

News Analysis: Barbados-Mexico Treaty Offers Substantial Benefits for Inbound, Outbound Investments

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Summary by **taxanalysts**[®]

When the Barbados-Mexico income tax treaty's provisions become applicable on January 1, 2010, Barbados will be removed from Mexico's blacklist of tax havens, and Mexicans will be able to establish Barbados-based structures without being subject to controlled foreign corporation rules and without extra reporting requirements.

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Barbados is faring well as an international financial center. After the April 2 G-20 meeting in London, it was placed on the OECD's white list of compliant jurisdictions, and after meetings with U.S. President Barack Obama at the April 18 Summit of the Americas in April, Barbados Prime Minister David Thompson confirmed that Barbados will not be on any blacklist issued by the United States.

The Barbados-Mexico treaty, signed April 7, 2008, generally follows the OECD model, but Barbados's special incentive entities still have access to separate key articles under the treaty.

When the treaty's provisions become applicable on January 1, 2010, Barbados will be removed from Mexico's blacklist of tax havens. Mexicans also will be able to establish Barbados-based structures without being subject

to controlled foreign corporation rules and extra reporting requirements of the Mexican authorities.

Following is an outline of the relevant provisions.

Residence (Article 4)

Barbados law is based on English common law, and residence in Barbados is based on central management and control and likely reflects the ratio of the latest cases in this area, including *De Beers Consolidated Mines v. Howe* (1905), 5 TC 198 HC, and, more lately, *Wood v. Holden* ([2006] EWCA Civ 26).

Given that in most common-law countries like the U.S., Canada, and the U.K., the law surrounding residence is in a state of flux, Barbados's principle of central management and control is as effective as any. No major jurisdiction has yet put residence on a statutory footing.

The test criteria outlined in article 4 of the OECD model are well trodden in case law, and "domicile, residence, place of incorporation, place of effective management, or any criterion of a similar nature" are concepts addressed in many of the key tax law tests and cases addressing residence.

Mexico's use of seat of management and effective management for tiebreaker purposes should cause no conflicts with the legal concept of central management and control. All of these principles imply a level of substance. As economic substance increases, the line between these concepts begins to fade.

The Barbados-Mexico treaty's residence article directly refers to domicile, a key legal concept in the tax law of persons resident in Barbados. A person resident but not domiciled in Barbados is not subject to tax on foreign-source income that is not remitted to Barbados.

Mexico has reserved the right to use a place of incorporation test for determining the residence of a corporation and, failing that, to deny dual-resident companies benefits under the treaty. The domicile of a Barbados resident person is not merely an approach used to make that person dual resident. Dual residency would likely require the use of an entity incorporated in another jurisdiction. There are several Barbados entities that can be structured to be deemed nondomiciled.

Subject to Taxation

A Barbados resident that is a nondomiciled person will likely be able to obtain full treaty benefits, albeit subject to the base erosion tests laid out in treaty article 28.

A Barbados person that is resident but not domiciled is not necessarily a special incentive entity.

Permanent Establishment [Article 5, Subparagraph 4(f)]

The inclusion of paragraph 7 in article 5 allows the usual exclusion of a permanent establishment if the person is acting in the other state through a broker, general commission agent, or agent of any other status. However, subparagraph 4(f) is subject to the following provision:

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of subparagraph (f) of this paragraph.

Although Mexico has reserved the right to exclude this provision from its treaties, it has been retained in this case so Mexico can consider a PE to exist if a fixed place of business is maintained for any combination of activities in

subparagraphs (a) through (e) of paragraph 4. This in itself is not unreasonable or unduly material to the use of article 5.

Miscellaneous Rules (Article 28)

Article 28 inserts a limitation on benefits clause in the treaty, which is still relatively reasonable when considering the use of Barbados as an international financial center.

Generally, the benefits of the treaty are available to residents of Barbados or Mexico who are individuals or entities. However, for an entity that is a resident of either country, the treaty benefits will be available only:

- if 50 percent or more of its beneficial interest is owned, directly or indirectly, by residents of Mexico; Barbados or another Caribbean Community and Common Market country; Canada or the United States; the government of Barbados or Mexico; or a public company listed on a recognized stock exchange of one of those countries;
- if it carries on a business and 50 percent or more of its assets are composed of fixed assets (including land and inventory); or
- if the principal objective of its establishment, acquisition, or maintenance and the conduct of its business was not to obtain treaty benefits.

Erosion Test and Substance

Under the base erosion test, no more than 50 percent of the company's gross income is used to make certain payments to persons that are not described in article 28(1) of the treaty's ownership test. Payments in this express test specifically refer to dividends, interest, and royalties. No other express payments are outlined here.

Article 28(1)(b) states that resident persons of a state for whose "principal class of shares there is a substantial and regular trading on a recognized stock exchange" may obtain treaty benefits. With the coming implementation

of the Barbados international trading platform, special purpose vehicles, mutual funds, and other structured finance entities will be able to receive the full range of benefits under the Barbados-Mexico treaty.

The ownership and erosion test limiting onward payments of dividends and royalties and other payments to non-North American Free Trade Agreement persons, whether directly or indirectly, is circumvented if the Barbados entity uses 50 percent of its assets in carrying on business activities.

Partial Carveout

Most importantly, special incentive entities in Barbados may access the PE and business profits articles of the Barbados-Mexico treaty.

The access of international business companies, international societies with restricted liabilities, and domestic and international trusts to the business profits and PE articles provides for a wealth of inbound Mexico planning opportunities when it is considered that those Barbados resident entities also have access to the PE and business profits articles of the U.S.-Barbados treaty.

Also, any entities that have a lower or effective tax as a result of domestic Barbados legislation or administrative practice may access all other articles of the treaty, including the business profits and PE articles.

Special incentive entities are expressly excluded from the benefits of the following articles:

- international transport (8);
- dividends (10);
- interest (11);
- royalties (12);
- capital gains (13); and

- independent personal services (14).

Conclusion

There is substantial opportunity to use Barbados for inbound investment into Mexico and for outbound investment of Mexican resident persons.

Barbados's special incentive entities have full access to the Barbados-P.R.C. income tax agreement. Because China is one of Mexico's major trading partners, Mexican residents can use Barbados resident entities to establish efficient cross-border business.

Barbados has now concluded 18 income tax treaties. Special incentive entities are entirely carved out only in its treaties with Finland, Sweden, Norway, and the Netherlands.

The business profits and PE articles are accessible under the other treaties Barbados has negotiated, most importantly with the U.S. and Mexico. Full access to treaty benefits for international business companies, international societies with restricted liabilities, and trusts resident in Barbados is available under the treaties with China, Cuba, Venezuela, Switzerland, Austria, and CARICOM countries.

New treaties with Luxembourg and Ghana also have been signed and are awaiting ratification, and negotiations are under way with Brazil, Ireland, India, and Russia.

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