

# Overview of the 2020 Mexican tax reform

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In December 2019, the Mexican Congress approved the 2020 Tax Reform Act (2020 Act), which includes a number of changes to Mexican tax laws. Most of the changes are focused on revamping Mexico's international tax regime, and combating tax evasion. The final 2020 Act was published Dec. 12, 2019.

Below we provide an overview of those items in the 2020 Act that are relevant to internationally active companies and individuals that have (or are planning to have) activities or interests in Mexico. Unless otherwise specified, the provisions of the 2020 Act are applicable for tax years beginning on or after Jan. 1, 2020.

## Quick recap

Most of the changes included in the 2020 Act revolve around the following topics:

- Adherence to the OECD's base erosion and profit shifting (BEPS) action plan to define the concept of "permanent establishment"
- Adherence to the OECD's BEPS action plan to address international anti-deferral and anti-abuse principles
- Changes in the shelter maquiladora tax regime
- A clear set of rules to tax electronic commerce
- Tax arrangement reportable measures
- Stricter consequences for pervasive tax evasion activity

## Income tax law

### Definition of permanent establishment

A foreign (non-Mexican) resident who has a permanent establishment (PE) in Mexico will be subject to Mexican taxes (income tax, value-added tax and any applicable excise taxes) as well as significant reporting and filing requirements in Mexico with respect to the revenue that is considered to be earned in Mexico through the PE. Typically, the revenue attributed to a PE is that which is earned from an activity performed by the foreign resident in Mexico, either directly, or through a dependent or independent agent.

The 2020 Act adds the concept of "principal role" to the traditional definition of PE. In general terms, a foreign resident has a PE in Mexico if it acts in the country through an agent who has a principal role in closing contracts.

A principal role exists if the contracts the agent closes for or on behalf of the foreign resident has one or more of the following features:

- Signed by the agent for or on behalf of the foreign resident
- Provides for the sale, rent or lease of goods or property located in Mexico that is owned by the foreign resident
- Creates an obligation for the foreign resident to perform a service

The above applies whether the agent is a dependent or independent agent to the foreign entity. The 2020 Act also establishes that an agent is deemed not independent if it is a related party to the foreign resident.

The list of permitted activities (those that can be performed in Mexico and that do not trigger a PE) remain largely unchanged. However, it is established that segmented activities or operations that the foreign resident performs in Mexico (either directly or through an agent) may be seen as part of a single activity if they are complementary to a revenue-generating common goal. This applies whether the single activity is a permitted activity or not.

Thus, under the right circumstances, a permitted activity that an agent performs in Mexico for or on behalf of a foreign resident can be considered to be part of a single activity with a revenue-generating goal. As a result, the foreign resident will have a PE in Mexico.

*Who can be affected by the new PE provisions?*

Determining whether a foreign resident has a PE in Mexico is a facts-and-circumstances exercise. However, two of the most commonly used structures that are vulnerable to the new PE provisions are as follows:

- Foreign companies that have a wholly-owned Mexican legal entity that operates as a sales force company, even if the Mexican legal entity gets paid an arm's-length fee or commission for its activities
- Foreign companies that have representative offices in Mexico performing seemingly auxiliary activities, or that have a sales representative in Mexico working from home

Foreign companies that have activity in Mexico through one of the above scenarios should examine their exposure to PE taxation. A potential way to reduce the exposure may be to add functions and risks to the Mexican legal entity by transforming it into a buy-sell operation. Those companies operating through representative offices (or a representative working from home) are more at risk. These should consider abandoning the representative office or individual sales representative arrangement and migrate to a buy-sell subsidiary structure. In either case, transfer pricing will be an important component of the restructuring of Mexican operations.

### **Foreign fiscally transparent entities**

The 2020 Act establishes a brand-new regime to tax foreign fiscally transparent entities that have effectively connected income in Mexico. This new tax regime is similar in concept to the one contained in U.S. Internal Revenue Code section 864(c) and applicable provisions.

The 2020 Act defines a fiscally transparent entity as one that has the following attributes:

- It is not a tax resident of the country in which it is legally formed.
- Its members, owners or shareholders are taxed on the income when earned by the entity, and not when the entity makes a distribution.

Notably, the 2020 Act does not include a definition for the term "effectively connected income." Also of note is that taxation under this regime happens at the entity level, and not at the owner, shareholder or member level, as is the common practice in other tax jurisdictions, including the United States (e.g., U.S. Internal Revenue Code section 864(c) and applicable provisions).

In most cases, the effectively connected income will be subject to Mexican income tax at the corporate flat rate of 30% on the net taxable profit obtained thereof, calculated under Mexican tax principles.

Foreign fiscally transparent entities that fall under this tax regime may still seek relief under the provisions of any applicable income tax treaty to which Mexico is a contracting state, provided such entities qualify for treaty benefits.

### **Private equity funds with effectively connected income**

Private equity funds that operate through a foreign fiscally transparent entity will also be subject to Mexican income tax on their Mexican effectively connected income. In general, they are considered to have effectively connected income with respect to the following elements:

- Interest earned in Mexico, directly or indirectly through Mexican portfolio companies of funds
- Dividends received or paid by Mexican portfolio companies or funds
- Capital gains on the disposition of property located in Mexico
- Income from a lease of property located in Mexico

In addition, the above private equity funds will have to appoint a tax-matters agent who lives in Mexico to pay Mexican taxes and file Mexican tax returns. They will also be required to disclose to the Mexican taxing authorities (SAT) the identity of all its owners or members. Under the enacted provisions, it is unclear what level of tiered ownership is subject to disclosure.

The regime for foreign fiscally transparent entities and private equity funds with effectively connected income will become effective for tax years beginning on or after Jan. 1, 2021. We expect that during 2020, additional guidance regarding the definition of effectively connected income and other rules of operation will be published.

### **Foreign tax credit limitations**

Certain limitations are imposed on Mexican taxpayers with respect to the ability to claim a credit of foreign taxes against their Mexican income tax. In general, no credit is allowed when one or more of the following conditions are met:

- A credit of the same foreign tax is also claimed in a foreign tax jurisdiction.
- The foreign tax is not an indirect tax paid on the distribution of earnings.
- The distribution made represents a deduction or reduction in the taxable base in another foreign tax jurisdiction.

An exception is granted if the revenue was subject to direct tax in a foreign tax jurisdiction. In this case, a foreign tax credit will generally be allowed.

### **Payments to foreign related parties**

Under the 2020 Act, payments made by a Mexican taxpayer are nondeductible when made to a foreign-related party if any of the following conditions are met:

- The foreign related party is subject to a foreign preferential tax regime. A preferential tax regime occurs when the foreign party is subject to an effective tax rate of 22.5% or less. An option exists to use the statutory tax rates (instead of the effective tax rates) to determine whether the foreign related party is subject to a preferential tax regime.
- The payment is made pursuant to a "structured agreement." A structured agreement is an arrangement between related parties where the compensation for services or activities is determined based on the most favorable result for the taxpayer, or that based on the facts and circumstances, it can be concluded that the arrangement was implemented solely to obtain a tax benefit.

An exception to the above rules applies when the recipient of the payment has the necessary assets, resources and personnel to perform the services or activities that give rise to the payment made by the Mexican taxpayer. This exception is not applicable if the payment is made to a hybrid entity. In general, a hybrid entity is deemed to exist when that entity has a tax treatment for Mexican tax purposes different from the tax treatment it receives under its appropriate foreign tax jurisdiction.

The provisions governing the limitation on payments to foreign related parties are rather complex and confusing. As such, we expect that additional guidance will be published shortly.

#### *What should companies do?*

While we wait for additional guidance, foreign companies whose Mexican subsidiaries make payments such as royalties, management fees, commissions, rent or other similar concepts should examine, together with their tax advisors, whether or not they are at risk of losing the deduction of those payments for Mexican tax purposes.

Foreign companies should bear in mind that, with these new rules, a robust transfer pricing policy, or the timely payment of any applicable withholding taxes are no longer sufficient to support the deduction of payments made to foreign related parties.

Under the new rules, in addition to the increase in income tax liability, other important (and often overlooked) consequences of the nondeductibility of payments made to foreign related parties include: an increase in the mandatory profit sharing liability,<sup>1</sup> and a nonrecoverable VAT that the Mexican offending taxpayer may have to pay to the SAT.

### Anti-deferral rules

Under the anti-deferral regime that has been in existence for several years, Mexican taxpayers who have an interest in a foreign entity subject to a preferential tax regime (i.e., subject to an effective tax rate of 22.5% or less) are required to include in their taxable income their share of the revenue earned by the foreign entity, and pay the Mexican income tax that results thereof.

The 2020 Act leaves the anti-deferral regime intact, for the most part, with two notable changes:

- The option to use the statutory tax rates (instead of the effective tax rates) to determine whether the foreign entity is subject to a preferential tax regime.
- The concept of "effective control," which in general terms exists if the taxpayer has an average daily participation in the foreign entity of 50% or more of the total voting rights, or 50% or more of the book value of its shares. If the Mexican taxpayer has no effective control over the foreign entity, it escapes the anti-deferral regime with respect to that entity.

The effective control test must be made separately for each foreign entity in which the Mexican taxpayer has an interest.

### Withholding tax on Mexican-sourced royalties paid to foreign residents

The rules governing the withholding tax rates on royalties sourced in Mexico have been realigned as follows:

Item	Withholding rate
Royalties for the lease of rail cars, trailers and containers that have been temporarily imported into Mexico for a period of up to one month, and that have an authorization from the Mexican government to be exploited commercially in the transportation of persons or goods	5%
Royalties for the lease of aircraft that have an authorization from the Mexican government to be exploited commercially in the transportation of persons or goods	1%
All other types of royalties and payments for technical assistance	25%

The 25% withholding rate mentioned above may be reduced to 10% or even 0%, as applicable, if an income tax treaty to which Mexico is a contracting state applies.

### Income tax withholding on e-commerce and digital services

The 2020 Act includes a mechanism to ensure that Mexican resident individuals selling goods, lease property or render certain services through intermediary digital platforms pay income tax for the revenue they earn therefrom.

Under this mechanism, the owner of the intermediary digital platform that the Mexican resident individual uses to sell goods or perform services is required to withhold the income tax before paying the proceeds to the individual. The owner of the digital platform is required to remit the tax withheld to the SAT by the 17th day of the month following the date when the transfer of the proceeds is made.

The withholding and remittance obligations described above apply to owners of intermediary digital platforms that are Mexican residents, as well as foreign residents (with or without a PE in Mexico).

The withholding rates differ depending upon the proceeds that the owner of the digital platform collects on behalf of the Mexican individual. The rates vary from 2% to 10%.

<sup>1</sup> The mandatory profit sharing is a benefit that by law Mexican employers have to distribute certain amounts to their employees. The distributable profit sharing amount is 10% of the net taxable basis determined for income tax purposes, with certain adjustments and must be paid to the employees by May 31 of each calendar year.

Examples of owners of digital platforms that are required to remit and withhold the tax include the following:

- Platforms to rent or lease real estate property
- Platforms to provide courier services
- Platforms to provide transportation services for individuals
- Platforms to sell personal or real estate property, either with a fixed price or through a bidding process

The owners of digital platforms, whether Mexican or foreign residents (with or without a PE in Mexico) must meet the following requirements:

- Obtain from the individual a copy of his or her Mexican tax identification number. If the individual fails to provide the Mexican tax identification number, the owner of the digital platform is required to withhold the tax at a 20% rate on proceeds paid to the individual.
- Obtain a Mexican tax identification number.
- Withhold and remit the tax at the appropriate rates.
- Provide the payee individuals with a certificate reporting the proceeds paid and tax withheld.
- Keep records of the taxes withheld and remitted.

Of course, in addition to the above requirements, foreign resident owners of the digital platforms that have a PE in Mexico have to pay their Mexican income tax on the net income they obtain from acting as intermediaries between the purchaser and the Mexican resident individuals.

#### **Limitation on interest expense**

In addition to thin capitalization rules already in Mexican tax law, the 2020 Act introduces a new limitation on the deduction of interest expense. Such a limitation will apply to all interest from debt acquired prior to Jan. 1, 2020.

Per the 2020 Act, the deduction of net interest arising from all financing cannot exceed 30% of adjusted taxable income as defined in the Mexican tax law (also referred to as EBIDTA). Although, interest expense exceeding this threshold can be carried forward 10 years.

Mexican taxpayers are required to perform both calculations, the EBIDTA limitation and thin capitalization limitation. Whichever calculation results in the highest nondeductible portion of interest will prevail.

#### **Shelter maquiladora new developments**

"Shelter maquiladora" is a colloquial term used to describe a Mexican enterprise taxpayer whose principal business activity is the rendering of contract manufacturing services to a variety of customers, all of which are unrelated to the shelter maquiladora. A shelter maquiladora charges its customers a contract manufacturing service fee in accordance with market-prevailing rates.

Under Mexican tax law, under certain circumstances, a foreign entity who uses a shelter maquiladora will have a PE in Mexico with respect to the manufacturing operations that the shelter maquiladora performs for the nonresident entity. Having a PE in Mexico will subject the foreign residents to Mexican taxes on all or a portion of the revenue that the foreign resident obtains from the sale of products manufactured by the shelter maquiladora, even if those products are sold outside Mexico. Mexican tax law provides the methodology under which the foreign resident pays taxes on the revenue attributed to its Mexican PE.

The law, in effect until Dec. 31, 2019, provided a mechanism under which a foreign resident who operates through a shelter maquiladora may not have a PE in Mexico. These rules operate as follows:

- The foreign resident has an automatic four-year tax holiday, during which it has no tax reporting obligations in Mexico. The tax holiday expires on the fourth anniversary of the date the foreign resident first signed the contract manufacturing agreement with the shelter maquiladora.
- After the four-year tax holiday expires, the foreign resident has the following alternative courses of action:
  - Have the shelter maquiladora pay, on behalf of the foreign resident, a "toll tax," calculated under the mechanics set forth by the income tax law, for an additional period of four years
  - Set up their own Mexican legal entity to operate as their own maquiladora
  - Create a PE in Mexico

## Changes brought in by the 2020 Act

Under the 2020 Act, the automatic four-year tax holiday is repealed. Therefore, foreign residents who sign a contract manufacturing agreement with a shelter maquiladora on or after Jan. 1, 2020, must decide which one of the alternative courses of action listed above they want to follow.

Under a grandfather provision, foreign residents who are still under the four-year tax holiday, or the four-year toll tax period, can continue using it until it expires. After the expiration date, these foreign residents must decide which of the above options to choose.

In most cases, having the shelter maquiladora pay the toll tax in perpetuity may be the most practicable alternative. However, due to cost efficiencies or to meet customer or supply chain demands to have a footprint in Mexico, setting up their own Mexican legal entity to operate as a maquiladora may be a viable solution for some foreign residents.

## Value-added tax

### VAT regime for foreign residents performing e-commerce activities in Mexico

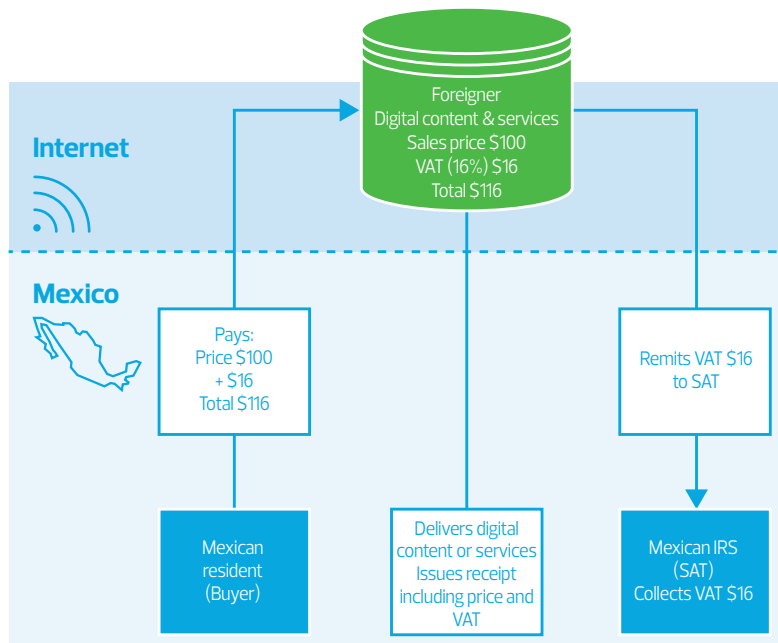
The 2020 Act sets forth a mechanism for foreign residents without a PE in Mexico to collect and remit VAT related to certain services performed through digital platforms.

The services to which this mechanism applies are those provided through a digital platform owned by a foreign resident when the following circumstances take place:

- The beneficiary of the services has provided an address or telephone number located in Mexico
- The IP address corresponds to the range of addresses used in Mexico

Examples of services to which these rules apply include: downloading or accessing films, video, music, games, online news streaming (books and periodicals are exempt), virtual chat rooms, dating services, and remote learning and testing.

Accordingly, the foreign owner of the digital platform through which the above services are performed is required to collect from the payer, and remit to the SAT the VAT at the rate of 16%. The following chart illustrates how this VAT regime works:



- Foreigner nonresident offers digital content and services to Mexican buyers utilizing its digital platform
- Foreigner nonresident advertises the digital content and services price plus VAT
- A Mexican buyer buys and pays digital content or services through digital platform including VAT
- Foreigner nonresident collects price and VAT
- Foreign nonresident remits to Mexican SAT 100% VAT collected

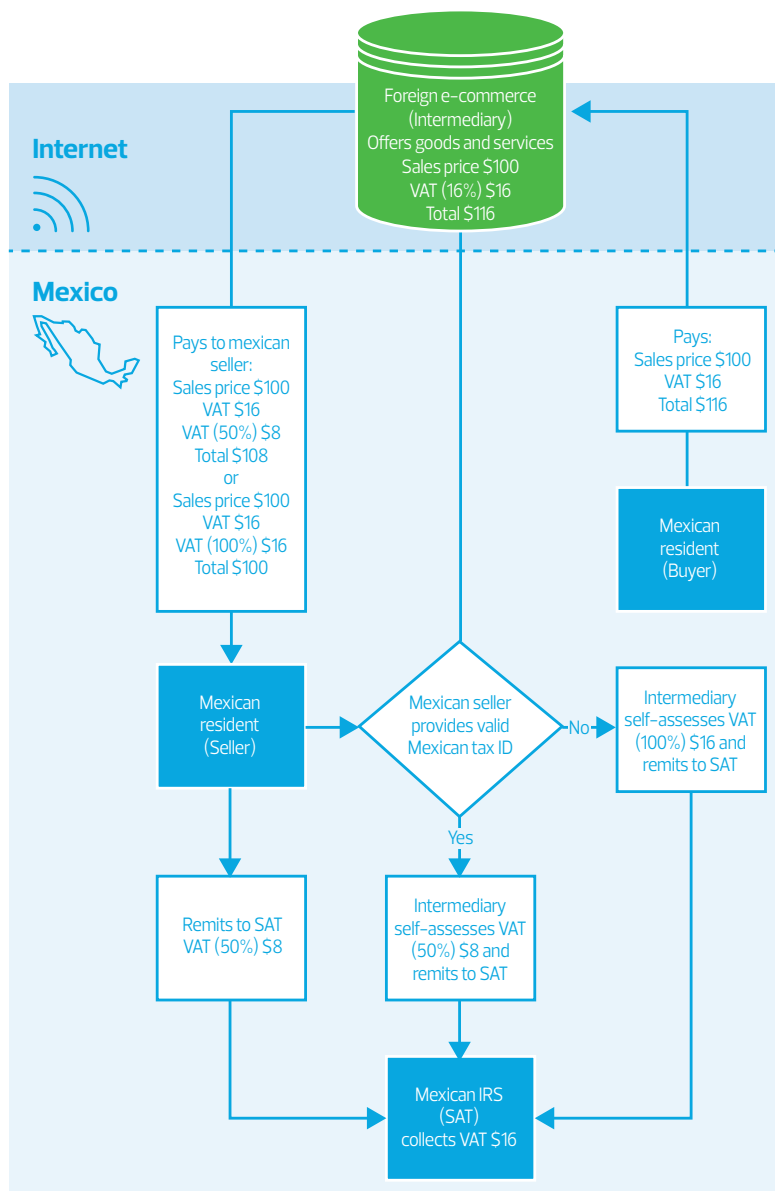
## Intermediaries

Certain special rules apply when the owner of the digital platform acts as an intermediary between a Mexican seller of goods and services, and the buyer of said goods and services. Under these circumstances, the owner of the digital platform is required to self-assess and remit to the SAT an amount equal to 50% of the VAT that it would otherwise have to pay the seller of the goods or services. The owner of the digital platform will still be required to transfer the remaining 50% of VAT to the seller.

In essence, the transactions that are subject to the intermediary VAT regime described above are the same to which the income tax withholding applies (see "Income tax withholding on e-commerce and digital services" previously in this white paper), when owned by foreign residents without a PE in Mexico and include transactions on the following:

- Platforms to rent or lease real estate property
- Platforms to provide courier services
- Platforms to provide transportation services for individuals
- Platforms to sell personal or real estate property, either with a fixed price or through a bidding process

The following chart illustrates how this VAT regime works:



- Mexican seller offers goods and services using a foreign intermediary utilizing its e-commerce platform
- Foreign e-commerce intermediary advertises the goods and services price plus VAT
- A Mexican buyer buys and pays for goods or services through the e-commerce platform including VAT
- Foreign intermediary requests and retains Mexican sellers' valid tax identification
- Foreign intermediary self-assesses and remits to Mexican SAT 50% of VAT collected
- Should Mexican seller be unable to provide a valid Mexican tax ID, the intermediary remits 100% of VAT collected to the SAT

The foreign residents subject to the above VAT regime must comply with the following:

- Obtain a Mexican VAT number
- Appoint a tax-matters registered agent and registered address located in Mexico
- Disclose the price and the VAT when pricing the services
- Collect the VAT at the rate of 16% when receiving payment for the services
- Remit the VAT collected during a calendar month by no later than the 17th day of the following month
- Maintain records of the VAT collected and remitted, readily available for inspection by the SAT
- At the request of the purchaser, produce supporting documentation (invoices) stating the VAT collected, separate from the price, as well as details about the transaction

Of note, under a specific provision, the collection, self-assessment and remittance of VAT under the above mechanisms do not necessarily trigger a PE for the qualifying foreign owner of the digital platform.

However, foreign residents who have a PE in Mexico by virtue of other provisions cannot apply the above VAT mechanism. Instead, they are subject to the traditional VAT input and output regime that applies to Mexican enterprise taxpayers.

## **Tax enforcement and prosecution**

### **Reportable tax arrangements**

Taxpayers and/or their tax advisors are required to file a report with the SAT on certain reportable tax arrangements. A tax arrangement constitutes any plan, project, proposal, set of instructions, explicit or implicit recommendation that results in a permanent or deferred tax benefit in Mexico. This definition applies to arrangements implemented by both Mexican and non-Mexican tax residents.

A tax arrangement does not include only tax positions or postures adopted by a taxpayer who may seem aggressive or frivolous under certain interpretations; certain tax stimulus or incentives expressly established in the tax laws may also qualify as reportable tax arrangements. For example, an advanced pricing agreement discussed with the SAT to reduce the net taxable income for a maquiladora may constitute a reportable tax arrangement.

Below is a list of the principal features that a reportable tax arrangement may have:

- Impairs the exchange of information between the SAT and their competent counterparts in foreign countries. This includes exchange of information under FATCA or CRS, or under treaties for the exchange of tax information to which Mexico is a signatory.
- Avoids Mexico's anti-deferral rules
- Allows for the transfer of net operating losses to entities that did not create such losses
- A series of connected payments that results in the return of all or part of the amounts paid to the entity or individual that originated them
- Allows for treaty shopping
- Intercompany transactions that involve the disposition of intangibles that are difficult to appraise, restructuring that include the shifting of functions, assets and risks, and do not include a payment, temporary transfer of goods or rights without a payment, and result in a weak set of comparables for transfer pricing purposes
- PE avoidance
- Transfer of fully depreciated assets to a related party with the purpose of creating a brand new depreciable basis
- Transactions involving hybrid entities, previously defined
- Avoidance in the identification of the beneficial owner of payments or income
- Transactions that extend the life of net operating losses
- Avoidance of the 10% withholding tax rate applicable to dividends
- Transactions in which the tax basis differs by 20% or more from the book basis

An SAT technical committee will be charged with identifying and publishing specific reportable tax arrangements.



## Types of tax arrangements

The 2020 Act identifies two types of tax arrangements:

- General tax arrangements—those marketable and applicable to a large number of taxpayers. The due date to report general tax arrangements is 30 days after the date the first contact to sell the arrangement is made.
- Personalized tax arrangements—those tailor-made for a specific group of taxpayers or for a single taxpayer. The due date to disclose personalized tax arrangements is 30 days after the date the tax arrangement is available to the taxpayer to implement.

## Tax advisors

Tax advisors are required to disclose the reportable tax arrangements they sell, propose or design for their clients to the SAT. For these purposes, a tax advisor is any person or entity whose main activity is the performance of tax advisory services, and is involved or is responsible for the design, marketing, organization, implementation or administration of a reportable tax arrangement.

A foreign tax advisor that participates in a tax arrangement is required to disclose any such arrangement through a related party located in Mexico that operates under the same brand or name.

If the tax advisor does not disclose a reportable tax arrangement to the SAT, or there is no tax advisor involved in the tax arrangement, the taxpayer who benefits therefrom becomes responsible for the disclosure.

The disclosure of a reportable tax arrangement does not imply its acceptance or disallowance by the SAT. There are, however, substantial penalties for failure to disclose, which can range between U.S. \$2,500 and U.S. \$1 million.

The requirement to disclose reportable tax arrangements commences on Jan. 1, 2021. Tax arrangements implemented prior to 2020, but the benefits of which materialize in or after 2020, are subject to disclosure. Accordingly:

- A reportable tax arrangement implemented in 2019, the benefits of which materialize only in 2019, is not subject to disclosure.
- A reportable tax arrangement implemented in 2019, the benefits of which materialize in 2019 and 2020, is subject to disclosure, (the due date to disclose will depend upon the date it is sold or implemented).
- A reportable tax arrangement implemented in 2020 or later is subject to disclosure during 2021 (the due date to disclose will depend upon the date it is sold or implemented).

### *What should foreign companies do?*

Foreign companies that have operations in Mexico should evaluate, along with their tax advisors, whether they may implement reportable tax arrangements and define a disclosure policy.

Additionally, foreign companies that are involved (or are planning on being involved) in an acquisitive transaction that includes a Mexican entity should add to their tax due diligence procedures the assessment of compliance that the Mexican entity has with respect to the reportable tax arrangements it may have in place.

## Business purpose

The 2020 Act brings stringent requirements to determine whether a transaction has a business purpose.

In general, if the tax benefit obtained in a transaction is higher than its reasonably expected economic benefit, the transaction may be considered to lack a business purpose. This applies even if the parties are not seeking a tax benefit. It thus becomes necessary to quantify both the economic and tax benefits of a specific transaction.

In addition, a transaction may also be considered to lack a business purpose if the reasonably expected economic benefit could have been achieved by executing fewer legal steps, and the taxes resulting from the execution of those steps would have been higher than the reasonably expected economic benefit.

If a competent SAT agent audits a transaction and, after evaluating all facts, circumstances and support for the transaction, considers that it may lack a business purpose, it must consult with a technical committee formed by the SAT consisting of tax subject matter experts. Only after the agent receives confirmation from the technical committee that the transaction lacks business purpose, can the agent disallow its tax effects and determine any resulting tax assessments. The taxpayer has the right to appeal the tax assessment through the proper administrative process, and if necessary, in court.

### **Pervasive tax evasion activity**

As part of the 2020 Act, under certain severe circumstances, pervasive tax evasion activities can be elevated from a federal offense to a category of organized crime.

Under the new rules, tax evasion typified as organized crime is committed when three or more persons or entities jointly and pervasively carry out any of the following:

- Contraband and smuggling
- Deliberate tax fraud, when the fraudulent activities result in tax avoidance in excess of MX\$7,804,230 (equivalent to approximately U.S. \$411,000)<sup>2</sup>
- Generation, purchase and sale of electronic supporting documentation (digital invoices) to document simulated or nonexistent transactions, when the amount reported in each fraudulent document exceeds MX\$7,804,230 (equivalent to approximately U.S. \$411,000)
- The performance of activities to advertise or promote the generation, purchase and sale of the above-mentioned supporting documentation, when the amount reported in each document exceeds MX\$7,804,230 (equivalent to approximately U.S. \$411,000)

In addition to substantial monetary penalties and fines, and depending on the severity of the circumstances, the individuals responsible for the commission of any of the above activities may face imprisonment of up to six years. The same applies to the legal representatives of any entities involved in such activities.

Furthermore, a competent court can strip the offending taxpayer of the legal ownership of any assets and properties that are used in, or associated with, the execution of pervasive and severe tax evasion activities.

<sup>2</sup> The U.S. dollar amounts shown in this document are for reference purposes only, converted from the official Mexican peso figures set-forth in the Mexican law, by using an exchange rate of MX\$ 19.00 per U.S. \$1.00.

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