DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF THE PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES SIGNED AT MEXICO CITY ON NOVEMBER 26, 2002, AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND MEXICO WITH RESPECT TO TAXES ON INCOME SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992, ALONG WITH A PROTOCOL, AND AN ADDITIONAL PROTOCOL THAT MODIFIES THE CONVENTION SIGNED AT MEXICO CITY ON SEPTEMBER 8, 1994.

This is a technical explanation of the Protocol between the United States and Mexico, signed on November 26, 2002, (the "Protocol") amending 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, along with a protocol, and an additional protocol that modifies the Convention, signed on September 8, 1994.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy and the U.S. Treasury Department's Model Income Tax Convention, published on September 20, 1996 (the "U.S. Model"). Negotiations also took into account the Model Tax Convention on Income and Capital , published by the Organization for Economic Cooperation and Development, as updated in April 2000 (the "OECD Model"), and recent tax treaties concluded by both countries.

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. References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her."

Article I

Article I of the Protocol replaces the existing Article 1 (General Scope) of the Convention with a new Article which reflects current U.S. tax treaty policy. Article 1 as amended extends to former long-term residents the tax treaty regime applicable to former U.S. citizens who renounce their citizenship for tax avoidance reasons (section 877 of the U.S. Internal Revenue Code (the "Code")), and provides rules that clarify the relationship between the Convention and other agreements between the Contracting States with respect to taxation measures.

Article 1 (General Scope)

Paragraph 1

Paragraph 1 of Article 1 provides that the Convention applies to residents of the United States or Mexico, except where the terms of the Convention provide otherwise. This paragraph has simply been restated and not amended. Under Article 4 (Residence), a person is generally treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile, residence or other similar criteria. However, if a person is considered a resident of both Contracting States, Article 4 provides rules for determining a single State of residence (or no State of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, Article 20 (Government Service) may apply to an employee of a Contracting State who is resident in neither State. Under Article 27 (Exchange of Information), information may be exchanged with respect to residents of third states.

Paragraph 2

Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States (*i.e.*, that no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other allowance accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States). This paragraph has simply been restated and not amended. The relationship between the non-discrimination provisions of the Convention and other agreements is addressed not in paragraph 2 but in paragraph 3.

Under paragraph 2, for example, if a deduction would be allowed under the Code in computing the U.S. taxable income of a resident of Mexico, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. For example, assume that a resident of Mexico has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profit of the profitable trade or business and invoke the Code to claim the loss of the losing trade or business against the profit of the permanent establishment. *See* Rev. Rul. 84-17, 1984-1 C.B. 308. If, however, the taxpayer invokes the Code for the taxation of all three ventures, the taxpayer would not be precluded from invoking the Convention, for example, with respect to any dividend income the taxpayer may receive from the United States that is not effectively connected with any of the taxpayer's business activities in the United States.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and Mexico. For example, if certain benefits are provided for military personnel or military contractors under a Status of Forces Agreement between the United States and Mexico, those benefits will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

Paragraph 3

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under other agreements. The provisions of paragraph 3 are an exception to the rule provided in subparagraph (b) of paragraph 2 of this article under which the Convention shall not restrict in any manner any benefit now or hereafter accorded by any other agreement between the Contracting States.

Subparagraph (a) of paragraph 3 provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning the interpretation or application of the Convention, including a dispute concerning whether a taxation measure is within the scope of the Convention, shall be considered only by the competent authorities of the Contracting States, and the procedures under Article 26 (Mutual Agreement Procedure) of the Convention exclusively shall apply to the dispute. Thus, dispute-resolution procedures that may be incorporated into trade, investment, or other agreements between the Contracting States shall not apply in determining the scope of the Convention.

Subparagraph (b) of paragraph 3 provides that no other agreement to which the United States and Mexico are parties shall apply with respect to a taxation measure unless the competent authorities agree that the measure is not within the scope of the non-discrimination provisions of Article 25 (Non-Discrimination) of the Convention. Accordingly, if the non-discrimination provisions of this Convention apply to a taxation measure, no national treatment or most-favored-nation ("MFN") obligations undertaken by the Contracting States in any other agreement shall apply to that taxation measure.

Although the language in paragraph 3 is somewhat broader than that of the equivalent provision in the U.S. Model, the effect of the two provisions is similar. Under the U.S. Model, the only national treatment or MFN provision that may apply to a taxation measure that is within the scope of the Convention are those that apply under the GATT with respect to trade in goods. In contrast, the provision in the Convention does not specifically affirm the applicability of GATT to taxation measures that are also within the scope of Article 25. However, Article 25 of the Convention is concerned with treatment of nationals and residents of the other Contracting State, not with the treatment of trade in goods. Therefore, it is unlikely that any taxation measure that would violate the national treatment or MFN provisions of the GATT would be found to be within the scope of Article 25. If the competent authorities agree that the relevant taxation measure is not within the scope of Article 25, then the national treatment and MFN provisions of the GATT would apply with respect to that taxation measure, just as they would under the provision in the U.S. Model.

Paragraph 3 defines a "measure" broadly. It would include, for example, a law, regulation, rule, procedure, decision, administrative action, or any other form of governmental action or guidance.

Paragraph 4

Paragraph 4 contains the traditional saving clause found in U.S. tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of Mexico performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of Mexico is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (*i.e.*, without regard to Code section 894(a)). However, subparagraph 5(a) of this Article preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in Mexico. See paragraph 4 of Article 24 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Residence). Thus, an individual who is a U.S. resident under the Internal Revenue Code but who is deemed to be a resident of Mexico under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. For example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of Mexico under its law, and that individual has a permanent home available to him in Mexico and not in the United States, he would be treated as a resident of Mexico under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the treaty.

However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3). The application of the saving clause to former citizens and long-term residents is not addressed in paragraph 4, but in paragraphs 6, 7, and 8.

Paragraph 5

Some provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 sets forth certain exceptions to the saving clause that preserve these benefits for citizens and residents of the Contracting States.

Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.
(2) Subparagraph 1(b) and paragraph 3 of Article 19 (Pensions, Annuities, Alimony, and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.
(3) Article 22 (Exempt Organizations) provides for reciprocal recognition of tax-exempt, charitable organizations resident in a Contracting State and qualifying for benefits of the Convention under paragraph 1(e) or 2 of Article 17 (Limitation on Benefits).
(4) Article 24 (Relief from Double Taxation) confirms the benefit of a credit to citizens and residents of one Contracting State for income taxes paid to the other, even if such a credit may not be available under the Code.
(5) Article 25 (Non-Discrimination) requires one Contracting State to grant national treatment to nationals of the other Contracting State in certain circumstances. Excepting this Article from the saving clause requires, for example, that the United States give such benefits to a national of Mexico even if that person is a citizen of the United States.
(6) Article 26 (Mutual Agreement Procedure) may confer benefits on residents or nationals of the Contracting States. For example, the statute of limitations may be waived for refunds and the competent authorities are permitted to use a definition of a term that differs from the internal law definition.

As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

Subparagraph (b) of paragraph 5 provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non- immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (*i.e.*, in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with statutory rules. The benefits preserved by this paragraph are the host country exemptions for the following items: government service salaries and pensions under Article 20 (Government Service); certain income of visiting students or business apprentices under Article 21 (Students); and the income of diplomatic agents and consular officers under Article 28 (Diplomatic Agents and Consular Officers).

Paragraph 6

Under subparagraph (a) of paragraph 6, each Contracting State reserves for a period of ten years its right to tax former citizens and long-term residents whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Thus, the saving clause in paragraph 4 applies to such persons for a period of ten years.

In the case of the United States, section 877 of the Code applies to former citizens and long-term residents of the United States whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Under section 877, the United States generally treats an individual as having a principal purpose to avoid tax if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status. The thresholds are adjusted annually for inflation. Section 877(c) provides certain exceptions to these presumptions of tax avoidance. Paragraphs 7 and 8 provide similar factors that will be considered in favor of the taxpayer for purposes of determining whether one of the principal purposes of a change in status of a former citizen or long-term resident is the avoidance of tax.

Subparagraph (b) of paragraph 6 defines the term "long-term resident" of a Contracting State as an individual (other than a citizen of that State) who is a lawful permanent resident of that State in at least 8 of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. In determining whether this threshold is met, the Convention provides that an individual will not be treated as a lawful permanent resident for any year in which the individual is: (1) treated as a resident of the other Contracting State, or as a resident of any country other than the first-mentioned State under the provisions of any other tax treaty of that Contracting State, and (2) the individual does not waive the benefits of such treaty applicable to residents of the other country. This test is consistent with U.S. law.

Paragraph 7

In the case of an individual who is a former citizen of a Contracting State, a number of factors may be considered by that Contracting State in determining whether or not one of the principal purposes of that individual's loss of citizenship ("expatriation") was the avoidance of tax. Paragraph 7 sets forth the following factors which will be considered in favor of the taxpayer for purposes of determining whether a former citizen had a tax avoidance purpose for expatriating: (1) the individual is, at the time of his expatriation, a resident fully liable to tax in the other Contracting State, or becomes a resident fully liable to tax within a reasonable period after his expatriation; and (2) the individual meets one of the following four additional requirements: (a) the individual was a citizen of both Contracting States at birth and has remained a citizen of the other Contracting State; (b) at the time of expatriation (or within a reasonable period thereafter), the individual was or became a citizen of the other Contracting State, and that other Contracting State is the individual's country of birth, the country of birth of that individual's spouse, or the country of birth of either of that individual's parents; (c) in the 10 years prior to expatriation, the individual was present in the Contracting State from which he expatriated for no more than 30 days in each taxable year or year of assessment; or (d) the individual expatriated before he reached the age of 18 ½ years. This provision is consistent with U.S. law.

Paragraph 8

In the case of an individual who is a former long-term resident of a Contracting State, a number of factors may be considered by that Contracting State in determining whether or not one of the principal purposes of that individual's loss of long-term resident status ("expatriation") was the avoidance of tax. Paragraph 8 sets forth the following factors which will be considered favorably for purposes of determining whether a former long-term resident had a tax avoidance purpose for expatriating: (1) at the time of the individual's expatriation (or within a reasonable time thereafter) the individual is or becomes a resident fully liable to tax in the other Contracting State and that other Contracting State is the individual's country of birth, the country of birth of that individual's spouse, or the country of birth of either of that individual's parents; (2) in the 10 years prior to expatriation, the individual was present in the Contracting State from which he expatriated for no more than 30 days in each taxable year or year of assessment; or (3) the individual expatriated before he reached the age of 18 ½ years. This provision is consistent with U.S. law.

Article II

Paragraph a) of Article II of the Protocol replaces Article 10 (Dividends) of the Convention. Article 10 provides rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a beneficial owner that is a resident of the other Contracting State. The Article provides for full residence country taxation of such dividends and a limited source-State right to tax. Finally, the Article prohibits a State from imposing taxes on a company resident in the other Contracting State, other than a branch profits tax, on undistributed earnings.

Paragraph 1

The right of a shareholder's country of residence to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends paid to them by a company that is a resident of the other Contracting State. This paragraph has simply been restated and not amended.

Paragraph 2

The State of source also may tax dividends beneficially owned by a resident of the other State, subject to the limitations of paragraphs 2 and 3. Paragraph 2 generally limits the withholding tax in the State of source on the dividend paid by a company resident in that State to 10 percent of the gross amount of the dividend. If, however, the beneficial owner of the dividend is a company resident in the other State and directly owns shares representing at least 10 percent of the voting power of the company paying the dividend, then the withholding tax in the State of source is limited to 5 percent of the gross amount of the dividend. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced withholding at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as such procedures are applied in a reasonable manner.

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 5 of Article 25 (Non-Discrimination).

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (*i.e.*, the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Residence)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the OECD Commentaries to Article 10. See also paragraph 24 of the Commentary to Article 1 of the OECD Model.

Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

Paragraph 3

Paragraph 3 provides exclusive residence-country taxation (*i.e.* a zero rate of withholding tax) with respect to certain dividends distributed by a company resident in one Contracting State to a resident in the other Contracting State. As described further below, the zero rate of withholding tax is available with respect to certain intercompany dividends and with respect to dividends received by tax-exempt pension funds.

Subparagraph (a) of paragraph 3 reduces the withholding tax rate to zero on dividends beneficially owned by a company that has owned directly 80 percent or more of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared.

Eligibility for the zero rate of withholding tax provided by subparagraph (a) is subject to an additional restriction which states that companies qualifying for treaty benefits by virtue of the active trade or business, ownership-base erosion or subsidiaries of a publicly traded NAFTA company tests must have acquired shares representing 80 percent or more of the voting stock of the company paying the dividends prior to October 1, 1998. This restriction supplements those imposed under Article 17 (Limitation on Benefits), and is necessary because of the increased pressure on the Limitation on Benefits tests resulting from the fact that the Convention is one of the first U.S. tax treaties to provide for a zero rate of withholding tax on intercompany dividends. The test is intended to prevent companies from re-organizing in order to become eligible for the zero rate of withholding tax in circumstances where the Limitation on Benefits provision does not provide sufficient protection against treaty-shopping.

For example, assume that ThirdCo is a company resident in a third state. ThirdCo owns directly 100% of the issued and outstanding voting stock of USCo, a U.S. company, and of MEXCo, a Mexican company. MEXCo is a substantial company that manufactures widgets; USCo distributes those widgets in the United States. If ThirdCo contributes to MEXCo all the stock of USCo, dividends paid by USCo to MEXCo would qualify for treaty benefits under the active trade or business test of subparagraph (c) of paragraph 1 of Article 17. However, allowing ThirdCo to qualify for the zero rate of withholding tax, which is not available to it under the third state's tax treaty with the United States (if any), would encourage treaty-shopping.

In order to prevent this type of treaty-shopping, the Convention imposes an additional holding requirement on companies that qualify for benefits only under paragraphs 1(c) (the active trade or business test), 1(d)(iii) (the subsidiaries of a publicly traded NAFTA company test) or 1(f) (the ownership-base erosion test) of Article 17. For those companies, the zero rate of withholding tax is available only with respect to dividends received from companies that the recipient company owned, directly or indirectly, prior to October 1, 1998.

Accordingly, in the example above, MEXCo will not qualify for the zero rate of withholding tax on dividends unless it owned USCo before October 1, 1998. If it did own USCo before October 1, 1998, then it will continue to qualify for the zero rate of withholding tax on dividends so long as it qualifies for benefits under at least one of the tests of Article 17. So, for example, if ThirdCo decided to get out of the widget business and sold its stock in MEXCo to FWCo, a company that is resident in a country with which the United States does not have a tax treaty, MEXCo would continue to qualify for the zero rate of withholding tax on dividends so long as it continued to meet the requirements of the active trade or business test of Article 17(1)(c) or, possibly, the competent authority discretionary test of Article 17(2).

The results would be different under the "ownership-base erosion" test of Article 17(1)(f). For example, assume MEXCo is a passive holding company owned by Mexican individuals, which was established in 1996 to hold the shares of USCo. MEXCo qualifies for benefits only under the ownership-base erosion test of Article 17(1)(f). If the Mexican individuals sold their stock in MEXCo to FWCo, MEXCo would lose all the benefits accorded to residents of Mexico under the Convention (including the zero rate of withholding tax on dividends) because the company would not longer qualify for benefits under Article 17 (unless, of course, the U.S. competent authority were to grant benefits under Article 17(2)).

Other methods of qualifying under Limitation on Benefits do not raise the same concerns. Accordingly, a resident of a Contracting State that satisfies Limitation on Benefits by virtue of being a publicly-traded company or a subsidiary of a publicly-traded company does not have to meet the October 1, 1998 holding requirement. Thus, a Mexican resident company that meets the listing and trading requirements of Article 17(1)(d)(i) or (ii) will be entitled to the zero withholding rate on dividends no matter when it acquired the shares of the U.S. company (subject to the 12-month holding period requirement of Article 10(3)(a)).

Under Article 10(3)(a)(iii), a company that is a resident of a Contracting State may also qualify for the zero rate of withholding tax on dividends if it satisfies the derivative benefits test of Article 17(1)(g), even if it acquired the U.S. company after September 30, 1998 (subject to the 12-month holding requirement). As of the date of signing of the Protocol no company can qualify for the zero rate under the derivative benefits test because neither the U.S.-Canada nor the Mexico-Canada tax treaty provides for a zero rate of withholding taxes on dividends.

If a company does not qualify for the zero rate of withholding tax under any of the foregoing tests, it may request a determination from the relevant competent authority pursuant to paragraph 2 of Article 17. Benefits may be granted with respect to an item of income if the competent authority of the Contracting State in which the income arises determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention. As noted below, paragraph 8 of Article 10 anticipates that the competent authorities may develop a commonly-agreed application of Article 17(2) as it relates to the zero rate of withholding tax.

Subparagraph (b) of paragraph 3 allows the zero rate of withholding tax for dividends beneficially owned by a trust, company, or other organization constituted and operated exclusively to provide benefits under a pension, retirement, or other employee benefit plan. In order to qualify for the zero rate of withholding tax, the trust, company or other organization must be generally exempt from tax in the Contracting State of which it is a resident, and the dividends must not be derived from the carrying on of a business, directly or indirectly, by such trust, company or organization. This exemption is parallel to an existing exemption from the withholding tax on interest available to pension funds under Article 11(4)(c).

Paragraph 4

Paragraph 4 modifies in particular cases the maximum rates of withholding tax at source provided in paragraphs 2 and 3.

Subparagraph (a) provides that dividends paid by a RIC or a REIT are not eligible for the 5 percent maximum rate of withholding tax in subparagraph (a) of paragraph 2 or the zero rate of withholding tax of subparagraph (a) of paragraph 3. As described below, the zero rate provided by subparagraph (b) of paragraph 3 (with respect to dividends paid to a pension plan) will be available with respect to dividends paid by RICs and REITs in certain circumstances.

Subparagraph (b) of paragraph 4 provides that the 10 percent maximum rate of withholding tax in subparagraph (b) of paragraph (2), and the zero rate of withholding tax of subparagraph (b) of paragraph 3 with respect to pension funds, shall apply for dividends paid by a RIC.

Subparagraph (c) provides that the 10 percent withholding rate in subparagraph (b) of paragraph (2), and the zero rate of subparagraph (b) of paragraph 3 with respect to pensions, shall apply for dividends paid by a REIT, provided certain conditions are met. Pursuant to subparagraph (c)(i) of paragraph 4, a pension plan will qualify for the zero rate of withholding tax with respect to dividends paid by REITs, provided that the pension plan holds an interest of not more than 10 percent in the REIT. Other investors will qualify for the 10 percent rate of withholding tax if one of three conditions is met. First, the dividend may qualify for the 10 percent rate of withholding tax if the person beneficially entitled to the dividend is an individual holding an interest of not more than 10 percent in the REIT. Second, the dividend may qualify for the 10 percent rate of withholding tax if it is paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividend is a person holding an interest of not more than 5 percent of any class of the REIT's stock. Third, the dividend may qualify for the 10 percent rate of withholding tax if the person beneficially entitled to the dividend holds an interest in the REIT of not more than 10 percent and the REIT is "diversified" (*i.e.*, the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property). For purposes of this diversification test, foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The restrictions set forth above are intended to prevent the use of RICs and REITs to gain inappropriate source-country tax benefits for certain shareholders resident in Mexico. For example, a company resident in Mexico that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and pay a U.S. withholding tax of 10 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC. If the RIC is a pure conduit, there may be no U.S. tax cost to interposing the RIC in the chain of ownership. Absent the special rule in paragraph 4, such use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at 10 percent, into direct investment dividends taxable at zero or 5 percent.

Similarly, a resident of Mexico directly holding U.S. real property would pay U.S. tax either at a 30 percent rate on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could transform real estate income into dividend income, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 4 prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. In the cases covered by the exceptions, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Paragraph 5

Paragraph 5 excludes from the general source country limitations under paragraph 2 and 3 dividends paid with respect to holdings that form part of the business property of a permanent establishment or fixed base situated in the source country. This paragraph has simply been restated and not amended. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the State in which the permanent establishment is located, as modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers. In such a case, Article 7 (Business Profits) applies with respect to business profits from a permanent establishment and Article 14 (Independent Personal Services) applies to income from the performance of personal services in an independent capacity from a fixed base.

The provisions of this paragraph shall apply to dividends attributable to a permanent establishment or fixed base even in the case of a permanent establishment or fixed base that once existed in the State but that no longer exists. See the Technical Explanation of paragraph 2 of Article 7 and of Article 14.

Paragraph 6

Paragraph 6 provides a broad and flexible definition of the term “dividends.” This paragraph has simply been restated and not amended. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.

The term dividends includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the State of source. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend.

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

Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State. Paragraph 9 of the Convention’s first protocol clarifies this by providing that each Contracting State may apply its statutory rules for distinguishing debt and equity or for preventing thin capitalization in defining dividends for purposes of this article. In the case of the United States, these rules include Code section 163(j).

Paragraph 7

A State's right to tax dividends paid by a company that is a resident of the other State is restricted by paragraph 7 to cases in which the dividends are paid to a resident of that State or are attributable to a permanent establishment in that State. Thus, a State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that State. In the case of the United States, paragraph 7, therefore, overrides the ability to impose taxes under sections 871 and 882(a) on dividends paid by foreign corporations that have a U.S. source under section 861(a)(2)(B).

Paragraph 8

Paragraph 8 provides that the competent authorities of the Contracting States shall consult each other with a view to develop a commonly agreed upon application of clause iv) of subparagraph (a) of paragraph 3 of this Article which provides that if a company does not qualify for the zero withholding rate under any of the tests provided for in paragraph 3, it may request a determination that the benefits of the zero rate of withholding tax shall be granted by the relevant competent authority pursuant to paragraph 2 of Article 17. To the extent a common application is agreed upon, the competent authorities shall publish regulations or other public guidance.

Relation to Other Articles

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 24 (Relief from Double Taxation), as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 17 (Limitation on Benefits). Thus, if a resident of Mexico is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 17 in order to receive the benefits of this Article.

Paragraph b) of Article II of the Protocol replaces paragraph 8 of the Convention's existing protocol. The new paragraph provides that if the United States agrees in a tax treaty to a dividend exemption under conditions more beneficial than those in paragraph 3, the Contracting States shall, at Mexico's request, consult each other with a view to concluding another protocol to incorporate a similar provision into paragraph 3 of Article 10 (Dividends).

Paragraph c) of Article II of the Protocol is a technical correction to ensure that the provisions of the Convention's existing protocol paragraph 9 (relating to the application of statutory thin capitalization rules) will continue to refer to the definition of "dividends," which in the new Article 10 is found in paragraph 6.

Article III

Article III of the Protocol amends Article 11A (Branch Tax) of the Convention by inserting an additional paragraph 3. Paragraphs 1 and 2 of Article 11A permit a Contracting State to impose branch taxes on the dividend equivalent amount and excess interest of a company resident in the other Contracting State which derives business profits attributable to a permanent establishment located in the first-mentioned State or which derives income subject to tax on a net basis in the first-mentioned State under Article 6 (Income from Immovable (Real Property)) or Article 13 (Capital Gains).

Paragraph 3 of Article 11A provides that the branch profits tax will not be imposed if certain requirements are met. In general, these requirements provide rules for a branch that parallel the rules for when a dividend paid by a subsidiary will be subject to exclusive residence-country taxation. Accordingly, the branch profits tax may not be imposed in the case of a company which, before October 1, 1998, was engaged in activities constituting a permanent establishment (whether or not the permanent establishment was actually profitable during that period) or to income or gains that are of a type that would be subject to the provisions of Article 6 or paragraphs 1 or 4 of Article 13. In addition, the branch profits tax does not apply to a company which is a qualified person by reason of clauses (i) or (ii) of subparagraph (d) of paragraph 1 of Article 17 (Limitation on Benefits) (*i.e.*, a publicly-traded company), nor does it apply to a company that is entitled to benefits with respect to dividends under subparagraph (g) of paragraph 1 of Article 17. Finally, the branch profits tax does not apply to a company entitled to benefits under paragraph 2 of Article 17 with respect to the dividend equivalent amount.

Thus, for example, if a Mexican company would be subject to the branch profits tax with respect to profits attributable to a U.S. branch and not reinvested in that branch, paragraph 3 may apply to eliminate the branch profits tax if that branch was established in the United States before October 1, 1998 and the other requirements of the Convention (e.g., Limitation on Benefits) are met. If, by contrast, a Mexican company that did not have a branch in the United States before October 1, 1998, takes over after October 1, 1998, the activities of a branch belonging to a third party, then the branch profits tax would apply, unless the Mexican company is a qualified person under clauses (i) and (ii) of subparagraph (d) of paragraph 1 of Article 17, or is entitled to benefits under subparagraph (g) of paragraph 1, or paragraph 2 of that Article.

Moreover, the transfer of assets from a branch that meets the requirements for an exemption under paragraph 3 into a subsidiary that meets the requirements of paragraph 3 of Article 10 should not change the result. Accordingly, in that case, it is expected that the U.S. competent authority will exercise its discretion to treatthe new parent-subsidiary to qualify for the zero rate of withholding tax, so long as the Mexican parent meets the 80-percent ownership requirement of paragraph 3(a) of Article 10 with respect to the subsidiary.

Article IV

Article IV of the Protocol amends paragraph 4 of Article 13 (Capital Gains) of the Convention.

Paragraph 4 allows the Contracting State of which a company is resident to tax certain gains from the sale of shares of that company if the gain is derived by a resident of the other Contracting State. This rule is the same as in the existing Convention. In the existing Convention, this paragraph contains a second sentence that provides that the State of residence of the taxpayer will treat the gain that may be taxed by the other Contracting State as arising in that Contracting State to the extent necessary to avoid double taxation. This sentence has been removed because it is no longer necessary in light of the change to paragraph 3 of Article 24 (Relief from Double Taxation) described below.

Article V

Article V of the Protocol replaces paragraph 3 of Article 24 (Relief From Double Taxation) of the Convention, the existing rule that re-sources income taxed in accordance with the Convention to relieve double taxation.

Specifically, paragraph 3 as revised states that the State of residence of the taxpayer will treat an item of gross income (as defined under its law) that may be taxed by the other State in accordance with the Convention as arising in that other State. In the case of the United States, this means that, if the Convention allows Mexico to tax an item of gross income (as defined under U.S. law) derived by a resident of the United States, the United States will treat that item of gross income as gross income from sources within Mexico for U.S. foreign tax credit purposes. In that case, however, section 904(g)(10) may apply for purposes of determining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(g)(10) generally applies the foreign tax credit limitation separately to re-sourced income. Furthermore, the paragraph 3 re-sourcing rule applies to gross income, not net income. Accordingly, U.S. expense allocation and apportionment rules, see, *e.g.*, Treas.Reg. section 1.861-9, continue to apply to income re-sourced under paragraph 3.

Article VI

This Article contains the rules for bringing the Protocol into force and giving effect to its provisions.

Paragraph (a)

Paragraph (a) provides for the ratification of the Convention by both Contracting States according to their constitutional and statutory requirements. Each State must notify the other as soon as its requirements for ratification have been complied with. The Convention will enter into force on the date of the later of such notifications.

In the United States, the process leading to ratification and entry into force is as follows: Once a treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice for the Senate Committee on Foreign Relations to hold hearings on the treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After receiving the Senate's advice and consent to ratification, the treaty is returned to the President for his signature on the ratification document. The President's signature on the document completes the process in the United States.

Paragraph (b)

The date on which a treaty enters into force is not necessarily the date on which its provisions take effect. Paragraph (b) contains rules that determine when the provisions of the treaty will have effect. Under subparagraph (i), the Protocol will have effect with respect to dividends paid or credited on or after the first day of the second month following the date on which the Protocol enters into force. For example, if instruments of ratification are exchanged on April 25 of a given year, the withholding rates specified in paragraph 2 and 3 of Article 10 (Dividends) as provided in Article II would be applicable to any dividends paid or credited on or after June 1 of that year. This rule allows the benefits of the withholding reductions to be put into effect as soon as possible, without waiting until the following year. The delay of one to two months is required to allow sufficient time for withholding agents to be informed about the change in withholding rates. If for some reason a withholding agent withholds at a higher rate than that provided by the Convention (perhaps because it was not able to re-program its computers before the payment is made), a beneficial owner of the income that is a resident of Mexico may make a claim for refund pursuant to section 1464 of the Code.

For all other taxes, paragraph (b) specifies that the Protocol will have effect for any taxable year or assessment period beginning on or after January 1 of the year following entry into force.

Article VII

This article provides that the Protocol shall remain in force as long as the Convention remains in force.