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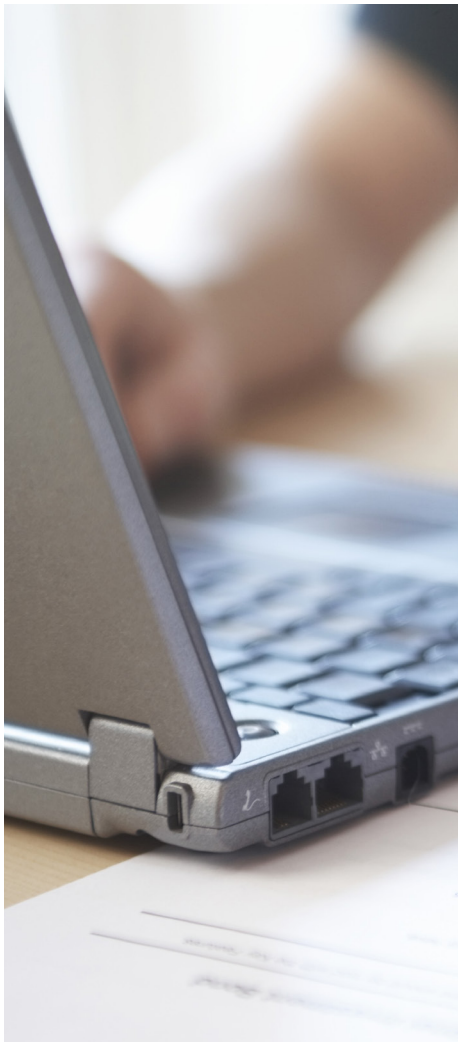
EY TAX Flash

Treaties to avoid double taxation



On October 3rd, 2017 the Mexican Senate approved a pair of treaties to avoid double taxation, and their respective protocols, which were previously signed by the Mexican Government with the Kingdom of Saudi Arabia and the Republic of the Philippines.

As a result of the foregoing, both treaties were remitted to the Federal Government to proceed with the respective publications.

These treaties reflect the recent commercial increase and investment between Mexico and both Asian countries. It should be mentioned that both treaties adopt a similar content to those negotiated in the past by Mexico in its previous bilateral agreements, gathering basic elements of the OECD model, but including some adjustments.

Tax Treaty with the Kingdom of Saudi Arabia

Regarding this Treaty, it was originally signed by Mexico on August 1, 2016.In this sense, diplomatic relations between Mexico and Saudi Arabia were established since 1952 and currently Saudi Arabia is Mexico's 41st trading partner worldwide and the 4th largest investor in the Middle East.

As a result of the recent signing of the Multilateral Agreement to adopt the measures from the BEPS project (the "MLI"), Mexico included this treaty as a Covered Tax Agreement ("CTA"). As of the date hereof, Saudi Arabia has not signed the MLI.

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Tax Residency

In the case of double tax residency of individuals, the Convention establishes tie-breaking rules similar to those adapted by Mexico in its tax treaties. In the case of double tax residency of companies, the Convention provides that the competent authorities shall endeavor to reach a mutual agreement concerning the application of the treaty, taking into consideration the place of effective management as a key element. This is consistent with other treaties recently negotiated by Mexico.

Permanent Establishment

The content is similar to the position that Mexico has taken in other tax treaties which is based on the United Nations Model Convention. Thereby, the treaty contains a broad definition of permanent establishment, which includes:

i. Consulting services provided to a company by employees or personnel who were hired by a foreign company, provided that the activities in the other Contracting State, last for a period or periods greater than 183 days in 12-month period.
ii. A building or constructions, assembly or installation projects, or supervisory activities in connection therewith, when such activities exceed six months.
iii. Activities that consist of or are related to the exploration, production, refining, processing, transportation, distribution, storage or commercialization of hydrocarbons, when those activities are carried out for a period or periods greater that 30 days in any 12-month period. It should be noted that this provision is consistent with the provisions set forth in Mexico's Revenue of Hydrocarbons Law.

Dividends

With respect to dividends, the Convention establishes that if the beneficial owner of the dividends is a resident of the other Contracting State, the tax shall not exceed 5% of the gross amount of the dividends. It should be noted that the Convention extends the application of such withholding tax rates to the benefits that a permanent establishment distributes to its head office in the other Contracting State.

Credit Revenue Income

The article related to "interest" is named "Credit Revenue Income". It is important to mention that this treaty provides a broad definition of this concept. In this regard, it this Convention provides that when the beneficial owner of the Income derived from Credit Revenue is a resident of the other Contracting State, the tax applied shall not exceed 5% of the gross amount of the income derived from credit income paid to financial institutions or pension funds and 10% of the gross amount of the income derived from credit income paid in any other case. This treatment is similar to the one adopted by Mexico in recent treaties.

Royalties and technical assistance

The Convention establishes a reduced withholding tax rate of 10% on the gross amount of royalties, compared to the domestic rate of 35% applicable in Mexico or 15% in Saudi Arabia.

Capital gains

The Convention broadly contemplates that gains derived from the transfer of shares or other similar rights in a company whose assets consist (directly or indirectly) of more than 50% in immovable property located in the other Contracting State, could be taxed in such other Contracting State. In addition, gain derived from the transfer of shares of stock in a company resident of a Contracting State, may be taxed only in the State in which the issuer of such shares is resident. Finally, neither the treaty nor its Protocol contains rules for reorganizations.

Limitation on Benefits

This Agreement does not contain rules on limitation on benefits and/or rules related to the principal purpose test ("PPT"). Thus, since Saudi Arabia had not signed the MLI, this could imply that the PPT would not be applicable to this Convention.

Exchange of information

The treaty includes provisions regarding the exchange of information as well as mutual assistance arrangements similar to the OECD model. It should be noted that itis a Mexico´s policy to include this type of provision in the treaties.

Miscellaneous Provisions

The Convention stipulates that provisions therein shall not affect domestic provisions to prevent fiscal evasion and avoidance, including thin capitalization rules and preferential tax regime. Mexico has included similar wording in other treaties.

Entry into force

The Convention shall enter into force on the first day of the second month following the notification by both Contracting States that they have complied with their internal procedures. In the case of taxes withheld at source, the Convention shall take effect the first day of January of the year following that in which comes into force.

Treaty with the Republic of the Philippines

The tax treaty between Mexico and the Republic of the Philippines was originally signed on November 17, 2015.

Regarding the MLI, Mexico included this tax treaty as a CTA. The Philippines did not sign the MLI.

Permanent Establishment

The Agreement contains a broad definition of a permanent establishment, which includes the provision of services (including consulting services) provided by an enterprise, its employees or other individuals engaged in by the enterprise in a Contracting State, but only when such activities continue for a period not exceeding 183 days in any 12-month period. Also, it includes a similar provision of permanent establishment for the provision of professional services and independent activities carried out by individuals.

Constructions and installation projects create a permanent establishment when such activities exceed six months, according to the rules contained within this Convention.

The Convention does not expressly establish a similar rule of permanent establishment to the one contained in the Revenue of Hydrocarbons Law in Mexico.

Shipping and air transport

The profits from the operation of ships or aircraft in international traffic from a Contracting State and which obtains an enterprise of the other Contracting State, may be taxed in that State in accordance with its domestic law.

Notwithstanding the above, profits derived from sources situated in a Contracting State obtained by an enterprise of the other Contracting State from the operation of ships or aircraft in international traffic may be taxed in the first State with a withholding tax that should not exceed 1.5% on the gross amount of the income obtained. It should be mentioned that this wording is new in the treaties negotiated by Mexico, since it is not commonly included.

Dividends and remittances

The Convention establishes a withholding tax rates on dividends of: (a) 5% of the gross amount if the beneficial owner is a company which owns at least 70% of the equity of the company paying the dividends; (b) 10% of the gross amount of the dividends, if the beneficial owner is a company that directly owns at least 10% of the capital of the company paying the dividends; and c) a rate of 15% in all other cases. It should be

mentioned that the maximum rate will not be applicable in the case of Mexico, since the domestic rate is lower (10%).

In the case of benefits that are remitted by a permanent establishment to its head office in the other Contracting State, the Convention stipulates that the withholding of such transfer shall not exceed 5% of the amount of the benefits.

Interest

The Convention establishes a withholding tax rate of 12.5% on the gross amount of interest payment if the beneficial owner of the interest is a resident of the other Contracting State.

Interest may be taxed only in the other Contracting State, and therefore, there shall be no withholding, in the following cases: (a) the beneficial owner is a Contracting State, a political subdivision or a local entity or the Bank of Mexico or Bangko Sentral ng Pilipinas; b) the interest is paid in respect of a bond, obligation or other similar title of the government of that State; (e) the interest is paid with respect of a granted, guaranteed or insured loan by the National Bank for Foreign Trade, National Financial Bank or the National Bank for Public Works and Services or by any other institution which may be agreed between the competent authorities of the States Part; (d) interest is paid in respect of a granted, guaranteed or insured loan by the Development Bank of the Philippines or the Philippine Real Estate Bank, or such other institution as may be agreed between the competent authorities of the both States.

Royalties

The Convention establishes a reduced withholding tax rate of 15% on the gross amount in case of royalty payments, compared to the rate of 35% applicable in Mexico or 30% in the Philippines. It should be mentioned that the rate of this Convention is higher than the rate provided in most of the treaties signed by Mexico (10%).

Capital gains

The Convention provides that a gain in the transfer of shares in a company whose assets consist, directly or indirectly, more than 50% in real state located in a Contracting State may be taxed in that State. Likewise, profits obtained by a resident of a Contracting State from the transfer of shares of stock of a company who is a resident of one of the Contracting States may be taxed in that State if the holder of the profits owns at least 20% in the capital of such company (either directly or through related parties) at any time during a 12-month period prior to the sale.

The Convention provides for a deferral of the capital gains tax in the transfer of legal ownership between members of the same group of companies, to the extent that the transferor and the acquirer reside in the same Contracting State and the consideration is made in shares. This is similar to the mechanism provided in some treaties previously signed by Mexico.

Imposition of Hydrocarbons

The Convention established that provisions therein shall not affect the right of Contracting States to extend their legislation relating to taxation of income derived from hydrocarbons. Thereby, although there is no express provision for permanent establishment in the field of hydrocarbons, perhaps this article could give the guideline to referring to the Mexican domestic law in the matter.

Limitation on Benefits

It should be noted that for the application of this Convention, it contains rules regarding the principal purpose test ("PPT").

Exchange of information

The treaty includes provisions regarding the exchange of information as well as mutual assistance arrangements similar to the OECD model.

Assistance in collection

The Convention provides the possibility for Contracting States to assist each other in the collection of tax assessments.

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