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PROTOCOL AMENDING THE TAX CONVENTION WITH MEXICO

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Mr. LUGAR from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 108–3]

The Committee on Foreign Relations, to which was referred the Second Additional Protocol That Modifies the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Mexico City on November 26, 2002, having considered the same, reports favorably thereon and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

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I. PURPOSE

The principal purposes of the existing income tax treaty between the United States and Mexico and the proposed protocol amending the existing treaty between the United States and Mexico are to re-

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duce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty and proposed protocol also are intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

II. Background

The proposed protocol was signed on November 26, 2002. The proposed protocol would amend the existing income tax treaty between the United States and Mexico that was signed in 1992.

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on February 25, 2003 (see Treaty Doc. 108–3). The Committee on Foreign Relations held a public hearing on the proposed protocol on March 5, 2003.

III. Summary

The proposed protocol includes provisions similar to those of other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the proposed protocol contains certain substantive deviations from these treaties and models.

As in other U.S. tax treaties, the purposes of the protocol principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. In the case of dividends, the proposed protocol contains provisions that would eliminate source-country tax on certain intercompany dividends in which certain ownership thresholds and other requirements are satisfied. In addition, the proposed protocol would provide a parallel exemption from the U.S. branch profits tax (Articles 2 and 3 of the proposed protocol).

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed protocol generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Articles 4 and 5 of the proposed protocol).

IV. Entry Into Force and Termination

A. Entry into force

The proposed protocol will enter into force on the date on which the second of the two notifications of the completion of ratification requirements has been received. Each country must notify the other through diplomatic channels when its constitutional requirements for ratification have been satisfied. The proposed protocol will be effective with respect to dividends paid or credited on or after the first day of the second month after the date on which the protocol enters into force. All other provisions of the proposed protocol will be effective for taxable periods beginning on or after the

first day of January of the year following the year in which the proposed protocol enters into force.

B. TERMINATION

The existing treaty, as amended by the proposed protocol, will remain in force until terminated by either country. Either country may terminate the treaty by giving notice of termination to the other country through diplomatic channels. In such case, a termination is effective in respect of taxes imposed in accordance with Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) for amounts paid or credited on or after the first day of the second month next following the expiration of the six month period following notice of termination. A termination is effective in respect of other taxes for taxable periods beginning on or after first day of January following the expiration of the 6 month period following notice of termination.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed protocol with Mexico (Treaty Doc. 108–3) on March 5, 2003. The hearing was chaired by Senator Hagel.[1] The Committee considered the proposed protocol on March 12, 2003, and ordered the proposed protocol with Mexico favorably reported by a vote of 19 in favor and 0 against, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty.

VI. COMMITTEE COMMENTS

On balance, the Committee on Foreign Relations believes that the proposed protocol with Mexico is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed protocol and believes that the following comments may be useful to the Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. ZERO RATE OF WITHHOLDING TAX ON DIVIDENDS FROM 80-PERCENT-OWNED SUBSIDIARIES

In general

The proposed protocol would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (subparagraph 3(a) of Article 10 of the current treaty (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Currently, no U.S. treaty provides for a complete exemption from withholding tax under these circumstances, nor do the U.S. or OECD models. However, many bilateral tax treaties to which the

[1] The transcript of this hearing will be forthcoming as a separate Committee print.

United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, the United States has signed a proposed treaty with the United Kingdom and a proposed protocol with Australia that include zero-rate provisions similar to the one in the proposed protocol.

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on certain dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 of the current treaty (Dividends)). Under the current U.S.-Mexico treaty, these dividends may be taxed at a 5-percent rate.

Benefits and costs of adopting a zero rate with Mexico

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., 5 percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit, withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Mexico, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since Mexico does not currently impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by Mexican companies, as opposed to direct investment in Mexico by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it.

However, it should be noted that, although Mexican internal law currently does not impose a withholding tax on dividends paid to foreign persons, there is no guarantee that this will always be the case. Indeed, Mexican law has changed recently in this regard—Mexico adopted a dividend withholding tax in 1999, but then repealed it in 2001 (effective for dividends paid after 2001). Thus, the inclusion of a zero-rate provision under the proposed protocol would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in Mexico, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc against increased foreign tax credit claims in the event that Mexico were to change its internal law in this regard.

Although the United States has never agreed bilaterally to a zero rate of withholding tax on direct dividends, many other countries have done so in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed protocol is unprecedented in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

Committee conclusions

The Committee believes that every tax treaty must strike the appropriate balance of benefits in the allocation of taxing rights. The agreed level of dividend withholding for intercompany dividends is one of the elements that make up that balance, when considered in light of the benefits inuring to the United States from other concessions the treaty partner may make, the benefits of facilitating stable cross-border investment between the treaty partners, and each partner's domestic law with respect to dividend withholding tax.

In the case of this protocol, considered as a whole, the Committee believes that the elimination of withholding tax on intercompany dividends appropriately addresses a barrier to cross-border investment. The Committee believes, however, that the Treasury Department should only incorporate similar provisions into future treaty or protocol negotiations on a case-by-case basis, and it notes with approval Treasury's statement that "[i]n light of the range of facts that should be considered, the Treasury Department does not view [elimination of withholding tax on intercompany dividends] as a blanket change in the United States' tax treaty practice."

The Committee encourages the Treasury Department to develop criteria for determining the circumstances under which the elimination of withholding tax on intercompany dividends would be appropriate in future negotiations with other countries. The Committee expects the Treasury Department to consult with the Committee with regards to these criteria and to the consideration of elimination of the withholding tax on intercompany dividends in future treaties.

B. MOST-FAVORED NATION PROVISION

Under the current U.S.-Mexico income tax treaty, dividends beneficially owned by a company that owns at least 10 percent of the voting stock of the dividend-paying company are subject to a maximum withholding rate of 5 percent (paragraph 2(a) of Article 10 of the current treaty), which is the lowest rate of withholding tax on dividends currently available under U.S. treaties. Under Protocol 1 to that treaty, the United States and Mexico agreed that if the United States agreed in a treaty with another country to impose a lower rate on dividends than the 5% rate, "both Contracting States shall apply that lower rate instead of the [5%] rate."

At the time the Committee considered the original Mexico income tax treaty, the Committee was concerned with the self-executing nature of the provision in the Mexico protocol. As a result, the Senate provided its advice and consent to the ratification of the treaty subject to an understanding "that the phrase 'both Contracting States shall apply that lower rate' . . . is understood to mean that both Contracting States agree to promptly amend the Convention to incorporate that lower rate."

The adoption of a zero-rate provision in the U.S.-Australia or the U.S.- U.K. treaty relationship would implicate this commitment to amend the current treaty with Mexico.

Committee conclusions

The Committee remains concerned with the self-executing nature of the provision in the original Mexico protocol. The Committee believes that a subsequent amendment to any previously ratified treaty should be subject to the advice and consent of the Senate. The Committee is not persuaded by those who have contended that the Senate would *de facto* approve the amendment in giving its advice and consent to a subsequent treaty that triggered the most favored nation clause. Such provisions disrupt the delicate balance of power between the legislative and executive branches of government.

It is the Committee's understanding that subsequent treaties have not included such self-executing provisions. The Committee notes its continuing concern regarding the effect of such provisions and expects that the Treasury Department will not include such provisions in future treaties.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed protocol is estimated to cause a negligible change in Federal budget receipts during the fiscal year 2003–2012 period.

VIII. Explanation of Proposed Treaty

A detailed, article-by-article explanation of the proposed protocol between the United States and Mexico can be found in the pamphlet of the Joint Committee on Taxation entitled Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Mexico (JCS-6-03), March 3, 2003.

IX. Text of Resolution of Ratification

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Second Additional Protocol That Modifies the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Mexico City on November 26, 2002 (Treaty Doc. 108–3).