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Mexico's 2020 Tax Reform

2020 Tax Reform. Mexican Income Tax Law Modifications.

Below you will find a brief summary of the modifications made to several provisions of the Mexican Income Tax Law ("MITL") which were recently approved by Mexico's Congress and that will be published in the Federal Official Gazette.

Concept	Amendments	Effects and issues to consider
1. Tax Transparent Entities. *Articles 4-A and 205, MITL.*	The "transparent entities" and the "legal vehicles" that obtain income from Mexican source, without regarding that its members or shareholders consider such as taxable income, will be deemed as corporations and will be obliged to pay Mexican Income Tax. The above mentioned will not be applicable against double tax treaties. Such entities or legal vehicles are considered transparent for tax purposes, when: *i)* they do not have tax residence in the country of incorporation or where they have the main business administration or actual address; and *ii)* their income is attributed to their members or shareholders. As a tax incentive, it is established that foreign transparent legal vehicles that have private capital investments in Mexican corporations will still be deemed as tax transparent for Mexican Income Tax purposes, only for the income obtained for interests, dividends, capital gains or real estate leasing if certain reporting obligations are met and such legal vehicles are incorporated in a country that has signed a broad information exchange treaty with México.	Companies will have to review their corporate structures that involve foreign legal vehicles, because the tax reform implies that certain income will not be attributed directly to the partners or members. It is important to analyze how this new provision affects "transparent structures" regarding the applicability of anti-double tax treaties, considering each particular treaty. It is common to find "transparent structures" that have private capital investments in Mexico, which are integrated by foreign and national members or partners. This new provision will affect the tax regime of such structures.

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	These provisions will enter into force until January 2021.	
2. Income of Mexican residents through tax transparent entities of foreign legal vehicles. *Articles 4-B and 178, MITL.*	A new tax regime has been created for taxpayers who obtain income through non-transparent tax entities (as could be a U.S. LLC) or foreign legal vehicles (whether they are transparent or not) as a Trust or a partnership. In this new regime, taxpayers will be obliged to consider as taxable income (in some cases only the profits) the one originated abroad by tax transparent entities or legal vehicles, according to the Mexican resident participation, even if such entities or legal vehicles do not distribute such income. The tax triggered will be 35% + 10% for dividend distribution. If taxpayers have operations through these entities or legal vehicles (transparent or not) they will have to file a tax report before the Tax Administration Service ("SAT"). The income will be directly attributed to the Mexican taxpayer and the tax paid abroad by these entities or vehicles will be considered as paid by the Mexican resident only for the taxable income that was considered. The tax paid will create a tax credit for the Mexican resident in the proportion that the income received by the entity or legal vehicle was considered by the taxpayer as taxable income.	Companies shall review the tax effects of foreign structures to determine if the income generated by such entities or legal vehicles trigger Mexican income tax. The interaction of the concepts for transparent entities and legal vehicles provided by Article 4-A is not clear enough, which generates legal uncertainty. The concept of "control" is not relevant anymore for these structures in the new regime; if a taxpayer has direct or indirect participation in such structures, the new regime will be applicable. This situation might affect certain fund investments where the taxpayer does not have control or access to all of the information of the structure in order to determine the tax triggered. In case of structures that involve transparent entities or legal vehicles with non-transparent entities, the taxpayer shall perform an analysis if this new regime will apply or if the income received is subject or not to a Preferential Tax Regime ("REFIPRE")

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		The taxpayer shall pay special attention when there is not a capital contribution or defined participation because the taxable income will have to be accrued according to such "participation", which is a situation that creates legal uncertainty to determine who is subject to the tax and in which proportion the income will be attributed. If a taxpayer performs operations through these entities or legal vehicles, they will have to file a tax report to the SAT. For such purposes, we consider that it is not clear in the MITL what should be understood as "performing operations", which will have to be clarified by the tax authorities through administrative rules.
3. REFIPRES. *Articles 176, 177 and 178, MITL.*	The REFIPRE regime continues. The taxpayer will trigger income tax (35% rate + 10% dividend) for income or profits generated directly or indirectly by a foreign non-transparent entity (when such entity´s tax rate is below 22.5% for Mexican entities and 26.25% for Mexican individuals). The exception of being considered as a REFIPRE when the taxpayer does not have "effective control" over the foreign entity continues.	Companies will have to analyze whether or not they trigger the REFIPRE regime according to the new rules to determine if there is effective control, which addresses the concept of participation in the entities (including related parties) and the possibility to receive its benefits against how it was regulated before the reform, which referred to the possibility to determine profit distributions.

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	Nevertheless, the rules to determine if there is effective control are substantially modified. Under these new rules there is effective control over the foreign entity if the taxpayer has more than 50% of the shares or rights, which allows such taxpayer to obtain the profits or the assets in case of a capital reduction or liquidation. To determine if the participation exceeds the 50% and thus there is effective control over the foreign entity, all rights owned by any related party or linked individuals shall be considered. The obligation to file the tax report to the SAT for income obtained in this regime continues.	It is important to consider that in the case of individuals participating directly or indirectly on such structures, the threshold to determine if the REFIPRE regime applies will be 26.25% of the income tax rate against the corporate tax rate of 22.5%. Before the reform, the rules permitted individuals to apply the corporate tax rate. In the case of foreign structures that involve foreign transparent entities or legal vehicles with non-transparent entities, taxpayers should test which regime is applicable, REFIPRE or the new regime transparent entities or foreign legal vehicles provided in article 4-B of the MITL. The taxpayers will have to file a tax report to the SAT for all income received from REFIPRES, according to article 178 of the MITL.
4. Tax credit for income tax paid abroad. *Article 5, MITL.*	As a measure to avoid hybrid structures[1], it is prohibited to apply the tax credit originated by income tax paid abroad when such tax has been credited in another country for different reasons than an indirect credit. This will not be applicable if the income for which the tax was paid was	To determine if the tax credit for taxes paid abroad is applicable by a Mexican resident, taxpayers shall review whether or not they trigger the cases provided in the new provision.

[1] Entities or legal vehicles regarding from which a deduction is generated in the country of residence of the payor, without the obligation for the recipient to accrue the income.

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	accrued by the taxpayer in such other country. The credit shall not be applied for dividend distributions considered as a deductible item or an equivalent reduction for the foreign resident that distributed the dividend.	
5. Permanent Establishment. *Article 2 and 3, MITL.*	A new set of rules to determine if a Permanent Establishment ("PE") is created when the foreign resident maintains a dependent agent (employee) in Mexico and such employee concludes a contract or performs the negotiation to conclude such contract, and one of the following cases is triggered: *i)* the contract is signed on behalf of the foreign resident; *ii)* the contract refers to the sale or leasing of real estate property owned by the foreign resident; or *iii)* the contract obliges the foreign resident to render a service. The rule of auxiliary or complementary activities is modified to consider that a PE is created even if such activities are separated but all refer to the same operation (Anti-fragmentation rule).	It is recommended to review the way the foreign residents act in Mexico to confirm if they create a PE regarding these new rules. It is necessary to review if the foreign resident develops auxiliary or complementary activities as part of a whole business operation, which will not be considered as such and will create a PE.
6. Limit on deductions for payments made to related parties or derived from structured agreements. *Article 28, section XXIII, MITL.*	Payments made to a related party or derived from a structured agreement will not be deductible items if the income for the counterparty is subject to a REFIPRE or if the party that directly or indirectly receives the payment uses such payment to make other deductible payments to other members of the same group or derived from a structured agreement subject to a REFIPRE. Two parties shall be deemed part of the same group when one of them has effective control	It is necessary to review each of the transactions carried out with related parties to determine whether such limitations are triggered, even if the payment is made to a non-related party, but the benefit or payment is ultimately received by a related party.

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	over the other, or when a third party has control over both. This limitation does not apply if the payment that is considered an income subject to REFIPRE derives from the recipient´s business activity, if it can be proved that it has the personnel and sufficient assets to carry out such activity (unless the payment is considered as income subject to REFIPRE as a consequence of a hybrid mechanism).	
7. Limit on deduction of interest. *Article 28, section XXXII, MITL.*	Net interest[2] that exceeds 30% of the "adjusted tax profits" will be a nondeductible item. This limitation only applies to taxpayers whose interest accrued from debt in the fiscal year exceeds MXP$20,000,000. This limitation does not apply to members of the financial system. Any nondeductible net interest will be able to be carried forward for up to ten years until the pending amount is finished. We understand that such limitation is supplementary to thin capitalization rules.	Companies shall review how this limitation affects the interest deductions and determine if it is necessary to restructure their debt. Companies with high expenses and low income (startup) even with the calculation to determine the adjusted tax profit might not be able to deduct the interest paid, which will make it more difficult for these companies to finance their operations with credit, creating a clear disadvantage.
8. Outsourcing. *Article 27, section V, MITL.*	To consider an outsourcing service payment as a deductible item, the contracting party must withhold and pay 6% of the value added tax ("VAT") triggered by the outsourcing company.	It seems that the definition provided in the VATL requires the withholding of VAT for both outsourcing services, as well as any other service by which personnel is provided to

[2] Net interest is "the amount resulting by subtracting from the total interest accrued during the fiscal year derived from the taxpayer's debt, the total amount of interest accrued for credit granted during the same period."

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Articles 1-A, section IV, 5 section II and 32, section VIII, Valued Added Tax Law ("VATL").	The obligations for the contracting party to obtain from the outsourcing company the digital tax invoice ("CFDI") of salary payments, receipts and tax returns to prove the VAT payment will be eliminated. Taxpayers who receive services by which the contractor provides directly or to a related party personnel to perform their activities inside or outside their facilities or the facilities of a related party, whether or not they are under the direction, supervision or coordination of the taxpayer, will have to withhold 6% of the value of the consideration effectively paid. According to the explanatory statement of the tax reform initiative, the withholding tax of 6% on the value of the consideration paid is proposed, because withholding the whole 16% of the VAT will create positive balances and consequently multiple requests for reimbursement. This will generate an undesired financial effect for the service providers and an additional administrative burden for the SAT.	perform the activities of the contracting company. This generates uncertainty for companies that hire independent personal services, since the definition given is very broad and ambiguous. This creates confusion for the taxpayers to identify which services payment will be subject to the withholding in connection to the activities performed by the personnel provided by the service provider. In order to apply the deduction of the payments and the VAT credit charged to the contracting party, companies will be obliged to withhold and pay 6% of the VAT payable by the contractor. Companies will not be required to: *i)* have the service provider's VAT returns and payments; and *ii)* file the report to the SAT regarding the payments, withholding and credit of VAT applied.
9. Payments made to foreign companies. *Articles 158 and 167, section I and III, MITL.*	Income derived from leasing movable property used for commercial or industrial activities will be considered as royalties (such income is eliminated from the provision that regulates income derived from leasing).	Payments derived from leasing vessels are subject to a 5% withholding rate, while airplane lease payments are subject to a 1% withholding rate. In the latter case a constitutional violation for inequity persists because such

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	The tax shall be determined applying to the income obtained, without any deduction, the 5% withholding rate in the case of temporarily imported containers and vessels with a concession or permit granted by the Federal Government to be commercially used, among others. Regarding royalties for leasing aircrafts with a concession or permit granted by the Federal Government to be commercially used, provided that such goods are used directly by the lessee in the transportation of passengers or goods, the tax shall be calculated applying to the income obtained, without any deduction, the 1% withholding rate. For income derived from charter contracts, it continues to be considered that the source of wealth is located in Mexico if the cabotage navigation is carried out in the national territory, but income derived from the lease of commercial, industrial or scientific equipment will be excluded (since such income will be taxed as royalties).	rate does not apply to all aircrafts (i.e. helicopters). This has been confirmed by the judicial precedents. Revenue from bareboat charter contracts are considered royalties.
10. Maquiladora shelter regime / foreign residents without PE. *Articles 183 and 183 Bis, MITL.*	Foreign residents who directly or indirectly provide raw materials, machinery or equipment to carry out maquila activities through companies with a maquila program under the shelter regime do not create a PE in Mexico, provided that they are in compliance with all tax obligations through the company that provides such services. Foreign residents are not entitled to sell any products manufactured in Mexico that do not have a customs export declaration (pedimento de exportación), nor are they	Previously to the reform such benefit could only be applied for a maximum period of 4 years.

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	entitled to sell the machinery and equipment owned by them or by their foreign related parties or foreign customers, to the company with a *maquila* program that provides the services before or during the period in which the provisions of the preceding paragraph are applicable.	
11. FIBRAS *Article 187, section V, MITL.*	Currently, the MITL allows the creation of Public and Private Real Estate Investment Trusts ("FIBRAS" as its acronym in Spanish). In the case of public FIBRAS, the trustee must issue certificates of participation for the assets property of the trust and sell such certificates to public investors. In the case of private FIBRAS, they should have at least ten unrelated members, without any of the members holding more than 20% of the certificates issued. The tax authority identified certain abuses by these private FIBRAS, thus the reform eliminates this class. In addition, the new provision establishes the obligation for public FIBRAS trustees to: *i)* submit information identifying the settlors; *ii)* submit information and documentation of each of the real estate contributions made to the trust; and *iii)* submit a report of each real estate property contributed to the trust.	A transitory provision establishes that the taxpayers who applied the private FIBRA scheme will have two years from the proposed reform to pay the income tax triggered by the gain obtained in the sale of the assets to the trust. The purposes of the new obligations established for public FIBRAS, are intended for the tax authority to have elements to identify the beneficiaries of the tax incentive provided in the MITL.
12. Digital platforms income. *Article 113-A, MITL.*	As of April 2019, an administrative rule was incorporated into the Miscellaneous Tax Resolution allowing to withhold income tax and VAT to drivers who provided transport services or delivery of food using digital platforms.	The intermediaries (entities, residents and non-residents in Mexico), that provide the use of digital platforms directly or indirectly, will be required to comply with several obligations, as withholding

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<tr><td></td><td>The MITL incorporates a new regime applicable to individuals with business activities that sell goods or provide services using these digital platforms, computer applications and similar things. It should be noted that the new regime is extended to cover hosting services, sale of goods and any other service different than transportation.

Under this new regime there is the obligation to withhold the income tax to providers of the service carried out using the indicated digital media.

This withholding obligation will be carried out by the entities or non-residents in Mexico that are considered intermediaries — those that directly or indirectly provide the use of technological platforms—.

The intermediaries considered as non-residents in Mexico will be required to register before the Federal Taxpayer Registry as a withholding agent and will have to issue the CFDI.

The withholding rates will be:

<table><tr><th>Activity</th><th>Approximate withholding rate</th></tr><tr><td>Private transport services and delivery of goods.</td><td>From 2% to 8%</td></tr><tr><td>Sale of goods and services.</td><td>From .4% to 5.4%</td></tr><tr><td>Hosting services.</td><td>From 2% to 10%</td></tr></table></td><td>income tax to individuals with business activities.</td></tr>
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