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Implications of New Mexican-Sourced Technical Assistance Ruling

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In June 2023, the plenary session of the Mexican Federal Tax Court ruled that technical assistance payments do not qualify as business profits under the Convention for the Avoidance of Double Taxation between Mexico and the Netherlands ("MX-NL DTT") and that, when Mexico is the source jurisdiction, such payments are subject to 25% withholding tax under Mexican domestic law (Jurisprudence IX-J-SS-70).

Although the Court had taken similar positions in the past, this ruling creates binding criterion that lower tax courts are required to apply in future cases under the Mexican principle of "jurisprudence by reiteration". In opinion of the authors, the Court's position could potentially qualify as a treaty override. Taxpayers making technical assistance payments to non-residents should carefully analyze the impact of this ruling. In particular, because reasonable arguments exist that a treaty override is inappropriate under Mexican law, U.S. taxpayers subject to withholding tax on Mexican-sourced technical assistance payments should consider the extent to which they may be required to pursue (and exhaust) Mexican administrative remedies before qualifying for a U.S. foreign tax credit.

Unpacking the Court's Position

Pursuant to MX-NL DTT, Article 3(2), any term that is not defined in the treaty shall have the meaning that it has "at that time" (i.e., the moment the treaty is being applied) under the law of that State for the purposes of the taxes to which the Convention applies. In this sense, when the treaty is applied to Mexican taxes, domestic Mexican provisions can be used to ascertain the meaning of undefined terms within the treaty.

As is typical of a double tax convention, MX-NL DTT, Article 7 provides that business profits obtained by an enterprise resident in a contracting State (e.g., Netherlands) shall only be taxable in that jurisdiction, except when such enterprise conducts business through a

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permanent establishment located in the other State (e.g., Mexico). As is also typical, under Article 7(7), such treatment does not apply to items of income that are dealt with separately in other Articles of the treaty.

In this context, the Court held that the fact that certain items of income are not included in other articles of the convention does not necessarily mean that Article 7 should apply. Moreover, the Court viewed "technical assistance" as an undefined term for purposes of the MX-NL DTT; consequently, Mexican law should inform the meaning of such term when Mexico is the source country.

Article 15-B of the Mexican Federal Tax Code provides a basic definition of "technical assistance," i.e., the provision of independent personal services through which one party provides non-patentable knowledge that does not involve the transmission of confidential information relating to industrial, commercial, or scientific experiences, and commits to be involved in the application of such knowledge. The Mexican Federal Tax Code also states that technical assistance payments should not be deemed to constitute royalties.

The key question is whether technical assistance should be treated as a business activity – and, further, whether income from those activities should constitute business profits for treaty purposes. Mexican law contains two relevant definitions of the term "business activities." The first, Article 16 of the Mexican Federal Tax Code, is a broad definition that encompasses, inter alia, commercial, industrial, and primary sector activities. The second, Article 175(VI) of the Mexican Income Tax Law ("MITL"), narrows the definition set forth in the Mexican Federal Tax Code by excluding technical assistance and certain other items of income.

The Court applied the MITL definition. Based on this reasoning, the Court concluded that technical assistance payments do not qualify as income derived from a business activity under domestic Mexican law and should not be treated as business profits under the MX-NL DTT, Article 7. Without providing significant analysis, the Court further ruled that technical assistance payments fall outside the scope of the other treaty articles. As a result, according to the Court, Mexican-sourced technical assistance payments received by a non-resident are subject to Article 167(2)(ii) of the MITL, which provides for a 25% withholding tax.

It is noteworthy that while the Court applied the more restrictive, MITL definition of business activities, the analysis may not be entirely straightforward. In particular since 2005, the Miscellaneous Tax Regulations ("MTR") provide that, for the purposes of Mexico's double tax treaties, the term "business profits" means income derived from the broader, the Mexican Federal Tax Code definition of business activities. The relevant regulation makes no reference to Article 175(VI) of the MITL. The Mexican Tax Administration, in Criterio Normativo 66/ISR/N, has also issued normative criteria confirming this position.

Nor does the Court reference the Commentaries to the OECD Model Tax Convention ("OECD Commentaries"). Pursuant to the Vienna Convention on the Law of Treaties, tax treaties celebrated by Mexico should be interpreted in accordance with OECD Commentaries, as

expressly recognized in domestic regulations under rule 2.1.33. of the MTR in force. The OECD Commentaries on Article 3 provide guidance as to what extent should domestic law be relied on for the application of the convention and state the following:

"11. This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e., when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly.

12. However, paragraph 2 specifies that the domestic law meaning of an undefined term applies only if the context does not require an alternative interpretation and the competent authorities do not agree to a different meaning pursuant to the provisions of Article 25. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided)."

In this sense, the OECD Commentaries recognize that domestic legislation can be used to determine the meaning of undefined terms. However, there should be a balance that protects the continuity of the commitments (e.g., treaty benefits) agreed between States upon signing. In other words, pursuant to OECD Commentaries, contracting States should not be able to make future amendments to their domestic law to prevent the application of the treaty (known as a "treaty override").

The MX-NL DTT was signed on September 27th, 1993, entered into force on October 13th, 1994, to be applicable as of January 1st, 1995 –the contracting States entered into an amending protocol in 2008; however, none of the treaty provision relevant for the analyzed case were amended–. Article 15-B of the Mexican Federal Tax Code (which includes the definition of "technical assistance") was introduced in December 1996; meanwhile, the predecessor of Article 175(VI) – former Article 162(VI) – that limits the definition of income derived from "business activities" for purposes of non-resident taxation, was introduced to the MITL in December,1998 to be applicable as of 1999.

Both of the domestic provisions that are fundamental for the Court's decision were introduced into Mexican law after the MX-NL DTT was signed, and even after the treaty entered into force. With this timeline in mind, the Court's position implies that Article 3(2) of MX-NL DTT allows the use of domestic law definitions introduced after the signing of the convention to prevent the application of treaty benefits agreed by the contracting states, which contradicts OECD Commentaries. In practice, such interpretation makes the treaty inoperative with respect to technical assistance payment made to a resident in the Netherlands. Is hard to argue that this was the intention of the parties upon celebrating the MX-NL DTT.

In addition, it should be noted that the Mexican Supreme Court has ruled that international treaties hierarchically supersede domestic law. This further strengthens the position that, even though Mexico is free to amend its domestic law, such changes should not override international treaties.

Future Implications

The recent jurisprudence by the Federal Tax Court could have significant implications for future cases, as it is legally binding on Mexican lower courts. The Mexican Supreme Court, Federal District Court, and Federal Circuit Courts are not obliged to follow Federal Tax Court rulings. The Court's criterion is also not binding for other taxpayers and the Mexican tax administration. However, during tax examinations, tax administration officials could adopt a similar position to challenge the application of treaty benefits with respect to technical assistance payments to a resident of the Netherlands or even of another treaty jurisdiction. Taxpayers that make Mexican-sourced, cross-border technical assistance payments should review the specific details of their operation and arguments to support the application of treaty benefits.

U.S. taxpayers face an additional nuance in the U.S. foreign tax credit rules. Those rules may require a U.S. taxpayer that finds itself subject to a 25% Mexican withholding tax on technical assistance payments to challenge the imposition of the tax under arguments such as the ones above. Failure to exhaust the administrative remedies available to resolve the issue, e.g., competent authority proceedings, could risk creditability of the withholding tax in the United States.