Taxation of income sourced in Mexico following changes to the OECD Model Tax Convention

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On July 17, 2008, the Organisation for Economic Cooperation and Development (OECD) published the final update to the OECD Model Tax Convention on Income and Capital (Model Tax Convention). It also updated the Commentaries on the Articles of the Model Tax Convention (Commentaries).

An interesting debate arose due to the changes to the Commentaries on Article 5 dealing with the definition of permanent establishment (PE). Such changes consisted in the addition of paragraphs 42.11 to 42.48 for the purposes of explaining the controversy between the State of residence and the State of source regarding the allocation of taxing rights with respect to income from services, and for including an alternative provision that extends the definition of PE for including independent services in some cases.

An important discussion has been in progress since then between OECD member countries, other groups, such as the Business Industry Advisory Committee to the OECD (BIAC) and the private sector. This controversy highlights a lack of consensus on the subject and explains the reasons for changing the Commentaries on Article 5 rather than the article itself.

The alternative provision: a service PE

Despite the fact that the working party[1] concluded that no changes should be made to the provisions of the Model Tax Convention and that services should continue to be treated in the same way as other types of business activities (i.e., not taxed in the source country unless attributed to a PE situated there, as long as they are not covered by other articles)[2], some countries expressed their opposition to not allowing taxation in the source country.

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The reasons for this are:

- according to generally-accepted policy principles for determining when profits should be considered to have their source within a jurisdiction, the State where the services are performed should have a right to tax even when the services are not attributed to a PE[3];
- the domestic law of many countries taxes services even in the absence of a PE[4];
- some business services do not require a fixed place of business for performing, on a substantial level of business, activities in the source country[5]; and
- although compliance and administrative difficulties may arise by taxing services without a PE, these difficulties do not justify exempting from tax in the source State[6].

Despite these objections, all OECD Member States agreed on certain basic rules for allowing taxation in the state of source:

- a state should not have source taxation rights on income derived from the provision of services performed by a non-resident outside the State[7];
- taxation will be applied only on the profits[8]; and
- taxation in the source State will not be allowed when the services are performed under certain circumstances, such as services provided during a very short period of time[9].

As a consequence of this discussion, and considering that some countries would like to keep their right to tax income from services performed within those countries, paragraph 42.23 of the Commentaries includes an example of a provision that would conform to these requirements, and that States are free to include in their bilateral tax treaties:

Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any 12-month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or

b) for a period or periods exceeding in the aggregate 183 days in any 12-month period, and these services are performed for the same project or for connected projects through one or more individuals who are present in that other State.

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

This alternative provision constitutes an extension to the definition of PE that would allow taxation of income from services provided by non-residents. However, commentaries on such provision will only apply if the alternative provision is actually included in a particular tax treaty; otherwise, a PE cannot be deemed to arise for a person for merely meeting the conditions described in Paragraph 42.23 of the Commentaries to Article 5[10].

Taxation of services in Mexico

Mexico has always sustained a position for taxing services rendered within its territory. For this reason, most of the bilateral double tax conventions executed by Mexico still include Article 14 (Independent personal services), even after the Article was deleted from the Model Tax

Convention in 2000. Article 14 in bilateral tax conventions entered into by Mexico allows for taxation of income from independent services in the country of source even in the absence of a fixed base.

This position is clearly reflected in Reservation 64 in Article 5 of the Model Tax Convention, which expressly states that "*Mexico reserves the right to tax individuals performing professional services or other activities of an independent character if they are present in Mexico for a period or periods exceeding in the aggregate 183 days in any 12-month period*". This reservation was originally included in the Commentaries on Article 14 and then moved to the Commentaries on Article 5 in 2000.

In addition, Mexico has also entered certain double tax treaties in which the definition of PE also includes the provision of independent services performed in the State of source where no PE would exist under the traditional concepts (i.e., fixed place of business or agents). Some of the double tax treaties including such provision were executed before the changes to the Commentaries on Article 5 were adopted in 2008.

Before describing the specific rules for taxation of independent services in Mexico, it is worth remembering that under domestic law, non-residents[11] are subject to income tax in Mexico only in the following cases (Article 1, Sections II and III, Mexican Income Tax Law; MITL):

- if they have a PE in Mexico, in which case, they will be taxed on all revenue attributable to such PE; or
- if their income is considered to be sourced in Mexico, in which case, they will only be taxed on such income.

PE under domestic law

The MITL, following the general concept of PE established in Article 5 of the Model Tax Convention, sets forth the cases under which a non-resident is deemed to have a PE in the country, as well as certain exceptions to such cases. There are three main cases under which a non-resident is deemed to have a PE in Mexico (Article 2, MITL):

Place of business

The first assumption is the existence of any place of business in which business activities or independent services are partially or totally carried out. Examples include branches, agencies, offices, factories, workshops, facilities, mines, quarries, or any other places of exploration or exploitation of natural resources. As a place of business, these locations are deemed as a PE.

Non-independent agents

A non-resident person will be deemed to have a PE in Mexico, even if it does not have a place of business in Mexico. This is applicable if it acts through a person (individual or entity), other than an independent agent. If this person exercises powers to enter into agreements in the name or on behalf of the non-resident, that are oriented to the performance of its business activities (including independent services) in Mexico, the non-resident will be deemed to have a PE for all the activities performed through such person.

Independent agents

Under the third assumption, a non-resident will be deemed to have a PE in Mexico if it acts within the country through an individual or entity considered an independent agent, and if the agent does not act within the ordinary course of its business[12].

It is worth mentioning that the MITL also provides for a construction services rule, similar to the one established in Article 5 of the Model Tax Convention, except for the duration of the service, since such services will be deemed to constitute a PE in Mexico if the works last more than 183 days in a 12-month period. There are other specific cases that would give rise to a PE, but we will not make reference to them as they are not relevant for the analysis of the provision of independent services.

It should also be noted that there are also cases in which the performance of certain activities of a preparatory or auxiliary nature through a place of business or agent would not create a PE (Article 3, MITL)[13].

Finally, emphasis should be made to the fact that in terms of domestic law, the provision of independent services in Mexico by a non-resident person may create a PE.

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Taxation of Mexican sourced income from independent services

If the non-resident does not have a PE in Mexico, it may still be liable to taxes in Mexico if the income obtained is deemed to be sourced in this country.

Professional and independent services in general, which are not regarded as business profits from entrepreneurial activities are taxable in Mexico, if the services are rendered within Mexican territory. The tax is paid by applying a 25% rate on the full consideration (i.e., gross income) received. It is presumed by law that the entire range of services are rendered in Mexico if part of them are rendered in this country. In addition, it is also presumed by law that the services are rendered in Mexico if the payer is a related party resident in Mexico for tax purposes (Article 183, MITL). Both legal presumptions apply, unless proven otherwise by taxpayers.

Income obtained by a non-resident from other types of services is taxed as established in each specific statute, under rules similar to the ones described for professional services[14].

Double tax treaties executed by Mexico

Mexico has entered into 37[15] double tax treaties following the OECD Model Tax Convention. Most of the tax treaties executed by Mexico include a provision (generally, Article 14[16]), in terms of which independent personal services rendered by a resident in a contracting State in the other contracting State can only be taxed in the State of residence, except if:

- the taxpayer has a fixed base in the source State; or
- the taxpayer is present in the source State for a period exceeding an aggregate 183 days within a 12-month period.

This provision maintains the hypothesis provided for in the Model Tax Convention before 2000, but also includes a 183 days rule, as announced in Reservation 64 in Article 5.

Double tax treaties executed with Austria (January 1, 2006[17]), Canada (January 1, 2008), Chile (January 1, 2000), Czech Republic (January 1, 2003), Indonesia (January 1, 2005), Iceland (January 1, 2009), Israel (January 1, 2000), New Zealand (August 1, 2007) and the Slovak Republic (January 1, 2008) include in Article 5 an additional provision regarding independent services. Such provisions are drafted similarly, and provide that the term PE also includes the rendering of services in the source country, as long as the presence exceeds a certain time within a relevant period.

Exhibit 1 summarises the main elements of the alternative hypothesis for PE.

It is worth noting that the alternative provision for PE included in some of Mexico's bilateral conventions is somehow similar to the text suggested in Paragraph 42.23 of the Model Tax Convention; however, important deviations include:

1. The wording suggested by the OECD in paragraph a) requires a percentage of income (more than 50% of the gross income shall be obtained from the services rendered in the source State), while Mexico does not require any test related with income.
2. The wording of paragraph b) requires that the services shall be performed for the same project or for connected projects, while Mexico does not always establish this requirement.
3. The period established in the double tax treaties executed by Mexico goes from 91 days, six months or 183 days in a 12-month period, or 12 months in a 24-month period.
4. The wording suggested by the OECD expressly states that services mentioned in paragraph 4, which if performed through a fixed place of business, would not create a PE, while Mexico does not make such a reference.
5. The wording suggested by the OECD is made considering that Article 14 (independent personal services) was deleted from the Model Tax Convention, while Mexico still keeps this Article in some of the double tax treaties in which an alternative provision for PE is provided (i.e., Indonesia and Israel).

Main elements of alternative hypothesis for PE **Exhibit 1**

Country	Range limited to individuals	Expressely mentions consultancy services	Expressly mentions administrative services	Services shall be rendered in connection with the same or related projects	Time threshold of 91 days in any 12-month period	Time threshold of 183 days in any 12-month period	Time threshold of six months in any 12-month period	Time threshold of 12 months in any 24-month period
Austria	x	x	x				x	
Canada*		x		x			x	
Chile		x				x		
Indonesia		x		x	x			
Iceland		x					x	
Israel		x		x				x
New Zealand*		x				x		
Czech Republic		x	x				x	
Slovak Republic		x	x			x		

* In addition to the general provision, the treaty provides an exclusive rule for individuals, profesional services and other activities rendered independently, provided in periods of time that exceed, in aggregate, any 12-month period

Source: Natera y Espinosa, S.C.

Conclusions

Even though the alternative provision for PE in the case of independent services was included in the Model Tax Convention in 2008, Mexico included a similar provision in some of its previous double tax treaties. However, there are relevant differences between the provisions included in Mexico's treaties in respect of the alternative provision suggested by paragraph 42.23 of the Commentaries on Article 5, which makes it easier to create a service PE in terms of Mexican treaties.

In this context, it is important to point out that there are disadvantages of establishing such an alternative provision, which are presented in the Commentaries 42.12 and 42.13 on Article 5. Special attention is paid to the difficulties related to the increase in the compliance and administrative burden of taxpayers and tax administrations derived from allowing source taxation through a service PE. In addition, since such rules are created based on the time spent in a country, taxpayers will face the risk of having a PE under unexpected circumstances in cases where they would be unable to determine in advance how long personnel would be present in a particular country, and taxpayers will be forced to retroactively comply with a number of administrative requirements associated with a PE.

Considering that a permanent presence (through a place or agent) is not required for having a PE under the alternative provision, serious complications regarding profit calculation and tax collection may arise for taxpayers and authorities.

Such disadvantages have much more relevance in cases where constituting a PE under an alternative provision is much easier, such as the case of some of the double tax treaties executed by Mexico.

Notes:

1. Working Party No. 1 on Tax Conventions and Related Questions of the OECD Committee on Fiscal Affairs.
2. "The tax treaty treatment of services: proposed commentary changes", public discussion draft of December 8, 2006. This conclusion is also taken in paragraph 42.11 of the Commentaries on Article 5: "[t]he combined effect of this Article [5] and Article 7 is that profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting state are not taxable in the first-mentioned State if they are not attributed to a PE situated therein (as long as they are not covered by other Articles of the Model Tax Convention that allow such taxation)".
3. Paragraph 42.15, Commentaries on Article 5.
4. Idem.
5. Paragraph 42.16, Commentaries on Article 5.
6. Paragraph 42.17, Commentaries on Article 5.
7. Paragraph 42.18 and 42.22, Commentaries on Article 5.
8. Paragraph 42.19 and 42.22, Commentaries on Article 5.
9. Paragraph 42.20, Commentaries on Article 5.
10. Paragraph 42.25, Commentaries on Article 5.
11. For these purposes, Mexico adopted a common rule in OECD countries for determining whether or not a company shall be resident in this country. In this regard, companies that have established in Mexico the main administration of their business or their place of management are considered as Mexican residents (Article 9, Federal Fiscal Code).
12. For such purposes, an independent agent will not be deemed to act within the ordinary course of its business when: (a) the independent agent has stocks of goods or merchandise with which it makes deliveries on behalf of the non-resident; (b) the independent agent assumes risks for the non-resident; (c) the independent agent acts pursuant to detailed instructions from or under the general control of the non-resident; (d) the independent agent conducts activities that from an economical perspective, are attributable to the non-resident and not to the activities of the agent; (e) the independent agent receives compensations regardless of the result of its activities; or, (f) the independent agent conducts transactions with the non-resident using amounts of considerations or prices other than those which would have been agreed by or between independent parties in comparable transactions.
13. Such exceptions are as follow: (a) using or maintaining facilities for the sole purpose of storing or exhibiting goods or merchandise belonging to the non-resident; (b) keeping stocks of goods or merchandise that belong to the non-resident for the sole purpose of storing or exhibiting said goods or merchandise, or having them processed by a third party; (c) using a place of business for the sole purpose of purchasing goods or merchandise for the non-resident; (d) using a place of business for the sole purpose of conducting activities of a preliminary or auxiliary nature for those carried out by the non-resident, whether such activities consist of advertising, supplying information, conducting scientific research, preparing for the placement of loans, or other similar activities; or, (e) the bonded storage (*depósito fiscal*) of goods or merchandise of a non-resident in a bonded warehouse (*almacén general de depósito*), nor the delivery of such goods or merchandise for import into Mexico.
14. In addition to independent personal services, technical assistance, construction services and services related with public spectacles, activities performed by artists and sportsmen are also taxed under Title V of the MITL (Articles 200, 201 and 203, MITL).
15. Germany, Australia, Austria, Barbados, Belgium, Brazil, Canada, Czech Republic, Korea, Chile, China, Denmark, Ecuador, Spain, United States of America, Finland, France, Greece, Indonesia, Ireland, Iceland, Israel, Italy, Japan, Luxembourg, Norway, New Zealand, the Netherlands, Poland, Portugal, United Kingdom, Romania, Russia, Singapore, Slovak Republic, Switzerland and Sweden.
16. Except for the treaties executed with Austria, Canada, Czech Republic, Iceland, New Zealand and Slovak Republic, which do not include an article regarding independent services, and Chile, which includes such provision, but the 183 days rule is not included.
17. Dates shown in this paragraph indicate the day in which the corresponding treaty is applicable.