# Mexico 2020 Tax Reforms

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The Mexican Congress approved with some adjustments the Tax Bill presented by the President on September 8, 2019, that included a proposal of Decree through which various provisions of the Income Tax Law, the Value Added Tax Law, the Special Tax on Production and Services Law and the Federal Tax Code are amended, added, and repealed (the "2020 Tax Reform"), and the bills that generated the Project of Decree through which various provisions of the Federal Law against Organized Crime, the National Security Law, the National Code of Criminal Procedures, the Federal Tax Code and the Federal Criminal Code (the "Criminal Tax Reform"), which soon will be published in the Official Gazette of the Federation. Most of the provisions of the 2020 Tax Reform and of the Criminal Tax Reform will become effective as of January 1, 2020.

Some of the most important changes consist in implementations in domestic legislation of recommended actions included in the OECD/G20 Base Erosion and Profit Shifting Project Final Report ("BEPS"), such as: changes to the definition of permanent establishment, provisions to neutralize hybrid arrangements, new rules for taxing foreign transparent vehicles, a new set of CFC rules, additional limits to the deduction of interest and new provisions to tax the digital economy. Other relevant changes include the repeal of private real estate investment trusts (FIBRAS), a general anti-avoidance rule, expansion of events that may trigger a joint and several liability of shareholders, managers, directors and liquidators of Mexican resident entities; and a new obligation of tax advisors and taxpayers to disclose certain reportable schemes. Lastly, in both the 2020 Tax Reform and the Criminal Tax Reform the sanctions and legal consequences of giving tax effect to tax invoices for transactions that are presumed to be inexistent, are severally aggravated.

Below is a summary of the most relevant changes.

## Income Tax Law

### Permanent establishment

The definition of permanent establishment ("PE") provided in the Income Tax Law is modified to implement some of the actions included in BEPS Action 7 ("Preventing the Artificial Avoidance of Permanent Establishment Status") and to make such definition consistent with the provisions of the OECD Model Tax Convention. Such definition is expanded as follows:

*Commissionaire arrangements:* A non-Mexican resident that is acting in Mexico through a person other than an independent agent will be considered to have a PE in Mexico if such person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts, and such contracts are for the transfer of the ownership of, or for the granting of the right to use, property owned by the non-resident, or that oblige the non-resident to provide a service.

*Closely related party* presumption: It will be presumed that a person that is acting exclusively or almost exclusively on behalf of non-residents that are its related parties does not act as an independent agent.

*Specific activity* exception: It is provided that the PE exceptions listed in Article 3 will be considered exceptions only when the activity or the overall activity of the fixed place of business is of a preparatory or auxiliary character.

*Anti-fragmentation rule*: In order to prevent the avoidance of the PE status through the fragmentation of activities between closely related parties, an anti-fragmentation rule is adopted. Under such rule, the PE exceptions listed in Article 3 shall not apply when a non-resident carries out functions in one or more places of business located in Mexico that are complementary as part of a cohesive business operation to that carried out by another permanent establishment of the non-resident, or by a Mexican resident related party of the non-resident.

## Neutralization of hybrid mismatch arrangements

The amendments below were made to implement some of the "recommendations for domestic law" included in BEPS Action 2 ("Neutralising the Effects of Hybrid Mismatch Arrangements"):

*Denial of foreign tax credits:* A paragraph is added in Article 5 to deny an indirect foreign tax credit on dividends received from a non-Mexican resident entity when such dividends were deductible to the distributing entity, and to deny a direct foreign tax credit on taxes paid abroad that may also be credited in another country or jurisdiction.

*Structured arrangements:* Article 28-XXIII is amended to deny the deduction of payments made to related parties through structured arrangements, when payee's income is subject to a preferential tax regime or when the direct or indirect recipient of the payment uses the payment to make other deductible payments to another member of the group or by virtue of a structured arrangement.

Similarly as defined in Recommendation 10 of BEPS Action 2, structured arrangement is defined as any arrangement in which the taxpayer or one of its related parties participate; and in which the consideration is priced in function of the payments made to preferential tax regimes that benefit the taxpayer, or when based on the facts and circumstances may be concluded that the arrangement was made for such purpose.

Unless otherwise proven, it is presumed the recipient of the payment made deductible payments to other members of the group if the amount of such payments is equal or higher than 20 percent of the payment made by the Mexican taxpayer.

Payments that derive from a business activity carried out by the recipient will be deductible, *provided* that it demonstrates it has the personnel and assets required to carry out such business activity and that the recipient is incorporated and has its effective place of management in a country that has entered into a Tax Information Exchange Agreement with Mexico.

*Hybrid mechanisms:* It is provided that the business income exception of the preceding paragraph will not apply to payments that are considered income subject to a preferential tax regime by virtue of a hybrid mechanism. A hybrid mechanism is deemed to exist when there is a mismatch between Mexican and foreign tax legislation, on the characterization of an entity or legal figure, income or owner of assets or of payment, and that mismatch results in the payment being deductible in Mexico and being non-taxable in the foreign country.

A payment made by an entity to a shareholder will not be considered a hybrid mechanism, when under the tax legislation of the country of residence of the shareholder, the payment is considered non-taxable or non-existent as consequence of considering the payee as a pass-through. The foregoing to the extent the shareholder recognizes such payment as taxable income in proportion to its participation in the payee and *provided* that such income is not subject to a preferential tax regime.

*Payments that give rise to a duplicate deduction:* Article 28-XXXI is amended to disallow the deduction of payments made by a taxpayer if such payments are also deductible for the taxpayer or for another member of its corporate group in a jurisdiction in which it is also considered a tax resident.

## Foreign transparent vehicles and private equity funds

Articles 4-A and 4-B are added setting forth new rules for taxing the income obtained by or through foreign transparent entities or legal figures ("Foreign Transparent Vehicles" or "FTV").

Article 4-A provides an opaque treatment to FTVs in case their administration or effective place of management is located in Mexico, in which case they will be taxed as Mexican tax resident entities. Absent tax treaty provisions, FTVs will be subject to income tax under the corresponding regime of the Income Tax Law (corporations, not-for-profit organizations, foreign residents, and preferential tax regimes) which is applicable to them. Article 4-A will enter into force in January 1, 2021.

Article 4-B provides a transparent treatment to income obtained by Mexican residents or PEs located in Mexico by foreign residents through FTVs. In consistency with Article 4-A it is provided that if an FTV is subject to income tax under any of the regimes of the Income Tax Law, then such income tax if effectively paid may be credited by the Mexican resident taxpayer.

Mexican resident taxpayers (and PE of non-residents) are obliged to keep an account for each FTV in which they participate.

Article 205 is added, setting forth a tax incentive for private equity funds that invest in Mexican resident entities. Pursuant to this provision, foreign legal figures that are considered transparent for tax purposes in the country in which they were incorporated will be considered transparent for Mexican tax purposes with respect to interest, dividends, capital gains, and rental income obtained from Mexican sources; *provided* that: (i) The manager or legal representative of the legal figure (the "PE Fund") discloses to SAT the identity and personal information of all the members of the PE Fund; (ii) the PE Fund is incorporated in, and its members are residents of, a country that has entered into a tax information exchange agreement with Mexico; (iii) that the members of the PE Fund are the effective beneficiaries of the PE's Fund income, and they consider such income as taxable income; and (iv) that any income obtained by members that are Mexican tax residents is reported pursuant to articles 4-B or 177, as applicable. This provision will enter into force January 1, 2021.

## CFC rules

The full chapter of the current Preferential Tax Regime rules is modified changing its title to Controlled Foreign Companies subject to Preferential Tax Regimes. The main purpose of the amendments is to implement some of the recommendations included in the Final Report of BEPS Action 3 ("Designing Effective Controlled Foreign Company Rules") and to clarify certain provisions. Among such clarifications, it is provided that the rules will only apply to income obtained through a Mexican tax residents controlled foreign company ("CFC"), if its income is subject to a preferential tax regime, the foregoing because the true objective of the rules is to set forth an anti-deferral regime.

A new definition of effective control is adopted that applies both a legal and an economic control test.

The new rules clarify that for purposes of determining whether income obtained by a CFC is subject to a preferential tax regime, all foreign income taxes effectively paid shall be considered, which includes federal or local taxes paid abroad and all taxes withheld in Mexico, except for Mexican dividend withholding taxes.

## Limitation to interest deduction

In line with the approach recommended in BEPS Action 4 ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments"), a fixed ratio rule is adopted in article 28-XXXII, limiting an entity's net interest expense deduction to 30 percent of the entity's adjusted taxable profits (EBITDA).

It is provided that foreign exchange gains or losses shall not be considered interest for purposes of this rule, except when such gains or losses derive from an instrument that generates a return considered interest.

It is provided that deductible interest that are non-deductible pursuant to this rule, may be carried forward for ten years, but would have to be considered in the interest-EBITDA ratio calculation.

A *de minimis* rule is included under which the interest-EBITDA ratio limitation would only apply to interest that exceeds MX$20 million, the foregoing amount shall be determined considering all interest of all companies that are members of the same corporate group.

Also, it is provided that the limitation will neither apply to financial entities, state owned enterprises (*empresas productivas del estado*) nor to interest derived from debt acquired to finance public infrastructure works, construction and land located in Mexico, exploration, extraction, and other projects of the extractive industry, transport, storage or distribution of oil and hydrocarbons, or for the generation, transmission or storage of electricity or "water".

## Royalties on aircraft leases

The incentive included in the Presidential Decree that compiles various tax benefits published on December 26, 2013 is included in a new paragraph of article 167, which reduces to 1 percent the withholding tax on royalties (or rent) paid to non-Mexican residents as consideration in aircraft leases, when the lessee is a passenger or cargo airline with a concession to operate in Mexico.

## Taxation of digital platforms and applications

In line with BEPS Action 1 ("Addressing the Tax Challenges of the Digital Economy") a new set of rules is added, titled "income from the transfer of goods or provision of services through internet via technological platforms, software applications or similar". Such rules set forth a special tax regime for taxing the income obtained by Mexican resident individuals for goods sold or services rendered through all forms of digital platforms and applications. It is provided that the tax applicable to such individuals shall be withheld by the domestic or foreign entities or figures that directly or indirectly grant the use of the digital platform, applications or similar platforms. The applicable progressive withholding rates are the following (except when the individuals fail to provide their Federal Taxpayer ID (RFC), in which case the withholding rate will be 20 percent):

| | Total monthly income | Withholding rate |
|---|---|---|
| **Transport services and delivery services** | Up to MX$5,500 | 2% |
| | Up to MX$15,000 | 3% |
| | Up to MX$21,000 | 4% |
| | More than MX$21,000 | 8% |
| **Lodging services** | Up to MX$5,000 | 2% |
| | Up to MX$15,000 | 3% |
| | Up to MX$35,000 | 5% |
| | More than MX$35,000 | 10% |
| **Sale of goods and rendering of services** | Up to MX$1,500 | 0.4% |
| | Up to MX$5,000 | 0.5% |
| | Up to MX$10,000 | 0.9% |
| | Up to MX$25,000 | 1.1% |
| | Up to MX$100,000 | 2% |
| | More than MX$100,000 | 5.4% |

The entities or figures that directly or indirectly grant the use of the digital platform or application are also obliged to: (i) register in the Federal Taxpayers Registry; (ii) issue digital invoices to the persons to whom they withhold taxes; (iii) comply with certain reporting obligations; (iv) remit the taxes withheld by filing a withholding tax return; (v) keep accounting records and; (v) comply with obligations imposed through general rules issued by the Revenue Service Administration ("SAT").

The aforementioned provisions will become effective June 1, 2020 and it is provided that SAT shall issue general rules by January 31, 2020.

## Maquiladora shelter program

The four-year maximum duration for the Maquiladora shelter regime is eliminated, making the regime applicable for an indefinite term. Also a new article (183-bis) is added to set forth specific obligations and requirements applicable to entities subject to this regime.

### Repeal of private REITS (FIBRAS)

Article 187-V is amended; eliminating the possibility of having a privately owned infrastructure and real estate investment trust (FIBRA). As of 2020, only FIBRAS that issue certificates that are publicly traded in Mexico will benefit from the FIBRA tax regime. A transitory provision is included setting forth a deadline (December 31, 2021) to trigger the obligation to pay deferred taxes due on the contribution of assets into existing private FIBRAs.

### Tax incentives

Certain tax incentives that used to be included in the Revenues Law of the Federation of each year are included in the Income Tax Law, such as the deduction of employees' profit sharing in determination of estimated payments, the 25 percent additional deduction for employing disabled persons and the right to apply the incentive to movie production and sports to reduce estimated payments. Also, the maximum amounts for the incentives to theatric, artistic and literary production are increased and other rules are modified to include the participation of SAT's representatives in the inter-institutional Committees that govern the incentives to movies and art production.

## Value Added Tax Law

### Taxation of digital economy

Non-Mexican residents with no PE in Mexico will be subject to VAT on digital services rendered in Mexico, being obliged to: (i) register in the Federal Taxpayers Registry (ii) include VAT on goods and services offered; (iii) keep record of recipients of services located in Mexico and amounts collected from them; (iv) file a quarterly informative return; (v) pay VAT on digital services rendered in Mexico by filing a monthly VAT return, (vi) issue digital invoices; (vii) appoint a legal representative and tax domicile in Mexico, and (viii) obtain an electronic signature, among others. Failure to comply with the foregoing obligations may be sanctioned with fines and with a temporary access blockage to the website of the digital service.

Digital services are deemed rendered in Mexico when the recipient of the services is located in Mexico. For purposes of the foregoing, the recipient of a digital service is deemed located in Mexico when (i) it has declared to the service provider a domicile in Mexico; (ii) the consideration for the digital service is paid through an intermediary located in Mexico; (iii) when the IP address used by the electronic devices of the recipient of the service is located in Mexico; or (iv) when the recipient of the service has provided to the service provider a phone number whose country code corresponds to Mexico.

It is provided that the following digital services will be subject to VAT: (i) download or access to images, movies, text, information, video, audio, music, games (including gambling), other multimedia content, multiplayer environments, cellphone ringtones, visualization of online news, traffic, wheather or statistical information. It is provided that the provisions are not applicable to downloading or access to books, newspapers and electronic magazines; (ii) intermediation between third parties that offer goods (except second hand movable goods) or services and the users demanding the same; (iii) online clubs and dating sites, and (iv) online teaching, tests and exercises.

It is provided that the aforementioned provisions will enter into force June 1, 2020 and SAT will issue general rules by January 31, 2020.

### Importation of digital services

Digital services acquired by Mexican persons will be considered an importation of services if the service provider is not included in a list that will be published by SAT.

### VAT withholding on labour outsourcing payments

Legal entities or businesses that receive outsourcing services will be obliged to withhold part of the VAT (6 percent) on payments made to their service providers. As consequence of this amendment, both the recipient and provider of the service will not be obliged to obtain and provide the information on the outsourcing relationship that used to be required in articles 5-II and 32-VIII of the Value Added Tax Law.

### Exemption to charitable organizations

The transfer or lease of goods or rendering of services by entities authorized to receive deductible donations will be exempted from VAT.

## Federal Tax Code and Criminal Tax Reform

### General anti-avoidance rule

A general anti-avoidance rule is enacted implementing a business purpose test as a standard that will be applied by tax authorities in the tax review of transactions that generate tax benefits.

Transactions that lack a business reason and that generate a tax benefit will be re-characterized according to their real economic benefit, or will be considered non-existent if they don't have an economic benefit. The re-characterization or non-existence of transactions will only be for tax purposes and shall be authorized by a committee formed by members of SAT and the Ministry of Finance.

It is presumed, unless otherwise proven, that a transaction lacks a business reason when the quantifiable economic benefit, whether present or future, is lower than the tax benefit received. Tax benefit is defined to include any reduction, deferral or elimination of a contribution.

It is also presumed, unless otherwise proven, that a sequence of acts lacks a business reason when the sought economic benefit may be obtained through the realization of fewer acts or steps and the tax effect of the latter result more burdensome.

### Universal compensation

The prohibition to use a favorable tax balance or undue payment to offset other tax liabilities (commonly referred to as Universal Compensation) originally included in the Revenues Law of the Federation for 2019 is now included in the Federal Tax Code and the VAT Law, making such prohibition permanent.

### Reportable schemes

As of January 1, 2021, taxpayers and their tax advisors will be obliged to disclose to tax authorities certain reportable schemes that are listed in Article 199 of the Federal Tax Code.

Tax advisors will be obliged to register and to disclose any reportable scheme in case they participate in its design, commercialization, organization, implementation or management.

Taxpayers will be obliged to disclose a reportable scheme if the scheme is designed, organized, managed or implemented by themselves. Taxpayers will also be obliged to report the scheme when; (i) the tax advisor does not provide them with a report number or with a certificate stating that the scheme is not reportable; (ii) the scheme is designed, commercialized, organized, implemented or managed by a person that is not considered to be a tax advisor; (iii) the tax advisor is a non-Mexican resident or the tax advisor has a legal impediment to disclose the scheme; and (iv) when the taxpayer and its tax advisor have agreed that the taxpayer will be responsible to report the scheme.

Failure to comply with obligations related to reportable schemes may result in the imposition of fines that range from 50 percent to 75 percent of the tax benefit embedded in the reportable scheme, and from MXN $15,000 to MXN $20,000,000, depending on the specific situation.

### Digital certificates to issue electronic invoices

As part of the government's strategy to strengthen SAT's capabilities to stop the issuance of fake electronic invoices, a set of events is added, in which SAT may temporarily restrict and ultimately revoke the digital certificate to issue electronic invoices ("CFDI"), as well as a procedure to expedite such revocation. Among such events, the following are included: (i) a delay of one month in the filing of the annual tax return, or two or more estimated returns, whether consecutively or not; (ii) being included in the Article 69-B blacklist, as a taxpayer that issues CFDI for non-existent transactions; (iii) giving tax effects to a CFDI issued by a blacklisted taxpayer if a month has elapsed since the publication of the list, and the taxpayer has not demonstrated it effectively acquired the goods or service described in the CFDI, or did not self-correct its situation; (iv) if it is discovered the tax domicile declared to SAT does not satisfy the requirements of article 10 of the Federal Tax Code; (v) if it is discovered the income declared or tax withheld in tax returns do not match those described in CFDIs, files, documents or databases to which tax authorities have access; (vi) if the contact information given to the tax inbox is incorrect or false; and (vii) being included in the Article 69-B bis blacklist as a taxpayer that unduly transferred tax losses.

## Joint liability of shareholders, managers and liquidators of legal entities

The limits and conditions of the joint and several liability of managers and liquidators for tax liabilities of a corporation are amended, as follows:

(i) Liquidators will be jointly and severally liable for any outstanding tax liability of the liquidating entity, regardless if they file the liquidation notices or not, which used to be a condition to trigger such joint liability.

(ii) The situations in which a general manager, general director, sole administrator or person entrusted with the administration of an entity, as well as a shareholder, may be held jointly liable for any tax liability of a legal entity, are expanded to include the following: (i) if the entity fails to remit to the tax authorities any tax withheld or collected from third parties; (ii) if the entity is included in the Article 69-B blacklist, as a taxpayer that issues CFDI for non-existent transactions; (iii) if the entity gives tax effects to a CFDI issued by a 69-B blacklisted taxpayer, but only in case the CFDIs received are for an amount higher than MX$7.8 million; and (iv) if the entity is included in the blacklist of article 69-B bis, in which case the shareholders of the entity that acquired the tax losses may also be held jointly liable.

## Fiscal crimes

As part of the Criminal Tax Reform, Article 113 bis of the Federal Tax Code is amended to consider as a criminal offense the purchase or acquisition of CFDIs that support nonexistent or false transactions or simulated legal acts.

Furthermore, the Federal Law against Organized Crime is amended to consider as organized crime the organization of three or more persons to carry out any conduct or conducts that have as consequence or purpose any of the following felonies:

- Smuggling and similar acts pursuant to articles 102 and 105 of the Federal Tax Code;
- Tax fraud and comparable crimes provided in articles 108 and 109, sections I and IV of the Federal Tax Code, if the fraud exceeds MX$7.8 million; and/or
- The issuance, transfer, purchase or acquisition of tax invoices supporting non-existent or false transactions or simulated legal acts (so long as the value of the invoices exceeds the amount stated above)

Lastly, the National Security Law is amended to consider the felonies listed above as threats to the national security and article 167 of the National Code of Criminal Procedures is amended to consider such felonies as aggravated crimes punishable with mandatory imprisonment without possibility of parole.

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