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Bilateral investment treaties as a strategic tool for foreign investors in Mexico

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Juan José Paullada, Alejandro Santoyo, and José Arturo Pérez of Ritch Mueller explain how foreign investors in Mexico can protect their investments in the face of increasingly stringent tax enforcement measures

In recent years, Mexico has solidified its position as a prime destination for foreign direct investment in Latin America, attracting substantial capital across various industries. However, with the current administration's robust tax enforcement measures and reformist agenda, foreign investors face challenges, particularly in the tax domain. These challenges often raise questions about the security of investments and whether governmental actions, such as tax assessments, could amount to indirect expropriation, under international investment law.

Bilateral investment treaties (BITs) present a significant opportunity for foreign investors to protect their investments in Mexico. These agreements safeguard against direct and indirect expropriation by providing

mechanisms for dispute resolution through international arbitration. This article explores the intersection of BITs and tax disputes, emphasising the importance of investment structuring and the conditions under which BIT protection applies.

Indirect expropriation and tax assessments

Indirect expropriation occurs when a state's measures substantially deprive an investor of the use, enjoyment, or value of their investment without formal nationalisation. Tax measures, though legitimate sovereign functions, can cross the threshold into indirect expropriation if they are arbitrary, discriminatory, or disproportionate.

Recent trends in Mexico include aggressive tax audits, reassessments, and retroactive applications of tax laws, which have led to significant financial burdens for foreign investors. In this regard, disproportionate tax penalties or targeted assessments that render a business unviable may provide grounds for invoking BIT protections.

However, not all tax disputes rise to the level of indirect expropriation. Investors must demonstrate that the measures significantly impact their investment's value and that such actions violate the protections guaranteed under the applicable BIT.

Criteria for BIT protection

To benefit from BIT protections, foreign investors must meet specific criteria under the treaty's definitions of "investor" and "investment". Key considerations include:

- The nationality of the investor – most BITs define an investor as a natural person or legal entity incorporated under the laws of a contracting state. For example, the Mexico–Netherlands BIT adopts a broad definition, allowing companies to structure their operations strategically to qualify for treaty protection.
- Substance requirements – BITs increasingly incorporate provisions requiring investors to have substantial business activities in the host country or their home jurisdiction. For instance, the Mexico–Hong Kong BIT includes a "substantive business operations" requirement to prevent treaty abuse.
- Qualifying investments – investments are broadly defined to include tangible and intangible assets, such as shares, property, intellectual property, and contractual rights. Some treaties, such as the Mexico–Netherlands BIT, align their definitions with OECD benchmarks, which often include a 10% ownership threshold for foreign direct investments.

Structuring investments for BIT protection

Given the nuances of BIT applicability, structuring or restructuring investments to meet treaty requirements is critical. Investors should consider:

- Jurisdiction selection – establishing or relocating holding companies to jurisdictions with favourable BITs with Mexico;
- Substantive business activities – ensuring sufficient operational presence in the chosen jurisdiction to satisfy substance requirements; and
- Tax implications – restructuring can trigger taxable events, such as capital gains or indirect transfer taxes; for example, transferring shares to a qualifying jurisdiction might lead to significant tax liabilities unless mitigated by treaty provisions.

Thus, careful planning is essential to optimise legal and tax outcomes before implementing a corporate restructuring that will provide such protection.

Scope of protection and dispute resolution

BITs typically offer robust protections for foreign investors, including:

- Fair and equitable treatment – ensuring a stable and predictable legal environment;
- Protection against expropriation – prohibiting expropriation without adequate compensation; and
- Non-discrimination – guaranteeing national and most favoured nation treatment.

When disputes arise, on some occasions, BITs allow investors to bypass domestic courts and seek resolution through international arbitration forums, such as the International Centre for Settlement of Investment Disputes. In some other cases, exhausting local remedies is necessary before accessing the international dispute legal framework.

Therefore, to file timely claims and preserve their treaty rights, investors must determine whether arbitral proceedings, including the submission of notices of intent to the host state's authorities, can be initiated upon the issuance of an unlawful tax assessment or if the assessment must first be challenged in domestic courts, either for a specific period or until a final decision is reached, before the possibility of submitting a notice of intent is available.

Also, it is important to bear in mind that there are some BITs that restrict the scope of protection for indirect expropriation (including those derived from disproportionate or arbitrary tax assessments), such as the United States–Mexico–Canada trade agreement, which is why it is key to determine whether an investment stemming from the US or countries with such limitations are, under the current political environment, a good and effective alternative.

Therefore, foreign investors in Mexico must proactively navigate the complexities of BITs and tax regulations. Key steps include:

- Evaluating the applicability of existing BITs to current and future investments;
- Structuring investments to align with treaty definitions and substance requirements;
- Assessing the tax consequences of restructuring and exploring mitigation alternatives; and
- Monitoring changes in Mexico's regulatory and tax landscape to anticipate potential conflicts.

In summary, by understanding the interplay between tax law and international investment agreements, investors can safeguard their assets and leverage dispute resolution mechanisms, when necessary, particularly in an era of heightened tax scrutiny. Professional legal and tax advice is indispensable for navigating this complex landscape and optimising outcomes for international investors.

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