishment. Allocable expenses would include executive and general administrative expenses, research and development expenses, interest, and charges for management, consultancy, or technical assistance, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment. However, as clarified in Point 5 of the Protocol, no double deduction is allowed, i.e., expenses included in the cost of goods sold or reflected in other charges deductible by the permanent establishment may not be included in the amount of expenses to be allocated in part to the permanent establishment.

Paragraph 3 also clarifies, as does the U.N. Model and the commentary to the OECD Model, that a permanent establishment may not take deductions for royalties, fees, commissions, or Service fees paid to its home office other than amounts which represent reimbursement of actual expenses incurred by the home office. Since the permanent establishment and home office are parts of a single entity, there should be no profit element in such intra-company transfers. The same rule applies to interest on an intra-company loan, with the exception that a Contracting State may permit a branch bank to deduct an interest payment to its home office or another branch in excess of reimbursement of costs incurred. The exception in the case of banks is included in the U.N. Model and in the OECD commentary to take into account that it is common practice for parts of the same international financial institution to make advances to each other and charge interest on those amounts. It is included in this Convention to address a problem under Mexican law.

Mexico does not currently have in place a mechanism analogous to United States Treasury Regulation §-1.882-5 for allocating an enterprise's interest expense to a permanent establishment. Mexico generally permits a branch to deduct interest only when it borrows money directly. The treaty confirms that in the event Mexico in the future permits a U.S. bank to establish a branch in Mexico, that branch will be able to deduct interest initially incurred by the home office or another branch. Paragraph 3 enables Mexico to consider actual transactions between the home office and its branch to determine the appropriate interest expense deductible by the branch.

The exception in paragraph 3 for bank interest was not intended to override § 1.882-5 in the context of a U.S. permanent establishment of a Mexican bank. Paragraph 3 does not prescribe or preclude any particular method for allocating interest expense to a branch. Thus, Mexico may consider actual intra-branch transactions, and the U.S. may approximate the appropriate interest expense of the branch under section 882. The exception for bank interest is written in a way that permits but does not require a deduction for an intra-company transaction. The general rule in the second sentence of paragraph 3 is that a Contracting State may not permit deductions for certain intra-company payments. Intra-company bank interest is an exception to this mandatory disallowance of deductions. Thus, a Contracting State may but is not required to grant a deduction for interest paid on actual intra-company transactions. If the actual amount of interest payable with respect to liabilities on the books of a U.S. branch of a Mexican bank (including amounts due to other offices) exceed the amount of interest allocated to the branch under Treas. Reg. § 1.882-5, the regulatory formula will prevail, and any such excess will not be considered incurred for the purposes of the branch under this Article (and will not be subject to a branch level interest tax under section 884).

Point 4 of the Protocol provides that nothing in Article 7 prevents a Contracting State from applying its internal law to estimate the profits of a permanent establishment where the information available is inadequate to determine those profits, or prevent Mexico from applying Article 23 of its Income Tax Law, that apports the worldwide net income of international transportation companies on the basis of the ratio of Mexican to worldwide gross receipts. In any case in which internal law is thus applied, the determination of the profits of the permanent establishment must be consistent, on the basis of the available information, with the principles of Article 7. Article 23 of Mexico's Income Tax Law, by recognizing that there may be cases where there is no taxable income, satisfies this condition.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs at least one function for the enterprise in addition to purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable with respect to its purchasing activities. If the sole activity were the purchasing of goods or merchandise for the enterprise, the issue of the attribution of income would not arise, because, under subparagraph 4(d) of Article 5 (Permanent Establishment), there would be no permanent establishment.

Paragraph 5 provides that the business profits to be "attributed" to a permanent establishment include only the profits (or losses) derived from the assets or activities of the permanent establishment. Thus, for example, a U.S. company may have a construction site in Mexico that constitutes a permanent establishment and may also export merchandise directly from the U.S. home office to independent distributors in Mexico; it would not attribute any of the profit from the merchandise sales to the Mexican permanent establishment if the assets and personnel of that permanent establishment were not involved in the sales activity. Note, however, that paragraph 1(b) provides an exception to this rule. Where it is applicable, paragraph 1(b) takes precedence over paragraph 5.

To ensure continuous and consistent tax treatment, paragraph 5 also requires that the method for calculating the profits and losses of a permanent establishment be the same from year to year unless there is a good and sufficient reason to change the method. A taxpayer may not vary the method from year to year simply because a different method achieves a more favorable tax result.

Paragraph 6 explains the relationship between the provisions of Article 7 and other provisions of the Convention. Under paragraph 6, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those other articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 7. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest), and not by Article 7, except where, as provided in paragraph 3 of Article 11, the interest is attributable to a permanent establishment, in which case the provisions of Article 7 apply.

## ARTICLE 8 Shipping and Air Transport

This Article provides the rules that govern the taxation of income from the operation of ships and aircraft in international traffic. "International traffic" is defined in subparagraph 1(d) of Article 3 (General Definitions). Such income, when derived by a resident of either Contracting State, may be taxed only by that State, the country of residence. If the other Contracting State is the country where the income arises, it must exempt the income from tax, even if attributable to a permanent establishment in that State.

Income from the rental of ships or planes on a full basis for use in international traffic is considered operating income and is covered under paragraph 1. Income from the bare-boat leasing of ships or planes is also exempt from tax at source if the ships or aircraft are used in international traffic by the lessee and if the rental income to the lessor is accessory to income derived by the lessor from operating ships or planes in international traffic. The profits referred to in paragraph 1 do not, however, include accessory profits derived from the furnishing of overnight accommodations by an international shipping or airline enterprise. Nor does paragraph 1 apply to profits derived by such an enterprise from furnishing other means of transport, such as inland transport by truck or rail, that the international operating company provides directly. If inland transport from the port of entry to the final destination is subcontracted by the international carrier to a domestic enterprise, no profit will be attributed to the international

carrier for that portion of the transport. (The domestic carrier will, of course, be subject to tax on its profit.) Mexico was not prepared to permit a U.S. company to provide such inland transport without incurring tax in the same manner as a domestic company. Similarly, Mexico was not willing to extend the exemption provided by this Article to include income from international transport by truck or rail, as is done in the U.S. treaty with Canada.

Paragraph 3 provides that income from the use of containers in international traffic and from the use of related equipment for the transport of such containers is exempt from tax at source under this Article, whether derived by an operating company or by a leasing company. The use of containers and related equipment includes charges for the rental of the equipment and charges for its delayed return.

Paragraph 4 clarifies that the exemptions provided by paragraphs 1 and 3 apply to profits from participation in a pool, joint business, or international transportation operating agency. For example, if a Mexican airline were to form a consortium with other national airlines, the share of the income derived from U.S. sources accruing to the Mexican participant would be covered by this Article.

Point 6 of the Protocol provides that the Mexican assets tax will not apply to assets used by residents of the United States to produce profits that are exempt from Mexican income tax under this Article.

When this Article takes effect, the provisions of the exchange of notes of August 7, 1989, concerning reciprocal exemption of international shipping and airline income will cease to apply. It was the request of Mexico that the Convention replace the 1989 note rather than having both documents apply simultaneously.

## ARTICLE 9 Associated Enterprises

This Article provides that, when residents of the two Contracting States that are related persons engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such persons to reflect the income or tax with respect to such transactions that each would have had if the transaction between them had been at arm's length.

Paragraph 1 deals with the circumstance where an enterprise of a Contracting State is associated with an enterprise of the other Contracting State and those associated enterprises make arrangements or impose conditions in their commercial or financial relations that differ from those that would be made at arm's length. Paragraph 1 provides that, under those circumstances, either Contracting State may adjust the income (or loss) of the enterprise that is a resident of that State to reflect the income that would have been taken into account in the absence of such a relationship. The paragraph specifies what the term "associated enterprises" means in this context. An enterprise of one Contracting State is associated with an enterprise of the other Contracting State if either participates directly or indirectly in the management, control, or capital of the other. The two enterprises are also associated if there is a "brother-sister" type



connection between them in that a third person or persons participate directly or indirectly in the management, control, or capital of both. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable.

Paragraph 2 provides that, where a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, and the other Contracting State agrees that the amount of the adjustment is appropriate to reflect arm's length conditions, that other State is obligated to make a corresponding adjustment to the tax liability of the related person in that other State in accordance with the provisions of paragraph 2 of Article 26 (Mutual Agreement Procedure). That paragraph imposes certain time limits within which the competent authority must be notified of the case and within which agreement on the adjustment must be reached. The Contracting State making the correlative adjustment will take into account the other provisions of the Convention, where relevant.

The saving clause of paragraph 3 of Article 1 (General Scope) does not apply to this paragraph. (See Article 1(4)(a).) Thus, even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax may be required to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under paragraph 2 of Article 1 (General Scope), the Convention cannot restrict any statutory benefit.

Point 7 of the Protocol provides that the benefits of the correlative adjustment required by paragraph 2 shall not apply if the misstatement of profits which gave rise to the initial adjustment was the result of fraud, gross negligence, or willful default.

Paragraph 3 preserves the rights of the Contracting States to apply internal law provisions relating to adjustments between related parties. Such adjustments - the distribution, apportionment, or allocation of income, deductions, credits or allowances - are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of the Article, so long as they accord with the general principles of paragraph 1, i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length.

## ARTICLE 10

### Dividends

This Article provides rules limiting the taxation at source of dividends paid by a company that is a resident of one Contracting State to a shareholder who is a resident of the other Contracting State.

Paragraph 1 preserves the residence country's general right to tax its residents on dividends paid by a company that is a resident of the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1.

Paragraphs 2 and 3 limit the right of the source State to tax dividends paid to a resident of the other State. The tax at source must not exceed 5 percent of the gross amount of a "direct

investment" dividend - that is a dividend to a beneficial owner that is a company owning at least 10 percent of the voting stock of the paying corporation; in other cases it must not exceed 15 percent. After the provisions of this Article have been in effect for five years (see Article 29 (Entry Into Force)), the 15 percent rate will decrease to 10 percent. The limitation of the tax at source to 10 percent on portfolio dividends is not part of the U.S. Model, which sets a 15 percent maximum rate on such dividends. It was accepted in this case as part of a package of concessions involving the withholding rates applicable to dividends, interest, and royalties and the treatment of the Mexican assets tax. Under current Mexican law, there is no shareholder level tax on dividends.

Point 8(b) of the Protocol further provides that, if the United States should agree in a treaty with any other country to reduce its tax on direct investment dividends to a rate lower than 5 percent, that rate shall also apply to direct investment dividends paid to residents of Mexico and the United States under paragraph 2(a) of this Article, in place of the 5 percent rate provided for in that subparagraph. Such reduction is expected to take effect at the same time as it takes effect in the U.S. treaty with the third country. In reviewing the treaty with the third country, the U.S. Senate would have the opportunity to consider the effects of the lowered rate with Mexico and take that effect into account in offering its consent to ratification.

Point 8(a) of the Protocol modifies the limitations on source country taxation for dividends paid by U.S. Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs). Dividends paid by RICs are subjected to the 15 (or, after five years, 10) percent portfolio dividend rate regardless of the percentage of voting shares of the RIC held by the owner of the dividend. The 5 percent rate, is intended to relieve multiple levels of corporate taxation. Since RIBS do not pay corporate tax with respect to amounts distributed, the only tax imposed on their distributions is the shareholder level tax. Moreover, a foreign shareholder could own a 10 percent interest in a RIC without owning a 10 percent interest in the companies in which the RIC invests. In the case of dividends paid by a REIT, the 15 (after five years, 10) percent rate will apply if the beneficial owner of the dividends is an individual and holds less than 10 percent interest in the REIT. In other cases the rate of domestic law applies to dividends paid by REITs; that rate is currently 30 percent, which approximates the applicable tax if the shareholder had invested directly in U.S. real estate.

The rate limitations provided by paragraphs 2 and 3 do not affect the taxation by either Contracting State of the profits out of which the dividends are paid. (The current rates of profits tax are generally 35 percent in both the United States and Mexico, although there is a proposal in Mexico to reduce its rate to 34 percent.) Under Mexican law there is no shareholder level tax on profits distributed as dividends, provided that the full corporate level tax has been paid. Where the corporate tax has been reduced by tax preferences, a compensatory tax is imposed on the corporation at the time of distribution to recapture those preferences. Imposition of this tax is not affected by the limitations of paragraphs 2 and 3.

Paragraph 4 defines the term "dividends" as used in this Article. It is a broad definition, encompassing income from any shares or rights that are not debt claims and that participate in profits, and income from other corporate rights treated for domestic law tax purposes as dividends in the country of residence of the distributing company. Point 9 of the Protocol provides that each Contracting State may also apply its statutory rules for distinguishing debt and equity or for preventing thin capitalization in defining dividends for purposes of this Article. In

the case of the United States, these rules include Code section 163(f) as modified by section 13228 of the Omnibus Budget Reconciliation Act of 1993.

Paragraph 5 provides that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains or maintained in the past in the country of source, they are not subject to the provisions of paragraphs 1, 2 and 3 of this Article, but are taxable under Article 7 (Business Profits) or Article 14 (Independent Personal Services), as appropriate.

Paragraph 6 provides that neither Contracting State may impose a tax on dividends paid by residents of the other State, or of a third State, except to the extent paid to a resident of the first State or attributable to a permanent establishment or fixed base in that first State. This paragraph precludes the U.S. from imposing its so-called "second-level withholding" tax, which generally accomplishes the same objective as the branch tax (which the treaty preserves). Paragraph 6 is drafted in such a way as to exempt not only Mexican corporations but also third-country corporations with U.S. permanent establishments from second-level withholding. Such third-country corporations may not be subject to the branch tax. However, those corporations will only be exempt from second-level withholding under this treaty to the extent their dividends are paid to Mexican shareholders who are entitled to treaty benefits. In any event, third-country corporations would be used to "shop" this treaty only in rare circumstances where the third-country company is itself exempt from the branch tax and where the rate of withholding on dividends paid from the corporation to Mexican shareholders is less than the 5 percent branch tax permitted by the treaty.

## ARTICLE 11

### Interest

This Article limits the taxation at source of interest paid by a resident of one Contracting State to a resident of the other Contracting State.

Paragraph 1 preserves the residence country's general right to tax its residents on interest arising in the other State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Paragraphs 2, 3, and 4 limit the right of the source State to tax interest beneficially owned by a resident of the other State. However, the reduced rates do not apply to interest paid with respect to back-to-back loans. Such interest will continue to be taxed in accordance with the domestic law of the source State.

Paragraph 3 specifies the rates that may be imposed at source during the first five years from the date on which this Article takes effect (see Article 29 (Entry Into Force)). During that period, interest on loans from banks and insurance companies, and interest on bonds or other securities that are regularly and substantially traded on a recognized securities market may be taxed at 10 percent of the gross amount of interest paid. (A recognized securities market for this purpose is defined in Point 15(b) of the Protocol.) This rate applies to a bank or insurance company that is the beneficial owner of the interest, whether or not the bank or insurance

company was the original creditor on the loan; it does not apply to interest beneficially owned by another person even if the loan was originally granted by a bank or insurance company.

During the first five years other interest, except that exempt from tax at source under paragraph 4, is subject to a maximum tax at source of 15 percent of the gross interest.

At the end of five years, the rates specified in paragraph 2 will apply. The 10 percent rate applicable to interest on loans by banks and insurance companies (except back-to-back loans) and interest on publicly traded securities will drop to 4.9 percent. The effect of the 4.9 percent is to ensure that the interest is not "high withholding tax interest" for purposes of the U.S. foreign tax credit limitation but rather financial services income or passive income, as applicable. The 15 percent rate will drop to 10 percent for interest paid by banks and interest paid to a seller to finance the purchase of machinery and equipment, but will remain at 15 percent for all other categories of interest. In the case of suppliers' credits, the 10 percent rate only applies to the original seller of the goods. If the loan is transferred, the rate will be either 4.9 percent, if the loan is acquired by a bank or insurance company, or 15 percent, if acquired by another person. (See Point 10(b) of the Protocol.)

Paragraph 4 specifies certain categories of interest that, notwithstanding the provisions of paragraphs 2 and 3, are exempt from tax at source when the beneficial owner is a resident of the other Contracting State. Those categories are:

- (i) interest paid to or by either Contracting State or a political subdivision or local authority thereof,
- (ii) interest beneficially owned by a tax exempt pension plan, provided that such pension plan is generally exempt from income taxation in its residence State and more than half of its beneficiaries are entitled to benefits of the Convention (see paragraph 1(e) of Article 17 (Limitation on Benefits)), and
- (iii) interest on loans of three years or longer that are made, guaranteed, or insured by a specified public lending institution.

The specified Mexican institutions are the Banco Nacional de Comercio Exterior, S.N.C., and the Nacional Financiera, S.N.C. The specified U.S. institutions are the Export-Import Bank and the Overseas Private Investment Corporation.

In the absence of the Convention, Mexico's withholding rates on interest paid to nonresidents are currently 35 percent, 21 percent, and 15 percent, depending upon the type of debt involved and on the identity of its holder. Mexico also exempts certain Interest from income taxation. In general the treaty exemptions correspond to the statutory exemptions of Mexican law, and the categories of debt to which the reduced rates apply reflect the Mexican statutory categories. The general U.S. statutory rate is 30 percent, with an exemption for portfolio interest.

The reduced rates of paragraphs 2, 3 and 4 do not apply to an excess inclusion with respect to a residual Interest in a U.S. Real Estate Mortgage Investment Conduit ("REMIC"), which will be taxed at the rate provided by U.S. domestic law. Point 10(a) of the Protocol is drafted to also permit Mexico to apply its domestic law if it in future develops a product identical to a REMIC. Further, the Protocol provides for consultations by the competent authorities as to the desirability of extending this rule to substantially similar entity or instrument developed in

future by either or both Contracting States.

Paragraph 5 defines the term "interest", as used in the Convention, to include income from debt claims of every kind, as well as income treated as income from money lent by the taxation law of the source State. In particular, income from government securities, income from bonds or debentures, and any premiums or prizes attaching to such securities, bonds or debentures are considered interest. Interest on bank deposits and on loans secured by mortgages is also covered. Point 9 of the Protocol clarifies that this definition does not override any domestic law distinction between debt and equity. The definition does not refer to penalties and fines for late payment. Thus, such amounts will be imposed in accordance with domestic law and may be taxed in at source under Article 23 (Other Income).

Paragraph 6 provides an exception from the rules of paragraphs 1, 2, and 3 in cases where the beneficial owner of the interest, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base situated in that other State and the interest arises in that other State and is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the interest is received, as long as the interest was attributable to the permanent establishment or fixed base when earned.

This paragraph does not affect the exemptions provided in paragraph 4. The interest described in paragraph 4 is exempt from tax at source even if attributable to a permanent establishment or fixed base that the beneficial owner has in the State where the interest arises.

Paragraph 7 provides a source rule. Interest is considered to arise in a Contracting State if paid by a resident of that State (including the State itself). As an exception, interest paid by any person which is borne by a permanent establishment or fixed base in one of the Contracting States is considered to arise in that State. For this purpose, interest is considered to be borne by a permanent establishment or fixed base if it is allocable to taxable income of that permanent establishment or fixed base. If the actual amount of interest on the books of a U.S. branch of a Mexican company exceeds the amount of interest allocated to the branch under Treas. Reg. § 1.882-5, any such interest will not be considered U.S. source interest for purposes of this Article.

Paragraph 8 provides that if, as a result of a special relationship between persons, the interest paid is excessive, Article 11 applies only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the laws of the source State, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend rather than as interest, but the tax would be subject to the rate limitations of paragraphs 2 and 3 of Article 10 (Dividends).

## ARTICLE 11A

## Branch Tax

Article 11A permits the U.S. to impose its branch taxes on the dividend equivalent amount and the excess interest of a Mexican company which derives business profits attributable to a U.S. permanent establishment or which derives income subject to tax on a net basis in the U.S. under Articles 6 (Income from Immovable Property (Real Property)) or 13 (Capital Gains). These branch taxes are imposed under Code section 884. The tax on the dividend equivalent amount is limited to 5%, the same rate that applies to direct investment dividends.

Excess interest is generally the portion of the entire enterprise's interest expense that is allocated to the branch over the amount of interest paid by the branch to third parties. The excess amount is deemed to be paid to the head office, and a tax is applied to the amount of that deemed payment. Excess interest is treated as U.S. source under Article 11 because it is borne by the permanent establishment. The rate of tax is limited to 10 percent, the rate generally applicable to interest payments to residents of the other Contracting State. After five years, the rate drops to 4.9 percent if the excess interest is deemed paid to a bank or insurance company branch, the same rate that will then apply to interest on loans made by banks or insurance companies. The formula for calculating excess interest in paragraph 2 (b) does not require that interest be fully deductible in one year. Rather, interest may be "excess interest," even though not "deductible" in a particular year, if it is "allocable" to the U.S. income under U.S. domestic law rules.

Just as, under Mexico's current system, there is no shareholder level tax on dividends, there also is no comparable Mexican tax on the dividend equivalent amount of branch profits or on excess interest of branches of foreign companies. Nevertheless, this Article is drafted reciprocally. Thus, if in future Mexico should adopt such branch taxes, it may apply them to U.S. companies, subject to the same rate limitations that this Article imposes on the United States. In that event the term "trade or business" in reference to Mexico will have the same meaning that the term "permanent establishment" has under Mexican tax law. (See Point 15(a) of the Protocol.) (Mexico uses the concept of a "permanent establishment" in its domestic law to determine when a foreign resident's income is subject to Mexican tax. The definition of "permanent establishment" for these purposes, contained in Articles 2 and 3 of the Income Tax Law of Mexico, is similar but not identical to the definition for treaty purposes and, where it differs, is generally broader than the meaning for treaty purposes.)

## ARTICLE 12 Royalties

This Article limits the taxation at source by each Contracting State of royalties paid to a resident of the other Contracting State.

Paragraph 1 preserves the residence country's general right to tax its residents on royalties arising in the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Paragraph 2 limits the tax imposed by the source State to not more than 10 percent of the gross amount of royalties beneficially owned by residents of the other State. In the absence of a

treaty, the U.S. rate is 30 percent, and the Mexican rates are 15 percent on literary copyrights and films and drawings and 35 percent on other royalties. The Mexican rate on equipment rentals is 21 percent in general and 5 percent on container rentals. (In this Convention, equipment rentals are treated as giving rise to royalties and container rentals are dealt with in Article 8 (Shipping and Air Transport).)

In applying the assets tax to income covered by this Article, Mexico agrees to credit the amount of income tax that would have been due at the statutory rates, rather than at the reduced treaty rates. The resulting credit, generally of 21 percent of the gross income, is expected to eliminate any asset tax liability in such cases. If no royalty is paid on account of the use of the property, then there would be an asset tax liability because there would be no income from the property to credit.

Paragraph 3 defines the term "royalties", as used in the Convention, to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including films, tapes and other means of reproduction for use in connection with television. The term "copyright" is understood to include the use or right to use computer software programs and sound recordings. Royalties also include payments for the use of, or right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, for information concerning industrial, commercial, or scientific experience, and for the use of or right to use industrial, commercial or scientific, equipment. However, payments for the use of equipment covered by Article 6 (Income from Immovable Property (Real Property)), such as equipment used in agriculture or forestry, are covered by that Article. Payments for the leasing of containers used in international transport and payments for certain leasing of ships and aircraft used in international transport are covered by Article 8 (Shipping and Air Transport). In financial leases, if the interest component is identified separately in the contract, Mexico taxes only the interest component and applies the relevant rate from Article 11 (Interest).

Point 11 of the Protocol clarifies that the reference to "information concerning industrial, commercial or scientific experience" is to be interpreted in accordance with paragraph 12 of the Commentary on Article 12 of the OECD Model, which distinguishes between information as embodied in know-how and the performance of technical services.

The definition of royalties also includes gains from the alienation of any royalty-producing right or property that are contingent on the productivity, use, or disposition of the property; as a consequence, such amounts may be taxed at source in accordance with this Article rather than being exempt from tax at source under Article 13 (Capital Gains).

Paragraph 4 provides an exception to paragraphs 1 and 2 in cases where the beneficial owner of the royalties, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base in that other State and the royalties arise in that other State and are attributable to that permanent establishment or fixed base. In such a case, the royalties are taxable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the royalties are received, as long

as the royalties were attributable to the permanent establishment or fixed base when earned.

Paragraph 5 provides that, if, as a result of a special relationship between persons, the amount paid is excessive, Article 12 applies only to the amount that would have been paid absent such special relationship (i.e., an arm's length royalty payment). Any excess amount of royalties paid remains taxable according to the laws of the source State, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits under the source State's law, such excess amount will be taxed as a dividend rather than as a royalty payment, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraphs 2 and 3 of Article 10 (Dividends).

Paragraph 6 provides a source rule. Royalties are, in the first instance, deemed to arise in a Contracting State if paid by a resident of that State, including the State itself, unless the royalties are borne by a permanent establishment or a fixed base in the other Contracting State, in which case the source is that other State. Royalties in general are considered borne by a permanent establishment or fixed base if deductible in computing the taxable income of that permanent establishment or fixed base. If royalties are neither paid by a resident of either State nor borne by a permanent establishment or fixed base in either State, but they relate to the use of a right or property in one of the Contracting States, the source will be in the State where the right or property is used. For example, if a Mexican resident were to license a patent to a resident of Panama for use in the United States, the royalty paid by the Panamanian licensee to the Mexican owner of the patent would be U.S. source income under this Article, subject to the 10 percent rate provided in paragraph 2.

### ARTICLE 13 Capital Gains

This Article provides rules governing when a Contracting State may tax capital gains derived by a resident of the other Contracting State.

Paragraph 1 provides that each State may tax gains on the alienation of immovable property situated in that State. The Convention does not interfere with the domestic law rules on the taxation of such gains, other than to require non-discriminatory treatment under Article 25 (Non-Discrimination).

Paragraph 2 elaborates on the rule of paragraph 1 by explaining that "immovable property" includes not only such property held directly, but also an interest in a partnership, trust or estate to the extent that its assets consist of real property, shares or comparable interests in a legal person if at least 50 percent by value of the assets of that legal person consist (or consisted) of immovable property, and any other right that confers the use or enjoyment of immovable property. Thus, for example, the sale of time shares for the use of vacation property in a Contracting State could give rise to a gain taxable by that State under this Article. Point 12 of the Protocol confirms that, in the case of the United States, immovable property includes a U.S. real property interest.

Paragraph 3 provides that gain from the alienation of personal property comprising part



of the assets of a permanent establishment or fixed base that a resident of one Contracting State has or had in the other Contracting State may be taxed by the State where the permanent establishment or fixed base is or was located. This rule preserves the U.S. tax imposed by Code section 864(c)(7) with respect to gain from the subsequent disposition of assets that were formerly used in a U.S. trade or business, except that the treaty substitutes a permanent establishment threshold.

Paragraph 4 provides a rule that, together with Point 13 of the Protocol, is similar to the corresponding provision in the U.S.-Spain income tax treaty. It permits Mexico to continue to impose its tax on the gain derived by U.S. residents on the alienation of shares in Mexican companies or other legal entities, but limits that tax to cases where the person disposing of the shares had a direct or indirect participation of at least 25 percent in the capital of the Mexican company or other legal entity at any time during the 12 months preceding the disposition. Point 13 of the Protocol further limits imposition of this tax in certain corporate reorganizations. The tax permitted by paragraph 4 may not be assessed in cases of transfers within a consolidated group when

- (i) both transferor and transferee are residents of the same State,
- (ii) there is an 80 percent or more ownership interest (direct or indirect) between the transferor and transferee or of the transferor and the transferee by another resident company before and after the transfer,
- (iii) the transferee carries over the transferor's basis, and (iv) the transferor receives an equity interest in the transferee or in another company that owns at least 80 percent of the transferee.

In such cases the tax on the gain is deferred until the shares or other property are transferred outside the group. These rules do not perfectly parallel the U.S. rules for tax-free reorganizations. Rather, they establish standards, solely for purposes of the Convention, for limiting tax on inter-company transfers.

The United States will treat gain taxed by Mexico under this paragraph as of Mexican source to the extent necessary to permit a credit for the Mexican tax, subject to the limitations of U.S. law (Code section 904). Thus, if the Mexican tax does not exceed the U.S. tax, there will be a full offset. Under Mexican law, the taxable gain is measured as the difference between

- (1) the sale price of the shares and
- (2) the original cost of the shares, adjusted for inflation, plus reinvested profits, also adjusted for inflation, less any losses.

Any excess of the sale price over that adjusted basis is considered gain attributable to untaxed profits and is subject to Mexican tax.

Paragraph 4 is reciprocal. If the United States were to introduce such a tax, it could be imposed in accordance with the rules of this paragraph.

Paragraph 5 provides that gains derived by an enterprise carried on by a resident of one of the Contracting States from the alienation of ships, aircraft, containers or related equipment used principally in international traffic may be taxed only by that State. This is intended to achieve the same result as the corresponding language in the 1981 U.S. Model. The reference to property

used "principally" in international traffic simply clarifies that an occasional use in domestic traffic does not cause the disposition to fall outside the scope of this provision.

Paragraph 6 confirms that contingent gains, described in paragraph 3 of Article 12, (Royalties), are covered in that Article and not in this one.

Paragraph 7, like the corresponding provision in the 1981 Model, reserves the exclusive right to tax gains with respect to any other property to the State of which the alienator is a resident.

#### ARTICLE 14 Independent Personal Services

This Article deals with income from self-employment services and Article 15 deals with the compensation of employees. Articles 16, 18, 20 and 21 provide exceptions to the general rules of Articles 14 and 15 in the case of personal service income derived by directors of companies (Article 16), entertainers and athletes (Article 18), government employees (Article 20), and students and business apprentices (Article 21). Like the U.S. and OECD Models, the Convention does not provide a separate rule for the remuneration of teachers. The compensation of teachers and researchers is taxable under this Article or Article 15 (Dependent Personal Services), as appropriate.

Income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity in the other Contracting State is exempt from tax in that other State unless one of two conditions is satisfied. The income may be taxed in that other State if the income is for services performed there and is attributable to a fixed base that the individual regularly uses in that other State and in performing the services. Alternatively, if the individual is present in that other State for more than an aggregate of 183 days in twelve consecutive months, that other State may tax the income attributable to the activities performed there, whether or not there is a fixed base. It is understood that the concept of a fixed base is to be interpreted consistently with the concept of a permanent establishment, as defined in Article 5 (Permanent Establishment). Under either the fixed base or 183 day presence test, it is understood that the taxation of income from independent personal services is to be governed by the principles set forth in Article 7 for the taxation of business profits. Thus, for example, it is understood that income may be attributed to a fixed base even after the fixed base has ceased to exist or to personal services in a year after the year in which they were performed. In addition, in accordance with the principles of paragraph 3 of Article 7, the tax base is net of expenses incurred in earning the income.

There is a rebuttable presumption in Mexican law that, when services are paid for by a resident of Mexico and were partly performed in Mexico, the entire payment is for services performed in Mexico. If part of the services were performed outside Mexico, it is the taxpayer's responsibility to so demonstrate.

Paragraph 2 notes that the term "independent personal services" is primarily concerned with professional services. It includes independent scientific, literary, artistic, educational or

teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account where he receives the income and bears the risk of loss arising from the services.

Point 14 of the Protocol further provides that Article 14 also applies to independent services furnished in Mexico by a U.S. company, in which case the income will be taxed as if it were attributable to a permanent establishment in Mexico. In the converse case, the United States will apply Article 7 (Business Profits) directly. However, under Mexican rules, a personal service company is not considered to earn "business" profits, so it is taxed under Article 14. The Protocol confirms that the tax will be imposed on a net basis.

## ARTICLE 15 Dependent Personal Services

This Article deals with the taxation of remuneration derived by a resident of a Contracting State from the performance of personal services as an employee in the other Contracting State.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed only by his State of residence except to the extent that it is derived from an employment exercised in the other Contracting State. Remuneration derived from employment in the other State may also be taxed by that other State, subject to the conditions specified in paragraph 2.

Under paragraph 2, a Contracting State may tax remuneration derived by a resident of the other State from services performed in the first State unless three conditions are satisfied:

- (1) the individual is present in that State for a period or periods not exceeding 183 days in twelve months;
- (2) the remuneration is paid by, or on behalf of, an employer who is not a resident of that Contracting State; and
- (3) the remuneration is not borne as a deductible expense by a permanent establishment or fixed base that the employer has in that State.

The twelve-month period must include the period in which the income was earned. All three conditions must be satisfied for the remuneration to be exempt from tax in the source State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer and deducts such reimbursement, neither condition (2) nor (3), as the case may be, will be considered to have been fulfilled. Conditions (2) and (3) are intended to assure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received.

Unlike the U.S. and OECD Models, this Convention does not provide a special rule for the taxation of members of the crew of international airlines and shipping companies. They are taxable in accordance with the provisions of paragraphs 1 and 2.

ARTICLE 16  
Directors' Fees

This Article provides that a Contracting State may tax the fees paid by a company that is a resident of that State to a resident of the other Contracting State for services as a director or overseer of the company, if the services are performed in the first State or in any third State. The reference to an "overseer" is meant to include persons who are not directors but who oversee, i.e., look out for, the shareholders' interests without engaging in day to day management functions. Mexican corporations frequently hire such persons.

This rule is a compromise between the positions of the OECD Model, which permits the taxation of such fees in accordance with domestic law, and the U.S. Model, which treats such fees as employment income under Articles 14 (Independent Personal Services) or 15 (Dependent Personal Services). In this case, Mexico is permitted to tax such fees paid by a Mexican company to its U.S. resident directors or overseers, provided that the services are performed outside the United States. As a consequence, the director or overseer will have foreign source income against which to credit the Mexican tax. Notwithstanding this Article, the United States will tax directors' fees for personal services rendered by Mexican resident directors of U.S. corporations only to the extent that the services are performed in the United States (and the remuneration is therefore sourced in the United States). Mexico generally taxes such fees whenever the paying company is a resident of Mexico.

ARTICLE 17  
Limitation on Benefits

Article 17 assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries - residents of the other Contracting State who have a substantial presence in, or business nexus with, that State. Absent this Article, if a resident of a third State were to organize a corporation in a Contracting State for the purpose of deriving treaty-benefited income from the other Contracting State, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to any limitations imposed by the domestic law of the source State (e.g., business purpose, substance-over-form, step transaction or conduit principles).

The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State the presence of any one of which will entitle that person to benefits of the Convention in the other Contracting State. Subparagraphs (d) (iii) and (g) of paragraph 1 expand the usual list of such attributes to extend benefits of the Convention to residents of any country that is a party to the North American Free Trade Agreement ("NAFTA"; currently, the parties are the United States, Mexico, and Canada) once that agreement enters into force. Paragraph 2 further provides that benefits may be granted to a person not entitled to benefits under the tests of paragraph 1 if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Point 15 of the Protocol defines certain terms and conditions of the Article.

The first category of residents of a Contracting State eligible for treaty benefits from the other Contracting State consists of individuals. It is unlikely that individuals can be used to derive treaty-benefited income on behalf of a third-country person, because the Articles of the Convention providing such benefits require that the beneficial owner of the income, not just the recipient, be a resident of a Contracting State.

The second category of qualifying residents is comprised of the Contracting States themselves or political subdivisions or local authorities thereof.

The third category consists of businesses that are engaged in the active conduct of a trade or business in the residence State and derive income from the other Contracting State in connection with, or incidental to, that trade or business. For this purpose, the business of making or managing investments is not considered an active business unless carried on by a bank or insurance company as part of its banking or insurance activities. Point 15(a) of the Protocol explains that the term "trade or business," in the case of Mexico, refers to a permanent establishment as defined in Mexico's Income Tax Law. As described in the discussion of Article 11A (Branch Tax), Mexican domestic law uses the term "permanent establishment" in a way that is analogous to the use of the term "trade or business" under U.S. tax law and that differs from the meaning of that term under the Convention.

The fourth category consists of companies whose shares are regularly traded in substantial volume on an officially recognized securities exchange (hereafter referred to as "publicly traded"). Point 15(b) of the Protocol defines "recognized securities exchange". It currently covers U.S. and Mexican exchanges, but permits the competent authorities to agree on additional exchanges. It would be appropriate, for example, to add Canada's exchanges to implement the provisions of part (iii) of subparagraph (d).

Three subcategories of publicly traded corporations are provided in subparagraph (d). Under the first, a company qualifies as a resident entitled to benefits of the Convention if its principal class of shares is publicly traded on a recognized securities exchange in either Mexico or the U.S. Second, it will qualify if, although its own shares are not publicly traded, it is the wholly owned subsidiary (through direct or indirect ownership) of a company that is a resident of the same State and whose shares are so traded. Thus, for example, a Mexican company not publicly traded but wholly owned by a holding company that is a resident of Mexico whose shares are publicly traded on a recognized exchange in the United States or Mexico and is publicly traded, will qualify under subparagraph (d)(ii). The third alternative permits a company that is not publicly traded to qualify if it is more than 50 percent owned, directly or indirectly, by one or more companies that are residents of the United States and/or Mexico and the remainder of its ownership is by publicly traded companies that are residents of any country that is a party to the ("NAFTA") (i.e., currently Canada). Thus, for example, a Mexican company will qualify if it is owned 51 percent by publicly traded U.S. and/or Mexican companies and 49 percent by a publicly traded Canadian company. This alternative does not take effect until the NAFTA is in force. (Protocol, Point 15(d)).

The fifth category covers tax exempt organizations, if more than half of the beneficiaries, members, or participants, if any, are individual residents of either Contracting State or other persons who qualify for the benefits of this Convention under the terms of this Article.

Subparagraphs (f) and (g) establish a sixth category of residents that are entitled to benefits of the Convention if they satisfy one of two alternative two part tests regarding ownership and "base erosion." The rationale for these tests is that, while substantial ownership of the equity of the resident entity by qualifying persons tends to demonstrate an entitlement to benefits of the Convention, it is not sufficient to prevent treaty benefits from inuring substantially to third-country residents. It is also necessary to ensure that the earnings of such entity not be "stripped" out in substantial part to non-qualifying persons, for example by financing the entity largely through third-country debt. In most U.S. Conventions, only one such provision is included. In this case, a second alternative is provided in recognition that one of the expected results of the NAFTA is to encourage joint ventures among residents of the three member countries.

Under the ownership requirement of the first alternative, benefits will be granted to a resident of a Contracting State if more than 50 percent of the beneficial interest in the person (or, in the case of a company, more than 50 percent of each class of its shares) is owned, directly or indirectly, by persons who are themselves entitled to benefits under the tests of paragraph 1 other than subparagraph (c). Subparagraph (c) refers to active businesses and the "safe harbor" it provides is meant to be limited to income earned by the active trade or business, not to cover other income earned by a subsidiary of such a business. In addition, the "base erosion" standard must be satisfied. Less than 50 percent of the person's gross income may be used, directly or indirectly, to make deductible payments, including interest and royalties, to persons not eligible for benefits under the tests of paragraph 1 other than subparagraph (c)). For this purpose gross income means gross receipts or, in the case of a manufacturing or producing activity, gross receipts less the direct costs of labor and materials. (See paragraph 15 (c) of the Protocol.)

Alternatively, once NAFTA is in force the benefits of the reduced rates on dividends, interest, branch profits and excess interest, and royalties provided, respectively, in Articles 10, 11, 11A, and 12, will also be available to an entity which is

- (i) more than 30 percent beneficially owned by residents of either Mexico or the United States who are themselves entitled to benefits under the tests of paragraph 1 (other than those who qualify only under the active business test of subparagraph (c)) and
- (ii) more than 60 percent beneficially owned by residents of NAFTA member states, provided that,
- iii) less than 70 percent of the gross income of such person is used to meet liabilities to persons other than those described under (i) above and less than 40 percent of the gross income is used to meet liabilities to persons other than those described under (i) or (ii) above.

It is understood that the definition of "gross income in paragraph 15(c) of the Protocol applies for this provision also. For this purpose, ownership by residents of a NAFTA State other than the United States and Mexico (currently Canada) will be taken into account only if

- (i) that other NAFTA State has a comprehensive income tax treaty with the country of source of the dividend, interest, branch profit or excess interest, or royalty;
- (ii) such treaty provides for a rate of tax no less favorable than that

provided by this Convention with respect to the same item of income; and  
(iii) the resident of the NAFTA State qualifies for the benefits of that treaty under its terms (e.g., its limitation on benefits provision).

For example, assume a Mexican company is beneficially owned 40 percent by residents of Mexico and 60 percent by residents of Canada, and meets the base erosion test of this provision. If such a company derives dividends from the United States, it will not be entitled to the benefits of Article 10 of this Convention, because the current U.S.- Canada treaty provides for higher rates on both portfolio and direct investment dividends. If, however, that company derives interest on credit sales of equipment to unrelated U.S. persons, or royalties of any kind from U.S. sources, it will be entitled to the benefits of this treaty, because it could have obtained at least as favorable a tax rate under the U.S.-Canada income tax treaty. As in the case of subparagraph (d), concerning the publicly traded test, this partial "derivative" benefits rule of subparagraph (g) only takes effect when the NAFTA is in force. (Protocol, Point 15(d).)

It is intended that the provisions of paragraph 1 will be self-executing. Unlike the provisions of paragraph 2, discussed below, claiming benefits under this paragraph does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted a particular subparagraph and is not entitled to the benefits claimed.

Paragraph 2 permits the competent authority of the State in which income arises to grant treaty benefits in additional cases, even if they do not meet the safe harbor standards of paragraph 1 (or the information is not available to make such a determination). This discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended treaty benefits.

## ARTICLE 18 Artistes and Athletes

This Article deals with the taxation of remuneration derived by artistes (i.e., performing artists and entertainers) and athletes who are residents of a Contracting State from the performance of their services as such in the other Contracting State. As explained in Point 16 of the Protocol, such remuneration includes remuneration for personal activities relating to the individual's reputation as an entertainer or athlete, such as compensation for services performed in personal endorsements of commercial products. This Article does not apply to the remuneration of other persons involved in a performance or athletic event, such as technicians, managers, or coaches.

Paragraph 1 overrides the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services) to provide that an individual covered by this Article who would be exempt from tax in the State where the services are performed under the terms of Articles 14 or 15 may, nevertheless, be taxed in that State if the gross remuneration, including reimbursed expenses, exceeds U.S. \$3,000 or its equivalent in Mexican currency during the

taxable year. Anyone receiving more than the \$3,000 gross income amount is subject to tax on the full amount, in accordance with the provisions of domestic law of the source country. Since it is often difficult to determine the annual amount of remuneration until the year has ended, the paragraph explicitly authorizes a tentative withholding of tax. Individuals entitled to exemption under this paragraph may claim a refund, and those subject to tax may apply the withholding against their final tax liability.

This represents a compromise between the position of the OECD and U.N. Models, which provide for immediate taxation at source of entertainers and athletes, and the 1981 U.S. Model, which seeks to preserve a threshold of gross income below which modestly paid entertainers and athletes will be treated the same as persons performing other services covered solely under Articles 14 or 15. In this case, the threshold is lower than in the 1981 U.S. Model. However, paragraph 3 of this Article provides a special exemption at source of the remuneration of entertainers or athletes whose visit is substantially supported by public funds of their State of residence or a political subdivision or local authority thereof. It is understood that the competent authorities may consult as to which visits meet this standard.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance accrues to a person other than the performer. For example, an entertainer performing as an "employee" of a closely held company not having a permanent establishment in the source State may be able to avoid tax at source by taking a salary below the threshold amount and diverting the remainder to a company of which he is the sole or principal owner. Paragraph 2 provides that, when an entertainer or athlete retains a beneficial interest in income that derives from his personal activities but accrues to another person, that other person may be subject to taxation on such income by the State of source, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services). For purposes of this paragraph, an entertainer or athlete is considered to retain a beneficial interest in performance income accruing to another person unless the individual can establish that neither he nor any person related to him participates, directly or indirectly, profits of such other person in any manner.

As mentioned above, paragraph 3 provides an independent exemption from taxation at source of the remuneration of entertainers and athletes whose visits are substantially supported by public funds of their country of residence or a political subdivision or local authority thereof.

## ARTICLE 19

### Pensions, Annuities, Alimony, and Child Support

Except as provided in Article 20 (Government Service), pensions and similar remuneration in consideration of past employment may be taxed only by the Contracting State of which the beneficial owner is, at the time of receipt, a resident. It is understood that the services need not have been performed by the beneficial owner of the pension; for example, a pension paid to a surviving spouse who is a resident of Mexico would be exempt from tax by the United States on the same basis as if the right to the pension had been earned directly by the surviving spouse. A pension may be paid in installments or in a lump sum.



In contrast, except as provided in Article 20 (Government Service), social security benefits and other public pensions paid by a Contracting State may be taxed only in the paying State. This rule is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Mexican social security benefit will be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen (whether resident in the United States, Mexico, or a third country).

Annuities derived and beneficially owned by an individual resident of a Contracting State may be taxed only by that State. This provision is intended to cover traditional annuity arrangements which provide retirement benefits to individuals. It is not intended to exempt from tax at source income from arrangements that are a variation of traditional annuities and that accrues to corporations or other legal persons.

Alimony and child support payments made by a resident of one Contracting State to a resident of the in the other State may be taxed only in the State of which the payor is a resident. This rule is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a U.S. resident deriving alimony or child support payments from a resident of Mexico will be exempt from U.S. tax on such payments. Under U.S. law, child support payments are not taxable to the recipient (and not deductible to the payer), while alimony payments are taxable to the recipient (and deductible by the payer). Under Mexican law, neither alimony nor child support payments are deductible to the payer or taxable to the recipient. Thus, under the Convention, child support payments by a resident of one Contracting State to a resident of the other State will be taxable to the payer (in the form of no deduction) and exempt from tax to the owner in both countries. Alimony paid by a resident of Mexico to a resident of the United States will be taxed in Mexico (again by disallowing a deduction to the payer). In the converse case, alimony that is deductible by the U.S. payer under U.S. law will be subject to U.S. tax to the recipient, and exempt from tax in Mexico.

## ARTICLE 20 Government Service

This Article follows the corresponding provisions of the OECD Model.

Paragraph 1 provides that payments by a Contracting State or political subdivision or local authority thereof to compensate an individual for performing governmental services may be taxed only in that State, provided that the individual is not a resident and national of the other Contracting State and was not a resident of the other Contracting State prior to performing the services. Under subparagraph (b), if the individual is either a resident and national of the other State or a locally hired resident of that other State, the compensation may be taxed only by that other State. It is understood, however, that the rule of subparagraph (b) does not apply to the spouse of a government employee described in paragraph 1 if the spouse becomes employed by the sending State after taking up residence in the host State.

Paragraph 2 provides rules for the taxation of pensions paid from public funds in respect of governmental services. Such pensions may be taxed only by the paying State unless the individual recipient is a resident and citizen of the other State, in which case only the other (residence) State may tax the pension. This rule does not apply to social security benefits and

other public pensions which are not in respect of services rendered to the paying government or a political Subdivision or local authority thereof; such amounts may be taxed only by the paying State under Article 19. However, this rule does apply to social security payments to U.S. Government employees for whom the social security system is the retirement plan related to their government service; i.e., in the unusual case where an individual who is a citizen and resident of Mexico derives a pension for U.S. Government employment that is paid under the social security system, only Mexico may tax that pension. This could happen, for example, if a locally hired driver for the U.S. Embassy in Mexico City were to retire in Mexico and receive U.S. social security benefits.

The rules of paragraphs 1 and 2 are an exception to the saving clause of paragraph 3 of Article 1 (General Scope) for individuals who are neither citizens nor permanent residents of the State where the services are performed. Thus, for example, payments by Mexico to its employees at the Mexican Embassy in Washington are exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by Mexico, even if they would otherwise be considered U.S. residents for tax purposes. (Under the 1984 modification to the definition of a U.S. resident in Code section 7701, this exception to the saving clause is of less relevance, since time spent in the United States as a foreign government employee does not count in applying the physical presence test of residence.)

Paragraph 3 provides that remuneration and pensions paid in respect of services performed for a government in the conduct of a business are covered by Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 18 (Artistes and Athletes), or 19 (Pensions, Annuities, Alimony, and Child Support), as appropriate. It is understood by both sides that this Article applies only to remuneration and pensions in respect of services rendered in the discharge of functions of a governmental nature.

## ARTICLE 21

### Students

This Article deals with visiting students and business apprentices and corresponds to the provision of the OECD model. An individual who is a resident of one of the Contracting States and who visits the other Contracting State solely for the purpose of acquiring education or training, will not be taxed by that other State on amounts received from abroad to cover his expenses. The reference to "solely" for the purpose of education or training is meant to describe individuals participating in a full-time program of study or training. It is not intended to exclude full-time students who, in accordance with their visas, may hold part-time jobs. The exemption, however, does not extend to any amounts received as compensation for services rendered, which are covered under Article 14 (Independent Personal Services) or Article 15 (Dependent Personal Services). The exemption also does not apply to any grant provided from within the host State, which is taxable in accordance with the domestic law of that State.

This Article is an exception to the saving clause of paragraph 3 of Article 1 (General Scope) for individuals who are not citizens of the United States or green card holders but are residents of the United States under the physical presence tests of Code section 7701(b).

## ARTICLE 22 Exempt Organizations

This Article provides for reciprocal recognition of tax-exempt, charitable organizations resident in a Contracting State and qualifying for benefits of the Convention under Article 17, paragraph 1(e) or 2. The effect of the reciprocal recognition is to exempt from source taxation income earned by a charitable organization resident in the other Contracting State and to permit deductions for cross-border charitable donations. In addition, the U.S. will recognize qualifying Mexican charities as "public charities." Thus, for example, a contribution to those charities by a U.S. private foundation will not constitute a "taxable expenditure" under section 4945 of the Code; as a result, the U.S. private foundation will not be required to exercise so-called "expenditure responsibilities" with respect to such contributions.

The provisions of this Article are exceptions to the saving clause of paragraph 3 of Article 1 (General Scope) in that they call for certain treatment by a Contracting State of its own citizens or residents. Thus, both States are required, even when domestic law would not do so, to permit a deduction to their citizens or residents for contributions to the Other State's exempt organizations that are recognized as charitable under the Convention.

The provisions of Article 22 were considered a desirable way to encourage contributions by U.S. residents to small Mexican charities that would have difficulty in organizing a U.S. entity through which contributions could be directed, or in satisfying the administrative requirements for recognition as a foreign corporation eligible for treatment as a "public charity" in the United States. Article 22 also enables taxpayers living and operating at the border to support organizations across the border from which they derive benefits. The physical, proximity of Mexico and the United States provides a unique circumstance for the reciprocal recognition of tax-exempt organizations.

Paragraph 1 provides that a tax-exempt organization resident in a Contracting State that is operated exclusively for religious, scientific, literary, educational, or other charitable purposes will be exempt from income tax in the other Contracting State on items of income that would be exempt from tax in the other Contracting State, under its laws, if the organization were recognized by that other State as being entitled to exemption from tax. Under paragraph (a) of Point 17 of the Protocol, the competent authorities of each Contracting State will accept the certification of the other State as to the status of a resident of that other State as an organization exempt from tax.

Paragraph 2 sets the standards for deductibility of contributions by a resident of the U.S. to a charitable organization resident in Mexico. It provides that if the Contracting States agree that Mexico's standards for organizations authorized to receive deductible contributions are essentially equivalent to the United States' standards for status as a public charity, then an organization that Mexico determines has met its standards shall be treated as a public charity in the United States for two purposes:

- (1) receiving grants from United States private foundations and
- (2) receiving deductible charitable contributions from residents or citizens of the United

States.

In 1992, Mexico adopted standards for the tax-exemption of charitable organizations that are modeled on United States tax laws governing exempt organizations. Paragraph (b) of Point 17 of the Protocol reflects that the United States has examined Mexico's new standards for organizations authorized to receive deductible contributions, contained in Article 70-B of the Mexican Income Tax Law, and determined that those standards are essentially equivalent to the United States standards for public charities. Thus, although paragraph 2 is not itself self-executing, the Protocol brings its provisions into effect immediately upon entry into force of the Convention. However, the United States competent authority retains the right, after consultation with the competent authority of Mexico, to deny the benefits of paragraph 2 to an organization resident in Mexico even though the tax authorities of Mexico have found that the organization qualifies under Article 70-B, if the circumstances of a case or cases warrant. Mexican and U.S. tax administration also expect to continue to cooperate to provide common guidance for taxpayers and common enforcement standards.

The deductibility of a contribution by a U.S. taxpayer to a Mexican charitable organization is subject to the limitations under U.S. law applicable to contributions to U.S. public charities. These limitations include, in particular, the percentage and other limitations under Code section 170 and the overall limitation on itemized deductions under Code section 68. The amount of the deduction for a U.S. taxpayer's contributions to Mexican charities is limited to the U.S. taxpayer's Mexican source income, as determined under the Convention, and the general limitations under U.S. law (for example, the percentage limitations of section 170) are applied to this amount. Any amounts, treated as charitable contributions under this paragraph that are in excess of the amounts deductible in a taxable year may be carried over and deducted in subsequent taxable years subject to the limitations of this paragraph.

Paragraph b) of Point 17 of the Protocol also reflects that Mexico has reviewed the U.S. standards for publicly supported organizations under sections 509(a)(1) and (2) of the Code and determined that they are essentially equivalent to Mexico's standards for organizations authorized to receive deductible contributions. This conclusion does not, however, pertain to religious organizations, which, although eligible for charitable status in the U.S., are not entitled to receive deductible contributions under Mexican law.

Paragraph 3 provides rules for purposes of Mexican taxation with respect to the deductibility of gifts to a U.S. resident organization by a resident of Mexico. The rules of paragraph 3 parallel the rules of paragraph 2.

Paragraph 4 provides an exemption from U.S. excise taxes on private foundations in the case of religious, scientific, literary, educational or other charitable organization that is a resident of Mexico and which has received substantially all its support from persons other than citizens or residents of the United States. These excise taxes are generally imposed by Chapter 42 of subtitle D of the Code. To claim benefits under this paragraph a Mexican non-profit organization must also meet the requirements of paragraph 1(e) or 2 of Article 17 (Limitation on Benefits).

## Other Income

This Article provides the rules for the taxation of items of income derived by a resident of a Contracting State from sources in the other Contracting State that are not dealt with in the other articles of the Convention, such as lottery winnings, punitive damages, cancellation of indebtedness income, [income from financial products such as swaps, and forward and futures contracts]. Such income may be taxed in the State in which it arises. Income arising in a third State is not dealt with in this Article. These domestic laws apply, unless the income constitutes business profits of a permanent establishment or fixed base of a resident of the other Contracting State, in which case Article 7 (Business Profits) or 14 (Independent Personal Services) applies.

## Article 24 Relief from Double Taxation

In this Article each Contracting State undertakes to relieve double taxation by granting a credit against its income tax for the income tax paid to the other country. It also provides a credit to a parent company (one owning at least 10 percent of the voting stock of a company which is a resident of the other State) for tax "indirectly" paid to that other State on the portion of the profits distributed as dividends to its parent company. The credit is subject to the limitations of domestic law, such as Code section 904 in the case of the United States.

For purposes of paragraph 1, the taxes referred to in paragraphs 3 and 4 of Article 2 (Taxes Covered) shall be treated as income taxes, and therefore eligible for the credit. However, Mexico's tax on distributed profits is considered to be an income tax only to the extent that it is imposed on previously untaxed earnings and profits as calculated under U.S. tax accounting rules. The distributed profits tax is imposed by Mexico to ensure that the full tax has been paid at the corporate level, since no further tax is collected from the shareholder on profits distributed as dividends. The tax is imposed on the corporation, at the regular corporate rate, on the amount of a distribution that exceeds the corporate income previously subject to tax. By agreeing to credit the tax only to the extent it is imposed on earnings and profits as calculated for U.S. purposes, the U.S. seeks to ensure that creditability is consistent with prevailing U.S. principles, which only permit credits for those foreign taxes that reach net income. Because Mexico's tax on distributed profits is imposed on the corporation, not the shareholder, it is creditable as an "indirect" or "deemed paid" tax under the principles of Code section 902. The amount of the distributed profits tax deemed paid and credited in accordance with this Article will be treated as a dividend for purposes of the Code section 78 "gross-up."

Paragraph 2 provides that, to the extent that the provisions of the Convention require Mexico to exempt from tax income derived by its residents, it will use the exemption rather than the credit method of avoiding double taxation. In such cases Mexico may take into account the residents' entire income, including the exempt amount, in calculating the applicable tax rate to be applied to the taxable portion. Thus, the exemption is calculated at the average rate of tax on total income, rather than at the rate applicable to the lowest or highest applicable bracket of income. This approach is Sometimes referred to as "exemption with progression" and is commonly used by countries that avoid double taxation by exempting foreign source income.

Paragraph 3 provides that, for purposes of this Article, income which may be taxed in a Contracting State under the terms of this Convention will be considered to have its source in that State. However, domestic law source rules that apply for purposes of limiting the foreign tax credit will govern if they differ from the rules resulting from the treaty source rules. This permits the United States to apply the anti-abuse rules of Code section 904(g), for example. An exception is made in the case of capital gains; to the extent that gains that would be U.S. source under the Code are resourced as Mexican source income under the Convention, the Convention source rule prevails, subject to the separate basket requirement of Code section 904(g)(1). Paragraph 4 of Article 13 (Capital Gains) resources domestic source capital gains as foreign source to the extent necessary to avoid double taxation under the taxing rules of that paragraph.

Paragraph 4 provides a special rule to avoid double taxation of residents of Mexico who are U.S. citizens. The United States, in such cases, is entitled to tax under its statutory rules, without respect to the treaty limitations that apply to residents of Mexico who are not U.S. citizens. In such cases, the United States agrees that Mexico, in imposing its tax based on residence, is required to credit only the U.S. tax that would have applied to the U.S. source income of a resident of Mexico who is not a U.S. citizen. The United States agrees to credit Mexico's tax (net of that credit) against its residual tax imposed on the basis of citizenship, and to resource enough U.S. source income as Mexican source to prevent double taxation of that income. For example, assume a U.S. citizen resident in Mexico has \$700 of Mexican income and \$300 of U.S. dividends. Assume that the U.S. tax rate is 30 percent and the Mexican tax rate is 35 percent. The U.S. tax is 300 less a credit of 210 (70% of 300), a net tax of 90. The Mexican tax is 350, less a credit for U.S. tax at the 15 percent treaty rate on dividends, or 45, a net tax of 305. The total tax will be 390, higher than either country's tax, indicating some double taxation of the U.S. dividends. To remove that double taxation, the U.S. will allow an additional credit for the Mexican tax, but the additional credit may not reduce the U.S. tax after credit below 45 (15% of 300). Thus, the additional credit in this case is 45. The total tax is reduced to 350, the higher of the two countries' taxes. (A similar example can be constructed for cases where there is income from taxes in the other countries result in excess limitation in Mexico, that may absorb some or all of the additional U.S. tax and reduce or eliminate the need for the additional U.S. credit.)

## ARTICLE 25 Non-Discrimination

This Article assures non-discriminatory taxation of similarly situated persons. Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State which are different from or more burdensome than the taxes and connected requirements imposed upon a national of that other State in the same circumstances. A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same tax treatment in Mexico as a Mexican national resident in that third country. It is acknowledged; however, that a national of a Contracting State who is subject to taxation of his worldwide income in that State and a national of the other State who is not subject to taxation of his worldwide income in the first-mentioned State are not in the same circumstances. Thus, the United States is not required to provide equal

income tax treatment of a U.S. citizen resident in a third country and a Mexican citizen resident in the same third country.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State carrying on the same activities. Neither Contracting State is required to provide to residents of the other Contracting State the same personal exemptions and deductions that it provides to its own residents to take account of marital status or family responsibilities.

Section 1446 of the Code imposes on any partnership with income which is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a Mexican resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraphs 1 and 2 of the Article. No distinction is made between U.S. and Mexican partnerships. The requirement to withhold on the Mexican and not the U.S. partner's share is not discriminatory taxation, but, like other withholding on non-resident aliens, is a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 3 specifies that no provision of the Article will prevent either Contracting State from imposing the branch taxes described in Article 11A (Branch Tax). Nor does the Article prevent Mexico from denying a deduction for presumed expenses related to income from real property to an individual resident of the United States who elects to deduct actual expenses in computing the Mexican tax on such income, as provided for in paragraph 5 of Article 6 (Income from Immovable Property (Real Property)).

Paragraph 4 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided in cases where the payment is excessive, as described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 5 of Article 12 (Royalties). The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expense.

Paragraph 5 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State but that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements that it imposes on similar resident

companies owned by residents of the first-mentioned State or of a third State. It is understood that the U.S. rules that impose tax on a liquidating distribution of a U.S. subsidiary of a Mexican company and the rule restricting the use of small business corporations to U.S. citizens and resident alien shareholders do not violate the provisions of this Article.

Paragraph 6 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), the non-discrimination protection provided by this Article applies to taxes of every kind and description imposed at all levels of government. Customs duties are not considered taxes for this purpose.

The saving clause of paragraph 3 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 4(a) of Article 1. Thus, for example, a U.S. citizen who is resident in Mexico may claim benefits in the United States under this Article.

## ARTICLE 26 Mutual Agreement Procedure

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention.

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States will result for him in taxation which is not in accordance with the Convention, he may present his case to the competent authority of his State of residence or citizenship. It is not necessary for a person first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a unilateral solution, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. However, the case must be brought to the attention of the competent authority of the other State within four and a half years from the due date or the date of filing of the return in that other State, whichever is later. This time limit was introduced to accommodate Mexico's five year limit in which to exercise its audit powers. In order to keep open a case beyond that time, Mexico must be notified in time to have initiated an audit within five years of the later of the due date or the filing date. The treaty ensures that Mexico will be given at least six months advance notice before expiration of the five year period. If a case is brought within that time period and an agreement is reached by the competent authorities, the agreement will be implemented, and any agreed refund made, within 10 years from the later of the due date of filing of the return in that other State, or the time within which the statute of limitations remains open within that other State for applying such treaty agreements. Thus, if domestic law, either currently or in future, permits holding the statute open longer than ten years, the taxpayer will be granted relief within that longer period. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.



Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. Mexico does not wish to include in this paragraph the list of examples found in the U.S. model of the kinds of matters about which the competent authorities may reach agreement. Mexico thought that some of those examples, such as the ability to adjust dollar amounts for inflation or to vary domestic penalties in international cases, would exceed the authority of its competent authority. Nevertheless, it is understood that the competent authorities will attempt to resolve difficulties or doubts about implementing the Convention to the maximum extent permitted.

Paragraph 4 authorizes the competent authorities to communicate with each other directly for these purposes. It is not necessary to communicate through diplomatic channels.

Paragraph 5 provides for an arbitration procedure, to be implemented subsequently by an exchange of diplomatic notes. Point 18 of the accompanying Protocol provides that the competent authorities will consult after the Convention has been in force for three years to decide whether it is appropriate to exchange the notes. One of the key factors for the U.S. competent authority in making that decision will be the U.S. experience under the arbitration provision of the U.S.-Germany treaty, that entered into force in 1991 and contains the first arbitration provision of any U.S. income tax treaty. Subparagraph (b) of Point 18 of the Protocol provides rules to be followed in the eventual implementation of the arbitration procedure. The competent authorities may supplement and/or modify those provisions, but must conform to their general principles.

This Article represents another exception to the saving clause of paragraph 3 of Article 1; the benefits of this Article are thus available to residents of both Contracting States. (See paragraph 4(a) of Article 1 (General Scope).)

## ARTICLE 27 Exchange of Information

This Article typically provides for the exchange of tax information between the competent authorities of the Contracting States. However, in this case such exchanges of information are authorized in the Tax Information Exchange Agreement ("TIEA") between the U.S. and Mexico that was signed on November 9, 1989 and is currently in effect. The terms of that Agreement will apply for purposes of this Convention also.

If for any reason the TIEA should be terminated, paragraph 2 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Convention or for administering and enforcing the domestic laws of the Contracting States referred to in Article 2 (Taxes Covered), as long as the taxation under those domestic laws is not contrary to the Convention. Point 19 of the Protocol further provides that, in that case, the Contracting States shall endeavor to promptly conclude a Protocol governing the exchange of information.

The information exchange is not restricted by Article 1 (General Scope). This means that

information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Mexico that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Any information received in accordance with this Article will be treated as secret, subject to the same disclosure constraints that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by these persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

This Article applies to all national level taxes. Thus, for example, information relating to an estate subject to national level tax or to a national tax on sales or assets could be exchanged for purposes of implementing the Convention or the domestic income tax laws, even if the transaction in question was purely domestic.

## ARTICLE 28 Diplomatic Agents and Consular Officers

This Article confirms that any fiscal privileges to which diplomatic agents or consular officers are entitled under the general provisions of international law or under special agreements will apply notwithstanding any provisions of this Convention. This provision also applies to residents of both Contracting States, provided that they are not citizens of the other State and, if the United States is the other State, are not green card holders. (See paragraph 4(b) of Article 1 (General Scope).)

## ARTICLE 29 Entry into Force

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides that each State will notify the other when its constitutional requirements for the entry into force of the Convention have been completed. The Convention will enter into force on the date of the later of such notifications.

The effective date of the provisions of the Convention concerning taxes on dividends, interest, and royalties imposed in accordance with Articles 10, 11, or 12, depend on whether the Convention enters into force during the first or second half of the calendar year. If it enters into

force during the first six months, the effective date of those provisions is with respect to amounts paid or credited on or after the first day of the second month after the entry into force. If the Convention enters into force later than June 30 of any calendar year, the effective date of those provisions is with respect to amounts paid or credited on or after the first day of the following January.

With respect to all other taxes, the provisions of the Convention will take effect for taxable periods beginning on or after the first of January of the year following the year in which the Convention enters into force.

Once the provisions of this Convention take effect, as provided in paragraph 2 (b), the provisions of the exchange of notes of August 7, 1989 on reciprocal exemption of income from the international operation of ships or aircraft shall cease to apply. It was Mexico's preference not to have two outstanding agreements on the same subject matter, and to rely on the treaty provisions once they are in effect.

### ARTICLE 30 Termination

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. The Convention may be terminated at any time after 5 years from the date of its entry into force, provided that written notice has been given through diplomatic channels at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest and royalties paid or credited on or after the first day of the second month following the six month period and with respect to other taxes for taxable periods beginning on or after the first of January following the six month period. Thus, for example, if notice of termination is given after June 30 of a given year, the termination will not generally be effective as of the following January 1, since the notice period must last for at least six months.

Point 30 of the Protocol relates to unilateral termination of the Convention by a Contracting State before the expiration of the five year minimum period provided for in paragraph 1 of Article 30. This provision was included at the request of Mexico to address the possibility of future U.S. legislative provisions overriding one or more treaty provisions. If that occurs in either Contracting State, and if the effect is to significantly limit a benefit provided by the Convention, the other State may request consultations with a view to modifying the Convention to restore the balance of benefits. The first State shall accede to such request by beginning consultations within three months of the request. If the States are unable to agree on how to modify the Convention to restore the balance of benefits, the affected State may terminate the Convention in accordance with Article 30 even if it has not been in force for five years.

Neither this provision nor Article 30 prevents the Contracting States from entering into a new bilateral agreement that supersedes, amends, or terminates provisions of the Convention either prior to the expiration of the five year period or without the six month notification period.

## PROTOCOL

The provisions of the Protocol are an integral part of the Convention. Each has been described in the discussion of the Article to which it refers.

### PROTOCOL 1

TREASURY DEPARTMENT  
TECHNICAL EXPLANATION OF THE ADDITIONAL PROTOCOL  
SIGNED AT MEXICO CITY, ON SEPTEMBER 8, 1994 AND  
MODIFYING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED  
STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES  
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION  
OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME  
SIGNED AT WASHINGTON, D.C., ON SEPTEMBER 18, 1992

### INTRODUCTION

This is a technical explanation of the Additional Protocol, signed at Mexico City on September 8, 1994 ("the Protocol") that Modifies the Convention between the United States of America and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992 ("the Convention").

The Technical Explanation is an official guide to the Protocol. It reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol.

### ARTICLE I

Article 1 of the proposed Protocol replaces the text of Article 27 (Exchange of Information) of the Convention. Under the new text of paragraph 1 of Article 27, the Competent Authorities are authorized to exchange information with respect to any tax covered by, and in accordance with, the provisions of any agreement between the Contracting States for the exchange of information with respect to taxes. The prior text referred to a particular agreement -- the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes signed on November 9, 1989 ("the TIEA"). The effect of the new text is to broaden the reference, authorizing information exchange under the TIEA, under a revised version of the existing agreement, or under any new agreement or agreements.

The broadening of the authorization under paragraph 1 of Article 27 will have an immediate effect as follows. Under a protocol to the TIEA, which is attached as Appendix I, information exchange under the TIEA will apply to taxes imposed by a state, municipality, or other political subdivision or local authority of a Contracting State. However, this agreement

shall not apply to taxes imposed by a possession of a Contracting State. This change to the TIEA will mean that information exchange with Mexico can be used to administer and enforce these sub-federal taxes. The Treasury Technical Explanation to the TIEA protocol is attached as Appendix II.

Under the new text of paragraph 2 of Article 27, information will be exchanged under the provisions of that paragraph in the event there is no agreement in effect between the Contracting States for the exchange of information with respect to taxes. Thus, if the TIEA is terminated and replaced by another information exchange agreement, information will be exchanged under the provisions of that other agreement rather than under the provisions of paragraph 2.

Under the new text of paragraph 3 of Article 27, information exchange under Article 27 will apply to all taxes imposed by a Contracting State, including taxes imposed by a state, municipality, or other political subdivision or local authority thereof. As the possessions are not covered by the convention, this change will not involve taxes imposed by possessions. Under the prior text of paragraph 3, information exchange was limited to all federal taxes.

The proposed Protocol does not contain a provision concerning the relationship of the Convention to other international agreements, including the General Agreement on Trade in Services (GATS). Such a provision is not necessary.

Article XXII (3) of GATS provides that a Member of the World Trade Organization may not invoke the obligation of national treatment under Article XVII of GATS with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In the case of a dispute between Members as to whether a measure falls within the scope of such an agreement between them, Article XXII (3), footnote 11, of GATS provides that, with respect to agreements on the avoidance of double taxation which exist on the date of entry into force of the WTO Agreement, the dispute may be brought before the Council for Trade in Services only with the consent of both parties to the agreement-on double taxation.

Both Parties agree that a protocol to a convention that is grandfathered under Article XXII (3), footnote 11, of the GATS is also grandfathered. Further, without regard to the grandfather provision, it is clear under the GATS and its interpretative documents that neither national treatment nor most-favored-nation obligations of GATS extend to mutual administrative or judicial assistance.

## ARTICLE II

Article II provides the requirements for entry into force of the proposed Protocol, which are that the Contracting States will notify each other when their respective statutory and legal requirements for the entry into force of this protocol have been satisfied. The protocol will enter into force when the later of the two notifications is received.

## ARTICLE III

Article III provides that the proposed Protocol shall remain in force-as long as the Convention and Protocol of September 18, 1992, remain in force.

PROTOCOL II (APPENDIX II)  
May 16, 1995

TREASURY DEPARTMENT  
TECHNICAL EXPLANATION OF THE PROTOCOL  
SIGNED AT MEXICO CITY ON SEPTEMBER 8, 1994  
AMENDING THE AGREEMENT BETWEEN THE UNITED STATES OF AMERICA  
AND THE UNITED MEXICAN STATES  
FOR THE EXCHANGE OF INFORMATION WITH RESPECT TO TAXES

INTRODUCTION

This is a technical explanation of the Protocol to the Agreement between the United States and the United Mexican States for the Exchange of Information With Respect to Taxes signed on November 9, 1989 ("the Protocol"). References are made to the Agreement ("the TIEA") and to the Convention between the United States of America and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992 ("the Convention").

The Technical Explanation is an official guide to the Protocol. It reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol.

PARAGRAPH 1

Paragraph 1 of the proposed Protocol amends the text of paragraph 4 of Article 2 (Taxes Covered), of the TIEA. Under the amended text of paragraph 1, the TIEA applies to taxes imposed by a state, municipality, or other political subdivision or local authority of a Contracting State, but not to taxes imposed by a possession of a Contracting State. The prior text provided that the TIEA shall not apply to taxes imposed by states, municipalities or other political subdivisions, or possessions of a Contracting State.

It is contemplated that information exchange under the TIEA as amended also will be the basis for exchange of information under the Convention. Article 27 (Exchange of Information) of the Convention currently requires exchange of information to take place in accordance with the TIEA unless the TIEA has been terminated. A protocol to the Convention is proposed to eliminate the cross-reference in Article 27 to the TIEA and replace it with a reference to exchange of information under any agreement between the Contracting States for exchange of information with respect to taxes. The prior text of the Convention authorized the exchange of information under a particular agreement -- the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes signed on November 9, 1989 ("the TIEA"). The effect of the proposed protocol to the

Convention is to broaden the authorization for exchanging information under the terms of an agreement between the Contracting States, extending it beyond the TIEA in its current form to an amended version of the TIEA or to any new agreement or agreements.

The competent authorities under the TIEA will develop procedures and understandings to ensure the effective and efficient administration of the exchange of information for sub-federal tax purposes. Such competent authorities will also meet periodically to review the administration of the exchange of information under this proposed Protocol, as they currently do in the administration of the TIEA.

## PARAGRAPH 2

Paragraph 2 of the proposed Protocol amends paragraph 4(b) of Article 4 (Exchange of Information) of the TIEA. Paragraph 4(b) of Article 4 of the TIEA prescribes the statutory provisions of a State that are to be utilized by one State in obtaining certain financial information at the request of the other State.

The current text of paragraph 4(b) provides that, if the United States is requested to obtain the types of information covered by section 3402 of the Right of Financial Privacy Act of 1978 (12 USCA 3402) as in effect at the time of signing of this agreement, it shall obtain the requested information pursuant to that provision. In the case of the United States, 12 USC §3413(c) of the Bank Secrecy Act permits the disclosure of information pursuant to procedures authorized by Title 26 (Internal Revenue Code).

The current text of paragraph 4(b) also provides that, if Mexico is requested to obtain the types of information covered by Article 93 of the Regulatory Law of Banking and Credit 'Public Service as in effect at the time of signing this agreement, it shall obtain the requested information pursuant to that provision.

Paragraph 4(b) also provides that laws or practices of the requested State do not prevent or otherwise affect the authority of the competent authority of the requested State to obtain and provide the types of information covered by the above-cited provisions pursuant to the Agreement.

The proposed Protocol replaces the reference in paragraph 4(b) to the banking regulations of Mexico. Whereas the TIEA refers to Article 93 of the Regulatory Law of Banking and Credit Public Service as in effect at the time of signing the TIEA, the proposed Protocol refers to Article 117 of the Credit Institutions Law as in effect at the time of signing the Protocol. The sole effect of this amendment is to replace an outdated statutory reference with the current one.

In addition, the proposed Protocol would allow certain financial information that is obtained pursuant to a provision of U.S. or Mexican law identified in the TIEA to be obtained under any similar or equivalent provision that may be added to or substituted for the provision cited in the TIEA. This change will eliminate the need to amend the TIEA if the relevant banking law is subsequently renumbered or revised.

The proposed Protocol shall enter into force upon an exchange of notes by the duly authorized representatives of the Contracting States confirming their mutual agreement that both sides have met all constitutional and statutory requirements necessary to effectuate this Protocol. The Protocol will remain in force as long as the TIEA remains in force.