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Mexico passes 2020 tax reforms

Mexico office

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On October 31, 2019, the Mexican Congress passed several reforms to the Income Tax Act, the Value Added Tax ("VAT") Act, the Act on Special Tax on Production and Services, and the Federation Tax Code.

This is a substantial tax reform aimed at implementing international recommendations issued by the Organisation for Economic Co-operation and Development ("OECD"), in relation to the actions that make up the Base Erosion and Profit Shifting Project ("BEPS").

The approved reform includes the incorporation of action 1 on digital economy, action 2 on neutralizing the effects of hybrid arrangements, action 3 on reinforcing controlled foreign company rules, action 4 on limiting tax base erosion through interest deductions, action 7 on preventing the artificial avoidance of permanent establishment status, and action 12 requiring taxpayers to disclose their tax planning arrangements.

The tax reform also includes measures to eradicate certain abusive practices specific to Mexico, such as the marketing and use of tax receipts that conceal nonexistent transactions, the incorporation and liquidation of shell companies for tax avoidance purposes, and withholding systems for outsourced services.

Below we present the 2020 tax reforms we consider most relevant and scheduled to enter into force from January 1, 2020, with certain exceptions that we mention in the relevant sections.

Income Tax Act

Permanent establishment

In line with the OECD's recommendations, particularly with action 7 of the Final Report of the BEPS Project, articles 2 and 3 of the Income Tax Act ("**ITA**") are amended to expand the definition of permanent establishment ("**PE**") in accordance with the following:

- It is established that when foreign residents act in Mexico through a person other than an independent agent, they will be considered to have a PE in Mexico if that person habitually concludes contracts, or habitually has the main role leading to the conclusion of contracts by the foreign resident, or for and on behalf or on behalf of that foreign resident, and these contracts are for the transfer of the ownership of or for the granting of the temporary right to use the property owned by the foreign resident or to which the foreign resident has a temporary right to use, or that oblige the foreign resident to provide a service.

- It is presumed that an individual or legal entity is not an independent agent when acting exclusively or almost exclusively on behalf of residents abroad that are related parties.

- The exceptions to the establishment of a PE in the country will be considered exceptions only when their activity is of a preparatory or auxiliary character.

- A provision that aims to prevent a foreign resident or a group of related parties from fragmenting a cohesive business transaction into several minor transactions with the aim of arguing that each transaction was part of preparatory or auxiliary activities to avoid being considered a PE.

These reforms seek to create consistency in national legislation with international treaties and the OECD's Multilateral Instrument ("**MLI**") to prevent the artificial circumvention of the definition of a PE in Mexico.

Combating hybrid arrangements and payments to preferential tax regimes

As part of the recommendations of the Final Report of action 2 of the BEPS Project, the last paragraph of article 5 ITA is amended to deny (i) an indirect tax credit when the dividends or distributable profit was deductible to the distributing entity; and (ii) a direct credit, when the tax to be credited is also creditable in another country or jurisdiction, if, in this case, it does not derive from an indirect credit or the income that led to the payment had been collected in the other country or jurisdiction.

In addition, article 28 section XXIX ITA is amended to extend the regulatory cases of "non-deductibility" of payments between related parties, specifying that payments made between related parties will not be deductible when they are deductible for other entities of the group or for the same taxpayer in another country or jurisdiction where they have tax resident status. Similarly, this provision will not apply if the entity of the same group or the taxpayer considers the income to be cumulative in the corresponding jurisdiction.

Finally, to combat "hybrid arrangements," article 28 section XXIII ITA is amended and article 28 section XXXI is repealed, to deny the deduction of:

- Payments made to a related party or through a "structured arrangement" when they are subject to a preferential tax regime. We highlight that the exception of considering payments to a preferential tax regime deductible when these had been agreed at market value is eliminated.

- Payments that are not considered subject to a preferential tax regime if the direct or indirect recipient uses the funds to make other deductible payments to a related party, or, based on a "structured arrangement," if the income is not considered subject to a preferential tax regime regardless of the time of payment.

These measures are aimed at combating discrepancies in treatment between the different domestic tax systems with regard to the classification of a person, legal entity, income or allocation of property rights on assets.

Payments made to transparent entities and foreign legal entities

Article 4-A is added to ITA to establish that foreign fiscally transparent entities and foreign legal figures must pay taxes in Mexico as legal entities, regardless of whether all or some of their members or beneficiaries accumulate earnings in their countries of residence.

When foreign fiscally transparent entities and foreign legal figures establish their administrative headquarters or main place of effective management in Mexico, they will be considered tax-resident legal entities in the country and pay taxes under the general regime applicable to Mexican legal entities.

On this point, under article 4-A ITA, the above treatment (non-recognition of fiscal transparency) will not apply to double taxation treaties, in which case those treaties will apply.

To counter the possible effects resulting from the reform mentioned above, article 205 ITA is added, recognizing a fiscal stimulus for the fiscal transparency of foreign legal entities that administer private capital investments and that invest in legal entities resident in Mexico.

This fiscal stimulus is conditional on compliance with formal requirements and will only apply to income from interest, dividends, capital gains and real estate leases.

In line with the transitory provisions, the entry into force of the rules mentioned in this paragraph will be effective from January 1, 2021.

- Income earned by residents in Mexico or PEs in national territory through fiscally transparent foreign entities or foreign legal figures

Article 4-B is added to ITA to establish that residents in Mexico or residents abroad with PEs in the country that obtain income through a fiscally transparent foreign entity or foreign legal figure must accrue the corresponding income based on their stake in that entity or legal person.

To determine the average daily participation in foreign transparent entities or legal figures, this article refers to the control rules applicable to preferential tax regimes.

When foreign transparent entities and foreign legal figures are considered taxpayers for tax purposes in their country of incorporation, the annual "taxable income" will be considered income obtained under Chapter II ITA, i.e., as if they were Mexican legal entities.

However, it is established that the income obtained by fiscally transparent foreign legal figures will be accumulated in the terms of the chapter corresponding to the participating taxpayer.

Taxpayers that receive income in the mentioned terms must meet formal obligations, such as keeping a net tax income account to have control over the accumulation of the income, and keeping accounting records and supporting documents of the foreign transparent entity or legal figure to have control over the expenses and investments that may be deductible depending on the average daily participation.

Controlled foreign companies whose income is subject to preferential tax regimes

The recommendations of the Final Report of action 3 of the BEPS Project are incorporated, introducing rules that apply to the income obtained by entities resident abroad that are directly or indirectly controlled by Mexican tax residents and whose income is subject to preferential tax regimes, which are those not taxed abroad or taxed below 75% of the income tax rate that would accrue and be payable in Mexico.

It is established that, to determine whether the income is subject to a preferential tax regime, the profit or loss generated by all the transactions carried out in the calendar year by each foreign entity will be considered; this can be carried out in a consolidated manner when there is a participation in two or more resident foreign entities from the same country and these are consolidated for tax purposes.

The method for comparing the tax actually paid against the tax accrued in the country is modified, as the option is incorporated to compare the statutory income tax rate of the country or jurisdiction of the tax residence of the foreign entity, with the rates established in articles 9 or 152 of ITA, as appropriate, to determine whether the income obtained is taxed at a rate less than 75% of the rate that would apply in Mexico.

The rules for determining the effective control that the taxpayer should exercise over the foreign entity for the application of the preferential tax regime have been substantially modified.

Under the new rules, the taxpayer is considered to have effective control when:

(i) it has an average daily participation in the entity enabling it to have over 50% of the voting rights or of the value of shares, it has a right of veto or it has a casting vote required for decision-making purposes or its stake corresponds to over 50% of the total value of the shares issued by the entity;
(ii) it is entitled to over 50% of the assets or profits of the foreign entity in the case of any type of capital reduction or liquidation;
(iii) when the sum of the two paragraphs above implies a holding of over 50% of those rights;

(iv) its financial statements are consolidated with those of the foreign entity and;
(v) it is entitled to determine, directly or indirectly, the resolutions passed in the meetings or the administrative decisions of the foreign entity.

To determine whether there is effective control, all the rights that the taxpayer and its related parties and related persons have will be considered, regardless of their tax residence or place of incorporation.

In addition, to determine whether the income is subject to a preferential tax regime, it is established that all income tax paid should be considered, including state taxes and those paid in Mexico by way of withholdings.

The possibility is established for the income tax paid by foreign entities on income subject to preferential tax regimes in Mexico and abroad to be offset against the income accrued in line with article 5 ITA.

Limitation to interest deduction

Section XXXII is added to article 28 ITA, incorporating a limitation on the deduction of the "net interest" for the year, when this interest exceeds the amount resulting from multiplying the adjusted taxable profits by 30%.

The limitation will apply to taxpayers whose interest accrued during the year derives from debts that exceed MXN 20 million. This amount will be applied jointly to all legal entities subject to Chapter II ITA and PEs of foreign residents that belong to the same group or that are related parties, specifying that this amount will be distributed in proportion to the cumulative income generated in the previous year by the taxpayers governed by this provision.

"Net interest" is defined as the amount obtained by subtracting the total interest accrued during a period arising from the taxpayer's total debt from the interest income earned during the same period and the amount of MXN 20 million. This will not apply when the amount of accumulated interest is equal to or greater than the amount of interest accrued.

"Adjusted taxable income" is defined as the amount resulting from adding to the total annual taxable income (taxable income minus authorized deductions and the company's taxable profit paid in the year) the interest accrued during the year from the taxpayer's debts, and the total amount deducted in the year in relation to fixed assets, differed costs, deferred charges and expenses in pre-operating periods.

The amount of net interest for the year that is not deductible may be carried forward for 10 years until it is exhausted. Any amounts not deducted in the following 10 years will not be deductible. The net interest to be deducted must be added to the net interest of the following year and the resulting amount must comply with this provision.

The above limitation will not apply to interest accrued on debts assumed to finance public infrastructure and debts arising from the funding of land acquisition and real estate construction projects located in national territory. It will also not apply to debts to fund projects related to the exploration, mining, transport, storage or distribution of oil and solid, liquid or gaseous hydrocarbons, and extractive industry projects and those aimed at the generation, transmission and storage of electricity or water.

Similarly, this limitation will not apply to productive state enterprises or to financial system operators conducting transactions in line with their corporate purpose.

The limitation in question will only apply when the amount of nondeductible interest is greater than the interest determined in line with the rules of "thin capitalization," in which case the limitation will not apply.

According to the rationale of the act, the limitation on the deductibility of interest will apply to the deductible interest as of the 2020 financial year, notwithstanding that the debts may have been assumed in previous years.

VAT Act

› Taxation of digital services provided by foreign residents

Chapter III BIS on the “Provision of Digital Services by Foreign Residents with no Permanent Establishment in Mexico” is incorporated into the VAT Act, establishing the regulatory framework for taxing certain types of digital services when the service recipient is located in Mexico.

Services that are subject to VAT include the downloading of multimedia content (music, movies, images), the intermediation between third parties that offer goods and services, online clubs and dating sites, as well as online teaching sites.

It is considered that the above services are provided in Mexico when any of the following assumptions arises:

- the recipient has declared a domicile in Mexico;
- the recipient pays for the service through an intermediary located in Mexico;
- the recipient's IP address corresponds to an address assigned to Mexico;
- the recipient has provided a phone number and its country code corresponds to Mexico.

Foreign resident taxpayers that do not have a PE in Mexico and that provide digital services under the above terms must meet certain formal obligations, including registration in the federal taxpayer registry; charging the VAT to the recipients or consumers; keeping records; calculating, withholding and collecting the tax; and issuing tax receipts.

Foreign resident taxpayers that do not have a PE in the country where they provide services and that provide digital services under a business model that implies intermediation in activities carried out by third parties will have the following additional obligations: publishing the tax corresponding to the services on their website; withholding 50% of the tax on individuals that sell goods, provide services or grant the temporary use or enjoyment of goods; withholding 100% when those persons do not supply their federal tax code; and issuing digital withholding tax receipts.

These tax measures will not lead to the creation of a PE for foreign residents providing digital services in the country.

The provisions on digital services will come into force from June 1, 2020.

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