

International Tax

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This article highlights some of the most significant international tax developments that took place in 2019 in Brazil, Canada, the European Union, Mexico, and the United States.

I. Brazil

The Brazilian tax system is unique and, in many ways, does not follow international standards. Some of these peculiarities were under the spotlight in 2019 because of new rules, case law, and debates regarding the digitalized economy.

This text briefly addresses: (i) the new industrial policy for the sectors of information technology, communications (ITC), and semiconductors; (ii) new tax rulings regarding royalties paid to foreign related companies for the right to commercialize software; (iii) new rules on the Internet of Things (IoT); and (iv) discussions for a broad tax system reform.

At the end of 2019, a new rule² was published regulating the industrial policy for the sectors of information technology, communications (ITC), and semiconductors, changing the legislation in force since the '90s. In general terms, the new law, which, as of April 2020, will be in force for the next ten years, replaces the tax incentives which were invalidated by the World Trade Organization (WTO).³ Such benefits correspond to financial

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2. Lei No. 13.969, de 26 de Dezembro de 2019, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 27.12.2019 (Braz.).

3. Koury Lopes Advogados, *Brazil: In the Wake of WTO Decision, Brazil Changes Tax Incentives for Information Technology, Communications, and Semiconductor Products*, MONDAQ (Jan. 10, 2020), <https://www.mondaq.com/brazil/telecoms-mobile-cable-communications/881860/in-the-wake->

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credits for companies with activities of research, development, and innovation.⁴ “The financial credits may be used to offset federal taxes within a term of up to five years, or may be refunded in cash.”⁵

A second issue related to the digitalized economy is the tax treatment of royalties. Generally, member countries (i.e., member states) of the Organization for Economic Co-operation and Development (OECD) apply the arm’s length standard (ALS) for determining the amount of royalty payments made between related or controlled parties.⁶ Brazil, however, does not apply the ALS and instead employs formulaic percentages—varying from one to five percent of net revenue—to determine the extent to which the royalty payments between related parties may be deducted from income for Brazilian tax purposes.⁷

In specific cases, such as royalties paid to shareholders or company managers, those payments are legally excluded from the general rule, and thus are not deductible at all.⁸ But on the first semester of 2019, the Brazilian Revenue published an Answer to Advance Tax Ruling Request, according to which, payments made to indirect controllers of the same economic group due to the right to software commercialization are not covered by the limitation regarding payments to shareholders, and thus are deductible from the tax basis of corporate income tax.⁹

The Brazilian Revenue’s position is especially important because it settles a common issue faced by tech companies that have been subject to discussion on the Brazilian Administrative Court of Tax Appeals (CARF). In 2018, a decision rendered for a Brazilian branch of a software company had already

of-wto-decision-brazil-changes-tax-incentives-for-information-technology-communications-and-semiconductor-products.

4. *Id.*

5. *Id.*

6. Masatsugu Asakawa, *Transfer Pricing in the New Global Landscape: the OECD’s Engagement Beyond its Borders*, ORG. FOR ECON. COOPERATION & DEV., http://www.oecd.org/tax/tax-global/Japan_TP_in_new_Global_Landscape.pdf.

7. The limits are established according to the royalties’ essentiality (i.e. royalties on the production and distribution of electricity – limited to 5%; royalties on food production – limited to 4%; royalties on production of scientific machinery – limited to 3%; royalties on the production of hygiene goods – limited to 2%; royalties on the use of trademarks not associated with patent, preceding or fabrication formula – limit of 1%). Trench Rossi Wantabe, *Transfer Pricing in Brazil*, LEXOLOGY (Sept. 9, 2019), <https://www.lexology.com/library/detail.aspx?g=c29c500d-9ad9-4b42-bfc1-bd963b314e6a#:~:text=Brazil%20does%20not%20follow%20the%20arm’s%2Dlength%20principle%20as%20established,the%20OECD%20Transfer%20Pricing%20Guidelines.&text=In%20other%20words%2C%20there%20is,result%20will%20be%20arm’s%20length.>

8. Lei No. 4.506, de 30 de Novembro de 1964, art. 71, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 30.11.1964 (Braz.).

9. Solução de Consulta Cosit No. 182, de 31 de Maio de 2019, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 21.06.2019 (Braz.).

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expressed the same positioning expressed by the Brazilian Revenue.¹⁰ This decision was subject to analysis by the Superior Chamber of CARF in 2019, and the understanding was not overruled.¹¹

A third important issue for the digitalized economy came out in the second semester of 2019, with the publishing of a rule establishing the National Plan of implementing and developing the infrastructure for the IoT.¹² It is debatable which indirect taxes could be imposed on the IoT. On the one hand, communication services are taxed by the States through the state value-added tax (ICMS).¹³ On the other hand, Municipalities impose a service tax (the ISS) on value-added services.¹⁴ Despite the controversies about it, many Municipalities have also taxed the exploitation of intangibles.¹⁵ By expressly stating that IoT involves “the provision of value-added services,” the National Plan suggests that this kind of technology should be taxed by the Municipality and not by the State, which represents a significant difference in terms of the tax burden.¹⁶

A fourth aspect being mentioned is the reform of the Brazilian tax system due to the challenges of the digital economy. These possible reforms involve direct and indirect taxes. For decades, Brazil has adopted a very complex system of indirect taxes, in which Municipalities, States, and the Federal Union compete to tax services and goods. The coexistence of these taxes has raised many problems in terms of efficiency, certainty, compliance costs, and litigation. When it comes to digitalized business models, such as streaming technology and collaborative consumption (so-called sharing economy), the controversies can be even worse. But a broad reform has been discussed, even at the constitutional level.¹⁷ Advocates of this tax reform claim that a Federal VAT would solve the matter by replacing many existing taxes.¹⁸

Regarding direct taxation, Brazilian transfer pricing rules have combined the OECD’s arm’s length standard with domestic formulas, which are based

10. See *Decisão de Conselho Administrativo de Recursos Fiscais [CARF] No. 1302-002.695*, de 9 de Abril de 2018 (Braz.), available at <https://carf.fazenda.gov.br/sincon/public/pages/ConsultarJurisprudencia/listaJurisprudencia.jsf?idAcordao=7251092>.

11. *Id.*

12. Decreto No. 9.854, de 25 de Junho de 2019, DIÁRIO OFICIAL DA UNIÃO [D.O.U.] de 26.06.2019 (Braz.).

13. Ana Claudia and Akie Utumi, *The Challenge of Taxing Digital Goods and Services*, INT’L TAX REV. (Mar. 30, 2020), <https://www.internationaltaxreview.com/article/b1ky678ck9px6q/the-challenge-of-taxing-digital-goods-and-services>.

14. *Id.*

15. *Id.*

16. See Decreto No. 9.854, at art. 2, § 1.

17. See Henrique Erbolato, *Brazilian Tax Reform—Framework and What to Expect*, BLOOMBERG (Jan. 22, 2020), <https://news.bloombergtax.com/daily-tax-report-international/brazilian-tax-reform-framework-and-what-to-expect>.

18. See *id.*

on fixed margins of profitability since 1996.¹⁹ Despite this, 2019 was marked by the Brazilian commitment to become an OECD member country, and the reform of its transfer pricing rules may represent one of the most critical requirements to achieve this purpose.²⁰ In this context, the Brazilian Revenue has joined a special OECD Committee to study alternatives to align Brazil's transfer pricing rules to OECD standards.²¹

Finally, it is worth mentioning that while many countries are discussing (or already adopting) digital services taxes, it seems to be far from the Brazilian priorities.²² One possible explanation for this is that Brazil traditionally taxes all companies that undertake business activities within the Brazilian territory by withholding taxes on payments made by Brazilian companies to foreign entities, even if it does not have a permanent establishment in the country. Many giant tech companies have incorporated subsidiaries in Brazil precisely to avoid withholding taxation.²³ While most of the countries are struggling because of their definitions of permanent establishment as a limitation to tax services provided by foreign companies, Brazil has never adopted such a pattern.

II. Canada

A. MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING

Canada ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) on the June 21, 2019.²⁴ The MLI enforces BEPS Action 2 (Hybrid mismatches), Action 6 (Treaty abuse), Action 7 (Permanent Establishments) and Action 14 (Dispute Resolutions).²⁵ The MLI co-exists with existing treaties and does

19. *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*, ORG. FOR ECON. COOPERATION & DEV., <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-in-brazil-towards-convergence-with-oecd-standard-brochure.pdf>.

20. *Id.*

21. *OECD and Brazil Share Outcomes of Project to Align Brazil's Transfer Pricing Rules to OECD Standard*, ORG. FOR ECON. COOPERATION & DEV. (July 11, 2019), <https://www.oecd.org/tax/oecd-and-brazil-share-outcomes-of-project-to-align-brazil-s-transfer-pricing-rules-to-oecd-standard.htm>.

22. *Id.*

23. *Doing Business and Investing in Brazil*, PWC (Mar. 2013), <https://www.pwc.de/de/internationale-maerkte/assets/doing-business-and-investing-in-brazil.pdf>.

24. Patrick Marley, Kaitlin Gray, and Taylor Cao, *Multilateral Instrument (MLI) will Enter into Force for Canada on December 1, 2019*, OSLER (Aug. 29, 2019), <https://www.osler.com/en/resources/regulations/2019/multilateral-instrument-mli-will-enter-into-force-for-canada-on-december-1-2019>.

25. ITR Correspondent, *MLI: Testing the "Principle Purpose"*, INT'L TAX REV. (Dec. 12, 2018), <https://www.internationaltaxreview.com/article/b1f7n2f6tqcfyx/mli-testing-the-principal-purpose>.

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not amend existing tax treaties.²⁶ A treaty to which the MLI applies is referred to as a Covered Tax Agreement (CTA).²⁷ In order for the MLI to apply, both treaty partners must identify the tax treaty as a CTA. The MLI consists of thirty-nine articles, most of which are optional.²⁸ The mandatory articles contain the OECD/G20 minimum standards most adopted by jurisdictions who have signed on to the MLI.²⁹

The minimum standards are found in Article 6 (Purpose of a Covered Tax Agreement), Article 7 (Prevention of Treaty Abuse), Article 16 (Mutual Agreement Procedure), and Article 17 (Corresponding Adjustments).³⁰ Articles 16 and 17 contain the minimum standards for the improvement of dispute resolution under BEPS Action 14.³¹ Signatories to the MLI may choose to adopt the minimum standards only or some or all of the optional articles.³² Each jurisdiction must notify the OECD Secretariat which of its tax treaties the MLI applies too and what articles of the MLI was adopted and ratified by that jurisdiction.³³

On December 1, 2019, the MLI entered into force in Canada and will apply to Canada's tax treaties that are covered by the MLI as of January 1, 2020.³⁴ Canada opted out of Article 3 (transparent entities), Article 5 (Application of Methods for Elimination of Double Taxation), and Articles 10, 11, 12, 13, 14, and 15 entirely.³⁵ Canada listed eighty-four of its ninety-three tax treaties as CTAs.³⁶ The list submitted by Canada does not include the United States, Germany, and Switzerland.³⁷ The United States is not a

26. *Id.*

27. *Id.*

28. See Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, Nov. 24, 2016, O.E.C.D. Archives.

29. See *id.*

30. ITR Correspondent, *supra* note 25.

31. Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting art. 16, 17, Nov. 24, 2016, O.E.C.D. Archives.

32. Patrick Marley, Kaitlin Gray, & Taylor Cao, *Multilateral Instrument (MLI) Will Enter into Force for Canada on December 1, 2019*, OSLER (Aug. 29, 2019), <https://www.osler.com/en/resources/regulations/2019/multilateral-instrument-mli-will-enter-into-force-for-canada-on-december-1-2019#:~:text=Canada%20announced%20today%20that%20the,Canada%20on%20December%201%2C%202019>.

33. Status of List Reservations and Notifications upon Deposit of the Instrument of Ratification, DEPT. OF FOREIGN AFF. (Aug. 29, 2019), <http://www.oecd.org/tax/treaties/beps-mli-position-canada-instrument-deposit.pdf>.

34. *Canada: Multilateral Instrument (MLI) is Ratified*, KPMG (Aug. 29, 2019), <https://home.kpmg/us/en/home/insights/2019/08/tnf-canada-mli-ratified.html>.

35. See Patrick Marley, Kaitlin Gray, & Taylor Cao, *Impact of Recent International Tax Developments on Canada*, OSLER (June 24, 2019), <https://www.osler.com/en/resources/cross-border/2019/impact-of-recent-international-tax-developments-on-canada>; see also Ehsan Wahidie & Michel Ranger, *Canada Ratifies the Multilateral Instrument*, MCMILLAN (Sept. 2019), https://www.mcmillan.ca/Files/216358_Canada_Ratifies_the_Multilateral_Instrument.pdf.

36. Status of List Reservations and Notifications upon Deposit of the Instrument of Ratification, *supra* note 33.

37. *Id.*

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signatory to the MLI and will not affect the Canada–U.S. Tax Treaty.³⁸ Although Germany and Switzerland are both signatories to the MLI, Canada has announced that it will commence bilateral treaty negotiations of its treaties with Germany and with Switzerland.³⁹

Canada adopted the mandatory binding arbitration provisions of Articles 18 to 26.⁴⁰ It also adopted the Mutual Agreement Procedure of Article 16, and the corresponding adjustments contained in Article 17.⁴¹ Canada has indicated that it may replace its current specific tie breaker rules with Article 4 of the MLI.⁴²

Canada adopted Article 8(1), adding a one year holding period test to access treaty based withholding tax reductions on dividends which depend on levels of ownership.⁴³ Canada also adopted Article 9, adding a one year look back test when determining whether capital gains result from the alienation shares or equity interests that derive their value principally from immovable property to its CTAs.⁴⁴

B. DIGITAL TAX

The Federal Government announced on December 9, 2019, that it plans to impose a three percent digital services tax on digital companies with worldwide revenue of at least \$1 billion and Canadian revenues of more than \$40 million effective April 1, 2020.⁴⁵ At the provincial level, Quebec and Saskatchewan are levying provincial sales taxes on non-resident digital service suppliers.⁴⁶

III. European Union

In the area of taxation, E.U. member states were busy implementing, or for the first time applying, various new E.U. tax legislation in 2019. In this regard, the most prominent topics are the introduction of mandatory disclosure requirements for certain tax arrangements under the Directive on

38. Marley, *supra* note 32.

39. Nathan Boidman et al., *Canada Enacts the OECD-Sponsored Multilateral Instrument*, DWPV (June 26, 2019), <https://www.dwpv.com/en/insights/publications/2019/canada-enacts-multilateral-instrument>.

40. Marley, *supra* note 32.

41. Boidman, et al., *supra* note 39.

42. Status of List Reservations and Notifications upon Deposit of the Instrument of Ratification, *supra* note 33.

43. *Id.*

44. *Id.*

45. Kelsey Johnson, *Canada Preparing to Slap Digital Giants with Tax Similar to What Got France in America's Bad Books*, FINANCIAL POST (Dec. 9, 2019), <https://business.financialpost.com/technology/canada-to-move-ahead-with-digital-services-tax-plan-finance-minister>.

46. Richard Asquith, *Canada Quebec Foreign Digital Services Sales Tax Sept. 2019*, AVALARA VATLIVE (Aug. 30, 2019), <https://www.avalara.com/vatlive/en/vat-news/canada-quebec-foreign-digital-service-sales-tax-sept-2019.html>.

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Administrative Cooperation 6 (DAC 6)⁴⁷ and anti-tax avoidance measures under the EU Anti-Tax Avoidance Directives (ATAD I⁴⁸ and II⁴⁹).

DAC 6 provides that intermediaries, such as lawyers, tax accountants, or banks, are obliged to disclose information on reportable cross-border arrangements to the competent authorities of their member states, which then exchange such information with other member states.⁵⁰ Reportable cross-border arrangements are arrangements concerning more than one member state or a member state and a third country, if certain “hallmarks” as defined in DAC 6 are met.⁵¹ A “hallmark” is a characteristic or feature of a cross-border arrangement that presents an indication of a potential risk of tax avoidance.⁵² Only some of these hallmarks require that the main benefit or one of the main benefits reasonably expected from an arrangement is the obtaining of a tax advantage.⁵³ The notification obligation aims at the disclosure of legal, non-abusive structures, so that member states can cut down on tax planning opportunities by legislative measures. Member states had the option to exempt intermediaries subject to legal professional privileges from the reporting obligation.⁵⁴ For example, Austrian intermediaries such as attorneys are not obliged to report information unless the relevant taxpayers have relieved them from their obligation to secrecy.⁵⁵ But in case of legal privilege, intermediaries have to provide the relevant information to taxpayers, which are then obliged to report the arrangement themselves.⁵⁶ While the DAC 6 rules are applicable as of July 1, 2020,⁵⁷ they already cover arrangements the first step of which has been implemented from June 25, 2018 onwards.⁵⁸ As a result of the COVID-19 pandemic, it is expected that the Council will shortly adopt a Council Directive providing

47. Council Directive 2018/822, 2018, O.J. (L 139) (E.U.) (amending Council Directive 2011/16 as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements). For more detailed information on DAC 6, see Niklas Schmidt & Eva Stadler, *Austria, in Income Tax Treaties: Competent Authority*.

48. Council Directive 2016/1164, 2017, O.J. (L 144) (E.U.) (laying down rules against tax avoidance practices that directly affect the functioning of the internal market).

49. Council Directive 2017/952, 2017, O.J. (L 144) (E.U.) (amending Council Directive 2016/1164 regarding hybrid mismatches with third countries).

50. Council Directive 2018/822, *supra* note 47.

51. *Id.* art. 1(1).

52. *Id.*

53. *Id.* at Annex.

54. *Id.* art. 1(2).

55. Abgabenänderungsgesetz 2020 [AbgÄG 2020] [Tax Amendment Act 2020] Bundesgesetzblatt [BGBl] No. 91/2019, as amended, § 11(1), https://www.ris.bka.gv.at/Dokumente/BgblAuth/BGBLA_2019_I_91/BGBLA_2019_I_91.pdf (Austria).

56. Council Directive 2018/822, *supra* note 47.

57. *Id.* art. 2(1).

58. *Id.* art. 1(2).

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that member states may defer certain time limits for the filing and exchange of information regarding reportable cross-border arrangements.⁵⁹

ATAD I and II provide for five general anti-tax avoidance measures, namely a general anti-abuse rule (GAAR), controlled foreign company (CFC) rules, hybrid mismatch rules, exit taxation rules, and an interest limitation provision. These measures generally apply to all taxpayers that are subject to corporate tax in one or more member states or have permanent establishments situated in the EU.⁶⁰

The GAAR has been applicable from January 1, 2019.⁶¹ It provides that, when calculating corporate tax, member states shall ignore arrangements which have been put in place for the main or one of the main purposes of obtaining a tax advantage if such arrangements defeat the object or purpose of the applicable tax law and are not genuine.⁶²

Under the CFC rules, generally subsidiaries situated in another member state or outside of the E.U. shall be treated as CFCs if the corporate income tax actually paid by the entity is less than fifty percent of the tax that would have been charged under local rules.⁶³ These rules have been applicable from January 1, 2019.⁶⁴ With regard to the inclusion of income of CFCs, member states had different options on implementation.⁶⁵ Austria, for example, chose to include only non-distributed passive income.⁶⁶

The hybrid mismatch rules introduced by ATAD I and ATAD II generally had to be transposed into domestic law by December 31, 2019, and will be applicable as of January 1, 2020.⁶⁷ While the hybrid mismatch rules under ATAD I apply to the legal characterization of a financial instrument or entity and only cover intra-E.U. mismatches,⁶⁸ ATAD II extended the scope to mismatches with third countries and to so-called “tax residency mismatches” (where a dual-resident taxpayer can deduct payments from the tax base in two jurisdictions).⁶⁹

By December 31, 2019, member states had to transpose exit taxation rules, which have been applicable from January 1, 2020.⁷⁰ Under these rules, hidden reserves are taxed if assets are transferred between head offices and

59. See General Secretariat of the Council, *ECOFIN Report to the European Council on Tax Issues*, Council Doc. ST 8450 2020 INIT (June 5, 2020), available at <https://data.consilium.europa.eu/doc/document/ST-8450-2020-INIT/en/pdf>.

60. Council Directive 2016/1164, *supra* note 48.

61. *Id.* art. 6, 11(1).

62. *Id.* art. 6.

63. *Id.* art. 7(1).

64. *Id.* art. 7, 11(1).

65. *Id.* art. 7(2).

66. Eva Stadler, *Austria: New Ordinance Regarding CFC and Switch-Over Rules*, LEXOLOGY (Apr. 2, 2019), <https://www.lexology.com/library/detail.aspx?g=5497a41d-021a-4e03-b6ef-003d9549782d>.

67. Council Directive 2017/952, *supra* note 49, at art. 1(7), 2.

68. Council Directive 2016/1164, *supra* note 48, at art. 2(9), 9.

69. Council Directive 2017/952, *supra* note 49, at art. 1.

70. Council Directive 2016/1164, *supra* note 48, at art. 5, 11(5).

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permanent establishments in different member states or third countries or if a taxpayer transfers its tax residence to another member state or a third country.⁷¹ The tax liability always kicks in if the transfer or move leads to a loss of a member state's right to tax assets due to the transfer; however, under certain circumstances payment in installments has to be granted.⁷²

Finally, member states were obliged to implement an interest limitation rule by the end of 2018.⁷³ But by way of derogation, member states which had equally effective interest limitation rules in place as of August 8, 2016, could delay the implementation of the interest limitation rule under ATAD I.⁷⁴ For example, Austria and Ireland have not yet implemented it as they rely on the derogation.⁷⁵ In November 2019, the European Commission announced that it will send reasoned opinions to Austria and Ireland.⁷⁶ In case of non-implementation, the Commission may bring these cases to the ECJ.⁷⁷

IV. United States

A. OECD'S DIGITAL TAX PLAN

U.S. Treasury Secretary Steven Mnuchin raised “serious concerns” over a plan being spearheaded by the OECD to alter the longstanding international tax allocation rules.⁷⁸ The Secretary's statement, contained in a December letter to OECD Secretary General Angel Gurría,⁷⁹ threw a wild card into the ongoing negotiations taking place in Paris.⁸⁰ The OECD's work is driven by concerns that multinational enterprises—big tech companies in particular—are not paying enough in taxes or paying them to

71. *Id.* art. 5(1).

72. *Id.* art. (5)(2).

73. *Id.* art. 4, 11(6).

74. *Id.*

75. Ulrika Lomas, *Austria, Ireland Have Failed to Adopt ATAD BEPS Measures*, TAX-NEWS.COM (Dec. 6, 2019), https://www.tax-news.com/news/Austria_Ireland_Have_Failed_To_Adopt_ATAD_BEPS_Measures___97448.html.

76. *See November infringements package: key decisions*, EUR. COMM'N (Nov. 27, 2019), https://ec.europa.eu/commission/presscorner/detail/en/inf_19_6304.

77. *Id.*

78. *See* Letter from Steven T. Mnuchin, U.S. Sec'y of the Treas., to Angel Gurría, OECD Sec'y-Gen., (Dec. 3, 2019) <https://www.orbitax.com/news/archive.php/U.S.-Treasury-Secretary-Sends—40283>.

79. *See* Letter from Angel Gurría, OECD Sec'y-Gen., to The Honorable Steven T. Mnuchin, U.S. Sec'y of the Treas., (Dec. 4, 2019) (on file with OECD).

80. Secretary General Gurría sent a letter back to Treasury Secretary Mnuchin the following day stating that “the notion that Pillar 1 could be a safe-harbour regime raises concerns “as it may impact the ability of the 135 countries that are now participating in this process, to move forward within the tight deadlines we established collectively in the Inclusive Forum.” *See* Letter from Angel Gurría, OECD Sec'y-Gen., to The Honorable Steven T. Mnuchin, U.S. Sec'y of the Treas., (Dec. 4, 2019) (on file with OECD).

the right countries.⁸¹ “Pillar One” of the OECD’s proposal would reallocate a portion of corporate profits to the jurisdictions where companies have users or consumers, using formulas and rules that depart from the longstanding arm’s length standard (ALS).⁸² In his letter, Secretary Mnuchin suggested that Pillar One should be treated as an optional safe harbor and emphasized that reaching an agreement is important “in order to prevent the proliferation of unilateral measures, like digital services taxes, which threaten the longstanding multilateral consensus on international taxation.”⁸³

Two days prior to the release of the Treasury Secretary’s letter, the United States announced it was considering placing immediate tariffs totaling \$2.4 billion on French goods including wine if Paris did not back down from imposing its new three percent digital services tax.⁸⁴ France has argued that its digital tax would ensure that the world’s technology giants paid the appropriate taxes for transactions even in countries where they have no major physical presence.⁸⁵ But the United States maintains these types of digital services taxes unfairly discriminate against U.S. technology companies like Google, Amazon, and Facebook.⁸⁶ In January 2020, the U.S. and France appeared to reach a détente, with France informally agreeing to suspend imposition of its digital services tax on U.S. tech companies in order to afford the time and opportunity to reach a multilateral agreement on the issue at the OECD level.⁸⁷

B. SCOPE OF “INTANGIBLE” IN COST SHARING AGREEMENTS

In August 2019, the Ninth Circuit Court of Appeals released its opinion affirming the U.S. Tax Court’s decision in the *Amazon* case.⁸⁸ The Tax Court had concluded that under the then applicable transfer pricing regulations, the definition of “intangible” did not include residual business assets, like the value of employees’ experience, and the enterprise’s going-

81. Rich Partington, *OECD aims to stop tech firms shifting profits to low-tax locations*, *GUARDIAN* (Oct. 9, 2019), <https://www.theguardian.com/politics/2019/oct/09/global-tax-shakeup-would-force-tech-firms-to-pay-more>.

82. See *Secretariat Proposal for a “Unified Approach” Under Pillar One*, *ORG. FOR ECON. COOPERATION & DEV.* (Oct. 9, 2019), <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf>.

83. Letter from Steven T. Mnuchin, *supra* note 78.

84. James Politi, *US Proposes 100% Tariffs on French Goods over Digital Tax*, *FIN. TIMES* (Dec. 12, 2019), <https://www.ft.com/content/52e4922a-1556-11ea-9ee4-11f260415385>.

85. James Politi, *France Signals Breakthrough in US Digital Tax Talks*, *FIN. TIMES* (Jan. 20, 2020), <https://www.ft.com/content/345a5850-3ba1-11ea-b232-000f447fbca>.

86. Daphne Leprince-Ringuet, *Digital Tax, Trade Wars, Big Tech: What’s Actually Going on Between Europe and the US?*, *ZDNET* (Jan. 14, 2020), <https://www.zdnet.com/article/digital-tax-trade-wars-big-tech-whats-actually-going-on-between-europe-and-the-us/>.

87. James Politi et al., *France Signals Breakthrough in US Digital Tax Talk*, *FIN. TIMES*, (Jan. 20, 2020), <https://www.ft.com/content/345a5850-3ba1-11ea-b232-000f447fbca>.

88. *Amazon.com, Inc. v. Comm’r of Internal Revenue*, 934 F.3d 976 (9th Cir. 2019).

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concern value, goodwill, innovative culture, and other unique business attributes.⁸⁹

The issue arose in the context of Amazon's 2005 cost-sharing arrangement with its Luxembourg subsidiary, which granted the subsidiary the right to use certain pre-existing intangible property in Europe.⁹⁰ Amazon-U.S. initially reported a buy-in payment by Amazon-Lux of \$255 million.⁹¹ But the U.S. Internal Revenue Service (IRS) concluded upon audit that the buy-in payment was not determined at arm's length, and valued the buy-in at \$3.6 billion, resulting in a large tax deficiency.⁹² Amazon petitioned the Tax Court, which held that the IRS's determination of the cost-sharing buy-in payment was arbitrary, capricious, and unreasonable.⁹³ On appeal, the Ninth Circuit considered the overall U.S. transfer pricing regulatory framework then in effect, and whether the Commissioner's regulations were entitled to deference.⁹⁴ Finding that residual business assets cannot be transferred independently from the business, the Ninth Circuit disagreed with the Commissioner's argument that the relevant cost-sharing regulation⁹⁵ supports the view that the definition of "intangible" includes such assets.⁹⁶

The Ninth Circuit noted that these were the same issues to arise under the 2009 U.S. transfer pricing regulations or under the 2017 amendments to the U.S. Tax Code, the government's view "no doubt" would prevail.⁹⁷

But given the transfer pricing regulations in effect in 2005 (the year at issue), the Ninth Circuit refused to accord deference to the IRS' position and held for the taxpayer.⁹⁸

C. PROPOSED DIGITAL CONTENT REGULATIONS

On August 14, 2019, the IRS published proposed regulations, which, if finalized, would modify the existing rules for classifying transactions involving the transfer of computer programs.⁹⁹ The existing regulations were promulgated in 1998 in an effort to provide much needed guidance in properly categorizing the transfer, sale, lease, and licensing of computer programs (and associated items) for purposes of the U.S. income sourcing rules.¹⁰⁰ The determination of a prospective income item's source—as U.S.

89. *Amazon.com, Inc. v. Comm'r*, 148 T.C. 8, Docket No. 31197-12, (Mar. 23, 2017).

90. *Amazon.com, Inc.*, 934 F.3d at 982.

91. *Id.* at 979.

92. *Id.*

93. *Amazon.com, Inc.*, 148 T.C. at 8.

94. *Amazon.com, Inc.*, 934 F.3d at 983.

95. See 26 C.F.R. § 1.482-7A (West 2009).

96. *Amazon.com, Inc.*, 934 F.3d at n.10.

97. *Id.* at n.1.

98. *Id.* at 993.

99. Classification of Cloud Transactions and Transactions Involving Digital Content, 84 Fed. Reg. 40,317, 40,320 (Aug. 14, 2019) (codified at 26 C.F.R. pt. 1).

100. *Id.*

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source or foreign source—can affect whether and how that item is taxed by the United States or another country.¹⁰¹ Further, the geographic source of an income item depends on the classification of the item—for example, as a payment for personal services, a royalty, sales proceeds, a dividend, etc.¹⁰²

The 2019 proposed regulations expand the scope of the existing regulations by, among other things, replacing the words “computer program” with “digital content”—a broader term encompassing “content in digital format that is either protected by copyright law or no longer protected by copyright law solely due to the passage of time.”¹⁰³ Examples illustrate how these proposed rules are to be distinguished from a companion regulatory proposal classifying “cloud transactions.”¹⁰⁴ If finalized, the digital content regulations will cover products such as e-books, downloadable movies, and downloadable music, as well as software and computer programs.¹⁰⁵

D. CLOUD TRANSACTIONS

As a companion to the proposed digital content regulations, the Treasury also issued proposed “cloud transactions” regulations which, if finalized, will characterize certain payments as being made in exchange for either cloud “services” or a “lease” of property for purposes of applying myriad U.S. international provisions of the U.S. Internal Revenue Code, including the new sections¹⁰⁶ enacted as part of the sweeping 2017 Tax Cuts and Jobs Act (the Act or TCJA).¹⁰⁷ The defining characteristic of a “cloud transaction” is one that involves a person obtaining “on-demand network access to computer hardware, digital content . . . , or other similar resources.”¹⁰⁸ Transactions involving only “de minimis” on-demand network access are exempt from this definition.¹⁰⁹ The proposals incorporate the codified principles for distinguishing services from leases.¹¹⁰ Eleven helpful examples illustrate the proposed rules’ application and the circumstances under which a cloud transaction, or one involving digital content, may be considered *de minimis* so that it is integrated, and not treated as a separate taxable transaction.¹¹¹ Unfortunately, the proposals do not offer guidance on how to

101. *Id.* at 40,320–21.

102. *Id.* at 40,321.

103. *Id.* at 40,322.

104. *Id.* (discussing proposed § 1.861-19).

105. Classification of Cloud Transactions and Transactions Involving Digital Content, 84 Fed. Reg. at 40,322.

106. Unless otherwise indicated, all “section” references are to the U.S. Internal Revenue Code of 1986, as amended through 2019.

107. Classification of Cloud Transactions and Transactions Involving Digital Content, 84 Fed. Reg. at 40,319.

108. *Id.*

109. *Id.*

110. *See id.* at 40,318–19.

111. *See id.* at 40,320 (noting that examples are provided in proposed § 1.861-19(d)).

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determine whether a component of a transaction is *de minimis*. No special guidance is provided on the source of income from cloud transactions; thus, the general income source rules presumably apply.

E. CLARIFICATION OF UNCERTAIN SOURCE RULE

Under a longstanding U.S. regulation, income from the sale of personal property is sourced to the country where the “rights, title, and interest” of the seller are transferred to the buyer.¹¹² But application of that rule has proved to be uncertain and vulnerable to manipulation—especially in the case of electronically downloaded software.¹¹³ Sometimes, no legal title passes when a copyrighted article is sold.¹¹⁴ In 2019, the IRS issued a proposed regulation,¹¹⁵ which provides that when copyrighted articles are sold and transferred through an electronic medium, the sale is deemed to occur at the location of download or installation onto the end-user’s device for purposes of determining the income’s source. The IRS expects that vendors will be able to identify the location of such download or installation—an assumption not all practitioners think is valid.¹¹⁶

F. ADMINISTRATIVE GUIDANCE IMPLEMENTING THE 2017 TCJA

The year 2019 saw the IRS issue an unbelievably voluminous amount of guidance with respect to the Tax Cuts and Jobs Act of 2017.¹¹⁷ Tax professionals can expect almost as much in 2020. The following sections are some of the highlights.

1. “*To Be or Not to Be a U.S. Shareholder of a CFC—That is the Question.*”

Like most U.S. international tax advisors, the IRS has struggled with the Act’s repeal of Code Section 958(b)(4), which had always turned-off some otherwise applicable downward stock- attribution rules¹¹⁸ in the context of the U.S. regime applicable to “controlled foreign corporations” (CFCs).¹¹⁹ Congress’ retroactive repeal of the Section 958(b)(4)—clearly aimed at crushing a post-corporate inversion de-control technique—has had myriad collateral consequences (apparently unforeseen by Congress). Chief among this parade of horrors was the overnight creation of many thousands of CFCs—i.e., foreign corporations suddenly meeting the statutory definition

112. *Id.*

113. Classification of Cloud Transactions and Transactions Involving Digital Content, 84 Fed. Reg. at 40,320.

114. *Id.*

115. *Id.*

116. *Id.*

117. See generally, *Tax Reform Guidance*, INTERNAL REVENUE SERV., <https://www.irs.gov/newsroom/tax-reform-guidance> (last updated June 12, 2020).

118. See I.R.C. § 318(a)(3)(A)–(C).

119. See I.R.C. §§ 951–964 (1962).

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of “CFC” which, in turn, caused U.S. shareholders to suddenly and unexpectedly be subject to tax under both the CFC rules and the new “Global Intangible Low Taxed Income” (GILTI) provision.¹²⁰ Another unforeseen result of the provision’s repeal was that many foreign investors were suddenly ineligible for the critical U.S. Portfolio Interest Exemption¹²¹—a dire effect which triggered a huge flurry of restructuring transactions around the planet. Moreover, with so many more “pop-up” CFCs, thousands more U.S. shareholders are now saddled with burdensome international tax reporting and ownership inquiries, including the submission of IRS Form 5471.¹²²

Although Congress has discussed mitigating the problematic effects of Section 958(b)(4)’s repeal, no technical corrections bill has so far been passed.¹²³ The IRS issued proposed regulations and Revenue Procedure 2019-40, which partially mitigate the due diligence reporting burden and penalty exposure for U.S. shareholders who fail to properly file IRS Form 5471.¹²⁴ But these rules do not provide relief for shareholders of foreign corporations that are actually U.S. controlled. Moreover, none of the administrative guidance issued in 2019 lessened the actual current U.S. tax exposure of ten percent U.S. shareholders of foreign corporations that would not be CFCs but for the hasty 2017 repeal of Section 958(b)(4) by Congress.¹²⁵

2. *GILTI as Charged*

The IRS issued more regulations implementing Code Section 951A—the centerpiece provision of the TCJA imposing current taxation on shareholder’s Global Intangible Low-Taxed Income.¹²⁶ Essentially, GILTI functions as a residual minimum tax in that whatever income a CFC earns that manages to escape taxation under the CFC rules of Subpart F (which U.S. tax advisors learned to manipulate) is now nonetheless taxed as GILTI to the extent such income exceeds a notional ten percent return on the

120. I.R.C. § 951A (2017).

121. I.R.C. §§ 871(h), 881(c).

122. See *Instructions for Form 5471 (02/2020)*, INTERNAL REVENUE SERV. (2020), <https://www.irs.gov/instructions/i5471>.

123. See generally *IRS Proposes Fix of Downward Attribution Rules*, GRANT THORNTON (Oct. 11, 2019), [https://www.grantthornton.com/library/alerts/tax/2019/Flash/IRS-tweaks-downward-attribution-rules.aspx#:~:text=Section%20958\(b\)\(4\)%20was%20repealed%20by%20TCJA%20in,by%20acquiring%20the%20CFC's%20stock](https://www.grantthornton.com/library/alerts/tax/2019/Flash/IRS-tweaks-downward-attribution-rules.aspx#:~:text=Section%20958(b)(4)%20was%20repealed%20by%20TCJA%20in,by%20acquiring%20the%20CFC's%20stock).

124. *Initial Impressions of Final Regulations under GILTI: Proposed Rules for Determining Stock Ownership*, KPMG (June 19, 2019), <https://home.kpmg/us/en/home/insights/2019/06/tnf-final-regulations-gilti-ftp.html>.

125. *Id.*

126. *Internal Revenue Bulletin: 2019-29*, INTERNAL REVENUE SERV. (July 19, 2019), https://www.irs.gov/irb/2019-29_IRB.

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CFC's tangible assets.¹²⁷ Thus, apart from that assumed, notional return on investment (which is forever exempt from U.S. taxation), the decades-old general rule of tax deferral of U.S. foreign subsidiaries' income has essentially been repealed.¹²⁸

Some 2019 proposed regulations offer a controversial high-tax exclusion from GILTI.¹²⁹ This proposal is roughly patterned on the "high-foreign-tax kick-out" exception to foreign base company income (a major category of CFC income).¹³⁰ Under this long-time exception, any income item that incurs foreign tax at a rate exceeding ninety percent of the current U.S. corporate tax rate is eligible to be excluded from "foreign base company income (and thus Subpart F) at the taxpayer's election.¹³¹ Under the proposed "GILTI High Tax Exclusion," all gross income items attributable to a single qualified business unit (QBU)—a measuring unit borrowed from the foreign currency rules—are aggregated for purposes of the effective rate test.¹³² Deductions would be allocated and apportioned to each QBU's gross tested income, and the effective rate of foreign tax on each would then be calculated.¹³³ If the item's effective rate exceeds ninety percent of the maximum corporate rate, it will be excluded from GILTI if an effective election is in place.¹³⁴ A "QBU" includes any corporation such as a CFC and any branch of the CFC that has a separately identifiable trade or business.¹³⁵ Practitioners have roundly criticized the use of QBUs as a method for determining whether an item is subject to high foreign tax as unfair and administratively burdensome and hope this aspect of the proposal is not adopted in the final regulations.¹³⁶

Many provisions of the TCJA strongly favor corporate shareholders over U.S. shareholders that are individuals or other flow-through entities.¹³⁷ For example, the 2017 Act provides that only C corporations are eligible to take

127. Greg Pudenz, Jamison Sites, & Ramon Camacho, *GILTI: A New Age of Global Tax Planning*, TAX ADVISER (Apr. 1, 2019), <https://www.thetaxadviser.com/issues/2019/apr/gilti-new-age-global-tax-planning.html>.

128. Eugenio Grageda, *U.S. Tax Reform: Impacts and Opportunities for Mexican Businesses, Part 1*, HOLLAND & KNIGHT (July 23, 2018), <https://www.hklaw.com/en/insights/publications/2018/07/us-tax-reform-impacts-and-opportunities-part-1>.

129. *Internal Revenue Bulletin: 2019-29*, *supra* note 126.

130. I.R.C. § 954(b)(4).

131. Beginning in 2018, the top U.S. corporate tax rate dropped to 21%, so that any income item of a CFC incurring foreign tax at a rate exceeding 18.9% is eligible for the high-foreign-tax exception provided by IRC § 954(b)(4).

132. *Internal Revenue Bulletin: 2019-29*, *supra* note 126.

133. *See id.*

134. *See id.*

135. *See id.*

136. *Initial Impressions of Final Regulations under GILTI: Proposed Rules for Determining Stock Ownership*, *supra* note 124.

137. *See*, Thomas Huckabee, *The Impact of Tax Reform on Choice of Business Entity Selection*, THOMAS HUCKABEE, INC. (May 23, 2018), <https://tehcpa.net/choice-of-entity/the-impact-of-tax-reform-on-choice-of-business-entity-selection/>.

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a fifty percent deduction from GILTI¹³⁸ and claim a deemed-paid foreign tax credit.¹³⁹ The IRS leveled the playing field a bit by issuing final regulations clarifying that any U.S. person that makes a valid Section 962 election (i.e., to be treated as a C corporation) may qualify for both the fifty percent GILTI deduction, as well as the indirect foreign tax credit.¹⁴⁰ Good planning for U.S. individuals owning a CFC will thus consider the advantages of making a Section 962 election. A Tax Court decision issued in 2018, however, makes clear that a Section 962 election is not tantamount to creating a C corporation for purposes of qualifying for the lower “qualified dividend income.”¹⁴¹ Thus, any person who makes a Section 962 election with respect to a CFC will still have to pay tax on actual distributions from the CFC at their marginal ordinary income rates, unless the CFC is organized in a country with which the United States has a qualifying bilateral tax treaty in effect, which treaty would make the CFC a “qualified foreign corporation.”¹⁴²

Finally, a Section 962 election does not qualify non-corporate shareholders for the 100 percent dividends-received-deduction (DRD) or “participation exemption” of Section 245A—the centerpiece of the 2017 Act glorified by the press—for which only C corporations owning at least ten percent may qualify.¹⁴³

3. *Do Section 956 Inclusions Exist?*

Enacted in 1962 to prevent an end run around the CFC rules, Section 956 treats an “investment in U.S. property” by a CFC—including loans to a U.S. shareholder—as an economic repatriation of foreign profits in the form of a deemed “dividend” worthy of current U.S. taxation.¹⁴⁴ Because the new 100-percent dividends-received deduction (i.e., Section 245A) eliminates tax for U.S. corporate shareholders receiving dividends, the IRS realized it did not make sense to apply Section 956 as a backstop.¹⁴⁵ Accordingly, the IRS issued final regulations in 2019 clarifying that C corporations will generally

138. See I.R.C. § 250 (2017).

139. See I.R.C. § 960 (as amended in 2017).

140. *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, DEPT. OF TREAS. (Dec. 2000), <https://home.treasury.gov/system/files/131/Report-SubpartF-2000.pdf>.

141. *Smith v. Comm’r*, 151 T.C. 5 (2018) (no qualified dividend treatment allowed; C corp. is not real).

142. Thus, to qualify for the lower “qualified dividend rate” on dividends paid to non-corporate shareholders making a § 962 election, it is necessary to confirm eligibility for the lower (capital gains) rate under the particular tax treaty. See I.R.C. § 1(h)(3)(B), (h)(11)(C) (2018) (defining “corporation” and “foreign”).

143. *Proposed Regulations Provide Relief for Individual and Pass-Through Shareholders of Controlled Foreign Corporations*, O’MELVENY (Mar. 13, 2019), <https://www.omm.com/resources/alerts-and-publications/alerts/proposed-regulations-provide-relief-for-individual-and-pass-through-shareholders/>.

144. *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, *supra* note 140.

145. *Id.*

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not have taxable inclusions under Section 956, although all other types of U.S. shareholders are subject to the full panoply of Section 956 rules.¹⁴⁶

4. *Back to the Future*

Section 864(c)(8)¹⁴⁷ reinstated the IRS' long held position that a foreign partner who sells an interest in a partnership is subject to U.S. taxation to the extent the gain (if any) is attributable to property of the partnership that was used to produce income "effectively connected" to the U.S. business (ECI). A companion provision—Section 1446(f)—was enacted stipulating that the transferee of the partnership interest must withhold tax equal to ten percent of the total "amount realized" on the disposition, with the partnership itself as the backup withholding agent.¹⁴⁸

Proposed regulations, which are expected to go final in 2020, offer a *de minimis* exception from withholding if the ECI allocated to a foreign partner is less than both \$1 million and ten percent of the partnership's total ECI.¹⁴⁹ Although this is a step in the right direction, many practitioners hope that the final regulations will find further ways to reduce the compliance burden on smaller partnerships.

5. *One-Year Wonder*

Section 965, also enacted by the TCJA and known as the "Transition Tax," created a one-time deemed repatriation in 2017 of all foreign earnings and profits of U.S.-owned foreign subsidiaries.¹⁵⁰ During 2017, the IRS issued 305 pages of regulation interpreting this highly complex Code provision.¹⁵¹ While many foreign corporations still struggle to get into full compliance with Section 965, few practitioners want to read—let alone study—305 pages of regulations pertaining to a provision that applies to only one tax year, and which will have greatly diminished importance as time passes.

146. Philip T. Pasmanik, *Look Out for Sec. 956 Inclusions*, THE TAX ADVISER (Nov. 1, 2017), <https://www.thetaxadviser.com/issues/2017/nov/sec-956-inclusions.html>.

147. *U.S. Proposed Regulations Address Characterization of Foreign Persons' Taxable Gain or Loss From Sale or Exchange of Interests in Partnerships Engaged in Business in the United States*, EY (Jan. 7, 2019), [https://www.ey.com/Publication/vwLUAssets/US_proposed_regulations_address_characterization_of_foreign_persons_taxable_gain_or_loss/\\$FILE/2019G_012715-18Gbl_US%20-%20Proposed%20regs%20under%20IRC%20Section%20864-c-8.pdf](https://www.ey.com/Publication/vwLUAssets/US_proposed_regulations_address_characterization_of_foreign_persons_taxable_gain_or_loss/$FILE/2019G_012715-18Gbl_US%20-%20Proposed%20regs%20under%20IRC%20Section%20864-c-8.pdf).

148. Brent Felten & Laurie Cameron, *Sec. 1446(f) Proposed Regs.: Withholding on Transfers of Partnerships Interests*, THE TAX ADVISER (Sept. 1, 2019), <https://www.thetaxadviser.com/issues/2019/sep/withholding-transfers-partnership-interests.html>.

149. Sarah-Jane Morin, Richard S. Zarin, & Richard C. LaFalce, *IRS Proposes Regulations for Withholding on Transfers of Partnership Interests*, MORGAN LEWIS (June 4, 2019), <https://www.morganlewis.com/pubs/irs-proposes-regulations-for-withholding-on-transfers-of-partnership-interests>.

150. Mary Beth Lougen, *Demystifying IRC Section 965 Math*, THE CPA JOURNAL (Nov. 2018), <https://www.cpajournal.com/2018/11/14/demystifying-irc-section-965-math/>.

151. *See* Guidance Regarding the Transition Tax Under Section 965 and Related Provisions, 83 Fed. Reg. 39,514 (Aug. 9, 2018) (codified at 26 C.F.R. pt. 1).

6. *We Got the BEAT (but not the Go-Go's)*

The IRS issued final regulations under Section 59A—known informally as the “BEAT”¹⁵²—a provision intended to discourage large corporate taxpayers (U.S. and foreign owned) from making deductible payments (e.g., interest, royalties) to “related” foreign persons, which deductions can erode the U.S. tax base. The BEAT functions as an alternative minimum tax for very large corporations that both (1) earn annual average gross receipts of at least \$500 million and (2) have a “base erosion percentage” of at least three percent (two percent for certain banks) during the three year period immediately preceding the taxable year.¹⁵³ When Section 59A applies, it imposes a minimum federal income tax (in addition to the corporate taxpayer’s regular tax liability) of ten percent for tax years up to 2025, increasing to twelve percent for tax years 2026 and beyond.¹⁵⁴ Final regulations issued in 2019 allow a C corporation to exclude a deductible payment that will allow C corporations to move below the critical three percent base erosion percentage (which is the application threshold) and, thereby, beat the BEAT.¹⁵⁵

Practitioners should expect more voluminous regulations and other guidance in 2020.

V. Mexico

For some years now, Mexico has been implementing domestic reforms developed in the context of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. The latest development in this trend, the so-called “2020 Tax Reform,” published on the Mexican Federal Official Gazette on December 9, 2019, is no exception.

The purpose of the 2020 Tax Reform was to strengthen revenue collection and address tax avoidance by actively developing and enforcing measures stemming from the BEPS Project.¹⁵⁶ This article provides an overview of some of these measures.

152. I.R.C. § 59A (West 2017) (The official name of this provision in the Internal Revenue Code is “Tax on base erosion payments of taxpayers with substantial gross receipts.” The informal acronym of “BEAT” was adopted amongst U.S. practitioners and drafters of the provision at the U.S. Treasury, and presumably stands for “Base Erosion Anti-abuse Tax.”)

153. *Id.*

154. *Id.*

155. U.S. *Final and Proposed BEAT Regulations Provide Some Relief for Taxpayers*, EY (Dec. 9, 2019), [https://www.ey.com/Publication/vwLUAssets/US_final_and_proposed_BEAT_regulations_provide_some_relief_for_taxpayers/\\$FILE/2019G_005622-19Gbl_US%20-%20BEAT%20regs%20provide%20some%20relief%20for%20taxpayers.pdf](https://www.ey.com/Publication/vwLUAssets/US_final_and_proposed_BEAT_regulations_provide_some_relief_for_taxpayers/$FILE/2019G_005622-19Gbl_US%20-%20BEAT%20regs%20provide%20some%20relief%20for%20taxpayers.pdf).

156. Decreto por el que se reforman, adicionan y derogan diversas disposiciones de la Ley del Impuesto sobre la Renta [LIR], de la Ley del Impuesto al Valor Agregado [LIVA], de la Ley del Impuesto Especial sobre Producción y Servicios y del Código Fiscal de la Federación [LIEPS], Diario Oficial de la Federación [DOF] 09-12-2019 (Mex.), http://dof.gob.mx/nota_detalle.php?codigo=5581292&fecha=09/12/2019 [hereinafter Tax Reform Act]; *see also Mexican Tax Reform*

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A. DIGITAL PLATFORMS

Because of BEPS Project Action 1, a measure to control the effective collection of income and value added tax caused by participants of the sharing economy through digital platforms, was introduced. This measure intends to collect the already-existing taxes that stem from activities that are now taking place via digital platforms, more than taxing digital platforms *per se*, until an international consensus exists.

A general rule, that entered into force on June 1, 2020, was introduced to facilitate the fulfillment of tax obligations and ensure the proper collection of taxes, including a simplified regime for these purposes. These new obligations cover activities related to ride-hailing services, delivery of goods, lodging services, downloading or access to images, digital intermediation, and, in general, any disposition of goods or rendering of services, when contracted for through digital platforms.¹⁵⁷ Digital platforms that reside both, in Mexico and abroad, will be obligated to withhold and remit such taxes.¹⁵⁸

Under this new legal framework for digital services, apart from specific rules for complying with different sets of withholding tax rates depending on the activity performed and on whether the opt-in simplified regime applies, formal obligations are implemented, including nonresidents applying for a Tax ID number, the issuance of digital invoices, and certain data sharing obligations.¹⁵⁹

B. PAYMENTS MADE TO LOW-TAX JURISDICTIONS AND HYBRID MISMATCH ARRANGEMENTS¹⁶⁰

The amendments in this newly approved package disallow the deduction of payments carried out to related parties or under structured arrangements, whenever the recipient's income is subject to a Preferential Tax Regime (PTR).¹⁶¹ A PTR is defined as income subject to taxation lower than seventy-five percent of the tax that would otherwise be taxed in Mexico.¹⁶²

In connection to this new rule, dealing with payments made to low tax jurisdictions, the threshold does not correspond to the current international tax environment, since seventy-five percent of the thirty-percent Mexican

for 2020 Enacted, EY (2019), <https://taxinsights.ey.com/archive/archive-news/mexican-tax-reform-for-2020-enacted.aspx>.

157. See Ley del Impuesto sobre la Renta [LIR] art. 113-A to 113-C, Diario Oficial [DOF] 11-12-2013, últimas reformas DOF 09-12-2019 (Mex.) [hereinafter MITL]; Ley del Impuesto al Valor Agregado [LIVA] art. 18-A to 18-M, Diario Oficial [DOF] 29-12-1978, últimas reformas DOF 09-12-2019 (Mex.) [hereinafter VATL].

158. See MITL art. 113-C.

159. *Id.*; VATL art. 18-A to 18-M.

160. See MITL art. 5, 28(XXIII).

161. *Id.* art. 176.

162. *Id.*

corporate tax rate is 22.5 percent.¹⁶³ There is a significant number of treaty partners with Mexico (including the U.S. and U.K.), whose corporate income tax rates have been reduced below the 22.5 percent threshold. In those cases, it will be very important to review the corresponding tax treaty rules and look for protection or relief against these new provisions which are meant to deny the deduction of the payments made from Mexico.

Furthermore, for these purposes, structured arrangements are defined as any agreement made by the taxpayer or related party by means of which the corresponding consideration will be subject to payments made to PTR jurisdictions that will grant a benefit to the taxpayer or its related party, barring certain exceptions.¹⁶⁴

Additional measures were included to avoid or neutralize the existence of hybrid mechanisms, based on tax symmetry principles. For instance, starting January 2020, payments made to related parties will not be deductible if a related party or the same taxpayer in another jurisdiction can also take the deduction.¹⁶⁵

C. FOREIGN INVESTMENTS THROUGH PRIVATE EQUITY FUNDS

In the 2020 tax bill there is new provision dealing with the tax treatment of foreign pass-through figures (vehicles) such as a Canadian Limited Partnership (Can LP).¹⁶⁶ This provision which will enter into force as of January 1, 2021 (due to a transitory provision), will have a significant impact for private equity fund structures, as explained below.¹⁶⁷

A Can LP has been widely used for this type of private equity structures because they have been regarded as fully transparent for Mexican tax purposes, at least until December 31, 2019; thus, Mexican-sourced income up until now has been granted the applicable tax treatment depending on the nature of the investor recipient of such income through the Can LP.¹⁶⁸

The rationale behind this, is that Mexican law first looks to whether or not the Can LP has a separate legal personality in accordance with Canadian legislation, and then follows the look-through treatment for Mexican tax purposes because the Canadian entity is not a person.

The present situation will change, since, as of January 1, 2021, Can LPs will be regarded as a person for Mexican tax purposes.¹⁶⁹ For instance, in the case of a capital gain on the disposition of stock issued by a Mexican company, this Mexican-sourced income will be subject to a twenty-five

163. *See id.*

164. *See id.* art. 28 (XXIII).

165. *Id.*

166. *See* MITL art. 4-A, 205.

167. Tax Reform Act art. 2.

168. *See generally*, Mario Piana & Jose Carrillo, *Private Equity in Mexico: Market and Regulatory Overview*, THOMSON REUTERS, [https://ca.practicallaw.thomsonreuters.com/7-504-2831?transitionType=Default&contextData=\(sc.Default\)](https://ca.practicallaw.thomsonreuters.com/7-504-2831?transitionType=Default&contextData=(sc.Default)) (providing a general overview of Canadian LPs).

169. *See* MITL art. 4-A.

percent tax on gross proceeds, as opposed to that under current legislation, where the treatment depends on the nature of the recipient. Under the current legislation: (i) it may be exempted under a tax treaty based on its individual situation (i.e., participation of less than twenty-five percent of the issuing entity); (ii) obtain a benefit with a reduced capital gain rate such as the ten percent, contained in different tax treaties; or (iii) at least, being able to apply the optional procedure of the thirty-five percent rate on net gain provided by domestic law.¹⁷⁰

Furthermore, if the Can LP is deemed to be managed and controlled in Mexico, it will be regarded as a Mexican resident entity, and thus, subject to a thirty percent corporate income tax rate on the capital gain; the subsequent distribution to the investors on top would be, additionally, subject to a ten percent withholding tax on dividends.

The new legislation may provide relief so that the same look-through treatment continues to be granted; unfortunately, the requirements set forth are, in most cases, very difficult to comply with.¹⁷¹

It will be very important to keep an eye on this new development. If this regime finally goes into effect, there will be a need to review each specific case and look for alternative solutions or protections under a corresponding tax treaty.

D. PTR RULES (CONTROLLED FOREIGN CORPORATION RULES)

The Executive Branch modified a series of PTR provisions to expand the definition of “control” over an entity.¹⁷²

These rules will only be applicable for entities located in a low-tax jurisdiction (with separate legal personality from its Mexican resident owners) at a first-tier level that are not regarded in the corresponding foreign jurisdiction as pass-through entities and will apply directly and indirectly for both foreign pass-through entities or vehicles underneath.¹⁷³

E. INTEREST-EXPENSE DEDUCTION LIMIT

Mexican tax legislation already regulates the deduction of interest payments in financing transactions carried out with related parties. The prevailing legal framework sets forth back-to-back and thin capitalization rules; however, starting from this year, in response to Action 4 of the BEPS Project, a new rule is included in order to further narrow the scope of the deductibility of interest payments.¹⁷⁴

170. See *Mexico's Tax Reform Affects Banking and Capital Markets Activities*, EY (2019), <https://taxinsights.ey.com/archive/archive-news/mexico-s-tax-reform-affects-banking-and-capital-markets-activities.aspx>.

171. MITL art. 205.

172. *Id.* art. 176–78.

173. *Id.*

174. *Id.* art. 28 (XXXII).

Under this new limit, the maximum deduction of net interest payments shall not exceed thirty percent of the adjusted tax earnings before interest, taxes, depreciation, and amortization (EBITDA) of taxpayers.¹⁷⁵

The mechanism provides a *de minimis* rule, by which the limit is not applicable to those taxpayers whose payable interest during the tax year does not exceed more than 20 million pesos.¹⁷⁶

Special rules for entities belonging to the same group may apply, as well as exceptions to certain industries, such as public infrastructure, construction business, energy and oil and gas industry, among other extractive projects.¹⁷⁷

F. PERMANENT ESTABLISHMENT DEFINITION

Domestic legislation was adapted to include the proposals provided by BEPS Project Action 7 and the Multilateral Instrument (MLI). These modifications were intended to broaden the scope of the situations under which a permanent establishment would arise in Mexico.¹⁷⁸

Specifically, non-residents carrying out activities through an agent that is not acting independently and that regularly concludes agreements, will be deemed to have created a permanent establishment in Mexico.¹⁷⁹

Likewise, a new assumption will apply for fragmentation of activities cases in which each business, separately, qualifies under the preparatory and auxiliary exception; for these cases, all the activities will be considered as a part of a comprehensive and coherent business, thus enforcing the creation of a permanent establishment in Mexico.¹⁸⁰

G. GENERAL ANTI-AVOIDANCE RULE

A BEPS-inspired general anti-avoidance rule is also incorporated.¹⁸¹ This rule bestows on tax authorities, during a tax audit, the power to assess tax consequences by recharacterizing legal acts that lack business reasons and generate a direct or indirect tax benefit to the taxpayer.¹⁸²

The tax authorities may only apply this rule when obtaining a favorable decision from a collegiate board comprised by officers of the Tax Administration Service (SAT) and the Ministry of Finance (SHCP).¹⁸³ In this context, tax authorities are entitled to presume, unless proven otherwise, that there are not enough business reasons for certain legal acts when: (i) the

175. *Id.*

176. MITL art. 28 (XXXII).

177. *Id.*

178. *Id.* art. 2–3.

179. *See id.* art. 2.

180. *Id.* art. 3; *see also Mexico's Tax Reform Affects Banking and Capital Markets Activities, supra* note 170.

181. Código Fiscal de la Federación [CFF] art. 5-A, Diario Oficial de la Federación [DOF] 31-12-1981, últimas reformas DOF 09-12-2019 (Mex.) [hereinafter FTC].

182. *Id.*

183. *Id.*

expected economic benefit is lower than the tax benefit; or (ii) the economic benefit was also achievable in fewer steps with a different tax consequence.¹⁸⁴

H. MANDATORY DISCLOSURE RULES

A new set of obligations are established by BEPS Project Action 12 for tax advisors and taxpayers in connection to the mandatory disclosure tax planning schemes.¹⁸⁵ Any plan, project, proposal, advice, instruction, or recommendation proposed in order to materialize a series of legal acts that generates or could generate, directly or indirectly, a tax benefit in Mexico will have to be reported by either the taxpayer or the tax advisor, regardless of the tax residence of the taxpayer.¹⁸⁶

A tax advisor is defined as any individual or entity that, in the course of their ordinary activity, is responsible or involved in the design, commercialization, organization, implementation or management of a tax planning arrangement or someone who provides a reportable scheme, even though a third party is responsible for its implementation.¹⁸⁷

These new provisions include a long list of different loosely and broadly defined situations that are to be considered as reportable tax planning arrangements.¹⁸⁸

These obligations will enter into force on January 1, 2021; however, any arrangement that was proposed or implemented beforehand, and that will or may have tax benefits as of 2020, should also be reported. Consequently, the provision may apply retroactively.¹⁸⁹

Severe penalties are included for the omission of complying with the rules regarding the listed transactions to report either by advisors or taxpayers.

As the reader may have undoubtedly noticed, these amendments attempted to control the proper collection of taxes and, therefore, tax avoidance. The inclusion of this new BEPS scaffolding in the infrastructure of the tax law will certainly have an impact from an international perspective which multinational companies around the world must consider cautiously and creatively.

184. *Id.*

185. *Id.* art. 197–202.

186. *Id.*

187. FTC art. 197.

188. *Id.* art. 198–99.

189. Tax Reform Act art. 8.

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