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The most impactful changes to the NL – MEX DTAA (following the ratification and deposit of the MLI by Mexico)

November 2023

In 2017, Mexico signed the MLI[1,2] (or "the Instrument") under the framework of the BEPS project[3]. However, it wasn't until October 2022 that the Mexican Senate ratified the Instrument and later, in November 2022, published it in the Mexican Gazette. In March 2023, Mexico deposited the ratification bill for the MLI with the OECD and entered into force for Mexico's double tax treaties on 1 July 2023. Provisions referring to taxes withheld at source on amounts paid to non-residents shall take effect from January 1, 2024, and all other provisions related to taxes on a yearly basis shall take effect from January 1, 2025.

Since the Netherlands has already ratified and deposited the MLI with the OECD in 2019, the Netherlands-Mexico DTAA (or "the DTAA") will be modified since the MLI entered into force for Mexico's DTAAs (i.e., 1 July 2023). The DTAA is modified based on each party's specific choice to opt in or opt out of the corresponding articles of the MLI. Articles of the MLI rejected by either of the parties will not impact the DTAA. For example, the Netherlands has opted for arbitration provisions (i.e., Art. 18 of the MLI) while Mexico has not. Hence, arbitration would not be included in the Netherlands-Mexico DTAA even upon implementation of the MLI by both countries.

The table below provides an overview of the most relevant MLI provisions and indicates whether the Netherlands and Mexico have opted in for each of these provisions. The last column in the table clarifies the impact on the Netherlands-Mexico DTAA (with effect from 1 July 2023). The columns highlighted in green are discussed in further detail below.

MLI Article	Position of the Netherlands	Position of Mexico	Impact on the DTAA
Article 2: Covered Tax Agreement	✓	✓	The agreement will be considered as "covered tax agreement".
Article 3: Transparent Entities	✓	✗	No impact/Art. 1(2) of the DTAA will not change.
Article 4: Dual Resident Entities	✗	✗	No impact/Art. 4 of the DTAA will not change.
Article 5: Application of Methods for the Elimination of Double Taxation	✓	✓	Article 22(2) of the DTAA will disallow the relief mechanism to income that is otherwise exempt or taxed at a reduced rate.
Article 6: Purpose of a Covered Tax Agreement	✓	✓	The preamble of the DTAA will be modified to state that the purpose of the DTAA is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.
Article 7: Prevention of Treaty Abuse	✓	✓	Articles 11(8) and 12(7) of the DTAA will include the principal purpose test ("PPT"). The simplified version of the limitation of benefits ("LoB provision") will no longer apply.
Article 8: Dividend Transfer Transactions	✓	✓	Article 10(2) of the DTAA will be modified to consider that the reduced rate of 5% will be subject to an ownership threshold within a 365-day period.

[1] OECD's Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting ("BEPS").
[2] The MLI intends to fight against BEPS by implementing the tax treaty-related measures developed through the BEPS Project in existing tax treaties. In general terms, the MLI modifies tax treaties that are in force between parties that have agreed to implement the Instrument (or some part(s) thereof) based on each party's specific choices to the corresponding articles of the MLI.
[3] OECD's project that aims at developing effective domestic and international instruments to tackle aggressive and harmful tax practices and to prevent BEPS.

MLI Article	Position of the Netherlands	Position of Mexico	Impact on the DTAA
Article 9: Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property	✓	✓	Article 13(1) of the DTAA will include a 365-day threshold for immovable property contributed to companies before the sale of shares.
Article 10: Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions	✓	✓	The DTAA will include a provision for the denial of benefits when the third jurisdiction (where the PE is located) exempts the PE profits from taxation or taxes the PE profits at a reduced rate.
Article 11: Application of Tax Agreements to Restrict a Party's Right to Tax its own residents	✗	✓	No impact/Art. 1(3) of the DTAA will not be included ("savings clause").
Article 12: Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies	✓	✗	No impact/Art. 5(5 and 6) the DTAA will not change.
Article 13: Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions	✓	✓	Article 5(4) of the DTAA will include the criteria that the specified activities need to be auxiliary in nature in order to avoid PE-status.
Article 14: Splitting-up of Contracts	✗	✓	No impact/Art. 5(3) of the DTAA will not change.
Article 15: Definition of a Person Closely Related to an Enterprise	✗	✗	No impact/Art. 5(6) the DTAA will not change.
Article 16: Mutual Agreement Procedure	✓	✓	Article 24 (1) of the DTAA will be updated to the latest OECD Model Tax Convention MAP provision.
Article 17: Corresponding Adjustments	✗	✓	No impact/Art. 9 of the DTAA will not change.
Article 18: General Applicability of Part IV (Arbitration)	✓	✗	No impact/Part IV. Art 19 of the DTAA will not change.

Based on the above, following is a detailed description of the most important changes in the Netherlands-Mexico DTAA (with effect from 1 July 2023).

Considerations – MLI impact on the Netherlands-Mexico DTAA

1. Hybrid mismatches (Article 5 MLI – Article 22 DTAA)

Hybrid mismatches arise when there are differences in the tax treatment of entities or legal arrangements between two countries. Under certain circumstances, this can lead to a situation where income is taxed in both jurisdictions or, on the other hand, not taxed in either of the jurisdictions. This (i.e., double non-taxation) usually occurs when an entity or legal arrangement is considered transparent for tax purposes by one of the countries involved, and the other country involved deems the entity or legal arrangement as a non-transparent entity. Hence, the inclusion of a provision addressing hybrid mismatches will provide relief from double taxation in instances where income is taxed in both countries and, on the other hand, prevent double non-taxation in instances where income is not taxed in either jurisdiction, thereby bringing about fairness in the tax system.

Accordingly, the inclusion of Article 5(2) of the MLI (which addresses hybrid mismatches) in the NL-Mexico DTAA provides a mechanism with respect to the elimination of double non taxation; specifically, to disallow the relief for double taxation methods (credit or exemption) for income that is exempt or subject to a reduced treaty rate in the other jurisdiction.

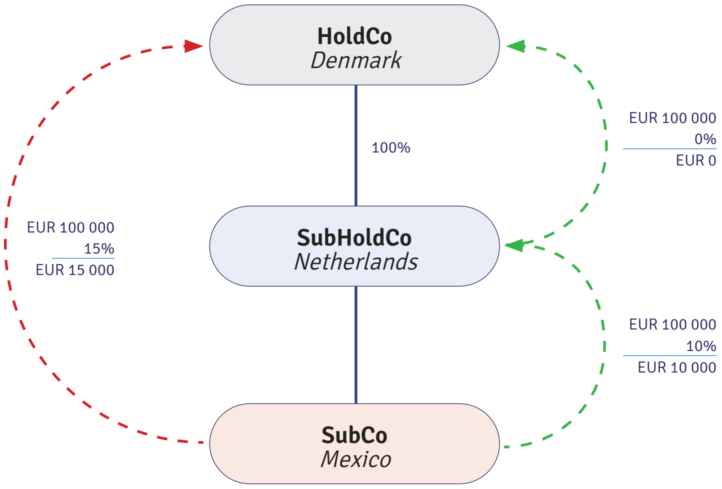
2. Principal Purpose Test (Article 7 MLI – Articles 11 & 12 DTAA)

The "principal purpose test" is one of the key provisions to be included in the interest and royalties' articles of the NL-Mex DTAA through the MLI, under which the benefits of a tax treaty may be denied if one of the principal purposes of a transaction/structure is to benefit from the tax treaty. In this way, the principal purpose test ("PPT") aims to prevent treaty abuse by ensuring that the benefits of a tax treaty are not granted in abusive situations. Arming tax authorities with such a provision helps maintain a level playing field for all taxpayers and ensures the tax treaty fulfills its intended purpose. The PPT must be applied (by the relevant tax authorities) on a case-by-case basis.

Following is an example of the type of structures that this provision aims to combat. The example is hypothetical and solely for illustrative purposes.

A Danish holding company receiving interest from its subsidiary in Mexico must pay 15% interest withholding tax ("WHT") in accordance with the tax treaty between Denmark and Mexico. However, if the Danish holding company were to set up a sub-holding company in the Netherlands and route the interest via the Netherlands, the tax due in Mexico (under the tax treaty between the Netherlands and Mexico) would be 10%, and further, interest from the Netherlands to Denmark would be exempt from taxation under the Interest Royalty Directive[4].

Reference is made to the diagram below, wherein the effective tax is reduced from EUR 15,000 to EUR 10,000 by interposing a sub-holding company in the Netherlands as described above.



With regard to the example above, the inclusion of the PPT in Articles 11(8) & 12(7) of the Netherlands-Mexico DTAA (with effect from 1 July 2023) arms the Mexican tax authorities with a provision to question the purpose of interposing the Dutch sub-holding company and, potentially, denying the application of the beneficial interest WHT rate provided for under the Netherlands-Mexico DTAA. If the Mexican tax authorities were to conclude that one of the main purposes of interposing the Dutch sub-holding company was to take advantage of the DTAA, it could lead to the denial of treaty benefits.

Since the inclusion of the PPT could have a major impact on the effective interest WHT rate for interest or royalty payments flowing from Mexico to the Netherlands, we consider it relevant to review (on a case-by-case basis) transactions/structures that might be affected.

3. Change in dividends & capital gains articles (Article 8 and 9 of MLI – Articles 10 & 13 of DTAA)

With effect from 1 July 2023, a (new) holding requirement of minimum 365-days prior to the dividend distribution is required to be met in order to avail the beneficial dividend WHT rate of 5% under Article 10 of the DTAA.

[4] COUNCIL DIRECTIVE 2003/49/EC of 3 June 2003 on the Common System of Taxation, applicable to interest and royalty payments made between associated companies of different Member States. The Directive is designed to eliminate withholding tax obstacles in the area of cross-border interest and royalty payments within a group of companies by abolishing: (i) withholding taxes on royalty payments arising in a Member State, and (ii) withholding taxes on interest payments arising in a Member State.

The change with regard to capital gains derived by real estate companies[5] addresses situations where a real estate company in one of the countries tries to circumvent the provisions of the pre-MLI Article 13 of the DTAA by reducing the value of immovable property in the other country (for example, by making capital contributions).

Article 13 of the DTAA allocates the taxing rights over income from immovable property to the country where the immovable property is located, and further, the taxing rights over income from the alienation of shares (other than shares quoted on an approved stock exchange) the value of which is derived principally (i.e. at least 50%) from immovable property to the country where the immovable property is located. With effect from 1 July 2023, the same allocation shall apply if the relevant value threshold is met during the 365 days preceding the alienation of the shares.

Hence, with regard to transactions involving dividend distributions and capital gains (for real estate companies), it is important to review certain aspects of the previous year and/or plan one year ahead.

4. Artificial Avoidance of Permanent Establishment Status through Specific Activity Exemptions (Article 13 MLI – Article 5 DTAA)

The presence of a PE triggers taxation of business profits allocable to the PE. Under tax treaties, PEs are recognized based on physical presence. However, certain activities, categorized as “ancillary activities” are excluded from the definition of PE (i.e., these activities, whether one or a combination thereof are carried out, do not create a PE). Accordingly, it is possible for a company to avoid taxation in a certain jurisdiction, even if it has a significant presence/income-generating activities in that jurisdiction, by engaging exclusively in the excluded/ancillary activities listed in the PE-article of the applicable tax treaty.

The Netherlands-Mexico DTAA includes a list of excluded/ancillary activities deemed not to constitute a PE. The inclusion of Article 13(2) of the MLI (with effect from 1 July 2023) provides that the exclusion from the PE-definition will only apply if these activities are of a preparatory or auxiliary character (the list of excluded/ancillary activities remaining the same).

The inclusion of Article 13(2) of the MLI/“Artificial Avoidance of PE Status” aligns with BEPS Action 7, which aims to prevent the use of artificial arrangements for avoiding PE status. Hence, this inclusion will provide clarity and guidance on what constitutes a taxable presence, especially in cases where enterprises engage in activities that do not meet the traditional thresholds. Explicitly addressing specific activities will become more effective in capturing the taxable presence and preventing tax avoidance.

5. Mutual Agreement Procedure (MAP – OECD 2014 update – Article 16 MLI – Article 24 DTAA)

In general terms, the mutual agreement procedure (“MAP”) is a dispute resolution mechanism that allows taxpayers to seek relief from double taxation or taxation that is not in accordance with the provisions of the applicable treaty. The MAP provides a mechanism for the competent authorities of both the treaty partner countries to work together to resolve cross-border tax disputes and reach a mutually acceptable solution.

The updated version of the MAP included in the Netherlands-Mexico DTAA with effect from 1 July 2023 provides a new level of certainty for taxpayers in both jurisdictions. This considering that the changes provided by the MLI would allow taxpayers to enter into a MAP with either of the jurisdictions. The updated MAP would provide clarity on the procedures and guidelines for resolving disputes and can ensure that taxpayers have access to the most current information and resources.

In addition, an updated MAP can reflect changes to the administrative and legal systems of the treaty partners, which can impact the way that disputes are resolved; this can help to ensure that taxpayers will be able to navigate the dispute resolution process effectively.

Furthermore, an updated MAP will also reflect changes in the interpretation of the treaty provisions and the application of the MAP itself. This can provide greater clarity and certainty for taxpayers who are seeking relief from double taxation or taxation not in accordance with the treaty.

[5] “Real estate companies” refers to companies resident in one country, deriving at least 50% of their value from immovable property located in the other country.

Key takeaways

- In March 2023, Mexico deposited its instrument of ratification for the MLI before the OECD. The Instrument entered into force for Mexico's DTAAs on 1 July 2023.
- January 1, 2024, any MLI provisions that refer to taxes withheld at source shall take effect.
- On January 1, 2025, all other provisions related to taxes on a yearly basis shall take effect.
- The MLI's provisions will modify the existing NL-Mex DTAA. This needs to be evaluated on a case-by-case basis by presenting the pertinent facts and circumstances.
- Following are the most important changes to the NL-Mex DTAA brought about by the MLI:
  - Inclusion of rule to deal with hybrid mismatches;
  - Inclusion of the principal purpose test;
  - Introduction of minimum holding periods for availing the beneficial WHT rates for dividends and capital gains (for real estate companies);
  - Activity exemptions for permanent establishment; and
  - Changes to the Mutual Agreement Procedure provisions (OECD 2014 update).

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